THE INSTABILITY OF AN EXPORT ECONOMY

GAMANI COREA

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TO THE MEMORY OF
MY GRANDMOTHER
THE LATE
MRS. ALICE KOTELAWALA

FOREWORD

The present volume was written during the latter part of 1951 and the early part of 1952 for presentation as a doctoral dissertation to Oxford University under the title "The Economic Structure of Ceylon in Relation to Fiscal Policy".

At the time the study was prepared there was a strong interest in the West in the so-called Keynesian economics and on the role of fiscal policy as an instrument for stabilising the economy. It was widely believed at the time that the problems of acute depression and massive unemployment such as occurred in Western societies need no longer recur because of the solutions offered by the "new economics". It was somewhat natural therefore to ask whether the same approaches and conclusions were equally applicable to the developing countries which were also the victims of acute cyclical instability. An examination of this central issue was perhaps the main objective of the present work.

Apart from the two introductory chapters, the volume is made up of three case studies analysing the behaviour of the economy of Sri Lanka in contrasting cyclical situations. These cover the depression of the thirties, the special boom-like situation created during the years of the Second World War, and the period of the post-war recovery. In each case the origins of disturbances and the mechanisms through which they were introduced into and transmitted throughout the economy are analysed in some detail. In each case too, a study is made of the actual response of fiscal policy to the situation and the options available to policy makers for dealing with it. Taken together, the three studies cover a continuous historical period starting from the depression of the thirties and reaching out to the end of the Korean boom in the early fifties. They essentially illustrate the workings of an export economy in a period in which it had already reached maturity following the establishment and development of the three main export staples – tea, rubber and coconut.

The case studies are preceded by two chapters of a historical nature. The first deals with problems of public finance and of taxation in an [illegible]ous economy in the period preceding the establishment of the main export crops. The second outlines the main features of the evolution of the export economy as we subsequently came to know it. It attempts to show that the economy was established in the course of certain recognisable phases of growth and activity each of which took it on to higher levels of total production. By the beginning of the thirties however the process had come to an end and a period of "relative stagnation" as well as of maturity had set in.

It is well recognised today that the policy prescriptions of the "new economics", however relevant to industrialised societies, are barely applicable to the vastly different circumstances of developing countries. Whilst massive unemployment in industrialised societies tends largely to reflect a deficiency of aggregate demand – which could be corrected by fiscal policies of a compensatory character – the problems of unemployment in developing countries are more chronic and are essentially related to deep seated structural and institutional factors. In this situation, the role of fiscal policy is necessarily a more limited one. Nevertheless, although the policies and prescriptions themselves are of limited applicability, the instruments and techniques of analysis developed by Keynesian thought proved to be of singular value in understanding the workings of an economy such as ours. The techniques of aggregative analysis do help to throw light on the behaviour of the economy as a whole.

Although I have had the opportunity of a direct involvement in policy matters in the period following that covered by this study I have not attempted to add to or revise the present work in the light of subsequent experience. I believe that the study continues to be of relevance not only as an analysis of the events of a particular period but also as an aid towards an understanding of the workings of an export economy. Despite the many structural and institutional changes of the more recent period the economy of Sri Lanka continues to be vulnerable to external disturbances. The way in which these disturbances react on the economy are still in some ways similar to that depicted in the studies presented here. Broadly, the present work is an illustration of the workings of an export-import economy and as such is of some significance towards an understanding of the problems of this type of economy whether of Sri Lanka or elsewhere.

It is somewhat late after so many years to recount my debt to each of those who were my teachers but I do wish to mention with gratitude the encouragement and guidance I received from Lady Ursula Hicks at Oxford during the writing of the thesis.

I am grateful to the Marga Institute for arranging the publication of this work and I owe a special word of thanks to Mrs. Shelagh Goonewardene of the Institute for her cooperation in preparing the bibliography and index.

Gamani Corea

Colombo,
12th October, 1975.

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Abbreviations employed in the text: C. O. – Colonial Office Archives at the Public Record Office, London.

S. P. – Sessional Papers published by the Ceylon Government.

CHAPTER I

THE TAXATION OF AN AGRARIAN ECONOMY

The problems discussed in this chapter mainly relate to the early period of British rule in Ceylon before the great coffee plantations were established. Prior to the arrival of the British, the maritime regions of Ceylon were ruled successively by the Portuguese and the Dutch. The Portuguese first came to the Island in 1505 and stationed a garrison in Colombo in 1517. Thereafter they rapidly extended their conquest of the coastal regions and remained in the country until evicted by the Dutch in 1658. The Dutch maintained their rule until the British occupation in 1796. Both the Dutch and the Portuguese failed to conquer the Kandyan kingdom of the interior. Indeed the Portuguese era was marked by continuous warfare against the Kandyans but the Dutch period was, in comparison, more settled. The first British rulers of Ceylon were the East India Company which administered the Island from Madras. In 1798 a short-lived experiment in 'dual control' was introduced, when Ceylon was administered jointly by the East India Company and the Imperial Government. But this arrangement was soon superseded, and in 1802 maritime Ceylon became a full Crown Colony. The next important event in Ceylon's history was the conquest of the Kandyan kingdom in 1815 which made possible the political unification of the country after a period of many centuries. On account of the treaty between the British and the Kandyan court, however, the maritime and the Kandyan regions of Ceylon were administered separately on somewhat different lines. The administrative unification of the whole country did not, in fact, come until 1833.

The evolution of the modern 'export economy' of Ceylon may be said to have commenced with the growth of the coffee industry during the late eighteen thirties. This type of economy was fully established before the end of the nineteenth century, and by then the fiscal system of the country was also transformed along modern lines. Customs duties, particularly import duties, now began to provide the main revenues of the Government. Prior to this transformation, however, public revenues were dependent on somewhat different sources. It is true that external trade was of great importance to Government revenues even before the establishment of the plantation system. As we shall see in the following chapter, the export trade in cinnamon played a central part in the fiscal system. But notwithstanding this, there was also a great dependence on the indigenous economy of the Ceylonese. It is this dependence which we mainly describe and discuss in this chapter. For, in spite of the importance of the cinnamon revenues, it was the taxation of the subsistence and indigenous economy that was generally felt by the population at large. Indeed, the fiscal significance of the transition to an export economy lies largely in the gradual removal of the great complex of imposts levied on this sector. It is, moreover in this field that we find the richest illustrations of the fiscal problems of a backward economy.

The taxation of the indigenous economy of Ceylon was not, of course, a feature introduced by the British. Prior to the coming of the Portuguese and the Dutch into Ceylon, foreign trade, although a royal monopoly, was too casual and uncertain an item to provide the main revenues of the Sinhalese kings. These rulers, had, in consequence, to turn to internal sources.[1] *Rajakariya,* or a system of tenurial services rendered to the king by his subjects, was the principal means through which labour was obtained for public works. But in addition to *rajakariya,* the most notable feature of the revenue system in ancient times was the general contribution to the state of one tenth part of all produce save that monopolised by the Government. Thus, a tenth of the produce of agriculture, a tenth of the yield of fish, a tenth of all pearls collected from the pearl fisheries and a tenth of the produce of lands yielding salt were some of the important contributions made by the people of Ceylon to the royal revenues.[2] A further source of wealth was the *marala* or death duty whereby a part of the property of a deceased person was surrendered to the king.[3]

The direct reason for the coming of the Portuguese into Ceylon, at the beginning of the sixteenth century, was trade. When, after

1. In the medieval period, however, the Sinhalese kings did make a conscious attempt to develop foreign trade, (specially in cinnamon), in order to make up for the decline in internal revenues arising out of the gradual disutilization of the formerly productive "dry zone". Vide G. C. Mendis: *Ceylon under the British.* p. 2.

2. C. 0. 54. 122 Rpt. of Lt. Col. Colebrook on the Revenues of Ceylon 31st Jan. 1832, p. 43.

3. Colvin R. de Silva, *Ceylon under the British Occupation,* vol. 1. p. 2.

1505, Lourenzo de Almeida, first took the Sinhalese king of the coastal region around Colombo under his protection, he obtained a promise of cinnamon as tribute.[4] However, as the Portuguese extended their occupation to a wider part of the maritime regions of the country, they secured, for their own administration, the tax returns of these regions such as the land revenues and the *marala*. They also succeeded to the revenues from the royal monopolies of cinnamon, arecanuts, pepper, precious stones, elephants and the pearl-fishery.[5] Nevertheless, the preoccupation of the Portuguese with trade led them to interfere but little with the indigenous economy of the Sinhalese, and the bulk of the revenues of their administration was derived out of the profits of foreign trade.

The Dutch East India Company, which succeeded the Portuguese, retained the administrative and economic system, which the latter had inherited from the Sinhalese kings. Profits from trade remained the chief source of revenue to the company,[6] which made no important alterations in the traditional sources of internal revenue.

In view of later developments, however, it is important to note the beginnings, in Dutch times, of a tendency to relax some of the monopolies which had been the strict preserve of the company. The substitution of private trade in place of the rigid government monopolies occasioned for the first time the emergence of export duties which were to play so important a part in the financial system of Ceylon in later years. The export duty was the natural means whereby the Government sought to compensate itself for the loss of the profits from its monopolies once trade was thrown open to private enterprise. "Originally, the Company had retained the exclusive trade in every article of export and import. Foreign vessels were permitted to buy and sell only at the Company's magazines, and the inhabitants were in the same predicament. These restrictions had, however, been subsequently relaxed to the extent of permitting foreign traders to sell rice and paddy in the bazaars, and to buy unimportant commodities in exchange. Consequently private trade had insensibly augmented, but without

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4. Colvin R. de Silva, *op.cit.* p. 1.
5. *ibid.* p. 2.
6. *ibid.* p. 9. Profits from the trade in cinnamon and merchandise were not, however, included in the Ceylon accounts, but were instead carried over directly into the Company's books at Amsterdam.

any visible increase in the Company's profits. The monopoly system had therefore been further loosened; private trade was further encouraged and high customs duties imposed instead. As the Company's servants thereby lost certain emoluments which had accrued to them from the monopolies, they were indemnified by the grant of a fourth of the produce of these duties as perquisites. Nevertheless, the Company's trade in merchandise remained considerable, the profits on a turnover of 200,000 rix-dollars a year amounting to about 160,000 rix-dollars or 80%."[7] The emergence of the customs duties as the cornerstone of the Island's finances, however, had to await a much larger degree of liberalisation of trade as well as an expansion of the export sector; but their growing importance was well appreciated by an early observer, Col. de Meuron, who wrote in 1798, "The produce of the duties on exports and imports ...... may now form one of the great articles of the revenue of Ceylon".[8]

When the British first arrived in Ceylon in 1796, they found that the Government revenues were in the main derived from the twin sources of trading monopolies and taxes on the indigenous economy. Though trading monopolies had their origins in the times of the Sinhalese kings they were, of course, perfectly suited to the commercial habits of the Portuguese and the Dutch. Since these powers were generally more concerned with trading than with governing they were also satisfied to leave the indigenous tax systems relatively unaltered. These systems were, in a sense, well adapted to the circumstances of a subsistence economy where monetary exchange was either non-existent or of negligible importance and where the collection of taxes was smoothly adjusted to local forms of administration and economic organisation. The British, however, were not enamoured by either the trading monopoly or the local taxes. The former was a negation of private enterprise and the latter was unsuited both to the requirements of a bureaucratic administration and to the ideals of a liberal outlook. The British uneasiness with the systems they inherited was shown from the very beginning of the occupation, but their attitude found particularly strong expression in the Report of the Colebrook

7. *ibid*, p. 11; an account of the revenue system of the Dutch based on the Company's books for the years 1786–7 to 1791–2, is to be found in the report of Col. de Meuron to Governor North.

8. *ibid.* p. 455.

Commission which visited the Island in 1828. The effect of Colebrook's recommendations on the cinnamon monopoly are discussed in the next chapter, but his views on some of the local taxes will be apparent in the course of the discussion that follows. It is, however, significant, that in spite of the administration's dislike for these taxes there was little alternative but to maintain them until the economy was sufficiently advanced. In fact, as we shall see presently, there were several premature attempts at reform but these were, in the main, frustrated.

The Land Tax

By far the most important of these taxes on the semi-subsistence sector, both from the point of view of its contribution to the revenue and of its general incidence on the population at large, was the land tax.

The origins of the land tax lie in the ancient and highly complex system of Sinhalese land tenure. This system has been described as consisting of three main types of tenure:[9] (a) land of which the Government had retained immediate possession; (b) non-service tenures and (c) service tenures. Each of these main groups include numerous sub-divisions and variants, but in general it was to the second group, the non-service tenures, that the land tax applied. Unfortunately it is not possible to estimate the respective proportions of the total cultivated acreage falling into each of these categories at a specified time.[10]

The evolution of the non-service tenure is itself obscure. Fundamentally, the economic organisation of the Sinhalese was based on the performance of various services, but non-service tenures seem to have originated with – "gifts, grants and sales of land and villages, with their service tenures, to individuals who sometimes might also sell or sub-let them in turn to others; the commutation of services for payments in kind and money; alterations made

9. *ibid.* p. 322. See also: M. W. Codrington. *Ancient Land Tenure and Revenue in Ceylon.*

10. In 1801, however, Governor North estimated that "lands held by tenure of service from nearly one-half of the Sinhalese districts of the Island". C. 0.54.3. North to court of Directors 18th Feb. 1801, quoted in de Silva *op. cit.* p. 341.

by the Portuguese and the Dutch; and, often, the failure on the part of the Government to exact due services."[11]

The non-service tenures may be subdivided into non-service fields and non-service gardens. The former category itself is broken up into 'Ottu Paraveni' lands, generally paying one-tenth of the produce to Government, 'Anda Paraveni' lands, paying half their produce, and a miscellaneous group paying varying proportions – often a fifth.[12] The non-service gardens referred to high lands not suitable for paddy on which generally coconut, jak and other fruit trees were grown. But ... "it is interesting to note that, by the time of the British occupation, the payment of taxes on these lands had entirely lapsed. The Dutch had either abandoned or neglected their collection. Although several attempts were subsequently made by the British to revive them in one form or another, the efforts always failed.[13]

In the very early period of the British administration where the maritime provinces of Ceylon were governed together with and from Madras by the British East India Company, a bold but disastrous attempt was made to abolish *rajakariya* or the service tenures altogether and to replace it with a general tax of half the produce of land, as well as a tax of about two pence per tree on owners of coconut lands holding over fifty trees. These measures were accompanied by a change in the personnel concerned with the collection of the land tax. Hitherto "the European Governments in Ceylon had governed the country through the indigenous organs of administration which they had preserved subject to supervision by European officers at the centre"[14]............. "The Mudaliyars were the chief military and civil officials of the districts. They collected taxes, exacted the services due to the Company, helped to settle civil disputes and to punish criminals,

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11. *ibid.* p. 321. The author refers to Bertolacci p. 286 and C. 0.54. 20, Maitland to Camden, 28th February 1806. A summary of the tenurial and inheritance systems of the maritime Provinces is given by William Boyd in C. 0.416 4 A 27.

12. *ibid.* p. 326–7. "De Meuron and Maitland were of opinion that anda paraveni lands were originally the property of Government. Persons who had cultivated them on behalf of the Government on the usual terms, receiving half the produce in return, had acquired them later by prescription and thus invested them with the character of paraveni lands."

13. *ibid.* p. 327. For this reason the land tax was predominantly a tax on paddy lands.

14. *ibid.* p. 192.

carried out the orders of the Dutch officials, and kept them informed of what was going on in the country. In short they possessed great powers and formed an 'imperium in imperio'. The Madras Government feared that they would be a serious obstacle to its rule. Therefore it relieved them of their duties and took away from them the *nindagans* (land grants) which had been granted to them as rewards in payment for their services. It gave the posts rendered vacant to South Indian officers called *Amildars,* and the lower posts to other officers that came with them.[15]

These measures were naturally unpopular both with the Mudaliyars whose authority was undermined, and with the common people who disliked the new and heavy taxes that came to be substituted for services which "were not particularly onerous and had largely fallen into desuetude". The coconut tax was specially resented as "most Sinhalese had some direct interest in coconut land and naturally objected to an unprecedented tax".[16]

The result of this discontent was open revolt, which had to be suppressed by elaborate military measures. But the disorders convinced the Government of the undesirability of the changes, and it consequently withdrew the coconut tax and replaced it with an export duty on coconuts. It also restored the right to retain land for services, dismissed the Indian officials and reinstated the Mudaliyars in their former positions.[17]

But though the performance of the customary services once again replaced the general tax of half the produce of land, the government of the day hoped for the gradual abolition of service tenure as being conducive to the improvement of agriculture and commerce. Consequently as a step in this direction, a proclamation was issued in 1800 making permissive the commutation of service tenure. "We declare that all persons holding land by tenure of service, whatever their caste or denomination, have permission to appropriate to themselves those lands, or the payment of one-tenth produce of the high lands, and one-fourth produce of the low lands annually to Government, the same being duly proved before the

15. Mendis, *op. cit.* p. 22.

16. de Silva *op. cit.* p. 197.

17. C. 0. 55 2. Proclamations of 31st May and 3rd July 1798 quoted in de Silva *op. cit.* p. 208.

Landraad, and registered in the Registry of the district".[18] However, this attempt to encourage voluntary commutation met with little response, and the Government sought in the following year to enforce the abolition of service tenure. A Proclamation of the 3rd September 1801 read "We............declare that on or after the first day of May 1802, all obligation of service on tenure of land throughout these settlements shall cease, and lands held duty free at this present time on account of such service shall, on and after the said day, pay to Government one-tenth of their produce if high lands and one-fifth of their produce if low lands."[19]

But once again the premature abolition of *rajakariya* proved a failure. On the one hand the Government faced a pecuniary loss as the increase in the revenues from the taxes was inadequate compensation for the increased cost of engaging paid labour. On the other hand the new system disturbed the established balance of the rural economy. "The amount of labour performed for each holding was fixed and was not generally heavy. Now instead a landholder had to give a share of the produce to Government. They had to pay more if they extended the cultivated area. The collection of the taxes was farmed out, and the farmer could harass them, if he desired. Moreover, they did not altogether escape the services as the chiefs continued to exact them. And their land could now be seized for debt as it was their personal property, while earlier a creditor had only a right to their crops.[20] The Government once more embarked upon a reversal of policy. At first it acquiesced, through a policy of 'administrative passivity' in the continued exaction of services; and later in 1809 it issued a regulation restoring the former system of tenure whereby all lands were held immediately under Government.[21] The return to the old system

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18. Proclamation of 3rd May 1800 quoted in de Silva *op.cit.* p. 342–3.

19. *ibid.* p. 344.

20. Mendis *op.cit.* p. 33.

21. A comparatively recent writer has passed the following judgment on the unsuccessful experiment: "Thus the abolitionist theory of Governor North and the Madras administration was completely discredited by the former's successors, if not actually disproved by facts, and economic considerations would appear to support the contention that North would have been better advised to have left the old system to be remedied in the course of general social and economic development than to have attempted to amend it by a legislative act."

    L. J. B. Turner: *Collected papers on the History of the Maritime Provinces of Ceylon*, 1795–1805. Published in 1923 by the Times of Ceylon Company Ltd.

was, however, only partial; for though the regulation was capable of being interpreted as renewing the obligation to services, services were not in fact universally reinstituted and lands continued to pay a share of their produce as tax.[22]

The land tax remained a part of the revenue system of Ceylon until its ultimate abolition in the eighteen nineties.[23] During this period its many shortcomings and inconveniences were recognised by contemporary observers including the Government. Among its most apparent defects were its complexity, its unsuitability for simple and efficient collection, its instability as a source of revenue and its inequitable incidence.

Early attempts were made to reduce the complexity of the land tax. Because of a difference in tenure some owners of fields were paying an *ande* duty of one half of the produce whereas others were paying one-tenth.[24] In November 1813 a measure was introduced which enabled owners of anda fields to "commute the difference between half and one-tenth by redeeming at eight to ten years' purchase the value of the difference as estimated on the preceding five years."[25] ...."A measure which has been attended with good effect."[26] Nevertheless differences in tax-rates continued to exist. "The great bulk of the lands are taxed at one-tenths and any variation from this arises from the difference of tenure, not of soil...... (but) ... in consequence of the Rebellion, Sir Robert Brownrigg thought it proper to make certain lands pay a fifth instead of a tenth."[27]

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22. de Silva *op.cit.* p. 350–51. Regulation No. 8 of 1809.
23. The tax was finally abolished on Jan. 1st 1893. vide Mills, Ceylon under British Rule p. 136.
24. "In the Malabar districts of the Island, the service tenures have been previously abolished, the assessment has been fixed uniformly at one-tenth of the produce of all cultivated lands, but in the Cingalese districts the rates of assessment varied from one-tenth to one half of the produce according to the tenures, which were extremely complex." C. 0. 54.122 Report of Lt. Col. Colebrook in the Revenues of Ceylon. 31st Jan. 1832, p. 34.
25. de Silva *op.cit.* p. 352–353.
26. Colebrook *op.cit.* p. 34.
27. C. 0. 54. 112. Governor Barnes' replies to criticisms by Mr. Peter Gordon Jan. 1831. Even as late as 1846 Sir Emerson Tennent wrote. "In point of amount, the assessments on the paddy lands exhibits some variations in particular districts, the result of the variety, in the value of the tenures, one-fourth or one-fifth of the produce being levied, in some cases and in others only one-tenth or one-fourteenth; but in many instances the excess above one-tenth was redeemed at former periods by the occupants, and at a general average, the amount now payable to the Crown may be taken at one-tenth of the actual produce." *Tennent Report on the Finances of Ceylon.* p. 67.

By far the most serious objection to the land tax arose out of the very difficult problem of collection. This problem is of crucial importance to public finance in underdeveloped countries in general and Ceylon's experiences in this connection provide an apt illustration of the very difficulties confronting tax collection in a non-monetary subsistence economy.

The land tax, as has already been indicated, was a tax in kind where the producer was under obligation to surrender a proportion of his output to the government. There were in fact two methods of collection open to the Government, both of which were attempted in Ceylon. One method was an indirect system where the rights of collection were farmed out or rented by the Government to individuals; the other was the method of direct collection through Government officers known in Ceylon as the *Aumany* system.

The farming system, as will be seen later, was of importance to Ceylon as it was not confined to the land tax. It was employed by the Dutch administration as well as the British. Under this system in the case of land the farmers "periodically rented the revenue from Government for a lump sum and themselves collected it in kind. The renter lodged a deposit at purchase, gave security and paid the remainder in instalments. The tax was sold in small portions as each crop became fit to cut. When the harvest approached, commissioners were sent into each district to register the land cultivated and to estimate the probable produce. On their report it was publicly notified that the share of the crop to which Government was entitled would be sold to the highest bidder. The report of the crop commissioners was given to the purchaser, who was not obliged, however, to abide by the estimates. Generally he made agreements with the proprietors upon the quantity to be delivered; in case of difference the matter was referred to the headman of the village, and if either party was still dissatisfied with the estimate, the crop was threshed in the presence of one of the renter's agents and the exact share handed over."[28] In the early British period one factor which led to the general public discontent over the revenue system mentioned earlier was the granting of permission to headmen and Government employers to become renters and arming them with judicial powers.[29]

28. de Silva *op.cit.* p. 373. See also *Tennent – Report on* the *Finances of Ceylon*, p. 67 et seq.

29. de Silva *op.cit.* p. 374.

From the point of view of the Government's immediate interests the farming system has several advantages. On the one hand it spared the Government the necessity to maintain an elaborate and expensive revenue department. On the other hand it offered an easy escape from the obligations to receive payment in kind, and from the consequent problems of the disposal of produce. The great advantage of receiving money in payment from the renter could not be dismissed lightly, as by this means the conversion of taxes in kind into money was simply and quickly effected. It is of course true that the ability of the renter to make payment in money rested on the possibility of monetary sale by him of his collections; but even so the system spared the Government the need to act as the link between the subsistence and the monetary sectors of the economy.

At the same time the defects of the system were glaring and obvious. The interest of the renter was to maximise his profits and to this end he indulged in extortion and oppression. "Harvests were often endangered by the intentional delay to attend at the partition of the crop until the cultivator was teased into a bribe. Disputes and quarrels were frequent, leading to much litigation ... and ... the Treasury suffered considerable loss from frequent defalcations and regular arrears ... (Moreover) the subletting of the rents resulted in the farming structure ramifying into a thousand branches involving the mortgage of a great deal of landed property."[30]

The superiority of the alternative system of direct collection was by no means outstanding. Direct collection was resorted to whenever bids at the auction of rents did not come up to expectation. It was, further, the general practice in the Kandyan areas where the tax was collected at a public granary or failing that at the head-man's house,[31] and then sold either locally or to the Commissariat Department.[32] But even this system was attended by the usual evils of corruption, irregularity, excessive cost and litigation. The Government reconciled itself to these difficulties as being an inherent and unavoidable feature of the land tax. In the words of one of

30. *ibid* p. 375. Tennent alleges that it is generally understood that the share of the tax which eventually reaches the Treasury does not form one-half of the amount which is extorted by oppressive devices from the helpless proprietors. *op.cit.* p. 68.

31. C. 0. 54. 112. Barnes' comments on Gordon. Jan. 1831.

32. de Silva *op. cit.* 381.

the Governors: "The collection of the (land revenue) is difficult and precarious, and must always be so where the proprietors are extremely numerous, the land divided into small portions, and the people too poor to pay in money – this leads to the renting system as it would be almost impossible for the Government to collect the taxes in kind, and, although every precaution is taken to prevent the renters from extorting more from the people than they have a right to, still it is to be feared that in some instances they do commit frauds; but on the other hand, if Government officers were appointed to collect the revenue, I should expect that the people would not be benefitted whilst the Government would certainly lose .... all the inconveniences appear to me to be the result of the primitive state of civilisation, and consequent poverty of the people and can only be removed by progressive improvement."[33]

The instability of tax yields is, of course, a familiar feature of agricultural taxation under a system of given tax rates. The liability to fluctuations of output was particularly strong in Ceylon where the cultivation of rice was entirely dependent on the regularity of the monsoons. In ancient times, rice cultivation was largely centred around the "dry zone" in the more northerly and eastern parts of the country where the processes of agriculture were based on an elaborate and controlled system of irrigation. In subsequent periods the centre of population shifted to the wetter and low lying districts of the south-west, where cultivation was based on direct rainfall. Now the timing and the duration of the monsoons come to play a more vital part in agricultural production and the stability of output became closely dependent on the regularity of the monsoon. The yields from the land tax which was generally a tax of one-tenth of the produce was bound to be affected and in consequence the finances of the Government were in some years seriously endangered.[34]

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33. C. 0. 54. 113. Barnes to the Commission of Enquiry, Sept. 10th 1830.

34. For example, the following type of explanation of the difficulties of the revenue is not uncommon: "It must be remembered that the colony had last year to struggle against the effects of a calamity totally unprecedented, viz. the storm which took place in November 1834 by which not only was the revenue materially affected but the expenditure greatly augmented. To what extent the revenue was injured indirectly by a calamity by which thousands of the inhabitants suffered most severely it is impossible to say, but the statements herewith enclosed attribute, and I believe justly, a deficit of upwards of £9,000 on the grain revenue, mainly to this cause." C. 0. 54. 147 Morton to Glenelg, 9th Feb. 1836.

A further objection to the land tax was that it was unfair and inequitable. Being a proportionate rather than a progressive tax it took the same share from the smallest peasant as it did from the large land-holders. Because of the fragmented nature of individual holdings it weighed heavily on a numerous class of small cultivators who were often already burdened with heavy debts and excessive rents. Moreover, certain properties such as temple lands and lands belonging to headmen, were exempted from taxation and the payment of taxes were often improperly avoided by the fraudulent registration of land as temple property.[35] Indeed it was estimated that even the legitimate exemptions reduced the possible land revenue by about one-third.[36] In later years a further exemption was made for lands cultivated with coffee and other colonial produce[37] – a form of discrimination which was strongly criticised by the Commission of Eastern Enquiry.[38]

One way in which the Government sought to overcome some of the defects of the land tax was to introduce a system of voluntary commutation of the tax. Proposals for a form of commutation were first made as early as 1813[39] when William Orr suggested a fixed land tax to be based on assessments which were to remain unchanged over a period of years. By this means all gains from improvements in productivity and extensions of area would remain with the cultivator. The scheme was, however, criticised by the revenue authorities on account of the difficulties of registration and the variability of crops. A limited experiment on these lines proved unsuccessful. In 1829, a scheme was successfully tried out in the Kandyan provinces under which the land revenue was commuted

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35. de Silva *op. cit.* p. 382.

36. C. 0. 54. 113. Report of George Turnour, Revenue Commissioner for the Kandyan Provinces to Governor: 3rd October 1831.

37. Proclamation, dated 20th December 1830. Other produce was exempted as early as 1824. Proclamation of 22nd March 1824.

38. C. 0.54. 122. Report of Lt. Col. Colebrook *op.cit.* p. 36. "Were I prepared to recommend the continuation of the land tax, I should consider it just to propose for the encouragement of the cultivators of grain, that the Proclamation of 1830, which exempts from tax the lands on which coffee and other colonial produce are raised, should be repealed, and that an equal assessment should be imposed on all cultivated lands throughout the country, whatever might be the produce raised upon them. Such a measure, however, would be attended with great difficulty and unpopularity in its application, and having failed on a former occasion (the reference is to the tax on coconut trees mentioned earlier) could not prudently be revived."

39. de Silva, *op. cit.* p. 379–384.

for a fixed assessment over triennial periods.[40] Its extension to the Sinhalese maritime provinces was, however, not a success, partly because of the lesser fertility of these regions, and the consequent necessity for Government to remit the rents in periods of crop failure. The Colebrook Commission of Eastern Enquiry, favoured the complete abolition of the tax, but in view of its impracticability at the time it recommended a revised system of redemption whereby landholders were given the option of redeeming at an equitable rate, by instalments, the whole amount of rents chargeable upon their land. For instance, when the tax was one-tenth of the annual produce, the payment of one-fifth for ten years would be equivalent to twenty years purchase of the tax. The payments could be made in consecutive years but in unfavourable seasons the landholder could choose to pay the ordinary proportional tax instead.[41] These recommendations were given effect to by the Government and the item 'revenue from tithes redeemed' came to be included regularly in the public accounts. But as we have already mentioned, it was not until 1893 that the land tax came to be abolished altogether.

The Fish Rents

Another tax on the indigenous economy of the Ceylonese, analogous in many respects to the land tax, was the fish rent. The fish rent was a duty, (originally perhaps of one-tenth, but later varying between one-third, one-fourth and one-sixth according to locality and productivity) levied on all fish caught off the shores of Ceylon. Its origins are to be found perhaps in the ancient contribution of a share of all produce to the Government but it was maintained by the Dutch and carried over into British times. Like the land revenue, the fish rents were farmed out and suffered from almost all the defects of this system of tax gathering. The farm of each station on the coast was annually sold. "From the perishable nature of the commodity this mode of collection is extremely vexatious, the fishermen being unable to dispose of their fish or to cure it until the farmer had taken his share."[42] Further, fishermen were compelled to sell their catch by public auction on the shore and were also often forced to go out fishing, by renters and head-

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40. C. O. 54 113. Turnour *op. cit.*
41. C. O. 54 122. Report *op. cit.* p. 36.
42. C. O. 54. 122. Report of Lt. Col. Colebrook p. 43.

men, against their personal wishes. Once again, as with the land tax, the Government was conscious of the evils of this system but justified its continuance on the grounds of the lack of an alternative.[43] In 1820 the Government introduced a system of annual licensing of boats in lieu of the tax but limited it to the Colombo district. But the measure was subsequently abandoned "in consequence of the poverty and dependence of the fishermen, and the influence of the headmen, who were interested in maintaining the former system."[44] A further unsuccessful attempt on the same lines, but permitting payment of licence fees in even daily instalments, was made in 1827.

Gradually the Government came round to favour the ultimate abolition of the fish tax. In June 1836 the Secretary of State for the Colonies wrote to the Governor: "It is my earnest wish to relieve the natives of Ceylon as much as possible from some of the burdens to which they are liable – I would specially instance the salt monopoly and the fish rents.[45] In 1837 the tax was generally reduced to one-tenth[46] and finally in 1839 the Governor was able to announce its entire abolition.[47]

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43. "The tax upon fish caught for home consumption is according to the general notions of political economy of a questionable nature, still I do not see why it should be so any more than the land tax which is equally objectionable upon the same grounds, viz. that it is a tax upon the food of the people." C. 0. 54. 112. Barnes to Commission of Enquiry, 10th September 1830.

44. C. 0. 54. 122. Report of Lt. Col. Colebrook *op. cit.* p. 43.

45. C. 0. 54.147. Secretary of State Lord Glenelg to Sir R. Horton June 1836.

46. C. 0. 54. 154. Sir R. Horton to Lord Glenelg, 11th Feb. 1837. (despatch No. 46).

47. C. 0. 54. 172. Sir Stewart Mackenzie to Lord John Russell. Sept. 18th 1839 (despatch No. 54).

The abolition of the fish tax gave rise to an interesting controversy pertaining to the relationship between income and effort of fishermen. Sir Emerson Tennent, in a report written in 1846, claimed that the reduction and subsequent abolition of the fish tax resulted in a diminution of supply, a rise in price and a progressive loss of the revenue. He adduced this result "to illustrate the caution which it behoves us to exercise in relying on European theories when dealing with the habits and customs of an oriental people, whose energies seldom respond to encouragement, and whose apathy prevents the realisation of our most familiar maxims of political economy".

Tennent's argument was rejected by a Committee of the British House of Commons to whom his report was referred. They described his inference as "an obvious mistake, proving not that there is anything peculiar in the Ceylon fishermen; but that their trade follows the usual course of all other trades." ...."since every reduction of the duty was accompanied by a progressive increase in the value of all fish caught". In a subsequent

Capitation Taxes

The taxation of the indigenous economy of the Ceylonese did not stop with the land and fish rents. Some classes of inhabitants were obliged to make direct contributions to the revenue of the Government in the form of a number of capitation taxes. Some of these taxes were introduced by the Dutch and the British, whereas others were said to be of ancient origin. For instance, the Dutch introduced a tax called the *Uliyam* on Moors and Chetties from the neighbouring continent as a form of commutation for personal services which the latter were obliged to perform in Ceylon in return for certain commercial concessions. Similarly there was the *'chicos'* – "a composition paid in lieu of personal service, which the ancestors of two classes of the inhabitants of the Jaffnapatam province, at a very remote period bound themselves and their families to perform, as the condition of their settlement there, and which was afterwards as an indulgence commuted for payment in money.[48] There was also a more general capitation tax of ancient origin which was perhaps first levied either as a substitute for or as a supplement to personal services.[49] During the Dutch period this tax had fallen into disuse in some of the provinces such as Colombo, but was still imposed in some provinces of the north and south, particularly Jaffna.[50]

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reply, Tennent defended his position by claiming that the increase in total value was merely the result of an increase in the price of fish more than offsetting a reduction in the amount of fish caught, rather than of an increase in supply. He produced evidence of a similar result in Lisbon, where the abolition of a tax on fish led to a decrease in supply and a rise in price. Emerson Tennent: *Ceylon*, vol. 2. ch. 11 note p. 148–9, London, 1860.

In fact, however, it is interesting to note that the basic assumption on which Tennent based his argument was not fully realised in practice. For although the fish rents were abolished by the Government, they were now paid voluntarily to the Roman Catholic Church to which most fishermen in Ceylon belonged. Indeed this practice continues to this day, and generally a tenth of the day's catch is contributed to the Church. The latter in turn provides a number of material services to fishermen such as assistance in time of need etc.

48. de Silva, *op.cit.* p. 510–511; quoting de Meuron's report C. 0. 55. 2. Proceedings of 10th Nov. 1798; Lt. Col. Agnew's minute.

49. According to Bertolacci, the tax was imposed "upon all those castes and ranks of people, who could not according to their ideal be subjected to bodily labour". (Bertolacci p. 393); but de Meuron's version is that "all the inhabitants of Ceylon, besides the obligation to employ a fourth of their time in personal service to Government were once subject to a capitation tax and an assessment of their lands and houses which varied according to the caste of the inhabitants, and the situation of the house or lands". (de Meurons report). vide de Silva *op. cit.* p. 511.

50. *ibid.* p. 512.

The first reaction of the British on their occupation of Ceylon was to abolish these capitation taxes altogether, but many of them were soon reintroduced in a modified form. The *Uliyam*, for instance, was reintroduced in 1802 on instructions from the Secretary of State who saw nothing disgraceful in the tax as a commutation for personal services.[51] Again, the *chicos* were reimposed in 1800 on toddy drawers and post carriers. Moreover, in the same year the British reintroduced a new tax known as the 'Joy tax' which proved to be singularly ill chosen and unpopular.[52] "Whereas it is our wish that contributions necessary for the maintenance of the State should fall as lightly as possible on the people of these settlements, and be levied rather upon the luxuries than upon the necessities of life, we have determined to farm out a tax on Joys (jewels) and ornaments, which are made or consist of gold, silver. or other metal, stone, pearl, ivory, glass, chank or bone."[53] Males and females of all ages and castes wearing joys had to take out a licence from the farmers costing one rix-dollar for males and half a rix-dollar for females or else be liable to a fine of ten rix-dollars.[54] The ornaments must appear on the garments or be affixed to the body itself to become subject to the tax.

The Joy tax became so unpopular that in some provinces no one would even dare bid publicly for the rent of it. "Its incidence was unjust and unequal.........It was unwise in its interference with a penalization of a deeply embedded and universal custom, for tradition had made certain ornaments, particularly in the case of females and as a badge of caste, almost a necessity – 'as much as shoes and stockings would be considered in England." 'It was,' said the Board of Colonial Audit at a later date, 'obnoxious...... owing to the interference which it admitted with the usual privacy of their females.' In this connection it was found that even the attendance at schools was detrimentally affected.[55] Attempts to enforce the tax resulted in discontent and much violence but notwithstanding this the annual yield of the tax during the years 1800–5 was over 100,000 rix-dollars. In 1800, however, the tax

51. *ibid* p. 513. Moors of ages between sixteen and sixty were allowed to purchase for four rix-dollars for six months a licence exempting from the liability to be called out for compulsory paid labour.

52. Proclamation of 1st April 1800.

53. *ibid.*

54. The head of a family could obtain for two rix-dollars a comprehensive licence for his family. de Silva *op. cit.* p. 515.

55. *ibid.*

was abandoned in the Sinhalese districts but it was continued in the Malabar (Tamil) areas where it was collected in *aumany* (i.e. directly through Government officers). In 1825 it was commuted in the latter districts for a general capitation tax of one rix-dollar on every male of over fifteen years. But even this measure was condemned by the Colebrook Commission – "This charge upon the inhabitants of certain districts, from which those of other districts are exempt, is unjust and objectionable in principle, and as the jewel tax has not been levied upon the Cingalese the commutation paid by the Malabar inhabitants of the Island should be repealed."[56] As a result of these criticisms, by January 1834 this and other vexatious capitation taxes were finally abolished – the *Uliyam* in fact being discontinued in 1830.[57]

Taxes on Internal Exchange

The land tax, the fish rents, and the capitation taxes were internal imposts on the indigenous economy of the Ceylonese which weighed, with the exception of the Joy tax, more or less directly on production. The attempts of the Government to squeeze out a revenue from a relatively backward economy did not, however, cease here. A cumbersome but nonetheless extensive system was also devised to take advantage of the limited amount of internal exchange that did exit in these conditions. A series of what may be called indirect taxes was imposed on the purchase and sale of local produce on the local market and on the movement of goods and persons within the country.

In the early period of British rule a general duty on internal trade inherited from the Dutch existed throughout the country. This was the land pass duty which applied on the one hand to all goods passing in either direction, between the Kandyan and the Maritime provinces, and on the other to goods passing between the several provinces of the Maritime region itself. These duties were exacted at the borders of the several trade routes. Originally their rates varied with the different localities, but in 1812 a uniform rate of 5% was introduced on goods entering into inter-provincial trade in the maritime region. These lands pass duties produced about 16,000 rix-dollars a year, but they were all abolished in 1816 after the conquest of the Kandyan Kingdom because of their

56. Report of Lt. Col. Colebrook, *op.cit.* p. 48.

57. Regulation of Government No. 5 of 1830.

undesirable effects on internal trade. Another group of taxes of a similar nature were the Passport duties. These were imposed on the one hand in Mannar being a relic of the days when this port was the outlet for the trade of the Kandyan Kingdom and on the other hand at several coastal stations where coast wide trade was taking place. These duties too were abolished with the land pass duties.[58]

Yet another tax on internal trade was the Bazaar tax.[59] In Dutch times there was a small levy on sites taken up for retail shops but in British times this was refashioned into an excise on all goods brought for sale at the bazaar or market. In 1800 it was further expanded into a general levy of 2% on grain and 3% on all other goods irrespective of whether they were of local or foreign origin or whether they had already been subjected to an import duty. The tax turned out to be fairly remunerative, yielding about 61,000 rix-dollars a year, but its defects were too great to be overlooked. All retail sales were confined to the public bazaars by the regulations and this condition alone imposed several inconveniences and hardships and encouraged evasion. The tax was as usual farmed out to renters who were also entrusted with the duty of keeping the bazaars in good condition and of providing certain minimum facilities. The great variety of produce as well as the small quantities involved led to serious problems of valuation and consequent abuses. Moreover, the necessity to transport trifling quantities over great distances to the authorised bazaars imposed numerous hardships. All these difficulties induced the Government to finally contemplate the abolition of these duties, but because of the resulting sacrifice of revenue, the Government decided to compensate itself for this action by an increase in the import duties. Consequently, when the bazaar tax was finally abolished in 1813, a new import duty, over and above that already existing, was imposed amounting to 2% on grain and 3% on all other goods.

Stamp Duties on Cloth

A duty which is of some interest today in view of Ceylon's almost complete dependence on imported cloth, was the stamp duty[60]

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58. de Silva, *op.cit.* p. 518–519.

59. *ibid.* p. 519–522.

60. *ibid* p. 522–525. Also Bertolacci. *A View of the Agricultural, Commercial and Financial interests of Ceylon* 1817 p. 221–231.

on locally produced cotton cloth. During the early British period small scale cloth manufacturing industries appear to have existed in many parts of Ceylon, particularly in the Northern and Eastern districts, where whole groups of families took up to weaving as an occupation. In the Sinhalese districts too weaving was a part-time industry amongst the peasants. The cloth produced was generally coarse except in Jaffna where a more refined product was manufactured out of cotton imported from India.[61] The raw material for the coarser product was generally grown in Ceylon itself mostly by peasant cultivators. Both the Dutch and British had experimented with large scale plantations but these were seldom successful. Indeed in some parts of the country, cotton seed was sown alongside grain on *chenas* or temporary clearings of jungle land.

Both the Dutch and the British took advantage of this local industry to augment the Government revenues. In the Dutch period a duty of 7½% was levied on the sale of local cloth in the main centres of Jaffna and Mannar, and this tax like most others, was farmed out yielding an annual revenue of 13,500 rix-dollars. The British were from the very outset desirous of encouraging this industry and as early as 1799 lowered the rate of duty to 5%. They also tried to arrange the supply of better quality seed to cultivators and better quality cotton to weavers. But notwithstanding these efforts the cotton industry of Ceylon generally languished and declined. On the one hand the manufacturers of Jaffna in the North were unable to withstand the competition of the cheaper cottons of India which were beginning to flow in. On the other hand, the Government itself confined its attempts to encourage the industry to the Northern provinces since it was fearful of the consequences of an extensive preoccupation with cotton manufacturers on the supply of labour for cinnammon production and other public purposes. "Although," wrote Governor North, "I certainly wish to encourage industry, I am by no means of opinion that measures should be taken which may divert their attention from the agricultural pursuits. . . to which the country is so peculiarly adapted. The introduction of an extensive manufacture of cotton in the Colombo district is undesirable as the people are so little inclined to it and constantly employed otherwise. This applies still more strongly to the Chaliyas whose numbers are at present scarcely sufficient for the supply of cinnamon which is more

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61. Bertolacci, *op.cit.* p. 222.

profitable to Government than cotton can ever be."[62] The effects of compulsory service on the cotton industry were not confined to Colombo and in districts like Chilaw it was reported that weavers were compelled to emigrate because of the pressure of compulsory service.

In 1821, the Government finally abolished the stamp duties on cotton cloth in order to encourage manufacture and further increased the duties on imported cloth, but these measures had scarcely a noticeable effect on the revival of a dying industry. "I abolished ten years ago," complained Governor Barnes "a duty that existed on cotton cloth manufactured in the Island, since which the import duty has been greatly increased, but notwithstanding this encouragement to the home cultivator and manufacturer nothing has been done and there is no more cotton grown nor cloth woven than formerly"[63]...... "Nothing can show the indolence of the people of this Island more than the little effect which has been produced by the alteration in the customs."[64]

Tolls and Special Purpose Taxes

A further source of revenue to the Government in the early transitional period with which this section is concerned was from a multitude of tolls levied on ferries, canals, roads and bridges. These tolls were also farmed out in the usual manner and were sometimes irksome and vexatious, being imposed on persons, cattle and goods. But they were justified by the Government as proper charges for service provided through the construction of adequate means of transport. Unlike the other internal taxes mentioned above these tolls were not abolished with the progressive expansion of the economy, and the liberalization of trade. On the contrary their profitability to Government was enhanced with the further opening up of the country and the coming of the plantations.

Mention must also be made of certain special purposes taxes of a local nature which were nevertheless administered by the Central Government. In 1820, a local assessment on houses was imposed in Colombo for repairing and lighting the streets of the town and a

62. North to Board of Revenue and Commerce, 22nd May 1805, quoted in de Silva *op.cit.* p. 524–5.

63. C. O. 54. 122. Barnes reply to Gordons criticisms. Jan. 1831.

64. C. O. 54. 112. Barnes to the Commission of Enquiry, Sept. 1830.

similar assessment was subsequently imposed in Galle.[65] By a regulation of 1830 four-fifths of the tax in Colombo was to be applied to the repair of roads and the remainder lent out at interest with the object of accumulating a fund. When the interest on this fund reached a certain amount (£1,200 per annum) the tax was to cease. This practice was, however, condemned by the Colebrook Commission which wrote: "From the poverty of the people, the collection of this tax has been made with considerable difficulty, and in all cases where rates may be imposed for similar objects, no more should be raised than is adequate to meet the probable demands. The amount when collected should be placed in the public treasury, and accounted for in the same manner as all other branches of the Colonial Treasury, which has not been done."[66]

Taxes on Liquor

Finally, we are left with the taxes on arrack and toddy,[67] which were at this period the most important products of the coconut palm as far as the revenue was concerned. In the Dutch period arrack contributed to the revenue both through a tax on its internal sale and through an export duty on sales abroad. In the early British period the export duty on arrack like most other export duties, was abolished but it was soon reimposed on the recommendation of the de Meuron Committee and yielded an average annual revenue of 20,000 rix-dollars during the years 1800 – 14. The export trade in arrack, however, did not flourish for long. Ceylon's chief markets were in India – at Madras, Bombay and the Malabar and Coramandel coasts, – but these were soon lost to rival substitutes from Batavia, Coramandel and Bengal. Batavian arrack began to flow in substantial quantities into the Indian market after the end of the Napoleonic wars and the higher priced Ceylon product was further affected by an import duty placed by the Madras Government for protective purposes.[68]

65. C. O. 54. 122. Report of Lt. Col. Colebrook p. 51.

66. *ibid.*

67. de Silva *op.cit.* 459 et seq. Arrack is the liquor distilled from the fermented juice, called toddy, drawn from the unexpanded flower spathes of the coconut palm.

68. "The export duty (on arrack) has greatly declined, in consequence of the excise duty of 440% imposed by the Government of Madras in 1813 upon Ceylon arrack, which diminished the consumption of it on the Continent of India. To effect a partial reduction of the export duty and to augment the revenue, a Regulation was passed in 1820 for licensing in certain districts the distillation of arrack, and also the retail of arrack, and of toddy from which it is distilled." C. O. 54. 122. Report of Lt. Col. Colebrook. *op. cit.* p. 44.

Moreover, an Indian firm secured a contract with the Indian authorities which enabled it to monopolise the supply of arrack to the army and navy who were in effect the principal consumers. All these factors combined to produce a sharp fall in the Madras price for Ceylon arrack and since attempts by the Ceylon Government to develop alternative markets in England and elsewhere were hardly successful, the Government was forced in 1823 to bring about a reduction in the export duty. The relief to the Ceylon producers together with a slight increase in the Madras price, led to a moderate revival of Ceylon's exports, but in subsequent years Ceylon's export trade in arrack never reached its previous dimensions.

The internal tax on arrack and toddy came to be of greater significance. The British at first continued the Dutch system of farming out licences for the retail sale of arrack and toddy in the Colombo district. The system was extended to certain other districts after 1800 and the cost of licences was further increased for temperance reasons. The need to check abuses led to the regulation of production itself after 1820. All distillers, wholesalers and retailers were obliged to take out free licences and supply regular information on the number of trees in tapping and the output produced. The licensing of wholesalers and retailers was extended to the Tamil areas where there was in general production. Later in the same year a tax was imposed on production itself by means of licences on stills in distilleries. The inconvenience of collecting the tax led to a banning of small distilleries – stills of under 25 gallons capacity were refused a licence. Provision was made for the payment of the still tax in arrack instead of cash.

In 1826 the Government devised a form of monopoly for itself in the Colombo district. It regulated and licensed the total number of retail taverns and prohibited their establishment in the neighbourhood of its own canteens. Retailers were given the option of securing their supplies either from licensed wholesalers or directly from the Government itself at a fixed price. If they made their purchases from the former, however, they had to pay a substantial tax on every gallon so that in practice they found it more profitable to make their purchases from the Government. In this manner the Government set itself up as an intermediary between the production and the retailing stages making substantial profits through licences and successive increases in its sales price for the commodity. This system of high prices and regulated sales served both the temperance

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motives and the revenues of Government. But it had its ill effects on the export trade and on the well-being of the producers. Many of the owners of coconut lands were small-holders, and whatever portion of the complex variety of taxes that could not be shifted forward to the consumer, was shifted back to these small-holders who remained in production through lack of an alternative means of livelihood. The price of coconut lands became depressed and complaints were numerous.

A further development in the excise policy was its extension to the Kandyan provinces. The production of arrack was prohibited by the Kandyan kings but supplies were procured through trade with the maritime districts. In the early British period of the occupation of the Kandyan provinces, this trade was prohibited, except upon licence, but the subsequent growth of illicit trading and the prospect of revenue improvements, induced the Government to alter its policy and introduce the whole excise system of the Maritime regions into the Kandyan provinces. In 1834, a general ordinance consolidated the various excise regulations into a uniform system for the whole Island. In its essentials the excise policy of today is based on the general principles laid down in this ordinance.

The importance of these spirit duties to the revenue of Ceylon in the period with which this section is concerned, is illustrated by the fact that on the average of the years 1827, 1828 and 1829 they yielded an annual sum of £28,620 (being made up of £3,647 through taxes on distillation, and £24,975 through retail sales). The spirit duties were the most fruitful of the sources of internal revenue discussed in these pages, contributing twenty-three per cent of the average total internal revenue of £97,722 for the years.[69] The spirit duties were, moreover the principal medium through which coconut lands made their contribution to the public revenue. Other products of the coconut tree – such as fresh nuts, jaggery, copra, coconut oil and coir – also paid in their share through a series of export duties. In fact, although coconut lands were free of direct taxation, the total revenue derived from them was a little under twice the total revenue derived from the whole of the general land tax.

The Salt Monopoly

A regular and lucrative source of internal revenue, of a somewhat different order to those discussed in the preceding pages, was

69. C. O. 54. 122. Report of Lt. Col. Colebrook, *op.cit.* pages 33 and 44.

afforded to the Government by the salt monopoly. Salt is collected with relative ease along the drier portions of the coastal regions of the country where it forms naturally in salt lakes or pans during the dry season of July to September. The Dutch who were in control of the salt producing Maritime provinces of the country established a monopoly in the commodity with the intention of utilising it as a major political weapon in dealings with the Kandyan Kingdom which lacked direct access to the salt lakes. After the conquest of the Kandyan Kingdom in 1815 by the British, revenue considerations came to play a dominant role in the maintenance of the monopoly. The salt was collected with the aid of compulsory or hired labour and shipped in small vessels to Colombo on Government account. From its stores in Colombo the Government transported the commodity to several districts of the Island where it was sold at licensed places of retail, by persons chosen and supervised by the Government, at a regulated price. The annual average gross revenue to Government from the sale of salt during the years 1827–29 was £27,781, whilst the amount of contingent expenses incurred on account of it averaged £4,000 annually, which together with the establishment costs contributed a charge of 20 or 25% on the gross revenue.[70]

The salt monopoly weighed heavily on the people to whom it was, of course, one of the commonest necessities of life. In order to maintain profitable prices, the Government ordered the destruction of all salt that was not delivered to its stores. "The effects of the monopoly," wrote Lt. Col. Colebrook "are injurious to the people in several respects. The salt collected is often of very inferior quality, and when otherwise it is liable to adulteration by the licensed retailers. The high monopoly price has checked consumption throughout the country, and also the use of salt in curing fish,[71] it has also prevented the exportation of it to distant places, where a profitable trade might be carried on, especially to the Malay Islands ...... The prosecutions against persons for infringing the laws enacted for the protection of this monopoly have been

70. C. O. 54. 122. Report of Lt. Col. Colebrook, *op.cit.* p. 42.

71. "The high prices (of salt) constituted a distinct setback to the manufacture of, and trade in, salt fish: an occupation peculiarly fitted to the Island which nevertheless imported over £2,000 worth of salt fish every year ...... (moreover) ...... An export value of salt of 15,000 rix-dollars in 1806 had fallen to about 1,000 rix-dollars in 1833" de Silva *op.cit.* p. 498-9.

numerous. In the years 1828 and 1829 there were not less than 304 cases."[72]

The Colebrook Commission suggested an immediate reduction in the monopoly price and the permitting of free collection for export and the curing of fish. As a long term objective they suggested the complete abolition of the salt monopoly and the substitution of an excise duty in its place. Some of these short term recommendations were subsequently carried out, but the salt monopoly, which for political reasons escaped the general liberalisation of trade in 1796 has survived to this day and absorbs the energies of a separate Government department.[73]

The preceding pages have outlined the more important internal taxes which were levied on the relatively backward indigenous economy of the Ceylonese. The difficulty of forcing a revenue out of a backward economy is well illustrated by this system which reached out directly to the very processes of subsistence production, and to the modest volume of internal exchange that did happen to exist. If measured by the standards of modern welfare economics or even by the contemporary canons of Adam Smith, the tax structure of the day would fail miserably. It was uncertain, inequitable and inefficient, and restrictive of production and enterprise in every possible way. The costs of collection were notoriously high. Colebrook estimated that in spite of the extensive system of farming which generally reduced costs to Government, the charges of collection to the State, including the establishments of the Commissioner of Revenue and the *cutcheries* or collectors offices, amounted to more than £20,000 per year or 22 per cent of the revenue. The contrast with the customs and harbour duties which were collected, at a cost of 7 per cent, could not escape notice.[74]

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72. C. O. 54. 122 *op.cit.* p. 42.

73. Perhaps the basis for the justification of monopoly in more recent times is not very different from the following argument as presented by Sir Emerson Tennent in 1848: "The collection of this natural deposit from lagoons and leeways, which are the absolute property of the Government, is not more objectionable than the claim of the Crown to mines and minerals throughout its own possessions, or the right to dispose of the timber of the Royal Chases and forests of England, nor is the assertion of its exclusive prerogative to gather and sell salt within the Island, for the purpose of revenue open to more grave remark than the monopoly of the post office for a similar purpose." Tennent, Report on Finances. *op.cit.* p. 56.

74. C. O. 54. 122. *op.cit.* p. 34.

The Government was not unaware of the defects of this system, but in its defence it pleaded the absence of any practicable alternative. Indeed it must be substantially admitted that this defence was justified by the realities of the economic situation of the period. The problem of a recurring deficit was then a regular feature of the public budget, and given the level of expenditure, every possible source of revenue, within the bounds of conscience, had to be exploited. The Government was in fact faced with a dilemma. It could not improve its revenue structure until the economy had further expanded and a system of monetary exchange has further developed. But the revenue structure itself was in turn an impediment to the expansion of the economy. It is, of course, possible to criticise the level of expenditure itself. There was first the heavy burden of the military occupation. The propriety of making the inhabitants of a country contribute towards a foreign occupation may seem questionable from the viewpoint of nationalism or democratic political theory. But this issue had no significance at the time. The occupation was a historical fact, and the resulting benefits to the inhabitants were not for a moment doubted by those in whose power it lay to change the revenue system. Second, there were the heavy establishment charges incident to a paternal but bureaucratic administration. The indigenous social and economic organisation of Ceylon was based on a complex but well adapted hierarchical system where power was transfused throughout a great number of holders of feudal authority. The attempts by the British to maintain as far as possible the paternal benefits accruing to the people through this system, but yet to administer its rule through the medium of a centralised bureaucracy, were bound to prove costly.[75] The public budget, in consequence, was proportionately large and the pressure on the revenue system was therefore understandably heavy. Even the Colebrook Commission, which proved to be the great agency for reform at this period, was forced to the reluctant conclusion that reductions in expenditure must necessarily accompany even the most moderate changes in the revenue system. "After a careful consideration," concluded Col. Colebrook, "of the state of the Colonial finances, and of the changes which are required for the relief of the Island from the effects of a system which has checked the industry of the people and the

75. J. S. Furnival's *Colonial Policy and Practice* offers ample reflections on this problem, as arising in Burma and the Netherlands Indies.

prosperity of the settlement, I cannot hold out the present expectation of an increase of the general resources of the Government, and with a view to the most indispensable and urgent reforms, my attention has been directed to the means of reducing the expense of the existing establishment."[76]

It was ultimately the growth of Ceylon's external trade which made possible the real transformation of the revenue system of Ceylon. The final abolition of the multitude of burdensome taxes on the internal economy was in the last analysis dependent on the realisation of an adequate compensatory revenue from the customs duty. The growing importance of the customs duty is, in fact, the main thread in the story of the evolution of the revenue system of Ceylon from the early period discussed in these pages to modern times. It is both interesting and important to note the role played by the customs duty as a weapon of reform. For it is common at the present time to deprecate the great dominance of customs duties on the revenue structures of export economies. But whatever merits may lie in this attitude, it must be admitted that as a substitute for the cumbrous system of taxation on the internal economy, the customs duty came to represent a fair improvement. It was indeed the relative superiority of these taxes that induced the Colebrook Commission to urge the general expansion of indirect taxation as a major objective of fiscal policy.

Revenue from External Trade

We must now turn to the revenue derived by Government from external trade. The attention given in the preceding pages to taxes on the internal sector of the Ceylon economy should not be taken to imply that external trade was of limited significance to the finances of Government. On the contrary, it must be remembered that from the earliest times trade was the chief concern of foreign governments in Ceylon. The profits from the trading monopolies were in fact the chief sources of revenue to the Portuguese and Dutch governments and to the British East India Company, whilst the yield of internal taxes were essentially of a supplementary nature. Even after the trading monopolies came to be abolished in British times, the link between the Government's finances and external trade was continued through the medium of the customs duty.

76. C. O. 54. 122. *op.cit.* p. 52.

Before we turn our attention to the increasingly important role played by the customs' duties in the revenue structure of Ceylon, we must mention two sources of revenue, which, though deriving in the last analysis from external trade, did not make their contribution through the medium of either the export or the import duty. These sources were the cinnamon monopoly and the pearl fishery. The cinnamon monopoly is discussed in some detail in the following chapter and will in consequence be omitted here. But it must not, for a moment, be forgotten that during this period cinnamon was the dominant element in both Ceylon's foreign trade and the revenues of the Government. In fact the profits from cinnamon were of far greater consequence to the Government's budget than any of the other sources of revenue discussed in this chapter.

The Pearl Fishery was an interesting, unusual[77] and lucrative source of revenue to the Ceylon Government. In the early period of British rule the Fishery was so remunerative that the Government came to place a great deal of reliance on it as a means of bridging the gap between revenue and expenditure.

The Pearl banks used to lie mainly off the north-west coast of the Island. Though numbering well over twenty, the individual banks varied considerably in number and productivity.[78] Scientific knowledge concerning the Pearl oyster was not specially advanced during this period, but it was known that the best pearls came from seven-year-old oysters which seemed to die or disappear soon after they had lived for that period.[79] Oysters of lesser age were generally less productive. During the Dutch and early British periods, the system of collection was haphazard and undiscriminating. Divers[80] used to immerse themselves for a minute or so and

77. It inspired the French composer Bizet to write his well-known opera "The Pearl Fishers".

78. de Silva *op.cit.* p. 501. The richest were the Mannar banks off Kondachi near Arippu numbering almost twenty. There were, besides, the eight Kalpitiya banks, the four Chilaw banks and the four Negombo banks.

79. "The Pearl oyster requires seven years to arrive at maturity, and the art of the fishery consists in so watching the various beds, as to enforce the protection of those that are under age, and to hit the precise time for lifting those oysters only which have arrived at maturity, and which would divest themselves of their pearls if left longer untaken" Tennent: *Report on the Finance and Commerce of Ceylon.* Parliamentary Papers (933) Vol. XLII. 1847–48; p. 54.

80. The divers, with few exceptions, came not from Ceylon but from amongst the Paravas of Tuticorin.

collect at random all oysters within their reach. The system was not only wasteful but harmful for future fisheries, for immature oysters were not supposed to survive even if returned to the sea.

The Government was able to profit from the Pearl Fishery by prohibiting the fishing of the pearl banks except on its own terms. The traditional method as followed by the Dutch and continued by the British for a period, was to rent out the fishery to speculators on certain conditions. The banks to be fished in any season were specified by the Government and both the number of days in which fishing could take place and the number of boats to be used were regulated as well. The fishing season fell generally during March and April when advantage could be taken of the favourable inter-monsoon weather conditions. The first fishery to be worked in the British period was in 1796 and yielded £31,000. But from the outset the Government encountered difficulties over the system of renting. The speculator to whom the fishery was rented, repudiated his contract, and the Government was forced to sell the boats separately each day to speculators. The total profits realised by the fishery were said to be almost double the sum accruing to Government which had, through ignorance, accepted unduly low bids. In the following two years, however, the fishery was more profitable to the Government, although the system of renting out to single speculators was maintained. The profits to Government were £107,000 and £123,000 in 1797 and 1798 respectively. In 1799, the alternate system of renting the boats separately on Government account each day was tried out with the aim of checking the surreptitious use of extra boats and of enabling smaller capitalists to participate. The fishery of that year was, however, a failure, due in part to the dishonesty of certain officials, but in large measure to the exhaustion of the banks on account of the intensive fishing in previous years. The revenue for 1799 was only £38,000.[81]

The Government now formulated a scheme for deriving a regular revenue from pearl fishing. Since the pearl oyster took seven years to reach maturity, it was proposed to divide up the banks into seven parts and to fish them in rotation. Accordingly, after an initial period of two years rest, a fishery was undertaken in 1801 under a system of daily renting of boats. But again the results proved disappointing and the profits to Government were

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81. L. J. B. Turnour: *History of the Maritime Provinces of Ceylon* 1795–1805. p. 215. For the action taken against the officials see Mills *op.cit*. p. 23.

only £13,000. The oysters turned out to be immature and unproductive. One of the causes of the failure was a defective system for charting and investigating the banks prior to fishing. A further fishery attempted in 1804 also came below expectations for similar reasons. In this year the old system of renting to a single individual was reintroduced but bad weather intervened to reduce the number of fishing days and a remission had to be made to the renter. The net revenue realised by the Government was £62,000. Further fisheries took place in 1806, 1808 and 1809, yielding £37,000, £28,000 and £24,000 respectively. Then, after a considerable pariod of rest a very remunerative fishery took place in 1814 which yielded a net revenue of £74,000. But this unfortunately turned out to be the last of the spectacular fisheries. Attempts in the years immediately succeeding were barely remunerative and in 1817 the oysters were found to have inexplicably disappeared from the banks which had been examined the previous year.

In 1820, yet another system was tried on a small scale fishery. "All boats were employed by Government, and every young oyster brought up was immediately thrown back into the sea. The oysters were sold in small lots of a thousand at a time, and brisk bidding occurred despite a conspiracy by the usual renter." Moreover, the additional step was taken of appointing a permanent Inspector of the Pearl Banks – a conscientious officer named James Steuart[82] – who did yeoman service during the next fifteen years – preparing an accurate chart of the banks and studying the habits of the pearl oyster.[83] The next fishery took place in 1828, and after that, save for the year 1834, there were almost annual fisheries yielding a varying but not inconsiderable revenue. Between 1828 and 1833 the annual average revenue from the Pearl Fishery was £24,193. The fishery of 1835 yielded £38,247 and that of 1836 £23,535. Then came the unsuccessful fishery of 1837 yielding only £9,393 and marking what came to be the end of this unusual and spectacular source of revenue. The Colebrook Commission had recommended the appointment of a naval officer to supervise the fisheries, chart the banks and take full charge. Unfortunately, the young naval officer who was appointed, being inexperienced and unfamiliar

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82. de Silva, *op.cit.* p. 507.

83. Steuart's *Account of the Pearl Fisheries* is a valuable source of information on this subject.

with the locality, "misread the chart that Steuart had left him, and the wrong banks were fished. In the result, the regularity which looked like being permanently established at last, disappeared for ever; and the pearl fisheries of Ceylon remain to this day a precarious and irregular gambling venture.[84]

It was mentioned earlier that the pearl fishery was, at first, so remunerative that the Government of the day came to depend upon it as a means of balancing the budget. But because of the instability of this source of revenue during the second and third decades of the nineteenth century, the Government of Ceylon received instructions from the Secretary of State (Lord Goderich) that the proceeds of the Pearl Fishery ought not to be calculated as a regular item of revenue, but that it should, instead, be held to meet extraordinary emergencies.[85] Indeed a budget deficit was the general rule during the years 1803–29, but the successful fisheries between 1829 and 1836 enabled the Government to produce an annual surplus varying from between £30,000 and £50,000.[86] It was on the basis of these surpluses made possible by the pearl fisheries, that the Government was able in the early twenties to undertake a considerable amount of road construction. In fact the subsequent failure of the Pearl Fisheries was one of the factors responsible for the curtailment of road building in the later thirties at a time when the growth of the plantations made road building an urgent necessity.[87]

The Evolution of the Customs Duties

We may now turn to the evolution of the customs duties which, from modest beginnings, developed into the principal item in the revenue structure of Ceylon. The origin of the customs duties have already been indicated.[88] In the main, they arose out of the liberalisation of trade in Dutch times when they were introduced to compensate the Government for the losses which might otherwise

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84. de Silva *op.cit.* p. 510. This year (1952), after a lapse of many decades, the Government has again announced its intention to hold a fishery.

85. C. O. 54. 147. Despatch No. 30. Sir R. Horton to Lord Glenelg, 9th Feb. 1836.

86. Mills: Ceylon Under the British p. 172n. The failure of the pearl fisheries after 1837 led to an unusual budget deficit which, between the years 1837 and 1842, averaged £16,000.

87. Mills *op.cit.* p. 233.

88. vide ante pp. 4 and 5.

have arisen through the relaxation or abolition of the State monopolies over all items of export and import.

At the very outset of the British occupation a step was taken the results of which are clearly illustrative of the limits set upon the revenue structure of the country by the realities of the economic system. In 1796, the Madras administration which was also concerned with governing the Maritime Provinces of Ceylon, endeavoured to change the whole revenue system as had gradually evolved through Portuguese and Dutch rule. Out of a general desire, in part, to improve the system and, in part, to bring it into conformity with the practices of the south coast of India, the Madras Government introduced a number of sweeping changes into the revenue structure of Ceylon. The most far reaching of those changes was, of course, the abolition of *rajakariya* or service tenure and the substitution in its place of a general land tax. Details of this measure and its disastrous consequences in Ceylon have already been elaborated upon in our discussion of the land tax. A further change, however, which attracted less attention, but which is of particular significance to us, was the attempt to completely liberalise the foreign trade of the country. There were two elements restrictive of foreign trade which the British had inherited from the Dutch. The first of these was, of course, the Government monopolies, and the second the customs duties which were generally present wherever trade was not monopolised. The first reaction of the new administration was to remove, as far as possible, both these restrictive elements. The first step was the unification of import duties at a low level. In May 1796, a duty of 5% was imposed on goods imported from British territories and a duty of 7½% on merchandise from elsewhere. Then came an attempt at complete abolition. The whole of the Ceylon trade, with the exception of cinnamon monopoly, was thrown open to private enterprise; and in July 1796, all customs duties, both on imports and exports, save those on the spices, coffee, pepper and arecanut, were abolished.[89] In effect, these measures meant a radical reform of the whole revenue system of the country. The old and cumbrous network of taxes and duties which were both burdensome to the population at large and restrictive of economic

89. At the same time reforms were attempted in the sphere of internal taxation. In addition to the abolition of *rajakariya*, the capitation taxes were done away with and the bazaar tax modified.

enterprise were removed and the stage was now set for the unfettered expansion of the economy.

It did not take long, however, for the authors of the reform to realise that their expectations were disappointed. The attempt at the removal of service tenures was causing widespread discontent, and the abolition of the customs duties was so prejudicial to the revenue that a return to the old system seemed inevitable. Consequently the de Meuron Committee which investigated the revenues recommended the reimposition of the former customs duties. By 1799 the country was back to what was substantially the original position,[90] and in 1803 a new tariff was introduced which levied a uniform duty of $2\frac{1}{2}\%$ on all goods,[91] except china goods which were free and cloth which paid $7\frac{1}{2}\%$, and a series of export duties varying from 5% to 75%.[92]

From this time onwards there were, as could be expected, several modifications in the customs tariff; but two main threads in the evolution of policy concerning the import and export duties are

90. Writing almost fifty years later, Sir Emerson Tennent described and explained the failure of the experiment in the following terms: "In the hope of still further encouraging the growth of native commerce which had latterly been partially tolerated by the Dutch, the experiment was tried of abolishing all duties both on exports and imports, in the expectation that the general prosperity to ensue would replace from other sources the amount of revenue thus surrendered, but unhappily this expectation was not realised. The natives, from that want of energy, which is their universal characteristic, as well as from want of capital, were indisposed to enterprise of any kind; it was speedily discovered that serious amount of income had been sacrificed without any correspondent advantage; and in 1799 Lord Guildford (North) was induced to restore (with great modification however), the import and export duties, as a source of revenue whose existence had caused no complaint, and whose removal had conferred no advantage in the then existing state of society." Tennent, Report on the Finances, *op.cit.* p. 48.

91. It is interesting to note the very early origins of Imperial Preference in Ceylon. The import duty of 1796, referred to earlier in the text, levied a discriminatory duty of $2\frac{1}{2}\%$ on merchandise from non-British territories. The tariff of 1803 provided for preference in a circuitous way: "The duty on goods from Britain and America in British and American bottoms was calculated on the invoice price, whereas 60% was first added to the invoice price of goods from China and foreign Europe, and 10% to that of other imports save in the case of cloth, on which the duty was calculated at a valuation 20% below the local market price." de Silva *op.cit.* p. 446.

92. The export duties were as follows: 5% on coffee, copra, coconut oil, chanks' chaya root, salt fish and unenumerated articles; 8% on pepper; 10% on arrack; 25% on gingelly, illuppai and margosa seeds and oils, and tobacco; 25–50% on timber; and 75% on arrack. Cinnamon, it must be remembered, was at this time still a government monopoly, *ibid.*

discernible. There was, first, a phase commencing from the reintroduction of the export duties mentioned above, and extending to about the year 1820 when the export duty, notwithstanding a regular adverse balance of merchandise trade, became the main contribution to the revenue from the customs. Secondly, there was the period after 1820 when the roles were reversed and the import duties attained a prominence which they were in fact to maintain through the subsequent financial history of Ceylon, save for exceptional years of wartime or post-war prosperity. This change of policy reflected changes in the ideas concerning these duties and are therefore worthy of brief attention.

In the early phase, the export duties were essentially substitutes for previous monopolies and the attitude of the Government towards them was inevitably conditioned by ideas of monopoly. The results of this attitude were singularly unfortunate as is amply illustrated by the history of the export duty in the case of successive commodities. The conviction that the export duty was a tax which can be shifted to the foreign consumer, remained firmly rooted in the minds of the authorities; and nothing but the actual occurrence of disaster in every individual case could shake this conviction. The results of this policy on Ceylon's position in the world trade in cinnamon is discussed in the following chapter. The export duty on cinnamon was not, however, imposed until the eighteen thirties. But even in the earlier period, the country was gaining experience in the limitations of the export duty in the case of such commodities as arrack, arecanut and tobacco, which were at the time the principal contributors to the revenue from export duties.

It has already been shown how the export trade in arrack to India, once a lucrative feature of Ceylon's external trade, was, after the eighteen twenties, reduced to negligible proportions as a combined result of competition from other sources and the maintenance of a stifling export duty. Arecanut followed a similar course. The principal foreign market for arecanut from Ceylon was India. The trade was monopolised in Dutch times, but with the coming of the British the monopoly was abandoned, and an export duty substituted instead. The rate of duty underwent numerous alterations, but by 1820 it amounted to as much as 75% being levied at the rate of 4 rix-dollars the hundredweight. Now followed the invariable sequence of events. Qualitatively inferior arecanut from the 'Peder Coast' of Malaya which had hitherto been exported, duty free, via Penang and Singapore to China,[93] began to enter into Bengal in return for cloth. Thereafter the market for the Ceylon product deteriorated and the export duty was subjected to the usual series of successive reductions. In 1823 it was brought down to 3 rix-dollars per hundredweight. In 1829 it was 3 shillings per cwt.[94] In 1830 it was again reduced to one shilling and six pence per cwt. Thereafter there was a revival in exports to India, but prices continued to fall and the revenue from the export duty ceased to be of outstanding significance.

The prominence of export duties in the customs' revenue of Ceylon in this early period was due, not so much to a mistaken and dogmatically held belief that the foreigner always paid the tax but to an excessive confidence in the privileged position Ceylon's products enjoyed in foreign markets. This attitude is well expressed by Bertolacci who was in general favourably inclined to the wide use of export duties: "If heavy duties are imposed upon goods exported, the policy of the measure would depend upon the following circumstances: namely, whether the commodity grows or can be manufactured in other countries; for if it cannot and the demand for that commodity continues abroad, the duty must be paid by the consumer there, and the quantity exported will continue the same. And, in fact, whether or not other commodities of the same nature can enter into competition with ours in the foreign market, the duty must never rise so high as either to diminish the demand for the commodity exported, or allow it to be undersold by what is produced abroad. But until the export duty reaches those limits, it can in no way be prejudicial, as it falls entirely upon the consumers abroad, and does not impede our industry at home.[95]

The first step towards the reversal of the relative importance of import and export duties in the revenue of Ceylon was taken in 1820. In that year the import duties on a number of commodities were stepped up. It is of interest to note that the principal motive for the change was protection for local industries and agriculture. In later years the protective aspect of import duties faded into the background and their outstanding importance was primarily based

93. A market which incidentally was inaccessible to Ceylon because of the heavy export duty.

94. The unit of account in Ceylon was changed from rix-dollars to sterling in 1825.

95. Bertolacci: *A view of the Agricultural, Commercial and Financial interests of Ceylon.* 1817 p. 342.

on revenue considerations.[96] The nature of the change-over in 1820 is best expressed in the words of Governor Barnes, the author of the reform: "In 1820, I changed the whole system of customs duties. In the first place the greater collection used to be upon the exports – secondly, the former practice used to be that of fixing an arbitrary value upon imported goods and charging a percentage thereon .... The import duties were greatly increased on articles the product or manufacture of which is such as were capable of being produced or manufactured on the Island, and the duties are charged according to quantity, that is, on the hundredweight, pound, yard, gallon, etc., etc."[97]

The following figures illustrate the result of the new measures on the customs' revenues:

Revenue from export and import duties 1810–1829 (in five year periods)

	EXPORT DUTIES £	*IMPORT DUTIES* £	*TOTAL** £
1810–1814	110,304	49,769	165,539
1815–1819	87,945	108,367+	204,594
1820–1824	92,749	149,544	253,927
1825–1829	106,235	202,275	326,650

* TOTAL includes revenue from port clearances, etc.

+ The great increase in import duties in the years 1815–1819 arose from the large importations of rice on government account during the military operations in the Kandyan Kingdom in these five years.

Source: C. O. 54. 112. Barnes to Commission of Inquiry appended statement from the Commissioner of Revenue, Colombo 8th September 1830.

The change in the relative importance of the import duties is clearly shown in the figures above. It must, however, be remembered that during the period covered by the table, cinnamon was still a Government monopoly. When the cinnamon trade

96. Lt. Col. Colebrook seems to suggest that revenue considerations influenced even the 1820 reforms: "The competition of countries to the eastward, from which many articles of Ceylonese produce are obtained more cheaply, has been unfavourable to the trade of Ceylon; and in the year 1820, when the export trade had declined, the regulations were revised which had imposed the larger amount of duties on the export trade. These duties were reduced, and the import duties were proportionately augmented, a change which has been beneficial to the trade and revenue of the Island." C. O. 54. 122. Report *op.cit.* p. 48.

97. C. O. 54. 112. Barnes to Commission of Inquiry 10th Sept. 1830.

was thrown open to private enterprise the scales were turned once more, for the new export duty on cinnamon greatly augmented the total revenue from export duties. It was really at a later date that a more lasting reversal of roles in favour of the import duties took place.

It was mainly two commodities, grain and imported cloth, which were responsible for the marked expansion in the revenue from import duties. Prior to the new measures the duty from these sources was negligible.[98] By 1829 they were making the following contribution to the revenue from the import duty:

	£
Grain	17,042
Cotton Cloth	17,146
All import duties	44,815

Source: C. O. 54. 122. Report of Colebrook Commission *op. cit.* p. 49.

Indeed by 1836 the duty upon grain came to yield as much as £25,000 per annum, amounting to about two-fifths of the whole customs revenue exclusive of cinnamon.[99]

As mentioned earlier, the need to protect local industries and agriculture, figured prominently in the change of policy concerning the import duties. The argument for protection was specifically put forward in the case of the duties on grain and cloth. In the words of Governor Barnes: "The import duty on articles the produce of India which can be equally produced in the Island is certainly high, and I think it good policy that it should be so. I do not conceive that the circumstances of the Island are such as to require these articles from adjacent countries; abundance of grain might be produced in the Island for the consumption of the population and as to cotton cloths I have to observe that the cotton should grow luxuriantly and produce abundantly in the Island."[100]

We have already commented elsewhere on the failure of the protective duties on cotton to stimulate any expansion in the local industry. In 1836 the Government contemplated a retreat from protective policy in the case of cloth. The duty was not to be

98. Bertolacci *op.cit.* p. 340: "Grain always pays but a trifling duty and the duty was suspended in times of urgency."

99. C. O. 54. 157. Minutes of meeting of the Governors Executive Council 11th Sept. 1836.

100. C. O. 54. 112. *op.cit.* Barnes replies to criticisms by Gordon, Jan. 1831.

abolished altogether but from now on its rate was to be largely determined by revenue considerations. In 1835 the revenue from the cloth duty amounted to £13,341 but the Government was of opinion that it could be augmented still further by a reduction in the rate of duty. "No doubt it appears to be entertained that the revenue is greatly injured by this excessive duty, and that a diminution of duty, would lead immediately to an increased import which would more than repair the deficiency from the diminution of duty."[101]

Similarly, doubts began to be entertained on the efficacy of the grain duty in serving its accredited purpose. For a number of reasons, amongst which the lack of irrigation facilities and the want of capital on the part of the peasantry were notable, there was no remarkable expansion in the output of home grown rice. On the other hand the growth in population was making necessary the importation of rice in ever increasing quantities. The local agricultural producer instead of having a surplus of produce to dispose of in a protected market was himself at times having recourse to imported supplies to augment his own consumption[102] and had in consequence to shoulder a share of the burden of the import duty. And since, in the case of many persons expenditure on food accounted for most of their income, an increase in food prices made this burden particularly heavy.[103] In addition there were

101. C. O. 54. 157. *op.cit.*

102. "A large proportion of the agricultural population, both in the interior and on the coast, are compelled, not merely on occasions of the failure of their own crops from drought or inundation, but habitually to subsist on imported rice." Tennent, Report, *op.cit.* p. 61.

103. "Owing to the sheer dependency of the natives upon the supply of rice, the occurrence of a failure in the crops, or any unexpected advance in the cost of rice which raises it above the amount of their wages is productive of the most disastrous consequences – consequences which are not to be estimated by a mere European example of the effects of scarcity. For although we do not find in Ceylon that the rate of wages adjusts itself to the fluctuations in the price of food, (as scarcity always forces an additional number of competitors into the labour market sufficient to keep down their average amount), still any sudden augmentation in the cost of rice is productive of greater misery to the labourer here than arises to the same class from the same causes in Northern countries. There the labourer's wages are necessarily spent on other articles besides food – on rent, clothing, furniture and fuel; and any increase in the cost of the one is adjusted by a retrenchment of expenditure on the other; but here, where generally speaking the whole of the labourer's gains are converted into the precise quantity of food which will supply his own wants and those of his family and dependants, every advance in its value which causes it to exceed his income in the smallest proportion, is productive of instant distress."

Sir Emerson Tennent: Report *op.cit.* p. 62.

other objections to the import duty. For instance there were complaints from the European planting community who often supplemented their labourers wages with rice at fixed prices and usually sustained losses if prices increased. Again, it was said that the heavy duty on rice prevented competition from small importers who did not usually have the capital to pay the duty;[104] a situation which was to the advantage of the wealthy Moors and Chetties but detrimental to the planters.[105]

The Government was itself aware of the shortcomings of the duty on grain, but unlike in the case of cloth, it did not have such confidence in the elasticity of demand for rice as to believe that a reduction in the duty would result in anything but a loss to the revenue. It was, in consequence, hesitant to reduce the duty. Thus in a review of the position in 1836 it preferred to leave the duty on grain untouched pending a reference to the Secretary of State, although it was itself of opinion that some reduction at least (from five pence to two pence per parrah) should be brought about, notwithstanding a possible loss to the revenue of £15,000.[106] Again, in 1841, a committee of the Legislative Council was appointed to consider the desirability of the entire abolition of the tax. It concluded that although the import duty contributed to a rise in the price of rice in the local market, its effects in all areas away from the coast, was negligible when compared to the role played by excessive transportation costs which were really responsible for the 'ruinous and unreasonable' price of rice in the interior and in the neighbourhood of the highland estates. The committee was of the opinion that the real solution to the problems lay in a forward and vigorous policy of road construction, and that the abolition of the duty on grain, however desirable for its own sake, was inimical to this end.[107] The committee made the further suggestion, (which however was not acted upon) that the revenue from the rice duty be applied to the improvement of the means of communication.

Thus the import duty, which was first introduced for protective purposes, now became an essential support for the whole revenue. Since it fulfilled this function admirably it is not surprising that

104. *ibid.* p. 62–3.
105. *ibid.* p. 63.
106. C. O. 54. 157. Meeting of the Executive Council, *op.cit.*
107. Tennent *op.cit.* p. 64.

it came to stay. Its importance naturally grew with the expansion in the volume of imports which accompanied the growth of the export sector. Its role in the fiscal system of modern times will become quite apparent in our later studies.

The export duties, on the other hand, did not have quite the same history. Indeed during the latter half of the nineteenth century, which was the crucial phase in the expansion of the export sector, the export duties were of negligible importance. We have shown how the extension of the import duties in 1820 led to a reversal of the relative importance of the export and import taxes in the customs revenue. There was wide variety in the rates of export duty levied on the several commodities at this time. Tobacco and arecanuts were subjected to particularly heavy taxes. On the other hand, the Government in 1830 totally exempted coffee from both the land tax and the export duty. The wide variety and inequality in the rates of export duty was criticised by several observers including Colebrook.[108] In 1836, all export duties, save those on tobacco and cinnamon, were generalised to a uniform level of 2½%, and all exports previously exempted, like coffee, were now subjected to the tax.[109] The Government, however, continued to hope for the ultimate abolition of all export duties. By the middle of the eighteen forties the revenue position had improved sufficiently to make this possible. The repaid expansion of the coffee industry led, indirectly, to an increase in the revenue from import duties, and the Government's optimism was further encouraged by a series of successful pearl fisheries. Accordingly, in 1847 virtually all export duties were abolished.

