

Fiscal Policy in Sri Lanka

Introduction

Fiscal policy like other public policies, derives its broader objectives and sets its direction, from the socio-economic goals of that society. The socio-economic goals of developing economies are aimed at upgrading the standard of living and the overall welfare of the citizens of these countries. In pursuance of these objectives, the central task of fiscal policy is to maximise savings, mobilise them for productive investment, and channel them towards achieving a balanced development process. While fiscal policy is assigned this vital role in the saving investment augmentation process, it also aims at achieving economic stability and desired distributional goals and also to provide appropriate incentives and signals to achieve efficiency in resource allocation. However, as governments have assumed a more dominant role in economic management, in a developing country like Sri Lanka, the role of fiscal policy has become more complex.

Fiscal Policy and Economic Performance prior to 1977

Until 1977, Sri Lanka followed a development strategy, in the familiar pattern of many developing countries- a state controlled and inward looking strategy that tended to restrict both public and private investment. Income distribution and welfare objectives became more pronounced than growth and investment goals. Fiscal policy was heavily influenced by this line of thought and highly progressive taxes and regressive welfare expenditure programmes were adopted. Consequently, the tax system was used to emphasize more revenue mobilization effort, rather than providing appropriate incentives and signals for rapid economic growth.

Despite a relatively successful effort on the part of the government at mobilising resources through taxation, its effort to raise public investment was frustrated by high current expenditure levels which created no savings in the budget. Thus the transfer of resources from private sector to public sector, through, fiscal means, did not make a significant contribution towards increasing capital formation so to promote a higher rate of economic growth.

Economic growth allowed only a marginal improvement in per capita income. In fact, the average annual per capita growth rate has been around 1 per cent. Lying behind this overall pattern of growth was some marginal shift in the economic structure. The aggregate performance of the economy was significantly influenced by low and negative growth rates in major agricultural crops. The country's performance in terms of employment suggested that growth of employment opportunities had not been proportionate to the increase in the labour force.

On the other hand a significant proportion of government expenditure was channelled into social welfare

programmes,- around 10 per cent of GDP- one of the highest levels attained by any developing country. This welfare oriented strategy, in which government provides basic food, education, housing, health and other community services, enabled Sri Lanka to achieve immense social progress. Accordingly, Sri Lanka ranked very high among all countries in terms of the physical quality of life index (PQLI=82 in 1970s). Thus, while welfare programmes contributed towards achieving social progress, there was no corresponding increase in capital formation which is an important factor in accelerating economic growth and to enhancing productive capacity in the economy. The relatively slow economic growth accompanied by increasing unemployment, suggested that the welfare level reflected in Sri Lanka's basic need indicators may not be sustainable in the long run. In other words, when looking at the overall development strategy in general, and fiscal policy performance in particular, there is a gap between development goals and their realization.

Theme of the 1977 Economic Reforms

In 1977 after a long period of economic control and with greater dependence on state enterprising system, Sri Lanka shifted to a liberalized economy with increased reliance on the market mechanism, and policy emphasis on rapid economic growth. The market oriented outward looking growth strategy aims at getting the right prices by freeing the market mechanism, while allowing the state to play a complimentary role by paving the way for the smooth functioning of market forces. Therefore, the overall development strategy should be based on the theory that economic efficiency has to be sought primarily through market based price signals, which guide resources allocation toward internationally competitive industries and encourage diversification of exports.

Fiscal Policy - its Role

The overall shift in the development strategy in 1977 necessitated important changes in fiscal policy. The primary task of fiscal policy is to facilitate the market oriented economy with the objective of promoting exports and industrialization within the guidelines of comparative advantages.

