not include cost of living allowances, the incomes themselves of many such persons are also variable and tend to increase with the general rise in prices and living costs. To the extent that this is true, there is no need to relieve them by means of subsidies. In any case, price fluctuations always result in alterations in relative shares of total income received by various groups. Even with the most extensive system of subsidies imaginable, it would be impossible for the Government to succeed in maintaining these shares according to some pre-existing pattern. The best that the Government can hope to do is to minimize some of the more obvious injustices and inequities produced by price fluctuations.

40. There are great advantages, on the other hand, both for employers and employees, as well as for the Ceylon economy as a whole, in a system of wage payments which gears wages rather closely to the cost of living. Flexible wages are advantageous to employers, because they enable them to compete more effectively with producers elsewhere in periods of depression when prices are low; and they are advantageous to workers, because their wages will rise with the cost of living when prices are high. A flexible wage system tends to make the Ceylon economy resilient and more readily adaptable to changing conditions in the outside world.

41. Domestic price stability is the goal of every government and of every central bank; but it should be frankly recognized that the difficulties of achieving the goal are more formidable in Ceylon, where the economy is so dependent upon its international trade than in more self-sufficient economies. If recent experience is a guide, it is not likely that Ceylon would enjoy a boom in exports without experiencing a rise in the cost of living. Several export commodities are at the same time important cost of living items. If these items rise, there will probably be a simultaneous rise in import prices. The present rise in prices is a worldwide phenomenon which we in Ceylon cannot control. It is enabling us to obtain high prices for what we sell: we must also expect to pay higher prices for what we buy.

42. In the last analysis, of course, the surest and most effective cure in an inflationary situation is an increased supply of goods. In the Ceylon economy this supply is likely to come in approximately equal measure from imports and from increased domestic production. It is obviously to our advantage to emphasize the contribution made by domestic production; we would be improvident if we managed our monetary and fiscal affairs so as to stimulate a flow of imports beyond our capacity to pay for them out of the proceeds of current exports, and thus in a period of prosperity drew upon external assets which should be conserved for more difficult times. As explained in Section V, there has been on the whole a gratifying increase both in production and in exports, during the past year. Monetary conditions are such at the present time as to encourage this trend. In general, however, the problem of an increase in production is a long-term rather than a short-term problem, though it is always possible, by giving higher priority to projects which will result in greater production in the immediate future, to give even a long-term development programme a short-term emphasis.

IV. Fiscal Policy in Relation to Monetary Policy

43. As explained earlier, the financial operations of Government have contributed to the increase in the money supply during 1950. Although the financial accounts of Government for several years have disclosed a surplus on revenue account alone, the total of all expenditures of Government, including those sums charged to loan and other funds as well as those charged to revenue, have exceeded its total cash receipts, so that the overall result has been a cash operating deficit in each of the past four years. This cash deficit may be financed by an increase of Government indebtedness, *e.g.*, by borrowing or by running down of accumulated cash balances, or by both. Unless it is entirely financed by borrowing from non-bank sources, one of its effects is an increase in the money supply. Statements 11, 12 and 13 describe Government revenue by sources, and Government expenditure by source of finance and by objects for a series of years. The following table analyses the net cash operating surplus or deficit of Government since 1945–46 :—

Government Net Cash Operating Surplus or Deficit

	1945–46	1946–47	1947–48	1948–49	1949–50
1. Net Cash operating surplus (+) or deficit (—) ..	+ 6·3	—164·9	—59·9	—113·1	—154·3
(i) Revenue Surplus—					
Revenue ..	383·3	461·2	540·6	576·1	623·3
Expenditure ..	312·9	405·4	447·5(*f*)	547·9	563·2
	70·4	55·8	93·1(*f*)	28·2	60·1
(ii) Deposits ..	— 1·4	—18·0	·5	7·7	14·0
(iii) Loan expenditure ..	—12·6	—32·1	—70·3	—122·5	—148·5
(iv) Reserve Fund ..	— 6·0	—	— ·6(*g*)	— 5·6(*g*)	— 6·6(*g*)
(v) Food subsidy ..	— 7·0(*b*)	—89·6(*e*)	—77·8	(*h*)	(*h*)
(vi) Stores and materials	2·0	— ·4	— 6·2	— 7·1	— 3·3
(vii) Advances ..	—28·8(*c*)	—81·5(*c*)	5·9	— 14·6	— 73·4
(viii) Miscellaneous ..	—10·3	·9	— 4·5	·8	3·4
2. Net Government borrowing (+) or repayment of borrowing (—) ..	+72·2	—10·5	+43·3	+42·5	+79·6
(*a*) Medium and Long term ..	45·2	31.4	24·0	56.1	12·4
(*b*) Treasury bills and Overdrafts ..	27·3(*a*)	—36·3(*d*)	24·0	— 7·8	76·5
(*c*) Sundry loans ..	— 0·3	— 5·6	— 4·7	— 5·8	— 9·3
3. Changes in cash balances (Item 1+item 2) ..	+78.5	—175.4	—16·6	— 70·6	—74·7

(*a*) Includes overdraft of Rs. 26·3 million from Joint Colonial Fund.
(*b*) Estimated net loss after offsetting profits assessed at Rs. 30·4 million previously accrued.
(*c*) Estimated.
(*d*) Includes Rs. 26·3 million repaid to Joint Colonial Fund.
(*e*) Estimated loss on food.
(*f*) Excludes the food subsidy in respect of the period up to 1946–47, brought into account in 1947–48 ; the cost of the subsidy has been distributed against relevant years under item(v)
(*g*) Expenditure financed from National Development Reserve.
(*h*) Included in Government expenditure financed from revenue.