From this period onwards, for well over half a century, Ceylon's trade was free of export taxes. There was a brief interlude in the eighteen seventies when a uniform export tax of 2½% on all exports was imposed in order to meet interest changes on monies borrowed for the construction of the Ceylon railways. But this tax had a limited life of about three years. Soon the railway was making

108. C. O. 54. 122. Colebrook went so far as to hope for the complete abolition of almost all export duties. "The improvement of the revenue, collected under the Regulation of 1820, having shown the effect of reducing the export duties, I can entertain no doubt that their progressive abolition would lead to a further augmentation of the trade and revenue of the Island. The substitution of a moderate export duty upon cinnamon will constitute for a time an exception to this principle as a means of superseding the effects of a dangerous monopoly." – *ibid. Report on the Revenues*, p. 50.

109. C. O. 54. 157. Ordinance No. 7 of 23rd December 1836.

sufficient profits not only to pay this interest but also to augment the general revenue. The export duties were therefore abolished, and were not reintroduced until the first world war. In 1916 export duties were universally levied as a wartime tax, but thereafter they came to stay. They were considerably relaxed during the depression of the thirties, but reintroduced with renewed vigour during and after the second world war.

During the long period when export taxes were absent, the Ceylon revenues were mainly supported by import duties, revenues from land sales and, later, by profits from the railways. All these sources were intimately linked up with the expansion of the export sector which we shall examine in the next chapter. In the twentieth century, however, the revenue from land sales had come to an end and railway profits were rapidly diminished by road competition. At the same time the Government's scale of recurrent expenditure had been raised to higher levels and new sources of revenue had to be found to bridge the gap. This may, in part at least, be the explanation for the re-emergence of the export duties after 1916, and for the gradual introduction of direct taxes like the death duty in 1923 and the Income tax in 1932.

We may perhaps conclude this chapter with a brief summary of the stages in the evolution of Ceylon's revenue system. In the early period of the Sinhalese kings revenues were mainly derived from direct taxes on indigenous and subsistence production. There were Royal monopolies in foreign trade but their importance was of a minor order. With the Portuguese and the Dutch, the trading monopolies became the major source of revenue, but the indigenous taxes remained as a supplementary support. The British abolished the monopolies and substituted customs duties in their place. They also attempted to remove or reform the taxes on the indigenous economy but these attempts were virtually unsuccessful. For a time, therefore, the customs duties and the local taxes co-existed as revenue sources. The expansion by the export sector, however, made possible the ultimate removal of most of the local taxes. During the phase of rapid economic growth, the customs duties provided the main source of revenue supplemented by other receipts, related to the export sector, like revenue from land sales and railway profits. Within the sphere of customs duties too there were significant stages. In the early period export taxes predominated, but soon the roles were reversed in favour of import duties and for a long period the export taxes disappeared altogether. They were to re-emerge in a much later period, but by then the export economy of Ceylon was well established. There has also been a partial return to direct taxes in recent times. But these taxes are of a modern type like the death duty and the income tax. All these stages in the growth of the tax structure since the early British period are, of course, related to the evolution of the export economy. It is, therefore, to this evolution that we must now turn.

CHAPTER II

THE EVOLUTION OF THE CEYLON ECONOMY

The trend of a growing institution

In 1798 Malthus, in his "Essay on the Principle of Population", advanced, as a law of population growth, the principle that population tends to grow in geometric progression. The same principle was applied to economic and social phenomena by W. S. Jevons who tested it with reference to England's industrial progress.[110] In 1920 Raymon Pearl and Lowell J. Reed suggested that the population curve should not continue to rise indefinitely but should level off after some period of time.[111] In their formulation of the law of organic growth, an initial period of relatively slow arithmetical growth is followed by a period of very rapid arithmetical growth and then by a period in which this rapid arithmetical growth slows down. This idea was extended to the field of industrial development by Raymond B. Prescott.[112] He discerned four stages in the growth of individual industries: a) a period of experimentation; b) a period of growth into the social fabric; c) a period where growth increases, but at a diminishing rate; and d) a period of stability. Rates of growth may, of course, differ between individual industries and between individual countries, but in general the pattern of growth may be represented by a similar type of curve. Kuznets[113] has also summarised the various factors making for growth under the three broad heads of population increase, changes in demand, and technological changes. He likewise enumerated the factors making for a slowing up of growth as–the slackening of technological progress, the retarding influence of other slower industries, the decrease in the relative size of funds available for expansion as industry grows, and the competition of later developing industries in other countries.

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110. W. S. Jevons: *The Coal Question* 1865.

111. Chapter XX p. 549: Smith and Duncan: Fundamentals of the Theory of Statistics: Elementary Statistics and Applications.

112. Raymond B. Prescott: "Law of Growth in forecasting demand". *Journal of the American Statistical Association,* Vol. XVIII. Dec. 1922 pp. 471–479.

113. Simon S. Kuznets: "Secular movements in production and prices". 1930.

The basis for the law of organic growth as outlined above is empirical. It has been derived from an examination of several statistical series. It is interesting however to extend this concept, which was originally applied to individual industries, to the growth of a whole economy or at least to specific phases in the growth of an economy. At a certain period, factors such as those outlined by Kuznets may stimulate development over a wide range of the economy and lead to an expansion in national income. After a period of rapid growth the limiting factors may appear and tend to dampen the rate of expansion until finally there is hardly any growth at all. Unless, during this latter stage new forces emerge which will result in a fresh burst of activity, leading to a new phase of development, the economy will remain relatively stagnant. Indeed it is possible to conceive of circumstances in which the economy will enter into a downward phase of actual decline. For instance such a downward movement will occur in the case of income per head in circumstances where national income remains more or less constant in the face of a rising population. Again, it is conceivable that national income will itself decline if its expansion was the result of the exploitation of exhaustible natural resources or, if for some reason or another, a nation's stock of capital equipment has not been maintained in working order.

The period with which we are concerned in the study of the evolution of the Ceylon economy is that which begins with the emergence of certain changes which transformed the primarily self-contained peasant economy of the country into the modern export economy of today. For reasons which will presently be apparent, this period can be said to commence about the years 1835–37, although it was preceded by an intermediate phase of a transitional nature. The major difficulty in the study of the trend of growth of the Ceylon economy during this period is, of course, the absence of a composite measure of overall growth such as would have been provided by statistics of national income. In the absence of such a measure it is necessary to turn to substitute criteria, or indirect measures, which can be expected to reflect to a greater or lesser degree the trend of growth of the economy as a whole. The substitute criteria that will be suitable for this purpose will fall logically into three categories: a) indices which reflect the trend of growth of the export sector of the Ceylon economy; b) indices which reflect the trend of growth of the internal exchange sector or the sector producing goods and services primarily for domestic consumption; and c) indices which reflect the trend of growth of the subsistence sector. Now if the *rate* of growth in each of these sectors were identical, a curve which traces the trend of growth of any one of them will represent in all characteristics, save absolute values, the trend of growth in the economy as a whole. The trend for the whole economy is essentially the sum of the trends of the three individual sectors. Consequently if one or two of the sectors of the economy showed no growth at all, the trend of growth of the whole economy will exhibit in a dampened form, the characteristics of the trend of the growing sector or sectors, to an extent which depends on the relative importance of the latter in the economy as a whole. The relationship between the overall trends and the trends for the individual sectors will be more complicated if the latter were quite unrelated or moved in divergent directions. Even in this case the influence of the trends of the individual sectors in the overall trend will be proportional to their relative importance or weightage, but there is the possibility that the influence of the most important sector is offset by the combined influence of the other two.

The available statistical data on the Ceylon economy do not, however, make it possible to obtain equally representative trends of growth for each of the sectors of the economy. Information concerning the export sector is much more readily available than information concerning the other two. There are, however, a number of reasons which make it possible to use the trend of growth of the export sector as a rough approximation to the trend of growth of the economy as a whole. In the first place, there is evidence to suggest that the size of the subsistence sector of the Ceylon economy, measured in terms of output (or acreage), remained relatively stable or at best increased at a very small rate of relative growth during the period under consideration. In the second place, the expansion of the export sector resulted in an increase in its relative importance in the economy as a whole. Finally, the nature of the relationship between the export sector and the sector producing for domestic exchange, as well as the available empirical evidence, suggest that the trend of growth of the internal exchange sector was broadly similar to that of the export sector.

Some idea of the development of the export sector can be obtained from the chart included at the end of this chapter. The value of the total merchandise exports of Ceylon are plotted on a ratio scale so as to depict relative rates of growth from year to year during the period 1831–1938. On the same chart the value of the total exports reduced to a per capita basis are also included. The chart suggests that there are in fact three clear phases, each of which tends to conform individually to the customary pattern of growth. In the first phase, there is a period of rapid growth followed by a slowing down of growth which continues until the early years of the eighteen eighties when an actual decline takes place. The second phase begins in the second half of the eighteen eighties, but there is a notable slowing down in the rate of expansion during the first five years of the twentieth century. The third phase commences about 1907 and tends thereafter to increase until the end of the twenties when a sudden decline takes place. Since the chart depicts a time series of the value of merchandise exports, it needs to be corrected for price changes before it is used as a measure of the course of exports in physical terms, and thus of the growth of the export sector. The limitations to the use of an uncorrected series are particularly important in the period after the beginning of the first world war when prices played a very significant role particularly during the boom years in the middle of the nineteen twenties and during the depression of the thirties. It will be seen later that in terms of physical output, the export sector ceased to grow appreciably after about 1920.

Each of these individual trends in the growth of the export sector can only be understood after an examination of the various forces which appeared at each stage to stimulate expansion. An analysis of the evolution of the Ceylon economy divides itself, accordingly, into the following sections corresponding to each of the phases outlined above: (i) the period prior to 1835 – a period of transition – (ii) 1835 to the 1880's – the first phase in the establishment of an export economy (iii) the 1880's to the first decade of the twentieth century – the second phase in the growth of the export economy, (iv) 1900–1920 – the final phase of growth, and (v) 1920 to the present day – a period of relative stagnation.

(i) The transition to an export economy

Throughout its history Ceylon has engaged in trading contacts with the outside world, and has been known to the ancient centres of civilisation as a valuable source for precious stones and tropical produce. But there is a significant difference between the foreign trade of Ceylon in early times and the present day relationship with the outside world. In the earlier period, the natural riches of Ceylon which were sought by foreign traders were to be found in casual abundance throughout the various parts of the Island. In the later period there was the systematic cultivation of produce for export – in plantations often with the assistance of foreign capital. In this latter period the entire Ceylon economy was transformed. The new plantations made deep inroads into the existing village economy which became less and less adapted for supplying even the everyday needs of the community. This transformation made Ceylon dependent on foreign sources for its basic necessities like food, clothing and building materials and brought into being the "export economy" which we know today.

Ceylon was subject to direct and continued contact with the West ever since the coming of the Portuguese to Ceylon in 1505. But during the three centuries that passed between this date and the British occupation, there were hardly any economic events that substantially affected or modified the rural economy of the Sinhalese. Both the Dutch and the Portuguese were primarily concerned with trade, and though they gradually modified the Sinhalese system of *rajakariya* – or services due to the king – to suit the needs of their trade and government,[114] they made no radical alteration in the Sinhalese form of feudal economy. This was essentially a village economy of peasant cultivators growing for themselves their essential foodstuffs such as rice. There must have existed a certain amount of inter-village exchange in produce[115] since the non-food requirements of the people were met out of local manufacturers, and Sinhalese handicrafts of various kinds were renowned from early times.[116] But substantially, the village was a self contained

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114. See the discussion in *Ceylon under the British Occupation* Vol. I. Ch I. by Colvin R. de Silva.

115. Often the several castes or vocational groups had villages of their own. Exchange however was largely by barter. "As all trade is carried on by barter, and as taxes are paid in kind, there is not much money in the country ...... (although) ...... the King of Kandy had allowed his subjects to make use of a kind of money which everybody was permitted to fabricate. It is of very pure silver and is made in the shape of a fish hook. The King also struck a kind of money called *panams* which it was forbidden to imitate under pain of death."

116. "The Sinhalese were distinguished as iron workers in very ancient days, and they were early workers in brass and glass as their ancient ruins show...... (They) are good carpenters, and supply furniture and carved work in abundance ...... Native cotton spinners and weavers were at one time common ....." John Ferguson: *Ceylon in the Jubilee year* 1887 London, pp. 57 and 58.

unit, organised in a feudal system under which all land was the property of the king who held a right to its ultimate disposal. When a village was conferred as a royal gift to a person it did not involve the conversion of the inhabitants into tenants of a landlord. Unlike in Europe, both the cultivator and the nobles held their lands from the king.[117] Thus the cultivator in Ceylon was more or less independent as far as his own lands were concerned and was not a serf in the European sense or even a tenant of any overlord save the King himself. For the King, however, the cultivator was obliged to perform certain services – known as *Rajakariya* in return for his holding of land.[118] These services were in part general services, such as repairing and maintaining the paths and bridges of the district in which a person lived, and in part specialised services determined by the caste or social and vocational group to which a person belonged by birth.[119] Through this system of *Rajakariya,* the kings were able to secure the labour required for military and public purposes and so were able to construct such important and ambitious works as the ancient irrigation tanks which are admired even to this day. *Rajakariya* was abolished in the nineteenth century; but not before it had made a substantial contribution to the development of Ceylon's export economy through the construction of a road system which made possible the extensive planting of coffee.

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117. (a) "The grant of a village ...... did not involve any title to the lands of the village but only to the ten, fifteen or twenty acres of what in the Kandy districts are called the *mutteto* fields (fields on which no person resided), and the right to compel the cultivation of these as well as exact menial service from the inhabitants of the village who, of course, remained and have always considered themselves freeholders of their own lands."

(b) "All tenures of land amongst the Sinhalese ...... as far as I could ascertain, had nothing of a feudal nature: a great proprietor, indeed, might give land to individuals for certain services, to be held whilst those services were performed; but the individuals were not bound to the soil, owed no allegiance to the proprietor, and might quit his service when they pleased." *An Account of the Interior of Ceylon,* by John Davy M.D., F.R.S. London 1821. Ch. VI p. 187.

118. Villages had of course to perform certain services to nobles on the latters' *mutteto* fields.

119. G. C. Mendis *Ceylon Under the British,* Colombo 1944 p. 20. A detailed description of the various kinds of services due to the Kings of Kandy is given by the Portuguese Captain John Ribero in his *History of Ceylon* presented to the King of Portugal 1685. English Edition 1847 Bk. 1. Ch. X pp. 39–42.

This system of rural economy dominated the economic life of the people of Ceylon right up to the beginnings of the great plantation industries in the British period. In the preceding chapter we discussed some of the problems connected with the taxation of this system prior to the establishment of the plantations. The plantations did not, however, completely displace this type of economic activity. They reduced its relative importance in the national economy and also reacted on its structure in a number of ways. But it continues to this day in the form of a semi-subsistence, rice growing, village agriculture on which the greater part of the population of Ceylon is still directly dependent.

The transition from a rural subsistence economy to a modern export economy was not really begun until the establishment of the coffee plantations in the 1830's during the period of British rule. But it was another commodity – cinnamon – which played an intermediary role as a sort of link in the chain of development from the one system to the other. Commodities such as arecanuts, pepper, precious stones, elephants, and pearls interested both the Portuguese and the Dutch as lucrative items of foreign trade. But cinnamon enjoyed an important role under both these regimes and, with the Dutch in particular, its importance was fundamental. Indeed up to the nineteenth century Ceylon provided almost the whole of the world's supply of cinnamon, and its monopoly was one of the most abundant sources of profit to the Dutch East India Company. But it was not till 1769 that this commodity was deliberately cultivated for export. It had till then been growing wild in the jungles of Ceylon and over three-fifths of its supply had to be obtained from territories under the control of the independent kingdom of Kandy. In 1769 the Dutch Governor established, for the purpose of securing more assured supplies, the first large scale export plantation in Ceylon – a cinnamon garden at Maradana near Colombo.[120] By 1795 there were four other smaller plantations in the maritime regions, and, in addition, the Sinhalese were encouraged to form 'an infinite number of small gardens'. Thus it was the trade in cinnamon that occasioned the emergence, for the

120. cf. *The Cinnamon Trade of Ceylon,* by George Lee, Ch.IX of the Appendix to Ribero's *History of Ceylon,* p. 234. The first garden covered "a space of ground extending nearly three miles in every direction, and covering about 4,000 acres". Previously the Dutch had tried to systematically cultivate crops like coffee, cotton and sugar but were largely unsuccessful in their attempts. cf. Mendis: *Ceylon under the British* p. 22, and Ferguson *op.cit.* p. 59.

first time in Ceylon, of the two types of producing units – plantations and small-holdings – which today characterise the organisation of agricultural export production in the country. In spite of this systematic cultivation, however the bulk of the cinnamon had still to be obtained from the forests. The actual trade in cinnamon was of course the monopoly of the Dutch East India Company.[121] "From 1691 to 1794, the date of the last Dutch shipment, the average annual export was limited to 400,000 lbs., the estimated world consumption. The price was fixed at as high a figure as the market could be induced to pay, the profit on the sales averaging 200 per cent."[122]

With the British conquest in 1789 the cinnamon monopoly passed over to the British East India Company who carried out the trade in much the same way as the Dutch. When Ceylon was transferred to the British Crown in 1802, the Government took over the control of cultivation as well as the collection of cinnamon, but agreed to deliver annually a quantity of 400,000 lbs. to the Company at a fixed price. In this way the Company retained the monopoly of the cinnamon trade in the world's markets. The Ceylon Government attempted to reduce its production costs by reorganising production into a few large units and by suppressing the small holdings since these, in the Government's view made the enforcement of the monopoly more difficult. The policy, however, was unsuccessful. The Government was unable to deliver the quantities stipulated under the agreement with the Company, and was still mainly dependent on the cinnamon production of the Kandyan interior for a good proportion of the quantities it did supply. In 1821, the last of the contracts with the Company expired; and in the following year, rather than renew the contract the Ceylon Government took over the monopoly of cinnamon. Although it had over 11,000 acres under cultivation in plantations, in addition to possible supplies from abandoned village gardens and the forests, the government found that the fulfilment of the contract was beyond the resources of the Island.

For a few years, under the new arrangement, the Govenment sold its supplies of cinnamon by public auction in Colombo. From

121. "The sale or export of a single stick of cinnamon except by the servants of government, as well as the wilful injury of the tree, were punishable by death" – Mills: *Ceylon Under British Rule* Ch.XI p. 203. Also Bertolacci Ch. I p. 25.

122. *ibid.*

there the purchaser was left free to export his cinnamon free of duty to any place whatsoever. This scheme was, however, abandoned in 1826 because buyers made a tacit agreement to bid at much less than the Government's reserve price. Instead the Government now exported all its cinnamon for sale in London. This system was continued until the Government monopoly, as well as its participation in the trade, was abolished in 1833. The profits made by the Government during the operation of the scheme were not, however, as large as anticipated, because on the one hand the East India Company, in pursuance of its policy of restricting sales, had accumulated stocks in London which were not exhausted until 1828, and on the other hand because, cassia, an inferior substitute for cinnamon was beginning to reach the London market in increasing quantities. Both the East India Company and the Ceylon Government had continued the Dutch policy of exploiting their monopoly to restrict sales and raise prices. This naturally encouraged the cultivation of inferior but competitive cinnamon in India and Java[123] and of cassia in South India, the Philippines, the East Indian Archipelago and in southern China. Thus Ceylon had its first lesson on the dangers inherent in a misuse of monopolistic powers. But the experience of this period came to be forgotten, for almost a hundred years later, in the twenties and thirties of this century there occurred a repetition of similar events in the case of rubber.

In 1833 the cinnamon monopoly was abolished on the recommendation of the liberally inclined Colebrook Commission. The monopoly was said to be expensive to maintain and oppressive and injurious to the Sinhalese. The cinnamon laws were to be repealed, the plantations were to be leased or sold, and cultivation and sale were to be free to all. The auctioning of cinnamon was to be held in Ceylon instead of London. The Government sought to derive its share of benefit from the cinnamon industry through the imposition of an export duty.[124]

The sale of the Government's stocks of cinnamon did not, however, prove easy and had to be spread over a period in order to minimise losses. The sale of plantations equally resulted in a

123. In 1925 a Dutch brig smuggled 3,000 plants from Ceylon to Java where plantations began to increase rapidly. Mills *op.cit.* p. 214.

124. As we have previously remarked, Colebrook himself was not particularly enamoured of export duties. But the Government revenues had to be sustained, and Colebrook preferred an export duty combined with private trading, to a Government monopoly.

serious loss of capital to the Government. They had, at the later stages, to be sold for whatever price they would fetch, and frequently these prices amounted to less than one-quarter of the value of the annual produce of the land.[125] By 1845 all stocks were disposed of and by 1847 all the plantations were sold save one garden which was abandoned through want of a buyer.

The ending of the Government monopoly of the cinnamon trade did not, however, result in the supply of Ceylon's output to the world market at competitive prices. The government still believed that Ceylon's position as a supplier of the world's cinnamon was unshakable and imposed an export duty in the confident expectation that the consumer would continue to pay high prices. An initial duty of 3/- per lb. was imposed in 1833 on all grades of cinnamon. The history of the cinnamon trade subsequent to the abolition of the Government monopoly provides an early but useful illustration of the limits of the export duty as a weapon of taxation and fiscal policy. The over-exploitation of Ceylon's monopoly led, as already indicated, to a stimulus to outside production. In 1835 Java was producing 2,200 lbs. of cinnamon. In 1845 the output had increased to 134,500 lbs. whilst by 1848 she was producing 250,500 lbs.[126] The natural result of these increases in world supply, unaccompanied by increased demand, was a fall in the prices fetched by Ceylon cinnamon. In 1835 the sale price per lb. of grade 1 cinnamon was 9/9d; in 1841 it was 5/1d; by 1846 it had fallen to 3/9d., and by 1855 it was no higher than 1/3d. The course of the export duty on Ceylon cinnamon can almost be deduced in the face of this downward trend in world prices. From an initial duty of 3/- per lb. on all grades in 1833 the duty has been reduced by 1837 to 2/6d. per lb. on grades I and II and 2/- per lb. on grade III. In 1841 the duty on all grades was 2/-; in 1843 it was brought down to 1/- per lb. By 1848 it had fallen to 4d. per lb. Finally in 1853 it was abolished altogether.

The Government revenues were heavily dependent on the returns from the export duty which was, of course, the successor to the profits from cinnamon in the days of Government trading. It was therefore not easy to impose in practice a flexible and finely adjusted duty, designed only to siphon off the economic rent,

125. Mills *op.cit.* p. 214.

126. Mills *op.cit.* p.215.

above costs and normal profits, that would otherwise have accrued to producers. As the price of cinnamon was brought down in the London market under pressure of foreign supplies the margin of profit left to Ceylon growers after payment of the export duty was corespondingly reduced. A point was soon reached when the output of marginal growers was affected. The export duty had then to be lowered, but meantime the London price would fall still further so that producers were deprived of any real relief. The export duty, as we have seen, was subjected to a series of reductions as the London price fell, but the reduction at each stage was belated and growers and merchants squarely blamed the government for the weakening of their competitive position vis-a-vis foreign suppliers. The chief opposition to a reduction of the export duty came, of course, from the Treasury in London whose natural concern was the Government revenue. "The Ceylon Government and the Colonial Office gradually realised the effect of the duty; but the Treasury stubbornly resisted any effective change until the Ceylon trade was in danger of extinction."[127]

It does not, however, seem reasonable to put the whole blame for the decline of the cinnamon industry in Ceylon on the export duties. In fact the seeds of the subsequent difficulties were sown in the earlier period of monopoly when prices were artificially raised by the deliberate restriction of output. These high prices succeeded in establishing production in other territories and supplies from these sources would in any event have led to a reduction in prices. The imposition of the export duty after the abandonment of the monopoly naturally meant a lower level of profits to producers than would have prevailed had there been no duty. In this way the expansion of production in Ceylon was prejudiced, whilst foreign growers were able to increase their output under the stimulus of relatively higher profits.[128] It seems therefore that, in the last analysis, although the duties were not the cause of the fall in the

127. Mills *op.cit.* p. 214. The Ceylon Government had no fiscal autonomy at the time and changes in taxation needed the authority of the Colonial Office which in turn referred financial problems to the Treasury in London. Ceylon was a "grant aided" colony whose finances were subject to Treasury control.

128. The export duty on Javanese cinnamon during this period was only ½d. per lb. The small preference which Ceylon cinnamon enjoyed in the United Kingdom tariff was progressively reduced between 1829 and 1853. In the latter year the preference was abolished altogether. *ibid.* p. 215 and 88.

London price of cinnamon, they helped considerably towards a reduction of Ceylon's share in the increasing world trade in this commodity.

By 1852 cinnamon had come to enjoy a relatively unimportant position in Ceylon's export trade. In the years that followed up to the present day, cinnamon continued to figure as a regular item in the export list but its importance to the total trade of Ceylon has been negligible. The European plantations were sold and the industry passed, in general, into Ceylonese hands.[129] An important feature was a reduction in the quality of the cinnamon exported which, in the 1860's partly assisted in the survival of the trade. But the repercussions of this were felt in Ceylon in later years when the product tended to fall out of favour in the London market.

It is now possible to obtain a broad picture of the Ceylon economy during the period commencing with the British occupation of the maritime provinces in 1789 and the beginnings of the great coffee plantations in 1835. Then, as in the later period, there were, so to speak, two sectors in the economy. On the one hand there was the rural village economy which regulated the economic life of the great bulk of the population. This was essentially a subsistence economy modified by a limited exchange of produce on a substantially barter basis. On the other hand there was the economic activity connected with the export trade centering largely but not exclusively round cinnamon. Arrack, tobacco, arecanuts, coffee and the produce of the Pearl Banks of Ceylon were other important items of export,[130] but, as mentioned already, cinnamon was the only agricultural commodity systematically produced for export, the rest being collected from forests and village gardens. Rice and cloth were the principal imports Ceylon obtained in return for her exports. This feature has continued up to this day and is one of the outstanding characteristics of the Ceylon economy. In subsequent years imported food came to supply an ever increasing share of Ceylon's total food requirements, and greater self sufficiency

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129. The cinnamon plantations in Colombo were eventually displaced by the expansion of the City. Colombo's luxurious residential area is still termed "Cinnamon Gardens".

130. Bertolacci's list of exports for the years 1806–1812 includes the following commodities: Arrack, pepper, coffee, cardamom, arecanuts, tobacco, coir, coconuts, coconut oil, copra, wood and timber, palmyrah, jaggery, choya root, chanks, salt fish, gingelly, margosa seed and ore, fruits the produce of the pearl banks and cinnamon. *Op.cit.* pp. 528–561.

has, for long, been one of the Government's chief economic aims. It is therefore interesting to note the relatively early beginnings of the dependence on imported food. In ancient and medieval times Ceylon was believed to have supported, on its own supplies, a population larger than in the period under discussion. During the period of the Portuguese and Dutch occupation the provinces of the Kandyan interior were cut off from the maritime regions, but the former territories were always self-sufficient in food.[131]. The first food imports were for the purpose of meeting the food requirements of the maritime regions. Both the Dutch and the British were accustomed to import rice from the south of India for the purpose of feeding their garrisons. In the first two decades of the nineteenth century, however, it became necessary to import rice to meet the requirements of the general population, specially in years of exceptionally low harvests caused by unfavourable weather conditions.[132] From that period onward the importation of rice has been a permanent feature in Ceylon's trade. Generally, the causes of the decline in self-sufficiency in rice are of two kinds. First, there was a decline in the productivity of rural agriculture, occasioned in part by the centuries old neglect of the ancient tanks and irrigation systems[133] and in part by the disturbance of the normal equilibrium of the rural economy caused by successive changes in administration and taxation.[134] Second there was the increase in population consisting, in part, of an increase in the local population assisted by improvements in medical science,[135] and, in part, of the importation into Ceylon of outsiders for service,

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131. Bertolacci *op.cit.* p. 71. Writing in 1816 the author confirmed that the Kandyan country was producing a "large surplus" of rice.

132. *Ibid.* p. 70–72. Bertolacci speaks of famine conditions in the Northern and Southern parts of the Island in the year 1812–14 when crop yields were low because of drought.

133. Mills *op.cit.* Ch. VIII p. 130.

134. *Ibid.* p. 131. In particular, the failure to maintain the *Gansabhavas*, or village councils, contributed a great deal towards the decline of rural agriculture. It was these councils that regulated the communal aspects of village agriculture such as the use and preservation of irrigation routes and so on.

135. Bertolacci agrees with a semi-official estimate of 1½ millions for the population of Ceylon at the beginning of the 19th century. 221,082 persons were inoculated against small pox between 1802 and 1812 and Bertolacci emphasises its effects on the growth of population. Indeed he regards the famines of 1812–14 as the first sensible check given the extraordinary increase of population in Ceylon, brought about by the introduction of vaccine innoculation. *op.cit.* p. 63, 65 and p. 72.

first in the military and then in the great plantations. This dependence on imported food was intensified in later years when the rise in population was assisted by continued improvements in the health services and by ever increasing immigration of labour from the mainland of India.[136] At the same time efforts to increase local productivity in rice growing met with only limited success whilst the establishment of coffee plantations in the interior of the country further disturbed the normal routine of rice production in those regions.

(ii) The establishment of an export economy – The first phase

Ceylon's export economy of today is chiefly based on the production and export of three commodities – tea, rubber and coconuts. But before these industries came to occupy a significant place in the economic pattern of the country, Ceylon had developed an export economy, in many ways similar to the present set-up, but based on a single export crop – coffee. The production and export of cinnamon served, as indicated, as a link in the transformation of the Ceylon economy from a primary self – contained peasant system to an open economy. But though the cinnamon trade was of importance to a section of merchants and traders and to the Ceylon Government whose revenues were largely dependent on it, its influence on the economic life of the country was marginal. It was really the coffee industry which transformed Ceylon into an export economy of the familiar pattern, and although, by the beginning of the twentieth century there were few remaining traces of the coffee industry, the structural characteristics of the Ceylon economy were in all fundamentals the same as in the coffee period.

The systematic cultivation of coffee[137] had not really been possible until the hilly Kandyan interior was made accessible through

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136. Also Ferguson mentions increased per capita consumption in prosperous times as a partial explanation of increased imports. *op.cit.* p. 47.

137. "The arabs first introduced coffee into India and Ceylon, and the shrub was grown here before the arrival of the Portuguese and the Dutch; but the preparation of a beverage from its berries was totally unknown to the Sinhalese, who only used the young coffee leaves for their curries, and the delicate jasmine like coffee flowers for ornamenting their shrines of Buddha...... The first attempt at systematic cultivation was made by the Dutch in 1740, but, being confined to the low country, it did not succeed, and they seem never to have exported more than 1,000 cwt in a year. The moorman (arab) traders and Sinhalese, having once discovered the use of coffee, kept up the cultivation and trade, but when the British took Ceylon and up to 1812, the annual export had never exceeded 3,000 cwts." Ferguson *op.cit.* VI p. 59–61.

political conquest and the construction of adequate roads.[138] In 1820 the Ceylon Government, on the initiative of the Governor Sir Edward Barnes,[139] embarked upon a policy of road building which was made effective through the diversion of monies hitherto spent on forts and through the exaction of a fortnight's compulsory labour from the Sinhalese who held their lands on *Rajakariya* or service tenure. Until 1820 Ceylon did not have a mile of metalled roads outside some of the principal towns. The existing means of communication were rough footpaths through the jungles, and these were unsuited for use by bullock carts which were the only practicable means for transporting coffee from the interior to the ports.[140] The early road policy of the Government was partly dictated by strategic consideration, but it also arose out of a conscious desire to enhance the economic value of the colony through the cultivation of commercial crops. Indeed it was through the construction of an extensive network of roads, and later of railways, that the Government of Ceylon made its largest and most direct contribution to the growth and development of Ceylon's export economy.

The first European coffee plantation was established near Kandy in 1823 by Col. George Bird a retired cavalry officer. In the same year a Government plantation of 200 acres was also begun near the Botanic gardens at Peradeniya, but this was sold in 1832 under instructions from the Colonial Office which disallowed the association of the Government in trading matters.[141] However, apart from a few plantations of this sort, the culture of coffee in plantations or estates did not expand significantly until the years

138. A further possible obstacle to the expansion of coffee cultivation was abolished as early as 1812. This was "The Dundas Regulation" which forbade Europeans to acquire land in Ceylon except within the district of Colombo. Mills, *op.cit.* XII p. 222.

139. "By comparison with the public works built by later Governors, Barnes's 300 or 400 miles of road may seem rather paltry. During the second half of the century, however, Governors were sustained by the comfortable certitude of a large and increasing surplus of revenue; while to Barnes fell the task of making a cartload of bricks with a fistful of straw. Eternally hampered by a small revenue and recurring deficits he contrived to build up the skeleton of what became a very fine system of communications. His roads made possible the formation of the coffee plantations, the ultimate basis of Ceylon's prosperity." Mills *op.cit.* XII p. 224.

140. The opening of the Colombo–Kandy road is said to have reduced the cost of transport to a twelfth. Mendis *op.cit.* V. 51.

141. Mills *op.cit.* XII p. 226. Other Government plantations were also opened up with the help of *Rajakariya* but these too were subsequently sold or abandoned.

1835–37 when two notable changes took place which gave a real stimulus to the expansion of coffee in Ceylon. The first favourable change was the equalisation of the United Kingdom duty on West Indian and Ceylon coffee in 1835. Hitherto Ceylon suffered from a discriminatory duty which preferentially treated West Indian coffee at the expense of all other coffee. The abolition of discrimination coincided with an expansion of demand for coffee in Western Europe[142] and a reduction in supply from the West Indies where the labour supply for the plantations was adversely affected by the liberation of the slaves. The second favourable change was the adoption in Ceylon of improved methods of cultivation based on West Indian methods. The pioneer in this field was R.B. Tytler a tropical agriculturist who had made a study of West Indian cultivation and who introduced these methods into Ceylon in 1837.[143]

For the next ten years there was a rapid and extensive expansion of coffee cultivation in Ceylon. "Coffee was the certain road to affluence, and a veritable mania arose for plantations."[144] Land, of course, was the prerequisite for cultivation and this was made available by the Government through the sale of Crown land at nominal rates[145] free of land tax. The almost phenomenal increase in the land sales of the Government are illustrated in the table below which serves as a good index to the rate of expansion of the coffee industry in Ceylon during this period. Crown lands were sold by public auction at which the Government in accordance with the Regulations of 1833, placed a reserve price of Rs. 5/- per acre. The Survey Department was insufficiently equipped to survey all

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142. Associated perhaps with a diminished consumption of wine. Mills *op.cit.* p. 227.

143. Ferguson (*op.cit.* p. 61) remarks that Tytler was usually regarded as the "father" of Ceylon planters.

144. Mills *op.cit.* XII p. 228. "By 1839 extravagant expectations combined too frequently with inexperience led to a period of rash speculation, which was more like a land boom in Western America than a sane business investment."

145. Mendis *op.cit.* V, p. 41. As early as 1824 Governor Barnes had exempted coffee plantations from the customary land tax of one-tenth of the produce. Mills p. 226. The sale of Crown land did not, however, commence until 1833. "The public lands were originally disposed of in Ceylon, as in other Colonies by free grant. In 1833 the system of disposing of them only by sale was introduced, five shillings per acre being tried as the upset price". Pridham: *Ceylon and its Dependencies* 1849. Vol. I part 3 Ch. IV p. 400.

lands and intending purchasers were permitted to select unsurveyed land and to make out the boundaries themselves subject to the risk of

Land sales of the Ceylon Government

Year	*Average*	*Value* £	*Year*	*Acreage*	*Value* £
1834	377		1840	42,841	19,995
1835	434		1841	78,685	29,712
1836	3,919	4,743	1842	48,533	25,956
1837	3,661	5,465	1843	58,336	29,601
1838	10,401	7,475	1844	20,415	26,534
1839	9,570	8,240	1845	19,062	37,947

Source: Acreage: Tennant "Ceylon" p. 230 f. Value: Pridham "Ceylon and its dependencies" Vol. II. Appendix p. 849.

being outbidden at the auctions. "Since this entailed great trouble and expense it had become a principle of honour in the community not to bid against parties who had thus selected land. In consequence crown land which was frequently worth 20/– an acre sold for only 5/– often to speculators who resold it for a large profit."[146] It was not until 1845 that the reserve price of crown land[147] was raised to 20/– an acre and private purchasers were prevented from demarcating their own boundaries.

The expansion of the coffee industry continued until 1847. The total value of the investment in coffee between 1837 and 1845 has been put at £3,000,000.[148] In 1847 there was a major set back

146. Mills *op.cit.* XII p. 231. Also Pridham, *op.cit.* p. 400.

147. Ferguson writing in 1887 gives the following information on sales of crown land:

Crown land granted and sold since 1833..........	1,300,000 acres
Revenue to Government........................	£2,100,000
Average price per acre (1833–1844)	10/8
Average price per acre (1844–1883)	£1. 17s. 9d.

"Upset price, now £1; highest price realised nearly £25 (per acre) for hill forest land – generally ranges £1 to £5 for forest land, and £400 per acre occasionally for building near Colombo. Half of lands sold, hill forest suited for coffee, cocoa, tea, plantains etc. Full title – no land tax (only 5 per cent on lands and houses *within limits of towns* for police purposes; in Colombo 3 per cent for lighting and 2 per cent just being levied for water); tithes (rent) levied on grain only, 10 per cent of produce (a few cases of 20 to 25) against 50 per cent tax often in India. Ferguson *op.cit.* p. 296.

148. Mendis *op cit.* p. 41 and Mills *op.cit.* p. 229. Ferguson (Ceylon Commonplace Book 144-45) and Tennant (Ceylon ii 231) rejected the general opinion that £5,000,000,000 were invested in five years. In 1848 there were 367 plantations with 60,000 acres under cultivation; in 1835 there were only a few European planters in Ceylon.

which was the combined result of the general financial crisis in Great Britain during 1845 and 1846 and the excessive speculation and unsound investment which Ceylon had experienced during the preceding decade. A further aggravating factor was the abolition of the differential duty in the United Kingdom which protected colonial coffee from the Javanese and Brazillian product.[149] Many Ceylon plantations were established by means of money borrowed at high rates of interest (often 9 or 10 per cent) on the basis of extensive mortgages. The financial crisis in Britain in 1845 and 1846 severely restricted the availability of credit and induced mortgagees to press for repayment. In the meantime the price of coffee in the London market was falling under pressure of the lower cost Brazilian and Javanese supplies. "By 1848 the London price had declined from 100/- per cwt. to 45/-, an amount which barely equalled the cost of production in Ceylon. Some shipments sold for as little as 28/- and in 1849 the price reached its lowest level at 27/-."[150] In such adverse circumstances the coffee industry was considerably dislocated and many pioneer planters were ruined. There was a sharp fall in land values and it has been estimated that about one-tenth of the plantations were abandoned and more than one-third were sold at nominal rates.[151]

The depression of 1847, however, was not without its benefits. The decline in land values made it possible for new proprietors to begin operations on a favourable basis free from the burden of excessive indebtedness and inflated capital outlays. By 1853 the industry had recovered and enjoyed a period of increasing prosperity. By 1856 the price of coffee on the London market had revived to Rs. 44/- and at the same time production costs in Ceylon had been reduced by the adoption of more efficient methods of cultivation.[152] There was an expansion in both quantities exported and in acreages. The intensification of the Government's policy of road building after 1855 and the construction of the Colombo–Kandy railway by the Government which was completed in 1867 were factors of the first importance which contributed to the expansion of the industry.

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149. Mills p. 235.

150. *Ibid.* p. 236. "Two further misfortunes occurred in 1847, a plague of rats which gnawed the young shoots, and a coffee blight which ruined large acres by killing the trees."

151. *Ibid.* p. 235. "a plantation which had been bought in 1843 for £15,000 was sold by auction in 1847 for £440".

152. Mills *op.cit.* p. 237.

A further improvement was the building of the breakwater in the Colombo harbour between 1874 and 1886 for dealing with the increased volume of shipping which was being attracted by the growth of the coffee industry.[153] In addition there was a continued supply of cheap immigrant labour from the Indian mainland. The unbridled confidence which planters placed in the industry was dampened by occasional fluctuations but the upward trend continued and reached the highest level in the years 1863, 1869 and 1870 in each of which years, "the exports slightly exceeded a million cwt. of a value in European markets of not less than four millions sterling, against 34,000 cwt. values at £120,000 exported in 1837: a marvellous development in thirty years of a tropical industry:"[154]

But if the export of coffee in 1870 was over 1,000,000 cwt., by 1905 it was no more than 5,310 cwt. The cause of the catastrophy was *Hemilia Vastatrix*, generally known as the coffee bug – a minute fungus which attacked the leaf and destroyed the tree.[155] It first appeared in 1868 but for a few years had only a slight effect on the crops. Its effects were disguised for a further period by an increase in prices and hence the value of coffee exported and an extension of the area of cultivation. Between 1871 and 1875 the average annual export was 856,570 cwt., which fell to 743,098 cwt. between 1876 and 1880. The full effects of the blight were felt between 1881 and 1885 when the average annual export was 364,488 cwt. In 1886 only 179,254 cwt. was exported.[156] "Sulphur, liberal cultivation with manure – every expedient that was suggested had been tried in vain: and the Botanic gardens at Peradeniya had completely failed to discover a remedy."[157]

'Misfortunes never come singly.' A series of wet seasons coincided to further reduce output. A serious decline in the London price delivered a further blow to the ailing industry. "The same fungus had extended to the coffee districts of India and Java, with similar results in devastated crops, but in the greatest coffee country of all – Brazil – the impetus to an extension of

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153. *Ibid.* p. 238–245. The construction of both the railway and the Colombo harbour was financed out of Government borrowings in the London Money Market.

154. Ferguson *op.cit.* p. 63.

155. *Ibid.* p. 64.

156. Mills *op.cit.* p. 245–247.

157. *Ibid.* p. 247.

cultivation which the high prices from 1873 onwards had given, was not checked by the presence of this fungoid, or other coffee diseases, and from thence soon began to pour into the markets of the world such crops as speedily brought prices to their old level, reacting disastrously on the Ceylon enterprise."[158] Banking disasters also came in to crown these evils. The Ceylon enterprise had to encounter the "monetary depression caused by the collapse of the city of Glasgow bank and other financial failures in Britain".[159] Even more important was the failure of the Oriental Bank Corporation in 1884 – one of the largest banking institutions in the East and "by far the largest institution in Ceylon".[160] "The bank from its very inception had financed the plantations, could not now face their sudden ruin",[161] and the Government had finally to step in and guarantee its notes.[162]

The speed and severity of the decline of the coffee industry was indeed striking. It is said that about 400 of the 1,700 European planters left Ceylon.[163] But it was not only the plantations that suffered. The decline in small holder production was equally remarkable. The comments that were made in previous pages on the decline of the cinnamon industry may as well be repeated for coffee by way of epilogue. Coffee still figures as an item in Ceylon's export list, but like cinnamon its importance is negligible.[164] But just as the decline of cinnamon was partially offset by the rise of

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158. Ferguson p. 67.

159. *Ibid.*

160. B. R. Shenoy: Ceylon Currency and Banking V. p. 88.

161. Mendis *op.cit.* p. 75.

162. "The failure of the corporation was bound to give the Island's economy a thorough shaking. When its notes were put out of use, there ensued a state of panic, and trade almost came to a complete standstill. Unless some speedy action was taken, food riots on the estate were feared, as rice could not be had from the traders except for silver, which was very scare...... Partly under pressure of representations and partly out of the conviction that speedy action on their part alone could prevent a general stampede, the Government, on May 5 (1884) guaranteed the notes of the bankrupt corporation. The guarantee produced the expected results." Shenoy, *op.cit.* V p. 89.

163. Mills p. 247. The authority for this statement seems to be Ferguson who in the course of an interview with the Pall Mall Gazette said: "There was a regular migration to Northern Australia, Fiji, Borneo, the Straits, California, Florida, Burma and elsewhere. I should say that out of our 1,700 planters, we lost at least 400 in this way." Ferguson, *op.cit.* p. 330.

164. The coffee now grown is the Robusta variety different from the former Arabian coffee which is no longer cultivated. Turner. *Handbook of Ceylon*, 1922. p. 93.

coffee; tea and cinchona emerged to cushion, in part at least, the impact of the coffee disaster. In 1870 the economy of Ceylon could justly have been described as being primarily a coffee economy. In 1900 the significance of coffee in the Ceylon economy was only historical.

Although the coffee industry was relatively short lived it introduced into Ceylon several features which survived it and which even today characterize the Ceylon economy. Some of these features merit attention since they throw light on the origins of certain of the fundamental structural characteristics of the economy of today.

The first of these characteristics is the investment of private foreign capital on a significant scale, and the consequent ownership by foreigners (both resident and non-resident) of a considerable proportion of the producing units of the country. The first foreigners to open up plantations in Ceylon were private individuals and English government officials serving in Ceylon. Civil servants in Ceylon were, since the early period of the British occupation, debarred from trade but in 1836 the Colonial Office ruled that the prohibition did not extend to agriculture.[165] "The East India Company's officers crowded to Ceylon to invest their savings, and capitalists from England arrived by every packet...... The previous Governor and the Council, the Military, the Judges, the Clergy and half of the Civil Servants" were amongst the purchasers of coffee plantations.[166] Thus the original sources of foreign capital in Ceylon were the savings of officials and monies brought in by private capitalists from England. The latter in turn was, to some extent at least, obtained through borrowing in England on mortgage from private and institutional credit agencies. Another source of capital, in the later years of the coffee industry, was the savings of the British public at large which were mobilized through the medium of limited joint stock companies. In addition to extending the sources of capital in Ceylon these companies provided a useful service by increasing the liquidity of capital invested in Ceylon. Until transactions in Ceylon shares on the London capital market were possible, prices of coffee property in Ceylon tended to remain depressed – because of the scarcity of buyers – below the values

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165. Mills *op.cit.* p. 229. In 1845, however, officials were forbidden to acquire plantations.

166. In Emerson Tennent: Ceylon ii, 231, quoted by Mills p. 239.

that would otherwise have been justified on the basis of annual yields.[167] A consequence of the investment of foreign capital in Ceylon has been the regular remission of profits and interest abroad. This meant that a portion of the annual national income of Ceylon was regularly retained abroad in service of foreign capital and was not as a result available for either consumption or investment in Ceylon. Profits earned in Ceylon were, of course, to some extent reinvested in the country, but this was not always the general rule as Europeans in Ceylon were not permanent settlers in the country.[168]

With the coming of foreign capital into Ceylon there emerged methods of management and organisation which are still largely in evidence in Ceylon. On the one hand there was the resident proprietor who managed his own plantation; on the other there was the absentee owner or company which entrusted its property to a firm of agents in Colombo. These agencies supervised estate managers by means of experienced visiting agents.[169]

The second notable feature of the coffee economy of Ceylon was the utilisation of immigrant labour from the South of India. The expectation that the abolition of Rajakariya in Ceylon would release local labour for work in the plantations was not fulfilled.

167. "Nothing could have been better calculated to promote the interest of the coffee enterprise than the *market* provided by such (a limited joint stock) company ...... Coffee estates began to have, not only a *nominal* value to their possessors, but a *real* market value! The *realization* of an estate ceased to be a mere matter of chance." Speculum *op.cit.* p. 25.

168. The disadvantage to Ceylon through the absence of profit re-investment was noted by contemporary observers: "Money was sent out to Ceylon to fell its forests and plant them with coffee, and it was returned in the shape of copious harvests to the home capitalist leaving in some cases the bare hill-sides from whence these rich harvests were drawn. Had the profits from the abundant coffee crops in those past days been located here and invested in the country, a fund of local wealth might have existed when the lean years came, manufacturers might now have been flourishing, etc........." Ferguson *op.cit.* p. 92. "Those who bring their money to Ceylon, are chiefly men of small means, who come to increase them by a few years of industry; and to return home when they have attained that end. It follows that the coffee estates are to a large extent owned either by absentees or by resident proprietors whose means have had largely to be supplemented by borrowed capital. These properties are therefore dependent, both for their creation and maintenance on capital which does not *belong* to the Colony, and *the profits of which do not remain to enrich the country*." Speculum. *op.cit.* p. 6.

169. Cf. K. Stahl. *The Metropolitan Organisation of Colonial Trade.* (Faber and Faber 1951) Part III pp. 125–173.

"Every Sinhalese was attached to his village. Both by custom and according to Roman-Dutch law he was entitled to a share of the property of his parent. When rajakariya was abolished he tended his own lands, and did not show any desire to migrate from his village and work in the coffee plantations."[170] Consequently a labour shortage was experienced from the earliest days of the coffee industry and in 1839 2,432 labourers were brought in from the Indian mainland. The availability of labour in India was in part dependent on the South Indian harvests. "A period of good harvests on the coasts means a decrease in immigration to Ceylon, and vice versa."[171] Generally Indian labour came into Ceylon for temporary work usually returning to the mainland with their savings after about a year.[172] But many of them came to be permanent inhabitants and so gave rise to what is even to this day a vexed political problem in the country. Ferguson estimates that during the 45 years ending 1884 nearly three million immigrants entered Ceylon. The census of Ceylon in 1881 showed about 200,000 immigrants currently residing on plantations.[173] A noteworthy feature in the employment of immigrant labour was that in times of depression labourers tended to return to India. Ceylon was thus spared the burden of maintaining an unemployed estate population.

A third characteristic of the Ceylon economy which was given rise to by the coffee plantations, was the development of a whole field of activities largely, but not exclusively, related to the coffee industry. On the one hand there were the subsidiary activities directly connected with coffee such as transport, processing, packing and grading in Colombo, warehousing, loading on to ships and so on. There was the development of a banking system whose primary function was to finance the foreign trade of Ceylon and also to provide the short term capital requirement of business and

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170. Mendis *op. cit.* p. 43.

171. E. B. Denham: *Ceylon at the Census of* 1911 Ch. IV p. 41. Ceylon Government Printer 1912.

172. Mills *op.cit.* p. 228 ff.

173. Ferguson *op.cit.* p. 285. "According to official papers there are sixteen millions of people in southern India whose annual earnings, taking grain etc. at its full value, do not average per family of five more than £3. 12s. 0d. ... No wonder that to such a people the planting country of Ceylon when all was prosperous, was an El Dorado, for each family could there earn from 9/– to 12/– per week, and save from half to three-quarters the amount." *Ibid.* p. 97.

the plantations.[174] On the other hand the employment and incomes generated by the coffee industry stimulated the economy in general and gave rise to a host of pursuits which depended in large degree on the expenditures of those who earned their monies through coffee. "The pioneer planter introduces into regions all but unknown to man a host of contractors, who in their turn bring in a train of pedlars, tavern keepers and others, eager to profit by the expenditure about to take place. To the contractors succeed the Malabar coolies, the working bees of the Colony. Each of these coolies consumes monthly a bushel of rice, a quantity of salt and other condiments, and occasionally cloth, arrack, etc. the import, transport and purchases of which find employment for the merchant, the retailer, the carrier and their servants; and again the wants of these functionaries raise around them a race of shopkeepers, domestics and others, who but for the success of coffee planting would have been unable to find equally profitable employment.... In fact, it is impossible to pursue in all their ramifications the benefits derived from the cultivation of the fragrant berry which has become the staple product of Ceylon."[175]

The fourth feature that merits attention is the break up of the relative isolation which the rural sector of the economy enjoyed before the coming of the plantations. The plantations reacted on the rural sector in a number of ways. First, there was some encroachment by the plantations on the lands of villagers. Previously there had been no system of land registration and records of the performance of personal service under the system of Sinhalese tenure were the prima facie proofs of ownership.[176] "On the British occupation of Ceylon personal service as a condition of holding land was abolished, and all land for which proof of ownership could not be produced was presumed to be crown land (Ordinance No. 12 of 1840). Many villagers, in consequence of

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174. Shenoy *op.cit.* p. 108. The first bank to be established was the Bank of Ceylon which commenced operations in 1841. In 1843 the Oriental Bank opened a branch in Colombo. In 1851 these two banks were amalgamated into the Oriental Bank Corporation. In 1854 the Mercantile Bank of India opened a branch in Colombo. It changed its name to the Chartered Mercantile Bank in 1858. The Bank of Madras established itself in Ceylon in 1867 and in 1881 the National Bank of India opened a branch in Colombo. Shenoy *op.cit.* Ch. VI p. 99–111.

175. Ferguson *op.cit.* p. 99–100.

176. C. K. Meek; Land Law and Custom in the Colonies. V. p. 27.

this law, lost lands to which they were by customary law entitled."[177] Secondly, there was the direct participation of peasants in certain areas in the cultivation of coffee for export in small holdings or village gardens. To this extent the villages were able to develop an alternative or subsidiary occupation and thereby entered the orbit of an exchange economy in which their produce was not consumed by themselves or bartered but exchanged for money. Thirdly, in a similar fashion some peasants were able to labour on the plantations and in road construction and thereby to further supplement their incomes with money wages.[178] In addition the coming of roads and railways linked up many parts of rural Ceylon with Colombo and other large towns thereby making it possible for peasants to exchange their surplus produce for money and to purchase imported articles of consumption. In this way their customary patterns of wants and incentives were in some degree at least modified.[179]

A fifth characteristic of the Ceylon economy which gained significance in the period of coffee was the dichotomy, in a physical sense, between the constituents of national output and of national consumption or real income. Such a divergence is of course the central feature of an open economy. Ceylon exported coffee and other tropical produce and in return imported almost the whole range of her requirements for both consumption and investment. The beginnings of the dependence on imported food has already been discussed. As population grew and money incomes increased Ceylon turned to foreign countries for the supply of both necessities

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177. *Ibid.* But the author adds: "But on the other hand (between 1840 and 1897) large areas of Crown Land, much of it forest reserve were illegally appropriated by cultivators."

178. Sinhalese labour was not easily available for regular work on plantations but it was relatively more willing to undertake part-time or temporary jobs such as the clearing of forest land for plantation.

179. A valuable description of changes in the pattern of consumption in rural households is found in E. B. Denham: *Ceylon at the Census of* 1911 Ch. VI – Changes in manners and customs.

The plantations also had adverse social consequences in the rural areas: "In the short space of 11 years the coffee industry brought into the Island an estimated capital of £3,000,000. A very large percentage of this was paid in wages to the labourers on the plantations. While the majority were Tamils the most profligate of the low country Sinhalese flocked into Kandy attracted by the good wages. Temptations to and examples of intemperance and vice of every kind were rife, and the new-comers spread far and wide their contaminating influences over a previously sober, orderly, honest race." Mills *op.cit.* p. 176.

and luxuries.[180] The food requirements of the plantation labour and the urban population had to be met almost entirely out of imports; and similarly the demand for clothing for practically the whole population. The standard of living in Ceylon became dependent not only on the level of earnings through exports but on the terms of trade or the relative prices at which she was able to exchange her exports for imports. Ceylon's concern with the long term trend in the terms of trade between primary products and manufactures was however modified by the fact that a substantial proportion of her expenditure on imports was spent on primary products like rice and other foodstuffs. A production-consumption pattern of this nature had, of course, far reaching effects on the character of the country's economic and social life. The development of local manufacturing industries was hardly favoured by the competition of modern imported goods produced in the factories of advanced industrial countries. At the same time European ways of life and patterns of consumption were penetrating the urban areas of Ceylon, and fashioning the manners and mode of living of a Ceylonese middle class whose growth was related to the increased opportunities in agriculture and commerce and to the spread of English education.

Sixth, mention must be made of the growing vulnerability of Ceylon to fluctuations originating abroad. The impact of structural changes in supply and demand conditions peculiar to the individual commodities with which Ceylon was concerned was clearly illustrated in the case of both cinnamon and coffee. Improvements in demand abroad as well as the emergence of foreign competition had a profound effect on the general economic prosperity of Ceylon. But in addition Ceylon was now concerned with economic fluctuations of a general kind which took place in Britain and other countries with whom she was commercially associated.

180. An English observer, writing as early as 1843, was struck by the growing tastes for western, specially English, goods in Ceylon: "The Sinhalese are partial to Manchester, Leeds, Sheffield and Birmingham manufactures, except certain agricultural implements, manufactured in the latter place which they consider inferior to those of Holland. The higher ranks indulge in the best wines, particularly Madeira and Champagne, which are liberally dispensed at their parties to European guests; and no people in the world set a higher value upon British medicines, stationery and perfumery; or relish with a keener zest, English hams, cheeses, butter, porter, pale ale, cider, perry, herrings, salmon, anchovies, pickles and confectionery, all of which they prefer to similar imports from France and America except in regard to price." – J. W. Bennet: *Ceylon and its capabilities* (1843) p. 31.

These fluctuations affected Ceylon in two ways. First, there was the effect of a general depression in prices in the London market with its unfavourable effects on the profitability of production in Ceylon. Second, and perhaps more important in the early period of the coffee industry, was the consequence of a tightening of credit or a financial crisis in Britain. Not only did this affect the flow of working capital to the plantations but it also gravely influenced the position of those who had borrowed money, through mortgages or other means, for the opening up of plantations. Fluctuations of this kind seemed to contemporary observers to possess a regular cyclical pattern of about ten or eleven years duration. Thus Ferguson writes: "There have been periods of depression before in the history of the Ceylon planting enterprise, and these, curiously enough, have been noted to come round in cycles of eleven years. Thus in 1845, wild speculation in opening plantations, followed by a great fall in the price of coffee and a collapse of credit, arrested progress for a time; in 1856/7, a sharp financial shock affected the course of prosperity which had set in; and again in 1866/7 the fortunes of coffee fell to a low ebb...... The depression which set in during 1879, was however the most prolonged and trying."[181]

Finally, the coffee industry gave Ceylon an early experience of the dangers of monoculture. The economic base in Ceylon today is somewhat wider than in the nineteenth century, but it is still relatively undiversified. A single unfavourable influence – like the coffee bug, or blister blight in tea, or a technical improvement in the production of synthetic rubber – can undermine the foundations of the whole structure of economic life in Ceylon.

(iii) The period of expansion – The second phase

The tea, and coconut industries which, together with rubber, form the base of the export sector of the Ceylon economy today were established within a comparative short period of about two decades beginning with the decline of the coffee industry in the eighteen eighties. During this period there was a rapid expansion

181. Ferguson *op.cit.* Ch.IX p. 90–91. Similarly an earlier writer speaks of the regular alternation of periods of confidence and periods of panic and fear: "These principles operate in cycles which have become a matter of calculation. The panic of 1847 and 1857 seemed to have established the decennial theory, and the semi-panic occurring in 1864 caused much discussion in consequence of its disturbing this theory. Till this took place economists were looking forward to the city seizure in 1867, with as much certainty as the doctor predicts the crisis of a fever." Speculum – *op.cit.* p. 16 and 17.

in acreages under cultivation, in quantities exported and in the value of exports in each of these commodities.

The effects of the coffee disaster were partly modified by the substitution of tea and cinchona as remunerative crops on the coffee plantations. The emergence of cinchona as an important commodity in the Ceylon economy was short lived but timely. In 1872 there were only 500 acres under cinchona, by 1883 the acreage had risen to 65,000. In this latter year, when the export of coffee had fallen disastrously, over 7 million lbs. of cinchona were exported at a value of £365,088 – a fair support to Ceylon's dwindling export earnings. Increased supplies, however, from both Ceylon and Java, weakened the London market and prices began to fall. The possibilities of tea as a substitute made cinchona cultivation relatively unremunerative and after 1884 "tea increasingly supplanted cinchona and over a wide expanse young plants of the latter were pulled out as weeds".[182] By 1902 only 300,000 lbs. were exported and in 1915 exports had fallen to 20,393 lbs. valued at £88.

There were attempts to cultivate cocoa[183] and sugar-cane but these crops did not meet with much success. Tea was grown experimentally in the Government Botanic Gardens as early as 1845 but the crop did not make much headway as long as coffee continued to show promise. In 1873 only 250 acres were cultivated with tea. In 1880 there were 9,217 acres. The rapid expansion of the tea industry took place after 1884 when cinchona was losing its attractiveness. The acreage increased from 35,000 in 1883 to 70,000 in 1884 and 150,000 in 1887. The value of tea exports in the latter year was £587,967 over five times the corresponding figure for 1884.[184]

182. Mills *op.cit.* p.

183. Cocoa cultivation was attempted in the Matale, Kurunegala and Uva districts. The cultivation of sugar-cane was tried at Baddegama. Mendis *op.cit.* p. 76.

184. Mills *op.cit.* p. 250. The market for Ceylon tea was expanding because of both an increase in per capita consumption in the United Kingdom and a growing preference for Ceylon tea as against China tea. The growth of per capita consumption in the U.K. is shown in the following table:

Year	*Tea – lb.*	*Year*	*Tea – lb.*
1840	1.22	1880	4.57
1850	1.86	1890	5.18
1860	2.67	1900	6.07
1870	3.81	1910	6.31
		1920	8.35

Source: Resources of the Brit. Empire: Rubber, Tea and Cacao. London, E. Benn 1924 p. 128.

The industry continued to expand for almost another decade. Acreages under cultivation grew from 220,000 in 1890 to 330,000 in 1896.[185] In 1896 there was a set back brought on by the effects of increased supplies from India and Ceylon in the London market. The expansion in acreage slowed down – there were about 417,000 acres[186] under tea in 1899 and the increases, if any. in the years immediately succeeding were small. There was a gradual recovery after about 1906 associated with the growth of new markets outside Britain[187] and the improvement in yields through superior cultivation methods in Ceylon.[188] There was a small expansion in acreage in this period but the rate of growth was slow in comparison to the earlier period. Indeed it is true to say that Ceylon's tea industry has not expanded substantially since 1900. The growing potential of rubber as a plantation crop was one factor which restricted the further extension of tea cultivation. However, although the physical expansion of the industry was not significant it entered upon a period of general prosperity.

The origins of the coconut industry in Ceylon are older than those of tea. The palm itself had for long been flourishing along the coastal regions of Ceylon and in village gardens. The great variety of uses to which its products could be applied made it a key factor in the economic life of the village. In the early 19th century, Ceylon was exporting some of the products of the coconut palm like fresh nuts, copra, jaggery and oil to India and neighbouring countries.[189] In 1820 the first cargo of coconut oil was shipped to England. The first attempts at systematic cultivation were in the years 1840–50 when a few European plantations were established but there was no significant expansion until 1860 when cultivation

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185. Mills *op.cit.* p. 250–51.

186. *Annual Blue Book*, 1900.

187. Particularly the British Dominions and Russia. Mendis *op.cit.* p. 98.

188. "... The formation of large Joint Stock Companies commenced bringing numerous separate estates under one management ...... Ceylon weathered the crisis more successfully than India because the planting industry was more centralised and better organised." *Resources of the British Empire op.cit.* p. 136.

189. Report of the Coconut Commission: Sessional Paper XII of 1949 Ch. 1. p. 10. Coconut oil was expressed by "chekku" worked by cattle. Governor Barnes encouraged a European firm in Galle to set up an engine to produce coconut oil. In 1832–33 Acland Boyd and Co. set up the first oil mill to be worked by steam. In 1902 the Government Blue Book stated that there were 2,729 chekku mills against 8 steam mills.

spread inland in the western and north-western provinces. In 1860, 250,000 acres were under coconut: in 1893, acreage had increased to 650,000. The Blue Book for 1903 gives 712,000 acres as the area of cultivation for that year, but Ferguson revises this to 650,000 acres. Of this latter area only 200,000 acres or roughly 30% was estimated to be regular and large coconut plantations, whilst the balance 70% was in the hands of small-holders. From the beginning there was Ceylonese participation in the development of the industry. The relatively low capital costs of opening up plantations as well as reduced labour requirements when compared to tea and coffee, were important factors which assisted investment by Ceylonese. Ferguson estimates that all but 30,000 of a total acreage of 500,000 in 1887 were owned by Ceylonese.[190]

The growing importance of the coconut industry in the Ceylon economy can be readily judged from changes in the proportionate value of its exports when compared to total exports:

1870	4
1880	9
1890	15
1910	17
1920	27

Source: Mills *op.cit.* p. 258.

Like the tea industry, the coconut industry did not substantially expand its cultivated acreage in the 20th century. As the Coconut Commission of 1949 remarked: "A good proportion of the lands now under coconuts must obviously be over 60 years of age."[191] Data on changes in the actual quantities of each type of coconut product exported do not adequately reflect changes in the size of the industry as a whole because these products are generally inter-convertible.

190. Ferguson *op.cit.* p. 48-49. "There is no more favourite mode of investment for the native mercantile, trading and industrial classes of the people (Sinhalese and Tamils) who have greatly increased in wealth during the past fifty years, than in gardens and estates of coconuts."

However, the qualification made by the Banking Commission of 1933 is important: "The capital in this industry is almost exclusively Ceylonese in the sense that the ownership is retained in Ceylonese hands. The non-Ceylonese share is generally reckoned at about 5% to 10%. But a considerable section of the coconut plantations has been opened up with the aid of borrowed capital, and much European and non-indigenous capital is interested in this industry by way of mortgages and loans." *Report of the Banking Commission* Vol. 1, section 665.

191. Coconut Commission 1949 *op.cit.* p. 9.

It is also important to note that, unlike tea and rubber where the bulk of the country's output is exported, a substantial proportion of the output of the coconut industry is consumed locally. The estimates in the Report of the 1949 Coconut Commission seem to suggest that the proportion of the Island's total coconut produce (in terms of nuts) that is consumed locally is over 50 per cent.[192] The coconut industry is not therefore, in any sense, an exclusively export industry.

(iv) The Period of Expansion – The final phase

Rubber is the youngest of the three major industries which form the base of the Ceylon economy of today. The Para rubber tree (Hevea brasiliensis) was introduced into the East in 1876 when the original plants received from the Royal Botanic Gardens at Kew were planted at the Government's Heneratgoda Gardens 17 miles from Colombo.[193] The original plantation can still be seen in these gardens and from these trees a large proportion of the rubber in the East is descended. The commercial cultivation of the crop did not however get under way until considerable technical improvements were made possible as a result of experiments at the Ceylon Botanic Gardens in the years 1897–9.[194] This factor, together with a decline in tea prices and an increase in rubber prices, encouraged the rapid extension of rubber cultivation between the years 1900 and 1910. Acreage under rubber increased from 1,750 acres in 1900 to 40,000 acres in 1905 and 188,000 acres in 1910.[195] The rapid expansion of the motor car industry, particularly in the United States, was, of course, the chief stimulant to rubber production. Prices for rubber remained at a lower level during the next 10 years 1910–20 but they were yet sufficiently

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192. The Coconut Commission places the average annual consumption of coconuts in all its forms per person in Ceylon as 130 – 140 nuts. The average total population for the 4 years 1945–1948 was 6,688,000 which gives an average total consumption of 889,504,000 nuts per year. The average annual production over the same four-year period was 1,762,000,000 nuts. In other words about 50.5% of total production is consumed locally. *Report of the Coconut Commission* 1949. *op.cit.* Ch. VII Section 7.

193. L. J. B. Turner: *Handbook of Ceylon* 1922.

194. These were the rediscovery of wound response which greatly increased the yield of latex, the discovery that trees could be tapped when 6 or 7, instead of 10 years old, and various improvements in the manufacture. Mills *op.cit.* p. 254.

195. *Report of the Rubber Commission,* Ceylon 1947, p.

high as to permit the continued expansion of the industry. By 1920 over 400,000 acres, or two-thirds of the present rubber acreage in Ceylon was under cultivation although of this total only 267,000 acres were actually in bearing. Thus Ceylon's exportable capacity continued to increase until 1930 although the industry was brought under the Stevenson restriction scheme in 1922. Ceylonese had a larger share in the opening up of rubber plantations than they did in tea. In 1947, 59% of the acreage was owned by Ceylonese. Small-holdings of under 10 acres accounted for 146,617 acres out of a total acreage of 659,909.

(v) The Period of Relative Stagnation

The final phase in the expansion of the export sector reached its close with the coming to maturity of the rubber industry. The growth of the rubber industry was limited by the introduction of government sponsored restriction schemes both in the early twenties and in the early thirties. But in spite of these restrictions the physical expansion of the industry, in terms of acreages and output exported, continued at a rapid rate until the thirties after which there was a marked slowing down in the rate of growth.

The following table illustrates the slowing down in the physical expansion of the export sector in the later period.

Annual Averages of Acreages and quantities exported of principal export products

	Tea		Rubber		Coconut Products
Year	*Acreage* (000)	*Quantity* (*lbs. million*)	*Acreage* (000)	*Quantity* (*lbs. million*)	*Acreage* (000)
1901–05	436	154	13	—	886
1906–10	513	181	128	1	975
1911–15	462	196	202	26	993
1916–20	503	195	285	73	951
1921–25	422	186	400	93	832
1926–30	453	235	513	147	970
1931–35	497	229	587	138	1,100
1936–40	555	229	604	145	—
1941–45	550	255	617	225	—

Source: Annual Blue Books.

It will be seen from the figures above that acreages under tea and coconuts did not expand substantially since 1906. Total acreages under exported products, however, continued to increase until the nineteen thirties because of the continued expansion in the rubber industry until this period. Acreage statistics provided in the annual Blue Books are, however, only rough estimates as there was no real census of cultivation until 1946.

It is not possible to obtain a complete picture of the course of the domestic sector of the economy during this period from the data at hand. But the partial evidence that does exist suggests that the expansion of this sector was not of sufficient significance as to offset the slackening of growth in the export sector.

Some indication of the expansion of the subsistence sector can be obtained from statistics of acreages under paddy.[196] These are presented in the table below, but it must be borne in mind that their accuracy is even less reliable than that of the corresponding figure for the export sector.

Year (averages)	*Acres* (000)
1901–05	698
1906–10	673
1911–15	677
1916–20	694
1921–25	774
1926–30	821
1931–35	850
1936–40	850
1944–45	963
1946–50	990

Source: 1901–35 *Annual Blue Books.*
1936–1950 *Commonwealth Economic Committee Review of Commonwealth Agriculture.* H. M. S. O. 1952, p. 103, Table 75.

Incidental data on certain select parts of the domestic sector show only a mild expansion after 1931 as illustrated below in the case of transport and buildings in villages.

Year	*Total Railway Mileage*	*Total Road Mileage*	*Total No. of Village Buildings*
1901	297	3,641	598,100
1911	605	3,873	691,900
1921	732	4,094	825,500
1931	951	5,049	1,021,400
1938	951	5,856	—

Sources: Annual Blue Books for Rail and Road Mileage; Report of the Census of Ceylon 1931 for No. of village buildings.

196. All paddy cultivation is not subsistence cultivation, but it is difficult to identify the proportion of total output which is exchanged instead of being consumed on the farm.

A further index of economic development in Ceylon is provided by movements in the total authorised capital of all joint stock companies registered in Ceylon. These companies, of course, include companies intending to produce for export and the figures are therefore of relevance to the economy as a whole. As can be seen below there is a marked slowing down in the rate of expansion after 1930. But it is not possible to reach any conclusion about the course of total investment in the economy from these figures because of the limited uses of the joint stock companies as a medium for investment.

Authorised Capital of Joint Stock Companies 1907–1944

Year	*Capital Rs.* (000)	*Year*	*Capital Rs.* (000)
1907	.. 14,010	1925	.. 258,705
1910	.. 63,890	1930	.. 372,290
1915	.. 120,595	1935	.. 392,945
1920	.. 202,160	1940	.. 420,483
		1944	.. 478,403

Source: Calculated from Annual Administration Reports of the Registrar of Companies.

Finally, a glance at changes in the occupational distribution of the population over a period, provides further evidence of the absence of significant structural changes in the Ceylon economy over a long period. The strict comparability of the data for each of the census years is limited by the inevitable changes in classification between periods. The following table has been constructed by regrouping the several census categories into broad classes for the purpose of this study.

Occupational Distribution of Population (as % of total)

	1891	1901	1911	1921
1. Total Population	3,007,789	3,565,954	4,106,350	4,498,605
2. Agricultural Population excluding estates	59.4	53.7	51.7	50.1
3. Estate Population	8.7	12.4	12.5	12.7
4. Industry, Mining, Trade and Transport	23.5	22.6	24.5	25.1
5. Professions	1.8	2.0	2.0	2.2
6. Administration	1.4	1.7	.9	.9
7. Domestic Service	2.4	3.6	2.1	2.6
8. Miscellaneous, mainly general unskilled labour	2.7	3.9	6.1	6.7

Source: Census reports and tables for the years 1891, 1901, 1911 and 1921.

The figures above refer to total population 'deriving subsistence' from each of the occupational groups, and therefore includes the families and dependants of actual workers as well as the unemployed belonging to each category. In the absence of information concerning actual employment in each year it is not possible to reach any conclusion from the table above on the question of the rate of growth of the economy. For instance the occupational distribution shown above may indicate a uniform rate of expansion in each of the categories, if it can be assumed that there was no unemployment. On the other hand the distribution would also be consistent with a position in which there was no expansion at all if it can be assumed that the surplus unemployed population is distributed between the several categories in the same proportion as the employed. These limitations must qualify the somewhat vague suggestions afforded by the table: these are a) an expansion in the percentage of estate population between 1891 and 1901 – a period of rapid growth in the export sector, b) a continued decline in the proportion of the general agricultural population, exclusive of estates. This is indicative of the increasing inability of the subsistence sector to support a growing population. c) A mild expansion in the relative importance of the broad category industry, mining, trade and transport, and d) a marked increase in the relative position of the general unskilled labour and miscellaneous group, which is often a natural consequence of a relatively slow rate of economic expansion in the face of a rising population. The figures given above do not extend beyond 1921. There was no further census of occupations from this date until 1946. A comparison with the 1946 results are, however, not possible because the latter refer only to the occupational distribution of the 'gainfully employed' population rather than to total population and thus excludes families and dependants.[197]

All the evidence examined above leads to the conclusion that in comparison with the last three decades of the nineteenth and the first two decades of the twentieth century, the period which followed was one of relative stagnation. Two of the three major export industries of Ceylon experienced a marked slowing down in the rate of growth as early as the beginning of the present century, whilst the rubber industry continued its expansion somewhat

197. The 1946 occupational distribution of the "gainfully occupied" population exclusive of families and dependants was as follows:

rapidly until the nineteen thirties and thereafter slowed down. The available evidence does not at the same time indicate that there was any marked expansion in the non-export sectors of the economy to a degree sufficient to compensate for the decline in the rate of growth of the export sector.

The fact that the economy of Ceylon has ceased to grow in recent years is a fundamental feature of the background to public finance during this period. But in addition there were certain other factors which made the economic background to this period even more unfavourable. These were:

(a) The continued increase in population. The following figures are illustrative of the growth of population in Ceylon.

Population in Millions

1837	1847	1857	1871	1881	1891	1901	1911	1921	1931	1946
1.3	1.6	1.7	2.4	2.8	3.0	3.6	4.1	4.5	5.3	6.7

Source: 1937–1931: *Report of the Census of Ceylon* 1931. Vol. 1 Ch. 1 p. 1. There was no formal census until 1871. 1946: *General Report of the Census*, 1946.

Total gainfully occupied: 2,623,000			(% of total)
Agriculture excluding estates		.. ..	22.9
Estates		.. ..	29.8
Industry ..	10.2		
Mining ..	.3	.. ..	21.9
Trade ..	7.8		
Transport ..	3.6		
Professions		.. ..	2.9
Administration and Defence		.. ..	2.5
Personal service		.. ..	9.0
Miscellaneous (mainly unskilled)		.. ..	11.2

Source: Calculated from S. P. II. of 1950:

Agricultural Wages and Earnings of Primary Producers in Ceylon p. 44. Table X.

The great divergence from the previous table in the relative importance of estates as compared to other forms of agricultural production is mainly due to the fact that a very large proportion of the total estate population, including women and children, is "gainfully occupied". The total estate population in 1946 numbered 851,000 of whom 783,000 or 92 per cent were gainfully occupied. The whole estate population, however, amounted to only 12.8 per cent of the total population of Ceylon in 1946. This compares with the figure of 12.7 per cent in 1921.

The category 'personal service' in the table above is not identical with the heading 'domestic service' in the previous table. Hotel and restaurant workers, etc., are included amongst the former.

"In seventy-five years the population of Ceylon has increased by 4.3 millions or by 177.3 per cent, the mean rate of the increase being about 14.7 per decennium. Kuczynski, rejecting Carr-Saunders estimate of the growth of the world's population by 1.16 per cent, per year, has concluded that the present increase is not more than $\frac{5}{8}$ths of 1 per cent. Ceylon's rate of increase is more than twice the world's rate of growth of its population. On the basis of this rate of increase, and of stability of conditions, the following estimates of the future population of Ceylon, which cannot be regarded as 'predictions' are recorded":[198]

Population in Millions

1951	1961	1971	1981
7.1	8.2	9.4	10.8

Clearly a continued rise in population in the face of constant total national output will lead to a decline in output per capita. Other things (particularly the terms of trade and foreign borrowing) remaining equal, this will mean a fall in the standard of living.

(b) The depreciation of physical capital in the export sector. The decline in the fertility of land which has been under cultivation for a long period of time is a familiar feature in agricultural production. In Ceylon the problem of diminishing fertility has been intensified by the fact of soil erosion which was a consequence of the planting of coffee, tea and rubber. The problems created by erosion in the highlands are not confined to the plantations. They extend to paddy cultivation in the lowlands which is affected by the regular flooding which takes place during the monsoons as a result of the silting of rivers.

There is, in addition, another form of capital depreciation whose short term consequences are perhaps even greater. Both the coconut and the rubber trees enjoy a relatively long period of productive life,[199] but obviously their productivity is not uniform throughout this period. A coconut or a rubber tree cannot indefinitely be maintained at constant productive capacity through

198. A. G. Ranasinha: *Census of Ceylon* 1946; General Report. p. 57.

199. "Coconut trees can be made to yield well until about their 60th year of life. Thereafter production reduces gradually not only in the number of nuts, but also in quality." *Report of the Coconut Commission,* 1949 p. 251.

partial replacements; once productivity falls off it has to be replaced altogether. Now one consequence of rapid expansion within a short period of time, as against gradual investment over a longer period, is a tendency towards an uneven distribution in the age composition of trees. In other words, at any given moment of time, a great proportion of the trees in existence tend to be of the same age. Consequently they age together, and the decline in productivity which inevitably results with the passage of time is widespread throughout the industry. This state of affairs implies, first, that there will tend to be a rapid tailing off of total output in these industries following a period of stability, and second that the necessity for replacement will call for heavy capital investment within a short period, corresponding to the "lumped" investment in the initial phase. Moreover, since a number of years are required before coconut and rubber trees come into bearing, there will have to be a period of waiting before output revives.

Since the coconut industry was substantially established by 1900 and the rubber industry by the end of the second decade of the twentieth century, it is reasonable to expect the present age composition of these industries to show a preponderance of trees in the older age groups. That this is, in fact, the case is suggested by the following tables:

Rubber: Percentage of 1940 area of 15 years

	Estates	*Smallholders*	*Total*
Ceylon	82	63	74
Malaya	65	79	70
Netherlands Indies	49	23	32

Source: P. T. Bauer: Visit to the rubber growing small holdings of Malaya. Table II.

The figures above refer to area and not to the actual age of trees. But the extent of replanting in Ceylon has been small even in relation to that of other countries. The percentage of replanted to total rubber in bearing in Ceylon and other countries was as follows:

Malaya (1940)	12 per cent
Netherlands Indies (1940)	16½ „ „
French Indo-China (1940)	44 „ „
Ceylon (1943)	7 „ „
Ceylon (1946)	10 „ „

Source: *Report of the Rubber Commission*, 1947, p. 6.

The Rubber Commission of 1947 put the average age of 'the majority of the country's rubber' at 'well over 35 years'.[200]

The uneven age composition of trees in the coconut industry is illustrated by the following figures which apply to estates of 20 acres and over with 10 or more resident labourers.

Age composition of Coconut trees in Ceylon

Over 60 years	9.7%
30–60 years	52.8%
10–30 years	28.8%
Under 10 years	8.7%

Source: Report of the Coconut Commission, 1949, p. 25.

There is no reliable evidence as to the age composition of trees in small holdings but the Coconut Commission is of opinion that here the trees are even older. Generalizing for the whole industry the Commission says: "In our view it would be reasonable to say that about 40 per cent of the coconut trees are over 60 years of age. This denotes a serious state of affairs. Therefore it becomes vitally necessary that we should embark forthwith upon schemes of replanting and under planting."[201]

The evidence above leads to the conclusion that in addition to the unfavourable effects of an increase in population there is the further possibility of an actual decline in national income due to depreciation in the physical capital of the export sector. It seems likely that the maintenance of capital though a policy of replanting, will require as much attention in any investment programme for Ceylon as the establishment of new industries.

(c) Instability. A third unfavourable factor in operation in Ceylon during this period was the marked fluctuations in prices and incomes which arose out of the economic disturbance in the world at large. Ceylon's vulnerability to external fluctuations is discussed in succeeding chapters and will not therefore be elaborated upon. here.

(d) Unfavourable movements in the terms of trade. Imported goods figure so prominently in the pattern of consumption in Ceylon that a rise in their prices relative to the prices of exports will lead to a

200. *Report of the Ceylon Rubber Commission,* 1947, p. 6.
201. *Report of the Coconut Commission,* 1949, p. 25.

reduction in the standard of living in Ceylon even though exports, or national output, in physical terms is constant. The Ceylon economy conforms to the customary pattern of exporting primary products in return for manufactures. Hence it was adversely affected by the general long term trend in the terms of trade against primary products which has been in evidence since the last decades of the nineteenth century.[202] There was, however, one mitigating factor. Ceylon imports an important proportion of her food requirements – particularly rice. The long term trend in rice prices was in the same direction as the trend in the prices of other primary products. In addition to the long term trend in the terms of trade there were the cyclical movements. Ceylon was sharply affected by the fall in the relative prices of her exports during the depression of the thirties although here again the fall in the price of imported rice was a modifying factor.

Conclusion

The outstanding feature in the long term trend of development in the Ceylon economy is the marked slowing down of expansion in recent years. In this respect the trend in the Ceylon economy conforms to the general pattern of growing institutions, or the organic law of growth, outlined at the beginning of this chapter. This fact in conjunction with the prospective increase in population and the depreciation of physical capital points to the unpleasant conclusion that unless new factors and new forces are to emerge in the Ceylon economy which will usher in a fresh burst of activity and a new phase of expansion, Ceylon will be faced with the prospect of a decline in national income and standards of living. It is also apparent that the need for these new stimulants is, at the present time, of some urgency.

The slackening off of the rate of expansion in recent years can be traced to a number of factors.

First, there was the cessation of foreign investment in Ceylon associated with a change in the international economic position of creditor countries like Britain after the beginning of the first world war. The central role played by foreign capital in the development

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202. For an interesting discussion on the causes for the unfavourable long term movement in the terms of trade between agriculture and manufacture, see Raoul Prebisch, *The Economic Development of Latin America* (Published by U.N.O.)

of the export sector has already been discussed. Corresponding to the cessation of foreign investment, there was a distinct change in the traditional pattern of Ceylon's balance of merchandise trade. During the whole period of foreign borrowing, there was an almost regular excess of imports over exports whilst in the succeeding period, if the years of acute depression are excluded, there was a regular export surplus through which Ceylon was able to meet the service charges of foreign capital.

Second, there were physical limits to the availability of land in Ceylon. In the "wet zone" of Ceylon where production is based on rainfall, cultivation has been carried near the limits of land availability, once allowance is made for the need for forest reserves. It is in this zone that the present day export crops are grown. In the remaining "dry zone" an extension of cultivation is limited by the need for irrigation facilities.[203] This area is, in any case, unsuitable for the growing of either tea, rubber or coconuts.

Finally, there were the general depressed conditions common to agriculture the world over, which discouraged investment in new export crops in Ceylon and prevented, through deliberate restriction schemes, the extension of existing products. The expansion of rubber was curtailed by both the Stevenson Scheme of the 'twenties and the International Rubber Agreement of the early 'thirties. Tea was also brought under international restriction during the depression.

