

# FISCAL POLICY AND ECONOMIC DEVELOPMENT

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**F**iscal policy is a tool of macroeconomic management implemented through public spending, taxes and subsidies. In economic theory there are two major tools of macroeconomic management. One is monetary policy which controls the money supply and the interest rates structure. The other is fiscal policy which controls the flow of income between households and firms and also determines the relative prices of goods and services. Both these tools are equally needed for a sound macroeconomic management. The fiscal policy loses its grip if the stock of money gets out of control. Monetary policy has little grip if the structure through which the monetization is transmitted remains a bottleneck. However, the fiscal policy is more effective than the monetary policy in dealing with structural problems in developing countries.

## **Functions of Fiscal Policy**

Fiscal policy has a number of functions in macroeconomic management of a country. First is the resource allocation function of fiscal policy. The total output of the economy depends on how the resources are allocated between different lines of production. Perhaps, the present total output may not be the potential (production possibility limit) level of output. In such a case a reallocation of resources will reduce the gap between current level of output and the potential level of output. Second is equity function of fiscal policy. Equity can be achieved through equitable distribution of income and wealth. Equity in taxation can be achieved by

taxing the income and wealth on the principle of ability to pay. The ability to pay, in fact, can be reckoned either in terms of income and wealth or in terms of consumption. However, in many countries priority is often given to income and wealth. A progressive taxation<sup>1</sup> of income and wealth and a zero or low commodity tax on goods largely consumed by low income households would ensure equity in tax policy. Provision of social safety net and other transfers to low income households would further strengthen the equity principle of fiscal policy. Third is the stability function of fiscal policy. Economic stability involves internal as well as external stability. Internal stability implies avoidance of high domestic inflation while external stability means avoidance of high current account deficits in country's balance of payments. The fourth is growth and development function of fiscal policy. We confine our discussion here to the growth and development function of fiscal policy.

Economic development implies an improvement in the living standard of the people of the country. The necessary condition to raise the living standards of the people is that the quantum of goods and services produced (total output) should grow faster than the population growth of the country. But it is not sufficient. The increased output or the income generated through the expansion of output should be equitably distributed among the households. Development implies a reduction of absolute poverty in the sense that the percentage of people below the subsistence level of income should come down with the passage of time. People should receive at least their basic needs if economic development

takes place. The rate of growth of total output or the gross domestic product (GDP) of the economy is called the growth rate of the economy. An increase in the growth rate alone may not simply mean economic development because development needs an equitable distribution of benefits of growth. The goods and services produced with the expansion of total output should really increase the human welfare. However, the growth is a necessary condition of development and hence we will try to find out how fiscal policy can influence growth.

## **Growth through Increased Productivity**

Given the limited resources in a country like Sri Lanka, the growth should come from increased productivity of resources. A growth of productivity can be achieved through:

- \* a more intensive use of existing productive capacity;
- \* increased technological development;
- \* investment in human capital.

There are three ways that fiscal policy can raise productivity growth.

- \* by financing or direct supply of goods and services that the private sector may not adequately supply due to various market failures (These may include some infrastructural projects and provision of basic education, health and sanitation which will directly boost private sector productivity);

- \* by minimizing the cost of supplying basic utilities (public goods) necessary for long term investment and entrepreneurial activity.
- \* by financing public sector activities without distorting private sector saving and investment decisions.

### **Public Investment to Raise Productivity**

We can identify broad areas where fiscal involvement could lead to productivity growth. One major area is public sector infrastructural investment. The private sector may not invest in infrastructural projects either because of market failures or owing to enormous risk or huge capital investment involved. But private sector economic activities can substantially increase their productivity owing to availability of necessary infrastructural facilities. Thus economic activities of infrastructural nature would be complementary to private sector economic activities. When the social profitability (national economic profitability) is greater than the private profitability, there is a case for public sector involvement in such projects. Furthermore, the huge initial capital needed and the inability to charge a price for the output can justify public sector involvement. In developing countries, the supply of domestic capital is quite limited owing to under-developed capital markets and hence foreign private investments are encouraged in infrastructural investments under build, operate, own and build, operate, transfer schemes. It is evident therefore, investment in infrastructure is of vital importance to productivity increase in entrepreneurial activities of the economy. In Sri Lanka before the establishment of Export Processing Zones, the necessary infrastructure viz. roads, electricity, telecommunication, water service, drainage, rail roads and international airport facilities were supplied by the state which had undoubtedly resulted in raising the productivity of the enterprises established there subsequently.

