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Does Sri Lanka Need More Rules or Better Compliance?

The government of Sri Lanka proposed introducing a new law to establish stronger rules on public finance management. The analysis shows that the core weakness in Sri Lanka is not the lack of rules but the lack of compliance. To be effective, any new law will need to contend with this problem of governance.

A proposal to introduce legislation in the form of a new Public Finance Management Act (PFM Act) was announced in the amendment to the 2022 budget (interim budget 2022). The proposal was intended to introduce stronger fiscal rules.

The idea behind this announcement is that Sri Lanka's current macroeconomic crisis is due, in part, to the lack of adequate fiscal rules. The analysis of this Insight suggests that, rather than the lack of fiscal rules itself, the more critical problem for Sri Lanka at present, may be the lack of compliance with fiscal rules in public finance management.

In 2003, Sri Lanka had the same

diagnosis: that macroeconomic stability required a better system of fiscal rules. This led to the adoption of the Fiscal Management (Responsibility) Act. By passing this Act, Sri Lanka adopted a set of fiscal limits, and a pathway for those limits, on the budget deficit, treasury guarantees and central government debt.

This insight shows that the benefit of having fiscal rules is undermined by a deep-seated governance problem in Sri Lanka: it is the problem of ensuring compliance. The parliament of Sri Lanka has consistently reneged on rules set out in the Fiscal Management (Responsibility) Act either by blatantly breaching them or by amending the rule whenever it became a constraint.

18

No. of years deficit limit was breached (2003-23)

5

No. of years treasury guarantees limit was breached (2005-22)

8

No. of years borrowing limit was breached (2006-21)

Introducing the Fiscal Management (Responsibility) Act

The Fiscal Management (Responsibility) Act, No. 3 of 2003 (FMRA) was adopted to entrench principles of responsible fiscal management and to facilitate greater public scrutiny of fiscal policy.

In pursuit of these objectives, the FMRA instituted some fiscal rules. These rules set out annual limits and a path for (1) the budgeted deficit, (2) central government debt and (3) treasury guarantees. This insight provides an analysis of compliance with these fiscal rules of the FMRA.

Rule 1: budget deficit limit – a dead letter

A budget deficit is an amount by which government expenditure exceeds its revenue in a given fiscal year.

In order to reduce government debt to prudent levels, the FMRA, in sec 3(a), introduced a rule limiting the budget deficit to 5% of the estimated GDP.

Since adopting the FMRA, the actual budget deficit of the government has consistently violated this rule that was adopted by law (Exhibit 1). That is, neither the parliament nor the Ministry of Finance ensured compliance with this rule instituted by the FMRA. In the 20-years since adopting the law, there were only four years in which the budget deficit approved by parliament fell within the 5% rule. But that too was not complied with in implementation of the budget. That is, the budget deficit limit set by the FMRA law has been reduced to a dead letter.

Rule 2: central government debt limit – changing the goal post

The FMRA, in sec 3(f), adopts a second rule with regard to the total liabilities of the government. Total liabilities, the law clarifies, refers to Sri Lanka's total debt obligations including domestic and foreign debt at the current exchange rate. The rule set out an immediate limit for the total debt obligations of the government, as well as a future pathway for reducing that limit.

The FMRA specified the initial limit

on total liabilities to be 85% of the estimated GDP by the end of 2006, and a pathway in which the total liabilities would not exceed 60% of the estimated GDP by the end of 2013.

In both 2006 and 2009, the government did not comply with this limit of 85%. Neither was it on a pathway to achieve compliance with the reduced limit of 60% by 2013. Instead, the level of debt in 2013 was almost 72% of GDP (Exhibit 2).

In this case, instead of simply not complying, as in the case of rule 1, the government proceeded to amend the law, and change the goalposts of the rule. The Fiscal Management (Responsibility) (Amendment) Act, No. 15 of 2013 changed the rule, by increasing the original limit of 60% from 2013 onwards, to 80%, and adopting a revised pathway in which reducing the limit to 60% was pushed back seven years, to 2020.

However, these revised targets too were not complied with. In both 2018 and 2019, the government did not comply with the new limit, that total liabilities would not exceed 80% of GDP for the respective years. As 2020 drew near, Sri Lanka was on a pathway of increasing the level of debt above the upper limit of 80% rather than decreasing it towards 60%, as would have been required for compliance with the revised FMRA (Exhibit 2). Finally, the level of central government debt in 2020 was at 101% of GDP (Exhibit 2), while even the revised FMRA rule was to achieve 60%. In 2021, the target of 60% was pushed out by another ten years to 2030, with no

interim targets for managing the debt level downwards.

