Poverty of Economics in Economic Management: An Analysis of the 1995 Budget[1]

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'Would you tell me, please, which way I ought to go from here?'
'That depends a good deal on where you want to go' said the cat.

Alice's Adventures in Wonderland

The first budget of the Peoples' Alliance (PA) government was presented to Parliament on 8th February by the Minister of Justice and Constitutional Affairs, Dr G L Pieris. At the outset, two points related to the issue of popular democracy need to be emphasized. First, this is the second time that the budget was presented by someone who is not the Minister of Finance. The first time was in 1993 when the 1994 Budget was presented to the Parliament. The PA Government also has taken cover behind an unfortunate phrase in the Constitution of Sri Lanka that any minister could present the budget. As Mr Bernard Soysa correctly pointed out in his comment on the 1994 Budget 'the failure to follow the normal practice is yet another instance of the devaluation of Parliament and Parliamentary procedure' (1994:1). Secondly, in previous years, the estimates of government revenue and expenditure had been revealed well in advance of the Budget speech. This time the budget estimates for 1995 were submitted to Parliament only one day before the Budget. It makes the budgetary exercise a 'secret' affair, thus making it difficult for Members of Parliament to prepare for the budget debate.

The budget is not only an exercise in garnering revenue to finance the estimated expenditure in the coming year but is also an important statement of how the new government is going to steer the economy in the next six years. The 1995 Budget was looked upon by the business community as a statement which would translate the policy statement of the President into a concrete plan of action. Similarly, the people who voted for the PA in two elections expected that the government would take steps towards the fulfillment of their aspirations. However, the options open to the PA government are limited and the track on which it has to manoeuvre is narrow and difficult. Although the economy is growing at the rate of 5 per cent per annum, the economic fundamentals are not good. There is double-digit inflation. More than 14 per cent of the labour force are unemployed. In addition, about 100,000 young people enter the job market annually. The deficit of the current account of the balance of payment will be more than SDR 1,000 million (about Rs. 67,000 million) this year. At the end of 1994, the total public debt stood at Rs. 548,563 million. Though the external reserve was adequate to finance

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six months of imports when the PA government assumed office, the Minister has recognized that it is not adequate to protect the country 'from the vagaries of international trade'. This shows the vulnerability of the Sri Lankan economy to the vicissitudes of the global economy. The recent developments in Mexico clearly demonstrate the vulnerability of a third world economy in the present world context. How the PA government is going to address itself to problems faced by the Sri Lankan economy was indicated first in the President's statement to Parliament on 6th January and now in the Budget speech. In this article, I propose to examine critically the soundness of the overall economic strategy of the budget and the underlying assumptions. Section One will be a profile of the Sri Lankan economy. In Section Two, the budgetary strategy of the new government and its theoretical basis will be examined. This section will focus on the first three sections of the budget speech. The soundness of this strategy in relation to the short-term stabilization objectives of the economic policy will be discussed in Section Three. In section four, the implications of the budget on economic growth and employment will be examined.

1. A Profile of the Sri Lankan Economy after 17 years of Adjustment

Sri Lanka is one of the first countries in South Asia to adopt the liberalization policy package with the aim of achieving newly industrializing country (NIC) status. The phrase 'liberalization policies' is a short descriptive term which is used widely and also in this article as synonymous with 'open economic policies', 'free market policies' and 'outward oriented policies'. It was often argued with some justification that policy changes in 1977 were the result of pressure from the multinational financial institutions. But this argument ignores the significance of local developments during the period of the 'control regime' (1960- 1977) under which on the one hand a somewhat powerful class of local bourgeoisie had emerged which finding the control regime to be an obstacle to its further expansion, exerted pressure on politicians to adopt a more liberalized regime, and on the other hand, there was a consensus among people that the unresolved structural problems of the economy needed a change in the policy framework. Although the basic characteristics of the policy framework remained unchanged in the last 17 years, they have undergone significant changes in emphasis in the different phases of implementation[3]. The economic indicators in Table 1 show the mixed results of the economic administration of the last regime.

