AN EMPIRICAL RELATIONSHIP AMONG TAX REVENUE, NON-TAX REVENUE, GRANTS, EXPENDITURES AND ECONOMIC GROWTH IN SRI LANKA : *An analysis of Co-integration and Causality*

Original Research Article

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ABSTRACT

This research article analyzed the objective of statistically finding the empirical relationship among tax revenue, non-tax revenue, grants, expenditures and economic growth in Sri Lankan context. The annual time series data used in this study were gathered from Annual Report of Central Bank of Sri Lanka for the time period of 1950 to 2014. Stability test, residual test for testing the best regression model, Johansen co-integration technique to test the long run relationship, Augmented Dickey Fuller (ADF) for unit root test, and Granger causality test for causal relationships between all the variables were the econometric technical process being used to achieve the objective of this study. It was found that ere was a direct association ship between the dependent and some of the independent variables. The R-squared of the regression model was higher than 0.9. Most of the variables were stationary at the level form I(0). It was found that there were the different types of causal relationships between all the variables. The long run relationship between all variables was identified through co-integration test.

Keywords:

Tax Revenue,
Economic Growth,
Grants,
Co-integration,
Causality

I. INTRODUCTION

A system according to which public revenue and public expenditure are managed is called fiscal system. It tells how a government receives its income (revenue) and how it spends. The system works through the government budget which presents statements of government revenue including tax receipts and government expenditure. And also fiscal policy is policy to influence economic activities through the medium of budget. As it is through budget that details of public revenue and public expenditure are presented, therefore, fiscal policy is referred to as a policy under which the government uses its expenditure and revenue programmes to produce desirable effects and avoid undesirable effects on national income, output and employment (Kapur, 2006). The policies that affect the level of government expenditures and taxes are known as fiscal policies and the term 'fiscal' means government taxation, spending, or financial matters (Shyamala Krishnamurthy, 2007). Thus, the overall fiscal operations of government briefly delineate the regularization of the revenue collection and the expenditures of the government.

The Organization for Economic Co-operation and Development (OECD) admits: Taxes and government expenditures affect growth both directly and indirectly through investment. An increase of about one percentage in the tax pressure can be associated with a direct reduction of about 0.3 per cent in output per capita. If the investment effect is taken into account, the overall reduction will be about 0.6–0.7 per cent (Daniel J. Mitchell, 2005). The role of fiscal policy on economic growth has led to several studies both on the theoretical and empirical framework. Modern macroeconomic literature emphasizes both the short-run and the long-run objectives of fiscal policy. In the short run it can be used to counter output cyclicality and/or stabilize volatility in macroeconomic variables. For the long-run, fiscal policy and the debt financing methods can also affect both demand and supply side of the economy. The subject on the effects of fiscal policy on economic growth is quite appropriate because the development of appropriate the instruments of fiscal policy can lead to a persistent and sustainable improvement on economic growth.

The policy of the government on fiscal operation continued in 2014 in Sri Lanka, with measures to address concerns over both revenue and expenditure aspects, while supporting economic growth. The focus of the fiscal policy in 2014 was to reduce the budget deficit to 5.2 per cent of GDP, while supporting economic growth. Accordingly, total government revenue, as a percentage of GDP, declined to 12.2 per cent in 2014 from 13.1 per cent in the previous year, while tax revenue as a percentage of GDP declined significantly to 10.7 per cent from 11.6 per cent in 2013. Non tax revenue as a percentage of GDP remained unchanged at 1.5 per cent. However, total revenue in nominal terms, increased by 5.1 per cent to Rs. 1,195.2 billion in 2014 from Rs. 1,137.4 billion in 2013. Further, total government revenue in 2014 was considerably below the expected level of Rs. 1,437.5 billion in the Budget for 2014. The declining trend of tax revenue to GDP ratio continued in 2014 as well, where it dropped from 11.6 per cent in 2013 to 10.7 per cent in 2014 (Central Bank of Sri Lanka, 2014).

