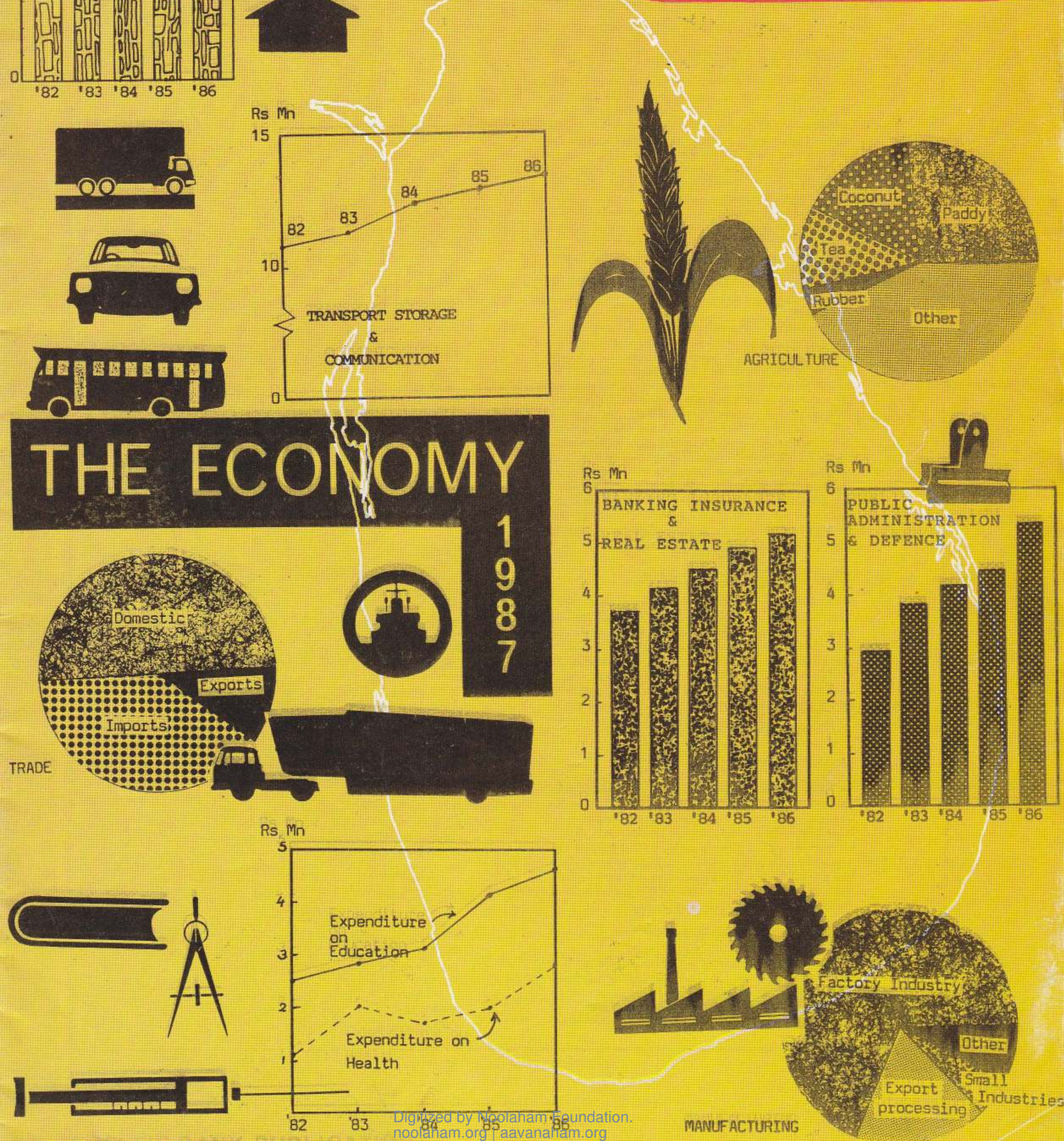
ECONOMIC REVIEW

MAY 1987



A PEOPLE'S BANK PUBLICATION

FINANCE MINISTER RONNIE DE MEL'S TENTH

SUCCESSIVE ADDRESS TO AID GROUP

Hon. Ronnie de Mel

Paris, June 25

Extracts from the statement by the Minister

Development Programme Uninterrupted

"While we all look forward to the restoration of peace and stability in Sri Lanka, we must not overlook the salient fact that four years of internal conflict and escalating military expenditure has not resulted in any deterioration of the high standards of prudent economic and financial management which we have consistently tried to maintain in Sri Lanka during the last ten years. We have also gone ahead with our development programme without a break. On behalf of the Government, I can also assure you, that we will continue to maintain the same high standards of economic and financial management in the future too, notwithstanding the stresses and strains of the present ethnic problem. This is outlined in the medium term financial strategy 1987-1989, which I have already outlined to you."

Regaining Past Momentum

"Restoration of high growth will be possible only if additional revenue resources are mobilized or if expenditure savings in other areas are attainable. This scenario of economic adjustment would no doubt entail an initial lowering of Sri Lanka's growth performance from the high levels achieved in the past. However, with increased resources made available to the private sector, and with the productivity gains made possible by the policy reforms and the infrastructure development of the last ten years, we could expect to regain the momentum of the rapid economic development of the past. This is of course subject to the crucial assumption that there will be an improvement in the political situation. Even with the present security situation, however, I am confident that the economic activity in the rest of the country which is not affected by violence could yield an overall economic growth rate of around 3-4 per cent in total in the coming years."

Medium Term Public Investment Programme

"The Medium Term Public Investment Program 1987-1991, which has been presented to you, has been prepared within this overall framework. The stabilization of the economy during 1987 and 1988 will be a major objective. While our exchange rate policy will be aimed at maintaining Sri Lanka's external competitiveness, and perhaps improving it, and while monetary policy will be directed essentially at containing inflation and improving the availability and cost of credit to the productive sectors, fiscal adjustment will continue to bear the brunt of this economic adjustment."

Creating New Environment

"We doubled the incomes of our people, reduced poverty and unemployment, protected the poorest, rehabilitated a run-down infrastructure and opened up income earning opportunities to millions, while preserving the democratic form of Government and our democratic way of life. We have thus created a new hope and a new expectation that rapid economic development can be achieved within a democratic framework and a liberalised economic system, while safeguarding the living standards of the poorest of the poor."

Commitment to Development

"What is most noteworthy is that our progress has been achieved under the most difficult circumstances that could have been faced by any country at any time. Despite our having to fight with our backs to the wall against such terrific odds, we have made courageous and determined efforts to nullify the remaining imbalances and to foster an incremental open economy, whose proven resilience under great adversity has kept incomes growing and hopes of a better tomorrow for our people very much alive. I shudder to think of the intolerable hardships Sri Lanka would have faced today if we had not completely transformed our economic system and our economic policies since 1977."

Reducing Public Sector Consumption

"With regard to expenditure, there could be some scope for reducing public sector consumption. A Committee on Administrative Reforms has made recommendations to streamline the administrative system. Also, greater progress in rationalisation of public enterprises could produce budgetary savings. Legislation has already been enacted to convert public corporations to public companies under the Company Law of Sri Lanka. Already a number of uneconomic public enterprises have been closed down, while some have been placed under private management. We are now in the process of privatising the Telecommunication Services, the State Distilleries Corporation, and the Sri Lanka Sugar Corporation. There are many other public corporations which will come up for privatisation in due course. A high level Presidential Privatisation Commission has been appointed to prepare the strategy and plan for rapid privatisation. Also, several measures have already been taken and will be taken in the future too, with World Bank assistance, to improve the management of the remaining public enterprises and improve their performance. An important means by which we hope to make public enterprises more efficient will be by discontinuing public sector monopolies and by encouraging greater competition from the private sector on equal terms."

Reducing Public Sector Consumption

"We are adopting a very pragmatic and practical approach towards public enterprises. Our policy is to bring in the private sector, where appropriate, so as to improve management and efficiency and make them less of a burden on the Exchequer and on the Budget."

Tighter Expenditure Control

"Meanwhile, we have also set in motion a process to further tighten Treasury control of Government expenditure. Some aspects of public expenditure control had tended to become somewhat relaxed in the early stages of the Government's large public investment program, in order not to retard or inhibit the pace of its implementation. We now feel that very strict expenditure controls should be restored once more, and several firm steps have already been taken in this direction since 1985. The Government has laid down strict procedures and guidelines for the identification, preparation and implementation of projects, involving a two-stage approval procedure. The appraisal capacity of line Ministries and Departments have been further strengthened in project evaluation."

National Priorities

"The Government has also laid down a set of national priorities. These include social welfare programs, maintenance and rehabilitation of existing infrastructure assets and the promotion of a dynamic export oriented private sector. The Public Investment Program will in future be essentially directed to the provision of the necessary infrastructure and also the safeguarding of the living standards of the most indigent sections of the population".

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COVER

Sepalika Fernando

THE ECONOMIC REVIEW is intended to promote knowledge of and interest in the economy and economic development process by a many sided presentation of views & reportage, facts and debate.

THE ECONOMIC REVIEW is a community service project of the People's Bank. Its contents, however, are the result of editorial considerations only and do not necessarily reflect Bank policies or the official viewpoint. Signed feature articles also are the personal views of the authors and do not represent the institutions to which they are attached. Similar contributions as well as comments and viewpoints are welcome.

THE ECONOMIC REVIEW is published monthly and is available both on subscription and on direct sale.

WORLD BANK VIEWS ON SRI LANKA'S ECONOMY

The Sri Lanka Aid Group's meeting at the World Bank's Paris office in June reviews the country's economic progress and discusses its external assistance requirements during the coming year.

The Bank's assessment of recent economic developments in Sri Lanka, the current state of the economy and its future outlook are summed up in the following extracts from its 1987 report.

Since liberalization in 1977, Sri Lanka has experienced an unprecedented economic growth rate of 5.6 percent per year. Per capita gross domestic product (GDP) is now 40 percent higher, in real terms, and unemployment is much lower than a decade ago. But there have been reversals in recent years. Growth is slowing, unemployment is rising, and the fiscal and balance of payments situation is precarious.

The deterioration of the economy is largely due to adverse external developments, adjustments in economic policies that were insufficient to correct the large macroeconomic imbalances that emerged in the early 1980s, and the outbreak of ethnic conflict in 1983.

Prices of Sri Lanka's traditional exports tea, rubber and coconuts are at their lowest level since World War II. The deterioration in Sri Lanka's terms of trade (about 30 percent since 1978), the quotas set by developed countries on Sri Lanka's garment exports, and, more recently, the decline in the price of oil, which brought a consequent stagnation in workers' remittances, have further weakened the country's balance of payments position. The ethnic conflict has reduced the flow of tourists, thus depriving the country of an important foreign exchange source, while higher expenditures for national security have increased the import bill.

Adjustments in economic policies have been insufficient in three important areas domestic resource mobilization, public sector deficits, and current account deficits. While the imbalances can be attributed in part to the absorption of the large inflows of funds made available to the country, they were also due to excessive consumption and investment growth.

The economy must adjust to consumption and investment levels that are compatible with the reduced domestic and foreign resources now available. It is unclear, however, whether this adjustment can be made without disrupting growth and plunging the economy into recession.

Economic Reform Program

The government has presented to Parliament a program for 1987-89 to reduce macroeconomic imbalances and allow sustainable economic growth. It includes (a) a gradual reduction in public spending from 32.5 percent of GDP in 1986 to 28.5 percent of GDP by 1989, (b) maintenance of government revenues at 20 percent of GDP, and (c) maintenance of a flexible and realistic exchange rate policy.

The government needs to implement these reforms quickly as further delays will increase their costs substantially.

The first priority is to achieve a more favourable balance-of-payments position. Second, the policy reforms should aim at reducing the high public sector deficits and ensure efficient public expenditures. Finally, industrial policies must be changed to improve the efficiency of the manufacturing sector and increase its export orientation.

The three-pronged economic reform program is consistent with government objectives to correct existing macroeconomic imbalances and provide the supply incentives necessary for sustained growth. In the medium term, it could create the employment opportunities necessary to reduce the currently high unemployment rate. Implementation of new adjustment policies will require a strengthening of the civil service.

Balance of Payments

In the medium and long term, expansion of Sri Lanka's export base is the only solution to the country's balance-of-payments problems that will also permit sustained growth. To achieve this objective, it is crucial that the exchange rate be kept at a level consistent with the volume of foreign exchange that the country needs to generate.

Public Expenditures

Rationalization of public expenditures and a reassessment of investment priorities are urgent tasks facing the government.

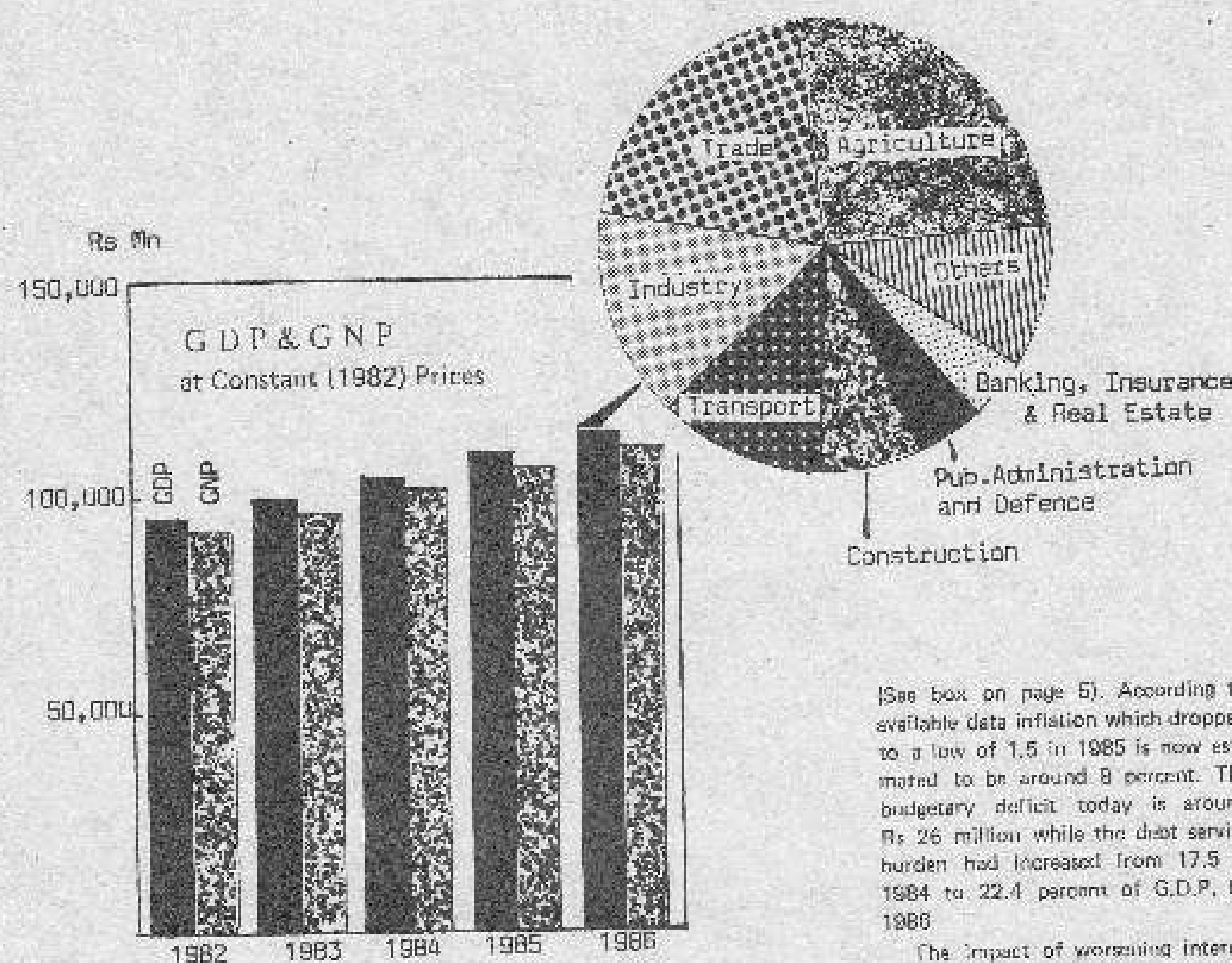
Industrial Policy Reform

The Industrial Policy Committee (IPC) report, approved by the Cabinet in February, is a major first step in introducing policies that will allow Sri Lanka's industry and industrial exports to develop more vigorously. The IPC proposals to introduce a tariff system that would provide a moderate low level of effective protection of about 50 percent and would reduce dispersion of effective protection rates across sectors should encourage a considerably more efficient industrial sector in Sri Lanka. However, this objective could be achieved more easily by a flat nominal tariff.

Aid Requirements

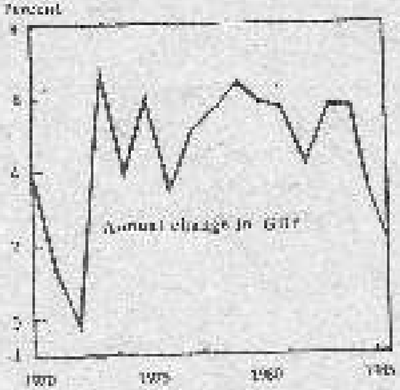
Because of the gloomy prospects for tea, rubber, and coconut, and the lack of diversification of Sri Lanka's export sector, the impact of the reform program on increasing exports will be felt only in the medium term. Even with the reduced GDP growth rate expected in the near future, and the consequent reduced growth rate of imports, the country will need a volume of capital inflows of about $ 730 million per year for three years (1987-89). Disbursements of about $ 590 million per year may be forthcoming from project financing and commodity aid during 1987-89.

If donors could maintain the average volume of aid, in real terms, that they provided to Sri Lanka in the last three years and increase the volume of commodity aid and/or non-project lending to compensate for the expected decline in disbursements associated with the reduction in the government investment program, only $ 415 million of external resource requirements will remain to be financed. This total should be manageable and could be obtained from multilateral agencies if the government succeeds in implementing a satisfactory adjustment program.



