

# REFLECTIONS ON AN ECONOMIC POLICY FOR DEVELOPMENT†

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## SECTION I — INTRODUCTORY

The scope of this paper is actually more limited than its title might suggest. It is not proposed, in this paper, to attempt a comprehensive discussion of the many issues involved in the formulation of an economic policy for development. That would be too ambitious an undertaking. What is proposed here is merely to discuss a few selected matters felt to be of immediate and urgent interest.

The Ceylon economy is passing at present through a troubled phase. In a sense hardly any economy is ever perfectly in balance; but the lack of balance of the Ceylon economy today is rather striking. In the attempt to restore some balance to the economy, drastic measures may have to be adopted. The danger is that in formulating corrective measures their implications for economic development may not be given the consideration they deserve. Even though the reasons which actually compel the choice of particular economic measures may have little to do directly with developmental problems, the choice of measures cannot fail in general to have a bearing on the prospects for development. It is a matter of urgency, therefore, to emphasise that when measures are taken to correct an immediate imbalance, they should as far as possible fit integrally into a framework of policy designed to encourage and promote economic development.

In conformity to this general theme, the present discussion will be concerned principally with the following issues. First, the question of the role of, and the limits to, deficit financing as an instrument of economic development will be considered. Secondly, there will be discussed the respective roles of import controls and import duties both as correctives of a balance of payments deficit and as means of protection for local industry. The relationship of import controls and import duties to each other and to government deficit financing will also be examined. Finally, the impact of budgetary and import policies

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†This paper was written in December 1962. The treatment of certain matters was inevitably influenced by their topicality at the time of writing.

\*The views expressed in this paper are personal and do not necessarily reflect the views of the Central Bank of Ceylon.

on domestic prices will be discussed, bearing in mind the over-riding importance for Ceylon of a development-oriented structure of prices.

The issues mentioned in the preceding paragraph do not, of course, exhaust the list of those which are of particular relevance to Ceylon in her efforts to achieve rapid economic development. The creation of an adequate statistical and planning apparatus is certainly an issue of the highest priority. For economic planning to be successful, much more statistical data are required than are now available. Economic planning itself will have to play a more central role in the economy. Methods will have to be devised for the participation of organisations and associations of all types both in the planning and in the implementation of detailed programmes. The central planning organisations will have to be built up to the point where they will be in a position to closely follow the implementation of programmes and to engage in continuous corrective action and, where necessary, in plan modification as implementation proceeds. The importance of administrative re-organisation for speedy and effective plan implementation has been well recognized, but a start in this field has barely been made. There is also the problem of how best to utilize the available human resources of the country. The exodus from Ceylon of technically qualified personnel in recent years has rendered urgent the problem of harnessing the services of those still available. This is an immediate problem. But there is also a long-term problem of increasing the supply of technicians to keep pace with the country's increasing needs. The solution of this long-term problem will call for changes in the educational field. It will also call for the evolution of a wage and salary structure<sup>1</sup> that will provide adequate incentives to persons to supply those forms of expertise which are most essential for economic development.

The issues just mentioned are sufficiently big and important to warrant separate treatment; so no attempt will be made to discuss them in the present paper. The discussion here will be focussed on the issues mentioned in an earlier paragraph, relating mainly to budgetary policy, import policy and prices. These will be discussed in general terms in Section II, while certain concrete problems will be discussed in Sections III and IV.

## SECTION II — SOME GUIDE-LINES FOR POLICY

### A. DEFICIT FINANCING AS AN INSTRUMENT OF DEVELOPMENT

Deficit financing by Government is often the principal source of expansionary finance in an economy; it has been so in Ceylon for a number of years. It is important, however, to bear in mind that deficit financing is not the only

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1. Such a wage and salary structure would, of course, be the complement to the price structure (for goods) referred to at the end of the preceding paragraph.

possible source of expansionary finance. An increase in external assets, an increase in active bank credit to the private sector or a decrease in time and savings deposits with banks would also serve as sources of expansionary finance. Thus, whether a given quantum of government deficit finance from the so-called "inflationary sources" (which involve the creation of new money) will lead in practice to inflationary pressures, will depend partly on these other factors such as the change in external assets, in bank credit to the private sector and in time and savings deposits. Partly it will depend on the extent to which supplies of goods, including imports, can increase. Thus, when government deficit financing from inflationary sources is regarded as excessive, what is meant is that, given the level of the other potential expansionary factors, and given the possible increase in real supplies, the level of government deficit financing is so high as to lead to a general increase in prices.

It has sometimes been argued that a mild rise in prices can act as a stimulus to production. While the evidence is not conclusive, there may be some justification for this view. On the other hand, it is possible also to achieve similar or even better results in the absence of rising prices so long as other incentives are available to producers in adequate measure. In an inflation the stimulus to increased production is provided by a widening of profit margins. But even in a mild inflation, after a lapse of time, wage increases become unavoidable. With the rise in wages, costs of production rise; so the stimulus of the higher selling prices of goods tends to disappear unless the rise in selling prices is continued a step further. There is a danger, then, that even though the rise in prices was initially mild, a process of progressively rising prices will be generated. If such a process continues for some length of time, the public will come to fear that the value of money will continue to decline indefinitely in the future. When apprehensions on this score become widespread, people will adopt all practicable measures to convert money into goods as speedily as possible. Thus an increase in the velocity of circulation of money will be brought about. Unless action, necessarily drastic, is taken to remove the sources of inflationary pressure, prices will continue to rise at an accelerating rate until eventually normal economic activities become almost impossible.

In any country, the social costs of inflation are likely to be severe. Fixed income groups will suffer a decline in their real incomes as prices rise. Producers will be encouraged to devote their energies to speculative buying and selling in preference to more socially productive activities. The certainty that there will be a demand for whatever goods are produced will lead to carelessness regarding quality. Normal production priorities will lose their force and there will be, by any reasonable social standards, a general mis-allocation and mis-use of resources.

✓ A country like Ceylon is particularly vulnerable to the dangers of inflation because of her dependence on export markets. As wages and prices both tend to rise in an inflation, the costs of producing export goods may soon rise to the point where exports are priced out of world markets. In Ceylon, moreover, rising export costs will necessitate a reduction in export duties, thus adversely affecting government revenues.

