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13% primary expenditure rule proposed for Sri Lanka departs from economic theory and practice

The 13% primary expenditure rule proposed in a new public finance bill is at odds with established economic theory. It will undermine "good" public spending that enhances growth, efficiency, and social welfare. It will also make Sri Lanka a global outlier, by setting a GDP based limit on primary expenditure, which is the lowest in the world.

13

Percent primary expenditure (PE) limit of GDP proposed for Sri Lanka

10

Countries (out of 151) with PE less than 13 percent of GDP in 2022

0

Countries with a PE limit below 20 percent of GDP

On May 22, 2024, the government of Sri Lanka gazetted the "Public Financial Management" (PFM) bill, aiming to implement wide-ranging reforms to enhance transparency, accountability, and control of public funds.[1]

The bill includes several improvements over the current Fiscal Management (Responsibility) Act, No. 3 of 2003 (FMRA); previously recommended by Verité Research. These included improvements to the FMRA such as (a) improving information disclosure, (b) mandating the publication of analysis supporting budget proposals and estimates, and (c) capping discretionary spending by limiting the line item that gives excessive allocative discretion, to 2 percent of the budget.

Despite these improvements, there are significant shortcomings as well. One of them is the replacement of the current budget balance limit in the FMRA with a limit on primary expenditure at 13 percent of GDP.

Box 1:

> The PFM bill specifies that "The primary expenditure of the Government shall not exceed thirteen per centum of the estimated nominal gross domestic product for the relevant financial year." [section 15(1)]. This means that annual government expenditure, excluding interest payments on debt, must be within 13 percent of GDP; regardless of revenue levels. The bill also repeals the existing budget balance rule of a negative 5 percent of GDP in the FMRA

This insight shows that the change is exceptional in two ways. First, empirically, it would make Sri Lanka a global outlier – both for having a GDP-based primary expenditure limit and for setting it at the lowest level in the world. Second, theoretically, it would make Sri Lanka adopt a principle that is at odds with established economic reasoning.

Empirical Exception: Makes Sri Lanka a global outlier in two ways

1. The Primary Expenditure Limit: A Rare Practice in Fiscal Rules

According to the IMF's fiscal rules database, which includes 106 countries, only 10 have a rule that limits primary expenditure independently of revenue (See Exhibit 1).[2]

2. The Most Extreme Limit

Exhibit 2 shows that these ten countries have much higher limits, as their primary expenditure is allowed to grow with nominal GDP or inflation– keeping the share of GDP effectively the same or lower. In some cases, the primary expenditure level exceeds 50 percent of GDP. Seven of these countries have a primary expenditure limit above 30 percent of GDP, while the remaining three range between 20-30 percent of GDP.

At 13 percent, the proposed limit for Sri Lanka would be the most extreme globally. Currently, the lowest limit is for Paraguay at 21.8 percent, which is more than one and a half times the proposed limit for Sri Lanka.

According to the IMF's Primary Expenditure database, only 10 out of 151 countries had a primary expenditure below 13 percent of GDP in 2022.[3]Successful economies can have high levels of primary expenditure, such as France, Japan, the UK, and China, which have primary expenditure levels of 56.6 percent, 48.8 percent, 40.3 percent, and 32.5 percent of their GDP, respectively. Countries with a lower per-capita than Sri Lanka also spend more than 13 percent of their GDP on primary expenditure. For instance, 33.2 percent in Bhutan and 23.4 percent in India.

Among the ten countries with a primary expenditure rule not tied to revenue, none have a limit as low as what is proposed for Sri Lanka.

Theoretical Exception: Policy at odds with orthodox economic theory

The purpose of government expenditure is to enhance present and future social welfare, which is the principal objective of economic policy. To achieve this in a sustainable manner, economic theory supports fiscal rules that manage deficits and debt. That means fiscal rules on expenditure are normally tied to revenue. Limiting primary expenditure independent of revenue, and tying it to GDP, as proposed for Sri Lanka, runs counter to what can be supported by microeconomic and macroeconomic theory.

