SRI LANKA'S ECONOMIC RECOVERY AND INCLUSIVE DEVELOPMENT: PROSPECTS AND CHALLENGES

EXECUTIVE SUMMARY

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Currently, Sri Lanka is undergoing a severe economic crisis with multiple setbacks, including negative GDP growth, twin deficits in the fiscal and current account of the balance of payments, foreign exchange shortage, debt unsustainability, inflation volatility, exchange rate and interest rate misalignments, excessive monetary expansion, low savings and investment, and tremendous economic contraction. Per capita GDP declined from US$ 4,082 in 2019 to US$ 3,851 in 2020 and to US$ 3,830 in 2023. As a result, Sri Lanka has been downgraded from upper middle-income status to lower middle-income status since 2021. Sri Lanka became a debt-default country for the first time in its history in April 2022.

The objective of this study is to diagnose the current policy gaps in recovering the economy in tandem with inclusive development and to present actionable policy recommendations. Inclusive development, defined as economic development that creates opportunities for all segments of the population and distributes the dividends of increased prosperity fairly across society, is central to this analysis. Simultaneous achievement of economic recovery and inclusive development is a tough policy dilemma facing the country today.

The economic crisis and the COVID-19 pandemic, have had devastating effects on the well-being of the people, reversing the declining trend of poverty experienced over a decade. Poverty has risen for four consecutive years due to the economic contraction that led to losses in employment, wages, and income. Approximately, 60 percent of households reported a loss in their income in 2023. The poverty headcount index (at the US$ 3.65 per capita per day level, 2017 PPP) more than doubled from the pre-crisis level of 11.3 percent in 2019 to 25.9 percent in 2023. Poverty levels are higher in destitute areas, which do not have adequate income-generating opportunities. Reflecting a rise in income inequality, the Gini coefficient rose from 37.7 in 2019 to 38.5 in 2023. High inflation resulted in a deterioration of the purchasing power of household income. The decline in foreign remittances also had negative effects on household income.

The Labour Force Participation (LFP) declined consecutively for four years from 52.3 percent in 2019 to 48.6 percent in 2023, as a result of the closure of 20 percent of Micro, Small, and Medium Enterprises (MSMEs). In 2023, female LFP remained much lower at 31.3 percent, compared to male LFP at 68.6 percent. Spatial-wise, LFP in urban areas at 46.0 percent was lower than rural LFP at 49.1 percent. The youth unemployment rate (20-29 years) rose from 15.3 percent in 2019 to 17.0 percent in 2023. The highest unemployment rate of 8.0 percent was recorded for the educated group (G.C.E. A/L) in 2023.

