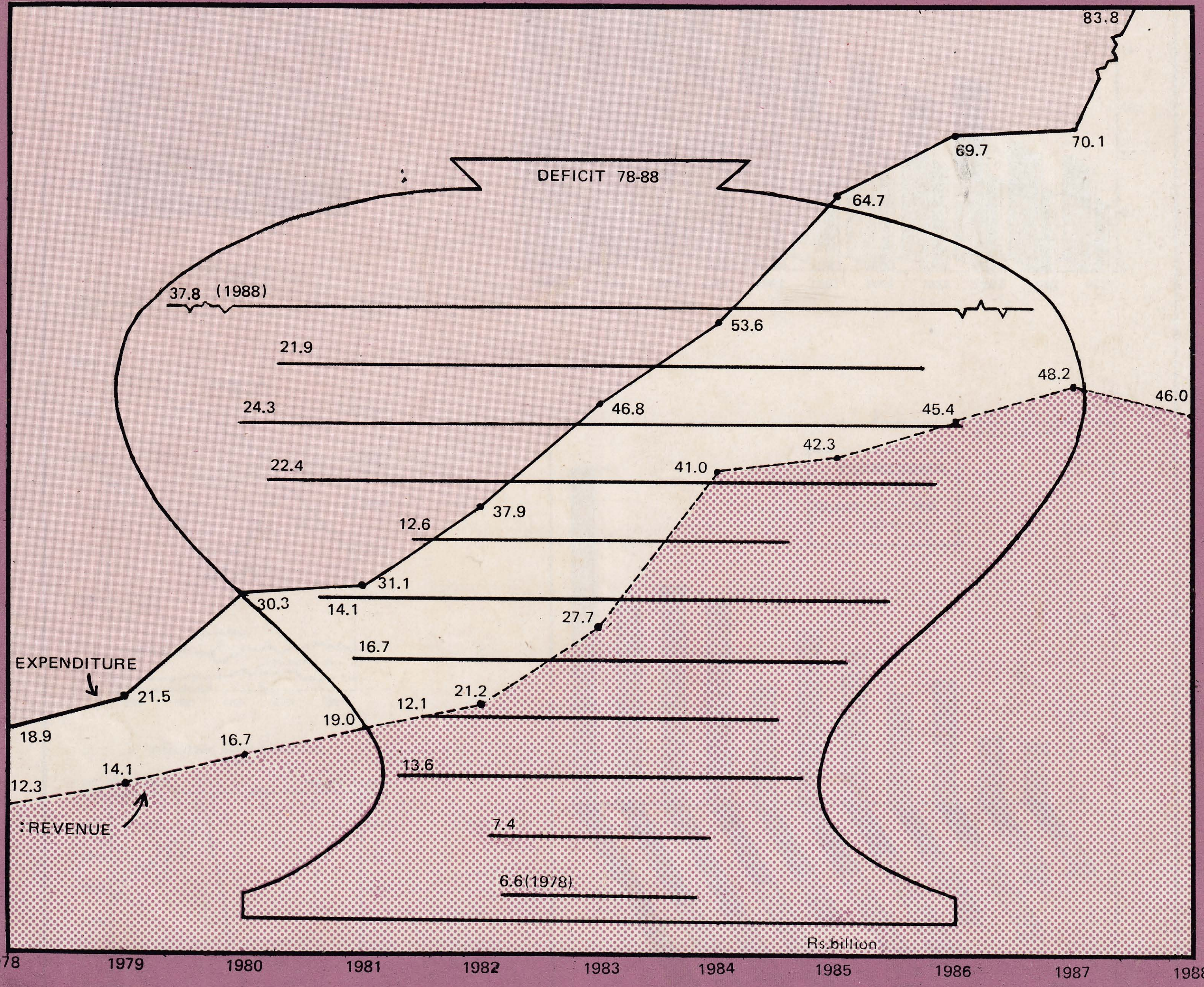
ECONOMIC REVIEW

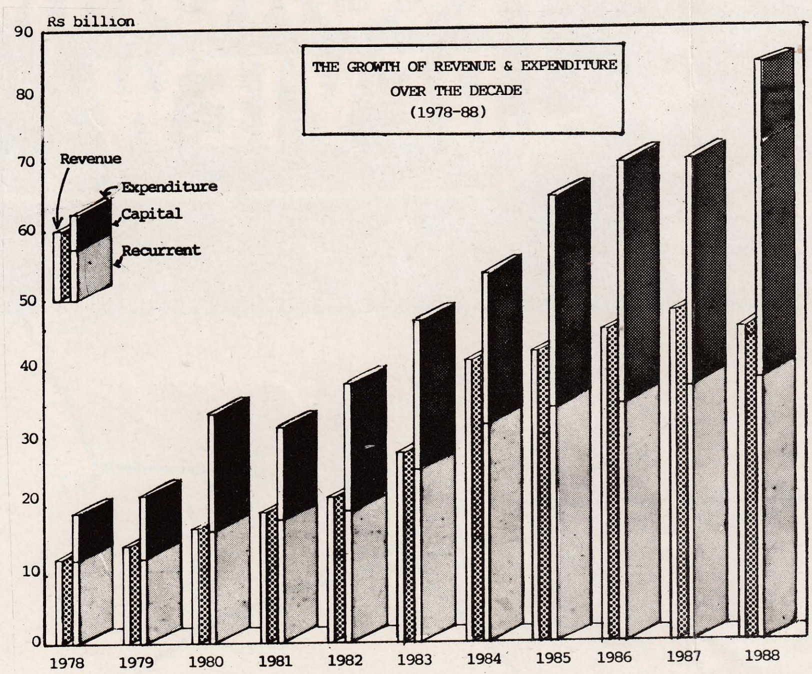
NOVEMBER 1987

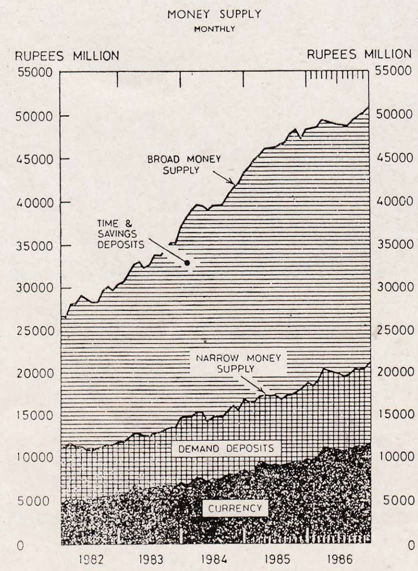


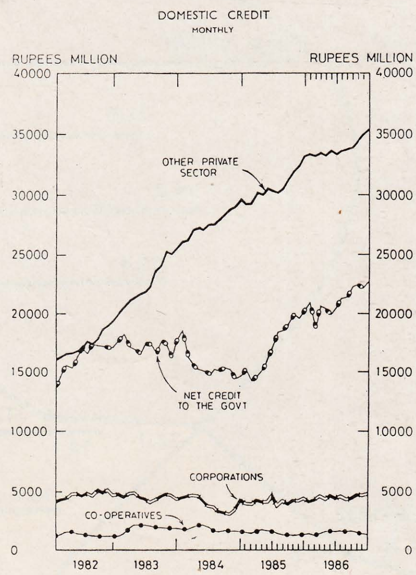
BUDGET 1988

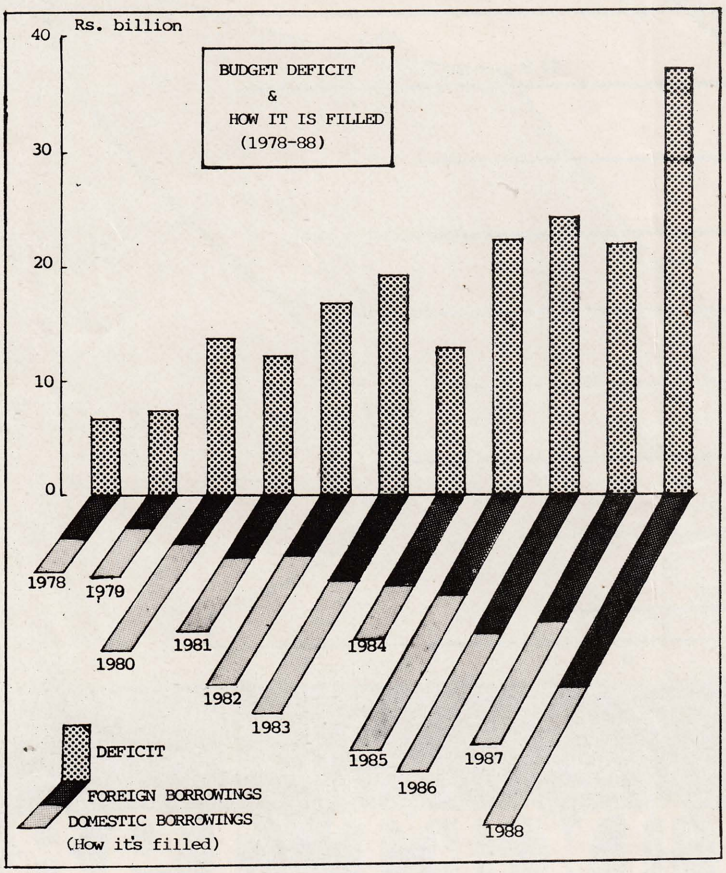
A PEOPLE'S BANK PUBLICATION

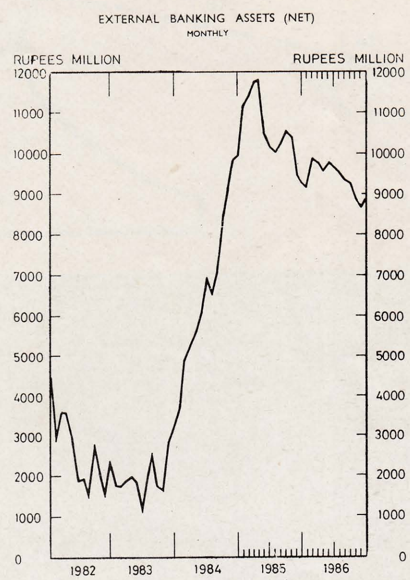
ECONOMIC INDICATORS











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COLUMNS

SPECIAL REPORT

FEATURES

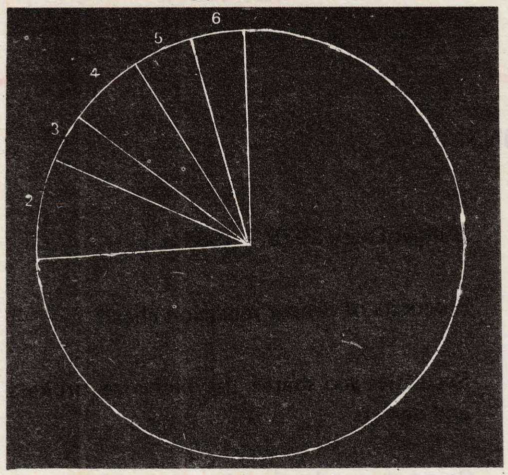
NEXT ISSUE

* Changes in the global economic system - Socialist and Capitalist doctrines re-examined at the roots
* The Mahaweli Project - a look back and into the future
* The stability of the private bus business - a survey
* What ails the undergraduate body

COVER

Sepalika Fernando

REVENUE

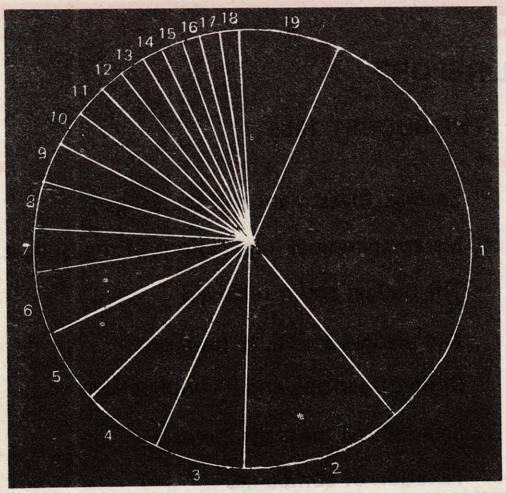


Revenue

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

EXPENDITURE

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



Expenditure

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

THE BUDGET 1988

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

This did not mean that the structural balances in our economy could not be tackled. Now that peace and stability was being gradually restored, he said, "the set backs in 1987 should increase our resolve to put our house in order as early as possible over the next three years. The medium term policy framework for 1988 to 1990 has therefore been revived in order that we may get back on track without any delay".

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

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

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

The evils of inflation, caused by excessive budget deficits, was another topic dealt with in detail. Among the four evils in inflation, the Minister listed were; firstly, inflationary price increases affect all people - rich and poor alike. Whereas the rich can look after themselves, because their profits and incomes generally tend to increase with inflation and they have the ability to hedge it, the poor especially the fixed income earners, are most vulnerable. The latter are the vast majority, and they will find their incomes getting wiped out.

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

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

The dangers of this situation are that the country could finally exhaust its revenue and foreigners would stop giving us credit. One solution would then be the imposition of import controls and exchange controls to limit imports and the outflow of scarce foreign resources. But the arbitary and bureaucratic solution of controls to a fundamental imbalance in the external payments situation has proved detrimental to the country in the past. The stark conclusion is that no country can run deficits in their balance of payments indefinitely. The Minister said "Whenever local inflation rates rise above those of our trading partners and competitors there is no alternate but to let the country's exchange rate depreciate to reflect the true relative economic conditions prevailing, if the external payments position is to be safeguarded. There is no alternative. A revaluation like that of 1976 borders on sheer lunacy. That is why, we have adopted a flexible exchange rate policy since we came to power".

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

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

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

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

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

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

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

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

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

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

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

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

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

There should be only modest local borrowing because we must leave a good part of domestic savings for the private sector, which is highly productive and generates more employment than the public sector.

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

Main Aspects of the Budget

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

These 15 measures outlined by the Minister are as follows:

1. Revive and restore economic growth from the present 3 percent to at least 5 percent in two or three years. We can do so, if we follow that programme.
2. Reduce the Budget deficit from 12 percent of GDP which is far too high to 9 percent GDP by 1990.
3. Reduce the deficit in the current account and the balance of payments from 9 percent of GDP to 6 percent of GDP in the same three-year period. You cannot do these things in one year.
4. Reduce inflation from the present 8 percent to 4 percent in the same three-year period.
5. Implement a new industrial policy which has been drafted by my Ministry in co-operation with the Ministry, particularly with a view to increasing exports.
6. Implement the tax reforms which I have outlined in my Budget Speech to increase investment and employment.
7. Implement the tariff reforms I have outlined in my Budget Speech. That is also to increase investment, employment and export in our land.
8. Reduce the losses of Public corporations. Many public corporations are doing so but there are still some which are white elephants. Reduce the losses of public corporations and their burden on the Budget.
9. Implement a series of reforms for the reorganisation of heavily indebted public enterprises like Air Lanka and the Shipping Corporation. Big reforms are necessary in these ventures. They are a great burden on the Budget and these reforms and re-organisations should be done.
10. Reduce import licensing to a minimum. It is a millstone round our neck.
11. Strengthen export promotion.
12. Facilitate investment procedures and cut out red tape and bureaucratic delays which investors, both local and foreign, still face from various departments — Not from the GCEC or the FIAC. You can get an investment approved even within two weeks by the GCEC or the FIAC.
13. Reduce cost of funds to investors. That should follow if the Budget deficit and inflation are reduced.
14. Improve accounting and expenditure controlling Ministries, departments and corporations. The Treasury is finding it extremely difficult to get proper accounts and accounts in time from certain government departments and corporations.
15. Implement a well thought out and planned programme of privatization.

SAVINGS, INVESTMENTS AND THE BUDGET

S.S.Colombage
Deputy Director, National Planning Division, Ministry of Finance & Planning

Low level of savings has been a major constraint to economic growth in Sri Lanka as in the case of many other developing countries. National savings as a ratio of Gross Domestic Product (GDP) in Sri Lanka was only about 14 per cent during the period 1978-86. Unless national savings are supplemented by foreign savings in the form of foreign loans and grants, the domestic investment will also remain at a low level and will restrain growth. Therefore, a consensus effort has been made in the successive Budgets in the past decade to push up domestic investment by means of absorbing foreign savings through the current account deficit of the balance of payments. Thus, the domestic savings gap has been filled by foreign resources and the gross domestic investment as a ratio of GDP was maintained around 24 per cent as against a savings rate of 14 per cent during 1978-86.

Continuing the recent trend, the Budget for 1988 indicates a further increase in savings arising from government fiscal operations. Government savings (or dis-savings) are equivalent to the Current Account surplus (or deficit) of the Budget. The Current Account surplus (or deficit) can be defined as the difference between the total government revenue and recurrent expenditure adjusted for under expenditure. The current account surplus for 1988 is estimated at Rs8.5 billion as shown in the following budgetary outturn; this is equivalent to about 3.8 per cent of GDP. These savings are sufficient to finance about one fifth of the capital expenditure in 1988. The balance sum of capital expenditure is expected to be provided through foreign aid and domestic borrowings.

It is important to note here that government savings have increased considerably since 1983. This was largely an outcome of the demand management policies adopted during this period. The Public Investment Programme envisages that government savings will remain around Rs. 7 billion per year during 1989-91.

The investment outlays presented in the Budget are closely tied up with the development projects identified in the Public Investment Programme, 1987-91. This Programme envisages that the total public investment during the period 1987-91 will be about Rs.154,156 billion. Of this amount, about Rs.151,376 million will be provided through budgetary provisions. The capital expenditure is allocated to various projects in the sectors of agriculture, industries, human settlements and economic and social infrastructure. The present Budget has allocated financial resources to these projects for the fiscal year 1988.

Within the broad framework of macroeconomic strategy, the recent budgetary policies are based on the Medium Term Policy Framework introduced in last year's Budget Speech. This Framework was initially meant for the period 1987-89. The recent Budget Speech has drawn up a Framework on the same lines for 1988-90.

GOVERNMENT SAVINGS (CURRENT ACCOUNT SURPLUS) 1978–88

	(RS'MILLION)	PERCENTAGE OF GDP
1978	– 551	–1.3
1981	+ 200	+0.3
1980	–2421	–3.6
1981	–1493	–1.8
1982	–1422	–1.4
1983	+ 128	+0.1
1984	+5889	+3.8
1985	+4854	+3.0
1986	+7042	+3.9
1987	+5954	+3.0
1988	+4544	+3.8

Sources: *Central Bank of Sri Lanka, Annual Review 1986 Budget Speech,1988*

The basic objective of this Framework is to stabilise the economy mainly by means of reducing the deficits in the Budget and the balance of payments. For this purpose targets have been set for government revenue, expenditure and current account deficit of the balance of payments. It is expected that these policies help to enhance domestic savings and investment and thereby contribute to economic growth.