Most countries that adopt fiscal rules allow rational rule that allows expenditure to increase in line with revenue... A GDP based primary expenditure limit is rare.

Microeconomics-based theory on public expenditure

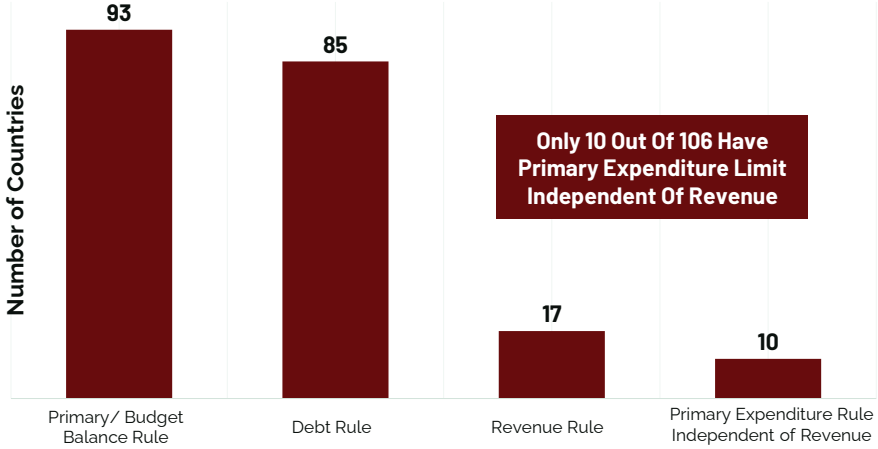
There are three main categories of efficiency and welfare-improving reasons in microeconomic theory that justify increasing primary expenditure, provided it is supported by revenue expansion.

i. **Correcting for Externalities:** Market failures exist when the value of a transaction to society is not internalised in the price. Correcting for this "neglected value" is a function of government. For example, there is an economic case for subsidising vaccines or public transport as it allows the consumption of these goods to increase in line with more efficient social outcomes – because vaccinated people provide protection to other people, and using public transport reduces congestion delays for others. .

ii. **Providing Public Goods:** Certain goods have characteristics that economists refer to as non-contestability or non-excludability, which create coordination and decision problems that prevent private markets from delivering them at efficient levels. For example, parks, roads, and street lighting

iii. **Social Redistribution:** Redistributing resources from the much better off to the much worse off improves total

Exhibit 1: Types of fiscal rules by level of adoption



social welfare, which is the main task of economics. This is because small redistributions have higher marginal welfare consequences for the poorest. This can be achieved through tax-funded social safety nets as well as the provision of health care and education for those who cannot afford it otherwise.

Macroeconomics-based theory on public expenditure

Both neo-classical and neo-Keynesian economic models support the expansion of primary expenditure for economic benefit, provided that such expansion is supported by revenue.

Neoclassical theories differ from the Keynesian approach in that they advocate for maintaining economic stability during short-term fluctuations around business cycles through monetary policy rather than fiscal policy.

Overall, established economic reasoning suggests that this proposed limit would adversely restrict the government's ability to spend, particularly on investments in human and physical capital, which are crucial for promoting growth, productivity, efficiency, and social welfare in the future.

Within neo-classical reasoning, well-established long-term growth theories, such as the Human-Capital-Augmented Solow model by Mankiw, Romer, and Weil (1992), identify investments in physical and human capital, as well as technology, as the key drivers of sustainable economic growth.[4]

Other endogenous growth models also highlight the need for government spending on physical infrastructure such as roads, bridges, and public utilities to enhance the environment for economic activities by reducing transaction costs and improving market access. Investments in education and training are crucial for developing a skilled workforce necessary for innovation and growth.[5] (Jones & Manuelli, 2005). Additionally, government funding for R&D is a key driver to stimulate technological advancements and drive innovation, which in turn fosters economic competitiveness.[6]

Meanwhile, the Keynesian approach advocates for actively stabilising the economy by increasing government spending (and reducing taxes) when the economy is below full output and vice versa.

