

*Fiscal Policy — some Problems and prospects**

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Sri Lanka in the last three decades has moved away considerably from the conventionally defined state whose role was confined to gather taxes necessary to provide public goods (e.g. defence, law and order, justice and sanitary affairs) whose production by individuals was considered both inappropriate and undesirable. Today, all shades of political opinion accept a wider role for the State.

This can be attributed, among other reasons, to two major influences. At the theoretical plane, a justification was found in the Keynesian economics, that gained widespread popularity in the post-war period. It is true that the prescription of Keynes was postulated in the context of a world affected by a serious economic depression; to those economics that could be reactivated with adequate liquidity. Yet, the policy makers schooled or influenced by Keynes regarded it as an endorsement of public expenditure in every conceivable type of economy.

Secondly, the more socialist oriented view of the state with a higher responsibility for economic management, justified the extended state intervention in economic activity. This strand of thought induced a commitment to state sponsored economic development and a wide range of welfare policies. So much so, in the more recent years the expenditure on welfare in Sri Lanka almost correspond to expenditure on development.

This outlook in political philosophy has manifested itself in a wider role of the State with direct intervention in all levels of economic activity including both production and distribution. Consequently, the role of fiscal policy as an aspect of overall economic policy, has to be assessed in a much broader framework. It can no longer be looked upon as an exercise confined to balance revenue and expenditure laid down in the Budget. It has to be examined as a statement of policy guiding and directing the economy in pursuit of wider economic goals of improving production, distribution and stabilisation.

The prime instrument of fiscal policy, the Budget is nevertheless a statement of planned income and expenditure for a given period. As a statement of income and expenditure, it provides the basis for appropriation

and control of expenditure, in conformity with the law. It is mandatory for the spending departments to observe the limits and guidelines laid down in the Annual Appropriation Act. Any deviations are answerable to the Public Accounts Committee appointed by the National State Assembly. As the key instrument to enforce the economic policy of a Government, the Budget is used to realise the multiple objectives of economic development, mobilisation of savings, redistribution of incomes and stabilisation of economic activity by guiding the level and direction of expenditure and revenue.

In the more developed countries, fiscal policy is generally associated with economic stabilisation. Instruments of taxation and expenditure are used to manage the aggregate demand. In times of economic recession, a tax cut or an increase in public expenditure is advocated to stimulate demand. This is designed to increase output and employment in the economy. Similarly in times of prosperity, with a potential for inflation, they would increase taxes and cut public spending to arrest the increase in aggregate demand. Usually these techniques of demand management and counter cyclical economic policy is applicable only in the framework of a more sophisticated economic system, endowed with a well organised economic structure sensitive to changes in demand. The applicability of such methods in less developed countries is subject to much controversy. One cannot draw a parallel with a developed system and advocate high spending or tax cuts in a less developed country to stimulate demand in the economy. Tax cuts or deficit financing to mobilise resources by raising the effective demand is bound to set in motion a process of inflation. On the other hand, one cannot eliminate the limited relevance of demand management type policies associated with higher taxes and expenditure cuts even in an under-developed economy system and mop up excess liquidity generated through expansionary policies followed in an earlier period.

It is well known that most developing countries are operating within a narrow economic base with a low level of income. The problem confronted by them is one of overcoming supply bottlenecks either in the very structure of that economy or in the process of transferring externally mobilised savings into proper forms

* This paper is a documentation of personal views held by the writer and these should not be regarded as the official views of the Central Bank.

of investment, wherever such savings are available. A lasting solution therefore, has to be found through investment and saving that would revitalise the framework and raise the productive capacity of the economy. There appears to be no short cut either within the capitalist framework or within the socialist framework to short circuit the process of development that could only be achieved through capital formation resulting from saving a share of the current income. At the best, internal savings, could be supplemented with external savings, but it is equally important to note that investment so made should help to generate an economic surplus and improve the net worth of the economy. Consequently, any urgency for economic development, if it exists must be accompanied by a similar urgency to generate savings. Unless a sense of urgency is displayed in the policies to curtail current consumption, little can be achieved through the policies to promote development.