Under the Policy Framework announced in the recent Budget, the government savings are to be maintained at a reasonable level in the next three years by curtailing current expenditure. This will be achieved mainly by adopting measures such as cutting waste, reducing overstaffing, avoiding unnecessary activities and elimi-

BUDGETARY OUTTURN FOR 1988 (RS.MILLION)

Recurrent Expenditure	–41,760	
Less: Savings 2.5%	+ 1,044	–40,716
Revenue		+49,260
Current Account Surplus		+ 8,544
Capital Expenditure		–44,620
Net Lending on Advance Accounts		100
Overall Budget Deficit		–36,176
Financing of Budget Deficit		+36,176
1. Foreign Outright Grants		5,000
2. Foreign Project & Commodity Loans		17,600
3. Domestic non-bank Borrowing		11,000
4. Domestic Bank Borrowing		2,576

Source: *Budget Speech, 1968.*

nating unproductive subsidies. As part of this broad programme, a major reform in the Public Service is also to be implemented shortly in order to improve its efficiency and productivity. A reduction in the government capital expenditure to more manageable level is also expected for the next three years. The large public investment programme launched in the recent past to improve the infrastructure will taper off in the future years. However, a considerable amount of resources will have to be provided for defence and rehabilitation purposes in the near future on account of the civil disturbances in the Northern and Eastern provinces. The constraints the ability to restrict the government expenditure to a certain extent.

It is anticipated that the present budgetary policies will help to avoid pre-emption of domestic savings available to the private sector. It has been observed in many countries that growing budget deficits arising from huge government expenditure lead to absorb a large proportion of bank lendings to the public sector and thus, pre-empts resources from the private sector. Also, government borrowings from the banking sector is inflationary. These repurcussions are found to be unfavourable to savings and investment activities in the private sector. In view of these considerations, it is planned to reduce the budget deficit gradually under the Medium Term Policy Framework. Accordingly, the budget deficit (excluding grants) is expected to be reduced from 12 per cent of GDP in 1987 to about 9 per cent by 1990. When grants are taken into account the budget deficit is to be reduced from 9.5 per cent in 1987 to 7 per cent in 1990.

This improved budgetary performance is expected to be achieved mainly by means of government expenditure controls. In terms of the Policy Framework, the government expenditure is targetted to fall from 33 per cent of GDP in 1987 to 29 per cent by 1990. However, the government revenue is expected to be around 20 per cent of GDP throughout this period.

In the background of these policy measures, it is envisaged in the Budget Speech that the private sector will take an active lead in the economic growth process by mobilizing more savings and effecting higher investments. The role of the private sector in these activities will be facilitated by a carefully planned privatization programme and improvements in money and capital markets.

These measures are expected to ease the pressures on the budget in the promotion of domestic investment. The level of domestic investment is projected to rise from Rs.45 billion in 1987 to Rs.68 billion in 1991 in terms of the latest Public Investment Programme. An increasing proportion of this total investment is to be borne by the private sector during this projected period. The present share of the private sector in domestic investment is about 38 per cent and the balance 62 per cent is financed by the public sector. It is envisaged that the private sector would bear about one half of the domestic investment by 1991 thus reducing the burden on the public sector. Domestic investment will be about 21 per cent of GDP in 1991 as against a savings rate of 18 per cent. The resulting domestic savings-investment gap to be financed by foreign resources will decline from the present level of 8 per cent of GDP to a mere 3 per cent in 1991. The rate of economic growth is expected to recover from about 3 per cent in 1987 to about 5 per annum in 1988-91.

The theme of these macroeconomic targets is to sustain a higher growth momentum while maintaining stability. This is to be achieved through an increased mobilization of domestic savings and a carefully designed expansion of the private sector in investment activities. A firm commitment to achieve these objectives is reflected in the present Budget.

MACRO-ECONOMIC IMPLICA-

P.B.Jayasundera

Ministry of Finance and Plannıng

The Government Budget is a financial plan showing an estimate of Revenue and Expenditure and the manner in which surplus is disposed of or a deficit is financed in a given time period. The Revenue - Expenditure-financing process of the Budget strongly influences the economic activities of the country. Mobilization of resources through tax and non-tax sources as well as through borrowings and allocation of these resources through expenditure programs influences overall economic activity by altering the resource allocation and redistribution of income and wealth among different income groups of the society. In this process the budget also influences prices, interest, exchange rate, employment and income.

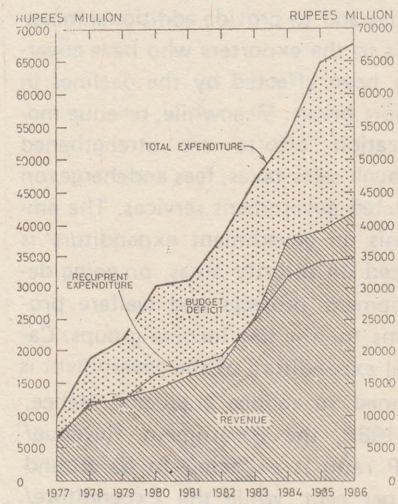
Hence, the budgetary policy alone or with the help of other policy measures can be used to achieve social and economic objectives in a variety of ways. For instance, it can introduce measures to increase the rate of savings and channel them into productive areas. Similarly, measures can be introduced to eliminate distortions in relative prices and designed to maintain stability in prices by minimising fiscal imbalances. Since these objectives are not mutually consistent and difficult to achieve simultaneously, policies have to be designed more often, with a view to achieving most important objectives. For instance, though rapid economic growth is a primary objective of a developing country like Sri Lanka, it cannot be pursued without giving due consideration to other development objectives such as welfare and income redistribution. However, the latter objective cannot be achieved without channelling sufficient resources to achieve an adequate rate of economic growth and employment. Both these objectives on the other hand could also be self-defeating ones unless adequate consideration is given to the importance of stability in prices, interest rates, exchange rates and balance of payments.

Sri Lanka witnessed sizeable budget deficits in recent years. For instance the average budget deficit for the period 1985-1987 was 12 per cent of GDP. The basic cause for a higher budget deficit is due to the tendency for government expenditure growth to outstrip growth in government revenue. Although, Government revenue was increased over 20 per cent of GDP, keeping government expenditure in check was a problem largely due to the escalation of defence related expenditure during the last few years. Although, a large part of the deficit has been financed by foreign and domestic non-bank sources as shown in table 1, borrowings from the banking system also has been a regular feature in recent years.

The higher budget deficit has a decisive impact on the economy. Firstly, the deficit financed from banking sources tends to increase the money supply in the economy exerting pressure both on prices and balance of payments, leading to a frequent loss in external reserves. In this context, maintenance of a stable exchange rate becomes a difficult task. In order to minimise the adverse consequences of liquidity effect of the budget, monetary policy is required to adopt a restrictive stance. However, this leads to higher interest rates which in turn affect private sector investments. Secondly, a higher deficit financed by foreign borrowings leads to an accumulation of foreign liabilities which in turn creates a debt service burden on the economy. Thirdly, a higher deficit also tends to pre-empt available resources to the private sector, and raise interest rates which in turn affect investment adversely.

Therefore, it is necessary to reduce the budget deficit to manageable proportions in order to achieve social and economic development objectives. For this purpose, mere increases in tax rates, or reduction in expenditure are not adequate. Instead, far reaching policy measures are necessary to expand the tax base and to rationalize government expenditure programs. Simplification of taxes, reduction in

GOVERNMENT REVENUE AND EXPENDITURE



the tax burden and improvement in tax administration can be useful to expand the tax base and at the same time minimise tax avoidance and tax evasion. Government expenditure can also be checked by selecting priority areas of social and economic development and through an effective fiscal monitoring system. Through these efforts borrowing requirements of the government can be reduced so as to contain debt service payments and provide more resources to private sector economic activities. It would also be of substantial assistance to ensure the stability in macro economic variables.

Budget for 1988

The Budget for 1988 carries as one of its main objectives the importance in the fiscal management and is designed primarily to enable the government to reduce its budgte deficit on a gradual basis, in order to achieve a sustainable level of economic growth and maintain financial stability and at the same time achieve a viable balance of payments position. For this purpose the budget is intergrated into a medium term policy framework to be carried out in the period 1988-1990. In essence the budget for 1988 laid a foundation for the medium term policy framework by setting initial targets for macro economic variables.

The main features of the proposals in the 1988 budget were the measures to simplify income taxes and import

TABLE 1

BUDGETARY COMPONENTS

(FIGURES ARE GIVEN AS PERCENTAGE OF GDP)

	1985–87 (Average)	1988
1. Government Revenue	21.3	20.4
2. Recurrent Expenditure	19.6	17.9
3. Government Savings (1–2)	1.7	2.5
4. Capital Expenditure	13.6	14.1
5. Overall Deficit (4–3)	11.9	11.6
6. Foreign Grants	2.2	2.2
7. Deficit after grants (5–6)	4.4	5.5
7.1 Foreign loans	4.4	5.5
7.2 Domestic borrowing	5.3	3.9
O/W Bank financing	2.2	1.1

Source: *Central Bank of Sri Lanka.*

duties and to provide additional incentives to the exporters who have adversely been affected by the declines in export prices. Meanwhile, revenue mobilization efforts are strengthened through sales taxes, fees and charges on selected government services. The emphasis on government expenditure is placed on priority areas, on-going development projects and welfare programs for the low income groups. Capital expenditure of the government is planned to reduce gradually. Hence, in 1988, the government Revenue/GDP ratio is expected to be around 20 per cent, while the Expenditure/GDP ratio is to be around 32 per cent.

As shown in table 1, the projected budget deficit for 1988 is 11.6 per cent, which is slightly lower than the average deficit for the period 1985-1987. Although the overall deficit/GDP ratio is 11.6 per cent, the borrowing requirements of the budget is 9.4 per cent of GDP, as foreign grants amount to 2.2 per cent of GDP in 1988. In financing the deficit, foreign loans are expected to contribute 5.5 per cent of GDP. Hence, resource requirements from domestic sources will decline to 3.9 per cent of GDP in 1988 from 5.3 per cent of GDP in the 1985-1987 period. Because of the reduction in the use of domestic resources for financing purposes, Bank borrowings in 1988 will be about 1 per cent of GDP as against 2 percent in the 1985-87 period. Hence , the inflation potential of the budget, resulting from liquidity creation, is reduced in the 1988 budget. Adjustments towards lowering budget deficits and at the same time towards reducing the recourse to Bank borrowings will contribute to ensure macro economic stability and thereby to bolstering confidence in Sri Lanka's effort to accelerate its economic and social development.

BUDGET

1978 –

15 Nov.1977

The first Budget presented by Minister of Finance and Planning, Mr. Ronnie de Mel introduced far reaching measures to liberalise the economy, including abolition of import and exchange controls, allocations and licensing procedures, and unification of the exchange rate. Total expenditure in the Estimates was Rs.18.9 billion and total revenue was Rs.12.3 billion, leaving a budget deficit of Rs.6.6 billion to be financed by foreign resources Rs.3.8 billion (58%); and Rs.2.8 billion (42%) domestic resources.

15 Nov.1978

Carying forward the objectives and policies laid down in his first Budget the Minister announced more reforms and concessions in taxation, duties, social welfare and wage structures in his Budget for 1979. Public servants and pensioners were granted a 10% increase in consolidated salary subjected to a minimum increase of Rs.50 per month. A new Inland Revenue Act to simplify and rationalise taxation was proposed while tax incentives were introduced for Housing, Savings and Investments, and the five year tax holiday for small and medium scale industries further extended. Total expenditure in the Draft Estimates was Rs.21.5 billion and total revenue was Rs.14.1 billion leaving a budget deficit of Rs.7.4 billion to be financed by foreign resources Rs.2.9 billion (39%); and Rs.4.5 billion (61%) domestic resources.

14 Nov.1979

The third Budget afforded relief to the plantation sector with price supports for Tea, and increases in the rubber replanting subsidy and also for coconut new plantings and replantings. Export duties for certain minor export crops were also abolished. The rate of taxation on resident companies was revised and new broad based companies offered tax exemptions. The maximum marginal rate of income tax was reduced from 70% to 55% and value of immovable property frozen at the March 31 1977 value for wealth tax purposes. Total expenditure in the Draft Estimates was Rs.30.3 billion and total revenue was Rs.16.7 billion leaving a budget deficit of Rs.13.6 billion, to be financed by foreign resources Rs.4.1 billion (30%); and Rs.9.5 billion (70%) domestic resources.

5 Nov.1980

The fourth Budget imposed a once and for all surcharge of 19% on income tax payable by all persons including companies for the year of assesment 1980–1981. It made provision to grant every employee in government services and government pensioners an allowance of Rs. 70 per month from January 1981, as a special Cost of Living Allowance. The guaranteed price for a bushel of paddy was increased from Rs.40 to Rs.50 a bushel. A withholding tax of 2% was brought in respect of contracts relating to building and construction, and changes were announced to rectify existing anomalies in the Inland Revenue Act regarding small quoted business companies, export oriented industries, and capital gains. Automatic penalties on tax in default were increased from 25 to 50 percent. Total expenditure in the Draft Estimates was Rs.31.1 billion and total revenue was Rs.19.0 billion, leaving a budget deficit of Rs.12.1 billion, to be financed by foreign resources Rs.5.5 billion (45%); and Rs.6.6 billion (55%) domestic resources.

12 Nov.1981

The fifth Budget introduced a surcharge on income tax and wealth tax covering companies and individuals with taxable incomes, exceeding Rs.25,000 per year; a cessation of tax holidays on approved projects and withdrawal of tax exemption to foreign contractors. A withholding tax of 33.5% was introduced on income of foreign entertainers, and artists, a 15% tax on interest on Minor's Deposits schemes, and a 10% tax on interest of compensation payments by the Land Reform Commission. Turnover taxes were extended to business turnover on several categories of imported and local sales items and fees and charges of certain government institutions doubled. Total expenditure in the Estimates was Rs.37.9 billion and total revenue was Rs.21.2 billion leaving a budget deficit of Rs.16.7 billion to be financed by foreign resources Rs.5.4 billion (32%); and Rs.11.3 billion (68%) domestic resources.

8 March 1983

The sixth Budget was presented four months later than the usual budget. The authority for expenditure until the approval of this budget was granted by way of a Vote on Account passed in November 1982. The minister announced extension of tax relief from 5 years to 15 years for individuals constructing a house using their own capital while no approval to be granted for 100% invest-

The Budget and Foreign Aid*

Ronnie de Mel
Minister of Finance and Planning

The total estimated expenditure in this year's Budget amounts to Rs 83 billion. The total estimated revenue before foreign aid amounts to Rs 46 billion. The Budget deficit for 1988 therefore is Rs 37 billion. This shows that we spend over twice as much as we earn and that we are living beyond our means. I hope to bridge this Budget deficit in a number of ways. I hope to get Rs 5 billion as outright foreign grants and Rs 17 billion as foreign concessional loans with interest ranging from 0·5 to 3 percent, repayable over periods of 20, 30, 40 or 50 years. I hope to get Rs 11 billion from non-inflationary sources within the country such as loans from the National Savings Bank and the Employees' Provident Fund. I am still left with a deficit of Rs 4 billion: Rs 2 billion of which I hope to get from my revenue proposals and the remaining Rs 2 billion from inflationary sources, that is, by printing currency notes which I am reluctantly compelled to do.

I have got Rs 22 billion as foreign aid whereas Mrs Bandaranaike in her time got only Rs 500 million as foreign aid inspite of her being the leader of the non-aligned world. We have been able to do all this during the last ten years for the development of the country, to create employment for our youth and to continue to maintain welfare services like free health, free education and to give food stamps to the neediest sections of the people because we have been able to get increasing foreign assistance from all countries which Mrs Bandaranaike could not do.

DIARY

— 1988

ment relief and continuation of tax holidays allowed only for exports other than Tea, Rubber, and Coconut. A 5% duty was introduced on all items hitherto free of duty and turn over taxes on sales increased from 2% to 4%. Planting subsidies were increased. The guaranted price of paddy was increased by Rs. 5, to Rs.55 per bushel. Total expenditure in the Draft Estimates was Rs.46.8 billion and total revenue was Rs.27.7 billion leaving a budget deficit of Rs.19.1 billion to be financed by foreign resources Rs.7.5 billion (39%); and Rs.11.6 billion (61%) domestic resources.

16 Nov.1983

The seventh Budget increased the exemption limit for income tax from Rs.12000 per annum to Rs.18000 per annum and a change of the income tax slabs. It further reintroduced the withholding tax on dividends at 20 percent; and introduced a rehabilitation surcharge of 10% on income tax, and a rehabilitation levy of 1% on the gross remuneration of all employees in both public and private sectors. The private sector tea planting subsidy was increased from Rs.29000 to Rs.36000 per hectare for low grown tea and from Rs.35800 to Rs.43000 per hectare for high grown and medium grown teas. Total expenditure in the Draft Estimates was Rs.53.6 billion and total revenue was Rs.41 billion leaving a budget deficit of Rs.12.6 billion to be financed by foreign resources Rs.8.0 billion (63%), and Rs.4.6 billion (37%) domestic resources.

14 Nov.1984

The eight Budget further increased the personal income tax exemption limit from Rs.18000 to Rs 24000 and exemptions were introduced for dividend income up to Rs.12000, and terminal benefits from Rs.50000 to Rs.100000; while tax slabs were widened from Rs 25000 to Rs.50000; and interest on NRFC accounts exempt on tax up to 10 years. It reduced rates on on-resident companies from 55% to 50%. Turn over tax on petrol (gasolene) was increased from 4% to 20%. The threshold price for duty on coconut oil was increased from Rs.13100 to Rs.20000 per metric ton, while export duty on Tea and Rubber were reduced. Total expenditure in the Draft Estimates was Rs.64.7 billion and total revenue was Rs.42.3 billion, leaving a budget deficit of Rs.22.4 billion tobe financed by foreign resources Rs.8.9 billion (40%); and Rs.13.5 billion (60%) domestic resources.

