ECONOMIC CRISIS IN SRI LANKA : POLICY CHALLENGES FOR THE NEW GOVERNMENT

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Introduction to the Policy Brief

Economic Crisis in Sri Lanka: Policy Challenges for the New Government

Being an independent, non-partisan research and advocacy think tank, Pathfinder Foundation regularly produces policy briefs on contemporary issues of national and international significance. Besides, it has been the organization's practice to prepare policy papers in advance of presidential and parliamentary elections to brief candidates and political parties.

In this context, the **"Economic Crisis in Sri Lanka: Policy Challenges for the New Government"** report was prepared in consultation with a team of local experts to offer recommendations to place the economy on a sustainable growth path.

The structure of the report consists of three main components.

1. The report begins with an analysis of the genesis of the economic crisis and its impact on the population. It provides a detailed examination of the root causes of the crisis.

2. The second section presents a set of recommendations for "Recovery from the Crisis," highlighting the importance of implementing the IMF program.

3. The third section emphasises that progress must extend beyond the recovery. Achieving macroeconomic stability and debt sustainability is just one step in a long process. The report offers several recommendations, such as strengthening the trade sector with an export orientation, implementing SOE reforms, advancing agricultural reforms, and promoting digitisation.

The report concludes by stressing that the new government must adopt a long-term vision to ensure recovery from the crisis and advance economic progress beyond mere recovery. It emphasises that Sri Lanka must avoid becoming a repeated client of the International Monetary Fund (IMF).

Economic Crisis in Sri Lanka: Policy Challenges for the New Government

INTRODUCTION

This policy brief is aimed at outlining key areas of reforms for a new government. Whatever the emerging political aspirations of the crisis-battered Sri Lankan society, the new government that will be elected at the forthcoming presidential and parliamentary elections is bound to face a series of policy challenges. The continuity of economic recovery from the crisis should be ensured, and the possibility of another crisis should be avoided. A clear vision to set the economy on a sustainable growth path is required. The policy options of old-fashioned tax cuts, politically motivated government jobs, salary hikes, and free hand-out deliveries have now ended because the government's fiscal discipline is a priority. Only higher economic advancement based on production and productivity growth would pave the way for the people of Sri Lanka to acquire high living standards and realize their future aspirations of living in a developed country.

The policy challenges of a new government are not about an ideological debate and discussion. Instead, they are about a pragmatic and robust reform agenda to build an enabling environment for economic recovery and sustained economic growth.

ECONOMIC CRISIS: GENESIS

People's 'two-fold' distress

Sri Lankans are now aware of the harsh reality of an economic crisis they had never experienced during the past 75 years. People suffer from the crisis in two ways: (a) they have faced the adverse effects of sudden economic collapse, such as domestic supply shortages, inflationary consequences, economic contraction, and income and job losses, and (b) they must bear the enduring burden of immediate policy responses to the crisis, such as direct and indirect tax increases, fuel and electricity price hikes, freezing nominal wages, and government expenditure cuts. The cumulative effect of all these is that people's living standards have deteriorated sharply while their poverty and vulnerability levels increased rapidly.

It's a 'man-made' crisis

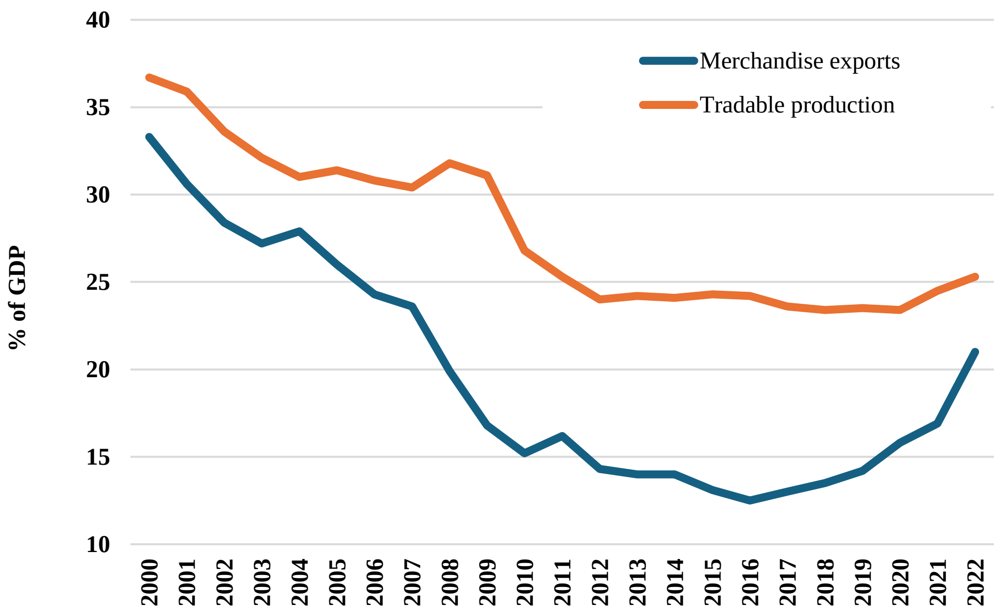
The crisis built up slowly over time, but the resultant collapse was sudden. It is a big question why a country, which had admirable economic and welfare standards throughout its post-independent history, has now fallen into an economic crisis of proportions and has been reduced to a 'hand-to-mouth' status of existence. It is argued that policy blunders by Sri Lankan policymakers over a long period created a fertile ground for its economy to be vulnerable to external shocks. "Covid-19 (external shock) was just the trigger, not the cause, of the crisis". The policy reform process of the country, which evolved through 1977 and 1989, did not move forward after the late 1990s. Instead, the policy environment that emerged since the turn of the century was characterized by production with non-tradable and anti-export biases. The policy reform programme that was previously implemented was reversed in the early 2000s.