The succeeding chapters in this work cover the period from 1930 onwards in greater detail. As we have already suggested, this was a period in which the long term growth of the economy was considerably slowed down. Nevertheless the Ceylon economy

203. The extent to which rice cultivation even at present, depends on artificial irrigation is surprising:

Systems of Irrigation for Paddy Cultivation (1937)

	Approx. Cult. Acres	*% of Total*
(i) Major works	160,000	20.0
(ii) Minor works: village tanks	200,000	25.0
(iii) Minor works: village channels	170,000	21.2
Total under artificial irrigation	530,000	66.2
(iv) Direct rainfall	270,000	33.8
Total	800,000	100.0

Source: *Colonial Reports Annual:* Ceylon 1937 p. 82.

was dominated in these years by somewhat violent changes of a short term nature. The six chapters that follow are devoted to the circumstances of the great depression, the wartime inflation and the post-war boom. The absence of long term growth has, in a sense, made it easier for us to study the 'mechanics' of a mature and well-established export economy. We are also able to examine the repercussions of varying and opposite international economic forces on the fiscal problems of an economy of this type. We have devoted two chapters each to the three outstanding phases in the period after 1930. In each case the chapter on public finance is preceded by a study of the behaviour of the economy as a whole.

CHAPTER III

AN EXPORT ECONOMY IN DEPRESSION (1929–1939)

Introduction

The period of relative stagnation in the Ceylon economy conveniently divides itself up into three phases. First there are the ten years, 1929–39, marked off at each end by the Great Depression and the outbreak of the second world war. The period is rich in factual illustrations of the economics of an export economy in periods of depression. Second, there are the war years themselves 1939–1945. In this period there arose a number of problems which were essentially due to the special conditions of wartime but in many respects there were also manifested the more general problems characteristic of periods of boom and inflation. The peculiar severity of both the depression of the 'thirties and the wartime inflation brings out in strong relief the contrasting problems of fiscal policy in highly divergent and indeed opposite situations. Finally there is the post-war period commencing with the immediate aftermath of the war in 1945 and extending up to the present day. The outstanding event of this period was of course the attainment of political independence in 1948. Both this event and the economic position of Ceylon at the end of the war had their bearing on the fiscal problems of the country.

The background to the depression

The problems facing public finance in Ceylon during the period of the depression were somewhat more than those of relevance to the downward phase of a cyclical movement. The depression coincided with a phase in which the long term trend of economic expansion in the country was itself coming to an end. The Ceylon economy is peculiarly susceptible to economic fluctuations emanating from the world at large. As a consequence it has experienced a succession of cyclical swings of alternating prosperity and depression. As early as 1847 economic conditions in the country were seriously disturbed by an external crisis which reacted strongly on the fortunes of the coffee industry.[204] Since that date the upswings and downswings of the trade cycle have been a somewhat regular and

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204. Vide ante pp. 60 and 61.

recognised feature of the economic life of the country. However, it is not only through the intensity and exceptional duration of the depression that the 'thirties differed from earlier periods of economic distress. There was in addition the outstanding fact of the cessation of long term economic growth. The earlier depressions had in the main been fluctuations around an upward trend. Prices, profits and employment may have fallen from time to time, but they were merely temporary set backs to the general upsurge of investment and economic expansion. Every succeeding recovery carried the economy to higher levels of output and activity. The depression of the 'thirties, on the other hand, imposed itself upon a different economic background. A number of factors of a long term nature were combining to reduce the tempo of economic expansion. The emergence of foreign competitors in tropical products, the weakened foreign lending capacity of Great Britain, and the decline in the physical availability of land in Ceylon suited for the further extension of the existing staples, together contributed towards the ending of the expansionary phase. This cessation of expansion alone, coupled with the continued increase in population and the social and political changes that were taking place,[205] would have sufficed to create a number of acute problems in the sphere of public finance. Upon all this came the Great Depression. The long term factors and the international depression interacted upon each other to aggravate the problems facing Ceylon. On the one hand the long term stagnation increased the intensity and duration of the depression and damped the subsequent recovery.[206] On the other hand, the depression itself cutailed long term expansion by promoting restriction schemes in such staples of export as tea and rubber.[207]

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205. A further adverse factor of a long term nature was the unfavourable movement in the terms of trade between agricultural products and manufactured goods in international trade (cf. UNO Dept. of Economic Affairs: Export and Import Prices of Primary Producing Countries). As mentioned elsewhere however Ceylon was shielded to some extent from this influence by the predominance of rice and food products in Ceylon's import list.

206. This was particularly evident in the case of the rubber industry where the general world depression coincided with the entry into the market of increasing supplies of rubber from the newly planted Netherlands East Indies.

207. As a result of the International agreement on tea, restriction of production and acreage was first introduced for five years between 1933 and 1938 (Tea Control Ordinance No. 11 of 1933). Since that date it has been successively extended in five year periods and the agreement is still in force today. The current period of restriction extends up to March 31, 1955.

The impact of the depression on the Ceylon economy

The outstanding feature of the economic set-up of Ceylon is the role of exports as a strategic factor in the process of income determination. The value of Ceylon's earnings from her export industries is almost entirely determined by external factors. Ceylon is too small a unit in world trade to have any influence, through internal changes in incomes, on the world demand for her products. The earnings of her export industry are thus a sort of independent variable largely unaffected by changes in the other sources of incomes in the country. Yet exports account for a substantial part of the national income and a change in exports sets in motion a whole train of consequences affecting almost all the other sectors of the economy. A decline in exports, for instance, has its inevitable repercussions on domestic investment, the production of domestic consumer goods and above all on the revenues and expenditures of the Government itself. One of the purposes of this chapter is to illustrate these repercussions and relationships by a case study of the Ceylon economy in the years of depression. It is therefore to the behaviour of exports that we must first turn our attention.

Changes in the total value of Ceylon's exports can of course be due to changes in price or changes in output or to a combination of both. As in the case of most agricultural commodities, however, prices tend to fluctuate more than output. Indeed it is fairly certain that a high degree of correlation exists between the national income of Ceylon and the index of export prices. The correlation is likely to be closer than that between national income and the export volume index.[208] Accordingly a fall in the prices of the principal commodities was the channel through which the world

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The Stevenson Scheme of 1922 for rubber was no longer in force in the 'thirties. A new phase of restriction was introduced in 1934 with the signing of the International Rubber Regulation Agreement. This Agreement prohibited all new planting until 1938. Thereafter new planting was strictly regulated on a system of permits. The International Rubber Regulation Agreement, however, expired at the end of 1943 and no new agreement has since taken its place. There is no restriction as such on new planting of rubber in Ceylon today but the opening up of new extents require the permission of the Ministry of Agriculture and Lands. (*Economic and Social Development of Ceylon* 1926–1950; Ministry of Finance 1951 pp. 4–7).

208. Similar relationships have been found to exist between national income and the price and quantity of sugar in Cuba. (H. C. Wallich: Monetary problems of an Export Economy, p. 198, quoting Alienes: *The National Economy of Cuba* p. 54).

depression was transmitted to Ceylon. The general price index for Ceylon's principal exports was showing a downward tendency as early as 1926, but its effects on the total earnings from exports was offset by a moderate expansion in the quantities exported of some of the commodities. In 1930 export prices fell sharply as a result of the depression and this together with a more moderate decline in quantities exported led to a serious fall in total export earnings. The trough of the depression in the export trade was not however reached until 1932.

The fall in prices applied almost universally to the whole range of Ceylon's export products, but some commodities felt the impact of the depression more severely than others. The decline in the price of rubber was spectacular. From a height of Rs. 1 and 21 cents per lb. in 1926, rubber fell to no more than 11 cts per lb. in 1932. In comparison with this tea prices were relatively stable. The prices of the principal coconut products were lower in 1931 than in 1932. They reached their minimum value in 1934 when tea and rubber prices were moving upwards. In spite, however, of the relative stability of tea prices, the absolute decline in the value of tea exports exceeded that of rubber. This, of course, was due to the greater importance of tea in Ceylon's exports. In 1932 Ceylon's total exports had fallen in value to Rs. 189 million, or by over 55 per cent, between the two dates. In the same period the value of tea exports fell by Rs. 97 million, the value of rubber exports by Rs. 74 million and the value of the exports of the principal coconut products by Rs. 27 million. Tea therefore accounted for 41.4 per cent of the decline in total export earnings, rubber for 31.6 per cent and the principal coconut products for 11.6 per cent. Together, these three commodities covered 84.6 per cent of the fall in total exports.

Since the depression was primarily externally determined it was natural that its first impact should fall on the export sector. There was a fall in both incomes and employment in the export industries. Wages in the export industries were subjected to a downward movement.[209] As a result of negotiations with the Government of India, a Minimum Wage Ordinance was introduced into Ceylon in 1927. The Ordinance applied only to Indian labour but this

209. The impact of the depression on plantation labour in Ceylon is discussed in more detail in P. T. Bauer: *The Rubber Industry*, ch. VI p. 242 et seq.

formed the bulk of employment on the plantations. Minimum wage rates came into force in 1929 with differential daily male rates of 54, 52 and 50 cents for up-country, mid-country and low-country estates respectively.[210] Lower rates were fixed for women and children. There was no distinction between the rates for tea and rubber estate workers. In order further to stabilise real wages, estates were also obliged to issue to workers a certain quantity of rice at a fixed price at regular intervals.

By 1930, with the sharp fall in prices, there was considerable pressure on the part of plantation owners, particularly from the rubber industry, towards a reduction in the minimum wage. In May 1931, money wages were reduced by 5, 4 and 3 cents for men, women and children respectively.[211] In December 1931, a further reduction in money wages was authorised. The male rates on mid-country and low-country estates was reduced to 43 and 41 cents respectively, with corresponding changes in women's and children's rates. Up-country wages were unaltered. The deepening of the depression in 1932, however, offset any relief that these wage reductions might have brought on the export industries. In that year the plantation interests agitated strongly for the complete abolition of statutory wage regulation. The procedure for adjustments in wage rates was lengthy and cumbersome and involved prolonged negotiations with the Indian Authorities. The demand for abolition was not, however, acceded to but instead a further reduction in wage rates was permitted.[212] The new rates were fixed at 41, 37 and 35 cents for men in the three districts and the issue price of rice was reduced to 4 rupees. The new rates were not, however, to come into force until May 1933 by which time the upward movement in tea and rubber prices had begun. In November 1933 the minimum wages were revised upwards to 46, 40 and 38 cents for men, and thereafter, in later years there were further upward adjustments.

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210. The differences were due to the somewhat greater cost of living at higher altitudes and the supposedly more strenuous nature of the work.

211. Since at the same time the issue price of rice was reduced from Rs. 6.40 to Rs. 4.80 it was claimed that the change in wages was essentially an adjustment rather than a reduction.

212. vide S. P. IV of 1933: Minimum rates of wages (ordinance No. 27 of 1927) – correspondence between the Governments of India and Ceylon regarding the reduction of the rates of wages fixed for Indian estate labourers in Ceylon.

The successive reductions in wage rates were, however, inadequate to prevent the widespread dismissal of labour. The minimum wage ordinance imposed a statutory obligation on employers to offer six days work a week or wages for an equivalent amount. This made it difficult for an employer to ease his problems by a reduction in time worked per man. The practice of paying three-quarters of the minimum wage for morning work only was declared illegal by the courts in February 1932. The offering of less than six days work a week was sometimes tolerated in order to prevent the closing down of smaller estates, but neither this nor the reduction in wages was sufficient to prevent the curtailment of employment. The total number of Indian labourers employed on estates fell from 563,000 in 1929 to 434,000 in 1933. Non-Indian labour on estates declined from 57,000 in 1929 to 47,000 in 1933.[213] Employment on rubber estates alone was estimated to have halved during the slump, from about 100,000 to 50,000.[214] Unemployment on the estates was not confined to wage earners. The Controller of Labour estimated in 1932 that 434 superintendents and assistant superintendents, 550 conductors, 334 clerks and 159 dispensers, connected with estates were then unemployed,[215] these being mainly Ceylonese.[216]

Through the export industries the depression was transmitted to other sectors of the economy. Industries and trades, such as transport and the Port of Colombo, which were partially geared to the export sector were early sufferers. These were followed by the internal sector of the economy whose prosperity was dependent upon domestic expenditure or demand. With the fall in income of those engaged in the export sector came a fall in earnings of those whose incomes were partly at least determined by the expenditure of the former. As will be seen presently the great importance of imports in the consumption pattern of the population tended to weaken the secondary reductions in incomes that were taking place in the domestic sectors. Nevertheless, a fall in incomes and employment was particularly heavy amongst artisans, domestic and hotel servants, motor car drivers, clerks and persons of similar status and

213. S. P. VII 1937. *Report on Unemployment in Ceylon:* Government Press ch.I. p. 5.
214. Bauer: *op.cit.*
215. S. P. VII 1937 *op.cit.* p. 5.
216. S. P. XII 1947. *Report of the Commission on Social Services* p. 4.

unskilled labour in general.[217] The problem became sufficiently acute to induce the Government take measures to alleviate hardship. The first steps were taken as early as January 1931 when the traditional form of organised charity was called into service with a special relief fund started by the Mayor of Colombo. In September of the same year direct relief work was started both by the Government and the Municipality of Colombo.[218]

Even the village economy of agrarian Ceylon did not remain wholly immune from the depression. Peasant producers who cultivated subsistence crops were sometimes also growers of rubber and coconuts on small-holdings, and often added to their incomes by part-time work on neighbouring plantations. Those who produced a surplus of rice for sale in the market were directly affected by the changes in the terms at which they exchanged their produce for consumer goods. "As in previous depressions, under-employment was more widespread than unemployment. Discharged labourers returned to the villages. Villagers who worked on estates, the road, the railways, building or other public works, lost their supplementary sources of income. Carters, blacksmiths, boutique-keepers, carpenters and tradesmen, generally lost their incomes. Also remittances from relatives in the towns (and in Malaya) were reduced or stopped altogether – an important factor, specially in the north. The village economy is not wholly dependent upon the export trade; nor are always paddy and chena products; but even the villager is affected ultimately by a fall in the price of

217. S. P. VII 1937 *op.cit.* p. 8 et seq. The artisan class comprised 23% of the Charity Commissioners waiting list for employment: domestic servants, car drivers and hotel servants, 10.6%; and clerks and persons of similar status 6.9%. It is interesting to note that bricklayers did not share in the general hardship: "Bricklayers are finding plenty of employment. Even in the worst years of the depression the number of building applications allowed by the Colombo Municipality showed only a slight decrease and in 1935 it was well up to the average. One reason for this seems to be that the wealthier classes are now investing their money in house property instead of in rubber, or coconut lands. Another cause no doubt is the cheapness of building material" *(ibid)*.

218. It will be shown at a later stage that total Government expenditure on relief was in no way proportionate to the fall in incomes and employment. As a Controller of Labour put it: "The real relief of the Island's distress comes not from formally constituted societies or Government aid but from the abiding charity of the people and the strength of family ties which help the many lame dogs over the innumerable stiles of life." *Administration Report of the Controller of Labour for* 1931. p. o. 38.

rubber. The depression of the 'thirties was, in fact, one of the pre-disposing causes of the great Malaria epidemic of 1934."[219]

Reference has already been made to the high propensity to import in Ceylon. The dichotomy between the physical composition of real income and national output is indeed one of the central features of an export economy. A substantial part of the national output is exported abroad and an almost equivalent portion of the real income of the country consists of imported goods. The food, the textiles and other consumer and capital requirements upon which income earners in Ceylon spend their money are largely imported from abroad. As a consequence when incomes in Ceylon fall in general the resultant curtailment of expenditure is directed in large part towards imports. This large dependence on imports, whatever its other disadvantages, has the merit of limiting the secondary or cumulative development of the depression in Ceylon. If most of the commodities upon which income earners reduce their expenditure in times of depression were produced in Ceylon, the secondary fall of incomes as a result of a reduction of export earnings would have been much greater than it was in fact. The small size of the national income multiplier in Ceylon is a grave limitation to the effectiveness of expansionary measures, but it also limits the spread of a downward movement. This, however, is poor consolation when the crux of the problem of instability is the violent fluctuation in the 'autonomous' factors themselves, as was seen in the case of exports between 1929 and 1932.

The extensive fall in incomes both in the export and domestic sectors led naturally to a reduction of expenditure upon imports. Since, however, the depression was world-wide and affected almost all commodities in international trade, the prices of imported commodities were also showing a downward movement.[220] If the reduction in import prices was exactly proportional to the reduction of expenditure upon imports there would be no change in quantities imported. In such an event real incomes in Ceylon. or strictly that part of real income which is composed of imports,

219. S. P. XLL 1947. *Report of the Social Services Commission. op.cit.* p. 4.

220. Because of the negligible contribution of Ceylon towards the world demand for imported commodities, it is fairly realistic to assume that the reduction of incomes and expenditure in Ceylon had, by itself, little to do with the fall in import prices.

will not fall in spite of the general decline in incomes. In fact, however, the fall in import prices was less than proportional to the decline in expenditure upon imports, and a reduction in the volume of imports was a resulting consequence. This reduction in the volume of imports was nevertheless much smaller than the reduction in total money incomes, indicating the greater stability of real incomes. There are no national income estimates for this period to tell us the fall in money incomes in the economy as a whole, but using the decline in export earnings as a roughly comparable index it is notable that whereas this fell by over 55 per cent between 1929 and 1932, the index of import volume fell by over 55 per cent between 1929 and 1932, the index of import volume fell by only 13 per cent during the same period and by 17 per cent between 1929 and 1933 when this index was at its lowest. In other words, the degree of price deflation during the depression was much more severe than the reduction in real incomes or the standard of living of the people as a whole.

Since, as has already been shown, export prices play a predominant role in the determination of total earnings in the export sector and indeed in the economy as a whole, the relative movement of export and import prices is of particular significance to the level of real incomes in Ceylon. It is generally recognised that the short-period terms of trade between agricultural and manufactured commodities in world trade tend to move against agriculture in periods of depression, and against manufacturing industry in periods of boom. Since Ceylon's foreign trade takes the form of an exchange of agricultural products against manufactures it is to be expected that the terms of trade will move unfavourably against Ceylon in periods of depression. That this was in fact the case is borne out by the relative movement of the export and import price indices during the period, illustrated in the table below.

There is, however, one important factor which distinguished the behaviour of Ceylon's terms of trade from the customary pattern in agricultural countries. This factor is Ceylon's heavy dependence on imported food. Reference has been made elsewhere in this work to the fact that about two-thirds of Ceylon's rice requirements in pre-war times was imported from abroad. In 1928 44 per cent of Ceylon's total import bill of Rs. 400 million was spent on food. In 1933 when total imports were at their lowest level the proportion

RELATIVE CHANGES IN EXPORT AND IMPORT PRICES IN CEYLON

Year	1926	1927	1928	1929	1930	1931	1932	1933	1934	1935	1936	1937	1938
1. Export Price Index (Av. 1934–36=100)	193	169	141	127	105	75	65	71	86	95	103	116	99
2. Import Price Index (Av. 1934–38=100)	194	190	183	177	145	117	106	98	101	104	97	99	102
3. Ceylon Terms of Trade (1 ÷ 2)	100	89	77	72	72	64	61	73	85	91	106	120	97
4. World Terms of Trade (1938=100)	121	125	121	118	105	93	89	89	96	98	102	108	100

Sources: Export and Import Price indices: Table II: Economic and Social development of Ceylon.
World Terms of Trade: United Nations: Relative Prices of Exports and Imports of Under-developed Countries, p. 22 table 5: Ratios of Primary to manufactured commodities in World trade, based on League of Nations: Industrialization and Foreign Trade (Geneva 1945). Represents major trading countries and others.

spent on food rose to 47.5 per cent.[221] The heavy weightage enjoyed by food in the import bill greatly modifies the unfavourable influence of the terms of trade for Ceylon in times of depression. Since most food products are agricultural commodities, their prices (and this is specially true of rice), tend to move at a rate similar to that of the prices of Ceylon's agricultural exports. This factor gives Ceylon partial protection from the effects of an adverse change in the terms of trade on the level of real incomes.

During the depression of the 'thirties there was a further factor of a more temporary nature which favourably influenced the terms of trade for Ceylon. Next to food, textiles loomed largest in Ceylon's import list, since the country's requirements in clothing were almost entirely met out of foreign supplies.[222] Cloth is of course a product of manufacturing industry and ordinarily its price movements may be expected to conform more to the general pattern of manufacturing industry than of agriculture. In the 'thirties, however, the behaviour of textile prices was exceptional. Primarily under the stimulus of a large influx of cheap Japanese cloth, textile prices fell severely. In fact the decline in the price index for clothing was somewhat greater than that for food. This favourable movement in food and textile prices must be recognised as a prime contributor to the relatively small reduction in real incomes in Ceylon during the depression when compared with the fall in money incomes or export earnings.

In the absence of both a regular national income series and representative price index with which it may be deflated, it is not possible to set out precisely the movement of aggregate real incomes for the whole economy. The closest approximation available is the index of the value of imports of consumer goods at constant prices

221. "Economic and Social Development of Ceylon", tables V and VII. Imports of food amounted to Rs. 177 million out of Rs. 400 million of total imports in 1928. In 1933 total imports were Rs. 177 million and food imports Rs. 84 million. Rice was the most important item in the food group, but the latter included such foodstuffs as dried and salted fish, curry stuffs, flour, sugar, onions, potatoes, milk foods, butter, fresh fruits, confectionery and so on.

222. Clothing accounted for 8.5 per cent of the value of total imports in 1928 and 9.6 per cent in 1933. Thus in the latter year food and clothing together accounted for over 57 per cent of the total value of imports. (*ibid* tables V and VII).

which is given below. This bears out the relatively small change in real incomes.

	1929	1931	1932	1933	1934	1935	1936	1937	1938	1939
Index of imports of consumer goods at constant prices 1938=100	106.9	94.8	93.5	88.2	99.8	99.7	98.8	103.5	100.0	100.2
Per capita	27.1	24.0	23.7	22.4	25.3	25.3	25.1	26.2	25.4	25.9

Source: *Economic and Social Development of Ceylon op.cit.* p. 11.

The fall in real incomes in the community was not, however, the sole problem created by the depression from a social point of view. A good deal of hardship arose out of violent disturbances in the distribution of incomes. Those who derived their incomes from the export industries and who succeeded in maintaining themselves in production or employment had to face a severe fall in money incomes. But, as we have seen, they were at least partly compensated by a fall in the prices of consumer goods. It was those who were thrown out of employment (and their numbers were substantial) who had to bear the crushing burden of the depression. There was no system of unemployment insurance in the country. A limited number of persons were able to secure a meagre subsistence out of Government sponsored relief schemes in the towns. Others returned to their villages to share with their families the precarious living that was being procured in these areas. Still others remained in the towns living on whatever temporary earnings that came their way.

There was one feature of the economy, however, which proved a great source of relief to Ceylon in the depression. This was the normal utilisation of immigrant Indian labour on the plantations. We have described in our earlier chapter how during the early period of growth of the export economy Indian labour was imported from the mainland because of the difficulty of securing local labour for work on the plantations. Indian labour did not become permanently settled[223] in Ceylon but tended to return to villages in the mainland at frequent intervals. In periods of prosperity in Ceylon when work on the plantations was plentiful or in years of bad harvests in India[224] the net influx of migrants tended to increase. Conversely in periods of depression when employment was scarce in Ceylon Indian labour left the country and returned to India. As is shown in the table below there was a heavy outflow of persons to India during the depression of the 'thirties. In all, over 100,000 persons left the Island and returned to India between

Migration of Indian Estate Labourers travelling between Ceylon and India

(To nearest thousand)

Year	*Total Resident*	*Assisted Immigrants*	*Emigrants*	*Net Influx or Outflow*
1929	740,000	105,000	104,000	+ 1,000
1930	735,000	91,000	106,000	— 15,000
1931	682,000	68,000	92,000	— 24,000
1932	651,000	51,000	72,000	— 21,000
1933	610,000	33,000	89,000	— 56,000
1934	689,000	141,000	55,000	+ 86,000
	Total net outflow 1930–1933 – 116,000.			

Source: Report on Labour Conditions in Ceylon p. 43 appendix VI.

Note: Figures include labourers repatriated under the rubber scheme 1930 and the tea scheme 1932.

Total resident population refers to both population employed on estates and dependants. The figures for assisted immigrants include both returning and new immigrants. The figures for emigrants cover both assisted and unassisted emigrants. Unassisted immigration was not a general feature in the supply of Indian estate labour.

223. A recent Indian writer makes the following comment on the Indian population of Ceylon: "Indians in Ceylon have not adapted themselves to Sinhalese culture. They have refused to be assimilated into the Sinhalese population and have preserved their identity. They regard India as their home and Ceylon merely as a place of temporary residence. Inter-marriage is completely absent. In political matters they have displayed an attitude typical of a minority, trying to safeguard its own interests against that of the country as a whole, and to claim disproportionate rights. Indian politics in Ceylon may be compared with Muslim League politics in India before partition – N. V. Sovani – *Economic relations of India with South-east Asia and the Far East* – Indian Council of World Affairs; Oxford University Press, New Delhi 1950 Ch. III p. 42.

224. For example during the great South Indian famine of 1876–1877 *ibid.* p. 38.

1930 and 1933. The loss was largely restored in 1934 when there was a renewed influx of labour following the general recovery in the export industries. This feature of a large scale return of labour to the mainland was a source of great relief to both the standard of living in the country and the finances of the Government. Had they remained in the Island these persons would presumably have joined the ranks of the unemployed. They would thus have added to the numbers amongst whom the reduced total of real income in the country would have to be distributed. Since this measure could only have been secured through Government relief measures the burden on the finances of the Government would have been considerably augmented. Here, in a very literal sense was the 'export' of unemployment.

It is perhaps not out of place to remark here that the chances of a recurrence of a similar situation in the future has been partly diminished in recent years by certain changes which have affected the position of Indian labour in Ceylon. The freedom of movement of labour between the Island and the mainland has been severely curtailed as a result of the total ban on new immigration into Ceylon that was imposed in 1939 by both the Ceylon and the Indian Governments. The temporary character of resident labour on the plantations has been reduced[225] and the new citizenship laws of the Ceylon Government directly discourage regular travel to and from India by limiting Ceylon citizenship to Indians permanently resident in the Island. It is therefore not unreasonable to expect that the relief afforded to Ceylon in times of depression by the return of labour to the mainland will be somewhat restricted in the future.

The Balance of Payments and the Depression

We may now turn to the impact of the forces described above on the balance of payments of Ceylon. The balance of payments is central to the problem of fiscal policy in an export economy and its behaviour in the varied conditions of boom and depression merits close study.

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225. In 1938 the Commission of Indian Immigration in Ceylon estimated that 60% of the so-called Indian labour on the estates had become a part of the permanent population of the Island. The tendency to settle was growing and the proportion of settled labour was much greater than it had been twenty years before. (Sovani *op.cit.* p. 39, citing *Report of Commission on Immigration into Ceylon.* (In Edward Jackson) 1938, p. 26.

(i) The Sterling exchange standard as a corrective force

Under a system of free exchanges the exchange rate of a country's currency in terms of foreign currencies will be determined by the relationship between the demand for foreign currencies, for the purposes of importing or making payments to foreigners, and the supply of foreign currencies as is made available through the sale of exports to foreigners or other payments by foreigners. If the supply of foreign currencies is reduced at any moment through say a decline in exports and the demand for currencies has not fallen proportionately, the rate of exchange or the price of foreign currencies in terms of the local currency will rise. This rise in the price of foreign currencies (or the depreciation of the local currency) will proceed to an extent adequate to equate demand and supply once more. If, however, the rate of exchange was fixed by the authorities, its stability could only be maintained in the face of a fall in the current supply of foreign exchange by the augmentation of this supply out of official reserves. If the excess of demand were to continue until the reserves were exhausted the continued stabilization of the rate would prove impossible.

Ceylon was, as she is now, a member of the Sterling Area and this implied, first, an exchange rate fixed in terms of sterling[226] and second, the holding of a foreign exchange reserve composed entirely of sterling (or Indian rupees which were readily convertible into sterling). The maintenance of the stability of a fixed exchange in the face of a severe curtailment of receipts from abroad would

226. More accurately the Ceylon rupee was directly linked to the Indian rupee whose exchange rate was in turn fixed in terms of sterling. A detailed treatment of the currency history of Ceylon is beyond the scope of this study. It is of interest to note, however, that the emergence of an exchange standard in Ceylon was the result of a process of evolution rather than of conscious planning or legislation. The basic law of the currency system during the period under review in this chapter remained the Paper Currency Ordinance of 1884. Under this Ordinance the Indian silver rupee coin was the standard coin of the Island and was final legal tender of payment, inconvertible into any other coin or foreign currency. The Ceylon Government was to issue notes covertible into Indian rupee coins and these notes could likewise be had in exchange for the Indian coins on demand at the office of the Commissioners of Currency in Colombo at the nominal par. An amending Ordinance (No. 6 of 1903) empowered the Commissioner to issue notes in exchange for gold sovereigns if they so desired but they were able to decline to do so if they considered it inexpedient to increase the gold part of the reserve. This amendment, however, ceased to have any meaning after the demonetization of the sovereign in August 1920.

therefore have imposed a tremendous strain on the country's foreign exchange reserves unless some mechanism was in existence to bring about a similar curtailment of imports or other payments made to foreigners. This mechanism was provided by the currency laws of the country which introduced a 100 per cent sterling exchange system.

The Ordinance of 1884 permitted the Currency Board to keep a portion of its reserves in the form of Indian or Sterling securities. It required however that the Indian rupee coin reserve should not fall below one-third of the notes in circulation and that no further investments in securities should be made until the coin reserve amounted to one-half at least of the notes in circulation. The occasions on which the coin reserve was over 50 per cent of the total was not however frequent before World War I so that opportunities for issuing notes against securities rather than rupee coins were not numerous. In 1903 the first issue of notes against sterling securities took place when the coin reserve was over the 50 per cent minimum and the operation was repeated in 1913 and 1917 and in several subsequent years after the war. In 1934 the commissioners even issued notes against securities when the coin reserve was below the legal one-third minimum because they considered themselves (it is believed wrongly) authorised to do so by an amendment of 1917.

Two points in connection with this system should be noted. First, no rate of exchange was specified by the law to govern the exchange of notes against securities, as the Paper Currency Ordinance did not even contemplate the redemption of notes against securities. The limits of the rate between sterling or Indian exchange and Ceylon currency was of course set by the mutual convertibility of the latter and Indian rupee coin, but within these limits the Currency Board was free to negotiate a rate of its own. Its bargaining position was strengthened by the fact that it was not *obliged* to receive or surrender Indian or Sterling Exchange for Ceylon currency. By threatening insistence on redemption or issue of Ceylon currency against coin it could subject the banks and others interested to considerable inconvenience. The maximum advantage it could derive from its bargaining was of course limited to the cost of shipping rupee coins from and to India. On the other hand the banks were not in a strong position whenever they realised that the Currency Board was not desirous of being overstocked with coins.

Second, the issue and redemption of notes against exchange became increasingly possible because of the mutual benefits to all concerned. In 1931 the coin reserve fell below the legal miminum, but in 1934 and in certain subsequent years the Currency Board preferred to issue notes against sterling exchange rather than restore the coin reserve to the legal minimum. It preferred, that is, remunerative assets to idle coin whose low level in the reserve had caused no difficulties. The banks in turn were now able to transfer their funds at once from London to Colombo without having to wait until their holdings of sterling were converted into Indian rupees and then shipped to Colombo. Similarly when remitting funds out of Ceylon they preferred exchange in return for notes rather than a quantity of coins delivered locally.

In this way an exchange standard gradually evolved in Ceylon. The issue of notes against rupee coins, the central feature of the law of 1884 which was still legally operative, progressively receded into the background and when in 1939 a new law came to be drafted to replace the old the practice had all but ceased. (For a detailed history, vide B. R. Shenoy, *Ceylon Currency and Banking*, Longmans 1941).

The nature of the exchange standard:

The hundred per cent sterling exchange standard was a sure guarantee that the economy as a whole would keep in step with upward or downward movements in foreign exchange receipts. Under this system the full value of the currency circulation in Ceylon was backed cent per cent by holdings of sterling or Indian rupees usually in the form of British or Indian Government securities. The issue of currency was the responsibility of a specially constituted Currency Board with narrowly defined powers. No fiduciary issue was permitted at all. Apart from the possibility of exercising a certain amount of judgment in regard to the investment of the foreign reserve in various types of securities, the work of the Currency Board was more or less of an automatic nature. The Board issued rupees in Ceylon to any person presenting sterling or Indian rupees in certain minimum amounts and conversely surrendered sterling or Indian rupees in exchange for Ceylon rupees.

From this system it will be readily apparent that the currency circulation in Ceylon at any given moment was the result of the foreign reserves in the possession of the Currency Board at the time plus the sterling (or Indian rupees) that were being currently offered minus the sterling (or Indian rupees) that were being currently withdrawn. If for example exports were rising and increasing quantities of sterling were being presented to the Currency Board there would be equivalent increase in the *issue* of rupees but if at the same time imports were also rising these rupees would be concurrently withdrawn. The net change in the note circulation will therefore depend on whether external receipts exceed or fall short of external payments. It will depend, in other words, on the balance of payments. From this it will be seen that the only way in which the country can increase its currency circulation under a hundred per cent standard is by having a regular export surplus.

A mechanism so rigid as this carries with it serious limitations. On the one hand an increasing volume of currency required to facilitate an enlarged volume of domestic transactions can only be secured through an export surplus. In the absence of such a surplus the rigidity of the currency circulation can impart a serious deflationary pressure on a growing domestic sector. If, alternatively, an export surplus is secured it represents an unnecessary sacrifice of imports. On the other hand, the foreign exchange cover provided for that minimum proportion of the currency supply required to finance purely domestic transactions was an extreme of caution entailing the immobilisation of a substantial quantity of foreign exchange that could instead be used to advantage in a country so critically short of capital.[227] But, however serious these drawbacks, it cannot be denied that as a device for protecting the stability of the exchange rate the hundred per cent standard is unrivalled. Through the rigid link between the local currency circulation and the country's earnings of foreign exchange the hundred per cent standard ensures that the movement in domestic incomes keeps in step with changes in the foreign exchange position of the country.

In this respect the hundred per cent sterling exchange system in no way differs from a rigid and automatic gold standard. A deficit in the balance of payments led to an automatic and simultaneous contraction in the currency supply. As long as people in the country had rupees to spend on imported goods there was a corresponding amount of sterling in the country's reserves to pay for these. Since there was no provision whatsoever for a fiduciary issue the currency supply in the country could not possibly increase whilst the foreign reserves were being reduced.

The volume of currency in circulation at any given moment is, of course, only a constituent part of the total money supply. Bank money, which is customarily measured by the demand deposits

227. The exchange and coin reserves of the Currency Board were in fact nearer a 110 per cent of the note issue than a 100 per cent. The Board was specifically instructed by the Secretary of State for the Colonies to maintain a 110 per cent reserve of assets. (vide *Ceylon Hansard* 1916, p. 337; and Report of the Colonial Auditor, 1921–22, paragraph 163). The extreme conservatism of the policy of the Currency Board is indicated by the following figures:

Percentage of total reserves held by the Currency Board to gross note circulation

Year	1926	1927	1928	1929	1930	1931	1932	1933	1934	1935
Percentage	111.63	111.86	113.14	108.44	108.27	111.31	112.01	113.20	113.30	113.32

Source: Calculated from B. R. Shenoy, *op.cit.* p. 213 compiled from the Reports of the Colonial Auditor (up to 1928) and from Reports of the Auditor General (after 1928).

of the public at the banks[228] forms the remainder. In countries with a highly developed banking system, bank money constitutes the predominant part of the total money supply. In these circumstances changes in bank money are of far greater significance than changes in the volume of currency in circulation. Careful regulation of the volume of currency will then be of little significance if the movement of bank money remains uncontrolled.

In Ceylon there were two factors which ensured that the corrective movements in currency circulation were not negatived by opposite movements in the volume of bank money. First, the ratio of bank money to currency in circulation was relatively small in Ceylon because of the limited development of the banking system and the banking habit; second, the banks themselves were accustomed to maintain relatively high cash reserves both in rupees and in sterling.[229] In the absence of support from a central bank the banks had to follow an extremely cautious policy in the sphere of credit creation. A decline in their cash reserves, which followed a decline in incomes in the country and a deficit in the balance of payments on current account, was therefore fairly consistently followed by a contraction in bank money. For these reasons, the existence of bank money in no way frustrated the workings of the hundred per cent exchange standard. It was not possible, in other words, to endanger the stability of the exchange in periods of depression by inflationary credit creation.

The hundred per cent standard was not, of course, a mechanism which prevented the occurrence of an adverse balance of payments. But by maintaining a strict relationship between the money supply

228. The note and coin reserve of the banks should, of course, be deducted from the demand deposits because the former is already included under currency in circulation.

229. The automatic exchange standard enabled the banks to hold a high proportion of their cash reserves in London where there was a developed short money market: "The obligation of any bank to its local depositors is to pay the local legal tender currency; if it does not hold its reserves wholly in actual local cash, it must hold them in something immediately convertible into such cash; and under the system (in the Colonies) the only thing which can be directly converted into colonial notes or coin is sterling in London. A Colonial bank which holds, directly or through a London head office, Treasury bills or other short securities in London can at any time secure cash on the spot by selling those securities and paying the proceeds to the currency authority in question." *Monetary Systems of the Colonies* – a revised reprint of eight articles appearing in The Banker between July 1948 and February 1949 and published by the Banker, p. 2.

of the country and its foreign reserves, it made certain that these reserves would always be sufficient to meet a deficit. As long as 'created money' is not a significant element in the total supply, and we have seen above that this condition was satisfied in Ceylon, the foreign reserves of the country, including both the reserves of the Currency Board and of the banks, cannot fall to zero unless the total money supply is also near zero!

(ii) The Behaviour of The Ceylon Balance of Payments in the Depression –

(a) The visible items.

It is not possible to construct a complete series of balance of payments accounts for Ceylon during the years of the depression. Statistical information is almost wholly lacking both on movements of the various invisible items on current account and on capital movements. The most accurate data at hand relates only to the merchandise items in the balance of trade – the aggregates of exports and imports of merchandise as valued by the customs. Exports and imports, however, do form the main elements in the balance of payments account, and an examination of these together with what can reasonably be expected of the other items will throw some light on the behaviour of the whole.

The investment of foreign capital played a leading role in the development of an export economy in Ceylon. It was shown in a previous chapter that, during the period of economic expansion an annual deficit in the balance of merchandise trade was a regular feature of the economics of the country. This deficit in the balance of trade did not, however, imply a continued running down in foreign reserves, because it was 'financed' by the inflow of foreign capital for investment in the plantations and other enterprises. In fact, during this period the deficit in the balance of merchandise trade was accompanied by an increase in the currency circulation and in the covering foreign reserves. After the initial period of expansion was over, however, the regular deficit in the balance of merchandise trade gave place to an almost equally regular surplus. This, again, was the natural consequence of the gradual cessation in the inflow of new capital from abroad and the drawing of rewards by the existing foreign investment in the form of profits and interest payments. The regular export surplus was the means whereby the country was able to service its foreign debt.[230]

A regular surplus in the balance of merchandise trade, increasing in periods of marked prosperity, was thus a normal feature in Ceylon in the years immediately prior to the Great Depression of the 'thirties'. During the years of the depression, however, the surplus rapidly dwindled and in one year gave place to an actual deficit. These movements in the balance of merchandise trade are illustrated in the table below.

TABLE

Balance of Merchandise Trade 1926–1929

(Rs. million)

Year		*Exports*		*Imports*		*Balance*
1926	..	532	..	395	..	+ 137
1927	..	479	..	406	..	+ 73
1928	..	418	..	400	..	+ 18
1929	..	423	..	403	..	+ 20
1930	..	323	..	302	..	+ 21
1931	..	233	..	218	..	+ 15
1932	..	189	..	196	..	— 7
1933	..	200	..	177	..	+ 23
1934	..	264	..	217	..	+ 47
1935	..	253	..	228	..	+ 25
1936	..	268	..	214	..	+ 54
1937	..	332	..	243	..	+ 89
1938	..	285	..	236	..	+ 49
1939	..	328	..	242	..	+ 86

Source: *Economic and Social Development of Ceylon* 1926–1951 *op.cit.* table V and *Annual Administration Reports on the Customs and Shipping.*

Note: The annual values of exports as given by the Customs include re-exports and postal articles and ship stores, but excludes the values of coal and of liquid fuel supplied to steamers. Since however the latter are included in the total value of imports as given by the Customs they have been added to the export figures in the above table. Statistics on the values of coal and liquid fuel supplied to steamers are given separately in the Customs administration reports. Imports and exports of bullion and specie are excluded from the table above. The fall in the positive trade balance in 1938 is due to the recession in export prices in that year.

230. This does not mean that the whole of the export surplus was absorbed in the servicing of the foreign debt. The difference between the total foreign receipts of the country and that part of it used to pay for merchandise imports was used in part for the servicing of foreign debt, in part for payment for invisible imports including remittances and pensions of foreigners employed in the country, and in part for the building up of the foreign reserve through a net increase in the currency circulation.

In periods of depression a decline in the earnings from exports is an experience common to almost every country. On the other hand, the foreign accounts of all countries cannot be adverse at the same time. In fact it is customary for certain types of countries to enjoy an improvement in their balance in bad years and for others to suffer a deterioration.[231] Ceylon belonged to the latter group. The chief reason for this is that in spite of the severe reduction in money incomes that took place on account of the fall in export earnings, the heavy dependence of the country on foreign sources for the supply of the necessities of life sustained the demand for imports. The demand for rice and other foodstuffs tends to be income inelastic and the total expenditure in imports would perhaps have been higher than they were, had there not been a compensating fall in the prices of this group. This heavy dependence on foreign supplies for 'necessities' renders the demand for them in Ceylon both price and income inelastic and thereby seriously limits the effectiveness of both income deflation and exchange depreciation as corrective measures for the balance of payments.

A further factor of lesser importance is the need to maintain imports of materials necessary for the export industries. The "import content" of exports include fertilizers, packing materials and coal and oil for the factories and transport. This is of some significance when output is kept up at high levels in the export sector in spite of the fall in prices.

(b) The invisible items.

Yet another source of pressure on the foreign exchange resources of the country which is excluded from statistics relating solely to the merchandise trade, arises from outpayments on invisible items. The Customs aggregates for merchandise trade themselves include certain invisible items since freight charges and insurance costs are included in total imports which are valued c.i.f.[232] On the other hand profits, interest payments and remittance abroad by individuals are excluded. We have already indicated that a part

231. The behaviour of the foreign accounts of individual countries will depend on a number of factors particular to the country concerned. In general, however, countries exporting manufactured goods tend to enjoy, as a group, a favourable balance vis-a-vis countries exporting agricultural products.

232. Exports on the other hand are valued f.o.b. Profits are generally included in the value of exports since these are valued at market prices.

of the normal export surplus of the country is absorbed in the servicing of foreign debt. One feature of foreign investment in Ceylon however is that it has taken the form of direct private investment by foreigners in enterprises operating in Ceylon. The bulk of these investments in the tea, rubber and coconut industries has been effected through 'extra-territorial' or sterling public companies whose capital has generally been raised through the issue of equity shares. A consequence of this feature is that the burden of servicing these investments varies directly with the prosperity of the economy. In years of depression where the balance of merchandise trade is itself unfavourable the remittance of profits abroad is reduced and the strain on the foreign reserves of the country is somewhat eased. The wide variation, between good years and bad, of the estimated remittance of profits abroad is indicated in the figures below. It will be appreciated that in this

Service payments on the foreign debt 1931–32 to 1937–38 (Financial years)

	1931–2	1932–3	1933–4	1934–5	1935–6	1936–7	1937–8
				(Rs. million)			
Dividends and profits remitted abroad	24	16	34	37	31	31	70
Interest payments abroad by the Government	10	10	10	9	12	10	8

Source: Government of Ceylon: Post-war Development Proposals 1946 p. 22 table IV.

Note: (1) Figures refer to the financial and not the calendar year.
(2) No high degree of accuracy is claimed for these estimates.
(3) Remittances by individuals are excluded.

respect direct investment by private foreign capital is unquestionably superior to certain other forms of foreign borrowing, such as the raising of loans abroad by the Ceylon Government, which impose an unchanging absolute money burden of interest payments in good and bad years alike.

It is not possible to measure accurately the total values of these invisible items in the balance of payments. Two sets of official estimates for the financial years 1931–32 to 1937–38 are given below.

Invisible Items in the Balance of Payments on Current Account
(Rs. million)

Year	1931-32	1932-33	1933-34	1934-35	1935-36	1936-37	1937-38
Estimate A:							
Total Payments on invisible items	74	65	83	89	86	86	125
Total receipts on invisible items	16	19	34	27	23	26	31
Balance	–58	–46	–49	–62	–63	–60	–94
Estimate B:							
Balance	–55	–45	–55	–68	–60	62	n.a.

Sources: Estimate A is taken from Table IV p. 22 of *The Government of Ceylon's Post-War Development Proposals* published in 1946.

Estimate B was made by the Department of Commerce. The figures for 1931–32 and 1932–33 were published in the "Administration Report for the General Treasury for 1936" pp. J. 55 and J. 56. Those for later years were published in B.R. Shenoy, *Ceylon Currency and Banking* 1941 *op.cit.* p. 222 Table XVIII.

Both sources lay stress on the tentative nature of their respective estimates.

The figures above, although of a rough character, are in accordance with the expected behaviour of the invisible items in Ceylon's balance of trade. An adverse balance in the invisible items is a normal feature because of the servicing of foreign investment in the Island. In normal or prosperous years this deficit is financed out of the customary export surplus in merchandise trade. In years of depression however this export surplus itself tends to dwindle and although the deficit in the invisible items is reduced it is reasonable to expect that the total balance of payments on current account becomes unfavourable. In these circumstances a moving down of the foreign reserves of the country and a fall in the money supply are inevitable.

(c) Changes in foreign reserves.

The changes in the foreign reserves held by the Currency Board are not of course a full measure of the total decline in the foreign assets of the country. The reserves held abroad by the public, the Government, and the banks must also be included. In the absence of statistics concerning the latter,[233] it is not possible to measure the total change in the country's foreign reserves. The fact however, that the reserves of the Currency Board and the note circulation did contract is adequate confirmation of the belief that Ceylon tends to suffer from a drain in her foreign reserves during periods of depression.[234] The following table indicates changes in the note circulation and in the reserves held by the Currency Board:

233. The Commercial banks did not publish details of their business at this time. In 1934 the Banking Commission was informed that total public deposits with the banks including time deposits, amounted to Rs. 122 million in 1933. The Commission complained of the reluctance of the banks to divulge information: "We endeavoured to get authentic figures of business of each of these banks, but have not succeeded in getting them. They, however, agreed to supply individual statements to the Hon. the Financial Secretary with a request that the consolidated figures of their business and that of the Imperial Bank should be given to us. According to the Consolidated statement the total public deposits with the seven Commercial Banks on December 31st 1933, was Rs. 122 million of which about 35 per cent was at the credit of the Ceylonese. In point of number the percentage of Ceylonese depositors was over 50 per cent. The total Government deposits on the same day amounted to Rs. 17 million. We are unable to give further figures regarding their business, as they were given to us in confidence. By restricting our discretion to use the figures for the report the banks have in a way done injustice to themselves, because we might have been able to dispel much of the general unfavourable impression that prevails in regard to their working." – S.P. XXII – 1934. *Report of the Ceylon Banking Commission* vol. 1, December 1934, p. 27.

It was not until 1939, under the Companies Ordinance, that the Banks began to file annual statements of accounts with the Registrar of Companies. In 1943 they agreed to furnish the Government with a more detailed quarterly statement. (vide Post-War Development proposals, *op.cit.* p. 24)

234. The total drain in the foreign reserves on the country must equal the deficit on merchandise trade plus the deficit on the invisible items less the net inflow of foreign capital. Normally new foreign investment in Ceylon coincides with periods of prosperity. But it is possible that a certain amount of foreign capital came into Ceylon during the depression as a result of the sale of plantations to foreigners by impoverished Ceylonese owners.

Changes in Note Circulation and Reserve of the Currency Board
(Rs. million)

Year	*Notes in Circulation*	*Increase or Decrease*	*Reserve*	*Increase or Decrease*
1926	61.7	—	66.9	—
1927	62.5	+ 0.8	69.9	+ 3.0
1928	57.4	— 5.0	65.0	— 4.9
1929	57.3	— 0.1	62.2	— 2.8
1930	57.2	— 0.1	62.0	— 0.2
1931	42.4	—14.8	47.3	—14.7
1932	42.0	— 0.4	47.0	— 0.3
1933	42.0	—	47.6	+ 0.6
1934	43.1	+ 1.1	47.8	+ 0.2
1935	44.2	+ 1.1	50.0	+ 2.2
1936	44.3	+ 0.2	50.3	+ 0.3

Total decline in Reserves between 1928 and 1932: Rs. 22.9 million

Source: Calculated from B. R. Shenoy, *op.cit.* Appendix I compiled from Monthly Statements of the Commissioners of Currency.

Notes: The figures relate to the 30th of September annually. Notes in circulation refer to the 'gross' circulation and thus includes reserves of currency notes held in banks.

The Reserves include both the metallic reserve (coin in vault) and Sterling and Indian rupee securities valued at cost.

It will be appreciated, from the discussion in the foregoing pages, that this drain on the foreign reserves of the country did not, in the circumstances of a hundred per cent exchange standard, require any conscious corrective measures on the part of the authorities. Since under this system, the scope for effectively augmenting the money supply by means of inflationary measures was virtually non-existent, the maintenance of expenditure in excess of current earnings was limited to the balances that had been accumulated by the community through past savings. But all these savings if they are held privately in the form of currency notes, or a large part of them, if they are held as deposits in the banks, were covered by foreign assets in the hands of the Currency Board and the banks – since the very process of saving leads to the accumulation of foreign reserves. There was therefore no danger that the foreign reserves of the country would be inadequate to meet the excess of demand for imports, both visible, and invisible, over current export earnings. Had the depression been more protracted the drawing down of reserves would only have lasted as long as past savings were still available for use by the community. Once the latter are exhausted the running down of reserves must cease[235] and the adverse balance of payments would disappear without the slightest need for corrective action on the part of the Government.

In other words, it is only because the community builds up its savings in prosperous years that it is enabled, under the hundred per cent exchange standard, to maintain an expenditure on imports in excess of current export earnings.[236] The hundred per cent system cannot however claim for itself the sole credit for the building up of reserves in the boom. In fact it generates forces favouring both increased expenditure and increased saving in the economy. On the one hand its very rigidity leads to the immobilization and accumulation of reserves as a cover for an increasing volume of domiciled rupees financing domestic transactions. On the other hand the increased volume of rupees that finds its way into the banking system during periods of prosperity in the export industries strengthens the power of the banks to engage in credit expansion. The fact that spectacular credit expansion does not annually occur in periods of boom is due in part to the scarcity of local investment outlets for the banks, and to the high cash ratios they maintain to provide for the high currency utilization which is a characteristic monetary habit of the public. It is to the caution of the banks, the budgetary surpluses of the Government and precautionary savings of the public, both individuals and business concerns, that the savings of the booms can properly be ascribed. As a result of these savings an element of stability is introduced into the real incomes of the community and the standard of living in the depression is supported out of the restraints practised in the boom.

235. The exhaustion of past savings does not imply that the foreign reserves have also been completely used up. Foreign reserves were 'saved' in the past both because individuals were building up their rupee balances and because an increasing amount of rupees become 'domiciled' for the purposes of financing transactions in the domestic sector. Even when individual balances are run down there would still be foreign reserves covering the minimum money supply required for the domestic sector in the trough of the depression.

236. Assuming, of course, that there is no foreign borrowing.

CHAPTER IV

PUBLIC FINANCE IN THE DEPRESSION

(a) The Political Background

The intense depression of the nineteen thirties was preceded in Ceylon by certain political changes of a far-reaching nature. The Donoughmore Commission of inquiry on constitutional reform had visited the country in 1928 and had recommended several reforms which represented a marked step forward in the political progress of the Island. Amongst those implemented were included the abolition of communal representation, the introduction of universal adult suffrage, and the appointment of elected ministers in charge of the departments of Government. There were also changes in the sphere of public finance. Hitherto the task of framing the budget was the responsibility of the Governor and his Executive Council of officials; but its passage into law normally required the approval of the legislature. With the introduction of an unofficial majority in the Legislative Council this arrangement with its separation of power and responsibility failed to function smoothly and its failure was one of the influential factors which prompted the reforms. Under the new Donoughmore Constitution the legislature itself was entrusted with executive tasks for the performance of which it divided itself up into seven Executive Committees who elected their own chairmen. These chairmen were termed Ministers and together they formed the Board of Ministers. The Board of Ministers met regularly and dealt with matters requiring mutual co-operation and co-ordination. As it developed in practice the Board became the closest approximation in Ceylon to a Cabinet in a parliamentary system on the British model. But, with one exception, the Constitution itself laid no general collective responsibility on the Board of Ministers for the framing or execution of Government policy. The exception related to the budget. The Constitution did not provide for a Minister of Finance and the departments of the Treasury were placed under an appointed official termed the Financial Secretary who sat but did not vote in both the Legislative or State Council and the Board of Ministers. But the framing of the budget as a whole was the special responsibility of the Board of Ministers who had to prune and approve the expenditure estimates, decide upon revenue measures, and introduce the budget into the State Council. Through this arrangement concerning the framing and presentation of the budget the public finances of the country were for the first time managed, in part at least, by the elected representatives of the people.

The executive committee system was a device adapted for a transitory stage where responsible government had to be made to function in spite of the absence of a well-developed party system. It was natural enough that the system had many shortcomings.[237] The Board of Ministers was not a united team with common political views and sympathies chosen by a single Prime Minister. Each minister was responsible to his own executive committee and had little interest in the policies of departments outside his own group. There was no such thing as a common government policy on the basis of which a unified government was elected. Particular ministers had to justify themselves in the eyes of their electorates and the public at large on the basis of their individual performance. In fact there was very little in the system to ensure that single ministers would even agree with the policies being pursued by their colleagues.

It was not unnatural that all these difficulties and inconsistencies should handicap the common task of budget making. Even under a cabinet system the authority of the Prime Minister and the concept of cabinet responsibility hardly eliminates entirely the vested interests individual ministers somewhat naturally develop in their own departments. With the executive committee system these restraints were absent and the play of personalities gained ample expression. In the process of framing a budget each minister strove to secure for himself as large as possible a share of the total expenditure vote, for this in a sense, was a measure of his success. In the result the final budget was less the expression of an agreed scheme of priorities than the product of innumerable pulls and pressures in which strength of personality and political prestige were substantial factors.

237. Detailed studies of the Donoughmore Constitution are to be found in *The Legislatures of Ceylon* by S. Namasivayam, Faber and Faber 1951, and *Government and Politics in Ceylon* 1931–1946 by J. D. S. Weerawardene, Ceylon Economic Research Association, Colombo 1951.

It is generally admitted, however, that in spite of its shortcomings the Donoughmore Constitution worked well. The difficulties in the way of framing and implementing a common policy and the emphasis that was placed on the individual minister did not erase entirely the sense of a unity of purpose. The desire to utilise the newly acquired power to the benefit of the people was perhaps universal. An emphasis on social expenditure is a feature common to most popularly elected governments. In Ceylon the pressure was specially severe with the growing intensity of nationalism, the sudden introduction of universal suffrage and above all with the extreme levels of poverty and economic backwardness. The tendency to expand as rapidly as possible the health and educational services of the country and expenditure on national development were thus features to be expected from the newly elected State Council and Board of Ministers.

At the present time it is usual for economists and prudent administrators to caution the governments of economically underdeveloped countries against a premature expansion of the services of the welfare state. In this connection the attitude of the Donoughmore Commissioners stands somewhat in contrast. They were stuck by the lack of attention being paid to the welfare of the mass of the population and believed that the introduction of universal franchise would go some way towards remedying this defect. In fact they pointed to the neglected condition of the people as evidence of the need for universal adult suffrage – "In view of the backward character of social and industrial legislation in Ceylon, which has no provisions for relieving destitution, no workmen's compensation, only the most elementary of factory regulations, and no control over hours and wages in sweated industry, a good case can be made out for regarding the extension of the franchise as more urgent than any increase of responsible government."[238] Whilst it may be admitted that with the Commissioners the stress was probably on legislation rather than expenditure[239] it is difficult to blame the

238. Cmd. 3131 Ceylon: *Report of the Special Commission on the Constitution H.M.S.O.* 1928 p. 83.

239. That expenditure on social improvements was also in the minds of the Commissioners is indicated by the following passage: "Ceylon has come to an important and even critical stage in its history. The absence of social and industrial legislation is no doubt due largely to the important place which feudal ties, family help and private charity have always occupied in Ceylonese society. Modern development by which Ceylon has been affected has tended to make domestic and private charity unequal

elected representatives of the people if, in their zeal to fulfil the mission that had thus been entrusted to them, they remained unmindful of the distinction.

These political changes with the stimulus they provided for an expansion in the social services and public expenditure, together with the underlying stagnation in the long term development of the economy and the continued increase in population, set the background before which the budgetary policy of Ceylon had to function in the years of the Great Depression.

(b) The scope for overall budgetary policy

It is hardly necessary to preface this study of budgetary problems in the depression with a reminder that the ideas of financial orthodoxy were deeply ingrained in the traditions of public finance in the Colony. The ability to balance the budget was almost universally looked upon as a measure of the competence of the administration. In the exceptional years during which current expenditure exceeded current revenue the resulting deficit was financed in the most conservative of manners. The outlook of responsible opinion is aptly summarised in the statement of an officially appointed commission of investigation written in the worst year of the depression: "It is unthinkable that we should borrow to meet current expenditure. That would be to saddle posterity with the cost of the present administration of the country and no statesmen worthy of the name could adopt such a course opposed as it is to all principles of sound finance."[240]

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to the solution of the economic problems of these days and especially of those which beset cities like Colombo and Kandy. Although Ceylon has not become industrialised, and is never likely to be largely so, there is already evidence of gaps which have been left in the social structure by the absence of any poor law system, of workmen's compensation, of up-to-date factory legislation, of proper or even decent housing for certain sections of people, of control over sweated trades or adequate facilities for primary education. We feel that the new constitution must be such as will give scope to the people of Ceylon, through their own representatives to remove any reproach which the absence of such provision brings" – Report *op.cit.*

It is hardly surprising that the Board of Ministers were led to cite this passage in 1939 in defence of their expenditure and revenue policy – cf. S.P. II of 1939 p. 34 – "Memorial to the Secretary of State dated January 7th 1938 and connected despatches on the subject of increased taxation." February 1939.

240. S.P.XII of 1932. Interim Report of the Salaries and Cadres Commission, August 1932. p. 3.

It is by no means certain, however, that it would be fair to condemn the budgetary policy of the Ceylon Government during the depression on the grounds of its adherence to the tenets of what is now regarded as mistaken orthodoxy. First, it should be remembered that the theory of balanced budgets was commonly held and implemented in most countries of the world including the United Kingdom. Second, it must be noted that even if the Board of Ministers had wished to pursue a more sophisticated policy of 'functional finance' it would not have been able to do so because it lacked the means or the techniques to implement such a policy. Finally, even if the Minister had both the desire and the techniques it is by no means clear that such a policy would have been basically appropriate to the special conditions of the Ceylon economy.

The ability to carry out a policy of deficit finance was severely limited by a number of factors of a technical nature. The financing of a deficit by the direct printing of notes was of course prohibited by the currency laws of the country which permitted no fiduciary issue whatsoever. Alternately the scope for deficits financed through credit creation by the banking system was also restricted through the rigidity of the hundred per cent exchange standard. It has already been mentioned that the experience of the banking system has prompted it to maintain a substantial reserve of cash (in the form of currency notes) against deposits. If it was to alter its policy and lend to the Government through the creation of deposits against government paper its reserve ratio of currency to deposits would fall. Once the newly created deposits are spent by the Government, and cheques drawn by the latter on the banks are received by the public, the demand for conversion into cash would have resulted in a severe drain on the cash reserves of the banking system. In the absence of a central bank to which the latter could turn, and with the inability of the Currency Board to issue notes against Ceylon Government paper, the banking system of Ceylon would have found no escape from their difficulties and would hardly have succeeded in surviving.[241] For these reasons it will readily be apparent that deficit financing by the Government through credit

241. Apart from the extent to which they could have drawn on their head offices in London. It is hardly likely, however, that the head offices would have permitted their Ceylon branches to get themselves into a position which would require such assistance.

creation was not a feasible solution. The remaining alternative was borrowing from the public. But with the general decline in incomes throughout the community it is extremely doubtful whether substantial sums could have been made available in this way even at fairly high rates of interest. To the extent that banks are the most important contributors to Government loans the attempt at public borrowing would have run up against the same difficulties we have just discussed unless the loans to Government were offset by a reduction in the loans to private borrowers. In this case, of course, the benefits of the Government deficit would be negatived by the corresponding fall in private investment.

Apart from the technical difficulties of financing the deficit, the wisdom of a policy of deficit finance is by no means obvious. During the depression there was, as we have seen, evidence to suggest that Ceylon was running down her foreign reserves. Any policy of deficit finance would clearly have led to a further aggravation of the balance of payments position. It is, of course, possible to argue that some of the reserves that were immobilised by the rigidity of the exchange standard could have been usefully released for this purpose. But apart from being beyond the power of the Ceylon legislature, this expedient would have been effective only as long as excess reserves were still available. Once the reserves were exhausted it would have been impossible to maintain the stability of the exchange rate unless strict import control was instituted. But import control coupled with the budget deficit would have resulted in an inflationary rise in prices and a further deterioration in the position of the export industries through an increase in the costs of production.

It may perhaps be added here that exchange depreciation too was quite incompatible with the currency laws of the country. We have shown that under the Paper Currency Ordinance of 1884 the unit of currency in Ceylon was not a separately constituted Ceylon rupee but rather the Indian silver rupee coin, which was unlimited legal tender in the country, and against which Ceylon rupee notes were issued at par. The only way Ceylon could have experienced a depreciation of her currency vis-a-vis the rest of the world excluding India would have been through a depreciation of the Indian rupee, and as long as the latter was fixed in sterling Ceylon could only experience depreciation relative to the rest of the world other than

India, the United Kingdom, and countries linked to sterling, through a depreciation of sterling. Since most of her trade was done with India, the United Kingdom, and the sterling area countries, the benefits of such limited depreciation would certainly have been small. This is not to say that depreciation, had it been possible, would have proved a solution to Ceylon's problems. The pros and cons of depreciation cannot be detailed here. But the important considerations in this connection are, first, that depreciation was unlikely to have helped the balance of payments position substantially both because the demand for imports tends to be price inelastic and the world prices of such products as rubber and coconuts are hardly influenced by supply conditions in Ceylon; and second, that the improvement depreciation would have caused in the rupee incomes of producers in the export sector would have been substantially offset by an increase in wages and costs brought about by the rise in import prices.

We may now turn to an examination of the Government's budgets during the depression. It will be useful at the outset to remind ourselves of the so-called "colonial approach" which characterised the process of budget making in Ceylon in earlier times. In accordance with this outlook, changes in taxation or in tax rates were few and far between. Each year expected revenue under existing tax rates was estimated in advance and the central task of budget making was the adjustment of expenditure proposals to fit in with this expected revenue. This approach was in contrast with the practice in the United Kingdom and elsewhere where expenditure was first assessed according to public needs and taxes then adjusted to secure the necessary revenue. This latter system, of course, allowed somewhat greater scope for the exercise of the art of budget making which consisted in extracting a given revenue with the minimum of hardship to the community. It is true that some modification of the 'colonial approach' to budgeting took place during the lifetime of the Donoughmore Constitution. But at the same time it was an influential background factor in the processes of budget making in the years of the depression.

The central features of public finance in the depression were the decline in revenue and the attempts of the Government to sustain it, the cuts in expenditure that were made in the effort to balance the budget, and the means whereby the deficits were financed when budgetary balance was not secured. We shall, in the succeeding pages, briefly examine these features in turn.

(c) The Revenues of the Ceylon Government

As early as 1928 the Government of Ceylon had become aware of a basic alteration in the financial position of the country.[242] The period of buoyancy in the Government revenues which reflected the expansionary phase of the whole economy was coming to an end and special care was now necessary to restrain the excessive growth of expenditure. In fact the revenue of the Government had to be actively augmented by the levying of increased customs duties during the financial year 1928–29, in order to contribute towards the balancing of the budget.[243] When the depression came in, the background was thus already unfavourable.

The true impact of the depression on the revenues of the Government is largely concealed in the figures of realised revenue as given in the official returns. We have already illustrated the severity of the fall in money incomes in the various sectors of the economy. The annual revenues of the Government, on the other hand, as shown in the returns do not exhibit quite the same degree of fluctuation. Indeed apart from the financial year 1931–32, total Government revenues in the years of the depression did not differ very markedly from the annual revenues of the immediate pre-depression years. The maintenance of the revenue in the face of the general economic difficulties of the period was in fact the combined result of fortuitous circumstances, increases in taxation and emergency measures of a desperate character. As the revenue predictions for each year at the time of budget making held out the prospect of further contraction, the authorities, in keeping with

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242. A warning was sounded by the Governor on his addresses to the Legislative Council in 1928 and 1929. The Acting Colonial Secretary introduced the Supply Bill for 1930–31 with the following words: "I will begin by recalling to the House the financial position of a year ago when I introduced the budget of the present year. At that time after a period of continued prosperity we awoke to the realisation of the fact that a period of lean years was before us. We had during the years of plenty accumulated large surplus balances which had encouraged us to spend freely with the result that the expenditure had grown more rapidly than our income, we found these surpluses greatly depleted and disappearing, and we were faced with the necessity for raising additional revenue by fresh taxation." Hansard 10th July 1930, p. 999.

243. Customs duties on imports were increased by one-twentieth with effect from July 5th 1929 – *Annual Colonial Reports: Ceylon* 1929 No. 1507. H.M.S.O. 1930 p. 4. A tax of 3½% on totalizer bets on horse racing was introduced with effect from 4th August 1930 – Ordinance No. 9 of 1930, Betting on Horse Racing (taxation) – Annual Colonial Reports 1930. Postage rates on letters and post cards were increased from October 1st 1929 – *ibid.*

tradition, strove as far as possible to curtail expenditure. When the cuts in expenditure were carried to their apparent limits and a deficit was still in prospect, extreme measures were resorted to in order to augment revenue.

Emergency and Windfall Receipts

Of all the receipts of an extraordinary character which helped to sustain the revenues of the Government, monies accruing from an item described as 'recoveries from loans' were the most important, particularly in the early years of the depression. Thus in the financial year 1929–30, the first year of the depression, 'recovery from loans' brought in Rs. 7.4 million into the revenue, and in the following year 1930–31 no less than Rs. 13.9 million was provided from this source. Again in the financial year 1936–37 a further Rs. 13.8 million was secured from the same item.

The explanation for this somewhat remarkable feature lies in the practice of meeting expenditure on works chargeable to loan funds out of current revenues pending the actual raising of the loans. It is the normal custom for the Government to finance works of a capital nature, which are likely to yield a net return, out of borrowed monies. Once these loan financed expenditures receive legislative sanction through the Appropriation Bill, work on the specific projects is allowed to commence if they can be temporarily paid for out of current revenue. Once the loans are actually raised the revenue is refunded with the sums advanced in this way. The accrual to revenue of a total amount of Rs. 21.3 million in the two financial years 1929–30 and 1930–31 was the result of a refund made out of the proceeds of a loan raised in the United Kingdom in these years under an Ordinance of 1929.

The classification of these recoveries from loans as current revenue in the official accounts is apt to confuse. Although the decision to borrow was taken before the depression the actual spending of borrowed monies took place in the years of the depression. As a result of this borrowing expenditure was maintained at a higher level than would otherwise have been possible. In order to give a truer picture of the budget deficit amounts accruing out of 'recoveries from loans' should therefore be properly excluded from the classification of current revenues. Moreover, the practice of lumping into a single year's revenue an aggregate amount representing the sum of numerous advances made over a period of years to loan works would normally lead to violent fluctuations in total revenue. It so happens that in the years under consideration this practice actually imparted an element of stability to 'revenue' and therefore to expenditure, but this result was accidental and due to the downward movement of normal revenues on account of the depression.

In the years of the depression there were other extraordinary receipts of a different kind. When the budget for the financial year 1931–32 was being prepared there were no fortunate coincidences such as recoveries from loans in prospect. Drastic measures were needed to augment the revenues. Preparations were made to rush through a Bill to introduce income tax which had been turned down by the previous Legislative Council at its third reading. But such a measure required time and in the interval more immediate steps were necessary. Of these the imposition of a temporary levy on the salaries of public servants was notable. The levy was enforced from February 1st 1932 until September 30th 1934. It consisted of a simple percentage charge varying progressively with the range of salary. Thus the rates of recovery were 10 per cent on salaries of Rs. 4,800 per annum and over, 7½ per cent on salaries between Rs. 4,800 and Rs. 900, 5 per cent on salaries between Rs. 900 and Rs. 450 and 2½ per cent on salaries below Rs. 450.[244] The temporary levy on salaries may, of course, be looked upon as a reduction in expenditure rather than as an increase in revenue. In fact, however, the savings from this source were added to the revenue side of the accounts. It yielded a sum of Rs. 1.7 million in the financial year 1931–32 and Rs. 2.5 million in each of the financial years 1932–1933 and 1933–34, totalling Rs. 6.7 million in the three years.[245]

Further emergency measures came in with the budget for 1932–33.

These were:

(a) The appropriation to general revenue of the whole of the balances standing to the credit of the railway renewals fund and the Colombo Electricity Supply depreciation fund

244. *Administration Report of the General Treasury for* 1936 p. J21.
245. *Annual Report of the Auditor General for* 1934 *and* 1935.

bringing in Rs. 2.1 million and Rs. 1.6 million, respectively. This was justified on the ground that the railway had failed to fulfil an undertaking to make an annual payment to the revenue representing interest on its capital.

(b) Drastic reduction of the provision to meet depreciation of railway assets in 1932–1933 to the bare sum required for expenditure on renewals in that year, and omission of all provision to meet depreciation of the assets of the Colombo Electricity Supply in 1932–33.[246] "Reduced provision amounting to Rs. 519,850 has been made for depreciation in the Railway Estimates and no provision at all for depreciation has been made in the Colombo Electricity Supply Estimates. In consequence, a sum of over Rs. 1,000,000, which would otherwise have gone out of Railway and Colombo Electricity Supply Revenue to meet depreciation will be available for payment into general revenue on account of interest in the case of the railway and on account of net revenue in the case of the Colombo Electricity Supply."[247]

In addition to the emergency measures the revenue for 1932–33 was blessed with a windfall item of a remarkable character which was not budgeted for. This was the sudden and spectacular increase in the revenue from estate or death duties. The financial year 1932–33 apart, the annual revenue from Estate duties during the whole period 1925–26 to 1944–45 only once yielded even the modest sum of Rs. 2 million. In 1932–33, however, when the depression in the export trades had barely passed its trough and imports were at their lowest level the revenue from Estate Duties reached the record figure of Rs. 9.3 million. Rs. 8 million of this came from a single source – the tax on the property (mostly tea estates) of Lord Inchcape who had died in 1932. This unexpected gain, together with the revenue from the newly introduced income

246. Railway accounts were separated from the General Revenue and Expenditure Statements after the financial year 1927–28 and Electricity accounts after the financial year 1929–30. The revenue and expenditure of the Colombo Electricity Supply and the Railway Department, however, form the subject of two separate budgets which are laid before the State Council with the Annual Appropriation Bill. The appropriation of the revenues of these departments is effected by means of separate schedules to the Annual Appropriation Bill. cf. Hansard 4th October 1932. *Report of the Board of Ministers on the Appropriation Ordinance* 1932–33. p. 2417.

247. *ibid.* Payments to the Electricity Depreciation Fund were resumed during 1933–34 – Hansard. 1st August 1933. p. 1313.

tax, helped revenue to rise to a figure well in excess of the level of the previous year, although the general recovery of the economy as a whole had hardly begun.

When the budget for the financial year 1933–34 was being considered economic recovery was in progress and no new emergency measures were initiated. The revenue for that year was, however, augmented by a windfall gain in the shape of Rs. 4.3 million representing the transfer to revenue of the surplus in the sinking fund of a loan raised in 1880 which was then redeemed.[248]

The last of the exceptional receipts that came into sustain total revenue occurred in the financial year 1936–37 when a sum of Rs. 13.8 million was refunded to revenue in reimbursement of the cost of works already met from revenue pending the floating of a local loan in 1937.[249]

The apparent stability of Government revenues is found to be misleading once allowance is made for fortuitous receipts and emergency measures. This is seen from the table appearing on page 125 even though no correction has been made for increases in taxation.

Changes in Taxation

We may now turn to the attempts of the Government to sustain revenue by changes in taxation. The decline in incomes and expenditure caused by the depression had led to a fall in the yield of various sources of revenue with tax rates unchanged. The only ways to improve revenue in these circumstances were either the introduction of new taxes or the increase in the rates of the old ones.

The severity of the problem was enhanced by the fact that in the case of one important source of revenue – that of export duties – taxes had to be lowered and in some cases abolished altogether. In an address to the first meeting of the newly constituted State Council in 1931 the Governor announced that he had, in view of the urgency

248. Hansard. 1st August 1933. p. 1430. *Report of the Board of Ministers on the Appropriation Ordinance for* 1933–34. The loan in 1880 was a sterling loan of £1,076,100 raised at 4%.

249. Hansard. 28th July 1937. *Report of the Board of Ministers on the Appropriation Ordinance for* 1937–38.

Abnormal items on the Revenue Accounts 1929–30 to 1936–37
(Rs. million)

A Year	*B* Description	*C* Total	*D* Total Current Revenue	*E* Normal Revenue (D-C)
1929–30	**Windfall:** Recovery from loan Rs. 7.4 million	7.4	110.9	103.5
1930–31	**Windfall:** Recovery from loan Rs. 13.9 million	13.9	101.8	87.9
1931–32	**Emergency measure:** Temporary levy on public servants – Rs. 1.7 million	1.7	84.8	83.1
1932–33	**Emergency measures:** Appropriation of Railway and Electricity Appropriation Funds – Rs. 3.7 million. Transfer from Railway and Electricity Revenues – Rs. 1.0 million. Temporary levy on public servants – Rs. 2.5 million **Windfall:** Duty on single Estate – Rs. 8.0 million	15.2	106.1	90.9
1933–34	**Emergency measure:** Temporary levy on public servants – Rs. 2.5 million **Windfall:** Surplus in Sinking Fund– Rs. 4.3 million	6.8	104.1	97.3
1934–35	—	—	99.0	99.0
1935–36	—	—	102.8	102.8
1936–37	**Windfall:** Recovery from loan – Rs. 13.8 million	13.8	119.2	105.4

of the situation, acted upon powers conferred on him by the constitution to remit altogether the duties payable on exports of rubber and coconut produce.[250] In the following year the State Council sanctioned a reduction in the export duties on tea and cacao as well. In this case, however, relief to the industries concerned was not the sole motive for the change.[251] The Income Tax Ordinance[252] had been enacted in that year introducing income taxation into Ceylon for the first time. Provision was made in that ordinance to afford some relief to agricultural industries from being doubly taxed on account of having to pay both export duty and income tax. According to sections 31 and 32 of the Ordinance relief was to be granted to agricultural products which were subject to export duty as long as the rate of duty was not less than four-fifths of the rate in force on January 1st 1931. In the case of tea

250. *Hansard* 1931.

251. cf. *Hansard,* March 15th, 1933. p. 878 et seq. – Observations and speech by Financial Secretary on the proposed reduction of export duties.

252. Ordinance No. 29 of 1932, taking effect from 1st April 1932.

any person liable to income tax was to be granted on application to the Commissioner of Income Tax a sum calculated at the rate of 85 cents per 100 lbs. of tea manufactured by him. In the case of other products the relief was to take the form of a reduction of income tax to the extent of 3 per cent of the income from the cultivation of such products. These provisions in the Ordinance were, however, in the nature of secondary safeguards. The intention was that the export duties themselves should be reduced with the introduction of income tax.[253] Accordingly, the duties on tea and cocoa, which were the only remaining products subject to the 1931 rate, were reduced with effect from 1st April 1932. The duty on tea was brought down from Rs. 3.14 to Rs. 2.51 per 100 lbs.[254] (which was one-fifth of a cent less than four-fifths of Rs. 3.14). The duty on cacao was reduced from Rs. 1.00 to 75 cents per 100 lbs – which was below four-fifths of Rs. 1.00 by 5 cents. Eventually (with effect from 4th October 1934) the export duty on cacao was abolished altogether.

The effects of these remissions and reductions and other factors in the revenue from export duties are detailed in the following table (See p. 127).

In the face of the urgent difficulties facing the Government and the desire to balance the budget as far as possible, it was inevitable that taxation itself would, wherever feasible, be increased. The efforts to increase taxation were, in the main, confined to two important measures. These were (a) the introduction of income tax for the first time in Ceylon in 1932, and (b) the increasing of import duties over a very wide range of articles.

(a) The introduction of income tax into Ceylon in the depression was coincidental to the extent that the step had been contemplated and even carefully prepared in the years prior to the depression. A specialist from the United Kingdom had previously been invited to report on the possibility of establishing an income tax. In a

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253. *Hansard*, March 15th, 1932. p. 878. op.cit. Observations and speech by Financial Secretary on the proposed reduction of export duties.

254. The aggregate export duty on tea of Rs. 3.14 per 100 lbs. on January 1st 1931 consisted of a customs duty of Rs. 2.85, a duty levied under Section 28 of the Medical Wants Ordinance, No. 9 of 1912 of 15 cents, and a duty of 14 cents levied under the Tea Research Ordinance of 1925 (as amended by Ordinance 12 of 1930). The reduction of the aggregate duty to Rs. 2.51 per 100 lbs. on 1st April 1932 consisted entirely of a reduction in the customs duty from Rs. 2.85 to Rs. 2.22 – ibid. p. 879.

YIELD OF EXPORT DUTIES 1928–29 TO 1938–39

(Rs., 000)

Financial Year	1928–29	'29–30	'30–31	'31–32	'32–33	'33–34	'34–35	'35–36	'36–37	'37–38	'38–39
Total Revenue from export duties	11,846	11,644	9,830	6,359	5,148	4,883	4,580	4,561	4,052	4,027	3,345
Percentage of total Government revenue	—	10.5	9.6	7.5	4.8	4.7	4.7	4.5	3.5	3.5	—
Overall rate of export duty	2.9	3.7	4.3	3.8	2.8	2.0	2.0	1.8	1.3	1.5	1.1
Yield of duty on:											
(i) Tea	—	6,934	7,003	5,980	4,786	4,856	4,595	4,363	4,276	3,685	—
(ii) Rubber	—	2,564	927	—	—	—	—	—	—	—	—
(iii) Coconut products	—	1,885	658	—	—	—	—	—	—	—	—
(iv) Cacao	—	78	73	66	44	41	—	—	—	—	—
(v) Other	—	32	18	15	12	10	13	18	15	9	—

Source: Annual Blue Books.

Note: The discrepancy between the figures for total revenue from export duties and the sum of the individual items is due, apart from rounding, to the inclusion in the tea export duty of yields from levies imposed under Tea Research and Medical Wants Ordinances.

The overall rate of export duty has been obtained by dividing the value of total exports each year by the total revenue from export duties in the same year.

report published in 1930[255] the adviser indicated that income tax could be levied in Ceylon without undue difficulty and appended a draft ordinance. This draft ordinance with certain amendments was introduced into the old Legislative Council on February 28th 1930; it passed its first and second readings and was referred to a select committee which adopted various modifications. But after passing through the committee stage the Bill was rejected at the third reading on December 17th 1930. Fresh attempts to enact the measure had to await the inaguration of the new State Council in 1931. In November of that year the Bill as rejected by the Legislative Council was introduced into the State Council and passed, with certain amendments, on February 9th 1932. The tax itself was imposed from April 1st 1932.[256] The Bill naturally aroused widespread interest and controversy and one of the important reasons for the delay in enacting it was the insistence by the legislature on amendments which were unacceptable to the Government. Due share must be given to the sense of urgency caused by the depression in securing the reconciliation of the opposing viewpoints.[257]

The Income Tax Ordinance intended (section 20) that Rs. 2,400 per year be the minimum limit at which assessable income would be exempt from taxation. But, because of the administrative difficulty of assessing incomes in the lower ranges before the Income Tax Department was fully organised, it provided for an exemption limit of Rs. 4,800 which applied during the first three financial years 1932–33 to 1934–35. Thereafter in 1935–36 it was lowered to Rs. 2,400 at which it remained unchanged for a long period until 1950–51 when the Rs. 4,800 limit was once more restored.

The rates of taxation remained unchanged from 1932–33 until 1937–38. The unit rate of tax payable by resident individuals

255. S.P.IV of 1930 – *Report of the Income Tax Adviser.*

256. vide – Administration Report of the Commissioner of Income Tax for the year to March 31st 1933. p. (1).

257. The Bill as passed by the State Council in February 1932 did not exempt interest on existing Government loans, (save those of 1929 and 1930 whose prospectus specifically promised such exemption) from income tax. This feature was carried by the legislature in spite of official opposition. Whilst, assenting to the Bill, however, the Governor informed the State Council of the intention to introduce an amending bill specifically providing such exemption. The Amending Ordinance (No. 7 of 1932) was passed by the Council and became law on March 21st 1932. *ibid.* p. 1. *Hansard* 1932.

liable to income tax was fixed at 5 per cent but this was confined to the first Rs. 6,000 of their incomes. The rate was graduated upwards for higher slabs of income.

The introduction of the income tax was a timely and vital factor which helped to sustain the revenue of the Government during the most difficult period of the depression. The importance of its contribution is clearly revealed by a glance at the chart facing page 135.

(b) A substantial increase in the import duties was brought into effect from February 20th 1932[258] for the declared purpose of raising further revenues to balance the budget. The aim was to raise a further sum of about Rs. 10 million in a full year. The duty on imported rice, however, which was one of the chief contributors to the revenue, was not to be raised although it was estimated that a sum of Rs. 4 million could be added by raising the duty to a level which meant an increase of half a cent per measure on the retail price of rice. The raising of the duty on rice was ruled out because on the one hand it had been increased in 1928, and, on the other, neither the Board of Ministers nor the State Council elected on universal franchise were likely to approve of it.[259]

There were three sets of commodities figuring in the import tariff before the change: a) Commodities paying ad valorem duties.

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258. The basic law under which import duties were levied was the Customs Ordinance No. 17 of 1869. At a given moment the import tariff in force consists of a schedule which is attached to this Ordinance. This schedule could be altered and varied by a resolution of the legislature approved by the Governor and the Secretary of State for the Colonies. The effect of such a resolution is to substitute a new schedule for the one already existing, or to modify an existing schedule – cf. Financial Secretary in *Hansard,* February 11th 1932. p. 471.

259. cf. Letter from the Board of Ministers to His Excellency the Governor dated July 14th 1932: "The suggestion that has been made by the Financial Secretary, that an additional duty of fifty cents may be imposed on imported rice, is based solely upon the present price of rice which is certainly cheaper than it has been for the past two or three decades. But he overlooks the important fact that even if the cost of rice has fallen 50 per cent, the earning capacity of the people who use rice as their staple article of food has fallen much lower, and in the case of thousands thrown out of employment as a result of the economic depression, it has dwindled almost to nothing. At this time of widely prevalent want, when large numbers, specially in towns like Colombo, are dependent on private or public charity, it is impossible to contemplate with equanimity even the smallest addition to the cost of rice as a result of increased taxation." S.P.V. of 1933, "Correspondence between the Board of Ministers and the Governor, and His Excellency the Governor and the Secretary of State relating to the Appropriation Bill, 1932–33" pp. 6–7.

The general basic ad valorem rate was 10 per cent. Some articles enjoyed special rates of either $2\frac{1}{2}$ per cent or $7\frac{1}{2}$ per cent; b) Commodities paying specific duties; and c) A free list. The increase in the duties in 1932 was brought about by raising the general basic ad valorem rate from 10 per cent to 15 per cent, by abolishing the special $2\frac{1}{2}$ per cent and $7\frac{1}{2}$ per cent rates, by increasing the specific duties on the chief articles subject to them, and by revising the free list.