It is true that an attempt could be made to retain export markets by replacing the present taxes on exports by subsidies. But, to the extent that this is done, there will have to be increased recourse to deficit financing, thereby strengthening all the more the expansionary forces acting on the economy. In the absence of measures of currency devaluation, export subsidies may well have to be increased progressively.

It will thus be seen that, although a mild inflationary policy could deliberately be adopted as a stimulus to domestic production, it is a policy that carries with it great dangers and that deserves, therefore, to be applied with the utmost caution. It is probably correct to say that the overall experience of most of the countries which have experimented with mild doses of inflationary financing has not been such as to encourage others to follow them. In those cases where inflationary financing has succeeded in stimulating production without at the same time generating a self-perpetuating wage-price inflation, the success has usually been due, in the main, to the presence of substantial surplus capacity in industry. Where such surplus capacity has existed, a rapid response in the volume of production to price increases has been possible. But in Ceylon today surplus capacity is not available to any substantial degree.

It is a point material to this discussion that, from a social or economic point of view, there are much more satisfactory ways of achieving the objective of economic development than by resort to inflationary financing. The main advantage of inflationary financing is that the relationship of government policy to the rise that takes place in the cost of living is not immediately apparent to the public. At the political level, therefore, reactions tend to be relatively mild, at least in the short term. On the other hand, it is also true that inflationary financing as a deliberate policy may not appeal to many political parties, because, to the extent that it succeeds in stimulating economic activity, it does so by increasing the profits of producers and traders.

## B. IMPORT CONTROL AND TARIFF POLICY

Quantitative import controls are often preferred to increased taxation of imports as a means for the correction of a balance of payments deficit. The preference for quantitative controls is probably due to the greater certainty of

their impact. Whereas the impact of higher import duties tends to be gradual, and the exact quantum of import restriction achieved by them to be uncertain, the impact of quantitative controls is immediate as well as determinate.

Nevertheless, there can be little doubt that restriction of imports by import duty adjustments is generally superior to quantitative controls from an economic and financial point of view. For the effect of quantitative controls is to create shortages in the supply of goods without any reductions in demand. As shortages develop, prices rise and traders obtain windfall profits. When these profits are spent they will have a secondary impact on consumer demand, part of which will constitute an increased demand for imports. Moreover, the reduction in the quantum of imports will lead to a loss of revenue to the government, thereby increasing the need for deficit financing. In contrast, restriction of imports by means of enhanced import duties has the effect of siphoning off to government revenue some of the consumer purchasing power that might otherwise have accrued to private traders in the form of increased profits. The relatively beneficial effect on government revenues of higher import duties thus enables a moderation of government inflationary financing that, in turn, serves to restrain consumer demand.

As a means also for the protection of local industry, tariff measures are usually preferable to quantitative restrictions. While high import duties confer protection on local industry, domestic consumers are not prevented from buying a higher priced imported product if the quality of the domestic article is unsatisfactory. In this way tariff measures offer not merely protection to the local producer, but also a degree of protection to the local consumer against shoddiness of quality.

There are certain situations, however, which may favour the use of quantitative restrictions. Where domestic industries find survival difficult, not because of any poorness of quality of the product, but due to an unjustifiable prejudice of consumers in favour of an imported product to which they have become accustomed, quantitative restrictions provide a direct corrective. As a check against excessive imports for purposes of smuggling abroad, too, quantitative controls have their usefulness. Further, the licensing apparatus that comes into being with comprehensive import controls not merely enables a record of imports to be kept, independent of the Customs and Exchange Control records, but also enables the authorities to know the intentions of importers much earlier than they otherwise would. The information thus derived will, of course, be very helpful in the formulation of economic policy.

Having discussed the relative merits of import controls and tariff measures for the correction of a balance of payments deficit in a context of deficit financing, it may now be added that the most effective course of action in a time of

emergency would be to use both import control and tariff measures in combination. Corresponding to a chosen level of quotas, there would be a certain level of import duties which would produce, per se, roughly the same impact as the quotas themselves. Generally speaking, this is the level of import duties that should be regarded as "appropriate" to the chosen level of quotas. When quotas are changed, they may be accompanied by appropriate variations in the level of import duties. The advantage of this procedure is that the increments in prices that are inevitable when quantitative restrictions are imposed would now be absorbed by the duty increases, with consequential benefit to the government revenues.

The protective aspect of quantitative restrictions and tariff increases also deserves further mention. As such measures generally result in a higher price for the imported product, an element of protection is conferred on the corresponding local industry. Unless it is deliberately decided that the particular local industry requires this measure of protection, or unless it is felt that there is sufficient competition within the local industry to prevent an undue increase in the price of the product, an appropriate excise duty should be levied on the local product. There is thus a strong case for linking policies for the indirect taxation of local goods with import control and tariff policy.

A policy of import restrictions—whether it takes the form of quantitative restrictions, import duty adjustments, or a combination of both—will have to take account of its probable impact both on the level of domestic prices and on employment.

Import restrictions will have an impact on the level of domestic prices via their impact on aggregate supply and demand. The position regarding aggregate supply is fairly clear. In so far as import restrictions reduce the supply of imported goods without at the same time evoking a compensating increase in the supply of domestic goods, aggregate supply will be reduced. As regards aggregate demand, the impact of the import restrictions may be analysed in monetary terms as follows. Firstly, to the extent that imports are reduced, there will be a favourable change in external assets; and a rise in external assets, it will be remembered, acts as a factor for monetary expansion. Secondly, to the extent that higher rates of import duty lead to increased revenues, this will reduce government inflationary financing and will thus act as a contractive factor; while, conversely, to the extent that quotas lead to a fall in import duty collections, this will act as an expansionary factor. The actual impact on aggregate demand will depend on the relative strengths of these different factors.

In general it can be said that the probable impact of import restrictions will be to reduce aggregate supply and increase aggregate demand and hence to raise the level of prices. As mentioned earlier in this paper, such a rise in

prices may carry the seeds of self-perpetuating inflation; on the other hand, in favourable circumstances, it may stimulate sharp increases in domestic production. If the latter happens, the overall effect on employment is likely to be favourable. But there may still be some hardship caused to persons employed by enterprises in the import sector, which may be forced to adopt measures of retrenchment, especially if the import restrictions have been sudden and drastic. However, if there is in fact an increase in production and in employment opportunities in other sectors of the economy, the hardship may only be temporary. Conversely, if the other sectors fail to expand sufficiently, the hardship may prove to be of long duration.