Savings and Investment

The relevance of fiscal policy for the promotion of savings and investment can be appreciated better by examining the concept of saving and investment in economic theory. From the fundamentals regarding the circular flow of income in the economy, we know that all transactions in real resources have its counterpart in factor payments or money incomes. The notion that savings in the economy corresponds to investment imply that there is an invariable equality between the unconsumed monetary incomes and unconsumed real resources. But there is nothing to prevent the accumulation of a part of this unconsumed income as idle cash balances with individuals and a corresponding amount of real resources as stocks or inventories. Given this kind of economic behaviour, the equality between savings and investments is always true and may become a mere tautology without much analytical content. The real significance of this concept is associated with the attempt in the economy to equate planned or desired savings with planned investment in the same time period.

In a sufficiently developed economy where transactions in real resources are adequately monetised, their unconsumed monetary incomes will be channelled to finance the purchase of unconsumed real resources through a broad range of financial intermediaries including banks. These institutions whether be it in the capital market or or in the banking sector serve as the channel that mediate between the saver and the investor. Given this institutional setting the entrepreneurs will bid away a share of the real resources for investments. The balance between the relative cost of capital as reflected in the rate of interest, and the return from capital as reflected in the profits will guide the course and magnitude of economic activity. Excess demand for capital and investment would raise the cost of capital above the potential returns from such investment and prevail upon the uneconomic enterprises to liquidate. Similarly, excess profits will induce the entrepreneur to bid away

resources from consumption to meet any shortfall in production. Market mechanism therefore, generates both the efficiency and allocation of resources on the basis of consumer preferences as revealed by the prices. It is clear that financial intermediaries including banks, capital markets, entrepreneurs, rate of interest, loanable funds, and profits, find a place in this scheme of things as a matter of routine.

Supposing one or more of these situations are deficient or inadequate in an economy, could it function in the same manner to guide the course and capacity of the desired level of economic activity. Deficiency in one or more of these would impair the circular flow of income to the detriment of economic behaviour. Inadequacy in the institutional framework would generate hoarding of monetary incomes and lead to unwanted accumulation of stocks and inventories in the economy. Withdrawal of a certain share of income from the circular flow would therefore create an inverted spiral in economic activity. Similarly a structure of interest rate not sensitive to the pulse of movements in the economy would fail to guide the economy in the allocation of resources. Non-monetised economic transactions would keep the level of activity at a lower level. Deficiencies in each one of these situations would affect the level of economic activity. And adequate and suitable institutional framework to monetise the transactions in the economy and intermediation that create financial assets and liabilities as the counterpart of transactions in real resources would contribute to enhance the net wealth of the economy, generate savings and channel them eventually into productive forms of investment. A sensitive structure in the rate of interest would guide the allocation of resources. Economic planning and fiscal policy should therefore be used to stimulate such areas in the economy.

Apart from the deficiency in institutional framework, and the prevailing insensitivity of economic variables to stimulate development, the lower magnitude of the economic activity itself impair the capacity to generate adequate savings in the economy. In Sri Lanka, the level of domestic savings has remained in the neighbourhood of 13 per cent of the GDP in the last decade or more. Economic policies in the past have clearly failed to raise it to the level anticipated in the planning documents issued from time to time, and lift the economy from its present subsistent level. It is evident that a determined effort to raise the level of national savings is needed as a matter of urgent priority.

If it is not coming from voluntary savings it has to be realised through state intervention. Inadequacy of voluntary savings has been a fundamental problem shared by most developing countries; and state intervention in this instance demands taxation of a higher order. This means that fundamental decisions pertaining to the postponement of consumption has to be taken by the state by reaching a consensus in political opinion to

divert a higher share of current incomes from consumption, into savings. In the short run this is a painful exercise. Nevertheless one cannot shed the responsibility by postponement of decisions if we were to achieve any meaningful results in economic development.

