

Impact of Fiscal Policy on Balance of Payments: Evidence from Sri Lanka

P. Anusha*

Department of Economics and Statistics, Faculty of Arts, University of Peradeniya, Sri Lanka

**pathmakanthananusha94@gmail.com*

Every economic system, irrespective of its political arrangement has to identify its economic goals such as full employment, adequate economic growth, price stability and equilibrium in the Balance of Payments (BOP). These goals are usually achieved through the formulation and implementation of economic policies, especially fiscal policy. One of the major economic policies that every economy uses is the fiscal policy to maintain a healthy BOP to safeguard the external value of the national currency. Currently, Sri Lanka faces a BOP crisis. Thus, this study tested whether fiscal policy measures were adaptable variables to remove this imbalance BOP situation in the country. Moreover, the theoretical underpinning of the fiscal approach to the BOP was developed by Alexander (1952). The data on BOP, tax revenue (TAX), government expenditure (GEXP), gross fixed capital formation (INVE), government total revenue (INCO) and real gross domestic product growth (GDP) were collected from the Central Bank of Sri Lanka and World Development Indicator database of the World Bank using annual data of Sri Lanka from 1991 to 2021. The ADF and PP unit root tests confirmed that none of the variables are I (2). This allows us to examine the relationship between them using Auto Regressive Distributed Lag (ARDL) Bound testing method. AIC criterion is suggested to employ ARDL (2,2,1,0,2,0) model as the best model among the top 20 models. The Bound testing results detected the co-integrating relationship between the variables under consideration in this research. The bound test suggested that taxation has a negative and statistically significant impact on BOP in the long run. The error correction version of the ARDL model found that the government's total revenue has a positive impact on BOP while taxation has a significant negative impact on BOP in the short run. Finally, Granger Causality test detected only unidirectional causality that stemmed from TAX to BOP, INVE to BOP and INCO to BOP at the 10 % significant level. This study concluded that fiscal policy has a meaningful effect on Sri Lanka's balance of payments during the period of study. This means fiscal policy is effective in attaining a satisfactory balance of payments in the country. In sum, the government of Sri Lanka should take necessary action to reduce taxation and increase the non-taxation revenue to bring the surplus of BOP and the economy well off.

Keywords: Fiscal policy, Balance of payments, ARDL Model, Sri Lanka