In any case, since import restrictions have an immediate impact on employment in the import sector that is wholly adverse, the restrictions should not be over-done. It sometimes happens that, after a prolonged period of hesitancy in taking measures to combat a balance of payments crisis, very abrupt and drastic measures are eventually taken which have the aim not merely of stemming the drain on external assets but of trying to rebuild them quickly to a "safe" level. But the more drastic the restrictive measures, the more severe the likely domestic repercussions. Thus, if a proper balance is not struck, it is possible that the first mistake, of failing to take timely measures to meet a developing balance of payments situation, may be followed by a second mistake, of taking measures which, while quickly rectifying the loss of external assets, have unnecessarily harsh effects on domestic employment and prices.

The foregoing remarks may serve to underline the need for careful thought in the formulation of policy, whether in regard to the form of import restrictions or in regard to their extent (or intensity). Not unusually the wood is not seen for the trees; and import policies are merely left to emerge from a series of ad hoc decisions taken in isolation in regard to individual cases. This is undesirable. Even in regard to the incidence of the restrictions (whether taking the form of quantitative controls or duty increases) on different items of imports, the decisions made will need to take into account their possible implications for economic development. For instance, due attention will have to be paid, in taking the decisions, to (a) the essentiality of particular categories of imports, whether from a development or a socio-political point of view; (b) the needs for protection of domestic industries; and (c) the probable elasticities of demand for different items of imports (since elasticities have a bearing on the likely impact of tariff adjustments on import duty collections).

The essential point of the present discussion is that the character of a country's import policy can vitally affect its economic progress. This fact limits to some extent the margin of freedom that is available for the choice of

an import policy appropriate to a particular situation. But, on the other hand, it also means that import policy itself can be used as an instrument of general economic control. For an amplification of this point, reference may be made to Appendix I where the relationship of import policy to overall budgetary policy in the control of a domestic monetary expansion is discussed in some detail.

### C. FISCAL POLICY AND A DEVELOPMENT ORIENTED PRICE STRUCTURE

To say that in formulating fiscal measures in the past their economic effects have been paid too little attention is probably fair comment. Consider, for example, the structure of personal taxation in Ceylon. One would expect that, in a development-oriented country, the system of personal taxes would be so designed as to provide strong incentives to people engaged in productive activities to put forth increased effort. But such incentives have barely been provided in the systems of personal taxation that have been in force. In fact, salaries and wages have sometimes received harsher treatment than other forms of personal income, a case in point being the National Development Tax.

Again, take the case of taxes like the Bank Debits Tax, the Tax on Company Share Capital or the Tax on Registered Businesses. All these taxes have in common the feature that they discriminate against the more organized forms of economic activity. The Bank Debits Tax discriminates against the banking habit, the tax on share-capital against corporate businesses, the tax on registered businesses against organized trade. In effect, therefore, these taxes tend to strengthen the incentives already present in the structure of the Ceylon income tax system for producers and traders to operate through primitive and illegal forms of organisation. Or take the case of the recent Land Tax, where the customary slab principle was ignored. During 1960/61, for instance, tax was payable on the entire acreage on holdings of 100 acres or more, whilst no tax at all was payable on holdings of less than 100 acres. A producer just liable to land tax was thus in a position to gain substantially if he could effect a slight diminution in the size of holding. Dis-incentives of this nature to large scale production would have been meaningful if they were part of an overall policy which envisaged, say, a gradual substitution of private sector enterprise by public sector enterprise. But this does not appear to have been the case. Thus, while it appeared to be part of official policy to stimulate and expand production in the private sector, tax measures were tending to have an opposite effect.

The implications of export duties also deserve some discussion. Ceylon is one of a minority of countries which levy discriminatory taxes on the export of goods, the more normal practice being for exports to be more favourably treated than goods for domestic consumption. In Ceylon, exports have been

able to maintain their viability mainly because Ceylon has been enjoying considerable comparative advantages in the production of tea, rubber and coconut. The world demand and supply position for these products usually resulted in a level of world prices significantly higher than domestic costs of production. Thus export duties could be levied without seriously restricting the quantum of exports. So long as Ceylon continues to enjoy a significant comparative advantage in these products, the levy of export duties could be continued. But care will have to be taken to ensure that the incidence of export duties does not inhibit the accumulation of funds within the industries for re-investment. Apprehensions have been voiced in recent times that the incidence of export duties, combined with the high levels of company taxation, has already in some cases adversely affected re-investment in the plantations. Perhaps these doubts and fears have been excessive. The tea industry in particular has been able to maintain a good record of growth of output for the past several years. However, this growth has been achieved not by measures of rehabilitation, but principally by the use of increased amounts of fertilizer. It is possible that the response of higher yields to increased fertilizer application may decline in due course. If this were to happen, the failure to rehabilitate the tea industry, by the use, for instance, of the technique of vegetative propagation, might at some future stage effect Ceylon's competitive position. This would be especially so if other countries were to go ahead with vegetative propagation and thereby achieve higher yields and, in consequence, lower costs of production.

While the above remarks are applicable only to the role of private sector investment in the development of the country, the impact on the pattern of prices of indirect taxation (e.g., import duties) and subsidies has relevance to investment both in the private and in the public sectors. A price structure that would favour development is one where investment goods are priced low, to encourage their increased utilisation in real terms, while most types of consumption goods are priced high, to discourage utilisation. These principles, which have been successfully used in most developing countries (a notable example being the Soviet Union), have not been consistently applied in Ceylon.<sup>2</sup> In Ceylon, in fact, investment goods and raw materials have often been subject to fairly substantial import duties. While many items of consumption goods have been heavily taxed, there have been exceptions and rice, for instance, has been heavily subsidised.

It could be stated as a broad principle that taxation of producers' goods — whether investment goods or raw materials — should in general be minimized. Taxation should be concentrated on final consumption goods, except that

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2. In fairness it should be mentioned that there appears to have been an improvement in recent years in respect of the application of these principles in Ceylon.

essential requirements of food, clothing, shelter and education may be lightly taxed or be altogether exempted from taxation. If investment goods and raw materials, which have many different uses, are taxed, the consequent increases in costs will affect a number of final goods indiscriminately, whether they are essential to the country or not. If taxes are levied principally on final consumption goods, a discriminating system of differential rates of tax would be possible that does not overlook the requirements of economic development.