In the face of these deficiencies, fiscal policy although not an adequate substitute for all these shortcomings, can be used effectively to rectify and set right much of it by creating the proper economic climate. It can be used to stimulate the process of saving. It can be used to channel such savings into investment. It can be used to step up the level of financial intermediation. It can be used to revitalise and restore the interest rate mechanism as an effective instrument of policy. These by no means are consistent goals. The objectives of one policy may conflict with the aim of another, but the Government has to strike a balance in its overall policy.

In regard to raising the level of savings, the Government can use budgetary policy to effect both the voluntary and forced savings. Voluntary savings is a matter for both fiscal and monetary incentives and the institutional framework. The scope for fiscal policy is mostly in the sphere of forced saving through taxation and it deserves more comment.

Taxation

Taxation we know could be both direct and indirect. Direct taxes can be levied on income and affect the disposable income. Indirect taxes could be levied on expenditure by taxing goods and services available for sale in the market. Under both methods it affects the real income of the people, to the extent that a share of the resource is channelled from consumption into savings in the form of taxation. Yet another alternative when one fails to take the decision to postpone current consumption is to generate resources for economic development through inflationary means. This again in the long run has the effect of a tax. In the first instance it brings about a transfer of resources to the State, but the consequent increase in prices and the erosion of real value of incomes constitutes the element of tax. Consequently, it is a method with strict limitations in regard to both cost and yield. Further if left control, it can lead to inflationary situations as was witnessed in certain Latin American countries, Indonesia or Korea in the recent past. Then it follows that there is no painless short cut to mobilise resources apart from voluntary savings or savings enforced through taxation.

Further the tax based savings do not create prior claim on a future increase in output; whereas private savings held in bonds and other instruments of indebtedness carry a cost of debt service and constraints the revenue-expenditure policy of the Government. Taxation as an instrument of policy has other advantages. It can be used to redistribute income resulting from the free working of market forces in the economy. However, the multiple objectives of state policy to

provide public goods, welfare and development expenditure tend to obscure the purposewise boundaries in taxation. Purposewise boundaries are important since they have major implications for expenditure policy. The state has a prime responsibility to provide law and order and the basic public goods. This needs taxation. Then the state can pursue a policy of redistribution through taxation. This latter justification for taxation commits the Government to certain welfare services. Thirdly, the Government can use taxation to generate savings for economic development. Now the real problem begins at this state. What is the level at which taxation for the supply of public goods and redistribution ends and taxation for development begins. In practice, it is almost impossible to draw a distinction. In normal fiscal classifications all proceeds from taxes constitute current revenue; and it could be claimed to finance redistribution oriented expenditure with a certain degree of justification. Nevertheless, one cannot avoid a demarcation if economic development with direct state intervention is a declared objective of the Government fiscal policy.

Economics in Expenditure

This obviously is a difficult political choice and the problem may be approached from another angle by examining the level and magnitude of desired re-distribution. Posed in this manner one has to examine the relative merits of different forms of redistribution as against the need for development.

In Sri Lanka even with massive re-distribution programmes the authorities have at the best been able to make only a marginal improvement in the living standards of low income groups. If the state were to raise the level of consumption and the living standards of these classes into what could even be remotely called "acceptable", massive doses of further welfare expenditure will be called for. Such a solution while perpetuating poverty and discontent will only remove the dignity and self-reliance of the large base in the population. In the alternative, a more longlasting solution appears to lie in economic growth that could broaden the base of employment and enhance the income levels of the population. Between the two extremes of all welfare and all development, a compromise solution seems to exist in selective welfare oriented re-distribution with a substantial allocation of tax receipts for development expenditure.

Selectivity in welfare leads to an examination of relative merits or consequences of the several kinds of welfare programmes now in operation. The bulk of such expenditure falls under education, health and transfer payments to households in the form of food subsidies and pensions.