The non-tradable bias of production

Part of the production activities are categorised as 'non-tradable', i.e., those that can be only bought and consumed where they are produced; hence, they are primarily directed towards catering to the local market. Since the early 2000s, the contribution of tradable production to GDP growth has been declining (Figure 1). Sri Lanka's GDP growth was increasingly dependent on non-tradable production sectors such as construction, infrastructure projects, power and energy, utilities, transport, telecommunication, finance, public administration, defence, education, and health. Compared with these non-tradable sectors, the growth of 'tradable sectors' such as agriculture and manufacturing has been limited.

A closer examination of public investment reveals that the government has played a major role in the expansion of the non-tradable sector. This policy of public investment to promote and expand the non-tradable sector, largely borrowing from external sources, has increased the budget deficit, external deficit and overall public debt. Furthermore, a study by the World Bank points to the fact that growth performance during the post-war period (2009-2014) has been mainly led by the non-tradable sectors within which construction, transport, domestic trade, banking, and insurance and real estate contributed to 50 per cent of the total growth.

Figure1: Tradable production and exports 2000-2022



The other side: anti-export bias

It is amazing to see that, despite being a 'liberalised' economy for over 45 years, Sri Lanka has been able to generate only US$ 12 billion worth of merchandise exports as of 2023. Sri Lanka experienced a rapid expansion in manufactured exports and a change in its export mix during the initial period of trade liberalisation. However, the country failed to maintain that export growth momentum during the latter period of trade liberalisation after the 1990s. From a comparative perspective, it is indisputable that Sri Lanka's export growth has lagged behind many of its peer countries in the region, including those neighboring countries that initiated trade liberalisation much later than Sri Lanka (Table 1). The slowdown in export growth momentum in Sri Lanka beginning in the early 2000s can be attributed mainly to the policy bias against exports – an inevitable outcome of increased protectionism and non-tradable bias in production.

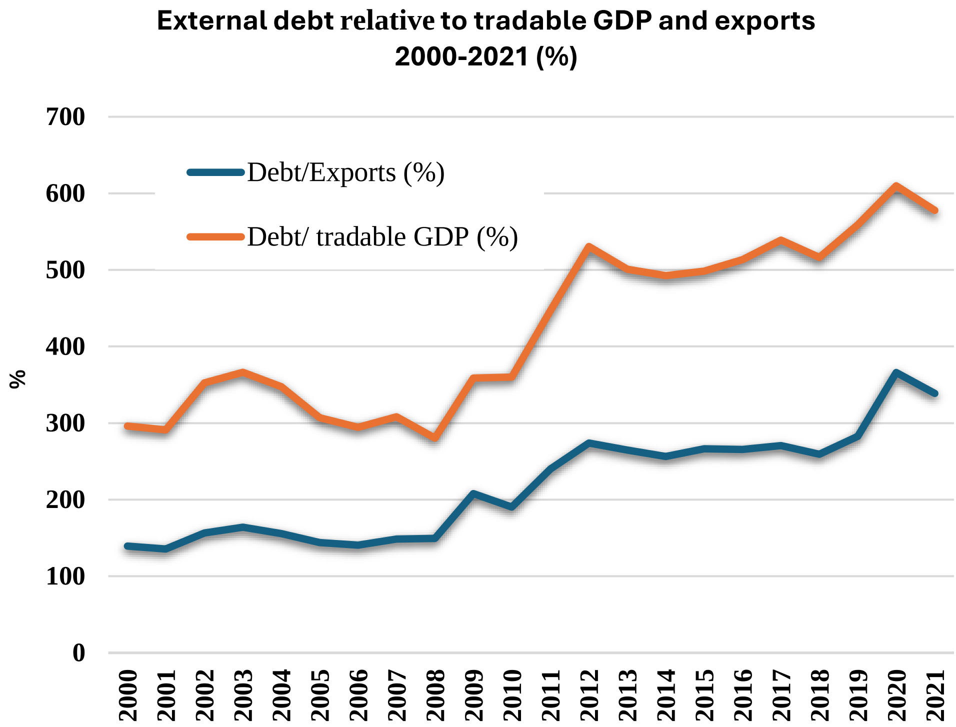
Table 1: Merchandise exports in selected Asian countries (US$ billion)

	1990	2000	2022	2023
Bangladesh	2	6	55	56
Cambodia	0	1	22	23
China	62	249	3,594	3380
India	18	42	453	432
South Korea	65	172	684	632
Malaysia	29	98	352	313
Myanmar	0	2	17	14
Singapore	53	138	516	476
Sri Lanka	2	5	13	12
Thailand	23	69	287	284
Viet Nam	2	14	371	354

Source: World Bank, World Development Indicators

Two episodes of performance

The growth performance of Asian countries is depicted in two episodes, one based on 'trade expansion' and the other on 'fiscal expansion'. In some countries, increased exports have become the main growth driver. Adopting such policies has enabled them to achieve enhanced trade performance and sound management of the government budget. This has been the story of successful export-oriented economies in East and Southeast Asian countries. In contrast, increased government spending has become the growth driver in some other countries, making their growth dependent more on fiscal expansion than trade expansion. Growth has become unsustainable, on the one hand, because it requires repeated increases in government spending, largely through credit financing. On the other hand, growth became increasingly biased towards 'non-tradable' sector expansion, but not emanating from export growth. The need for continuous increases in government spending caused a widening budget deficit and growing public debt. The increased bias towards the non-tradable sector and anti-export bias policies led to a widening trade deficit.