### SECTION III—THE PROBLEM OF THE GOVERNMENT INFLATIONARY DEFICIT FOR 1962/63

The question of whether a mild rise in prices would act as a stimulus to economic development was discussed in Section II A above in general terms. The view was expressed that while a mild rise in prices might act in this way, the problem of maintaining an effective control over the inflationary pressures generated might become a formidable one.

If the question is now posed whether it is possible to quantify a safe limit for an annual increase in the price level, the reply will have to be that no general answer is possible. In one economy a 5 per cent rise may occur in the general price level in one or two years without the generation of a serious inflationary spiral. In another an attempt to maintain a 2 per cent annual increase in prices may end in disaster, with wages and prices chasing each other upwards with increasing velocity. The factors which are likely to determine the nature of the result are (a) the speed with which supplies can respond to price stimuli, this being largely a function of the excess capacity present in the economy; (b) the degree to which labour will tolerate a decrease in living standards without pressing for wage increases, this being related to the strength of Trade Unionism in the country; (c) the confidence with which the public views the future of the economy — if people believe that the price increases are once-for-all and that the situation will quickly be brought under control, they are unlikely to act in ways which make such control difficult to achieve.

For some years after World War II the view appeared to have been fairly widely held among economists that annual increases in the price level of up to 2 or 3 per cent could be tolerated in a developing economy for several years running, provided other circumstances were favourable. More recently the confidence of economists in the ability to judiciously use inflation as an instrument of development has been somewhat tempered by the economic experience, particularly of Western Europe, of the nineteen-fifties.

These remarks serve to underline the need for caution in any prescriptions made for the Ceylon economy regarding a reasonable annual increase in prices. A level of government deficit financing which allows for a 2 per cent annual increase in prices may work for a few years, if confidence is meanwhile maintained that prices will level off in the not too distant future. However, an annual increase in the price level of 2 per cent would leave too little margin of safety in the event of unexpected adverse developments. Hence, a policy which allows for such an annual increase in prices should not be adopted until all possible alternatives have been fully explored.

If price stability is to be achieved in Ceylon in 1962/63, the inflationary gap for the year will have to be of quite modest proportions. Even if a 2 per cent rise in the level of prices is to be allowed for, the magnitude of the inflationary gap will still have to be substantially below that anticipated at present for 1962/63. In any attempts that will be necessary, and that are likely to be made, to reduce the inflationary gap to a more tolerable level, the needs of economic development deserve to be kept carefully in view.

While it may be possible to reduce the magnitude of government inflationary financing by increasing revenues by means of tax adjustments, it is important that the taxes chosen should not be such as would lead to adverse effects on production. As forms of taxation, a differential sales tax or a system of excise duties has much to commend it. It is unfortunate, therefore, that the attempt to impose even a uniform sales tax has had to be abandoned for administrative reasons. Apart from sales taxes or excise duties, the most obvious, and the most easily manageable, instrument for increasing government revenue is import duties. As it is felt that the role of import duties, and of import policy generally, has not been adequately studied in relation to over-all economic policy, these subjects will be discussed at some length in Section IV and again in Appendix I. Meanwhile, in the rest of this Section, it is proposed to examine the scope for achieving a reduction in government inflationary financing by means of a reduction of expenditure.

The need for economic development dictates that, in any attempts to reduce expenditure, capital expenditure should not, in general, be curtailed. Even in regard to current expenditure, the selection of items to be subjected to cuts should be made very carefully so as not to affect development. It is true that genuine economies in government current expenditure may sometimes be achieved merely through administrative re-organisation. These might, for instance, enable the release of staff for capital works without any diminution of the current productive services rendered by government. Economies may also be realised if the government could be persuaded to abandon some of those activities which, though desirable on certain social grounds, nevertheless

tend by their very nature to be relatively fruitless, for example, prohibition and certain administrative controls on prices. Such activities may have political implications, however, which make their abandonment difficult.

Even to the extent that economies are possible by purely administrative measures of re-organisation, these will take time to work out and implement. Hurried attempts to achieve economy, without a sufficiently careful study to identify the existing defects of organisation, procedure or control,<sup>3</sup> may lead not to economy, but simply to confusion. It is evident too that attempts to restrain expenditure, for example, by withholding recruitment of stenographers, clerks, etc., or by postponing the purchase of needed equipment, can sometimes only lead to a loss of output which more than offsets the value of any economies achieved. Thus, although there should be no relaxation of the efforts to achieve economy, they should not be pursued to the point where there is loss of efficiency. Unfortunately, it is probably true that the scope for achieving economy without sacrifice of efficiency is rather limited in the short term.

While it is often the case that attempts to reduce current expenditures, unless planned ahead with sufficient care, tend to affect productive activities adversely, there is an important exception. This is the field of transfer payments. In Ceylon, there are two major items of transfer payments — the consumer subsidy on rice and the producer subsidy on paddy. Conceptually, the Guaranteed Price Scheme for paddy, as a form of incentive to producers, appears to have more economic justification than the subsidy to consumers. Nevertheless, a reduction of the Guaranteed Price to say Rs. 9 per bushel is unlikely in practice to act as a dis-incentive to paddy production, provided fertilizers, tools, seed paddy etc. are made available to producers at subsidised prices. In fact, part of the saving that would result from a reduction in the guaranteed price by, say, Rs. 3 per bushel could be used to provide additional services not merely to producers of paddy but to producers of other agricultural crops as well. Equipment, fertilizers, seed, etc. could be made available, say, at 40 to 60 per cent of cost price, while a network of tractor stations could be established by the government to provide the services of tractors and other mechanical equipment at nominal rates to producers. Agricultural extension activities too could be developed more rapidly. As incentives to increased agricultural

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3. An example which illustrates the devious ways in which economy measures can affect Government activities may be of interest here. It was reported that when travelling allowances were reduced a couple of years ago the validity of the crop cutting sample surveys for paddy was seriously affected. It was said that the enthusiasm of the field officers who had been conducting the crop cutting experiments grew lukewarm when they were inadequately compensated for the expenditures they had to incur. It came to be believed at the time that, in the preparation of the statistical returns on paddy yields, field data were gradually giving way to armchair speculation.

production, these would be more effective ways of spending money than the present scale of cash subsidy.