Here again, one cannot look upon re-distribution with a welfare objective as something distinctly alienated from investment and growth. So called welfare expenditure to enhance the quality of human capital by raising

the standards of education, health and nutrition makes a positive contribution for growth. This however needs further elaboration. Usually in the standard classification of Government expenditure, outlays on hospitals and schools are undisputedly regarded as capital expenditure. Similarly, the outlasting equipment used in education and health is also classified under the same category. But salaries and wages in either instance is regarded as current expenditure. This now is a debatable point. If investment in hospitals and schools is regarded as capital, the expenditure on doctors and teachers who contribute to the productivity of these investments should also belong to the same category. If one were to use a concept of human capital there should be no dispute on this issue.

Regardless of this debate, the state through its policies over the last several decades is committed to provide free education and health to the public in this country; and the real issue is the ability of the state to undertake these services and maintain adequate standards befitting the development in these fields elsewhere in the world. Absolutely free education and health services though a laudable effort in promoting welfare, impairs the capacity of the government to mobilise resources for further development work. Further, one has to note that these services are financed from tax revenue and examine whether it is within the reach of the state to devote a still higher share of the revenue to finance these services at the expense of alternative development projects.

Public discussions related to these issues have often failed to isolate two important aspects. One is the desirability of the state to undertake these services and the other is the method of financing these services.

Given the political environment in Sri Lanka and the widening role of the state in economic management, one cannot dispute the right of the state to undertake these services. Necessarily it does not follow that the state should bear the full financial burden of these services. As much as there is a right for the state to tax the community to defray the costs of public goods such as law enforcement and basic utilities, the state could exercise the right to tax the services rendered by education and health. This could very well be done without violating the principles of equity usually observed in enforcing a tax. A graduated scale of subsidies offered to each individual depending on his or her circumstance would not violate the welfare aspects embodied in the current programmes. Those who are in destitute circumstances who fall below an officially adopted poverty line could continue to receive the same benefits they receive now, and the others depending on their ability could be made to pay for the services they receive.

In the field of health, a system of insurance analogous to the national health insurance scheme in U.K. may be adopted to service the working population. In the

field of education absolute free education could be extended upto a certain level but the state financing of further education could be subjected to suitable criteria of selectivity. A system of public assistance could finance the really promising students regardless of their circumstance. The criteria for selectivity are many and could be worked out to the satisfaction of the community, provided the principle of selectivity is adopted in the first instance. Adoption of this principle will certainly go a long way to improve the quality of the services that could be rendered and improve the state of public finances in this country to accommodate further development projects, to increase the productivity and enhance the level and quality of the community at large.

Food subsidies that constitute the bulk of the transfer payments of the government could be handled in very much the same manner. Here again one does not question the desirability of a food subsidy extended to those who really deserve a subsidy. What may be questioned is the need and desirability of extending this subsidy to all, regardless of their circumstances.

However, the food subsidy that constitutes the bulk of the transfer payments from the Government to the public, has acquired a degree of political sensitivity unparalleled in matters of economic management elsewhere in the world. In the first instance, it appears to be due to a policy of wooing the consumer for over three decades; but the more fundamental reasons could be found in (a) the relative stagnation of the economy with low growth rates that has failed to make an appreciable increase either in the per capita income or in the level of employment in the economy and (b) the failure of the domestic food grain sector to meet the demand for cereal production.

Since a political solution to appease the consumer further, would only perpetuate the problem and trap the government in deeper political impasse; a more lasting solution has to be found through a growth oriented economic policy that would transform the subsistent agriculture to a market oriented sector and raise the peasant incomes to a level above a minimum poverty line through suitable investment programmes.

It is clear that investment in agriculture to uplift the productive capacity of the rural farmer, and in industry to create more employment without sacrificing the productivity of such projects, demands the highest priority; but assuming that plans and projects to realise these objectives are forthcoming, the issue for fiscal policy is one of raising resources.