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3. Three phases may be identified: (i) the formative period of stabilization, 1977 -83; (ii) the period of stabilization through deflation, 1983 -88; (iii) the period of structural adjustment, 1989 - (Liyanage, 1993: 13)

Table 1
A Statistical Profile of the Sri Lankan Economy

KEY RATIOS	1978	1985	1993
Gross Domestic Investment/GDP	21.3	23.8	25.8
Exports/GDP	33.9		22.6
Gross Domestic Savings/GDP		16.8	13.8
Trade Balance (deficit)/GDP	5.6	10.4	11.1
Trade Balance (deficit)/Exports	18.1		55.4
Total Debt/GDP	79.7	81.9	97.4
Foreign Debt/GDP	37.5	59.0	75.3
Debt Service/GDP			4.8
Debt Service/Export Earnings	15.5	21.0	13.7
Fiscal Deficit/GDP	18.8	18.6	8.1
Direct foreign Investment/GDP		0.5	1.8
GROWTH RATES			
GDP	8.2	5.0	6.9
Agriculture	4.2	8.6	4.9
Manufacturing	8.4	5.2	10.5
Exports	3.0	-8.0	17.0
Imports	63.0	5.0	15.0
Consumer prices	12.1	1.5	11.7

Source: Central Bank of Sri Lanka, *Annual Reports*, various years

Table 1 shows that many structural weaknesses of the Sri Lankan economy remain unresolved even after a 17 year period of structural adjustment. The average annual rate of growth of GDP which stood at 7 per cent between 1977 -1983 declined to 3.3 per cent between 1983 -1988. The economy, however, has started to rebound from this low level after 1990. The Budget Speech notes:

> Growth in agriculture in the past has been weak, about 2.3 per cent on average during 1978 -1993 compared to 3.5 per cent in Indonesia, 4.4 per cent in Thailand and 3.5 per cent in the People's Republic of China. (Parliament of Sri Lanka, 1995: 16)

Although the performance of the industrial sector is relatively better than that of the agricultural sector, Sri Lanka still lags behind the more dynamic economies of the Asian region. While Thailand has recorded a 13 per cent annual growth rate between 1988 - 1994, industrial production both in Malaysia and the People's Republic of China grew at the rate of 12 per cent per annum. In Sri Lanka, the annual growth rate was 7.2 per cent between 1990 -93. Although the economic strategy in *toto* has been oriented towards an increase in exports, exports in Sri Lanka grew at the rate of 8 per cent on average in the last ten years.

> All economies in East Asia achieved their high growth performance through rapid growth in exports. The annual average growth in exports in Thailand during the last ten years was 21 per cent. Malaysia achieved 12 per cent growth while the People's Republic of China maintained a 16 per cent growth. (Parliament of Sri Lanka, 1995: 16)

While some of the structural weaknesses remain unresolved, new problems have arisen as a direct corollary of the open economic policies. This is clearly demonstrated by the key ratios in Table 1. Trade deficit as a percentage of GDP has increased from 5.6 per cent in 1978 to 11.1 per cent in 1993. There is no sign of bringing it back to its 1978 level in the immediate future. The 1995 Budget speech estimates that it will be 12 per cent in 1995. Total public debt as a percentage of GDP has risen from 79.7 per cent in 1978 to 97.4 in 1993. Although the foreign debt service ratio is at a manageable level, foreign debt as a percentage of the GDP has increased from 37.5 per cent to 75.3 per cent in 1993.

2. The Budgetary Strategy

he criticism of the policies of the existing regime provides the basis for the political parties which seek power to formulate the policies and strategies that they plan to adopt when they assume office. Consequently, these criticisms of the existing policies may also indicate the corrections which would be introduced by them to the existing policy framework. It is natural that the Minister of Finance, in presenting the maiden budget of the new government, uses significant part of his/her speech to examine critically the policies of the previous government, and to explain how the economic policies of the new government would differ from them. The Minister has devoted the first part of his Budget speech to examining 'the legacy that [the new government] inherited from the 17 year U[nited N[ational P[arty]-coalition administration'. However, the legacy of the past is not interpreted by the new regime as an outcome of an incorrect economic strategy. Rather the Minister argues that the policy framework of the UNP government was basically correct.

> The dismantling of these controls and liberalizing the economy commenced slowly in 1977 and was accelerated after 1988. While these gave an immediate spurt to the economy, the previous regime frittered away a golden opportunity to galvanize the economy to new heights by the practice of fuelling unprecedented inflation through reckless government expenditures on grandiose ceremonies and conspicuous but inefficient projects. (Parliament of Sri Lanka, 1995: 5)

The Budget speech further states:

> This type of expenditure accompanied by the enthronement of crony

> capitalism in its most naked form, sapped the energies and incentives that were released by economic liberalization. (Ibid)

The inference is that without waste, corruption and cronyism, the UNP policy framework would have produced the expected results. The UNP policy would have produced better results if the UNP had been able to minimize these 'evils'. So what is necessary is to follow the same set of policies without the corruption and the grandiose ceremonies. This seems to be a simplistic explanation of the failure of the UNP policies to direct the country on a self-sustained growth path.