The decline in total expenditure and net lending was a combined outcome of the reduction in recurrent expenditure by 0.4 percentage to 13.5 per cent of GDP and capital expenditure and net lending by 0.6 percentage to 4.8 per cent of GDP. Total grants received during the year declined to Rs. 9.4 billion in 2014 from Rs. 15.9 billion in 2013 but economic growth increased in 2014 from 6.3 in 2012 and 7.2 in 2013 (Central Bank of Sri Lanka, 2014).

II. LITERATURE REVIEW

The following pre-literatures are reviewed in connection with this study. Around all these studies are from international arena. In Sri Lanka, this sort of study is not circulated from the academicians/researchers up to now to the pursuit of our study.

Ayako Kondo and Justin Svec (2010) explored differences in the rigidity of balanced budget rules across US states to estimate the impact of the cyclicality of fiscal policy on GDP growth of US using cross section growth regression method by collecting the data of the variables such as state and local total expenditures, the primary deficit, current operations, capital outlays, total debt, and intergovernmental transfers. They found evidence that a more counter-cyclical primary deficit increased the average growth rate per capita of a state.

Gerti Shijaku and Arlind Gjokuta (2013) analyzed the impacts of fiscal policy on the economic growth in a small open developing country, Albania, by employing an endogenous growth model on a GMM approach. They found that those government revenue policies had a higher effect on economic growth than those on government expenditure.

Arindam Das-Gupta (2014) developed a conceptual framework to estimate the growth and distribution effects of fiscal resources such as debt, other capital receipts, foreign aid and other unilateral grants, non-tax revenue, including resource rents, seigniorage, and taxes in developing Asia. His analysis suggested that so as to expand the relatively low fiscal resource bases, developing Asian economies needed to pay greater attention to non-tax revenue and to taxes other than broad-based taxes on income and consumption, such as property taxes and corrective taxes.

Vincent N. Ezeabasili, et. at, (2012), examined the controversial relationship between fiscal deficits and economic growth within the Nigerian context, using data over the period, 1970 – 2006 by employing a modeling technique of cointegration and structural analysis. They found that (i) fiscal deficit affected economic growth negatively, with an adjustment lag in the system; (ii) a one percent increase in fiscal deficit was capable of diminishing economic growth by about 0.023 percent; and (iii) there was a strong negative associationship between government consumption expenditure and economic growth.

Aloysius Ajab Amin (1998) Cameroon has experienced periods of economic growth and decline. During the growth period public expenditures increased the size of the public sector. The decline period, which started in 1986, has been characterized by government expenditures that outstripped revenues. The government's recovery programme has meant drastic reduction in public expenditures and desperate efforts to raise revenue. Since the programme started, Cameroon's key macroeconomic indicators of performance have continued to show adverse trends. There are few single country studies relating government budget to growth through private investment. More so nothing has been done on Cameroon. This study analyzes the relationship between public and private investment, stressing the crowding in or crowding out of private investment by public expenditures. Based on secondary data from the public sector, the results of a growth model show that the relevant factors have positive effects on growth while those of the investment model show the crowding in of infrastructures and social sector. The study concludes by recommending the reallocation of more resources to productive sectors and increasing and sustaining of spending on those productive sectors or those components of public expenditures that crowd in the private sector.

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Daniel J. Mitchell (2005) evaluated the effect of government spending on economic performance in America using the theoretical arguments, reviews of the international evidence, highlights of the latest academic research, cites of examples of countries. He concluded that a large and growing government was not conducive to better economic performance and reducing the size of government led to higher incomes and improved the competitiveness of America.

Abu Maji and Joseph Oboba Achegbulu (2012) investigated the effect of deficits of fiscal operations on economic growth in Nigeria in 1970 – 2009 using OLS technique to test the type of relationship between the variables. They found that deficits of fiscal operations positively affected economic growth in Nigeria and money supply was significant in explaining economic growth (GDP) variation in Nigeria.