13 Nov.1985

The ninth Budget raised the personal income tax from Rs.24000 to Rs.27000 while the maximum rate of tax was reduced from 55% to 50%. Tax bands were reduced from 11 to 5 percent. Railway charges were increased from 8 % to 30% and the airport embarkation tax rate increased from Rs.100 to 200. The guaranted price for paddy was raised from Rs.62.50 to Rs.70 per bushel. The total expenditure in the Draft Estimates was Rs.69.7 billion and total revenue was Rs.45. 4 billion leaving a budget deficit of Rs.24.3 billion to be financed by foreign resources Rs.12.1 billion (50%); and Rs.12.2 billion (50%) domestic resources.

12 Nov.1986

The tenth Budget announced that capital gains arising from the business of purchasing and selling property were to be taxed, and a 20% tax on interest income of provident, pension and saving funds, and 10% tax on interest income (in excess of Rs.27000) of thrift and savings societies. Abolition of the 10 year tax exemption time limit for NRFC accounts and tax exemption on capital gains on the transfer of ownership of shares in public quoted companies. Stamp duty on letters of credit, turst receipts and letters of trust were increased from Rs.1.00 for every Rs.1000 or part thereof to Rs.20.00 for every Rs.1000 or part thereof. Duty on tobacco was increased from Rs.603.50 per kg, to Rs.665.50 per kg, and a special levy of Rs.500 million made on the Petroleum Corporation. Total expenditure in the Draft Estimates was Rs.70.1 billion and total revenue was Rs.48.2 billion leaving a budget deficit of Rs.21.9 billion to be financed by foreign resources Rs.11. billion (51%); and Rs.10.8 billion (49%) domestic resources.

17 Nov.1987

The eleventh Budget announced a pay increase for public servants; annual licence fees on bookies and casino operators; and increased prices on arrack and cigarettes; a reduction on the maximum rate of personal income tax from 50% to 40%, and also a reduction in turnover taxes; and the imputation system in taxation of profits of companies and their shareholders. The total expenditure in the Draft Estimates was Rs.83 billion and total revenue was Rs.46 billion, leaving a budget deficit of Rs.37 billion to be financed by foreign sources Rs.22 billion (59.5%); and Rs.15 billion (40.5%) domestic sources.

We have been able to get all the Foreign Aid needed for the forward march of this country during the last ten years; and in the years to come foreign Aid amounting to Rs 80 billion or Rs 100 billion is needed to keep the country going. No other party can hope to get so much foreign aid as we have been able to get.

The Budget for 1988 is a Budget for 'Economic Recovery' and 'Economic Revival'. This is a new beginning and not the beginning of the end or the end of the beginning. Peace and Law and Order are absolutely necessary if we are to succeed. Since 1983 we have been a nation that has lost it's way. Now the time has come for us to steadfastly work towards repairing the damage caused since 1983, by increasing investment, growth and employment opportunities for our youth.

Some of the major aspects of areas proposed for consideration in my Budget Proposals for 1988 are (1) the medium term Economic Policy Framework for three years. (2) The medium term investment program for five years. (3) Reconstruction and Rehabilitation of the areas devastated by the ethnic violence since 1983 (4) Employment Generation - creating at least 500,000 jobs for the youth. (5) Administrative Reform, which includes a salary increase about ten times as large in nominal terms as any previous increase (6) Creating a share-holding democracy through a well thought out program of privatisation.

The two main points that our critics have advanced are that we depend too much on foreign aid and that the salry increase is inadequate. No country in the world has developed without foreign aid. It was the Marshall plan that helped all the countries that were devastated by the Second World War to develop so fast. If I did not get the sum of Rs 22 billion which I got as foreign aid I would have had to cut salaries and not increase them.

** From a speech at a seminar on the Budget. 1988. Organised in Colombo by the Organisation of Professional Associations.*

AID PLEDGES FOR RS. 15 BILLION MORE*

Ronnie de Mel, *Minister of Finance & Planning.*

"As a first step, my Ministry made an assessment of the damage that had occured as a result of the ethnic conflict with the assistance of a team of experts from the World Bank and our own officials both in my Ministry and the Ministry of Rehabilitation. This report was prepared in August when there was comparative peace in the land before the out-break of fresh hositilities in October and November. This report tentatively estimated the damage at Rupees 60 billion including losses in domestic production, tourist earnings foreign investment and additional outlays on defence.

"The physical damage to the infrastructure alone was estimated at around Rs.12 billion. Since these estimates were made, further damage has occurred in the country after the end of September. This additional damage may be tentatively estimated at about Rs. 3 billion, the actual damage may be more.

"The programme of reconstruction was clearly beyond our own financial resources. If we had tried to undertake this work without foreign assistance, we may well have taken decades to repair the damage. I therefore sought the assistance of the international community for this gigantic task.

"It must be appreciated that this reconstruction programme is of critical importance to Sri Lanka in not only strengthening and holding the peace but also strengthening and reviving the economy in the long run.

"So from all points of view, this Special Aid Group Meeting in Paris which has just been concluded was of supreme importance to the entire future of Sri Lanka.

"This meeting was a resounding success for Sri Lanka. We were able to obtain pledges of aid totalling Rs.15 billion. Nearly half this aid is in the form of out-right grants which we do not have to repay at all, not one cent either in the form of capital of interest. In actual terms Rs.7.3 billion are out-right grants. The balance is in the form of highly concessional loans, some with no interest whatsoever, others with interest of 1/2%, 1% or 2%.

"We are allowed to repay in 30 years, 40 years or 50 years with a ten years grace period. No country could have ever obtained better terms for reconstruction and rehabilitation after four years of ruinous civil war. The aid which we obtained surpassed all our expectations. When I spoke during the second reading debate on the Budget in this House a few weeks ago, I stated that we hope to get about Rs.9 billion at this meeting. We have actually obtained Rs.15 billion – i.e. 6 billion more than I expected. These pledges of aid are additional to the Rs.18 billion which we have already obtained in June this year for the normal development programme of Sri Lanka.

Therefore in the two meetings held this year, we have obtained a total of Rs.33 billion in aid pledges for Sri Lanka which is a record for this country in any single year. We have every reason to be happy that the international community still has confidence in Sri Lanka, despite everything that has happened in the last four years".

"I also thank the World Bank and the donor countries and organisations for taking the trouble to meet twice in one year to help our country which I think is rather unique for any aid receiving country. This must also be the highest volume of aid ever pledged for any country in a single year relative to its population, its national income or its GDP.

"When we compare this amount with the total revenue of the Government this year which is only Rs.41 billion and the total capital expenditure of Government this year which is only Rs.22 billion by any yardstick this is really substantial and unprecedented international support".

"The international community is prepared to assist us even more in the next six months if we are able to put our own house in order and restore peace in our land. I am negotiating with the International Monetary Fund for a Structural Adjustment Facility of Rs.12 billion which I hope to obtain in the next three months if possible. If this Government continues in power after the next election and if we also continue with the same sen-

Deficit Financing and Its Implications*

W.D.Lakshman
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A budget presented annually can be viewed from a number of different viewpoints. Depending on whose viewpoint one takes it may be pronounced good or bad. Focussing specifically on the budget for 1988, public sector employees might feel very happy about it at least for the salary increase promised. Similarly, for its various benefits to business, the business community might also be very happy with it. There might be others, who, for various sectarian interests would pronounce the budget unacceptable. Can one really rise above these sectarian interests and examine it objectively. It is clearly a difficult task; yet one ought to try to do it. Let me try,given the time constraint, to focus, as objectively as I could, on just one aspect of the budget, namely deficit financing and its implications.

sible economic and financial management, this Rs.12 billion which I hope to obtain from the International Monetary Fund can go up to about Rs.42 billion from the International Monetary Fund alone. This will help us to ensure a very viable balance of payments in the ensuing period.

"I am also negotiating with the World Bank and the Asian Development Bank for loans for industrial development amounting to about Rs.6 billion. This will develop small and medium scale industry and create widespread employment in our land. Most of this money will be for private sector industrial development and will create employment for our youth in a very big way. I also hope to obtain some assistance to improve the public sector industries which can be made viable.

** Extracts from a Statement in Parliament on the results of the special Aid Group meeting convened in early December to consider assistance for Sri Lanka's post peace accord reconstruction.*

The Minister Finance and the Government have been talking quite extensively about privatization, free market efficiency and advantages of these. Yet we have seen, under the management of Sri Lankan government finances, after 1977 an increasing involvement of the government in the economy.

I have absolutely no objection to it. In fact some of the "achievements" the government boasts about have come about through "big government". If one looks at the behaviour of the government budget over the last ten years or so, one cannot but be impressed by its remarkable expansion, achieved in the context of a lot of "privatization rhetoric". Those who are familier with economic history of various countries in the world would agree with me that within market-dominated structures, early development was generally combined with increasing inequality in society. We in Sri Lanka under the "open economy", ourselves experienced this situation but because of continuing "big government" and the continued maintenance of services like free education, free health, food stamps and similar schemes the conditions of the poor did not perhaps become intolerably bad. These conditions perhaps deteriorated but not very sharply so. This is one major reason why I do not object to "big government".

Yet there are certain aspects of expanding government activity in Sri Lanka over the recent past which arouses economists' concern. A main aspect of concern here is the consequent sharp growth of budget deficits. We have had a gradually increasing budget deficit since 1979. In this year the government started with an estimated deficit of Rs.10 billion which turned out to be an actual of Rs 12 billion. The actual budget deficit had gone up to Rs.22 billion in 1983 and Rs.28 billion in 1986. After 1986 it has been increasing and this year the forecast for 1988 is a deficit of Rs.37 billion.

The maintenance of a large government expenditure, without an increase, *pari passu*, of government revenue, is bound to raise enourmous financing problems. What happened over the recent past was that the growth of government revenue fell short of the growth of expenditure. Economists might tend to argue that running large budget deficits is not all that objectionable provided they are financed through non-inflationary sources. The present government seems to have tried its very best to finance its increasing deficits through such sources --particularly foreign assistance. This attempt has not succeeded all the time and money supply increased sharply over the period.

The inflation aspect of deficit financing is an important matter to be discussed but I wish to focus on the debt implications of deficit financing in this brief presentation. Even if the entire budget deficit is financed through foreign sources, i.e. even if the "inflationary" financing is considered totally absent, yet the debt problem would remain as a real problem. The total public debt over the recent past has grown from 78 per cent of GNP in 1978 to 84 per cent in 1980 and 98 per cent in 1986. More menacing has been the foreign public debt in relation to an aggregate like export earnings: 103 per cent of exports in 1978, 122 per cent in 1980 and 253 per cent in 1986. As per cent of total foreign earnings (exports plus service earnings plus private transfer receipts), external public debt rose from 88 per cent in 1978 to 159 per cent in 1986.

These are clearly grave problems, which emerged from the extensive deficit financing of the last ten years--problems all of us, nationally minded people, should be concerned about.

If the government takes increasing volumes of loans to finance deficits, it has to try to channel substantial proportions of those loan funds to productive activities in order to make the nation able to pay the loans it takes. If this happens we need not be too much concerned for our future generations who will eventually be bearing the burden of repaying today's debt. The increasing debt to GNP proportions and increasing external debt to exports proportions seem to indicate that this has not happened in the recent past to an adequate extent. This is why we ought to be concerned about this increasing resort to deficit financing and its debt implications. Particularly noteworthy is the sluggish growth of exports and other exchange earnings. The increase in the debt service ratio from 19 per cent of exports of goods and services in 1982 to 26 percent in 1986 is particularly disturbing in this context. Indications are that this ratio might go up further.

Let me conclude by referring to a certain continuing problem, a contradiction, which has affected government budgetary policy over the recent past. What I am referring to here is the contradiction between the revenue requirements and needs for maintaining a large public sector and the need for keeping private incentives high in a market - dominated strategy. Because of the latter requirement the, private sector would not be taxed heavily. On the other hand, a large public sector is required to prevent the erosion of the living standards of the general mass of people, in turn giving rise to the need to maintain government expenditure at a high level. These conflicting forces have been in operation on public finances of Sri Lanka over the recent past. Growing deficits, with their adverse debt and inflationary implications, have been perhaps the result of the unsatisfactory resolution of the above conflict between the two contradictory policy aims. Let us hope that there will be a satisfactory solution of this contradiction in policy at least in the years to come.

* *Prepared from a talk delivered at the Organisation of Professional Associations.*

Salaries and the Wage Increase

The absence of a substantial increase in wage levels of the government sector during the last few years, strongly necessitated a wage increase, among other measures, if public sector efficiency is to be revamped. As the Minister of Finance himself stated, inadequate salaries was one of the causes for the deterioration in standards in the Public Service. To quote the Minister "I am sure that all Hon. Members of the House will agree with me when I say that salaries at present paid to public servants are inadequate. This had led to several undesirable consequences for the Public Service of Sri Lanka. It has sapped Public Service morale. It has reduced the efficiency of the administrative machine and hampered the effective implementation of Government's development programmes. It has increased the level of corruption in the Public Services. It has made it increasingly difficult for the Government to attract and retain able and efficient officers, particularly in the professional and managerial grades of the Public Service. Together, these factors have triggered a process of administrative deterioration which, if not checked, will have serious consequences for the Government and for the country as a whole"

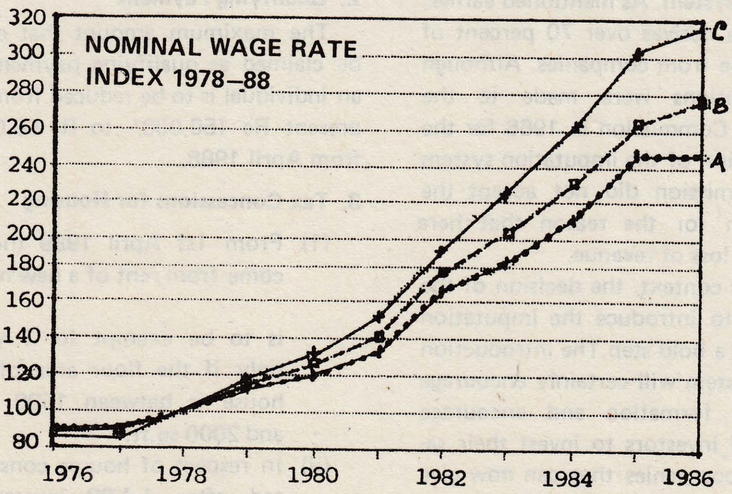
The administrative Reforms Committee in its report on salaries of Public Servants also attributed the prevailing inadequate wage levels of government servants as a contributory factor for reduction of efficiency in the public administrative system. If thus proposed a revision of salaries of government servants. The budget proposals for 1988 are "to pay each public officer with effect from 1st January 1988, one half of the difference between his present salary and the salary to which he is entitled under the new scheme and to pay the balance with effect from 1st January 1989...."

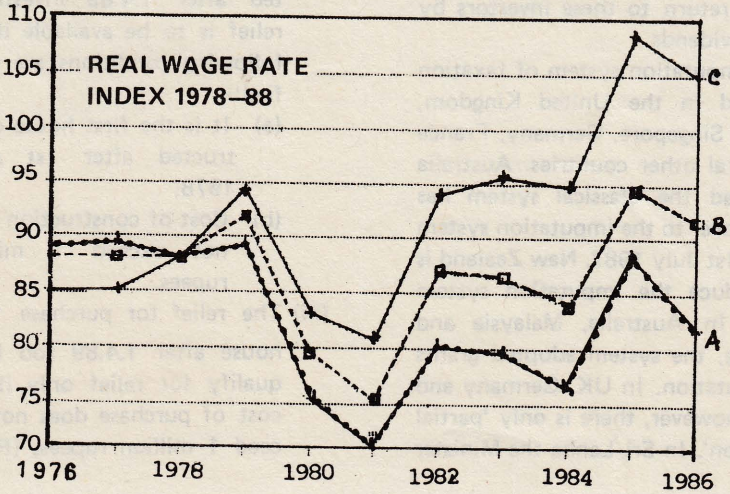
According to the nominal wage rate index numbers of government employees, prepared by the Central Bank of Sri Lanka, nominal wages of the government sector employees has increased considerably during the last ten year period, that is, between 1976 and 1986. The nominal wages of teachers; non executive officers, (clerical employees, skilled and unskilled); and employees); and minor employees' (skilled and unskilled); has increased by 177%; 214%; and 274% respectively during this period.

Such a high rate of increases in the nominal wages of government employees does not necessarily mean that purchasing power of these employees too increased at the same rate because of the continuous inflation prevalent over this 10 year period. To estimate the changes in their real salary income (purchasing power of their nominal salary income) it is necessary to deflate nominal salary index rates by a suitable price index. When these nominal salary index rates are deflated by the Colombo Consumer Price Index— the most suitable price index available for comparing salaries which can be used here as deflator— a different picture emerges of the magnitude of the increase in government employees real salary income over this 10 year period. Infact, teachers' real salary income have decreased by 8 percent; while with regard to the non executive officers, real salary income has increased marginally (by 4%) over this period. Only the minor employees' real salary income has increased by a considerable rate of 24 percent. However, it should be noted here that minor employees are the smallest category in number compared to the other two categories mentioned above and also this 24 percent increase covers a considerably long period of ten years. Accordingly teachers were the most adversely affected group during this ten year period.

When the changes in government employees' real salary incomes are observed (see diagrams) some other important features can also be seen in the changes of their real salary income over the last ten year period. Within this period minor employees' real salary incomes had increased even in those years where the real salary incomes of the other two categories did not increase; for example, in 1978 and 1983. This and the salary increase of the minor employees may be analysed by some as an attempt to reducing income disparity between minor employees' and other employees. When only teachers and non-executive officers are considered there is a clear trend in the changes of their real salary income over the recent years. After two years of decrease in their salary income in every third year their real salary income has increased. For instance, in 1979, 1982 and 1985 their real salary income has increased while in other years it has decreased. After the increase of their real salaries in 1985 there was a decrease in 1986; again another decrease in their salary income is expected in 1987, since there was no considerable salary increase during the year to overcome the effect of inflation' In 1988, after two years of decrease, their real salary incomes would increase because a considerable salary increase is expected from January 1988 according to the current budget proposals. Another significant feature is that during this period all these three categories of government employees have received their lowest real salary income in 1981 over this period. When, over the 10 year period, non executive officers and teachers are taken separately, in the 5 years from 1980 to 1984 they received lower real salary incomes than in any of the other years.

