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BOX 3
Fiscal Consolidation: Path to Macro Fiscal Stability

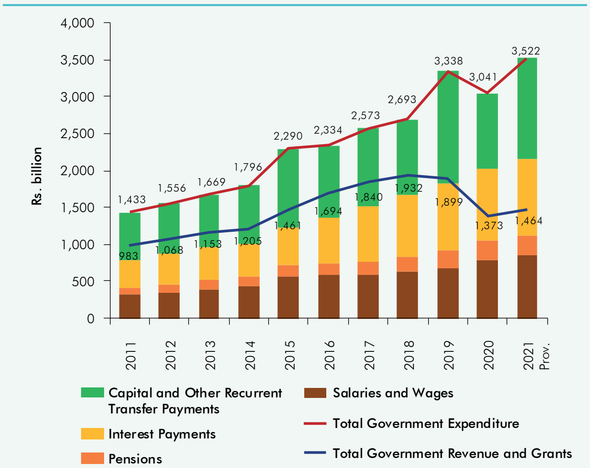
Fiscal Policies during the Pandemic

Fiscal policy responses to the COVID-19 pandemic curbed the scarring effects on economies across the world facilitating post pandemic recovery, albeit with a notable bearing on public finances, and in turn resulting in fiscal stress in these countries. The swift fiscal measures deployed in response to the unanticipated and unprecedented economic headwinds were disparate in scale, type, and coverage and were dependent on the specific structural, inherent and fiscal leeway of each economy. Advance markets and large emerging markets were in relatively better positions with ample fiscal space to accommodate such fiscal stimuli, compared to small emerging markets and developing economies. Direct budgetary measures such as increased spending on health, provision of unemployment benefits and other reliefs, tax concessions and tax deferments, liquidity support, equity injections, and indirect actions including provision of guarantees for deferred debt repayments were among common fiscal policy measures implemented by numerous countries. The steady stream of fiscal stimuli via deficit spending, and lingering effects of the pandemic together with the slowdown in economic growth have put pressure on fiscal operations of most economies, thereby threatening macroeconomic stability in respective countries.

The outbreak of the pandemic and related uncertainties have severely affected Sri Lanka, prominently the fiscal sector, as reported in many other lower middle-income and market access countries. Despite insufficient fiscal space to undertake hefty fiscal intervention, the Sri Lankan Government also committed to providing a number of fiscal stimuli to address pressing priorities since the onset of the pandemic. With increased expenses for healthcare and pandemic control measures as well as financial and in-kind transfers to vulnerable groups, the Government spent at least Rs. 117.5 billion and Rs. 165.6 billion as pandemic related expenses for 2020 and 2021, respectively. The Government instituted a low tax regime to boost the sluggish economic activity since the latter part of 2019 and this low tax environment was upheld during the pandemic period. Several tax reliefs for certain essential imports such as medicines were also granted during this period. Consequently, government revenue dwindled sharply during the pandemic period owing to modest tax rates, and diminished tax base due to the increases in tax free thresholds as well as subpar economic growth. Accordingly, fiscal deficit in 2020 and 2021 increased to 11.1 per cent and 12.2 per cent of the GDP, respectively. Meanwhile, as per the Fiscal Monitor Database of Fiscal Policy Responses to COVID-19 Pandemic – October 2021, the cumulative value of additional spending and foregone revenue by the Sri Lankan Government in relation to the pandemic was around 1.1 per cent of the GDP, which is low in comparison to several regional peers, such as India (4.1 per cent), Pakistan (2.0 per cent), Bangladesh (2.3 per cent), and Maldives (8.0 per cent). In addition, with limited fiscal space to manoeuvre, pandemic affected individuals and businesses in Sri Lanka were mainly supported by accommodative monetary policy. Moreover, reduced foreign inflows amidst the pandemic and substantial debt service payments added further stress on the fiscal and external sectors. With limited avenues for new foreign financing sources, liquidity constraints in the international capital markets as well as sovereign rating downgrades of Sri Lanka, the Government was compelled to resort to higher domestic borrowings, especially through the Central Bank and the banking sector, to meet the government financing gaps. Such fiscal imbalances led to the government debt reaching 100.6 per cent and 104.6 per cent of GDP by end 2020 and end 2021, respectively.

