VERITÉ RESEARCH
Strategic Analysis for Asia

PROPOSAL FOR A REVENUE-LINKED PRIMARY EXPENDITURE RULE

THE PROPOSAL

Verité Research recommends replacing the fiscal rule of a fixed primary expenditure ceiling at 13% of GDP under the Public Financial Management Act, No. 44 of 2024 with a fiscal rule that is revenue-linked rather than fixed. The proposed rule is for an annual primary expenditure ceiling that is two percentage points below the previous year's revenue-to-GDP ratio. This will ensure fiscal prudence, while incentivizing revenue generation and creating fiscal space to enhance public investment, growth and social welfare.

SHORT ABSTRACT

The current PFM Act imposes a rigid and globally unprecedented cap on primary expenditure at 13% of GDP, regardless of revenue performance. This is both theoretically unsound and empirically extreme. By fixing expenditure at such a low ceiling, Sri Lanka risks chronically underfunding essential public goods, social welfare, and capital investment. Replacing this with a revenue-linked rule ensures that expenditure grows responsibly alongside revenue, protecting fiscal and debt sustainability while safeguarding growth and social outcomes.

TOPLINE VIEW

Objective of the Proposal

- ☒ Economic Growth
- ☐ Governance
- ☐ Justice and Rights
- ☒ Social Welfare
- ☐ Other: .....

Implementing Agency:	Ministry of Finance
Primary Beneficiaries:	General population
Cost Estimate (if available):	LKR 0
Policy Type:	Legislative Reform

HOW IT ADVANCES THE OBJECTIVES

1) Economic Growth: A revenue-linked rule allows continued investment in infrastructure, education, and health, sectors that are critical for enhancing productivity and supporting long-term growth. Unlike a rigid expenditure cap, this approach does not constrain essential capital spending when revenues increase.

2) Social welfare: The proposed rule reduces the risk of disproportionate cuts to social expenditure (health, education, safety nets), which are crucial for vulnerable populations.

CASE FOR THE PROPOSAL

This proposal is motivated by the fact that the current fiscal rule stipulated in Section 15 of the Public Financial Management (PFM) Act, No. 44 of 2024 makes Sri Lanka an **exception in two fundamental ways: empirically and theoretically**.

AN EMPIRICAL EXCEPTION: A GLOBAL OUTLIER IN TWO DIMENSIONS

First, few countries use a primary expenditure rule detached from revenue.

According to the IMF's Fiscal Rules Database, only 10 out of 106 countries studied had a primary expenditure rule that was independent of revenue. The overwhelming majority of countries rely on rules that manage budget balances, debt, or revenue, rather than imposing hard ceilings on expenditure.

Second, Sri Lanka's rule is the most extreme among those rare cases.

Of the 151 countries in the IMF's Primary Expenditure database, only 10 recorded actual primary expenditure below 13% of GDP in 2022.

Even among the limited set of countries with Primary Expenditure (PE) rules, Sri Lanka's approach is unparalleled in its restrictiveness. The lowest legislated PE ceiling in the world—Paraguay's 21.8% of GDP—is already one and a half times higher than Sri Lanka's 13% limit. Advanced economies such as France (56.6%), Japan (48.8%), and the UK (40.3%), as well as middle- and lower-income countries like Bhutan (33.2%) and India (23.4%), all sustain much higher expenditure shares.

In sum, Sri Lanka is a global outlier twice over: first, by adopting a GDP-based PE rule rarely used internationally, and second, by setting it at an exceptionally low threshold.

A THEORETICAL EXCEPTION: AT ODDS WITH ECONOMIC REASONING

The purpose of government expenditure is to enhance welfare, efficiency, and growth. Economic theory therefore favours fiscal rules that keep deficits and debt under control while allowing expenditure to expand in line with revenue. By contrast, a rigid GDP-based cap is both conceptually flawed and economically counterproductive.

Why a GDP-based cap conflicts with theory?

Microeconomic theory supports increasing government expenditure when revenue rises, for three main reasons:

1) Correcting externalities, such as subsidising vaccines or public transport, where the private market undervalues wider social benefits.

2) Providing public goods, such as roads, parks, and street lighting, which private markets systematically underprovide.

3) Redistribution, where reallocating resources from higher-income groups to vulnerable populations, particularly through tax-funded health, education, and social protection, which can raise overall welfare.

Macroeconomic theory also support the expansion of primary expenditure for the benefit of the economy, when that expansion can be supported by revenue. For instance, *neoclassical growth models* (such as the Human-Capital-Augmented Solow model) highlight the role of public investments in education, health, infrastructure, and technology as drivers of long-term

productivity. *Endogenous growth theories* stress emphasise the importance of government expenditure on innovation, R&D, and capital formation. Meanwhile, *Keynesian* perspectives advocate for counter-cyclical fiscal policy—allowing governments to increase spending during downturns to stabilise the economy.

In sum, **both schools of thought converge on a common principle: public expenditure should be aligned with fiscal capacity, not arbitrarily constrained by a fixed share of GDP**.

The problem with Sri Lanka's 13% cap

Sri Lanka's legislated ceiling of **13% of GDP** is not revenue contingent. This means that even if revenue rises to 16% of GDP, expenditure would still be capped at 13%. Such rigidity forces the government to underinvest in essential areas, even when fiscal space expands. Historically, Sri Lanka's primary expenditure ranged between 20% and 30% of GDP, supported by revenues exceeding 20%. Under the new cap, however, public sector salaries, health, and education—already absorbing 8–10% of GDP—consume the bulk of the 13% cap, leaving little room for capital investment. This heightens the risk of repeating past cycles in which fiscal consolidation relied disproportionately on ad hoc capital cuts —an approach that the IMF itself has cautioned against.

The alternative: A revenue-linked rule

Verité Research therefore proposes replacing the rigid cap with a **revenue-linked primary expenditure ceiling**: two percentage points below the previous year's revenue-to-GDP ratio. For example, if revenue is 14% of GDP, expenditure may be up to 12%. If revenue increases to 16%, expenditure can increase to 14%. This balances fiscal sustainability with the need to support welfare and growth. By linking expenditure to revenue, the rule allows Sri Lanka to increase its fiscal capacity gradually, matching spending with income, rather than arbitrarily constraining it by GDP.

HOW DOES IT HELP THE COUNTRY

1) Ensures sustainable growth by protecting investment in infrastructure, health, and education, thereby strengthening the foundations of long-term productivity.

2) Aligns with global norms and prevents Sri Lanka from being seen as a global outlier, enhancing the credibility of its fiscal framework in the eyes of investors and multilateral partners.

3) Protects vulnerable populations by ensuring continued support for welfare programmes, redistributive measures, and essential public goods, without resorting to arbitrary cuts.

4) Maintains fiscal discipline by setting expenditure below revenue, ensuring that fiscal deficits remain under control.

PUBLISHED SUPPORTING ANALYSIS

Verité Research. *13% Primary Expenditure Rule Proposed for Sri Lanka Departs from Economic Theory and Practice* (July 2024) at https://www.veriteresearch.org/publication/13-primary-expenditure-rule-proposed-for-sri-lanka-departs-from-economic-theory-and-practice/ [last accessed 25 August 2025]

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