Although their real salary incomes have not decreased much over the last 10 year period all categories of government employees have been feeling the pressure of inadequate salaries and therefore they have been awaiting a considerable increase in salaries. The expectations for a higher salaryincrease is due to other factors as well. Among these, one factor is the expansion of their expenditure requirements on various types of goods and services, over the last few years. This was manily the result of the various economic and social changes that have taken place in the country under the liberalised economic policies. Another factor is the considerably higher increase of money income and thereby purchasing capacity of people in some other sectors (like the private sector employees and profit makers) compared to the government sector employees. A second factor can be partly explained by unequal distribution of increasing real GNP per capita between government sector employees and others. For instance, during the 10 year period (1976 to 1986) real GNP per capita has increased by 58 percent though the real salary income of government sector employees has increased at lower rates, varying from - 8 percent to 24 percent during the same period.





In this context a considerable salary increase for the government sector employees has become a prime necessity in order to increase the living standards of the government sector employees, to narrow the disparities in incomes between government sector salary earners and other sectors who earn much higher incomes compratively, and to increase the efficiency of the government administrative mechanism. More significant is the following note of warning struck by the Salaries Review Committee in its report: "Public servants require to be assured that their emoluments will not erode by increases in the cost of living. The sense of insecurity which would arise if this is not done would certainly affect the productivity and performance of the public service as a whole"

H.L.Hemachandra
Research Department, People's Bank.

TAXATION OF COMPANIES

P.Karalasingham
Attorney-At-Law- and Tax Consultant

The taxation of companies assumes great importance to a country like Sri Lanka because 70 percent of the income tax revenue comes from companies. From 1932 upto 1958 the system of taxation adopted in Sri Lanka for the taxation of companies was the imputation system. In 1958 with the introduction of the Kaldor system of taxation, the classical system was adopted. The Minister of Finance in his budget speech for 1988 has announced that as from 1st April 1988 companies will be taxed on the imputation system.

In the classical system of taxation companies are treated as seperate legal entities and are taxed on their profits. When the shareholders are paid a dividend the companies have to pay a dividend tax. Under this system there is what is called "economic double taxation". Under the imputation system companies pay only one tax and the shareholders receive credit for the tax paid by the company. The system is called the 'imputation system' because when dividends are paid it imputes or allocates to individual shareholders the profits and tax paid by the company in which they own shares.

Each of these systems has its relative merits and demerits. The classical system has the effect of discriminating in favour of debt rather than equity. New equity becomes more expensive than new debt because interest income is taxed only once, while dividends are taxed twice. Secondly, the double taxation of dividends could induce companies to retain rather than distribute their profits. Thirdly, the high tax burden under the classical system can inhibit the formation of companies, with a shift towards unincorporated business organizations, such as partnership. There are equally compelling arguments in favour of the classical system. In developing countries where the capital market is rudimentary, the necessary funds must come from within the enterprise itself as reserves. Under the classical system, companies are encouraged to build up reserves rather than distribute their profits as dividends. Another serious difficulty with an imputation system arises in the international context. Should foreign shareholders be given the same credit that is given to resident shareholders? If this is permitted, it would be at a very high revenue cost. The yield from the taxation of companies under the classical system is far in excess of the yield under the imputation system. As mentioned earlier, Sri Lanka derives over 70 percent of its revenue from companies. Although representations were made to the Taxation Commission in 1966 for the introduction of the imputation system the Commission did not accept the suggestion for the reason that there would be loss of revenue.

In this context, the decision of the Minister to introduce the imputation system is a bold step.The introduction of the system will certainly encourage company formation and encourage the small investors to invest their savings in companies that can now give a better return to these investors by way of dividends.

The imputation system of taxation is applied in the United Kingdom, Malaysia, Singapore, Germany, France and several other countries. Australia which had the classical system has changed over to the imputation system as from 1st July 1987. New Zealand is to introduce the imputation system shortly. In Australia, Malaysia and Singapore, the system adopted grants full imputation. In UK, Germany and France, however, there is only 'partial imputation'. In Sri Lanka the Minister of Finance has proposed a 50 percent imputation. The legislation giving effect to this proposal is to be introduced shortly and it is hoped that the shifting from the classical system to the imputation system will be done smoothly.

TAXATION MEASURES

Fouteen major taxation measures introduced with the Budget Proposals 1988 may be summarised as follows:

Reduction of the Maximum Rate of Personal Tax

The maximum rate at which individuals are liable to tax is to be reduced from 50% to 40% from the Year of Assessment 1988/89. The new slabs will be as follows:

First Rs 21,000	- 10%
Next Rs 24,000	- 20%
Next Rs 24,000	- 30%
Balance at	- 40%

2. Qualifying Payment

The maximum amount that could be claimed as qualifying payment by an individual is to be reduced from the present Rs 150,000/- to Rs 50,000/- from April 1988.

3. Tax Concessions for Housing

(1) From 1st April 1989 the Income from rent of a new house is to be exempt for 7 years only if the floor area of the house is between 1500 sq.ft and 2000 sq.ft.

(ii) In respect of houses constructed after 1.4.89 investment relief is to be available if the following conditions are satisfied:-

(a) It is the first house constructed after 1st April 1978.

(b) Cost of construction does not exceed 1 million rupees.

(iii) The relief for purchase of a house after 1.4.89 too is to qualify for relief only if the cost of purchase does not exceed 1 million rupees. (Relief upto Rs 1 million is irrespective of cost of construction or purchase).

(iv) Construction and sale of Houses and Flats- Sec.21of the Inland Revenue Act granting exemption from the sale of houses and flats by persons (both individuals and companies) is to be amended to grant a flat exemption of 75% of the profits on the sale. The floor area of 3000 sq. ft is however to be reduced to 2000 sq.ft. This proposal is to be effective from 1.4.88.

4. Imputation System of Taxation for Companies

In future companies will pay only one tax on the profits unlike as at present where they pay a refundable tax and a non-refundable tax. This system of taxation is called the imputation system. The present (existing) system of taxation is known as the classical system. In Sri Lanka, the imputation system of tax on companies was the system from 1932 to 1958. With the introduction of the Kaldor system, the classical system was introduced.

There is economic double taxation under the classical system. Company formation is discouraged. The Budget proposes to introduce a partial imputation system. Individual shareholders in receipt of dividends from companies will receive a 50% inputation tax credit of the tax paid by the company. (For a fuller discussion, see note above).

5. Inter-Companv Dividends

Under the present system if a tax holiday company A distributes a dividend to a company B which in turn distributes it to company C and C in turn distributes is to an individual shareholder, the dividend is not exempt in the hands of the shareholder. This is an anomaiy. The law is to be amended granting exemption right down the line

6. Withdrawal of Investment Relief

Under Section 31(7) of the Inland Revenue Act, if there is a change of ownership of shares in respect of which relief has been obtained within 5 years of the date of investment, additional assessments will be issued by the withdrawal of the relief. The section is to be amended as follows:—

Where only part of the investment is withdrawn then only a proportionate part of the tax relief granted will be withdrawn and not the entire relief.

7. Tax Incentives for Export Industries

(a) A"Transferable Tax Credit" scheme, T.T.C. as it is called, is to be introduced to replace the present tax holidays and export grants available to exporters. Actual implementation is still being studied and this is to be implemented later after a Committee appointed by the Minister prepares a report.

(b) Definition of the term 'export turnover' in the Inland Revenue Act to be amended to include sales of raw materials and intermediate goods to G.C.E.C. enterprises provided payment is made from monies drawn from F.C. B.U. i.e. payments in foreign exchange

8. Capital Gains

The period of ownership of gifted or inherited property is to be calculated from the date of the gift or from the date of inheritance and not from 1st April 1977.

9. Depreciation

Under the present law, depreciation is granted on the difference between the purchase price of the new asset and sale price of the old asset. This is to be amended to grant depreciation on the difference between purchase price of the new asset and the profit on sale of the old asset. This is to be effective on sales after1.4.88.

10. Taxation of Provident Funds and Terminal Benefits

(a) At present, there is a 20% tax on the investment income of provident funds excluding the income from government Securities. A member of the fund is liable on the income he receives as terminal benfits at retirement. This is to be amended as follows:—

From the terminal benefits received by a member will be excluded the portion attributable as represents the investment income which has already been taxed.

(b) Receipts from ETF (Employers Trust Fund) also will be liable to the concessionary rates of tax.

11. Non-Residnet Status of Individuals

The basis of determining non-resident status of an individual as contained in Section 67 of the Inland Revenue Act is to be amended.

The amendments contemplated are as follows:—

(a) A period or periods aggregating not more than 30 days in a year is ignored in determining non-resident status.

(b) An individual who became non-resident could become a resident if he or she spends an aggregate of more than 183 days in Sri Lanka during that year of assessment. (Assessment is not from date of arrival but year of assessment).

12. Time Bar for Assessment

There is a 3 year period for time bar if a person furnishes the return before 30th November. If he fails to furnish by that date, there is no time bar under the present law. This is to be amended as follows:—

If the person furnishes the return between 30th November and 31st March of the following year, the time bar is 5 years and not indefinite.

13. Accounting Year

Certain persons are allowed by the Commissioner-General of Inalnd Revenue to keep their accounts to a date other than the 31st March under Section 25 (3) of the Act. These persons however under the present law pay taxes on their income from 1st April to 31st March. This is to be amended by making those persons pay the tax also on the profits of the accounting year.

14. Turnover Tax

The changes in the Turnover Tax would include:

DEFENCE EXPENDITURE GIVEN PRIORITY

Ronnie de Mel
Minister of Finance and Planning

In his final reply at the end of the Committee Stage of the Budget debate the Minister (as reported in the Daily News of 25.12.87) emphasised the the significance he was compelled to place on defence expenditure, although it involved a curtailment of expenditure on development and also increasing the already heavy budget deficit which must inevitably lead to inflation. The Minister stated:

In spite of the serious budgetary constraints which I faced, I have acceded to each and every request made by His Excellency the President, in his capacity as Minister of Defence, for additional funds, both capital and recurrent, needed by the Armed Services to prosecute the war against the separatists. While the requests for budgetary funds made by other Ministers have been scrutinised and slashed by the Treasury, in order to reduce our budget deficit, the requests made by the Ministry of Defence were given utmost priority and took precedence over all other requests for expenditure. In fact we acceded to the requests for defence votes and supplementary estimates as and when required. Supplementary estimates for defence and security were the only estimates allowed. The figures speak for themselves. 300 million in your time 14000 million in ours. Over 400 fold. 430 times. In 1982, the year before the ethnic conflict escalated into violence, the total expenditure on defence was only Rs. 1 billion which represented 2.8% of the Government's expenditure, and only 1% of the country's Gross Domestic Product. Five years later, in 1987, defence expenditure has escalated nearly ten-fold to Rs.10.8 billion and accounted for 15% of Government's total expenditure, or 5.4% of the country's GDP. 20% of our budget without foreign aid. I am sure that the House will agree that this was a very rapid and substantial expansion. An expansion of a type almost unprecedented in any country.

I have, as I said, given the highest priority to meeting the financial requests of the military establishment from the limited budgetarv resources available to me. This did not mean, however, that I did not point out to the Government, and to the country, the severe effects which the mounting defence expenditure was having on the country's economy.

I would have been wholly failing in my duty as Minister of Finance if I had not done so. Let me explain what these adverse effects are. In the first place, the escalating defence expenditure has caused large and mounting fiscal deficits in Sri Lanka. In 1987, the budget deficit is likely to be about 12% of GDP. The House is aware of the massive world attention that is now being focussed on the budget deficit of the US Government. Yet, this is 5% of that country's GDP. If the richest and most prosperous country in the world is unable to sustain a budget deficit of under 5% of GDP without a continuing decline in the value of its currency and the threat of a serious recession, how can little Sri Lanka.

The inevitable result of these massive budget deficits is inflation. By Herculean efforts, I had managed to reduce the rate of inflation in Sri Lanka to nearly zero, two or three years ago. It has now crept up again to 8 percent. If our budget deficits continue, we shall soon have hyper inflation with all the suffering and hardship which this will entail for all the people of this country.

The second result of our mounting defence expenditure has been a curtailment of our expenditure on development. We have not, for instance, been able to proceed with the downstream development of the Mahaweli Project as rapidly as we mightotherwise have done. We have spent billions of rupees on the construction of the four major reservoirs under the Mahaweli Project but we have not so far been able to reap the full agricultural benefits from the water which they store.

The impact of reduced development expenditure on employment has been tragic. Our Government had succeeded in its first few years in office in halving the rate of unemployment in this country.

Unfortunately, with the reduced scale of development expenditure, unemployment is again rising. It is 18% today. Not only has the mounting defence expenditure curtailed development; it has also restricted the funds available for social services and welfare payments.

Recent surveys reveal increasing malnutrition among the children of the poor. This is surely a development which we must all deplore. Similarly, we have not been able to allocate sufficient funds for schools and hospitals. Schools often make do without adequate equipment and hospitals without sufficient drugs. These are some of the tragic results of the increasing demands of defence on our budgetary resources - demands which I have tried my best to satisty.

1. Reduction in the rate from 3% to 1% of certain items.
2. Turnover tax on Transport Services reduced from 3% to 1%.
3. A licensing fee of Rs 1 million is payable by operators of Casinos and Rs 100,000 is payable by bookmakers. (This is alternate to BTT).
4. Rate of turnover tax on Investment Companies reduced from 5% to 1%.
5. Beedi Manufacturers - Rate of tax is 3%.
6. Business of Buying and Selling Furniture and Timber—
   (a) Both on the manufacture of buying and selling of furniture and the business of buying
   (a) Both on the manufacture of furniture and the business of buying and selling of furniture the rate is 5%.
   (b) Similarly on the sale of timber whether in the sawn or log form, the rate is 5%.
7. Turnover Tax exemption on sales to Exporters - Sale of raw materials to exporters will be exempt from turnover tax. Under the present system the supplier has to claim a refund and this takes time. (Unless specified this concession can be abused an Exporters Certificate is required.

FOREIGN NEWS REVIEW

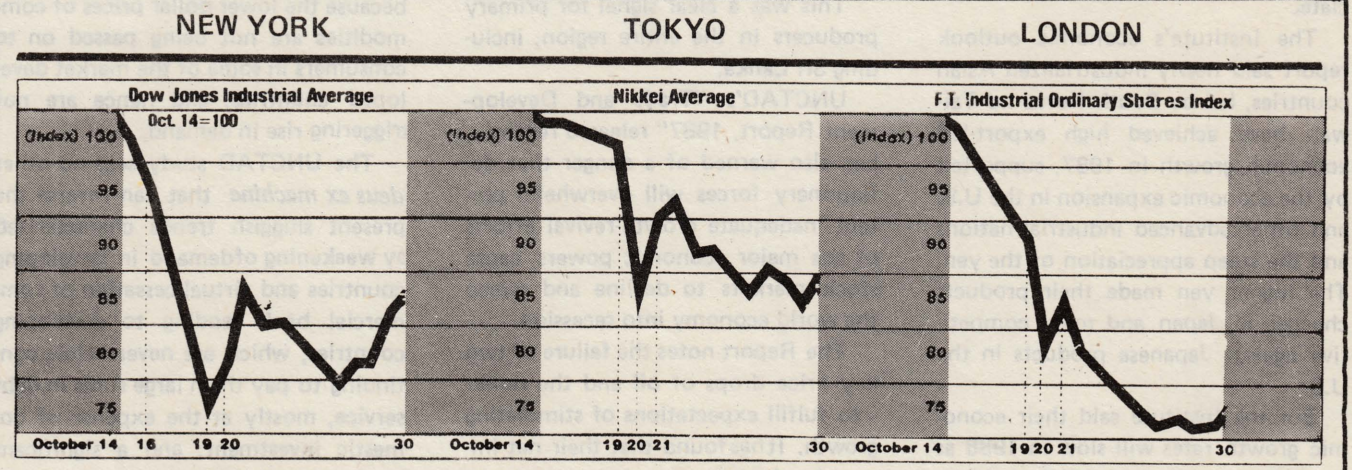
Forecasts of deeper global recession ahead

Signs of a likely global recession in the early part of 1988 have been signalled from various quarters of both the developed and developing world. Looking at the global economy, at the beginning of December, leading economic experts warned in Washington that the world economy faced the prospects of collapse not equaled since the Great Depression of the 1930s, if the major nations failed to take action. They called for quick and drastic steps to cut the US trade deficit, and equivalent surpluses in Western Europe and Asia.

The prospects of such a collapse they said, was the signal given by the October crash in stock markets around the world and an earlier plunge of the American bond market. The economist's conclusions were contained in a report issued by the Institute for International Economics, Washington. Specially, the economists warned, a new meeting of finance ministers and central bankers of the Group of Seven major industrialized nations, which is widely expected to take place next month, would be futile and even counter productive "unless more decisive action is taken to correct existing imbalances at their roots".

In the EEC the European Commission's experts responsible for drawing up economic forecasts have revised their growth estimates for 1988. The EEC's economists who were predicting a 2.5 per cent economic growth for the 12 member nations of the European Community, have now suggested that since the crash of "Black Monday" (Oct.19) the EEC countries would be lucky to reach a growth level of 1.5 percent next year. They warn that another fall in the US dollar's value, even without a recession in the US, could push Western Europe into a recession. They also indicated that European Governments were not taking sufficient steps to avert a recession.

Most analysts, in Europe are still seriously wondering if the U.S. has deflated its economy enough to create room for a shift of resources from consumption to exports. The budget cuts are minimal and monetary policy is loose. But the latest trade figures represent a pre-crash economy. By January with the postcrash devaluation of the dollar and the growing American dislike for imports, the U.S. economy will present another picture. A prominent analyst at a London bank predicts that the deflationary impact will be greater in the U.S. This would suggest higher interest rates and a further fall in stock markets. The major stock markets are expected to fall bet-

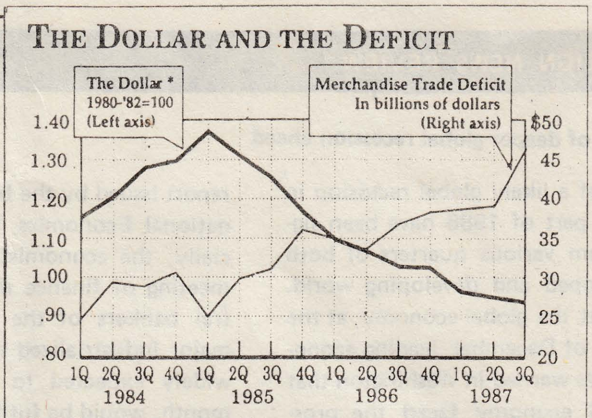


The crash suffered by the world stock markets following the October 19 Black Monday plunge was most deeply felt on Wall Street where it shattered much of the entrenched sense of financial security in the US. A look at thethreemajor stock markets shows how inter-related global financial markets are. Severe jolts were felt throughout the world's global financial markets when investors wary of the massive Trade and Budget deficits of the US, and the weakening dollar began a major sell-off. The New York Dow Jones average declined a record 508 points or 22.6 percent in one day; while in London and Tokyo investors sold a staggering amount of stocks. During the week of the crash, the Dow Jones and Financial Times indexes fell below their year-high levels by 31.6 percent and 36.1 percent, respectively.