Nevertheless, the current weak fiscal position and the resultant macroeconomic issues in Sri Lanka are not entirely due to the pandemic situation, but rather a reflection of longstanding and unresolved issues in the fiscal sector. For several decades, Sri Lanka has been plagued by persistent fiscal deficits, compelling the Government to continually borrow from both domestic and foreign markets and accumulate public debt. As a result, a large fraction of government revenue and foreign currency inflows to the country are required to be channelled for debt service payments, permitting little leeway for productive investments. Since 1994, revenue and grants have not been sufficient to meet at least recurrent expenditure of the Government, necessitating government borrowings to cover recurrent expenses that generally do not contribute to future growth and

Figure B 3.1
Government Expenditure and Government Revenue



Source: Ministry of Finance

the country's debt repayment potential. Moreover, as depicted in Figure B 3.1, revenue and grants in 2020 and 2021 were well below the rigid expenses that include salaries, pension, and interest payments, amplifying the severity of the issue. The unprecedented large tax reductions announced in end 2019 aggravated the issue of low revenue mobilisation of the Government, compelling monetary financing of the budget deficit during 2020 and 2021.

The Medium Term Macro-Fiscal Framework which is unveiled along with the Budget Speech outlining the Government's targets to reduce the overall budget deficit and debt levels to a sustainable level over the past several years has never materialised, as reflected in the historical trend of actual data. Over ambitious targets for government revenue in the Budget and planning of annual expenditure in line with the overestimated revenue have always resulted in a wider than expected budget deficit. Meanwhile, the Fiscal Management (Responsibility) Act, No. 3 of 2003 (FMRA) was enacted to ensure responsible fiscal management, prudent debt management and public scrutiny over fiscal affairs via

Figure B 3.2
Government Revenue – Budget Estimates vs. Actual

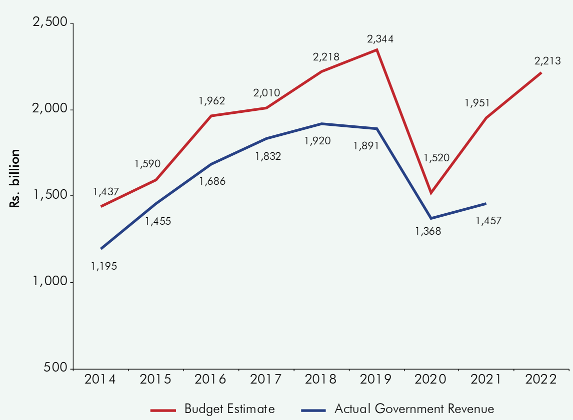


Figure B 3.3
Government Expenditure – Budget Estimates vs. Actual

Source: Ministry of Finance

implementing 'fiscal rules' that are, however, not binding rules. These fiscal rules pertaining to fiscal deficit, public debt and contingent liabilities of the Government as stipulated in the FMRA have been subsequently amended as given in Table B 3.1. Successive Governments constantly have not met the fiscal deficit rule, while fiscal rules in relation to public debt reduction and limiting of contingent liabilities have not been attained at specified milestones. Instead, the FMRA has been amended several times, extending the time targets along with several approvals for supplementary budgets. A strong commitment to ensure prudent fiscal management has not been evident as against the proposed path of fiscal consolidation.

