Recent Trends of Public Sector and Financial Management in Sri Lanka

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Abstract

It is difficult to imagine a situation where there is no government. As the leader in an economy as well as the authority in charge of the State, government can contribute much towards economic development. If the government is not moving along a proper path of development, the results may be different. The gradually expanding public sector is an example of such an occasion. Derailed government can sometimes be corrected if citizens are familiar with the critical limit of the government in economic activity. The size of the government is increasing in some developed and developing countries. This undermines the role of the State in economic development. In the late 1970s Sri Lanka opened its economy and privatised many public ventures. This paper reviews the trends of the financial aspect and the size of the public sector in Sri Lanka. The paper compares government related variables such as expenditure, tax revenue, public debt and the number of public sector employees in Sri Lanka over time and with that of other countries in a given period of time. The paper concludes that in Sri Lanka, in spite of massive privatisation, the public sector is expanding. The critical variables, budget deficit and foreign debt are also increasing. However, the downward turning point has just originated. The citizens in a country ought to be made familiar with the fact that government is to provide goods with indivisible benefits and that government and the market are complementary and not substitutes. They should not always ask the government for more jobs. By introducing new taxes the government may increase income to narrow down the budget deficit.

Key words: cost of government; government expenditure; public debt, public goods

Introduction

Economic efficiency is a goal of an economic organization. In achieving this goal, it needs to be determined which is more efficient; market or government (collective institution). What government can and cannot

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do are two basic questions regarding the role of the government. The configuration of States[2] has varied widely across continents, but arguments over the proper roles of the public and private sectors have not. In early writings, Niccolo Machiavelli (*The Prince*), Kautilya (*Arthashatra*), Confucius' writings and Ibnkhaldoun (*The Muqaddimah*), the mutual rights and obligations of States and citizens have been reviewed. Almost all of them recognised a role for the State in providing public goods. According to modern understanding, government provides certain collective goods such as common defence, law and order, environmental protection, monetary stability, infrastructure and regulating measures. However, in practice, some other services such as transport are also provided by government in both developed and developing countries and as a result the size of the public sector is increasing. Examples include Australia as a developed country and both India and Sri Lanka as developing countries for provision of rail transport by the government. According to the critical-limit hypothesis postulated by Colin Clark (1945), when the share of the government sector exceeds 25 percent of total economic activity of the country, inflation occurs even under a balanced budget.

In some developing countries (i.e. South Asian, Pacific Islands and African economies), including Sri Lanka, there is yet to emerge a good understanding of the proper roles of the market and the government in development. They think that market and the government are substitutes, not complementary. In Sri Lanka, for example, some people dislike privatisation of public ventures incurring gigantic losses and running with low efficiency. Examples are the Ceylon Electricity Board and Sri Lanka Railways. In the meantime, people ask the government for more jobs. On the other hand, during the election campaigns politicians promise more jobs for electors and also promise not to privatise public ventures. This paper makes an attempt to clarify the role of the government and to examine the trends of public expenditure and related variables such as tax income and public debt. To achieve this objective, firstly, time series data on government expenditure, public debt, and tax income of the post independent economy of Sri Lanka will be analysed. Secondly, government expenditure in Sri Lanka will be compared with that in other selected developing and developed countries. These exercises enable one to understand changing patterns of the role of the government. The whole exercise reveals to the citizenry the burden of government activities on themselves. The paper consists of five sections. In the second section, the role of the government (or State) in economic development and the methods of providing public services are discussed. The third section explains the measures of government and the fourth

2 In this paper both State and government are considered same.

section reviews costs of government in different countries. The fourth section is devoted to reviewing taxation and borrowing as funding sources of government. Conclusions are presented in the last section.

Role of the State in economic development and public service provision

The World Bank (1997) suggests a two-pronged strategy to fulfil the role of the State. Under the first, the State is expected to: (a) establish a foundation of law; (b) maintain a non-distortionary policy environment including macroeconomic stability; (c) invest in basic social services (education and health) and infrastructure; (d) protect vulnerable sections of the population; and (e) protect the environment. Under the second, the State is associated with adopting effective rules and restraints (independent judiciary and restraining corruption), making competition sharper within government in the provision of public goods and services, and increasing citizen vigilance and partnership (democracy, participation, and devolution of power).

