

Which is More Effective to Sustain Fiscal Consolidation in Sri Lanka: Expenditure Cuts or Revenue Increases

G.P. Paranamana

Department of Economics, University of Ruhuna

gp.paranamana1992@gmail.com

INTRODUCTION

Fiscal consolidation is a policy aimed at reducing government deficits and debt accumulation. In many developing countries, the focus is on correcting financial imbalances, reducing government deficits and thereby reducing public debt accumulation. However, there is no consensus on the best policy combination to achieve that. Fiscal consolidation can be achieved by reducing spending, increasing revenue, or using a combination of these two policies. Expenditure constraints should focus on limiting non-productive spending, especially well-planned effective spending on infrastructure and human development, especially to ensure long-term growth for the country. Revenue-based fiscal consolidation targets enhancing revenue through expanding the tax base, improving the tax administration, minimizing tax avoidance and evasion, revising the tax rates and rationalizing tax incentives.

Although fiscal consolidation is important for a country, the government miscarried to implement some necessary policies. For example, the government does not want to increase the tax rate or cut down subsidies as it could be politically disadvantageous. In support of this, De Rato (2004) pointed out, “The reality is that countries that decide to postpone fiscal reform and adjustment for fear of the political and economic consequences usually end up paying a much higher price when economic necessity forces them to act.”

When considering the budgetary outlook of Sri Lanka, it is important to take steps to reduce the fiscal deficit. It is important to follow proper fiscal policy and fiscal consolidation methods which are introduced by authorized institutions. In implementing this fiscal stabilization policy, it is significant to choose the most appropriate policy strategy that meets the Sri Lankan needs. Also, it is timely to understand which of the two methods is more effective, either the cost-cutting method or the revenue rising method to sustain fiscal consolidation in Sri Lanka.

In the analysis of literature, Alesina and Ardagna, (1998, 2010); Alesina and Perotti, (1995, 1997); Giudice et al., (2007); McDermott and Wescott, (1996) and Ardagna (2001) conclude that increasing tax rate is more effective than reducing expenditure to achieve fiscal consolidation. In contrast, De Rato, 2004 argues that reduction of government spending is more crucial than raising tax rates in a permanent solution of fiscal adjustment. However, it is acknowledged that such a reduction of spending is much more challenging in countries because of necessary social needs and infrastructure developments.

Although there are many debates, dialogues and economic and political implications over the feasibility of achieving the expected outcomes, no adequate research been conducted systematically to understand the appropriate fiscal consolidation path in Sri Lanka. Therefore, this research aims to examine which is more effective i.e., expenditure cuts or revenue increases to maintain fiscal consolidation in Sri Lanka. This study examines the components which are related to government revenue and expenditure, how to handle to achieve fiscal consolidation. Further, the study is expected to focus on the short-term and long-term behavior of government revenue and expenditure-related components. The results of this study may help to refresh the policy recommendation

to prevent further accumulation of public debt and find the way out of low tax revenue and high amount of government expenditure.

METHODOLOGY

The study used annual data for Sri Lanka over the time period of 1950-2020 to achieve the above-mentioned objectives. This study adopted public debt to GDP ratio (PD) as the dependent variable and indirect tax revenue (IDT), direct tax revenue (DT) as a proxy for tax policy reforms and public spending (PS), Social spending (SS) and economic spending (ES) as a proxy for expenditure policy changes, consumer price index (IN), budget deficit (BD), lending interest rate (LIR) and exchange rate (ER) as explanatory variables. Where PD and BD were measured as a percentage of GDP. DT and IDT were taken as a percentage of total revenue and PS, SS and ES were taken as a percentage of total expenditure by the government. IN is measured as an index, LIR is the rate that meets short and median terms finance need of the private sector, ER was taken as a percentage of local currency unit per dollar. All variables except the exchange rate were transformed into a natural logarithm form. Data for all variables used in the analysis were extracted from Central Bank Annual reports. The estimated model is specified in Equation 1.

$$\ln PD = \delta_0 + \delta_1 \ln DT + \delta_2 \ln IDT + \delta_3 \ln PS + \delta_4 \ln SS + \delta_5 \ln ES + \delta_6 LIR + \delta_7 IN + \delta_8 \ln ER + \delta_9 \ln BD \varepsilon_t \quad (1)$$

Where \ln represents the natural logarithm. The term, ε_t represent error term and t demonstrate the period of time.

FINDINGS AND DISCUSSION

ADF and PP unit root test results confirmed that all the variables except IN and SS are non-stationary in level form. Whereas all of them became stationary at their first difference. According to the

lag length selection criteria, LR, AIC and HQ, lag one was selected as the most appropriate lag length.

The results of the Johansen cointegration test confirmed that there is one co-integrating relationship between the variables under this study. This indicates that there is a long-run relationship between the variables.