London's free fall began on Black Monday when blue chip stocks crashed and on Tuesday the rest followed. But turnover in London, unlike New York, was not high; though the index dropped 250 points or 22 percent over the two days. In Tokyo it was only on October 20 when investors learnt of the Wall Street crash that everyone rushed to sell and the index fell 15 percent. In this period the farthest the Nikkei Average fell below its 1987 high was 17.8 percent and by the week's end, the Nikkei Average had rebounded a strong 4.2 percent reflecting the Tokyo market's resilience.

In Australia the stockmarket dropped 25 percent; and in Singapore 21 percent. The Hongkong Stock market closed. The financial crash of 1987 is not expected to end in economic slump, but already economists foresee recession by mid 1988.

The X-Curve



*The Dollar's value against 15 industrial-country currencies weighted by trade

Sources: Morgan Guaranty Trust Co. ; Commerce Department

The US trade deficit was expected to move up nearly S 20 billion ahead of last year's S 157 bn and exceed S 175 bn in 1987 according to all indications. This news, states the Asian Wall Street Journal, will incite the J-curvers to call for a still lower dollar. The theory, is that a lower dollar balances trade by making imports expensive and exports cheaper. In other words, the path to riches is buy high, sell low, well, after the initial dip the theory goes, you make it up on volume. Hence the curve that is supposed to look like a J. The Asian Wall Street Journal it plotted a few weeks ago and it appeared more as an X-curve.

ween 10 and 20 per cent before there is any stabilisation.

But apart from what happens to the dollar and stock markets, the present mood portends serious worries about the ensuing recession both in the U.S. and Europe, and possibilities in the rise in unemployment. The European Commission experts responsible for drawing up economic forecasts for the EEC have prepared new estimates in the background of the October crash and the dollar's devaluation.

Meanwhile Japan's Institute of Developing Economies predicted that lower exports and upward pressure on the currencies of newly industrialising countries such as South Korea, Taiwan, Singapore, Thailand and the Philippines would slow down economic growth in these countries in 1988. The Institute forecasts that the economic growth of these countries would slow in 1988 as the US economy on which their exports largely depend, is expected to slow somewhat. It is said the U.S. would also press these countries harder to let their currencies appreciate.

The Institute's economic outlook report said newly industrialized Asian countries, led by South Korea nd Taiwan have achieved high export-led economic growth in 1987, supported by the economic expansion in the U.S. and other advanced industrial nations and the steep appreciation of the yen. The higher yen made their products cheaper in Japan and more competitive against Japanese products in the U.S.

But the Institute said their economic growth rates will slow in 1988 as the U.S. economy, on which their exports largely depend, slows down.

Again a leading Indonesian economist predicted from Jakarta that the main industrial economies would experience recession starting in the second quarter of 1988. The impact would be felt in Indonesia three months later, mainly through falling demand and declining prices for primary commodities, he warned.

Sumitro Djojohadikusumo, a former Economic Minister turned advisor to President Suharto, was quoted as saying that Indonesia should immediately cut its strong reliance on primary commodities to ease the impact of the recession.

This was a clear signal for primary producers in the entire region, including Sri Lanka.

UNCTAD's "Trade and Development Report, 1987" released recently, has also warned of a danger that deflationary forces will overwhelm present inadequate growth-revival efforts of the major economic powers, cause stock markets to decline and sweep the world economy into recession.

The Report notes the failure of two key price drops of oil and the dollar - to fulfill expectations of stimulating growth. It has found that their net impact has been contractionary and as a result the pace of global expansion slowed to 2.8 per cent in 1986 from 3.0 per cent in 1985.

Continued weakness from the low levels of 1986 was foreseen for 1987. Output growth for the world economy, and the growth of the volume of world trade is expected to continue its deceleration. Forecasts are that the terms of trade of developing countries would continue to worsen despite the partial recovery of oil prices from their 1986 levels. Dollar prices of commodities are expected to lag behind those of manufactures, in part because of the depressive effect of the slow pace of world economic growth, and partly because the lower dollar prices of commodities are not being passed on to consumers in some of the market developed countries, and hence are not triggering rise in demand.

The UNCTAD study sees no other *deus ex machina* that can reverse the present sluggish trends characterized by weakening ofdemand in developing countries and virtual cessation of commercial bank lending to developing countries, which are nevertheless continuing to pay them large sums in debt service, mostly at the expense of domestic investment; and a significant escalation of tensions on the trade front as the struggle grows more intense for shares of shrinking markets. "It is difficult to see, " this study emphasis "how bilateralism — and, for that matter, mercantilism — can be avoided if the pace of world economic activity does not revive sufficiently to allow business and national economies to realize their growth potential. Warns UNCTAD "while the situation is bad, worse may be yet to come".

Securities and Shares, the Exchange, Brokers and Dealers

The Securities Council Act No. 36 of 1987 which became law on August 20, 1987 has been introduced both to regularise the trading of securities in listed companies and also to encourage trading and infuse more confidence in the financial markets of the country. The government's intention is to provide private investors with the necessary investment and infrastructure facilities and incentives to undertake further investment. Furthermore, a substantial increase in the average savings rate would be required if the growth momentum of the economy is to be maintained in the face of reduced levels of capital inflow. To achieve this objective both public and private savings are being encouraged, and fiscal policies and institutional facilities that support private savings are being strengthened. It is in this context that the establishment of the Securities Council is of importance in the development and growth of business and finance in Sri Lanka; since the Act could ensure and reinforce investor confidence and promote the development of a healthy capital market. There is no doubt that the promotion of an active and orderly securities market is essential for the development of an efficient capital market. For a country like Sri Lanka, an active capital market could play a vital role in mobilising and channeling private savings into investment activities, which in turn could genrate more income and employment opportunities. The legal and institutional frame work has therefore been provided in this new Act for the mobilisation of savings required for private sector growth through the share market.

The Minister of Finance in his recent Budget Speech also emphasising the need for the private sector to play a greater role, pointed out that at present the private sector in this country was over-reliant on loans funds to finance its investment and working capital needs. The debt ratio in Sri Lankan companies was extremely high by the norms prevailing in other countries.

The records indicate that there has been a revival and development of the share market over the last ten years, compared to the previous two decades when the share market was virtually dead. The number of quoted companies has increased from 80 in 1977 to 173 by 1986; while the volume of trading in the share market per week had moved up from hardly any transactions 10 years earlier to almost Rs 10 mn per week by 1986.

The new Securities Council Act No. 36 is intended to regulate the trading of securities in listed companies, so as to ensure (1) the creation of a securities market in which they could be traded in a fair manner; (2) the regularization of the securities market to establish fair and professional standards, principles, and guidelines; and (3) the protection of the interests of the investors and their investments by operating a compensation fund.

The implicit objectives of the Securities Councils appear to have been the revamping and reviving of the securities market in the country. This is dependent, to a great extent on the building up of a high level of confidence and raport among investors. It was expected that this move would help in channeling a substantial portion of "black money" that is available in the economy to productive investments and ventures. Consequently, an active participation of real and potential investors in the securities market could help solve the problems of the paucity of private investments in economic activities.

Thus, the whole process has been viewed to be dependent on the possibilities to broadbase the public participation in investment activities, for which a set of new institutions, instruments, and guidelines need to be introduced. Amongst these institutions have been the stock exchange, stock brokers and stock dealers. The Act stipulates a comprehensive set of guidelines to regularize the operation of these instruments. They include (a) granting of licences to stock exchanges, stock dealers and stock brokers; (b) suspension or cancelling of trading activities performed by these institutions. (c) suspension or cancelling of trading activities performed by those institutions which pose threats to the interests of investors, (d) publicizing evidence against the unscrupulous activities of any such institution, (e) granting of compensation to those investors whose interests have been affected by unprofessional dealings of stock brokers and dealers.

The provisions in the Securities Council Act had distinguished the nature of functions and roles expected to be performed by the stock brokers and stock dealers. A stock broker acts as an intermediary or "middleman" between his client (a potential investor) and a stock dealer; while a dealer specialises in trading shares in particular companies. At present there are about 10 companies performing the functions of stock brokering. This number is expected to swell with the picking up of securities market operations in the future.

A person who wishes to buy or sell securities may give instructions to a stock broker to obtain quotations for such securities. A quotation is the price at which a broker could arrange a deal, with a stock dealer. However, before finalising the transaction the stock broker could obtain further instructions from his client.

The functions of stock dealers are different. They are expected to perform a specialized function. At present there are about twenty categories of what may be called sub markets within the securities market. Share in the subset of Banks and Finance would be an example for one such category. Stock dealers are the specialists on various aspects of trading within such sub-categories in the broader securities market. This distinction between stock brokers and stock dealers has been identified as very important by the Securities Council Act, and hence the operation of the two categories have been segregated to avoid manipulations that would endanger the interests of investors. Therefore, neither of the two categories have been allowed to obtain a licence to function both as a dealer and a broker simultaneously.

This Act emphasises the duty of the Securities Council to protect the financial interests of investors in securities. It is empowered to grant compensation to investors; and an investor who has suffered a financial loss due to a stock broker or dealer failing to meet his contractual obligations may within three months apply to the Council's Compensation Committee for compensation.

Two specific prohibitions in the Act are that a stock broker or dealer is prohibited from trading in listed securities outside the stock exchange of which he is a member; and also a stock broker or dealer is prohibited from pledging, as gurantee for the repayment of money, securities held by him on behalf of his customers, unless he obtains their written consent.

The level of penalties laid down in the Act are comparatively severe with the quantum of fines going up to Rs 10 million

The penalties (upto Rs 10 million or imprisonment or both) apply to persons contraveing the provisions of the Act or any regulation made under it, or wilfully obstructing a member, officer or servant of the Securities Council in the performance of his duties. Also, a person who in connection with an application or appeal, under this Act, wilfully makes a false statement or wilfully omits a material statement and found guilty of an offence is liable on conviction to a fine upto Rs 1 million.

U.V.

COMMODITIES

COCONUT – Production Drops over 50 percent

Sri Lanka's coconut exports have been seriously affected by the drop in production in 1987. Coconut production suffered a severe set back during the year largely due to the drought conditions which prevailed in the coconut growing areas in 1986 and also as a result of the lagged effect of lower fertilizer application consequent on depressed nut prices and dry weather conditions. There was also the natural down turn in the yield cycle of the coconut plantations after two previous years of bumper crops.

The volume of coconut kernal products exported during the first nine months of 1987 were as much as 55 percent below that in the same period of 1986 (1986 mt in 1986 as against 439 mt in the 1987 period). Prices, however, were comparatively favourable and despite the 55 percent drop in the volume of exports the value of exports fell by only 23 percent (Rs 1,476 m in the 1986 period as against Rs 1,138 mn in 1987). The worst effected kernal products were coconut oil and poonac exports which suffered a 82 percent drop compared with exports in 1986.

Desiccated coconut exports however were able to maintain almost the same volume level as in 1986 while in terms of value there was a 30 percent increase. Fresh nut exports showed an increase of 12 percent in volume and 54 percent in value over that of 1986. The new export product, coconut cream, also showed a remarkable increase, particularly in value.

Local market prices of fresh nuts also recorded a sharp increase as a result of the drop in production. The average wholesale price per 1,000 nuts which was Rs861/85 in September 1986 had reached Rs 2,080/- by August 1987. Coconut Development Authority records of production indicate that only 56,798 mt of coconut oil (less than 50 percent of 1986) were produced in January-September 1987 as against 119,839 in the same period of 1986. Local users of coconut oil, particularly the soap and food industries were seriously effected as a result of the production shoratge and were turning to substitutes. A metric ton of coconut oil in the local market which sold at Rs 6,759/50 per mt in September 1986 had more than doubled to Rs 14,286/75 per mt by May 1987 and almost trebled to Rs 18,206/25 per mt by August 1987.

EXPORTS OF COCONUT KERNAL PRODUCTS

PRODUCTS	VOLUME (METRIC TONS) Jan–Sept			VALUE (RS MN) Jan–Sept		
	1986	1987	% change	1986	1987	% change
Coconut Oil	76,737	14,239	– 82	665.36	187.71	– 72
Desiccated Coconut	44,627	41,130	– 07	625.66	819.27	+ 30
Copra						
M.S.I.	6,647	6,663	+ 0.2	60.08	58.42	– 03
Edible	139	08	– 94	1.57	.12	– 92
Fresh & Seed Nuts	11,232,017	12,542.066	+ 12	32.53	50.11	+ 54
Coconut Poonac	33,280	5,500	– 83	90.06	16.16	– 82
Coconut Cream	47	253	+ 43	1.10	6.50	+490
Sub - Total	986.01	438.99	– 55	1476.36	1138.29	– 23
TOTAL VALUE OF ALL COCONUT PRODUCTS (Rs mn)				2218.70	1999.91	– 10

Industrialisation and Foreign Trade

What is the relationship between industrialisation, trade and economic performance?

Sarath Rajapatirana

In this paper Sarath Rajapatirana, formerly of the Central Bank of Ceylon and now Chief, Policy Analysis Unit in the Office of the Vice President of Economics and Research of the World Bank, examines critical issues in the interrelationship between industrialisation and foreign trade and the impact of different trade strategies on industrialisation and economic performance in developing countries. This paper is based on the Bank's "World Development Report, 1987" which was prepared by a team of economists led by Rajapathirana.

In the first decades following World War II, economists viewed industrialization as an essential stage in reaching rapid economic development. But the real question is not how fast an economy can industrialize but how its industrial sector can be structured to support sustained growth. In other words, the aim is to seek ways of achieving efficient industrialization. This quest for efficient industrialization relates directly to foreign trade. Foreign trade allows countries to realize gains by subjecting domestic production to foreign competition and by providing access to a wider market to achieve economies of scale. At the national level, trade has allowed countries to specialize between industry and other sectors, between different branches of industry, and increasingly even between different stages in pro duction. Trade has provided access to citical industrial inputs, including technology, for countries incapable of producing them. In turn, the advent of new technologies has shaped the pattern of specialization, and hence the pattern of trade. Trade has also meant expanded demand for exports which itself can spur technological development, and thus smooth the way for industrialization.

This article, based on the World Development Report, 1987, examines three critical issues in the relationship between industrialization and foreign trade . These are:

Factors that determine the pace and efficiency of industrialization, in particular the role of the government in that process.

The impact of different trade strategies on industrialization and economic performance in developing countries.

Lessons from trade policy reforms.

Factors in industrialization

There has been no single path to industrialization. It involves the interaction of technology, specialization, and trade, bringing about structural change within economies and leading to high investment and employment. At the heart of the process has been the role of the government in influencing both the pace and the efficiency of industrialization. A broad view of the history of industrialization reveals five factors that have shaped this process.

Initial conditions. A country with a large domestic market is in a better position to establish industrial plants that take advantage of economies of scale. Since distance between countries in many cases confers natural protection to domestic firms, everything else being equal, a country with a larger domestic market, in terms of area and population, can begin industrializing earlier than one with a smaller domestic market. But size is not the only factor necessary for industrialization, as shown by the cases of Japan and the United Kingdom. A rich endowment of natural resources may provide a country with the financial means to import foreign technology and its high income level may support a large domestic market for industrial products.

Domestic and foreign trade policies. The transition from a primarily agricultural and trading economy to an industrial economy has required, at least in the initial stages, an increase in the skills of the labour force. More than general education is required, but high achievement at the frontiers of science is not necessary for this transition.

State support for technical education made significant contributions to French and German industrialization. The United States broadly emulated the German system, with government financial support for research in universities. Private industry also maintained research laboratories that sometimes received public support. In Japan today most industrial research is carried out within private firms, but in the early period of industrialization the government helped to promote technological change, for example by setting up demonstration factories that were later sold to the private sector.

Transport and communications. Transport and communications networks integrated domestic and foreign markets into the global economy, making it easier for exporters to compete. But transport and communications networks are very capital-intensive and therefore expensive during the early stages of industrialization. They demand direct or indirect government support.

A stable institutional and macroeconomic environment. Laws and institutions that allow markets to function efficiently-property rights, standardized weights and measures, patent laws, and so forth-have all helped to promote faster and efficient industrialization. Such laws and institutions help promote long-term investment and risk taking. Yet they should also be flexible enough to allow institutional innovation.

Industrialization, especially in its early stages, requires large investment in machines and infrastructure. Moreover, one of the most important means by which technological innovation has been incorporated in production has been investment in new machines. Macroeconomic policies in the countries that were industrialing in the nineteenth century encouraged domestic savings and foreign finance required for investment.

Role of government. Markets and governments complements each other on the path to industrialization. Markets, while effective in pricing and sifting through investments, are rarely perfect. Government must sometimes intervene to achieve an efficient outcome. First governments have to set the "rules of the game" to define the use, ownership, and conditions of transfer of physical, financial, and intellectual assets. Irrespective of the type of economy-whether if favours private enterprise or is a command economy-these rules impinge on economic activity. The more they are certain, well defined, and well understood, the more smoothly the economy can function. When these rules are unclear, interpreted in unpredictable ways, and managed by a cumbersome bureaucracy, they raise the costs of doing business and thereby discourage the increase in the number of transactions that are essential for industrial specialization.

As experience has shown, governments must continue to be the main providers of certain services to fabilitate industrialization:

* All governments play a dominant role in education, especially in providing the basic skills of literacy and numeracy that are vital to a modern industrial labour force.

* Most governments provide the physical infrastructure of industry: transport, communications, and power systems.

* Most governments provide economic information and regulate such standards a weights, measures, and safety at work.

* Governments in the industrial economies promote scientific and technological research.

* State-owned enterprises are often established to carry out some of these tasks.

Governments also intervene somewhat less directly in the running of their economies. This indirect role creates the policy environment. Trade policy, fiscal incentives, price controls, investment regulations, and financial and macroeconomic policies are the main instruments available to governments. Capital-market failures and externalities are the justifications most often cited for direct intervention. Capital market failures arise when entrepreneurs cannot borrow adequate amounts or at opportunity costs that allow them to undertake investments. Externalities arise when the beneficial effects of an investment cannot be recouped by the investor himself. Both concepts have been used, for example, to defend policies toward new, or "infant" industries.