SRI LANKA'S ECONOMY 1987

The Sri Lankan economic experience during the past nine year period (1978-1986) is interesting in several ways. With the introduction of the 1977 reforms the post independent largely import substitution economic development strategy was partially dismantled. It was replaced by what was termed an 'outward looking' strategy which advocated an increasing role for market forces; a partial dismantling of tariff and other barriers and a greater role for the private sector. The initial response to this package of changes has been positive in the spheres of economic growth and employment. However, more recently, there have been some disquieting signs in the economy. The initial high growth rate had declined steadily and continuously from a high of 8.8 percent in 1978 to 4.5 percent in 1986, employment which had dropped from 24 percent in 1977 to a low of 12 percent in 1981 had gone up to 17 percent in 1986.



(See box on page 5). According to available data inflation which dropped to a low of 1.5 in 1985 is now estimated to be around 8 percent. The budgetary deficit today is around Rs 26 million while the debt service burden had increased from 17.5 in 1984 to 22.4 percent of G.D.P. by 1986.

The impact of worsening international price levels for primary commodities, the recent drought and the ethnic tensions; together with increasing defence allocations from the budget have restrained growth potential in the economy to a greater extent. The problem, as the Finance Minister put it is "Despite the successes, some basic structural weaknesses continue to exist in the Sri Lankan economy. The two most crucial imbalances are the Budget deficit and the narrow export base. However, little progress can be made on these two fronts if peace is not restored in the country".

The following pages present a discussion on the performance of the economy during the past nine year period, its achievements and the problems it now faces.

1978

[illegible]

Public Investment 1979-1983

1979

[illegible]

Public Investment 1980-1984

1980

[illegible]

[illegible]

Public Investment 1981-1985

1981

[illegible]

[illegible]

Public Investment 1982-1986

1982

[illegible]

trends and map out future strategies. The overall picture which emerges is a very encouraging one. A dormant economy has been resuscitated and its growth impulses set in motion to bring about significant changes for the future. The average rate of growth of the GDP, during the last five years from 1978 to 1982 has been more than double that of the previous five years. Employment creation too has been buoyant. Unemployment as a proportion of the labour force has dropped from 25.9 percent in 1977 to 13.4 percent in 1982.

Public Investment 1983-1987

1983

The Public Investment Programme for the next five years is being presented against the background of the experience in the period 1978 to 1983. The events of July 1983 had some impact on the economy, the speed and resilience shown in recovery however was remarkable. Economic growth in 1983 suffered marginally in comparison with the preceding year but was still much higher than the annual average before 1977. The slow down was mainly in industreis and the service sectors, while there was unprecedented growth in the production of paddy, the staple food crop. Incomes and employment consequently continued on a favourable trend. There is, no cause for deviation from the strategy sketched out in the document presented last year.

Public Investment 1984-1988

1984

It is possible to look back on the past seven years with as sense of achievement. In the first few years under the new policies the Government succeeded in giving a new orientation and dynamism to a virtually stagnant economy. The soundness of the new strategy was confirmed when the economy not only achieved very encouraging growth in real terms but also displayed remarkable resilience in the face of adverse external and internal circumstances.

Public Investment 1985-1989

1985

The Sri Lanka economy displayed yet again, in 1985, its capacity to sustain the momentum of growth, generated by the economic reforms of 1977. In spite of the disturbances in the North and the East of the country, affecting production and distribution of goods and services, and mounting defence expenditure, the economy was able to register an overall growth rate of 5 percent last year.

Public Investment 1986-1990

1986

Several exogenous factors have tested in 1986 the resilience of the Sri Lanka economy and the will and determination of the country's policy makers to continue on the path of development embarked upon in 1977......A severe drought, the wrost experienced by Sri Lanka in 25 years, has appreciably reduced Agricultural output and farm incomes in 1986 and continues to do so in the first quarter of 1987.......The country's balance of payments has also been adversely affected due to the increase in imports as well as a drop in export earnings.......Export earnings from tea, rubber and coconut dropped drastically in 1986 due to price declines.......The drop in commodity export prices had an impact also on producer margins and government revenue.

Terrorist activity and consequently security operations in the Northern and Eastern regions continued to exert an adverse impact on several sectors of the economy.........A number of government buildings, educational establishments, banks, telecommunication and electricity equipment, roads and bridges have been destroyed, cutting down drastically the availability of infrastructure services.....The Government's security bill as a percentage of total budgetary expenditure has soared from 3.2 percent in 1982 to 13.6 percent in 1986.

The net impact of these factors is a slower growth of GDP and a deceleration of employment generation in 1986. While GDP grew only by 4 percent, the lowest since 1977, there is evidence that unemployment which dropped to about 14 percent in 1984, is already in the region of 16 to 17 percent. If the growth momentum is not restored, it is possible that unemployment will reach 19-20 percent by 1990. One of the most disturbing features of economic performance in 1986 is the heavier debt service burden, which has risen to 27 percent, reflecting both a loss in foreign exchange earnings from exports and tourism, as well as maturing of service payments in respect of commercial borrowings incurred earlier to sustain investments in several state owned enterprises.

Public Investment 1987-1991

A REVIEW OF THE ECONOMY

Tilak Samaranayake

In this review of the economy in terms of GDP growth performance and the developments of key macro economic indicators economist Tilak Samaranayake discusses the slowdown in growth trends and maintains that the economy was feeling the impact of adverse cyclical and structural effects, in addition to the external factors associated with the ethnic situation. He concludes that while there is little that can be done about cyclical effects, such as weather and also to an extent the adverse developments arising from terrorist activities, it is necessary to strive to remedy the structural effects through implementation of corrective policies.

Performance in 1986

Sri Lanka's economy, measured in terms of the Gross Domestic Product (GDP), grew by 4.3 percent last year in real terms (1982 constant prices) or by 10.4 percent in current (1986) prices. The value of GDP in constant prices increased from Rs 109,570 million in 1985 to Rs 114,261 million in 1986, and in current prices from Rs 148,321 million in 1985 to Rs 163,713 million in 1986. Gross National Product, which is computed by adjusting the GDP for net factor income from abroad, increased by 4.5 percent in constant prices and by 10.8 percent in current prices. However, the values of GNP, in constant (Rs 114, 261 mn) and current (Rs 163,713 mn) prices in 1986 were lower than the respective values of GDP during the year which implied, that there has been an outflow of resources in 1986 as well. This trend has been a continuing feature in Sri Lanka's national accounts during the last few years.

Sectoral breakdown indicates that growth rates have varied from a minimum of 2.6 percent in the agricultural sector to a maximum of 8.4 percent in the manufacturing sector. Among the principal GDP sectors, only three registered a growth rate of more than the overall growth rate, that is, mining (6.2%) manufacturing (8.4%) and unclassified (6.0%). Besides agriculture, lower growth rates were recorded in construction (3.0%), transport (3.2%), wholesale and retail trade (3.9%), and banking and real estate (4.0%).

With a growth rate of 8.4 percent (nearly twice the growth rate of GDP and a 15.4 percent GDP share), the manufacturing sector in 1986 accounted for the highest contribution of 29 percent of the GDP growth, in value terms. Despite a GDP share of 26.4 percent, agriculture accounted for only 15 percent because its growth rate of 2.6 percent was nearly half the overall GDP growth rate. Among other sectors, wholesale and retail trade accounted for 18.4 percent of the increase in GDP (in value terms) construction 6.0 percent, transport 8.4 percent, banking and real estate 4.1 percent and unclassified 7.5 percent. Manufacturing, agriculture and wholesale and retail trade taken together, accounted for more than two third of the increase in GDP.

In comparison with the growth standards of the past, since 1978 the year which recorded the highest growth rate the 1986 growth rate turns out to be the lowest. Since 1978, the economic growth rate has been progressively declining and with the 4.3 percent growth rate in 1986, the declining trend has extended further. However, in the context of the circumstances under which this growth rate in 1986 has been achieved, the Sri Lankan economy has done remarkably well. The continuing ethnic conflict and the adverse effects associated with it, such as (a) lower production and reduced markets in the Northern and Eastern provinces, (b) unfavourable investment climate for both local and foreign entrepreneurs, (c) significant drop in tourist traffic and earnings from tourism, and (d) rapid increases in defense expenditure; currently remain major obstacles to economic development. Adverse external markets also caused added constraints in 1986, with extremely lower market prices for major export commodities such as tea.

REVIEW OF TRENDS OF KEY INDICATORS

Revenue and Expenditure

As demonstrated in Table 1, the developments of key macroeconomic indicators show mixed performance. As a ratio to GDP, revenue declined from 24 percent in 1985 to 23 percent in 1986, but in comparison with the 1981 to 1983 period, the 1986 performance was still satisfactory. With regard to both total and capital expenditures, the ratios were lower in 1986 relative to 1985 which indicated that there were some efforts to restrain public expenditure in order to hold down the budget deficit. The 1986 deficit ratio also suggests a marginal improvement in budgetary discipline. However, if the final figure on the total expenditure will be different from the provisional figure currently reported by the Central Bank, the 1986 picture will show an overall deterioration in fiscal variables compared with the experience in 1985.

Money Supply

The developments in the monetary variables show a marked improvement in 1986. The rate of increase in narrow money supply (MI), moderated in 1986 with an increase of only 13 percent. In the case of the broad money supply indicator (M2), the picture looked even better, with a growth rate of 5 percent, the lowest rate recorded during the 1980-1986 period. This decline has been a result of the combination of two factors; (a) a decline in external assets and (b) a reduction in demand for domestic credit from the banking system. While both these developments helped to reduce the pressure on money supply, they are not necessarily encouraging developments with regard to other sectors in the economy. The decline in external assets suggests some deterioration in the ba-

TABLE I

SELECTED MACRO—ECONOMIC INDICATORS (1980-1986)

	1980	1981	1982	1983	1984	1985	1986
Budget (% of GDP)							
(a) Revenue	23	21	18	21	25	24	23
(b) Expenditure	49	39	36	39	35	40	38
(c) Capital	22	17	19	18	14	19	18
Money Supply							
(a) M1 (% increase)	23	6	17	26	14	12	13
(b) M2 (% increase)	32	23	25	22	17	11	5
Inflation							
(a) CPI (% increase)	26	18	11	14	17	1.4	8.0
(b) GDP Deflator (% increase)	18	21	10	15	17	1.0	5.8
Exchange Rates							
(a) SLRs/$ Rate	16.5	19.3	20.8	23.5	25.4	26.2	28.04
(b) Depreciation Rate (%)	6.8	16.6	7.5	11.6	7.5	3.1	6.5
Terms of Trade (1981=100)							
(a) Overall Index	102	100	92	113	134	108	102
(b) Export Index	92	100	98	125	160	142	126
(c) Import Index	90	100	107	110	119	132	124
Foreign Trade (Rs Mn)							
(a) Exports	17603	20507	21008	25038	37198	35729	33881
(b) Imports	33915	36123	41501	45206	49048	55629	54898
(c) Current Acct. Balance	-10912	-8496	-11844	-11122	-1406	-11408	-11461

Source: *Central Bank of Ceylon*

lance of payments while the drop in demand for domestic credit may have been caused by a slower pace in economic growth.

Inflation

Compared with 1985, the rate of inflation, measured in terms of the Colombo Price Index (CPI), increased, but the 8 percent rate in 1986 was still a marked improvement, compared with the experience in the decade before 1985. The GNP deflator, which measures the price movements in aggregate terms, also captured an increasing inflationary trend in 1986 in comparison with the experience in 1985. Although both measures suggest relatively higher price increases in 1986, the increases were still within manageable limits. In the context of continuing budget deficits of substantial magnitudes, and the growing defence budget, inflationary experience would have been much greater if not for the timely action taken by the government during the year such as the downward revision of the interest rates. In the CPI composition, clothing registered the highest increase of 15.5 percent, followed by the miscellaneous category 14.4 percent, food 7.1 percent and fuel 1.5 percent.

Exchange Rates

The Sri Lankan rupee depreciated against all major currencies in 1986, with the only exception being the Indian Rupee. The highest depreciation rates were recorded for the Deutsche Mark and the Japanese Yen, followed by the French Franc and the SDR. The rupee depreciated against the US dollar by 6.5 percent on an annual average basis and by 3.9 percent from the beginning and the end year basis. A much greater depreciation of the exchange rate was prevented by the moderate inflation and the relative weakness of the U S dollar, the intervening currency for exchange rate determination in Sri Lanka, particularly during the second half of the year.

Terms of Trade

International price movements for major export commodities from Sri Lanka remained less encouraging in 1986 compared with 1985, and particularly compared with the experience in 1984 when the international price of tea reached unprecedented price levels. One redeeming feature in the movement of price indices in 1986 was that import prices also experienced a decline, helping Sri Lanka to reduce its expenditure bill on imports.

Both earnings from exports and expenditure on imports declined in 1986, in rupee terms; exports by 5.2 percent and imports by 1 percent. When adjusted for rupee depreciation, the value of exports declined by 10.5 percent and expenditure on imports by 6.5 percent. The current account deficit in the balance of payments marginally increased in rupee terms from Rs 11,408 mn in 1985 to Rs 11,461 mn in 1986 and as a ratio to GDP, it declined from 7.7 percent in 1985 to 7 percent in 1986.On the other hand, the overall resource gap in the balance of payments increased from Rs 28,739 million in 1985 to Rs 31,300 million in 1986. The principal sources of financing this gap was (a) official grants (Rs 4,988 million), (b) long terms loans (Rs 9,916 million), (c) Short term Credits (Rs8,018 million) (d) Commercial borrowings (Rs 2,722 million) and (e) Reserves (Rs 1,215 million). The use of Reserves in financing balance of payments in 1986 led to the decline in the value of gross reserves from Rs 18,367 million at the end of 1985 to Rs 17,512 million at end of 1986.

KEY DETERIMANTS IN ECONOMIC GROWTH

While the economic growth performance and the developments of the key economic indicators in 1986, were to an extent encouraging given particularly the extremely vulnerable economic and political environment currently prevailing, the declining economic growth and the remote prospects of maintaining economic stability in the coming years warrant immediate policy attention. Lower economic growth directly translates into lower production which in turn leads to lower income, earnings from exports, government revenue and domestic investments. In the absence of concerted efforts, this process could repeat itself year after year, reducing the growth next year, relative to this year, together with a decline in overall socio-economic standards.

The issue raised here is whether the economy can perform better, even under these difficult circumstances. While a straight forward answer to this point is not easy, and requires a great deal of analysis of the different facets of the economy, any potential for an improved economic performance lies in favourable developments in the fiscal front and the balance of payments as the developments in these two areas will be the key determinants of growth and economic stability. Apparently, the developments in these two areas will in turn depend largely on the developments of the production base; and the fiscal and balance of payments fronts suggest that it is the improved production performance that eventually determines improved growth performance and economic stability.

The rest of the paper explores the potential for higher economic growth by reviewing the production trends in agricultural and manufacturing sectors in the recent past. This will be undertaken following a brief review of the roles of fiscal and balance of payments in economic development in order to highlight the need to consolidate development strategies and economic policies to increase production and overcome the constraints imposed on the economy by a weak revenue base and a traditional export sector.

Role of Fiscal Developments

Increased mobilization of investment has been a major determinant of the impressive growth performance during the last ten years, since economic liberalization in 1977. Between 1978 and 1986, gross domestic investment averaged 24.0 percent of GDP compared with 16.0 percent between 1970 and 1977. Investment in the public sector accounted for 14.5 percent of GDP while the private sector share in domestic investment averaged 9.5 percent of GDP during the 1978-86 period. The disaggregation of domestic investments after 1978 in terms of national and foreign savings indicate that national savings contributed 14.3 percent of GDP and foreign savings 9.6 percent of GDP. The respective ratios between 1970 and 1977 were 12.7 percent and 3.3 percent. These ratios of the two periods demonstrate that higher domestic investment since 1978 has been made possible largely because of the increased foreign assistance consisting of concessionary foreign loans and outright grants. The difference in the national savings ratios of the two periods, (between 1970 and 1977 and after 1978) is very small which means that the role of national savings has been practically the same during both periods.

The fiancing of the public investment programme during the 1978-86 period indicates that 14.3 percent of GDP has come from national savings and 9.6 percent of GDP from foreign savings. Of the national savings, the private sector share has been about 11.7 percent of GDP. The volume of savings that occured in the public sector after 1978 amounted to 2.7 percent of GDP, but the amount of public sector national savings that resulted from budgetary operations was equivalent to only 1.7 percent of GDP. Thus even within the public sector, a greater part of public investment (excluding the contribution made by the private sector) has come from sources outside the budget.

The significance of non revenue sources in financing Sri Lanka's economic development is well demonstrated in Table 11. During the six year period between 1981 and 1986, total public spending (both current and capital) amounted to Rs 300 billion, of which domestic revenue accounted for about Rs 178 billion. About 5 percent of the overall deficit, which amounted to Rs 124 billion, has been financed by foreign loans and grants (52%) and the balance by non-bank sources (36%) and the banking system (12%). This breakdown clearly places foreign assistance as a highly dominat source of deficit financing after 1978.