Ekanayake assessed the debt sustainability in Sri Lanka using Structural Vector Auto Regression Model (SVAR) so as to project endogenous variables related to debt dynamic and to estimate the joint dynamic impact of structural shocks on the variables that affect the debt level. He identified the key fiscal and macro economic variables such as the real interest rate, the exchange rate and economic growth rate. He concluded with the result that incorporated in to a debt dynamic equation to project the debt to GDP ratio and to measure the combined impact of shocks to the level of debt and the fiscal effort required to maintain the debt to GDP ratio at the projected levels.

From the above literatures, it is found that no previous studies are directly connected with this title of study and especially in Sri Lankan context, there is no such sort of studies connected to this study even in descriptive analysis.

III. OBJECTIVE OF THE STUDY

1. To statistically and empirically measure the dynamic contribution of fiscal operations of government on economic growth of Sri Lanka.

Sub objective

a. To direct the policy makers to appropriately and empirically indentify the contribution of fiscal operations of government on economic growth of Sri Lanka.

IV. METHODOLOGY

The quantitative approach is used in this study to fulfill the objectives of this study. Real gross domestic product, government tax revenue collection, government non-tax revenue collection, government expenditure and dummy are used in this study as variables. Real gross domestic product is used as the dependant variable. Other variables are used in this study as independent variables. Du is used as dummy variable which consists of two binaries, 0 and 1. 0 stands for the period before the open economic situation in Sri Lanka and 1 stands for the period after the open economic situation in Sri Lanka. The annual data for the period from 1950 to 2014 of fiscal operations in Sri Lanka are used in this study. The appropriate data used in this study are collected from Annual Report of Central Bank of Sri Lanka (CBSL) from the period of 1950 – 2014. The variables are transformed into the Natural Logarithms to measure the percentage changes in the model. Accordingly, the model is fitted as follows:

$$Y = f\,(GRA, TAX, NTAX, EXPN, DU) \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots \quad (1)$$

$$\ln RGDP_t = \pi_0 + \pi_1 \ln GRAt + \pi_2 \ln TAXt + \pi_3 \ln NTAX_t + \pi_4\, EXPN_t + \pi_5 DU_t + \varepsilon_t \ldots\ldots\ldots (2)$$

Where,

ln*RGDP* = Natural logarithm of Real Gross Domestic Product and proxy for economic growth
ln*GRA* = Natural logarithm of grants
ln*TAX* = Natural logarithm of tax revenue collection
ln*NTAX* = Natural logarithm of non-tax revenue collection
ln*EXPN* = Natural logarithm of total expenditure
ln*DU* = Dummy variable
ε = The error term with the conventional statistical prosperities
$\pi_0, \pi_1, \pi_2, \pi_3, \pi_4, \pi_5,$ = Coefficients of the model

The stationarity of each time series data of the variables is first tested using Augmented Dickey-Fuller (ADF) in the methodology of this study. Stationarity means that mean and variance of a time series data don't vary systematically over time period (Damordar N. Gujarati, 2005, 26). Johansen Cointegration test is performed to identify the existence of the long run equilibrium relationship between the variables (Jeffry 2005). Error correction mechanism is used to find the short run equilibrium relationship and Granger Causality test is performed in this study to find the causal relationship between the fiscal operations and economic growth. OLS (Ordinary Least Square method) is used to run the regression model. The data analyses are executed with the use of E-Views, Minitab and Excel statistical software.

V. EMPIRICAL RESULTS AND FININGS

Unit Root test (Augmented Dickey Fuller Test):
Under the unit root test the stationarity of variables are tested. If a time series data is found as non-stationary, all the regression results are suffering from the problem of spuriousness/nonsense/meaninglessness. Therefore, the regression results may lead to incorrect conclusion and findings. It may be leading to meaningless and biased results. The results of Augmented Dickey Fuller test are shown in the following table (Table - 1).

