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**ECONOMIC ISSUES OF FISCAL POLICY IN SRI LANKA
(POST ECONOMIC LIBERALIZATION PROCESS)**

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ABSTRACT

Public budgeting based on the functional finance principle was introduced as a tool of crisis management in 1940s. Despite the existence of a viable public resource base, functional finance principle was transformed into formal system of public budgeting in Sri Lanka, aiming at achieving social and economic objectives of the Government. The re-introduction of neo-liberal economic policies in 1977 emphasized private sector as “engine of growth”. This led to re-thinking of fiscal discipline and its role in economic management. The doctrine of crowding - out effect in contrast to the Keynesian doctrine of socialization of investment says that deficit financing process displaces private investment and becomes an ineffective policy tool. In analytical terms, in addition to private investment, interest rate, exchange rate and inflation can also be used as variables to analyze the existence of crowding - out effect.

This study was designed to empirically analyze the presence of crowding - out effect in Sri Lanka during the period of 1978 to 2004 by using the Error Correction Model based upon Co-integration technique. The study supports that there is statistically significant evidence for the presence of crowding out effect in Sri Lanka. It existed in relation to private investment, general price level as represented by the Colombo consumer price index and nominal exchange rate while it did not evidence in the case of interest rate as represented by Treasury bill rate. Accordingly, empirical evidence for the presence of the traditional crowding - out says that persisting deficit financing displaces private investment. Thereby, hypothesis of the study is rejected and crowding - out effect of deficit financing emerges an economic issue of fiscal policy in Sri Lanka.

In the policy front, deficit financing does not conducive for pro private sector economic policy. It could be resulted at the patterns of government expenditure on social spending rather than economic spending, sources of deficit financing, corruption etc. In this context, the policy direction of government needs to comply with provisions of the Fiscal Responsibility Act, while rationalizing its expenditure on public service including defense, social spending and focusing towards pro private sector infrastructure facilities improving private economic participation.