The consumer subsidy on rice has still less economic justification. Perhaps the only economic justification is that, through its favourable impact on living costs, it serves to some extent to raise real incomes and ease pressures on money wages. But as a means for raising the real incomes of poor people, the consumer subsidy on rice is unduly wasteful. Outright income transfers would accomplish this purpose more effectively.<sup>4</sup>

The disadvantages of the present consumer subsidy are twofold. Firstly, some of the well-to-do receive the benefits as well as the poor. Secondly, the consumption of rice is unnecessarily encouraged, despite the lack of a case for increased rice consumption on nutritional grounds and despite the heavy foreign exchange expenditure involved. On economic grounds, therefore, there seems to be a case for completely removing the present consumer subsidy on rationed rice, and arranging instead for rice to be sold at a price equivalent to the full cost of imported rice. The savings thereby achieved could be utilized for a scheme of income supplements which would safeguard the living standards of poor families.<sup>5</sup>

The scheme of income supplements could be so designed that, while poorer families would receive the cash equivalent of the present rice subsidy, the government would effect some financial savings at the expense of the relatively well-to-do. Such a substitution of cash payments for the present subsidy on rice would also have the indirect consequence that the total amount of rice consumed in Ceylon would be somewhat reduced. This might have favourable repercussions on the foreign exchange situation (if not also on domestic nutritional standards). Furthermore, the likely diversion of consumer demand to food crops other than paddy — for example, manioc, sweet potatoes, kurakkan, etc. — would have an impact on domestic production that is wholly favourable.

The implementation of a scheme of income supplements may, however, lead to administrative difficulties. In formulating the details of a scheme the need to minimize these difficulties will have to be kept in view. In Appendix II, a proposal which takes account of the practical problems likely to arise in the Ceylon context is spelled out in some detail. The proposal is necessarily tentative.

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4. It is widely accepted in economic theory that, as a means for increasing a person's economic welfare, a direct cash payment is superior to an equivalent subsidy on an article of consumption.
  5. A report in the *Ceylon Daily News* of the 13th December, 1962 suggests that some similar scheme has been adopted successfully in recent times in Israel.

Apart from administrative difficulties, a scheme of income supplements may also lead to certain political problems. As envisaged here, the income supplements would form an alternative to the rice subsidy. But it is possible that, once the principle of income supplements is accepted, political pressures may build up for the disbursement of income supplements side by side with consumer subsidies. If this happens the objective of easing the strain on the government finances will not be realised. In fact, it is not impossible that political pressures might build up to the point where the scheme of income supplements has to be enlarged to such an extent that, far from effecting savings, an increase in expenditures becomes necessary.

Thus, while the economic advantages of a scheme of income supplements conceived as an alternative to the rice subsidy are substantial, it is also important that the administrative and political problems inherent in a scheme of this nature be adequately recognised.

#### SECTION IV—FORMULATION OF A RATIONAL IMPORT POLICY

The bearing of import controls and import duties, not merely on the balance of payments, but also on the sources of expansionary finance and, hence, on the control of inflation, has been discussed in Section II B. However, a pre-requisite for the use of import quotas and import duties as instruments of economic control is a complete classification of imports on the basis of a rational order of priorities. While the priorities observed in import policy in the past have been on the correct lines to some extent, there has been a tendency to make quota and tariff changes in a random and haphazard manner. However, should there be available a complete classification of imports on the basis of a rational order of priorities, the urge to make haphazard changes would disappear. There would not, then, be variations in the classification without special reason, while any adjustments of import policy that are necessary would, in general, be related to the framework of this classification.

In the classification of imports into priority groups, due weight would be given to the essentiality of different items of imports from a development angle. This would mean that investment goods and raw materials would generally be given the highest priority, along with essential food imports. The needs of particular domestic industries for protection would also be given consideration. Attention would be paid, too, to the elasticities of demand for particular items of imports, in so far as they can be assessed; for it is relevant from a revenue point of view to have some idea as to whether a given increase in import duties will lead to a reduction in import duty collections. (If it is a matter of urgency that government revenues be increased, the import even

of relatively non-essential items having low demand elasticities may be permitted, subject to the payment of very high import duties).

A tentative classification of imports on a priority basis into six major groups is shown below. The classification is incomplete and is intended only for purposes of illustration.

*Group A* (High priority producers' goods)

- (a) Industrial and agricultural machinery and spares
- (b) Basic constructional materials—steel, cement, tar and pitch, etc.
- (c) Feeding stuffs and fertilizer

*Group B* (Other high priority items)

- (a) Essential food—rice, flour, sugar, milk foods etc.
- (b) Books and publications; educational and scientific instruments and apparatus.
- (c) Commercial vehicles and spares; typewriters; tabulating machines etc.
- (d) Fuels and raw materials mostly used by priority industries—diesel oil, coal, raw cotton etc.

*Group C* (Medium priority items)

- (a) Essential non-food consumer goods—utility textiles, drugs, etc.
- (b) Raw materials mostly used by low priority industries—newsprint, etc.
- (c) Spares for motor cars; tyres and tubes

*Group D* (Low priority items)

- (a) Other consumption goods—quality textiles, sports goods, etc.
- (b) Fitments for buildings

*Group E* (Luxuries)

Luxury consumption goods, including most consumer durables—refrigerators, washing machines, wrist watches, medium and small private cars, petrol for private transport, radios, cosmetics, etc.

*Group F* (Dispensable goods)

Goods that may be completely banned depending on the foreign exchange situation—large motor cars, most types of imported liquor, diamonds, etc.

In the above classification some of the major groups are shown divided into sub-groups. The division into sub-groups would, of course, have to be carried much further in a complete classification.

Once the order of priorities has been decided and the classification into groups and sub-groups is complete, the next step would be to assign a range of duties to each sub-group of items. Sub-groups in major group (A) would be subject to the lowest levels of duty and sub-groups in major group (F) would be subject to the highest levels of duty, while appropriate duty levels would be assigned to sub-groups in the intermediate major groups. The actual assignment of duty levels would be a major undertaking, to be accomplished with all possible care; but, once completed, it is essential that items should not be transferred from one group or sub-group to another without adequate reason. Such a reason may be forthcoming if, for instance, there is an emergence of a new domestic industry which deserves protection by levy of a high import duty on the corresponding imported product. Another reason may be that evidence comes to light that certain items imported into Ceylon are subsequently smuggled into India. In that case the import duties on these items may be adjusted to correspond to the levels of duties imposed by India. (If import of the items has been banned by India, high import duties may have to be combined with strict quantitative controls).