The increase in duties covered substantially the whole range of imports with the exception of rice and coal.[260] Important raw materials which were previously either free or charged at the minimum $2\frac{1}{2}$ per cent rate were now paying 5 per cent. These included acetic acid, cotton yarn and twist, tea chests, tea shooks, raw cotton, manures, paper for printing and writing and unmanufactured tobacco. Machinery, previously taxed at $2\frac{1}{2}$ per cent, was now charged 10 per cent ad valorem. 'Necessities' such as sugar, cotton piece goods, kerosene oil, curry stuffs and dried fish and flour suffered varying increases in rates. 'Luxuries' like satin and artificial silk were raised from 10 per cent to 20 per cent and playing cards, clocks and watches and musical instruments from 10 per cent to 30 per cent.[261]

The increase in the rate of taxation on imports in general can be obtained by simply dividing the annual values for total imports by the corresponding revenues from import duties. Unfortunately an accurate representation is impossible because import statistics relate to the calendar year whereas the revenue statistics cover only the financial year from October 1st to September 30th. Nevertheless, by ignoring the distinction a rough idea of the change in the rate of taxation of imports can be obtained.

The effective rate of taxation on imports was more than doubled as between the immediate pre-depression period of the late 'twenties and the hard years of the depression in the early 'thirties. It must be emphasised, however, that the whole of this increase in the effective rate is not the result of the passing of import duties by

260. Coal was left untaxed because four-fifths of imports were used for bunkering ships in the Colombo Harbour. cf. *Hansard,* February 11th 1932. p. 475.

261. *ibid.* p. 470 to 471.

Year				Rate of taxation of imports
1925–1926	..	..	..	9.2
1926–1927	..	..	..	9.4
1927–1928	..	..	..	10.1
1928–1929	..	..	..	10.2
1929–1930	..	..	..	13.2
1930–1931	..	..	..	15.4
1931–1932	..	..	..	18.5
1932–1933	..	..	..	21.8
1933–1934	..	..	..	20.3
1934–1935	..	..	..	20.3
1935–1936	..	..	..	22.3
1936–1937	..	..	..	20.6
1937–1938	..	..	..	21.1
1938–1939	..	..	..	21.4

legislation in the financial year 1932–33. The effective rate of taxation can change even if the Customs schedule remains unaltered. This is shown by the figures above since the effective rate of taxes on imports was increasing even before the legislative changes of 1932. There are a number of possible reasons which explain this. First, where the import duty is levied ad valorem the effective rate of taxation may increase if there is a shift in the distribution of expenditure upon imports from commodities which are subject to low ad valorem rates to commodities which carry high ad valorem rates. In this case the fall in the revenue from import duties will be less than proportionate to the fall in the value of the imports. This explanation, however, does not seem adequate to account for the increase in the effective tax rates on imports in Ceylon. Most of the commodities which were subject to relatively high ad valorem duties were nearer 'luxuries' than 'necessities' and it appears reasonable to suppose that the income elasticity of demand for them was high. An alternative explanation seems more plausible. A substantial and major proportion of the imports of Ceylon consist of goods which are subject to duties levied not at ad valorem but at specific rates. These commodities which include rice and grain, sugar, kerosene oil, petrol, dried fish, curry stuffs, flour and unmanufactured tobacco, are the major contributors to the revenue from import duties. To the extent that the fall in the value of these imports was due to a fall in their prices rather than in the quantities purchased, the revenue from the specific duties on imports must fall less than in proportion to their value. It is a fact that the average value of the index of import prices was lower in Ceylon than the average of the index of import volume during the depression.

This was specially so in the case of rice imports where the fall in prices was notable. It seems, therefore, fairly safe to conclude that the increase in the effective rates of taxation on imports in the depression was due to the existence of specific duties on important commodities whose prices fell to a greater extent than quantities imported. It is useful to note here that the opposite result – a reduction in the effective rate of taxation – is likely to take place in boom conditions when the rise in prices is generally greater than the increase in quantities imported.

The result of all these factors, which helped to keep the revenue from import duties at a high level, was to increase still further the normally dominant role of import duties in the revenue structure of Ceylon. This is clearly shown in the following table which also sets out the contributions to revenue from the chief commodities subject to import duties. (see page 133).

All the factors discussed above, viz. the windfall receipts, the emergency measures taken to support revenue, the introduction of the income tax and the increase in the customs tariff, tended to obscure the intimate relationship between the revenues of the Ceylon Government and the earnings of the export sector. Thus whilst the (calendar) year 1929 represented the turning point in total export values, the turning point in Government revenues was not reached until the financial year 1929–30 (which includes the first nine months of the calendar year 1930 and only the last three months of the calendar year 1929). In fact, however, as we have seen, the total revenues for 1929–30 and for 1930–31 included windfall items by way of recoveries from loans. Once the revenue figures are corrected by deducting these items the correspondence between exports and Government revenues is remarkably close. The accompanying chart and the table on page 135 attempt to represent for purposes of comparison the movement of the "normal" revenues of the Government. The emergency and windfall items are deducted from the revenue aggregates; in addition the yield from the income tax and the estimated increase of Rs. 10 million in the annual yield from import duties are excluded from the financial year 1932–33 onwards.[262] It must be emphasised, however, that

262. Only Rs. 5 million has been deducted in the financial year 1931 – 32 since the revised duties came into force on February 20th 1932. This was the official estimate of the yield of the new duties for the remainder of that financial year.

YIELD OF IMPORT DUTIES 1928–29 TO 1937–38

(Rs., 000)

Financial Year	1928–29	'29–30	'30–31	'31–32	'32–33	'33–34	'34–35	'35–36	'36–37	'37–38
Total revenue from import duties	40,900	39,818	33,528	36,168	38,640	44,033	46,147	47,790	49,983	52,153
Percentage of total Government revenue	38.0	35.5	33.4	42.5	36.4	42.3	46.5	46.5	42.0	46.0
Yield of duty on grain	—	9,872	9,214	9,351	9,280	10,102	11,429	10,992	10,782	10,955
Kerosene oil and motor spirits	—	6,945	5,625	7,225	6,733	7,883	8,271	7,687	10,215	11,096
Sugar	—	5,061	5,003	5,475	6,478	7,058	7,541	8,118	8,179	7,955
Malt, liquor, wines and spirits	—	3,292	2,714	1,861	2,078	2,730	2,473	2,507	2,686	2,547
Cotton manufacturings	—	888	740	1,251	1,024	1,397	1,226	963	1,065	1,009
Tobacco and cigarettes	—	—	—	—	—	—	—	—	3,864	3,370
Other	—	12,304	9,381	12,765	13,188	16,579	16,158	16,087	15,44[illegible]	13,881

Source: Annual Blue Books

the corrections for increases in taxation are only rough approximations. The increases in the rates of import duties were expected to bring in an additional Rs. 10 million in a full year. Even if this estimate was realised it was meant to apply to a year of acute depression. It is more than likely that larger sums were produced in the subsequent period of recovery since the increased rates of import duty were still maintained. On the other hand it is possible that the export duties on tea and cacao would have remained unchanged had income tax not been introduced in 1932. No allowance has been made for these factors in the figures on page 135 and it is possible that the revenue figures as corrected for increases in taxation are somewhat overstated in the years of recovery.

It is clear that the efforts of the Government to sustain the revenues produced substantial results from the financial year 1932–33 onwards. In that year the depression in exports had barely begun to show signs of improvement. The total value of exports was still Rs. 223 million below the corresponding value in 1929. Yet total government revenue was only Rs. 1.7 million behind the 1928–29 figure. We have already seen how this was achieved. Of the total revenue of Rs. 106.1 million, Rs. 8 million was a windfall in the shape of death duty. Rs. 7.2 million of the remainder was provided from the "raids" on the railway and electricity funds and revenues and from the levy on public service salaries. The new income tax brought in a further Rs. 8.6. million and the increased import duties presumably contributed another Rs. 10 million. The emergency measures, the income tax and the new customs duties together added approximately Rs. 25.8 million or 26 per cent of the total revenue exclusive of the windfall items. This certainly was a substantial factor which helped in the task of balancing the budget, for the total revenue of the Government was raised from a probable figure of about Rs. 72.3 million in 1932–33 to a realised sum of Rs. 106.1 million.

(d) Government Expenditure in the Depression

Since the Government of Ceylon was firmly tied to the principle of attempting to balance its revenues and expenditures, it was inevitable that a reduction in expenditure would take place in the depression. Moreover, as the "Colonial approach" to budgeting was as yet a prevalent feature it was to be expected that the cuts in expenditure would precede the measures adopted to increase

REVENUE OF THE CEYLON GOVERNMENT 1928–29 TO 1938–39

Year	1928–29	'29–30	'30–31	'31–32	'32–33	'33–34	'34–35	'35–36	'36–37	'37–38	'38–39
1. Total revenue (Official accounts)	107.8	110.9	101.8	84.8	106.1	104.1	99.0	102.8	119.2	113.3	116.9
2. Total revenue less emergency and windfall receipts	107.8	103.5	87.9	83.1	90.9	97.3	99.0	102.8	105.4	113.3	116.9
3. Total revenue as in (2) less increases in taxation	107.8	103.5	87.9	77.9	72.3	80.7	81.2	93.3	96.4	89.8	89.6

revenues. The sequence was, in fact somewhat as follows. As revenues decline attempts are made to bring expenditure into line. The first line of attack is to obtain a seeming balance between current revenues and current expenditures by transferring certain items of capital expenditure from the current expenditure account to the loan account. If this measure is nevertheless inadequate to secure a balance, attempts are made to bring about a real reduction in expenditure. Expenditure on new projects is first curtailed and this is accompanied, or rather followed, by economising on maintenance charges. A stage is eventually reached when expenditure becomes progressively less amenable to curtailment. When it reaches a level which the authorities consider representative of a hard core of essential services, attention is turned to the revenue side of the budget and steps are taken to sustain, or increase, revenues. The expenditure of the Government of Ceylon in the year 1928–29 was Rs. 126.1 million inclusive of loan fund expenditure. In the following year 1929–30 the corresponding amount was Rs. 122.9 million but current expenditure was now reduced to Rs. 110.3 million as against Rs. 125.9 million in the previous year and loan expenditure increased to Rs. 12.6 million as against Rs. 0.2 million in the preceding year. Such a step was possible because monies raised from previous loans were still available. In the year 1930–31, however, the position was different, and it was in this year that the biggest cuts in expenditure were made. Total expenditure was reduced Rs. 17.8 million from Rs. 122.9 million to Rs. 105.1 million. In the case of revenues, on the other hand, the bulk of the efforts to increase revenue did not take place until 1932–33.

There are, broadly, two ways in which retrenchment can be brought about although the distinction between them is by no means absolute. First, there is the possibility of continuing to provide the existing services of the Government at a reduced cost; and second there is the problem of curtailing the services themselves. It is natural that any government would attempt to deal with the problem of retrenchment along both these lines if it cannot indeed confine itself to the first.

There are, however, factors which broadly determine the extent to which a government can successfully pursue either of these paths. Take first a reduction in the cost of the existing services. Now it is true that some relief is afforded to the government in periods of depression by a fall in prices which should automatically contribute to a reduction in the cost of government services. There is no doubt that there was some easing of the problem in Ceylon on account of this factor. This is borne out by the under-expenditure of their votes by several departments in the early years of the depression. But the scope for relief of this sort is unhappily limited by the predominance in the expenditure of payments such as salaries and other personal emoluments which are of a long term contractual nature. Any reduction in salary scales is, for this reason, generally confined to temporary employees and new entrants into the public service. In fact, of course, as has already been shown, a reduction in the salaries of existing employees of government was effectively made through the temporary levy on the salaries of public servants. But this measure was officially credited to the revenue side of the budgetary account and was not reckoned as a reduction in public expenditure. The other way in which the cost of services can be reduced is through an improvement in efficiency which would lead to economy in the resources required to perform a given service. The reorganisation of government departments with this end in view is often investigated in periods of depression but it is doubtful whether substantial savings are in fact quickly achieved through this means.

For these reasons an actual curtailment in the services provided by the Government is often unavoidable. Indeed it is a general tendency for governments to attempt a reduction in services as a first step in retrenchment, even before measures are taken to reduce the costs of existing services, since the latter is often a difficult and protracted process which does not always ensure substantial success. But the reduction in services is itself made difficult by a number of factors. First there are the contractual payments which are more or less inflexible in the short period. In Ceylon payments on account of the public debt, pensions, and certain other items such as the Governor's salary were not dependent on annual legislative sanction through the Appropriation Ordinance but were provided for out of special law. A sum of well over Rs. 20 million annually was on this account placed beyond the reach of the budget makers. In the years of the depression such payments amounted to over twenty-five per cent of total expenditure. Second, there is the expenditure on the essential administrative departments which perform what is generally described as the primary functions of government. These include the expenses of the legislature, the audit office, provincial administration, the departments of law and justice, police and prisons, defence, and the revenue and financial departments. Where expenditure on this function normally occupies a substantial proportion of the public budget as it usually does in some Colonial and underdeveloped territories, the flexibility of expenditure is naturally small. In Ceylon the administrative departments accounted for about 20 per cent of total expenditure in the immediate pre-depression period.

It is thus reasonably likely that if retrenchment has to come the axe will fall most heavily on the social services and on the economic departments. But even here certain factors broadly determine the scope for retrenchment. Quite apart from any preference the authorities are likely to develop as between the social services and the economic departments, it is clear that it is generally easier to call a halt to expenditures on new projects than to those required for maintaining or operating existing services. The group which happens to be enjoying sizeable capital expenditures in the form of new projects at the time of retrenchment is likely to have to shoulder a heavy proportion of the cuts. It so happened that the economic departments in Ceylon, in particular the Public Works Department, were incurring heavy "extraordinary" expenditures (which broadly corresponds to capital expenditures) at the beginning of the depression and were thus more liable than the social service departments to fall victim to retrenchment. There is a further consideration. To the extent that retrenchment requires undermaintenance the economic departments are again more vulnerable than the social service departments. Depreciation and maintenance charges form a much bigger proportion of the current expenditure on roads, bridges, railways and harbours, than of schools and hospitals where direct operating or running costs bulk large in current expenditure. It is possible to postpone a good part of the recurrent expenditure on roads, bridges, railways and harbours, and still enjoy the services they provide, but it is not the same with schools and hospitals.[263]

263. The following extract from the address of the Officer Administering the Government in the Legislative Council in 1930 is indicative of the relative inflexibility of expenditure on health and education: "I feel myself that in some outlying places expensive hospitals have been provided, where, had the present depression been foreseen, we should have been content to maintain dispensaries only. But that is past history, and we are now faced with the necessity of staffing and maintaining these institutions. The plain fact is that, except by actually reducing existing facilities or failing

Finally, a word about the types of expenditures that are likely to increase in periods of depression. In most countries payments on account of unemployment insurance or public assistance are almost certain to increase in periods of economic distress. There is no doubt that in Ceylon the depression was followed by a severe curtailment of employment, and it is perhaps natural to expect that expenditures for providing relief to the unemployed would increase *substantially*. But this was not the case. The scantiness of the provision for unemployment assistance is indeed one of the striking features of Ceylon's public finance in the depression. It is true that expenditure on account of the relief of distress increased somewhat in the years of difficulty, but these increases were of small dimensions when compared either with the magnitude of the unemployment problem or with the size of the budget as a whole. There were of course a number of reasons which explain this feature. On the one hand, there was the repatriation of unemployed plantation labour to the mainland of India. On the other hand, there was the absorption of the indigenous unemployed within the family and the village, a source of assistance complacently described as "the abiding charity of the people". There was no scheme of unemployment insurance in the country; there was no machinery for dealing with the problem of unemployment on a nation-wide basis. The limited amount of financial help which reached the unemployed came through by way of charitable payments for the destitute and hastily improvised relief schemes administered by the Municipal Authorities in the cities. Behind all these deficiencies was the stringent budgetary situation facing the Government itself. It is, after all, too much to expect that extensive schemes for the relief of the unemployed are likely to capture the sympathies of a government so anxiously concerned with the

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to provide staff for extensions to existing facilities which have been completed or will be completed during the present year, there is no method by which expenditure on medical and sanitary services can be kept down to the amount provided in the estimates for the current year.

"To maintain a constant level of expenditure on Education is even less feasible. In theory Education in Ceylon is compulsory. In practice 7 children out of 11 receive education. The number of pupils in Government schools increases every year, and increases rapidly, and yet last year only one new Government school was built, the amount allotted to District Education Committees proving insufficient even for the proper maintenance of existing buildings. Unless we are to abandon the theory of compulsory education and refuse admission annually to thousands of applicants, the only practicable means of keeping down expenditure on education would appear to be to charge substantial fees in all Government Secondary Schools." – *Hansard*, Vol. II, 10th July 1930. pp. 950–951.

retrenchment of public expenditure and with the curtailment of employment in the public sector itself. It is perhaps hardly necessary to add here that the absence of a substantial programme of unemployment assistance was accompanied by a similar absence of any scheme for subsidising those sectors of the economy in which employment was subjected to the greatest pressure.

The actual course of expenditure during the 10 years 1928–29 to 1938–39 is summarised on page 141.

The drop in expenditure on the administrative departments in the year 1931–32 when compared with the three previous years is largely due to a change in the official accounts of expenditure following a regrouping of certain Government departments under the new Donoughmore Constitution. Some of the items appearing under the heads of 'clerical service' and 'civil service' were now distributed over the different Ministries. Similarly some of the items in the 'miscellaneous' group were reallocated – in particular, expenditure on local government.

Two principal features reveal themselves in the table on page 141. (i) The severe drop in expenditure in the Economic Departments which had, as expected, to shoulder the main burden of retrenchment. (ii) The gradually rising trend in expenditure, notwithstanding the general depression, on the social services, the public debt and pensions.

(i) The Economic Departments include such services as public utilities, agriculture, irrigation and survey, labour, and industries and commerce. The cuts in expenditure were not, of course, uniformly distributed amongst these various groups. In fact, apart from a very moderate drop in expenditure on agriculture, irrigation and survey in 1932–33, almost the whole of the cuts in expenditure were centered on the public utilities.

A number of heads of expenditure are included under the classification "Public Utilities". These comprise the expenditures incurred on account of public works, electrical undertakings, the Colombo Port Commission and other ports, posts and telegraphs, the railway deficit and, in 1938–39, civil aviation. There again the bulk of the reductions in expenditure was concentrated on public works as is illustrated on page 143.

PUBLIC EXPENDITURE FOR THE PERIOD 1928–29 TO 1938–39

(Rs. million)

Year	1928–29	'29–30	'30–31	'31–32	'32–33	'33–34	'34–35	'35–36	'36–37	'37–38	'38–39
Administrative departments	24.3	23.5	22.6	19.8	18.8	18.6	19.5	20.6	20.6	22.5	24.1
Economic departments	56.2	39.2	31.0	27.6	24.1	24.6	27.4	33.2	34.1	36.5	42.6
Social services	22.1	23.4	22.7	23.3	22.9	23.3	33.9	30.9	29.2	31.2	33.0
Public debt	11.2	11.7	11.8	12.4	12.5	12.3	11.9	11.9	8.5	9.2	9.4
Pensions	7.5	7.6	8.4	9.8	10.4	10.3	10.3	10.5	10.7	11.1	11.8
Local Governments	.2	.2	.2	2.6	2.6	2.7	2.5	2.6	2.5	2.7	2.9
Miscellaneous	4.1	4.8	4.0	1.7	1.3	1.4	1.6	1.3	2.6	2.0	3.3
Total	125.9	110.4	100.6	97.1	92.7	93.4	107.3	110.9	108.8	115.3	127.1

Source: Annual Blue Books

One of the important consequences of orthodox financial policy is the extreme susceptibility of expenditure on public works to cyclical changes in the economy as a whole. Since the public works department is one of the biggest employers of wage labour it plays a considerable part in aggravating the effects of cyclical fluctuations on employment. A given reduction in Government expenditure is likely to lead to a greater curtailment of employment when it is directed to public works than to most other departments of government.[264] As we have already seen expenditures on public works are the most amenable to cuts in periods of depression; it is particularly unfortunate that it is precisely these reductions which have the most harmful consequences on the economy as a whole.

It is important to note that in the subsequent years of recovery expenditure on public utilities as a whole did not regain its pre-depression levels – in contrast to total government appropriations. This is specially true of the item "public works extraordinary". The conclusion which suggests itself is that the expansion, both absolute and relative, in the social services and pensions, though financed in part out of increases in taxation, was also carried through at the expense of capital expenditure in certain of the important economic departments. This may possibly be interpreted as a reflection of the

264. Even within the public works group the incidence of expenditure cuts falls not on the administrative expenses of the department (i.e. personal emoluments for office staff) but on "other charges" which cover expenditure on materials, labour, etc. For this reason the share of personal emoluments in total expenditure on public works falls in the boom and rises in the depression.

Year	1928–29	1929–30	1930–31	1931–32
% of personal emoluments to total expenditure in public works ..	9.0	12.0	18.9	23.8

Source: Calculated from *Administration Report of the Director of Public Works for* 1932. p. A.3.

The relative inflexibility of these 'overhead' expenses of the Public Works Department are officially explained as follows: "Expenditure on work is only one factor of many that determine the size of the staff required .... It should be remembered that from a half to two-thirds of the energies of the Department are taken up in investigating, planning and reporting on schemes under consideration, many of which are never executed, and in advising local authorities and other departments, and in dealing with enquiries and petitions, and in attending to the business of various Boards, Committees and Commissions appointed by Government." ibid. p. A4.

EXPENDITURE ON PUBLIC UTILITIES 1928-29 TO 1938-39

(Rs. million)

Year	1928–29	'29–30	'30–31	'31–32	'32–33	'33–34	'34–35	'35–36	'36–37	'37–38	'38–39
Total expenditure on all public utilities	47.0 (40.8)	30.1	21.8	18.1	15.8	15.8	18.1 (17.4)	22.2 (19.4)	23.7 (19.6)	25.2 (21.0)	26.1 (21.5)
Public Works Department	2.3	2.2	2.0	2.1	1.9	1.8	1.8	1.9	1.9	2.0	1.9
Public Works annually recurrent	10.5	9.4	6.2	4.9	4.2	3.9	4.4	5.5	5.3	5.1	5.0
Public Works extraordinary	12.7	6.9	2.8	1.2	.5	.6	1.6	1.8	2.5	2.9	3.7
Other public utilities	21.4 (15.2)	12.5	10.8	9.9	9.1	9.3	10.3 (9.6)	13.2 (10.3)	14.0 (9.9)	15.2 (11.1)	15.4 (10.8)

Note: Figures in brackets from 1934–35 onwards show expenditures exclusive of railway deficits.
Source: Calculations from the Annual Blue Books.

political changes which had culminated in the Donoughmore Constitution. Could it be that popularly elected Ministers, taking office at a time when a general phase of expansion in the economy as a whole had come to an end, and having to choose between the scanty social services and more direct forms of economic development, shifted the emphasis in favour of the fomer? The evidence does indeed seem to support this view. But in fairness to the legislators of the time it must be mentioned that they did not view the problem in terms of such a conflict. Improvements in the health and education of the people were not looked upon as mere facets of income redistribution, but as essential external economies for economic development itself.

(ii) (a) The rising trend in expenditure on the social services, which consists almost entirely of expenditure on health and education, was largely the result of conscious policy. Reference has already been made to some of the political factors which favoured this course. In the worst years of the depression, however, the relatively steady level of expenditure on these subjects was not due to any substantial expansion in the provision of new facilities, but to the heavy recurrent or operating expenses of the existing services.

Mention must be made here of the sudden increase in expenditure on the social services during the financial year 1934–35. Part of the increase was due to greater expenditure on health and education. Expenditure on health rose from Rs. 9.7 million in the preceding year to Rs. 11.9 million, whilst education increased from Rs. 13.9 million to Rs. 17.3 million. A part of the increase in the whole social services group, however, was the result of the devastating and unprecedented malaria epidemic which swept through the country in 1934. Epidemics of malaria had in the past been periodical occurrences in Ceylon. They affected not the malaria ridden and thinly populated "dry zone" region of the country where the sickness was prevalent in a chronic, epidemic form, but the thickly peopled "wet zone" where almost all the country's economic crops are cultivated. The important physical factor which contributed to the epidemic was the prolonged drought at the end of the preceding year following upon the failure of the all-important North-East monsoon. The drying up of rivers provided numerous pools of stagnant water which were conducive to the breeding of the mosquito. In addition to this, official accounts attribute importance to the economic factor as a contributory cause. The general economic depression of the preceding years had led to the impoverishment of the population. The incidence of the epidemic was most severe in the coconut producing region of the country. The coconut industry was particularly hard hit during the depression, but it was unhappily the source of sustenance to a much larger number of small producers than was either tea or rubber. The fall in incomes during the depression had aggravated the under-nourishment of the population in these regions and had thereby increased their vulnerability to sickness. The extreme gravity of the epidemic was borne out by the high toll it took in human lives. In addition it cast an unfortunate financial burden on the Government at a critical moment. Not only had more money to be provided for the requisite medical services, but large sums had to be distributed as relief payments to the victims or their families. A Commissioner of Relief was appointed, and in 1934–35 a sum of Rs. 4.7 million was spent through him. A further Rs. 2.8 million was spent in the same way in the following financial year. Relief payments by the Government on account of the malaria epidemic were, of course, far in excess of relief payments on account of unemployment in the earlier years of acute economic depression.

(b) The mild increase in the public debt was, of course, beyond the control of the Government. No actual decision to borrow money afresh was taken during the depression although, as we have already seen, the proceeds of a loan authorised in 1929 became available in the early' thirties. There was a reduction in expenditure on the public debt in 1936–37 following the repayment of a previous loan.

Expenditure on the public debt as classified in the official accounts include contributions to sinking funds. These contributions are provided for out of special law and are not subject to annual legislative sanction. Nothing can illustrate better the extreme caution which characterised policy relating to provision for debt repayment than the fact that in some cases contributions to sinking funds had to be continued even when these funds were "potentially full".[265] Once the loan was actually repaid the

265. A sinking fund becomes potentially full when it reaches a level which, together with the accumulated interest it earns by the date of maturity of the loan, is adequate for repayment.

surplus in the sinking fund that results from such a policy is credited to revenue.[266]

It must be emphasised that, with the exception of an internal loan in 1937, the whole of the public debt was an external debt. The payment of interest on the debt, therefore, did not in any sense represent a transfer or redistribution of incomes within the community. It constituted a charge not only on the revenues of the country but also on its foreign exchange reserves. The Government of Ceylon was further deprived of any relief from the burden of financing its indebtedness by the fact that interest on the external debt was specifically exempt from payment of income tax. This issue of the liability of interest on the external public debt to income taxation was the central point in the controversy between the Legislative Council (and subsequently the State Council) on the one hand, and the Governor and the Secretary of State on the other, during the introduction of the Income Tax Bill. It was one of the reasons which prompted the Legislative Council to reject the Bill. In 1932 the State Council passed the Bill in a form which did not exempt interest on the debt from taxation,[267] but such exemption was subsequently secured at the insistence of the Governor through an amendment to the Income Tax Ordinance which was passed shortly afterwards.

(c) The increasing cost of pensions was a matter of which both the Board of Ministers and the State Council were acutely conscious. It gave rise to a controversy on fundamental constitutional issues between the Board of Ministers on the one hand and the Governor

266. This procedure was explained by the Colonial Treasurer in regard to contributions to the sinking fund of a loan which was due for repayment in 1934: "We did intend to discontinue contributions to this particular sinking fund, but the Secretary of State was advised legally that under the terms of our Inscribed Stock Ordinance it was not permissible to do this unless notice had been given in the prospectus of the loan that the sinking fund would be discontinued as soon as it is potentially full. He was advised that it was necessary, notwithstanding that the whole amount was there in the sinking fund, to continue the contributions until the date of extinction of the loan. So it comes about that in the case of this particular loan, although we have enough money to pay, we must go on placing the money in the sinking fund till the date of maturity. The Colony will lose nothing by it because all the excess, including the excess interest, will come into the revenue of the Colony." *Hansard* 1930. Vol. II. p. 1123.

267. Except interest on the loans of 1924 and 1929 when exemption from income tax was specifically promised in the prospectus.

on the other. Before we explain the causes of the increase in pensions it will be convenient to comment briefly on the wider question of public service salaries in the depressio ..

As we have already indicated, the salaries of the permanent public service are of a long term contractual nature, and are therefore not easily amenable to reduction in periods of depression. On the other hand salaries were partially reduced, if indirectly, by means of the temporary levy. In spite of the difficulty of reducing existing salaries, however, it was widely felt that some measures ought to be taken to reduce the heavy and increasing share of personal emoluments in the total expenditure bill. With this end in view a Commission of Inquiry, termed the Salaries and Cadres Commission, was appointed on March 30th, 1932, with the task of recommending reductions in the cost of personal emoluments.[268]

That no great expectations were placed by the Government on the possibility of securing sizeable reductions in the salaries of existing members of the public service is borne out by the fact that the Commission was specially requested to give prior attention to the problem of future entrants and to issue an interim report on this point. Moreover, even if the Government, or rather the Board of Ministers and the State Council, did wish to reduce existing salaries, there was an important constitutional difficulty barring their way. This was Section 88 of the Constitution Order-in-Council which made the question of public service conditions a subject reserved for the Governor and the Secretary of State. Indeed, the Salaries and Cadres Commission itself considered this the only obstacle to a reduction in existing salaries.[269] The Governor and

268. The Commission was instructed to "investigate and make recommendation, forthwith in regard to, a) the salaries, allowances and general conditions of service of i) existing members of the public service, ii) future entrants, and b) the Cadre of Departments, with a view to reduction of the expenditure of the Island, and with a view to the fixing of salaries on a rupee basis, and in accordance with a Ceylon standard". S.P. XII of 1932 – *Interim Report of the Salaries and Cadres Commission.* August 1932. p. 1.

269. "We have given the question of the salaries of the existing members of the public service our most anxious consideration, and we have come to the conclusion that there is no justification, logical or otherwise, for treating existing personnel better than new entrants, *but for clause* 88 *of the Order-in-Council.* The large number of highly qualified young men awaiting appointments in the public services – many of them better qualified than those already in the service – satisfied us that the efficiency of the services will in no wise be jeopardised by giving effect to this conclusion." S.P. XVI of 1932. *Report of the Salaries and Cadres Commission, October,* 1932. The words underlined appear in italics in the report.

the Secretary of State in their turn were clearly averse to any reductions in the salaries or conditions of existing public servants, and for this reason, if for no other, the attempt to reduce existing salaries did not prove fruitful. In a communication to the Board of Ministers on the question of pensions the Governor stated: "......The Secretary of State requests me to impress upon the Board of Ministers that under the present constitution public officers have certain guarantees, that the Secretary of State and the Governor are the guardians of their rights, and that this position must be strictly maintained...... An interference with guaranteed conditions of service is on a different plane from temporary measures such as a levy on salaries, and to allow such a step would in his opinion be inconsistent with his duty under the Constitution."[270] The principal effects of the recommendations of the Salaries Commission applied to the revision of salary scales for new entrants, but, since these measures did not amount to a sizeable reduction in expenditure in any given year of the depression, it is not necessary to discuss them here.

We may now turn to the increase in pensions. There were two factors additional to the annual payment of pensions to those who had retired from the public service. There were, first, the permission given to public servants on account of the introduction of the new Donoughmore Constitution to retire with compensation for loss of career before reaching pensionable age. The second was the scheme which was introduced in 1928 with the approval of the Legislative Council providing for the partial commutation of pensions.[271] Both these factors were contributing to the increase in the burden of pension payments during the depression.

In 1932 both the Board of Ministers and the Salaries Commission were of opinion that the scheme for the partial commutation of pensions should be suspended as an emergency measure. Accordingly a proposal was submitted to the Governor

270. S.P.V of 1933 – "Correspondence between the Board of Ministers and His Excellency the Governor, and His Excellency the Governor and the Secretary of State, relating to the Appropriation Bill 1932–33." (April 1933) p. 8.

271. The scheme provided for the commutation of one-fourth part of 10 years' pension. Retired public servants were given the privilege of receiving a fourth part of their total pension over a period of 10 years in one lump sum instead of annually. This scheme naturally increased the pressure on the Government's budget in the early years of its operation.

by the Board of Ministers for the suspension of the scheme. The Ministers argued that when in 1928 the former Legislative Council had approved the scheme the financial situation was very satisfactory, and that the premature retirement of public servants with compensation for loss of career could not have been anticipated. The Ministers' proposal was, however, referred to the Secretary of State by the Governor and was then turned down. The Ministers then made the alternative proposal that payments on account of commuted pensions should be met out of loan funds[272] and that the privilege of commutation should be denied to future entrants to the public service. These proposals were agreed to by the Secretary of State.[273] On account of this measure expenditure on pensions out of current revenue was kept relatively stable after 1932–33.

Budgetary balance and the financing of deficits in the depression

In the preceding pages we have outlined the major factors influencing the course of revenues and expenditures during the depression in Ceylon. It now remains to consider the budgets as a whole. In this connection the relevant questions are first, the degree of success in achieving budgetary balance, second, the size of the deficit when balance was not achieved, and finally, the ways in which the deficits were financed.

272. The Ministers proposed: "The setting apart of a sufficient sum of money from the balance that will become available out of the loan fund after making necessary provision for loan works for 1932–33 to form the nucleus of a fund to be earmarked for payment of commuted pensions. The annual savings of commuted one-fourth part of the pensions will be paid into this fund, and all payments of commuted pensions will be made out of this fund." S.P.V 1933 *op.cit.* p. 9.

The Financial Secretary gave his qualified approval to this practice. In his observations on the Appropriation Ordinance 1932–33 he said: "The use of borrowed money to meet the cost of partial commutation of pensions appears to be financially justifiable on the grounds that such partial commutation effects an extinction of future liabilities, and is therefore in the nature of capital expenditure. It would be preferable, in my opinion, to borrow separately for this purpose as I doubt both the wisdom and the propriety of using for such a purpose money borrowed with the intention of using it to pay for public works of development. Moreover, money borrowed to effect the partial extinction of a pension should be borrowed for a period roughly equivalent to the period for which the pension to be extinguished would otherwise be payable, whereas the two instalments of the 1929 loan have a maximum currency of 40 and 35 years respectively." – *Hansard.* 4th October 1932 – p. 2417.

273. A further proposal by the Ministers requesting the repeal of an amendment to the Pension Minute made by the Governor was rejected by the Secretary of State after a long correspondence. The amount of expenditure involved was, however, small. S.P. V of 1933 *op.cit.*

From the point of view of the Government, budgetary balance was looked upon in terms of equating *current* expenditures[274] with current revenues. The balancing of *total* expenditures of all sorts with current revenues was not a necessary condition for 'sound finance' as long as the difference between them was due to certain relatively well defined factors. These were, first, expenditure on works of a capital nature which fulfilled the somewhat strict requirements for qualifying for finance out of loan funds, and second, expenditures which were met out of the previously accumulated surplus balances of the Government.

As a measure of the influence of budgetary policy on the economy as a whole, however, the balancing of current revenues and current expenditures is of limited significance, and deficits and surpluses, which may result from such a procedure, may prove misleading. It is useful to find out the net impact of the budget as a whole on the economy and from this point of view it is desirable to assess the extent to which budgetary policy resulted in either a net injection or a net withdrawal of purchasing power in the economy. For this purpose it is necessary to arrive at some approximation to the 'true' deficit or 'true' surplus in a given year's budget, and this will not be always revealed by a comparison of current revenues with current expenditures.

A clear idea of the concept of the 'true' deficit or 'true' surplus may perhaps be obtained if all Government expenditure, in a given period, is looked upon as one of the determinants of income in the economy and Government revenues (whether obtained by taxation or other means) are looked upon as leakages from the income stream, to the extent that had they not entered the coffers of the Government they would have added to the total of expenditure in the economy. It can then be seen that the budget would have a net positive impact on the economy only if total expenditure, or what the Government puts into the expenditure stream, exceeds the leakages or those revenues which represent funds which have been taken away by the government from this stream.

From a statistical point of view, however, there is a serious obstacle to measuring the 'true' deficit in the sense defined above.

274. The term 'current expenditure' is officially used to refer to expenditure which is normally chargeable to current revenues. It does not, therefore, include expenditures which are paid for out of loan funds.

Whilst there is no special difficulty in identifying total Government expenditure, whether current or otherwise in a given period as a (gross) determinant of income, there is a considerable problem in ascertaining how much of the revenues of the Government represent a leakage from the expenditure stream of the community. Monies borrowed by the Government from the public, for instance, ought not to be generally regarded as a leakage, since it may fairly be assumed that they were provided for out of the savings of the public. In so far as the monies were borrowed from foreigners it is fairly certain that the expenditure stream would not be affected. Similarly monies drawn out of surplus balances may be excluded in assessing the leakage. But there is, on the other hand, a very real difficulty in dealing with the current revenues of the Government, including both tax and non-tax revenues. Not only is it necessary to ascertain whether these revenues were provided for by the public through cuts in savings or consumption, but it must also be known, when consumption is sacrificed, whether the reduction affects imports or the domestic sector. Expenditure on imports is as much a leakage from the income stream as savings, and the diversion of monies, which would otherwise have been spent on imports to the coffers of the Government would not result in any change in the total leakage. For this reason it can be shown that it is possible for even a balanced budget to constitute a net injection into the expenditure stream. If the whole of the expenditure of the Government is, for example, balanced by revenues from taxes, which have been paid for through a reduction in savings or in imports, then this expenditure, or more strictly that part of it which is spent locally, will have a net income creating effect. An accurate estimate of the incidence of taxation in Ceylon on imports, saving, and expenditure on the domestic sector is hardly possible with the available information. But the high propensity to import (both average and marginal) of the private sector in Ceylon suggests that it is likely that a good proportion of the revenues of the Government are diverted from expenditure on imports. This, together with the fact that the greater part of Government expenditure is spent locally, makes it fairly certain that even a balanced budget in Ceylon has a net income creating effect. For this reason a mere estimate of the budgetary deficit, however carefully measured, will not give a true picture of the net additions to the income stream through public finance. Indeed, we may suggest here that in the conditions of Ceylon, the size of the Government budget, as measured for instance by total public expenditure, is a much more significant measure of the effects of public finance on the economy than the mere deficits or surpluses in the budget accounts.

The measure of the budgetary deficit in what follows is not, for the reasons given above, a true assessment of the net income creating effect of public finance in the depression. It is nevertheless of importance in that it shows the extent to which the Government of Ceylon was able to maintain an expenditure in excess of its current revenues. Insofar as it can be assumed that in the absence of the deficits Government expenditure would have been cut down to the level of current revenues, then these deficits can undoubtedly claim to represent a part (whose importance depends on the size of the deficits) of the income creating effect of the budgets. As already mentioned, the official accounts estimate the deficits by merely subtracting the total of current revenues from the total of expenditures chargeable to these revenues. This procedure is inadequate for our purposes for two main reasons. These are, first, that the aggregate for Government expenditure excludes expenditure out of loan funds, and second, that certain items are included in current revenues which clearly do not represent leakages from the expenditure stream of the public.[275] Under the official system of accounting there can be deficits only to the extent that there are surplus balances to finance them. All other sources of finance for expenditures chargeable to current revenue are allowed to enter into the classification of current revenues.[276]

On the expenditure side the only correction needed for our purpose is the addition of loan fund expenditures to expenditures chargeable to current revenues. This will give the aggregate of all Government expenditure. On the revenue side there are more adjustments to be made. In fact three heads of revenue ought to be deducted from the official classification of current revenues. These are i) recoveries from loan, ii) surpluses on the sinking funds of loans which have been credited to revenue on the extinction of the loan, and iii) the appropriations from the Railway and Electricity Renewals Funds.[277] All these items are more analogous to

275. i.e. additional to the ordinary tax and non-tax revenues whose incidence, as has been shown, is uncertain.

276. For example, recoveries from loans, surpluses from sinking funds, etc.

277. Not, of course, the accruals to revenue which arose out of the failure in some years to make provision for the depreciation of railway and electricity assets. cf p. 27 above.

borrowing or a reduction in surplus balances than to a draining away of the expenditure of the public through taxes or the sale of Government services. They shall be discussed presently.

The estimates of the budgetary deficits which emerge under this scheme are shown in the table on the next page.

It would be apparent from these figures that a fair proportion of Government expenditure was 'deficit financed' in all but two years of the eleven year period 1928–29 to 1938–39. It is important to note, however, the sources of finance for the deficits.[278] The rigidity of the currency laws and the nature of the banking system prevented deficit financing through either currency expansion or short term borrowing from the banks. The sources of finance for the deficits were of a different nature. They fall into two groups – i) borrowing from the public, and ii) drawing down of various balances in the hands of the Government.

Monies borrowed from the public include items entered into current revenue as 'recoveries from loan'. As we have shown earlier these items represent the use of borrowed monies for current expenditures on the ground that current revenues had previously been used for loan expenditures in anticipation of the raising of loans. The practice of meeting prospective loan expenditure out of advances from current revenues does, of course, amount to the indirect building up of reserves, but the availability of these reserves for financing deficits in the depression is coincidental. It is easy to see that an acute budgetary problem would have arisen in the financial years 1929–30 and 1930–31 had there been no 'recoveries from loan' to augment the revenues. These sums were the fortunate consequence of a decision to raise a loan in 1929[279] – a decision which was taken independently of any prospect of a forthcoming depression.

278. It is necessary to qualify what follows with the comment that the sources of finances for the deficits described were not always entirely used to finance deficits. In the surplus years 1932–33 and 1933–34 some of these funds were used, paradoxically, to 'finance' surpluses. When they were not used to finance deficits, however, they came to be added to the surplus balances of the Government. The use of these funds from year to year and the resulting adjustments are shown in the table on page 158.

279. The loan was actually subscribed to in 1929 and 1930. Hence the return to revenue of the sums due in the financial years 1928–29 and 1930–31.

OVERALL RESULTS OF GOVERNMENT BUDGETS (1928–29 TO 1938–39)

(Rs. million)

Year	1928–29	'29–30	'30–31	'31–32	'32–33	'33–34	'34–35	'35–36	'36–37	'37–38	'38–39
Total Government expenditure including loan expenditure	126.1	122.9	105.1	99.9	94.3	94.5	109.2	111.7	111.7	120.4	134.7
Current revenues exclusive of capital items	107.8	103.5	87.9	84.8	102.4	99.8	99.0	102.8	105.4	113.3	116.9
Deficit or surplus	–17.3	–19.4	–17.2	–15.1	+8.1	+5.3	–10.2	–8.9	–6.3	–7.1	–17.8
Deficit or surplus in official accounts	–18.1	+.5	+1.2	–12.2	+13.4	+10.7	–8.3	–7.0	+10.4	–2.0	–10.1

The other way in which borrowed monies were utilised to finance expenditure in the depression was the actual financing of loan expenditures by monies borrowed for the purpose. But here, again, the decision to borrow was taken before the depression. No fresh borrowing took place until 1937. However, it may be seen from the table on page 154 that loan expenditures proper were not specially significant during the depression. Until 1937 borrowed monies constituted funds borrowed in the London Money Market. Their expenditure in Ceylon clearly represented an addition to the stream of total expenditure. In 1937 Ceylon raised her first internal loan and after this period the bulk of the expenditure from borrowed monies were out of funds raised locally. Such expenditures would still be regarded as additions to the total expenditure stream if it can be assumed that they were subscribed to out of idle savings (or at the expense of imports which is less likely). However, to the extent that the loans to the Government were made at the expense of loans to the private sector, they may not in fact represent such additions.

The financing of deficits in the form of drawing down various balances in the hands of the Government applied to three groups of funds: i) the surplus balances proper; ii) the surpluses in sinking funds which reached maturity; and iii) the balances of the railway and electricity funds.

The surplus balances proper refer to the surplus cash balances of the Government which appear in the official capital accounts as an excess of assets over liabilities. They have in the main been built up out of budgetary savings in the past through an excess of current revenues over all expenditures chargeable to current revenue. Generally these surplus balances were built up either accidentally in periods of rising revenue when expenditure could not quickly be adjusted upwards, or on account of the deliberate building up of an emergency reserve. Although lip service was always being paid to the principle of building up reserves for use in bad times, no rigorous policy was pursued in the predepression period for building up a stabilisation reserve. In fact there was a general belief that a sum of about Rs. 10 million would suffice as a reserve for unforeseen emergencies. The reduction of the reserve below this level was frowned upon even in the depression. On the other hand, a substantial increase in reserves above this level usually resulted in pressure for a reduction in taxation.

These surplus balances were, in part, held locally in the form of Government deposits held with the various commercial banks.[280] Their main use in the depression was to finance the deficit in 1931–32 which led to their initial exhaustion. Thereafter they were built up once more, because subsequent deficits were financed from other sources.

The surpluses in the sinking funds of loans which are repaid, were, like the recoveries from loans, an indirect form of building up reserves and a fortuitous source for financing deficits. They only occurred in the financial year 1933–34. Unlike the surplus balances proper the whole of the sinking funds were invested in London.

The balances of the Railway Renewals Fund and the Electricity Renewals Funds were held by the Government on behalf of the railway and electricity departments after their accounts were separated from the budget and commercialised. There were other funds of a similar nature such as the Widows and Orphans Pension Fund and the University Buildings Fund held by the Government on behalf of these agencies.

Whilst the raiding of these special funds is often a violation of the purposes for which they were constituted, the undisturbed existence of such other funds like the Widows and Orphans Pensions Fund and the University Buildings Fund may suggest that the Government had not exhausted all its possible resources during the depression. Such an impression is, however, not wholly valid because of a serious difficulty which emerged during this period. This was the growing scarcity of liquid cash available to the Government. Not all the assets standing in the capital account of the Government were in a liquid form available for appropriation for purposes of expenditure. In fact, as a result of the running down of the surplus balances proper for the financing of the 1931–32 deficit, the cash resources of the Government had reached a dangerously low level. The Rs. 4½ million belonging to the University Building and Equipment Fund was held as a fixed deposit at the bank. Apart from this, "the only liquid resources remaining (were) some £600,000 with the Crown Agents, some Rs. 7 lakhs in

280. In the absence of a Central Bank to act as banker to the Government, the latter's custom was distributed over the several commercial banks.

Ceylon Inscribed Stock and some £500,000 in Sterling Securities...... Even assuming that there is no falling away in revenue, it is clear that these cash resources will be practically exhausted by the end of 1932–33...... There is therefore a risk that by the end of the year, if not earlier, the Government's liquid resources would be negligible, that in the meantime the Government may be forced into the grave necessity of temporary borrowing with the attendant danger of impairment of its credit, and, that if action to restore the financial situation is too long delayed, the measures adopted to that end will take effect only after the financial stability of the Island has been endangered".[281]

The magnitudes of the various sources of deficit finance discussed above are set out on the following page.

The economic effects of public finance in the years of the depression

We may conclude our survey of the financial problems of the depression with a brief assessment of the economic effects of budgetary policy during these years. It is our contention that in spite of the deficit financing of this period, the effects of budgetary policy as a whole on the economy were not expansionary but depressive. The chief factors responsible for the unfavourable consequences were the absolute reduction in the size of public expenditure in money terms and the change in the distribution of this expenditure in real terms between different sections of the community.

It has already been argued that with a given total of money incomes in the community a more expansionary effect is likely to result if money is taxed away from the public and spent by the state than if it is left in private hands. This is because the 'propensity to consume' domestic goods and services (both average and marginal) is probably higher in Ceylon for the Government sector than for the private sector. It is likely that a given cut in public expenditure has a worse effect on, say, employment in the economy than an identical cut in private expenditure. It is for this reason that we suggested that the size of the budget rather than the method of financing it is the significant measure of economic effects. A big budget which is balanced is likely to have a greater expansionist

281. S.P. V of 1933. Enclosure to No. XIV. Statement by the Financial Secretary. pp. 30–31.

SOURCES OF DEFICIT FINANCE (1928-29 TO 1938-39)
(Rs. million)

Year	1928–29	'29–30	'30–31	'31–32	'32–33	'33–34	'34–35	'35–36	'36–37	'37–38	'38–39
1. Deficit (or surplus)	–17.3	–19.4	–17.2	–15.1	+8.1	+5.3	–10.2	–8.9	–6.3	–7.1	–17.8
2. Sources of finance:											
(a) Recoveries from loan	—	7.4	13.9	—	—	—	—	—	13.8	—	—
(b) Loan funds (expended on loan works)	.2	12.5	4.5	2.8	1.6	1.1	1.9	1.0	2.9	5.1	5.3
(c) Surplus in sinking funds	—	—	—	—	—	4.3	—	—	—	—	—
(d) Railway and electricity renewals funds	—	—	—	—	3.7	—	—	—	—	—	—
(e) Contributions from surplus balance proper	17.1	—	—	12.2	—	—	8.3	—	—	.2	—
3. Adjusting additions to surplus balances	—	+.6	+1.2	—	+13.4	+10.6	—	—	+10.4	—	—
4. Size of surplus balances	13.6	14.2	15.4	3.2	16.6	27.2	18.9	12.0	22.4	20.4	10.3

effect than a very small budget which is deficit financed. This is not to deny, however, that at a given size a deficit budget is likely to be more expansionist than a balanced budget. What we are doing is to draw attention to the fact that in the context of Ceylon it is probable that the beneficial effects of the budgetary deficits in the depression were somewhat offset by the reductions in the absolute scale of public expenditure.

The second unfavourable factor, and in our opinion the more important one, resulting from budgetary policy in the depression was the change in the shares of public expenditure received by the different recipient groups in the community. It has already been shown that the cuts in Government expenditure during the depression were not spread uniformly between the several departments but were concentrated on such employment creating branches as the public works department. Indeed it can be argued that, although public expenditure fell considerably in money terms, there was no significant change in the scale of expenditure in real terms because of the sharp fall in prices, and that the bulk of the adverse consequences of the depression budgets were the result of a violent distortion in the distribution of an approximately constant volume of 'real' expenditure. We have already shown that very little progress was made towards the reduction in the salaries of existing permanent members of the public service. Since there was a sharp fall in prices during this period it may safely be assumed that the real incomes of this salaries class in the public service actually increased during the depression. This sectional increase in real income was made possible in the context of an approximately constant total of real expenditure by a reduction in the real incomes of the wage earning groups in Government employment many of whom lost their jobs altogether.

In assessing changes in the size of the public sector during the depression it is useful to consider not only the expenditure budget of the central government, but also the expenditures of public agencies like the railway and electricity departments whose finances are separated from the latter and also the expenditures of local authorities. Hitherto the finances of local authorities have been excluded from our discussion. Unlike in certain of the more developed countries local governments occupy a relatively small place in the finance of the public sector and a good many of the functions, which are performed by local authorities elsewhere, are undertaken by the central government.[282] Grants from the central government provide an important source of revenue to some local authorities and these sums are included in the expenditures of the central government. The chief economic significance of local finance pertains to changes in the size of local government expenditures as a whole and it is therefore appropriate that this aspect of it should be considered at this stage.

The table below has attempted to set out changes in the size of the public sector by taking total expenditure as an index of size. An imperfection must be noted. The figures for the expenditure of local authorities relate to the calendar year instead of the financial year. Here again we have followed the previous practice of assimilating the calendar year with the financial year which corresponds most closely to it (e.g. Calendar year 1929 with financial year 1928–29). Since local government expenditure remained relatively stable during the period no great distortion is likely to arise from this practice. The figures in the table below relate to three contrasting years representative of the predepression period, the depression and a normal year after recovery.

Total Expenditure of the Public Sector
(Rs. million)

Year	1928–29	1931–32	1936–37
Central Government	126.1	99.9	111.7
Railway	23.6	20.6	18.7
Electricity Department	.7	.8	2.3
Local Government	15.6	14.6	15.0
Total	166.0	135.9	147.7

Source: Annual Blue Books

Note: Local government expenditure relates to the calendar year.

282. "In Ceylon our national expenditure includes a vast amount of expenditure that is in other countries largely the expenditure of local authorities; there are all sorts of services found in our budgets which you do not find in the budgets of many governments and certainly not in the budget of the United Kingdom with which our budget is so often compared. Services like road, maintenance of hospitals and of the patients in the hospitals, maintenance of ports, maintenance of schools, and services of that sort – they are largely the expenditure of local authorities in England, the central government share being mainly in the form of grants. That sort of expenditure in our budget amounts to about one-fourth of the total, and if we could eliminate all those services from the expenditure of the central government and transfer them to local authorities, which we know perfectly well we cannot do, our national expenditure would shrink to comparatively modest dimensions." – Speech of the Colonial Treasurer – *Hansard*. 10th July 1930, p. 1119–20.

It will be appreciated that, although public expenditure in 1931–32 was over Rs. 30 million less than in 1928–29, the proportionate reduction in size was much smaller than the corresponding falls in export earnings. Indeed it is likely that, in spite of the reduction in the absolute size of the public sector during the depression, its relative size in relation to the economy as a whole actually increased during the depression. There is no continuous national income series for this period from which to arrive at an accurate idea of the changing share of the public sector. A coefficient of relative size may, however, be provided by the changing ratio of total public expenditure to total export earnings. It is possible, however, that such a coefficient overstates the relative share of the public sector in the depression for, although exports are a major constituent of national income with considerable influence on the other constituents, their fluctuations are likely to be more than in proportion to the fluctuation in national income as a whole. The movement in the coefficient of relative size is shown by the figures below. The increase in the size of the public sector relative at least to the size of the export sector in the years of the depression is certainly confirmed by these figures.

Coefficient of the relative size of the public sector*

Year	1928-29	'29-30	'30-31	'31-32	'32-33	'33-34	'34-35	'35-36	'36-37	'37-38	'38-39
Central Government	2.88	3.61	4.51	5.26	4.71	3.58	4.30	4.16	3.36	4.11	4.10
Total public sector	3.93	—	—	7.20	—	—	—	—	4.45	—	—

*i.e. Central government and public sector expenditure divided by value of exports for corresponding calendar year.

Of greater significance than changes in the money values of public expenditures is, however, the changes in these expenditures in real terms. There is unfortunately no index of retail prices with which the aggregate values of public expenditures may be deflated. Some approximation to the real value may, however, be obtained by using the index of import prices as a substitute. Since imports constitute an important part of total consumption, changes in import prices are fairly representative. The results are presented on the following page.

Public expenditure at constant prices

Year	1928-29	'29-30	'30-31	'31-32	'32-33	'33-34	'34-35	'35-36	'36-37	'37-38	'38-39
Central government	71.2	84.9	90.1	94.1	96.4	93.5	105.0	115.0	112.9	118.1	133.1
Total public sector	94.0	—	—	128.0	—	—	—	—	149.1	—	—
Import price index (av. 1934-1938 =100)	177	145	117	106	98	101	104	97	99	102	101

Source: Import price index from *Social and Economic Development of Ceylon. op.cit.* Table II.

Note: The import price index is for the corresponding calendar year.

The figures in the table above suggest that public expenditure in real terms far from contracting in the depression actually increased. In fact the increase, according to this table, was not only appreciable but practicably continuous (excepting 1933–34) right up to 1938–39. Even if allowance is made for the possibility that the import price index exaggerates the fall[283] in the general level of prices from 1928–29 onwards it can hardly be doubted that the real value of public expenditure probably increased during the depression.[284] This indeed would be the natural result of the relative stability of public expenditure.

If the public sector was in fact generating more purchasing power in real terms during the depression than before it, in what way can the consequences of budgetary policy in these years be said to be unfavourable? The answer is, in our opinion, to be found in the extreme unevenness with which this increased real income was

283. An alternative index for deflation is available from 1938 onwards. This is the cost of living index for the working class of Colombo town. It cannot be said that the movement of these two indices are parallel after 1938. The period was one of rising prices and the imports price index rises at a much faster rate than the cost of living index. But this result was largely due to the limited coverage of the cost of living index which was dominated by subsidised or price controlled commodities. It does not prove in itself that the import price index exaggerated the fall in the general price level during the depression.

284. The foregoing argument must not be taken to imply that there was an actual increase in the services provided by the Government during this period. Salaries account for the major portion of the cost of these services and, as we have already shown, salaries did not decline. The point we are making above refers to the increased real value of government disbursements to the recipients of these disbursements rather than to the Government itself.

distributed as between the different groups who are normally in receipt of public expenditure. When the money revenues of the Government fell in the depression money expenditures had to be reduced since the budgets had to be balanced as far as possible. If this reduction in expenditures was equally distributed between the several Government departments, or between the different groups who received their incomes from the Government, then the real incomes of the latter would have evenly increased notwithstanding the fall in their money incomes or in total Government expenditure. In fact, however, as we have seen, the cuts in public expenditure were not evenly distributed. Those who remained in Government employment had their money incomes maintained virtually intact and so enjoyed an increase in their real incomes. Those who did not, presumably joined the ranks of the unemployed and were denied their customary source of income whether real or monetary. In short, since salaries and employment in the salaried grades were inflexible, employment and wage rates in other grades had to suffer. Those who remained in employment were benefitted at the expense of those who were thrown out. And the fact that the numbers thrown out were not inconsiderable is borne out by the following figures of employment in the public service of the central government.

Total number of persons employed in the public service in November of each year

1930	.. 70,455	1935	.. 63,087
1931	.. 65,627	1936	.. 64,909
1932	.. 62,631	1937	.. 66,400
1933	.. 60,919	1938	.. 67,537
1934	.. 60,856		

Source: "*Administration Report of the General Treasury* 1936" p. J24.

Note: The figures include (i) officers confirmed in pensionable employment (ii) officers on agreement or on probation serving in pensionable posts, (iii) non-pensionable officers permanently employed on monthly pay, (iv) temporary officers in temporary appointments, (v) employees on daily pay paid from any funds provided by the Annual Appropriation Ordinance.

In discussing the impact of the depression on the Ceylon economy we pointed out that the existing evidence suggested that the fall in aggregate real incomes in the community as a whole was not very extensive but that perhaps one of the most serious problems of the depression was caused by the violent distortion in the distribution of incomes due to heavy unemployment. It can now be seen that the effect of the operation of the public sector was not to correct this distortion but to aggravate it. In fact the contribution of government retrenchment to the total of unemployed remaining in Ceylon was perhaps second only to that of the plantations. Between 1930 and 1934 employment in the public service fell by about 9,600. Although about 129,000 people were thrown out of employment by the plantations between 1929 and 1933, a good many of them left the Island. Indeed, if the whole of the net migration in this period was composed of unemployed plantation labour, and this is not very far from the truth, the contribution of the plantations to unemployment resident in Ceylon would fall to about 23,000. It can safely be asserted that the contribution of the budget to this shift in the distribution of incomes through unemployment was the outstanding effect of public finance on the economy as a whole during the depression.

We may conclude with a note on the effects of public finance on the balance of payments. It was shown earlier that the balance of payments on current account tended to be adverse during the depression, and the limited data at hand supported the conclusion that there was a running down of the foreign exchange reserves of the country. At the same time we argued that this feature did not threaten the stability of the exchange because it was protected by the rigidity of the monetary system of the country. For this reason there was no need for any conscious attempt to correct the adverse balance of payments through budgetary policy. In fact we have seen that instead of the corrective surpluses the budgets of this period actually incurred deficits. On the other hand, there is little to suggest that the budgets themselves were responsible for a substantial proportion of the decline in reserves. The reason for this is that the major source from which deficits were financed in the period before 1937 were 'recoveries from loans' which were essentially a form of foreign borrowing. Such a source, like the surpluses on sinking funds for foreign loan credited to revenue, made an equivalent addition to the available foreign reserves of the country.

CHAPTER V

THE WAR YEARS — A STUDY IN THE SPECIAL CASE OF DEMAND INFLATION

The previous chapter analysed the experience of an export economy in depression and its effects on budgetary policy. In this chapter we are concerned with an opposite situation. In keeping with the expositional technique of the preceding section we shall first examine the behaviour of the principal determinants of income and activity in the economy as a whole. Thereafter we shall study the impact of these forces on the Government budget. Finally, an attempt shall be made to assess in turn the effects of budgetary policy on the general economy.

I. The Singular Character of the Inflationary Problem in Ceylon

Although the period of war was characterised by high prices and high incomes and prosperity in the export sector the experience of these years was exceptional and in a sense unique. Indeed, we shall endeavour to show that for a small export economy with a rigid monetary system the 'demand inflation', which emerged during this time, was a special phenomenon possible only in singular circumstances. At the same time we emphasise that the lessons of this period are invaluable. In many respects they are illustrative of some of the dangers and problems that are likely to arise under a possibly active policy of compensatory finance in periods of depression. In addition they have revealed in practice the extent to which the administration is competent to deal with these problems.

The uniqueness of the situation of demand inflation followed[285] from two properties of Ceylon's economic and monetary set up. These were, first, that Ceylon was a relatively small country in

285. One of the properties mentioned above was subsequently modified by the establishment of a Central Bank. The Bank is empowered to depart from the rigidity which characterised the hundred per cent exchange standard. Once the close link between foreign exchange earnings and local incomes is broken 'demand inflation' is no longer a remote possibility but a very real danger. By 'demand inflation' we mean a rise in price due to an excess of total demand over total supply.

international trade which nevertheless imported the bulk of its consumer requirements, and second, that Ceylon was subjected to a rigid monetary system which maintained a close parallel between incomes in the country and earnings of foreign exchange. The first property implies that in normal circumstances the supply of imports to Ceylon was perfectly elastic as regards price. An increase in demand in Ceylon can always be satisfied by an increase in imports and apart from the period of time required for the imports to enter the country there need be no rise in import prices.[286] In other words Ceylon's demand in itself is too small to have any influence on the prices of imported goods. These prices are, in effect, determined for her by external circumstances. It must, of course, be clearly understood that this perfect elasticity of supply applies only to imports. Prices of domestically produced goods, for which there are no imported substitutes, can rise in periods of increased demand because the response of output in the domestic sector is generally slow and inadequate. Our generalisation about the exceptional character of inflationary price increases in the economy under pressure of excess demand is only applicable to imported goods and services and must not be taken to deny the likelihood of rising prices in the domestic sector in periods of increasing incomes. Land values, for instance, offer a good example of such price increases under the stimulus of high incomes. Nevertheless it is not unrealistic to confine our analysis, subject to these qualifications, to the behaviour of imports and import prices since this is the source of most of the consumption requirements of Ceylon which come to be satisfied through the channels of monetary exchange.

The perfect elasticity of supply of imported goods is, however, conditional upon the availability of foreign exchange. It is here that the second property of the economy mentioned above becomes significant. The hundred per cent exchange standard provided a mechanism which kept incomes, and therefore demand, in step with the availability of foreign exchange. In other words, it ensured that there was always a sufficient foreign reserve to meet the demand

286. This assumes, of course, that the import trade in Ceylon is fully competitive. There are no studies in this field to tell us whether such an assumption is wholly realistic. The existence of exclusive agencies for differentiated import products and the fact that access into the import trade which is substantially in the hands of foreigners is difficult for various reasons suggests that the assumption may indeed stand in need of modification.

for imports at the given rate of exchange. The monetary circulation of the country including currency and bank money was carefully geared to the levels of foreign reserves and for this reason increases in the monetary circulation were generally possible only in periods of rising foreign reserves. This, for example, is the normal experience of the economy in the upward phase of the trade cycle. The boom in exports leads to increased incomes and an increase in consumer demand, but this demand is satisfied out of additional imports which are financed out of the increased foreign exchange earnings of the export sector. The conservatism of the monetary system acts as an effective safeguard against an expansion of incomes in excess of what the foreign reserves could carry. This is not to say, however, that there is usually no rise in import prices during the boom. On the contrary such a rise is familiar enough. But the main point is that this rise is due to external factors and not to an excess of demand over supply in Ceylon.

The period of the war, however, saw the removal of one of the properties mentioned above. This was the marked change in the supply position of imports brought on by the war situation. There was now no longer any question of the supply of imports being perfectly elastic at a given price. Although as we shall see presently import prices did rise substantially during the war there was nothing to ensure that the supply of imported goods in Ceylon was adequate to meet the demand for them at even these enhanced prices. A situation of potential demand inflation thereby arose out of the removal of one of the customary safeguards against such inflation. This result was, of course, the special creation of wartime. The physical scarcity of supplies in the United Kingdom at existing prices, the acute shortage of shipping for transport, and the strict control exercised by Ceylon over imports as a contribution to the war effort were the main operative factors responsible for this result. There need of course have been no inflation if incomes kept in step with the fall in supplies. But this was not the case. The hundred per cent exchange standard, it is true, continued faithfully to fulfil its role of adjusting incomes to earnings of foreign exchange. But for once foreign exchange was not the limiting factor in the supply of imports.

In the following pages we shall analyse the nature of the wartime inflation and outline its chief repercussions on the economy as a whole. We shall then see how public finance adjusted itself to these exceptional circumstances.

II. Inflationary Factors in the Wartime Economy

A. The increase in incomes

Let us first turn our attention to the principal determinants of income in Ceylon during wartime.

(i) Exports

Exports and foreign investment usually play the role of the chief independent variable in income determination in the Ceylon economy. But as we have shown before, foreign investment ceased to be a major determinant after about the period of the First World War. The total value of Ceylon's exports increased steadily after the relatively short lived recession of 1938 and continued to increase during the whole of the wartime period. The record values of 1926 were regained in 1942 and surpassed thereafter.

Total export values are, of course, a product of both prices and quantities exported. The war years were not exceptional as regards the greater importance of prices in the determination of total values, but since there were special factors affecting the course of output as well, it may be helpful to consider here the behaviour of both prices and output in this period.

The outstanding factor about prices of exports was the abolition of normal free markets after 1942 and the fixing of prices by inter-governmental agreement. The United Kingdom Government became the exclusive agency which purchased the whole of the exportable supplies in a number of commodities and the Ceylon Government in turn became the sole supplier.

In the case of tea the first step towards control was taken as early as 1939 by the U.K. Government which took charge of all supplies imported into the United Kingdom. Purchases were made in Ceylon by the U.K. Government on the basis of voluntary contracts with individual estates at fixed prices. The procedure for price fixing is of some interest as the main principles were later extended over a number of other commodities in addition to tea. A contract price was fixed for each estate on the basis of the average price realised by it for teas exported during the three basic pre-war years 1936, 1937 and 1938, and adjusted to a level f.o.b. Colombo.[287] To this basic contract price was added an extra rate per pound, uniform for all estates, to cover the increase in production costs since the basic period. The extra price to be paid for cost increases was generally fixed annually[288] but since 1943 some flexibility was introduced within the annual period by means of a schedule of limited price adjustments varying with the rates of "dearness allowances" which the estates had to pay to labour.

In September 1942, the United Kingdom Ministry of Food became the sole purchaser of tea on behalf of all the Allied Nations. In accordance with an agreement between the Ceylon Government and the U.K. Government the export of all teas from Ceylon was prohibited, save at the orders of the U.K. Ministry of Food, and the system of price fixing described above was extended to all estates. The Tea Commissioner in Ceylon, who had hitherto been in charge of the administration of the restriction scheme, became the agent of the Ministry of Food for the purchase of teas in Ceylon.

In the case of rubber there was a similar centralisation of sales and purchases but there was no contracting with individual producers. In fact no controls at all were introduced until 1942, but thereafter a good deal of attention was focussed on rubber production since Ceylon became almost the sole supplier[289] of this essential strategic material to the allied nations after the loss to Japan of Malaya, Indonesia and Burma. The British Ministry of Supply became the sole purchaser of rubber on behalf of the allied powers and from the 5th March 1942 the Rubber Commissioner in Ceylon acting as its agent became the sole exporter of rubber from

287. Estates which did not have any sales figures for the basic years were paid contract prices based on prices paid to other estates in the district. cf. "The Ceylon Year Book for 1948", p. 59.

288. The additional price paid for cost increases each year turned out as follows:

	(per lb.)		
1940	.. 1.25d	1943 (May)	.. 4.75d
1941	.. 1.25d	1944	.. 6.75d
1942	.. 1.75d	1945	.. 6.75d
1942 (Sept.)	.. 4.00d	1946	.. 9.25d

cf. *The Ceylon Year Book* 1948 p. 59

289. This is, of course, only true of natural rubber. There was a rapid expansion of the U.S. synthetic industry during the wartime period.

the Island. It was found convenient to continue using the existing market organisations as far as possible with their facilities for buying, packing and grading of rubber. Ten approved shippers were appointed to purchase rubber from various dealers in the country and to make shipments on the instructions of the Rubber Commissioner. After the Japanese air raid on Colombo in April 1942 a number of dealers closed down their establishments and the flow of rubber from the producing areas to the shippers' stores was somewhat dislocated. As a result the Government found it necessary to establish 34 rubber purchasing depots in various parts of the country and the supplies procured through these depots were then sold to the shippers in the ordinary way. These purchases by the depots were financed out of advances by the British Ministry of Supply which provided a sum of Rs. 4 million for the purpose.

As a result of the centralisation of all purchases in the hands of the Rubber Commissioner, who was both an agent of the British Ministry and an official of the Ceylon Government, the price paid for rubber was effectively controlled by the sole buyer. There was no intergovernmental agreement on price or even contracting between the U.K. Government and individual rubber producers. The Rubber Commissioner simply fixed a price which he was prepared to pay to the various dealers bringing in supplies. There were no alternative buyers to outbid him and dealers had no incentive to withhold supplies except to the extent that they anticipated an increase in his own price. In his turn, the Rubber Commissioner fixed a price that was likely to secure as large an output as possible. Prices were not only adjusted upwards with increases in the cost of production as in the case of tea, but increases in the profit margins themselves were permitted in order to induce greater output. For this reason it was possible for the rubber industry to enjoy a period of comfortable prosperity during the war years.[290] The establishing of direct purchasing depots of the Government throughout the country ensured that the increases in prices reached the producers, particularly the smallholders themselves. "Maximum prices were paid at these depots and all facilities were afforded to producers to dispose of their rubber promptly. Owing to the existence of these depots dealers were compelled to pay competitive

290. The Rubber Commission of 1943 compared the increases in prices with the following estimates of the average cost of production. The various constituents in production costs have been left undefined.

prices for the rubber and maximum prices were thus assured to producers."[291]

Similar arrangements were made in respect of other commodities. A Department of Commodity Purchase was set up to purchase the whole of the exportable surplus of such products as copra, coconut oil, plumbago and citronella oil.[292] The centralising of purchases through this agency prevented prices from rising to a greater extent than was required by increased production costs. In addition a further department, known as the Department of General War Supplies, obtained miscellaneous supplies in Ceylon to help the war effort of the South East Asian Command in India.

It does seem reasonable to assume that given the urgent demand during the war for most of Ceylon's export products the course of export prices was generally at a lower level than would perhaps have prevailed had the export trade been conducted through the normal pre-war channels. In this sense it may possibly be argued, for instance, that Ceylon's accumulated wartime sterling balances would have been greatly enlarged if free commodity markets on

Year	*Average cost of production*	*cents per lb. Average selling price of smoked sheet*	*Average margin of profit*
1939	24	46	32
1940	23	56	33
1941	28	56	31
1942	29	67	38
1943	36	71	35
1944	45	98	53
1945	53	96	43

Source: S.P. XVIII, of 1947. *Report of the Ceylon Rubber Commission*, p. 3.

291. *Ceylon Year Book*, 1948 p. 63.

292. The Department of Commodity Purchase was established in April 1942. Its chief functions were the purchase of coconut oil, copra, plumbago, cinnamon and mica on behalf of the British Ministries of Food and Supply. In May 1942 the Department itself was obliged to operate as a shipper of copra on its own account by establishing stores in Colombo and in outstations in order to help the producer to dispose of stocks, and owing to lack of storage facilities at shippers' stores. The other commodities, coconut oil, plumbago, cinnamon and mica were not purchased direct from producers by the Department, but the Department only acted as agent of the British Ministries of Food and Supply in the purchase of the requirements from the shippers." – *ibid.* p. 69.

pre-war lines had remained. But the fact is that such markets had ceased to exist and Ceylon would in any case have had to negotiate a price with the U.K. Government which had centralised not only its own purchases but those of the other allied powers as well. The point however is academic as Ceylon was committed to full co-operation in the allied war effort and there was no intention on either side to squeeze out benefits through a process of selfish bargaining.

A part of the increase in total export values was also due to an increase in quantities exported. We have pointed out in an earlier chapter that from about the beginning of the nineteen thirties, the Ceylon economy had entered into a phase of relative stagnation. After this period there was no great expansion in the productive capacity of the Island and, although there was an increase in output in many of the export crops during the war, this increase was mainly brought about by the maximum utilisation of existing capacity and in some cases by the actual neglect of capital maintenance. Rubber was the extreme example of the vigorous attempts to increase output. In May 1943, the Government offered the payment of capital compensation for the replacement of areas "slaughter tapped", to all producers who were willing to adopt intensive systems of tapping which were likely to exhaust their trees within two years.[293] There were also numerous other inducements offered by the Government. For example, quarterly prizes were offered to superintendents of rubber estates which produced the highest increases in crop when compared with production in the corresponding quarter of 1942. The Rubber Commissioner's Department called for and carefully scrutinized returns of production from the various proprietors, and when an appreciable falling off in production was detected the estate was inspected and advice

293. "Producers who claimed benefit under this scheme were required to tap at least 20 per cent of the total tappable acreage on "Double Two" or at least 200 per cent intensity and the remaining extent on "Double Three" or at 133 per cent intensity for a continuous period of two years from date of commencement or until complete exhaustion of slaughter tapped trees."

At the same time it was decreed that participants under the capital compensation scheme were not entitled to benefits from any increase in rubber prices which might arise after the introduction of the scheme. In fact they were required to refund the difference between the prices fixed immediately prior to February 14th 1944, when the scheme was actually introduced, and any increase in price notified thereafter. – *ibid.* p. 64.

given on the improvement of crops. A fleet of lorries was maintained by the Department for the quick transport of rubber from the outstation depots to Colombo and these lorries were often made available to producers who found difficulty in securing suitable transport. In addition the various raw materials and supplies required in the process of production were controlled by the Government and distributed to the producers on a system of permits. Similar controls weie exercised for the efficient distribution of the various materials required in the production of tea.

As a result of all these measures output was in most cases successfully increased over the average levels of the 'thirties. But as we have remarked this increase in output was not due to any expansion in long term productive capacity. On the contrary, in the case of rubber the increase in output was actually secured at the expense of this productive capacity, for even if the whole of the slaughter tapped areas came to be replanted in the future there would still be a falling off in yield during the initial period of growth.

The course of exports from Ceylon in wartime are summarised in the table below.

(Rs. million)

Year	1939	1940	1941	1942	1943	1944	1945
Value of Total Exports	305	361	396	508	539	620	595
TEA	188	208	225	254	269	311	278
% of total	(61.6)	(57.6)	(56.8)	(50.0)	(50.0)	(50.2)	(46.7)
RUBBER	68	113	118	173	169	223	218
% of total	(22.2)	(31.3)	(29.8)	(34.1)	(31.4)	(36.0)	(36.6)
COPRA	7	10	15	28	37	29	39
% of total	(2.3)	(2.8)	(3.8)	(5.5)	(6.9)	(4.7)	(6.6)
COCONUT OIL	13	7	8	12	21	20	21
% of total	(4.3)	(1.9)	(2.0)	(2.4)	(3.9)	(3.2)	(3.5)

Source: *Statistical Abstract of Ceylon* 1949 Tables 123 and 135.

Note: Value of total exports cover total exports of Ceylon produce inclusive of postal articles and ships stores which are the produce of Ceylon. Re-exports, ships stores other than Ceylon produce and coal and oil bunkered have been excluded.

It will be seen above that total exports more than doubled between 1939 and 1944. The biggest increase between any two years occurred in 1941–42. As shall be shown later this is consistent with the general development of inflationary forces in the economy as there is a notable distinction between the periods prior to and after Japan's entry into the war. The preceding table also indicates changes in the relative importance of the principal export commodities. Tea tended to decline relative to rubber and coconut products. This is in contrast to the experience of the depression when the relative importance of tea greatly increased. Even in the period of war tea prices maintained their relative stability.

It is perhaps worth while to remark here upon one feature concerning export prices and values which was, in a sense, peculiar to the special conditions of war. Normally, with the possible exception of tea, the prices of most of the country's export products were determined in the world markets which were barely influenced by conditions in Ceylon: in other words Ceylon's share in the total world output of these commodities was too small to have any appreciable influence on prices. Accordingly, in periods of inflation any increase in the cost of production in Ceylon would lead to a reduction in profit margins unless world prices also happened to move upwards. There is no reason as to why world prices should increase if the inflation in Ceylon was of purely local origin. In such conditions a continued increase in production costs would lead either to a reduction in output and a loss in export earnings through the closing down of estates, or to a continued depreciation in the rate of exchange. In the period of the war, however, the position was changed fundamentally. Not only was it the case that prices for exports were closely related to cost conditions in Ceylon but also an increase in costs of production was virtually the only way by which an increase in prices could be secured. Ceylon's export earnings tended, in fact, to vary directly with the degree of inflation generated in the country.[294]

(ii) Military expenditure

In normal circumstances changes in exports are adequate to explain the major changes in incomes in the economy. In the period of the war, however, there was an additional source of

294. Given the physical shortage of imports this implies, somewhat paradoxically, that the more inflation there is the greater the export surplus and the larger the sterling balances! It would perhaps be too much to claim that this situation did in practice dampen the incentive of the Ceylon Government to control inflation. If there was a substantial danger of this it is likely that the U.K. Government would have modified its policy of automatically linking up the prices it paid out with movements in the cost of production in Ceylon.

incomes of an entirely new character which eventually assumed a magnitude comparable to total exports themselves. This source was the expenditure of the military authorities in the Island after Japan's entry into the war. "After April 1942 there was a regular flow of services personnel into the Island. To begin with they came to defend Ceylon; later their presence was due to the Island having become a spring-board for the assault on Malaya. By 1944, Ceylon had acquired such importance strategically that the Headquarters of the Supreme Commander of South East Asia Command, Admiral Lord Mountbatten, was transferred to Kandy."

The conversion of Ceylon into a military base had far reaching effects on the whole economy of the country.[295] From the point of view of incomes there were two factors of relevance. The first was the actual earnings of the service personnel themselves which were likely to be spent in Ceylon and the second the expenditure of the military authorities in the Island on a variety of constructional and other purposes. Official estimates of the total military expenditure in Ceylon by the allied governments on both these accounts are as follows:

Year	*Military Expenditure of Allied Governments (Rs. million)*
1941	12
1942	204
1943	261
1944	435
1945	417

Source: These figures were made available to the writer by the Department of Census and Statistics, Colombo.

295. The impact of this was not confined to the economic sphere – "The presence of tens of thousands of troops in Ceylon had other effects. In the past the social contact of British Europeans were mainly confined to the better educated Ceylonese and even then there was often an innate reserve on both sides which prevented widespread mixing. In the nineteen thirties there came about a better understanding but the change was nothing compared to what happened from 1942 onwards. The British troops specially the rank and file fraternized freely with the local inhabitants. In Colombo, the middle-class Ceylonese contributed considerably to the entertainment of troops both in public halls and in their own homes, many of them acquiring in the process a sense of freedom from convention hitherto associated with Western countries. But there was no revolution and many of the visitors remained puzzled at Ceylon standards of propriety. In the rural areas, contacts were of a different kind, the difficulties of language and custom being paramount. But the exemplary behaviour of the troops and their spirit of good humour created a very good impression

In 1944 and 1945 military expenditure in Ceylon was in excess of the total value of exports in any pre-war year. The great importance of military expenditure in the increase of incomes in Ceylon is clearly brought out when the annual increase in this expenditure is compared with the annual increase in exports.

Annual Increases in Military Expenditure and Exports in comparison with preceding years

(Rs. million)

Year	*Increase in Military Expenditure*	*Increase in Exports*
1942	+ 192	+ 107
1943	+ 57	+ 39
1944	+ 174	+ 110
1945	— 18	— 14

The particular importance of the years 1942 and 1944 are illustrative of separate phases in the war since it was about the latter year that preparations for an offensive against the Japanese were beginning to get under way.

Apart from the absolute size of military expenditure, the manner in which this expenditure was financed was of special significance to the problem of inflation. The automatic nature of the currency system of Ceylon was utilised to make available the rupees in Ceylon that were required for military purposes. Using the link between sterling, the Indian rupee and the Ceylon rupee which we have described elsewhere, the Imperial Government was able to get rupees created in India by giving sterling to the Indian Reserve Bank in Bombay. These Indian rupees were then in turn presented to the Ceylon Currency Board for conversion into Ceylon rupees. The Currency Board had no option but to issue Ceylon rupees against Indian rupees and in this way the currency requirements of the military authorities were smoothly satisfied. At the same time the Currency Board, because of the limitations in imports, accumulated a large reserve of Indian rupee exchange which it subsequently converted into sterling and thereby built up a large part of what later came to be called Ceylon's sterling balances.

and removed any lurking fears of the population. For the first time, in this manner, the average Ceylonese came to know and understand the average citizen of Britain – *Ceylon Year Book* 1948 – *op.cit.* p. 9.

It is interesting to speculate as to the alternative ways in which military expenditure may have had to be financed if the automatic device of the exchange standard was not available. Then presumably, the Imperial Government, in order to secure rupees in Ceylon, would have had either to increase exports to Ceylon, or to increase the prices of these exports, or alternatively, to cut imports from Ceylon. It could further have obtained rupees by selling British investments in the country or by raising loans in Ceylon either directly or through the Ceylon Government.

It can hardly be doubted that all these alternative methods, though not equally feasible, would have, in varying degrees, lessened the inflationary pressure of military expenditure in the Island. Thus an increase in exports to Ceylon would have augmented the supply of goods in the Ceylon market; an increase in the price of these exports would have absorbed some of the excess demand in the country; a reduction in imports from Ceylon would have in part offset the increase in incomes resulting from military expenditure. All these measures were, needless to say, barely practicable. The possibility of increasing exports to Ceylon was limited by wartime scarcities in Britain and a reduction in imports from Ceylon was likewise undesirable because of the importance to the war effort of supplies from the Island. An increase in the price of British exports to Ceylon was, of course, an alternative possibility but here again its effects would have been frustrated, at least partially, because of the system of relating the prices paid for Ceylon produce with changes in the costs of production.

The remaining alternatives were the sale of British investments in the country or the raising of loans in Ceylon by the U. K. Government. The latter alternative would have encountered certain technical difficulties if attempted on a large scale. On the one hand it is doubtful whether private individuals were in a position to make very substantial contributions even at high rates of interest. The experience of the Ceylon Government in internal borrowing has shown that the commercial banks and other financial institutions were the major subscribers to loans. On the other hand the banks themselves would not have found it very easy to make up the difference. Normally the banks in Ceylon are able to invest in Government securities in periods when they enjoy excessive cash reserves, as Government loans afford a profitable outlet for their surplus cash. They seldom yield to the temptation of financing government borrowing through pure credit expansion in the sense of creating deposits against government securities irrespective of their cash position. Now it is true that during the war the banks did in fact enjoy substantial reserves of cash and that their customary ratio of cash to deposits was generally exceeded. But it must be remembered that military expenditure itself was partly responsible for this result and if this is excluded the major remaining source of the excess cash would be the export surpluses of wartime. Although these surpluses were large in themselves, it is difficult to imagine that they would have improved the cash position of the banking system to a degree sufficient to enable the latter to finance the whole requirements for military expenditure.

If, however, the financing of military expenditure through internal loans had been practicable, it is likely that the result would have been somewhat less inflationary than the actual technique adopted in practice, insofar as interest rates or other inducements offered would have stimulated increased savings or have diverted funds from other types of investment. Such a system would have been decidedly less inflationary if military expenditure were met out of loans by the Ceylon Government to the U.K. Government, and if the Ceylon Government had secured the monies for these loans out of budget surpluses. But this did not in fact take place. As we shall see later the Ceylon Government did make a loan to the U.K. Government during the war but this merely represented the re-lending to the U.K. of an internal loan raised from the public by the Ceylon Government and was not an investment of budget surpluses.

If it had been practically possible for military expenditure to be financed out of credit expansion by the banking system, the result would of course have been more inflationary than other forms of internal borrowing. In effect the situation would not have been very different to what actually took place. Instead of the Currency Board issuing Ceylon rupees against sterling and Indian rupee exchange, the banks would have expanded bank deposits against sterling [296] and the total money supply would still have

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296. We are assuming here that the auomatic device of the Currency Board is not available. If it were, the banks could easily create deposits for the military authorities against sterling and then strengthen their cash reserve

increased although bank money would now predominate over currency in circulation. The technique of utilising the Currency Board to issue rupees in Ceylon against "unusable" sterling[297] is in a sense analogous to the financing of public expenditures through borrowing from the banks against government securities. If anything, the comparison is too moderate. For the issue of currency to finance expenditures has the secondary effect of strengthening the cash reserves of the banks and thereby lays the foundation for a corresponding expansion of credit by the banking system. It may be more realistic to compare the issue of currency against unusable sterling with a vast fiduciary expansion of the currency[298] for, although the note issue was backed cent per cent by sterling exchange, this sterling was not convertible into goods in the short term.

