

## Fiscal Policy and Aid in Sri Lanka

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The main objective of this paper is to investigate the controversial issue - how government fiscal policy can be designed to ensure the efficient use of aid money. This matter is of high importance mainly for three reasons. Firstly, foreign aid flows are the main source of external finance in many developing countries and thus a key element in fiscal policy. According to the recent evidence, foreign aid has more significant impact than borrowing in the economy of the least developed or low-income countries. Secondly, aid is limited. Therefore in order to maximise the benefit the recipient country not only should establish affective management aid system avoiding corruption and mismanagement, but also should design aggregate fiscal policy by taking into account the macroeconomic implication of aid financed spending. Both these will also help convince donors that their money is well-spent. Thirdly, and more significantly, the recent criticism among the recipient economies about the 'good governance and leadership' requirement imposed by the donor agencies such as IMF and World Bank has made the topic more sensitive and debatable. The paper investigates all these highly contentious issues, besides suggesting the most efficient fiscal policy model for aid-effectiveness with special attention to fungibility and fiscal response studies. The empirical case study is based on Sri Lanka - one of the highest aid recipient countries in the world.

Before embarking on econometric analysis, the paper discusses the movements in the fiscal aggregates of Sri Lanka in recent years and the political economy background of the fiscal policy. Broadly, it reflects that Sri Lanka found itself in the midst of the increasing debt burden and faltering growth and worsening macroeconomic management, despite a fairly good period of economic stability in the late 80s and early 90s. The econometric results are obtained using PC Give, Microfit and E-Views on time series data from Sri Lanka 1970-2001. The results show that effects of fiscal policy are complex and varied, but aid tends to be associated with a rise in government spending and increases welfare. Aid does increase total expenditure. Tax revenue seems to fall as aid increases. Even though this finding is not so desirable for Sri Lanka, since expanding the tax base is the effective way of financing expenditure and reduce debt. There is high positive correlation between aid and capital expenditure. The findings of the paper reflects that for a sustained fiscal policy that ensures the best channel for aid money, Sri Lanka needs to reduce government expenditure and expand tax base. Another crucial issue is that achieving peace would obviously be beneficial as defence spending would fall, aid may be increased and it would spur growth and therefore, expand tax base.

Key Words: Fiscal Policy; Aid; Government; Sri Lanka; Expenditure

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