TABLE II

SUMMARY OF BUDGETARY OPERATIONS (1981 - 86)

Revenue, Expenditure and Financing (Rs Mn)	1981	1982	1983	1984	1985	1986	Total 1981-1986
(a) Revenue	16,228	17,809	25,216	37,731	39,010	41,955	177,949
(b) Current Expenditure	17,721	19,221	25,083	31,842	34,156	34,602	162,635
(c) Capital Expenditure	13,373	18,869	23,131	21,769	30,520	32,948	140,401
(d) Revenue Surplus Over current Expenditure	1,493	1,422	127	5,889	4,854	7,353	15,308
(e) Budget Deficit	14,880	20,091	21,606	15,881	25,676	25,596	123,886
Financed By							
(a) Foreign Grants & Loans	8,708	8,794	10,950	11,251	12,205	13,575	64,983
(b) Domestic Borrowing							
(i) Non-Bank	2,779	7,697	10,182	6,589	8,520	8,963	44,730
(ii) Bank System	3,917	3,915	1,165	-2,644	7,451	2,298	16,106
(iii) Other	-38	-315	694	808	-2,501	760	2,123
AS GDP SHARE							Average
(a) Revenue	20.6	19.4	22.8	24.5	24.0	23.4	22.4
(b) Current Expenditure	22.3	21.9	22.6	20.7	21.0	19.3	21.1
(c) Capital Expenditure	16.9	20.4	20.8	14.1	18.8	18.4	18.2
(d) Budget Deficit	18.7	21.9	19.4	10.2	15.8	14.5	16.7
Other							
(a) Budget Deficit	92	113	86	42	60	79	80
(b) Foreign Assistance As a rate of Capital spending	61	47	47	52	40	41	48

Source: *Central Bank of Ceylon*

According to the five year Public Investment plan for the 1987 to 1991 period, the projected investments on development projects and programmes amount to Rs 151 billion (Table III). During the last six years, the actual development expenditure totalled Rs 120 billion compared with Rs 94 billion that results from the aggregation of annual totals in respective plans during the 1981-86 period. It should be noted that the amount of development expenditure for the 1981-1986 period, differs from the amount in the capital budget (Table II), as the latter includes capital transfers to public corporations. During the 1981-86 period only about Rs 15 billion of the capital budget has been met from budgetary savings, that is the surplus of revenue over current expenditure, and the bulk of capital expenditure has been financed from non-revenue sources of which, as demonstrated above, the role of foreign financing has been extremely important.

A major concern of the next five year Public Investment plan is the ability of the government to mobilize adequate resources to finance the five year development budget. In the medium and long term, foreign financing is unlikely to be easily available, at least at the same magnitude as in the recent past, which means that the financing of development in the coming years will have to be mostly met from domestic sources. According to current projections, the volume of financing from external sources has been projected at Rs 44 billion or 42 percent of the total five year investment budget during the 1987-1991 period, compared with 52 percent during the last six years. A large part of investment during the next five year period is expected by the government from its own revenue sources. According to tentative estimates, about Rs 88 billion or 58 percent of the investment budget is accounted for by domestic revenue.This share during the 1981-86 period remained around 12 percent.

As the Public Investment plan expects approximately Rs 88 billion to come from domestic revenue sources, compared with only Rs 15 billion during the 1981-1986 period, a substantial increase in revenue appears extremely important during the plan period. However, the past trends do not provide supportive evidence of the ability of the government to increase revenue by any substantial margins. In 1986, for example, domestic revenue increased only marginally by 7.6 percent over 1985, and this increase has been lower than the average price increase of 8 percent during 1986. Substantial increases in government revenue after 1977 occurred only in 1983 and 1984 (Table IV). In 1983, the government revenue went up by 42 percent compared with 1982, and in 1984 by another 50 percent. In both years, the revenue increases were essentially a result of the increases in tax rates on turnover, sales and import duties. The agreement with the International Monetary Fund (IMF) for SDR 100 million in November 1983, was a major factor for the increases in tax rates in 1983 and 1984.

Whether the government can effectively implement the Public Investment Plan thus depends largelly on its ability to raise adequate revenue from domestic sources. While the role of foreign assistance is expected to decline progressively, the picture with regard to non-bank domestic sources also remains uncertain. As the Minister of Finance and Planning remarked during the budget speech last year, the availability of budgetray support from the non bank sector such as Provident Fund and Trust Fund, and savings institutions, is extremely limited particularly as a source of additional support in the event of increasing budget deficits or reduced availability of foreign assistance.

While the revenue picture is not encouraging, the situation could be further aggravated if defence expenditure continues to demand an increasing share of budgetary expenditure. From 1985, the defence expenditure allocation has remained extraordinarily high; in 1985, the defense budget amounted to Rs 6 billion and in 1986 to Rs 9 billion. The allocation is expected to go up to Rs 15 billion in 1987 and to Rs 18.5 billion in 1988. If such high spending has to be maintained on security operations, the government would have to either raise more revenue or reduce spending on development activities. Unfortunately, both are extremely difficult options.

Defence expendi ture as a ratio to revenue has increased from about 15 percent in 1985 to 25 percent in 1986, indicating the tremendous pressure brought about by rapid increases in defence expenditure on revenue. However, defence expenditure as a ratio to GDP is still around 10 percent which is relatively modest in comparison with most other countries in the region such as Pakistan, India, Thailand and Singapore, where this ratio is in the region of 20 percent. The picture that emerges from the comparison of two ratios, that is, defence/revenue and defence/GDP is that the budgetary pressure currently experienced by the economy is not entirely a result of increasing defence expenditures. An equally important role has also been played by the marginal increases in revenue; with the exception of 1983 and 1984. The defence revenue ratio will not be so large if revenue also can be raised correspondingly. This ratio could go up further in 1987 and 1988 as the revenue base at present is not capable of absorbing even marginal increases in defence spending.

In 1986, the government made strong efforts to contain inflationary pressures by maintaining a reduced growth in money supply. While this has proved successful, the effectiveness of such management policies in the future will largely depend on the fiscal front and more specifically on the amount of budget financing that will be required by expansionary sources such as bank borrowings and sale of treasury bills to the Central Bank. If appropriate measures are not taken to limit financing from this source, high inflation will be an added constraint to development. Since 1977, average prices have more than doubled and Sri Lanka's inflation rate remained high relative to its major trading partners, with few exceptional

TABLE 111

SECTORAL CLASSIFICATION OF PUBLIC INVESTMENT PROGRAM

(Rs.Million)

	1981-86 (Actual)	1981-86 (Planned)	1987-1991
Lead Projects	37,040	36,983	24,051
Mahaweli	32,171	32,440	19,441
Housing and Urban Development	4,545	4,253	4,451
Greater Colombo Economic Commission	324	290	159
Other Projects and Programs	15,004	14,894	14,396
Non-Mahaweli Irrigation	4,900	4,571	4,942
Plantation Agriculture	3,246	3,413	1,356
Field and Minor Export Crops	3,495	3,747	3,365
Animal Husbandry	380	674	562
Forestry and Lands	873	950	2,510
Fisheries	965	1,085	1,123
Industry	1,145	454	538
Major Economic Overheads	19,823	21,361	31,023
Power	4,989	3,899	11,226
Ports, Transport and Civil Aviation	5,751	8,532	9,971
Posts and Telecommunications	3,172	2,797	3,698
Integrated District Development	2,133	1,945	2,980
Decentralized Budget	2,588	1,606	1,192
Other Construction	1,190	1,606	1,192
Social Overheads	9,815	9,806	18,667
Water Supply	4,143	4,323	4,767
Education	3,743	3,500	5,890
Health	1,929	1,448	6,907
Social Overheads	-	535	1,103
Economic and Administrative Overheads	-	6,567	25,987
Unallocated	-	5,984	11,121
New Projects	-	-	24,329
Miscellaneous	38,518	-	1,800
Grand Total	120,200	95,596	151,376

Source: *Public Investment Reports, Ministry of Finance and Planning* years such as 1985 and 1986. This difference in the inflation rate, between Sri Lanka and the rest of the world is reflected in the depreciation of the rupee against major currencies. For example value of the Sri Lankan rupee has dropped against the US dollar by over 50 percent between 1978 and 1986.

The picture that emerges from the above analysis is that economic development in the coming years is likely to be affected by the lack of resources to finance the investment programme, particularly if adequate foreign assistance is not forthcoming and defence expenditure continues to increase even further. The present revenue outturn does not show any potential for supplementing resource shortfalls that could be created by reduced foreign assistance or increased defence spending. As demonstrated in Table IV, revenue from exports is on a declining trend, and in the absence of some buoyancy in international tea prices, this trend is unlikely to be reversed. Substantial increases in import duties, sales and business turnover taxes are also not promising unless the economy maintains a high degree of dynamism. The opportunities of obtaining additional resources from other domestic non-bank sources are also extremely limited. On the other hand, using the banking sector to finance development expenditure could exacerbate the economic problems. Given this extremely complex situation, the government has only two options: (a) cutback development expenditure and rephase development programmes, with the possible outcome of lower economic growth or (b) re-consider development priorities and policies with a greater focus on income and revenue generating activities.

Balance of Payments

In order to sustain liberalized economic policies in the long run, Sri Lanka needs a healthy balance of payments support, which has not been the experience so far, particularly since the removal of foreign trade controls and exchange rate restrictions. Apart from a favourable balance of payments out turn in 1984, and to some extent in 1985, a weak balance of apyments position continued over most other years. The explanations for the persistence of balance of payments difficulties lie in a number of factors including (a) international market factors, with fluctuating commodity demand and prices; (b) continued dependency on traditional exports such as tea, rubber and coconut as major sources of export earnings; (c) removal of trade restrictions and liberalization of foreign exchange transactions; and (d) spill over effects of expansionary monetary and fiscal policies on higher imports. In addition, high domestic inflation relative to the inflation of trading partners, high cost of commercial borrowings between the 1981-84 period, stagnation in foreign remittances since 1985 and reduced tourist receipts since 1983 are other factors that contributed to further exacerbate the balance of payments deterioration from time to time.

Table V provides data on the balance of payments for the 1984-86 period. The most favourable year for Sri Lanka in terms of balance of payments has so far been 1984, at least since 1978 and and this improvement resulted mainly from the unprecedented earnings from tea exports. By mid 1985, tea prices plummeted in the world market which resulted in a downward trend in export earnings accompanied by considerable pressures on balance of payments. Although partial price recoveries were observed from time to time, they lasted over only short durations. Thus, the favourable or adverse developments in the balance of payments are still determined largely by the price movements of tea in the international market and its external demand and domestic production. Tea earnings in 1986 declined by $ 106 million compared with 1985, and by $ 284 million compared with 1984. If the 1984 international tea prices were maintained during the last two years, the price advantage would have amounted to nearly $ 400 million, which would certainly have eased the balance of payment pressures that Sri Lanka is beginning to experience once again.

The experience of drastic price fluctuations for exports, of the developing countries exporting primary commodities has been quite common. The experience could certainly repeat itself in the future because demand and supply conditions do not stay fixed. Moreover, a number of other developing countries are beginning to include crops such as tea (which is traditional for Sri Lanka) in their export diversification plans. Although Sri Lanka has made a few important inroads into the non-traditional external market, the progress has been very marginal. Even the long term outlook does not show total export composition consisting of

TABLE IV

VALUE OF EXPORT 1977-1986
(SDR MILLION)

	1977	1982	1983	1984	1985	1986
Tea, Rubber, Coconut	467	421	499	790	613	410
Petroleum Products	57	147	107	126	140	72
Other Industrial Products	37	217	244	367	372	411
Minor Agri.Products	48	98	75	74	76	69
Gems	25	30	38	24	17	22
Other	27	36	31	61	34	61
	661	934	986	1432	1311	1036

a variety of products and services, capable of providing a regular source of export earnings. Excluding agricultural exports, there are only three other major sources of foreign exchange earnings at present, namely, industrial exports, tourism receipts and private remittances, but their growth in the coming years is constrained by a variety of factors. The capacity to expand industrial exports is limited by the nature of demand for such products, particulalry petroleum, and by the prevalence of quotas in the case of textile exports, while a recovery in the tourist trade has so far not been possible and remains uncertain, there is visible stagnation in the case of foreign earnings from private remittances.

Sri Lanka's import bill is quite significant in relation to the absorption capacity dictated by foreign exchange earnings.

In the last ten years, however, Sri Lanka was able to maintain a liberalized trade policy without quantitative restrictions on imports or controls on imports through the rationing of foreign exchange, largely because of the uninterrupted flow of external assistance. In 1984, for example, project assistance ($ 396 million) accounted for 13 percent of the expenditure on imports; in 1985 it was 13.5 percent ($ 404 million) and in 1986 it went up to 14.6 percent ($ 452 million). If external project assistance comes down, the country's imports would invariably be affected. Borrowing from the international money market, at commercial rates, has also serious limitations due to poor prospects for higher export earnings and the growing external debt problem. At the same time, large scale trimming of the import bill is clearly not possible because a major share of imports consists of essential inputs, raw materials and capital goods. Thus the only feasible answer to the balance of payments problems lies in the expansion and promotion of new non traditional exports.

While the identification of the solution to the problem is not difficult, specially when the gap between export earnings and import expenditure is quite explicit, the implementation of appropriate export promotion strategies is extremely difficult and likely to be confronted with increasing complexities because Sri Lanka is not the only country pursuing export promotion strategies; more than half of the developing countries are currently engaged in manufacturing of industrial products for markets in the developed world and others are contemplating doing the same. A number of some developed countries have already ac-

TABLE V

FOREIGN EXCHANGE EARNINGS, PAYMENTS AND RESERVE POSITION
($ MILLION)

	1984	1985	1986	Absolute Change 1985 to 1986	Absolute Change 1984 to 1986
Total Foreign Earnings	2,100	1,933	1,949	16	151
a) Tea	620	442	336	-106	-284
b) Other Agricultural	267	258	237	-21	-30
c) Industrial	608	626	677	51	69
d) Tourist Receipts	105	69	71	2	-34
e) Private Remittances	300	294	332	38	32
d) Other	220	237	307	70	87
Total Foreign Payments	3,044	2,993	3,090	97	46
a) Imports	1,928	2,044	1,996	48	68
b) debt Amortization	686	497	542	45	-144
c) Other	430	452	552	100	120
Resource Gap	-944	-1,060	-1,141	81	197
Borrowings and use of Reserves	716	840	949	109*	233
Grants & Investments	240	196	212	16	-28
Other	-12	24	20	-	
Gross Reserves	745	670	624	82	-121
Net Reserves	392	341	322	-19	-70

Source: *Central Bank of Ceylon*

quired a fairly steady share of the developed countries markets. Competing with such countries with similar products, is no easy task.

In this setting, Sri Lanka faces stiff competition from other countries and any immediate improvement in the situation, is being clouded by the social and political instability caused by the on-going ethnic confrontation. Under these circumstances, the export development strategies adopted need to be extremely sound and highly competitive.

EXAMINING POTENTIAL FOR IMPROVED ECONOMIC GROWTH

This section reviews the prospects for higher economic growth, by examining the recent sectoral growth trends. The objective of this analysis is to identify the sectors or sub sectors where higher growth potential exists and to stress the need for further research towards the design of appropriate development policies and priorities in order to maintain a higher growth momentum in the economy. This appears to be the only alternative to cushion the impact of advance factors such as terrorist activity and higher defence expenditure and to improve both domestic revenue and export earnings. The focus is mainly on agricultural and industrial production since their roles are vital to the overall economic growth, as well as the growth in other GDP sectors.

Sectoral Growth Trends

Table VI provides GDP shares and average GDP growth rates by major sectors from 1978 to 1986. The averages have been computed for the entire period (1978-86) and also for the 1978-82 and 1982-86 periods. This disaggregation into two periods is necessary since the Central Bank introduced a new series of national accounts in 1982 which does not very neatly correspond to the series before 1982. The last column shows the growth rates by sectors for 1986.

A comparison of growth rates by sectors makes it clear that only manufacturing and mining performed better in 1986 than their respective performance in the past. The 8.4 percent growth rate achieved by the manufacturing sector in 1986, was higher than the average growth rates of 4.1 percent (1978-82) and 7.3 percent (1982-86) or the overall (1978-86) average growth rate of 5.6 percent. Mining also achieved a higher rate of 6.2 percent in 1986 more than the average that works out after 1978. However, with only about 2 percent shares in the GDP composition, the rate of growth in the mining sector, makes no major impact in the economy. All other sectors show a disappointing performance in 1986 relative to the average performance since 1978, with the exception of construction and other sectors. These two sectors have grown relatively faster during the 1978-82 period.

TABLE VI

GDP GROWTH RATES BY SECTORS (1978–86)

	GDP SHARES a/ (%)		GROWTH RATES (%)			
	1978	1986	1978 to 1982	1982 to 1986	1978 to 1986	1986
Agriculture	28.2	25.4	3.3	4.1	4.0	2.6
Tea	7.3	2.4	1.5	3.1	0.6	-1.3
Rubber	1.0	0.7	-4.9	2.0	-1.0	-
Coconut	2.8	3.4	4.4	5.1	4.9	2.8
Paddy	6.4	5.3	3.4	5.1	4.3	-2.5
Other	11.2	9.5	5.2	5.9	5.6	6.1
Mining	3.6	2.3	5.0	4.2	4.6	6.2
Manufacturing	14.7	15.0	4.1	7.3	5.8	8.4
Construction	4.6	7.2	12.0	1.1	7.0	3.0
Transport	9.3	11.7	7.3	6.4	6.8	3.2
Wholesale and Retail Trade	10.8	20.8	7.7	5.2	6.5	3.9
Banking and Real Estate	1.8	4.5	16.6	33.0	24.5	4.0
Other b/	21.0	12.8	6.4	6.8	6.0	6.0
Overall	100	100	6.2	4.9	5.6	4.3

Source: *Central Bank of Sri Lanka*

a/ Sector share as a percent of total GDP.

b/ This sector includes (a) Banking, insurance and real estate, (b) public administration and defence, and (c) services not reported elsewhere.

TABLE VII

COMPARISON OF ANNUAL GROWTH PERFORMANCE 1978-86
(1986 GROWTH RATES = 100)

	1978	1979	1980	1981	1982	1983	1984	1985	1986
GDP Growth	191	147	135	135	118	116	119	116	100
Agriculture	203	77	119	239	89	192	185	231	100
Manufacturing	93	55	[illegible]	62	57	77	145	67	100
Construction	340	697	367	-70	-10	39	0	50	100
Transport	225	212	222	200	194	141	310	131	100
Wholesale	228	223	205	123	134	106	159	106	100
Banking	193	250	370	379	399	505	275	248	100

Source: *Central Bank of Ceylon*

Using 1986 as the base year, Table VII compares the sectoral growth rates in 1986 with the annual growth rates since 1978. As demonstrated, the annual GDP growth rates between 1978 and 1985 have all been higher than the GDP growth rate in 1986. Compared to 1986, the GDP growth rate in 1978, for example, which registered the highest growth rate during the reference period, was 91 percent higher, which means that the economy in 1986 has grown only half as fast as the growth rate in 1978. Even compared with the previous lowest growth rate of 5.0 percent, recorded in both 1983 and 1985, the 1986 growth rate was down by 16 percent.