Part 2 of the Budget speech gives a long account of the development strategy of the new PA government. As the Minister has indicated, '[t]he Budget is presented in a 3-year budgetary framework and a six year economic planning framework , consisting of a 2 year initial period of fiscal stabilization and economic reforms which will pull the economy on to a path of self-sustaining growth, which will see us earning twice our current incomes by the end of the century' (Parliament of Sri Lanka, 1995: 1). While three fundamental aspects of the Sri Lankan economy namely unemployment, cost of living, and income growth, are the focus of the government economic strategy, the three year budgetary framework has the following three broad macro-economic targets.

a) A gradual acceleration of economic growth from the estimated 6 per cent in 1995 to 7 -8 per cent in 1997;

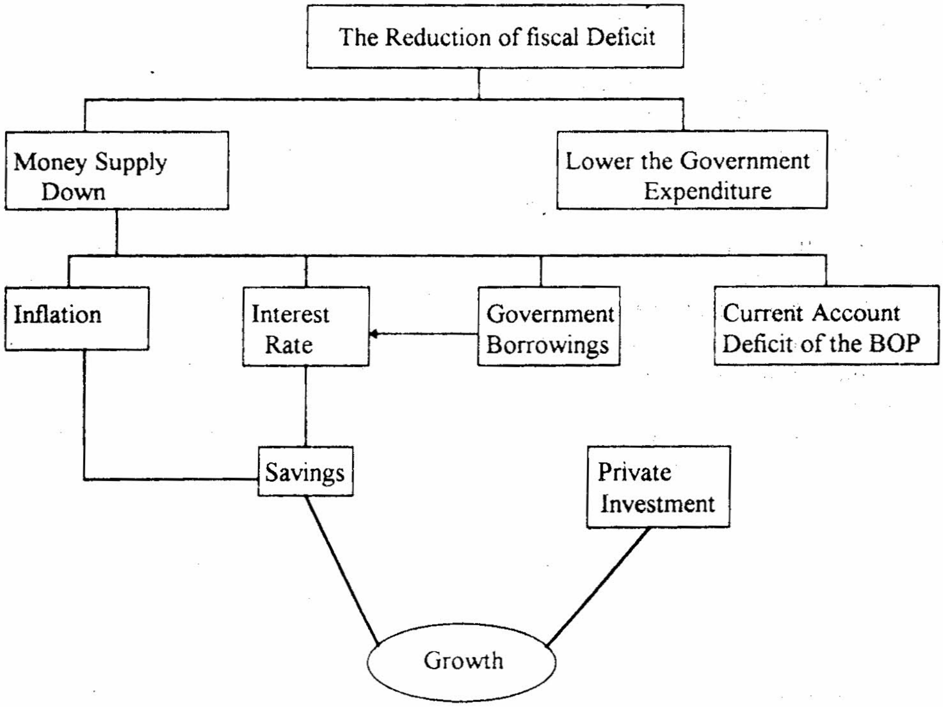
b) The reduction in the rate of inflation from a range of 7 -8 per centin 1995 to a range of 5 -6 per cent in 1997;

c) Reduction in the country's external current account deficit from about 6.4 per cent of GDP in 1995 to about 5 per cent of GDP in 1997. (Parliament of Sri Lanka, 1995: 45)

According to the Minister, 'the key to achieving macro-economic stability and to build confidence in our economy is prudent fiscal policy [because] persistently high budget deficits raise prices, drive up interest rates, reduce domestic savings, and take resources away from productive economic activities'. With this strategy, the government seeks not only to extricate the economy from the current 'mess' but also to raise the per capita income per month from the current Rs. 2,700 to Rs. 5,800 by the year 2000. In a small open economy, there are two fundamental stabilization objectives in any macro-economic programme, namely, (i) the reduction of the current account deficit of the balance of payments; (ii) the reduction of inflation. The short-term stabilization of the economy may be a necessary condition for medium and long-term growth but in it self will not ensure growth. Stabilization involves cost. Sau (1993) identifies two of them, namely (i) output loss, and (ii) exchange loss. So stabilization programme should take precautionary measures so that short term adverse effects do not leave permanent marks in the economy. Or in Sau's words, the possibility of 'hysteresis' effects involved in any short-term stabilization programme has to be minimized. Fiscal discipline is an essential aspect of any macro-economic strategy of stabilization. Nevertheless, it appears that there is an over-emphasis on this aspect in current economic discourse due to ideological reasons.

