

# **Fiscal Regimes and Fiscal Sustainability in Sri Lanka**

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## **Abstract**

This paper employs the regime-switching model-based fiscal sustainability test of Aldama and Creel (2017, 2018) which extends Bohn's (1998) fiscal reaction function approach. There is evidence of a regime-switching fiscal rule in Sri Lanka for the period 1961-2017. Non-sustainable fiscal regime is identified only in two periods - 1978-1983 and 1986-1990 - while the other periods are defined by sustainable regimes. By considering the regime-specific feedback coefficients of the fiscal policy rule and the average durations of fiscal regimes, we find that Sri Lanka's fiscal policy satisfies the No-Ponzi game condition. Nevertheless, the country's long-term fiscal sustainability is in question given that the stricter debt-stabilizing condition is violated. Our results pose concerns for the credibility of adopting an inflation targeting framework in the absence of long-term fiscal sustainability.

**JEL Classification:** C2, E6, H6

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