Another major area in which public involvement is necessary to raise productivity is expenditure on education. The state intervention in education can be justified on market failures. Market failures can be defined as the inability of the competitive markets to achieve an efficient allocation of resources. In certain countries, education is supplied by the private sector to some extent but if it is left to the private sector alone, there are no reasons to believe that everybody gets equal opportunities and the society receives an adequate level of education. This is particularly true in low income countries where a small fraction of the population has the ability to pay for education. After all, the ultimate benefit of education or training will not accrue only to the student who received the education or to the employer who had trained the employee. The benefit of education, training or skills acquired would accrue to the society as a whole. The entire country would be benefitted as a result of educated and skilled labour force. The ultimate effect of education, training or skill development would be the growth of labour productivity. There is a substantial difference in labour productivity between work force of our countries and that of industrially developed countries. That can be explained in terms of investment in human capital (expenditure on education, training and skill development). Public expenditure on education is no longer treated as social service but it is an investment in human capital. Investment in human capital raises labour productivity and hence the public spending in raising of quality of labour can be justified as necessary.

The experience of East Asian economies shows that productive labour force was the secret behind rapid growth and it was the necessary result of investment in education. For example in Japan, the government intervention in universal free education created a more egalitarian society. It also helped in transforming the traditional agrarian economy to a rapidly industrializing economy. Egalitarian society facilitated political stability that was a necessary condition for successful long-term economic growth. Discarding established theories of growth<sup>2</sup> the East

Asian economies showed that high level of savings could be attained in an egalitarian society and the increase in human capital is very important, if not more important than the increase in physical capital. Increase in human capital raised the labour productivity.

The level of education, training and skills acquired have a profound bearing on the income distribution and social stratification. Therefore, public expenditure on human development projects forms a vital instrument in fiscal policy. Inequalities in the distribution of income are strongly related to inequalities in investment in human capital. Unequal education and skills perpetuates poverty, while more equitable distribution of education and training facilities helps to reduce poverty. Investment in human capital formation thus opens an opportunity for raising productivity in order to achieve higher growth on the one hand and on the other, to achieve a desired social goal of reduced inequality. The expenditure on investment in human capital can be spent discriminately so as to strike more emphasis on less privileged groups. This may be more desirable as a superior form of distributional adjustment rather than indiscriminatory public expenditure on all groups.

Another sector government fiscal involvement can be justified is public health care. Expenditure of health care increases labour productivity and the social benefits associated with preventive and primary care (i.e. clinical and community health) promote growth. Expenditure on health care and sanitation like the expenditure on education can be treated as investment in human capital because it can prolong a person's productive life. There is a strong case for government fiscal intervention in the provision of preventive and primary health care because of high social benefit-cost ratio. The cost of providing preventive and primary health care is relatively small to the enormous benefits that would be accrued to the society in terms of healthy and productive work force. This is more important in countries like Sri Lanka where a large segment of the population cannot afford

to pay for health care on the one hand and on the other, they are quite ignorant of the preventive devices such as immunization unless the government enlightens them and made those facilities available to them. Furthermore, if labour productivity is adversely affected by malnutrition (particularly of children and pregnant mothers), all measures taken to improve the nutritional levels of the people can be treated as investment in human capital.

Another role of fiscal policy in economic development is prevention of environmental degradation. The importance of this aspect has become widely accepted only during the past quarter century. We now know that increases in GDP does not necessarily equal to the increases in standards of living of the people or increases in measured GDP today does not necessarily mean increases in long term wealth. These points have been recognized by the recent attempts at building "green" accounts. In green accounts, the loss of natural resources and environmental degradation in the course of economic activity are measured and quantified to be adjusted to the measured GDP. The green accounts highlight the enormous environmental damage caused particularly by many rapidly developing and transitional economies. The development experience of Japan illustrates that fiscal intervention of the government to prevent environmental degradation towards the end of 1960s resulted in the search of new technology. The increasing concern of the Japanese government on environmental degradation such as air pollution and water pollution led to imposing taxes and other regulatory measures on those polluting industries. The low-tech heavy industries were a major source of pollution, the regulatory measures increased the production cost of such industries. The comparative advantage enjoyed by those industries on relative factor abundance was lost partly as a result of regulatory measures and a need arose for less polluting technology. The shift from low-tech to high-tech industries had been the result.