Table B 3.1
Fiscal Rules Framework of Sri Lanka

Fiscal Rule	FMRA 2003	Amendment 2013	Amendment 2016	Amendment 2021
Fiscal deficit	Less than 5 per cent by 2006 and beyond	Unchanged	Unchanged	Unchanged
Public debt (share of GDP)	Less than 85 per cent by 2006 and less than 60 per cent by end 2013	Less than 80 per cent by 2013 and less than 60 per cent by end 2020	Unchanged	Less than 60 per cent by end 2030
Treasury Guarantees (share of GDP)	Less than 4.5 per cent based on 3-year moving average GDP	7.5 per cent of GDP	10 per cent of GDP	15 per cent of GDP

Source: Fiscal Management (Responsibility) Act, No. 3 of 2003 and subsequent amendments

The Impact of Weak Fiscal Performance on Price Stability and Financial System Stability

According to Sargent and Wallace (1981), amidst fiscal dominance, the central banks are compelled to generate seigniorage revenues to ensure the solvency of governments, when fiscal operations are fixed to a given higher fiscal deficit path. Blanchard (2004) also asserts that inflation targeting only through monetary policy may not be successful in a high debt environment. The monetary authority's attempt to raise the real interest rate with the aim of maintaining inflation at a targeted rate may aggravate debt levels through increased borrowing costs, if the fiscal authority is disinclined for fiscal consolidation. Moreover, rising debt levels could intensify sovereign default risk and exert exchange rate depreciation pressure, and thereby result in higher inflation instead of lower inflation. Therefore, Blanchard (2004) emphasises that in a high debt environment, inflation should be managed through fiscal policy by attempting to reduce fiscal deficits, and thereby government debt levels, instead of only using monetary policy to combat inflation. Meanwhile, some academics have argued that inflation and financial repression[1]

1 Financial repression is used to lower the cost of borrowing for the Government by way of explicit or implicit caps on interest rates, direct lending to the Government by captive domestic sources such as pension and provident funds, regulation of cross-border capital movements, and a strong connection between the Government and banks.

are possible solutions to cope with a surge in public debt (Reinhart & Sbrancia, 2011). However, long term financial repression could be detrimental to financial system stability as it creates tight liquidity conditions for banks and deteriorates banks' balance sheets, especially when the Government is on a borrowing spree from domestic banks. On the other hand, allowing inflation to rise in the economy to increase nominal GDP and thereby improving the budget balance and debt to GDP ratio could be counterproductive, especially when market participants internalise higher inflation expectations in government securities yield rates, which in turn raise borrowing costs for the Government.

At present, the Central Bank of Sri Lanka conducts monetary policy under the Flexible Inflation Targeting (FIT) framework with the aim of maintaining inflation at low and stable levels in line with the Bank's mandate for economic and price stability. Persistent fiscal deficit, high government debt levels, and the heavy reliance of the Government on the Central Bank for deficit financing in the recent times, however, have undermined the effective conduct of monetary policy while threatening the financial system stability. Although supply-side disruptions have stemmed from the acceleration in inflation during the latter part of 2021, breaching the upper bound of the county's inflation target, demand fuelled mainly by increased credit to the Government by the banking sector has also been seen as a cause for the uptick in inflation. The economic history of Sri Lanka suggests that high inflation episodes in the country coincide with fiscal imbalances. Hence, in order to ensure long term price stability, fiscal consolidation remains to be a key condition.

Fiscal Consolidation Amidst an Economic Downturn

Drawing lessons from the rest of the world, alongside a tightened monetary policy stance, fiscal consolidation should be carefully designed and implemented without depressing the demand too much to circumvent scarring effects on the economy due to its fragile state. The standard Keynesian proposition suggests that fiscal consolidation, also called fiscal austerity, has a contractionary effect on economic activity in the short run. Accordingly, as a result of attempts for fiscal consolidation, a country's fiscal performance may even deteriorate further due to lower revenue collection and lower nominal GDP following the slowdown in economic growth. Hence, as the economic growth of the country has already been affected by the COVID-19 pandemic, fiscal consolidation during the pandemic period itself may be a greater concern for policymakers. However, persistent weak fiscal conditions have instigated a myriad of macroeconomic imbalances in the Sri Lankan economy, such as high inflation, weak currency and tight liquidity conditions of the banking sector, creating greater uncertainties, reducing investor confidence, and aggravating vulnerabilities in the financial system, thereby hindering high and sustained economic growth. Therefore, at this critical juncture, the objective of attaining macroeconomic stability by resolving the macroeconomic imbalances supersedes the objective of achieving near term higher growth. Contrary to the traditional Keynesian view, recent studies have also indicated the possibility of offsetting contractionary effects of fiscal consolidation, when the fiscal consolidation is large and perceived to be credible by the public, especially when public debt levels are high (Giavazzi & Pagano, 1990). On one hand, private consumption could increase if households perceive there is a permanent reduction in the government borrowing requirement when the Government is committed to achieving fiscal consolidation. Such a reduction in government borrowings implies lower taxes in future and thus, a higher lifetime income for the households, encouraging them to increase their consumption from the current period. On the other hand, a reduction in government borrowing requirements will reduce inflation risk premia and default risk premia associated with public debt issuances due to lower inflation expectations and fewer economic uncertainties. This will lead to a fall in real interest rates and promote more productive private investment. As such, given the serious macroeconomic imbalances emanating from weak fiscal conditions, well-planned fiscal consolidation measures are more likely to be beneficial for the Sri Lankan economy, particularly to ensure macroeconomic stability and growth in the medium to long term. However, it is crucial that Sri Lanka implements the optimal combination of consolidation strategies to minimise possible contractionary effects in the short term and thereby avert fiscal austerity being a 'self-defeating' strategy.