While the declining trend of GDP is clearly evident in Table VII it is not quite clear as to what causes this drop in the growth over time. There is no clear pattern which reflects or contributes to the progressive decline of the overall GDP growth. In the case of the agricultural sector, for example, growth has been better in the past, with the exception of 1979 and 1982, than the performance in 1986. With 8.4 percent growth, the best growth performance in the agricultural sector has been reported in 1985 and its contribution to overall GDP growth in that year was around 43 percent. Unfortunately, because of the relatively weak performance of most other sectors, this substantial contribution of the agricultural sector failed to impact upon the overall GDP growth.

In the manufacturing sector, the 8.4 percent growth rate achieved in 1986 was the second highest after the 1984 growth rate of 12.2 percent. In all other years since 1978, the growth rate in the manufacturing sector has been less than the 1986 performance. For example, compared with 1986, the achievement in the manufacturing sector was equivalent to 93 percent in 1978 and 55 percent in 1979. The larger unknown factor with regard to the manufacturing sector is why it could not perform better before 1986 and why it is doing better now. The growth rate in the construction sector has been substantially high during the 1978 to 1980 period, but thereafter, until 1986, its growth has been practically stagnant. Although all other sectors, such as transport, wholesale and retail trade, banking, and other or unclassifieds, show higher indices in relation to 1986, the year to year fluctuations in growth rates among the major GDP sectors make it difficult to determine the extent to which the respective sectors have contributed to overall growth.

The important message that comes out in the foregoing analysis, is that there is no straightforward explanation to the performance of the economy during the period from 1978 to 1986. Starting from a very impressive performance in 1978, as reflected by the growth rate of 8.4 percent, the economy progressively slowed down. However, this slow down cannot be attributable either to the performance of a single sector or a few selected sectors, as there is no discernible relationship between the trends in the overall GDP growth and the growth trends of respective sectors. It is also not possible to explain the behaviour of the economy in a specific period such as the period after 1983, following the communal disturbances and stepping up of terrorist activity. The declining overall growth rate was not exclusively limited to the period after 1983, but it was a feature of a continuing trend.

The difficulty of identifying the causes of the slow down in growth performance makes the solutions to the problem more complex. If the slow down can be explained by a single factor or few inter-related factors such as terrorism and the associated increase in defence expenditure, the solution to the ethnic problem will certainly be the answer to bringing dynamism into the economy. Unfortunately, the intertemporal trends, as mentioned earlier, do not suggest such a simple explanation.

VALUE ADDED BY MAJOR GDP SECTORS

Agriculture

A brief review of the value added in agriculture and industry overtime is useful to extend the above argument further. Agriculture accounts for approximately 25 percent of the GDP composition. Within agriculture, there are five sub categoreis; tea which accounts for 10 percent, rubber 3 percent coconut 13 percent, paddy 24 percent, and other categories 50 percent. This breakdown within the agricultural sector shows that it is primarily the non-traditional sector, consisting of subsidiary crops, cash crops, animal husbandry and home gardening, that contributes greatly to the share in the agricultural GDP.

Perhaps the most useful approach to evaluate the progress in the agricultural sector and its contribution to overall economic development in the country, particualrly in a macro setting, is to review the trends in value added by agricultural sub sectors. Table VIII provides this information in the form of percentage contributions in the annual increase in value added (in the agricultural sector) for the 1978-86 period.

As demonstrated in Table VIII, there is no consistency in the contribution to the increase in agricultural GDP by its sub sectors. The contribution by respective sub sectors fluctuates from year to year, frequently by subtantial margins. Sometimes, the percentage contributions turn from positive in one year to negative in the next year. Only in the case of the "Other" sub sector which primarily includes non-traditional crops, has there been no negative contribution to agricultural GDP growth during the 1978-1986 period; but even in this sector there is no consistency in terms of the contribution to the increase in agricultural value added. All other sectors have experienced negative contributions during the reference period.

The bottom line in Table VIII indicates the share of the agriculture sector in overall GDP while the preceding line provides the percentage contribution of agriculture in the overall GDP increase. The figures in the line showing the contribution to GDP (that before the last line) clearly point out substantial year to year fluctuations in contribution of agriculture to GDP growth ranging from 5.7 percent in 1979 to 42.5 percent in 1985. Throughout the entire period, the contribution of agriculture to GDP growth raging from 5.7 percent in 1979 to 42.5 percent in 1985. Throughout the entire period, the contribution of agriculture to GDP growth exceeded its GDP share only in three years.

Not all sub sectors performed better even in those three years (1981, 1983 and 1985) when the value added in agriculture was greater than its share in GDP composition. The increase in value added in 1981 principally came from the "Other" category; in 1983 from paddy and "Other" category; and in 1985 from paddy and coconuts. Apparently, the annual growth in the agricultural sector, including those years where performance was relatively better, has been contributed by only a few sectors. The figures in Table VIII demonstrate the fact that there was no single year when all the sectors contributed positively to the increase in value added. Accordingly, this trend explains the year to year fluctuations in both value added in agriculture and its annual contribution to GDP. The magnitude of the fluctuations largely depended on the difference between the positive and negative contributions by different sectors.

The above analysis of sub sectoral trends in agriculture leads to a number of vital observations. First, the overall performance in the agricultural sector shows no evidence of a positive trend, or in other words an increasing trend, in value added in agriculture in an overall context or at least by a single sub sector throughout the period. The year to year fulctuations in value added in this sector, makes it increasingly difficult to assess its role in the overall GDP growth. By looking at the trends in the past, it is not possible even to predict, in the very short term, the performance in the agricultural sector. This situation appears to be a result of a combination of a number of complex factors which might include weather, prices, production costs, domestic and foreign demand, availability of inputs including low cost credit, marketing, storage facilities and government policies pertaining

TABLE VIII

PERCENTAGE CONTRIBUTION TO INCREASE IN AGRICULTURAL GDP BY MAJOR CATEGORIES IN THE AGRICULTURAL SECTOR

	1978	1979	1980	1981	1982	1983	1984	1985	1986
Tea	-9.0	22.2	-28.4	13.2	-37.8	-9.9	86.1	3.4	-4.4
Rubber	6.0	-3.2	-26.6	-4.5	.	8.7	3.0	-1.2	0.6
Coconuts	32.7	49.2	-52.3	18.4	48.7	-110.9	59.7	13.3	24.7
Paddy	63.3	25.4	124.0	16.0	-36.9	76.0	-35.2	28.0	-21.1
Other	7.0	6.3	67.4	56.9	126.2	49.9	157.0	10.0	78.0
Contribution to Increase in GDP	15.0	5.7	10.1	25.4	11.3	23.3	8.6	42.5	17.1
Ag.Share in GDP	24.0	23.0	22.2	22.3	21.8	22.0	21.4	22.4	21.9

Source: *Central Bank of Ceylon*

TABLE IX

RATES OF GROWTH AND CONTRIBUTIONS TO VALUE ADDED BY RESPECTIVE SUB GROUPS

	1978	1979	1980	1981	1982	1983	1984	1985	1986
1. Growth Rates:									
Overall	7.8	4.9	1.0	5.7	4.5	0.8	12.2	6.8	8.4
Export Processing	2.1	4.4	-9.8	7.6	5.0	-4.8	9.3	6.2	0.2
Factory Industry	11.0	4.0	6.0	4.8	8.9	2.3	15.0	3.0	12.0
Small Industry	2.1	5.5	-	6.1	10.1	4.1	4.0	3.0	3.9
Other	4.4	3.8	2.9	4.2	9.8	2.7	3.3	1.8	2.4
2. Contributions to Value Added:									
Export Processing	9.2	31.4	-65.1	43.2	23.3	-120.2	15.9	29.8	-
Factory Industry	73.3	48.6	109.9	43.2	102.2	161.5	80.0	64.1	85.0
Small Industry	2.2	17.8	-	-8.6	15.5	28.3	1.9	2.1	2.8
Other	2.3	4.2	43.2	5.0	17.6	26.3	2.2	2.1	2.4

Source: *Central Bank of Ceylon*

to fiscal, monetary and foreign exchange variables.

The second point is that the contribution of traditional sectors such as tea, rubber, coconut and also paddy to agricultural GDP is relatively small compared with the contribution by the non traditional sector. However, these sectors constitute priority areas in agriculture and accordingly they regularly claim substantial resources in annual investment programmes. Unfortunately, the same focus is not to be seen in the case of the subsidiary crop sector, despite its highly important role in the agriculture sector and thus in the overall GDP growth.

Industry

Sri Lanka's manufacturing sector is divided into three sub categories: Export processing, factory industry and small industry. Export processing industry consists of processing activites in the plantation sector with great concentration in the state owned plantation, and manufacturing in the export promotion zones. Factory industry includes large and medium scale industreis located mostly in Colombo and the suburbs mainly in the public sector. The last category includes a wide variety of activities mainly concentrated in the private sector, and located in principal towns and cities as well as outside urban centres.

Within the manufacturing sector, factory industries account for a share of about 65 percent, followed by export processing 22 percent, and small and other category 13 percent. Given this highly significant share, for factory industry, it plays a vital role in overall growth in the manufacturing sector. Table IX illustrates the growth trends and contribution to value added in manufacturing by each of these sub groups.

Examining closely the figures in Table IX, it is clear that contribution to the increase in value added by the factory industry group has been remarkable. In some years its contribution has been much greater than its relative share in the GDP composition. However, the export processing industries also play an important role. When its contribution to value added has been negative, the growth rate in the manufacturing sector has also declined, at times the decline has been quite substantial. In the case of the small industry and other category, the contribution has been of extremely limited significance and the growth trends of this group have no major impact on the overall growth performance in the manufacturing sector.

The picture that emerges from the above analysis leads to two major considerations. First, factory and export processing industries are the two major industrial groups influencing the overall growth in the manufacturing sector. Factory industry, in particular, plays a vital role in the overall growth of the manufacturing sector and therfore in order to strengthen production the implementation of appropriate policies in this sector becomes imperative to sustain the overall stability of the manufacturing sector. The experience with the production performance in this sector, where nearly 70 per cent of the industries belong to the public sector, have in the past been disappointing in part due to stiff competition from imports and in part due to inefficiencies in management and un-

TABLE 2 DEBT INDICATORS 1980–1986

Category					
1. Debt Service Payment	2023	2136	3028	8892	11647
(a) Amortization	1281	3121	2657	4437	6687
(b) Interest	983	4018	3569	4625	4805
2. Gross Aid Flows					
(a) Long term	4896	7330	9498	8834	8978
(b) Grants	2281	4016	6164	4828	4966
(c) Total (a+b)	7177	11346	15662	13662	14944
(d) Short term	6963	14370	11080	9066	8178
3. Debt Service as a Ratio to Aid Flows 2(c) of 1	28	40	56	68	78
4. Debt service ratio	12.3	15.8	12.5	21.0	26.2
5. Outstanding Debt as a ratio to GDP					
(a) Sri Lanka	48.9	58.0	57.5	58.9	65.0
(b) India	6.3	7.8	7.8		
(c) Philippines	-	11.8			
(d) Pakistan	27.0	27.8	26.5		
(e) Korea	17.2	18.5	17.7		

Source: Central Bank of Ceylon, World Bank Reports

External Debt

Sri Lanka's external debt increased tremendously during the last ten years. Outstanding external debt at the end of 1978 totalled Rs 17,223 million, and at the end of 1986 Rs 113,308 million. The increase between 1978 and 1986 has been more than six fold. However, a part of this increase was due to the rapid depreciation of the value of the rupee. [illegible] remained at the 1978 level, the external debt at the end of 1986 would be around Rs [illegible] million, which is nearly half the figure for the outstanding debt at the end of 1986 in current rupee terms.

Long term loans obtained by the government, including government guaranteed loans to the public sector corporations, account for the largest share of the external debt outstanding. In fact, its share has increased during the last three years, from 64 percent in 1983 to 76 percent in 1986, due to reduced borrowing by the public and private sector from commercial sources and increased utilization of project loans by the government. Nearly half of the long term loans are obtained from foreign governments (bilateral), about 40 percent from international organisations (multilateral) and the balance from commercial sources. Among short term borrowings with less than 1 year repayable period, private sector, including public sector corporations without government guarantee, accounts for the highest share.

With increasing external debt, the servicing requirement of the external debt has also gone up. In 1980, the debt servicing (amortization and interest payments) accounted for Rs 2.2 billion and a debt service ratio of 12.3 percent or as a share of export earnings and service receipts of that year. In 1986, this payment increased to Rs 11.6 billion which resulted in a debt service ratio of 26.2 percent, [illegible] the highest in [illegible] (as in Table 2). At the same time, increased debt servicing is also resulting in a decline in net aid flows. As shown in table 2, debt service payments as a ratio to long term loans and grants increased from 38 percent in 1980 to 78 percent in 1986. Unless export earnings are significantly increased in the coming years, Sri Lanka will have to depend more on commercial short term borrowings. This will further exacerbate the already serious debt problem.

The increasing debt service ratio provides a clear indication as to the growing external debt burden that Sri Lanka has been confronted with during the last few years. According to IMF estimates the average debt service ratio for the world as a whole was around 21 percent in 1986. Only a few countries outside the Western Hemisphere (Latin American countries) fall into the category of having a debt service ratio of more than the average, which also included Sri Lanka. The outstanding debt to GDP ratio also shows that Sri Lanka's debt burden in relation to its economy is also the highest in the Asian region. According to the 1987–1991 public investment programme, the debt burden is projected to be eased by 1991. However, this projection depends on two major assumptions: (a) increased export earnings and (b) reduced borrowings. On recent trends, on recent performances both these assumptions appear difficult to achieve.

TABLE 1 EXTERNAL DEBT OUTSTANDING 1983–1986 (RS MILLION)

	1983	%	1984	%	1985	%	1986	%
1. Long term	48025	64	53191	68	67755	72	86334	76
(a) Project Loans	19631	27	25871	33	36408	39	50418	44
(b) Non-Project	24390	33	24895	32	28667	30	33877	30
(c) Other Loans	4004	4	2005	3	2684	2	2081	2
2. Supplier's Credit	888	1	587	1	564	1	528	1
3. IMF Credit	8826	11	8544	11	7814	8	7252	7
4. Bank Borrowing	1654	2	-		5			
5. Other Commercial	15188	21	15490	20	18039	19	19292	18
Total	73178	100	78412	100	93244	100	113308	100

Source: Central Bank of Ceylon

ECONOMIC DEVELOPMENT, GROWTH AND WELFARE

Sri Lanka has achieved a considerably high economic growth from 1977. In late 1977 the present government introduced liberalised (or outward looking) economic policies which resulted in a steep increase in economic activity. This economic growth is more pronounced when compared with the growth achieved during the period from 1970 under the previous government when restrictive (inward looking) economic policies were implemented.

During the period commencing 1977 real Gross National Product (GNP) in Sri Lanka increased annually by growth rates varying from 4.1 percent to 8.8 percent, while during the period from 1972 to 1977 it increased annually by rates varying only from 0.5 percent to 4.4 percent. From 1977 in real terms the GNP per capita income increased annually from a rate of 2.5 percent to 6.8 percent; varying from 1.0 percent to 3.0 percent during the period between 1970 to 1977.

In recent years very few among the countries in the developing as well as developed world have been able to achieve a higher economic growth rate than that achieved by Sri Lanka in terms of GNP or per capita income.

Though during the period after 1977 Sri Lanka's economy has been growing at considerably faster rates in terms of direct economic indicators at the same time there has been an increase in some indicators such as foreign debt, income disparities, inflation and cost of living which diminish the favourable impact of economic growth and also could have an adverse effect on overall economic development.

Over the 5 year period from 1972 to 1977 Sri Lanka's foreign debt had increased from Rs 3,249 million to Rs 6,826 million, more than two fold. At the end of 1977 again the amount almost doubled, mainly due to the rupee devaluation,over the 9 year period,from end 1977 to 1986, it increased from Rs 13,321 million to Rs 113,308 million, almost ninefold. (The diminishing value of the rupee has to be considered here when comparing the rupee values of 1977 and 1986). At the end of 1986 total foreign debt had increased to as much as 70 percent of GNP, while the total foreign debt at the end of 1977 as a share of GNP was only 39 percent. However, the composition of foreign borrowings has been more favourable over recent years, with a much higher grant element. While in 1977 the share of project loans among total foreign loans were 23 percent,in 1986 the share had gone upto 44 percent. The overall increase in foreign debt, however, is expected to increase future burdens on repayments of foreign loans. Inequality in income distribution has been increasing over the period after the early 1970s. According to the Consumer Finance and Socio Economic Surveys of the Central Bank while over the 5½ year period from 1973 to 1978/79 the Gini Ratio (a summary measure of the degree of income concentration) for income receivers increased from 0.41 to 0.49, over the 3 year period from 1978/79 to 1981/82 the ratio has further increased from 0.49 to 0.52. These trends indicate that the benefits of the economic growth in this period have not been distributed equally among all income groups but in favour of higher income receivers. The findings of a recent Central Bank Researcher's * study, based on the Bank's Consumer Finance and Socio Economic Surveys also emphasises this point and states that "price changes between 1979 and 1982 had a greater impact on the low and middle income groups than on the affluent classes... real income levels have deteriorated for the low and middle class households between 1978/79 and 1981/82. The study adds in respect of affluent households, there was a 10 percent improvement in real incomes when the deflator assuming constant housing costs is used. Even when the other two deflators (or adjusted index) are used, real income deteriorated by less than 1.5 percent. For low income households this deterioration was 13-15 percent when the adjusted index was used...for middle income households the deterioration was around 8 to 10 percent".