From where these investment resources could be mobilized? If neither unused domestic resources are available nor can they be mobilized from abroad, the current consumption has to be squeezed to release resources for investment purposes. In many countries, the unutilized labour resources can be used for simple form of capital formation such as irrigation dams, roads and drainage. The investment funds from abroad can be obtained in the form of official loans and grants and as direct private investments. In each case the fiscal policy has a large role to play showing fiscal prudence in the case of receiving foreign assistance and providing necessary attractions in the case of private foreign investment. However a large part of investment resources should be extracted from current consumption. The domestic capital formation should be generated both from private and public savings. If conducive conditions prevail for voluntary savings an increased domestic saving can be mobilised from the private sector. Fiscal and monetary policies can be utilized to create necessary environment conducive to raise increased saving by keeping the inflation low and providing appropriate financial institutions to attract household savings and direct them to productive investment avenues. Taxation has an important role to play in providing incentives to savings and/or disincentives to luxury consumption. The corporate sector capital formation can be enhanced through incentive schemes to promote reinvestment of corporate profits.

The main objective of a tax policy is to design a system that generates adequate revenue for the provision of public services inclusive of transfers to needy households and for investment in infrastructural and human capital. Taxation creates distortions in resource allocation because it alters the relative prices of both final products and factor inputs so that they no longer reflect relative scarcities. Taxes on goods and services and also on factor prices create two sets of prizes viz. after-tax prices and before-tax prices. Producers and consumers of goods and services as well as factor owners decide on quantities to be supplied and demanded on the basis of after-tax prices. This causes

a distortion in resource allocation in the sense that the resulting resource allocation is different from market-determined resource allocation. A good tax system should minimize adverse distortions.

Redistribution of income and wealth is considered another important objective of taxation. The ownership of resources (physical capital, wealth, education and human capital) is unequal and hence the individual incomes are unequal. The free market system hasn't its own mechanism to correct any distributional imbalances that may initially exist in the economic system. If the existing distribution of income is socially unacceptable, the tax system should be directed to achieve a socially acceptable distribution of income. Redistribution is implemented most directly by (1) a tax-transfer scheme, combining progressive taxation of high incomes with a subsidy to low-income households. Alternatively, redistribution may be implemented by (2) progressive income taxes used to finance public utilities which particularly benefit low-income households. Lastly, redistributional justice may be achieved by (3) a combination of commodity taxes on goods purchased largely by high-income consumers with subsidies on commodities largely consumed by low-income households.

However, there is a fundamental trade-off between allocation efficiency and equity objective of taxation. Levying of higher tax rates on the rich would be needed in achieving equitable redistribution but it creates a larger gap between pre-tax and post-tax prices which can result in larger distortions causing greater inefficiency. Similarly higher commodity taxes on luxuries may be justified on redistributional grounds but unjustified on efficiency grounds. It is this conflict between the efficiency and the equity objectives of taxation led to the view that distribution objective should be achieved through other measures such as land reforms, transfers and other government policies leaving the tax policy to focus primarily on the efficiency objective.

## Public Expenditure on Economic Development of Sri Lanka

Before political independence in 1948, the role of fiscal policy in Sri Lanka was confined to the general public administration and to the provision of basic social services such as public health and free education. Thus the revenue need was very small. The government had only very little participation during that period in the production and distribution of goods and services as the private sector was expected to take care of them. Even after the political independence, the government has not implemented a rigorous fiscal policy until the Six Year Programme of Investment was introduced in 1954 with a view to minimize utilization of limited resources among different public sector investment projects.

However, a sharp increase in government fiscal involvement could be observed during the 20-year period between 1957 and 1977. The direct involvement of the government in production, distribution and financing and also the increase in government expenditure on social services resulted in an expansion of government expenditure. The nationalization of private business undertakings and the establishment of a large number of public corporations caused the public sector expansion. The social welfare services were expanded incurring huge government expenditure while high population growth raised the government expenditure on education, health services and social welfare services.