Figure 1 is a schematic presentation of the budgetary strategy. It shows how the reduction of fiscal deficit, through intermediate processes and mechanisms, would influence growth.

Figure 1: The Growth Strategy of the 1995 Budget



The PA government seems to believe that the insistence on the reduction of the fiscal deficit will produce four main results. First, it will reduce the rate of inflation since the main cause of inflation is viewed as the increase of money supply caused by the excessive borrowing of the government. Secondly, it will reduce the rate of interest because the lower the demand of the government for loanable funds the lower the demand pressure in the capital market. The lower rate of interest rate will in turn encourage more investment. Thirdly, the budget deficit will reduce the stock of public debt and debt servicing of the government. Fourthly, it will reduce the current account deficit of the balance of payments since the fiscal deficit is the principal cause of external imbalance. On the basis of this logic, the government appears to have assumed that the correction of the fiscal imbalance is the key to any stabilization and growth programme. So, the Budget speech does not even mention any specific measures aimed at correcting the current account deficit.

The government seems to assume that the correction of the fiscal imbalance and its anticipated outcomes will bring about long-term economic growth with a high level of employment. The Minister thinks that this 'beautiful dream' can be achieved 'if we are willing to face a short period of initial hardship needed to put our house in order'. The similarity of this policy framework to the policy framework of the UNP is obvious. Moreover, this policy framework is based on policy reforms advocated by the multilateral financial institutions. Along with fiscal discipline, the government has proposed that the structural reforms programme initiated by the last regime will be continued with certain safeguards to prevent corruption. This structural reform package includes customs reform, tax reform, the introduction of goods and service tax in place of the turnover tax and the public enterprise reforms (a new term for privatization). The basic thrust of the economic policies expounded by the Minister in the Budget speech seems to have been derived from the ideological position held by the WB-IMF. Prof Prabhat Patnaik aptly calls this perspective 'transcendental marketism' because 'the case for it is made on general principles (1994: 683). The main features of these reforms may be described as follows:

> Structural reforms seeks to shift resources: (a) from the non-traded goods sector to the traded goods sector and within the latter from import competing activities to export activities; and (b) from the government sector to the private sector. Apart from resource allocation, structural reform seeks to improve resources utilization by; (i) increasing the degree of openness of the economy, and (ii) changing the structure of incentives and institutions, which would reduce the role of state intervention to rely more on the market place, dismantle controls to rely more on prices, and wind down the public sector to rely more on the private sector. (Nayyar, 1993: 641)

This framework includes certain positive aspects the strength of which is obvious particularly in the current world context which I shall consider in the fourth section of the paper. However, this policy framework raises many theoretical and substantive problems to which I shall turn presently.

3. Inflation and Trade Balance: Two Goals of Macro-economic Stabilization

If we can single out one objective in the Budget as the most fundamental one, it is certainly that of curbing inflation. The second stabilization objective, the correction of trade imbalance, seems to be put to the back burner on the assumption that the anti-inflationary measures will correct it in the process.

> A fundamental requisite to achieve our saving-investment objective together with the full exploitation of growth potentials in agriculture, industry and service sectors, is the maintenance of price stability or curbing inflation. (Parliament of Sri Lanka, 1995: 17)

No one can deny the importance of curbing inflation as a short and medium term goal in macro-economic management. Nevertheless, this singleness of purpose has to be legitimized. So, the budget speech argues that inflation is 'the cruellest tax' on the poor.

Since the rate of inflation in Sri Lanka is well below 20 per cent, in the Sri Lankan context giving primary importance to the containment of inflation may also be justified by showing that all the other macro variables and micro behaviour of the economic agents are determined by this single macro variable, i.e., inflation. Let us for a moment assume that this presumption is correct. What causes inflation? The Minister's diagnosis is that '[d]uring the last two decades, Sri Lanka has failed to achieve price stability largely owing to high budget deficits'. This diagnosis as well as the medicine prescribed by the Minister seem to have based on the assumption that the inflation can be curbed through the reduction of the fiscal deficit. This assumption may be questioned on both theoretical and empirical grounds. Table 2 gives data on Sri Lankan inflation.

