Downsizing the government and containing public investment

by Kanes

Perhaps the most salient feature in the Sri Lankan economic scene in recent years is the downsizing of government and emasculating the role of government in economic activity. This has been well illustrated by the privatization of state-owned enterprises, cessation of setting up new state-owned economic undertakings, deregulation, decontrol and the elevation of the private sector to be the engine of economic growth. This policy is no accident; it has been formulated deliberately in keeping with the Washington Consensus of making the markets work without hindrance by systematic national policies of liberalization, deregulation, privatization and downsizing of government. It is the cardinal belief of the Washington Consensus that governments are inefficient in economic activities and should therefore hand over their operations to the efficient private sector and further remove all obstacles for it to function freely. The free or open market, according to this approach, is the panacea for all economic ills and the developing countries remain poor because they have failed to open and free their markets. The Central Bank, which is the de facto economic adviser to the government, has been urging the government, in all its annual reports, to minimize its involvement in all production and trading activities and repeats this admonition in its latest report pressing for reforms of "further encouragement of private sector participation in commercial activities currently undertaken by the government".

Reduction of Expenditure

The policy of emasculating the government's involvement in economic activities is reflected clearly in government finances, where government expenditure and government revenue have been reduced in relation to the GDP over the years. Total expenditure has been reduced from 30.5 per cent of GDP in 1995 to 25.1 per cent of GDP in 1999. Current expenditure has been cut from 23.1 per cent of GDP to 18.7 per cent of GDP and public investment from 7.8 per cent of GDP to 6.4 per cent. While attenuating the government's operations by cutting expenditure, taxes were reduced to encourage the private sector to save and invest. Thus, tax revenue too declined simultaneously from 17.8 per cent of GDP in 1995 to 14.9 per cent in 1999. The failure to raise taxes to meet rising expenditure resulted in deficit financing: budget deficits were high, although the deficit was reduced from 10.1 per cent of GDP in 1995 to 7.5 per cent in 1999.

Table (I)

The cuts in current expenditure resulted in a fall of expenditure in relation to GDP in all major sectors except civil administration. Current expenditure on social services declined between 1995 and 1999 from 8.6 per cent of GDP to 6.6 per cent with expenditure on education, health and welfare all falling in relation to the GDP as shown in Table 11. Current expenditure on economic services, particularly agriculture, irrigation, transport and communications dropped in this period from 1.2 per cent of GDP to 0.9 per cent. These relative cuts in current expenditure would have squeezed the funds needed for proper maintenance of economic and social services. In fact, some services showed no improvement while others deteriorated. In education, for instance, the pupil/teacher ratio in government schools remained the same in 1995 and 1999 at 22, but the number of teachers per government school dropped from 18.3 to 18.1 as not enough teachers- were recruited. In the case of the health sector, the number of in-patients per nurse has risen from 222 in 1995 to 263 in 1998 reflecting the inadequate intake of nurses. De Soysa Maternity Home in Colombo, for example, has been forced to cut down on admissions as it is short of 144 nurses for its full cadre of 312.

Pruning of capital expenditure or public investment was mainly in respect of economic services which fell from 5.4 per cent of GDP in 1995 to 4.0 per cent in 1999. The share of agriculture and irrigation fell from 0.9 per cent of GDP to 0.6 per cent and that of transport and communications dropped from 2.8 per cent of GDP to 1.5 per cent. On the other hand, the share of energy increased, as did the shares of education, and health in social services. Expenditure on agriculture and irrigation in absolute terms was lower in 1996, 1997 and 1998 than in 1995 and even in 1999 was only 2.5 per cent higher than in 1995 and expenditure on transport and communications in absolute terms, was lower in 1999 than in 1995. Restricting public investment in agriculture and irrigation is likely to have contributed to near stagnation of paddy production (which increased by a mere 2.0 per cent between 1995 and 1997) and the marked fall in the production of subsidiary food crops: potatoes by 67 per cent, chillies by 30 per cent, cowpea by 26 per cent, and greengram, red onions and maize by 10-14 per cent. The transport sector too seems to have been adversely affected: operated kilometres which had been rising since 1990, began to fall after 1995 and passenger kilometres which had peaked in 1996 declined thereafter; the former fell by about 2 per cent and the latter by 7 per cent between 1995 and 1999. Road maintenance has slowed down as shown by the fact that the expenditure on roads by the Road Development Authority dropped by 4 per cent in 1999 over the previous year; the conditions of many roads, especially provincial and local roads, appear to have deteriorated due to resource constraints. Thus, the claim that the war effort has been funded without restricting economic and social development is without foundation.