Table – 1: The results of ADF test

Variable	ADF test	Intercept/ constant		Trend and Intercept		None/Neither intercept nor trend		Overall Decision
		Test statistic value	Test Critical Value (5%)	Test statistic value	Test Critical Value (5%)	Test statistic value	Test Critical Value (5%)	
RGDP	Data Level	8.38	2.92	1.25	3.51	12.51	1.94	Can't not be decided
	First Difference	1.29	2.93	5.94	3.51	0.24	1.94	Can't not be decided
	2nd Difference	6.54	2.93	6.55	3.52	10.51	1.94	Stationary
GRA	Data Level	1.44	2.91	2.64	3.48	0.84	1.94	Non- Stationarity
	First Difference	7.45	2.91	6.29	3.49	7.47	1.94	Stationarity
TAX	Data Level	10.49	2.91	8.85	3.49	10.98	1.94	Stationarity
NTAX	Data Level	7.51	2.91	7.32	3.49	7.49	1.94	Stationarity
EXPN	Data Level	7.26	2.91	7.19	3.49	7.15	1.94	Stationarity

At the second difference, RGDP is perfectly stationary and GRA is stationary at the first difference. All other variables are stationary at its level form 1(0). Most of the independent variables used in this study are free from the problem of spuriousness at their data level by fulfilling all the three conditions in testing the stationarity of the time series data because the value of test statistic is greater than test critical value at all the conditions. Only RGDP and GRA are stationary at their differences. As a result, this model becomes meaningful at different level to test the relationship between the variables used in this study.

Regression results:

Table - 2: Regression results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1.923133	0.437347	4.397273	0.0001
LOG(EXPN)	0.298470	0.407570	0.732316	0.4685
LOG(GRA)	-0.029734	0.065455	-0.454271	0.6522
LOG(NTAX)	0.107404	0.121049	0.887282	0.3805
LOG(TAX)	0.565533	0.411422	1.374579	0.1773
DU	0.335244	0.187583	1.787172	0.0819
R-squared	0.988248	Mean dependent var		12.55725
Adjusted R-squared	0.986702	S.D. dependent var		1.836147
S.E. of regression	0.211742	Akaike info criterion		-0.140768
Sum squared resid	1.703725	Schwarz criterion		0.102531
Log likelihood	9.096896	Hannan-Quinn criter.		-0.050541
F-statistic	639.0916	Durbin-Watson stat		0.841835
Prob(F-statistic)	0.000000			

The value of R-squared is 0.988248 (98.82 percent). This value is more than 60 percent. It means inside variables/factors can influence the dependant variable (RGDP) by 98.82% and the dependant variable can be influenced only by 1.18% of not good fitted variables. Therefore, it means the model is nicely fitted or the data used in this model is nicely fitted. The Adjusted R-squared is also very higher. The value of F-statistic is 639.0916 and corresponding probability value is less than 5% respectively. As a result, there is no serial correlation. Therefore, all the variables are prominent to explain the model. It means all the independent variables can jointly influence the dependant variable.

The estimated model is given below:

$$\ln RGDP_t = \pi_0 + \pi_1 \ln GRAt + \pi_2 \ln TAXt + \pi_3 \ln NTAX_t + \pi_4\, EXPN_t + \pi_5 DU_t + \varepsilon_t$$

$$log(\text{RGDP}) = 1.92 - 0.029 log(\text{GRA}) + 0.56 log(\text{TAX}) + 0.10 log(\text{NTAX}) + 0.29 log(\text{EXPN}) + 0.33\text{DU}$$

The estimated coefficient of GRA (Grants) is negative (– 0.029) which indicates that 1% change of increase in GRA lowers RGDP (Real Gross Domestic Product) only by around 0.029% and TAX (tax revenue) increases RGDP by 0.56%. 1% increase in NTAX (non-tax revenue) increases RGDP by around 0.10% and EXPN (expenditure) increases RGDP by around 0.29. Thus, TAX (tax revenue) is mostly significant in contributing for economic growth in Sri Lanka. In the meantime, only GRA is inversely related with RGDP. As a result, this component of fiscal operation in Sri Lankan context is insignificant in determining economic growth in Sri Lanka.