Sri Lanka's external debt conundrum: earning rupees and paying dollars

Sri Lanka is a classic example of a government's attempt to sustain growth in non-tradable sectors with forgone policy reforms towards export promotion. Since 2000, successive governments have placed increased reliance on non-tradable sectors as the major source of economic growth, which has become a key feature of the Sri Lankan economy.

As anticipated, such policies have led to a widening of both the budget deficits and trade deficits. Sri Lanka has persistently faced this ever-growing twin deficit during the last two decades. As foreign borrowings on concessionary terms depleted, Sri Lanka turned to foreign commercial borrowings in 2007 by issuing International Sovereign Bonds (ISBs). From 2007-2019, Sri Lanka borrowed US$17.6 billion from ISBs. Compared with that, the country attracted only US$11.3 billion in foreign direct investments (FDIs), which also flowed primarily into the non-tradable sector. Sri Lanka had already reached a point where debt payment obligations were met with further borrowings from domestic and foreign sources.

The issue of foreign debt payments became persistently more critical because rupee incomes generated from investments in the non-tradable sector did not help service the foreign debt obligations in foreign currency. Consequently, successive governments have been compelled to borrow more to service maturing external debts in addition to recurrent fiscal deficits yearly over a considerable period of time. This untenable situation plunged the country into a vicious circle of large fiscal deficits and unfavorable debt dynamics.

Although the country narrowly escaped possible collapse several times previously, the COVID-19 pandemic and a series of internal policy errors triggered the current economic crisis. Sri Lanka suspended the payment of bilateral and private foreign debt on 12 April 2022, anticipating a debt-restructuring plan and a recovery programme through the IMF.

RECOVERY FROM CRISIS

Given the unprecedented economic crisis that Sri Lanka currently faces, the country needs two-tier policy reforms. The first is implementing an immediate set of policy reforms aimed at economic stabilisation, including debt sustainability. These policy reforms are intended to ensure 'recovery from the crisis' as per the Extended Fund Facility (EFF) agreement that the Sri Lankan government has entered with the IMF and approved on 20 March 2023. The second set of long-term reforms is required to ensure 'economic progress beyond recovery' by pursuing concrete policies addressing "non-tradable sector bias of production" and "anti-export bias" in the economy. However, there are many interrelationships between the two-tier reforms as they could overlap and reinforce each other. Economic stabilisation cannot be sustained without unlocking the country's growth potential, which should be realised by eliminating the obstacles to export growth and creating a conducive environment for private investment.

Five key pillars of the IMF arrangement

The stated objective of the EFF arrangement with the IMF is to "restore Sri Lanka's macroeconomic stability and debt sustainability, mitigate the economic impact on the poor and vulnerable, safeguard financial sector stability, and strengthen governance and growth potential". It is based on five key pillars: (i) revenue-based fiscal consolidation, (ii) restoration of debt sustainability, (iii) price stability and rebuild foreign reserves, (iv) financial sector stability, and (v) structural reforms:

i. Revenue-based fiscal consolidation with efficient tax administration is required to reduce the budget deficit to manageable levels and to minimise borrowing needs. The government does not have an efficient tax collection system for direct taxes. Consequently, tax revenue has been disproportionately based on indirect taxes. Fiscal consolidation could be supported further by adopting cost-recovery of fuel and electricity prices by ending the country's energy price subsidies. However, given the crisis's severe impact on increased poverty and vulnerability, Sri Lanka needs a targeted, time-bound social safety net scheme.

ii. Sri Lanka's public debt had increased to 128 per cent of GDP by the end of 2022. It is unsustainable because the government cannot meet debt repayment obligations with its current level of tax revenue. As per estimates, public debt must be reduced to 95 per cent of GDP by 2032 to make it sustainable. This target could be achieved through debt restructuring on the one hand and improving the capacity to meet future debt obligations with fiscal consolidation on the other. Additionally, external debt sustainability requires reducing the current debt servicing of 9.4 per cent of GDP in 2022 to an annual ceiling of 4.5 per cent of GDP by improving the foreign exchange earning capacity through export promotion.

iii. Sri Lanka needs a "multi-pronged strategy" to restore price stability, as average inflation was 46.6 per cent in 2022. Hyperinflation has wiped out the people's real income, causing a sharp increase in poverty and vulnerability. It is also necessary to build up foreign reserves, which had dropped below US$2 billion by the end of 2022, equivalent to just one month's imports. The usable forex reserve by the middle of April 2022 was negligible. While maintaining a flexible exchange rate, Sri Lanka should improve its ability to purchase essential goods abroad.

iv. The financial sector's stability must be strengthened to eliminate the stress on the banking sector and maintain a healthy monetary policy discipline. The economic crisis has adversely affected the financial sector's stability. The Central Bank must do away with its "bad habit" of printing money to meet the expenditure needs of the government as well while ensuring its independence. This policy has already been adopted, but the country must continue to adhere to it.

v. Finally, the country needs to undertake structural reforms to unlock its growth potential and to address corruption vulnerabilities. As a medium-term programme, growth is essential to enhance income generation and job creation, address the crisis's impact on the nation, and support fiscal consolidation with enhanced tax revenue for the government. At the same time, Sri Lanka's growth potential has been blocked by its corruption vulnerability, which has been growing but ignored for a long time.