At the same time, fiscal consolidation may have disproportionate effects on different economic segments resulting in widening inequalities. Fiscal austerity could worsen the prevailing inequalities that have been aggravated by the COVID-19. Therefore, consolidation strategies should be implemented with due consideration of not only output effects but also of possible consequences of austerity measures on social divide.

Way Forward

Fiscal conditions in Sri Lanka left much to be desired even prior to the onset of the pandemic, and the pandemic has compounded the pre-existing maladies of the fiscal sector. Hence, fiscal consolidation remains the utmost priority to ensure stability and long term sustainable growth. Whilst economic recovery is underway, fiscal consolidation packages should be designed in a 'growth-friendly' manner by using

Table B 3.2
Income Taxes in Sri Lanka vs. Regional Peers

Sri Lanka		India		Pakistan		Singapore		Thailand	
Taxable Income slabs (LKR mn)	Tax Rate (%)	Taxable Income slabs (INR mn)	Tax Rate (%)	Taxable Income slabs (PKR mn)	Tax Rate (%)	Taxable Income slabs (SGD mn)	Tax Rate (%)	Taxable Income slabs (THB mn)	Tax Rate (%)
0-3	0	0-0.25	0	0-0.6	0	0.005-0.02	1	0-0.15	0
3 -6	6	0.25-0.5	5	0.6-1.2	5	0.02-0.035	3	0.15-0.3	5
6-18	12	0.5-0.75	10	1.2-1.8	10	0.035-0.05	8	0.3-0.5	10
18 above	18	0.75-1	15	1.8-2.5	15	0.05-0.07	13	0.5-0.75	15
		1-1.25	20	2.5-3.5	17.5	0.07-0.1	21	0.75-1	20
		1.25-1.5	25	3.5-5	20	0.1-0.25	24	1-2	25
		1.5 above	30	5-8	22.5	0.25-0.4	24.5	2-5	30
				8-12	25	0.4-0.6	25	5 above	35
				12-30	27.5	0.6-1	26		
				30-50	30	1-2	28		
				50-75	32.5	2 above	30		
				75 above	35				

Source: PricewaterhouseCoopers – World Tax Summaries

fiscal instruments that have small fiscal multipliers[2] in order to ensure that the policy package is generating required fiscal effects with the lowest economic costs. To this end, a clear understanding of the fiscal policy transmission mechanism and the size of multipliers of different fiscal instruments, such as the disaggregated level fiscal multipliers related to different revenue and expenditure components, are required to design a consolidation package that has benign effects on output and inequalities.