Hence, it is not possible to draw on either of these approaches to support the policy of an exceptionally low GDP-based limit on primary expenditure that is not tied to revenue, as proposed in the PFM bill.

Exhibit 2: Countries with a GDP linked primary expenditure limit

Country	Primary Expenditure Limit as a % of GDP set to increase in step with:	Primary Expenditure as a % of GDP
Finland	Inflation rate (for primary non-cyclical expenditure)	52.5%
Belgium	Inflation rate	52.0%
Brazil	Inflation rate	38.3%
Ecuador	Long Term Real GDP growth	37.7%
Andorra	Positive Nominal GDP growth	35.5%
Argentina	Positive Nominal GDP growth or Inflation (if negative growth)	35.2%
Grenada	Inflation rate	30.6%
Uruguay	Potential Real GDP growth	27.8%
Mexico	Potential Real GDP growth – which is 2%	23.2%
Paraguay	Inflation rate + 4%	21.8%

Source: IMF Fiscal Rules Dataset

A Low Absolute Limit on Primary Expenditure Harms Economic Prospects

Limiting primary expenditure at such low levels can harm welfare, productivity, and growth. Studies by Ospina and Roser (2016) have shown a positive correlation between a country's income and its expenditure share of GDP.[7] This indicates that as a country's income increases, the expenditure share of GDP also rises, supporting sustained growth.

Advanced economies, which spend around 43 percent of their GDP on primary expenditures, have achieved enhanced social welfare and economic growth through such spending. Emerging economies also spend around 28 percent of their GDP on primary expenditure. Historically, Sri Lanka, too, had primary expenditures ranging from 20-30 percent of GDP, while revenue exceeded 20 per cent of GDP.

Currently, public sector costs and welfare spending (including health and education) take up around 8-10 percent of GDP. An expenditure limit of 13 percent could crowd out capital expenditure, as seen under repeated fiscal consolidation efforts in Sri Lanka. In its latest review, the IMF emphasised the importance of reducing the reliance on ad-hoc cuts to capital expenditure, noting its detrimental effects on growth. Therefore, an expenditure limit that is not tied to revenue is likely to harm growth potential both in the present and the future.

An Alternative Approach: A Budget/Primary Balance Rule

In contrast to the GDP-linked primary expenditure limit, a budget or primary balance rule, which ties expenditure to government revenue, allows for the expansion of public goods and social welfare without compromising fiscal prudence and sustainability. Such a rule would ensure that any increase in expenditure is matched by a corresponding increase in revenue, maintaining fiscal discipline while fostering economic growth and social welfare. ◆

Endnotes

1 Extraordinary Gazette No. 501/2024 issued in May 2024 at http://documents.gov.lk/files/bill/2024/5/501-2024_E.pdf [last accessed 18 June 2024]

2 Davoodi, Hamid, Paul Elger, Alexandra Fotiou, Daniel Garcia-Macia, Andresa Lagerborg, Raphael Lam, and Sharanya Pillai. 2022. "Fiscal Rules Dataset: 1985-2021", International Monetary Fund, Washington, D.C. https://www.imf.org/external/datamapper/FiscalRules/map/map.htm [last accessed 18 June 2024]

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4 Mankiw, N. G., Romer, D., & Weil, D. N. (1992). "A Contribution to the Empirics of Economic Growth." Quarterly Journal of Economics, 107(May), 407-437. DOI: 10.2307/2118477

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7 Esteban Ortiz-Ospina and Max Roser (2016) - "Government Spending" Published online at OurWorldInData.org. Retrieved from: 'https://ourworldindata.org/government-spending' [Online Resource]