Rule 3: Treasury guarantees limit – a misinterpretation

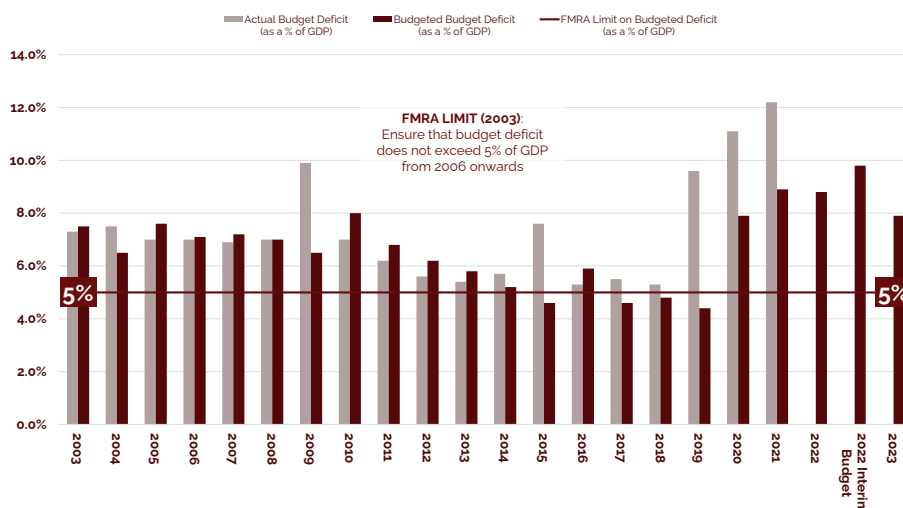
A Treasury guarantee is a means by which the government takes on a contingent liability to support a third party to take a loan. It provides that the relevant loan repayment obligations will be met by the government if the primary borrower goes into default. State-owned enterprises tend to be the main beneficiary of treasury guarantees.

Provisions of the FMRA, as adopted in 2003, place the following (convolutedly worded) limits on treasury guarantees:

"...the sum which is calculated as the guarantee and given as a percentage of the gross domestic product for the current financial year along with the two preceding financial years, does not in the aggregate exceed 4.5 per centum."

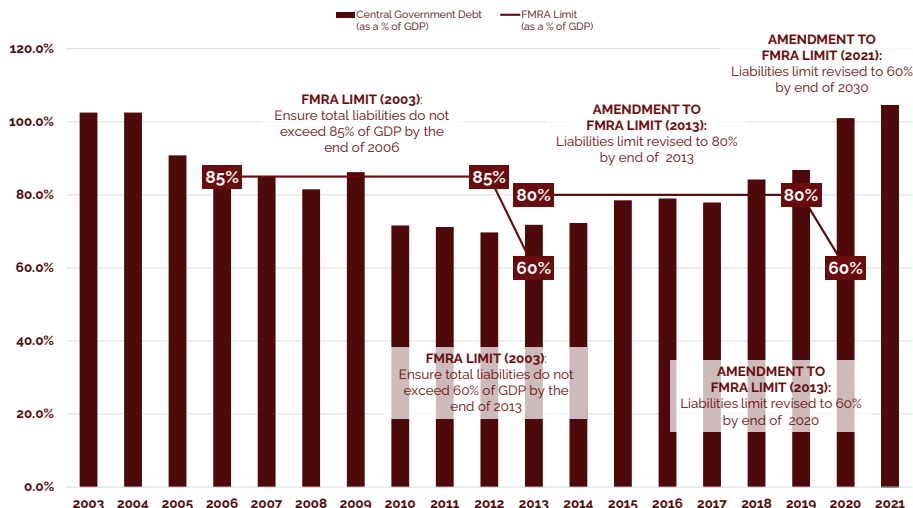
The Act seems to directly limit only the issuance of new treasury guarantees. That is, it sets a cumulative limit of how much in treasury guarantees can be issued within the time span of the last three years (including the present year). However, the government bureaucrats may have read the act as placing a maximum limit on the total stock of treasury guarantees. Therefore, when the total stock of treasury guarantees approached the limit of 4.5% the law was amended. It was amended first in 2013, and then twice after that in 2016 and 2022, when the limit was revised up to 15%. The three-year cumulative limit

Exhibit 1: Actual and Budgeted Deficits compared with the FMRA Limit (2003 - 2023)



Source: Budget speeches 2003 - 2023 | Central bank of Sri Lanka Annual Report 2021 | Fiscal Management (Responsibility) Act, No. 3 of 2003 and its amendments

Exhibit 2: Central Government Debt as a % of GDP compared with the FMRA Limit (2003 - 2021)



Source: Central bank of Sri Lanka Annual Report 2021 | Fiscal Management (Responsibility) Act, No. 3 of 2003 and its amendments

on treasury guarantees (as stipulated in the law) exceeded the 4.5% limit in 2017 and rose to 11.9% in 2021.