Table 2: Change in indicators of stability 2023/24

	Indicator	Time	Δ∇	Remarks
Rate of GDP growth (%)	7.8	Q1/2024	Δ	Positive since Q3/2023
Rate of unemployment (%)	4.5	Q1/2024	Δ	Decline from 4.7% in Q1/2023
Rate of inflation (%)	0.9	Mar-24	Δ	Decline from 69.8% in Sep-2022
Average prime lending rate (%)	12,4	End-23	Δ	Decline from 28.2% end-2022
Change in reserve money (%)	-1.5	End-23	Δ	Decline from 34.4% end-2021
Tax revenue (LKR billion)	2.7	2023	Δ	Increase by 55.4% from 2022
Primary balance (% of GDP)	0.6	2023	Δ	Increase from -3.7% in 2022
Budget deficit (% of GDP)	-8.3	2023	Δ	Decline from -10.2% in 2022
External debt (US$ billion)	55.4	Q1/2024	∇	Increase by 1.0% from Q4/2023
Domestic debt (LKR trillion)	17.3	Q1/2024	∇	Increase by 1.4% from Q4/2023
Foreign reserves (US$ billion)	5.4	May-24	Δ	Increase from $1.9 billion end-2022

Source: Central Bank data

Economic turnaround

During the past two years (2022-2023), with IMF assistance, the government has adopted reforms and implemented a series of new policy measures aimed mainly at restoring macroeconomic stability. Although there have been implementation weaknesses and structural rigidities, Sri Lanka has made remarkable improvements, as acknowledged by the IMF, which continues to recognise this in its biannual assessments. Sri Lanka has been able to turn around its crisis-ridden economy within a relatively short period – as short as two years, and to stop potential deterioration from falling into a much deeper crisis (Table 2).

Improvement in stability, remarkable

Economic contraction during five consecutive quarters ended in the third quarter of 2023 when the real GDP growth rate turned negative to positive. The rate of inflation started to fall after its highest rate of 68.9 per cent, reported in September 2022, reaching a single-digit level in mid-2023. Accordingly, the interest rates that rose steeply to around 30 per cent in 2022 have also come down to around 8.25- 9.25 per cent in the second half of 2024. This is based on the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) announced by the Central Bank of Sri Lanka. Fiscal consolidation improved with increased tax revenue by more than 55 per cent in 2023. The government budget reported a positive primary balance of 0.6 per cent of GDP and a reduction in the fiscal deficit. At the same time, the Central Bank has continued building up its official foreign reserves, which increased to over US$5 billion by May 2024. Although external and domestic debt has increased moderately by around 1 per cent during the first quarter of 2024, there has been a remarkable slowdown in public debt accumulation.

PROGRESS BEYOND RECOVERY

The achievement of short-term macroeconomic stability and debt sustainability is only the first step in a long process. The process of reforms must continue to achieve medium-term and long-term economic progress beyond and above the recovery for several reasons:

- Despite the signs of an economic turnaround, the crisis-ridden Sri Lankan economy is not yet out of danger. It remains highly vulnerable to external shocks and can collapse even further.
- Apart from that, economic stability must be sustained by unlocking the country's growth potential. Only with economic growth can the government maintain its fiscal consolidation by raising the tax revenue.
- The room for improvement in debt sustainability through a negotiated debt-restructuring process is limited. Debt sustainability should be addressed meaningfully through economic growth.
- "Recovery" means achieving the pre-crisis status quo of the economy, which is not at all the desired level of economic prosperity and living standards that the nation aspires to. Economic progress should be sustained in the long run as the key to ensuring the progression of Sri Lanka to a 'developed country' with higher incomes and living standards for the people.

Self-sustaining growth from the 'tradable' sector

The pre-crisis growth pattern of Sri Lanka must be overhauled, shifting away from the 'non-tradable' to the 'tradable' sector that would generate export production. The tradable sector growth supported by non-tradable sector inputs would set the conditions for establishing the required momentum for self-sustaining growth. The government has an ambitious goal of achieving a 'high-income' status by 2048, which is not an unrealistic target by international experience. It requires maintaining a 7-8 per cent annual average rate of GDP growth over the next 20-25 years. As per the 2023 classification of countries by income levels, the high-income threshold is US$ 14,005 per capita, whereas Sri Lanka's current per capita income level is US$ 3,706. Consequently, the country is currently classified as a 'lower-middle-income' country.

Export expansion and investment promotion

Self-sustaining growth requires production for export markets, which are the global markets with billions of customers and competitive markets with many other suppliers. Therefore, export-led production would provide greater opportunities for industrial expansion, benefitting from the economies of scale and providing incentives for innovations. Increased production from the tradable sector aiming at export markets, in turn, requires accelerated private investment flows from both local private investment and foreign direct investment (FDI). The country needs to focus on multiplying its current export earnings of US11.9 billion (2023) to a target of US$100s billion within the next 10-20 years. This ambitious export growth target cannot be realised without attracting FDI, which comes with state-of-the-art technology, management best practices, export market access, and supply chain connectivity. It also requires factor market reforms. Since Sri Lanka has a poor record of attracting FDI, it is necessary to establish a conducive business environment and to win investor confidence by undertaking reforms and setting the required conditions.

Policy reforms for export-orientation

In planning and designing the future direction of Sri Lankan policy reforms, it is crucially important to learn from one's own past experiences to understand what policies have worked or failed in generating growth and employment. Sri Lanka has experimented with all manners of trade policy regimes, from a comprehensive socialist system to a major liberalisation experiment. Though it was a halfhearted exercise, the liberalisation programme implemented in 1977 is widely considered a striking success in generating growth and employment. The resultant reforms helped transform a primary product-exporting economy into one dominated by manufactured goods for the export market. However, reforms failed to persist and were, reversed in the early 2000s, weakening the trade sector. Based on such experience, returning to an 'inward-oriented' policy regime with incentives for importing businesses and domestic sales will be a costly venture. This appears to be the policy scenario pursued during the post-crisis period. This policy orientation should be changed into an 'outward-oriented' one by adopting policies conducive to tradable production and export expansion, necessary to integrate with global value chains to take advantage of economies of scale and scope, benefit from and aimed at opening and facilitating international trade.