How can government provide its services? To reap the benefits of governing, citizens ought to be familiar with the concept of government. It is difficult to imagine a situation in which there is no government at all. Government is the means or process through which individuals provide themselves with certain goods and services that they decide to secure collectively rather than privately and individually. Government can provide public goods with indivisible benefits for users in two ways. The first is paying for public good provision and directly providing the goods or services. The second is to hire private firms with governmental funds to provide goods or services. The latter decision rests solely on efficiency grounds. However, in Sri Lanka, in the provision of public goods, the first method is always adopted. The second method can be applied fully or partly to many public provisions including education and health in the country.

How to measure government activity?

To assess government intervention it needs to measure the size of the government. Four separate indicators are used to measure the importance of governmental activity: (a) the value of governmental goods and services; (b) the real cost of governmental services; (c) the extent to which collectively made decisions replace private or individual decisions in the economy; and (d) the extent to which resources are organised by the market economy or by the governmental bureaucracy

(Buchanan and Flowers 1987:61). Before discussing the advantages and pitfalls associated with these measures, a caveat is in order. The most important one is that before measuring the real size of the government, care should be taken to take account of negative externalities created by the government (if any). No prices are directly set for public goods and services. As such, it is impossible to measure the value of public goods and services. Government expenditure is the *most satisfactory measure* of the real cost of public goods and services. It provides a helpful and readily available index of the direct economic importance of government, especially when used to compare various levels over short periods. Government expenditure also provides the public with some measure of year-to-year changes in the size of total government. When there is inflation, it is necessary to adjust with a price index. Per capita government expenditure can take account of changes in population. Thus, real government expenditure over time has been selected for the analysis.

Size of government and changing pattern of spending: some comparisons

Table 1 shows government expenditure in selected countries in relation to their respective GDP. The size of government varies from country to country. In many developed and developing countries, government expenditure is high and has increased over time. Finland, Belgium, Italy, Sweden, Hungary, Iceland, and Norway are developed countries with high levels and Switzerland, Singapore, are some other developed countries with comparatively low levels of government expenditure. In Sri Lanka, the proportion is relatively high when compared to other developing countries. Among the Asian countries, as well, Sri Lanka stands at a higher level, exceeding expenditures in Malaysia, Indonesia, India, Pakistan and Nepal.

Table 1
Government expenditure as a percentage of GDP, selected countries, selected years

Country	1999	2005	2012
Australia	24	22 (2002)	35
Belgium	18	19 (2004)	55
Croatia	33	40 (2002)	40
Finland	30	24	56
Hungary	44	44 (2004)	48
Iceland	28	30 (2004)	47
Italy	29	31	51
Norway	35	37 (2003)	42
Singapore	19	16	13
Sweden	31	27	50
Switzerland	10	10	33
Bolivia	29	10	25
Bulgaria	34	36	32
Colombia	19	21	28
Cyprus	34	41 (2003)	44
Czech Republic	28	31	45
Guatemala	14	12	n.a
Indonesia	20	19 (2004)	16
Nepal	16	15 (2003)	n.a
Pakistan	21	16	n.a
Sri Lanka	24	24	29a

Sources: Basic data – IMF, International Financial Statistics 2006 and 2014; IMF, Government Finance Statistics 2013 Central Bank of Sri Lanka, Annual Report 2013

With massive economic reforms in and after 1977 in Sri Lanka, attempts were made to reduce the size of the government. The economy was opened up for international trade, prices were liberalised and a number of government enterprises including road transport service, telecommunications, banks, insurance, textiles, cement, and steel production were transferred to the private sector. The private sector was encouraged to grow and the government began to work as a facilitator in the market. Government sought advice and financial support from the Washington Institutions. Government sought to provide national defence and national security, establish foundations of law, maintain a non-distortionary policy environment as far as possible, invest in infrastructure and basic social services (education, health, research), and protect the vulnerable sections and the environment respectively with social security measures and by enacting laws and establishing institutions such as the Central Environmental Authority.

Government provides some excludable goods such as houses, lands and land development, hydro-electric power, road and rail transport and intervenes in agriculture. Government is active in allocating resources as well as in stabilisation and redistribution functions. Government made an attempt to safeguard independence of the judiciary and reduce corruption and devolve its power. However, after the introduction of the open economy in 1977, government expenditure has been growing at an increasing rate. During the period 1977-2012 total real expenditure has increased more than five times (Appendix 1) and per capita expenditure has more than tripled (Appendix 2).