Different forms of intervention will have different effects on the economy. Indeed, in most cases the important question often is not whether to intervene, but how. Quantiative restrictions on imports, for example, may be used to protect domestic infant industries. But these will raise social costs more than a tariff, because they enourage unproductive activities and may lead producers to avoid the controls. Tariffs, on the other hand, raise prices to consumers. Subsidies to the infant industry could give the same assistance without raising prices-but they raise public spending and add to budgetary deficits.

Classification of forty-one developing economies by trade orientation, 1963-73 and 1973-85

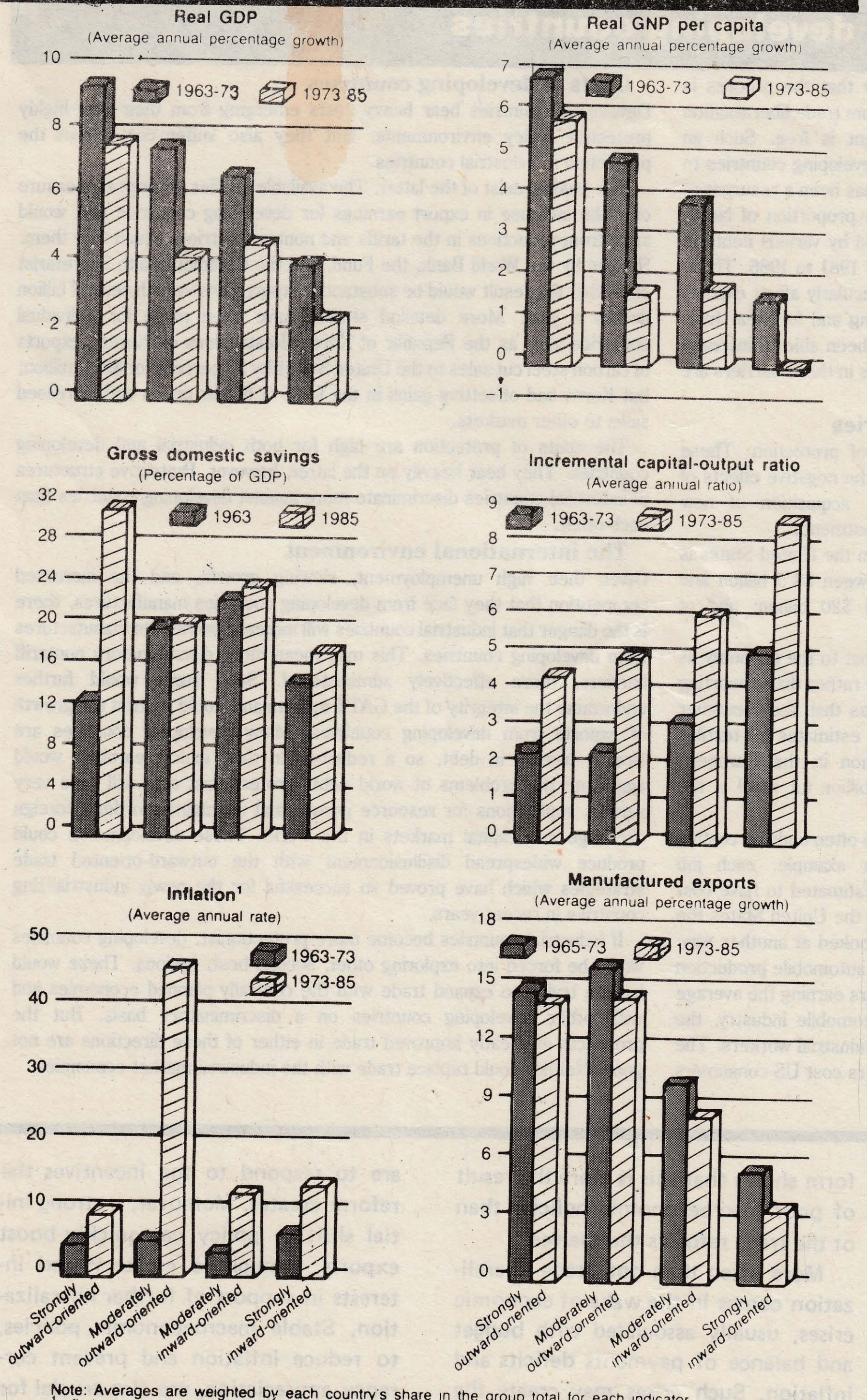
Outward-oriented		Inward-oriented	
Strongly	Moderately	Moderately	Strongly
		1963-73	
Hong Kong	Brazil	Bolivia	Argentina
Korea, Rep. of	Cameroon	El Salvador	Bangladesh
Singapore	Colombia	Honduras	Burundi
	Costa Rica	Kenya	Chile
	Côte d'Ivoire	Madagascar	Dominican Rep
	Guatemala	Mexico	Ethiopia
	Indonesia	Nicaragua	Ghana
	Israel	Nigeria	India
	Malaysia	Philippines	Pakistan
	Thailand	Senegal	Peru
		Tunisia	Sri Lanka
		Yugoslvia	Sudan
			Tanzania
			Turkey
			Uruguay
			Zambia
		1973-85	
Hong Kong	Brazil	Cameroon	Argentina
Korea, Rep. of	Chile	Colombia	Bangladesh
Singapore	Israel	Costa Rica	Bolivia
	Malaysia	Côte d'Ivoire	Burundi
	Thailand	El Salvador	Dominican Rep
	Tunisia	Guatemala	Ethiopia
	Turkey	Honduras	Ghana
	Uruguay	Indonesia	India
		Kenya	Madagascar
		Mexico	Nigeria
		Nicaragua	Peru
		Pakistan	Sudan
		Philippines	Tanzania
		Senegal	Zambia
		Sri Lanka	
		Yugoslavia	

Trade, industry and growth

Economists and policymakers in the developing countries have long agreed on the role of government in providing infrastructure, promoting market efficiency, and maintaining stable macroeconomic policies. But they have disagreed on trade strategies that have enabled countries to attain high growth and develop their industrial potential.

Outward- and inward-oriented policies. Trade policies can be characterized as outward oriented or inward oriented. An outward oriented strategy provides incentives which are neutral between production for the domestic market and exports.Because international trade is not positively discouraged, this approach is often, though somewhat misleadingly, referred to as export promotion. In fact, the essence of an outward-oriented

Macroeconomic performance of 41 developing economies grouped by trade orientation



Note: Averages are weighted by each country's share in the group total for each indicator
[1] Inflation rates are measured by the implicit GDP deflator. Values are group medians.

strategy is neither discrimination in favour of exports nor bias against import substitution. An inward-oriented strategy, on the other hand, is one in which trade and industrial incentives are biased in favour of domestic production and against foreign trade. This approach is often referred to as an import substitution strategy.

An inward-oriented strategy usually involves overt and high protection. This makes exports uncompetitive by raising the costs of the foreign inputs used in their production. Moreover, an increase in the relative costs of domestic inputs may also occur through inflation-or because of an appreciation of the exchange rate-as the quantitative import restrictions are introduced. Industrial incentives are administered by an elaborate and extensive bureaucracy.

Outward-oriented policies favour tariffs over quantitative restrictions. These tariffs are usually counterbalanced by other measures, including production subsidies and the provision of inputs at free trade prices. Governments seek to keep the exchange rate at a level that maintains equal incentives to produce exports and import substitutes. Overall protection is lower under an outward-oriented strategy than under inward orientation; equally important, the spread between the highest and lowest rates of protection is narrower.

Which policy has fostered greater success? An analysis of 41 economies by Bank staff explored the relationship over 1963-85 of trade strategies to economic performance. The results of this study indicate that outward-oriented economies have performed better than inward-oriented ones (see chart).

Some economies which did not fall clearly in either the outward- or inward-oriented category showed mixed results. There was no strictly discernible relationship between trade orientation and economic and industrial performance. This is not surprising, since factors other than trade strategy influence economic performance.

Lessons of policy reforms

If outward-oriented strategies are associated with better economic performance than inward-oriented strategies, why are policymakers in developing countries generally hesitant to undertake trade policy reforms to achieve such strategies? One reason is that there are many unresolved issues in the area of trade reform that economic research is only just beginning to answer. Another is that many trade re-

The international trading environment and the developing countries

While the lessons from trade policy reforms show that the process is manageable under certain conditions, the benefits from trade liberalization can be increased if the world trading environment is free. Such an environment will also make it politically viable for developing countries to undertake trade reforms. But in recent years there has been a resurgence of protection in the form of nontariff barriers. The proportion of North American and European Community imports affected by various nontariff restrictions has risen by more than 20 percent from 1981 to 1986. These restrictions cover large volumes of imports and particularly affect exports of developing countries. Nontariff barriers in clothing and footwear have proved porous, so some developing countries have been able to increase their exports to the industrial economies even as gaps in these barriers are being plugged.

Costs of protection to industrial countries

There are several ways of measuring the costs of protection. These methods generally underestimate the costs due to the negative effects of restraining competition on managerial efficiency, acquisition of new techniques, economies of scale, and savings and investments.

- ***Costs to the consumers.*** Protection of apparel in the United States is estimated to have cost US companies in 1984 between $8.5 billion and $18.0 billion; of steel, between $7.3 billion and $20 billion; and of automobiles, around $1.1 billion.
- ***Welfare costs.*** This concept covers the extra cost to the economy as a whole of producing more of the goods domestically rather than importing them. Normally the welfare cost is considerably less than the consumer cost--particularly for tariffs or quotas. Even so, the estimates for textiles and apparel range from $1.4 billion to $6.6 billion in the European Community and the United States and nearly $2 billion for steel in the United States.
- ***The cost of preserving a job.*** Each protected job often ends up costing consumers more than the worker's salary. For example, each job preserved in the automobile industry in Britain is estimated to have cost consumers between $19,000 and $48,000 a year. In the United States the cost was between $40,000 and $108,500 a year. Looked at another way, the cost to consumers of preserving one worker in automobile production in the United Kingdom was equivalent to four workers earning the average industrial wage in other industries. In the US automobile industry, the equivalent cost would be the wages of six ordinary industrial workers. The voluntary export restraints by foreign steel producers cost US consumers $114,000 per protected job each year.

Costs to developing countries

Developing countries bear heavy costs emerging from their own highly protective policy environments. But they also suffer costs from the protection in industrial countries.

Few studies exist of the latter. The available studies attempt to measure only the increase in export earnings for developing countries that would arise from reductions in the tariffs and nontariff barriers which face them. Studies by the World Bank, the Fund, and the Commonwealth Secretariat show that the result would be substantial export gains—worth several billion dollars a year. More detailed studies have been made for individual countries such as the Republic of Korea. Restrictions on Korean exports of carbon steel cut sales to the United States by 33 percent, or $211 million; but Korea had offsetting gains in the form of higher prices and increased sales to other markets.

The costs of protection are high for both industrial and developing countries. They bear heavily on the latter, however. Protective structures in industrial countries discriminate more against developing countries than each other.

The international environment

Given their high unemployment, slowing growth, and the increased competition that they face from developing countries manufactures, there is the danger that industrial countries will increase barriers to manufactures from developing countries. This may mean more discriminatory nontariff barriers, more effectively administered. Such steps would further undermine the integrity of the GATT system and would restrict the growth of exports from developing countries. Many developing countries are already heavily in debt, so a reduction in their export earnings would aggravate the problems of world debt. Protectionist acts will have very serious implications for resource growth and maintaining orderly foreign exchange and capital markets in the world. These developments could produce widespread disillusionment with the outward-oriented trade strategies which have proved so successful for the newly industrializing countries in recent years.

If industrial countries become more protectionist, developing countries would be forced into exploring other, second-best, options. These would include trying to expand trade with the centrally planned economies and with other developing countries on a discriminatory basis. But the prospects of greatly improved trade in either of these directions are not good. Neither could replace trade with the industrial market economies.

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forms have had to be reversed, leading to the perception that they entail high costs and produce limited benefits.

The shift toward outward orientation inevitably involves transitional costs. Major shifts in resources accompany trade reforms aimed at liberalizing the trade regime, as some activities contract and others expand in response to the changes in prices. If the economy is highly distorted to begin with, the changes that are likely to be necessary are very large. One visible cost is increased unemployment, though recent research on trade reform shows that this is more the result of poor macroeconomic policies than of the trade reforms themselves.

More often than not, trade liberalization comes in the wake of economic crises, usually associated with budget and balance of payments deficits and inflation. Such crises may create the political will for change-an important ingredient for undertaking trade reforms - but reforms undertaken in a crisis atmosphere may not be sustainable. So a government's long-term comittment to reform needs to be substantial and credible if economic agents are to respond to the incentives the reform creates. Moreover, a strong initial shift in policy can quickly boost exports, enough to create vested interests in support of further liberalization. Stable macroeconomic policies, to reduce inflation and prevent currency appreciation, are also crucial for the success of trade reforms. The fate of the reforms, once undertaken, often rests mainly with what happens to the balance of payments-and this is determined by macroeconomic policy.

Experience suggests that export performance is closely related to the level and stability of the exchange rate. Conversely, using the exchange rate to stabilize domestic prices hinders trade reform. In the countries of the Southern Cone of Latin America, Argentina, Chile, and Uruguay-that attempted trade reforms., capital inflows led to the appreciation of exchange rates, which offset the incentives for increasing the production of exports and import substitutes. Large capital inflows were in some cases the result of an ill-timed or uncoordinated liberalization of the financial markets in which domestic interest rates rose very sharply. This provoked heavy borrowing from abroad. Thus poor macroeconomic policy was more to blame than the trade reforms for the crisis that followed. Trade reforms, however, fell into some disrepute because of their guilt-by- association with poor macroeconomic policies.

The design of trade policy reform. A review of the recent history of trade policy reform suggests that three elements seem to matter most in the design of such efforts. The first is the move from quantitative restictions to tariffs. This links domestic prices to foreign prices and allows greater access to foreign inputs while increasing competition. The second is the narrowing of the variation in rates of protection even as its overall level is reduced. The third is direct promotion of exports to offset the effects of import tariffs. Specific measures to promote exports risk acquiring a permanent status, however, and lead to the postponement of more fundamental changes relating to the exchange rate. They also contravene rules of the General Agreement on Tariffs and Trade (GATT), create domestic lobbies that will oppose their removal, and risk countervailing duties from trading partners.

Trade reforms alone cannot lead to efficient industrialization and improved economic performance without addressing a number of areas that constrain domestic supply response. Among these, four areas are particularly important.

Structure of manufactured exports from developing countries, 1970–84

Description	Share of developing countries' exports[a] 1970	Share of developing countries' exports[a] 1984	Growth rate[b] 1970–84
Traditional manufactured exports			
Labor-intensive			
Textiles and apparel (84 and 65)	31.3	24.8	11.8
Footwear (85)	1.8	2.9	18.2
Other labor-intensive (61 and 83)	2.9	2.3	11.6
Total	36.0	30.0	12.4
Resource-based			
Wood and cork (63)	3.6	1.5	6.9
Paper manufactures (64)	0.8	1.1	17.6
Other resource-based (52 and 56)	0.8	0.9	14.5
Total	5.2	3.5	12.2
Nontraditional manufactured exports[c]			
Electrical machinery (72)	16.1	16.7	14.1
Chemicals (51)	8.3	9.9	15.3
Nonelectrical machinery (71)	4.2	8.7	20.1
Transport equipment (73)	2.6	5.2	20.0
Iron and steel (67)	6.2	6.5	14.2
Other nontraditional[d]	21.4	19.5	12.9
Total	58.8	66.5	15.1
Total	100.0	100.0	14.0

Note: Figures in parentheses are the SITC categories for the respective product group.
a. Developing countries' exports of the listed product as a share of developing countries' total exports of manufactured products defined as SITC categories 5, 6, 7, and 8, less 68.
b. The rate of growth of developing countries' exports of the listed product during 1970–84 in constant dollars.
c. Total manufacturing exports less traditional manufactured exports.
d. Rest of nontraditional exports.
Source: Murray (background paper).

* *Reduction of price controls*. Such controls are pervasive in developing countries and are usually aimed at protecting consumers from monopolies and helping industry by restraining increase in prices of inputs. They restrict supply and distort relative prices, however, causing inefficiency and retarding industrial growth.

* *Investment licensing regulations* These regulations are imposed to influence the pattern of private investment in line with government priorities. If designed poorly, however, they distort patterns of prices and incentives, discourage foreign private investment, and encourage foreign investments, if any, in activities with low social returns.

* *Financial market reforms.* Interest rate and portfolio controls can discourage savings and distort investment patterns. Reforms are needed to let resources move from one activity to another in line with the incentives created by trade reforms.

* *Labour market reforms.* Some of these regulations also distort factor prices, technology choices, and lead to lower employment. Labour market flexibility is also an important ingredient in trade reform.

The combination of trade and domestic market reforms can make countries move from inward-oriented to outward-oriented trade strategies. This, of course, presupposes that the other ingredients of industrialization and growth-physical infrastructure, education, and legal and institutional factors-are adequate for the task. But benefits from trade reforms can be increased only if the international trading environment is freer than it is now(see box) and protection is both low and relies more on price measures than quantitative restrictions.

TOURISM: The Sri Lanka situation and global trends

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By the end of 1986 as many as 23 of the hotels in Sri Lanka, constructed to cater to international tourist demand remained totally inoperative. Tourist Board data showed that tourist arrivals in the country from all destinations had plunged sharply, from a peak of 407,000 in 1982 to 203,106 in 1986, resulting in a fall of tourist inflows by nearly 43 percent. One effect of this slump in tourist arrivals was that the hotel sector was in crisis and not being able to repay its bank loans had to seek government relief. By 1986 a total of 186 hotels were asking for a rescheduling of their loan repayments and 66 had been granted concessions. Amidst this deteriorating situation there was an increase to six of the major new hotels operating in Colombo, with the opening of a Colombo Hilton of 19 stories, covering 7 acres of prime property in the heart of Colombo and adding 309 more rooms to the 2,150 already operative in the Colombo resort area.

Definitions

The definition of tourism covers both the entire activity of travelling for recreation and like purposes; or the industry involved in guiding and accomdating tourists. A tourist is generally regarded as a person who visits a country, other than that of his permanent residence, at least for twenty four hours, irrespective of his motive to travel. Tourist travellers are largely composed of vacationers, business travellers, excursionists, pilgrims etc. A vacationer as explained in the European literature is a person who visits a country other than that of his permanent residence, for a period of at least four nights in any one trip.

