

Paradise squandered – what really happened to Sri Lanka’s economy



Photo Credit: Thilina Panduwawala

by Yolani Fernando

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Sri Lanka is often held up as poster child for the **dangers** of Chinese ‘debt trap diplomacy’, even though Chinese debt is just one element in a complexity of structural problems. If we take a decades-long view, Sri Lanka’s current economic trajectory was obvious, and its impending sovereign default a foregone conclusion. As high external debt repayments, a forex crisis, and the pandemic push the country to the brink of an unprecedented default in 2022, decades of strong performance on social indicators are now at serious risk.

Domestic authorities, including the Central Bank Governor, have resisted increasing national and international calls for an International Monetary Fund (IMF) agreement and debt restructuring, insisting that Sri Lanka will service its debt and **keep** the interests of foreign creditors ‘at heart’. The President, however, recently signalled the government’s intention to **restructure** its debt with the assistance of its allies and the IMF. Meanwhile, the Sri Lankan public bears the brunt of the crisis, with daily power cuts, fuel shortages, and skyrocketing prices for essential goods becoming the ‘new normal’.

From the 1950s through to the 1980s, high revenue collection supported generous expenditure on food subsidies, health and education. Sri Lanka consistently outperformed peers on social indicators. Since the early 1990s, the tax-to-GDP ratio has declined from an average of 18.4% (1990-92) to one of 12.7% (2017-19), reaching a low of 8.4% in 2020. Interestingly, the revenue decline **started** after Sri Lanka’s civil war ended in 2009. Governments began spending substantially less on social goods than they did in the past, with average health and education spending in 2010-19 amounting to 1.8% and 1.4% of GDP, respectively.

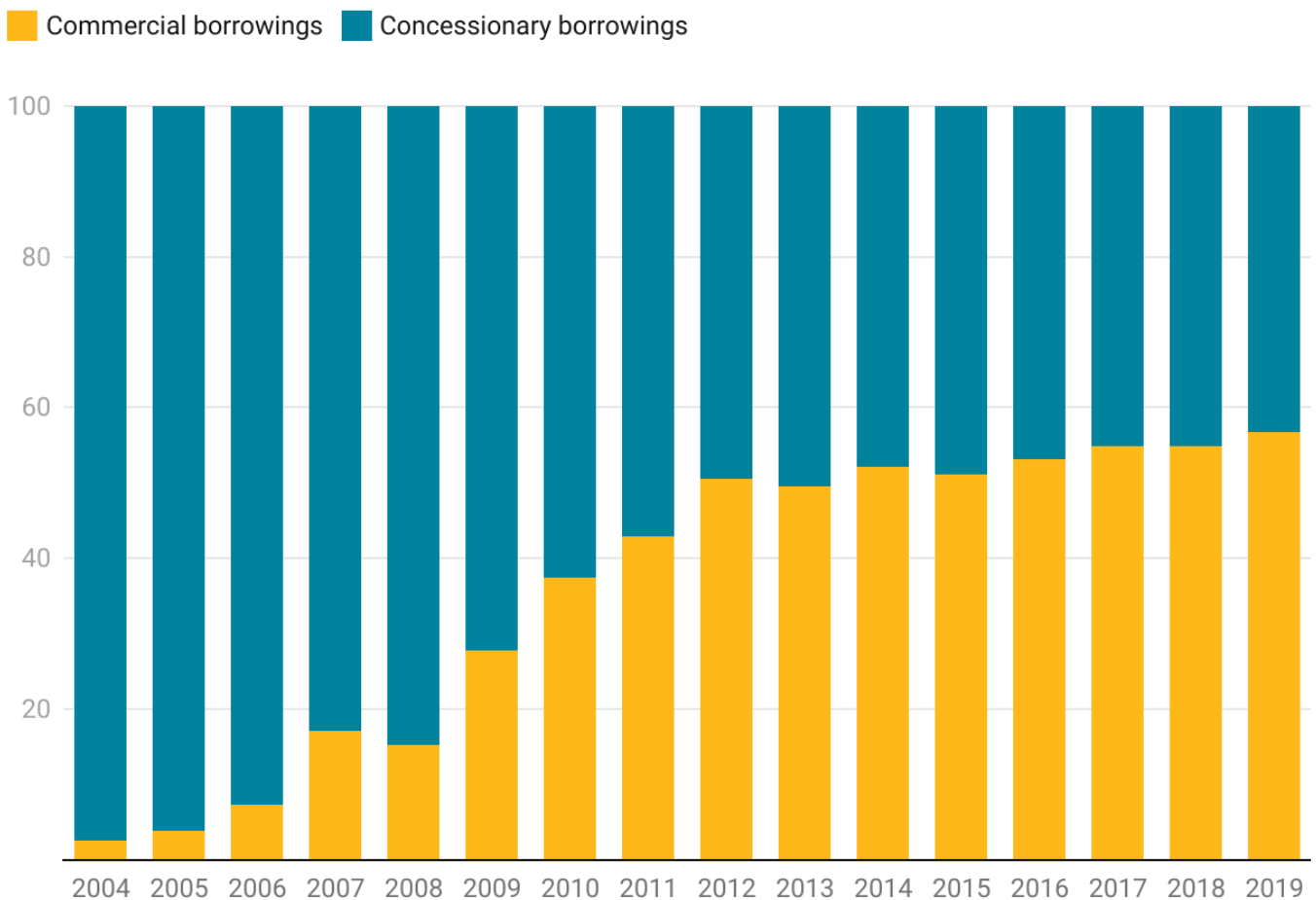
Since the 1990s, successive Sri Lankan governments committed three cardinal sins, which may be forgivable on their own, but together form an unholy trinity of economic disaster: heavy reliance on commercial borrowings to finance the budget deficit since the mid-2000s; failure to widen the tax net and thereby shrinking