Table 2
Inflation in Sri Lanka

1951 -60	0.7
1961 -69	2.9
1970 -79	8.2
1980 -87	17.6
1988 -93	14.9

Source: Central Bank of Ceylon, Annual Reports (various years)

The monetarist explanation is that 'inflation is everywhere and always a monetary phenomenon'. The fiscal imbalance and government's borrowing are principally blamed for the increasing money supply. Does the Sri Lankan data support this proposition? Howard Nicholas who studied the phenomenon of inflation in Sri Lanka between 1971 and 1987 testing the monetarist and the structuralist hypotheses against the time-series data found that the Sri Lankan data did not support the monetarist view on inflation. He concludes:

> The general conclusion which emerges from the present study is that structurally induced cost-push, relative price and demand-pull factors emanating from predominantly external impulses have had greater bearing on movements in the aggregate prices than autonomous monetary impulses. (n.d.: 4)

He further states:

> The published data .. does not appear to provide much support for the existence of behavioural relations between money stock changes and the aggregate price level in the Sri Lankan economy over the period 1971 -87. .. The data appears to contradict the view that the major component of money stock expansion has been credit to the public sector. Or to put it another way, the Sri Lankan expansion does not appear to lend support to the view that inflationary pressure are brought about by excessive public sector borrowing. (Ibid: 33)

Nicholas also found that if there is any causal relationship between money stock and the aggregate price level, it is not from money stock to aggregate price level but the reverse. This is similar to the conclusions of many writers with different theoretical positions. For example, Deepak Lal (1985), a well-known neo-classical theorist, also comes up with the same conclusion when he says that 'most of inflation that Sri Lanka has faced since 1977 can be attributed to two [external] factors', namely foreign prices and the devaluation of the Sri Lanka rupee. The import content of production and consumption has increased significantly in the last 17 years so that the influence of foreign prices of imported capital, intermediate and consumption goods on Sri Lankan domestic prices became significant. This was further exacerbated by the continuous devaluation of the Sri Lankan rupee in relation to the currencies of major trading partners. Moreover, the constant increase in domestic prices makes further devaluation necessary in order to preserve and maintain the competitiveness of our exports. The unrealistic and unjustified emphasis on the fiscal deficit in controlling inflationary pressure may not produce the expected results. This will also have adverse implications. An experienced observer who is sympathetic to the new economic policies in India has given the following warning:

> Inflation is essentially the result of a struggle between different sections of the community for a larger share in the national cake that what others are prepared to surrender; and its outward manifestation generally is an excessive supply of money. Too much attention to the medium -that is money supply - can divert attention from the underlying forces; and hence concepts like budgetary deficits, however defined and however important, should be used with care and not as simple or single yardsticks. (Patel, 1992: 42)

The question of inflation may be viewed from another angle. Curbing inflation is often described as a panacea for all economic ills. According to this line of thinking, the problem of inflation should be dealt with at any cost because the price stability would ensure a high level of savings and investment and any move away from this target may lead to a cumulative departure. However, this issue should be viewed with care and the measures to curb inflation have to be selected carefully. In an economy in which a substantial amount of resources is not utilized or is under utilized, anti-inflationary policies may produce more adverse results. As Dornbusch writes:

> On the issue of inf-lation targets, pragmatism prevail. Central bankers should talk about zero inflation, but they also should compromise with reality. At the margin there are trade-offs, and pushing zero inflation at any cost is not only socially irresponsible but also bad economics. (1991: 22)