In some countries, government is used as a source of employment. Sri Lanka is no exception. Therefore, it is useful to analyse the level of public employment. Moreover, the number of public employees is a part of the second measure of the size of the government discussed earlier. In Sri Lanka, the size of the public sector as measured by the number of public servants has expanded, especially in recent years. For every 18 persons there was a public servant in Sri Lanka in the 1990s. This is higher than in many Asian countries (Table 2). By 2012, in Sri Lanka, the proportion of employees in the public sector went up to 15.4 percent, and for every 16 citizens, there was a public employee (CBSL 2014). In India, Pakistan, Indonesia, Singapore, Malaysia and Nepal both the number of public employees and government expenditure was less than in Sri Lanka. (Tables 1 and 2) Continuous recruitment to public institutions irrespective of staff requirements has inflated the public sector. In the late 1990s, the percentage of public sector employees in the labour force in Sri Lanka was greater than that in many countries in Asia. By 2008 also, the situation had desirably changed in some countries, but not in Sri Lanka (Appendix 3).

Table 2
Size of the public sector in selected Asian countries

Country	Workers in the public sector per 1000 population[b]	Proportion of government employees in the total labour force (%), 1996-97
Bangladesh	10	1.8
India	19	4.7
Pakistan	19	8.0
Indonesia	21	n.a
Philippines	23	n.a
Thailand	31	n.a
Singapore	37	n.a
Malaysia	45	n.a
Nepal	n.a	1.0
Sri Lanka	57	12.0
Thailand	52	8.6
Vietnam	48	8.2

Note: a. public sector includes public corporations and semi-government institutions.
b. Size of the public sector in each country is based on data for the 1990s.
Sources: Schiavo-Campo, S. (1997), "An International Statistical Survey of Government Employment and Wages", WPS 1806, the World Bank, Washington, D.C. and World Bank (2000), Sri Lanka: Recapturing Missed Opportunities, Report No. 20430-CE.

Table 3
Size of the public sector in selected Asian countries, 2008

Country	Proportion of employees in the public sector (%)	Employees in the public sector per 1000 population
Bangladesh[a]	4.5	15
Hong Kong	6.3	33
India[a]	n.a	17
Philippines	7.4	30
Thailand	8.6	52
Malaysia	12.2	57
Singapore	18.5	26
Sri Lanka	13.5	56
Vietnam	8.2	48

Notes: 1. a- In year 2005; 2. n.a – Not available; Sri Lanka excluding the Northern Province
Source: Based ILO data

Taxation versus borrowing

Government needs revenue to cover its expenditure. Taxation is its major source of income. Taxation is the normal way a government secures revenue to finance public services. Taxes are the 'prices' individuals pay for public activities. Thus, individuals acting through the elected representatives (political process) are subject to reductions in the real income of one kind (private goods) in order to be able to secure real income of another kind (public goods). As for government borrowing, it is essentially an alternative means of raising revenue to cover expenditure. It enables governments to finance public services without reducing the real wealth of private individuals while the funds are required. Borrowing as opposed to taxation does not characterize a coercion or compulsion. Private individuals purchase government securities, not as a result of compulsion, but in exchange for a government promise or obligation to provide them with future income.

Government spending through taxation deprives consumption of private goods and services by citizens during the period of tax collection. In contrast, issue of debt instruments does not impose any such real burden or cost on citizens during the period of spending. In Sri Lanka, government debt is very high in comparison with tax income and the gap between these two variables is also increasing. In recent years, foreign debt is being replaced with domestic debt (Appendix 3). The real cost of present public debt must be shouldered by the future individuals who pay taxes to service and amortize the debt obligations. Thus, borrowing postpones the real payment for public services until future periods. When budget deficit is created it can be financed by public debt and when the size of the budget deficit increases it can be financed by either real debt (borrowing money) or fake debt (money creation) or both. In a high-employment economy fake debt must be inflationary. The situation in an economy with excess capacity and large unemployment is different. Currency creation is positively desirable under certain conditions. Unless bottlenecks and rigidities make prices rise before an acceptable level of employment is attained, an increase in the supply of money should increase real income and employment without inflation. When substantial excess capacity and unemployment exist but a general increase in aggregate demand leads to inflation, money creation will, of course, resemble taxation.