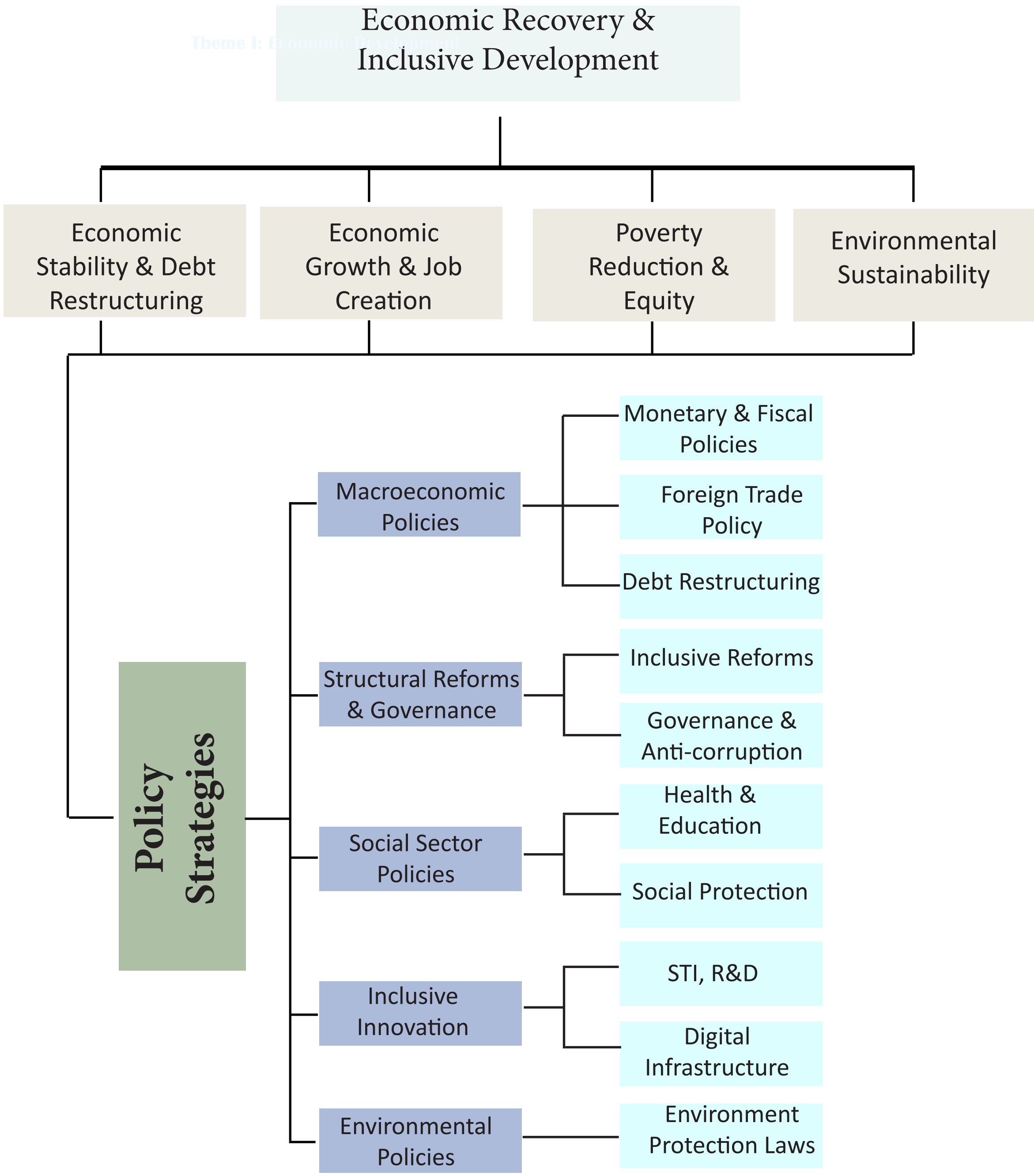
The current economic crisis is the culmination of imprudent economic policies adopted by successive governments over decades. Macroeconomic policy decisions have been mostly taken at the discretion of political authorities, in the form of political budget cycles, to gain election victory, without longer-term planning and consistent policies. Sri Lanka's debt stock had been increasing to unsustainable levels, particularly after the end of the civil war, which coincided with the Global Financial Crisis. The Government began a binge of commercial borrowings particularly by floating International Sovereign Bonds (ISBs) at very high interest rates, when interest rates in the West were close to zero leading to supply-side push of global finance capital into the emerging markets.

A series of ill-advised policy decisions taken by the Government and the Central Bank during 2019-2022 triggered the economic crisis. They included abrupt tax cuts, monetary financing of the fiscal deficit, money printing, interest rate and exchange rate fixing, import and foreign exchange controls, and a sudden ban on agrochemicals.

Following the default on its external debt, the Government signed onto a 4-year Extended Fund Facility (EFF) with the IMF in March 2023, towards restructuring external debt based on the IMF's Debt Sustainability Analysis (DSA) and reforms toward economic revival. The IMF reform program seeking to bring economic stability involves severe austerity measures impacting the social and economic conditions of the people. Furthermore, GDP growth is projected to remain only at 3.0 percent per annum during the period 2026-2028, even after making the policy adjustments. This indicates extremely limited prospects for inclusive development.

The macroeconomic imbalances and the economic downturn have frustrated Sri Lanka's development efforts and therefore, attempts to promote inclusive development must go hand in hand with the economic recovery process. Accordingly, a broad-based policy framework is proposed in this study to achieve the ultimate goals of economic recovery and inclusive development, as illustrated in Figure 1. It entails intermediate goals of (a) economic stability and debt restructuring, (b) economic growth and job creation, (c) poverty reduction and equity, and (d) environmental sustainability.