Adverse Effects of Expenditure Restriction

Constraining government expenditure, it is hardly necessary to point out tends to slow down the country's economic and social development. Rapid economic growth, whatever the economic system or approach to development, demands improved and efficient economic infrastructure - roads, railways, ports, communications, irrigation schemes, water supply, electricity, etc. — and social infrastructure - hospitals, schools, universities, housing etc. — to provide healthy and skilled manpower. Constraints on expenditure — both capital and current - has tended to slow the pace of upgrading the infrastructure and manpower, as shown by a few examples earlier. This in turn tends to reduce economic growth. Even if the private sector is the engine of growth, it is improved infrastructure and skilled manpower that attracts private investment including foreign capital. Narrow congested roads, breakdowns in power supply due to uncertain rainfall and graduates with no skills and not proficient in English are hardly conducive to foreign investment. Infrastructure facilities are needed not only by big investors but also by small farmers and craftsmen: tanks for irrigation, roads to transport their produce, marketing and credit facilities for production and sale and agricultural research and extension services to raise yields.

Table (II)

Slow growth in public investment also causes slow growth in private investment. Public investment stimulates private investment because they are complementary; increase in public investment, apart from providing a better infrastructure, generates contracts to the private sector - government buildings, bridges, irrigation schemes, power stations, machinery and equipment - boosts private trade through higher imports and expands demand for private sector produced goods and services through the multiplier effect of employment and incomes created. The argument that higher public investment will crowd out private investment is not valid in developing countries such as Sri Lanka. On the contrary, higher public investment in infrastructural facilities, human resources, social services and productive undertakings tend to attract private investment. This is the experience of East and South East Asia. The slow growth of public investment is a major cause of slow overall economic growth in Sri Lanka. It was in the period 1978-1982 that Sri Lanka achieved the highest sustained average economic growth - 6.2 per cent - and this was precisely because it was in these years that public investment reached its zenith - as high as 30 per cent of GDP - mainly on account of the accelerated Mahaweli scheme. Further, increasing public investment in 1978-1982 was accompanied by rising private investment - from 7.5 per cent in GDP in 1978 to 14.7 per cent in 1982. When public investment declined in relation to GDP thereafter so did economic growth.

Constraints on government expenditure also resulted in retrenchment in the public sector: employment in the public sector declined by 14.3 per cent between 1995 and 1999, mainly on account of retrenchment of manual labour in state-owned enterprises/corporations which were downsized or privatized. The closure of some government departments such as the Marketing Department and the Commodity Purchase Department and the closure of the Paddy Marketing Board, to make way for the free market denied the small producer/farmer a fair and reasonable price for his produce. These institutions had provided competition to private traders and checked their tendency to pay very low prices to producers. Privatization has led to the eventual closure of the enterprises and consequent national waste or the too rapid increase in prices of the products to the consumer, for example, gas and telephone charges on account of the precedence of profit over social considerations.

Poor Response of Foreign Investment

Public investment was contained, the public sector emasculated and taxes reduced in the hope that private investment, particularly foreign investment, would undertake investment on a large scale to promote rapid growth. Average economic growth, however, as shown earlier, was modest - 4.9 per cent a year. This was partly because private investment had failed to increase as expected; in the five years 1995-1999, it averaged 18.7 per cent of GDP; this is too low for the East Asian countries like Malaysia, Thailand, South Korea, Singapore and China, had an annual average rate of gross investment of 35-40 per cent of GDP in the five years before the currency crisis. A major reason for the low level of investment in Sri Lanka is the low level of foreign investment, the average for the five years 1995-1999 being $109 million; foreign direct investment rose from $16 million in 1995 to the peak of $177 million in 1999; as a proportion of GDP it was 1.1 per cent in 1999. Foreign direct investment including privatization proceeds amounted to $606 million in the three years 1995-1997 in Sri Lanka while it amounted to $24,800 million in Singapore, $15,213 million in Indonesia, $14,362 million in Malaysia, $8,137 million in Thailand and $6,940 million in Korea. China received in these three years a staggering sum of $120,265 million!