When should government borrow is the next question. The answer depends on the economy's situation – full employment or unemployment. In the case of unemployment, suppose the economy is characterized by substantial excess capacity. Then an increase in total demand will have little or no effect on the level of prices but will increase production and employment. Therefore, the government can increase money in such a situation. No taxation or real borrowing should take place. The great advantage of direct money creation is the absence of interest cost. It does not place a burden on future taxpayers too. When the economy is characterised by both underemployment and pressure on prices, the same conclusions hold. Here, there is a basic conflict between full employment and monetary stability. If the full employment objective is promoted, budget deficit should be financed by direct money creation (Buchanan and Flowers 1987:287-288). Deficits should not be financed with real borrowings which reduces current purchasing power that the deficits are designed to increase. The Sri Lankan economy belongs to this group. It is characterized by underemployment and inflation bubbles at the same time. The budget deficit is financed by both real borrowings and money creation. Real borrowing is increasing. In 2005, total borrowing by the Sri Lankan government stood at 94 percent of country's GDP. But this percentage was lower than 81 percent or less during the early years up to 1985. In recent years, government borrowing has been increasing. Also, in 2004, expansionary impact of fiscal operation (bank borrowing) was Rs. 43,290/= million which represents 27 percent of net cash budget deficit of the country. In 2008, these figures have risen up to Rs. 195,233 million and 60 percent respectively. However, by 2011 the figure has slightly decreased to Rs.191, 850 (Central Bank Annual Report).

In the open economy, budget deficit is gradually increasing in absolute terms (Appendix 4). In 2003, the Sri Lankan government passed the Fiscal Management (Responsibility) Act No 3. This Act contains seven objectives. The first is to reduce budget deficit which results in increase in government expenditure at a higher rate than that of revenue, to at least five percent by end of 2006. Even though the budget deficit has risen up to 23 percent of GDP in 1980, in later years, it came down. However, in 2003 it was eight percent and after that the rate increased. For example, it went up to 9.8 in 2009 and in 2011 and 2012 it was 15 percent. Thus, the objectives of the above Act seem impossible to be achieved. By another objective of the said Act, the government was expected to ensure that at the end of the financial year 2006 the total liabilities of the government (both the domestic and foreign) do not exceed 85 percent of GDP. This objective has also not been achieved. When someone sees the data of 2006 and 2009, they stand respectively at 88 and 86 percent of GDP. However, by 2011 and 2012 the said objective has been achieved by decreasing the proportion of public debt in GDP to 79 percent. Also, government debt has been steeply increasing in recent years (Appendix 3).

Conclusion

An economy requires a government to provide people with collectively consumed goods. In developing countries, understanding the difference between the roles of the market and the government is essential in the quest for rapid development. In other words, both the government and its residents need to know what the former should do. Government is essential for facilitating the role of the market. Hence, the government and the market are complementary, not substitutes. This points to the limits of government intervention in economic development and the need to make residents of a country familiar with costs of government, taxes and government debt.

However, in many countries, whether developing or developed, the size of the government has been increasing with time. In some other countries, the size of government is small, allowing the market to grow.

In Sri Lanka, the size of government in terms of both expenditure and the number of employees has increased in spite of massive privatisation of public ventures. Government expenditure increased rapidly in the liberalized economy introduced in 1977. According to the critical-limit hypothesis postulated by Colin Clark (1945), when the share of the government sector exceeds 25 percent of total economic activity of the country, inflation occurs even under the balanced budget. Sri Lanka has reached this critical limit (Table 1) and its public expenditure and budget deficit are ever increasing. It is now, therefore, the time to contract government intervention. On efficiency grounds, even though the public services can be provided through private agents, in Sri Lanka, the number of government employees has grown rapidly. Government functions as a source of employment. Growth of employees partially accounts for ever increasing government expenditure. Furthermore, the government continues to provide some services with divisible benefits and some others with both divisible and indivisible benefits (quasi-public goods). The Ceylon Electricity Board and Sri Lanka Railways are the striking examples for the first and school education falls into the second.

In the attempts to contract the budget deficit, government can impose new taxes to expand its revenue. For instance, government can impose a tax on domestic animals (i.e. dogs). It may be a solution to control rabies too. Fines for drivers who violate road rules can be increased. Fines for crime can be increased and new laws may be enforced to pay such fines by instalments. It may be a solution to decrease conversion of fines into imprisonment. These are some possible means for the government to increase its tax income.