44. The cash deficit of Government in the financial year 1949–50 was altogether Rs. 154·3 million, Rs. 79·6 million of which was financed by borrowing (net) and Rs. 74·7 million by drawing down cash balances. The budget for the year 1950–51 provided for an estimated revenue surplus of Rs. 85·3 million and a loan expenditure of Rs. 143.3 million. The net result was an apparent cash deficit of Rs. 58* million without taking into account outlay on other expenditures, such as stores and materials, advances and loans.

45. Statement 16 and chart 4 on which it is based show the Government's monthly cash surpluses or deficits since September, 1949. From the statement it will be noted that Government's financial operations during the calendar year 1950, resulted in a total cash deficit of Rs. 153·6 million. The previous analysis (see page 3) has shown that Rs. 79·3 million of this deficit was financed in ways which tended to expand the money supply. Less than half of the deficit (*i.e.*, Rs. 74·3 million), therefore, was financed by the non-inflationary method of borrowing the current savings of the people. The fact that a good portion of this cash deficit was incurred for loan works does not mean that the policy was necessarily sound. The very least that Government should do at a time when a surplus in the balance of payments is already expanding the money supply at a rapid rate is to reduce its overall deficit to an amount which can be met by borrowing current savings. It would be sounder policy, in fact, for Government to budget for a surplus. This surplus could then be spent during the next recession of economic activity in order to maintain employment and incomes.

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*According to the statement made by the Minister of Finance in Parliament on March 14, 1951 the revised estimate of revenue for 1950–51 shows an increase of Rs. 39·0 million to Rs. 774·4 million and the revised expenditure chargeable to revenue, an increase of Rs. 132 million to Rs. 787·1 million.

The revised estimate therefore provides for a revenue deficit of Rs. 12·7 million. Assuming loan expenditure remains at the original estimate of Rs. 143·3 million, the estimated cash deficit before taking into account the additional revenue from the new export duties announced by the Minister amounts to Rs. 156 million. The new taxes were estimated to yield Rs. 100 million in a full year. Assuming that Rs. 50 million will accrue in 1950–51, the revised estimate of the cash deficit may be put at a minimum of Rs. 106 million.

46. **From the monetary point of view, therefore, it is most disturbing that in 1950 the Government should have run a deficit which added an average of more than Rs. 6 million a month to the money supply at a time when other factors were already causing private incomes to expand.** As these funds get into the hands of the public, there is an increase in the demand for imported goods and a tendency for the balance of payments to worsen. It would be shortsighted for Ceylon to generate a balance of payments deficit through an excessively large Government budget deficit at a time when export income is unprecedentedly high. When export income is high, the country can live on its income and conserve its external assets to be utilized at times when export income falls.

47. The budget deficit has not yet created a deficit in the balance of payments. In fact, external assets have shown a tendency to rise during the last six months. (See Statement 9 and chart 5). A surplus in the current balance of payments ordinarily causes these assets to increase, and a deficit causes them to decrease. There can be little doubt, however, that unless the budget deficit is rather sharply reduced, it will, before long, help to generate a balance of payments deficit, even though export prices and incomes remain high. The size of the balance of payments deficit might be substantially increased, of course, if there were a further rise in import prices (which the continuance of a threat of a world war makes likely) unaccompanied by a corresponding rise in export prices—in other words, a worsening of the terms of trade.

48. It should be mentioned, lest the Bank be accused of neglecting it, that a part of the Government budget deficit during the first nine months of this year was caused by an increase of food stocks. At the end of December, 1949, such stocks were Rs. 37·4 million worth, and by the end of December, 1950, the figure had risen to Rs. 80 million, or an increase of Rs. 42·6 million. The importance of this expenditure of Rs. 42·6 million should not be over-emphasized, however, partly because the stocks at the end of December, 1949, were unusually low and partly because these stocks are valued at cost rather than at selling price. This method of valuation hides a very large implicit loss that is only regarded as an expenditure at the time the stocks are sold. Since most rice is now sold at considerably less than half its cost price, it would probably not be unreasonable to reduce the figure of Rs. 42·6 million by about one half. Thus of the total deficit of Rs. 153·6 million during the year probably no more than Rs. 20 million should be attributed to the increase in food stocks.

49. As argued earlier, it is regrettable from the economic point of view that such a large share of the budget deficit is the result of increasing food subsidies. The subsidies in the financial year 1950-51 are estimated to cost Rs. 133 million. Food subsidies, together with such payments as public assistance grants, are ordinarily classified in fiscal parlance as "transfer payments" because, unlike payments rendered for goods or services, they are merely outright transfers of income from one section of the population to another. Such payments ought to diminish rather than enlarge during a boom.

50. The experience of the last few months has revealed a weakness in the fiscal structure of the Ceylon Government. As the national income has risen, there has been no apparent tendency for the budget deficit to close. This is not as it should be. It is a widely recognized principle of fiscal policy that the structure of a government's taxes and expenditure should be such that budget surpluses and deficits will automatically operate in a compensatory way. When a country is prosperous, government revenues ought automatically to increase relative to expenditures, even without a change in tax rates. In this way, deficits would automatically shrink and surpluses, if there be any, would automatically grow. On the other hand, when a country's economic activity slackens, the tax burden on the community should automatically lighten and, if necessary, government expenditure may be permitted to increase relative to revenue.

51. The deficit may obviously be reduced in either of two ways, by reducing expenditures or by increasing revenues. Elimination of waste and the reduction of non-essential expenditures by Government are always important but never so important as when the deficit is contributing to economic instability. Greater Government economy would not mean, however, that the country's development programme need be curtailed in any way.