The remaining hypothetical source of finance for military expenditure during wartime was a reduction in Ceylon's foreign indebtedness through either the purchase of British investments in the country or the repayment of Ceylon's sterling public debt. Neither of these possible devices was utilised. Ceylon's sterling public debt was in any event too small to provide, through its liquidation, the whole of the requirements for military expenditure.[299] But British capital invested in Ceylon was of substantial dimensions. In most countries in the sterling area military expenditure was financed by credit creation against sterling assets, but in many countries outside the sterling area, and notably in Latin America, purchases for Britain's war effort had sometimes to be financed through the sale of British investments in those territories. It is conceivable that military expenditure in Ceylon should have been financed in a similar way. It would take us too

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in Ceylon by converting a part of this sterling into rupees with the Currency Board. In this case military expenditures would in effect be indirectly "financed" by the Currency Board though to a lesser extent. The increase in the currency issue will now represent, not the total of military expenditure, but that proportion of it which the banks wish to hold as a currency reserve.

297. The sterling was "unusable" because of the physical difficulty of procuring imports and because of import control. Ceylon's sterling assets were never "frozen" by Government decree.

298. From the point of view of confidence in the currency, however, a backing of unusable sterling was presumably preferable to no backing at all.

299. From 1940 to 1948 Ceylon's sterling public debt remained at Rs. 125 million. (*Statistical Abstract for* 1949 Table 164) Total military expenditure between 1941 and 1948 amounted to Rs. 1,329 million.

far afield to discuss the possible techniques whereby this might have been effected. How far such a method of meeting military expenditures would have been inflationary would largely depend on the manner in which local funds for the purchase of these assets were obtained. The question however is purely hypothetical and there is no evidence that the possibility was even considered. The general attitude in Ceylon of co-operation in the war effort and the willingness to share its burden, together with the existence of a convenient, secluded and automatic device for financing war expenditure prevented the question of alternative methods of finance from ever becoming a real issue.

(iii) Bank Credit

We have so far analysed exports and military expenditures as the major determinants of incomes in wartime Ceylon. It would perhaps be reasonable to describe both these factors as external determinants of incomes since they were largely the result of forces operating outside Ceylon and since they raised incomes in the country by increasing its external receipts. We must now turn to the possible internal determinants of incomes and see what part they had to play in the wartime inflation. The main potential expansionary forces internally would be the credit policy of the banks and the budgetary policy of the Ceylon Government. We shall postpone an examination of budgetary policy to a later stage when we shall assess the impact of the budget on the economy as a whole. Here we shall glance briefly at the behaviour of bank credit.

It is the normal practice for the banks in Ceylon to create a demand deposit against either rupees or sterling deposited with them. Thus when the earnings of their customers, whether in rupees or in sterling, increase and these earnings are deposited with the banks, the total of bank deposits in the country will show a corresponding increase. If the banks restrict themselves to establishing deposits in amounts exactly equivalent to the rupees, or sterling deposited with them, they will clearly be playing an entirely passive role in the expansion of the money supply. This is readily apparent when rupee currency is deposited with the banks against demand deposits. There is, it is true, a change in the composition of the money supply as rupees are now withdrawn from the active circulation and remain in the vaults of the banks whilst an equivalent amount of demand deposits or bank money take their place; but the total money supply consisting of bank money and currency in active circulation remains unchanged. The position is somewhat different when sterling is deposited against bank deposits because here rupees are no longer withdrawn from the active circulation; but in fact the situation is not very different from what would take place if the banks were not prepared to create deposits against sterling. In this case customers could present the sterling (after conversion into Indian rupees if necessary) to the Currency Board and obtain Ceylon rupees in exchange. They could now proceed to deposit these Ceylon rupees with the banks against bank deposits and the resulting increase in the money supply would be no different. If the banks always pursued a passive rôle on these lines the ratio of Ceylon rupees, plus sterling, to bank deposits in Ceylon, would continue to remain at a hundred per cent. The banks would not, in other words, be 'creating' money; they would only be substituting bank money for either actual or, in the case of deposits against sterling, potential rupee currency.

Now it is true the banks in Ceylon do play a relatively passive role in the determination of the total money supply when compared to certain other countries. The ratio of the rupee cash plus sterling reserves to demand deposits is generally believed to have been extraordinarily high. No detailed figures are available before 1939 but in that year the total demand deposits of the commercial banks in Ceylon amounted to Rs. 124.4 million, whilst their external assets were as high as Rs. 84.5 million, and their cash reserves in Ceylon were Rs. 9 million, a ratio of over seventy-five per cent. It is not difficult to understand why 'credit creation' was generally a factor of negligible importance in the policy of the Ceylon banks. On the one hand, the outlets for secure but profitable loans and advances in Ceylon were hardly significant.[300] On the other, the banks derived the bulk of their profits from the purchase and sale of foreign exchange, a process which is well reflected in the creation of deposits against sterling (and indeed other foreign currencies) and vice versa.[301] What we are concerned with at present, however,

300. There was no internal borrowing by the Ceylon Government until 1937. Even this was a long term loan. There was no short term borrowing by the Government on the basis of Treasury bills or other short paper before the war.

301. The banks derived their profits in the form of a commission. The margin of profit was determined by the costs and inconvenience for the public of operating through the Currency Board.

is whether there was during wartime any modification in the degree of passivity in bank policy on the question of credit creation. For this purpose it is necessary to ascertain how far the increase in bank money in this period was merely a reflection of the increase in the cash and external assets of the banks and how far it was due to an active policy of credit expansion.

Banking statistics are fortunately available since 1939 because in that year the banks began to furnish the Government with statements of accounts. In the following table only demand deposits have been taken to represent bank money since it would be misleading to include time deposits as a part of the money supply. We shall take the difference between total demand deposits and the cash and external reserves of the banks as being representative of 'created' bank money. The results are summarised below:

Changes in Bank Money and Bank Reserves 1939–1945
(Rs. million)

Year End of (Period)	(1) *Total demand Deposits*	(2) *Total Currency Reserve*	(3) *Total External Assets*	(4) (2)+(3)	(5) *Total 'Created' Money* (1–4)
1939	124	9	87	96	28
1940	162	11	148	159	3
1941	181	13	133	146	35
1942	298	18	211	229	69
1943	295	18	225	243	52
1944	392	22	283	305	87
1945	461	113	237	350	111

Source: *Administration Report of the Controller of Exchange* 1949 Appendix I for demand deposits from 1939 to 1942. *Central Bank of Ceylon – Monthly Bulletin* – Nov. 1951 Table I and 19 for the rest of Column (1) and for columns (2) and (3).

Note: Demand deposits exclude inter-bank deposits but include Government deposits.

The figures above do in fact suggest that the policy of passivity on the part of the banks was progressively modified during the later years of the war in favour of active credit creation. A decline in the reserve ratios of the banking system also reflects this development. This is illustrated on the next page.

It will be noticed in this table that, although the total reserve ratio fell progressively between 1940 and 1945, the cash or currency ratio increased considerably in 1945. This is readily

Reserve Ratios of the Banking System 1939--45

Year (end of period)	(1) *% Ratio of currency reserve to demand deposits*	(2) *% Ratio of external assets to demand deposits*	(3) *% Ratio of total reserves to demand deposits*
1939	7.3	68.5	75.8
1940	6.8	91.4	98.2
1941	7.2	73.5	80.7
1942	6.0	76.9	82.9
1943	6.1	76.3	82.4
1944	5.6	72.3	77.9
1945	24.5	51.4	75.9

understandable. Credit creation entails an increasing drain on the cash reserves of the banks and as the process continues the banks will find it necessary to fortify their cash position by converting a portion of their external assets into local cash reserves. The marked increase in the cash reserve in 1945 was accompanied by a steep reduction in the external assets of the banks in the same year.

Some caution is required in interpreting the effects of the credit policy of the banks as a factor in the general expansion of incomes in the community. The fact is that a good deal of this credit was extended to the Ceylon Government through investment by the banks in Government securities.[302] Whilst it would be permissible to regard this credit creation as a contribution by banks to the increase in the spendable incomes of the Government, its inflationary effects would depend on whether these monies were in fact spent. In normal times it is usual for both Governments and private persons to borrow monies for the purpose of spending them, but in the special conditions of the war the Government did not always spend its loan receipts. We must defer a consideration of this point until we come to discuss the Government's finances. In any case, even if the Government did spend the whole of the

302. Investments by the commercial banks in Ceylon Government Securities increased from Rs. 80.0 million in 1943 to Rs. 153.1 million in 1945. At the same time, loans and advances for industrial, agricultural and other purposes only rose from Rs. 17.2 million to Rs. 21.4 million. Short term lending by the banks through the purchase of bills of exchange dwindled considerably during the war with Government participation in internal trade. Bills discounted actually fell from Rs. 7.9 million in 1943 to Rs. 5.7 million in 1945. When more normal conditions were restored after the war there was a revival in this type of lending. Thus in 1947 Bills discounted increased to Rs. 40.9 million. (cf. *Statistical Abstract for Ceylon* 1949, Table 185).

credit it received from the banks, it would be erroneous to include both this bank credit and the Government deficit as separate inflationary factors.

In short, since the expansion of credit by the banks to the domestic sector of the economy other than the Government was of negligible importance, and since the credit policy of the banks was closely related to the loan policy of the Government, we may justifiably exclude bank credit as a significant and independent factor in the determination of incomes in the general economy during the war.

B. The response of supply to the increase in demand

(i) Imports

The wartime increase in incomes would not of course have had an inflationary effect if there was a corresponding increase in the supply of goods to the home market either from external or domestic sources. We have shown that in normal circumstances an increase in demand in Ceylon will be satisfied out of additional imports. Prices of home produced goods and services for which there are no imported substitutes can of course increase if supply does not readily expand to meet the rise in demand, but there is no reason why the prices of imports, which after all provide a substantial proportion of the country's consumption requirements, should increase except in the very short term. In the conditions of the war, however, things were different and we shall, in this section, briefly examine the behaviour of supplies of both imports and home produced goods.

The outstanding fact about the supply of imports in wartime is that far from increasing in response to the expanded demand in Ceylon imports actually suffered a spectacular decline. Details of changes in quantities imported are given in the table below. The facts are striking. In 1940, 550,000 tons of rice were imported into Ceylon, in 1944 112,000 tons came in. In 1940, Ceylon imported 76 million yards of cotton piece goods, in 1944 only 41 million yards were imported. In 1940, 1,145 cars were imported, in 1944 there were only 9. Imports of fertilizers dropped from 2,000,000 cwts. in 1940 to 948,000 cwts. in 1944. The only increases of any significance were in imports of wheat flour and other subsidiary grains which were brought in as substitutes for rice in order to ease the threatening food situation in the country. Thus in 1940, 363,000 cwts. of wheat flour were imported, the corresponding figure in 1944 was 5,913,000 cwts. The overall index of volume of all imports into Ceylon with the average of the years 1934–38 as 100 fell from 103 in 1939 to 67 in 1944.

Volume of Imports of Selected Commodities (1939–48)

Year	1939	1940	1941	1942	1943	1944	1945
Rice (cwt. 000)	11,675	10,996	10,937	4,710	2,772	2,239	3,577
Wheat flour (cwt. 000)	380	363	443	1,797	4,066	5,913	4,400
Fish, dried and salted (cwt. 000)	320	322	360	310	419	477	413
Curry stuffs (cwt. 000)	361	367	397	341	226	277	251
Cotton Piece goods (yds. 000)	65,823	76,619	61,308	32,680	54,827	40,921	48,992
Motor vehicles no.	1,565	1,145	307	42	17	9	69
Overall index of import volume 1934–38=100	103	103	93	65	69	67	78

Source: *Statistical Abstract of Ceylon* 1949, Table 134; and *Economic and Social Development of Ceylon,* Table II for import volume index.

It should be mentioned that the decline in imports was most severe in the case of commodities which were normally imported from the United Kingdom, the United States or Europe, and from the South East Asian regions which were overrun by the Japanese. The decline in rice imports was primarily due to the cutting off of Burma, Indo-China and Siam which were Ceylon's customary suppliers. Imports from the mainland of India were not, in comparison, so seriously restricted. Thus supplies of dried and salted fish, curry stuffs, onions etc. continued to flow in at a relatively stable rate. Moreover, imports of certain items connected with the prosecution of the war or the presence of large numbers of servicemen in the Island, actually increased during our period. Petroleum and cigarettes are appropriate examples of this.

The inflationary impact of the reduction in imports at a time when incomes were rising was, however, in part offset by a rise in the foreign prices of these imports. We have already distinguished between an increase in the foreign prices of Ceylon's imports and an increase in prices due to excess demand in Ceylon. It would be necessary to exercise some caution in applying the term "inflationary" to the former type of price increase for, though it may be analogous to what is sometimes described as 'cost inflation', it usually has little to do with incomes and demand in Ceylon. Indeed, from the point of view of incomes and demand in Ceylon, high foreign prices for imports are a disinflationary force because purchasing power is drained away from the country and make no further contribution to local incomes.[303] Expenditure abroad on imports, like savings and taxation, constitute a leakage from the income stream of the community.

The increase in import prices during wartime is no less striking than the reduction in the volume of imports. The main elements in import prices are presented in the table below.

Price Indices of Selected Imports 1939–45 (1938 = 100)

Year	*Food*	*Clothing*	*Household Goods*	*Kerosene oil*	*Overall import price index* (1934–38 = 100)
1939	101	91	98	102	101
1940	117	95	137	112	120
1941	141	125	149	111	147
1942	212	166	169	117	220
1943	267	431	244	97	315
1944	241	793	274	76	349
1945	292	645	207	70	340

Source: *Economic and Social Development of Ceylon* Tables III, VII and VIII. The indices for food, clothing, household goods and kerosene oil have been derived by dividing their customs values by their values at constant 1938 prices as given in Table VIII of the above report. Since no details have been given concerning the items in each of these groups and their weightage the indices should only be regarded as broad indicators of price changes.

It will be seen that the degree of price variation was not the same for each group. Textile prices, for instance, seem to have increased much more than food prices, whilst the price of kerosene oil actually decreased. The general trend is, however, indicated in the overall import price index which increased more than three fold between 1939 and 1945. The significance of these price increases will be appreciated when we remember that whilst in 1939 the value of imports of merchandise into Ceylon was Rs. 242 million, in 1944, for a quantity of imports reduced in volume by

303. The disinflationary effects would, however, in part be negated when the rise in import prices directly leads to an increase in export earnings. As we have seen earlier, this was partly the case in Ceylon as export prices were varied with changes in the costs of production.

almost 40%, Ceylon was paying Rs. 518 million or over double the total value of the 1939 imports.

The marked increase in the prices paid for imports had the result of increasing the total value of imports into Ceylon during the war years in spite of the fall in the physical quantities imported. As we have mentioned, this rise in the value of imports was from the point of view of excess demand in Ceylon a disinflationary force.

That the rise in import values was nevertheless inadequate to drain away the whole of the increases in incomes in Ceylon, caused by the rise in export earnings and military expenditure, is shown by a glance at the behaviour of Ceylon's balance of payments on current account.

(Rs. million)

Year	1939	1940	1941	1942	1943	1944	1945
I. Receipts							
(a) Merchandise exports	328	387	424	531	570	680	666
(b) Invisible items	29	34	31	33	34	39	
(c) Military expenditure	—	—	12	204	261	435	417
Total	357	421	467	768	865	1,154	
II. Payments							
(a) Merchandise imports	242	283	287	296	447	518	621
(b) Invisible items	132	147	143	178	159	188	
Total	374	430	430	444	606	706	
Balance	–17	–9	+ 37	+324	+259	+448	

Source: Board of Ministers Post War Development Proposals. p. 19.

Note: The estimates for invisible items are tentative and incomplete.

The surpluses in the balance of payments on current account[304] had a dual aspect in that they represented both the net contribution of internal trade (inclusive of military expenditure) to the "inflationary gap" in Ceylon as well as the accumulation of the Island's external balances. Ceylon's sterling balances came to play

304. Except, of course, to the extent that they were offset by outflows on capital account. Direct and accurate statistical data on capital movements are almost completely lacking, but there is no evidence to suggest that there was a substantial net outflow of capital from Ceylon, although it is generally believed that certain European owned plantations were purchased by Ceylonese during wartime. Rough official estimates put the magnitudes as follows:

an important part in the background to economic changes in the country in the post war period and it will be useful at this stage briefly to survey their development.

The accumulation of Ceylon's external assets was the result of the excess of her external receipts through exports and military expenditure over her external payments (mainly imports). This excess was not due to any natural reduction in the country's propensity to import caused, for instance, by a voluntary increase in savings or a shift to domestically produced goods, but was brought about by the physical difficulties of procuring imports in wartime. There was no 'sterilising' or 'freezing' of Ceylon's external receipts by official decree from London, but rather the balances happened to accumulate because of the wartime difficulties of importing. The so-called blocking of the sterling balances came later in the post-war periods when by agreement between the United Kingdom and Ceylon Governments a part of Ceylon's external assets were earmarked into a separate "blocked" account. The external assets themselves were held or "owned" by a number of agencies in Ceylon – by the Governments, by semi-government institutions, by the Currency Board, by the Commercial Banks and by individuals and firms. That part of the increase in external assets which was held by the Currency Board and the Commercial Banks had, of course, its counterpart in an increase in the local money supply consisting of both currency and bank money.

It is important to note that Ceylon's external balances were almost entirely sterling balances. This feature was a consequence

(Rs. million)

	1940	1941	1942	1943	1944
(i) Purchase by Ceylon nationals of real estate in Ceylon from foreigners	2	5	12	14	11
(ii) Purchase by foreigners of real estate in Ceylon from Ceylon nationals	2	4	3	2	2
(iii) Difference	—	–1	–9	–12	–9

Source: Board of Ministers Post War Development Proposals. 1946, *op.cit.* Table II p. 20.

The fact, however, that Ceylon's external assets are known to have increased is sufficient proof that capital outflows were inadequate to offset the current account surplus in the balance of payments.

of Ceylon's membership of the sterling area, and it does not signify that the actual surplus was entirely earned in sterling. On the contrary a good proportion of the surpluses were dollar surpluses, and it has been argued that if not for the country's connection with the sterling area the bulk of Ceylon's post-war sterling balances would have been dollar balances. The available statistics, though incomplete, support this view. In normal pre-war years Ceylon tended to enjoy a consistent surplus in her balance of merchandise trade with the United States of America and Canada due primarily to exports of rubber and tea. This surplus tended, however, to offset or "finance" a customary deficit with the sterling area from whence Ceylon obtained most of her imports and to which most of her payments for invisible items (profits on foreign investments etc.) were made. In the war years this deficit with the sterling area was either heavily reduced or wiped out altogether because of the curtailment of imports and military expenditure whereas the surplus with the dollar area actually increased. The result was not only that Ceylon enjoyed an overall surplus and a consequent increase in her external assets during this period, but also that the whole of this increase was the result of the surplus with the dollar area, except in those years in which Ceylon enjoyed both a dollar and a sterling surplus. In other words, in the years when the dollar surplus exceeded the increase in total external assets the whole of the increase in the latter would represent an increase in dollar reserves, the difference being used to finance the sterling deficit. In the years when the increase in total external assets exceeded the dollar surplus, then only a part of the increase in the former would represent an increase in dollar reserves as the remainder would be the result of a concurrent sterling surplus. The existing statistics on the surpluses with the dollar area and the increases in external assets are partial in that only merchandise trade is taken into account in the case of the former and that only assets held by the Government, the Currency Board and the banking system are included in the latter.[305] But a comparison of the available data gives the following results:

305. These difficulties need not however, be serious. Invisible items of trade with the dollar area are believed to be small (cf. *Administration Report of the Controller of Exchange for* 1949. p. U4); and privately held external assets are not included in what is generally regarded as Ceylon's sterling or external balances. We are only endeavouring to see whether Ceylon's dollar surpluses are adequate to explain the increase in the external assets held by official agencies and the banking system.

(Rs. Million)

Year	1940	1941	1942	1943	1944	1945	1946
Dollar trading surplus	101.4	138.6	126.8	71.2	193.8	139.3	44.5
Annual increase in total external assets	49.3	110.3	87.6	150.2	288.4	298.1	–49.6
Residual sterling deficit or surplus	–52.1	–22.3	–39.2	+79.0	+96.4	+158.8	–94.1

Source: Balance of merchandise trade in dollars from *Administration Report of the Controller of Exchange for* 1949. p. U4. Increase in total external assets from *Central Bank of Ceylon – Monthly Bulletin November* 1951 Table 19.

Notes : (a) The dollar trading surplus only refers to the balance of merchandise trade with the United States of America and Canada.

(b) The total increase in external assets constitute increases in the assets held by the Government, Government Agencies and Institutions, the Currency Board and the Commercial Banks.

(c) The residual sterling area deficits or surpluses represent the difference between the annual dollar surpluses and the increase in external assets. All countries except the U.S.A. and Canada have been included in the sterling area. This is not exactly accurate but Ceylon's trade with non-dollar non-sterling countries is small.

(d) No adjustments have been made in this table for the dollar content of liquid fuel retained for local consumption which has been estimated at a total of Rs. 130 million for the 10 years 1940-1949 (*Administration Report of the Controller of Exchange. op.cit.*) Since petroleum imports increased significantly between 1943 and the end of the war it is likely that the sterling surpluses in this period are appreciably understated and the dollar surpluses overstated.

The figures in the table above conform to the view that the greater part of Ceylon's external assets represent surpluses with the dollar area. Indeed from 1940 to 1942 inclusive, the whole of the increase in external assets represents dollar surpluses as there was in this period the customary deficit with the sterling area. From 1943 to 1945 only a part of the total increase in external assets is represented by dollar surpluses. These were the years when military expenditure in Ceylon reached substantial proportions and, since this expenditure was financed by exchanging sterling assets for rupees, a surplus of sterling receipts on current account replaced the customary deficits. In 1946 the deficits emerged once more with the cessation of military expenditure and in that year there was an actual running down in total external assets. Between 1940 and 1945 Ceylon's total external assets increased by Rs. 983.9 million. Rs. 651.5 or 66.3 per cent of this amount was made up by dollar surplus and the remaining Rs. 332.4 million by surpluses in sterling (and other foreign currencies). These are of course only rough estimates and the dollar share is probably overstated for the reason given in the note to the table above. They do, however, suggest that the view put forward by the Controller of Exchange in his Administration Report for 1949 is only partially true in the case of the accumulation of Ceylon's sterling balances in wartime: "These assets are nothing less than the counterpart of Ceylon's dollar surplus surrendered to the sterling area dollar pool. Had Ceylon been in a position to act otherwise and retain her dollar contribution as an independent gold or dollar reserve, she would not only have held her external assets in a currency convertible into gold instead of in sterling which she now finds blocked but she would also have avoided the depreciation in the value of her reserves which she has had to suffer in consequence of devaluation. With the establishment of a Central Bank, the question of Ceylon building up an independent gold or dollar reserve, the retention of which has already been agreed to in principle, will take a practical form."[306]

(ii) Home Output

We may now return to our analysis of the inflationary factors in the Ceylon economy. We have seen that imports instead of increasing in response to the increased incomes and demand in Ceylon, actually contracted but that the effects of this on excess incomes in the economy was in part offset by the rise in import prices. We must now consider the behaviour of domestic output and see whether this output expanded sufficiently in response to increased demand and whether the increase was adequate to compensate for the decline in the volume of imports.

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306. *Administration Report of the Controller of Exchange for* 1949 *op.cit.* p. U4.

The calculation of Ceylon's dollar earnings has been based on exports of Ceylon produce consigned to the U.S.A. or Canada. (It excludes Ceylon produce re-exported to the dollar area from other countries). The fact that exports from Ceylon were directly consigned to the United States or Canada does not mean that the whole of the equivalent dollar payments were made to individuals or firms resident in Ceylon. On the contrary a good proportion of the dollar settlements was usually made with firms resident in London. Under British Exchange Control Regulations these dollar earnings were sold to the Bank of England for sterling. Moreover when the U.K. Government became the sole purchaser of Ceylon's exports almost all payments to Ceylon were made in sterling. The argument that, if not for the sterling area mechanism, Ceylon would have been able to build up substantial dollar reserves of her own, presupposes the existence of exchange control machinery to take over the whole of Ceylon's dollar earnings. This assumption was only fulfilled in 1950 when the newly created Central Bank of Ceylon opened independent accounts in New York and other dollar centres.

There were two elements to the increase in demand for the output of the domestic sector. On the one hand there was the increased demand for those goods which by their nature are always supplied out of domestic sources – the so-called sheltered industries whose products cannot be substituted by imports. The rise in demand for this type of product is largely a function of the increase in local incomes and is barely affected by the availability of imports in general. The range of products of this sort is, however, not very wide in Ceylon, as almost the whole of the country's requirements of manufactured consumer goods are imported. But services of various kinds, particularly domestic services and real estate, are obvious members of this group. On the other hand there was in wartime the diversion of demand to the domestic sector for goods which would normally have been procured through imports. With the acute shortage of imported goods it was natural that demand would turn to whatever domestic substitutes were available in spite of their relative inferiority. If the problems of supply could have been successfully overcome industrial and agricultural expansion in Ceylon would have benefitted from a rare opportunity.

In addition to the usual stimulus of high demand the expansion of local output was actually encouraged by vigorous Government action. This was specially conspicuous in the case of food production where the Government made extreme exertions to remedy the perilous food position brought about by the drastic and sudden curtailment of imports. Indeed a much publicised Island-wide drive for increasing food production was initiated by 1942. Individuals were exhorted to utilise every bit of available land. Estates over thirty-five acres were ordered to bring under food production each year a proportion of their total extent which varied from 24 per cent in the case of tea estates to 12 per cent in the case of other estates. Exemption from this order was only allowed on the payment of an annual sum of Rs. 10 per acre.[307] A number of Emergency Assistant Government Agents were appointed in many rural areas with the principal task of stimulating food production, and field officers from the Department of

307. The Food Production (Estates) Ordinance No. 2 of 1943 – cf. *Economic and Social Development of Ceylon. op.cit.* p. 8.

Agriculture were sent out to assist in improving yields by demonstration and to distribute suitable planting material.[308] A specially constituted Agricultural Corps was formed in April 1944 on semi-military lines, for the specific purpose of providing labour for increased food production.[309] This organisation still exists. Mention must also be made of the impetus given in wartime to the rate at which long term schemes for the colonisation of land in the dry zone were executed.[310] These schemes are now the central feature of the development plans of the Government, and the difficulties of the wartime food position had much to do in commending them to public opinion. Moreover, the advances in the control of malaria made during the war – largely the result of intensified research on tropical diseases made necessary by the presence of service personnel – contributed more perhaps than any other factor to the actual and potential development of the "dry zone".

In ascertaining the extent to which domestically produced output actually increased as a result of the general wartime stimuli, we are even more handicapped than usual by the paucity of statistical material. Information on production in Ceylon, other than that portion which passes through the Customs House as exports, is hopelessly inadequate. This is specially true of rural production by peasant cultivators, and is particularly serious since it concerns the production of paddy and other food crops. There are, of course, official estimates of rice production, but it is doubtful as to whether they provide a reliable basis on which to frame conclusions concerning changes in output over a relatively short period. In fact the estimates of rice production show not an increase in total production, but a contraction relative to 1939 in spite of the intensified efforts.

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308. cf. *Ceylon Year Book for* 1948. pp. 94 and 95.

309. "A Base Camp was formed at Colombo attached to the Headquarters as well as a depot camp within easy reach to which recruits were sent on enrolment and five operational camps in selected areas where labour was needed for food production and long term land development schemes, to which recruits were drafted as they came into, the Depot Camp. Within six months the strength of the corps reached 2,500 and from the very first month they were occupied on food production schemes in various parts of the Island." *ibid.* p. 96.

310. During the period 1st October to September 30th 1945 an extent of 13,500 acres has been opened up under these schemes in spite of the labour shortage caused by the war." – *ibid.* p. 99.

Estimate of Rice Production 1939–1946
(in tons '000)

Year	1939	1940	1941	1942	1943	1944	1945	1946
Production (cleaned rice)	200	n.a.	n.a.	n.a.	200	185	147	154

Source: *Commonwealth Economic Committee – a Review of Commonwealth Agriculture: Production and Trade H.M.S.O.* 1952, p. 103.

Note: The figures after 1944 can claim a greater degree of accuracy because of the Internal Purchase Scheme. The years 1945 and 1946 were years of drought and this probably accounts for the decline in output.

In the case of rice, however, it is likely that, whatever the course of total output, the actual supplies reaching the market expanded somewhat during the war. This was due to the Internal Purchase Scheme initiated by the Government for securing supplies from the producing areas for general distribution. The scheme was first introduced in 1942 to purchase the surpluses which producers were voluntarily willing to sell to the Government, but it was not a success in this form as supplies were being diverted to the more remunerative black market.[311] In 1944 sales to the Government were made compulsory. A basic levy was imposed of two bushels per acre on all fields cultivated for one season, and three bushels on fields cultivated for more than one season. In addition all quantities of paddy in excess of a fixed consumption allowance for owners of paddy lands had to be compulsorily sold to the Government. As a result of this scheme the rural surplus was artificially enlarged,[312] and increasing supplies of local rice were made available for consumption in the non-rice producing areas.

The enlarged supplies of local rice made available in this way, however, were quite inadequate to compensate for the decline in imported supplies. This is obvious from the following figures:

311. Rice was rationed at the time and distributed by the Government at controlled prices.

312. 3,000,000 bushels of paddy were purchased under the compulsory Internal Purchase Scheme in 1944. "In reality this 3,000,000 bushels is in part only – to the extent of approximately 1,300,000 bushels – an annual surplus...... The balance in the compulsory levy under the Purchase Scheme which producers ordinarily used for normal consumption, unrestricted by the fetters of controls imposed in the emergency." – *Statistical Data of Paddy Production* by D.P. Ellepola, Superintendent of Surveys and Controller Internal Purchase Scheme; printed by The Colombo Apothecaries Ltd. 1947. 1947 p. 7.

Marketable Supplies of Rice in Ceylon
(in tons '000)

Year	1939	1943	1944	1945	1946
Purchases by I.P.S.	—	26	45	33	39
Rice Imports	584	139	112	179	254

Source: I.P.S. purchases from D. B. Ellepola, Controller Internal Purchase Scheme – *Statistical Data on Paddy Production.* p. 25.

Rice imports from *Review of Commonwealth Agriculture. op.cit.* p. 105 and *Statistical Abstract of Ceylon* 1948 (for 1943 figure).

Note: I.P.S. purchases recorded in terms of bushels of paddy have been converted into tons of rice on the basis of 70 bushels of paddy to 1 ton of rice. (cf. *Statistical Data on Paddy op.cit.* p. 7) The increase in I.P.S. purchases between 1943 and 1944 is due to the compulsory levy from the latter year. The decline in purchases in 1945 and 1946 is due to "acute" drought and "partial" drought respectively. (*ibid.* p. 6).

It cannot, in the light of this evidence, be doubted that it was not increased home production (or increased home supplies) that was the decisive factor in compensating for the reduction in imported rice in wartime. Indeed, if it had not been for the emergency imports of wheat and wheat flour as substitutes, a situation of the utmost gravity would have resulted.[313]

In regard to other types of domestic production there is no evidence to suggest that there was a substantial expansion of output during the war although a number of scattered ventures were started. "Under the stimulus of wartime scarcities and high prices .... many local bids were made for entry to the production quota of this country. There were many starters and many varieties were produced. A few have survived the last hurdle."[314]

313. The role of these substitutes in alleviating the food shortage is apparent from the following figures (in tons '000):

Year	1939	1944	1945	1946
Imports of rice	584	112	179	254
Imports of wheat flour	19	296	220	213
Imports of other cereals and flour ..	31	47	65	35
Total imports of cereals	634	455	464	502

Source: *Review of Commonwealth Agriculture, op.cit.* p. 105.

Note: No figures are available for the annual production of food crops other than rice in Ceylon.

314. *The Ceylon Year Book for* 1948, p. 117. Private enterprise is mentioned as having interested itself in the following types of activity: "Saw mills and factories (really workshops) for moulded rubber goods, batteries, eau-de-cologne, packing chests, toilet goods, bricks and tiles, plywood, hosiery, lacquered goods, glass, ink, matches, soap, ceiling wax, hand-made paper, twine, and a host of other items some of which have now survived as permanent peace time units." – *ibid.* p. 120.

Although market conditions at this time were exceptionally favourable, there were serious technical difficulties which impeded the course of industrial development. "Power and fuel were extremely limited, being released only for highly essential purposes. Petrol, tyres and vehicle control had a profound effect on the transport of materials; labour was scarce (and) minimum wages prescribed by legislation, together with compulsory payment of dearness allowances, completed the picture."[315] In fact in some cases, such as salt, output was actually reduced because of these difficulties and supplies had even to be obtained from abroad.[316] Ceylon's limited capacity for textile production too was impeded by the shortage of imported raw materials, and at one stage the Government itself had to undertake the direct importation of yarn. All existing looms were registered and textile equipment and yarn were distributed through a system of rationing.[317]

Whilst the expansion in domestic industrial output was barely of significance from the point of view of filling in the enormous gap between imported supplies and incomes, the wartime period is nevertheless a distinctive phase in the industrial history of the country. It was in these years that the Government itself began to partake in manufacturing activity through the establishment of a number of state-owned industrial enterprises. Several state-owned factories were constructed and operated for the purpose of manufacturing either materials urgently required by the export industry or

315. *Ceylon Year Book for* 1948 p. 117.

316. Salt production (a government monopoly) fell progressively from 36,000 tons in 1939 to 14,000 tons in 1943. "... due to very great labour difficulties. In order to guard against a possible famine in salt, small quantities of salt were imported in 1944 and 1945. As it happened these imports were not really needed, but they were an insurance against possible local deficiencies – a contingency which might have had the most serious consequences" – *ibid.* p. 118.

317. *ibid.* p. 120. There was, however, a great expansion in the production of cotton vests. The general course of textile production is illustrated in the following figures:

Textile Production in Ceylon 1939–45

	1939	1940	1941	1942	1943	1944	1945
Cotton yarn (lb. mill.)	1.9	1.9	1.6	1.5	1.7	1.7	1.5
Cotton fabrics (sq.yds. mill.)	8.7	8.5	6.6	5.6	7.0	7.0	6.0
Cotton vests (dozen)	—	—	—	18.0	27.0	30.0	32.0

Source: ***Statistical Abstract of Ceylon*** **1949, Table 120.**

consumer goods for supplying the domestic market. The pioneer in this field was the Coir Factory which was first started as an experimental factory in 1939 but came later to be established on a permanent basis. This was followed in 1941 by a Plywood Factory conceived on a somewhat larger scale. "The high strategic value placed on packing material for tea chests and building boards during the war rendered its establishment unassailable, and today the factory is accepted as the mainstay of the tea chest industry."[318] In the same year a Shoe Factory and tannery was introduced, which also produced glue as a by-product, and also a plant for the production of glassware from local silica deposits. In addition a factory for the manufacture of acetic acid, a material widely used in rubber production, was established. In 1942 a Steel Rolling Factory was begun to manufacture rolled bars and rods for constructional work using scrap steel as raw material. In the following year a Government paper mill was started to produce paper from scrap. Its entire output was taken up by a British tobacco firm in Ceylon for use as linings and discs in cigarette tins. A Quinine Factory was also opened in 1943. Finally, in 1944, came the Ceramic Factory manufacturing both earthenware and porcelain from local clays.

These wartime ventures of the Government are undoubtedly of special significance to the general problem of Ceylon's industrial development. Although they are as yet nothing more than a series of individual plants or factories on a modest scale[319] they nevertheless mark a beginning and also illustrate the willingness of the Government to actively and directly sponsor industrial expansion. For this reason alone this development of the war years is an important event and deserves to be recorded. But though the output of these factories was of some help in alleviating the difficulties arising out of the short supply of particular commodities,[320] neither the range of products nor their scale was sufficient to make a substantial difference to the general problem of inflation.

318. *ibid.* p. 118.

319. Not all of them succeeded in running at a profit, especially in the post-war period.

320. The following figure show the increases in output in some Government factories:

We may therefore end our survey of the behaviour of home produced output during wartime with the conclusion that although there was some increase in the production of domestic goods as substitutes for imports, this expansion was not of sufficient significance either from the point of view of offsetting the wartime inflationary pressure or from the point of view of making a permanent and fundamental change in the basic economic structure of the country. But, as we have already mentioned, the period is significant in that a number of beginnings were made.

C. Some effects of the wartime inflation

In the preceding sections we have seen that the severe curtailment of imports during the war was not substantially offset by an expansion in domestic production. We can therefore be fairly certain that the country as a whole suffered a contraction in the total of its real income available for consumption and investment. This fall in total real income and the problem of its distribution between the different sections of the community is, in a sense, one of the outstanding features of the wartime experience of the Ceylon economy. We shall, in the pages that follow, examine some of the implications of this situation. In fact a good part of the energies of the Government were absorbed in attempts to deal with its consequences.

The reduction in real incomes (due to a reduction in that portion of real incomes which is imported) is one of the important ways in which the period of the war differs from other periods of boom. In the usual upward phases of the trade cycle Ceylon tends to enjoy an increase in total real incomes because the relative prices of her exports as compared to her imports – the terms of trade – move in her favour.[321] During the war, on the other

	1939	1942	1943	1944	1945
Plywood (sq.ft. '000)	—	327	975	2,423	2,489
Rolled steel (tons)	—	—	549	587	739
Glass ware (lb. '000)	—	—	11	253	385
Footwear (pairs '000)	—	2	13	15	21

Source: *Statistical Abstract of Ceylon* 1949, Tables 117 and 119.

321. Even if the terms of trade remained constant in the boom, Ceylon may be able to import more and so raise her real incomes, because total quantities exported (and therefore total export earnings) tend to increase. But as we have seen elsewhere fluctuations in quantities exported are of little significance when compared with fluctuations in the prices of exports. In other words, fluctuations in real incomes between boom and slump are mainly explained by fluctuations in the terms of trade.

hand, the movement was in the opposite direction. As we have shown the free market in Ceylon's export staples was abandoned and supplies were purchased in bulk by the United Kingdom Government at prices which were closely related to production costs. At the same time Ceylon had to procure a wide range of imports from a number of countries at prices which were beyond her control.[322] The result was a severe deterioration in her terms of trade as is shown in the following figures:

Indices of Export and Import Prices and the Terms of Trade (1939–45)
(average 1934–38 = 100)

Year	1939	1940	1941	1942	1943	1944	1945
(i) Export Price Index	114	120	133	156	166	190	205
(ii) Import Price Index	101	120	147	220	315	349	340
(iii) Terms of Trade (1 ÷ 2)	113	100	91	71	83	54	60

Source: Export and Import Price Indices from *Statistical Abstract of Ceylon for* 1949. Table 199.

It should be noted that that the worsening of the terms of trade during the war was even more severe than during the depression. The index of the terms of trade (calculated on the same base as in the above table) reached a minimum value of 61 in 1932 as against 53 in 1944.

The relative increase in the price of imports as compared to exports was not, however, the central factor behind the decline in the quantity of imports. As we have stressed already there were physical difficulties in the way of securing supplies, from abroad at even the given prices, and Ceylon was thereby virtually forced to continue adding to her external assets through a series of surpluses in her balance of payments on current account.[323] Indeed, if supplies of imports were freely available at the given prices, it is unlikely that real incomes in the country would have actually fallen

322. Ceylon's dissatisfaction with this state of affairs was expressed in the following words by Mr. D. S. Senanayake: "When the Secretary of State affirms his inability to increase the prices of tea, rubber and copra, and also at the same time does not propose to do anything to prevent the rising spiral of prices of at least the food we have to buy, I find it difficult to meet the criticism that in regard to the purchase of rubber, tea and copra, we are being subjected to a most unfair arrangement." – *Hansard* 18th July 1943, p. 1258.

323. Indeed, with the physical restriction in imports, the relevance of changes in the terms of trade became confined to the accumulation of external assets rather than to the course of real incomes in the economy.

quite so severely in spite of the deterioration in the terms of trade. This, of course, is due to the fact that Ceylon's total foreign receipts through exports and military expenditure were expanding at almost as fast a rate as import prices.[324]

The following table of the imports of consumption goods at constant prices is roughly indicative of the extent of the fall in imported supplies for the domestic market as a result of these factors:

Index of Imports of Consumption Goods (1938=100)

Year	1939	1940	1941	1942	1943	1944	1945
Total imports of consumption goods	102.2	98.4	92.7	72.1	76.0	88.0	88.3
Per capita	25.9	24.9	23.5	18.3	19.3	22.3	23.2

Source: *Economic and Social Development of Ceylon* 1920–30. p. 31.

The inflationary impact of this reduction in total real income or total supplies in the face of rapidly expanding money income was, however, partly modified by an increase in savings. It is difficult to assess the contribution of savings towards dampening of the inflationary pressure for, even if complete statistics of the volume of actual savings in each year are available, these would only reflect the "ex post" situation. In fact the very existence of price control and rationing can lead to an increase in savings if the excess of purchasing power that is suppressed in this way can find no alternative outlets. Figures showing the growth of savings are, however, of some interest as they show the rate at which purchasing power was immobilised from year to year as a result of the complex of factors which prompted savings in wartime. The available data on savings in Ceylon are partial in that they refer only to deposits with the Post Office Savings Bank, the Ceylon Savings Bank, the Commercial Banks (savings and time deposits)

324. This can be shown, as below, by deflating the total value of external receipts for current account (we have no figures for the net inflow of capital) by the import price index:

(Rs. million)

	1939	1940	1941	1942	1943	1944
(i) Total external receipts (actual value)	357	421	467	768	865	1,154
(ii) Total external receipts at constant import prices	355	351	317	349	224	340

and the total value of outstanding Government issued savings certificates.[325] These figures are summarised below.

Savings in Ceylon
(Rs. million)

1939	..	82.3	1943	..	100.1
1940	..	94.6	1944	..	141.4
1941	..	90.8	1945	..	205.9
1942	..	67.3	1946	..	253.2

Source: *Central Bank of Ceylon Monthly Bulletin November* 1951, p. 24.

The figures of savings given above, of course, exclude the holdings of currency notes by the public. They are nevertheless of some interest as they reflect the changed conditions between the distinct phases in the war period. There was only a very mild increase in this form of savings between 1939 and 1940. In 1942 there was a severe reduction in the total of savings deposits which signifies an active drawing down of balances by the public in spite of the fact that total incomes in this year, through exports and military expenditure, were expanding. This phenomenon is probably due to confidence being shaken by the Japanese air raids and the threatened invasion. From 1943 onwards there were large increases in these savings. Between 1943 and 1946 the average annual increase of these savings was Rs. 46.4 million. It was in these years that the whole Government machinery for price control and rationing came into extensive use. A war savings campaign was started in 1942 and received great publicity throughout this period. Above all it was after 1942 that the most rapid increases in total incomes took place.

The total increase in savings from 1942 onwards as shown in the partial figures above, however, do not compare with the corresponding increase in total incomes during the same period.[326] We may conclude, therefore, that even if a reasonable allowance is made for other forms of savings, the total increase in savings was by no means sufficient to offset the total expansion in incomes.

325. Subscriptions to long term Government loans are excluded since they would be included in the estimation of the overall budgetary surplus in the following chapter.

326. If we take the total money supply ("active" currency plus demand deposits) as a very rough indication of the increase in incomes, the total increase between 1942 and 1945 was Rs. 329.3 (cf. *Central Bank of Ceylon – Annual Report for* 1950. p. 36). The increase in savings in this period was Rs. 138.6.

Indeed, the very fact that there was in this period a marked tendency for prices to rise (in addition to the external prices of imports) is fairly conclusive evidence that the inflationary effect of the increase in incomes was not neutralised by an adequate expansion in savings.

In these circumstances, it is clear that the reduced quantum of total real income would, in the absence of controls, have been distributed between the different sections of the community by means of a rise in prices. Those whose money incomes moved upwards would have been better off, or less worse off, than those whose money incomes were relatively fixed. There were, however, two factors which prevented an extreme distortion in the distribution of this reduced real income. These were first the price control and rationing policy of the Government and second the general increase in employment and wages.

A detailed examination of the machinery for price control in wartime would take us outside the scope of this chapter. A bare outline of the main elements is, however, of some interest as the experience of these years, in addition to being valuable in itself, is illustrative of the capacity and competence of the administration to deal with an inflationary situation.

The growth of the machinery for control in wartime falls into two phases divided by the entry of Japan into the war. In the first phase the framework for control was established in an elementary way but the controls themselves were hardly applied. The second phase saw the development of an elaborate administrative structure which exercised an extensive and rigorous control over the prices and distribution of a number of important commodities.

Preparations for control began as early as 1937 when a Food Control Department was established to deal with the problem of food supplies in the event of an emergency. In early 1939 an Essential Commodities Reserves Ordinance was enacted to ensure that importers of such commodities as rice, sugar and flour, maintained certain specified reserves. In September of the same year a control of Prices Ordinance came into force giving the Government the necessary powers to fix prices. The scare caused by the declaration of war obliged the Government to utilise these powers and maximum prices were in fact introduced for a number of important foodstuffs as well as for certain other articles. The position improved, however, in the subsequent months and in consequence most of the price controls imposed in this way were later withdrawn. In addition to these measures the only other controls of importance which were introduced in this preliminary phase related to petroleum[327] and the regulation of imports, exports and exchange. The main purpose of the control over external trade and exchange was to economise on imports of scarce materials and to conserve dollar and other non-sterling currencies for augmenting the resources of the sterling area. In fact exchange control did not apply to the sterling area until the post war period.[328]

After Japan's entry into the war controls began in earnest. There were two new factors which made controls necessary. These were the sudden curtailment of food supplies following the loss of the customary sources in South East Asia, and the rapid expansion of incomes locally as a result of military expenditure. A number of new Government departments were established to deal with the situation and in one way or another almost the whole range of economic activity in the country became subject to some sort of regulation. Broadly the types of control may be divided into three groups. First there was direct retail distribution of certain commodities at fixed prices by the Government itself through agencies set up for the purpose. Second there was the control over the distribution and prices of certain commodities, which, though sold through the normal private channels, could only be obtained by the consumer on the authority of Government permits. Finally there was the simple price control unaccompanied by any distributional control, over a number of articles. In this case maximum selling prices were fixed and charges in excess of these were made punishable by law.

Direct distribution through Government sponsored agencies applied mainly to the food supply. Rice rationing was actually

327. Petrol control came into being with effect from September 1st 1941 (Ordinance No. 52 of 1941). At the commencement of control, however, the rations were liberal (90% of pre-war consumption). It was only in the second phase of our period that consumption was severely curtailed. By July 1943, all private cars and cabs that did not serve the war effort (over 3,000 in number) were immobilised and the rations on others were reduced. The majority of these (about 7,000 in number) had their rations cut down to provide for a bare 60 miles running per month – cf. *The Ceylon Year Book* 1948, pp. 73–74.

328. *ibid.* pp. 73 and 75.

introduced in February 1942 but in the early stages the distribution was effected through the ordinary private dealers and retailers. In April of that year, however, there was a serious breakdown in the normal machinery for food distribution in the Island. Following the Japanese air raid on Colombo on 4th April a large number of Indian traders, who normally handled the retail distribution of food, left the Island and returned to the mainland causing thereby a serious disruption in the ordinary channels of distribution.[329] The Government had no alternative but to fill in the void itself. As a first step it took over the distribution of foodstuffs through a series of hastily improvised "People's Depots" run by the Department of Agricultural Marketing. "From July 1942 onwards People's Depots were established ...... two or three a week, until by March 1943, there were 120 People's Depots in Ceylon towns, from Jaffna to Matara, all managed and run by the Marketing Department and served by its stores in Colombo ...... It was soon found that queues at People's Depots were becoming unmanageable. In order to relieve the pressure, the Department started Mobile People's Depots. These were bullock half carts, 27 of them, each with a complete range of stocks, a manager and a salesman. These mobile carts brought the necessaries of life to the people's doors in Colombo and reduced the queues very considerably."[330] The second step in Government sponsored distribution was the establishment of consumer Co-operative Societies which replaced the People's Depots and took charge of food distribution.[331] The period saw an impressive expansion in the co-operative movement throughout the Island – a development due largely to the initiative of the Government and its Co-operative Department which acted upon the opportunity afforded by the wartime food problem. In 1938 there were 1,300 Co-operative Societies registered in Ceylon although the co-operative movement in the country was over 25 years old. In the latter year the total number of societies was 6,383 with a membership of over one million representing "almost every family in the

329. *ibid.* p. 6.

330. *ibid.* p. 73. Other foodstuffs in addition to rice were distributed in this way although only rice and cereal substitutes (wheat flour, whole wheat and kurakkan) were distributed on the ration.

331. "The People's Depots were intended to maintain distribution while the Consumers' Co-operative Societies organised by the Co-operative Department were getting into action. As soon as sufficient Co-operative Societies were ready to function in any area, the local people's depot was closed and its goodwill was taken over by the Consumer Co-ops." *ibid.* p. 73.

country."[332] Indeed, the total number of ration books attached to the Societies amounted to 4 million, which was nearly two-thirds the size of the total population.[333]

The establishment of Government sponsored agencies facilitated the combination of distributional control with price control, as the Co-operative Societies were able to retail out a number of price controlled articles in addition to the rationed foodstuffs. In this way they enhanced the effectiveness of the Government's policy of price regulation. The controlled prices at which foodstuffs were sold were until 1943 closely related to the costs of imported supplies and for this reason there were many upward revisions between 1941 and 1943. From the middle of 1943, however, it was decided to freeze prices of foodstuffs at the then existing level and it was from this date that a policy of Government subsidies to stabilise prices was commenced.[334] The impact of this subsidisation policy on public finance will be discussed in the following chapter. It is sufficient to remark here that this subsidy expenditure was not directed to private traders but was merely received by Government departments which imported foodstuffs at certain prices and sold them at a loss to the distributive agencies.

In addition to direct distribution through Government agencies which as we saw applied mainly to foodstuffs, rationing and distributional control was extended to certain other articles which were sold through private channels. Specialised departments of Government were set up to deal with individual commodities of importance. There were separate departments of petrol control, tyre control, paper control, and textile control.[335] And there was in addition a general department of price control which dealt with

332. *ibid.* p. 139.

333. *ibid.* p. 139. It must be remembered that rural cultivators were not issued with rice ration books.

334. *ibid.* p. 47.

335. Tyre control was started in 1942 and paper control in 1943. The Textile Control Department was started in 1943. "At the commencement, the activities of the Department were confined to licensing of dealers and the control of prices – there was no control of distribution. But with the increasing stringency in the supply situation and the complaint of the poorer classes of the community that they were unable to get a fair share of the available supplies, a full-fledged scheme for the rationing of textiles on the points system, almost identical with the system in the U.K. was inaugurated with effect from April 1945." – *ibid.* p. 76.

a whole group of miscellaneous commodities. In the case of the specialised departments mentioned above, supplies were regulated through the introduction of a system of coupons (as with petrol and textiles) or of permits as authorisation for sales. The Price Control Department, on the other hand, adopted a variety of techniques for regulating the commodities with which it was concerned. Thus, in some cases it introduced a system of permits, whilst in others it was satisfied with merely fixing maximum prices without administering any control over distribution.[336] Altogether, about 125 major articles in short supply ranging from feeding bottles and sewing machine needles to push cycles were brought under its purview.

The enforcement of the wartime structure of controls was initially left to the police but an increasing number of Price Control Inspectors were later appointed to assist the police. From 1944 onwards the police gradually withdrew from this field and left the task almost entirely to the Price Control Officers.[337]

It is difficult to say exactly how far these controls were in fact effective in preventing a serious distortion in the distribution of reduced real income by suppressing an inflationary rise in prices. It is true that the controls covered a very wide range of commodities but supplies were not always available at the controlled prices and a black market in a variety of articles is known to have flourished. No estimates of black market prices are, of course, available. Indeed there is even no index of general retail or wholesale prices with which we may measure the general course of prices in the economy. For this purpose we have to be satisfied with the working class cost of living index for Colombo town. This index has numerous drawbacks as an accurate measure of general price changes[338] but it was of special importance since it was officially

336. Thus, articles such as cycles, bricks and tiles and sewing machine needles required permits, whereas articles like inks, tooth paste and shoes were subject only to price control – *ibid.* p. 75.

Rent control would also fall into this category. A Rent Restriction Ordinance was introduced in 1942 to control rents in urban areas. The requisitioning of houses by the Military Authorities led to an acute housing shortage after 1942. There is unfortunately little information to help us assess the effectiveness of rent control in wartime.

337. *ibid.* p. 57.

338. The index was calculated on a limited budget relating to a pattern of working class consumption in Colombo. Subsidised items such as rice and flour enjoy a particularly heavy weightage in working class expenditure. Moreover in all cases where items entering into the index

used as the basis for calculating "dearness allowances" to labour in the wage regulated trades and to salaried Government employees. In this sense it played a central part in the course of the wartime inflation because it largely determined the extent of the secondary increase in incomes which followed the rise in prices. The table below sets out the movement of the cost of living index and – for comparative purposes – the import price index.

Year	1939	1940	1941	1942	1943	1944	1945
Cost of living index	104	112	122	164	196	200	221
Import price index	101	120	147	220	315	349	340

Source: *Economic and Social Development of Ceylon* Table II.

Note: The base for the cost of living inded is the average price November 1938 – April 1939 (= 100). The base for the import price index is average 1934–1938 = 100.

The cost of living index as shown above reflects the effect on prices of the changed circumstances after 1941. The result of the Government's subsidy policy after 1943 can be seen from the fact that the index was virtually stable between 1943 and 1944 although the import price index was still increasing. In 1945, however, the cost of living index rose significantly in spite of an actual decline in the import price index and the continuation of the subsidy policy. The chief explanation of this is an increase in the prices of certain home produced commodities entering into the index.[339] It will be noted that the import price index remains consistently above the cost of living index. This is in itself partly a reflection of the limited character of the cost of living index as a measure of general price increases. At the same time it must be remembered that the import price index is not a suitable alternative measure because it

were subject to price control, only these controlled prices were taken into account. For this reason alone it is extremely likely that the index understates even the true working class cost of living. Articles were not always available at controlled prices and workers would either have had to obtain them from the black market at higher prices or to have altered their patterns of consumption. This is admitted in the "Official Year Book for 1948": "The cost of living index was based logically enough on controlled prices but in spite of all efforts many patronised the Black Market, and the actual cost of living was therefore much higher." – p. 9.

339. There was no change in the price of subsidised rice or flour between 1944 and 1945. The prices of the following articles included in the index, most of which are home produced, showed increases; coconut oil, sugar, vinegar, tea dust, vegetables, spices, firewood, arrack, toddy, betel leaves, arecanuts, tram fares, education (Stationery), laundry, house rent and clothing. cf. *Statistical Abstract for Ceylon* 1949. Table 196.

excludes both home produced goods and the effects of the all important subsidies on rice and other imported cereals after 1943.

Since the cost of living index probably understates the general increase in prices, and the import price index excludes the effects of the food subsidies, it is possible that a more representative index of retail prices would remain somewhere between the two.[340] This is about all that we can say about the course of prices in wartime. It is almost certain that the prices of different groups of commodities behaved differently. Thus "unessentials" and articles which were either uncontrolled or subject to mild controls are likely to have risen in price much more than the commodities which were subject to both price and distributional control.[341] Although the Government controls themselves were subject to the inevitable abuses and evasions it would certainly be wrong to dismiss their effectiveness altogether. There were many factors in Ceylon which facilitated the administration of controls. For one thing the small size of the country, relative to its administration was a favourable factor. For another, the fact of Ceylon being an Island, which obtained a good proportion of its requirements from abroad, made it relatively easy for the Government to keep a check on supplies. The great bulk of the imports into Ceylon entered through the Port of Colombo and was subject to scrutiny by the Customs. The authorities were thereby aware not only of the total quantities imported but also of the distribution of these imports between the various merchant houses.

Apart from price control and rationing, the other important factor which prevented a serious maldistribution of real incomes during the wartime inflation was the increase in wage rates and, above all, the increase in employment. As we shall see Ceylon's experience in this field is of some interest to the problems of fiscal policy.

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340. This is not necessarily so, since even excluding home produced goods, the retail prices of imported goods may well exceed their external prices because of the local inflation and this factor may offset the influence of the subsidised groups in lowering the general level of prices.

341. For instance, "Food, competed for by both serviceman and local inhabitant shot up to unprecedented heights. An egg available pre-war at 5 cents commanded 15 to 30 cents according to season while a chicken which fetched a rupee before new fetched five rupees and more." "Ceylon Year Book for 1948." *op.cit.* p. 10.

There are no comprehensive statistics to illustrate the course of money wages in Ceylon for the various classes of labour. There are, however, two factors which make it reasonably certain that there was a fairly general increase in money wages throughout the Island during this period. First wage rates in all industries which came within the official wage regulation machinery were raised by Government order from time to time to keep in step with the cost of living.[342] Wage rates paid by the Government to its own employees also increased correspondingly. Second, this was a period of acute labour scarcity, and employers were not able to secure easily their supplies of labour unless they were prepared to bid up their wages. It is, of course, difficult to say accurately whether the increase in money wages was sufficient to offset the increase in prices. The partial data which exists, however, (relating to the minimum wages of tea and rubber estate labour) suggests that there was even a slight improvement after 1942 in the real wages of the group to which it applies. This is shown below:

Index of Wages of Tea and Rubber Estate Workers (1939 = 100)

Year	1 *Minimum money wages*	2 *Cost of living index*	3 *Real wages* (1) ÷ (2) x 100
1939	100	100	100
1940	100	107	94
1941	109	119	92
1942	115	154	107
1943	201	196	103
1944	212	211	100
1945	244	222	110

Source: Central Bank of Ceylon: *Annual Report* 1950 Statements 20 and 21, pp. 66–67.

Note: The cost of living index used here is an index for estate labour and therefore differs slightly from the cost of living index for the Working Class (Colombo Town). The index was computed after an inquiry into the consumption patterns of estate labour in 1943 (S.P. XV of 1943). Since Estate Labour as a group is more homogeneous than the "Working Class, Colombo Town" this index is probably more representative of the group to which it applies than the corresponding index is for the Working Class of Colombo.

From the point of view of the quantum of real income distributed amongst the working class as a whole, however, the increase in total employment was probably of much greater

342. Generally the legal minimum wage consisted of a basic rate which was changed only at intervals and a dearness allowance which varied directly with changes in the cost of living index. cf. *The Ceylon Year Book for* 1948 pp. 24–25.

significance than the increase in money wages. In fact there were a number of factors operating during the war which raised employment to levels which were probably in excess of those normally reached at the peak of a cyclical upswing. On the one hand the normal productive or labour absorbing capacity of the Island was stretched to a maximum. The export sector was working at its fullest capacity; and as we have seen, the domestic sector was even increasing its capacity. On the other hand there was the totally new factor of intensive military activity in the Island. The Ceylon defence force was largely expanded in size and a large number of men were recruited into the armed services. In addition the Imperial Military Authorities were carrying out extensive building operations and were employing large numbers in the construction of camps and stores and other military sites. In 1945 the size of the civilian labour force directly employed by the Imperial Military Authorities in Ceylon was estimated at 83,500.[343] A large number must also have been employed indirectly through contractors. There are unfortunately no complete statistics of employment in Ceylon during this period, but the improvement in the employment situation is clearly reflected in the decline in the numbers registered as unemployed on the Colombo Labour Exchange and the increase in the numbers placed in employment.[344] This is shown on page 211.

The employment of labour in large numbers by the Military Authorities was as we have said a new factor which raised total employment to heights which had, in all likelihood, never been reached before. In normal times the notion of "full employment" is barely of relevance to the Ceylon economy because land and capital and other co-operant factors of production are hardly adapted to utilising the whole of the employable population of the country. Even in normal periods of boom when the existing industries of the country are working to maximum capacity there

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343. These were divided between the three armed services as follows: Military 39,000, Navy 32,000 and R.A.F. 12,500. In this year, however, military expenditure had fallen from the peak reached in 1944.

Source: Director of Census and Statistics.

344. The great improvement in the employment situation is also reflected in the fact that the relief works for the absorption of the unemployed which had been continuing since the depression of the thirties were discontinued in 1942. (cf. *Report of the Social Services Commission*. S.P. VII of 1947, p. 38). Indeed the labour problem became so serious that the Government formed in 1943 an Essential Services Labour Corps on semi-military lines to provide a mobile force for the performance of essential tasks.

Unemployment in Colombo

	1939	1940	1941	1942	1943	1944	1945
Total number registered as unemployed	26,677	27,645	20,458	19,333	8,335	1,053	10,784
Total number placed in employment by the Labour Exchange	2,583	5,936	9,071	8,129	4,170	1,875	4,537

Source: *Ceylon Labour Gazette* Vol. I. No. 1. January 1950, *Department of Labour* p. 42 and 43. Tables IV and V.

Note: The total number of registered unemployed refers to the numbers on the 31st December of each year. This explains the excess of the numbers placed in employment in 1944 over the registered unemployed. The figure for the number placed in employment in 1945 is not strictly comparable with the rest because it includes placements by the new labour exchanges opened outside Colombo in that year.

is a surplus population which remains in either direct or "disguised" unemployment. This was demonstrated all too clearly in the post-war period when, in spite of an unprecedented boom in the export industries, a serious unemployment problem emerged. In the period of the war, however, the military needs of the country were so great that a position approximating to full employment was reached through the absorption of the "backward area" surplus. Once military expenditure began to decline, from 1945 onwards, unemployment re-emerged.

The usual short run method of dealing with excess labour even in boom times is the inauguration of relief works. Military expenditure and employment in wartime was in many ways analogous to a vast relief scheme executed on an immense scale – with the difference that the monies were not financed out of taxation. Since the total of real incomes declined during the war – as it usually does during a depression – the situation also suggests an interesting parallel with an extensive counter cyclical employment policy, carried out by the Government in periods of depression and financed out of budget deficits. Such a policy would aim to prevent the gross distortion in the distribution of real incomes which usually takes place when the unemployed have to suffer the major part of the reduction in employment.[345] But here again the parallel is not exact. In contrast to depression deficits, the wartime expenditure actually improved, rather than damaged the balance of payments position since, as we have seen, the external prices of exports increased directly with the degree of inflation!

345. See ante, chapter V.

CHAPTER VI

PUBLIC FINANCE IN WARTIME

I. Alternative Lines of Budgetary Policy

The preceding chapter was devoted to an analysis of the impact of the war on the Ceylon economy. We have seen that the basic fact of the period was the vast expansion in money incomes throughout the country accompanied by a contraction in the supply of goods available for consumption. The result was the generation of an inflationary pressure of some magnitude. We have shown that such a situation was peculiar to the special circumstances of the war, since in more normal periods an increase in incomes and demand in Ceylon is likely to lead to an increase in imports rather than to an inflationary rise in prices. Indeed this expansion in imports will tend normally to weaken the country's balance of payments position. In the period of the war, however, the rise in local incomes was accompanied by a continuous and impressive expansion in the Island's external assets.

From the point of view of the government's budget, the outstanding characteristic of this period was the welcome buoyancy in revenues. Even if tax rates had remained unchanged there would probably have been an increase in revenue from such sources as the income tax. In addition the great expansion in incomes made the imposition of new taxation a much easier task than during the depression. In such circumstances the government enjoyed some scope in the choice of a budgetary policy. It could, in fact, have pursued three alternative lines of policy. It could, first, in theory at least, have adopted the so-called colonial approach to budgeting, by refraining from increasing the tax rates and by contenting itself with a mild upward adjustment in expenditure to conform to the spontaneous increase in revenues. Secondly, the government could, if it so desired, have taken the opportunity to increase its expenditures beyond the limits of the spontaneous increase in revenues and to have financed this extra expenditure by imposing additional taxation. Finally, there was the possibility of using the budget as a medium for countering the inflationary pressure in the whole economy through the conscious creation of effective budgetary surpluses.

The first of the alternatives mentioned above may, however, be ruled out as being barely practicable in the conditions of the war. The war itself made several demands on the services of the government and certain types of new expenditures in fields such as defence and food production were almost unavoidable. Unless the government was prepared to curtail its other expenditures in order to finance these, the total of expenditure was almost certain to increase beyond the ordinary revenues of the government at existing tax rates. In view of the relative facility of imposing additional taxes in the war period it is not surprising that any curtailment of ordinary expenditures was hardly considered by the government. In fact it would be true to say that the strict 'Colonial method' of budgeting was virtually disposed of during this period. The successive budget speeches of the Leader of the House in introducing the annual Appropriation Bill afford ample evidence of the fact that in these years at least revenue was adapted to expenditure rather than vice versa.

In the pages that follow we shall examine the nature and magnitude of the increase in expenditure, and then assess the extent to which the revenue policy of the government went beyond the limits of the second alternative, mentioned above, of merely keeping pace with the increased expenditure. It is worthwhile remembering that unlike the case of deficit financing in depressions, there were no technical difficulties in the way of creating budgetary surpluses. If the government so desired it could broadly have pursued a budgetary policy which had overall anti-inflationary effects on the economy as a whole.

II. The Expansion in Government Expenditure

The pattern of government expenditure during the years with which we are here concerned is so much the result of the wartime situation that it can hardly be regarded as being representative of ordinary boom conditions. In our analysis of expenditure policy in the depression we noted the drastic reductions in expenditure on public works. Indeed in the course of the normal trade cycle expenditure on public works tends to be the most flexible single item in government expenditure – falling in the depression and rising in the boom. In the years of the war, however, the ordinary boom time behaviour was not reproduced. Expenditure on public works remained remarkably stable when compared to other types of expenditure. In fact some of the major constructional activities of the government such as the Hydro-electric scheme at Laxapana had to be temporarily restricted because of the shortage of materials and other factors. At the same time the requirements of the war were giving rise to new types of expenditure which seriously distorted the ordinary pattern of government spending. In fact as we shall see below the major part of the great increase in expenditure in the war period was due to these new activities of the government.

The course of total expenditure in Ceylon and its distribution between the various branches of government activity is depicted in the table below:

Total Government Expenditure 1935–40 to 1944–45
(Rs. million)

Year	1939–40	1940–41	1941–42	1942–43	1943–44	1944–45
Total Govt. Expenditure charged to current revenue:	127.4	127.3	153.3	185.0	210.7	254.4
Administrative Departments	17.8	17.9	17.9	21.0	22.8	24.7
Defence	9.0	9.9	10.0	22.8	19.4	15.8
Economic Department	34.4	36.1	32.5	48.9	56.9	68.9
Social Services	33.1	34.2	37.2	40.9	48.3	57.3
Public Debt	9.6	10.1	11.6	12.6	15.3	18.4
Pensions	13.7	13.0	12.8	13.4	13.8	17.0
Local Government	3.0	3.1	3.2	3.6	4.0	6.0
Miscellaneous and Emergency	1.7	2.7	27.8	21.8	30.2	42.8
Total Expenditure charged to Loan Funds	6.5	5.4	23.7	26.2	27.7	31.6

Source: *Annual Reports of the Auditor General, and Statistical Abstract of Ceylon for* 1949.

Note: Details concerning the classification are given in the appendix. The sum of the individual items do not necessarily add up to the total because of rounding. The aggregate of total expenditure for 1939–40 excludes a gift of Rs. 5 million from the Ceylon Government to the U.K. Government.

The effect of the two distinct phases in the wartime period, corresponding to the years before and after the commencement of hostilities with Japan, is clearly reflected in the course of government expenditure as shown in the table above. In the first phase, which ends with the financial year 1941–42, both the total of expenditure and its distributional pattern remained relatively stable. Indeed the only notable changes in expenditure in this period were due, first, to a gift of Rs. 5 million from the Ceylon Government to the United Kingdom Government in 1939–40 as a contribution to the latter's war effort,[346] and second, to the increase in expenditure on defence as compared to the pre-war years.[347] But even here the expansion of the defence services was of a precautionary nature and does not compare with the more active mobilization that took place after the Japanese war.

In the second phase the major increases in expenditure were absorbed by a number of sectors. The most important of these were: (a) defence, (b) the economic departments, (c) the social services, and (d) the miscellaneous and emergency groups. In the course of the following pages we shall analyse the increases under these heads. There were, of course, increases in other sectors as well, but these were of a relatively minor order. The rise in the expenditure of the Administrative Departments after 1941–42 was mainly due to an expansion of the police force.[348] The increase in crime that was recorded in these years may have been due, in part at least, to the unsettled conditions of the period. The increase in the Public Debt was due to the borrowing policy of the government during the war which we shall discuss later. The expansion in expenditure out of loan funds in 1941–42 was largely absorbed by the defence services. In addition loan funds were also used to meet the capital cost of many of the new industrial factories set up by the government in this period.

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346. cf. *Hansard,* 24th July 1940 p. 1452. The contribution was unanimously approved by the Ceylon State Council. It was 'financed' out of the accrual to revenue of a sum of Rs. 9,500,000 from the surplus in a sinking fund of a loan which matured in that year.

347. The expenditure on defence in an average pre-war year such as 1936–37 was Rs. 4.6 million as against nearly Rs. 10 million in 1940–41. "The increase is due partly to the expansion and modernization of fixed defences in Colombo and Trincomalee; partly to war defence measures such as mobilization of the Ceylon Defence Force and the Ceylon Naval Volunteer Force and the establishment of several emergency organisations such as the Censorship, Information Department, Internment camps and the Coast Watch Service." Budget speech of Sir Baron Jayatilaka, Leader of the House, *Hansard,* 24 July 1940, *op.cit.* p. 1452.

348. The expenditure on Police and Prisons increased from Rs. 4.9 million in 1941–42 to Rs. 6.6 million in 1942–43 and Rs. 8.8 million in 1944–45. (cf. *Annual Reports of the Auditor General*).

(a) Defence Expenditure

Until 1942 Ceylon's commitments for defence expenditure were estimated in a somewhat peculiar manner. The Imperial Government was in fact responsible for organising the defence of Ceylon and defence was accordingly a subject which was placed beyond the legislative competence of the State Council under the Donoughmore Constitution. At the same time Ceylon was obliged to make a financial contribution to the Government of the United Kingdom towards its own defence. There were two elements in Ceylon's financial burden on account of defence. First, Ceylon had to maintain at her own cost a local military force which consisted principally of the Ceylon Defence Force and the Ceylon Naval Volunteer Force. Secondly, she had to make contribution to the United Kingdom Government to meet the cost of whatever Imperial garrisons were stationed in the Country, with the proviso, however, that this contribution need not exceed 9½ per cent of the total revenue of the Island. In addition Ceylon had to bear the cost of all the lands and buildings which might be required by the garrison.

It is easy to see that this arrangement which was conceived of in peacetime was hardly likely to function smoothly in the extremely different conditions of total war. Ceylon's own military force was now a part of all the allied forces stationed in the country and its size had to be determined in accordance with all the resources at the disposal of the Supreme Military Command. In addition the size of the Imperial garrisons in the country would certainly have required the full 9½% contribution from revenue. If, over and above all these commitments, Ceylon had to bear the cost of the "land and buildings" required by the enormous allied forces her financial burden on account of defence would certainly have been formidable. On account of these difficulties the Ceylon Government negotiated and arrived at a new arrangement for defence finance with the United Kingdom Government during the early part of 1942. Under this scheme Ceylon agreed to make a total fixed defence contribution to the U.K. Government to cover the active defence of the Island by land, sea and air. The amount of this contribution was settled at Rs. 27 million per year. The Imperial Government was to bear the entire cost of the Ceylon Defence Force and each government had to pay for whatever lands or buildings it acquired. The cost of the Ceylon Naval Volunteer Force was, however, to remain a charge on the Ceylon Government.

It cannot be doubted that this arrangement was, under the changed conditions, far more advantageous to Ceylon than the preceding system. As the Leader of the House explained: "At first glance the amount of this contribution (Rs. 27 million) may appear large, but on a full examination of the figures it will be seen that such is not the case. Our liability under the arrangement which existed at the beginning of the war was for a contribution towards the cost of the garrison, not exceeding 9½% of the revenue of the Island. The question may well be asked, what is the garrison today? It might well be held to include all the overseas troops now in Ceylon, and even the R. A. F. stationed in the Island...... It might therefore be expected that the full 9½% of the revenue in the estimates for 1942–43 should come to Rs. 16 million, but that does not discharge our liability in full. The law compels us to provide from Ceylon funds all lands and buildings which may be required by the garrison. If a wide view is taken of the meaning of "garrison" it can be left to the House to imagine what the liability is likely to be. On top of this we are liable for the cost of the Ceylon Defence Force. That cost was estimated at Rs. 11 million per annum when the estimates for 1941–42 were framed. Since that date, not a month has passed without some addition to the cadre of the force proving to be necessary. On the present arrangements the expenditure on the Force might well be nearer Rs. 20 million. In the light of these figures the contribution of Rs. 27 million cannot be regarded as excessive."[349]

In 1943 a further arrangement was made with the United Kingdom Government under which the financial liability of Ceylon for the Ceylon Naval Volunteer Force was fixed at Rs. 3 million. This raised the total defence contribution made by Ceylon to Rs.30 million.[350]

The whole cost of defence expenditure, inclusive of the contribution to the United Kingdom Government, was not however financed out of current revenues. A glance at the preceding table will make this apparent since the total expenditure chargeable to current revenue figuring under the item 'defence' falls short of even the Rs. 30 million contribution to the United Kingdom

349. *Hansard* 10th July 1942 p. 1249. This arrangement for defence finance was to remain valid until the armistice.

350. *Hansard* 15th July 1943, p. 1253.

Government. The reason for this is that the Ceylon Government decided to finance a certain proportion of its defence expenditure out of borrowed monies. The overall borrowing policy of the Government in the war years will be analysed in a subsequent section. In regard to defence, however, the decision to charge a portion of these expenditures to loan funds was made as early as 1941, even before the revised arrangement with the United Kingdom Government was arrived at. In the words of the Leader of the House in introducing the budget for 1941–42: "The Board of Ministers does not consider it fair to charge the whole of the proposed expenditure on defence to next year's revenue account. These defence measures are not meant to meet immediate needs. They are intended to benefit, not only the present generation of taxpayers, but also the future."[351] Accordingly it was decided that only a sum representative of "normal" defence expenditure should be charged to revenue and that the remainder should be paid for out of loan funds. The normal expenditure chargeable to revenue was fixed at "a round sum of Rs. 10 million."[352] This method of apportioning defence expenditure between current revenue and loan funds was, however, changed in the subsequent years. There were two stages in the revised policy. In the first stage it was decided that since most of the increases in government expenditure were due to defence and other factors directly brought on by the war, the whole of the government deficits that arose in these years should be charged to loan funds.[353] If such a policy was continued throughout the war it would certainly have aggravated the inflationary situation specially if non-military expenditures were also included

351. *Hansard* 9th July 1941, p. 1396.

352. *ibid.* "The total provision for defence in the estimates before the House is Rs. 18,724,258. It is the intention of the Board of Ministers to move an amendment to the Appropriation Bill at the committee stage to transfer to loan expenditure a sum of Rs. 8,724,258, leaving a round sum of Rs. 10,000,000 inclusive of the military contribution of Rs. 4,000,000 to be charged to next year's Estimates. If the total sum spent on defence is less than the estimated figure, the amount charged to loan will be correspondingly reduced. If on the other hand it exceeds the estimated figure, the amount to loan will be increased."

353. cf. Leader of the House. *Hansard* 10th July 1942. p. 1248: "It will be observed that the anticipated revenue for 1942–43 falls short of the estimated expenditure by Rs. 17 million when this is added to the anticipated deficit of Rs. 13 million on Sept. 30th 1942, there will be, on Sept. 30th 1943, a deficit of Rs. 30 million to be reckoned with. The Board of Ministers proposes that this deficit, or in other words the amount by which expenditure may exceed revenue in each year, should be charged to the Home Defence Loans which the council authorised to raise in February last."

as 'defence' items. It was not, of course, the intention of the Board of Ministers to keep tax rates unchanged; but under such a policy, if strictly applied, tax increases would be divorced from the need to secure overall budgetary balance. In the second stage, however, this policy was replaced by a more conservative approach. Instead of assuming that the whole of the budget deficit in any given year was due directly or indirectly to defence expenditures, and that it could for this reason be safely debited to loan funds, the government now sought to limit the total expenditure financed out of borrowed monies to a specified sum. In July 1943 the Leader of the House announced that for the financial year 1943–44 the amount of defence expenditure to be financed out of borrowed monies would remain fixed at Rs. 20 million.[354] The practice was continued in the succeeding financial year 1944–45 and the Rs. 20 million charged to loan funds was left unaltered.[355]

(b) The Economic Departments

The Economic Departments embrace a somewhat varied group of government activities and it must be pointed out that the increase in expenditure on the group as a whole was by no means uniformly distributed over the several members. In fact even in this field the pattern of distribution of expenditure was clearly dominated by the special requirements of the wartime period. This will be evident from the breakdown in expenditure on this group given in the table below:

Expenditure on Economic Departments
(Rs. million)

Year	1939–40	1940–41	1941–42	1942–43	1943–44	1944–45
Total Expenditure on Economic Departments	34.4	36.1	32.5	48.9	56.9	68.9
(a) Public Utilities	22.4	23.3	19.6	23.6	26.6	29.8
(b) Agriculture, irrigation and survey	8.6	9.1	8.7	21.0	23.9	30.7
(c) Labour	1.4	1.1	1.1	.7	1.3	1.9
(d) Industrial and Commercial	2.1	2.7	3.1	3.7	5.2	6.5

Source: *Annual Reports of the Auditor General.*

354. *Hansard* 15th July 1943, p. 1239.

355. *Hansard* 20th July 1944, p. 1358.

It will be seen from these figures that the major increases in expenditure were experienced by the sub-group Agriculture, Irrigation and Survey. This expansion was primarily due to the intensive food production campaign which was conducted during the war in order to ease the difficult food situation. The bulk of the expenditure on that sub-group was in fact taken up by the Land Commissioner and the Department of Agriculture which were the principal instruments of the Government in the Food Production campaign. Since the efforts of the Government in increasing food production have been outlined in the previous chapter we shall not dwell on them here.

We have already commented upon the relative stability of expenditure on public works. The mild expansion in expenditure on public utilities after 1942–43 was largely the result of increased road maintenance activity made necessary by the heavy strain imposed on the Island's transport system by the movement of military convoys and other wartime traffic.[356]

(c) The Miscellaneous and Emergency groups

Almost the whole of the increase in total expenditure in the financial year 1941–42 as compared to the preceding year was due to an increase in the miscellaneous and emergency group whose expenditure rose from Rs. 2.7 million in 1940–41 to Rs. 27.8 million in 1941–42. This was the first year of the Japanese war and in the early months of 1942 the Ceylon State Council voted a supplementary estimate for a global sum of Rs. 20 million to cover a variety of emergency expenditures whose exact nature was not at that time carefully specified. When the budget for the financial year 1942–43 was introduced, however, the situation had become somewhat more clarified, and the monies required for the several emergency departments and activities were now voted separately under specified heads.

From the financial year 1942–43 onwards the major share of expenditure under the Miscellaneous and Emergency group was accounted for by two types of spending. These were, first, the expenditure on war allowances paid by the Government to certain classes of its employees, and second, the expenditure on the several

356. *Hansard* 20th July 1944, p. 1379.

new emergency departments that were created to deal with the various problems thrown up in wartime.[357] The aggregate annual expenditure for these purposes are shown in the table below:

(Rs. million)

Year	1939–40	1940–41	1941–42	1942–43	1943–44	1944–45
Total Miscellaneous and Emergency expenditure	1.7	2.7	27.8	21.8	30.2	42.8
War allowance	—	—	n.a.	13.9	19.7	30.7
New departments	.2	.5	1.0	5.5	8.4	9.8

Source: *Annual Reports of the Auditor General* and accounts of the Island of Ceylon published annually.

Note: The expenditure under new departments in 1941–42 does not include the expenditures of certain departments created in that year. The latter is, however, included in the overall total for the year shown above.

The system of paying war allowances to certain classes of Government employees merits some attention. Although this type of expenditure was brought about by the general rise in prices in wartime it is in a sense distinguishable from the expenditures discussed so far, in that it is not necessarily confined to a wartime situation alone. In fact, as we shall see in a later chapter, this expenditure was continued in the post-war period under the title of "dearness allowances".

The war allowance was a device to adjust the earnings of Government employees to enable the latter to keep up with the rise in the cost of living. Since the Government itself was regulating wages in important parts of the private sector through legislation it had no alternative but to extend this policy towards its own employees. The payment of a special allowance calculated on the basis of the Cost of Living Index was a more flexible and satisfactory method of raising incomes than frequent upward revisions of

357. These new departments, whose expenditure is shown in the table, were those of the: Food Controller, Commissioner of Motor Transport, Petrol Controller, Controller of Exports, Imports and Exchange, Director or War Supplies, Commissioner of War Risks Insurance, Director of Transport, Compensation Claims, Port Requisitioning Agent, War Savings Commissioner, Provincial Administration (Emergency Scheme), Civil Defence Commissioner, (Food, Supply and Control), Director of Salvage, Controller of Textiles and Controller of Prices (Miscellaneous articles). Expenditure under the general emergency vote after 1942–43 is also included in this category.

permanent salaries. The policy was based on the assumption that the increase in the cost of living was essentially a temporary phenomenon, and that after the war prices would tend to return to their pre-war norms. Accordingly, there were hardly any upward revisions in permanent salaries during the war. It was only in 1946 that the Government decided to introduce an upward adjustment in certain basic salaries as an acknowledgement of the fact that prices were not expected to revert to their 1938 levels.

The war allowance to government employees was first introduced in March 1941, even before the commencement of the Japanese war. At first it was confined to those whose basic salaries or wages were less than Rs. 100 per month. In subsequent years the range of eligibility was successively widened to include by 1944 those earning Rs. 500 per month and less.[358]

The system of war allowances, though sound in principle, was not free from certain defects in application. The major part of the war allowances paid by the Government went to salaried employees. Notwithstanding this, all war allowances were calculated on the basis of a cost of living index designed for the Working Class of Colombo Town. Apart from the objection that this index being based on controlled prices was not an adequate measure of the true cost of living for even the working class, there was the difficulty that the pattern of working class consumption differed from that of salaried groups. Food, for instance, which was largely rationed out of subsidized prices, enjoys a much heavier weightage in working class expenditure budgets than in those of higher income groups. In consequence the working class Cost of Living Index would almost certainly understate the increases in the cost of living of the latter groups. For this reason, we may be fairly certain that the real incomes of even those salaried groups which were in receipt of war allowances, underwent a certain contraction during the war period.

358. The stages in the extension of the eligibility range were as follows:

	Salary or wage
March 1941	Rs. 100 or less
March 1942	Rs. 200 or less
November 1943	Rs. 300 or less
November 1944	Rs. 500 or less.

cf. *Administration Report of the General Treasury for* 1940–46.

It is important to realise that the Cost of Living Index, apart from measuring prices, came itself to play a part in the determination of prices. This is because the secondary expansion in incomes was closely related to changes in the Index. The movement in the Index not only determined the scale of war allowances received by government employees, but also influenced the increase in incomes in the private sector. "Government policy with respect to cost of living allowances sets the pace for private enterprise and government scales are regarded by employers in general as the irreducible minimum."[359] For this reason it is easy to see that the lower the Cost of Living Index the lower the increase in incomes, and this, in turn, by reducing the pressure of inflation, will result in lower prices. If the Cost of Living Index in Ceylon did err on the side of understatement in respect of what it was supposed to measure, it must at least be admitted that it carried with it the incidental advantage of dampening the upward movement of the general price level.

The increase of expenditure on new departments shown in the preceding table was of course the inevitable result of the wartime expansion in government activity. Most of these departments were set up after the beginning of the Japanese war and their costs naturally increased, as government controls over the economy were elaborated and intensified. The figures in the table actually understate the true costs of these departments since a portion of the war allowances accrued to the staff employed by them. It must be mentioned that, apart from the permanent members of the government services who were transferred to these departments, the major portion of the personnel were employed on a temporary basis.[360]

(d) The Social Services

The social services group consisting mainly of the health and educational services of the country, is about the only category in which the increase in expenditure was not directly occasioned by

359. *Central Bank of Ceylon, Annual Report for* 1950, p. 9.

