

PUBLIC SPENDINGS AND ECONOMIC PROSPERITY SPECIAL REFERENCE TO POST INDEPENDENCE SRI LANKA

A. Koswatta*

Department of Social Studies, The Open University of Sri Lanka

INTRODUCTION

Abstract:

This paper empirically investigates the relationship between expenditure and taxation policies and economic growth in Sri Lanka. The country's overall level of taxes and government spending are substantially lower compared to the advanced economies. Therefore, this study is launched to identify the impact of fiscal policy changes on economic growth in Sri Lanka under different political regimes. Estimated results demonstrate that even though the Fiscal significance influence on Sri Lanka's economic growth in the short run, but in the long run the impact is considerable. To identify this impact in the short run the study employs the error correction mechanism, for the long run the study employs the Engle Granger Technique. The Granger Causality test suggests that the Fiscal Policy does cause the Economic Growth. The Study also examines the external shocks to the fiscal variables in Sri Lanka and its impact on Economic Growth.

Introduction:

In every country the fiscal policy plays a significant role in economic growth. In the short term, In the short run, fiscal expansion can help aggregate demand and growth to improve during cyclical downturns. Conversely, contractionary fiscal policy can stabilize an economy that is growing at an unsustainable pace and thus faces the risk of overheating. Developing Economies like Sri Lanka in particular have a long history of using taxes and larger government spending to improve the economy by smoothing the business cycle. And also, fiscal policy can also have a major impact on medium and long term economic growth. This is especially true in Sri Lanka where the private sector is relatively weak and underdeveloped. Public spending on physical infrastructure, such as roads, ports, and highways, affects the productivity of all types of industries, and the entire economy. Likewise, public spending on education and research and development fosters human capital, a vital ingredient to long-term growth. Therefore, it is essential to improve the fiscal policy in order to improve the economic growth strategically.

Literature:

Comparing various taxes, Skinner found that personal income and corporate tax rates had a negative direct effect on output growth, trade taxes had little direct effect, and sales and excise taxes were neutral with respect to both output growth and investment. King and Rebelo (1990) showed that tax policy can have a potentially large impact on long-term growth. Public policies can exert a significant influence on economic growth rates by affecting private incentives for accumulating physical and human capital. Even relatively small changes in tax rates can lead countries to stagnate or even regress if these policies eliminate incentives for growth.

* Corresponding author: Email - achinthyatharangani@gmail.com

Objectives:

The objectives of the study can be broken down into main objective and specific objectives based on the contribution to this study.

Main objective

The main objective is to investigate the impact Fiscal policy basically taxation and expenditure, changes on economic growth of Sri Lanka.

Specific objectives

- To analyze the time series properties of the variables used in this study.
- To understand the behavior of the fiscal policy tools known as taxation and expenditure in Sri Lanka.
- To analyze the short run and long run effect of fiscal policy changes on Economic growth.
- To suggest policy implications.

METHODOLOGY

This section summarizes the main variables, the frequency of data, the source of data study period, and the analytical methods.

i. Method of Data Collection

Time series data from 1956 to 2014 of the related variables will be collected from the Central Bank of Sri Lanka. The variables are real gross domestic product, Direct taxes, Indirect taxes, Government recurrent expenditure, Government capital expenditure non-oil taxes and total debts of the government of Sri Lanka

ii. The model

The model specification will be based on the growth theory that fiscal policy impact on the economic growth of Sri Lanka stated by Appah (2010) but with modifications. Consequently, the functional form of the model specification will be:

$$RGDP = f(NTR, REX, CEX, TD)$$

Explicitly, equation 1 can be written as: in statistical form

$$RGDP = \beta_0 + \beta_1 NTR + \beta_2 REX + \beta_3 CEX + \beta_4 TD + U$$

Where:

$RGDP$ = Real Gross Domestic Product (proxy for economic growth);

NTR = Non-oil Taxes;

REX = Recurrent expenditure;

CEX = Capital expenditure;

TD = Total debt defined as domestic and foreign borrowings.

Where β_0 = Y-intercept term. This gives the mean or average value of $RGDP$ when all the explanatory variables included in the model put at zero.

And $\beta_1, \beta_2, \beta_3, \beta_4$, are parameters known as partial regression coefficient or partial slope coefficients (Gujarati & Porter, 2009; Gujarati, 2006; Osuala, 2010).

U = the stochastic term or the unexplained variation in $RGDP$. Sweeney et al. (2006) stated that it accounts for the variability in the dependent variable that cannot be explained by the linear effect of all the independent variables in the model.

iii. Econometric tools

The variables have been described by the graphical methods and summary statistics. To identify the order of time series properties of this study unit root test is employed. To test the stationarity of the time series this is basically used. This study employs Johansen's cointegration method to investigate both long-run and short-run relationship between the tax policy changes and expenditure policy changes on economic growth in Sri Lanka. The granger causality test is used to determine whether one time series is useful in forecasting another. To identify the causal impact of fiscal policy and economic growth, the granger causality test has been applied. The impulse response function is used to determine the effects of external shocks to the variables used in this study.