Empirical evidence related to other countries suggest that expenditure based fiscal consolidation is less likely to be contractionary, as opposed to revenue based consolidation (Alesina, Favero, & Giavazzi, 2019). However, given the low tax revenue to GDP ratio, Sri Lanka still has space for manoeuvring fiscal consolidation through revenue policies with minimal disruptions on output. Successful revenue based fiscal consolidation measures in other countries, such as in Brazil, Canada, Finland, New Zealand, and South Africa, have focused on broadening the tax base and introducing reforms to simplify tax administration (Okwuokei, 2014). Since raising indirect tax rates such as Value Added Tax (VAT) could disproportionately affect consumption of low income households during these hard times, widening the VAT base (increasing the number of VAT paying businesses) would be the appropriate option to augment government revenue while minimising output and distributional effects. In this regard, the VAT free threshold could be revised downwards to the levels that prevailed prior to the last VAT threshold adjustment.[3] Meanwhile, considering the modest impact on economic growth, taxes on capital income could be raised at the personal level.

2 Fiscal multipliers measure the effect of increases in fiscal spending or taxes on GDP.

3 In December 2019, the VAT free threshold was revised upward from Rs.12 million turnover per annum to Rs. 300 million turnover per annum.

Given the relatively sticky wage structures and rigid employment contracts in Sri Lanka, Advance Personal Income Tax (APIT)/ personal income tax rates could be raised to a level comparable to the country's regional peers while adjusting tax free thresholds and tax brackets to the levels that prevailed prior to the last income tax revision, without causing notable impact on firms' costs and labour input. More importantly, a range of administration and enforcement reforms is key to enhancing government revenue in the medium to long term by curbing tax evasion and corruption.

Past experiences of other countries suggest that fiscal austerity through expenditure reduction is more successful since expenditure cuts reflect greater commitment of the Government and efficiency gains (Price, 2010). Although a reduction in wages and transfers are proven to be more effective in fiscal consolidation in other countries, such a move will not be an easy feat in the Sri Lankan context given the associated political cost and stringent labour market conditions. Hence, at least, new government recruitments and major public wage revisions should be considered with caution along with better targeting of subsidies. On the other hand, the reduction in capital expenditure and expenditure on health and education could create more contractionary effects both in the short and long term, especially due to the country's deficiencies in physical and soft infrastructure. Therefore, fiscal consolidation through sizeable capital expenditure cuts should be achieved through 'value for money' strategies, instead of across the board expense cuts. In this regard, the Central Government as well as local government authorities should streamline capital expenditure by selecting infrastructure projects that generate the highest economic value and future growth potential. Moreover, streamlining and digitalising

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work processes, and trimming unproductive recurrent expenses are essential for efficiency gains and reducing the pressure on government expenditure.

Fiscal consolidation coupled with growth-promoting investments and long overdue structural reforms would be a welcome move in this dire economic situation to address the challenges and capitalise the opportunities presented by the pandemic. Since the debt burden of inefficient, loss-making State Owned Business Enterprises (SOBEs) translates into contingent liabilities of the Government, reforms related to SOBEs should be expeditiously implemented in tandem with fiscal austerity. Cost-reflective pricing mechanisms, institutional restructuring for efficiency gains, and market-oriented product and service delivery are several overdue reforms related to SOBEs. In addition, legislative and administrative reforms are required to monitor the progress of fiscal consolidation, strengthen public scrutiny over the consolidation process, and ensure accountability of the policymakers and government officials for meeting austerity targets. It may be noted that the continuous reliance of major SOBEs on the two state banks, and eventually on central bank financing, has created numerous challenges to price stability. Hence, SOBEs should be held accountable for their operations and such entities should not pass their debt burden on commercial banks and the Central Bank.

The Sri Lankan economy has reached a critical juncture where fiscal consolidation is imperative and any further delay in implementing the same effectively would be economically and politically very costly. However, the Government's strong commitment to adhere to fiscal rules and the fiscal consolidation path is paramount for the actual realisation of desired outcome. Major impediments such as the lack of broad political consensus, lacklustre approach of authorities and resultant 'stop-go', short term and ad hoc policies should be wiped out to contain the derailment of the fiscal consolidation process. At the same time, as success and continuation of fiscal consolidation hinges on the support of the general public, creating awareness among the general public on the repercussions of the 'subsidy mindset' is of high significance to transform the voter-base to be more fiscally prudent, and in turn deter policymakers pursuing fiscal profligacy.

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