* *Miss A.S.de Alwis, Assistant Director Dept. of Statistics, Central Bank in "Survey Analysis Series", August 1986.*

GROSS NATIONAL PRODUCT, PER CAPITA INCOME AND COST OF LIVING

Year	Gross National Product		Gross National Product PER CAPITA		Colombo Cost of Living		Foreign Debt	
	Amount (Rs.Mn.) at current factor cost price	Growth rate at constant factor cost price	Amount as at current factor cost price	Growth rate at at constant factor cost price	Index	% Increase	Rs.M	Debt Service Ratio
1970	12987		1038		138.2			20.1
1971	13486	0.6	1062	1.0	141.9			18.3
1972	14542	3.4	1123	1.4	150.8	6.3	3249	21.8
1973	17737	4.0	1355	3.0	165.4	9.7	3725	23.0
1974	23119	3.2	1740	1.8	185.8	12.3	4446	17.8
1975	26478	2.7	1888	1.0	198.3	6.7	5625	22.9
1976	27750	2.8	2023	1.2	200.7	1.2	6826	20.1
1977	34432	4.4	2470	2.8	203.2	1.3	13321	16.0
1978	40242	8.8	2836	6.8	227.8	12.1	17276	15.0
1979	49542	6.4	3424	4.3	252.3	10.8	19279	13.0
1980	61814	5.6	4194	3.6	318.2	26.1	30001	12.4
1981	77626	4.1	5179	2.5	375.4	18.0	44601	16.8
1982	92720	4.9	6104	3.5	416.1	10.8	56142	18.6
1983	110684	4.0	7179	2.5	474.2	14.0	72179	21.6
1984	136638	5.1	8759	3.9	553.1	16.6	78413	17.5
1985	144921	5.3	9151	3.7	561.2	1.5	94303	21.0
1986	169952	4.5	9918	2.7	606.0	8.9	113308	26.3

Source: *Annual Reports - Central Bank of Ceylon.*

Note: *The growth rates from 1970 to 1982 are based on 1970 as the base year. The growth rates from 1982 are based on a New Series of National Accounts with 1982 as the base year.*

due political pressures. While the on going efforts of the government to correct the situation appear encouraging, the delay in implementing such measures could result in both direct and indirect costs.

However, an important strategy that needs to be given high priority is the promotion of small and medium scale industries in order to broad base the activities in the manufacturing sector. This is particularly important in the Sri Lankan context where entrepreneurs mostly fall within these two categories.

[illegible]

Even if there is a considerable improvement in public sector manufacturing corporations, the transmission of the added benefits from the large scale sector to the rest of the economy is limited due to the lower value added in most of these public sector enterprises. Of the major industrial groupings in the public sector, food and beverages, textiles and chemicals account for nearly 75 percent of the total value added in manufacturing; but the ratio of value added to value of production is relatively low in both textiles and chemicals. The main implications of this situation is that they depend heavily on imported raw materials and inputs.

Given the industrial composition in the Sri Lankan economy the growth rate in industry is not an appropriate indicator to assess its impact on the rest of the economy. As demonstrated above, a greater part of industrial growth originates in the factory industry category which is mostly located in Colombo and the suburbs and they therefore have very limited spread effects; and also there is low value added in relation to value of production. If the manufacturing sector is to make a meaningful contribution to growth, employment and household incomes, efforts need to be concentrated in industries where the value added ratio is relatively high.

SUMMARY AND CONCLUSION

The first part of this paper briefly reviewed the economy in 1986 in terms of the GDP growth performance and the developments of key macroeconomic indicators. The rest of the paper has been devoted to emphasize the need for increasing domestic revenue and generating increased export earnings. As demonstrated by the analysis of sectoral growth trends, the most effective means of achieving both these objectives is clearly through higher production in agriculture and industry.

A conclusion that emerged from the analysis of sectoral growth trends was that the economy appears to be affected by cyclical and structural effects, in addition to exogenous effects such as terrorism. All these adversities are now operating in the economy, both singly and collectively, forcing the economy to slow down and at the sametime, making economic management extremely difficult. While there is little that can be done about cyclical effects, such as weather factors, and adverse developments arising from terrorist activity, structural effects need to be remedied through the implementation of corrective policies. If this is not undertaken, even if normalcy is returned to the country, the economy is not likely to improve significantly on a sustainable basis. Given the current characteristics in the economy, a solution to the ethnic problem will only result in a marginal improvement in economic growth and even this growth cannot be sustained overtime without addressing the structural effects that reflect in highly irregular growth trends in major GDP sectors.

Economic planning is currently guided by the rolling five year investment plan. While this planning approach certainly has merits over the national planning approach undertaken prior to 1977, the entire thrust on a particular planning technique may not necessarily result in obtaining desired results. Under the rolling five year planning approach, there is increasing attention towards strengthening economic and physical assets and infrastructure.

Unfortunately, what appears to be lacking is the appropriate direction to translate the improvement in economic and physical infrastructure to higher production, more employment and improved income. Planning involves both vertical and horizontal integration and one without the other makes the planning process less effective and the targets and outputs that result under such circumstances less than optimum.

Declining Tourist Arrivals and Loan Rescheduling Measures

Arrivals

Sri Lanka's growing prominence as a leading tourist centre in the East was halted after 1982. At this stage the tourist industry had been the fourth leading source of foreign exchange only after tea, remittances from earnings abroad, and ready-made garments. Unfortunately for the industry tourist arrivals after 1982 dropped nearly 44 percent upto 1986 and this had adverse repercussions on the entire hotels and tourism sector in the country. An examination of the figures shows that there has been a continuous decline in the growth rate of tourist arrivals over the last four years between 1983 and 1986.

The decreases are evident not only in the tourist arrivals, but also in the number of guest nights, the room occupancy rate and earnings from the tourist sector over the period. The following table shows arrivals in Sri Lanka from 1978-1986.

It may be observed from the above statistics that total tourist arrivals in 1986 at 230,106 was the lowest on record since 1978. The major contributory factor responsible for the decline in tourist arrivals had been the adverse publicity abroad regarding security and civil unrest in the country.

However, this disturbing situation for the tourist sector has also affected employment opportunities in the sector as well as business in the hotel industry. The total number employed in the tourist sector during 1986 was estimated at around 48,000 as compared to 54,533 employed in the previous year, indicating a decrease of 12 percent.

In 1986 the tourist industry witnessed a further setback when gross earnings from tourism in 1986 were estimated at SDR 70 million, as against SDR 81 million in 1985. Against the background of the unfavourable conditions, while the inflow of tourist traffic in 1986 declined by 10.6 percent, the average spending by a tourist also decreased marginally from SDR 315 in 1985 to SDR 306 in 1986.

Table I

GROWTH OF TOURIST ARRIVALS

Year	Arrivals	Growth Rate
1978	192,592	25.3
1979	250,164	29.9
1980	321,780	28.6
1981	370,742	15.2
1982	407,230	9.8
1983	337,530	-9.6
1984	317,734	-5.9
1985	257,456	-18.9
1986	230,106	-10.6

Sources: *Ceylon Tourist Board, Annual Statistics*
Annual Report Central Bank of Sri Lanka, 1986.

In addition, the capacity of the graded hotels accomodation declined from 143 units in 1985 to 127 in 1986. This was due to the closure of 12 of the 13 graded hotel establishments on the East Coast.

It does not mean, however, that there was no new activity or growth in this sector; for instance, during the fourth quarter of 1986, approval was granted by the Tourist Board for the construction of a 50 roomed hotel at Wellawatte, while preliminary clearance was given to a "Thai" Speciality Restaurant in Colombo and final approval to a "Chinese" Speciality Restaurant in Negombo.

Loans

In the slump situation the view of most hotel managements, however, has been that the industry was in serious financial difficulties and that relief should be provided in the form of concessional tax rates and a reduction in service charges such as electricity rates; and that repayment of financial facilities obtained through the Banks should be rescheduled. Representations had been made since 1984 by the Association of Hotel Owners that these concessions be introduced urgently. The Government therefore introduced a scheme for rescheduling of loan facilities granted to hotel pro-

Table II

RE SCHEDULING OF LOANS–TOURIST SECTOR CUMULATIVE TOTAL AS AT DECEMBER 1986

Name of Credit Institution	Re-schedulings completed		Re-schedulings under consideration		Total		
	No.of Hotels	Loans Amount Rs.mn	No.of Hotels	Loans Amount Rs.mn	No.of Hotels	Loans Amount Rs.mn	Percentage
D.F.C.C.	25	132.69			25	132.69	21.5
N.D.B.	10	105.68	2	14.38	12	120.06	19.4
People's Bank	11	34.63	20	120.54	31	155.17	25.1
Bank of Ceylon	10	53.73	11	38.68	21	92.41	15.0
Hatton National Bank	5	36.61	2	2.67	7	39.28	6.4
Commercial Bank	4	4.94	9	28.78	13	33.72	5.5
Grindlays Bank			1	6.96	1	6.96	1.1
Deutsche Bank	1	3.06			1	3.06	0.5
Banque Indo-suez			3	33.66	3	33.66	5.5
Total	66	371.34	48	245.67	144	617.01	100

Source: *Annual Report 1986- Central Bank of Sri Lanka* ties by commercial banks and other long term credit institutions. According to this scheme the Banking sector was advised to suspend the levy of penal rates of interest and the recovery of loans/interest upto 1987. Considering the continuing slump in tourism the moratorium of two years which was originally granted upto 1987, was extended until March 1989, with a further concession of 100 percent scheduling as against 80 percent a allowed earlier. In addition, interest free loan facilities were granted by the Government to meet the working capital needs of the affected hotels.

Table 11 shows the rescheduling of loans that were made available through the banking system to the tourist sector as at December 1986, and the percentage commitment of each financial institution. The total value of loans rescheduled by the end of 1986 amounted to Rs 371.34 million. The highest amount of rescheduling completed was carried out by the Development Finance Corporation of Ceylon amounting to Rs 132.69 million in respect of 25 hotel projects. The other reschedulings by institutions were Rs 105.68 million (National Development Bank); Rs 53.73 million (Bank of Ceylon); Rs 36.61 million (Commercial Bank), and Rs 34.68 million (People's Bank).

When considering both the amounts of rescheduling completed and the reschedulings under consideration, the highest amount was Rs 153.17 million or 25.1 percent of the total (rescheduling completed and under consideration) from the People's Bank; which was about one fourth of the total tourist industry loans of the entire banking system. The other leading financial institutions where rescheduling of loan facilities for the tourist sector was being carried out were the Development Finance Corporation (Rs 132.69 million or 21.5%); National Development Bank (Rs 120.06 million or 19.4%), and Bank of Ceylon (Rs 92.41 mn or 15.0%). The average amount per hotel project granted by the four main lending institutions was People's Bank Rs 5.0 mn per project; D.F.C.C. Rs 5.3 mn; N.D.B. Rs 10.0 mn and Bank of Ceylon Rs 8.4 mn.

M.J.

HEALTH

Rabies Controls Intensified

Rabies, recognised as a public health problem in Sri Lanka from the early 1950's, had reached serious proportions by the early 1970's. By 1986 however, it appeared to be coming under control with a series of intensified anti-rabies measures introduced during the early 1980's.

From the 1950's rabies was accorded low priority in health programmes due to the apparent dangers from other communicable diseases that have been prevalent in the country. Between 1963-1973 the number of human deaths from rabies averaged 312 annually; amounting to as much as one human death in the island every 30 hours. The number of human deaths from rabies reached a peak figure of 377 in 1973, when in that year a total of 75,386 dogs were vaccinated for rabies. In 1985 the number of human deaths had come down to 62 and the number of dogs vaccinated was 268,561. The rate of deaths per 100,000 of the population had dropped progressively over the years from 2.90 in 1973 to 0.5 in 1985. The 1986 position was slightly above that of 1985. (See table).

STATISTICS PERTAINING TO RABIES CONTROL ACTIVITIES IN SRI LANKA

Year	Dogs Vaccinated	Dogs Eliminated	Animal Rabies	Human Deaths	Rate per 100,000 Population
1973	75,386	3,128	681	377	2.90
1974	21,617	312	442	347	2.60
1975	42,252	1,610	456	288	2.13
1976	68,932	2,236	389	257	1.87
1977	65,798	3,031	401	312	2.24
1978	111,299	7,986	412	242	1.7
1979	127,070	22,434	517	265	1.8
1980	128,143	36,845	420	153	0.11
1981	135,268	37,733	292	136	0.92
1982	189,600	48,364	375	136	0.90
1983	194,046	42,237	368	119	0.76
1984	197,470	52,862	410	93	0.08
1985	268,561	66,238	—	62	.05
1986	216,292	73,749	—	98	.08

Source: Division of Medical Statistics, Ministry of Health; Registrar General's Dept.

Human mortality from rabies is regarded as the main indicator in assessing the impact of the anti-rabies programme. There are many unique features in Sri Lanka's programme. Firstly, the vaccine available for human treatment till the beginning of this year was the Semple Type Nerve Tissue Vaccine derived from the adult animal brain, which is not totally free from risk of infection. This type of vaccine has been discontinued in almost all the developed countries for some time and the same trend has been followed here. Today Sri Lanka is the only country in South Asia which is importing a complication free Cell Culture Vaccine for post-exposure treatment of humans, though it is costing the country a large amount. Another important factor is that unlike in the case of most other ailments in rabies ayurvedic treatment has not proved effective, and health education programs are alerting the public towards this aspect, according to the Director of the MRI.

Secondly, Sri Lanka is the only country in South East Asia which has an infrastructure for Rabies Control as recommended in a Technical Report Series of the WHO Expert Committee. Furthermore, the Veterinary Public Health Unit has gained sufficient experience in the field of Canine rabies control.

Thirdly, the Arab Gulf Funded UN Programme (AGFUND) has selected Sri Lanka from among one of the three countries in the world to implement a human canine rabies programme. The AGFUND Programme has selected seven districts, Kurunegala, Gampaha, Colombo, Kalutara, Galle, Matara and Hambantota - where the immediate objectives are to reduce human deaths to zero level, at the end of the programme and also undertake a dog ecology study in Sri Lanka. The growing intensification of rabies control activities in Sri Lanka may be observed from the statistics in the above table.

K.G

Indonesia urged to change production policies

The World Bank has warned Indonesia that its " yawning debt service ratio and fragile balance of payments situation will constrain the economy for several years". The Bank estimates that the ratio of total debt payments to gross exports which reached 37 percent in 1986 would peak to 41 percent in 1988. Extracts from the Bank's confidential report on the Indonesian economy, reproduced in a May issue of the *Asian Wall Street Journal,* calls for a "sweeping review of government agricultural policies, and urges a move away from the country's increasingly costly emphasis on rice production and toward deversified cash crops".

"Indonesia adjusted quickly to the collapse of world oil prices in 1986, but still faces several difficult years of budget austerity, sluggish growth and swelling debt payments", the World Bank says. It adds that "Jakarta must continue on its path of regulatory reform while maintaining strict control of fiscal and monetary policy". To stimulate the economy and raise exports in the face of a prolonged slump in oil prices, the Bank repeats calls from past reports for Jakarta to continue dismantling trade and industrial monopolicies that fetter manufacturers and limit export potential".

Indonesia is the Bank's largest client after India. The Bank has committed about $ 10 billion to Indonesia over the past two decades, with annual aid currently about $ 1 billion. The World Bank recommends that the Inter Governmental Group of Indonesia (IGGI) provide $ 2.5 billion in assistance in the 1987-88 fiscal year that began on April 1.

The Bank says that Indonesia had been reacting well to the decline in world oil prices since the 1980s. It says the government's response to the collapse of oil prices in 1986–including budget austerity, a devaluation of the rupiah and relaxation of import licensing restrictions–was "rapid and well-balanced".

The Bank says "the government has been correct to slash its national budget despite the trade-off of slower economic growth". It calls for continued budget austerity and improved use of limited funds. Rather than starting new projects, the Bank says that the government needs to spend more on maintaining roads and other infrastructure in danger of deteriorating.

Impact of Yen's Rise

The Bank says much of the increase in the debt-service ratios has been outside the control of the government. Besides the sharp fall in oil prices, the bank blames the depreciation of the dollar against the yen and European currencies for raising Indonesia's debt burden. A third of the government's debt is in yen.

With rising debt payments and a clouded outlook for oil exports, Indonesia will be hard pressed to protect its balance of payments position, the Bank says. Non-oil exports are rising, but not enough to help in the near-term. Imports have to be contained, but without resulting in additional import barriers.

Barriers, such as high duties or controls, would suggest the government is "faltering" in its commitment towards creating a more open economy. The brunt of import restraints should fall on capital goods, the Bank suggests, rather than consumer goods.

Increasing non-oil exports through continued deregulation of the manufacturing sector is vital, the bank says, both for stimulating growth during the doldrums in the oil market and for creating jobs. "Without strong measures to promote economic recovery, unemployment could reach serious proportions" the Bank warns. The Bank report calls on the government to focus public expenditures on labour intensive projects and to be lenient toward street vendors, pedicab drivers and other informal businesses that absorb labour.

Agricultural growth essential

The Bank says that continued growth in the agriculture sector is essential for economic recovery and for creating jobs. About 75 percent of the country's 165 million people live and work in the countryside. Government policies aimed at raising rice production have to be re-examined now that the country has reached self-sufficiency in rice and because of budgetary constraints, the Bank says, Indonesia became self-sufficient in rice production in 1984 after years of being the world's largest rice importer.

Stop Subsidies

The Bank says the government can't continue the 'huge' subsidies for fertiliser and pesticides that helped produce a surplus of rice, which has little export potential. It says the country also needs to diversify crops according to market demand rather than government targets. It particularly criticizes huge government outlays to raise sugar production when Indonesia has no comparative advantage in growing sugar. Sugar imports are restricted, forcing consumers to pay double the World market price.

The Bank says Indonesia needs to encourage private investment in tree crops such as rubber and palm oil, and it says state plantations are inefficient. It also suggests that the country's National Logistics Board, or Bulog, should have less control over the national and international marketing of wheat, corn and soyabeans and that more agricultural trade be turned over to private companies.