360. Cf. *Administration Report of the General Treasury* 1940–46, p. J. 16: "The new Emergency Departments had to be manned, and additional staff appointed to the permanent Departments. The new posts were filled by the appointment of temporary officers, where, the consequential vacancies were filled by temporary appointments. The number of officers thus employed by the government increased from 67,466 in 1939 to 122,483 in 1946."

purely wartime needs. As is apparent in the figures below the government took the opportunity of utilising the satisfactory revenue position to secure a permanent expansion in the country's health and educational facilities. Such a policy was in keeping with the general attitude of the Board of Ministers and the State Council ever since the inauguration of the Donoughmore Constitution in 1931. We have already seen, in a previous chapter, that the government took advantage of the recovery in revenues after the depression to expand its social services in preference to public works. This expansion continued in wartime. The following table provides evidence of the fact that the increase in expenditure on the social services in this period was not merely a reflection of higher prices and costs:

Expansion in Health and Educational Services (1938–1945)

Year	*Total Number of Government Schools*	*Total number of Teachers in Government Schools*	*Total number of Hospitals*	*Total number of beds in Hospitals*
1938	1,992	7,165	115	10,282
1939	2,060	7,613	120	n.a.
1940	n.a.	n.a.	126	n.a.
1941	n.a.	n.a.	129	n.a.
1942	2,204	8,124	132	n.a.
1943	2,221	8,750	134	n.a.
1944	2,308	9,921	141	12,445
1945	2,391	10,320	153	15,650

Source: *Economic and Social Development of Ceylon* 1926–1950 tables XIV, XV and XVII.

The expansion of expenditure on the social services is of special significance in our period, because, unlike some of the other items discussed above, it involves, in addition to the capital outlays on the construction of schools and hospitals, a permanent raising of the level of the government's recurrent expenditures. The implications of this policy were brought to the attention of the Board of Ministers and the State Council as early as 1941 by the Financial Secretary. In his Observations in the Appropriation Bill for 1941–42 he said: "The abnormal expenditure on defence is inevitable during a war, and can be met by special wartime taxation or other means. But this does not apply to the increase in ordinary expenditure...... In my view expenditure at such a rate (i.e. as intended in the budget estimates) is beyond the financial capacity of Ceylon in normal years, and will lead to an acute financial crises in the next trade depression."[361] This advice, however, was not acceptable, in toto, to the Board of Ministers. As the Leader of the House replied when introducing the budget for 1941–42, "The Financial Secretary has in his Observations appended to the Appropriation Bill sounded a very serious note of warning as regards our public expenditure. In making these observations he has done no more than his duty. But we find though his warning has not fallen on deaf ears, that it is not possible to follow his advice in its entirety......He advises us to suspend (the increase in) the social services...... I must say that we have not found it possible to follow that advice...... What we have done during the past 10 years and what we are endeavouring to do today is to rescue the masses of this country from the depth of poverty to which they have sunk, and save them from the grip which disease has got hold of them."[362]

(e) Subsidies on food

Although subsidies on foodstuffs do not enter into the official classification of expenditures in this period they deserve some attention. As a result of government policy in this sphere certain public departments came to handle very large sums of money outside the regular budget and for this reason the normal financial accounts do not in any way give a true picture of the full range of government activity or the size of the public sector in this period.

We have in the preceding chapter shown how, with the rapid deterioration in the food supply position of the country, the government was obliged to take upon itself the task of directly importing rice, wheat and certain other important foodstuffs. We also saw that in 1943 the government decided to stabilize the cost of living as far as possible. With this end in view, it refrained from increasing the retail price of rice and reconciled itself to the possibility of having to bear any losses that might result as a consequence of a continued increase in external prices. The policy of stabilisation was not however extended to all the foodstuffs imported by the government. In some cases the government was not merely charging the consumers the full external price plus its own costs but was actually making profits through the raising of prices above costs.

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361. *Hansard* 9th July 1941, p. 1391.
362. *ibid*, p. 1397 and 1398.

Whether these trading activities of the Government gave rise to any net expenditure would therefore depend on the extent to which the profits on these other foodstuffs were adequate to offset the losses on rice.

Unfortunately this whole process was kept outside the ordinary budget accounts. As the Auditor General complained: "For each of the years 1942–43 and 1943–44 the Food Controllers Advance Account for the purchase and distribution of rice and other food-stuffs was authorised by the State Council on a token vote under a sub-head; this sub-head, as given in the estimates for both years, stated as follows: 'the resulting profit or loss at the end of the year will be transferred to revenue or debited to a vote to be obtained as the case may be' – It was, however, observed that, on the authority of the Treasury, the profit or loss has been carried forward from year to year without action being taken as stated in the estimates."[363]

The result of this procedure was to exclude from the budget accounts not only the global aggregates of revenue and expenditure on account of these trading activites but even the net profits or losses. The functioning of the trading departments was based on small, nominal or token votes passed annually by the State Council; on the basis of these token votes advances were obtained from the Treasury to meet the expenses for the purchase and transport of foodstuffs and other items. The accounts of these departments, however, apart from being divorced from the regular budget, were not even published from year to year. Some of the accounts of trading activities in the war years began to emerge in 1947 and 1948, but even these were not complete and no attempt has hitherto been made to publish a consolidated account.

The growth of government trading during the war did, of course, lead to a vast expansion in the size of the total public sector far beyond the magnitudes suggested by ordinary budgetary receipts or expenditures. For instance the value of rice, wheat flour, and whole wheat purchased by the government internally and externally for sale to the public totalled Rs. 164.4 million in 1943–44 and Rs. 189.6 million in 1944 – 45 amounting to well over two-thirds the size of the ordinary budgetary expenditures for those years.[364]

363. *Report of the Auditor-General for* 1943–44. S.P. XVIII of 1945 p. 99.

364. The value of foodstuffs paid for through the Crown Agents for the Colonies alone during 1942 and 1946 are as follows:

These were only the major trading activities; there were in addition a number of other minor activities financed on Advance Accounts. From the point of view of the net effects of government activity on the economy as a whole, however the significant question is whether the trading departments, taken together, were making net losses or net profits during the wartime period. If for instance net losses were being made these should be added to the government's budgetary expenditure before the overall budgetary surplus or deficit is assessed. Although, as we have mentioned, no consolidated account of the activities of all the trading departments working on Advanced Accounts has been published, the net results of the major activities have been officially estimated. These show that during the war years the losses sustained on such commodities as rice, were more than offset by the profits earned on other commodities like wheat flour and whole wheat. The final effect in this period was therefore a net profit. Since these profits were not utilised for ordinary government expenditure but were instead carried forward from year to year by the departments concerned, it would seem as though the final effects of government trading in wartime were on the whole slightly disinflationary. The official estimates of the overall trading profits are given in the table below.

(Rs. million)

Year ..	1942–43	1943–44	1944–45	1945–46
Total profit or loss on advance account ..	+16.2	+19.1	+17.6	–49.5

Source: Communication from Director of Census and Statistics, Colombo.

Note: The Central Bank of Ceylon in its Annual Report for 1950 estimates the total loss on *food* in 1945–46 at Rs. 37.4 million. The divergence when compared to the corresponding figure in the table above may be due to the fact that the latter includes the results of all Advance Account activities. Both estimates are however agreed that prior to 1945–46 there were net profits on these accounts. The Central Bank estimates the total cumulative net profit on food prior to 1945–46 at Rs. 30.4 million as against Rs. 52.9 million in the figures above for all Advance Account activities.

	Rs. mil.		*Rs. mil.*
1941–42	.. 16.8	1944–45	.. 184.3
1942–43	.. 93.7	1945–46	.. 267.6
1943–44	.. 155.4		

Source: *Administration Report of the General Treasury for* 1940–46. p. J9.

It will be seen from the figures above that the actual losses on account of government trading and the policy of food subsidies did not in fact arise until the post-war period. They may for this reason be excluded from our analysis of the net effects of government activity in wartime. As we shall see in a subsequent chapter food subsidies came to play a predominant role in the expenditure pattern of the Ceylon Government in the post-war period and they continue right up to the present day. We may, however, remark here that the unsatisfactory policy of working on extra-budgetary Advance Accounts was abandoned by the government in 1947. The cumulative losses from 1945–46 onwards (less the profits in the preceding period) were nominally debited to the ordinary budgetary expenditure for the year 1947–48. Thereafter the net loss on subsidies was annually provided for in the budget under a seperate head of expenditure.

Summary

Our analysis of expenditure in the preceding pages shows that, although there was a considerable expansion in the total of government expenditure in this period, a good proportion of the increase was of a temporary nature. The temporary outlets for expenditure were themselves of two kinds. First there were the expenditures for direct physical contributions to the war effort, such as defence and emergency food production. Second, there were expenditures incidental to the control and modification of the wartime inflationary situation. The dearness allowances and the expenditure on price control and distribution fall within this category. This type of spending, although of a temporary nature, is not necessarily confined to periods of war. On the contrary it may arise in any phase of severe inflation or high prices. Indeed the cost of living allowances and subsidies on food were carried forward to the post-war period and absorb an appreciable share of the Government budget to this day. All these expenditures, however, are temporary in the sense that are not likely to arise in normal peace-time periods of low incomes or depression. They do not, in other words, tend permanently to orientate the pattern of Government expenditure in a certain direction: they are relatively flexible types of expenditure susceptible to reductions in times of low prices and monetary stringency.

On the other hand the expansion in expenditure on the social services has different implications. An increase in the number of schools and hospitals will permanently affect the expenditure pattern of the Government since it raises the recurrent spending necessary for their maintenance. In our analysis of expenditure policy during the depression, we saw that schools and hospitals were not quite so amenable to 'under maintenance' as roads and bridges. As a result of the recurrent expenditure made necessary by these and other services, the government found it difficult to pursue a policy of reducing expenditures beyond a certain point and was obliged to introduce increases in taxation in the hard years of the slump. The result of the continued expansion in the numbers of schools and hospitals in the war years was to increase still further the hard core of relatively irreducible government expenditures. To the extent that government revenues and the levels of taxation in pre-war years were more or less adapted to the requirements of government expenditure in that period, the further expansion of the minimum levels of expenditure during the war, would imply a permanent increase in the amount of taxation needed to finance them. In this sense, the expenditure policy of the Government during the war did imply a relatively permanent rise in the country's burden of taxation as compared to the pre-war years.

We must, at the same time, avoid exaggerating the implications of this tendency. On the one hand it should be realised that not all the increase in expenditure on the social services was of a permanent nature. Part of the increase was due to the capital costs of constructing the schools and hospitals; and even a part of the expenditure on "maintenance" was due to increased costs of medical and educational equipment. On the other hand, the actual increases in the health and educational services in this period were not of revolutionary magnitudes. There are not a great many types of useful new expenditures that can be introduced in periods of boom which do not leave behind some permanent burden in the form of recurrent expenses. It is in fact these increases in recurrent expenditure in periods of prosperity that often stimulate in the search for new sources of revenue, the growth and development of country's tax structure. The expenditure policy of the Board of Ministers during the war was, on the whole somewhat restrained. We have already shown that the amount of defence expenditure financed out of loan funds was limited to a certain maximum figure. The remaining expenditures on defence as well as the costs of war allowances and emergency departments were met out of current revenue. When the government did decide to indulge in a moderate expansion in the health and educational services, it did so after due deliberation, often tempered by the repeated cautioning of the Financial Secretary. It was not easy to resist the inclination to expand the various Government services in the face of the favourable, and indeed unprecedented, revenue situation. In fact, as we shall see in a succeeding section, the government was able to exercise sufficient restraint in its expenditure policy to enable it to build up its surplus reserves in the latter years of the war.

III. The Course of Government Revenue in Wartime

The great expansion of total incomes in the community as a result of increased export earnings and military expenditure naturally imparted an upward pressure on the government revenues. The "built-in" flexibility of the revenue structure – or the capacity of revenues to increase spontaneously without an increase in tax rates – had been somewhat improved by the introduction of the Income Tax into Ceylon in 1932. As money incomes expand a greater number of incomes fall within the minimum taxable range, and a greater number also move upwards into the higher ranges which are liable to higher rates of taxation. The element of spontaneous flexibility introduced by the income tax was, however, somewhat offset by the removal of export duties during the depression, and by the fact that most of the revenue from import duties was derived from taxes levied at specific rather than ad valorem rates.[365] Indeed, the revenue from import duties, instead of automatically increasing in this period, was actually tending to all quite appreciably as a result of the severe curtailment in the volume of imports.

For these reasons the government could hardly have expected a substantial improvement in its revenues without an increase in taxation. In more normal times the moderate expansion in revenues might have sufficed to finance any spontaneous increases in expenditure due to increased costs. Indeed it might even have been possible for the Government to repeal some of the increases in taxation that were imposed during the depression. In the

365. cf. ante ch. 4 p.

conditions of the war, however, such fiscal passivity was virtually out of the question. Even in the first phase of the war period the pressure of defence requirements was imposing a strain on the budget and it was necessary to introduce additional taxation. In the pages that follow, we shall analyse the nature and sources of these increases in government revenue and assess the results of wartime tax policy on the revenue structure of the country.

The course of total governments revenues and their major sources during the war years are depicted in the following table:

Total Revenue of the Ceylon Government 1938–39 – 1944–45

(Rs. million)

Year		*Total Revenue*	*Tax Revenue*	*Non-Tax Revenue*
1938–39	..	116.9	87.9	28.9
1939–40	..	132.7	90.6	42.1
1940–41	..	135.5	100.5	34.8
1941–42	..	158.8	118.1	40.6
1942–43	..	200.0	154.4	45.5
1943–44	..	250.6	191.9	58.7
1944–45	..	303.9	224.1	79.8

Source: *Annual Reports of the Auditor-General* and *Accounts of the Island of Ceylon.*

The figures above indicate that, like expenditure, the increase in revenues in the second phase of the war period after 1941–42 was much more marked than in the first. The average annual increase in revenue between 1938–39 and 1941–42 was Rs. 14.0 million a year whereas the corresponding average from the period between 1941–42 and 1944–45 was Rs. 48.3 million. In normal times government revenues follow somewhat closely the trend of total exports. After 1942, however, as we have already seen, allied military expenditures were making an annual contribution to incomes in Ceylon of a magnitude equivalent to that of total exports before the war. There can be no doubt that this factor was indirectly responsible for a part at least of the enhanced rate of expansion in revenues after 1941–42. It will also be seen from the tables above that the major part of the increase in revenues between the pre-war year and 1944–45 was due to an expansion in tax revenues. The increase in tax revenues between these dates amounted to Rs. 136.2 million, or 72.7 per cent of the total increase in revenues, whereas non-tax revenues increased by only Rs. 50.9

million representing 27.3 per cent of the total increase. In the sections that follow, we shall analyse the changes that were taking place within these major components of total revenue.

A. The Increases in Tax Revenues

With the exception of the income tax whose collections would almost certainly have increased without changes in tax rates, the increase in tax revenues in this period was due to the imposition of additional taxation by legislation. Apart from the estate duty and other minor taxes, rates of taxation were increased over almost the whole field of tax revenues. In addition the export duty on the major staples which had been withdrawn in the depression was now reimposed, and an altogether new tax, the excess profits duty, was introduced in 1941. The principal increases in taxation may be summarised as follows:

(i) The income tax

The income tax was one of the first taxes to be raised in the wartime period. The budget for 1940–41 was threatened with a prospective deficit on account of preparatory defence expenditures. In order to bridge the gap, the "unit rate" of income tax, which is the rate applied to incomes at the minimum exemption limit (Rs. 2,800 per annum), was raised from 6% to 7½%. The rates on the higher income slices were also correspondingly raised. In fact the sub-division of income slices for the purposes of a graduated income tax was relatively simple. For resident individuals[366] there were only three income ranges: the first slice from Rs. 2,800 per annum to Rs. 6,000 which, as we have mentioned, had its rate increased from 6% to 7½%; the second from Rs. 6,000 to Rs. 30,000 whose rate rose from 12% to 15%; and finally the portion of incomes over Rs. 30,000 which had now to pay 22½% instead of the previous

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366. Income of non-resident individuals fell into only two slices: the first between Rs. 2,400 and Rs. 50,000, whose liability was raised from 12% to 15%, and second above Rs. 50,000 whose rate was increased from 15% to 22½%. It is interesting to note that because of the varying differentiation between resident and non-resident individual incomes, resident individuals at a certain income range (e.g. Rs. 40,000 per annum) had to shoulder a higher burden of taxation than non-resident individuals.

The Hindu undivided family, bodies of persons, executors and trustees, the Mutual Life Insurance Co. and Government (other than the Imperial Government or Ceylon Government) constituted separated categories in the Income tax classification.

cf. *Economic and Social Development of Ceylon, op.cit.* table XXV.

18%. Resident and non-resident companies had to pay a flat rate of income tax which was raised in this period from 12% to 15% in the case of the former, and from 15% to 18% in the case of the latter.

There were no further important changes in the rates of income taxation until the financial year 1944–45.[367] In that year the unit rate was raised from 7½% to 8½% and the graduated rates were also increased upwards. Thus tax rates for individual resident incomes between Rs. 6,000 per annum and Rs. 30,000 were raised from 15% to 17%; for Rs. 30,000 to Rs. 50,000 from 22½% to 25½% and incomes over Rs. 50,000 paid 34% instead of 30%. At the same time the flat rate for resident companies was raised from 15% to 17% and for non-resident companies from 18% to 20%.

These increases in the rates of income taxation during the war period were not, it will be noticed, particularly heavy. This is borne out by the following table which sets out the average

Overall Rate of Income Taxation
(Rs. million)

Year		*Gross Income*	*Yield of Income Tax*	*Overall rate of Taxation %*
(1938)	– 1938–39 ..	236.2	17.3	7.3
(1939)	– 1939–40 ..	204.1	14.4	7.1
(1940)	– 1940–41 ..	245.0	23.0	9.4
(1941)	– 1941–42 ..	272.1	27.6	10.1
(1942)	– 1942–43 ..	326.2	33.8	10.4
(1943)	– 1943–44 ..	391.7	39.4	10.0
(1944)	– 1944–45 ..	383.3	41.9	10.9

Source: Gross income from Statistical Abstract for Ceylon 1949 table 168.

Note: The yield of income tax for a given financial year is expressed as a percentage of the gross income of the preceding income tax year because of the lag in tax payments. The income tax year (shown in brackets) usually ends on the 31st March.

367. A minor change introduced in 1942–43 was the sub-division of the resident individual income group of Rs. 30,000 and over, into two slices of Rs. 30,000 to Rs. 50,000, and Rs. 50,000 and over. The former continued to pay the existing rate of 22½% whilst the latter slice had now to pay 30%.

The sub-division of non-resident individual incomes was also increased from two groups to three. Similarly the Hindu undivided family which had hitherto no income sub-divisions and which consequently paid a flat rate, was now differentiated and made subject to graduated tax rates. These improvements in the income classification were however of a relatively minor order. A far greater degree of differentiation was introduced for all the important categories in 1945–46. But this was the first year of the post-war period and falls outside the scope of this chapter.

overall rate of income taxation, obtained by expressing the total annual revenue from income taxation as a percentage of the total gross incomes (i.e. incomes prior to the deduction of allowances etc.) for all those (individuals and companies) liable to income taxation.

It will be seen from the figures above that the increase in the total revenue from the income tax during the war was only partly due to the increases in tax rates through legislation. The average rate of taxation in 1944–45, for instance, would have yielded a much smaller revenue than Rs. 41.9 million if applied to the incomes of, say, 1938. In other words, the increase in the total yield of the income tax was, in part, the result of the built-in flexibility we mentioned earlier. At the same time we can discern the results of the legislative increases in tax rates in 1940–41 and 1944–45 The effects of these increases are particularly evident in the latter year when the yield of the income tax increased although gross incomes had fallen.[368]

Although the increase in the overall rate of taxation illustrated above was relatively mild, it must be remembered that the 'real' burden of taxation was in fact considerably increased for certain groups of individuals. This is generally a feature characteristic of inflationary situations and would occur even if there were no increases in tax rates. In such periods many individuals who were previously below the minimum tax exemption limit may find themselves liable to income taxation as a result of an expansion in their money incomes. At the same time their real incomes may not have increased at all or may even have fallen because of the comparatively greater rise in the cost of living. In such cases they would now have to pay taxes whereas previously they paid no taxes at all. Similarly even those who were previously eligible for taxes may find the real burden of taxes increased, irrespective of legislative changes, because the increase in their money incomes may place a part of their incomes in ranges subject to taxation at

368. The decline in gross incomes liable to income tax during the income tax year 1943 (1st April 1942–31st March 1943) was mainly due to the extension of the excess profits duty to the agricultural industries during the financial year 1942–43. (cf. Hansard 10th July 1942 p. 1248). It was not, therefore, due to a recession in total incomes in the community. On the other hand the decline in gross incomes during the income tax year 1939 was the result of the general recession in the value of total exports during the calendar year 1938.

a steeper rate. Again, if we assume that their 'real' incomes haven't changed it is easy to see that they will now be paying more taxes in 'real' terms and will consequently be worse off than before.

(ii) Export Taxes and the Excess Profits Duty

In a previous chapter we saw that the export duties on the major commodities were either removed or reduced during the difficult years of the depression. Thus the duty on rubber and coconuts was completely withdrawn in 1931 and the duty on tea was reduced in 1932.[369] With the recovery in export prices after the war and the need to secure extra revenues to finance the expanded wartime budgets it was inevitable that the reintroduction of export duties would once more be considered. In fact the export duties were reimposed simultaneously with the introduction of a new tax, the excess profits duty on non-agricultural profits.[370] The arguments underlying the imposition of the excess profits duty was that it was justifiable to finance the increase in expenditure during the war out of taxes levied on excess profits born of wartime prosperity.[371] The export duty was meant to be the counterpart for agriculture of the new excess profits duty from which agriculture was exempted. The rates of the export duty for the various commodities were, in fact, designed to equalise the rates of taxation between the export industries and the industries subject to the excess profits duty. The main reason for imposing an export duty on agriculture instead of an excess profits duty was the administrative convenience of the former. However, as we shall see presently, the excess profits duty was eventually extended to the export industries on account of certain new factors which tended to outweigh this difficulty.

The export tax on tea was raised from $1\frac{1}{2}$ cents per lb. to 3 cents per lb., and a new duty of $2\frac{1}{2}$ cents per lb., was imposed on rubber. At the same time a duty of Re. 1 per cwt. was imposed on exports

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369. cf. ante ch. 5.

370. A previous unsuccessful attempt was made to introduce an excess profits duty as soon as the war started, but this was rejected by the State Council. cf. *Hansard* 8th July, 1941 p. 1397.

371. "In time of war, when a country is faced with additional expenditure necessitating additional taxation, no tax is more justified than one which affects those whose incomes have benefited by reason of the war. The excess profits duty is, therefore, an eminently suitable form of war tax". – *ibid.* Budget speech, Leader of the House.

of plumbago which, like agriculture, was also made exempt from the excess profits duty. It should be noted that no export duty was imposed on coconut products at this time. Since the coconut industry was also exempt from the excess profits duty which did not tax agricultural profits, it enjoyed a specially privileged position.

The imposition of the enhanced export duty on tea and rubber necessitated an amendment of the Income Tax Ordinance. We explained in a previous chapter that the Income Tax Ordinance, which became law in 1932, sought to afford some relief to agricultural industries from being doubly taxed on account of having to pay both export duty and income tax. Sections 31 and 32 of the Ordinance made provision for the granting of relief to agricultural products which were subject to export duty as long as the rate of duty was not less than four-fifths of the rate in force on Jan. 1st 1931.[372] In the case of tea the relief was to take the form of a refund of a certain portion of income tax paid by producers. In the case of other commodities there was to be a reduction in the income tax itself. The new duties on both tea and rubber exceeded the four-fifths maxima and an amendment to the Income Tax Ordinance was therefore introduced in order to free the Government of its liability to grant relief. A lifetime of three years was prescribed for both this amendment and the excess profits duties Ordinance in order to signify the temporary nature of both the export duty and the excess profits duty.[373] In fact, however, both Ordinances were subsequently prolonged, and the sections 31 and 32 of the original Income Tax Ordinance remain inoperative to this day. As far as the export industries are concerned, this provision for relief from double taxation is a dead letter.

The excess profits duty, which was introduced at the same time as the new export taxes,[374] was really nothing more than a flat rate levy of 50 per cent on the excess profits of all businesses

372. In 1931 the export duty on tea was 3 cents per lb. and 2½ cents per lb. on rubber. The new rates were in fact identical with the 1931 rates. cf. *Hansard* 7th July 1941, p. 1397.

373. "The excess profits duty is and must be a purely temporary wartime tax. I can think of no worse tax in peace time." – Financial Secretary, *Hansard* 14th August 1942, p. 1648.

374. Its applicability was however made retrospective to include all accounting periods ending after December 1st 1940. *ibid.* p. 1397.

other than agriculture and plumbago mining.[375] In August 1942, an Amending Bill was introduced extending the Excess Profits Duty to include agriculture and plumbago (Ordinance No. 39 of 1942). The reasons for the change in the treatment of agriculture and plumbago are interesting. Since the export duties were introduced in 1941 there was a radical alteration in the manner in which Ceylon's staple products were disposed of in the world markets. We have described this change in the preceding chapter. Its principal result was to make the United Kingdom Government the sole purchaser of the whole of Ceylon's exportable output. The prices paid for the Island's produce were, under this arrangement, closely related to changes in the cost of production. It will be apparent that under this system an increase in export duties would have given rise to a tricky, if not embarrassing, problem. Since the two elements in the prices paid to producers by the United Kingdom Government were supposed to be the basic pre-war price and the increase in the cost of production, it would have been difficult, or at least illogical, to shift the export duty backwards to the producer. On the other hand, the shifting of the export tax forward to the United Kingdom Government as the purchaser would, apart from raising ethical issues relating to Ceylon's war contribution, have provoked inter-government conflict or controversy. In fact, according to the arrangements for the purchase of Ceylon's exports, the purchaser was liable for payments in respect of increased export duties, but there does not seem to have been any intention on the part of the Ceylon Government to exploit this provision.[376] For these reasons an increase in the export duties were barely feasible. But since it was decided that

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375. *ibid.* p. 1392 – The Ceylon Ordinance generally followed the United Kingdom Finance (No. 2) Act 1915. Excess profits were assessed on the basis of a "standard rate" of profit which was taken as either the average profits of the last three prewar years, or as ten per cent of the costs of the capital assets of a business enterprise at the time they were acquired. The taxpayer was generally, permitted to choose whatever basis was favourable to him. The taxable excess profit was the difference between total net profits, and this "standard profits" plus a fixed statutory allowance of Rs. 3,000 per annum. cf. *Administration Report of the Commissioner of Income Tax Estate Duty and Stamps* 1947 and the *Excess Profits Duties Ordinance No.* 38 of 1941.

376. Indeed the very idea appeared somewhat preposterous to the Financial Secretary: "I drew the attention of an Hon. Member to the fact that under the agreement for the sale of Ceylon produce any increase in export duties is to be paid by the purchaser, and that his suggestion (for an increase in export duties) appeared to be a delightful way of getting out of all our financial troubles by imposing higher and higher export

additional taxation was, nevertheless, necessary the extension of the excess profits duty to include agriculture and plumbago was thought to offer a way out of the difficulty.

The extension of the Excess Profits Duty to agriculture and plumbago mining was accompanied by various concessions to these industries. The rate of duty for agriculture was fixed as before, at 50 per cent of profits in excess of a standard profit plus an allowance of Rs. 3,000. But certain concessions were allowed in the calculation of prewar standard profits. As in the case of other businesses, producers could choose to assess their standard profits on the basis of 10 per cent of capital costs. But in the case of agriculture rather generous minimum levels were prescribed in the estimation of capital values. The minimum capital values varied with the different agricultural industries. Thus the minimum capital value for estates under tea was fixed at Rs. 800 per acre, for estates under rubber at Rs. 600 per acre, and for estates under coconut at Rs. 400 per acre. With a percentage standard of 10 per cent, this meant that no liability for excess profits duty arose unless the profits exceeded Rs. 80 per acre in the case of tea, Rs.60 per acre in the case of rubber and Rs. 40 per acre in the case of coconuts. The government claimed that these were high minimum figures which would afford "great relief to all but the very best estates in the Island."[377] A different arrangement was provided for the Plumbago industry which was allowed the concession of a paying flat rate duty of 30 per cent on its total current profits in place of the 50 per cent duty on excess profits to which the agricultural industries mentioned above were liable. This special treatment was justified on the grounds that the industry was primarily a war industry whose peacetime profits were depressed; that plumbago was a wasting asset; and that it was desirable that mine owners be encouraged to accumulate certain reserves to help them face the setback they were "bound to incur" as soon as the war was over.[378]

duties on our produce until our Budget balanced, those extra export duties being paid by someone else...... He assured me that, that was not his idea." – *Hansard* 9th July 1942, p. 1208.

377. *ibid.* p. 1206. The rubber industry was given an additional concession as an incentive to extra production. Rubber estates were charged the full excess profits duty up to only 75 per cent of their standard production. Half the duty was charged on profits derived from production between 75 and 100 per cent of the standard assessment. Production in excess of 100 per cent of the standard assessment was exempt from all excess profits duty.

378. *ibid.* p. 1208.

Although the introduction of the Excess Profits Duty was an alternative to increasing the export tax, it must be remembered that the additional export duties previously imposed in 1941 were still in force. These duties preceded the commodity purchase arrangements so they may be regarded as having been incorporated in the prices paid (i.e. shifted forward). Nevertheless, it was decided to relieve agriculture and plumbago from the liability to pay both the export tax and the excess profits duty. This was done without actually withdrawing the export duty which was then in force. The procedure was simple. The export duty chargeable on a producer's output was added to his actual profits in order to arrive at a hypothetical total of profits. The excess profits duty was estimated on the basis of this hypothetical profit. The full amount of the actual export duty was then deducted from the excess profits duty and the taxpayers liability was confined to paying the difference. In other words, the effect of this arrangement was to subject the taxpayer, in theory at least, to the payment of the higher of the two taxes. The export duty was, of course, in all cases physically collected at the Customs House. But if the assessed excess profits duty fell short of the export duty imputed to each producer, he was totally exempted from the former, whereas if it exceeded the export duty he only paid the difference.

It should be noted that the underlying assumption behind this arrangement was that the export duty was actually shifted back to the producer. The export duty to which his produce was liable was added to his actual profits in the belief that prices and total profits would have been higher in the absence of such a duty. But as we have already seen, this assumption is open to serious doubt. The export duties were already in existence when the bulk purchase scheme was brought into force and it can reasonably be supposed that they played their part in the determination of prices. Were the duties totally absent, for instance, prices would presumably have been lower. If the export duty was entirely shifted forward to the purchaser, the total profits of the producers would, other things being equal, have remained unchanged. If this was so it could hardly be argued that the additional imposition of an excess profits duty involves the producer in double taxation.

If the export tax was in fact shifted forward in its entirety, the provision in the Ordinance for deducting the export tax prior to the payment of the excess profits duty would not mean, as believed by the Government, that the producer was paying the higher of the two taxes. On the contrary he would either be paying no tax at all (where the excess profits duty falls short of the imputed export tax) or (where the excess profits duty exceeds imputed export tax) only a limited tax, equal to the difference between the excess profits duty for which he is assessed and his imputed export tax. This can be readily illustrated by a simple numerical illustration. Let us take for example the case of a producer of tea whose production costs per lb are 60 cents and whose prewar standard rate of profit amounts to 20 cents per lb. Now if we assume that no export tax was in force and we ignore middlemen's margins, we can consider the price paid by the purchaser as being equal to the price received by the producer. Let us suppose that this price is Re. 1.00 per lb. Now with a cost of production of 60 cents per lb. the producers net profits would amount to 40 cents per lb. Since his prewar standard profit was 20 cents his excess profits would be 20 cents per lb. and he would be liable for the payment of a 50% excess profits duty of 10 cents per lb. His profits after payment of the tax would be 30 cents per lb.

Now let us take the case where an export tax of 10 cents per lb. is introduced which is entirely shifted **backwards.** The purchaser's price would then remain at Re. 1.00 but the producer's receipts would amount to 90 cents and his net profits would be reduced to 30 cents instead of 40 cents as before. But in calculating his total 'hypothetical profit' the export tax is added to his net profit. This total amounts to 40 cents. When the 20 cents allowance for standard profits is deducted, his hypothetical excess profits come to 20 cents, and his excess profits duty assessment to 10 cents. But since the producer can now deduct the export tax (10 cents) from his excess profits duty assessment his true liability for excess profits duty is really nil. His residual profit would therefore be 30 cents as in the previous case where there was an excess profits duty without an export tax. If the export tax was less than his excess profits tax assessment he would of course have to pay in the difference, but even here his residual profits would still remain unchanged. Thus if the export tax was 5 cents instead of 10 cents his net profit would be 35 cents, but his hypothetical profit would still be 40 cents. His excess profits duty assessment, after deducting the standard profit allowance, would remain at 10 cents but he would now have to pay in the difference of 5 cents between this and the export tax. His residual profit would, however, still be 30 cents. These examples show that in cases where the export tax is shifted backwards the provisions for relief from double taxation are in fact effective and that the producer would really be paying the higher of the two taxes.

The position is, however, quite different when the export tax comes to be shifted forward to the purchaser. Suppose for instance that the export tax of 10 cents is shifted forward so that although the purchaser is now paying Rs. 1.10 cents per lb. the producer is continuing to receive Re. 1.00. His net profits would remain at 40 cents as before. His hypothetical profit would now be 50 cents and his total excess profit 30 cents. His excess profits duty assessment would be 15 cents but he would actually have to pay only 5 cents as he is allowed to deduct the export tax. His residual profit would now be 35 cents instead of the 30 cents of the previous case where there was either no export tax or where the export tax was shifted backwards. He is therefore decidedly better off. Indeed, if the export tax which is shifted forward is as high as, say, 20 cents, he would not be liable to pay any excess profits duty at all, and his residual profit would be 40 cents, which is just what he would have enjoyed had both the export duty and excess profits duty been totally absent!

Since, as we have already shown, there is good reason to assume that the export taxes levied on tea and rubber were actually shifted forward in this period, it may be reasonable to suppose that the provisions for relief from double taxation did in fact result in a greater reduction in the burden of taxation on these industries than was perhaps intended. It must be mentioned that the coconut industry was not in a position to benefit from this situation. Coconut products, it will be remembered, were not subject to export taxes at this time. If we assume that the prices received by producers would not have been very different even if a duty was in force, then it is clear that the coconut industry was, ironically, the loser out of the existing state of affairs.[379]

379. The industry, however, had other compensations. For one thing, as already mentioned, it had the benefits of a high capital value placed on coconut lands in the calculations of a percentage profits standard. For another, it is likely to have specially benefited from the constant statutory allowance of Rs. 3,000 in excess of normal profits before liability to excess profits duty was involved, as unlike tea and rubber, coconut is predominantly a small-holders industry.

In view of all the concessions granted to agriculture it is hardly surprising that the main contributors to the revenue from the excess profits duty were not agriculture or plumbago mining, but business enterprises of other kinds. The total revenue from the excess profits duty and the contributions from the main sources for the years for which figures are available are depicted in the figures below. The total revenue from export duties is also included in the table.

Revenue from the Export Duty and the E.P.D.
(Rs. million)

	'38–39	'39–40	'40–41	'41–42	'42–43	'43–44	'44–45
Total revenue from export duty	3.3	3.7	5.6	14.0	14.4	14.1	13.0
Total revenue from Excess Profits Duty	—	—	—	5.1	19.1	21.7	28.5
Revenue from E.P.D. on agriculture and plumbago	—	—	—	—	8.2	8.6	n.a.
Revenue from E.P.D. on other business	—	—	—	5.1	10.9	13.1	n.a.

Source: Export duties from *Economic and Social Development of Ceylon. op.cit.* Table XXIII. Excess Profits Duty from *Annual Administration Reports of the Commissioner for Income Tax, Estate Duty and Stamps.*

Note: The low revenue from the E.P.D. in 1941–42 is due, apart from the exclusion of agriculture and plumbago mining, to the preliminary organisational delays in completing assessments.

It will be seen from the table above that the revenue from the export tax remained relatively constant after it was initially raised in 1941–42. In our study of public finance during the depression we noted the tendency for the overall rate of taxation of exports, (i.e. the total revenue from export duties expressed as a percentage of the total value of exports) to fall in the slump, in contrast to the rate of taxation of imports which generally increases.[380] In years of prosperity, on the other hand, we may expect the rate of taxation of exports to increase. In the war period, however, this expectation was only realised during the year 1941–42 when, as as we have seen, the duties were increased by legislative act. Thereafter the overall rate of taxation gradually declined although the total

380. The fall in the rate of taxation of exports is of course due to the fact that export duties are invariably reduced or withdrawn by legislative act in years of depression. If they were not so reduced the rate of taxation would probably increase in the depression because the export duties are specific taxes and the volume of exports tends to fluctuate less than the prices of exports.

value of exports was increasing. It must be remembered that the export taxes are levied at specific rather than ad valorem rates. Unless these taxes are related to prices by means of some form of sliding scale, their total collections will depend only on quantities exported. Since there was no such scale in existence in Ceylon the decline in the rate of taxation after 1942, as shown in the table below, was hardly surprising.

Overall Tax Rates for Exports

Year	1939	1940	1941	1942	1943	1944	1945
Total value of exports (Rs. mill)	305.4	360.9	395.8	508.1	589.3	619.5	595.1
Revenue from export duty (Rs. mill)	3.3	3.7	5.6	14.0	14.4	14.1	13.0
Rate of taxation	1.1%	1.0%	1.4%	2.8%	2.7%	2.3%	2.2%

Source: *Statistical Abstract for Ceylon* 1949 *and Economic and Social Development of Ceylon. op.cit.*

Note: Export values refer to the calendar year, whilst revenue from export duties refer to the corresponding financial year.

The change in the rate of taxation shown above would, of course, be altered if the revenue from the excess profits duty in agriculture and plumbago is included in the total of tax collections from exports. In any event the whole conception of the taxation of exports takes on a somewhat different significance in the special conditions in which export taxes are shifted forward to the consumer. In these conditions the revenues from export taxes do not signify the amounts transferred from producers to the government and they cannot thus be taken as a measure of the burden of taxation on producers. The possibility that the export duty was shifted forward in Ceylon during this period was, of course, the result of the peculiar circumstances of the war. In normal boom times, Ceylon's products are sold in world markets at world prices and these prices are, with the possible exception of tea, scarcely influenced by supply conditions in Ceylon. In these circumstances there would be little scope for the forward shifting of export taxes and producers would then have to carry the burden of these taxes themselves.

(iii) Import Duties

We have seen in a previous chapter that during the financial difficulties of the depression the Government was obliged to increase almost the whole range of import duties in the attempt to achieve budgetary balance. These duties were not, in the main withdrawn during the subsequent years of recovery. In the period of the war they were even increased still further with the result that there has been a continuous increase in the rates of taxes on several imported commodities ever since the beginning of the nineteen thirties. It must, however, be remembered that the war gave rise to a special sort of situation, and we must be cautious lest we interpret Government policy in these years as being typically illustrative of a normal boom. In ordinary periods of prosperity the revenue from import duties would tend to increase even if no additional taxes are imposed by legislation. This is specially true of the revenue from commodities which are subject to ad valorem rather than specific duties, although the revenue from the latter is also likely to increase on account of an expansion in quantities purchased. In these circumstances it is possible that the Government may not find itself under pressure to increase the import taxes still further, specially if it happens to be following a relatively passive expenditure policy. In the period of the war, however, the behaviour of the revenue from import duties was fundamentally altered. Instead of a spontaneous increase, the government was threatened with a serious contraction in the revenue from imports because of a severe drop in their volume. In addition there was the pressing need to secure extra funds to finance the enhanced defence expenditures. Unless the government was prepared to develop and exploit other sources of revenue to fill in the gap it had no alternative but to raise the import taxes by legislation so as to increase or even maintain the dwindling collections from this source.

There is, however, one respect in which the additional taxation on imports during the war differed from the increased taxation imposed during the depression. With the exception of rice, the major part of the increase in revenues from new import duties during the 'thirties was derived from taxes on 'necessities' or commodities of mass consumption like textiles, currystuffs and kerosene oil. The taxes on 'luxuries' were also increased at this time, but since the demand for them generally tended to be both price and income elastic, luxuries did not provide the major contribution to the increase in revenue. In the period of the war, however, the situation was reversed. On the one hand money incomes had increased considerably whilst the supply of imports was severely restricted. There was hardly any doubt that an increase in the duties on luxuries would result in anything but a suitably augmented revenue.[381] On the other hand almost all the important 'necessities' were either being directly imported by the Government or being subject to rigorous price control. Since the Government was striving to restrain the increase in the cost of living it would hardly have been logical to impose additional taxes on these commodities. Indeed from even the narrow revenue point of view it was apparent that any gain from extra import duties on necessities would, in part, have been offset by extra costs to the Government in the shape of enhanced war allowances. For these reasons the increase in import duties during the war was confined broadly to articles which fell outside the Cost of Living Index group. There was, in addition, another factor which influenced policy in regard to import duties. This was the need to conserve shipping space by restricting as far as possible imports of those commodities which the country could manage to economise on. The import duty was in some cases utilised as a weapon to achieve this end. Thus, as early as 1940 the import duty on sugar was increased in the expectation that it would benefit both the revenue and the freight situation.[382] In 1941–42, "Customs duties on liquor and cigars were increased, not as a taxation proposal to increase revenue but with the intention of reducing the demand on shipping space and luxury goods from overseas."[383]

The actual increases in import duties during the war may be briefly summarised. In December 1939 additional duties were placed on malt liquor, wines, spirits, tobacco, cigarettes, petrol and heavy oil, in the expectation of an additional revenue of Rs. 4.5 million. In the financial year 1940–41 the duties on petrol and sugar were raised in the hope of adding Rs. 1 million and Rs. 1.2 million, respectively, to the revenue. In 1941–42 import duties on cigars and liquor were increased with a view, as already mentioned, to saving freight but in the same year there was a general increase in the duties on petrol, beer, wines, spirits, tobacco, cigarettes

381. Since 'luxury' articles unlike 'necessities' are generally taxed at 'ad valorem' rates, the revenue would have benefited from the increase in the total value of these imports even though the quantities imported were falling.

382. *Hansard* 24th July, 1940 p. 1454.

383. Leader of the House, *Hansard* 15th July, 1943 p. 1254.

and cement. An additional revenue of Rs. 7.5 million was anticipated on account of these measures. Finally in 1944–45 there were further increases in the duty on certain luxury articles and a general surcharge on all customs duties except those on food and necessaries.[384] The effect of these measures on the total revenue from import duties are shown in the table below.

Revenue from Import Duties (1938–39 to 1944–45)
(Rs. million)

Year	1938–39	'39–40	'40–41	'41–42	'42–43	'43–44	'44–45
Total revenue from import duties of which:	51.9	56.1	55.4	49.6	63.4	81.0	99.0
(a) Cotton manufactures	1.0	1.0	1.2	.6	3.4	4.2	5.2
(b) Grain	11.7	11.6	11.1	8.5	11.2	13.6	13.4
(c) Kerosene oil and motor spirits	10.5	12.6	13.0	10.9	7.9	10.0	11.6
(d) Malt liquor, wines and spirits	2.7	2.7	2.6	1.9	1.3	2.0	3.0
(e) Sugar	8.3	7.6	8.4	10.2	8.3	10.5	12.0
(f) Tobacco & cigarettes	3.6	6.6	5.9	8.8	18.4	24.8	34.4
(g) Other goods	14.0	14.0	13.2	8.6	13.0	16.0	19.4
Overall rate of taxation on imports	21.4%	19.9%	19.3%	16.8%	14.2%	15.6%	15.9%

Source: *Annual Reports of the Auditor-General* and *Accounts of the Island of Ceylon.*

Notes: (i) From the financial year 1942–43, cotton manufactures are classified as cotton yarn, twist and piece goods.

(ii) From the financial year 1942–43, grain includes grain and flour.

(iii) The overall rate of taxation on imports represents the total revenue from import duties expressed as a percentage of the total value of imports for the corresponding calendar year.

The increase in the revenue from cotton after 1942–43 was due in part to a widening of the classification, but it was also the result of the rapid rise in the external prices of textiles which helped to increase the yield of the ad valorem duty on this group. It is interesting to note that grain and flour were continuing to pay the import duty although they were being imported by the Government. The revenue from these duties could well be included on the receipts side of the Government's trading accounts for these commodities. If they are so included the moderate profits which

384. cf. *Administration Report of the General Treasury* for 1940–46 pp. J 13 and 14.

the government is estimated to have earned during the war through trading in foodstuffs would be enlarged still further. Apart from textiles and grain whose rates of duty, as we have seen, were not increased by legislation, the main contributors to the increase in revenue were tobacco and cigarettes, sugar and 'other goods'. All these groups, were, of course, subjected to tax increases in 1941–42 but the main expansion in the yields from the duties on cigarettes and tobacco were spectacular, rising as they did from Rs. 3.4 million in 1938–39 to Rs. 34.4 million in 1944–45. In Ceylon, as elsewhere, tobacco has proved to be a particularly remunerative tax subject. In spite of the increased taxes, the volume of imports of cigarettes and tobacco rose rapidly during the war. In fact as we saw in the preceding chapter, tobacco, cigarettes and petroleum were amongst the few commodities whose imports, in physical terms, actually increased during this period.

The average or overall rate of taxation of imports tended to decline during the war years. As we have argued elsewhere this result is likely to emerge in periods of prosperity and high import values under a system which taxes a good many of the revenue earners at specific rates. With the severe curtailment in the quantity of imports during the war the tendency was intensified still further. The overall rate of taxation fell steadily from 21.4% in 1938–39 to 14.2% in 1942–43. Thereafter the decline was arrested as a combined result of the legislative increases in taxation and the expansion in imported supplies of such commodities as cigarettes and tobacco. It will be remembered that during the depression the overall tax rate in imports increased in contrast from 9.5% in 1928–29 to 21.8% in 1931–32.

It is interesting to note that, in the special conditions of wartime, import duties had the effect of draining away some of the excess purchasing power in the hands of consumers, without necessarily involving an increase in the retail price of imported commodities. Since the supply of imports was physically restricted in wartime, excess demand in Ceylon had the effect of raising the retail prices of imported commodities well above the limits of their external prices.[385] The imposition of higher import duties in these circumstances may only mean the transfer to the Government of the

385. This, of course, is only true of commodities for which price control was either absent or ineffective. It would then be applicable to luxury goods or even perhaps to most articles of middle class consumption which escaped rigorous rationing or price control.

potential profit margins of retailers. If the extra revenues from these taxes were not spent by the Government their effect would have been decidedly disinflationary. Indeed some writers have suggested the use of import duties in this way as part of a counter depression policy to be pursued in 'export economies'.[386] In periods of depression the governments are to expand local money incomes and protect the balance of payments by rigorous exchange control. A part of the resulting inflationary pressure would then be tapped away by increased taxes on commodities in short supply, particularly 'luxuries' whose prices do not play an important part in the determination of wages and costs. As we have remarked before, the wartime position in Ceylon was in many respects analogous to a depression situation of this sort[387] and the increased import duties did have the effect of transferring a part of the excess purchasing power in the country to the coffers of the Government. It is indeed possible that the policy of raising import duties on 'non-essentials' might have been pursued still further. For, in spite of the increased duties, it is well known that a good many commodities of this type were in fact helping to sustain a thriving black market in wartime Ceylon.

(iv) Other tax increases

The taxes discussed in the preceding pages accounted for the major part of the increase in tax revenues during the wartime period. There were in addition increases in rates in some of the other components of the tax structure. The major increase in revenue came from excise and salt. The excise duty on local malt liquor was raised in 1941–42 and the selling price of arrack was increased on two occasions in the succeeding financial year. The price of salt was also increased after 1942 to offset the effects on revenue of the contraction in salt production that took place during the war. The total revenue from excise and salt increased from Rs. 10.1 million in 1938–39 to Rs. 33.1 million in 1944–45. There were also other minor changes in taxes. The stamp duty on receipts was, for instance, raised from five to six cents in 1941–42.

386. cf. for instance *The Economic Development of Latin America* by Dr. Raoul Prebisch, (Published by U.N.O.)

387. It should, however, be remembered that there was an important difference during the war period in that the prices of exports were closely geared to cost conditions in Ceylon. The effects of inflation on production costs did not therefore involve the same dangers as are likely to arise in a period of depression when export prices are given to Ceylon by external conditions.

On the other hand, there was no change in the rate of estate duty whose yield remained remarkably stable during the war in spite of the increase in capital values. In fact the revenue from the estate duty never reached Rs. 2 million in any single year. The only tax whose yield actually declined during the war was the betting tax on totaliser bets. The revenue from this tax fell from about Rs. 300,000 in 1938–39 to zero after 1942–43 on account of the temporary suspension of horse racing in the country. The Colombo Racecourse was, in fact, converted into an airfield during the Japanese war.

B. The Increase in Non-Tax Revenues

We have seen in the table on page 231 that Rs. 50.9 million of the increase of Rs. 187 million in total government revenues between 1938–39 and 1944–45 was accounted for by a rise in the non-tax receipts of the Government. Details concerning these receipts are given in the appendix to this study. The greater part of the increase in these receipts took place after 1941–42 and the most important single contributor to this expansion was the general category termed "Interest and annuities" which increased from Rs. 4.1 million in 1938–39 to Rs. 25.7 million in 1944–45. This in turn was mainly composed of payments by the Ceylon Railways which are state owned and which managed at long last to reverse the perpetual series of losses suffered since the development of road competition. The restriction of road transport during the war as a result of petrol rationing, the immobilisation of vehicles, and other factors, resulted in an increasing pressure on the railway services, which had, in addition, to cope with the transport requirements of the military authorities. "The traffic carried by the railway in the five years 1934–39 was more than doubled during the period 1940–45."[388] As a result the railway was enabled to make a profit from 1941–42 onwards.[389] A part of these profits were credited to government revenue as interest payments on railway capital provided by the government. The remainder was mainly credited to a special Railway Maintenance Reserve. These profits were unfortunately shortlived: in the post-war period the railway was once more experiencing its customary losses.

388. *Ceylon Year Book for* 1948 p. 170.

389. The net revenue of the railways (gross earnings less total working expenses) during this period was as follows:

In addition to the railway revenues there were certain other non-tax revenues that increased in this period. Most of these were, however, of a minor order. A sum of Rs. 9.6 million accrued to revenue in 1939–40 from the surplus of a sinking fund of a loan that matured in that year. Port and Harbour dues tended to decline in the first few years of the war with the fall in the volume of commercial shipping entering Ceylon. Port Commission charges had to be increased by 10 per cent in 1940 in order to sustain the receipts from this source. Similarly postal rates on foreign and Empire air mails were increased in the same year. Interest receipts on a loan re-lent by the Ceylon Government to the United Kingdom Government was a new but minor source of revenue which did not exceed Rs. 2.2 million. In general the expansion in non-tax revenues was of a moderate nature. If not for the contributions of the railway, the relative share of non-tax receipts in the total revenues of the government would have tended to decline somewhat during the war. As it happened, however, non-tax receipts maintained their relative share in total revenue. In 1938–39 this source provided 28.9 per cent of total revenues. In 1944–45 its relative share was 26.3 per cent.

C. Effects of the Wartime Revenue Policy on the Structure of Taxation

We may conclude our survey of government revenue in wartime with a brief assessment of the effects of the changes in taxation on the country's revenue structure. The relative importance of the major tax changes discussed above may be summarised as follows: between 1938–39 and 1944–45 the total revenue of the Ceylon Government increased by Rs. 187 million from Rs. 116.9 million to Rs. 303.9 million. Rs. 136.2 million of the total increase was due to extra tax collections. Of this amount the income tax brought in an additional Rs. 24.6 million as compared to pre-war. The excess profits duty yielded an additional Rs. 28.5 million and the export duty a further Rs. 9.7 million. Together these two taxes provided Rs. 38.2 million of the total increase. The yield of the import duty increased by Rs. 47.1 million in the same period and excise

(Rs. million)

1938–39	.. —	1942–43	.. 10.8
1939–40	.. —	1943–44	.. 19.8
1940–41	.. —	1944–45	.. 19.8
1941–42	.. 3.9	1945.46	.. 4.2

Source: *Ceylon Year Book for* 1948 *op.cit.* p. 168.

and salt revenues expanded by Rs. 23.0 million. In other words import duties accounted for 34.6 per cent of the total increase in **tax revenues,** the excess profits duty for 20.9 per cent, the export duty for 7.1 per cent, the income tax for 18.0 per cent and excise and salt for 16.9 per cent. Together these groups provided as much as 96.5 per cent of the total increase in tax revenues.

Although the import duty was the major contributor to the increase in tax revenues, and although it continued to remain the most important single source of tax revenue in the country, its relative importance in the total tax structure tended to decline in this period. The gradual change in Ceylon's revenue structure during the war years is illustrated in the following table which sets out the changes in the percentage importances of the various sources of revenue.

Revenue from the various taxes as a percentage of total tax revenue
%

Year	'38-39	'39-40	'40-41	'41-42	'42-43	'43-44	'44-45
A. Taxes on Expenditure & Consumption							
i. Import duties	59.0	61.9	55.0	42.0	41.1	42.2	44.1
ii. Excise & salt ..	11.4	11.8	10.4	13.0	10.8	14.3	14.8
iii. Other ..	4.7	4.5	4.1	4.1	3.8	3.4	3.2
iv. Total	75.1	78.2	69.5	59.1	55.7	59.9	62.1
B. The Export Duty	3.7	4.1	5.6	11.8	9.3	7.4	5.8
C. Taxes on Income and Capital							
i. Income Tax	19.8	16.0	22.9	23.4	21.9	20.6	18.6
ii. Excess profits duty	—	—	—	4.3	12.4	11.4	12.7
iii. Estate duty	1.3	1.7	1.8	1.3	.7	.9	.6
Total	21.1	17.7	24.7	29.0	35.0	32.9	31.9

Source: Calculated from *Economic and Social Development of Ceylon* tables XXLL and XXIII.

Note: Group iii under Taxes on Expenditure and Consumption consist of Revenue from licences, Tax on heavy oil motor vehicles, the betting tax and stamp duties.

The income tax includes contributions by Government Department in lieu of income tax. The amounts involved were, however, small and did not exceed Rs. 1 million in any year.

The table above indicates the decline in the relative importance of taxes on expenditure and consumption which are sometimes described as 'indirect' taxes. On the other hand the so-called 'direct' taxes or the taxes on income and capital tended to increase, particularly after 1941–42 when the excess profits duty was introduced. In fact the share of the taxes on expenditure and consumption were lowest in 1942–43. Thereafter it tended to revive slightly on account of the yields from the additional import duties and the excise and salt taxes. We have placed the export duty in a separate group since there were certain changes in its nature during the war and it would perhaps be misleading to include it in any of the other groups. As we have already seen, the export duty gained in importance in 1941–42 when it was first imposed on a wide scale. Thereafter its relative importance declined on account of the stabilisation of export taxes at the existing levels after the extension of the excess profits duty to agriculture and plumbago.

Although the revenue structure of Ceylon underwent certain changes during the war period, there is little to suggest that these changes were of a permanent nature. The excess profits duty was introduced as a purely wartime tax and the export taxes are invariably confined to periods of prosperity in the export industries. The increase of rates in the income tax and the import duty may of course be maintained, at least partially, in less expansive periods, but even if this were the case, the yields from these taxes would tend to fall, and there is little certainty that their relative importance would be changed in any particular direction. Indeed if the excess profits and export duties were excluded the import taxes would regain their customary predominance even in the war period. For these reasons we may assert that there were no really fundamental or lasting changes in the tax structure during the war comparable, for example, to the introduction of the income tax in 1932.

In spite of the spectacular increase in tax revenues the share of taxation in the total national income seems to have decreased significantly during the war years. Certain tentative estimates of national income are available for selected years in our period. These make possible a rough estimate of changes in the share of taxation appearing in the table overleaf.

The figures in the table tend to confirm the view that the total increases in taxation were relatively mild during the war. In fact these increases do not seem to have kept up with the expansion in incomes. This feature is in strong contrast to the tendency during

Taxation as a percentage of National Income

	1938	1942	1943	1944
National Income (Rs. million) ..	556	1,103	1,455	1,785
Share of Tax Revenues (%) ..	15.9	10.7	10.6	10.8
Share of Total Government Revenue (%) ..	20.3	14.4	13.7	14.1

Source: *National Income from U.N.O. National Income Statistics* 1938–47, p. 43.

Note: The National Income figures refer to 'Domestic Net National Product at factor Cost'.

National Income Statistics refer to calendar years whereas revenues are for the nearest financial year.

the depression when revenues remained relatively stable when compared to the fall in export values and incomes.

IV. The Wartime Borrowing of the Ceylon Government

It is generally recognised that budgetary surpluses are appropriate objectives of fiscal policy in periods of inflation and excess demand. By the creation of these surpluses on an adequate scale, a government is enabled to drain away surplus purchasing power from the hands of the public and thereby abolish or reduce the 'inflationary gap'. Moreover, the government can take advantage of these surpluses to repay the public debt and thus secure a reduction in the burden of interest payments. The anti-inflationary effects of the budget surpluses would not be damaged by this process as long as the former debt holders refrain from spending their liquid holdings of cash.

During the wartime inflation in Ceylon, however, public debt policy followed a somewhat curious path. The ordinary revenue and expenditure budget of the government did, as we shall see in the following section, result in surpluses. But instead of a reduction, the period witnessed an impressive expansion in the country's public debt. At the same time the policy underlying the extra government borrowing was, in part at least believed to be counter inflationary. For, as will be shown presently, the major portion of the borrowed monies were not utilised for purposes of public expenditure.

Ceylon's first local loan was raised in 1937 for the purpose of financing certain public works expenditures. In 1938 a sum of Rs. 30.9 million had been raised under this loan. At this date the gross public debt of the country stood at Rs. 194.2 million consisting of the local loan just mentioned and a sterling debt of

Rs. 163.3 million (or £12.2 million). In the course of the war the composition of the public debt came to be completely reversed. A part of the sterling debt redeemable during the war years was repaid and there was no fresh borrowing of significance in the London Money Market. At the same time the local debt expanded considerably as a result of a succession of new issues in the local money market. By the end of the war period, in 1946, Ceylon's total public debt stood at Rs. 437.6 million consisting of a sterling debt of Rs. 125.5 million (or £9.4 million) and a rupee debt of Rs. 312.1 million.

The increase in local borrowing was not, however, matched by an equivalent increase in expenditure out of borrowed funds. The last of the instalments of the 1937 Public Works Loan was raised in 1941 and thereafter there were no further borrowings for public works purposes until 1945. The first new loans to be raised in wartime were a number of "war loans" amounting to about Rs. 100 million which were re-lent to the United Kingdom Government. Since in the case of these loans the Ceylon Government was really an intermediate agent between the United Kingdom Government and the Ceylon public, the sums involved are excluded from the total of Ceylon's public debt.[390] In our analysis of defence expenditure, we saw that it was decided after 1941 to finance a portion of the costs of defence out of loan funds. For this purpose the Government raised a number of "Home Defence Loans" in 1941 and 1942 totalling about Rs. 50 million. In the following year, 1943, the Government embarked upon a new policy of raising public loans without the intention of spending the whole of the receipts obtained from them. In accordance with this policy it was decided to initiate a "National Loan" of Rs. 125 million. Rs. 25 million of this sum was to be used to repay some of the Home Defence Loans which were due to mature in 1945 and 1946. A part of the remainder was to be used to finance

390. It is possible that a part at least of these funds were spent by the U.K. Government in Ceylon as payments for exports or military requirements. The sums involved would then be included amongst export values and the aggregate for military expenditure.

It is known that a portion of voluntary public contributions to help the war effort was spent locally. For instance out of the total collections of Rs. 7.8 million by the Government sponsored "War Purposes Fund" Rs. 4.0 million was sent to the U.K. Treasury and Rs. 3.0 million spent locally on the local Red Cross and Services Welfare Organisations – cf. *Administrative Report of the General Treasury for* 1940–46, p. J. 12.

defence expenditure but the rest was to be credited to a reserve to be used after the war for the purpose of financing the Government's post-war development scheme. Finally, in 1945 it was decided to raise the remaining instalment of the 1937 public work loan (amounting Rs. 43 million) and to launch out on a further series of National Development Loans for which a target of Rs. 200 million was set. Rs. 68.6 million of this latter sum was realised in 1945.

In addition to the relatively long term loans listed, we must mention the issue of Treasury Bills, which commenced in August 1941 and continued throughout the war years. The total amount of Treasury Bills outstanding at the end of any financial year did not exceed Rs. 12 million.

The following table compares the annual borrowings of the Government with the annual expenditure out of loan funds. This shows quite clearly that a decreasing proportion of borrowed monies were spent towards the latter years.

(Rs. million)

	1938-39	'39-40	'40-41	'41-42	'42-43	'43-44	'44-45
Total net receipts from borrowing	9.3	5.0	54.5	35.0	38.4	88.0	120.4
Total Expenditure from loan funds	7.6	6.5	5.4	23.7	26.1	27.7	31.6
Defence Expenditure from Loan Funds	—	—	—	18.3	20.0	20.0	17.9
Excess of Loan Receipts over loan expenditure	+1.7	—1.5	+49.1	+11.3	+12.3	+60.3	+88.8

Source: Director of Census and Statistics and *Statistical Abstract for Ceylon* 1949 Table 163. *Administration Report of the General Treasury* 1940–46 p. J. 10 for Defence Expenditures out of loan funds.

Note: Total net receipts from borrowing are made up from the total annual proceeds of all government loans raised in Ceylon (including receipts from war loans to be re-lent to the U.K. and Treasury bills) less the total repayments of loans and Treasury bills.

Total expenditures from Loan Funds include expenditure out of monies advanced from revenue for loan works. These sums are included here since they do not figure in the ordinary current expenditure budget.

The policy of borrowing money in excess of expenditure requirements was said to satisfy the twin objectives of enabling the Government to accumulate a fund for post-war development purposes, and of curbing the inflationary pressure on the economy by immobilising purchasing power. There is no doubt that the public loans raised during this period fulfilled the first objective. Both the banks and the public were accumulating monetary reserves, and there was some justification for the Government in attempting to secure these funds for its own uses. There was, after all, no certainty regarding the practicability of borrowing on similar terms in the post-war period when consumers might well be inclined to use their wartime savings for satisfying their accumulated 'back log' demand.[391]

The policy of postponing the spending of these borrowed monies was likewise a prudent approach, for expenditure out of loan funds would clearly have added to the inflationary pressure of the period. Whether the Government borrowing was, on the other hand, actually counter inflationary is less certain. The building up of reserves of borrowed money is not really analogous to the creation of budget surpluses through taxation. It is, of course, admittedly possible that taxes are, in certain cases, paid for out of savings. In our chapter on the depression we argued that all taxation need not necessarily have deflationary effects on the domestic economy because taxes may largely be paid for out of funds which might otherwise have been devoted to imports, if not to savings. In the period of the war, however, there was an upward pressure on prices of scarce imported goods due to excess demand. Even if taxes were paid for out of potential expenditure on imported goods they would, for this reason, have had a disinflationary effect. The 'surplus borrowing' of the Government could not therefore be compared to ordinary budget surpluses through taxation as regards their anti-inflationary effects. Government securities provided, in the main, an alternative form in which the public could hold its savings. It is hardly likely that the public would have restricted their consumption expenditure in order to subscribe to government loans. Even where commercial banks were subscribers to the loans, it is not certain that they would have, in the absence of government securities, departed from their conservative approach towards investment in the domestic sector. On the other hand, it must be admitted that, in some

391. There was, of course, nothing to prevent the public from selling their government securities for cash in order to possess funds for post-war expenditure. But such a process would not affect the monetary reserves of the government unless the latter was obliged, in the absence of a central bank, to give extensive support to its own securities in the money market.

ways, lending to the Government may discourage expenditure. When assets are held in a relatively liquid form as demand deposits or cash, they may prompt increased expenditure. Or, alternately if the wartime savings were invested in some outlet other than government securities, such as land or buildings, they may encourage an inflationary increase in the capital values of these assets. For these reasons the surplus borrowing of the government may have exerted a beneficial effect. As the Financial Secretary remarked, the loans "would do little or nothing to stop inflation as regards the ordinary necessaries of life. People likely to subscribe are unlikely to leave themselves so short of money that they cannot pay the black market price for a measure of rice if they felt so inclined. But it must be anti-inflationary to take off the market, so to speak, some tens or hundreds of millions of money which would otherwise, in all probability lie in the bank accounts of our subscribers until they felt an urge to spend it on something which would probably be purchased at the inflated price.[392]

When, in the final section of this chapter, we analyse the overall effects of the Government budget in wartime, we shall consider subscriptions to unspent government loans as a part of the savings of the public rather than as a contribution of budgetary policy towards a narrowing of the general 'inflationary gap'.

V The Overall Effects of the Wartime Budgets

In the previous sections, we analysed in some detail the course of public expenditure and revenue and the borrowing polices of the Government during the war. It remains for us, in the pages that follow, to bring together these varied aspects of the budget and to assess the overall effect of wartime finance on the economy as a whole.

In the course of this study of the Ceylon economy in the war years, we have repeatedly emphasised the distinction between the peculiar characteristics of the wartime inflation and the properties of a more normal period of cyclical expansion. In ordinary periods of prosperity governments in countries such as Ceylon are generally advised to aim at the creation of budgetary surpluses as a means of assisting the economy to accumulate external reserves. The aim of these budgetary surpluses is not, in general, the prevention of inflationary rises in prices, because in normal times the type

392. *Hansard* 22nd September 1943, p. 2231.

of inflation hardly takes place on account of the almost perfect elasticity of the supply of imports. In the period of the war the roles were reversed. Budgetary surpluses were no longer needed for the purpose of building up foreign reserves, because the economy was already experiencing an impressive expansion in its external assets. On the other hand overall budgetary policy could have been used to combat the inflationary rise in prices by immobilising, through a series of surpluses, the excess demand in the economy. Such a policy would not, unless carried to extremes, have led to an actual increase in external assets through the further reduction in the supply of imports.[393] But by canalising an increasing part of the money supply into the possession of the Government it would have indirectly placed an equivalent portion of foreign exchange at the Government's disposal.[394]

We shall, in the paragraphs that follow, attempt to assess the overall effects of the budgets and to see whether budgetary policy as a whole tended to aggravate or correct the wartime inflation. We have already seen that the main inflationary factors in Ceylon were the surpluses in the balance of payment on current account and military expenditure. We shall not attempt to measure in precise terms the size of the total 'inflationary gap' in this period because the available data is quite inadequate for this purpose. Nevertheless the fact that estimates of the favourable balance of payments on current account between 1941 and 1944 when cumulated show a surplus of Rs. 1058 million, as compared to a total increase in the same period of Rs. 263 million in savings deposits and subscriptions to government loans, suggest that this inflationary gap was of a substantial magnitude.

For the purpose of assessing the overall budgetary surpluses or deficits, we shall compare the total expenditure of the government, whether paid for out of current revenues or loan funds with total revenues including both tax and non-tax revenues. The proceeds of loans raised during the period will, however, be excluded since

393. Indeed, it is possible, that in the circumstances of the war, a successful policy of disinflation might paradoxically have resulted in a decrease in external assets. As we have shown elsewhere, the external prices for Ceylon's exports were closely related to production costs in Ceylon and would presumably have decreased with greater disinflation.

394. In the sense that the running down of these external assets would largely depend on the Government's future fiscal policy – on future budget deficits, for example.

it would be more appropriate to regard them as a part of the savings of the private sector. The estimated profits on food trading are included on the receipts side, although these funds were held departmentally instead of being credited to general revenue. Similarly, the annual contribution out of railway profits to the Railway Maintenance Reserve is added to the budget surpluses. As we have shown elsewhere, the railway was earning a profit in some of the war years, but only a part of this profit was credited to current revenues through interest payments. The remainder was held in a separate reserve to meet future requirements. It is proper that these amounts to be added to the receipts side of government finance in the same way as railway losses were added to government expenditure during the depression.

Overall results of Government Finance 1939–40 to 1944–45
(Rs. million)

	1939–40	'40–41	'41–42	'42–43	'43–44	'44–45
Total current expenditure	131.4	127.3	153.3	185.0	210.7	254.7
Total current revenue	132.7	135.5	158.8	200.0	250.6	303.7
Official budget surplus	+1.3	+8.2	+5.5	+15.0	+39.9	+49.0
Expenditure inclusive of loan expenditure	133.9	132.7	177.0	211.2	238.4	286.0
Revenue inclusive of food profits	132.7	135.5	158.8	216.2	269.7	321.3
Surplus or deficit	–1.2	+2.8	–18.2	+5.0	+31.3	+34.7
Surplus or deficit inclusive of additions to railway reserve	–1.2	+2.8	–18.2	+12.0	+47.3	+38.3

Source: *Statistical Abstract of Ceylon for* 1949 for government revenues and expenditures including war expenditure. *Director of Census and Statistics* for estimates of trading profits on food. *Administration Report of the General Treasury for* 1940–46 p. K. 13 for additions to Railway Maintenance Reserve.

The results in the table above show that although the official 'current' revenue and expenditure budgets showed regular surpluses right through the war years, the overall accounts of government activities yielded a sizeable excess of receipts only after 1942–43. In 1941–42 there was an actual deficit, and government activity in that year must have tended to aggravate the inflationary situation. Moreover, in view of the substantial magnitude of the inflationary gap that emerged in the later years of the war, it would seem as though the corrective effects of the surpluses after 1942–43 were barely adequate.

If we were to appraise the results of overall fiscal policy in this period we would be inclined to conclude that the possibilities of using the budget as a counter inflationary force were not utilised to the fullest degree. We have already seen that in spite of a number of legislative increases in taxes, the yield of taxation fell short of the increase in total incomes. The increase in the average rate of the income tax was mild; the increase in import duties was not sufficient to frustrate a thriving black market in a number of commodities. The export tax and the excess profits duty were modified by a number of concessions which made it doubtful as to whether the agricultural industries were, in reality, paying the taxes which were intended for them.[395] In fact, it was only in the post-war period that the Government set out to make a fuller use of the opportunities before it. In 1945–46, a year which falls outside the scope of this chapter, additional taxation was imposed in a number of fields with the deliberate intention of raising revenues well above the amounts required for expenditure. In introducing the budget for that year, the Leader of the House remarked regretfully: "I am very sorry that during the past years of the war this policy (of budgeting for surpluses) has not been followed quite fully. We blame ourselves for the fact, but we can only do our best at the present stage."[396]

Nevertheless it must be appreciated that the budgets of the war years did enable the government to accumulate a reserve with which to face the post-war situation. In June 1944 the State Council apportioned a part of the surplus funds of the government into a specially created National Development Reserve – "for the purpose of meeting expenditure on schemes of Reconstruction and Development after the War". At the end of the financial year 1944–45 this reserve had a sum of Rs. 119 million to its credit.[397] This sum, together with the accumulated proceeds of unspent loans, placed the government in possession of sizeable financial reserves at the conclusion of the war.

395. This is not to prejudge the question as to whether increased taxes on the agricultural industries were desirable. A relatively light burden of taxes might enable producers to build up reserves for much needed capital expenditures in the post-war period.

396. *Hansard* 19th July 1945, p. 3542.

397. cf. *Statistical Abstract for* 1949 p. 165. In 1942 the accumulated "Current budget" surpluses of previous years were held in two funds – a general Reserve Fund of Rs. 10 million and an ordinary surpluses fund of Rs. 15 million. The General Reserve Fund was maintained at a constant level of Rs. 10 millon right through the war years, but in 1944 the whole of the Rs. 15 million in the Ordinary Surpluses Fund was transferred to the new National Development Reserve, to which was also added the whole of the annual budget surpluses from 1942–43 onwards.

CHAPTER VII

THE CEYLON ECONOMY IN THE POST WAR PERIOD— THE PARTIAL RETURN TO THE NORMAL PROPERTIES OF AN EXPORT ECONOMY

In this chapter, we shall make the third and concluding study of the mechanics of an export economy. The first study analysed the behaviour of the Ceylon economy under the impact of the world depression, and also the repercussion of these forces on the Government's budget. The second covered the characteristics of a boom of a somewhat specialised nature which gave rise to the problem of price inflation through excess demand. In this last study we shall trace the gradual return to the conditions of a more normal type of boom, where the availability of imports is at least partially restored, and where the rise in the general level of prices is mainly produced by external factors. In the succeeding chapter we shall show that, for this and other reasons, the budgetary problems of the period were more representative of those in the upward phase of a trade cycle than they were during the war.

The period considered here, begins with the cessation of hostilities in 1945 and ends with the year 1951, which is the last year for which a reasonable coverage of statistics is so far available. The period is one of boom in the sense that the absolute value of exports shows a continuous expansion in each succeeding year and remains far ahead of pre-war levels. Nevertheless we must distinguish between at least three distinctive phases within this post-war period. Some of the important variables in the Ceylon economy behaved in a different fashion over these separate phases, and, as a result, there was an alteration in the principal economic problems facing the country. The central analysis in this chapter is accordingly divided up into three parts corresponding to each of these phases in the post-war period.

Before we carry out this analysis, however, it is useful to preface our study with an outline of the post-war pricing arrangements for Ceylon's major export commodities. In some cases these arrangements were common to all the phases dealt with here, and it is therefore convenient to outline them in advance.

The Post - War Marketing Arrangements for Ceylon's Exports

With the conclusion of hostilities, the wartime arrangements, under which the United Kingdom Government was the sole agent of all the allied countries in the procurement of supplies, were rapidly suspended. In some cases the arrangements were replaced by the restoration of free markets. In others, a system of contracts was introduced which maintained, at least partially, a form of centralised purchasing.

We outline below the marketing arrangements for the principal commodities tea, rubber and coconuts. Free markets were restored in the case of almost all the other minor exports. The outstanding factor concerning the post-war marketing arrangements is the removal of the wartime system under which prices were safely geared to costs of production in Ceylon. Even where the return to free markets was only partial, the movement of prices was not completely dependent on changes in the cost of production. It is true, as we shall see below, that in the case of the tea contracts production costs were allowed to play a part in prices. But even here the dependence was of a minor order. The prices offered by the United Kingdom under the tea contracts were influenced more by the prices in the free markets than by production costs in Ceylon. Indeed, we can say quite confidently that, in contrast to the wartime situation, an inflationary rise in domestic costs was now a definite danger to the profitability of Ceylon's export industries.

(a) Rubber

The position of the rubber industry during the post-war period was exceptional in the sense that, unlike the other major commodities, rubber exports declined in value after the war. Moreover, rubber was the one important commodity for which no inter-governmental agreement was provided in place of the wartime system of centralised purchases and sales.

The scheme for the purchase and export of the entire output of rubber in Ceylon, on behalf of the U.K. Government, terminated in October 1946. Purchases were, however, continued in a similar manner until the end of the year. The price that was in operation at the termination of the agreement (71 cents per lb. Raw Smoked Sheet No. 1 with differentials for other grades) was allowed to remain. In January 1947 however there was a complete return to free markets. The immediate consequence of this was a sharp fall in the world price of rubber.[398] In January 1947 this price fell from 71 cents per lb. to 62.9 cents. By June it was as low as 37.3 cents per lb. The rubber industry in Ceylon, naturally enough found itself in rather severe difficulties. Indeed the position was considered to be sufficiently serious to induce the Government to subsidise the industry.

The Government subsidy to the rubber industry took the form of a "floor price" at which the Government declared itself willing to purchase supplies of rubber. The "floor price" was, of course, fixed above the existing world price at 65 cents per lb. (R.S.S.No. 1 sheet). Rubber was, at first, purchased at this price only through Government agencies such as the Rubber Commissioners' Stores in Colombo and the Depots at the outstations. This had the effect of reducing the supplies offered to the established shippers who were only able to pay prices approximating to the world price. The shippers, thereupon, complained that "they were obliged, apart from ceasing to buy rubber, to disband their labour forces employed in sorting, grading and baling of rubber with consequent unemployment for a large number of people". In order to obviate this difficulty, the shippers were authorised to purchase rubber at the floor price on behalf of the Rubber Commissioner, but stocks of rubber so purchased were sold at the discretion of the Commissioner at the best prices offered. These arrangements helped the shippers to continue their activities uninterrupted.[399]

Towards the latter part of 1947 the world price of rubber tended to recover. The stocks that had been accumulated for war purposes were being gradually absorbed under the impetus of post-war reconstruction, and supplies from countries like Indonesia and Burma were being restricted on account of political disturbances in these areas. In December 1947 the Government decided to

398. The immediate reason for the fall in rubber prices was, perhaps, the relaxation of war production and the availability of accumulated stocks. In addition the war saw the rapid emergence of a new factor – the U.S. synthetic rubber industry – which had grown considerably in this period and which was protected by the mandatory requirement that manufacturers of rubber goods must use a certain proportion of the synthetic product. A further factor which exerted a depressive effect on prices was the prospective availability of supplies of natural rubber from Malaya and Indonesia.

399. *Ceylon Year Book for* 1949 p. 36.

lower its floor price from 65 cents per lb to 55 cents. The world price had, however, risen above this sum with the result that the Government subsidy ceased to be effective. In January 1948 the system of floor prices was withdrawn altogether and Government support for the price of rubber ceased. The table below compares the floor price with the world price of rubber during the course of 1947.

Rubber Price in 1947 (R.S.S. No. 1)
(cents)

End of:	*Government Price*	*World Price*
January	65	62.9
May	65	44.3
June	65	37.3
August	65	40.6
September	65	47.2
October	65	56.9
November	65	61.4
December	55	61.7

Source: B.B. Das Gupta: *A Short Economic Survey of Ceylon.* Colombo 1949 p. 37.

The system of subsidies through "floor prices" is of some interest as this was the first occasion in which the Government directly subsidised prices in any of Ceylon's major export industries. It will be recalled that no comparable measure was introduced during the depression when prices of rubber and other products slumped to even lower levels. 1947 was, however, very different from any of the depression years as far as the financial position of the Government was concerned. The fact that an industry was subsidised in a period of general monetary prosperity does not necessarily indicate that a similar policy would hereafter be pursued in times of depression.

The problem of the price of rubber in the post-war period was bound up with another factor of a long term nature. As we have already mentioned, the position of natural rubber production throughout the world has been affected by the growth of the synthetic rubber industry in the United States of America which is the major consumer of rubber. This so-called "structural change" in the rubber industry may exert a depressive effect of a long term character on the price of natural rubber. In these circumstances a policy of subsidies aimed at maintaining the total physical productive capacity of the Island may well have to be permanent instead of being confined to purely temporary or cyclical changes. In recognition of this difficulty the Ceylon Government appointed a commission of enquiry to investigate the long term prospects of the Island's rubber industry. The Commission published its Report in 1947. It pointed out that, for a number of reasons, Ceylon was a relatively high cost producer of natural rubber as compared to Malaya or Indonesia. In the light of what it considered to be the long term world prospects for natural rubber, it declared a portion of Ceylon's rubber producing capacity as 'uneconomic'. In consequence it recommended that certain marginal areas be converted away from rubber to the production of certain other crops, particularly rice. The Government was to offer a capital subsidy for producers who prepared their rubber lands for the cultivation of rice.

The Report of the Commission was accepted, in principle by the Government which sought to implement some of the recommendations such as the offer of monetary assistance to producers who "asweddumised" (i.e. prepared for paddy cultivation) their rubber lands. It was realised that the "floor price" system of subsidies may tend to interfere with, or delay, a process of conversion away from rubber. Accordingly, floor prices were not restored after their withdrawal in January 1948. Throughout that year the world price of rubber remained uneasily around an average of 62 cents per lb. The Rubber Commission had estimated that the average cost of rubber production in Ceylon in 1946 was 61 cents per lb. In 1949, world prices fell to disastrous levels as far as Ceylon was concerned. Largely under the influence of the American recession in 1949, the price of rubber fell to a minimum of 47.6 cents n 1949.[400] It was, in fact, the devaluation of the rupee, relatively to the dollar, in September that rescued the industry from a severe crisis. Indeed the position of the rubber industry was a major consideration behind the Government's decision to devalue the rupee. With devaluation, the fortunes of the industry began to recover. A climax was reached in 1950 under the impetus of the Korean war when the price of rubber attained to heights previously unsurpassed. The long term problems of uneconomic production tended to fade out of public consciousness, and, not unnaturally, the Government's offer of incentives for the conversion of rubber lands met with little response. At some future date, however, the problem may well present itself once more. Indeed by the middle of 1951 there were signs that the Korean boom had ended.

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400. *Quarterly Bulletin of Statistics* March 1950. Table 94. The Government's assistance to the ailing industry was confined to withdrawing the applicability of the Minimum Wages Ordinance to Rubber.

(b) Tea

As we have already mentioned, rubber was the only major commodity for which there was a complete return to free markets after the war. With tea the restoration of free markets was only partial. The wartime arrangement under which the full exportable surplus of Ceylon was sold to the U.K. Ministry of Food, was terminated at the end of 1946. From January 1947 producers were permitted to sell or export their produce freely and on the 20th of January the Colombo auctions were resumed after a lapse of over four years. The British Ministry of Food, however, chose to make its purchases not at the auctions, but under annual contracts with producers. The Tea Commissioner in Ceylon acting as its agent called for tenders to supply 150 million lbs. of tea in 1947 under a system of agreed prices. The response was, however, partial as only 94½ million lbs. were offered. The prices offered under the contracts were based on the wartime principle of a basic price plus an adjustment for changes in the cost of production.[401] Producers who chose to dispose of their supplies under contract were thus given the advantage of a measure of security for a period of a year as against the risks involved in selling on the free market. However, the quantity of tea sold under contract amounted to only about a third of the total of Ceylon's exports of 287 million lbs.

The decision to resume the Colombo auctions and to permit the U.K. Government to make its purchases under contract was made after an unsuccessful approach by the Ceylon Government to secure a long term agreement with the United Kingdom. The Ceylon Government was desirous of an agreement covering a period of three to five years. However, Ceylon's bargaining power in this respect was restricted by the prospective availability

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401. The price paid by the British Ministry of Food for teas purchased under the 1947 contract was the average price realised by teas exported or sold with export rights by each estate during the basic years 1936, 1937 and 1938 plus 12½d. per lb. plus an increase or decrease of one farthing per lb. for any increase or decrease as the case may be by a full 3 cents of the daily minimum time rate of 125 cents appertaining to a male worker not under 16 years of age. The price paid under the 1948 contract represented an increase of 2d. per lb. over the price paid under the 1947 contract. *Ceylon Year Book for* 1949 p. 33.

Although these contracts were between the British Government and individual tea producers in Ceylon, the basis for the determination of prices described above was the result of inter-government agreement between Ceylon and the U.K. Bargaining centered on the basic addition to the pre-war average – the 12½d. in 1947 and the 14½ d. in 1948.

of Indonesian supplies and the negotiations fell through. The Government thereupon decided, almost simultaneously with the restoration of the Colombo auctions and the U.K. contract scheme, to impose a heavy export duty on tea. The existing export duty of 4.8 cents per lb. was raised in February to 38.8 cents per lb. As far as the U.K. purchases under contract were concerned, the effect of this measure was a full forward shifting of the whole of the new duty. The U.K. Government as purchaser was now obliged to pay the contract price plus the full duty. As regards the free sales at the auctions, it is difficult to say whether or not the duty was shifted forward in its entirety. The resumption of the auctions was accompanied by keen competition amongst buyers as a number of foreign countries were now entering the market for the first time. It is conceivable that, even in the absence of a duty, this competition would have sufficed to sustain prices at a high level. On the other hand, the fact that India, the other major producer, also raised her export tax, though to a lesser extent, suggests that these taxes may in fact have been shifted forward – at least partially.

The coexistence of the contract scheme alongside the Colombo auctions resulted in the emergence of two prices for Ceylon teas. During 1947, prices at the auctions remained consistently higher than the contract price of the U.K. Government, even when the export duties are taken into account. The average price at the auctions for the whole year was 4d. per lb. in excess of the average contract price. This fact was responsible for the disappointing response to the invitation for tenders for the 1948 contract. The U.K. Government asked once more for 150 million lbs. but was offered only 97½ million lbs. although it increased its contract price by 2½d. In 1948 the market price fell below the contract price in certain months but, on an average for the whole year, it still remained slightly in excess of the latter. It would, of course, be erroneous to take the prices at the auctions as an exact measure of what Ceylon would have earned if the whole of her output was sold at these auctions. About a third of her supplies were withheld from the auctions as these were subject to the contracts. On the other hand, if there was no system of contracting, the United Kingdom may herself have been obliged to secure her purchases at the auctions. It is thus difficult to say precisely what prices would have been if the whole output was sold at the auctions. If the system of contracts was not available to the U.K. Government, it may have turned to India for a greater portion of its supplies.