I shall now turn to the second objective of any macro-economic programme, namely the external balance. In this respect, it is essential 'to pre-empt a collapse of the balance of payments situation in the short term and to reduce the current account deficit in the medium term' (Nayyar, 1993: 640). In correcting the current account imbalance, attention should be paid to achieving equilibrium in the trade balance. According to the budget speech, the trade deficit is estimated to rise from SDR 825 million in 1993 to SDR 1,062 million in 1994. This will lower the overall surplus of the balance of payments in 1994. The trade deficit estimated for 1995 is SDR 1070 million, marginally higher than the projected deficit in 1994. The monetary approach to the balance of payments views the trade deficit as a reflection of excess demand in the domestic economy. As a widely- used text book in macro-economics puts it, '[this] analysis implies that a persistent deficit on the BOF [Balance of Official Financing] must be the result of continuous domestic credit creation by the central bank. This will occur either in the process of sterilizing the deficit or through the central bank's direct financing of a government's budget deficit together with sterilisation of the BOF deficit' (Levacic and Rebmann, 1982: 182). The prescription given by the multilateral financial institutions to correct the external imbalance is to contain the fiscal deficit and to extend and expedite trade liberalization with the hope that imported cheap capital and intermediary goods would facilitate export production. The argument is that while the former will reduce the domestic demand pressure emanating from the budget deficit the latter will improve efficiency in resource utilization which will make the country's exports internationally competitive. The Budget speech appears to have unhesitatingly followed this logic. Thus import duties on many items have been slashed. Already some industrialists have expressed their concern regarding duty reduction on certain goods such as bicycles, textiles and apparel, tyres and tubes and food items because of the possible adverse implications for local industries. The minister attempts to justify it on the grounds that the reduction of import duties would lower the domestic prices and, hence, the cost of production thus facilitating an export production. There is some truth in this argument. Nevertheless, certain complexities would also enter into the equation which may produce different results. Lower tariff rates may lead foreign suppliers and their local agents to increase the price of imports. Nambiar and Mehta observed, in the light of the Indian experience, that the foreign prices of imported goods 'tend to be high when tariff rates are low and when tariff rates are high, prices relatively tend to be low' (quoted in Sau, 1993). If this is the case, the import bill will rise because of the increase in volume and price.

Moreover, the causal link between the fiscal deficit and the external imbalance is also problematic. The domestic demand pressure leading to a high level of imports is not merely a result of the fiscal deficit but is also an outcome of increasing expenditure of the people, particularly of those with high incomes, on imported goods and services. Therefore, if the reduction of the fiscal deficit is offset by an increase in private expenditure, the external imbalance will persist. In the budget proposals, there are no specific measures for the reduction of unproductive private expenditure.

4. Medium-Term Prospects on Growth and Employment

The economic growth and development of an underdeveloped country cannot be designed in isolation. In the 1960s and 70s, the popular notion was that the world system dominated by the centre countries of the first world deliberately blocked the development process of the developing countries in Asia, Africa and Latin America. Therefore, economic development necessitated 'delinking' from the world system. Coupled with this was the view that the state should play the dominant role in the development effort. In practice these two propositions did not produce the intended results and most of the developing countries which followed the strategy based on these ideas continued to remain underdeveloped and poor. In many instances, the situation in some countries had worsened. As the theoretical weakness of these popularly held views have been discussed by many analysts, there is no need to repeat them here. On the other hand, countries which adopted a different economic strategy, were able to develop their economies and emerge as the NICs. Any national economic policy, in the present world context, should recognize two important principles, namely that (i) the developing countries have to integrate their economies with the international economy in many ways, and (ii) the market mechanism works much better than the populist notion had posited. The acceptance of these two principles will not mean that the systemic problems of the world system have now disappeared. Nor does it mean that there are no systemic errors in the market mechanism. However, any realistic national economic strategy should take into consideration all these factors when the national economic policies are designed.

The economic policies of the PA government as manifested in the 1995 budget speech take these principles as a point of departure. But it appears that its policy-makers following the advice of the multilateral financial agencies have raised these two principles to the level of an ideology. Hence the PA government's economic strategy seems to have based on an ideology rather than a realistic assesssment of the international situation. I have discussed this aspect in the previous section in relation to the stabilization objectives. But this will become more obvious when the government's medium term objectives of income growth and employment creation are considered. According to Dornbusch, '[a]djustment is a necessary, but not necessarily a sufficient, condition for resumptions of growth, because asset holders may postpone repatriating flight capital, and investors may delay initiating projects'. He also notes that 'these factors raise an important problem of coordination that classical economics does not recognize' (1991: 19). The 1995 budget speech outlines how the government intends to move in order to achieve a higher rate of growth of GDP and generate more employment. It emphasizes the need to raise investment from the present 24 per cent to 30 per cent of GDP over the next several years. This requires an increase of domestic savings which is now at 14 per cent of the GDP. The projections for 1995 are given in Table 3.

