Prime Comment

Economic Crisis of Sri Lanka

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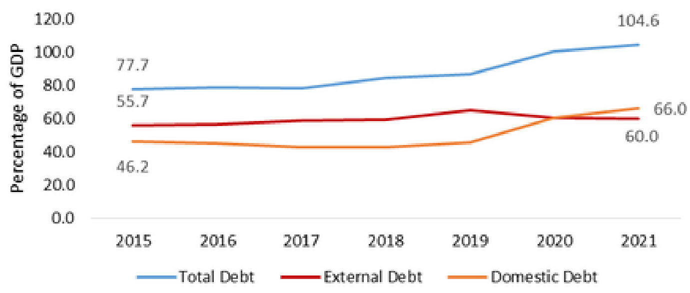
Weak economic management and reliance on tourism for foreign exchange earnings made economy unsustainable with the onset of COVID-19.

Sri Lankan Government announced a default on the external financial obligations in April 2022 to preserve forex for food and fuel imports.

The Sri Lankan economy was performing reasonably well among developing economies with an average real GDP growth rate of 5.2 percent from 2011 to 2018. However, the economy took a downturn with the onset of COVID-19 and subsequent lockdowns, and the real GDP growth rate declined from 3.3 percent in 2018 to a negative 3.6 percent in 2020 and rose to 3.7 percent in 2021. The government was struggling to manage its fiscal operations facing fiscal and current account deficits like most developing countries. Nonetheless, the situation worsened due to an exponential rise in global commodity and energy prices, a halt in tourism activities due to pandemic enforced lockdowns and travel restrictions, soaring external obligations from a rise in external debt, and a significant loss in tax collection due to ill-conceived tax reforms. Resultantly, Sri Lanka had to announce bankruptcy on external obligations in April 2022 where the government's external debt stood at $51 billion in 2022 and was unable to fulfill its external obligations because foreign exchange reserves fell to $1.94 billion.

The fiscal performance of the country started to deteriorate as a result of the pandemic and weak economic policies. The total debt as a percentage of GDP increased from 84.2 percent in 2018 to 104.6 percent in 2021 (Figure 1). The public debt stood at Rs. 12 trillion in 2018 and Rs. 17.5 trillion in 2021.

Figure 1: Debt as a Percentage of GDP

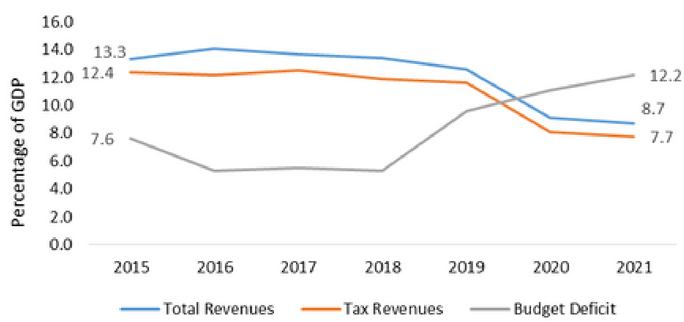


Source: Annual Report 2021, Central Bank of Sri Lanka
*Total Debt and domestic debt data were taken in LKR while external debt data was taken in USD.

The budget deficit as a percentage of GDP increased from 5.3 percent in 2018 to 12.2 percent in 2021 (Figure 2). The budget deficit was Rs. 760 billion in 2018 and Rs. 2 trillion in 2021.

The total revenues as a percentage of GDP declined from 13.4 percent in 2018 to 8.7 percent in 2021. The total revenues stood at Rs.1.91 trillion in 2018 and Rs. 1.45 trillion in 2021. The tax revenues as a percentage of GDP declined from 11.9 percent in 2018 to 7.7 percent in 2021. The tax revenues stood at Rs. 1.71 trillion in 2018, Rs. 1.73 trillion in 2019 and Rs. 1.29 trillion in 2021.

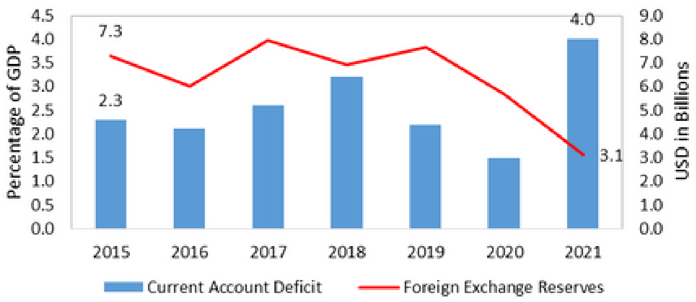
Figure 2: Fiscal Performance of Sri Lanka



Source: Annual Report 2021, Central Bank of Sri Lanka

On the external front, the current account deficit as a percentage of GDP increased from 3.2 percent in 2018 to 4 percent in 2021. The current account deficit was $2.7 billion in 2018 and $3.3 Brillion in 2021. Furthermore, the foreign exchange reserves fell from $6.9 billion in 2018 to $3.1 billion in 2021 and $1.9 billion in April 2022. Resultantly, the Sri Lankan Rupee experienced a devaluation from Rs. 184 in 2018 to over Rs. 200 in 2021 against dollars.