Residual Test:

Serial correlation test:

Table – 3: Breusch-Godfrey Serial Correlation LM Test:			
F-statistic	1.976857	Prob. F(17,21)	0.0698
Obs*R-squared	27.07896	Prob. Chi-Square(17)	0.0569

Corresponding probability value (Chi-Square – 17 lags) of Observed R-squared is 5.69% which is more than five percents and the value of F-Statistic is 6.98% which is more than five percent. Thus, the residual is not serially correlated after the certain level of lag period. The null hypothesis of 'the residual is not serially correlated" is accepted because the corresponding probability value is more than five percent after the adjustment of lags.

Heteroscedasticity test:

Table – 4: Heteroskedasticity Test: Breusch-Pagan-Godfrey			
F-statistic	2.306378	Prob. F(5,38)	0.0633
Obs*R-squared	10.24397	Prob. Chi-Square(5)	0.0686
Scaled explained SS	5.382855	Prob. Chi-Square(5)	0.3710

Corresponding probability value of Observed R-squared is 6.86% which is more than five percents and the value of F-Statistic is 6.33% which is more than five percent. Thus, the residual is not heteroscedastic. Therefore it is homoscedastic. A critical assumption of the classical linear regression model is that the disturbances u_i (residual) have all the same variances, □□. If this assumption is not satisfied, there is heteroscedasticiy. In the presence of heteroscedasticiy, the variances of OLS estimators are not provided by the usual OLS formulas. But if the usual OLS formulas are used, the *t* and *F* tests based on them can be highly misleading, resulting in erroneous conclusions.

Johansen Cointegration test:

To test the cointegration of the variables and long run relationship/associationship of the model/variables, Johansen Cointegration test is used. The results of the Johansen Cointegration test are described in the following table (Table - 02).

Table – 5: Unrestricted Cointegration Rank Test (Trace)				
Hypothesized		Trace	0.05	
No. of CE(s)	Eigenvalue	Statistic	Critical Value	Prob.**
None *	0.827460	178.5102	69.81889	0.0000
At most 1 *	0.780978	106.4679	47.85613	0.0000

Table – 6: Unrestricted Cointegration Rank Test (Maximum Eigenvalue)				
Hypothesized		Max-Eigen	0.05	
No. of CE(s)	Eigenvalue	Statistic	Critical Value	Prob.**
None *	0.827460	72.04226	33.87687	0.0000
At most 1 *	0.780978	62.26195	27.58434	0.0000

Table – 7: Result of Johansen Cointegration test				
Hypothesis	**statistic**	**Critical value 0.05**	**P-Value**	**Decision/results**
Variables not cointegrated	178.5102 (Trace)	69.81889	0.0000	Variables are cointergrated. Therefore all the variables are having long run relationship/associationship/eventually move together in the long run.
Variables not cointegrated	72.04226 (Max-Eigen)	33.87687	0.0000	Variables are cointergrated. Therefore all the variables are having long run relationship/associationship/eventually move together in the long run.

From the Johansen Cointergation test, all the variables are having long run relationship and eventually moving together ensuring the close relationship between the variables, i.e, between the endogenous and exogenous variables. Trace test indicates that there is cointergration between the variables at 5% level. It means there is one cointergrated equation at 5% level. And also the value of Maximum Eigen is greater than Critical value. Therefore, according to the Max-Eigen test, all the variables are connected to the long run associationship or long run equilibrium relationship.