Table 1: The results of Long-Run Relationship: Dependent Variable – LNPD

<i>Lndt</i>	<i>lnidt</i>	<i>lnes</i>	<i>lnps</i>	<i>lnss</i>	<i>lnin</i>	<i>lnex</i>	<i>lr</i>	<i>lnbd</i>
-0.066	-0.181	0.209	0.349	0.663	0.596	0.135	0.2588	0.406
(-1.971)	(-1.65)	(7.349)	(4.211)	(2.712)	(7.889)	(2.296)	(2.224)	(4.533)

Source: Author's calculation based on CBSL data

According to the long-run relationship, direct tax and indirect tax have a significant negative impact on public debt in the long run. When other factors are constant, if direct tax increases by 1 percent, then the public debt will decrease by 0.065 percent. When the indirect tax revenue increase by 1 percent, then the public debt will decline only by 0.181 percent. This implies that tax policy reforms are essential to the reduction of debt levels in Sri Lanka under the revenue-based fiscal consolidation.

In contrast, government expenditure which is categorized as social service, economics service and public service, was found to have a statistically significant positive impact on public debt when other factors are held constant. If government expenditure of economics service increases by 1 percent, then, public debt will increase by 0.21 percent. When government expenditure of public services increases by 1 percent, then the public debt will increase by 0.35 percent and also, when the expenditure of social services increases by 1 percent, public debt increases by 0.66 percent. According to the test results, social services have highly positive significant impact on public debt.

Moreover, budget deficit, lending interest rate exchange rate and interest rate have statistically positive significant impacts on public debt in the long run as expected and in line with the existing literature (Thanabalasingham & Jothirathne, 2021).

The long-run adjustment part of the results of ECM is shown in Table 2.

Table 02: The results of Long Run Adjustment of ECM

ECT	CoinEQ	Pro. Value
D(LNPD)	-0.1450	-1.7031
D(LNDT)	-0.0610	-0.4053
D(LNID)	0.0256	0.3084
D(LNES)	0.4870	2.7782
D(LNPS)	0.1991	1.2426
D(LNSS)	0.1359	1.2546
D(LNIN)	-0.3699	-0.4896
D(LNEX)	-0.1971	-2.4135
D(LR)	-0.2233	-1.7966
D(LNBD)	0.5529	2.4190

Source: Author's calculation based on CBSL data

As per the results, the speed of adjustment coefficient of public debt (dependent variable) is negative (0.1450) which implies that 14.50% of the short-run disequilibrium that arises from exogenous shocks is corrected within a year. That is one period after the exogenous shocks the variable move back towards a steady - state line with the speed of 14.50% in each year. According to the short-run relationship part of ECM, only debt and exchange rate positively affect public debt.

CONCLUSIONS

Results of the study imply that tax revenue contributes to the reduction of government debt, but government expenditure has a further positive effect on the debt burden. Social services expenditure, expenditure on public services and expenditure on

economic services also increase the public debt burden. Since the expenditure component coefficient is higher than the revenue side coefficient, it can be concluded that decreasing expenditure is more effective than increasing tax revenue, in maintaining public debt at a sustainable level.

REFERENCES

- Alesina, A. & Ardagna, S. (1998). Tal of the fiscal adjustment. *Journal of economics policy*, 27, 489-545.
- Alesina, A. & Perotti, R. (1995). Fiscal expansion and adjustment in OECD countries. *Journal of Economics policy*. 21, 5-248.
- Alesina, A. & Ardagna, S. (2010). Large changes in fiscal policy: Taxes versus Spending. *The University of Chicago Press Journals*. 35-68.
- Ardagna, S. (2001). Fiscal policy composition, public debt and economic activity. *Public choice*. 109 (3). 301-325.
- Central Bank Annual Report (1950- 2020). Economic and Social Statistics of Sri Lanka, Published by Central Bank of Sri Lanka, <http://www.cbsl.gov.lk>.
- De Rato, R. (2004). Benefits of Fiscal Consolidation. *Remarks to the Real Academia de Doctores, Barcelona, Spain*.
- Mc Dermott, C.J., & Wescott, R, F., (1996). An empirical analysis of fiscal adjustment. IMF Paper. 4, 725-753.
- Sinha, P., Arora, V., & Bansal, V., (2011). Determinants of Public Debt for middle income and high income group countries using Panel Data regression. *Munich Personal RePEc Archive*, <https://mpira.ub.uni-muenchen.de/3207>.
- Thanabalasingam V., & Jothiratne G., S., (2021). Public debt, budget deficit and tax policy Reforms for fiscal consolidation in Sri Lanka: rationale and feasibility. *Sri*

Lanka Journal of Social Sciences, 44 (1), 97-109.
<https://dx.doi.org/10.4038/sljss.v44i1.7953>.