On a rough application of the essentiality criteria discussed earlier, broad ranges of import duties are assigned below, for illustrative purposes, to the different major groups of our classification:

- Group A — No duty (some items may even be subsidised)
- Group B — Nil or low duties (range 0 to 10%)
- Group C — Moderate duties (range 10 to 30%)
- Group D — High duties (range 30 to 75%)
- Group E — Very high duties (range 75 to 200%)
- Group F — Prohibitive duties (range 200 to 1000%)

Apart from serving as the basis for the assignment of levels of import duty, the classification of imports according to priority groups would also serve as the principal basis for the determination of quota levels. Moreover, the levy of excise duties, too, would be linked up with that of import duties, especially in the case of domestically produced counterparts of imported products.

The main advantage of a relatively stable classification of imports in terms of priority groups would be that the levy of import duties or the imposition of quotas would be based on sound and well-thought-out criteria and not

on ad hoc considerations. There would also be the advantage that traders as well as consumers would feel confident about the general lines of government policy and would, therefore, be less inclined to indulge in speculative stock-piling of goods. As fears of shortages would be minimized, there would be beneficial effects too on domestic prices.

From the government's point of view, a classification of this nature would enable the rational use of import controls and import duties for purposes of general economic control. Instead of experimenting with random duty increases on hastily selected items of imports, changes in government fiscal policy would take the form of operation on specific major groups or sub-groups. To give an example, a worsening of the government's financial position may lead to a decision to levy a surcharge, say of 20 per cent, on the duties applicable to the utility textiles sub-group, with corresponding duty increases on lower priority sub-groups (say, a 100 per cent surcharge on the duties on consumer durables etc.). Or it may happen that a favourable turn in the balance of payments situation or in the government financial position will permit a reduction of a certain percentage (say 10 per cent) in the duty levels applicable to specified sub-groups. Such adjustments may be accompanied, where necessary, by corresponding changes in import quotas and in the excise duties levied on domestically produced goods. In this manner, import policy could be used with promptitude and consistency — along with domestic fiscal policy — as an integral part of overall economic policy.

Before concluding, a few remarks may be ventured regarding the need for judgment and discretion in the application of import controls. Sometimes, measures are adopted administratively, which have little economic justification. As an example may be cited the extension of import licensing recently to cover spares for motor vehicles. For a certain length of time licences were not issued for imports of motor spares, with the result that shortages occurred (whether due to supplies being sent underground or not) and prices rose considerably.<sup>6</sup> The economic dislocation thus caused, minor though it was, was surely unnecessary. There had been no evidence that motor spares were imported into the island for purposes of smuggling abroad; so there was no reason to believe that imports of motor spares were larger than were really required for the maintenance and repair of the island's stock of motor vehicles. Also, there was nothing to be gained by allowing vehicles already available within the island to deteriorate through lack of spares. Thus, while import licensing of motor spares may conceivably have been adopted for purposes of maintaining records,

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6. There was a similar pattern of events in the case of a number of other items of imports which were simultaneously brought under import licensing e.g., tyres and tubes, radio spares, slates and slate pencils, etc. In the case of many of these items, it was fairly clear that available supplies had gone underground, partly due to the lack of clarity as to government policy and consequent general uncertainty.

the decision to suspend imports for any period was obviously unnecessary and injurious. This example is mentioned not because it is important in itself, but because it typifies the unnecessary use of administrative controls where no economic good but only harm can result.

### **Appendix I—The Relationship of Import Policy to Overall Budgetary Policy.**

The object of this Appendix is to clarify the relationship of restrictive policies on imports to overall budgetary policy in an expansionary context.

A preliminary word about terminology. In the present discussion, the term "import restrictions" will be used to refer not merely to quantitative restrictions or quotas but also to restrictions effected through adjustments of import duty. And the term "inflationary deficit" will be used as shorthand for "deficit financing from inflationary sources".

An increase of import restrictions achieved by a reduction in quota allocations (import duties remaining unchanged) has two results of relevance to this discussion. Firstly, total import values will decline so that the balance of payments will benefit. Thus an increase in quantitative restrictions tends to increase external assets. The greater the reduction in quotas the higher the likely increment in external assets (or the lower the decline). Secondly, a reduction in quotas, with an unchanged level of import duties, will involve a reduction in total import duties. Thus a reduction of quotas tends to increase the inflationary deficit. To summarise the position: the greater the reduction in quotas, the greater the benefit to external assets, but also the greater the inflationary deficit.

Now, an inflationary deficit and a positive change in external assets have both an expansionary impact on the domestic monetary situation. Corresponding to different levels of quantitative restrictions, there will be different levels of the inflationary deficit and of the net change in external assets for the time period considered (say one year). Therefore, if it is assumed that other material factors (the level of bank credit to the private sector etc.) remain constant, the expansionary impact of a given level of quotas will be measured by the sum of the corresponding inflationary deficit and net change in external assets for the year. The position may be illustrated graphically as in Diagram I.