Alternatives for the policy-maker are fairly obvious. Hesitation to contain welfare expenditure at a level warranted by tax revenue would retard growth activity and defer the opportunity to extricate the state from this vicious circle; and measures to cut subsidies on the other hand is likely to receive instant hostile reaction from

the public. In view of this delicate situation, one must not necessarily question the desirability of a subsidy to those who really need it. What may in fact be questioned is the justification of extending it to the bulk of the community who really does not depend on it for their survival. If the state were to adopt a principle of selectivity to exclude those who do not depend on it for their very survival, and essential food items at subsidised prices are issued to that section of the population that falls below a suitably defined poverty line, considerable savings could be generated to finance the needs of development.

Implications of deficit financing

With almost the whole of total revenue used to finance current expenditure, the progressively increasing development expenditure is financed from floating a debt, both foreign and local. Consequently, fiscal management in the post-war period moved progressively towards deficit financing the budget. Throughout the period, the justification for the debt was the need to incur public expenditure to increase the productive capacity of the economy. Growth of the debt was relatively low in the earlier years, but the phase was more accelerated in the more recent years.

Quite apart from the issues related to debt management, any sizeable public debt would tend to pose a problem of debt burden with implications for Balance of Payments.

In the context of the burden it is pertinent to examine the time spread of the debt burden and the cost of benefit to each generation. It is known that the domestic debt raised to harness unemployed resources is beneficial to both the present and future generation, but interest paid on that debt is an irrelevant subsidy to the present generation at the expense of future tax payers. The more efficient method, purely in the context of burden would be to finance such projects with interest free creation of currency or interest free borrowing from the Central Bank. If such credit creation is solely for the purpose of utilising unemployed resources it cannot generate a substantial degree of inflation. On the other hand, if the debt is floated to shift factors of production to a preferred area, it is bound to raise the market rate of interest and adversely affect the rate of private investment. Here again the burden is shifted to a future generation and interest paid now is a subsidy on the present generation.

The external debt in either instance is a transfer of real resources in the current period whose burden is invariably shifted to a future generation. Further, the external debt has a direct bearing on the Balance of Payments. In an operational sense one could show that the debt contracted to finance the Government Budget constitutes a built-in import content into the economic system. Similarly, it is also true to say that a Government deficit not financed directly with external loans also cause a deficit in the Balance of Payments. That is, no matter how the budget is financed any deficit is likely to show up partly as a deficit in the balance of payments and partly as a saving in the non-government sector in the national accounts of the economy. This could be shown conveniently in the framework of Keynesian Income Identity.

* $Y = C + I + G - T + X - M$. This expression could be transformed and rewritten as $G - T = (S - I) + (M - X)$

Since a deficit in one sector has to be financed by other sectors in the economy, it follows that a deficit in the Government sector is invariably financed by savings in the private sector ($S - I$), and transfers from external sector shown as ($M - X$). The external sector savings transferred to the economy appear as a deficit in the Balance of Payments. It does not necessarily follow that the Government deficit is financed with external borrowings, but it means that the Government deficit will induce an import demand in excess of exports in the rest of the economy. It can be shown that the expenditure that constitutes the Government deficit, raise output and employment until planned saving equates planned investment and the planned savings, if not released through the domestic sector is forced through a deficit in the external sector. It is clear from this that unless an increase in Government expenditure (G) is followed by an increase of taxation (T) it is bound to aggravate the external deficit in the economy sooner or later. The usual remedy suggested to choke off this demand for imports is a devaluation of the exchange rate, but there is no clear evidence to suggest that this will balance the external account, and the savings to finance investment in both the Government and private sector accounts will come from the private sector. In fact, the experience in Britain and Italy in recent years has been that private investment rose as much as private savings and the balance of payments deteriorated as much as the budget deficit.

* The symbols stand for the following—

Y = Gross National Income
 C = Consumption
 I = Investment
 G = Govt. expenditure

T = Tax Revenue
 X = Exports
 M = Imports
 S = Savings