Trade Agreements

The unilateral reform is the first best policy option to transform the country into an export-oriented and globally competitive economy. As the second-best option, free trade agreements can promote regional economic integration, address market access barriers, and facilitate capacity development and structural reforms. Today, regional trade agreements have become integral to the multilateral trading system. Thus far, Sri Lanka has entered into four Free Trade Agreements (FTAs) with India, Pakistan, Singapore and recently Thailand. Sri Lanka is also a signatory to several regional trading groupings, such as the Asia Pacific Trade Agreement (APTA), the South Asia Free Trade Agreement (SAFTA) and the Global System of Tariff Preferences (GSTP) etc. Negotiations of several comprehensive economic partnership agreements (CEPA) with China and India are underway. Sri Lanka has also submitted a letter of intent to join the Regional Comprehensive Economic Partnership (RCEP), which stands out as a significant opportunity for Sri Lanka, offering a platform to integrate into broader Asian supply chains. By aligning with RCEP, Sri Lanka can leverage economies of scale and scope, enhancing its competitiveness in global markets.

There have been many concerns about whether these trade agreements have brought about commensurate gains for the country. Hence, before entering into an FTAs, an assessment of the potential costs and benefits of the prospective trade deals must be undertaken. It is also crucially important to carefully select the partner countries, as FTAs would not promote trade in the absence of significant compatibility in trade patterns of the parties to the agreement. Finally, the outcome of FTAs or unilateral liberalization also depends on supply-side reforms needed to improve the capability of business enterprises to reap gains from market opening.

Transparent and Predictable Tariff Policy

Tariff policy, the centerpiece of trade policy in a market system, can play a critical role in creating a more competitive and export-oriented economy. Under the GATT/WTO discipline, tariffs are superior and acceptable trade policy instruments for legitimate protection. Rationalising the tariff structure with a long-term vision should be a priority for the government, striking a delicate balance between safeguarding sensitive industries and ensuring efficient resource allocation to achieve greater economic diversification and more robust export growth.

Unlike other countries in the region, Sri Lanka has a complex tariff regime that maintains a two-tiered tariff schedule that distorts the structure of the economy. This is because, in addition to regular customs duties, the country has imposed multiple taxes and levies known as para-tariffs with various exemption schemes. Adding to the complexity, these levies and charges have been subjected to frequent changes, either raising or lowering the rates; hence, it is argued that Sri Lanka's tariff regime lacks predictability and transparency. Though the country's tariff structure is characterised by a relatively low Most Favored Nation (MFN) average duty of 5.9%, with a trade-weighted average of 5.4% (2022), these low MFN averages conceal the actual level of protection as there is a second layer of duties and charges described above as para tariffs creating an anti-export bias in the economy.

The Effective Rate of Protection (ERP) is a better measurement than the Nominal Rate of Protection (NRP), such as the MFN tariff level, for evaluating the impact of tariff policies on domestic industries and trade distortion. In the case of Sri Lanka, the ERP initially declined after economic liberalisation in 1977—from a peak of 137% to 56% by the early 2000s. According to the recent estimates by the Department of Census and Statistics (DCS), this trend has lately reversed, recording high ERP for most protected industries. Finally, the complexity of the tariff regime has resulted in corruption and inefficiencies in the trade system.

For the above reasons, Sri Lanka's tariff policy requires significant reform to produce a more transparent, predictable, and resource-mobilising tariff regime beyond the objective of mere revenue generation. Designing, formulating, and implementing a transparent, affordable, and predictable tariff regime with a long-term vision is needed for addressing the anti-export bias, minimising trade distortions, and paving the way for the country to better integrate into the regional and global value chain while safeguarding domestic agriculture and industries and ensuring availability of goods for consumers at affordable prices.

Investment promotion and ease of doing business

Investment promotion and the environment for doing business should be enhanced with regulatory and institutional reforms to make the country a competitive business enclave in the region. The regulatory framework within which investment promotion and doing business operate should be simplified and rationalised, lengthy and cumbersome bureaucratic procedures should be eliminated, and an efficient institutional network should be established. Public sector reforms should create a 'demand-driven' sector serving the nation's development needs with responsibility and accountability. In undertaking a wide range of reforms for investment promotion and doing business, Sri Lanka must restore 'investor confidence' and avoid differentiated treatment between local and foreign investment. A conducive business environment is far more important than tax concessions and special favors in attracting foreign investment.

Land and labour market reforms

Currently, Sri Lanka adopts an outdated and complex set of laws for labour utilisation and land allocation for investment, which deviates Sri Lanka from being a competitive business enclave among its peers in the region. These laws should be revised and modernised to meet the modern factor market requirements and to establish a competitive factor market in the country. Furthermore, being a smaller country with 22 million people, Sri Lanka has a scarcity of skilled labour and professionals, hindering potential investment promotion. Many countries overcome their labour shortages by adopting flexible regulatory procedures for recruiting "foreign talents".