Table 3
Projections for 1995

	1994	1995
GDP growth rate	5.5	6.0
Investment/GDP	26	24
Manufacturing sector growth rate	9.0	10.0
in which factory sub-sector	9.0	11.0
Agriculture growth rate	3.0	4.0
Tea (million kgs)	243	250
Rubber (million kgs)	108	110
Coconut (million nuts)		2750
Paddy (Million metric tons)	2.65	2.70
Construction growth rate	6.0	7.0
Tourism growth rate	2.4	2.5
Rate of inflation	10	8.0
Total exports (SDR million)	2207	2501
Total imports (SDR million)	3269	3571
Trade deficit/GDP	13	12
Net private transfers (SDR million)	442	486
Official transfers (SDR million)	115	120
Current account deficit (SDR mn.)	584	554
Official loans (SDR million)	138	260
Direct Foreign Investment (including portfolio) (SDR mn.)	131	160

Source: Parliament in Sri Lanka, 1995

I shall now examine how and to what extent the budgetary strategy would help to achieve the objectives of growth and employment. As the Figure 1 shows, it was expected that the reduction of fiscal deficit would bring about a fall in the rate of interest which in turn will encourage private investment. This depends on two elasticities, namely the responsiveness of the interest rate to the changes in fiscal deficit, and interest elasticity of investment. The interest rate under this strategy is not under the control of local policy makers. The interest rate was kept at a very high rate for many reasons. The high interest rate is an important aspect of the financial liberalization programme propagated by the multilateral financial agencies. It was argued that a high rate of interest would encourage savings, contain the demand for funds and discourage low quality investments, and will be anti- inflationary. Besides, the interest rate has to be fixed at a higher level in order to attract foreign short-term capital. Because, it is argued that a high interest rate would result in the piling up of foreign exchange reserves through the short- term capital movements when other factors remain intact. As Patnaik (1994) has pointed out this situation will present the government with a real dilemma. On the one hand, if the monetary authority reduces the interest rate, there will be an outflow of foreign short term capital. On the other, if it keeps the interest rate high, there will be a real appreciation of currency due to piling up of foreign exchange reserves which may have adverse effects on exports and the trade balance precipitating a balance of payments crisis. Even if the government chooses to do nothing, there will be no escape. As Patnaik has shown, this will lead to a stock-market boom under a so-called market-friendly regime. So the government may become impotent in influencing the interest rate structure in this set up. In this context, as an outcome of the reduction of fiscal deficit, a fall in the rate of interest will be highly unlikely. This was recently demonstrated when the state banks lowered their lending rate in some sectors in response to the appeal made by the government, the private banks have refused to do so. The high rate of interest will adversely affect the investment decisions in general and the investment decisions of the small entrepreneurs in particular. It may also affect the construction of houses for personal use.

As Nayyar (1993) has pointed out, the IMF-WB structural adjustment programme is concerned mainly with the supply-side of the economy. This is also the case with the 1995 budget. These institutions propose demand-side management through fiscal and monetary discipline in order to stabilize the economy. However, there is no synchronization between the demand-side adjustment and the supply-side adjustment.

> The fundamental problem of transition arises from the fact that the speeds of adjustment on the demand side and on the supply side are considerably different. .. [t]he speed of adjustment on the demand side is fast. On the other hand, the speed of adjustment on the supply side is inevitably slow, particularly in economies characterized by structural rigidities where resources are not easily mobile across the sectors or perfectly substitutables in uses. This is so even if all the price incentives of a market economy can be brought to perfect function. Supply adjustment typically requires structural change through creation of capacity, alleviation of infrastructural bottlenecks, streamlining of input supplies, creation or reorientation of public utilities, and so on, all of which take time. The fast dynamics of demand and slow dynamics of supply have .. major macro-economic implications. (Nayyar. 1993: 641)

These important issues seem to have been ignored in the budgetary strategy. The government's decisions not to engage in large capital projects would definitely make the supply-side adjustment more difficult and slower. The reduced demand of the government may lead to a further reduction of output particularly in the private sector. The empirical evidence particularly in the late 1970s and the early 80s shows that the public sector investment in fact crowds-in private investment. This is the experience of South Korea and Taiwan. The confidence of the private sector which the government seems to think as crucial, is a function of the level of economic activities. If there is sluggishness in the private sphere of the economy, it cannot be overcome by an economically inactive government with a defeatist line of thinking. Robert Wade (1990) in his excellent book on the role of the governmen in East Asian development has shown how the government played a 'big leadership' role in those countries. Public investment has in fact increased in the high performance Asian economies (HPAEs). A recent publication of the World Bank reports:

> In the 1970s overall levels of public investment did not differ markedly between the HPAEs and other developing economies; during the decade public investment rates in all economies rose from about 7 to 10 percent. But during the 1980s the HPAEs and other developing economies diverged. In other economies, the fiscal contraction of macroeconomic adjustment was reflected in lower public investment rates. In HPAEs, conversely, public investment shares actually rose between 1979 and 1982 and then remained at a level nearly 4 percentage points above their 1970s average. .. In short, in striking contrast elsewhere, public investment in 1980 -87 in these East Asian economies was counter-cyclical to the reduction in private investment. (World Bank, 1993: 43)

The high level of capital accumulation, increased allocation efficiency, and the productivity gains invariably contribute towards the achievement of high growth rate in GDP. In most HPAEs, the state played a crucial role in improving these contributory factors. The Malaysian government was initially involved in investment in heavy and chemical industries. The private sector, both foreign and local, has been looking at the new government from the time it assumed office. Although its commitment to the private sector-led development has been reiterated, the government is not yet able to win the confidence of the private sector. This is crucial because the budget speech clearly indicates that the government is planning to move away from its traditional domain of infra-structure development. The inadequate private investment both local and foreign is often attributed to the poor infra-structure facilities. The government is inviting private investors to enter this area. Since these investments are invariably large and expensive and their returns spread over a long period, is it realistic to think that private investors would invest in these sectors particularly at the present conjuncture?

All these trends may make the realization of growth targets for 1995 difficult. The situation on the employment front appears to be more serious. The Budget speech says:

> Prospects for increased employment in the public sector are not encouraging, because employment in this sector has reached saturation point. Because of the large number of employees in this sector, even with a low salary structure, the government has to spend nearly 1/4 of its current expenditure on salaries -a very high burden. The private sector, unlike the government sector, can expand rapidly under good incentives and can create highly gainful employment through high investment and production. Also the Government will be encouraging self-employment under the Samurdhi Programme. (Parliament of Sri Lanka, 1995: 14)

As mentioned earlier, the main focus of the 1995 budget is the reduction of the rate of inflation. The generation of employment appears to be viewed as a necessary by-product of the anti-inflationary strategy. In my view, this is the Achilles' heel of the government strategy. Anti-inflationary strategy is flawed due to two reasons. First, even if the budget strategy works as intended, steps should be taken to solve the mis-match between the available skill and the required skills. This calls for a complete change in our education system which is biased towards the arts and humanities and oriented towards the requirements of the public sector. The government accepts the need for this. But, the necessary funds have not been allocated for re-training, improvement of the quality of education, and new skills development. The total estimated expenditure of the Ministry of Education and Higher Education remains almost unchanged when adjusted to inflation. Resources allocated to other ministries for similar purposes are also not adequate. Secondly, will the budgetary strategy in operation generate adequate employment opportunities? This is also problematic. When unemployment and under-employment have become persistent problems, past as well as contemporary experience shows that deliberate policy measures are required to overcome it because growth in itself may not generate employment opportunities to absorb the available labour. This may be revealed by the fact that the high level of employment opportunities created between 1977 -82 in Sri Lanka was not an outcome of the stabilization and structural adjustment programme but a result of the high level of public investment in infra-structure development. According to the survey conducted by the Department of Census and Statistics, 175,000 to 200,000 employment opportunities were created during this period. The employment elasticity of output growth may vary in different sectors. As Adelman argues, the sectoral mix of output has implications for substitution of labour for capital. She argues that the employment elasticity of the industrial sector is typically very much lower than the employment elasticity of the agriculture and service sector. (see Edwards, 1993) Stern (1994) suggests that employment created by major construction programme initiated by the government accounted for nearly half the total employment increase during 1977 -83. So, the creation of employment requires positive intervention directly or indirectly by the state in determining the sectoral mix in the process of growth.

Conclusion

The PA government, in the 1995 Budget, has failed to address the crucial issues of the Sri Lankan economy. The government seems to have taken up a defeatist position assuming that it will not be able to articulate an independent national development strategy at the present historical conjuncture. In my view this is incorrect. The government has to rethink its economic strategy by re-reading the real experience of the East- and South East- Asian countries and fulfilling its election promise of economic development with social justice and democracy. As Blinder and Blank (1986) have shown, the poor suffer more under unemployment than they do under inflation. Adam Smith related economic growth and development with the increase in productive employment thus emphasizing the fact that growth and employment are overdetermined in the development process. In an employment-oriented economic strategy, some elements of the current stabilization and structural adjustment programme, acquiring a new meaning, will definitely play an important and useful role.

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