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Article

What Effect does Foreign Aid have on the Fiscal Framework of Sri Lanka?

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Abstract

The purpose of this paper is to analyze how the fiscal framework has deviated from the intended development objectives in the presence of foreign aid in Sri Lanka. The nation's low credit rating is a sign that its fiscal position is in trouble, and the Official Development Assitance (ODA) influx is partly to blame. We consider the overall influence of aid on the fiscal sector by regressing the fiscal response model. We estimated the model by employing the Three-Stage Least Squares method (3SLS). According to the estimation results, bilateral aid redirects resources from consumption whereas multilateral aid displaces. Additionally, it shows that multilateral aid favors socioeconomic consumption by diverting more of the aid intended for consumption, while bilateral aid favors civil administration consumption by taking less away from it. In the case of bilateral assistance, tax revenues continue to decrease, often more rapidly than the reduction in consumption. Whereas in the presence of multilateral aid, tax revenue declines while consumption increases. As a result, it is anticipated that the budget deficit and domestic borrowing will grow more than they would have without aid. Thus, the declining investment which is bounded to expanding trend of domestic borrowings will negatively affect the economy's long-term growth prospects.

Key words: aid effectiveness, economic growth, fiscal behavior, fiscal policy, foreign aid, public consumption, public investment, 3SLS
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