State-owned enterprise reforms (SOEs)

In recent years, reforms of State-Owned Enterprises (SOEs) have become a focal point in both public and academic discussions. The chronic poor performance and persistent losses of many SOEs have increasingly burdened the economy, exacerbated government budget deficits and contributed to rising national debt. There are about 527 SOEs engaged in a wide variety of economic activities, of which 52 SOEs are considered strategically important. Alarmingly, the cumulative losses incurred by these SOEs have reached Rs 1.5 trillion between 2007 and 2021. The emerging consensus in public policy circles is that rationalization and restructuring of SOEs are essential. The goal is for strategically placed SOEs to operate profitably, blending public sector ownership with private sector management.

Meanwhile, other SOEs should be transferred to the private sector. There are several reasons why such reforms are crucial. Many SOEs operate inefficiently, leading to significant financial losses. Poor management systems, widespread corruption, and high levels of political interference have created weak and underperforming SOEs. Politicians have often used SOEs to employ loyalists and extended family members, many lacking the business acumen and qualifications to run these enterprises efficiently. This practice has further compounded the inefficiency and financial woes of SOEs. The continued operation of loss-making SOEs drains government resources. If these SOEs ceased operations, the government could save substantial resources, redirecting funds towards more productive areas.

Given the extensive role of SOEs in the economy, their restructuring and reform must be a priority for the government. Such reforms can be undertaken in both immediate and long-term contexts. In the immediate context, the government can pursue restructuring and disinvestment initiatives. This involves reorganizing SOE's operational and managerial structures to enhance efficiency and reduce losses. Gradually reducing government stakes in SOEs and inviting private sector participation can improve management practices and financial performance. Wherever possible, forming public-private partnerships (PPPs) can leverage private-sector efficiency while maintaining public-sector oversight. Long-term reforms require a comprehensive approach to address the underlying issues plaguing SOEs. Implementing robust governance frameworks to limit corruption and political influence is critical. Transparent and accountable management practices must be established to restore the credibility and performance of SOEs. Enhancing operational efficiency through modern management practices, technological adoption, and performance-based incentives for employees can significantly improve the productivity of SOEs. SOEs should adopt pricing strategies that reflect actual costs, reducing the financial burden on the government and ensuring sustainability. In sectors where SOEs hold monopolies, unbundling operations can introduce competition, driving efficiency and better service delivery. Allowing private sector competition in sectors dominated by SOEs can improve service quality and financial performance through market-driven practices.

A detailed examination of financial data from 2007 to 2021 highlights the urgency for SOE reform. The cumulative losses of Rs 1.5 trillion underscore the economic drain caused by inefficient SOEs. In contrast, privatized entities or those operating under PPPs often show marked improvements in efficiency and profitability. For instance, the partial privatization of Sri Lanka Telecom in the early 2000s led to a significant turnaround in its financial performance and service quality. The reform of SOEs is not just an economic imperative but a strategic necessity for the sustainable development of Sri Lanka. The government can transform SOEs into valuable assets rather than liabilities by adopting immediate restructuring measures and pursuing long-term governance and efficiency improvements. Integrating private sector management practices and fostering competitive markets will be crucial in this transformative journey.

Digitisation and digitalisation

Converting data into digital forms and transforming manual systems and processes into digitalised forms are two key areas that need to be improved to accelerate the country's development. Although these changes have been taking place in an ad-hoc and piecemeal manner in both private and public sectors, the lack of infrastructure, knowledge and skills, regulatory mechanisms, and incentives have prevented digitisation and digitalisation by international standards. In business operations, agriculture development, and industrialisation, digitisation and digitalisation remain fragmented and often, in many cases, limited to outdated technological standards. Reforms aimed at digitisation and digitalisation enhance productivity and efficiency while improving in many other areas, such as evidence-based decision-making, time and cost saving, and reducing corruption vulnerabilities.

Strengthening Digital Public Infrastructure (DPI) in Sri Lanka

Digital transformation is vital for Sri Lanka's national growth and societal development. This transformation involves integrating digital technologies across all aspects of governance and public service delivery to improve efficiency, accessibility, and transparency. Despite significant investments, Sri Lanka still ranks 96th on the UN's E-Government Development Index, indicating the need for continued efforts in digital infrastructure, service quality, and human capital development. A national strategy centered on Digital Public Infrastructure (DPI) can drive these efforts, focusing on enhancing public services, fostering economic growth, ensuring digital inclusion, and strengthening cybersecurity. Emphasising data-driven decision-making and adopting principles such as interoperability and inclusivity will be essential for successful digital transformation.

Effective digital leadership, robust governance frameworks, and public-private partnerships are crucial for building resilient DPI systems. These systems should be based on common design principles, ensuring openness, scalability, and modularity. Furthermore, a unified approach to data standards and integration will enhance functionality and secure data exchange. Inclusivity and accessibility should be prioritised to bridge the digital divide and build public trust. By investing in connectivity, digital identity, payments, and cloud infrastructure, Sri Lanka can position itself as a leader in the global digital economy. A comprehensive DPI strategy will streamline government operations and foster socio-economic opportunities, paving the way for a digitally empowered society.

Environmental sustainability

Economic growth generates environmental implications by using the stock of natural capital, exhausting the material inputs from the planet, and creating negative externalities on the environment. Modern approaches to economic activities are sensitive to their environmental implications on pollution, climate change, and biodiversity loss. In addition, sustainable production and consumption practices have become integral parts of the core business in every form of economic activity, making them more competitive in the global marketplace where voluntary sustainable standards are increasingly gaining ground. The future growth path of Sri Lanka must integrate strategies for sustainable use of natural capital and better environmental management practices, minimising and mitigating the environmental impact of growth and development.