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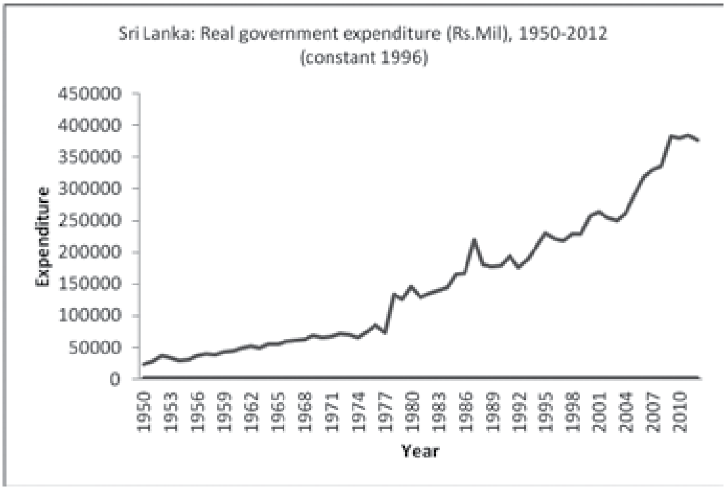
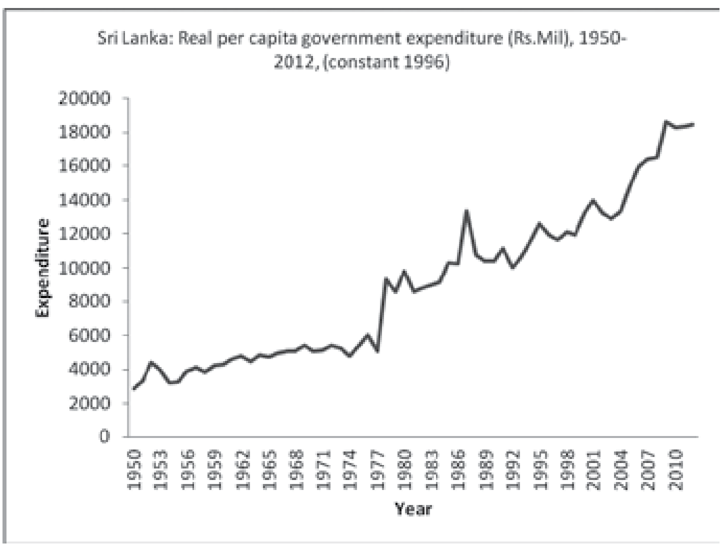
Appendix 1



Source: Basic data - Central Bank Annual Report

Appendix 2



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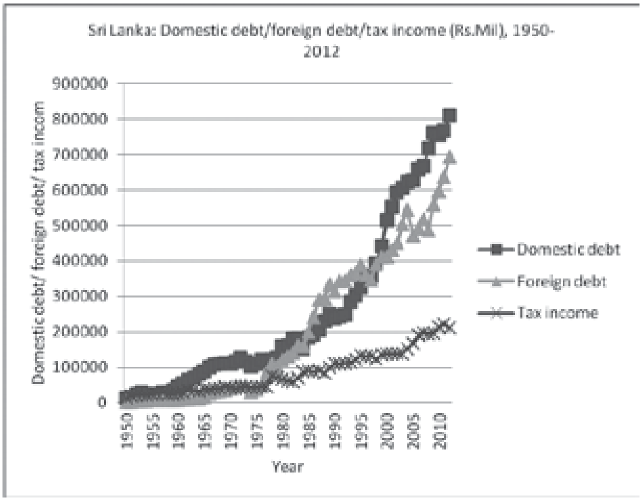
Appendix 3



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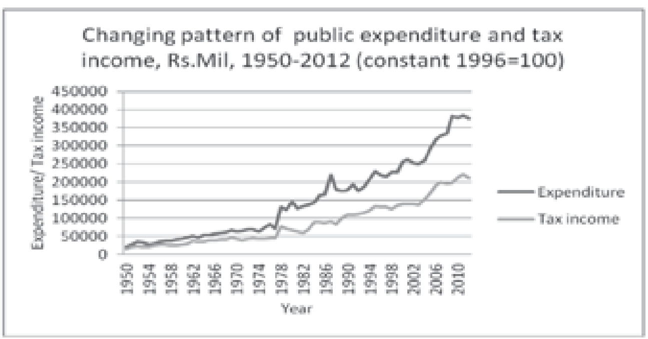
Appendix 4



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