A general growth strategy in a developing country like Sri Lanka, calls for substantial government expenditure on infrastructure development activities that would provide basic facilities to increase private sector participation in the development process. In pursuing this task, Sri Lanka's public sector resource allocation since 1977 aimed at placing high priority on rehabilitation and expansion of infrastructure, in order to broaden agricultural and industrial activities. Thus more than one half of government investment was

directed toward multipurpose irrigation schemes and to build up a basic infrastructure network, aimed at removing the supply bottlenecks in the economy. As a result, the share of government expenditure in GDP increased to nearly 35 per cent since 1977. On the other hand, a substantial increase in capital expenditure contributed to an increase in the Investment/GDP rate from 14 per cent in the 70s' to 26 per cent in the post 1977 period.

Sri Lanka's long-standing commitment to provide basic needs to its population and achieving favourable distribution of income was also integrated into the new policy package adopted in 1977. A significant feature of the new strategy was to move the population away from its dependence on welfare programmes, thus enabling government to use its resources more efficiently on productive areas to the benefit of its people. The Food Stamp Scheme introduced in 1979, therefore, aimed at a specific targetted income group. The prime objective of the scheme being to assist low income households purchase one or more of the basket of goods, comprising essential consumer goods. From the point of view of the economic theory the Food Stamp Scheme can also be considered a better instrument for improving income distribution, as cash transfers are free from price distortions.

The new economic policy was also aimed at ending public sector monopoly, and encouraging private sector participation in production and distribution of goods and services. The private sector therefore is expected to play a vital role in the industrial, agricultural and commercial activities. In implementing this task, government is expected to provide sufficient competition in order to ensure consumer welfare and to this end government agencies were also allowed to compete with the private sector, to avoid imperfect market practices.

As part of a general growth strategy, fiscal policy could be used as a major instrument in stimulating the private sector in the economy. Tax holiday status was extended to encourage foreign investment while a wide range of concessions and reliefs were made available to promote savings and investments. With the emphasis on the promotional role of fiscal policy, direct taxation emerged as a major policy instrument in resource allocation, rather than resource mobilization.

Although overwhelming tax incentives could lead to an erosion of the existing tax base, such incentives are necessary in creating a favourable climate for private sector activities. On the other hand, for outward looking growth strategy to be successful, the incentive structure should be comparable with those found in the neighbouring competing countries, which have already offered attractive incentives and have gained some competitiveness in international markets.

As part of a general growth strategy, fiscal policy is also required to lessen the undesirable variations in

economic activities excessive balance of payments deficits and fluctuations in price levels. Budgetary policy, therefore, is required to be consistent with monetary and balance of payments policies. Towards achieving this objective, a stabilization programme that would neither retard the pace of economic growth nor lead to adverse consequences in income distribution should be followed. Therefore, fiscal policy should aim at improving the efficiency in government budgetary management. To this end, instead of adopting standard measures such as increasing taxes and direct cuts in expenditures Sri Lanka has attempted to reduce un-productive expenditure, programmes by setting targetted savings in current and capital expenditure items. A 5 per cent saving in current expenditures and 15 per cent saving in capital expenditures have been accepted as guidelines. Meanwhile, efforts have been made to reduce the recourse to deficit financing through expansionary sources.

To sum up the fiscal policy adopted in Sri Lanka since 1977 has been playing a promotional role. Direct taxation has been heavily used to provide incentives to encourage private investment. In designing export taxes the primary concern has been to ensure a reasonable profit margin so as to enable producers to enhance productive investment in export oriented production activities. Import duty structure aimed at playing a dual role, by way of providing protective elements to domestic value added industries on the one hand and revenue source for the government on the other. While the supply side is favoured through taxation the demand side has been used as a major source of government revenue mobilization. Consumption oriented taxes, with greater tax burden on non-essential consumer goods, have been used to achieve both, revenue goals and distributional objectives.

Conclusion

Like all other policies the success of fiscal policy depends not only on the formulation but also on the environment within which they are to be implemented and the manner of its implementation. Due to the complications of the problems, conflicting nature of the objectives, rigidities in the institutional framework, an ideal solution may be difficult to achieve. But the recent experience in Sri Lanka clearly indicates that despite several limitations and unfavourable movements in external and internal environment, the policy framework adopted since 1977 has been effective in accelerating economic growth in the country.

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