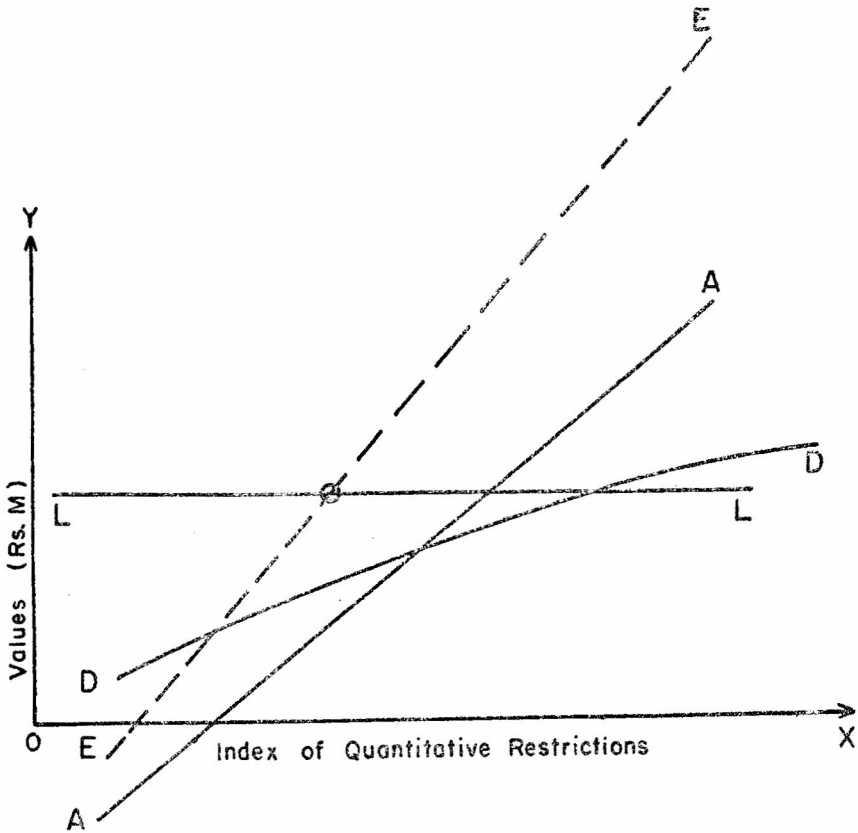


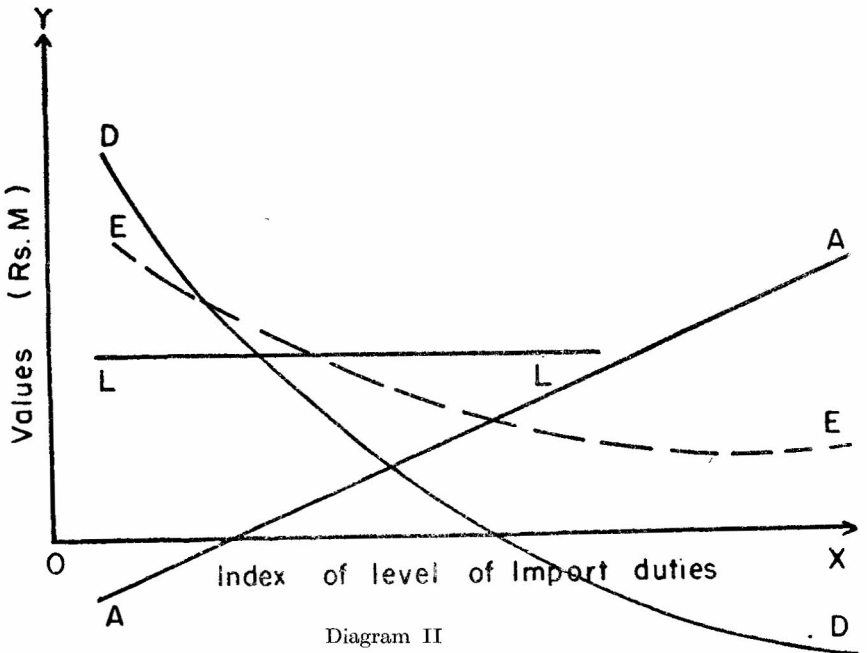
Diagram I

In this diagram the level of quantitative restrictions is measured along the X axis, while the net change in external assets (curve AA) and the inflationary deficit (curve DD) are both measured along the Y axis. The sum of the net change in external assets and the inflationary deficit is shown by the broken curve EE, which thus represents the combined expansionary impact.

The size of the expansionary impact that is regarded as appropriate for the economy at any given time will, of course, have to be determined by reference to the overall economic situation. The greater the confidence in the capacity of the economy to expand production rapidly, the greater the size of the expansionary impact that would be regarded as appropriate. Assuming that a decision regarding the overall expansionary impact has been taken, a second decision could be made regarding the total expansionary impact that could be generated by the two sources of the net change in external assets and the inflationary deficit. Let us suppose that the level that is thus determined for the expansionary impact from these two sources is given by the line LL of

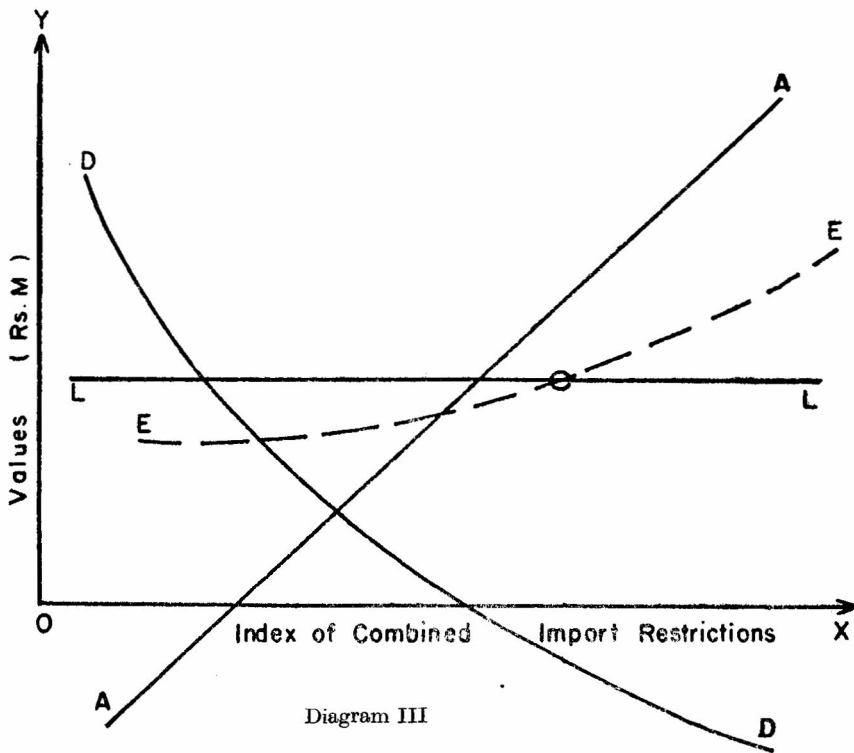
the diagram. In that case the point of intersection of curve **EE** with line **LL** gives the level of quotas assessed to be suitable for the particular economic situation.

However, the argument in the preceding paragraph has taken no account of the possible use of the instrument of import duty adjustment, which may also serve as an instrument for restriction of imports. With a constant level of quotas, an increase of import duties will have the effect of increasing external assets (invariably)<sup>7</sup> and of reducing the inflationary deficit (generally). The inflationary deficit will be reduced, in general, because, though the enhanced import duties will lead to a reduction in the quantity of imports, import duty collections will rise. However, if the elasticity of demand for imports is very high, then the price increase consequent on the increased import duties may have the effect of reducing the volume of imports so drastically that import duty collections fall. In this rather exceptional situation the inflationary deficit will itself be increased. In general, however, the effect of an increase in import duties, with an unchanged level of quotas, will be as illustrated in Diagram II. The higher the level of import duties imposed the more favourable would be the change in external assets and the smaller would be the inflationary deficit.