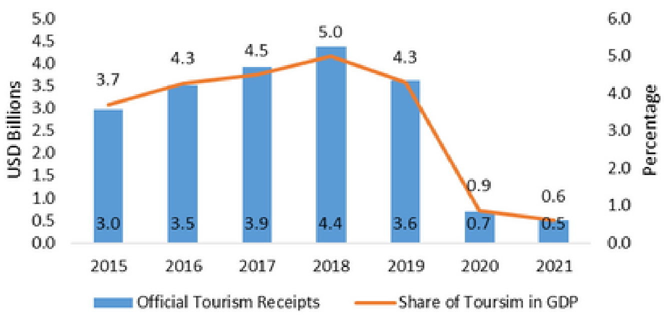
Figure 3: External Account of Sri Lanka



Source: Annual Report 2021, Central Bank of Sri Lanka

Sri Lanka is a tourist destination for foreigners and a source to earn foreign exchange reserves. Tourism in the country was gaining momentum, but the pandemic enforced lockdowns, closure of borders, and a halt in tourism activities resulted in a significant drop in the earnings of the country. The share of tourism in GDP stood at 5 percent in 2018 and started to decline due to the pandemic thus reaching 0.6 percent in 2021 (Figure 4). The revenues generated by tourism stood at $5 billion in 2018 and dropped to $600 million in 2021.

Figure 4: Tourism in Sri Lanka



Source: Annual Reports, Ministry of Finance Sri Lanka

Ill-advised tax reforms based on political aspirations contributed significantly in the revenue shortfall and fiscal imbalances.

The Sri Lankan Government announced tax reforms on November 27, 2019, with effective implementation from December 1st, 2019 to boost the economic activity in the country and fulfill the promises made by Gotabaya Rajapaksa during his presidential election campaign. Following is the list of taxes removed or reduced.

- The Nation Building Tax (NBT) imposed on household goods and services was completely removed from 2 percent.
- The Value Added Tax (VAT) was reduced from 15 percent to 8 percent. Moreover, the registration threshold for VAT was increased from Rs. 12 million to Rs. 300 million per year.
- VAT on the supply of services by hotels, guest houses, restaurants, and other similar services was removed so long as the business is registered with the Sri Lanka Tourism Development Authority and more than 60 percent of the total value of the inputs are sourced from local supplies/sources.
- The government abolished the Pay As You Earn Tax (PAYE) on any employment receipts to any resident or non-resident person. In PAYE, annual income up to Rs. 750,000 was exempted from tax, income tax of 6 percent was charged on Rs.750,001 – 1,500,000, income tax of 12 percent was charged on Rs. 1,500,001 – 2,250,000 and income tax of 18 percent was charged on Rs. 2,250,001 and above.

- On April 1st, 2020, PAYE was replaced by the Advance Personal Income Tax (APIT) which was an optional scheme. The tax-free threshold for personal income tax was also increased from Rs. 0.5 million to Rs. 3 million per annum.
- Withholding Tax on interests was removed.
- The debit tax imposed on banks and other financial institutions as well as the Capital Gains Tax imposed on the Colombo Stock Exchange was removed.
- The income tax on the construction industry was reduced from 28 percent to 14 percent.
- All taxes imposed on the remittances made by ex-pat workers were removed.
- The places of religious worship were exempted from all taxes.

Resultantly, the number of registered taxpayers declined by 33.5 percent from 1.7 million to 1.1 million. Increasing the threshold of VAT resulted in a decline in registrations by 72 percent from 28,914 to 8,152.

The Sri Lankan economy, like the rest of the developing countries, was a consumption-led economy with high reliance on imported commodities and petroleum products. Therefore, the exponential rise in international commodity and petroleum prices, hike in the interest rate and subsequent rise in debt burden, currency devaluation, and rise in transportation cost due to pandemic enforced supply chain disruptions resulted in the inability of the country to fulfill external obligations. In addition, the country relied on tourism as a source to earn forex but the pandemic restricted that stream of earnings. Furthermore, imprudent taxation reforms exacerbated the crisis by undermining the sustainability of the economy and the smooth operation of government.

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