RESULTS AND DISCUSSION

Government expenditure has consistently exceeded revenue, often by a considerable margin. From 1960 to 1977, expenditure was about 28 percent of GDP. After 1977 it increased, mainly as a result of investment in infrastructure. Between 1978 and 1987, the government spent around 38 percent of GDP. Of the nearly Rs.70 billion spent in 1986, about half was identified as recurrent expenditure, and fifty percent goes as capital expenditure.

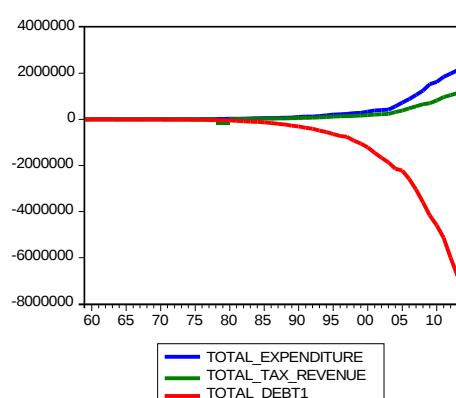


Figure 1. Total Expenditure , Total Tax Revenue and Total Debt in Sri Lanka

According to figure 1, the total expenditure always exceeds country's total revenue. Therefore, the total debt amount continues to expand.

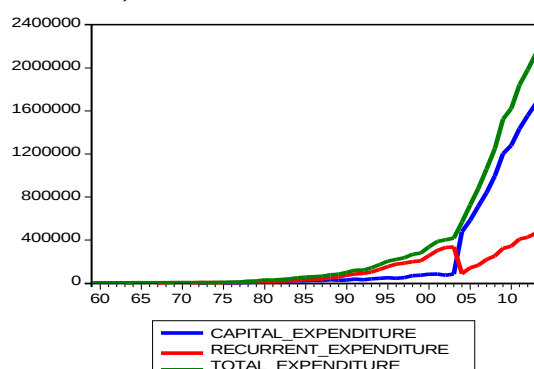


Figure 2. Capital Expenditure, Recurrent Expenditure and Total Expenditure in Sri Lanka

Figure 2 shows the composition of the total expenditure of Sri Lanka. According to the statistics the highest amount records by capital expenditure due to the investment

programmes hold in the last few years.

The effectiveness of growth-friendly fiscal policy is enhanced when reforms reinforce each other and are accompanied by complementary structural reforms. Combining fiscal reforms (e.g., scaling up infrastructure investment while improving the public investment process) increases their effectiveness.

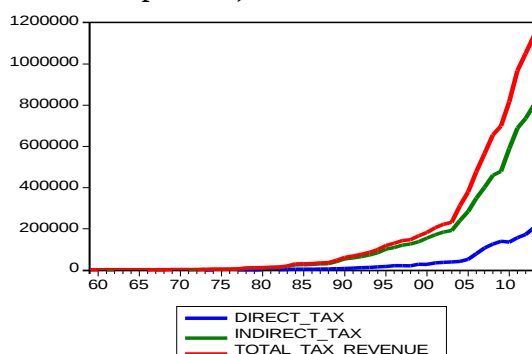


Figure 3. Direct Taxes, Indirect Taxes and Total Tax Revenue in Sri Lanka

In a healthy economy, the direct taxes should always greater than indirect taxes. But according to figure 3, Sri Lanka's highest income was recorded by indirect taxes. Higher indirect taxes leads to higher income disparities, poverty and inequality. But the government is purposely doing this in order to collect the revenue smoothly. Appropriately this is a chronic failure most of the developing countries face.

Policy design and social consensus matter for the successful implementation of reforms. Therefore, designed fiscal reforms can serve both growth and equity objectives. A proper decision can be taken based on the real values of an economy since the real values exclude the inflationary impact. The following figure summarizes the real GDP behavior over time.

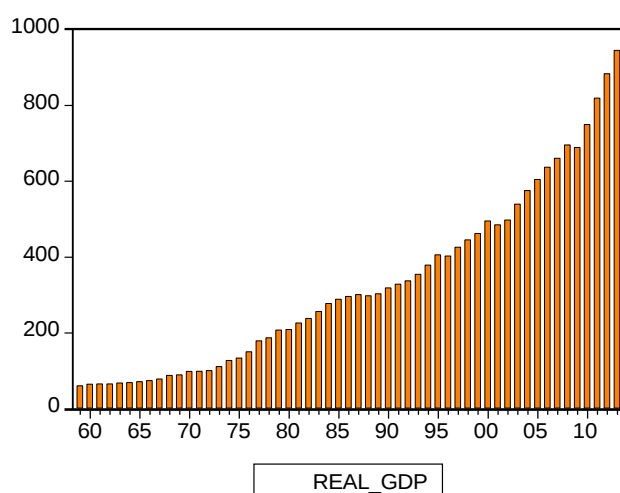


Figure 4. Real GDP Growth in Sri Lanka.