Table I

Government Finances 1995-1999

Year	Total Government Expenditure as % of GDP	Current expenditure as % of GDP	Public Investment as % of GDP	Tax Revenue as % of GDP
1995	30.5	23.1	7.9	17.8
1996	28.5	22.8	6.0	17.0
1997	26.4	20.8	5.8	16.0
1998	26.3	19.6	6.7	14.5
1999	25.1	18.7	6.4	14.9

(Central Bank Annual Report 2000)

Table II

Government Expenditure in 1995 and 1999 as % of GDP

	Current Expenditure		Public Investment	
	1995	1999	1995	1999
Public Service	7.1	5.7	0.9	0.6
Civil Administration	1.0	1.3	0.6	0.6
Defence and Security	6.2	4.4	0.3	-
Social Services	8.6	6.0	1.5	1.6
Education	2.3	1.9	0.5	0.7
Health	1.3	1.0	0.3	0.4
Welfare	4.8	2.8	0.3	..
Economic Services	1.2	0.9	5.4	4.0
Agriculture & Irrigation	0.6	0.5	0.9	0.6
Transport & Communications	0.3	0.2	2.8	1.5
Energy	0.1	0.1	0.7	1.0
Total	23.1	18.7	7.9	6.4

(Based on figures of the Central Bank Annual Report 2000)

Table III

Washington Consensus - No Panacea

Should Sri Lanka wait indefinitely, Micawber-like, until foreign investment flows in to accelerate the pace of the country's development? *It appears as if Sri Lanka as well as other South Asian countries are not favourites of foreign investors.* **India, for example, received only an average of $2.6 billion a year in 1995-1999 when China received an annual average of $40.1 billion. Pakistan received even less than a billion dollars a year - only $784 million and Bangladesh even less than Sri Lanka - a mere $52 million a year.** It cannot be said that they are not offering attractive concessions to foreign capital; nor can it be said that they have not liberalized their economies enough; in any case, the least liberalized Asian country -China - is the largest recipient of foreign capital among developing countries. Liberalization, deregulation and privatization alone, do not seem to impress foreign investors. The Philippines is perhaps the most liberalized economy in East Asia but it received the lowest volume of capital in East Asia — $1.4 billion a year - even lower than the centrally controlled Vietnam — $2.5 billion!

If foreign investment is only trickling into the country and if domestic private investment is sluggish, in spite of Sri Lanka being liberalized - in fact, the most liberalized in South Asia - there is no alternative but to expand public investment to fill the gap. It is important to recognize that both the public sector and the private need to combine to be the engine of economic growth; private sector is necessary, but is too weak to be the engine of growth alone.

It may be difficult for those who have swallowed the 'Washington Consensus' hook, line and sinker to accept the need for an increase in public investment — the need for the state to play a more active and positive role in economic development, but as Joseph Stiglitz, the former chief economist of the World Bank pointed out at the last IMF/World Bank Conference, the most successful developing countries (which achieved high growth) have not followed the precepts of the Washington Consensus. He *cited China as the most successful developing country both in terms of growth and in terms of poverty reduction and emphasized 'China' is proof that* developing countries ignoring Washington's economic policy prescriptions fare better than those who follow their dictates". Further, according to the Heritage Foundation in Washington, more than half of the 89 developing countries which had received IMF assistance and followed the Washington Consensus prescriptions since 1965, are not better off than they were before and 32 or more than one-third are actually worse off.

Table III

Foreign Direct Investment (as $ million)

Country	1995	1996	1997	Total	Annual Average
China	35,859	40,196	44,261	120,265	40,087
Singapore	7,206	7,884	9,710	24,800	8,267
Indonesia	4,346	6,194	4,673	15,213	5,071
Malaysia	4,178	5,078	5,106	14,362	4,787
Thailand	2,068	2,336	3,733	8,137	2,712
India	2,144	2,426	3,351	7,921	2,640
Vietnam	2,000	2,500	2,950	7,450	2,483
South Korea	1,776	2,325	2,844	6,940	2,313
Philippines	1,478	1,517	1,222	4,217	1,406
Pakistan	720	919	714	2,353	784
Sri Lanka	56	120	430	606	202
Bangladesh	2	14	141	157	52

(Asian Development Bank: Asian Development Outlook 2000)