The point we wish to stress here is that, although the restoration of free markets was only partial, the price of Ceylon's tea was becoming more dependent on world supply and demand conditions than during the war. There was now no certainty that prices would in all events be safely and securely linked up to changes in the cost of production in Ceylon. An inflationary rise in costs did hold out some dangers to producers and to the economy.

(c) Coconut products

The arrangements for the export of coconut products after the war had some similarities with the schemes for tea, but there were some differences as regards the various stages in the approach to free markets. The wartime system of centralised purchases of the whole of the exportable surpluses was terminated at the end of 1945. But these arrangements were not, at first, replaced by even a partial return to free markets. Instead the Ceylon Government entered into a five year agreement with Britain covering the whole of the exportable surpluses of copra and coconut oil which are the major products of the coconut palm. Britain was to purchase, for a period of five years from 1st January 1946, the whole of the Island's exportable copra and oil at a net price to the *producer* of Rs. 100 per 'candy' (of 5 cwts) of copra, and a corresponding price for oil.[402]

After the experience of the first year's working of this contract it was becoming increasingly apparent that contract prices were lagging far below the world market prices for coconut products. The world shortage of fats and oils was acute, and there was no evidence to suggest that, as in the case with tea, the shortage was purely temporary. Indeed it appeared as though the Ceylon Government had committed itself to a rigid contract in a period of continuously rising prices.

In an attempt to remedy the situation the Ceylon Government, in January 1947, imposed a heavy export duty similar to the tax on

402. To ensure adequate export of copra and oil to Britain, limits were placed to the quantity of nuts, desiccated nuts and other processed coconut goods which could be exported to other countries. cf. *A Shor Economic Survey of Ceylon op.cit.* p. 39.

tea. The export duty on copra was raised to Rs. 50. Since the terms of the contract provided for a price of Rs. 100 per candy to the producer, the duty was shifted forward to the purchaser in its entirety. Britain was, in other words, paying a price of Rs. 150 per candy. At the same time the Ceylon Government appropriated for itself only half the proceeds of the tax. The remaining half was paid back to the producers who were thereby enabled to secure an effective price in excess of the contract price.

Even this device did not prove to be wholly satisfactory. On the one hand world prices were still continuing their upward trend, on the other, production costs in Ceylon were increasing, largely because of the rise in import prices. It should be noted that, unlike the contract scheme for tea, the agreement for coconut products did not provide for an adjustment of prices to changes in the cost of production. Thus in spite of the indirect increase in price secured for producers through the export duty, profit margins were tending to fall at a time when the world price of coconut products was reaching extreme heights. In preference to the possible alternatives of either cancelling the contracts or raising the export tax still further, the Government sought and obtained a revision of the agreement with the United Kingdom. The new agreement came into force from 1st July 1948.

The new agreement was intended, like the previous one, to last until 1950. But the terms of the agreement were rather different. Instead of providing a flat rate price for the whole duration of the agreement, separate provisions were now applied to each of the years from 1948 to 1950. In addition, the contract did not cover the whole of Ceylon's exportable surplus of copra and coconut oil. Instead Ceylon was now given the opportunity of disposing of part of her produce in free markets. The position was in this respect analogous to the arrangements for tea.

The provisions for each of the years are of some interest because, as far as Ceylon was concerned, they combined the desired security with an element of flexibility. The new agreement covered purchases by the U.K. and Pakistan during the period 1st July 1948 to 31st December 1950. For 1948 Ceylon had to supply Pakistan with 8,000 tons in terms of oil at a fixed price of £55 per ton of copra (approximately Rs. 183 per candy) f.o.b. Ceylon ports. If Pakistan did not take the whole or any part of this, Ceylon was entitled to dispose of the balance to any destination at any price. The U.K. was bound to accept any copra offered by the Ceylon Government at the rate of £50 per ton (Rs. 166.5 per candy) f.o.b. Ceylon ports, but Ceylon was at liberty to sell her output in the open market if she so desired. In other words, for the rest of 1948, Ceylon had, apart from the commitment to Pakistan, the opportunity of selling her entire output in the free markets whilst being protected at the same time by a minimum price.

For 1949, the agreement provided that Ceylon was to supply the U.K. and Pakistan with 40,000 tons and 8,000 tons respectively in terms of oil at a price of £55 per ton of copra. In addition, the U.K. was also bound to accept any quantity of copra or coconut oil offered by Ceylon in excess of this quantity at £55 per ton of copra. In other words, Ceylon was committed to sell a total of 48,000 tons, which is a little less than half her normal exportable output, at a fixed price, whilst she was protected by a minimum price for the remainder.

It was intended that a fresh five year agreement be negotiated at the end of 1949. But if this was unsuccessful, provisions were made for 1950 which were identical with those of 1949 as regards quantities, but which allowed for a price between £47.12s. and £47.8s. per ton of copra.

It should be noted that this revised agreement specified prices as "f.o.b. Ceylon ports". This meant that the export duties were included in the agreed prices and Ceylon was no longer able to secure an increase in prices by raising her export taxes. Since Ceylon was not able, by herself, to influence the free market prices, it may be said that there was now no scope for the forward shifting of export taxes in the case of coconut products.

We are now in a position to analyse the behaviour of the basic forces in the economy over the post-war period. As we have said before, the post-war period may conveniently be divided into three phases. The first phase commenced with the end of the war in 1945. The main feature of this period was the gradual working off of the accumulated 'inflationary gap' of the war years. As a resulting consequence there was a progressive deterioration in the balance of payments. The phase may be taken as ending in 1948, when it became necessary to correct the balance of payments' position by the imposition of rigorous exchange control. The second phase is covered by the years 1948 and 1949. The restriction of imports through exchange control restored a state of affairs which was potentially akin to the wartime situation when incomes were high and imports were in short supply. If incomes had been high enough there would have been the danger of an acute inflationary rise in prices brought on locally through excess demand. In fact, however, the inflationary potentialities of this situation were modified by the fall in rubber prices and the American recession in 1949 which had a restraining influence on the expansion in export earnings. On the whole, the period was not, therefore, one of severe inflation. The third and final phase commences in 1950. The primary characteristic of this period was the rapid expansion in incomes as a consequence of devaluation and the effects of the Korean war. This, together with the restriction of imports, led to a progressive improvement in the balance of payments. In order to avoid an acute inflationary problem exchange control was gradually liberalised and the availability of imports was once more improved. Conditions, in general, became more typical of a normal boom. The general level of prices of consumer goods continued to rise impressively, and the problem of the cost of living began to dominate public policy. But, in the main, this increase in prices was the result of a rise in the external prices of imported goods rather than the product of local inflation through excess demand.

The remaining sections of this chapter will be devoted to a closer analysis of the characteristics of each of the phases outlined above. In the next chapter we shall consider the problems which the post-war period posed for fiscal policy; and, of course, the actual response of the Government's fiscal policy to the changing situation.

(i) The First Phase (1945–1948)

The end of the war had at least one immediate and rather obvious effect on the Ceylon economy. Military expenditure, which by 1944 had reached a level well in excess of the pre-war value of total exports, began to decline rapidly. By 1947 it was only of minor importance.[403] This factor had its effects on both the aggregate of money incomes in the country and the balance of payments. But, in addition, it had a further consequence which helped to bring into relief one of the basic features of the Ceylon economy. This consequence was the large and rapid increase in unemployment.

We have already seen that unemployment virtually disappeared during the war. The vast increase in employment was related to the expansion in military activities when large numbers were absorbed in the defence services or in constructional work. It was not the product of the high level of aggregate incomes in the community brought on by the wartime export surplus or the *monetary total* of military expenditure. When military activity ceased unemployment re-emerged, although total incomes continued to remain at a high level. In fact, in the later post-war years total national income in money terms was considerably higher than during the war, but there was still a considerable pool of unemployment.[404]

This feature is illustrative of what is sometimes called 'backward area' unemployment. The normal productive capacity of the country, even when extended to the full, is capable of absorbing only a limited portion of the employable population. The

403. The value of annual military expenditure by the allied authorities in Ceylon was as follows:

	Rs. million		
1941	.. 12	1945	.. 417
1942	.. 204	1946	.. 136
1943	.. 261	1947	.. 20
1944	.. 435		

Source: Director of Census and Statistics. *op.cit.*

404. Statistics of unemployment in Ceylon are unfortunately incomplete and are confined to registrations at the Labour Exchanges. Up to 1945 the Labour Exchanges were only existing in Colombo. Thereafter they were opened up in certain other towns as well. The figures of registrations are given below. These figures are in themselves imperfect. On the one hand those who fail to re-apply once their period of registration has lapsed are re-registered as being unemployed. On the other hand, the registrations were found to include persons who were in employment. (vide *Administration Report of the Commissioner of Labour for* 1947.)

Registrations of Unemployed Persons ('000)

1940 ..	27.6	1943 ..	8.3	1946 ..	36.5
1941 ..	20.5	1944 ..	1.1	1947 ..	34.7
1942 ..	19.3	1945 ..	21.4	1948 ..	66.7

Source: *Statistical Abstract for Ceylon,* 1949.

remainder form a surplus which can only be absorbed, in the long term, through a process of development. As we have repeatedly emphasised, the Ceylon economy has ceased to expand significantly over the last two decades or so but population has continued to grow at a rapid rate. The result has been a tendency for the surplus population to increase. In previous periods of boom, before the depression of the thirties, the problem of unemployment was hardly considered important enough to receive specific attention from the Government. But, excluding the period of the war, the problem has been a chronic one ever since the nineteen thirties. Relief works are the 'ad hoc' remedy for the situation and, though they were first initiated during the depression, they remained right up to 1941. In that year they were discontinued because of increasing military employment. As we have suggested elsewhere, military expenditure was in a sense comparable to a vast relief scheme which absorbed the excess labour in a field outside of the normal productive capacity of the country. It had, in addition to size, the unique advantage of being largely paid for by others. Once military expenditure ceased, relief works had to be re-introduced in its place. The problem of unemployment became so serious that in 1948 a special committee of the Cabinet was appointed to deal with it. In the later post-war period there was some improvement in the situation on account of greater employment in the intensified development programmes of the Government. Nevertheless, it is a significant fact that relief works had to be kept in progress at the height of what was, from the point of view of aggregate incomes, an unprecedented boom in the economic history of the country.

Exports

As we have already mentioned, the principal feature of this first phase in the post-war period was the tendency for the accumulated purchasing power of the war years to work itself off gradually. The decline in military expenditure was, in itself, an important factor in relieving the inflationary pressure on the economy. A number of other factors were also of significance in this connection. These will be examined in the course of this section. However, it is important to realise that this process took place in spite of a continued *increase* in the total earnings from exports.

The course of total exports in this period are given in the table overleaf:

Value of Exports

(Rs. million)

Year	Tea	Rubber	Coconut products	All exports
1945	278	215	65	595
1946	380	228	63	721
1947	567	182	93	838

Source: *Statistical Abstract of Ceylon* 1949 Table 135.

Note: Coconut products include copra, oil, desiccated nuts and fresh nuts.

The factors determining export prices have already been discussed. The increase in prices generally followed the return to free or partially free markets after the war. Although rubber prices declined in 1947, total export values continued to increase. The growing adverse balance of payments position, which shall be analysed presently, was not therefore due to a decline in export values. We have to turn to other factors to explain this.

Imports

Although total incomes in the export sector were increasing, the first phase of the post-war period was one in which the excess purchasing power, accumulated during the war, was gradually worked off. There were two factors primarily responsible for this – the improvement in the availability of imports and the continued rise in import prices.

The physical restriction of imports during the war resulted in an inflationary internal pressure on prices. With the gradual inprovement in supplies from abroad there was a return to the more normal type of situation in which excess demand leads to increased imports and a pressure on the balance of payments, rather than to an inflationary rise in prices. In this first phase of the post-war period imports had to satisfy not only the demand out of current incomes but also the 'backlog' of wants which were left unsatisfied during the war. In addition, as we shall see in the following chapter, the Government itself was beginning to spend the proceeds of the loans it had been raising during the latter years of the war. The improvement in the supply position of imports after the war made it possible for this increased demand to be met out of increased supplies. This is illustrated in the table overleaf which shows the increase in the indices of quantities imported.

	Import volume index	Indices of volume (1938 = 100) imports of:		
Year	*Av.* 1934–38 = 100	*Food*	*Clothing*	*Household goods*
1942	.. 65	81	42	22
1945	.. 78	99	62	29
1946	.. 87	109	54	95
1947	.. 108	128	77	172

Source: *Economic and Social Development of Ceylon op. cit.* Tables II and VIII

Note: The indices for imports of food, clothing and household goods have been based on the figures for these imports given at constant 1938 prices. The figures should only be taken as a rough approximation.

In addition to the improved availability of imports, the rise in the external prices of these imports was the other important disinflationary factor in this period. Problems of inflation and rehabilitation in the outside world led to a continued rise in the prices of Ceylon's imports to levels well in excess of even those prevailing during the war. This was particularly true in the case of food prices which had naturally enough a predominant influence on Ceylon's total import bill. The index of import prices for Ceylon, based on the average for the years 1934 to 1938, rose from 220 in 1942 to 340 in 1945. In 1942 the index stood at 358 and in 1947 it rose still higher to a figure of 413 points. We have already seen that in the period of the war the rise in import prices was insufficient to absorb the increased earnings through military expenditure and exports. In the initial post-war phase, on the other hand, the rise in import prices proved to be an important contributory factor in the reduction of the wartime inflationary gap.

Notwithstanding the continued rise in import prices, the adverse trend in the terms of trade during the war years was slightly reversed in the initial post-war period. The terms of trade, of course, still remained well below their immediate pre-war position, but from 1945 to 1947 export prices were tending to rise at a somewhat faster rate than import prices. Thus the index of the terms of trade, which stood at a minimum of 54 points in 1944, rose to 60 in 1945, and to 63 and 73 points in 1946 and 1947 respectively.

Normally in periods of boom Ceylon tends to have a favourable balance of payments accompanied by, and indeed associated with, a favourable shift in the terms of trade. In periods of depression both the balance of payments and the terms of trade tend to become unfavourable. But in both the war and post-war periods we have a somewhat different behaviour. Thus during the war, for very special reasons, a deterioration in the terms of trade was accompanied by a fast improving balance of payments position. In the first post-war phase, on the other hand, a favourable shift in the terms of trade emerged alongside of a rapidly deteriorating balance of payments.

This deterioration in the balance of payments on current account was the culminating result of all the factors mentioned above, viz., the decline in military expenditure, the spending by the public and the Government of their accumulated cash balances, and the progressive rise in import prices. In 1945 Ceylon was still enjoying a sizeable surplus on current account. By 1946 this surplus was reduced substantially. The climax was reached in 1947 when the surplus vanished altogether and gave place to a large deficit. Estimates of Ceylon's balance of payments on current account are set out in the table below. These estimates, like those for earlier years, must be taken as tentative as invisible items can only be roughly assessed.

Balance of Payments on Current Account (1945–1947)
(Rs. million)

Year	1945	1946	1947
(i) Merchandise Trade			
Exports	666	765	889
Imports	608	684	972
Balance	+58	+ 81	– 83
(ii) Invisible Items			
Receipts	471	193	78
Payments	215	149	137
Balance	+256	+ 44	– 59
(iii) Overall Balance	+314	+125	–142

Source: The estimates for 1945 have been taken from B.B. Das Gupta, *A Short Economic Survey of Ceylon* Table 39. No estimates for 1945 have been published officially but the figures quoted here have been obtained from the Director of Census and Statistics. The estimates for 1946 and 1947 are from the *Statistical Abstract for Ceylon* 1949 Table 204.

Note: The surplus in the balance for invisible items in 1945 and 1946 is due entirely to the inclusion of military expenditure on the receipts side. The figures for exports include re-exports.

The logical counterpart to the weakening balance of payments' position was both a reduction in the money supply and a decline in the country's external assets. As the community drew down its cash balances for the purpose of securing imports from abroad, the external assets of the banks and the Currency Board were correspondingly reduced — likewise, a rising bill for Government imports of food and increased expenditure out of loan funds resulted in a reduction in the external assets held by the Government.[405]

The decline in the money supply and the external assets of the Island held by the Government and its agencies, the Currency Board, and the Commercial Banks, are shown below. The change in external assets need not of course be identical with the balance of payments' results shown in the preceding table because the latter applies only to current account receipts and payments, and also because the external assets data are confined to commercial bank and official holdings only.

(Rs. million)

Year	*External assets*	*Increase or decrease over preceding year*	*Money supply*	*Increase or decrease over preceding year*
1945	1,260	+ 300	729	+ 113
1946	1,210	— 50	667	— 62
1947	947	— 263	563	— 104

Source: Central Bank of Ceylon, *Annual Report for* 1950, Tables IA and 9.

Note: The money supply is made up of currency in active circulation plus demand deposits exclusive of inter-bank deposits.

The wide contrary movement in 1946 between the balance of payments on current account and changes in external assets may be due to (a) errors in the balance of payments current account estimates, (b) offsetting capital movements, or (c) offsetting changes in privately held external assets.

It is important to note that a running down in external assets was the natural result of the country's attempts to divest itself of a part of the excess purchasing power accumulated during the war. Unless this excess purchasing power was effectively and permanently 'neutralised' through savings or budget surpluses, the economy could only proceed towards monetary equilibrium via disequilibrium in the balance of payments. The expanded external

405. Apart from a working reserve held locally in the form of deposits with the commercial banks, the Ceylon Government was accustomed to investing its surplus balances in London. During the latter years of the war the external assets of the Government increased rapidly in spite of its external food purchases because of the investment in London of a part of both its current budget surplus and its unspent proceeds from loans.

assets of the country were, in part at least, the counterpart of the swollen money supply. The subsequent adverse balance of payments was thus the manifestation of a corrective force tending towards a reduction in this money supply.

For this reason the decline in external assets was not, in any sense, a danger or threat to the stability of Ceylon's exchange rate. Since the hundred per cent sterling exchange standard was still in operation in Ceylon the whole of the currency in circulation was covered by external reserves. In a similar way a substantial proportion of bank money was backed up by reserves of cash or foreign exchange. Under these conditions the adverse balance of payments could appear only as long as the community was in possession of cash balances upon which it could draw. Once these cash balances were exhausted, the run on the country's external reserves would automatically correct itself. In other words, the stability of the exchange rate was assured because the demand for foreign currencies invariably kept pace with the supply.

There may, of course, be other reasons, unconnected with the stability of the exchange rate, which might induce a Government to take corrective measures to check the drain on external reserves. For example, there may be a desire to utilise as large a part as possible of the external balances to finance imports of capital. Until such time as the country is ready to put into effect its plans for capital development, it may be necessary to conserve the external assets instead of permitting them to be used up in the satisfaction of consumer wants. But it must be emphasised that, if the demand for imports is artificially restricted for this or any other reason, the excess purchasing power in the economy will now be deprived of one of its most important outlets. Unless it could be effectively neutralised or absorbed in other kinds of 'leakages' like savings or budget surpluses, it will continue to exert an inflationary pressure on prices and so postpone the attainment of financial equilibrium.

As it happened, the Government of Ceylon did take corrective measures to arrest the adverse trend in the balance of payments. The reason behind this decision was not, of course, the protection of the exchange rate; nor was it, at this stage at least, the conscious desire to conserve external assets for purposes of capital development. The Government's motives are best explained in the following words of the Controller of Exchange: "It was inevitable that at the end of hostilities Ceylon should use her accumulated balances to finance essential imports which her people had gone without during the war. This alone would have produced an adverse balance in Ceylon's international accounts. However, the use of these balances in this manner aggravated the difficulties of the United Kingdom, as the principal debtor, in her endeavour to restore her shattered economy and to regain a degree of equilibrium in her own international accounts. The depletion of sterling balances upon which Ceylon, along with other holders, began to draw in order to finance their current purchases from abroad thus multiplied the balance of payments' difficulties facing the United Kingdom. In the circumstances it was in Ceylon's own interest to regulate the rate of withdrawal of her sterling balances as by doing so it enabled the United Kingdom to adjust her external finances better to meet the individual demands made on her...... By the third quarter of 1947, the drain on Ceylon's overseas balances was so severe that the Government had tentatively reached the decision to enforce exchange control on transactions between Ceylon and the outside world at the earliest opportunity. Between December 1945 and September 1947, Ceylon's external assets fell by Rs. 255 million or approximately 20 per cent below the level they had attained at the close of the war. Withdrawals at this rate were causing serious financial difficulties to the United Kingdom, specially after the 'convertibility crisis' of August 1947, and the United Kingdom Government while suggesting that Ceylon should take steps to balance her payments on current account, expressed the desirability of concluding a specific agreement with the Ceylon Government covering both the rate of drawing on Ceylon's sterling and amount which could be made available in dollars."[406]

The decision to correct the adverse balance of payments was thus bound up with Ceylon's membership of the sterling area and with the inability of its chief member, the United Kingdom, to support, at that stage, a continued drawing down of the large sterling balances owned by foreign countries. The principal means through which the Government sought to implement its decision was the extension of exchange control to cover all transactions between Ceylon and the outside world, including the

406. *Administration Report of the Controller of Exchange for* 1948 pp. EF 8 and 9.

sterling area.[407] Before the imposition of this extended control. however, Ceylon entered into an agreement with the United Kingdom in order to regulate, by mutual understanding, the rate at which Ceylon was to draw upon her sterling balances. In addition, the agreement sought to make Ceylon's claims for dollars from the common pool as determinate as possible.

The Sterling Balances Agreement was published in May 1948. Its principal features were the determination in quantitative terms of the total sterling assets of the Ceylon Government, the Currency Board and the banks and the allocation of this amount, with some exceptions, to a 'blocked' account known as the "No. 2 account".[408] Ceylon's *current* earnings of sterling were credited to a "No. 1 account" to which was also added a certain sum from her sterling assets. Thus at the time of the agreement, Ceylon's total sterling assets were estimated at £45.1 million. With the exception of a sum of £3½ million which was to be transferred to the No. 1 account, the whole of these assets were credited to a 'blocked' account. The Ceylon Government pledged itself to regulate its balance of payments so that it would not have to draw on its balances in the No. 2 account to an extent in excess of £3½ million. In other words the Government was to attempt to restrict a possible deficit in the balance of payments to a sum of £3½ million. An element of flexibility was, however, introduced into the agreement through the provision that a further sum of £4 million could be released from the No. 2 account "as a working balance which may be drawn upon from time to time to meet any temporary shortage in Ceylon's available means of payments abroad". In addition there was provision for the release, after consultation between the governments, of another £1 million to meet any deficit in Ceylon's balance of payments caused by an unforeseen rise in the price of essential food stuffs. Capital movements between Ceylon and the rest of the sterling area were also to be estimated at agreed

407. It must be remembered that exchange control over transactions with countries outside of the sterling area had been in existence since it was first introduced at the commencement of the war in 1939. But even in this field the control was not strictly applied and substantial dollar imports began to flow into Ceylon during the first phase of the post-war period.

408. This was of course only an accounting device. The assets themselves were held in a variety of forms by the Government, the Currency Board and the banks. They were 'blocked' in the sense that the Ceylon Government was committed by agreement to refrain from using them.

intervals. If the net capital movement is away from Ceylon, an amount equal to the sum involved was to be transferred from the No. 2 account to the No. 1 account. On the other hand, if the net movement of capital was to Ceylon, the equivalent amount would be transferred from the No. 1 account to the No. 2 account. The aim of this provision was, of course, to ensure that outward capital payments would not have to be paid for out of current earnings, and that inward movements would not be used to finance current expenditures. Finally, it must be mentioned that the agreement commited Ceylon to monetary co-operation with the United Kingdom in strengthening the exchange resources of the sterling area. In pursuance of this commitment, Ceylon undertook to keep her dollar expenditure within a rough limit of Rs. 100 million during 1948. The Agreement visualised further meetings between representatives of the two governments in order to make arrangements for subsequent years. In fact such agreement became an annual feature until 1950 when a more general agreement on the sterling balances was reached relating to a period of seven years. The central points of the annual negotiations from 1948 onwards were a settlement of the amounts which Ceylon was to draw upon each year from the No. 2 account, and an understanding on the question of Ceylon's dollar expenditure.

The first phase of the post-war period may conveniently be considered to end with the introduction of exchange control and the signing of the agreements on the release of the sterling balances. In a sense these measures interrupted the return to the normal or customary workings of the Ceylon economy. The process by which the wartime accumulations of cash balances were being worked off was not allowed to complete itself. The new situation was somewhat analogous to the condition during the war when imports were physically restricted and excess demand in Ceylon gave rise to an inflationary pressure on prices. But there was, admittedly, a difference in degree. In the period of the war the 'inflationary gap' was being expanded in a cumulative fashion on account of successive surpluses in the balance of payments on current account. In the new situation an attempt was made to secure a balance in Ceylon's external transactions on current account. To the extent that this was achieved, the amount of inflationary pressure in the economy was, if we exclude credit creation, largely confined to the residue of the surplus cash holdings built up in wartime. In theory it can be visualised that this inflationary gap is neutralised by a once and for all budgetary surplus. But this is a question that must be left over for the following chapter.

(ii) The Second Phase (1948–1950)

The second phase of the post-war period begins, as we have said, with the introduction of exchange control before the middle of 1948. It may be regarded as terminating with the devaluation of the Ceylon rupee relative to the dollar in September 1949.

The outstanding feature of this period was the reversal of the unfavourable balance of payments' position of 1947. Indeed the final result of exchange control was a favourable balance of payments on current account in 1948. This was brought about as a result of a fairly drastic reduction in imports. The reduction was most severe in the case of luxuries and imports from dollar sources. As we shall see in the following chapter, exchange control was supported by the imposition of high import duties on luxury articles. A comparison of the balance of payments on current account for 1948 with that of the previous year, 1947, brings out the effectiveness of these measures.

Balance of Payments on Current Account 1947 and 1948
(Rs. million)

	1947	1948
(i) Merchandise trade		
Exports	889	1,056
Imports	972	962
Balance	–83	+94
(ii) Invisible items		
Receipts	78	111
Payments	137	109
Balance	–59	+2
(iii) Overall Balance	–142	+96

Source: *Statistical Abstract of Ceylon for* 1947, Table 203.

The reversal of the balance of payments' position naturally arrested the decline in external assets and the local money supply. External assets which had by 1947 fallen to Rs. 947.3 million now rose to Rs. 989.0 million in 1948;[409] and the money supply increased between the same period from Rs. 562.5 million to Rs. 606.8 million.[410]

409. Central Bank of Ceylon – *Annual Report for* 1951, Table 25.

410. *ibid.* Table I. These features suggest that the current account results of the balance of payments were not reversed or wholly offset by capital movements.

It must be mentioned that exchange control was not administered with the deliberate aim of securing a surplus in the balance of payments. The surplus was in the way of a residual result arising out of the attempt to secure an overall balance. Even if it were possible to adhere to a strict target as regards imports or external payments, an exact regulation of the balance of payments was difficult because exports or other receipts were liable to fluctuate. The favourable balance, though unintended, did tend, however, to exert an inflationary pressure on the economy additional to the already existing pressure carried over from the period of the war.

The effort to overcome the adverse trend in the balance of payments up to 1947 was partly assisted by a moderate increase in the value of total exports. On the other hand, the task was made more difficult by the fact that import prices were continuing to increase. The import price index rose from a figure of 413 points in 1947 to 443 points in 1948.[411] In fact the gradual improvement in the terms of trade since 1944 was reversed in 1948. The index of the terms of trade fell in 1948 to 69 points as compared to 73 points in the preceding year.

1949 was a difficult year for Ceylon because of the adverse fortunes of the rubber industry. The price of rubber was particularly affected by the American recession of that year. Rubber prices (for Raw Smoked Sheet No.1) which were as high as 96 cents per lb. in 1945, had by 1948 averaged 62 cents per lb. In the first quarter of 1949 they had fallen to an average of 53.8 cents per lb. The deterioration continued during the second quarter when the price averaged 50.8 cents per lb. In July, the first month of the third quarter, the price fell to as low a level as 49 cents.[412] The position of the rubber industry gave rise to considerable anxiety in both official and producing circles. Rubber ranks next to coconuts as an industry in which there is an appreciable Ceylonese interest.[413] The fall in prices was not, in any way, compensated

411. *ibid.* Table 26. Base: average 1934–38 = 100.

412. *Quarterly Bulletin of Statistics* March 1950. Table 94.

413. "It used to be said in Great Britain that the spirits of Members of Parliament rose and fell with those of the London Stock Exchange. So the spirits of Members of the House of Representatives rise and fall with the price of rubber." Sir Ivor Jennings. *The Economy of Ceylon* Second Edition. p. 20.

for by a decline in production costs. Indeed were it not for the food subsidies of the Government, production costs might have been even higher. A number of marginal estates were already beginning to fall out of production and total exports were falling in comparison to the preceding year.[414] The position was sufficiently serious as to induce the Government to consider ameliorative measures. A revival of the floor price system of 1949 was, however, ruled out partly because of uncertainty as regards the future prospects of the industry. Instead, the principal measure adopted by the Government was the withdrawal of the applicability of the Minimum Wages Act for the rubber industry. Producers were now given the freedom to lower wages as this was considered to be a preferable alternative to the widespread dismissal of labour.

The rubber industry continued to face this rather precarious position until it was rescued by the devaluation of the rupee relative to the dollar in September 1949. Its experience during the early part of 1949 provides an illustration of one of the basic characteristics of an export economy. In spite of the difficulties facing rubber, 1949 was a year of inflationary pressure. The total value of export earnings was maintaining itself because of the continued scarcity in the markets for tea and coconut products. This factor, together with the effects of exchange control and the inflated cash balances, was helping to sustain a high level of total demand and an upward pressure on prices. This buoyancy in total internal demand, however, had but little influence on output or employment in one of the major sectors of the economy whose fortunes were, in effect, externally determined.[415]

Devaluation

The devaluation of the rupee relative to the dollar was the indirect result of the decision of the Ceylon Government to maintain

414. In 1943, rubber exports totalled 18.3 million lbs. In 1948, they had fallen to 17.2 million lbs. In 1949, exports stood at 16.4 million lbs. In spite of the recovery in exports in the latter months of the year after devaluation. Ibid. Table 50.

415. In other words, this position reflects the fact that a self-generating inflationary spiral of the type arising in a closed economy is hardly possible in Ceylon. Even if domestic inflation, through the physical restriction in the supply of imports, was allowed to take place producers in the export sector would not be able to raise their prices to keep up with the increase in costs. Increasing costs will in effect result in narrowed profit margins and, ultimately, a fall in output and employment.

the existing sterling-rupee rate when sterling was devalued in September 1949. We mentioned in a previous chapter that the currency system of Ceylon was based on an Ordinance of 1884 which made the Indian silver rupee full legal tender in Ceylon. Under this arrangement Ceylon did not have an independent currency of its own, but Ceylon rupee notes were issued at par against the Indian rupee. We have also referred to the gradual development of a situation where the Indian rupee coin ceased, in practice, to circulate in appreciable quantities, so that the effective currency circulation was largely made up of Ceylon rupee notes. An amendment to the Currency Ordinance was introduced in 1941[416] which gave legal recognition to the existing state of affairs. The Ceylon rupee was now made the legal unit of currency in Ceylon and the Indian silver rupee was no longer legal tender. The 1941 Ordinance provided that the exchange rate of the Ceylon rupee be maintained at par with the Indian rupee, but it also provided for an alternative optional linking of the Ceylon rupee to sterling in the event of an alteration of the exchange rate between the latter and the Indian rupee.

This was the position of the Ceylon currency when Britain devalued the pound in September 1949. Under the law as it stood at the time, Ceylon was unable to alter its exchange rate as long as the sterling-Indian rupee rate remained unchanged. Even if the latter did change Ceylon was limited to choosing between one or the other of these external currencies. Almost immediately after the devaluation of sterling, however, Ceylon changed its currency laws and abandoned the automatic sterling-Indian rupee link.[417] The exchange rate of the Ceylon rupee, instead of being fixed in terms of sterling or the Indian rupee, was now linked directly to gold. This enabled the country to alter, at will, its exchange rate in relation to all foreign currencies including, of course, sterling and the Indian rupee. In fact, however, the Government decided to establish a gold value for the Ceylon rupee which did not involve any alteration in the existing rupee-sterling rate.[418]

416. *The Ceylon Currency Ordinance No.* 2 of 1941.

417. *The Currency Amendment Act* No. 40 of September 1949.

418. "The Amending Act fixed the gold content of the Ceylon rupee at 2 grains and 88 hundredths (2.88 grains) of fine gold, which preserved the parity of the Ceylon rupee with sterling at 1s.6d. to the rupee, and with the Indian rupee at par." – *Administration Report of the Controller of Exchange for* 1949 p. U6.

In other words, the effect of the devaluation of the British pound was to induce the Government to acquire for itself the power to refrain from following Britain's example in relation to non-sterling currencies. But in the result it decided against this course so that, in effect, the Ceylon rupee was devalued in terms of the dollar from September 1949.

It would be worthwhile to pause at this stage to consider briefly the implications of a change in exchange rates for the Ceylon economy. With the possible exception of tea, Ceylon's share in the total supply of her principal exports in international markets is small. This means that cost conditions in Ceylon have little effect by themselves on the supply price of these commodities in world markets. The world price is given to her by external circumstances, and the external demand for her products is approximately one of perfect elasticity at this price. In other words, Ceylon can dispose of whatever output she can produce at the prevailing world price. Now it follows from this that a change in Ceylon's exchange rate will, under these conditions, have no effect on the world price (in foreign currencies) of Ceylon's produce. A fall in the exchange rate, for example, will not lead to a fall in the world price and a consequent increase in the world demand for the commodity concerned. Moreover, since Ceylon can always sell her whole output at the existing world price, she has nothing to gain by an increase in the world demand for her commodities brought about by a reduction in world prices.

Since the exchange rate of the Ceylon rupee has little effect on the world price for Ceylon's exports, it follows that the significance of a change in exchange rates for Ceylon's total **earnings** of foreign exchange is limited. In fact, under these conditions its significance would be confined to the effects of a change in exchange rates on total output in the export sector. If the rupee is, for example, devalued in terms of all foreign currencies, the rupee earnings of producers of export crops would rise. The prices of imports in terms of rupees would also increase, but if wages or costs of production do not increase in the same proportion the profit margins of producers would expand and this may stimulate an increase in total output. This increased output, when sold abroad at the given world price, would bring in a higher total of foreign exchange earnings. But if the elasticity of supply in the export sector in terms of rupee prices is small, the increase in total earnings of foreign exchange brought about by such an expansion in quantities exported may not be substantial. If the possibility of variations in output is ruled out, the country's total earnings of foreign exchange would in fact be completely independent of its exchange rate.

What, then, is the significance of a change in exchange rates? The answer to this lies in the distribution of incomes within the community. When the exchange rate is changed the rupee incomes of exporters and the rupee prices of imported goods tend to change in the same direction.[419] On the other hand, incomes in the domestic sector do not change immediately or automatically. Since the cost of living or the 'real' value of incomes in Ceylon is largely determined by the (rupee) prices of imported goods, a change in exchange rates involves a change in the distribution of both money and real incomes in the community. The real incomes of exporters may not be very greatly affected because, as we have said, import prices tend to move in the same direction as the rupee prices of exports. But the real incomes of the groups whose money incomes are relatively fixed can vary with changes in exchange rates. The latter stand to lose by a depreciation of the external value of the rupee which makes imported goods more expensive. On the other hand, they would gain by an appreciation of the rupee because the cost of living would now tend to be cheaper.

It would follow from this that, even though a change in exchange rates will not affect the economy's total earnings of foreign currencies, it may affect the balance of payments through its influence on the economy's spending of this foreign currency. A change in exchange rates involves a change in the distribution of money incomes and a change in the level of prices. These factors may well alter the demand for imports. For example, if the external value of the currency was appreciated, fixed income groups would find imported goods cheaper, and this may tempt them to increase their demand for imports. Conversely a devaluation of the currency would raise prices relative to the incomes of these groups and this may induce a reduction in consumption. How far these tendencies would actually manifest themselves in practice would

419. Assuming of course that the world prices of both exports and imports are externally determined.

depend on a number of factors, such as the extent of the change in exchange rates, the elasticity of demand for imports and so on. But we need not elaborate upon this here. The main point we wish to emphasise is that, even though changes in the exchange rate may not affect total earnings of foreign exchange, the balance of payments may still be affected because of changes in the distribution of incomes.

The brief analysis set out above is, of course, highly simplified and must not be applied in toto to the more complex situation in the Ceylon economy. But it is important to bear in mind the relationship between a change in exchange rates and the distribution of incomes, because the possibility of correcting the cost of living problem through a change in exchange rates has, in recent years, been receiving the attention of the Government.

The relationships discussed above were only partially reflected in the devaluation of the Ceylon rupee that took place in September 1949. The main reason for this is that the devaluation itself was, as already mentioned, only partial. The rupee-sterling rate was left unchanged. Moreover, since the Indian rupee was devalued in line with sterling, the rate between the Ceylon rupee and the Indian rupee was also left unaltered. In fact the only significant change for Ceylon was the devaluation of the rupee in terms of the dollar.

In analysing the effects of this devaluation in the Ceylon economy, it is important to distinguish between the indirect repercussions on Ceylon of the devaluation of sterling and other currencies, and the direct consequences of the decision to devalue the Ceylon rupee in terms of the dollar. The behaviour of world commodity markets, and the course of prices in the countries from which Ceylon obtained her imports, may have been closely affected by the devaluation of sterling and other currencies. But these results were independent of Ceylon's devaluation and would have occurred even if the Ceylon rate was varied in a different fashion. On the other hand, the devaluation of the Ceylon rupee relative to the dollar had itself certain consequences on the economy, and it would be useful to separate these out.

Ceylon obtains most of her imports from sterling sources. With the exception of rubber, the bulk of her exports are also sold to sterling countries. Since the rupee-sterling rate was left unchanged the devaluation of the rupee in terms of the dollar made no impression on the rupee prices of most of Ceylon's imports. The fact that the sterling prices of these imports increased after September 1949 had nothing to do with the devaluation of the Ceylon rupee in terms of the dollar. Similarly, since rubber was the one commodity whose price was substantially determined in dollar markets, it was only the rupee price of rubber that increased immediately upon the devaluation of the Ceylon rupee. The markets for tea and coconut products, on the other hand, were largely in sterling countries. Since the rupee-sterling rate remained the same, the rupee prices of tea and coconut products were not immediately affected by devaluation.

In other words, the effects of the partial devaluation of the rupee was the raising of the rupee incomes of rubber producers. The rupee prices of goods imported from dollar areas also increased with devaluation, but as we have already mentioned the major portion of Ceylon's imports come from the sterling area. In general, it would be fair to say that retail prices, and therefore costs of production in Ceylon, did not increase substantially as a direct result of the partial devaluation of the Ceylon rupee. Rubber producers were therefore decidedly better off and their profit margins began to increase. The price of rubber, which stood at the dangerously low level of 50.4 cents per lb. in August 1949, rose in September to 59.7 cents. In October it reached 66.2 cents and by December it was as high as 72.7 cents.[420] It is no exaggeration to say that the industry was rescued from a really perilous position by the timely intervention of devaluation. Indeed, as we have already suggested, the position of the rubber industry was one of the important factors behind the Government's decision to devalue the rupee in respect of the dollar. There were, of course, other factors. The alteration of the long established sterling-rupee rate would have caused some disturbance or inconvenience[421] as the major part of Ceylon's trade is with the sterling area. On the

420. *Quarterly Bulletin of Statistics* March 1950. Table 94.

421. It is of some interest to note that an appreciation of the rupee relative to sterling would have altered the 100 per cent sterling backing of the Ceylon currency. The rupee value of the sterling assets of the Currency Board would now fall and the existing currency circulation would exceed the rupee value of these assets. In other words a part of the currency circulation would immediately take on a fiduciary character.

other hand, an appreciation of the rupee relative to sterling would have lowered the rupee prices of most imported goods and therefore the cost of living. This would have benefitted salaried and other groups whose money incomes had not kept pace with the sustained increase in the cost of living since the war. It is difficult to say what effects an appreciation of the rupee in terms of sterling would have had on the prices of Ceylon's other exports. Given the fact that the Indian rupee-sterling rate was left unchanged, it is likely that the price of tea would have fallen in terms of Ceylon rupees. India is, after all, the major supplier of tea, and the sterling price of tea would, to an appreciable extent at least, be influenced by Indian cost conditions. Similarly it is likely that the rupee prices of coconut products would also have fallen since Ceylon is by no means the major supplier of these products in the world's markets. Moreover, the rupee prices of produce sold under contracts would have fallen automatically since the contracts were in terms of sterling and did not include any devaluation clauses. An appreciation of the rupee in terms of sterling would have brought in a compensating fall in the rupee cost of imports and therefore in production costs. But in so far as this fall in production costs was insufficient or delayed, producers of tea and coconut products may have been worse off as a result of appreciation. If the appreciation of the rupee relative to sterling left the previous rupee-dollar rate unchanged, the rupee price of rubber would have remained unaltered.[422] The rubber industry would nevertheless have obtained some relief from the possibility that production costs would have fallen owing to cheaper imports. But again, this process might have been partial and protracted, and for this reason it is likely that a devaluation of the rupee relative to the dollar was a more certain way of assisting the rubber industry than an appreciation of the rupee relative to sterling, which left the rupee-dollar rate intact.

(iii) The Final Phase (1949–1951)

The outstanding feature of the last phase of the post-war period covered in this chapter was the vigorous intensification of the inflationary pressure on the Ceylon economy. This feature, together with the rise in the external prices of imports, had marked

422. Unless, of course, the dollar price of rubber itself changed. But this would have been independent of Ceylon's decision as regards her exchange rate.

effects on the level of retail prices. The problem of the cost of living acquired serious dimensions and became a preoccupation of Government policy. The pages that follow would be devoted to a brief analysis of this new situation. In addition there were two other important developments during this period. These were, first, the initiation of the Government's six-year plan of development which was eventually incorporated into the Colombo Plan; and, second, the establishment of a Central Bank and the simultaneous break with the hundred per cent sterling exchange standard. We shall postpone a discussion of the development plan until the next chapter. The establishment of a Central Bank shall, however, be dealt with, in the latter part of this section.

The intensified inflation and the Korean boom

The principal operative factors behind the increase in inflationary pressure were, on the one hand, the rapid expansion in incomes and, on the other, the continued restriction of imports through exchange control.

As usual, the main factor responsible for the increase in incomes was the rapid expansion in the value of exports. The expansion was promoted by three important forces. These were, in the words of the Central Bank Report, "first, devaluation which tended to increase the rupee price of exports, particularly rubber; second, the increase in the level of activity in the hard currency world in spite of the adverse effects upon it which had been expected to result from devaluation; and third, the entirely new and added stimulus provided by the Korean war and the subsequent rearmament programme of the Western democracies."[423]

The price of rubber soared upwards to levels well in excess of even the prosperous wartime levels. In July 1949, prior to devaluation, the rubber price had reached a trough of 49 cents per lb. By January 1950 it had recovered to 75 cents per lb. Thereafter it rose progressively through every month reaching a peak of Rs. 3.17 cents per lb. in February 1951![424] The industry whose productive capacity was partly condemned as being 'uneconomic' in 1946 was now enjoying a singularly prosperous boom. Marginal

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423. Central Bank of Ceylon: *First Annual Report* 1950 p. 12.

424. The monthly price of rubber (R.S.S. No. 1) was as follows, (Rs. per lb) in 1950;

estates which were closing down in 1949 were restored to active production and quantities exported began, once more, to increase. But the market for rubber is volatile. After February 1951 the upward sweep was reversed. By December of that year the price had fallen to Rs. 1.72 per lb. In the early months of 1952, a period which falls outside the scope of this chapter, the price was back at the pre-Korean war level.

Tea prices, on the other hand, exhibited once more their relative stability. The average annual price of tea (average for all grades) increased slightly in the free market from Rs. 1.96 per lb. in 1949 to Rs. 2.11 in 1951. Coconut prices fared better, but did not in any way compare with rubber prices. The price of copra, outside the contracts, rose from an average level of Rs. 150 per candy in 1949 to Rs. 209 per candy in 1951. The prices of almost all Ceylon's export products rose with the world boom in primary products after the Korean war. But it was, as mentioned, the performance of rubber that was really spectacular.

The increase in prices stimulated an increase in output in the export sector, but as usual it was the former that was of primary importance in the determination of total export earnings. Moreover, the increase in output was not due to any long term expansion in capacity. In the words of the Central Bank, "Although production showed a significant increase in 1950, much of the increase was due to over-cropping of exports, notably rubber."[425] In addition there was the return to production of marginal rubber estates which had closed down in 1949. The increase in the total value of exports, as a result of the increased prices and higher outputs, was substantial. In 1948 total exports stood at Rs. 1,011 million. In 1949 they had increased moderately to Rs. 1,063 million, but in 1950 they leapt up to a figure of Rs. 1,563 million representing an

1950			
January	.75	July	1.40
February	.80	August	1.86
March	.82	September	2.10
April	.98	October	2.39
May	1.19	November	2.80
June	1.29	December	2.23

Source: *Second Annual Report of the Central Bank of Ceylon* (1951) Table 32 p. 71.

425. *Annual Report for* 1950 *op. cit.* p. 13.

increase of Rs. 500 million in a single year.[426] As we shall shortly see, this increase in export earnings was responsible for a substantial improvement in the balance of payments position.

A second factor of smaller importance in the expansion of incomes in 1950 was bank credit. The Central Bank has estimated that net credit creation by the banking system throughout 1951 amounted to Rs. 135.1 million. Over half of this amount (Rs. 74.6 million), however, represents credit extended by the banks to the Government through investment in Government securities and treasury bills. Whether this amount actually resulted in an expansion in the incomes of the community would depend on the net results of the Government budget. The effects of credit creation on behalf of the Government shall therefore be dealt with in the following chapter. As for credit creation on behalf of the private sector, it must be mentioned that the major portion of this was of a short term nature, related to the financing of the increased value of external trade. The bulk of the amounts involved represents investment by the Commercial Banks in export and import bills and overdrafts. Although recurrent short term lending of this sort implies that at any given moment a fair volume of created money is extant, the feature is a helpful and perhaps inevitable corollary to trading prosperity. That the commercial banks remained conservative in respect of credit creation for purposes of long term lending to the private sector is reflected in the fact that loans and advances to industry increased by only Rs. 5.3 million between December 1949 and December 1950.[427]

A third possible factor contributing to the increase in incomes is the net deficit in the Government budget. But in keeping with our usual treatment, we shall defer a consideration of this until the next chapter.

426. Central Bank of Ceylon – *Annual Report for* 1951 p. 65.

427. As regards the expansion of credit to the private sector of the economy, the Central Bank has been very much concerned to know whether it has been for non-essential or speculative purposes. Its investigations have disclosed that the bulk of this credit has been essential in order to finance the growing volume of Ceylon's trade in recent months, particularly its exports. For example, the value of export and import bills purchased rose from Rs. 30.2 million in December 1949 to Rs. 52.8 million at the end of December 1950, the value of overdrafts increased from Rs. 75.1 million to Rs. 98.1 million, and the value of other bills and various cash items in process of collection rose from Rs. 0.9 million to Rs. 10.5 million, all of which increases can mainly be accounted for by the higher value of trade. Loans, on the other hand, have even increased from Rs. 26.2 million to Rs. 31.5 million." *Annual Report for* 1950 p. 4.

The inflationary pressure in this period was the combined result of the expansion in incomes and the restriction of imports through exchange control. As we have said before, exchange control was introduced into Ceylon in 1948 for the purpose of correcting the unfavourable trend in the balance of payments which began to manifest itself during the first phase of the post-war period. Once export earnings begin to increase rapidly it becomes possible to relax some of the controls over imports, and yet secure a balance in the country's trading accounts at a higher level of total trade. There is, however, in practice, an inevitable lag in the adjustment of administrative controls to the expansion in exports. In addition, there is a further lag between the time when more generous import licences are distributed and the arrival of actual supplies of imported commodities on the consumer market. In Ceylon the administration of controls over imports did come to be progressively relaxed[428] as the increase in export earnings got under way. But the process was protracted, and, in the intervening period, there was a strong pressure of demand on the limited supplies of imported goods. As we shall see presently, the year 1950 produced a considerable surplus in the country's balance of payments on current account. The existence of exchange control may not have been responsible for the whole of this surplus. An increase in the country's external assets is often a familiar feature of prosperous times.[429] But given the fact that a certain amount of inflationary pressure was carried over from previous periods, we can be almost certain that the existence of exchange control enlarged the scale of the actual balance of payments surplus in 1950.

The 1950 boom in primary product prices was accompanied by a marked improvement in the terms of trade for Ceylon. The index of import prices (av. 1934–38 = 100) rose from 423 in 1949 to 434 in 1950, but the export price index rose much faster over the same period from 324 to 439. The index of the terms of trade which stood at 77 points in 1949 increased to 101 points in 1950. This

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428. This did not apply in general to the control over imports from the dollar area. In accordance with the agreement with Britain, Ceylon aimed at restricting her dollar expenditure to an absolute target level rather than at securing a balance in her trade with the dollar area. The expanding surplus of dollar earnings was surrendered to the dollar pool.

429. The surpluses in normal periods of boom, when imports are not restricted by controls, are largely the result of voluntary savings and would not for this reason exert an inflationary pressure on prices.

was the first time since the commencement of the war in 1939 that the terms of trade recovered to pre-war levels. During the last three months of 1950 the terms of trade stood at as high an average as 116 points.[430] The effect of the improvement in the terms of trade was an increase in the volume of imports into Ceylon in spite of the existence of exchange control and the favourable balance of payments. The import volume index rose from 119 points in 1949 to 133 points in 1950.

The reversal of Ceylon's balance of payments position on account of exchange control, the devaluation of the rupee relative to the dollar, and the Korean boom, is shown below.

Balance of Payments on Current Account
(Rs. million)

		1949	1950	1951
(i)	Merchandise trade			
	Exports ..	1,064	1,485	1,859
	Imports ..	1,027	1,156	1,516
	Balance ..	+37	+329	+343
(ii)	Invisible items			
	Receipts ..	155	158	163
	Payments ..	220	341	390
	Balance ..	—65	–183	–227
(iii)	Overall Balance ..	+28	+146	+116

Source: Central Bank of Ceylon *Annual Reports for* 1950 *and* 1951 Statement 10 and Table 24A respectively. *Administration Report of the Controller of Exchange for* 1949 p. U27.

Since the imposition of exchange control covering all Ceylon's external transactions, it has been possible to acquire a more accurate picture of capital movements. The Central Bank has estimated that during the years 1950 and 1951 there was a net outward movement of private capital amounting to Rs. 19 million and Rs. 38 million respectively. This tendency partially offset the favourable balances on current account transactions. The net outflow of private capital in this period is of some interest. The inflow of foreign capital in periods of boom has generally been regarded as a characteristic feature of export economies. In periods of boom the profitability of plantation crops increase, and this factor acts as one of the stimulants to foreign investment. This foreign investment in turn aggravates the boom by intensifying the increase in domestic incomes. Ceylon's

430. Central Bank of Ceylon – *Annual Report* 1950 *op.cit.* pp. 60 and 61.

experience during the boom in 1950 and 1951, however, points to a reversal of the customary behaviour. The principal explanation of this is that, whilst there was no significant increase in foreign investment in Ceylon, a certain amount of existing foreign assets, mainly tea and rubber plantations, were purchased by Ceylonese nationals. During the boom the incomes of Ceylonese had increased. Their expectations concerning the profitability of investment in tea, rubber and other existing enterprises might have also risen. The purchase of these assets was thus a feasible outlet for their savings. The process may have been helped by the existence of exchange control which, by restricting imports, probably encouraged an increase in savings. It is interesting to note that the decline in commodity prices in early 1952 was accompanied by a marked reduction in the outflow of capital.[431] The period for which knowledge of capital movements is available is too short to permit of any generalisation. But the limited evidence we have suggests the possibility that the customary pattern of capital movements in export economies is being modified in Ceylon. We have argued elsewhere that there has been no foreign investment on a significant scale in Ceylon for a considerable period of about two decades. Given the absence of foreign investment in the future, a net outflow of capital in periods of prosperity would not, for the reasons we have given, be unlikely. It is, in a sense, a reflection of increased Ceylonese participation in business. The tendency has, of course, both advantages and drawbacks. At a time when foreign capital is said to be urgently needed for development purposes the net outflow of capital may be considered disturbing. Total productivity in the economy might have been increased if the Ceylonese capital invested in existing plantations had instead been directed to new fields. The purchase of these plantations in periods of high capital values is another disadvantageous feature.[432] On the other hand, as the Central Bank has argued, "the repatriation of capital should not be regarded as necessarily unfavourable to

431. Statement by the Central Bank of Ceylon, reported in the *Ceylon News Weekly* of 23rd May, 1952.

432. cf. *Report of the Central Bank for* 1951 p. 23: "Repatriation of foreign owned capital on this scale would not have been possible without an active real estate and share market. There is no evidence that foreign investors liquidated their assets at low prices; on the contrary some estates have been bought by Ceylonese at decidedly high prices. For example, the Colombo share market was active throughout the year and share prices rose significantly, specially in rubber, less so in tea.

the national interest. It is encouraging that Ceylonese show a greater willingness and capacity to take over and manage estates and other premises hitherto managed by foreigners. Moreover, the movement was readily financed from the large foreign exchange surplus. Liquidation of foreign ownership of existing enterprise reduces the future outflow of profits and dividends. Finally, a policy of freely permitting an export of capital actually encourages an inflow of capital. Few investors would bring their capital into a country unless they had firm evidence that they could take it out at will.''[433]

The outflow of capital during 1950 and 1951 was insufficient to offset the big surpluses on current account during these years. Ceylon's external assets, which had declined rapidly in 1947 were, by the middle of 1951, very near to their 1945 level. The increase in these assets was naturally accompanied by an expansion in the money supply. This is shown in the table below.

Changes in External Assets and the Money Supply
(Rs. million)

		External Assets	*Money Supply*
1945 (Dec)	..	1,260	729
1946	..	1,210	667
1947	..	947	562
1948	..	989	607
1949 (4th quarter)	..	934	587
1950 (4th quarter)	..	1,077	911
1951 (March)	..	1,240	1,028

Source: Central Bank of Ceylon: *Annual Report for* 1951 Tables 1 and 25.

Note: External assets comprise holdings of the Government, Government Agencies and Institutions, Currency Board, Central Bank, and Commercial Banks.

Money supply consists of currency in active circulation plus demand deposits exclusive of Government and inter-bank deposits.

As we have already seen, the principal motive behind the imposition of exchange control in 1948 was the reduction of the strain placed on the United Kingdom and the Sterling Area by a running down of sterling balances. In 1950 and 1951 Ceylon's

433. *ibid.* p. 23. In its attempt to control non-essential and speculative' credit creation by the banks in 1950 and 1951, the Central Bank instructed bankers not to "extend credit for the purchase of shares or estates except in cases where Ceylon residents were borrowing to buy shares or estates from foreign investors who wished to repatriate their investments". – *ibid.* p. 13.

external assets were actually increased. At a time when the sterling area as a whole was experiencing acute difficulties the country made no claim towards using its existing reserves. "At the London Conference of Finance Ministers in January 1952," remarked the Central Bank, "it was generally recognised that Ceylon had maintained a stable economy through a very trying period and that it had not contributed to the current Sterling Area crisis."[434]

Although 1951 as a whole was a year of increasing export values which resulted in a considerable increase in external assets, it must be mentioned that an important change took place during the course of the year. After about April in that year the increase in export prices was not only arrested but was actually reversed. The index of export prices (av. 1934–38 = 100), which stood at a record peak level of 607 points in April, began to decline progressively and by December had fallen to 473 points. Import prices, on the other hand, were continuing their upward movement. The import price index rose from 505 points in April 1952 to 602 points in December. The favourable trend in the month's balance of payments accounts was gradually modified and ultimately reversed. Both external assets and the money supply began to decline. The former fell from Rs. 1,240 million in March to Rs. 1,185 million in December, and the latter from Rs. 1,028 million to Rs. 1,006 million over the same period. There was strong evidence that the Korean boom had come to an end.[435] The downward movement has continued throughout the initial months of 1952, but this latter period lies outside the scope of our study. The third phase of the post-war period with which we are here concerned may well be taken as ending with the reversal, after the first quarter of 1951, of

434. *Annual Report for* 1951 *op. cit.* p. 12.

435. The average and total figures for 1951 conceal a serious deterioration during the year. The deterioration is shown most plainly in the terms of trade. On a 1934–38 base of 100 the terms of trade were 113 in January 1951, and rose to a peak of 123 in March. Thereafter they worsened rapidly and nearly continuously. The figure of 79 reached in December was almost the same as that for 1949 before the Korean war. In sympathy with this adverse movement, the monthly export surplus also declined and at one stage even became negative. For an export-import economy, this persistent fall in the terms of trade is a very disquieting development. The boom enjoyed by Ceylon as a result of the outbreak of the Korean war has ended ...... The fall in export prices that took place after April did not affect all commodities equally. Comparing the peak prices with the lowest near the end of the year tea fell by 20 per cent, rubber by 31 per cent, and coconut products by 22 per cent. Thus rubber prices declined most." Central Bank of Ceylon: *Annual Report for* 1951 op. cit. p. 4.

the upward sweep of prices since devaluation and the Korean boom. Thereafter it seems as though the economy has run into a different phase which has not, as yet, reached its conclusion.

The establishment of the Central Bank and the break with the hundred per cent sterling exchange standard

A development of some importance to the Ceylon economy during the post-war period was the establishment of a Central Bank which began its operations in August 1950. The decision to establish a Central Bank was one of the major decisions taken by the Ceylon Government constituted under the Soulbury Constitution in 1947.[436] An adviser, who was one of the economists to the Board of Governors of the Federal Reserve System in America, was invited to report on the type of bank most suitable. The outcome of his deliberations was the Monetary Law Act, No. 58 of 1949, which established the Central Bank and outlined its powers and constitution. A detailed analysis of the Central Bank is outside the scope of this study. But one important consequence of great relevance to fiscal policy merits attention. This was the abandoning of the automatic exchange standard, and its replacement by a more flexible apparatus for the administration of monetary policy and management.

The Central Bank of Ceylon superseded the existing Currency Board and took over its assets as well as its functions relating to the issue of currency. In itself, this need not have implied a departure from the hundred per cent sterling exchange standard. But the Monetary Law Act went much further. It laid down that the Central Bank should have amongst its objectives the protection of the external value of the rupee and the maintenance of domestic monetary stability. Within the limits imposed on it by these broad objectives the Central Bank was free to determine at its discretion the volume of currency in circulation. Under the previous system the Currency Board was unable to increase the currency issue unless an equivalent amount of foreign assets were deposited with it. The result of this was that the volume of currency in circulation in

436. The Soulbury Constitution gave Ceylon a cabinet form of government on the British model. There was now a Finance Minister who took over the functions of the former Financial Secretary who was a Government Official. Under the new constitution, Ceylon had self-government in "all matters of internal administration". Full Dominion status did not come until 1948. But this step did not involve any important changes in the form of government.

Ceylon was made directly dependent on the balance of payments. This mechanism made the exchange rate thoroughly secure, but it was believed to have certain drawbacks. For instance, an increasing volume of currency, which may be required to finance an expanding volume of domestic transactions, could not be secured save through an export surplus. This may prove an inhibiting factor in the growth of the domestic sector. Moreover, there was the further criticism that, even from the point of view of the security of the exchange rate, a hundred per cent backing was excessive. Even in the trough of a depression there would be a certain portion of the money supply which, being required to finance a minimum of domestic transactions, would not seek conversion into foreign exchange. The backing for this portion of the local currency is thus superfluous and represents a 'wasteful' immobilising of external assets. The Monetary Law Act empowers the Central Bank to depart from the rigidity of this system and so permits an element of 'monetary management'. The scope for management of this sort is, of course, limited by both the fundamentals of the economic background and the specific objectives of policy laid down by the Act itself. Nevertheless it is true the new system admits of some flexibility when compared to the previous mechanism. Since its inauguration in 1950 the Central Bank has in no way undermined the conservatism with which the currency supply had hitherto been regulated. In fact the foreign reserve of the Central Bank has so far remained above the volume of currency in circulation. But the recent background has been one of boom and inflation. In different circumstances the Bank may well decide to depart from the traditional orthodoxy.

The establishment of the Central Bank with its wide discretionary powers is specially significant to the problem of fiscal policy. Fiscal measures can now be supported by parallel measures in monetary policy. In addition, the existence of a Central Bank tends to widen the scope for fiscal policy itself. In our study of public finance during the depression we saw that, even if the Ceylon Government was willing to carry out a policy of deficit financing, it was precluded from doing so by a number of technical difficulties. The currency laws did not permit a fiduciary expansion of the note issue; whilst the ability of the commercial banks to indulge in credit creation was limited by the absence of a supporting Central Bank.

The Central Bank of Ceylon is, of course, a partially autonomous body akin to a public corporation.[437] But various clauses in its constitution provide for co-operation, and consultation with the Government. For instance the Bank is governed by a Monetary Board of three members all of whom are appointed by the Government. In fact one of the members of the Board is ex-officio, Permanent Secretary to the Ministry of Finance.[438] In addition, certain important measures of the Central Bank, like a change in exchange rates, require the concurrence of the Minister of Finance. In fact there is an overriding clause in the constitution of the Bank which empowers the Minister of Finance to issue directives to the Bank on any matter over which there is disagreement. The Central Bank is, in its turn, directly able to influence the Government by making suggestions on fiscal policy and other matters. Indeed one of the functions of the Bank specified in the Monetary Law Act is that of economic adviser to the Government. All these provisions offer scope for the co-ordination of monetary and fiscal policy.

Prior to the establishment of the Central Bank the Ceylon Currency System was not only a hundred per cent standard but also a sterling exchange standard. All the assets of the Currency Board were held in either sterling or in Indian rupees which were freely convertible into sterling. The Monetary Law Act breaks away from this feature. Under it the Central Bank is required to hold an 'international reserve' of whatever foreign currencies it deems desirable. It was thought that the holding of a 'mixed bag' would help to insulate Ceylon against the drawbacks of maintaining her entire assets in one currency. When the Central Bank was set up all the country's external assets were held in sterling which was not only inconvertible but also blocked. In addition these assets suffered depreciation in terms of gold and the dollar after the devaluation of sterling in 1949. The Monetary Law Act sought to overcome some of these drawbacks by providing that Ceylon should build up a mixed international reserve of her own out of her net earnings of foreign currencies.

437. As we have seen the Bank has been established by Statute of Parliament. Its entire capital has been provided by the Government.

438. The other two consist of a full-time Governor appointed by the Prime Minister and a part-time member appointed by the Minister of Finance. The latter has no administrative duties and is chosen for his knowledge and experience of the financial world.

This feature of the new Monetary Law raised some important issues connected with Ceylon's membership of the Sterling Area. A detailed discussion of this problem is outside the scope of this chapter, but a brief outline is perhaps of some interest. As we have seen Ceylon's economic policy in recent years has been closely related to her membership of the Sterling Area. The imposition of exchange control in 1947 and its continuation throughout the subsequent years is a good illustration of this relationship and of its importance to Ceylon.

It is a feature of Ceylon's normal pattern of trade that she has a surplus with the dollar area and a deficit with the sterling area. The dollar surplus was utilised to finance the sterling deficit. If an excess of dollars was still left over after this offsetting process – or in other words, if the overall balance of payments was favourable – these dollars were converted into sterling.[439] In this way the country accumulated a reserve composed of sterling assets. This is, of course, a highly simplified version of a multilateral process but it depicts the fundamental relationship. In normal pre-war times the external assets referred only to the assets of the Currency Board. Private individuals and institutions were permitted to hold balances in foreign non-sterling countries, but these assets did not, of course, form a part of the official external reserve. In any case the commercial banks were in the habit of holding most of their external assets with their head offices in London. The Currency Board was required to hold its assets in sterling or (Indian rupees) by the Currency Law. It could issue rupees only against the offer of Indian or sterling exchange, and it could not, of course, convert the exchange it acquired into other foreign currencies.

In earlier periods the holding of the entire official reserve in sterling did not involve any serious drawbacks. It was, indeed, of some advantage to a country like Ceylon. As long as sterling was on the gold standard and freely convertible into gold, a country had nothing to lose by holding its assets in sterling. On the contrary, there was even a distinct advantage, for investment in sterling assets was remunerative whereas the stocking of gold was costly. In these conditions a country on a sterling exchange standard was able to enjoy whatever advantages there were in

439. For our present purpose we include the Indian rupee with sterling.

keeping its own rate stable in terms of sterling whilst at the same time it was, if necessary, always able to use its sterling assets to finance any payments in non-sterling currencies. Britain's departure from the gold standard in the early nineteen thirties did not negative the merits of the sterling exchange standard because sterling still remained convertible into gold although its value in terms of the metal had depreciated.

It was the war which brought in new developments which seriously altered the balance of advantages of the sterling exchange standard. In 1939, as we have previously remarked, exchange control was imposed by Ceylon and most other Commonwealth sterling countries on all transactions outside the sterling area. The purpose of this measure was to conserve scarce resources for the benefit of the common war effort. Countries were to restrict their non-sterling or, more accurately, their 'hard currency' expenditures to a minimum; and all earnings of foreign currencies were to be surrendered, and, in the last analysis, sold to the Bank of England in return for sterling. In this way hard currency resources were pooled together with the Bank of England, and the common Sterling Area Dollar Pool emerged.

We have, in a previous chapter, commented on some of the consequences for Ceylon of this arrangement during the war. As we then pointed out, a substantial portion of Ceylon's sterling balances was in reality dollar balances surrendered to the common Pool in return for sterling. The wartime arrangements for the conservation of dollars and other hard currencies were continued into the post-war period on account of the difficulties confronting the United Kingdom and the sterling area as a whole. All sterling area countries economised on their dollar expenditure and earnings were contributed to the Pool. The dollar deficits of some members were, in this way, financed out of the surpluses of others. Apart from a brief interlude in 1947 sterling has remained inconvertible. The effect of the pooling arrangement is that members with dollar surpluses sell these for inconvertible sterling whereas members in deficit with the dollar area purchase dollars with sterling.

For a country like Ceylon this type of arrangement has certain drawbacks. If there were no controls on trade and the country were free to make its purchases in the cheapest market, it would not be affected by the inconvertibility of sterling as long as its foreign accounts were in overall balance and its dollar surpluses were just adequate to offset its sterling deficits.[440] But where these conditions are not satisfied, the position can be disadvantageous to Ceylon.

Let us, for example, take the case where Ceylon's foreign accounts in any year result in an overall surplus. Since the country has a customary deficit with the sterling area it would be likely that this overall surplus is the result of a positive dollar balance in excess of the sterling deficit. Under the pooling arrangements these surplus dollars are surrendered to the pool in return for sterling. Ceylon's total foreign reserve increases on account of the overall balance of payments surplus, but this increase takes the form of an expansion of assets in an inconvertible currency.

There would be some symmetry in the system if there were times in which Ceylon experienced a dollar deficit. She would then meet this deficit by purchasing dollars from the pool in exchange for sterling. In other words, Ceylon would then enjoy a 'quid pro quo'. Her net dollar contributions to the pool in years of surplus would be compensated for by net drawings on the pool in years of deficit. But in practice this advantage, or privilege, has little meaning for Ceylon. Her pattern of trade has been such that over the last twenty-five years she has hardly ever experienced a dollar deficit.[441] Moreover, if future circumstances should be such that the country is actually faced with such a deficit, it is highly likely that the dollar earnings of most of the other members of the sterling area would also be adversely affected and the strain on the common pool particularly severe.

440. Assuming for the sake of simplicity that all its trade was with the dollar and sterling areas.

441. Ceylon's balance of trade with the U.S.A and Canada since 1925 is shown. With the exception of 1947 Ceylon has enjoyed a consistently positive balance.

Balance of Trade with U.S.A. and Canada
(Rs. million)

1925	+149.1	1931	+20.8	1937	+ 59.6	1943	+ 70.7
1926	+134.5	1932	+15.8	1938	+ 37.5	1944	+192.5
1927	+ 98.2	1933	+20.6	1939	+ 67.1	1945	+137.7
1928	+ 64.0	1934	+34.8	1940	+100.9	1946	+ 41.3
1929	+ 69.6	1935	+28.8	1941	+134.9	1947	— 11.6
1930	+ 42.5	1936	+45.1	1942	+124.6	1948	+121.5
						1949	+ 68.7

Source: Minister of Finance; *A Full Employment Policy – Budget Speech* 1949–50 Department of Information, Colombo, Appendix C.

There is a further point. The conversion of surplus dollar earnings into inconvertible sterling assets is, as we have indicated, in itself an unsatisfactory feature. It would remain so even if Ceylon's trade was perfectly free and imports were obtained from the cheapest sources. In fact, however, her trade is not free. Imports from the dollar area are rigorously restricted by exchange control and the country's dollar surplus is artificially enlarged. This means that Ceylon is sacrificing the advantages of making her purchases in the cheapest markets and of establishing the most favourable pattern of trade for reasons which are not necessarily connected with her own balance of payments position. If Ceylon's trade with the dollar area was free, we can be almost certain that her dollar surplus would be reduced. The maintenance of discriminating restrictions on dollar imports has not been justified by Ceylon's balance of payments position in relation to the dollar area. In fact the practice has met with some criticism from the International Monetary Fund.

The foregoing paragraphs have outlined the inconveniences of the pooling arrangement for Ceylon. But against this must be set the fact that there is at least one very good reason which would justify Ceylon's participation in the arrangement. This is the fact that Ceylon has an overriding interest in the stability and strength of sterling. As we have emphasised, almost all her external assets are sterling assets. As such she has a strong interest in the strengthening of this currency. Ceylon has much to gain by the restoration of convertibility and the removal of restrictions on the free use of her assets. Her dollar contributions to the common pool are of assistance towards this ultimate goal, and this is an argument as to why they should be continued. It must at the same time be admitted that the strengthening of sterling can best be achieved by a common effort on the part of all sterling area countries. In the absence of such an effort it is possible that the sacrifices of some members are offset or negatived by the policies of others. From this point of view the regular conferences of Commonwealth Finance Ministers represent an important step forward. There have even been suggestions, in recent times, for the setting up of some permanent machinery, representing all members, for dealing with common problems.

As we have already seen, the recent Monetary Law Act provides that the Central Bank should hold an international reserve of foreign currencies in place of an exclusively sterling reserve. This provision was somewhat in conflict with the current sterling area principle that members do not hold independent gold or dollar reserves of their own, but instead contribute their net earnings of dollars to a common pool.[442] With the intended establishment of the Central Bank the Ceylon Government entered into negotiations with the United Kingdom Government in an attempt to reconcile this conflict. A tentative agreement, which was embodied as a clause of the more general sterling assets agreement, was reached in August 1949. Under this agreement, the United Kingdom Government recognised Ceylon's right to retain an independent reserve of gold or dollars out of her "net surplus of dollars on current account". This is of some significance as it settled an important question of principle. The agreement reconciled this decision with the problem of contributions to the pool by providing that Ceylon would, during the period of one year for which the agreement applied, only build up a token reserve of one million dollars. She would continue to surrender the residual surplus to the pool. Similar agreements were reached in subsequent years when the size of Ceylon's independent dollar reserve was established by mutual agreement, and residual surpluses were contributed to the common pool. All these agreements were, however, of a short term nature, and, although this is broadly the position as it stands today, it is possible that different arrangements would be provided for the future. It is, for instance, conceivable that the present practice of fixing the size of the dollar reserve (and leaving the residual surplus to the pool), was reversed and that the opposite principle of fixing the size of the dollar contribution, be adopted instead. Under this scheme any residual surplus in dollars would accrue to Ceylon and the country would then have a direct incentive to economise on its dollar expenditures.

442. The sterling area, as such, has no "constitution" and no strict "rules". It evolved, generally speaking, after 1931 when Britain went off the gold standard. A number of countries which had close economic ties with Britain decided to maintain the stability of their exchange in terms of sterling. Since the war the sterling area took on a more definitive form with the emergence of the common pool. Member countries sold their dollar earnings to, and made their purchases from, the Bank of England. The United Kingdom, in turn, permitted the free movement of sterling between Britain and member countries. Presumably if Ceylon were to "leave" the sterling area she would lose the privilege of drawing on the pool if she suffered a deficit with the dollar area. It is doubtful whether the rules of the International Monetary Fund would permit the imposition of exchange control by Britain on current transactions with Ceylon even if the latter ceased to be a member of the area. The Ceylon rupee is, after all, a "soft currency" to Britain.

CHAPTER VIII

PUBLIC FINANCE IN THE POST-WAR BOOM

1. Objectives of Government Policy

As we have indicated in the preceding chapter the background to public finance in the post-war period was one of high prices and incomes throughout the economy at large. There were, of course, variations in the intensity of the boom. We sought to emphasise this by distinguishing between the several phases in the post-war period. But, taken as a whole, there is little doubt that the background was one of general expansion.

In this chapter we analyse the course of public finance in this period. It is inevitable that some of the problems in this field are similar to those we have already discussed in our study of wartime finance. But there are also important differences. During the war years budgetary policy was dominated by the special requirements of the emergency. Defence, rationing, food production, and other emerging activities came to dominate the pattern of Government spending. Temporary taxes like the excess profits tax were brought in to augment the Government revenues. Even public debt policy was conditioned by the special circumstances of the war in which the possibilities of borrowing were not matched by the existence of practicable projects on which the proceeds of loans could be spent. With the return to peace there was a natural searching for constructive policies. The notion of post-war development came to occupy a similar place in the minds of the public in Ceylon as did post-war reconstruction in Europe. Even before the conclusion of hostilities Government departments began preparing their schemes for post-war expansion. These schemes were brought together in a single document and published by the Board of Ministers in 1946 under the title "Post-War Development Proposals". Although this document was later superseded, it marked the beginnings of an approach towards long term 'planning'.

The war was not the only factor which gave an impetus to the idea of a conscious and concerted effort towards economic and social development. There were also the constitutional changes which culminated in independence in 1948. The Soulbury

Commission, which visited Ceylon during the latter years of the war, recommended a change in the constitution and the introduction of a cabinet system on the British model. These proposals were implemented in 1947 and a cabinet was formed under the leadership of the late Mr. D. S. Senanayake, Ceylon's first Prime Minister. The new constitution fell short of complete independence because Ceylon was not given full autonomy in certain reserved subjects like defence, external affairs and currency. But within a few months even these restrictions were removed, and on February 4th, 1948 Ceylon emerged as an independent nation and a fully responsible member of the Commonwealth.

These events were of considerable importance to the sphere of public finance and, indeed, to economic policy. As we have already mentioned, the previous constitution made difficult a co-ordinated economic and fiscal policy. The Board of Ministers was a poor substitute for a cabinet and was not in any way committed to a common programme. The Treasury and other financial departments were the responsibility of an Officer of State who had a seat, but not a vote, in both the legislature and the Board of Ministers. The new constitution remedied these shortcomings. The cabinet was now a united body capable of pursuing a common policy and of fashioning its own order of priorities. A Minister of Finance presided over the departments of the Treasury and presented the annual budget to Parliament. These developments naturally enough gave a further impetus to the schemes of development and social improvement. The Government had to justify its existence before the electorate on the basis of its common achievements. In a poor and under-developed country, the improvement of social services and the initiation of development schemes became an obvious measure of the Government's success.

It is perhaps true to say that public finance in post-war Ceylon was dominated by the problems and requirements of economic development. But, although the war and constitutional events played a large part in underlining the urgency of development, the process itself is, in a sense, the manifestation of the general economic boom in this period. It was the monetary prosperity of Ceylon during the war and post-war years which provided the Government with the funds for financing its programmes. In this sense the emphasis on development is merely a reflection, though perhaps a magnified one, of a normal cyclical tendency. We have commented elsewhere on the cyclical flexibility of expenditure on public works which expand and decline with prosperity and depression. The emphasis on development activities and capital expenditures in the post-war budgets is not therefore exceptional. What is outstanding, however, is the magnitude of the effort. In previous times there was the 'colonial approach' to budgeting to exert a restrictive effect on expansive expenditures. Increases in expenditure were more or less confined to extents permitted by a spontaneous increase in revenues without significant increases in taxation. In the post-war period, on the other hand, revenue policy was not quite so passive, and there was in addition a far more liberal use of the possibilities of public borrowing. These developments will, of course, be analysed in greater detail in the sections that follow.

The influence of the boom on the Government's budget was not confined to development expenditures. There was another and somewhat different problem which made a heavy claim on the financial resources of the Government. This was the problem of the cost of living. The high level of money incomes in Ceylon was matched by a high level of prices for consumer goods in general. Since the money incomes of all classes and groups in the community did not increase proportionately, the rise in the general level of prices involved a distortion in the distribution of real incomes. Such a shift in the distribution of real incomes is a characteristic cyclical feature of the Ceylon economy. In our study of the depression we found that the fall in money incomes and prices was much more severe than the fall in total real incomes. The striking feature of the depression was the change in the distribution of this real income when those with fixed incomes and those who remained in employment generally benefitted at the expense of the unemployed. In periods of boom, on the other hand, the process was reversed to the disadvantage of those whose incomes are relatively fixed.

It is of some interest that the Government should concern itself with this problem of the high cost of living and the distribution of real incomes. We have seen that Government policy did very little to correct the distortion in real income distribution that took place during the depression. In fact we were able to show that the Government budgets of the 'thirties considerably aggravated this tendency through retrenchment in public works expenditure. That the Government should adopt a different attitude in periods of boom may be due to a number of factors. On the one hand, Government policy in respect to the cost of living is an inheritance from the war years when money incomes were rising fast and the supply of imports had shrunk to dangerously low levels. In this background the cost of living index became a measure of the success of the Government's efforts. As we shall see presently, the cost of living problem in the post-war period was not on all fours with that of the war years. Nevertheless the Government's concern with the problem has continued. On the other hand, we cannot neglect the fact that the fixed income groups, who are most seriously affected by high prices, are a more influential and articulate section of the community than wage earners who suffer in times of depression. Salaried Government servants, and particularly those in the clerical grades, constitute a substantial proportion of the former category, and it is not surprising that their position should win the attention and concern of the Government. It is of course possible, and indeed likely, that the wage earners themselves have become more organised and articulate since the nineteen thirties. In a future depression they may be in a better position politically to exert their influence against a reduction in wages and employment. But so far there is little doubt that the Government has shown a greater willingness to modify the shift in the distribution of real incomes in the boom than it has during the depression. There are, of course, other factors besides the political to explain the Government's pre-occupation with the cost of living problem. It is perhaps easier, both administratively and financially, to attempt to control a rise in the price level in a boom than to cure unemployment in a depression. Further, a rise in the cost of living imposes a direct burden on the Government's finances by raising the amounts spent on "dearness allowances" to public servants. But it must be admitted that this argument loses much of its force in conditions where the control of the cost of living proves to be more expensive than the burden of dearness allowances.

Since Government policy in Ceylon has been considerably occupied with the cost of living, and since, as we shall see later, this attitude has had a considerable influence on post-war public finance, it is useful at this stage to single out analytically the main elements of the problem. We shall then be in a better position to appraise the effectiveness of the alternative measures open to the Government in dealing with the problem.

We may conceive of the "general level" of retail prices as some representative and weighted index of the prices of all commodities entering into the retail market of Ceylon. No such index has in fact been calculated, and it is not our intention here to go into this problem. As we have mentioned elsewhere, the nearest available substitute in Ceylon has been the Working Class Cost of Living Index for Colombo Town. For our general purpose, however, it is sufficient to be clear as to what is meant by the term the "general level of retail prices".

The magnitude of this general consumer price level in Ceylon would depend on the magnitudes and importance of the prices of the individual commodities which enter into it. The suitability of various Government measures for controlling the general price level would therefore largely depend on the manner in which the prices of the different commodities are in fact determined. For example, in a closed economy, or in an economy in which most consumer goods are produced locally, an excess of aggregate demand over supply can lead to a general rise in prices. In these circumstances a government can presumably influence the general level of prices by a disinflationary policy of budget surpluses designed to immobilise the excess demand. But in different conditions a policy on these lines may prove ineffective. As we shall see now, such a method of controlling the price level would have been inadequate for post-war Ceylon.

The prices of commodities entering into the Ceylon consumer market are, of course, all subject to their own particular supply and demand conditions, and any generalisations made here may not be universally applicable. We may, however, distinguish between three broad groups of commodities whose prices are determined in somewhat different ways. These are, (a) imported consumer goods, (b) goods produced locally for the domestic market, and (c) goods which, though produced domestically, are mainly exported. The import group is almost certainly the most important of these, since, in addition to clothing and other manufactured goods, Ceylon imports a large part of her food supply. The export group is perhaps the least important for the domestic consumer market since the country's range of exports are not particularly varied. However, commodities like tea, coconuts and coconut oil have some place in domestic consumption. The purely domestic group probably lies somewhere between these two in the order of importance. Perhaps these goods provide a higher proportion of total consumption in rural areas than in towns like Colombo.

Let us briefly examine the factors affecting prices in each of these groups.

(a) On the assumption that imports are perfectly free, it will be readily apparent that the prices of imported goods are entirely determined by factors external to Ceylon. As long as the exchange rate is unchanged, the rupee prices of imported goods would reflect more or less exactly their external prices. Ceylon is too small a country to affect the external prices of imports by virtue of her own demand. The supply of these imports to Ceylon is, in other words, perfectly elastic at the given world price. An expansion or contraction of total demand in Ceylon will not therefore affect the price levels of imported goods. All this, of course, holds true on the assumption that imports are freely permitted. But even on this assumption there may be a temporary rise in the prices of imported goods because of a time lag before the arrival of supplies. Where imports are artificially restricted by monopolies or by import control, the domestic prices of imported goods can increase on account of excess demand in Ceylon. In this case there will be a rise in the profit margins of importers or retailers. We have already shown that this sort of price inflation in imported goods took place during the war years when the local prices of these goods tended to rise considerably beyond their external prices. Import duties are yet another possible cause of a divergence between external and local prices. Ceylon's inability to influence the external prices of imports makes it fairly certain that almost all import duties are shifted forward to the local consumer. Heavy import duties can therefore make an appreciable contribution to the general level of retail prices.

The brief analysis above enables us to consider the possible methods open to the Government for reducing the local prices of imported goods. If the rise in prices is due to restricted imports and heavy local demand, the Government can either liberalise its controls and encourage free entry into the trade, or reduce the level of demand by budget surpluses and other disinflationary policies. Similarly, where import duties are a factor, the Government can secure a reduction in the price level by relaxing these taxes. Where, however, the rise in the prices of imported goods is entirely due to increasing external prices, there is little that can be done outside of subsidies or an appreciation of the external value of the currency.

(b) In the case of local goods which are produced entirely or substantially for the domestic market, it is easy to see that prices can increase on account of excess demand. This is so where supply is inelastic in respect to price. Such a condition is generally fulfilled in Ceylon where the domestic sector is relatively small and is dominated by agricultural activities.[443] An increase in demand beyond the supply price of the maximum (short term) output of the domestic sector will result in an inflationary rise in the retail prices of domestic goods. We can imagine an "equilibrium" level of total incomes and demand in the community which is just sufficient to secure maximum output in the domestic sector. A higher level of incomes and demand would produce an inflationary rise in prices, and in these circumstances the Government can help to bring down price levels by disinflationary policies. There is, of course, no reason as to why the level of total incomes, adequate to secure equilibrium in the domestic sector, should be also the level at which the balance of payments is in equilibrium. The level of incomes at which expenditure on imports is, at a given rate of exchange, equal to earnings from exports may generate a volume of demand for domestic goods which is not equal to the supply price of these goods. Consequently, if the Government were to regulate total demand in order to secure equilibrium in the domestic sector, it may produce a disequilibrium in the balance of payments.

(c) The third group consists of goods which, though produced domestically, are largely sold in export markets. As we have said before, tea and coconut products are the only important commodities in this group which figure in domestic consumption. The prices of these goods are externally determined by world conditions, and Ceylon's own consumption is too small in relation to her

443. For instance, the 'domestic group' entering into the Working Class Cost of Living Index is largely made up of such commodities as "country" rice, vegetables, roots and yams, fresh fish, meat, firewood and housing. vide *Annual Report of the Central Bank of Ceylon for* 1950 p. 6.

total output to exert an influence on prices. In other words, the supply of export products to the home market is, like imports, perfectly elastic at the existing world price. An expansion in total demand locally will not lead to an increase in prices, and, conversely, a reduction in prices cannot be secured through a contraction in local demand. The Government can, however, bring about a reduction in the prices of export goods to the domestic market by the imposition of an export duty in conditions under which this tax is shifted backwards. If, for example, an export tax is imposed on tea, and the world price remains unchanged, buyers would only offer producers a sum equivalent to the world price less the export tax. Any purchaser wishing to obtain supplies for the domestic market could now do so at the reduced price. In this way the Government is able to secure a reduction in the domestic prices of exported goods. An appreciation of the external value of the currency would also, of course, produce a similar result.