The scope and the activities of the government were increased during these two decades with the establishment of new public sector enterprises, nationalization of private sector enterprises and creation of public sector monopolies. The employment in the public sector rose rapidly because the public sector provided the heaven for educated youth with job security and high wages. By the latter half of 1970s, the size of the public sector became relatively large

compared to formal private sector and the public sector wages and pension payments amounted to a sizable proportion of government expenditure.

The economic reforms of 1977 were intended to introduce significant changes in the fiscal sector of Sri Lanka. One change was to encourage private sector led growth in order to lessen fiscal burden on the government budget. The second change was to reduce the size of the government budget by targeting welfare expenditure to the needy segment of the population and curtailing non-essential public expenditure. The third change was to revise administered prices by the public enterprises with a view to alleviate dependence of public enterprises on government budget. However, a complementary expansion of infra-structural investment and social overheads was necessary for inducing private sector led growth. As private sector could not be relied upon for such investments owing to number of reasons, the government had to undertake the provision of infrastructure and social overheads. The continued expansion of government expenditure as a proportion of GDP even in the early 1980s, despite reduction of fiscal burden following economic reforms, was owing to infra-structural and social overheads expenditure of the government.

The government expenditure, however, recorded a decline in the 1990s mainly owing to the completion of public sector investment projects undertaken during the 1980s, privatization of loss making public enterprises and reduction of less productive government expenditure under fiscal stabilization policies of the structural adjustment programme implemented since mid-1980s. For fiscal stabilization, the government welfare expenditure was contained by abolishing subsidized price system and targeting the subsidy to beneficiaries of Poverty Alleviation Programme. The subsidy was paid in cash to buy goods at market prices. The government involvement in the financial sector was reduced in the present decade mainly owing to aggressive expansion of private sector

financial institutions even to the small towns in countryside.

In the 1990s, the government has also remarkably reduced its role of investment and employment generation relative to previous decades. It has encouraged private sector participation in infrastructure development projects under BOO/BOT systems. The government involvement in manufacturing industries have come down considerably with divestiture programme compared with its major involvement in the 1970s. The divestiture programme has also resulted in reducing the level of public sector employment. Thus the direct fiscal involvement in economic development has been significantly reduced over the last two decades and it was evident in the greater inequality in income distribution as illustrated by the Consumer Finance Surveys conducted by the Central Bank.

The trend towards greater equality in income distribution shown until mid-1970s has been reversed particularly in the 1980s. The GINI ratio which summarizes the extent of concentration has risen from 0.35 in 1973 to 0.44 in 1978/79 and further to 0.45 in 1981/82 and to 0.46 in 1986/87 as shown by the Consumer Finance Surveys conducted during those years. The share of the poorest 40 per cent of the families declined from 19.3 per cent of the total income in 1973 to 16.1 per cent in 1978/79 and further to 15.3 per cent in 1981/82 and 14.2 per cent in 1986/87. Thus the benefit of growth originated mainly through the expansion of private sector (reduction of public sector) appears to have distributed more unequally. As long as the state remained a provider through fiscal policy, the income distribution remained more equitable and once the role of the state was shifted from that of a provider to a facilitator the income distribution immediately turned inequitable.

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The Consumer Finance Survey 1996/97, however, reveals an improvement in the equality in income distribution. According to provisional results published, the GINI ratio has come down to 0.43 in 1996/97 compared to 0.46 in 1986/87 while the share of the poorest 40 per cent of families has been increased to 15.3 per cent total income compared to 14.2 per cent in 1986/87. This seems to suggest that trickle-down effect is taking place possibly with the expansion of private sector employment particularly in the secondary and tertiary sectors of the economy. However, the close relationship between the equity and the development role of fiscal policy cannot be denied.

<sup>1</sup> Progressive taxation implies a tax structure in which the proportion of tax to income rises with the increase in income and ownership of wealth.

<sup>2</sup> Arthur Lewis argued that inequality in income distribution is necessary for capital accumulation which is hub of growth. Simon Kuznets argued that economic growth was associated with increase in inequality.