WORLD BANK'S BIGGEST 5 BORROWERS (upto June 30,1986) (US$ million)

Borrower	IBRD No.	Loan Amount	IDA No.	Credits Amount	No.	Total Amount $ mn	%
India	97	10,692	170	13,828	267	24,520	15
Brazil	149	13,085	--	---	149	13,085	8
Indonesia	111	9,123	46	932	157	10,056	6
Mexico	94	8,818	--	---	94	8,818	5
Korea Rep.of	82	6,431	6	111	88	6,542	4
Sub total					755	63,002	38
110 other countries					3,527	102,919	62

Source: *World Bank Annual Report, 1986.*

Agreement over Thai Purchases of Sri Lanka's Geudas

The trade in geudas between Sri Lanka and Thailand is to be formally controlled in terms of an agreement signed between the two governments. The controls will be operated through a system of special passports and visas issued to Thai geuda traders coming into Sri Lanka. Also, the period of stay in Sri Lanka for such traders would be limited; and they would have to remit a stipulated amount of foreign exchange to Sri Lanka prior to receiving visas in Bangkok. Furthermore, all purchases of geudas are expected to be made by them only at a Trading Floor located in the city of Ratnapura. The trade protocol has also agreed to abolish the black list of Thai traders presently maintained by Sri Lankan Immigration Authorities.

Prior to around 1978 the geuda stone, which is essentially the immature state of the blue saphire, had little value placed on it. The ready availability of this stone in the Ratnapura area came to the notice of Thai traders around this time. The Thai traders had prefected a system of heat treatment for this stone and giving it the value of a blue saphire. Very soon the geuda began to increase in value and after some time was fetching almost as much as a blue saphire. This made geudas very popular in the Ratnapura district and brought in hundreds of Thai traders who began to dominate the business. In terms of government regulations any foreign national engaged in business in Sri Lanka had to obtain prior authority; in the case of Thai nationals engaged in the geuda business however, they violated this authority as well as the rules pertaining to visas. They often came as tourists or pilgrims and continue with their unauthorized business here. For almost ten years officials have kept silent and been inactive on this issue, except for a few rare occasions. Among the institutions who needed to be concerned were the State Gem Corporation, the Immigration Department and the Police Department.

Leading gem merchants in the country registered strong protests of this open flouting of authority. The Sri Lanka Gem Trader's Association, the Sri Lanka Jeweller's Federation, the Gem Merchants Federation were the organised bodies who protested over the Thai involvement in the Gem trade. These protests covered the illegal immigration of Thais and unauthorised involvement in business activities; illegal buying of gems or keeping of uncut gems in their possession and illegal export and smuggling out of these gem stones. It was also pointed out that though they purchased several million rupees worth of gems the money they brought in was limited, generally around US$ 300.(Some of these issues were highlighted in the Economic Review of April 1985). There was also much debate at the political level over the illegal trade of geudas. Some politicans were for action to curb this activity by Thai tradera, while others were against any action. Finally, after nearly 5 to 6 years of debate on how to control this trade it was decided to work to out this agreement. In the view of a spokesman for the gem trade an agreement was resorted to on the principle that if you cannot defeat them then join them.

For purpose of this agreement, the 'geuda' condition would refer only to stones in the corundum family. "Geuda" is a local term applicable to a condition seen in certain types of Gemstones. Generally gem-stones containing Geuda, display a smoky, milky or murky appearance. This phenomenon is caused by the presence of excessive, often microscopic mineral inclusions within the stone. As a result, this impairs the passage of light through the stone to some extent. Geuda in a gem stone could occur throughout the stone concerned or could be confined only to certain areas. It could vary greatly in appearance depending on the nature and the amount of inclusions present. While "Geuda" could be seen in any gem-stone variety, it is most abundantly seen in the corundum family followed by the stones of the chrysoberyl group. It could be found in other stones as well, although in a lesser degree. Scientifically the corundum with a genda condition should contain titanium.

Further, in terms of the agreement the term "Geuda" will bear meaning and significance only to that portion of the gem stone that displays this phenomenon. For example, a Corundum may have geuda confiend only to a particualr area of the stone, while the rest of the stone would be free. This would mean that a portion of the stone is fashioned or could be cut encabochon to display a star or fashioned in any other form. Simply, by virtue of the fact that corundum bears a certain amount of geuda which is localised the whole stone would not be classified as a Geuda. It would therefore be necessary to seperate the geuda portion from the rest of the stone; and only the seperated portion will be classed as geuda.

TABLE 1. SRI LANKA'S GEM EXPORTS TO THAILAND (RS MN)

Year	SGC	Private	Total
1982	4.6	9.4	14.0
1983	0.7	43.0	43.7
1984	0.8	14.4	15.2
1985	-	10.1	10.1
1986	-	20.5	20.5

** State Gem Corporation*

TABLE 2

Sri Lanka's Gem Exports - 1986

Japan	329.7
USA	93.4
Hongkong	63.0
Switzerland	45.9
West Germany	23.9
Indonesia	23.6
Singapore	21.0
UK	7.7
Australia	3.5
Malaysia	2.1
South Arabia	1.2
Belgium	1.5
Israel	1.1

Overview

It is necessary to consider, in the light of past experience and prevailing activities, how far this new agreement could provide relief against undue Thai influence and illegal practices in the local gem trade. A significant provision in the agreement is that the sale and purchase of geudas should take place only at a trading floor and such sales should be managed and operated by the State Gem Corporation. At present there are several hundred Thai traders who buy geudas mainly in a location called Baragedera close to Ratnapura town. There are a host of agents, brokers, the owner's of premises operating sales stalls, housowners, transport agents and other intermediaries all connected with this business and they work closely with the Thai traders and have strong interests in this type of informal trading. It is difficult to say whether once the Thai buyers are brought to the Trading floor that private buying will not operate.

Another requirement in the agreement is that payment by authorised Thai traders for geudas should be only in the form of bank drafts or certified cheques. Also, that if in the opinion of the State Gem Corporation there has been undervaluation of geudas to be exported, the Corporation would purchase such stones at the declared price. Maintaining only the official price may be difficult as there can be tendencies of attempts to depress trading floor prices.

It is apparent that the authority to monitor the entire business is vested in the Gem Corporation and therefore it is on the efficiency and integrity of those who operate the scheme that the success of the scheme would depend. It may be necessary to operate an incentive system to attract the gemmers and middlemen to the trading floor, possibly granting them some compensatory payment or exchange allowance to purchase at the duty free shop. Even income tax exemptions on certain levels of earnings from this trade may be an advantage.

In the meantime, it is very necessary that official encouragement be given to perfect a heat treatment process for producing blue saphires from geudas and adopting these techniques for further innovation in the gem industry.

W.G.S.

INDUSTRY

Sri Lanka's Textile Industry Back from the Brink

The four big public sector textile mills which encountered serious financial problems by the end of the 1970's and found difficult to compete in the newly liberalised market had all turned the corner by the end of 1986. In 1980 all four mills - Thulhiriya, Pugoda, Veyangoda and Mattegama - ran at a loss aggregating Rs 38 million. The management of the mills were restructured and local and foreign private sector management and technical collaboration introduced thereafter. Production efficiency improved and by 1985 three of the four mills showed profits amounting to Rs 105 million, while one ran out at a loss of Rs 31 million. In 1986 all four made profits totalling Rs 175 million.

Over this period these mills have proved to be classic examples of how industrial ventures could stand on their own despite the competition posed by quality imported products. The liberalisation of imports in November 1977 helped consumers, who were starved of a free choice of textiles, to meet their pentup demand. This new policy also resulted in a considerable quantity of imported textiles coming into the local market. The local textile industry therefore faced severe marketing problems upto 1979 with these textiles flooding the market.

Meanwhile, questions were being raised regarding the efficiency of certain public sector ventures and how far they could be subsidised by the government. Their poor performance was being related to government interventions and controls and the lack of flexibility in decision making regarding investment, location, pricing and recruitment policies. Public enterprises were told by the Government that they would have to rely on their own funds and bank borrowings rather than the Treasury, and efficiency must be improved. In the case of the textile mills, management contracts were entered into with leading international firms and this step provided positive results.

By 1980 the estimated (medium) demand for textiles was about 150 mn. meters per year and a total of about 115 mn. meters was being produced locally. Locally manufactured textiles were categorised under cottons and synthetics, with the cottons being produced largely under the public sector and synthetics under the private sector.

The milled cotton textiles produced by the public sector were from the four major mills at Veyangoda, Thulhiriya, Pugoda and Mattegama. The first three mills manufacture the yarn as well as textiles while the forth manufactures only yarn. The first three were the main suppliers of textiles to the country when import controls prevailed upto 1977. After 1977, however, these mills had problems as a result of the liberalisation of imports. The textiles produced in these mills lost a major share of their market to the imported product, mainly because their quality was low compared to the imported textiles. As a result both the private and public sector textile manufactures were being edged out of the market and faced liquidity problems.

At this stage the government invited international textile consultant firms to enter into management con-

Table I

TURNOVER OF 4 TEXTILES MILLS (RS MILLION)

	1982	1983	1984	1985	1986
1. Thulhiriya	265.5	312.2	432.8	483.0	408.0
2. Pugoda	97.0	161.0	245.2	335.0	388.0
3. Mattegama	72.0	66.3	[illegible]	106.0	122.0
4. Veyangoda	122.0	[illegible]	185.0	[illegible]	398.0

Source: Ministry of Textile Industries

Table 2

PROFIT SITUATION OF 4 TEXTILE MILLS

	1980 (Rs mn)	1985 (Rs mn)	1986 (Rs mn)
Thulhiriya	-(26.2)	56.0	60.0
Pugoda	(20.4)	34.0	79.0
Mattegama	-(02.2)	15.0	38.0
Veyangoda	-(36.2)	-(31.0)	07.0

Source: *Ministry of Textile Industries*

tracts with the government mills in order to assist in improving the quality of the textiles produced. As stated at the outset the mills were run at very heavy losses at this time as seen in table 2. Barely two years after the operation of these mills were let out to foreign managements the production of yarn and textiles increased sharply. (See table 1).

Following on the changes and developments introduced Thulhiriya mill showed a profit of Rs 1.7 mn in 1983 and Rs 6.0 mn in 1984, while by 1985 the situation in the first three mills had turned towards profits, and at the end of 1988 all four mills reflected a profit situation. See table 2.

What is significant in this situation is that profits were finally achieved despite continuous input cost increases. The cost of raw cotton went up from Rs 33.47 per kg in 1980 to Rs. 41.18 per kg in 1983. The cost of power and also fuel went up similarly, while interest rates on bank loans taken by these mills also went up considerably. Meanwhile, wages of workers increased on an average from about Rs 700 a month to about Rs 1,200 per month between 1981 and 1984.

Furthermore, a severe threat was posed to the local industry in the form of smuggled textiles, and fabrics imported for the export industry leaked on to the local market.

Today the output of these mills is similar in most respects to the imported textiles. With growing demand for the textiles from these mills the export of cotton textiles for resale has been stopped for the last few years. Salu Sala, the sole importer of textiles for resale and also the government's textile distributor, today sold mainly the textiles produced by these mills.

The Ministry of Textile Industries reported that the quality of products both in the public and private sectors had improved considerably and in 1986 the export oriented garment industry was using more local material for their exports than ever before.

Authoritative sources said the Finance Ministry had recommended privatisation of the mills in the shortest possible time, as the management agreements were unfavourable to the government, since the foreign companies shared profits but there was no provision to split losses. It was reported that at Pugoda the company is entitled to 35 percent of the profits but there is no provision for loss sharing.

Powerloom Projects

A privatisation policy was pursued in other categories of the textiles sector. Apart from the large textile mills there were 12 powerloom projects and six textile finishing plants under the public sector, operated by the Department of Textile Industry (DTI). By 1981 as many as 10 of the 12 powerloom projects had been sold to the private sector. Some of these projects ran into difficulties consequent to the 1983 disturbances and also due to the severe competition from the mills. The two powerloom projects retained by the DTI, were at Galle and Anuradhapura and the ability of the Department to concentrate resources of these two looms only, had provided beneficial results. Meanwhile, work on the six textile finishing plants was completed by the DTI in 1983 and action was taken in 1984 to sell 4 of these finishing plants to the private sector, although there was big demand for finishing plants both from the public and private sector.

Handlooms

The handloom sector appeared to be the most effected after the liberalisation of imports and faced considerable problems in the early 1980's. Steps were taken to revive this sector but in a climate of severe competition from the powerlooms and mills the growth of the handlooms sector was understandably slow. By 1983 the value of export of handlooms had gone up to Rs 8.5 mn from Rs 6.0 mn the previous year and the Department of Textile Industries was providing handloom material to the private sector for conversion and export. By 1984 the Department launched a programme to set up three handloom centres afresh in each electorate where handloom weaving could be done. By 1986 a total of 303 centres had been opened in terms of this programme. An incentive package for handloom weavers was also initiated for those centres where marketable products were produced. Also, with a view to promoting handlooms, manufacturers were allowed to import yarn of high quality and maintain buffer stocks in order that they could meet urgent export orders. It has been found that handloom products have very good export potential in some of the European countries. One of the advantages of handlooms in the export market is that there is no quota restriction; which has been imposed by many foreign countries on milled products. Natural silk being produced from mulberry cultivation at Pallekele also has good potential in the export market. Silk weaving has been given emphasis in some of the handloom centres and a greater availability of silk yarn locally is expected to further promote silk weaving.

Private Sector

The ownership of the synthetic textiles in the country is in the hands of the private sector. From the late 1950's the management of the cotton textile industry was assigned to the public sector while the synthetic textiles sector was opened to the private sector, and as a result the manufacture of synthetic textiles was confined to the private sector all along. Today there are more than 10 private owned synthetic textile mills performing well despite the threat of the foreign synthetic textiles coming into the market.

Most of these mills ran at a loss after 1977 as the market was flooded with foreign materials. The foreign made textiles came into the market in three ways, namely: legal imports for re-sale, smuggled textiles; and leaked textiles imported for ready-made garment export factories.

Legal imports was not a big problem for the local textile producers as they were controlled by a state organisation, namely Salu Sala. The smuggled textiles posed the biggest problem and was an uncontrollable obstacle for the local industry. Various types of fabrics mainly synthetics flooded the market after 1977; and some of these textiles of fairly high quality were sold in the local market at very cheap prices. Sarees, suiting and shirting are the major items among these imports. Even today a large part of the sarees sold in the market are from these illegal channels. Although at times the Customs uncovered big consignments of illegal imports this has not helped to stop the illegal inflow of foreign textiles.

The other form of entry of foreign textiles into the local market is through leakages from the readymade garments export sector. As the export of garments has become a major foreign exchange earner for the country, various concessions have been granted to the garment industry and one of them was the waiving of import duties. Some of these manufacturers who do not pay the usual duty on their textile imports which are meant for the export market sell these fabrics illegally in the local market. A large amount of shirtings and dress materials available in the market came into the market in this way.

Despite these obstacles the private sector has reached standards of production more or less similar to some of the imported materials. It can be seen that some materials (eg.suiting) are today sold in the open market, by retail traders, under the label of 'imported'. Data relating to the manufacture of synthetic textiles for the last five years is given in table 3.

It is evident from this table that the installed capacity of the private sector synthetic mills has grown tremendously after 1979 although there were grave marketing problems, and to day this sector has been able to increase production to a considerable level. However, a drawback that has arisen in this situation is that actual annual production is well behind the installed capacity. Actual production of the synthetic textiles in 1986 was only 47.8% of installed annual capacity compared with 72.3% in 1980. It should be noted that installed annual capacity has increased by 262.7% and illegal imports still dominated the local market although the local industry is well equipped with very sophisticated machinery to supply all most local needs.

Table 4 TOTAL PRODUCTION OF TEXTILES (MN METRES)

Year	Rated annual Capacity	Cottons	Synthetics	Total	Capacity Utilisation
1978	248.08	85.16	30.71	115.87	46.7
1979	248.10	78.72	27.00	105.72	42.6
1980	248.30	62.73	27.27	90.00	36.2
1981	257.50	66.72	31.19	97.91	26.6
1982	270.54	80.85	34.11	114.96	42.6
1983	257.84	58.64	31.87	91.51	35.6
1984	245.84	84.50	34.66	119.16	48.6
1985	243.83	95.54	34.85	130.39	53.6
1986	256.56	97.94	42.73	140.67	54.8

Source: *Ministry of Textile Industries*

Overall Situation

The overall situation of the textile industry is somewhat different when compared with the individual sectors of the industry. For instance, in the cotton sector production has gone up tremendously although installed capacity has come down. Considering the private sector, installed annual capacity has increased heavily while the actual production has increased only marginally. In the case of the overall situation (or that of the whole industry) there is a very slight increase in the rated annual capacity as seen in table 4.

However, the actual production of the industry has shown an increase from 46.7 million meters to 54.8 million meters. Therefore, the overall capacity utilisation has gone up from 46.7% to 54.8%. Table 4 gives the position relating to the overall situation of the textile industry. The fact that total local textile production has moved up consistantly after 1983 and was supplying almost 75 percent of local requirements through the mills sector proves that the industry has been revived and placed on a stable footing over the last seven years.

Another significant development is that textiles and garment exports reached an all time high of Rs.9,679.2 mn. This figure stands in marked contrast to the Rs.400.0 m, earned in 1978.

There is no doubt however garment exporters should endeavour to increase the nett earning content which stands at anything between 25%-30% today. This nett earning increase has to be achieved systematically, just as the volume increase was achieved over a span of five to six years in textiles.

W.G.S.

Table 3

MANUFACTURE OF SYNTHETIC TEXTILES IN PRIVATE MILLS (MILLION METRES)

Year	Rated Annual Capacity	Actual Production	Capacity Utilization
1978	22.84	14.03	61.4
1979	23.00	14.58	63.4
1980	24.84	17.97	72.3
1981	34.66	24.94	72.0
1982	45.00	28.81	64.0
1983	46.00	25.75	60.3
1984	46.00	28.57	62.1
1985	60.00	28.66	47.8
1986	60.00	28.68	47.8

Source: *Ministry of Textile Industries*

Fiscal Policies for Agriculture and Supporting Agro Industry

N.Manoranjan

This paper, presented by N.Manoranjan as Adviser, Fiscal Policy, Ministry of Finance and Planning at a seminar on 'Newly Emerging Agro Industries', in 1985, focuses on fiscal policies for agriculture and supporting agro industries. Although his analysis is timed after the Budget 1985, the significance of the paper is that it explains the rationale behind the fiscal measures such as taxation, subsidies and duties. The paper deals specifically with non-traditional agriculture, that is, cultivation of crops other than tea, rubber, coconut and paddy, and with industries for the processing of these crops. In the area of fiscal policy, special attention is paid to three main subjects: firstly, income tax concessions; secondly, the area of subsidies; and finally, the operation of import duty, export duty and turnover tax.