International Tourism

International tourism is composed of three broad categories of travellers:

(a) Travellers among the developed countries;

(b) Travellers confined to the region where they are domiciled; and

(c) Travellers touring to long distant destinations.

In the case of international tourism the bulk of travel yet takes place between the developed countries. One reason for this is that most of the developed countries in the West are physically and economically bound close to each other and travel formalities such as transport, visas, exchange etc. are generally not a problem. For instance, any European inhabitant can travel in an EEC country or EFTA country without the obligation of obtaining a visa.

International tourism, as travel trends over the last few decades reveal, generated largely from three bases, namely:

(a) North America, including U.S.A. and Canada;

(b) Western Europe, including EEC and EFTA countries; and

(c) Pacific developed countries including Japan, Australia and New Zealand.

Another significant generating base had been South Africa, but over the last two decades its importance has declined considerably.

Growth of Global Tourism

The growth in international tourism showed rapid advances only after the early fifties. The removal of the post World War 11 restrictions for across the board travel and exchange transactions from the 1950's cleared the way for this growth.However, post war anti-Nazi feeling and the destruction of the country kept Germany apart for some time, while Japanese tourism became prominent only in the late 1960's when travel sanctions imposed by some nations ceased to exist.

During the 1950's and early 60's tourist travel in Europe and America was mainly confined to destinations within the region and very largely to the neighbouring countries. The rapid economic reconstruction and progress in the West in the late 1960's with enhanced disposable family incomes induced the traveller to seek more variety in their holiday destinations. Also, increased air traffic operations with 'jumbo' sized long range carriers at reduced or off schedule prices induced more travellers to enjoy the environment, culture, scenery and habitats of distant destinations. This thrust was further intensified when these travellers realised they could enjoy a considerably cheap consumption level and the traditional hospitality of most third world countries. Instead of being trapped in a high cost winter, it was also financially profitable for some inhabitants in developed countries to travel to the tropics where they could enjoy a cheap holiday package, cheap accomodation and food, travel and entertainment. The receiving countries too when they found tourism to be a good source of hard currency promoted it, providing these tourists with competitive facilities and complete freedom of movement and behaviour.

From 1950 to 1970 the global visitor arrivals including those of vacationers, business travellers etc. grew from 25 million to 168 million registering an average annual growth of 10 percent. The recipts from this tourism within this period grew even faster than the volume of tourists. For example, total receipts increased from U.S.$ 2.1 billion to U.S.$. 17.4 billion, undergoing an average annual growth rate of 11 percent.

During the decade of 1970's global tourist arrivals increased by 116 million, going up to 284 million in 1980 from 168 million in 1970. However, the average annual growth rate during this decade of the 70's compared to the 10 percent of the two earlier decades was at a reduced rate of 7 percent. Although receipts from tourism fluctuated, a six fold rise was sustained from US$ 17.4 billion in 1970 to US$ 102.4 billion in 1980. The comparative average annual growth rate too increased more than four times from the earlier to 48.8 percent per year.

These trends of these three decades, of faster growth both in numbers and receipts of tourism, changed after 1980. It is true that excluding the year 1982 the overall volume increased. For example, arrivals in 1986 amounted to 340 million, and recorded 155 million over the 285 million arrivals in 1980. (See table 1). The relative annual growth rate averaged 3.3 percent. Arrivals in 1982 underwent a drop of 2 million from 1981. Again, from 1985 to 1986, the annual growth rates kept continuously deteriorating dropping by 7.5 percent, 5.4 percent and 2.4 percent respectively.

The most depressing picture for the industry during the 80's is portrayed in earnings from international tourist receipts between 1980 and 1986 which had growth by only $ 1.26 billion. This was a very disappointing figure compared to the growth of $ 85 billion during the previous decade. These receipts dropped to $ 98.5 and $ 98.3 billion in 1982 and 1983 respectively from $ 102.4 and 104.3 billion in 1980 and 1981. The earnings in 1984 which amounted to $ 102.5 billion was an insignificant marginal improvement over the earnings of 1980.

The total receipts from global tourism in 1986 accounted for 5.1 percent of the $ 2,250 billion total value of global exports of all commodities in the same year. The comparative percentage was higher in 1981 at 5.3 percent. During the 10 years ending 1985, the tourist industry emerged as the largest component of the world trade in services. In 1985 international tourism receipts had accounted for 28.5 percent of the worlds $ 345 billion earnings from global trade in services.

Regional Concentration of Tourism

During the 1960's and 70's tourism had been a phenomenon peculiar to the industrialized countries. Total arrivals in the OECD countries had accounted for 70 percent of the global total. Receipts of the countries during this period had amounted to over 80 percent of the global tourism receipts. This high significance of arrivals from the developed countries, relative to global arrivals, continued into the 1980's. For instance, the OECD countries total arrivals which amounted to 231.4 million in the 1980's formed 81.5 percent of the global arrivals (see table 2). In 1986 this number had risen to 261.5 million, making up 76.9 percent of the global total. Comparative data relating to receipts during the two years 1980 and 1986 are $ 73.9 and $ 82.1 billion, accounting for 72.5 percent and 71.3 percent respectively of the aggregate global arrivals. The magnitude and growth of arrivals in Europe and the receipts in these countries have been the largest relative to different regions where tourism was concentrated in the 1980's. The average annual arrivals during 1980–1986 inclusive, in Europe, amounted to 207.3 million while the receipts amounted to US$ 59.7 billion. Compared to the global averages $ 306.1 and $ 104.4 billion in receipts, arrivals had grown from 196 million in 1980 to 227.5 million in 1986, an increase of 31.5 million and shown an average annual growth rate of 2.3 percent. The receipts for this period had increased at an average annual growth rate of 1.3 percent to $ 66.5 billion in 1986 from $ 61.5 billion in 1980. From 1982 both the growth of arrivals and receipts had been continuous and steady.

The downward trend in the percentages of Europeancountries was largely in numbers, though the fall in receipts was less marked,indicating a preference for diversification in tourism towards the developing countries.

In the first three years of the 80's the Central, South American and Caribean region arrivals decreased from 18.3 million in 1980 to 16.8 million in 1983. The curve turned upwards, in 1984 and was followed by a steady improvement through 1986. However, in contrast to this situation in arrivals, the receipts in this region were unsteady and volatile. While arrivals fell from 18.3 million to 17.5 million in 1981 receipts increased from $ 13.2 billion to $ 14.6 billion. With the 4.6 percent fall in arrivals in 1982, recipts fell by 20 percent. Again the rise in arrivals in 1983 did not result in increased receipts. Country wise receipts fell from $ 11.6 billion to $ 10.5 bil-

TABLE 1

WORLD TOURISM STATISTICS

YEAR	INTERNA–TIONAL ARRIVALS (IN'000)	INTERNA–TIONAL TOURISM RECEIPTS (US $ MILLION)	INTERNA–TIONAL TOURISM EXPENDITURE (US $ MILLION)	EXPORTS (US $ MILLION)	IMPORTS (US $ MILLION)	NUMBER OF ROOMS	NUMBER OF BEDS AVAILABLE
1980	284,841	102,363					
1981	288,848	104,296	98,581	1,952.081	1,915,003	8,701,423	17,002,223
1982	286,958	98,598	93,498	1,859,240	1,801,349	9,216,782	18,078,855
1983	293,944	98,338	92,327	1,858,311	1,760,882	9,683,001	18,839,485
1984	315,359	102,482	92,671	1,985,314	1,879,617	9,801,437	19,145,536
1985	332,991	109,566	98,626	1,930,400		9,931,874	19,392,333
1986*	340,000	115,000		2,250,000			

Prepared by: Sanath De Silva. * Estimated.

lion. From 1983 arrivals increased at an annual rate of 6.0 percent while receipts grew at a slower pace of 5.4 percent. Hence, what the region could receive in earnings from tourism in 1986 remained considerably below the receipts in 1981.

Tourist arrivals in the middle east region also did not undergo a significant growth during the first six years of the 80's, either volumewise or receipt-wise. Arrivals in 1985 reached 7.1 million, from 5.8 million in 1980, but fell to 6.0 million in 1986. The receipts increased by $ 1 billion between 1980 and 1985. Since 1983, receipts moved in the same direction the arrivals moved, but before 1983 so close a concommitant change could not be seen.

Among the developing country resort regions, the South Asian region, including Sri Lanka did not develop to any significant extent. The arrivals of this region in 1986 was 2.5 million relative to 2.3 million in 1980. The yearly movement stayed closely around the average annual arrivals of 2.45 million. On the contrary receipts of the region kept continuously dwindling from 1981 through 1986.

If the absorption of tourists by the Central, South American and Carribean region countries in the period since 1982 (which did not have an impressive income effect) is excluded, the concentration of tourists arrivals seems to have been largely diverted towards the East Asian and the Pacific region. Not only have the arrivals of this region almost doubled from 19.9 million in 1980 to 39.5 million in 1986, but the growth rate has been continuous and steady. The average annual growth rate during the period has amounted to 16.4 percent ranging from a high of 17.9 percent to a low of 4.7 percent.

The receipts of the East Asian and Pacific Region also had increased considerably though they were a little below the growth rates achieved by the arrivals. For example, the receipts had grown from $ 7.5 billion in 1980 to $ 12.5 billion in 1986, averaging a growth rate of 11.9 percent per year. The growth has been steady and continuous. The average arrivals in the region and the average receipts of the region accounted for 9.4 and 9.5 percent of the average global arrivals and receipts; and 13.9 and 16.7 percent relative to the average annual European arrivals and receipts during the period 1980 to 1986 inclusive.

Sri Lankan and Global Tourism

Compared with the global tourist arrivals Sri Lanka arrivals are infinitesimally small. For example, in 1980 Sri Lankan arrivals accounted for only 0.1 percent of the global arrivals. By 1986 this percentage further diminished to 0.7 percent. Within the South Asian region Sri Lankan arrivals formed 14.1 percent of the region's total in 1980 and this percentage dropped to 9.0 percent by 1986. Receiptwise too Sri Lankan tourism generated only 0.1 percent of global returns in 1980, which moved down to 0.06 percent in 1986; while as far as tourist revenue generation in the South Asian region was concerned the receipts in the years 1980 and 1986, accounted for 7.1 percent and 5.0 percent of the region's total. Compared with both the global and Asian figures there is a clear indication that Sri Lankan tourism in the 1980's especially in 1986 as compared to 1980, experienced a definite setback.

Upto 1982 both the Sri Lankan arrivals and receipts generated from tourism progressively moved up. In 1982, Sri Lanka had 407,000 tourist arrivals, a 26.4 percent increase over the 322,000 that arrived in 1980. Compared with the 118,971 arrivals in 1976, the increase in 1982 was as much as 242 percent. The receipts of Sri Lankan tourism between 1980 and 1982 increased from $ 111 million to $ 132 million representing a growth of 18.9 percent, a progress less significant than that of the growth in arrivals. Relative to the earnings in 1975, the earnings in 1982 showed an improvement by 12 times at current prices.

Tourist arrivals in Sri Lanka experienced a falling trend from after 1982 with an average annual rate of decline of 10.8 percent. The arrivals in 1986 amounted to only 230,106. The receipts from tourism fell to US$ 7 million in 1985 with income generated over these three years being almost halved. Despite the continuous fall in arrivals recipts in 1986 resulted in a marginal increase. (During the first six months of 1987 the Central Bank reported a 37 percent drop in earnings from tourism as compared with the first six months of 1986). Although the number of tourists and receipts were dwindling the number of rooms had increased from 6,797 in 1980 to 10,897 in 1985. This number of rooms formed 0.08 and 0.1 percent of global room capacity in 1980 and 1985.

Recent Trends in Tourism in Sri Lanka

During the end of the 70's and the early 80's tourism provided a large slice of foreign exchange earnings and generated substantial economic activity in Sri Lanka. In the year 1982 tourism added Rs 3,050 million to the foreign exchange earnings of the country; which was 132.7 million in SDR terms. The foreign exchange generated by this sector was only below those of earnings from tea, petroleum, apparel exports, and foreign employment remittances during that year. In terms of SDR, earnings from tourism had shown a continuous rise since 1976.

Since 1982, incomes generated in the tourist industry were on the decline both in absolute and relative terms. In 1983 foreign exchange earnings in the sector amounted to Rs 2,896 million, which in later years continued to drop further to Rs 2,670 million, Rs 2,239 million and Rs 2,000 million respectively. In SDR terms these earnings amounted to 115.1 mn, 105.0 mn, 72.6 and 60.8 mn respectively from 1983 to 1986. Earnings in 1986 in SDRs were only marginally above what was earned in 1979, seven years earlier.

In 1980 there were 182 establishments providing accomodation for tourists both in the formal and informal sectors of the tourist industry in Sri Lanka. Among them 101 were graded establishments consisting of 6,042 rooms, equipped with 11,790 beds. Establishments, in the informal sector in the same year had 765 rooms with 1,546 beds. During the year 321,780 tourists arrived in the country. Of these arrivals 21,594 had come for business purposes while 291,999 had come for holidays, leisure etc. 68.3 percent of the arrivals in the year had been from Europe inclusive of EEC, EFTA and East European countries. Second to this area were arrivals from Asia, which numbered 72,022 or about 22 percent of total arrivals. The Asian arrivals in the early 80's were largely dominated by Indians who came mainly with the purposes of making purchases in the duty free shopping complex.

Tourists visiting Sri Lanka in 1980 stayed in the country for an average of 11 days per tourist. Graded hotels had tourists for two million guest nights, whereas, the informal sector hotels and guesthouses could operate only 200,000 guest nights. Thus the average operative guest night per graded hotel was 19,801; while in the informal sector this amounted to 2,469 guest nights.* In terms of room capacity the average effective guest nights per room in graded hotels was 331; while in the informal sector it amounted to 261. This indicates that the guest night capacity utilization in the formal sector was better than that of the informal sector. For instance, in the formal sector the guest night capacity was 4,303,350 and the utilization amounted to 46.5 percent. In the informal sector the guest night capacity was 564,290 out of which 200,000 guest nights or 35.4 percent of the capacity had been utilized.

The average per capita expenditure incurred by tourists during the year had amounted to S 31.20 or Rs.561.60. The average occupancy rate in the whole country had amounted to 57.8 percent, while the regional figures were 70.7; 64.1; 52.2; 47.3; 34.2; 54.3; and 25.4 percent in the resort regions of Colombo City; Greater Colombo; South Coast; East Coast; Hill Country; Ancient Cities; and Northern Region, respectively.

During 1981 and 1982 tourists arrivals kept increasing with the arrival figure going up by 26.6 percent to 407,230 in 1982. During the five years ending 1982 tourist arrivals into Sri Lanka had increased at an average annual rate of 21.8 percent. Annual growth rates within these five years had ranged between 29.8 percent and 9.9 percent, and from 1979 the growth rates showed a consistant decline from 28.6 to 15.2 and 9.9 percent.

* (guest nights or tourist nights capacity= The number of beds x 365).

In 1982 as many as 360,824 arrivals, comprising 88.5 percent of the total, had come for purposes of entertainment; while 27,489 came for business purposes. This was a reduction from 90.7 percent arrivals for entertainment purposes in 1980. Although in absolute numbers there was an increase between 1981 and 1982 total arrivals reached a peak in 1982 mainly because of the big increase in arrivals in the Asian region. The number of Asian arrivals in 1982 was 133,886 or 85.9 percent more than the number in 1980. If these Asian arrivals in 1982 were excluded from the total it would appear that the peak in tourist arrivals was in 1981 and not in 1982. Between 1980 and 1981 the arrivals from North America and Australia also increased though this increase could not be considered quite significant in terms of both growth rate and number of arrivals. To mee the increased demand from the larger number of tourists in 1982, the number of establishments providing accomodation increased by 58 establishments bringing the total number of establishments to 290. These were made up of 120 establishments in the formal sector and 140 in the informal sector. Expansion in terms of establishments was faster in the informal sector. For instance, the increase between 1980 and 1982 in the formal sector was 21.8 percent while in the

TABLE 2 INTERNATIONAL TOURIST ARRIVALS BY REGION (IN '000)

YEAR	AFRICA	NORTH AMERICA	CENTRAL & SOUTH AMERICA & CARIBBEAN	EAST ASIA AND THE PACIFIC	EUROPE	MIDDLE EAST	SOUTH ASIA	(SRI LANKA
1980	7,070	35,376	18,327	19,967	196,000	5,821	2,280	322
1981	8,046	35,891	17,573	23,446	195.289	6,160	2,443	371
1982	7,646	34,099	16,797	24,521	194,490	6,983	2,422	407
1983	7,854	32,932	18,344	26,839	199,433	6,053	2,489	338
1984	8,618	32,326	19,729	31,302	214,405	6,513	2,466	318
1985*	9,070	32,487	20,307	36,985	224,488	7,115	2,539	257
1986*	8,800	34,000	21,650	39,500	227,500	6,000	2,550	230
INTERNATIONAL TOURISM RECEIPTS BY REGION (US S MILLION)								
1980	2,710	12,342	13,163	7,471	61,654	3,474	1,549	111
1981	2,878	14,715	14,563	8,899	57,240	4,130	1,871	132
1982	2,767	13,740	11,628	9,334	55,577	3,886	1,666	147
1983	2,612	14,006	10,529	9,800	55,824	3,920	1,647	126
1984	2,517	14,247	11,485	10,432	58,054	4,130	1,617	105
1985	2,854	11,906	11,308	62,779	62,779	4,477	1,523	74
1986*	2,900	15,650	12,250	12,500	66,500	3,700	1,500	75

* Revised, estimates

Prepared by:- Sanath De Silva.

informal sector it was 48.4 percent. Also the formal sector was able to make available 7,539 rooms with 15,001 beds. The bed strength in the formal sector was increased by 24.7 percent while in the informal sector it increased by 51.5 percent.

But the increase in the number of rooms was more rapid than in the actual number of arrivals between 1981 and 1982. These releaved slightly the pressure of tourists for rooms; as in 1982 the number of tourists per room was 46.8 percent compared to 47.3 percent in 1980. The impact of slow down was further compounded by the reduction of duration of tourists stay in the island. The average duration per stay of a tourist in 1982 amounted to 10 nights in 1980. The number of occupied guest nights in the graded hotels increased to 2.1 million reflecting an increase of 0.1 million; while the stay in the informal sector dropped from 0.2 million to 0.1 million in 1982. Thus the average occupied tourist nights per hotel amounted to 17,073 in graded hotels and 854 in informal sector establishments. In terms of rooms the average occupied tourist nights per room were 278.5 in the formal sector hotels while it amounted to 86.3 in the informal sector.