According to the results given in the long run relationship the total expenditure increases economic growth by 66% in Sri Lanka while the taxation reduces the economic growth by 19%.

Table 1. Long Run Relationship among the variables

Included observations: 220

Variable	Coefficient	Std. Error	t-Statistic	Prob.
DIRECT TAX	-0.16 (16%)	0.094573	-1.742958	0.0482
INDIRECT TAX	-0.19(19%)	0.133979	1.453456	0.0330
TOTAL EXPENDITURE	0.66(66%)	0.254929	-2.597275	0.0127
RECURRENT EXPENDITURE	0.28 (28%)	0.090960	3.125530	0.0031
CAPITAL EXPENDITURE	0.32 (32%)	0.093456	3.504511	0.0010
DEBT TO GDP RATIO	-0.366028	0.100041	-3.658768	0.0007
FOREIGN DEBT	0.500508	0.079623	6.285993	0.0000
TOTAL DEBT	-0.68 (68%)	0.263315	-2.604222	0.0124
TOTAL DOMESTIC DEBT	0.538839	0.147774	3.646362	0.0007
C	4.182901	0.457987	9.133239	0.0000

Table 2 presents results from the pair wise Granger- causality tests which were obtained with two lag for each variable.

Table 2. Causal Relationship among the variables

Null Hypothesis:	Obs	F-Statistic	Probability
LTOTALTAX does not Granger Cause LREALGDP	220	1.16908	0.01934
LTOTALEXP does not Granger Cause LREALGDP		5.88657	0.00517

According to the figure 5, when the total expenditure is affected by an external shock, the effect will not makes a significance impact on economic growth in the first two years just after the policy change then the impact will decay slowly.

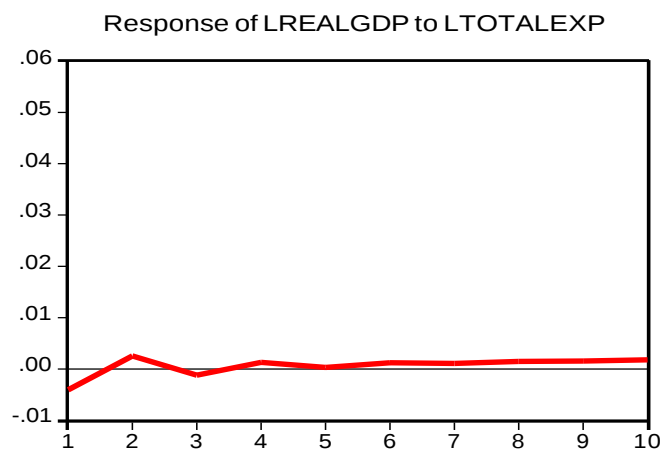


Figure 5: Direction of Economic Growth due to external shocks

CONCLUSIONS/RECOMMENDATIONS

Fiscal policy can help Sri Lanka to meet the challenges in Economic Growth. Therefore, a strong fiscal policy can improve the economic growth effectively in the past, present and the future. This analysis indicates that in Sri Lanka, the composition of taxes and government spending matters for economic growth. According the outcomes of the study, public spending and taxation also has a significant effect on economic growth. This study proves that there is a considerable long run relationship between taxation and expenditure policies and the economic growth in Sri Lanka. And this growth can be improved using fiscal policy tools such as growth oriented taxation and expenditure policies.

REFERENCES

- Acosta-ormaechea, s. And a. Morozumi. 2013. Can a government enhance long-run growth by changing the composition of public expenditure? Imf working paper 13/162. Washington, dc: international monetary fund.
- Bose, n., h. M. Emranul, and d. R. Osborn. 2007. Public expenditure and economic growth: a disaggregated analysis for developing countries. The manchester school. 75 (5). Pp. 533–556.
- Devarajan, s., v. Swaroop, and h. Zou. 1996. The composition of public expenditure and economic growth. Journal of monetary economics. 37 (2). Pp. 313–344.
- Easterly, w. And s. Rebelo. 1993. Fiscal policy and economic growth: an empirical investigation. Nber working paper no. 4499. Cambridge, ma: national bureau of economic research.
- Gemmell,n. And j. Au. 2012. Government size, fiscal policy and the level and growth of output: a review of recent evidence. Working paper in public finance 10/12. Wellington: victoria business school.