Initial Investment

We first examine the fiscal measures which assist the initial investment in the agricultural and agroindustry sectors. The initial cost of investment in approved companies is reduced through the grant of a deduction from the income of the investor for tax purposes, for the amount of the investment made by him. A person who purchases ordinary shares in a company approved by the Minister of Finance and Planning for the purposes of the grant of investment relief, could deduct from his income the full amount of the investment subject to an upper limit of one-third this income. With effect from April 1985, a limit of Rs.500,000 per year also applied to persons, other than companies, who approved investments.

The effect of the grant of this relief on the initial cost of an investment made by a company within the limit of one-third of its income is to reduce the cost of the investment by one-half. Assuming that the company pays income tax at 50% of its profits, it would in effect pay only Rs.5 for a Rs.10 share. The balance Rs.5 is met out of the income tax otherwise payable by it. This is a substantial incentive for investment in shares of approved companies. Similar relief applies to individuals who purchase ordinary shares in approved companies.

Companies are approved on a case by case basis by the Minister of Finance and Planning for the purposes of this relief. In general, the policy has been to approve for investment relief purposes companies that qualify for tax holidays.

Deduction of Capital Expenditure

In an agricultural venture, the largest item of capital expenditure is normally, the expenditure incurred in the opening up of land for cultivation. Such expenditure includes clearing the land, filling up and draining marshy land, constructing fences, constructing irrigation canals, preparing the land for planting and cost of the plants. Expenditure on the maintenance of immature areas until the plants reach the bearing state would also constitute part of capital expenditure.

Our income tax law permits a person, in calculating the profits from an agricultural venture, to deduct from his receipts the entire amount of such capital expenditure. Expenses incurred in replanting the land with the same or a different crop are also deductable in computing profits.

The effect of these provisions is that the profits of an agricultural venture will not be liable to income tax until the entire capital expenditure in opening up the land for cultivation has been recouped. Ordinarily, in commercial accounting, such expenditure would have been capitalised and written off from receipts over a number of years and any balance profits for an year would have been treated as income of that year.

The government also pays subsidies for the planting or replanting of specified agricultural products in order to reduce the initial capital cost of investment of an agricultural venture. Under our taxation laws, these subsidies are not treated as income even though the entire cost of planting or replanting are deducted from the receipts of the venture in calculating the profits liable to income tax. This double concession that is the payment of a subsidy and its exclusion from income for tax purposes, is provided as a special incentive for agricultural development.

[illegible]

Payment of Subsidies

Subsidies are paid by the Department of Minor Export Crops for the new planting or replanting of cardamoms, cinnamon and cocoa and for the new planting of cloves, nutmeg, pepper and coffee. The Department of Agriculture operates a subsidy scheme for the initial cultivation of fruit varieties such as passion fruit, mango, and citrus fruits.

Tax Holidays

A tax holiday increases the return from a venture which is retained for the use of the owner. A tax holiday is thus a major incentive for investment as the owner's real concern is with his after tax rate of return.

As a matter of policy, tax holidays are now restricted largely to the non-traditional export sector. In the agricultural sector, cultivation of sugar cane qualifies for a tax holiday. A tax holiday is also available to a company which is set up for the production, from the agricultural produce of Sri Lanka, of specified commodities. Thus, selected agrobased industries could qualify for a tax holiday. Where the product of non-traditional agriculture or agroindustry is exported, liberal tax holidays are available in our tax system.

Any business organisation, whether it is a proprietory concern, partnership or a company, is entitled to a five year tax holiday on its profits from non-traditional exports from 1st April 1984 to 31st March 1989. It is not necessary for a business to be specifically approved for the purposes of this tax holiday. The manner in which this tax holiday is structured gives the largest benefit to a business which enters the export field early. A business which commenced exports on or prior to 1st April 1984 could enjoy the full five year tax holiday.A company which commences exports in, say April 1986 will obtain only a three year tax holiday. The tax holiday was so structured to encourage business to commence exports as early as possible.

A five year tax holiday from the date of commencement of exports is available to companies which engage in the manufacture and export of non-traditional export products. This tax holiday is granted under section 20 (1) (b) of the Inland Revenue Act and has to be approved by the Minister of Finance & Planning on a case-by-case basis. Companies which are incorporated to carry on export oriented agro-based industries could apply for this tax holiday.

The third category of tax holidays for export undertakings was announced in the Budget 1985. This takes the form of a ten year half tax holiday and is available to a company which makes exports of non-traditional products where the net foreign exchange earnings is more than 75% of the F.O.B. value of the exports. This level of net foreign exchange earnings could be obtained by non-traditional agricultural products including particularly agro-based industrial products. These companies too have to be approved by the Minister of Finance & Planning on a case-by-case basis.

The tax holiday for the non-export sector is also restricted to approved companies and is for a period of five years from the date on which the company commenced to carry on business. In the case of all the tax holidays except the ten year half tax holiday on export profits, the tax holiday is allowed to flow through from the company to the shareholder. Dividends declared by a company out of its tax holiday profits, during the period of the tax holiday or within one year thereafter will be exempt from income tax in the hands of the shareholder. Provision is also made to exempt in the hands of the ultimate shareholder a dividend declared by a company out of tax holiday dividends received by it.

Export Production Village Companies

The fiscal incentives provided for village level development have necessarily to be different from those provided to encourage the setting up of large-scale agricultural ventures. In order to take the export effort to the villages a new form of organisation, has been set up called the export production village company. The export production village company is incorporated under the Companies Act. The share-holders of this Company are the village level producers. The Export Development Board provides assistance to these companies by way of capital participation and management and marketing assistance.

The shareholders sell their products to the Export Production Village Company which, in turn, sells these products to export concerns. Thus, for the first time, direct export effort has been organised at the village level. The products exported are mainly fruits and vegetables.

The Export Production Village Company is granted a five year tax holiday on its profits. Dividends declared by the company out of its exempt profits are also exempt from income tax in the hands of the shareholders.

In addition, as an initial incentive for the growth of the Export Production Village Company form of organisation, the Export Development Board pays them a cash grant of 2% of their sales. Export concerns which purchase commodities from the Export Production Village Companies also receive from the Export Development Board a cash grant of 2% of the value of such purchases.

10 Year Tax Holiday and 100% Investment Relief

The Inland Revenue Act contained provision earlier which enabled the grant of a 10 year tax holiday to approved companies engaged in large agricultural activities. These companies had to be quoted public companies with a minimum issued share capital of at least Rs.100 million. The Company could engage in the cultivation of non-traditional agricultural products or in the cultivation and processing of such products. Companies approved for this tax holiday included three companies set up for the large scale cultivation and processing of sugarcane.

Where the total capital of the company was Rs. 500 million or more, investors in shares of the company were granted 100% relief from their income for the investment made by them. They could deduct from their income the full amount of the investment.

These liberal tax concessions were granted to encourage the formation of companies which would engage in large scale agricultural ventures. As a policy measure, it was considered necessary to encourage the establishment of such companies side by side with the encouragement of production in the medium scale enterprises and at the village level.

Fiscal concessions of this nature cannot be continued for long without giving rise to serious problems of equity in taxation. They are granted to attract large scale pioneering ventures. Once a few firms are established it would not be necessary to continue to grant to all firms in the industry the same tax concesions.

Export Grants

Export grants are used as instruments of fiscal policy to increase the return on investments and to induce investments in export industries.

The operation of a scheme of grants involves the determination of the area in which grants should be made and the method of computing the amount of the grant. Measures should also be adopted to ensure that the grants are used for the purposes for which they were intended. An example of this type of assistance is provided by the export development and investment support scheme of the Export Development Board.

To qualify for the grant, the net foreign exchange earning of the product exported should be more than 20% of its F.O.B. value. The export earnings of the business concern, measured in S.D.R. terms, should have also shown an improvement over the average export earnings of the three preceding years. The extent of the grant increases with the percentage of the net foreign exchange earning on the product. Thus, in the case of agricultural products, there is an inducement to increase the value of the products by processing.

Of the grant 25 percent is paid in cash, the balance is paid in Development Certificates issued by the Export Development Board. These certificates do not bear interest as it is intended to encourage early use of the certificates. The certificates are valid for five years and could be encashed for investment in export-oriented projects approved by the Export Development Board. These grants are also exempted from income tax, thereby ensuring that the full amount of the grant is available for investment.

Import Duties

At present, import duty performs a protective function. Earlier, import duties were used as source of government revenue. With the introduction of the turnover tax at the point of import, this tax took over the revenue function of import duties.

The tariff structure introduced with the Budget 1985 provided protective duties ranging from 60% to 100% for the majority of locally produced agricultural commodities and agro-based products. These products are thus provided a considerable level of protection against competition from imports. The grant of reasonably high rates of protection encourages local production in areas where expansion of production is possible.

While tariff protection is provided for these commodities, the import duties on machinery used in industry and on raw material inputs have been reduced to keep down costs of production. A low rate of duty of 5% is levied on machinery imports. Further, no import duty or turnover tax at the point of import is levied on machinery imported for use in an industry where at least 40% of the output is exported. A number of essential inputs in agriculture are allowed to be imported free of duty. These include fertiliser and a large variety of chemicals used in agriculture.

A relief measure which operates along with import duties is the import duty rebate scheme for exports of manufactured products. The principle of this scheme is to refund to the exporter the import duty paid on imported inputs used in the product which is exported. The Export Development Board, along with the Ministry of Finance & Planning operates this scheme. Each manufactured product which is exported is analysed to ascertain the import duty content of its cost; a rebate is then granted as a percentage of the FOB value of the export to cover the import duty borne by the product which is exported.

Export Duties

Export duties are a major source of govenment revenue. However, in order to encourage the export of non-traditional agricultural produce almost all these products are exported free of export duty. Even the products liable to export duty are taxed at very low rates. These include 5% for cinnamon chips and 10% for cinnamon quills.

Turnover Tax

The turnover tax is so structured that exports do not bear this tax. Undertakings for the export of commodities manufactured or processed in Sri Lanka are exempt from turnover tax on their export sales. Where an export undertaking purchases raw material inputs from other manufacturers, the export undertaking is entitled to a refund of the turnover tax paid by those manufacturers when sales of the raw materials were made by them. The same concession applies where an export undertaking purchases components, packing materials etc. The export undertaking which is entitled to a refund of the turnover tax paid by

REVENUE OF THE GOVERNMENT OF SRI LANKA(a)

Rs million

Heads of Revenue	1978	1980	1982	1984	1986 Provisional	1987 Approved Estiamtes
Taxes on production and expenditure of which:	9,217.2	10,372.0	12,432.6	25,652.1	29,906.1	30,949.5
General sales and turnover raxes	1,143.4	1,640.1	4,061.4	8,143.5	10,052.3	10,920.0
Selective sales taxes	1,884.0	1,877.6	2,273.1	5,787.4	4,476.2	5,056.2
Import levies	1,469.3	2,924.5	3,222.4	7,946.4	10,014.3	11,540.3
Export levies						
Tea	2,781.0	1,920.3	1,443.9	1,768.3	934.1	895.0
Rubber	1,001.0	1,386.5	753.4	1,009.0	306.8	520.0
Coconut	344.9	218.2	191.1	296.9	231.9	140.0
Other	109.2	113.2	95.1	100.5	100.6	125.0
Other Items Of Revenue	2470.7	3,696.4	5,376.0	12,078.5	12,048.9	13,165.5
Total Revenue	11,687.9	14,068.4	17,808.6	37,731.0	41,956.0	44,115.0

Source: *General Treasury, Central Bank of Sri Lanka.*

(a) Figures of revenue for 1978 to 1985 and 1986 (provisional) differ from the published figures, in the Government Accounts.

those manufacturers when sales of the raw materials were made by them. The same concession applies where an export undertaking purchases components, packing materials etc. The export undertaking which is entitled to the refund could pass-on this benefit to the businesses from which it purchased the raw materials, components or packing materials.

Agroindustries which manufacture commodities for export are thus freed from turnover tax. Where a business has exports as well as local sales, the turnover tax exemption applies to its exports while the refund of turnover tax is related to the proportion of its inputs which are used in production for export.

A number of non-traditional agricultural products have been gazetted as exempted articles for purposes of turnover tax. The effect of declaring an article to be an "exempted article" is that, businesses which sell such articles are not liable to pay turnover tax on those sales. These exempted articles include cardamoms, cinnamon, cloves, papain and pepper. This concession has been granted to facilitate the operation of the exemption from turnover tax of export products. Representations were made that most of these products go through a number of sales points before the final sale to the exporter. The exporter could claim a refund for only the turnover tax paid by the business which sold the product to him. If it were not for the declaration of these articles as exempted articles, the turnover tax paid at earlier sales points would go unrelieved. However, this concession could be granted only where a larger part of the commodity produced in Sri Lanka is exported and there are anumberof sales points in the chain of transactions from the producer to the exporter.

Summing up

Fiscal Policy has thus been used to reduce the cost of the initial investment through investment relief and subsidies and to increase the rate of return to investments through tax holidays and grants. Import duties, export duties and turnover taxes have been kept neutral in so far as exports are concerned.

A Note on Developing System "A" of the Accelerated Mahaweli Programme and Soviet Offers of Assistance

Ariya Abeysinghe

The Soviet Union has indicated its willingness to be associated with the multi-national assisted river based multi purpose project, the Mahaweli programme. The Soviet commitment for the Accelerated Mahaweli Programme (AMP) is reported to be Rs 2,250 million in the form of a state loan to fund techno-economic activities. The AMP has in the Head works, Swedish assisted Kotmale, British assisted Victoria, German assisted Randenigala and Rantambe, and Canadian assisted Maduru Oya. The downstream development is assisted by Japan, USA, Saudi Arabia, Kuwait, Netherlands, Belgium, EEC, China and Australia. The international donor organizations include the IBRD and IDA ADB, UNDP, UNFPA, UNICEF, WFP, IFAD and OPEC. The latest addition to the group of aid donors is the Soviet Union. The total expenditure incurred on the AMP upto the end of 1986 was Rs 38.3 billion and when the Programme is fully completed by 1992 the final cost is estimated to be over Rs 50 billion. Total expenditure over the next five years, 1987-1991, is estimated at Rs 19.4 billion of which about Rs 10 billion is expected to be foreign assistance.

Most of the reservoirs under the AMP have been completed and are sufficient to irrigate nearly 300,000 acres of new lands for agricultural development. Of this about 140,000 acres of new lands have been covered and settled with farm families in System "H" under Kalawewa; System C on the Mahaweli Right Bank; System G under Elahera; and System B under Maduru Oya. At the end of 1986 over 41,000 ha.of new land had been provided with irrigation waters and another 77,200 ha.of existing land was receiving supplemental irrigation. The AMP's contribution towards rice production in the country had risen to 8.2% of the total in 1986, while it accounted for nearly 8% of the country's cultivated area under rice.

New towns have emerged in both the upstream and the downstream areas. They include Digana and Karaliyadda in the Kandy district;the new Kotmale township; Girandurukotte, Dehiattakandiya, Sandunpura in System C; Hinguralkandiya, Dimbulagala, Welikanda, Aralaganwila in System B; and Galnewa, Tambuttegama and Galkiriyagama in System H. New roads have also been built such as those linking Kandy via Gampola, Victoria Randenigala and Mahiyangana – Polonnaruwa which has reduced the time taken in travelling and transporting men, materials and goods.System 'A' whose development is to be assisted by the USSR is an integral part of the downstream development. In addition to a potential irrigable area of over 30,000 ha to be developed here on both banks of the Mahaweli, is also the other potential. The CECB has prepared engineering designs for the Headworks of Kandakadu, and some other studies have already been done on this project.

The Setting

System A lies in three Districts: Trincomalee, Batticaloa and Polonnaruwa. In the north it is bordered by Koddiyar Bay, in the West by Irrigation System D of the Mahaweli and in the South by System B of the Mahaweli. In the East it is bordered by a line approximately parallel to, and 5 km from the coast line. Thus, System A which is located on the lowest reach of the Mahaweli Ganga extends some 70 km from Kandakadu to the river mouth in Koddiyar Bay south of Trincomalee. It covers 45,300 ha as follows:

Unit 1 – consits of flood protected low lands north of Verugal Aru and comprises the existing Allai Scheme.

Unit 11 is the Western Part of Sys

tem A with a gross area of 12,900 ha, of which 9,700 ha are irrigated. Presently the area is prone to floods and a greater part of it is in jungle.

Unit 111 is the South Western part of System A. The gross area is 11,000 ha. of which 2,200 can be irrigated.

Climate

System A is located in the Dry Zone of Sri Lanka with an average rainfall of less than 1,900 mm. The average for Allai Tank is 1,750 mm. The wet season, Maha, associated with the north-east monsoon, lasts from October to January. The period from May to September is usually dry, with February- April being a variable transition period.