Strategies for a green economy

The transition to a green economy is a pressing need in the face of environmental challenges and a strategic road to reach the Sustainable Development Goals (SDGs). To align economic growth with environmental sustainability, Sri Lanka must implement green economy strategies that prioritise the efficient use of natural resources and emission reduction and promote sustainable practices in all sectors. Key strategies include investing in renewable energy, enhancing energy efficiency, and implementing waste reduction and recycling programmes. By integrating these approaches, Sri Lanka can minimise adverse environmental impacts and foster a resilient economy that supports SDGs.

Sri Lanka's current initiatives, such as solar, wind, hydropower, and bioenergy investments through the Sri Lanka Sustainable Energy Authority (SLSEA), demonstrate a commitment to green economy strategies and achieving the SDGs. Expanding renewable energy projects, improving energy efficiency, and introducing more comprehensive environmental management techniques can help Sri Lanka's green economy and long-term sustainable development.

Poverty and income vulnerability

The impact of the economic crisis on the country’s poverty has been devastating. As per the international poverty line of middle-income countries, World Bank estimates show that 5.7 million people (25.6 per cent of the population) earn less than US$3.65 a day. In addition, people above the poverty line have fallen closer to it, showing an increase in vulnerability. While the government has implemented immediate poverty alleviation schemes, inclusive growth-promoting policies should be adopted as part of the long-term poverty reduction strategy for narrowing inequalities through sustained economic growth, which could generate employment and income opportunities. In situations where large-scale poverty exists, such as in the case of Sri Lanka after the economic crisis, a sustainable poverty reduction strategy will require more than economic growth and the adoption of pro-poor policies.

Modernisation of the agriculture sector

Sri Lanka's agriculture sector, comprising plantation and non-plantation crops, has lagged due to the lack of modernisation and productivity growth. From a comparative perspective, the Netherlands – a small country with a similar labour force as Sri Lanka, has only 200,000 farmers. Yet, it has become the world's third largest agricultural exporter after the USA and Brazil. The agricultural value addition to its US$ 1 trillion GDP is less than 2 per cent in the Netherlands. Due to high farmer productivity, however, the share of value addition by an average farmer is as high as US$ 78,000 a year. In Sri Lanka, with its 2.2 million farmers in the agriculture sector, an average farmer's value addition is only US$ 3,500 a year, which can be largely attributed to low productivity, low-value chain development, and low application of technology in the sector, causing persistently high-level of rural poverty. Accordingly, over 90 per cent of the country's poor live in the rural and estate sectors. The Sri Lankan agriculture sector needs more significant reforms for both modernisation and productivity enhancement, investment in 4IR technology transfer, and increased scale of operations.

Modern industrial development drive

A successful industrialisation process requires creating a conducive business and policy environment that eliminates impediments to industrial expansion and enhances the global competitiveness of industries. Industrial policy intrinsically links with a range of other policy domains: While it cuts across trade, investment, technology, factor markets, and education, a conducive business environment also requires various enabling and modernising policies and regulatory mechanisms, including those needed for greening and digitalising industries. Industrial sector development is directly linked to agriculture sector development because they fulfill each other's input requirements and help absorb excess labour from the rural agriculture sector. Sri Lanka needs to create an enabling environment for industrialisation by (a) knitting together a series of diverse policies and regulations, (b) adhering to 21st Century industrial standards in terms of knowledge, technology, digitalisation, and environmental standards, and (c) reflecting the national priorities and the need for inclusive growth.

Modernisation of education and healthcare

Although Sri Lanka could boast about its "free education" and "free healthcare" maintained historically, they lack modern international standards regarding quality improvements. In addition, the inequalities concerning service delivery and access to opportunities in both sectors continued to prevail, resulting in equity issues in the outcomes. The two industries must undergo reforms and provide opportunities to perform competitively and efficiently by minimising inequalities.

Education to match economic development strategy

Sri Lanka's education was formalized by the C.W.W. Kannangara Reforms in 1943, and the Free Education Act of 1945 recognized education as a right to be provided free of charge on an equitable basis by the state. Since then, a series of laws, reforms, and strategic policy documents have ensured that education remains relevant and adaptable to the country's needs and global changes. Significant milestones include the Education Reforms of 1972, the ratification and adaptation of the World Declaration on Education for All Framework for Action in 1990, the Compulsory Education Regulations and education reforms of 1998, and the adaptation of the World Declaration on 'Education for All' (Dakar Framework for Action) in 2000, all of which have shaped policy and practice to maintain the relevance of education to the socio-economic context of the country.

The youth unrest in the north and south of the country was also a driving force for change in education in the 1990s. However, by 2010, the state realized that piecemeal reforms and laws had resulted in a disjointed education system that lacked equity, quality, and relevance. Therefore, a new Education Act was drafted in 2010 to reorient education according to a new set of goals and principles that recognise the country's multiethnic, multi-religious, and multi-linguistic society and establish equity in education.

The Draft Act also argued that curricula were not updated and aligned to learning outcomes, methods of learning, and teaching and evaluation practised globally, which prepared young people for a diverse and competitive world of work. The draft Act, however, was not fully approved, and the National Education Policy Framework for 2020-2030 was drafted throughout 2020 after a diagnostic review of the education system and its nexus with the economy. Sri Lanka has been struggling to make lasting changes in its education system as proposed reforms were interrupted due to changes in government. The challenge ahead is, therefore, to implement a dynamic education policy that addresses the mismatch between the skill set required for economic development and what exists in the labour force and the implementation of policy with full participation of the stakeholders.