Of a total capacity of 5,475,000 tourist nights in the formal sector and 856,290 in the informal sector, capacity utilization had decreased to 38.3 percent in case of the formal sector and 11.7 percent in case of the informal sector.

The average tourist per capita expenditure in 1982 had increased to US$ 36.21 or SLR 771 compared to that of 1980, although capacity utilization showed a decline. The average occupancy rate in the whole country amounted to 47.8 percent; while it amounted to 62.4, 49.3, 46.6, 45.0, 37.6, 40.0 and 20.2 respectively in the regions of Colombo City, Greater Colombo, South Coast, East Coast, Hill Country, Ancient Cities and the North.

The deterioration that set in to Sri Lanka's tourism from 1983 is reflected in several aspects of the industry's activity. The drop in receipts can be related to the fall in arrivals which declined over these four years from 337,530 to 317,734; 257,456 and finally to 230,106 in 1986. The annual rate of decline for this period was 17.1, 6.9, 18.9 and 16.6 averaging 13.3 percent for the period. The most severe drop was recorded in 1985.

Upto 1984 the number of establishments providing accomodation for tourists and increased (Table 4). In the year 1985 the available accomodation came down to levels prevailing in 1983, that is, 271 establishments in both 1985 and 1983. The decline continued into 1986 when the number came down further to 237; which was even below the available accomodation level of 1982.

The drop in accomodation in 1986 was heavier in the informal sector with 14 hotels in the formal sector closing for business; while 20 establishments in the informal sector ceased functioning. The number of rooms in the graded hotel sector increased faster than those in the informal sector upto 1986. For instance, between 1982 and 1986, in the graded sector 2,287 rooms were added bringing the total to 3,784. In 1986 the number of rooms in the sector was 6,084 and therefore between 1980 and 1985 there had been an increase of 3,374 or 62.8 percent.

In the informal sector the number of rooms addded since 1982 is considerably small with an increase of only 21 rooms between 1982 and 1985. On the other hand between the years 1980 and 1982 there was an increase of 404 rooms in the informal sector. Unlike the formal sector the drop in the informal sector occured from 1985; and in this year accomodation capacity was reduced by 90 rooms. However, in 1986 in contrast to the drop in the formal sector in the informal sector there was a slight increase in room capacity.

The gradual decrease in the availability of rooms with a faster decline in tourist arrivals created greater pressure on the unutilised room capacity. During 1985 the number of tourists per room averaged 20.9 percent which was over 50 percent less than the 47.3 percent and 43.6 percent per room in 1982 and 1983. The number of guest nights in graded hotels dropped to 1.7 million while in the informal sector too it declined to 90,000. The average tourist nights per occupied establishment was 7,173 and 849, respectively, reflecting a sharper fall in the graded sector. Compared to a capacity utilisation of 38.3 percent in the graded sector and 11.7 percent in the informal sector in 1982 capacity utilisation came down to 24.1 percent and 10.3 percent, respectively. The average expenditure per day of tourists also dwindled from the peak of 28.3 percent in 1985 to 29.6 percent by 1986. Although there was a slight improvement in the average room occupancy rate in graded rooms from 32.7 percent in 1985 to 33.1 percent in 1986, this was more the result of a reduction in the number of hotel rooms due to hotel closure rather than an improvement in room occupancy.

Resort-wise occupational rates also declined with hotels in the Northern and Eastern regions virtually unutilised and the Ancient Cities region also experiencing very low occupancy levels. Resort wise occupancy rates in 1985 were Colombo City 38.0; Greater Colombo 35.1; South Coast 34.1; East Coast 7.9; Hill Country 28.0; Ancient Cities 27.6 and Nothern Region 1.6; while in 1986, the respective occupancy rates declined to 37.2, 31.9, 32.7, 2.9, 26.8, 29.5 and 0.9.

During this period there was a significant drop from arrivals in the Asian region, particularly Indian tourists. Since 1984 arrivals from India had continued to decline owing to the imposition of stringent regulations in regard to allowances granted by the Indian government to its nationals returning from Sri Lanka. The Asian market which was the second largest for Sri Lanka declined as a result, by 16 percent in 1986. Arrivals from other main markets such as North

TABLE 3
EARNINGS FROM EXPORTS AND TOURISM 1976–1986

YEAR	TEA	RUBBER	COCONUT	APPAREL PRODUCT	GEMS	PETROLEUM	TOURISM	GNP
								Value SDR Million
1976	215.8	91.4	50.8	7.1	26.9	52.3	24.4	3019.8
1977	336.1	89.3	47.5	13.4	28.6	57.3	34.8	2852.0
1978	326.9	103.2	64.9	24.3	27.1	47.3	44.4	3304.4
1979	284.3	123.8	84.4	54.8	24.3	95.7	59.0	2460.6
1980	286.7	120.4	57.3	84.0	30.8	89.6	85.0	2872.4
1981	284.3	127.4	63.4	130.4	27.9	137.7	110.3	3424.1
1982	276.0	101.1	65.1	142.7	29.8	142.7	132.7	4034.8
1983	329.7	113.3	76.3	127.5	37.4	106.6	115.1	4398.4
1984	604.5	126.6	79.0	261.2	27.1	126.1	105.0	5239.2
1985	434.4	92.9	111.0	262.6	31.6	140.3	72.6	5245.1
1986	281.0	80.0	73.0	261.4	23.0	72.0	60.8	4858.7
								Value Rs.Million
1976	2099.7	889.6	374.6	68.7	261.4	509	237.8	27750
1977	3502.5	930.6	334.7	139.7	297.9	597	363.1	34432
1978	6400.9	2020.6	971.6	475.3	531.0	926	870.0	40232
1979	5722.2	2491.4	1297.6	1103.5	490.1	1926	1188.0	49532
1980	6170.1	2590.4	753.8	1808.4	663.7	1928	1830.0	61814
1981	6444.0	2889.0	1010.7	2956.8	632.5	3122	2500.0	77625
1982	6342.2	2322.6	1002.6	3278.9	684.9	3280	3050.4	92720
1983	8295.2	2851.8	1409.1	4466.2	940.9	2682	2896.1	110,664
1984	15764.3	3301.3	1552.7	6812.4	616.5	3288	2737.8	136638
1985	12002.8	2566.0	2383.0	7256.7	560.6	3877	2239.3	144921
1986	9252.8	2622.0	2401.7	8600.0	755.1	2358	2000.0	159,852

America, Australasia, and Eastern Europe by 11, 28 and 10 percent, respectively. West European arrivals which reached a peak of 250,474 in 1982 had come down to 145,786 by 1986.

Economic Importance of Tourism

In 1975 income from tourism had accounted for 0.6 percent of Sri Lanka's Gross National Product at current factor cost prices (See table 3). In terms of SDR it was 0.8 percent and in that year receipts from tourism were below those of foreign exchange receipts from tea, rubber, petroleum products and gems. By 1980 the difference in earnings from petroleum products and tourism had narrowed, with tourist earnings increasing at a faster rate. In 1982 the significance of tourism in the GNP had increased to 3.3 percent and during this year receipts from tourism exceeded those from rubber and occupied 4th place as a source of foreign earnings in the country. By 1986, however receipts from tourism dropped to 5th position and its significance in the GNP also came down to 1.2 percent.

The Ceylon Tourist Board has estimated that gross foreign exchange earnings from tourism in 1986 was Rs.2,000 million (SDR 61 million), the lowest since 1980. Though a marginal decline over 1985 in Rupee terms, in SDR terms it was a decline of 16 percent. When compared with the peak ot level of earnings of SDR 133 million in 1982, earnings in 1986 had shown a 54 percent drop. In 1987 too the country's balance of payments showed a significant deficit in the Servives Account; and this decline is partly attributed to a drop of almost 35 percent in the earnings from tourism when compared to that of 1986.

Employment opportunities provided by the tourist industry also continued to contract. Compared to an estimated 50,000 employed in 1985 the numbers came down to 48,000, indicating a 12 percent decrease. Of these employed in 1986 about 20,000 were directly employed and about 28,000 were estimated to be employed in the ancillary sector.

"The most serious criticism made against me was that I relectuant to provide funds needed for the country's essential defence requirements. The Leader of the Opposition stated that, while I had opposed defence expenditure, I had at the same time, permitted wasteful expenditure of large sums of public money on subsiding Air Lanka".

The country's financial and budgetary problems, he said, were due, not to escalating defence expenditure, but to gross financial management, and in particular, to the country's mounting debt service burden. It was my duty, as Finance Minister, he added, to provide the necessary funds for defence, because, as he put it, defence expenditure was sacrosanct and it was the primary duty of the government in power to defend itself against outside threats and internal subversion.

The unstated implication of this long violent harangue in my absence, was that I had not given my full support to the defence establishment in its efforts to maintain the unity, sovereignity and territorial integrity of the country. I want to state most emphatically once and for all that this is a completely baseless allegation. I prize the soveringnity and territorial integrity of Sri Lanka as much as any other member of this House.I have always been ready and willing to meet all the requirements of the Armed Services".

Major Determinants in Tourist Arrivals

From the perspective of the tourism generating countries sample surveys have found that the levels of income, distribution of income, educational levels, social structures, changing vacation habits, degrees of urbanization and geographical location and costs of transport and travel are the principal socio-economic determinants of growth of vacation travel which is the major component of tourism. As a rule of thumb the vacationers in the West are more prone to spend an amount equivalent to one months income per family on annual leave. This may vary according to the living standards not only from country to country but also within each country. Paid vacations also play a crucial role in the decision making process relating to holiday travel .

From the host country's angle what is important is where the tourists select to travel and what kind of income and social groups are engaged in travelling. In addition to the above determinants the competitive position in the travel services supply sector such as hotels, resorts, entertainment packages, food, beaches and other attractions, travelling and transport facilities, different exchange rates, personal security of travellers etc. influence very much the alternative decision making process regarding destination selection. Tourists are also extensively motivated by the inclination to see different environments cultures, scenery etc. Hence, any country planning for tourism, involving large financial and resource transfers always faces a quandry as to the returns on their investment and viability of their pro jects, since there is no definite indication of tourist movements and their habits. These elements of risk and uncertinity are comparatively high in the tourism sector. This unpredictable situation has resulted in extensive resources diversification. and speculative investment in the early stages and after sometime has caused many of the developing countries, including Sri Lanka, to face a position of capital resources redundancy.

Empirical studies have indicated that the demand for vacation travel, both domestic and foreign is strongly price elastic and expenditure on long distance foreign travel are highly income elastic. Prices depend on the internal prices of accomodation, food, transport and other levies etc. and the changes in value of individual currencies in terms of hard currencies. However among the tourists a certain amount of rational and comparative thinking in the selection of destination to travel takes place before the decisions are made. They always prefer to maximize the receiving side of the package.

School and worker holiday patterns, individual vacation customs, climatic and geographical factors in both the tourism generating and host countries have made most vacation tourism highly seasonal.

New leisure and promotional practices compatible with climatic and economic conditions are adding to the

TABLE 4 SRI LANKA TOURISM 1977–1986

Item	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
1.0 Total Tourist Arrivals (No.)	153.665	192,592	250,164	321.780	370.742	407.230	337,530	317,734	257,456	230,106
2.0 Regional Distribution (% change)		25.3	29.9	28.6	15.2	9.9	-17.1	6·9-	-18.9	- 10.6
2.1 North America	10,137	12.426	13,941	15,408	16.554	17,686	15,852	15.020	10.358	4,232
2.2 Latin America & The Caribbeans	371	498	609	676	652	532	568	486	430	402
2.3 Europe	109,278	134.397	168.801	220.588	250.474	236.228	181,240	194.340	156.084	145,786
2.4 Africa	1,237	1.497	1.646	2.380	2.584	3,012	2,834	2,954	1.512	454
2.5 Middle East	1,077	1,268	1,646	1,986	3.014	3,098	2,780	3.228	1.752	2134
2.6 Asia	26,158	35.996	56,187	72,022	87,894	133,886	123.798	89.736	79,230	66,280
2.7 Australasia*	5,407	6,510	7,334	8,720	9,570	12,788	10,458	11,972	8.090	5,808
3.0 Purpose of Visits (No.)										
3.1 Business	5.844	11.651	13,406	21.594	23,540	27,484	17,022	10.934	18.214	
3.2 Pleasure	144,148	177.824	227,218	291.999	331.638	360,824	306,824	300.336	234,038	
3.3 Other	3,633	3,117	9 486	8,192	15,564	18,922	13,496	6.464	5.204	
4.0 Excursionist Arrivals (No.)	7,672	8,494	5,563	8,636	7.737	6,632	7,208	8,838	9,882	
5.0 Total Charter Arrivals (No.)	44,125	50,000	63,510	75.270	77.360	65,792	48,654	53.488	49,884	
6.0 Total Engaged in Tourist Industry (No.)	—	—	43,409	47.900	55.255	64,262	53,608	59.026	55,000	
6.1 Direct Employment	13,716	15,404	18,472	19.878	23.023	26,776	22,374	24,594	22 723	20,000
6.2 Estimated Indirect Employment	—	—	24,937	28.022	32.532	37,489	31,234	34,432	31,810	28,000
7.0 Foreign Exchange Earnings (Rs. Mn.)	363	870	1,209	1.830	2,547	3,050	2,896	2.670	2,239	
8.0 Establishments Providing Accommodation (No.)	194	174	169	182	224	240	271	277	271	237
8.1 Graded Establishments	90	96	95	101	115	123	138	146	145	131
8.1.1 Rooms	—	—	5.599	6.042	6,891	7,539	8,852	9,627	9.826	9794
8.1.2 Beds	—	—	11,212	11.790	13,773	15,001	17,605	18.970	19,358	19301
8.2 Supplementary Establishments	104	78	74	81	109	117	133	131	126	100
8.2.1 Rooms	—	—	740	755	993	1,159	1,251	1.270	1.180	1137
8.2.2 Beds	—	—	1.541	1,546	2,014	2,346	2,584	2,599	2.837	2386

* Including Australia, New Zealand and Fiji Islands.

Note.—The term "tourist" is used to describe visitors who spend one night or more in the country. The term "excursionist" identifies those who do not make an overnight stay but spend several hours in the country.

Source : Ceylon Tourist Board.

tourist attractions. Apparel and fashion exhibitions, new and exciting sports events and revival of indigeneous customs and rituals, theatrical and music festivals are increasingly being tied up with the holiday and vacation travel sector.

Increasing Tranasnational Impact

A striking feature of the present day global tourist industry is the increasing penetration and dominance of the transnational service conglomerates in almost every facet of activity related to both the supply and demand sides of the holiday, travel, hotel and leisure industry. International tourism has continued to move more and more within the control of these major service conglomerates; and therefore the principal and increasingly overlapping subsectors of the tourism industry now comprise hotels, airlines, tour operators and travel agents. Despite the economic crises of the 1970's, returns from international tourism kept rising rapidly, and according to the World Tourism Organisation Statistics international tourism receipts moved from $ 10 billion in 1964 and $ 17 billion in 1970, to $ 41 billion in 1975 and $ 81 billion in 1979; surpassing $ 100 billion by 1982. Of an estimated 10 million hotel rooms available globally, the twelve largest hotel chains together owned more than one million. These one million rooms were dispersed over 5,000 hotels which had an annual turnover of approximately US$ 15 billion.

In the overall picture of tourism a notable feature has been the trend towards service conglomeration. Although the specialised transnationalised hotel chains continued to operate (with almost half of them located in the developing countries), they were being increasingly superseded by more complex forms of transnational service conglemerates. Predominant among these were the hotel chains related to airlines. In 1982 twenty of the leading airline companies with tourism related chains together had a turnover of more than US $ 40 billion. There were eight airlines dominating tourist travel (outside the socialist countries), each with over $ 10 billion revenue passenger miles in 1977, among which were TWA, British Airways, Japan Airlines, Air France , Air Canada and Lufthansa.

The tour operator sector, in which "package tours" account for more than 80 percent of tourists is yet not as much under the dominance of transnational corporations (TNCs) as air transport. Nevertheless, this sector is becoming increasingly associated with TNCs, and market shares of some big tour operators have been growing rapidly especially in West European countries.

Another sector feeling the influence of the TNCs is that providing infrastructure facilities for tourism. Hotel construction, roads, esplanades and other buildings, installations, furniture and fittings etc. which are increasingly being connected up with internationally operated design, architectural and construction ventures.

Developing countries, interested in promoting tourism and activities connected with tourism are obliged to seek close connections with the TNCs. These TNCs have found it easier to expand into the tourism sector as a result of their enormous resources and facilities such as computerised reservation systems, brand names and massive promotion campaigns. Foreign exchange, technical expertise, booking arrangements, air transport etc. have to be resorted to from internationally located TNC's which sooner or later influence the activities within the host country. These countries ultimately become vulnerable and dependent on the power of the TNCs. The TNCs have been able to operate with such dominancy because they have been able to acquire substantial assets, diversified experience and technology, management systems and organisational methods required for the rapid development of gains from tourism. These TNCs have become owners of human resources specialisation transport facilities and control accomodation and have also established commercial access to the tourist generating markets and worldwide control of management systems.

The rate of growth in tourism began to slow down internationally from around the mid 1980's, although the number of tourists going abroad had increased from only 25 million in 1950 to 333 million by 1985. In Sri Lanka's case, as has been observed, the slowdown was far more rapid than that of global trends mainly because of the disturbed local conditions and adverse publicity the country received after 1983. Conditions were expected to improve for the local industry from 1987, but these expectations have been put back another year, while the industry continues to be propped up with various forms of government concessionary supports. The local industry remains hopeful that events would turn for the better.

There is a ray of hope in the future of tourism, particularly in the context of the recent International Labour Organisation report which predicted that by the end of the century tourism would be the world's biggest industry. The ILO report states that between 400 and 600 million tourists will take a foreign holiday in 1990 and tourism and connected activities will be the world's biggest industry by the year 2000. It adds that although growth had slowed down, tourism and related industries would still have a greater turnover than all other economic sectors by the year 2000.

The competition among tourist destinations and host countries for capturing these growing markets and revenues is bound to grow more intense. It is here that countries like Sri Lanka with much tourist potential have to decide on how far they can go. In the battle to attract tourists, these developing countries face a crucial choice: either join the TNC cricuit and get the benefit of their connections, or lose a sizeable tourist traffic and income to those competing countries that do.

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