7: The argument takes no account, of course, of the possibility of an increase in imports for speculative reasons due to changes in people's expectations about the future that may result from the very increase in import duties itself.

Thus far the effects of changes in quantitative restrictions and of changes in import duties have been discussed in isolation one from the other. If, however, simultaneous adjustments of import quotas and import duties are considered, there would result a number of combinations of import quota and import duty levels that are consistent with the required measure of expansionary impact. Thus a certain degree of flexibility is possible in the determination of an import policy. However, it has been argued above, in Section II B of this paper, that given a certain level of quotas, there is an "appropriate" level of import duties which would produce, per se, roughly the same restrictive impact as the quotas themselves. If each level of import quotas is now combined with its "appropriate" level of import duties, then to each such combination of quotas and duties there would correspond a certain net change in external assets and a certain inflationary deficit. Generally speaking, the net change in external assets will rise as import restrictions increase, while the inflationary deficit will fall (at least up to a point). In graphical terms, the relationships may be illustrated as in Diagram III.



The optimal level of import restrictions in the given economic situation is determined as before by the intersection of the curves EE and LL.

It is fair to observe that the practical usefulness of graphical exercises on the lines shown will be limited by the difficulties of determining the actual form of the curves AA and DD. But it should not be altogether impossible to obtain some rough idea of their form for working purposes. Apart from questions of direct practical usefulness, however, the exercises serve to illustrate the underlying theoretical relationship of import restrictions to overall budgetary policy.

### Appendix II—Proposed Scheme of Income Supplements

A scheme for the grant of income supplements as a substitute for the present consumer subsidy on rice is set out below. The details of the proposal as presented here do not possess any sanctity and a more careful study of the problem might suggest better alternatives. The present proposal is advanced, however, in the hope of stimulating discussion on the subject and also of showing that the problems of working out a scheme may not be altogether insuperable.

The consumer subsidy amounts at present to roughly  $-/25$  cents on each measure of rationed rice. As each person is eligible to receive 8 measures per month, the subsidy per person is roughly Rs. 2 per month.

The present proposal for income supplements envisages cash payments once a month to all families on the following basis—(a) Rs. 2 per month to families with monthly incomes below Rs. 100; (b) Rs. 1 per month to families with monthly incomes in the range Rs. 100-400; (c) no payments to families having monthly incomes exceeding Rs. 400.

In the administration of the scheme the following two objectives will have to be kept in view. Firstly, fraudulent collection of income supplements by persons not eligible to receive them must be prevented as far as possible. Secondly, trafficking in claims to income supplements must also be prevented.

In order to achieve these objectives, the following measures may be suggested. The present series of rice ration books would be withdrawn and replaced by three new series of ration books.<sup>8</sup> In the first series each set of 8 coupons would be followed by an income supplement voucher for Rs. 2. In the second series each set of 8 coupons would be followed by an income supplement voucher for Re. 1. In the third series there would be no income supplement vouchers. At the time of issue of ration books, the head of each household

8. It would be advantageous to continue the system of rice rationing so long as the producers' subsidy on local paddy is retained. Rice would then be sold on the ration to consumers at a price equivalent to the full cost of imported rice i.e., at a price well below the cost of GPS rice.

would make a declaration as to the total family income during the preceding year, the sources of this income, the occupations of the different members of the family, etc. Every ration book allotted to members of his household would be signed by the head of the household at the time of issue, besides being signed in due course by the members concerned. At the time of issue of the ration books the head of each household would also sign a separate form, to be retained for official use, to facilitate identification. (People who are unable to sign would, of course, have to set down their thumb impressions).

The disbursement of the income supplements would take place through the local Post Office. Every month the head of each household would have to present himself personally at the Post Office and would be granted the total income supplements due to his family on signing a form kept at the Post Office for this purpose. A system of checks would be instituted to see that the signatures on these forms correspond to the signatures at the time of issue of the ration books. There would be penalties for incorrect declarations of income and other particulars. The rules regarding personal collection of income supplements by heads of households would be relaxed only in very special circumstances such as proven grounds of old age, disablement, etc. If any head of a household does not present his vouchers in the month in which they are due, his claims to that month's income supplements would automatically lapse.

The procedure for collecting income supplements, as outlined here, would be sufficiently tiresome to make it unattractive for some proportion of persons in the income bracket Rs. 100-400 to claim their share of the money. National appeals could also be organized to try to persuade people not in special need to voluntarily desist from claiming the income supplements due to them.

Notwithstanding all this, it is very likely that the total amounts disbursed as income supplements would be somewhat in excess of what would be legitimately due for payment if people correctly declared their family incomes. In other words, a certain amount of false declaration and fraudulent collection of income supplements would inevitably take place. But this would not greatly matter. Perhaps the chief gain would be that the cost to the State of the disbursement of income supplements would be obvious to the general public. Moreover, the level of income supplements would no longer be tied, as happens in the case of the consumer subsidy on rice, to the ruling price of rice in world markets. Thus, on this scheme, the burden on government revenues would not increase automatically with an increase in the world price of rice.

The total cost of the consumer subsidy on rice is estimated to have been in the region of Rs. 230-240 million during the financial year 1961/62. The gross savings resulting from the adoption of the scheme of income supplements

may be reckoned, on the basis of certain broad assumptions, at Rs. 40-50 million. As the implementation of the new scheme may involve the recruitment of much new staff, allowance will have to be made for a rise in administrative costs, amounting perhaps to a few million rupees. Nevertheless, the net saving to government will be considerable.

Moreover, the rise in the cost of rationed rice will make it inevitable that most persons who receive the income supplements will not spend the full amounts received on the purchase of rice (assuming, of course, that eligibility to receive the full income supplements is not made conditional on drawing the full monthly ration of 8 measures per head). It is very likely that some proportion — perhaps as much as a third — of the total amount disbursed as income supplements may be diverted to the purchase of commodities other than rice. This would result in a substantial reduction in the total quantity of rice consumed in Ceylon, even if well-to-do people (who are not eligible to receive income supplements) do not also reduce rice consumption. Thus a considerable saving in rice imports and, hence, of foreign exchange, may result. Expenditure on locally grown foodstuffs other than rice may also increase substantially. It is possible too that there may be some increase in total household savings as a result of saving out of the income supplements disbursed.