The fact that different groups of commodities in the consumer market are subject to varying influences in respect of prices, suggests that the control of the cost of living requires a variety of measures. The actual steps taken by the Government which have a budgetary significance will be apparent in the course of the discussion that follows. In fact, as we shall see, the post-war budgets of the Government were dominated by the twin problems of economic development and the control of the cost of living.

The Development Plans of the Ceylon Government

Apart from the expenditures that were directly occasioned by the cost of living problem, most significant changes in the pattern of post-war expenditure are explained by the Government's programmes for economic and social development. It would therefore be useful to preface our analysis of the post-war budgets with a few brief comments on these schemes.

We have already remarked that in 1946 the Board of Ministers under the old Donoughmore Constitution published a single document under the title "Post-War Development Proposals". This was, in effect, little more than a bringing together of the projects which the several Government departments had in mind. The estimated costs of these projects were summed up into a single total, but the projects themselves were hardly related to each other and even a common time limit was not specified. In fact, the whole document lapsed with the change of the constitution in 1947, but it has some historical significance in that it represented the first 'global' approach to the problem of development. Moreover, some of the projects that were listed here were subsequently incorporated into later plans.

The next stage in the approach to development 'planning' came in 1948 when the Minister of Finance, in the course of his budget speech outlined a new Six-Year Plan for "the future development of the country". Although the plan was claimed to be comprehensive, only the Government's scheme for agricultural and industrial development were listed in any detail. No estimates were given of the total cost of all development expenditure over the six-year period, and no suggestions were made about the ways in which the programme as a whole was to be financed. Nevertheless some of the projects mentioned in the plan were commenced, and this work was beginning to make its claims on Government expenditure.

The Conference of Commonwealth Foreign Ministers, held in Colombo during January 1950, led to a further advance in the idea of development planning. The need for a co-ordinated development plan for South East Asia, linked up with external aid, was stressed at this conference. A Commonwealth Consultative Committee met in Sydney in May 1950 and requested individual Asian countries to draw up practical and realistic plans for economic development on a six-year basis.[444] These plans were submitted to the Committee at its next meeting in London during September 1950, and they were published jointly as "The Colombo Plan for Co-operative Economic Development in South and South East Asia". The total development expenditure proposed in these programmes amounted to £1,868 million, of which Ceylon's share was £102 million. These plans were further revised at a later meeting in Karachi during March 1952. Since the Colombo Plan overlapped with the last two years of Ceylon's previous Six-Year Plan, the remaining portions of the latter were embodied into the former.

All these events stimulated the Ceylon Government to improve the presentation of its own plan. The term 'development' was

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444. The period covered by the Plan extends from July 1st 1951 to June 30th 1957. The overall objective of these plans was the modest one of preventing a decline in the standard of living in most of the countries concerned.

given a wide interpretation and the projects included in the programme were no longer confined to agriculture and industries. Transport and communications, education, health, and housing were also included, together with their respective shares in the total estimated expenditure over the six year period. The Plan is, however, still confined to Government projects and does not include the private sector. Moreover, the programme has yet to be divided up on the basis of annual targets.

A detailed discussion of the content of these plans would take us too far afield,[445] but we cannot over-emphasise the urgency of development for Ceylon. As we have repeatedly stated the Ceylon economy has been in a state of relative stagnation for a period of over two decades. The great phase of expansion in tea, coconuts, and rubber, which established the present export sector, has largely spent itself. Unless there is a fresh burst of activity and investment to carry the economy to new levels, living standards in Ceylon would not just remain static but would in all probability decline. We have shown elsewhere that, whilst population is increasing at a very rapid rate, the existing capital assets of the country are beginning to depreciate. It is not only per capita income, but also total real income that is threatened. The development plans of the Government aim at the establishment of new capital assets and new productive ventures. It would, however, be unfortunate if the maintenance of the existing assets is neglected since it is these assets which provide the domestic resources for the finance of development. A large proportion of Ceylon's rubber and coconut lands are of considerable age and stand in urgent need of replanting.

The main emphasis in Ceylon's development programme is on the extension of agricultural cultivation. Economically backward countries, which have already reached the limits of cultivable land, are obliged to think in terms of industrialisation as a potential outlet for their surplus labour. Ceylon is, however, fortunate in that a fair acreage of cultivable land is still available for development. The total land surface in Ceylon covers about 16½ million acres. Geographically, this area is divided by a central mountain mass

445. The Colombo Plan is described in Cmd 8080 – *The Colombo Plan for Co-operative Economic Development in South and South East Asia;* and in Cmd 8529 – *The First Annual Report of the Consultative Committee on Economic Development in South and South East Asia.* – Published by H. M. Government in November 1950 and March 1952, respectively.

into two 'zones' known as the 'dry zone' in the north and east and the 'wet zone' in the south and west. The dry zone, which is by far the more extensive, is watered by only one monsoon, the North East. It is therefore dependent on irrigation for the regular cultivation of crops such as paddy. The centuries old neglect of irrigation works in this zone as well as the prevalence of malaria has led to its virtual depopulation. In contrast, the wet zone is both thickly populated and intensively cultivated. Almost the whole of Ceylon's present day productive acreage under tea, rubber, coconuts and paddy, covering about 3¼ million acres, is in this region. The wet zone is virtually independent of artificial irrigation since it receives the benefits of two monsoons, the North East and the South West, during the course of the year. Since there is hardly any extra land available for expansion in this area, agricultural development is generally confined to attempts at increasing productivity in existing holdings. It is really to the colonisation of the dry zone that the main efforts of the Government are directed.

The attempt at the rehabilitation of the dry zone has a long history behind it. In the early period of British rule, the Government paid some attention to the repair of ancient tanks and canals, but with the emergence of the plantations its energies were diverted towards road construction and other activities. In recent times the movement has largely been associated with the name of the late Mr. D. S. Senanayake who, as Minister of Agriculture from 1932 to 1947, pursued these schemes with much vigour. The successful establishment of colonization schemes requires long and careful preparation. The land (which is largely Crown land) has to be surveyed, the ancient bunds have to be restored, and the canals have to be repaired. The gathering momentum of the colonization movement today is largely due to the patient preparatory work that was carried out during the Donoughmore period.

The colonization of the dry zone is inevitably a costly process and these costs have increased with the progressive evolution of Government policy. During the early 'thirties the Government's part in colonization was confined to repairing the ancient irrigation tanks and clearing the main canals. Landless peasant families from the wet zone had then to be persuaded to venture out into these remote forest ridden areas and to fashion out a new life against heavy odds. They had to clear the forest on the lands allotted to them, build the minor canals, construct their own houses, and manage to subsist during the initial period before their first crops matured. These difficulties and the prevalence of malaria often overcame the early pioneers, and many were obliged to abandon their holdings and return to their villages. Indeed in the early stages the Government found such difficulty in finding willing settlers that it had to offer substantial extends of land as inducements. Individual holdings in some of the early colonies are often as large as thirty acres.

As the Government gained in experience, however, it increased its services towards the colonist. Today the Government, in addition to providing the irrigation facilities, clears the forest, builds the major and minor canals, constructs a permanent house for the colonist, pays him a subsidy for stumping his land, offers him credit facilities and gives him a guaranteed price for his produce. As a further measure of assistance it stations technical officers to carry out instruction in scientific methods of cultivation.[446] Most of these activities were carried out by the departments under the Ministry of Agriculture,[447] but other ministries provided the supplementary requirements of these communities like transport, health, and postal facilities. Indeed the virtual elimination of malaria (towards which D.D.T. and other modern insecticides made a large contribution) has been a supremely important factor in the progress of these schemes. All these measures of assistance, whilst considerably increasing the costs to Government, have at least ensured the success of these schemes. Today each peasant family is only given a holding of eight acres consisting of five acres of paddy land and three acres of 'high land' suitable for cattle grazing and fruit trees. But the demand for these allotments far exceeds the rate at which new land is opened up. It may indeed be possible for the Government, at a later stage to reduce some of its services and to rely some more on the individual endeavour of the colonist.

446. Paddy yields per acre in the colonization schemes are considerably in excess of average yields in the wet zone. Colonists are urged to transplant seedlings from nurseries in preference to sowing.

447. After the recent elections in June 1952, however, the Departments of Land and Land Development were separated from the Ministry of Agriculture and placed under a new Ministry of Land Development.

The costs of many of the colonization schemes in existence today have been limited by the fact that the Government has been able to utilise the vast network[448] of tanks and canals built by the ancient Sinhalese kings. They had been constructed with such technical skill that in most cases it has only been necessary to repair the breaches in the bunds and to clear the canals. In the post-war period, however, the Government embarked upon a completely new and spectacular project known as the Gal-Oya multi purpose scheme which is expected to bring in 100,000 acres into cultivation and also to supply hydro-electric power. The construction of the dam and reservoir, which is now largely complete, was entrusted to a firm of American engineers. A public corporation, the Gal-Oya Development Board, has been set up to deal with the problems of settlement. It is proposed to utilise the hydro-electric power for the development of cottage industries[449] for colonists whose work as cultivators is only seasonal. The capital cost of schemes of this kind is particularly heavy as the whole system has to be built anew. The Ceylon Government is about to embark upon a second and similar project, the Walawe Scheme, whose scale is only slightly smaller than Gal-Oya. Work is also in progress on a number of other colonization schemes of lesser dimensions.[450]

We must also mention the success of recent experiments in Ceylon which hold out great promise. Hitherto the colonization of the dry zone has been based on the provision of irrigation facilities which are naturally somewhat costly. It may not, however, be technically possible to provide irrigation for the whole of the dry zone. The Government has therefore been experimenting in recent years on a system of 'dry farming' under which colonies are established for the production of crops which do not require a regular water supply. The colonies themselves are of a similar pattern to those under the irrigation schemes, but, instead of producing paddy, the settlers grow such crops as cotton, ground nuts, chillies, onions, and sorghum. The experimental colonies which have been set up on these lines have proved successful and the

448. One of the artificial 'tanks' now restored, the Parakrama Samudraya or 'Sea of Parakrama', covered an extent of over a hundred square miles.

449. The Gal Oya area is expected to grow, in addition to rice, sufficient cotton to furnish the colonists with raw material for textile production.

450. The Colombo Plan includes eleven major schemes of irrigation and land development besides Gal Oya and Walawe. cf. *Central Bank of Ceylon Bulletin*, February 1952, p. 15.

Government has announced its intention of speeding up the establishment of 'dry farming' colonies.[451] This would make possible the bringing into productive use, at a relatively low cost, of vast extents of land. The development of the dry zone would thus be rapidly accelerated.

The rehabilitation of the dry zone has a great popular appeal in Ceylon on account of its historical associations. It forms, indeed, the keystone of the whole development programme of the Government. "The rivers that flow through the large open and flat spaces of the dry zone, such as the Mahaweli-ganga, the Gal-oya, the Walawe-ganga, the Nilwala-ganga and the Deduru-oya, to mention the largest, draw their strength from the waters that fall on the central hills. They therefore carry a perennial supply of water. The ancient Sinhalese, who depended entirely on food crops such as rice for their existence, did not civilise the wet zone except for a few small settlements on the side of the river banks, such as the Kelani-ganga civilisation of King Kelani Tissa and the Nāga Kings before him. Our ancestors preferred to utilise the waters that flow through the dry zone rivers by tapping these rivers at convenient places, conducting the water through huge elas, river-like in their size and length, and at suitable places bunding up the water so conveyed in wewas or lakes. Every one of the rivers I have mentioned was so utilised hundreds of years ago. The Mahaweli-ganga and its tributaries were tapped in several places, and the early Sinhalese civilisation from the Vijayan period to the end of the Polonnaruwa era, extending over a period of 1,500 years, may truly be called the Mahaweli-ganga civilisation. The value of this method of irrigation was that the water thus collected could be used by the cultivator independent of the vagaries of the weather. Today these ancient artificial lakes are being brought into use again, the broken bunds reconstructed, the elas restored, 'the land reclaimed, and with the land the men, and with the men the

451. *Hansard* 26th July 1950, Minister of Agriculture. p. 866: "Experiments have been carried on for quite a long time by the Department of Agriculture whereby it was sought to gather information by settling a certain number of families in the dry zone for dry farming and rotation crops cultivation. This experiment was tried out for almost 12 years at a place called Kurundankulam near Anuradhapura. Figures and statistics were collected to see what extent of land would be necessary, what type of crops would have to be given in rotation, and what sort of income would be derived, and we have now got sufficient data to launch out on dry zone dry farming colonization schemes.

race'. It is anticipated that the resources of the dry zone can supply a regulated and constant flow of water for the vast extent of land that the Government contemplates bringing under cultivation in the immediate future. It is only in the dry zone that this is possible."[452]

For the improvement of peasant communities in the wet zone, the Government has in recent years initiated a Rural Development Movement. "The programme is an attempt at state-village partnership towards utilising the fund of unemployed and under-employed rural labour in order to build up local amenities of a capital nature. The state would provide the tools and the materials, the village will supply the labour. The projects include community centres, playing fields, minor roads and culverts, wells, bathing places, latrines, irrigation channels and improvements in cultivation methods."[453] This scheme is expected to spread over 20,000 villages, and to cost Rs. 400 million or 12 per cent of Ceylon's total expenditure under the Colombo Plan.

The development expenditures of Ceylon in recent years and those contemplated for the future are not, of course, confined to agriculture. The wartime policy of establishing Government sponsored factories has been carried through to the post-war period and to the Colombo Plan.[454] The Port of Colombo is being modernised on a big scale and the Plan envisages the building of roads on the dry zone and the improvement of the railway. There

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452. Minister of Finance, Budget Speech, 1948–49. *op.cit.* p. 9. Writing in 1930, before the systematic attack on the dry zone, John Still romanticised the long course of Ceylon's history in terms of the eternal ebb and flow of the jungle. "The tank age endured for more than fifteen centuries, and then the jungle tide rose over it and all signs or memory of it became lost............ In time the jungle tide will swing once more, and then those who care for other things than wealth will wander back to the wet side of the monsoon line, and while elephants browse where tea is now plucked, antiquaries will unearth the ancient bungalows of the British period, or even of the Scottish which will lie beneath it and classify the different kinds of bottles found among the ruins, and arrange them in museums. Having both planted tea *and* arranged the antiquities of a museum, I venture to prophesy that this picture will be realised in very much less than fifteen centuries, perhaps in one-fifth of that or perhaps in one-tenth..." John Still, *The Jungle Tide,* Wm. Blackwood and Sons, pp. 77–78.

453. *Central Bank of Ceylon Bulletin,* April 1952. pp. 9–10.

454. A cement factory with a capacity of 80,000 tons was constructed since the conclusion of the war and is now in production. The Colombo Plan stipulates the establishment of 9 individual factories producing fertilizers, sugar, ceramics, iron and steel, acetic acid, D.D.T., caustic soda and chlorine, paper, cotton textiles and vegetable oils.

is also the major hydro-electric scheme at Laxapana whose first stage, providing power for lighting, is now complete.

Apart from economic development the Government Plan includes, under the heading of 'social capital', proposals for the expansion of education, health facilities, and housing. We have previously noted that public expenditure on the social services has been progressively increasing since the beginnings of the Donoughmore Constitution. The post-war emphasis on economic development has not in any way checked or reversed this feature. Indeed the State Council crowned the final years of its life with an expansive scheme for free education 'from the kindergarten to the University'. This scheme as originally conceived ran into a number of practical difficulties, but the principle of free education has been adopted by the present Government and is being applied in Government schools.[455] This factor has been largely responsible for the increase in the cost of education in the post-war period. Costs of free education would have been even higher if the denominational schools, amongst which are some of the leading schools in the Island, were included in the scheme as originally intended. These have, however, been allowed to charge fees, and they still receive partial grants from the Government. The development proposals of the Government visualise the construction of new schools and the provision of better equipment. The recurrent expenditures implied by this would, under the free scheme, be particularly heavy.

Ceylon's development programme under the Colombo Plan, covering the six-year period from July 1st 1951 to June 30th 1957, is summarised in the table overleaf. The plan, as placed before the Commonwealth Consultative Committee in September 1950, was revised in 1952 during the meeting at Karachi. The cost as originally estimated has more than doubled. This is due, in part, to the increase in prices, but in part also to the inclusion of new projects.

The greater part of the Colombo Plan falls outside the period covered in this study. But the development expenditures of the Ceylon Government in the post-war period have been on the types of project which we have discussed in connection with the Plan. We need not therefore re-describe these expenditures when we analyse

455. cf. Minister of Finance, Budget Speech, 1948–49, *op.cit.* p. 31.

Development Expenditures of the Ceylon Government under the Colombo Plan
(Rs. million)

	Programme in 1950		*Programme as revised in* 1952	
	Cost	*% of Total*	*Cost*	*% of Total*
Agricultural and multi-purpose projects ..	503	37	900	28
Transport and communication ..	297	22	600	19
Fuel and Power ..	109	8	150	5
Industry ..	75	6	200	6
Social capital ..	375	27	758	24
Rural development ..	—	—	400	12
Research ..	—	—	25	1
Miscellaneous ..	—	—	167	5
	1,359	100	3,200	100

Source: *Central Bank of Ceylon Bulletin*, April 1952. p. 9.

Note: "The original estimate of Rs. 1,359 million for the six-year programme represented the aggregate of only the major items of Ceylon's net capital investment and did not include the minor works and other development of a capital nature financed out of current revenue. The revised estimated programme, which now stands at Rs. 3,200 million, represents the total gross capital investment of the Government for the period of the Plan." – *ibid.* p. 9.

the pattern of public spending in this period. Although the Colombo Plan envisages external assistance,[456] the Government's development expenditures have, until now, been almost entirely financed out of domestic sources. During 1950–51, the first year of the Colombo Plan, the Ceylon Government incurred an expenditure of Rs. 233 million on its development programme.[457] This leaves about Rs. 3,000 million according to the above estimates for the remaining portion of the Colombo Plan. An annual rate of expenditure on capital works alone of about Rs. 600 million for the rest of the five years is clearly beyond the competence of even such boom time budgets as those of 1950–51 and 1951–52. It seems fairly safe to conclude that Ceylon's share of the Colombo Plan is hardly likely to be fulfilled in the absence of external aid.

456. The external assistance received by Ceylon so far has been financially of a minor order consisting mainly of scholarships for technical training abroad. In 1952 Ceylon accepted a gift of Rs. 3.2 million worth of flour from Australia and an offer of Rs. 3.3 million from New Zealand for the construction of an agricultural research station. – *Central Bank of Ceylon Bulletin*, February 1952. p. 16.

457. *Central Bank of Ceylon, Monthly Bulletin*, April 1952. p. 10.

Even the financing of development expenditures out of domestic resources is likely to involve a running down of Ceylon's external reserves since a good proportion of these expenditures are financed from internal borrowing. In this respect we must mention the sterling assets agreement of 1951 which has considerably improved the availability of Ceylon's sterling balances. The United Kingdom Government has agreed to transfer a sum of £21 million from Ceylon's blocked No. 2 account to the No. 1 account over a seven-year period beginning July 1st 1950. These transfers would only be made when the total balances on the freely usable No. 1 account fell below £12 million. By the end of 1950 Ceylon's total balances in the No. 1 account stood at £37 million. Thus a sum of £58 million was potentially available to Ceylon at that date out of her total sterling assets of £81 million.[458] This Agreement was closely connected with the Colombo Plan. Britain has, in fact, made similar arrangements with some of the other participating countries and these sterling releases must be counted as an important part of Britain's contribution to the Plan.[459]

II. The Post-War Budgets of the Ceylon Government

Since we have already outlined the nature of the Government's development expenditures it would not be necessary to re-describe each of the categories on which expenditure was incurred in the post-war period. The distribution of the current expenditures of the Government is shown in the table overleaf. But it is important to remember that a rapid increase in loan expenditures was a notable feature of public finance in this period.

The figures for current expenditure extend from 1945–46 to 1949–50. The detailed financial accounts for the year 1950–51 are unfortunately not available at the time of writing. We have had to make a correction of the official figures for current expenditure in order to allow for a change in accounting practices in respect of food subsidies. We have already seen in a previous chapter that the wartime trading activities of the Government were recorded in a special 'advance account' which was kept outside the normal budget. The practice was continued during the first two years of

458. *Central Bank of Ceylon, Annual Report for* 1950. p. 15.

459. Cmd 8529. *First Annual Report of the Consultative Committee*, March 1952, p. 59. Provision has been made for the release of £224 million of blocked balances to India and Pakistan over the six-year period of the Plan.

the post-war period, but a change was made from the financial year 1947–48 onwards. It was now decided to bring in the net losses or net profits from government trading in food into the ordinary revenue and expenditure accounts. Accordingly all the accumulated net losses of the preceding years were nominally added to the 1947–48 budget together with the net losses actually incurred in that year. Thereafter the annual losses were included with the total expenditure for each year. The result of this change in accounting procedures is that the official accounts understate total expenditure in 1945–46 and 1946–47, but overstate it in 1947–48. We have made a correction for this factor in the table below by allocating the losses on government trading to each of the years in which these losses were actually incurred.[460]

Distribution of Current Expenditure (1945–46 to 1949–50)
(Rs. million)

	1945–46	1946–47	1947–48	1948–49	1949–50
Total current expenditure ..	350.3	495.0	544.2	547.9	563.0
Administrative Departments ..	36.9	49.1	61.7	66.8	69.1
Economic Departments ..	92.8	105.5	164.4	178.8	172.9
Food subsidies ..	37.4	89.6	77.8	53.7	35.8
Social services ..	72.4	99.2	138.2	153.4	170.0
Public debt ..	23.4	30.5	32.0	33.7	37.3
Pensions ..	18.8	21.6	24.8	27.4	29.6
Local Government ..	8.6	20.2	18.9	23.7	32.4
Miscellaneous ..	58.9	78.2	7.3	9.8	14.9
Emergency Departments ..	.7	.8	.1	.1	—

Source: *Accounts of the Government of Ceylon* (*annual*). Data on food subsidies from *Annual Report of the Central Bank for* 1950 for the year 1945–46 to 1947–48, and the *Ceylon Trade Journal*, March 1951 for 1948–49 and 1949–50.

Note: The detailed budgetary accounts for the period after 1949–50 are not available. The global totals for current expenditure are, however as follows:

	(*Rs. million*)	
1950–51	736.8	(provisional)
1951–52	898.6	(estimate)

Source: *Central Bank of Ceylon, Annual Report for* 1951. A large part of the increase shown above is accounted for by food subsidies.

460. The difference between the official and the corrected figures for total government expenditure is as follows:

	Official (*Rs. million*)	*Corrected*
1945–46	312.9	350.3
1946–47	405.4	495.0
1947–48	622.0	544.2

The strict comparability of the annual figures shown on page 325 is limited by the fact that the dearness allowances paid to Government employees were removed from the miscellaneous category after 1947–48 and distributed over the different Government departments. The increase in expenditure shown by most items between 1946–47 and 1947–48 is mainly due to this factor. This is specially important in the case of both the economic departments and the social services where large numbers are employed, and also in the case of pensions.

The main point of interest in the pattern of post-war expenditures is, of course, the emergence of the new and important item of food subsidies. The other items of expenditure do not require much elaboration. There was a steady increase in the expenditure on the social services associated mainly with the introduction of the free education scheme in 1946–47. The results of the Government's wartime and post-war borrowing policies were reflected in the steady expansion in the cost of the public debt. The increase of expenditure on Local Government was partly due to the establishment of a Local Government Service made up of trained officers to assist the various local authorities. But the main increases under this head are accounted for by a large expansion in grants to local bodies. Most of the expenditures of the Ceylon Government on economic development were financed out of loan funds and do not therefore figure in the current expenditure budget. The increased spending on the economic departments in the current budget was largely due, apart from the dearness allowances, to the losses on the railway which began to reappear after the war. The emergency departments, which were set up during the war to administer price control and rationing, were gradually disbanded with the return to peace. Defence expenditures were also reduced to a peace-time level of between Rs. 5 and 6 million per year.

The food subsidies deserve some attention. In addition to making a heavy claim on the budget, they possess a wider economic significance. As we have argued before, subsidies are, apart from exchange appreciation, about the only method available for offsetting a rise in the cost of living caused by an increase in external prices. The Government's policy of food subsidies commenced in 1943 when it was decided to stabilise the cost of living as far as possible. The Government monopolised the importation of food and sold certain foodstuffs in the local markets at prices lower than costs. During the war years, however, the Government was able to make a small net profit on its total trading activities because the losses on such articles as rice and flour were more than offset by profits on other foodstuffs. With the return to peace the Government maintained its monopoly of rice and flour imports but restored the import trade in most of the other foodstuffs to private enterprise. This resulted in net losses on account of government trading since rice and flour were the principal subsidised items.

In 1948, when the losses on food were included in the ordinary budget, the Government decided to abandon all subsidies save that on rice. This led to a gradual reduction in the cost of subsidies which fell from a figure of Rs. 89.6 million in 1946–47 to Rs. 35.8 million in 1949–50. The actual losses to Government on foodstuffs were in fact somewhat lower than these amounts since grain and flour were continuing to pay an annual import duty of about Rs. 13 million during these years.

The Korean war and the aftermath of devaluation, however, brought about a marked reversal of this trend. A rapid increase in import prices and an expansion in domestic purchasing power led to a serious rise in the cost of living. In an attempt to deal with this problem the Government, in October 1950, reintroduced the subsidy on flour and increased the subsidy on rice. The latter was increased still further in December 1950 and certain other commodities like coconuts and firewood were also subsidised. These measures have led to an enormous increase in the cost of subsidies. In 1950–51, subsidies were estimated to cost no less than Rs. 133.0 million which was about a fifth of the total current expenditure budget.[461] They were expected to continue on a comparable scale in 1951–52. Indeed the problem had become so serious that the Central Bank drew the attention of the Government to it in forceful terms. "Toward the end of the year (1951) the subsidy problem was becoming steadily more difficult. With rice and flour prices continuing to rise, and Government revenues continuing to fall, the mounting subsidy bill was producing an embarrassing deficit: by December the bill was running at about 22 per cent of total expenditure chargeable to revenue .... Already, in

461. *Food Prices* by K. Alvapillai, Food Commissioner, in *Ceylon Trade Journal*, March 1951, Vol. XVI No. 3.

early 1952, the rate of actual spending on rice and flour subsidies had exceeded that on the total of the Government's development projects under the Colombo Plan.''[462]

The subsidies have come to occupy so important a place in the Government budget[463] that it would be useful to consider their implications. As we have argued before, periods of boom in Ceylon are generally characterised by both an increase in money incomes and a rise in import prices. It is usually this increase in import prices and the distribution of the increased money incomes which determine both the total volume of imports entering the country and its distribution between the various sections of the community. In periods of very high import prices, salary earners and other groups whose money incomes are relatively stable are liable to suffer a serious decline in real income. A good deal of hardship might thereby arise. The Government may wish to modify this situation on grounds of social justice or even on other grounds. Apart from a change in exchange rates there are two approaches open to the Government. On the one hand it can offset the rise in external prices by a policy of subsidies which keep down the prices at which imported goods are sold on the local market. On the other hand, it can encourage an upward adjustment of those money incomes which do not increase automatically with the boom. These methods are not of course exclusive as they can be used, and indeed are used, in combination. But it is mainly the effects of the subsidies which we wish to consider here.

In spite of their beneficial effects on the cost of living, the subsidies have a number of drawbacks. First, it is easy to see that the subsidies are indiscriminate in their benefits since they favour all sections of the community including those whose money incomes have risen. It is true that subsidies keep down the cost of dearness allowances to Government employees by depressing the cost of living. But the total expenditure on subsidies is far in excess of the

462. *Central Bank of Ceylon, Annual Report* for 1951. p. 15.

463. The end of the Korean boom might, however, lead to some easing of the cost of living problem. On the other hand 1952 has seen an acute world shortage of rice and Ceylon may well have to pay higher prices for her principal subsidised commodity.

expenditure on dearness allowances.[464] It is somewhat paradoxical that the Government should keep wages low through subsidies at a time when the export industries are exceptionally prosperous. Indeed it is hardly logical that the export sector should be both subsidised and subjected to export taxes at the same time. Third, subsidies tend to distort the cost structure in the country and thereby impede the efficient allocation of resources. Sub-marginal areas may be brought under such crops as tea, rubber, and coconut, because the pattern of real costs is artificially disguised. There is, in addition, the further fact that the subsidies may in certain special circumstances reduce the prices which Ceylon receives for her export crops. This was well illustrated during the war when the prices for almost the whole range of Ceylon's exports were directly linked to costs of production. An element of this was also present in the post-war period in the case of the tea contracts with the United Kingdom. Finally, there are the effects of subsidies on both the fiscal structure of the Government and the balance of payments. When important consumer goods are subsidised the public is left with more money for other types of spending. This may lead to increased imports and higher prices for domestic goods. These effects may be neutralised to some extent if the subsidies are financed out of taxes. But if the subsidies were absent there might well be different consequences. The abolition of the subsidies may require some relaxation of such taxes as the export duty, but the decline in tax yields may still fall short of the saving on subsidies. In this case the Government could either increase its total spending on development projects or finance a greater proportion of its present development expenditures out of taxation. The latter procedure would decidedly have a salutary effect on the balance of payments.

The rationale of the whole subsidy policy was questioned by the Central Bank. "Increased subsidies are practicable when the expected rise in the cost of living index is small, but, if there is a rise in prices outside Ceylon which is large and sustained, the

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464. "It is estimated that the saving involved in war allowances for every four point decrease in the cost of living index would amount to Rs. 7,125,000. To effect a four point drop in the cost of living index we shall have to give a subsidy of the magnitude shown below in the case of each item or combination of items according to the rations given: Flour – Rs. 17 million, Rice – Rs. 33 million, Sugar – Rs. 42 million." Minister of Finance – *Hansard*. 1st December 1947, p. 407.

subsidy weapon becomes unwieldly and impracticable, and its adverse effects on the Government budget, and ultimately on the balance of payments, far outweigh its advantages...... Price fluctuations always result in alterations in relative shares of total income received by various groups. Even with the most expensive system of subsidies imaginable, it would be impossible for the Government to succeed in maintaining these shares according to some pre-existing pattern. The best that the Government can hope to do is to minimise some of the more obvious injustices and inequities produced by price fluctuations."[465]

The alternative to subsidies is an upward adjustment of money incomes in both the Government and the private sector. This can, with advantage, be confined to those whose real incomes tend normally to fall in the boom. It would also be cheaper from the Government's point of view. On the other hand it has the drawback of tending to raise wage and cost structures. But the dangers of this can be modified by utilising the flexible mechanism of dearness allowances which relate changes in wages and salaries to movements in the cost of living.

Loan Expenditures

We have already remarked that most of the Government's development expenditures were financed out of loan funds. The rapid expansion of expenditures charged to loans was, in fact, one of the notable features of post-war public finance in Ceylon. In the decade or so before the war, loan fund expenditures constituted only a small proportion of total expenditure. This proportion increased during the war when a share of the defence expenditures was charged to loans. But it was the post-war period which witnessed a substantial growth in the importance of loan expenditures. This is illustrated overleaf.

The expansion in loan fund expenditure was accompanied by a gradual change in the Government's attitude towards the uses to which loan funds are generally applied. In the period prior to the Donoughmore Constitution, the Government usually followed the strictly orthodox practice of financing out of loan funds only those forms of capital expenditure which were expected to yield a money

465. *Central Bank of Ceylon, Annual Report for* 1950. pp. 8 and 9.

(Rs. million)

Year	*Total Government Expenditure*	*Loan Expenditure*	*% of Total*
1938-39	134.7	7.6	5.6
1945-46	386.3	36.0	9.3
1946-47	527.1	32.1	6.1
1947-48	614.5	70.3	11.5
1948-49	670.4	122.5	18.3
1949-50	718.8	155.6	21.6
1950-51(a)	883.5	146.7	16.7
1951-52(b)	1,243.9	345.3	27.8

(a) Provisional figures.

(b) Estimated figures.

Source: *Central Bank of Ceylon, Annual Report for* 1951. p. 55. Table 17.

Note: Total Government expenditure consists of both current expenditure and loan expenditure. The official figures for total expenditure have been corrected, as before, for food subsidies. The figures for 1951-52 are from the budget estimates for that year. It is possible that, in keeping with the tendency in recent years, actual expenditures from loan would fall short of the estimated amounts.

return adequate for payment of interest and amortisation. The construction of the Ceylon railway and of the Port of Colombo in the latter part of the nineteenth century were the outstanding examples of development expenditures financed from loans. During the Donoughmore period there was some relaxation of this principle and loan funds were applied to the building of such public works as roads and bridges whose contribution to the national income and the Government revenue was indirect. In the exceptional circumstances of the depression and the war, even such items as commuted pensions and defence expenditures were debited to loan funds. In the post-war period, the liberal attitude towards the use of loan funds was carried much further and was also applied on a much larger scale. In addition to the capital expenditure on the Government's projects for agricultural and industrial development, loan funds provided almost the whole of the capital costs for the extension of the social services. Schools and hospitals were built and equipped out of loan funds and housing schemes for Government workers and officers were similarly provided. Indeed the expenditures from loan funds covered such a wide range of items as the purchase of embassy buildings abroad, the provision of relief to flood victims, and the building of an independence memorial.[466]

466. cf. S.P.IX of 1951. *Accounts of the Government of Ceylon for the Financial Year* 1949-50. (p. 1) Statement No. 16.

It is useful to consider some of the implications of this expanded loan fund expenditure. We shall discuss the inflationary effects of post-war loan expenditures at a later stage because these expenditures were offset in some years by surpluses in the current budget. For the present we wish only to draw attention to two aspects of loan expenditures which are of some significance to the long term fiscal structure.

First, it is easy to see that increased Government borrowing will raise the cost of the public debt. This did not lead to any problem when borrowed funds were applied only to remunerative ventures whose returns were adequate to service the debt. But when the use of borrowed monies is extended to include all varieties of capital expenditure, the resulting increase in the public debt would not be automatically serviced. In this event a permanent increase in taxation might well be involved since the expansion of the public debt would tend to enlarge the scale of the Government's current budget. This expansion would, at the same time, also reduce the flexibility of Government expenditure. Interest on the public debt is a contractual payment which does not even require annual parliamentary sanction. The financial implications of an increasing debt service are not likely to be felt in periods of boom, when revenues are generally buoyant, and when they are sustained by such fair weather taxes as the export duty. But the Government's budgetary problems might tend to be seriously aggravated in periods of depression. There is, however, one way in which the consequences of the increased public debt in the war and post-war periods would differ from those in previous periods. All public borrowing after 1951 has been internal borrowing. Although the servicing of this borrowing is likely to require increased taxation, this process would only imply a redistribution of incomes within the community. An increase in the cost of the local debt would not have the same direct results on the balance of payments as would an equivalent increase in Government borrowing abroad. On the other hand it must be remembered that foreign owned banks and insurance companies are amongst the major contributors to Government loans. To the extent that interest earnings form part of their profits, even internal borrowing is likely to have indirect effects on Ceylon's balance of payments.

The second point to which we wish to draw attention does not apply only to loan expenditures but to all types of expenditure on capital development. The rapid expansion of Government services is likely to involve, in addition to capital costs, a raising of the level of recurrent expenditures. Some of the Government's industrial and agricultural projects may ultimately pay their way. But in the post-war period most of the state-owned industrial factories were showing net losses, whilst the finances of the colonisation schemes were not even separately accounted. Capital expenditure on the provision of schools and hospitals are, of course, certain to lead to substantial recurrent expenditures. These costs are likely to be particularly large in view of the free education scheme and the policy of providing free health services. This aspect of Ceylon's development plans has so far been neglected and no estimate has been made of the recurrent expenditures which the loan financed development projects are likely to involve. It is important to emphasise this relationship between the Government's loan expenditure budget and its current budget. Like the increase in the cost of the public debt, capital development would tend both to enlarge the size of the current budget and to reduce its flexibility. This again would point to the need for a widening of taxation in the future in the 'search for revenues'.

III. The Course of Post-War Revenues

We have seen that the increase in post-war expenditure was made up of two parts – an increase in current expenditure, and an increase in expenditure charged to loan funds. Since the latter was financed out of borrowed monies, an expansion in Government revenues was only required to meet the costs of the current budget. The Government might, of course, decide to increase taxation in excess of the requirements of current expenditure. In this case it would budget for a 'surplus' and credit the difference to a special reserve to be used for future purposes. Under this system it is quite possible for the Government to be both borrowing and adding to its reserves at the same time. Moreover, its total budget might well be in deficit because its loan expenditures exceed its current surpluses. We shall examine the 'overall' effects of the post-war budgets in the next section. For the present we shall only concern ourselves with current revenues.

The course of total revenues in the post-war period is shown overleaf.

(Rs. million)

	Total Revenue	Tax Revenue	Non-Tax Revenue
1945–46	* 383.3	299.6	83.7
1946–47	461.2	387.9	73.3
1947–48	540.6	466.7	73.9
1948–49	576.1	499.5	76.6
1949–50	623.3	533.1	90.2
1950–51	836.0	736.5	99.5
1951–52	909.8	824.0	85.8

Source: Annual Accounts of the Government of Ceylon for 1945–46 to 1949–50. *Annual Report of the Central Bank of Ceylon for* 1951 for later years.

Note: The figures for 1950–51 are provisional, whilst the figures for 1951–52 are estimates.

It will be seen that the increase in tax revenues accounted for virtually the whole of the increase in total revenues. In our study of public finance during the war we noticed that, in spite of the increase in taxation, non-tax revenues retained their share in the overall total. The main reason for this was the wartime profits from the railway. In the post-war period, however, the railway losses re-emerged, and, although the revenues from such items as harbour dues and postal and telecommunication services increased, total non tax revenues remained at a relatively low level. During the latter years of the war these provided about 26 per cent of the total revenues. In 1949–50 their relative share had dropped to 14.5 per cent.

The post-war increases in taxation were, of course, needed to finance the current expenditure budgets which were enlarged by such items as dearness allowances and subsidies. The prospects for a substantial 'spontaneous' increase in revenues, without a change in the rates, was somewhat depressed during the first phase of the post-war period. Although the supply of imports had improved, military expenditure had rapidly dwindled, and some increases in taxation would have been necessary if the current budgets were to be balanced. But the actual increases in post-war taxation cannot all be explained in terms of balancing the current budgets. The taxation policy of the Government was in fact influenced by other motives from time to time. We have already indicated that, towards the end of the war, the Government felt it had not made the fullest use of its opportunities to increase its revenues through taxation. Accordingly in 1945–46 it introduced a series of tax increases designed to raise revenues in excess of the requirements of current expenditure. In this way it hoped both to counter inflation and to add to its reserves. Again, in early 1947, the Government imposed a very severe export duty on a number of commodities for reasons not wholly connected with the revenue. Similarly, import duties were substantially raised towards the end of 1947 for balance of payments purposes. It is, indeed, this complex of motives which explain the courses of the various individual items of revenue shown below.

Receipts from Taxation (1945–46 to 1949–50)

(Rs. million)

	1945–46	1946–47	1947–48	1948–49	1949–50
Total Tax Revenue ..	299.6	387.9	466.7	499.5	533.1
Sources:					
(i) Taxes on Expenditure and consumption					
Import duties ..	132.6	166.7	177.0	180.2	188.3
Excise and salt ..	38.6	40.8	46.8	46.2	43.7
Licences ..	.6	.7	.9	1.0	1.1
Tax on heavy oil motor vehicles ..	.2	.1	.1	.2	.3
Betting Tax ..	—	.2	.9	1.8	3.1
Stamps ..	7.9	8.0	7.9	8.3	8.8
Total ..	179.9	216.5	233.6	237.7	242.2
(ii) Tax on Exports ..	13.7	83.1	136.7	148.7	167.2
(iii) Taxes on Income and Capital					
Income Tax ..	61.8	55.1	62.0	76.7	79.0
Estate Duty ..	2.7	2.5	3.8	2.6	6.2
Excess Profits Duty ..	41.5	30.7	21.5	15.4	14.1
Profits tax ..	—	—	9.1	18.4	24.4
Total ..	106.0	88.3	96.4	113.1	123.7

Source: *Annual Accounts of the Government of Ceylon.*

The table above brings out the four principal features of post-war taxation. These are (a) the striking increase in the revenue from export duties whose relative contribution to total tax revenues rose from 4.6 per cent in 1945–46 to 31.3 per cent in 1949–50; (b) the rapid increase in the yield of import duties between 1945–46 and 1946–47, and its steady expansion thereafter; (c) the rise in the revenue from the income tax after 1946–47; and (d) the fall in the returns from the excess profits duty and the introduction of a new tax, the profits tax, from 1947–48. We shall comment briefly on each of these developments in turn.

(a) The preceding chapter has already indicated the origins of the increased export duties. When the wartime purchasing arrangements for most of Ceylon's exports were terminated, and when the

Government had failed to have these replaced by satisfactory long-term agreements, it imposed some sudden and sharp export taxes. The duty on tea was raised from 4.8 cents per lb. to 38 cents per lb. in early 1947, and a new and heavy duty on all exports of coconut products was also imposed. As we have said before these measures were not entirely prompted by revenue considerations. They were not announced, as is customary, at the time the budget for that year was introduced.

These taxes were imposed in the confident belief that they would be shifted forward to the consumer. This expectation was, as we have seen, partially realised. Tea and coconut products were partly sold under post-war contracts with the United Kingdom, where the liability for enhanced duties was laid upon the consumer. In fact one of the reasons for the tax on coconut products was to secure an indirect increase in prices for the producers who were reimbursed with half of the total yield of the tax. There was, in addition, another motive for the export taxes on coconut products. The Government wished to encourage the full utilisation and development of Ceylon's milling capacity for the extraction of oil from copra. In pre-war times Ceylon used to export the bulk of her coconut products in the form of copra which was converted into oil abroad. In 1947 the Government used the export duty as a weapon for discouraging the export of copra. It imposed a discriminatory duty which penalised exports of copra and fresh coconuts relatively to exports of oil and this had the effect of increasing the proportionate share of oil exports.

The rubber industry made no contribution to the outstanding increase in the revenue from export duties in 1947–48. We have already commented upon the adverse fortunes of this industry during the period prior to devaluation. The export tax on rubber, far from being increased, was removed altogether during 1947 and was not re-imposed until after the Korean boom. The Korean war brought exceptional prosperity to all Ceylon's export staples, and in October 1950 export taxes were increased over a wide range. The tax on tea was raised from 38 cents per lb. to 53 cents per lb. Rubber was subjected to a tax of 15 cents per lb. whilst a new duty of Rs. 2 per lb. was imposed on exports of pepper. The yield from these increased taxes would, of course, fall within and after the financial year 1950–51. The detailed accounts for these later years are unfortunately not available, but we can be almost certain that these measures increased still further the relative importance of export taxes in the total revenue. The enhanced duty on tea alone was expected to yield an additional Rs. 44.3 million, whilst the estimated revenue from the new tax on rubber was Rs. 30.0 million.[467] Details of the revenue from export duties during the period 1945–46 to 1949–50 are shown below. The importance of tea as a source of revenue to the Government is strikingly demonstrated.

Revenue from Export Taxes (1945–46 to 1949–50)
(Rs. million)

	1945–46	1946–47	1947–48	1948–49	1949–50
Yield of tax on					
Tea ..	7.8	66.5	113.3	113.2	122.1
Rubber ..	5.7	1.9	—	—	7.8
Coconut products ..	—	(a)	22.9	35.2	36.8
Other goods ..	.2	14.7	.6	.3	.4
Total ..	13.7	83.1	136.7	148.7	167.2
Overall rates of (b) taxation of exports: ..	1.8%	9.3%	13.6%	14.0%	10.9%

Source: *Account of the Government of Ceylon* (*Annual*)

Note: (a) The revenue from coconut products is not separately specified for 1946–47 and is included amongst 'other goods'.

(b) The overall rate of taxation of exports depicts the total revenue from export taxes as a percentage of the total value of exports during the corresponding calendar year.

The taxation of exports on the scale shown in the table above has, of course, been quite unprecedented in recent years. But the greatly enhanced importance of these taxes in the post-war revenue structure ought not to conceal their fundamental limitations. We can, perhaps, find no better illustration of the instability of export duties than Ceylon's experience of these taxes since the nineteen-thirties. During the depression most export taxes had to be withdrawn altogether. In the post-war boom, on the other hand, they have become one of the mainstays of the Government revenues. The expansion in revenues caused by the export taxes can itself lead to serious consequences. Under the stimulus of these temporary revenues, budgets are expanded and extra services provided. These often lead to a permanent raising of the level of recurrent expenditures and a number of difficulties are thereby set

467. Minister of Finance, Budget Speech 1950–51. *Hansard* 20th July 1950. p. 609.

in store for the future. It is true that the dangers of this tendency are somewhat mitigated for Ceylon as post-war expenditures consist of such relatively flexible items as subsidies and dearness allowances. But the practice of crediting the yield of export taxes to current ex-revenues is always liable to cause difficulties.

Export taxes have the further defect of reducing the competitive position of local producers as against foreign suppliers. The export duty on Ceylon tea, for instance, is much higher than the corresponding duty on Indian tea. Foreign producers are thereby placed in a better position to expand their output or to improve their plantations than local producers whose financial resources are reduced by the heavy taxes.[468] It is true that in Ceylon, producers are favoured by subsidies which artificially keep down costs of production. But, as we have argued before, the propriety of heavy subsidies, in times of prosperity and high export taxes, is itself open to question.

Another drawback of the export tax as it has operated in Ceylon in the past, is its administrative inflexibility. The export duties are levied at specific rates at times when world prices are high. There are the usual administrative delays in reducing these duties when prices begin to fall, and producers incomes are thereby adversely affected. This feature is reflected in the preceding table where we find that the overall rate of taxation of exports increased during the recession of 1949 and fell during the early part of the Korean boom. The taxes imposed in early 1947 were, of course, substantially unchanged during this period. We must, however, mention that the inflexibility of the export tax, in the sense described here, has been somewhat improved in recent times. In 1950, the Government replaced the flat rate specific tax on tea and rubber exports with a sliding scale of duties which varied with the price of the commodity. The tax still remained specific in the sense that it applied to quantities exported, but there is now a schedule which alters the tax rate according to changes in prices.[469]

468. Even when the export tax is shifted forward to the consumer, local production can be adversely affected by the fact that higher prices stimulate foreign competition. The history of Ceylon's trade in cinnamon and arrack in the early nineteenth century provides good illustrations of this.

469. The schedule, however, stops at a certain minimum rate of tax which is to apply when prices remain below a given level. Further reductions in the tax, in circumstances where prices continue to fall, would still require legislative action.

It must, of course, be admitted that the export tax has some merits. It is easy to administer, and its costs of collection are low. Ceylon's total capacity for the production of export crops cannot easily be expanded in the short period. A boom in world prices well in excess of production costs, or of short period supply prices, often leaves producers with 'abnormal' profits somewhat akin to economic rent. The tapping away of these profits through export taxes may not therefore harm production. Moreover, if, instead of spending the proceeds of these taxes, the Government were to credit them to a reserve, export taxes may even prove a useful anti-inflationary weapon. We have argued that export taxes are liable to harm the competitive position of local producers by reducing their total profits. Producers could, however, be compensated for this if the proceeds of boomtime export taxes are used to subsidise prices in the depression. The total profits of producers would thus be maintained over a period. Applied in this way, the export tax can become an effective weapon for a stabilization programme. The conserving of the proceeds of the export duty in the boom would have the effect of building up the country's reserves of foreign exchange. This would make possible a higher level of real incomes during a depression than is otherwise likely. There are, of course, other ways in which a stabilization policy might be implemented.[470] But if export taxes are to be levied it seems desirable that they be used towards some such end instead of being credited to current revenues. Since most of the areas under export crops in Ceylon are in urgent need of replanting, it might even be feasible to use some of the proceeds of the export taxes for the payment of subsidies or rebates to producers who undertake such replanting. This would, of course, reduce the funds available for stabilizing prices, but it would still ensure that the full benefits of the boom are transmitted to the export industries.

(b) The second notable feature of the post-war revenues is the expansion in the yield from import duties. We have seen that import duties had been periodically raised ever since the depression of the nineteen thirties. This process was continued during the early post-war years even though increased supplies from abroad

470. For instance, stabilization may be achieved through marketing boards which pay producers prices which are lower than world prices in the boom but higher than world prices in the depression. Again, overall budgetary surpluses and deficits may also serve the purposes of stabilization.

at higher prices were almost certain to raise the revenue at existing tax rates. When the Government decided on a budget surplus in 1945–46 it imposed a general surcharge on all imports and also increased the individual duties on petrol and tobacco. An even more drastic increase in import taxes took place in 1947. In that year Ceylon imposed rigid import controls in order to correct an adverse balance of payments situation. The curtailment of imports by quotas was accompanied by the levying of heavy taxes on the restricted articles. With the exception of tobacco no new duties were imposed on commodities entering into the cost of living index. But all other imports were grouped into three rough groups termed luxuries, general consumer goods and conventional necessities. High, medium and light taxes were then imposed on these respective groups.

It should be noted that though the import tax increases of 1945–46 and 1947–48 benefitted the revenue considerably, they were not imposed for the purpose of balancing the budget. There was, however, much to be said in favour of these measures. The artificial restriction of imports by physical controls would have led to a heavy pressure of demand on the limited supplies. In the absence of heavy taxes or effective controls this would either have resulted in high prices and swollen profit margins for dealers, or in scarcities and a thriving black market. The import taxes had the advantage of channelling some of the excess purchasing power into the coffers of the Government. At the same time, retail prices were not raised to levels very much in excess of what they were, in any case, likely to attain.

Devaluation and the Korean boom led to a progressive improvement in Ceylon's balance of payments and soon the country was accumulating sizeable reserves of foreign exchange. In response to the changed situation, the Government gradually liberalised its physical controls over imports and also relaxed some of its import taxes. Many of these taxes were reduced in 1950–51 and a further measure of reductions were introduced in 1951–52. In fact, by 1952, import duties were substantially back to their pre-1947 levels.

The following table details the yield of import duties from 1945–46 to 1949–50.

Yield of Import Taxes (1945–46 to 1949–50)
(Rs. million)

	1945–46	1946–47	1947–48	1948–49	1949–50
Revenues from duties on:					
Cotton yarn, twist and piece goods ..	3.3	6.0	8.2	8.2	7.2
Grain and flour ..	13.8	16.3	13.4	13.6	13.7
Kerosene oil and motor spirits ..	16.6	20.8	27.7	34.0	36.5
Malt liquor, wines and spirits ..	5.7	9.6	4.8	5.6	7.1
Sugar ..	10.8	14.3	11.2	11.9	14.9
Tobacco and cigarettes ..	46.0	43.9	40.0	36.5	34.6
Other goods ..	36.4	55.7	71.8	70.3	74.4
Total yield of import taxes ..	132.6	166.7	177.0	180.2	188.3
Overall rate of taxation of imports ..	19.0%	17.3%	17.8%	17.5%	16.1%

Source: *Accounts of the Government of Ceylon Annual.*

Note: The overall tax rate on imports expresses the total yield of import taxes as a percentage of the total value of imports for the corresponding calendar years.

The Government's post-war tax policy is reflected in the figures for the overall rate of taxation shown in the table above. In 1944–45 the overall tax rate stood at 15.9%. The rate rose to 19% in 1945–46 as a result of the legislative increases in import taxation during that year. In the following year the supply of imports expanded rapidly but since the legislative rates remained unchanged, the overall rate of taxation declined. In 1947–48 import taxes were again increases substantially, but the volume of imports was restricted by import control. The result was only a slight increase in the overall tax rate. Thereafter the overall rate continued to fall since legislative rates remained unchanged, whilst the total value of imports increased. We have argued elsewhere that this is a customary feature of periods of boom. Most of the important revenue earners in the import list are taxed at specific rates, and in times of prosperity the increase in total import values is due more to a rise in prices than to an expansion in quantities imported. We do not have the detailed figures for the years 1950–51 and 1951–52. But since the legislative tax rates were themselves lowered in this period of exceptionally high import values, we may be certain that the overall rate of taxation of imports has continued to fall.

The table above also suggests an improvement in the normally regressive character of import taxation. During the depression the bulk of the revenue from import duties was provided by the taxes on grain (including rice) and cloth. In the post-war period the duties on these articles were left unaltered, and, as we know, grain was even subsidised. On the other hand, petrol, tobacco and the general category 'other goods' (which includes a wide variety of commodities) were severely taxed and began to provide the major share of the revenue. In our study of wartime finance we noticed the remunerative nature of tobacco as an object of taxation. Tobacco was subjected to even higher doses of taxation during 1945–46 and 1947–48, but the gradual falling off in the yield from this source suggests that the taxes might possibly have overstepped the range of relatively inelastic demand. The revenue from tobacco was declining even after import controls were relaxed in 1949. The yield from the tax on liquor on the other hand seems to have revived with the liberalization of controls.

(c) The increase in the revenue from the income tax does not require detailed elaboration. It was due both to legislative increases in tax rates, and to the expansion in the total value of taxable incomes. Tax rates were raised in 1945–46 when the number of income ranges was increased by subdivision. Enhanced rates were imposed on the higher slabs.[471] In spite of these measures, the total yield from the income tax fell in 1946–47 on account of the decline in military expenditures. But it recovered thereafter with the growing expansion in export earnings. In 1947–48 the income tax on companies was raised from 20% to 25%.[472] There were no further changes in the income tax until 1950–51. In that year the minimum tax exemption limit for incomes was raised from Rs. 2,400 to Rs. 4,800 per annum. At the same time, rates of taxation were increased over all ranges of income that remained liable to the tax.[473] In 1951–52 there was a revision of the various deductable allowances for the purpose of affording greater relief to taxpayers. Both this measure and the raising of the minimum exemption limit were needed in order to correct the

471. The number of subdivisions were increased from four to six. The unit rate, or the rate on the lowest slab was left unchanged at 8½%, but all other rates were scaled upwards. cf. *Economic and Social Development of Ceylon, op. cit.*, Table XXV.

472. Non-resident companies had to pay 31%. The higher rate on non-resident companies was due to the fact that "their shares are not immovable property situate in Ceylon and therefore not liable to pay estate duty". *Hansard*, 1st December 1947, p. 428.

473. The unit rate on the lowest slab was raised from 8½% to 9%. The rate on the highest slab (over Rs. 100,000) was raised from 64% to 66%.

adverse effects of price increases, which reduced the real values of both tax reliefs and of money incomes.

(d) Lastly, there was the withdrawal of the excess profits duty, and the introduction of a new profits tax in 1948.[474] As we have already seen, the excess profits duty was introduced as a temporary tax during the war. The Act enforcing this tax was not renewed after its expiry in December 1946 but a dwindling revenue continued to come in from this source until 1949–50 on account of delays in assessments and arrears in payments. The profits tax was introduced to compensate the revenue for the decline in E.P.D. In announcing the new tax, the Finance Minister quoted precedents in both India, where a profits tax had recently been introduced, and the United Kingdom, where such a tax had replaced the National Defence Contribution. The profits tax was said to be considerably simpler to administer than the excess profits duty, and it was extended to include professions, vocations and 'gainful undertakings of every description'.

The tax was levied at a flat rate of 20%. But it was only payable on the surplus of profits above the minimum exemption limit of the higher of either Rs. 50,000 per annum, or 6% of the value of the capital employed. In 1951 the rate of tax was increased to 25%. The profits tax was, of course, made an allowable deduction in the calculation of net income liable to income taxation.

In view of the liberal provisions for exemption, the profits tax is, in effect, little more than a revised version of the former excess profits duty. Its yield in recent years has been considerably in excess of the returns from the E.P.D. in wartime. The divergence is partly due to the differences in rates, methods of assessment and aggregate profits between the two periods. But is also due, in part, to the limitations imposed on the old E.P.D. by the somewhat singular provisions relating to the deduction of export taxes. These provisions have not been incorporated into the new profits tax.

The introduction of the profits tax marks a permanent extension of the sphere of direct taxation in Ceylon's revenue structure. Such a development was, perhaps, to be expected in view of the progressive expansion in the Government's current budget, and the consequent

474. *Profits Tax Act*, No. 5 of 1948.

need to uncover new sources of revenue. It would, however, be apparent that the profits tax is, in its present form, particularly susceptible to cyclical changes. A sharp falling off in yields during periods of depression is more than likely. In this sense, perhaps, the profits tax bears some resemblance to the export duties.

The other tax changes in the post-war period were of a minor order. In fact, we need only mention the moderate increase in the rate of estate duty in 1948, and the 50% increase in the stamp duty on share transfers which had remained unaltered since 1909. The total increase in revenues from these sources was relatively insignificant.

We may conclude our survey of post-war taxation by comparing the increase in tax revenues with the course of the national income in money terms. As we have said before, the national income figures are only rough estimates, and we can only use the results that follow as rough approximations.

Taxation as a percentage of National Income

Year	*Gross National Income* (*Rs. million*)	*Tax Revenue* (*Rs. million*)	*Percentage*
1947	2,409	388	16.1
1948	2,762	467	16.9
1949	2,967	500	16.8
1950	3,501	533	15.2
1951[a]	4,670	737	15.8

Sources: National Income figures 1947 to 1950 from Statistical Abstract of Ceylon for 1951. The figure for '1951' is from the *Annual Report of the Central Bank of Ceylon for* 1951, p. 5.

Note: National Income figures up to 1950 refer to the calendar years, whereas tax revenues refer to the corresponding financial year.

(a) The National Income figure for 1951 refers, not to the calendar year, but to the Colombo Plan Year ending June 30, 1951. The figures for 1951 in the table are therefore not strictly comparable with the previous ones.

Our comparison between national income and tax revenues in wartime seemed to suggest that the share of taxation was falling during that period. The reversal of the position in the early post-war years, when the percentage of taxation increased, is readily understandable. During that period the growth of national income was restrained by the fall in military expenditure. At the same time there were a number of increases in taxation. Thus in 1945–46 there was a general raising of taxes for the sake of a surplus in the current budget; in 1947 export taxes were heavily raised with the partial return to free markets; and again, by the end of 1947, import duties were severely increased for balance of payments reasons. The percentage of taxation seems to have fallen markedly after devaluation and the Korean boom. This is explained by the fact that there were no substantial increases in taxation during the financial year 1949–50. In 1951, however, export taxes were raised still further, and the income tax was also increased over the higher slabs. In that year the share of taxation in the national income seems to have risen.

Both the figures shown here and the figures for wartime suggest that the 'built in' flexibility of Ceylon's tax structure is inadequate to ensure that tax revenues keep pace with national income in periods of boom. Unless taxes are increased by legislation, the share of taxation in the national income would tend to fall.

Public borrowing in the post-war period

In our study of the wartime budgets, we discussed the borrowing activities of the Government and noted the rapid expansion in the locally held national debt. A part of the proceeds of these wartime loans were spent on defence, but the major share was held in reserve for the financing of post-war development schemes. We have already seen how this latter purpose was fulfilled in the post-war years when loan fund expenditure increased rapidly. With the introduction of the Six Year Plan, the Government made known its intention of raising a further series of local loans totalling Rs. 400 million. This was partly implemented in 1950 after the establishment of the Central Bank which took over responsibility for the management of the public debt. The response to the post-war loans was very satisfactory. "Subscriptions were opened on November 1st, 1950, for two new loans, the first borrowing under the National Development Loan Act, No. 3 of 1950, which authorises the raising of a total of Rs. 400 million. One was a 3 per cent long term loan of Rs. 50 million maturing 1966–71, and the other a $1\frac{1}{2}$ per cent two year loan of Rs. 40 million. There were no sinking fund provisions for either loan. Lists were declared open for the two year loan for one month and for the long term loan for three months. The response of the market was extremely satisfactory, the short term loan was fully subscribed in two weeks and the long term loan in three weeks, which was a record for Ceylon ... also the short term loan was a new departure in Ceylon Government finance and found a ready acceptance in the market, especially by the banks.[475]

These developments increased both the total national debt of Ceylon and the rupee share of that debt. There has been no new borrowing from the London money market since the nineteen thirties. Indeed, the absolute value of the net sterling debt in recent years has been somewhat reduced through sinking fund contributions. The following table sets out the recent changes in Ceylon's public debt. It will be seen that in spite of the increased Government borrowing, the total size of the public debt is not as yet excessive when compared to, say, Government revenues.

Ceylon's Net Public Debt 1945–51
(Rs. million)

	Net-Sterling Debt	*Net Rupee Debt*	*Total*
1945 ..	93.4	248.8	351.2
1946 ..	88.6	288.8	387.4
1947 ..	86.6	309.2	395.8
1948 ..	82.3	320.2	426.5
1949 ..	80.1	363.8	460.1
1950 ..	75.7	366.0	520.3
1951 ..	73.3	471.7	574.9

Source: *Central Bank of Ceylon, Annual Report* for 1951, p. 60. Table 22.

Note: Net debt refers to the gross debt less sinking fund contributions. The above figures do not include the volume of Treasury bills outstanding.

In our analysis of loan fund expenditure we discussed some of the fiscal implications of increased Government borrowing. The expansion of the rupee debt, however, has one advantage. It has enlarged the scope for the execution of monetary policy by the newly-formed Central Bank. The existence of a large volume of Government paper would facilitate open market operations. Indeed, the Central Bank has already ventured into such operations on a small scale. "At various times (in 1951), the Bank both bought and sold Government Securities, but sales on balance exceeded purchases. The deflationary measures of open market

475. *Central Bank of Ceylon, Annual Report for* 1950, pp. 16–17.

selling operations and the reduction of bank-held short term Government debt partly accounted for the unusual stability of the money supply during most of the year."[476]

The overall effects of the Post-War Budgets

We are now in a position to assess the overall effects of the Government's budgets. We must see whether the budgets as a whole tended to aggravate or correct the adverse effects of the complex of forces influencing the post war economy.

Before we do this, however, we must draw attention to an interesting change in the Government's attitude regarding the proper functions of the budget. In the days of the Donoughmore Constitution, the Board of Ministers generally adopted a cautious and conservative approach which placed a high value on the successful equating of current expenditures with current revenues. By the end of the year, however, the 'New Economics' had reached Ceylon and had forced its way into budget speeches. In 1949, the Minister of Finance went so far as to announce a full employment policy for Ceylon. "For the first time," he said, "this Government starts by affirming that one of its primary aims and responsibilities is the maintenance of a high and stable level of employment. To achieve this, it affirms the second principle – its cardinal principle – that out of the national income a sufficient amount must be spent to enable the wages of the whole working community to be paid....... The Government, after estimating private expenditure, must then propose public expenditure which will suffice, together with the estimated private expenditure, to secure full employment."[477]

Such a statement, of course, does imply a misunderstanding of the properties of the Ceylon economy. On the one hand most of the employment in Ceylon during periods of boom is of the 'backward area' variety where the labour supply is in excess of the absorptive capacity of the existing stock capital. Once the existing capacity of the economy is extended to the fullest, employment would hardly

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476. *Central Bank of Ceylon. Annual Report for* 1951, p. 13.

477. Minister of Finance, – "A Full Employment Policy" – (Budget Speech 1949–50), published by the Department of Information, Colombo, p. 19.

respond to further increases in total demand.[478] On the other hand, an increase in internal incomes and demand will not by itself greatly stimulate employment in the export sector since such employment is for the most part externally determined. An internally generated expansion in domestic incomes and expenditure can only lead to increased imports and balance of payments difficulties.

No attempt was made, fortunately, to implement a policy on the lines suggested in the budget speech. In the post-war years the Government did, on occasion, incur surpluses and deficits in the current budget. But these were caused by factors other than the direct attempt to secure full employment. The overall results of the budgets are examined below. Since the post-war period was, in general, a period of high incomes and inflationary pressure, overall surpluses tended to exert a corrective influence, whereas deficits were liable to aggravate the position. One noticeable factor, however, was that deficits in the current budget did not cause as much concern as they would perhaps have done in earlier periods. This may, presumably, be ascribed, in part, to the influence of the 'New Economics'.

In the table below, we repeat the practice adopted in previous chapters. Total Government expenditures are obtained by adding the current budget expenditures, as corrected for food subsidies, with total loan expenditures. The total revenues of the Government, consisting of both tax and non-tax revenues, are then deducted to leave the residual overall deficits or surpluses. The official current budget deficits and surpluses are also shown below for purposes of comparison.

The table above indicates quite clearly that the overall budgets of the Government were consistently in deficit during the post-war

478. During the war employment was at a high level because the military authorities directly employed a large number of persons. This was undoubtedly the answer to the problem which seemed to perplex the Minister of Finance. "The Government has increased its expenditure which was Rs. 250 million in 1944, to Rs. 666 million in 1948, and though the total monies expended in Ceylon has increased from Rs. 685 million in 1944 to Rs. 719 million, it would seem that this increase has not created full employment, because the direction of spending has not been properly chosen or that there are some causes of which we are unaware and which keep away employment although money was spent on a larger scale in 1948 than in 1944." – *ibid* p. 21.

Overall results of Post-War Budgets (1949–50 to 1951–52)
(Rs. million)

	1945–46	1946–47	1947–48	1948–49	1949–50	1950–51(a)	1951–52(b)
Total expenditure inclusive of loan expenditure	386.3	527.1	614.5	670.0	718.8	883.5	1,243.9
Total Revenue	383.3	461.2	540.6	576.1	623.3	836.0	909.8
Overall surplus or deficit	−3.0	−65.9	−73.9	−93.9	−95.5	−49.5	−334.1
Official current budget surplus or deficit	+70.4 (+33.0)	+55.8 (—33.8)[1]	−81.4 (−3.6)	−28.2	+60.1	+99.2	+11.2

(a) Provisional

(b) Estimate

Note: As mentioned elsewhere, food subsidies were excluded from current expenditures until 1947–48, when the total losses for previous years were nominally debited to the 1947–48 budget. The official accounts, therefore, give an incorrect impression of the net results of the current budget for these years. The figures in brackets show the official current budget surpluses and deficits when corrected for this factor.

period. In some years the Government made a conscious attempt to secure a surplus in its current budget. But the effects of even these efforts were nullified by increased loan expenditures. In 1945–46 the overall budget was almost balanced on account of the deliberate measures to create an excess of current revenues over current expenditures. But during the three succeeding years even the current budget was in deficit. As we have already seen, the food subsidies were largely responsible for this feature. During the period of intense boom, following devaluation and the Korean war, the current budget was again in surplus, but the corrective influences of this were more than offset by loan expenditures. Loan expenditures on a scale approximating to Rs. 345.3 million are contemplated for 1951–52. At the same time the current budget surplus is expected to fall to Rs. 11.2 million. If these expectations are realised, there would be serious repercussions on the balance of payments since all the economic indices point to a reversal of the Korean boom. On the other hand, recent precedents suggest that actual loan expenditures may fall short of the estimates, since various bottle-necks inevitably delay the execution of development projects.

We may conclude, from the figures above, that Government finance played a significant part in aggravating the growing balance of payments deficit during the immediate post-war years, 1946 and 1947. In 1948 the adverse balance of payments was corrected by import control. During that period the Government deficit would have tended to intensify the inflationary pressure on the restricted supply of imports entering Ceylon. Devaluation and the Korean boom saw an improvement in the balance of payments and a relaxing of controls. During this period, again, Government finance tended to aggravate the general expansion in incomes although the budgetary deficits were insufficient to prevent an accumulation of external assets. The overall deficit was, in fact, considerably reduced during 1950–51.

CHAPTER IX

CONCLUSION

Our three studies of the contrasting phases of depression, war and post-war prosperity, have given us a fairly detailed picture of the impact of cyclical forces on the Ceylon economy. We have observed the principal properties of the country's fiscal structure and noted the ways in which the latter has responded to these varied and opposite forces. It now remains for us to consider in a general way the scope and limitations of fiscal policy in the type of setting with which we are familiar.

The general nature of the cyclical process in Ceylon is clear enough. Fluctuations in the external world are transmitted to Ceylon through changes in the prices of exports. These changes lead, in turn to wide fluctuations in money incomes in the export sector. The upward or downward movement in money incomes is partially transmitted to other sectors of the economy, but the extent of secondary or induced changes of this sort are somewhat limited on account of the high propensity to import.

The fluctuation in money incomes is usually accompanied by fluctuations in real incomes or the physical quantities of goods and services available for consumption and investment. A part of these real incomes are provided through domestic production, but a substantial part is imported from abroad. The volume of imports tends to fall in the depression and rise in the boom because the prices of imported goods do not usually change in the same proportion as the prices of exports or export earnings. In the depression the terms of trade tend to move against Ceylon, whilst the movement is generally reversed in periods of boom.

It is important to note, however, that the fluctuation in total real incomes or at least in the volume of imports, is usually much less severe than the fluctuation in total money incomes or in export earnings. One of the main reasons for this is that the movements in the terms of trade are themselves limited because both export and import prices generally move in the same direction. Another reason is that the country increases its savings in the boom and then draws on these savings to sustain its imports in the depression. The contrast between the range of fluctuations in the volume of imports and in money incomes through prosperity and depression is reflected by the fact that whilst the import volume index fluctuated between a minimum of 83 points and a maximum of 133 points in 1932 and 1950, the index of export values ranged from 68 points to 558 points over the same period.

But though the fluctuation in total real incomes is comparatively moderate, the cyclical process in Ceylon is marked by somewhat violent shifts in the distribution of real incomes, between the various sections of the community. This is primarily due to the fact that the wide fluctuations in money incomes are themselves unevenly distributed. During the depression the export sector bears the main burden of the fall in money incomes, and large numbers are thrown out of employment altogether. The real incomes of the latter are obviously reduced to the lowest levels imaginable. On the other hand, it is quite probable that groups whose incomes are relatively fixed actually enjoy an increase in real incomes during the slump. Periods of boom usually witness the converse process. The export sector probably acquires an increasing share of the moderate expansion in total real incomes through higher earnings and greater employment, whilst fixed income groups may suffer a decline in living standards on account of the enhanced cost of living.

Our study of the Government budgets over the last two decades seems to indicate that public finance has, on the whole, tended to aggravate these cyclical disturbances. In the first place, the rise and fall in the size of the budget over periods of prosperity and depression have tended to intensify the movement in total money incomes. We have argued before that even a balanced budget has a probable income creating effect because a fair proportion of taxes are paid for out of potential expenditure on imports. A cut in the scale of the budget during a depression is therefore likely to exert a depressive effect on incomes even if these cuts were accompanied by remissions in taxation. Conversely an expansion in the budget in periods of boom is likely to increase local incomes even if the extra expenditure is matched by additional taxation. In the second place, the Government budgets have tended to reinforce the cyclical shifts in the distribution of real incomes. The cuts in expenditure during the depression were concentrated on the employment creating public works departments instead of being distributed evenly over the whole public service. The real incomes of dismissed Government workers were reduced to precarious levels, whilst the permanent salaried staff probably enjoyed an actual improvement in living standards. The process was reversed in the post-war boom when employment was stimulated by the development expenditures, whilst the high cost of living tended, in spite of the supplementary dearness allowances, to reduce the real incomes of the existing salaried staff.

We have now to consider whether fiscal policy could possibly be used in a different way so as to correct, rather than to intensify, these cyclical disturbances. It must, of course, be recognised that the external fluctuations might themselves be reduced through various stabilization measures undertaken either internationally or nationally at the centres of cyclical disturbance. Long term agreements and stabilization schemes for individual primary products may also contribute towards this end. A discussion of these measures is, however, outside the scope of this study. For our present purpose we shall assume that cyclical fluctuations continue to afflict Ceylon, and examine the scope for a compensatory fiscal policy.

Two implications of importance to fiscal policy follow from the special properties of the Ceylon economy. First, the relatively limited scale of induced changes in money incomes make it fairly certain that the Government cannot hope to correct a substantial downward or upward movement in money incomes by a relatively small injection into or extraction from the income stream. Second, a general injection of purchasing power in times of depression would not by itself necessarily restore employment in the sectors where such employment has fallen. If employment and incomes in the export sector have fallen because of a drop in external demand, it is easy to see that a general budget deficit, however large, would not in itself restore this employment. This is because the increased incomes generated by the Government would be expended in such other directions as imports. In order to offset the effects of a fall in export earnings the Government would have, specifically, to direct its compensatory expenditures towards the export sector. This it might presumably do by a policy of subsidies which would maintain employment by raising the returns to producers above the level of world prices. The maintenance of employment in the export sector would modify the distortion in income distribution that would otherwise take place.

But measures of this sort would soon invoke serious difficulties. It would hardly be possible, during a depression, to finance a large scale subsidy scheme out of taxes which would further reduce the incomes and expenditures of other groups. Our study of the depression showed that it was difficult enough to raise taxes to finance the Government's regular budget. If, on the other hand, a depression subsidy scheme was 'deficit financed' through credit expansion, it is not difficult to see that serious balance of payments problems might ensue. In periods of depression the country suffers a decline in its total earnings of foreign exchange. If the parallel downward movement in money incomes is offset or negatived by Government deficits, expenditure on imports would exceed the earnings from exports and the country's foreign assets would decline. We have then seen that Ceylon's foreign assets tend to be reduced in the depression even in the absence of Government deficits. The introduction of large scale deficit financing would obviously aggravate the problem much further.

The Government may attempt to arrest the decline in reserve through import controls. But this would lead to an inflationary pressure of demand on the restricted supply of imported goods. This, in turn, might result in a rise in production costs which would damage the economic position of producers in the export sector. The narrowing of profit margins may require a further increase in subsidies which would, again, intensify the inflationary position. A situation bearing some resemblance to this occurred during the war when money incomes were high and imported supplies were low. We saw that the Government's attempts to control the inflation were only partially successful. But during the War the dangers of inflation were limited by the fact that export prices varied directly with the costs of production.

It is, however, possible to conceive of a compensatory policy of a more modified type. The main obstacle to expansive measures in the depression is the adverse balance of payments. But the running down in foreign assets need not cause concern, or threaten the stability of the exchange, if the country was already in possession of sizeable reserves. This condition would be realised if the country were to accumulate substantial reserves of foreign exchange during periods of prosperity. The accumulated reserves of the boom could then be used to support expansive measures in the depression. We have seen that a process on these lines takes place spontaneously during periods of prosperity and depression. The community is able, partially, to sustain its expenditures in the depression by virtue of the restraint it has practised in the boom. It is possible for fiscal policy to reinforce this tendency. The Government can assist in the accumulation of foreign reserves by budgetary surpluses or other disinflationary measures during periods of prosperity. It would then be in a better position to initiate such ameliorative measures as export subsidies in times of depression. General budgetary surpluses are not, of course, the only means for enforcing such a policy. As we have remarked elsewhere, the funding of export taxes or the establishment of marketing boards would serve a similar purpose. The latter may not, however, be expedient on account of the existence of large production units organised through the medium of companies.

We do not intend to discuss the feasibility of variations in the exchange rate as a weapon of counter cyclical policy. As we have said before exchange manipulations are not likely to prove an efficient corrective to balance of payments problems. On the other hand a change in exchange rates may succeed in modifying the cyclical shifts in the distribution of incomes between the export sector and fixed income groups. There are, however, many dangers involved in such a course, and there is much to be said in favour of exchange stability for a country which looks forward to substantial foreign investment.

It should be clear that even a modified counter cyclical policy on the lines outlined above, would differ fundamentally from the type of policy that could be pursued in more advanced countries. In such countries fiscal policy seeks to sustain real incomes at a maximum level by continuously maintaining full employment. In countries like Ceylon a stabilization policy can only hope to average out real incomes between boom and slump, and to modify violent distortions in the distribution of these incomes. There might, of course, be some improvement in real incomes by virtue of the fact that output is possibly maintained at a higher level in both the domestic and export sectors. But it is the external price of export products which mainly determines total export earnings and hence the volume of imports. There is little that Ceylon can do about export prices and the terms of trade. A stabilisation policy must therefore largely content itself with cutting down the peaks in order to fill up the troughs.

But even a stabilization scheme on such limited lines runs up against another, and perhaps more important, objective of Government policy. This objective is economic development. There are some senses in which economic development and stability are complementary. In the long run increased development might reduce Ceylon's extreme vulnerability to external fluctuations, whilst stability may in turn encourage investment by providing greater security to investors. But from the point of view of conserving financial resources for stabilization, there is a hard conflict between the claims of development and of stability. An effective stabilization policy requires the country to restrain its consumption and other expenditures in the boom in order to husband its foreign assets for use in depressions. This process cannot be implemented if extensive development schemes which use up foreign reserves are undertaken in periods of prosperity. Only the most extreme austerity would succeed in reducing consumption to provide resources for both investment and stabilization.[479] Such austerity is hardly conceivable in a poor country where most of the expenditure on imports is directed to such necessities as food and clothing. Indeed a poor country would have a difficult task in securing, out of its own meagre savings, an adequate scheme of resources for either investment or stabilization.

There is really no solution to this difficulty outside of foreign borrowing or the severest economies. It may be urged that development expenditures be postponed until periods of depression when they may partially serve the purposes of stability. But a democratically elected Government could hardly be expected to let its urgent development projects await the onset of an uncertain recession. The emphasis we have laid on the conflict between development and stabilization should, however, underline the very real

79. "Divide the wealth you earn into four parts. Of that wealth one quarter should be spent on maintaining yourself and your family. Two quarters should be spent on future investments to your business in order to develop it; the fourth quarter you should save for a time of depression." Buddhist maxim, quoted by the Minister of Finance – *Hansard* 1st December 1942, p. 397.

importance of a cautious approach to the financing of development. Inflationary methods of finance tend to reduce foreign exchange resources. The country's capacity to modify future fluctuations might thereby be impaired to a greater extent than is necessary.

Our studies of fiscal policy in recent years have shown that the Ceylon Government has not, so far, pursued any sort of stabilization policy. As we have seen, the Government budgets have made no contribution to the building up of external reserves in the post-war boom. Ceylon accumulated substantial external assets during the war, but this result was the accidental outcome of the wartime restrictions on the supply of imports. Ceylon's external assets were partly reduced during the early post-war years but they were again replenished by the Korean boom. The recent reversal in the upward trend of exports and the expected deficits in the overall budget may, if continued, reduce the country's external assets to a mere working balance.

At the same time, it must be noted that recent developments in expenditure policy have tended to expand the scale of recurrent expenditures in the budget, and to thereby reduce the flexibility of public expenditure. A budgetary deficit in a period of depression might well arise even in the absence of compensatory policies. The existence of a Central Bank would, of course, facilitate the financing of such deficits, but an unrestrained use of this device may present unwelcome problems in the balance of payments.

APPENDIX

Items entering into the classification of revenues and expenditures used in the tables included in the text.

Expenditure

Each of the individual 'heads' of expenditure appearing in the official accounts have been regrouped, for the purposes of this study, into a few broad but economically meaningful categories as follows:

I. ADMINISTRATIVE DEPARTMENTS

(a) *Civil Administration*

H. E. the Governor, State Council, Chief Secretary, Audit Office, Civil Service, Clerical Service, Stenographers Service, Minister for Home Affairs, Provincial administration, Government Stores, Government Press, Superintendent of Census, Registrar General, Prime Minister, Cabinet Office, Senate, House of Representatives, Public Services Commission, Accountants Service, Department of Information, Department of Parliamentary Elections, Commissioner for Registration of Indian and Pakistani Residents, Minister without Portfolio, Provincial Administration Emergency, Department of Immigration and Emigration.

(b) *Revenue and Financial Departments*

Treasury, Department of Income Tax, Customs, Excise, Minister of Finance, Controller of Exchange, Currency, Loan Board, National Savings.

(c) *Law and Justice*

Supreme Court, Attorney General, Public Trustee, District Court, Court of Requests and Magistrates Court, Village Tribunals, Fiscals, Legal Secretary, Legal Draftsman, Judicial Service, Claims Department, Compensation Tribunal, Minister of Justice, Judicial Services Commission.

(d) *Police and Prisons*

Police, Department of Prisons and Probation, Government Analyst.

(e) *Defence*

Defence expenditure, Ceylon Defence Force, Ceylon Royal Naval Volunteer Reserve, Coast Lights, Minister of Defence and External Affairs.

II. ECONOMIC DEPARTMENTS

(a) *Public Utilities*

Minister for Transport and Works, Public Works Department, Public Works annually recurrent, Public Works extraordinary, Electrical installations to Government buildings, Civil Aviation, Commissioner of Motor Transport, Director of Transport, Department of Engineering Production, Colombo Port Commission, Ports other than Colombo, Post Office and Telegraphs, Basic Technical Training Institute, loss on railway, Minister of Posts, Salvage.

(b) *Agriculture, Irrigation and Survey*

Minister of Agriculture and Lands, Commissioner for the Development of Agricultural Marketing, Appeal Board Land Settlement Ordinance, Land Commissioner, Land Settlement Department, Survey Department, Department of Agriculture, Forest Department, Irrigation Department, Irrigation annually recurrent, Irrigation extraordinary, Agricultural Corps, Department of Land Development, Debt Conciliation Board, Department of Meteorology, Department of Wild Life, Valuation Department.

(c) *Food, Rural Development and Co-operation*

Minister of Food and Co-operative Undertakings, Food Commissioner (Control), Food Commissioner (Supplies), Registrar of Co-operatives, Department of Co-operative Development, Department of Rural Development.

(d) *Labour*

Minister of Labour, Commissioner of Labour.

(e) *Industry and Commerce*

Minister for Industries, Industrial Research and Fisheries, Department of Industries, Department of Mineralogy, Salt Department, Department of Fisheries, Minister of Commerce and Trade, Department of Commerce, Registrar of Companies, Government Tourist Bureau, Controller of Imports and Exports, Marketing Department.

III. SOCIAL SERVICES

(a) *Education*

Minister for Education, Education, Grant to University of Ceylon, Archaeological Department, National Museums, Ceylon Technical College, Zoological Gardens, Department of Government Archivist, Educational Publications Board.

(b) *Health*

Minister for Health and Local Government, Quarantine, Medical and Sanitary Services, Indigenous medicine.

(c) *Department of Social Services – ibid.*

IV. PUBLIC DEBT – *ibid.*

V. PENSIONS

Pensions, Widows and Orphans Pensions Office.

VI. LOCAL GOVERNMENT

Commissioner of Local Government, Local Government Services Commission, Department of Elections to Local Bodies, Department of Town and Country Planning.

VII. MISCELLANEOUS SERVICES

Dearness allowances, other miscellaneous expenditures.

VIII. EMERGENCY DEPARTMENTS

Emergency expenditure, Petrol Control, Director of War Supplies, Commissioner of War Risks Insurance, Port Requisitioning Agent, War Savings Movement, Civil Defence Commissioner (Food and Supplies), Director of Salvage, Controller of Textiles, Controller of Prices (Miscellaneous Articles).

Revenue

I. TAXES ON EXPENDITURE AND CONSUMPTION
Import Duties, Excise and Salt, Licences, Tax on heavy oil motor vehicles, Betting Tax, Tolls.

II. EXPORT DUTIES - *ibid.*

III. TAXES ON INCOME AND CAPITAL
Income tax, contributions by Government Departments in lieu of income tax, Estate Duty, Excess Profits Duty, Profits Tax, Stamps.

IV. NON TAX REVENUE
Port, harbour, wharf, warehouse and other dues, Fees of Court or Office and Payment for specific services, Medical services, reimbursements, Postal and Telecommunication services, Interest, annuities etc., Miscellaneous receipts, Land revenue, Land sales, Colonial Development Fund, War loan interest, surpluses in sinking funds, currency surplus, Post Office Savings Bank surplus, sundries.

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ERRATA

Page 10 – line 5: the word 'real' should be inserted between 'very' and 'difficulties'

Page 23 – line 22: the word 'no' should be inserted between 'general' and 'production'

Page 24 – line 28: this should read 'average total internal revenue of £97,722 for these years'

Page 41 – line 23: the word 'rapid' should be inserted in place of 'repaid'

Page 60 – Table of "Land Sales of the Ceylon Government". The title of the second column should be 'Acreage'

Page 63 – Note 162 – line 5: the word 'scarce' should be inserted in place of 'scare'

Page 93 – Note 219 – The reference should read SP XII and not SP XLL

Page 194 – Note 312 – line 7: the author's initials should be 'D.B.' and not 'D.P.'

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