government revenue; and missing opportunities to diversify and grow the export market, which in turn led to reliance on a few sources for most forex earnings. The current forex crisis was triggered by the decline in exports and tourism in 2020 and foreign remittances in 2021. The first two sins highlight the weak foundation of an economy that is now collapsing in on itself.

The country's current crisis has roots in the surge of aid inflows after the economy opened in 1977. This allowed successive governments to run large fiscal deficits while neglecting revenue collection. Aid and avenues for concessionary borrowing dried up as Sri Lanka upgraded to lower middle income status. This led to a heavy **reliance** on commercial borrowings to finance the national budget.

These loans, unlike concessionary loans from multilateral institutions, had no strings attached. Most of this debt took the form of International Sovereign Bonds (ISBs). But this 'quick and dirty' solution came at a **price** – high interest rates, shorter maturity periods, and higher risks. By 2019, commercial borrowings, which were a mere 2.5% of foreign debt in 2004, had ballooned to 56%.

Foreign debt composition in Sri Lanka



Source: Central Bank of Sri Lanka Annual Reports (various years) and External Resource Department

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In comparison, Chinese-owned debt (including public debt and publicly guaranteed debt) **represented** only 17.2% of foreign debt in 2019. But the real devil lies in the **effective interest rates** of the ISBs, which are more than double those of Chinese loans. Sri Lanka's interest payments alone **took up** 95.4% of government revenue in 2021. For comparison, its credit rating peers Ethiopia and Laos have rates of 11.8% and 6.6%, respectively.

While Sri Lanka's higher development status should have resulted in greater direct taxation and growth of the tax-to-GDP ratio, its tax system is highly inequitable, with indirect taxation accounting for an estimated 80-82% of revenue. The falling tax ratio is due in part to **failing** to expand the tax net, reliance on indirect taxation, tax policy instability, and a plethora of tax concessions and reliefs.

Import duties are Sri Lanka's preferred form of revenue collection, with more than half of government revenue being raised this way. Rich and poor are taxed equally on consumption of essential food imports, cooking fuel, and even sanitary pads. Heavy taxes on consumer goods have created a regressive taxation system which struggles to collect sufficient revenue to finance public spending. In contrast, progressive taxation **failed** to grow since the 1990s, with the number of individual taxpayers not keeping up with economic expansion.

These unsound policy decisions can be attributed in part to the expansion of the Executive Presidency's **influence** over the Treasury and the absence of powerful finance ministers. This was demonstrated in November 2019, when President Gotabaya Rajapaksa fulfilled a campaign **promise** to slash taxes that ultimately compounded the revenue loss due to the pandemic.

The pandemic can be seen as the 'straw that broke the camel's back' rather than the cause of Sri Lanka's woes. The situation spiralled out of control when tourism earnings and other sources of foreign exchange took a hit. While worker remittances actually increased in 2020, they reached a ten-year low in 2021 as the fixed exchange rate led to the increased use of informal channels to repatriate earnings.

After sweeping tax cuts in 2019 led to a credit rating downgrade in 2020, Sri Lanka lost access to international financial markets and, subsequently, its ability to roll over the ISBs. While some of the repayments were **supplemented** with increased multilateral and bilateral borrowing, Sri Lanka started dipping into its foreign reserves to meet its debt obligations. This resulted in foreign reserves **plummeting** from a healthy level of USD8,864 million in June 2019 to USD2,361 million in January 2022 (of this, **usable** reserves are in fact only USD792 million). Unable to bring its foreign earnings back to pre-pandemic levels, Sri Lanka now faces a dire

forex crisis. Again, the pandemic merely exposed the country's vulnerabilities rather than precipitating its crisis.

Sri Lanka has a globally unique problem of consistently outperforming its peers on development indicators while contending with dangerously low levels of government revenue. Its economic decline presents a cautionary tale of weak public finance management and short-sighted policies. Rather than being a victim of pervasive lending practices, Sri Lanka is a victim of its own crumbling and politicised institutional foundations. Its trifecta of sins has brought it to the brink of a default and could undo decades of progress and post-conflict stability. The government insists that "Sri Lanka always pays its debts", and while this seems like an admirable stance, how long will the Sri Lankan people bear the cost of that stance?

This post is part of a collaborative series?with [The Asia Foundation](#).

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