FIGURE 1: PROPOSED POLICY FRAMEWORK



Source: Developed by the Authors

In the backdrop of the economic catastrophe, the highest priority should be given to macroeconomic policy reforms to restore economic stability, supporting those affected by the crisis. Furthermore, the ongoing demand-oriented policy adjustments need to be balanced with supply-side policy reforms aimed at reorienting the production system for the benefit of all.

The policy strategies proposed in this study are five-fold, namely (a) macroeconomic policies, (b) structural reforms and governance, (c) social sector policies, (d) inclusive innovation, and (e) environmental policies, as discussed below.

(a) Macroeconomic Policies: Prudent macroeconomic policies, mainly fiscal and monetary policies, are required to achieve low inflation, external balance, and debt sustainability, creating a conducive environment for private saving and investment, facilitating economic growth. For this purpose, fiscal policies need to be counter-cyclical by raising government expenditure and curtailing taxes during a recession and vice-versa. Fiscal operations should promote efficient resource allocation and minimize the distortionary effects including arbitrary incentives and concessions. Action needs to be taken to reduce the tax burden on the poor and to provide sufficient funding for the social sector. With the flow of incomes declining during the crisis, redistribution of wealth is necessary through measures such as wealth taxes. The Central Bank has the responsibility to adopt counter-cyclical monetary policy for price stability.

(b) Structural Reforms and Governance: It is necessary to do away with stop-go type policies adopted by successive governments. Governance should be rule-based, ensuring corruption is brought to an end, addressing state procurement and expenditure processes. Structural reforms should have a spatially inclusive orientation with investment reaching all regions of the country and weighted towards the rural and excluded sections of society, and not concentrated in the Western Province. Priority should be given to land reforms to strengthen rural communities, and development focused on value addition and agro-based industries utilizing local resources. Clarity with reforms on the sectors and the purview is critical; some sectors such as utilities and transport should remain public, production and export-oriented sectors can be private, and rural livelihoods can come under the cooperative sector. Parliamentary oversight over debt management including approval for foreign borrowings and agreements with the multi-lateral institutions, including the IMF, prior to such agreements is essential to ensure democratic responsibility and transparency. Institutional reforms in economic management are needed to prevent politically-biased policy decisions.

(c) Social Sector Policies: Social welfare and services including health, education, and social protection over the decades have seen a secular decline in funding and the situation has worsened in recent years due to the economic crisis. In 2023, the government's recurrent and capital expenditure to GDP ratio was only 1.50 percent for health and 1.61 percent for education. In contrast, the government's interest payments on public debt amounted to 8.89 percent of GDP in 2023. This reflects the limited fiscal space available to raise expenditure for the social sector. Higher expenditure on defence and security services, which amounted to 1.70 percent of GDP in 2023, is another factor that constrains social sector spending. There is worldwide evidence that corruption, particularly associated with higher military spending, shrinks government expenditure on health care and education. Hence, action should be taken to reallocate fiscal resources from less-priority sectors to health and education, which are instrumental in advancing human resource development.

(d) Inclusive Innovation: Science, Technology and Innovation (STI) should be outreached to low-income earners and excluded groups, particularly in rural areas to enhance productivity of their economic activities. In the current policy reforms, there is hardly any emphasis on inclusive innovation. Government expenditure on Research and Development (R&D) is only 0.12 percent of GDP. In this context, the National Science Foundation (NSF) could take the lead in formulating a national inclusive innovation policy framework for Sri Lanka.

(e) Environmental Sustainability: Economic policies geared to achieve economic development should not be compromised with environmental sustainability. The people with livelihoods dependent on natural resources such as fisherfolk and farmers should be mobilized to ensure sustainable development through a participatory process, even as they prepare to face the shifting landscape with climate change. Finally, it is necessary to identify and promote economic reforms matched with environmental goals.

Greater political commitment is essential to vigorously pursue the above policy framework to resolve the policy dilemma of economic recovery vis-à-vis inclusive development so as to assure no one is left behind during this difficult period. More importantly, economic management should be based on rule-based procedures, instead of politically-favourable arbitrary decisions.