No compulsion for compliance

The FMRA does not explicitly identify a specific person as responsible for compliance with the Act. However, certain tasks such as presenting the financial strategy and Mid-Year Fiscal Position Report are assigned to the Minister of Finance.

Section 26 of the act allows for deviations from the act in "exceptional circumstances" with a Resolution of the Parliament, for the period specified in the Resolution; where the minister, at every instance of such deviations, should inform the parliament: the reasons for the departures, the period

of time within which the Government expects such deviations from the requirements to come to an end and the steps that the Government will be taking to overcome the causes necessitating the deviation.

The Act does not, however, penalize non-compliance. Instead, Section 25 of the Act states that no civil or criminal proceeding shall be instituted against a public officer for anything done in good faith or omitted to be done by such public officer under the Act.

Improving economic governance is a priority

The Auditor General has consistently raised concerns regarding the breach of the FMRA in recent Audit Reports on the Ministry of Finance financial statements. The regular violations of the

The flagrant flouting of compliance with fiscal laws has eroded the power they otherwise hold as an internal anchor of credibility in Sri Lanka

FMRA rules, since they were adopted, and even after they were amended, has continued unabated, despite the rules being entrenched in law. Even the existence of regular audit complaints, about the law being violated, has not contained non-compliance, to accommodate the habit of fiscal profligacy.

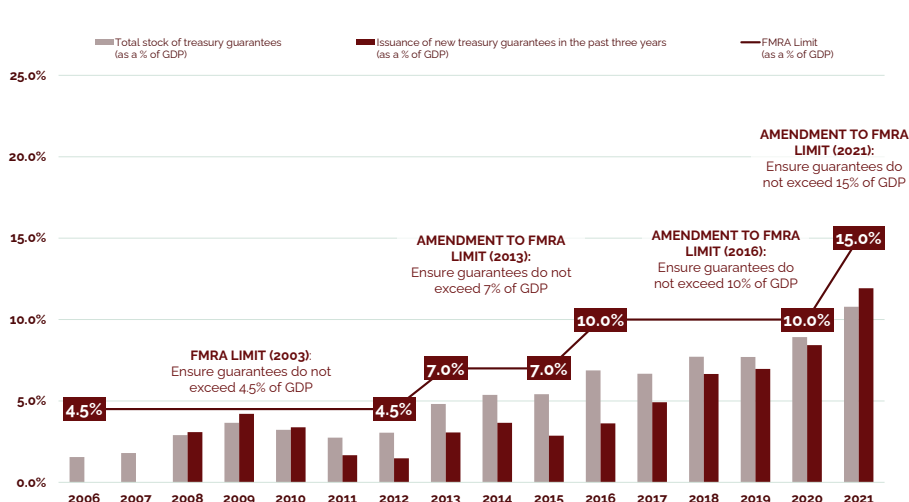
Adopting laws with rules normally serve as a tool for building and anchoring confidence in government. In the case of Sri Lanka however, the lack of compulsion for compliance renders such rules moot. In such a context, rules are neither a means of improving fiscal discipline nor of building confidence in the future path of fiscal consolidation.

The flagrant flouting of compliance with fiscal laws has eroded the power they otherwise hold as an internal anchor of credibility in Sri Lanka. The additional consequences are that the country faces lower levels of confidence, is evaluated to be a higher risk, and thereby has higher costs of borrowing. It also creates an increased need for external anchors of credibility, such as an IMF program.

The IMF engagement in Sri Lanka may have been the impetus for the proposal in the interim of the Budget of 2022 to introduce new legislation under a Public Finance Management Act (PFM Act) that will include stronger fiscal rules. However, the potential benefits a new PMF Act becomes questionable, based on the analysis in this insight: Sri Lanka has problem of non-compliance with fiscal management laws.

Therefore, this insight suggests that this repeat prescription of more fiscal rules might be ineffective, unless it is paired with a separate prescription to address the pervasive problem of poor compliance with economic governance laws in Sri Lanka. ♦

Exhibit 3: Stock and New Issuance of treasury guarantees compared with the FMRA limit



Source: Ministry of Finance Annual Reports (2005 - 2021) | Fiscal Management (Responsibility) Act, No. 3 of 2003 and its amendments