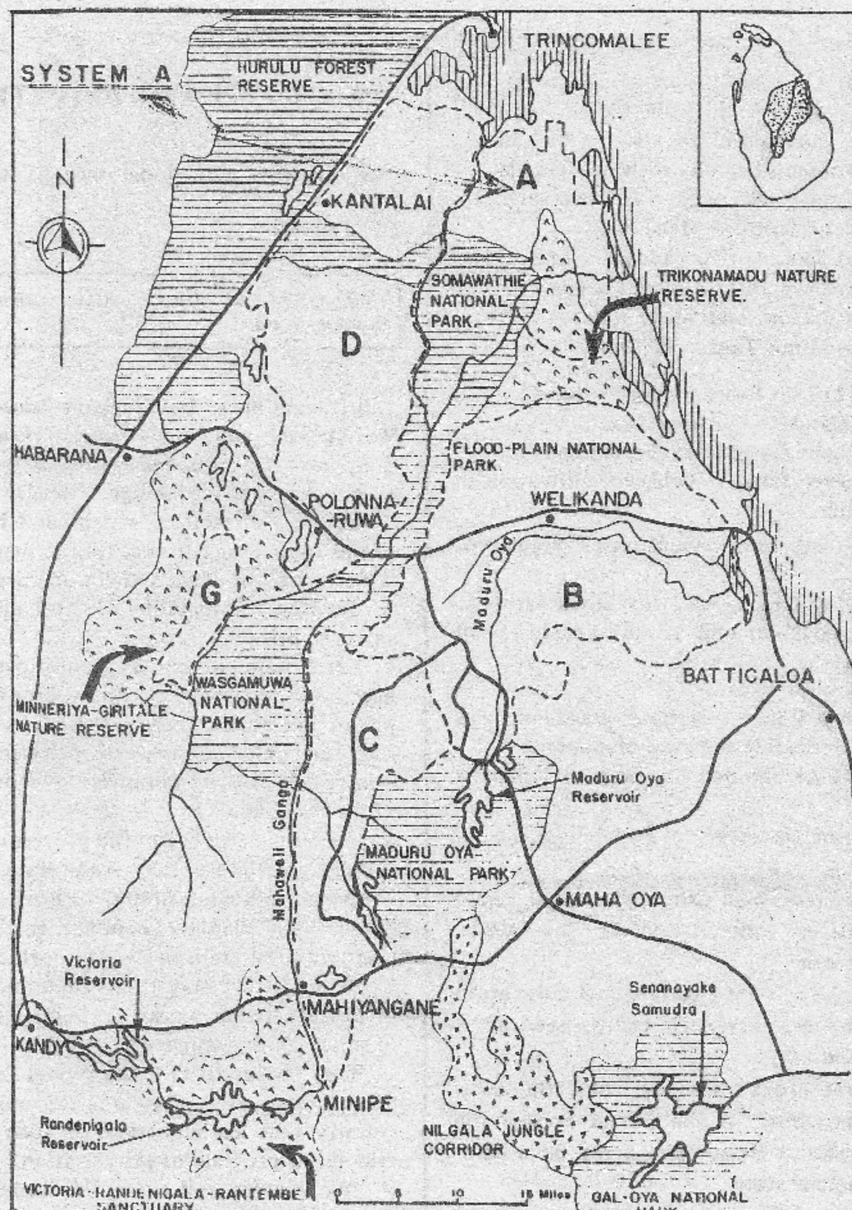
The hottest months are July-August with daily maximum temperature averaging $37^{o}c$ dropping to $25^{o}c$ by night. January is the coolest month with an average daily range from $29^{o}c$ down to $20^{o}c$. Relative humidity is highest in December 89-83% at 08.30 and 1730 hours. The average daily wind velocity is highest in the south west monsoon, Yala season, ranging from 11.0 km/hr during May to September. It is lowest from November to April ranging from 4.8 km/hr to 5.7 km/hr. Average daily sunshine ranges from 5.5 hours in December to 8.8 hours in May. Pan evaporation reaches its highest at 8.0 mm/ day in August dropping to 3.6 mm/ day in December.

Geology

The area is characterised in the East and South East by a range of Pre Cambrian rocks of the "Vijayan Series". To the West lie the "Higland Series" of the Pre Cambrian origin which extends from the Central Massif of the island North Eastwards to Trincomalee. Between them is the 'Transition Zone'. In the central part of system A the rocks are mantled by the alluvial filling of the flood plain of the Mahaweli river and the Verugal Aru. In some places along the coast are marine deposits.

Soils and Drainage

The soils of System A are (a) Fringing the Western boundary - soils developed on pre-Cambrian rocks of the



Transition Zone. They are red and brown medium textured residual soils. These soils are well drained. (b) Eastern - Western soil flow- coarse sandy soils. The drainage is imperfect. (c) Alluvial flood plain soils which are heavier textured mainly silty and clay material. (d) Sandy soils of the beaches and dunes along the coast. They are well drained.

Land Use

With the exception of some 8,000 ha of irrigated paddy in the Allai scheme and 1,460 ha of improved pasture lands, the area is poorly developed. Levee cultivation and illicit chena is carried out on approximately 10% of the total area. The reasons for underdevelopment in this area are:

(i) Unreliable rainfall distribution
(ii) Lack of irrigation facilities
(iii) Flooding during the Maha season
(iv) Forest reserve of 26,000 ha.
(v) Somawathie Chaitiya Sanctuary of 22,000 ha.

Unit 1	- 21,400ha.
Unit 11	- 12,900 ha.
Unit 111	- 11,000 ha.
	45,300

About 35,000 ha of soil along the coast is of marginal use for agricultural development.

The land use pattern at present is:

(1) Permanent Agriculture-

River Irrigated Rice (Two crops)

(a) Allai Paddy Scheme - 8,000 ha
Mean Yield 3,000 kg/ha/Crop
Size of holding - 1.2 ha - 1.6 ha
Problems-Scarcity of water in Yala
Scarcity of farm power
-Tank Irrigated Maha Rice
(a) Kadumuriyu Paddy Scheme-320 ha tank fed 160 ha upland paddy
Problems: Scarcity of water
(b) Minor Tanks - 1050 ha.

(II) Low Intensity Agriculture-
-Upland Rice - Maha season
-Chena Cultivation- Field Crops
-Levee farming-Tobacco cultivation in Yala
-Homesteads - Field crops, vegetables

(III) Grasslands - Livestock farms at Kandakadu and Tirikumamadu -1460 ha

(IV) Villus - Natural grasslands - 8 months flooded after Maha rains
(V) Abandoned Clearings - (Damanas)

Some Development Possibilities

1. Traditional Crops - rice, soya, sugar, maize, tobacco, pulses, oil seeds, onions
2. New crops - commercial cultivation of sugar cane, soya, maize, green gram, onions

Tree crops - Cashew along the coast, Tarmarind in the Forest Programme Coconut in suitable areas on a commercial scale.
- Jute in boggy soils including cane and bamboo cultivation
-Horticulture commercial farms - Banana on a commercial scale
-Irrifated Guava, mango, pineapple
3. Livestock - Large scale development of draught animal programme
4. Aquaculture - Commercial scale inland fisheries programme
—Dried fish, fish meal and processing of inland marine products.

Another factor in favour of developing System 'A' on a commercial scale is the availability of direct access to Trincomalee harbour which could be an export outlet and the China Bay airport could be developed for exports of fresh Mahaweli produce from Systems 'H', 'B','G','C', and 'A' to terminal markets including Hong Kong, Singapore, Maldives and the Middle East.

Possible Agro-Industries

—Modernised rice milling packetting
—Sugar milling
—Tobacco Processing
—Soya Bean oil and Meat
—Livestock feed mill
—Jute weaving
—Cashew decortication
—Fruit processing and packetting
—Milk based products

PROTOTYPE FOR PRIVATIZATION

Britain leads the global race to turn state assets into private enterprise

David Winder

Staff writer of The Christian Science Monitor, in London

Britain,home of Buckingham Palace, Wimbledon, and the Tower of London, now has an added tourist attraction that is drawing foreign officials.

The new attraction, which can't be found on a conventional tourist map, is privatization. That's the word used to describe the handing over of state assets to private enterprise.

Yet Britain, which has handed over nearly 40 percent of its state sector to private enterprise in the last 8 years is not the only country to privatize. Some 100 other countries - from China to Cuba, and from Brazil to Bangladesh - have begun the process of rolling back the frontiers of the state.

Even the Soviet Union, with its rigid centrally planned economy, is flirting with capitalism. A law, which went into effect May 1, lets thousands of Soviet citizens work for themselves in small family businesses.

What makes Britain the model for other countries is that it is the only country that has embarked on such a systematic program of privatization.

"We are far and away the leader. We were the first to start it, and we've built on the expertise", says a British Treasury source.

So far 16 state-controlled companies, including such household names as Jaguar and British Airways, have been taken over by private enterprises. This has brought 600,000 workers into the private sector, of whom over 400,000 have taken out shares in their companies on highly favourable terms. Another 1 million former tenants in public housing now own their homes. And dozens of city and town councils have contracted out their public services, such as refuse collecting and school and hospital cleaning to private firms.

According to Madsen Pirie, president of the Adam Smith Institute in London, a free enterprise think tank, representatives from as many as 50 countries have visited his London office to see how privatization works.

Other stops on what Dr.Pirie dubs the "Cook's Tour of Privatization" include the British Treasury, banks, local privatizing councils (authorities that have privatized essential services), and the National Freight Consortium in Bedford, England. The NFC became privatized in 1982 under a management employee buy out.(See accompanying story in Box).

Pirie says privatization is spreading like a brushfire world-wide.

The Scots-born economist who sports a bow tie, speaks as fast as an express train, and is a leading member of Mensa, the high I.Q.society, sees the transfer of power from the government to the people as representing a social revolution.

"It's the biggest story of the 20th century. Bigger even than the collapse of Keynesianism. It marks the reversal of 100 years of collectivism" says Pirie.

He says the world is now heading full speed ahead in the opposite direction. Both France and Japan have had huge sales of state assets, while privatization is growing apace in the third world. Even communist China and Cuba allow some tenants to buy their own homes.

Countries that have turned to privatization do so for different motives. Some, like socialist Tanzania, feel excessive state control has stifled Incentives to produce. Others, like oil-producing Malaysia and Nigeria, are pushed for cash because of the fall in oil prices.

But the road to privatization has plenty of bumps.

Last month nearly 1 million workers in Bangladesh shut down banks and industries in both public and private sectors across the country in a one-day strike intending to force the government to repeal its policy of returning nationalized industries and banks for private ownership.

In what has been seen in many quarters here in Britain as the greedy (and therefore unacceptable) face of capitalism, a Conservative member of Parliament was forced to stand down when it was found he was guilty of making multiple applications for British Telecom shares.

Opponents of privatization in Britain charge that the government is giving away some £ 4 to 5 billion in national assets every year to bankroll tax cuts in an effort to win voters. And some say the government has not effectively curbed the market dominance of newly-privatized monopoly utilities. The government defends privatization, saying it spurs competition and eliminates sluggish, state subsidized enterprises that are a drain on public funds. It also maintains that commercial decisions are no longer subject to political considerations.

The Thatcher government also has ideological objectives: to turn Britain into "a property-and share-owning democracy." Thatcher makes no secret of her desire to "bury socialism".

There is some evidence to suggest that Thatcher's free enterprise ideology is catching on. Between 1979 and 1987, the number of people owning shares in Britain almost trebled from 7 percent of the adult population to 20 percent. Many came aboard with the privatization of such giant utilities as British Telecom and British Gas and were induced to buy because a minimal number of shares could be purchased at installments.

In the view of the Treasury source, the reason so many countries are starting to follow Britain's lead is that, by and large, people were finding that the state is not the best employer. "Running a country and industry is incompatible," he says.

Not surprisingly, privatization dramatizes the ideological divide in Britain between the free market Conservatives and the socialist-leaning Labour Party and its trade union supporters. According to John Smith, Labour's trade and industry spokesman who is often tipped as Labour's next leader, privatization has more to do with politics than economics.

"First, it satisfies the basic intention of Conservatives to dismantle the state, secondly, it finances tax cuts, and thirdly, its irrelevant to the economy", he said in interview at the House of Commons.

Yet Thatcherism has so radically altered the political climate that Labour no longer calls for wholesale re-nationalizations as it would have done in the past.

As an American diplomat put it: "The Labour Party is in a position of electoral ambiguity"

One straw in the political wind was provided during the recent flotation of British Telecom stock. The trade union movement urged British Telecom workers not to buy shares, but as many as 96 percent of the work force chose to ignore their union's advice.

The end of privatization is not yet in sight. Other potential areas include forestry, prisons, the steel and coal industries, and the post office. Pirie of the Adam Smith Institute goes so far as to say he could even foresee the government selling off the derelict land it owns. With a potential price tag of £ 200 billion, selling off government wasteland could keep the privatization business going, at the current annual rate of about £ 5 billion, for another 40 years.

British freight firm shows how privatization can bring prosperity

David Winder

Six years ago when he was a herdsman on a Hertfordshire farm and unable [illegible] mortgage to buy a home, Peter [illegible] could scarcely have imagined [illegible] he would be placed today.

Mr. Willis is a perfect model [illegible] Minister Margaret Thatcher's [illegible] property owning, share-owning democracy of Britain.

Not only has Willis purchased a three-bedroom house, which has doubled in value, [illegible] also buying up stock in his company [illegible] the National Freight Consortium (NFC) - in which he is employee, owner, and shareholder all wrapped [illegible]

But so, too, are the [illegible] NFC, Britain's largest freight transport company, as a result of a remarkable management-worker buyout.

Michael Sweet, director of corporate [illegible] at NFC, explains the significance [illegible] stand on privatization. "The big difference is that control of the company rests with the shareholders, which are largely employees and pensioners. [illegible] companies doesn't rest with the [illegible]

The 1982 buyout of the company from the government for £ 53.5 million brought a dramatic reversal in the firm's fortunes. One London banker says that prior to the buyout [illegible] complete shambles [illegible] a lot of money and providing [illegible] services".

Since the buyout, the company can scarcely put a foot wrong. Last year saw turnover increase 12 percent, profits grew 45 percent while earnings per share went from 14.3 percent to 21.4 percent.

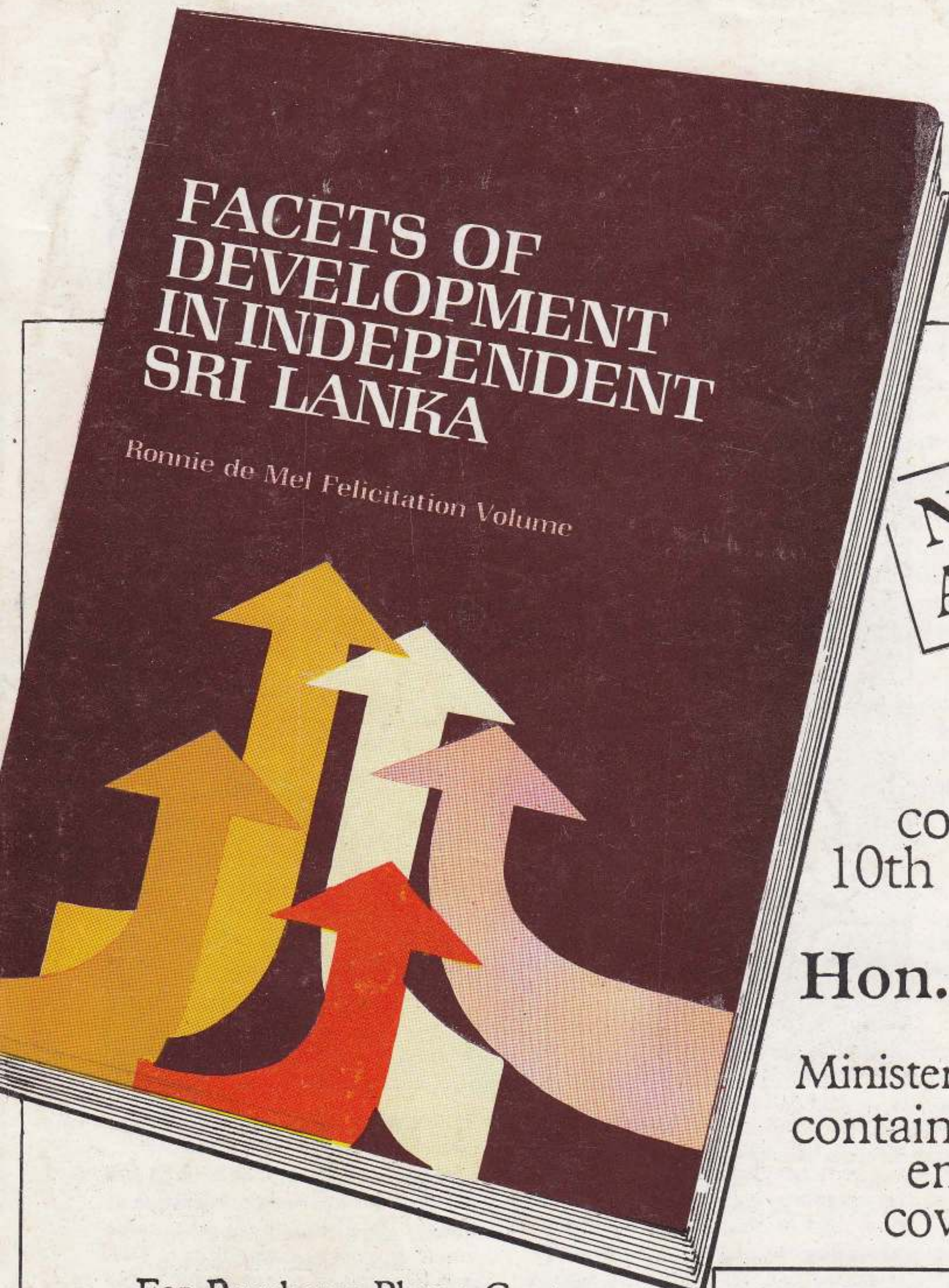
Initially only a third of the workers invested in the newly privatized firm. That [illegible] jumped to 65 percent.

[illegible] invested their life savings or remortgaged their homes to buy into the company. Practically none of them had ever held stock in a company. Those who came in at the beginning to pay for the shares that could be purchased [illegible] each have seen their investment [illegible] fold.

[illegible] workers previously of modest [illegible] found they could buy more expensive homes, take world tours, visit relatives in far off places.

Willis who is an office [illegible] was unwilling to reveal [illegible] he invested at the start, but [illegible] buy stock even though the shares now cost £ 42 each. Willis says things have worked out very well. "I'm very happy with what [illegible] life to be easier. I have [illegible] now which I didn't have previously. Your capital is building up all the time and increasing all the time".

One manager, more forthcoming on the return on his money, said he had invested £ 10,000 initially. Although he had disposed of some of his stock, his remaining investment [illegible] 000. "It transforms [illegible] changed my life," he says. "It gives you all sorts of problems, but what wonderful problems!"



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