GRANGER CAUSALITY TEST

THIS MODEL (EX. CONSISTING OF TWO VARIABLES) IS ESTIMATED AS FOLLOWS:

$$RGDP1t = \alpha + \sum_{j=1}^{k} \beta\, jRGDPt - j + \sum_{j=1}^{k} \gamma j\, BRAt - j + u1t \ldots\ldots\ldots\ldots\ldots (3)$$

$$BRAt = \alpha' + \sum_{j=1}^{k} \theta\, jRGDPt - j + \sum_{j=1}^{k} \gamma j\, BRAt - j + u2t \ldots\ldots\ldots\ldots\ldots (4)$$

TABLE – 8: PAIRWISE GRANGER CAUSALITY TESTS

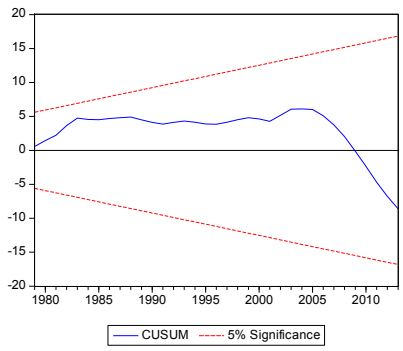
NULL HYPOTHESIS:	F-STATISTIC	PROB.
RGDP DOES NOT GRANGER CAUSE EXPN	9.16587	0.0006
RGDP DOES NOT GRANGER CAUSE TAX	10.0398	0.0003
NTAX DOES NOT GRANGER CAUSE EXPN	3.88048	0.0263
EXPN DOES NOT GRANGER CAUSE TAX	10.1150	0.0002
GRA DOES NOT GRANGER CAUSE NTAX	6.64216	0.0026
TAX DOES NOT GRANGER CAUSE GRA	6.03555	0.0043
GRA DOES NOT GRANGER CAUSE TAX	6.50973	0.0029
NTAX DOES NOT GRANGER CAUSE TAX	5.27611	0.0079

RGDP causes EXPN and RGDP causes TAX. EXPN causes TAX and GRA causes NTAX. GRA causes TAX and NTAX causes TAX. TAX causes GRA. Accordingly, all the Null Hypotheses cannot be accepted at five percent level because the corresponding probability values are less than five percent. Further, there is a two way causal relationship between GRA and TAX. Another causal relationship is statistically unidirectional between RGDP and EXPN and TAX at 5% level.

Validity of the estimated model

CUSUM approach of test is used to ensure the validity of this estimated model. The shape of CUSUM is shown below:

Figure - 1: Shape of CUSUM



As per the above diagram, within 5% significant level, this estimated model is located. As a result, the validity of this model is perfectly ensured from this test of stability.

VI. CONCLUSIONS

The main objective of this study is to statistically and empirically measure the dynamic contribution of fiscal operations of government on economic growth of Sri Lanka and to direct the policy makers to appropriately and empirically identify the contribution of fiscal operations of government on economic growth of Sri Lanka. It is found from the statistical results that the components of fiscal operations such as tax revenue collection, non-tax revenue collection and government expenditure are directly related to Real Gross Domestic Production other than the grant which is inversely connected to the dependant variables. The contribution of tax revenue collection compared with non-tax revenue and expenditure is greater in influencing the dependant variable, Real Gross Domestic Production in Sri Lankan context. Most of the variables are stationary at their level form I(0). Thus, the model is free from the problem of spuriousness. All the variables are having the long run equilibrium associationship to determine economic growth in Sri Lanka. The results of the Granger Causality test show that there is a two way causal relationship between the grant and tax revenue collection. Another causal relationship is statistically unidirectional between Real Gross Domestic Production and expenditure and tax revenue collection. The overall validity of the model is ensured through CUSUM.

VII. RECOMMENDATIONS

The policy makers and the government in Sri Lanka should be vigilant about the components of fiscal operations which are paving the way to economic growth in the varied magnitude. One of the significant components of fiscal operations is tax revenue collection to boost the economic growth/development of Sri Lanka along with non-tax revenue collection. As such, it should be taken into their account while designing policies in promoting economy of Sri Lanka. It is vividly evident that grant is inversely related to the economic growth. Thus, this variable especially must be taken into consideration in verifying the effects of the grant on economic growth in Sri Lankan context.

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