Mainstreaming gender into development policies in Sri Lanka

Mainstreaming gender into development policies in Sri Lanka is a multifaceted endeavor aimed at achieving gender equality and empowering women and girls in all spheres of life. The National Policy on Gender Equality and Women's Empowerment, launched in 2023, provides a robust framework for incorporating gender perspectives into national laws, policies, programs, and mechanisms. This policy ensures women have equal rights and opportunities within the governmental, public, and private sectors. By recognizing women's unique challenges, especially during crises, the policy aims to reform archaic laws, address gender-based violence, and promote economic empowerment through targeted interventions. For instance, it includes measures to improve the livelihoods of displaced women and enhance access to education and state services for female heads of households.

Sri Lanka's commitment to gender mainstreaming is further reflected in its alignment with international goals, such as the Sustainable Development Goals (SDGs). Achieving SDG 5, which focuses on gender equality, involves eliminating discrimination and violence against women and girls and ensuring their full participation in economic, social, and political spheres. The country's efforts include implementing gender-responsive budgeting, promoting women in leadership positions, and enhancing data collection to inform evidence-based policies. Despite significant progress, challenges remain, particularly in translating the educational achievements of women into labor force participation and addressing the underrepresentation of women in decision-making roles. Strengthened regulations and continuous policy reforms are essential to overcoming these barriers and fostering a more inclusive and equitable society.

Reducing corruption vulnerability

The corruption vulnerability of the Sri Lankan economy and its potential expansion is high, so even the Extended Fund Facility (FEE) arrangement with the IMF specified the need to reduce corruption vulnerability. Corruption affects the economy through its negative implications of creating market distortions, damaging the investment climate, eroding the ease of doing business, increasing the costs of doing business, and promoting misallocation of resources. While regulatory reforms and digitalisation are needed to reduce corruption vulnerabilities, the reforms that directly address the issue at source are necessary to combat corruption and unlock the country's growth potential.

FINAL REFLECTION AND FUTURE DIRECTION

Contrary to the widespread perception that the COVID-19 pandemic caused Sri Lanka's unprecedented economic crisis, the root cause is largely attributed to the culmination of debt distress that has been building up for over two decades, aggravated by several major policy blunders, including tax cuts in 2019. Those policy blunders made the country more vulnerable to external shocks, priming the economy to collapse. It resulted from 'non-tradable' sector bias in the country's growth momentum, in which credit-financed fiscal expansion played a significant role. Without a sustainable growth momentum from an export-oriented 'tradable' sector, the government could not finance its growing import requirements and meet the maturing external debt obligations. Eventually, the Covid-19 pandemic (external shock) triggered the economy's collapse.

Sri Lankan authorities mistakenly overestimated their capacity to manage the crisis independently without entering into a stabilisation arrangement with the IMF. A decision to seek IMF support was significantly delayed despite repeated professional advice, including from leading independent think tanks to seek IMF support. Timely action with IMF support could have helped the government to manage the crises at a lower economic and socio-political cost and avoid a sovereign debt default.

Sri Lanka's policy response to the crisis has been two-fold: First, the country needed immediate adjustments to restore economic stability and debt sustainability. Secondly, Sri Lanka must ensure recovery from the crisis and economic progress beyond the recovery.

Immediate policy responses

Along with the assistance from the FEE arrangement with the IMF, the Sri Lankan economy was able to make a quick turnaround within two years (2022-2024). Despite the painful adjustment cost, this unique achievement is remarkable, as confirmed by improved macroeconomic indicators. The domestic and foreign debt restructuring (except for commercial debt) has already been concluded, improving the room for internal and external finance management.

Progress beyond recovery

Sri Lanka must undertake its long-overdue structural reforms to unlock its growth potential, shifting the policy focus from the 'non-tradable' sector towards the 'tradable' sector. This is fundamentally important not only to sustain economic stability and debt sustainability but also to ensure a long-term progressive growth path of the economy and to avert possibilities for another crisis. Accordingly, Sri Lanka must achieve a fast track of export expansion, which in turn depends on effectively addressing supply-side limitations and constraints in generating FDI inflows. A series of structural reforms in the medium term is needed to ensure economic progress is on the right track to achieve high-income status by the mid-21st Century.

"Nation that disregards new things…"

Challenges to reforms exist primarily because of resistance to changes, even though many would acknowledge the value of Munidasa Kumaratunga's famous poetic line: "The nation that disregards new things in the world does not rise!" Reforms are aimed at long-term benefits of the nation so that they may not be politically correct in the short-run and for everyone, referred to as "adjustment costs". However, the cost of any deviation from the structural reform process would be heavy on the economy and the nation's future.

Stop being a repeat IMF client

It is, however, a remarkable development that there is now a broader political consensus over the EFF arrangement with the IMF. Being a "repeating client" of the IMF, Sri Lanka has resorted to IMF assistance 17 times from 1965 to 2023. India, for example, sought IMF assistance for the last time in 1991. Since then, India has never asked for IMF assistance because the country has continued with reforms and achieved economic recovery and progress. Similarly, Thailand never sought IMF assistance after 1997. Thailand, too, recovered from the financial crisis with IMF assistance and continued with reforms since then to recover from the crisis and ensure greater economic performance. Sri Lanka must stop the cycle of repeatedly resorting to IMF assistance by not abandoning the current reform process but by implementing it to achieve economic stability and progress.

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Pathfinder Foundation is a premier think tank that has played a catalytic role in research and analysis aimed at contributing to economic policy reforms in Sri Lanka. Over the years, it has established a wide network of partner organizations worldwide, thereby enhancing bilateral and multilateral partnerships to promote economic, social, and political development, in addition to its security and strategic focus. Serving as a platform to engage in critical thinking and cross-disciplinary analysis, the Pathfinder Foundation aims to increase knowledge and raise awareness of salient issues with relevant stakeholders locally and internationally.