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MINISTRY OF FINANCE – SRI LANKA

Fiscal Sector: Present Situation and Way Forward

Highlights

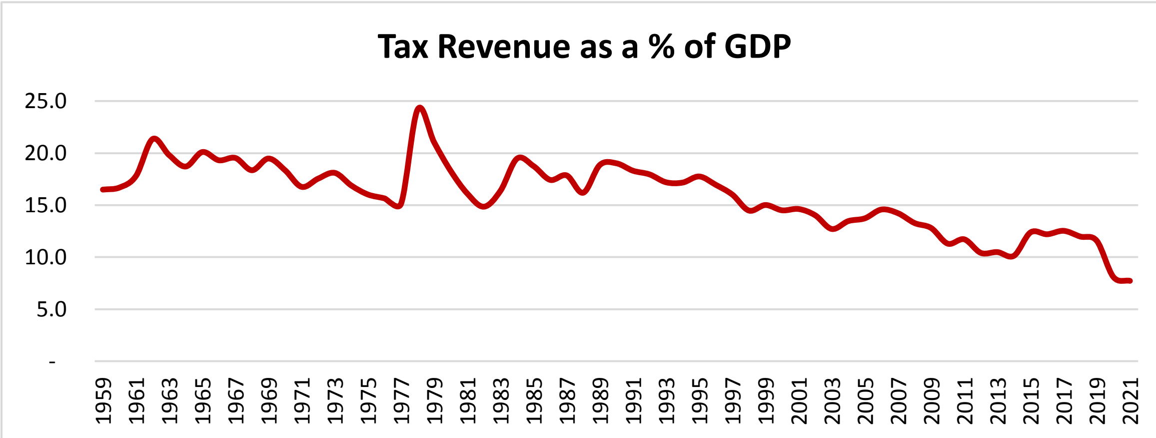
- *Government's fiscal operations have played an important role in improving economic and social conditions in Sri Lanka over the years.*
- *However, at present, dismal fiscal sector performance has caused many imbalances in the macroeconomy.*
- *Exceptionally low tax revenue, rigid recurrent expenditure, a large budget deficit, accumulated and now unsustainable debt are the key concerns in the fiscal sector.*
- *Deficit financing poses a critical challenge due to the shortfall of foreign financing following the loss of international capital market access.*
- *The resulting rise in monetary financing has caused severe macroeconomic imbalances.*
- *Hence, strong revenue-based fiscal consolidation measures are imperative to improve the fiscal performance in the near to medium term.*
- *Sri Lanka should urgently undertake difficult, but much needed and far-reaching reforms to address the accumulated and persistent issues.*
- *The time has come to put the "house in order" and revamp the Government's fiscal operations to strengthen macroeconomic stability and facilitate economic growth in the medium to long term.*
- *The Government's decision to seek the assistance of the International Monetary Fund (IMF) will be a starting point and a catalyst to implement these critical reforms with the support of the citizens and other stakeholders.*
- *Responsible and disciplined fiscal management has become more important than ever.*
- *In this process, the country and its citizens will have to go through a period of difficulty.*
- *A strong social protection network is required for the vulnerable and needy segments as reforms will be painful.*
- *Failure to implement required policy reforms at this critical juncture will be very costly.*
- *However, it will lay a strong foundation to create a modern and robust economy for the future generations to come.*

Government fiscal operations have played an important role in improving economic and social conditions in Sri Lanka during its post-independence history. However, the dismal performance of the fiscal sector over the years has contributed to macroeconomic instability and failed to support long-term growth. The excess aggregate demand generated by unsustainable fiscal deficits has resulted in elevated inflation, pressure on the balance of payments (BOP) and currency volatility. Sri Lanka today is facing a severe BOP crisis with insufficient foreign exchange to buy essential imports such as food, energy, and pharmaceuticals, let alone meeting its debt service obligations. Sound macroeconomic fundamentals cannot be achieved without prudent and sustainable fiscal outcomes. Accumulated issues in the past have now exploded and caused severe disruptions to the day-to-day lives of Sri Lankans, leading to widespread public displeasure and social unrest.

The fiscal sector performance in the recent past is characterised by exceptionally low government revenue, rigid recurrent expenditure, high budget deficits, and accumulated debt which is now unsustainable. The weak fiscal position has manifested in credit rating downgrades, loss of access to international capital markets and foreign financing. As a result, the Government has increasingly relied on domestic financing of the budget, including monetary financing by the Central Bank, in turn leading to significant macroeconomic imbalances.

Government revenue declined particularly sharply in the last two years due to various reasons including the economic downturn caused by the COVID-19 pandemic, import restrictions imposed to ease the external sector pressure, but most importantly, due to the ultra-low tax regime introduced in late 2019 and the COVID-19 related easing measures in early 2020 (Chart 1). Even before these tax cuts, Sri Lanka was a country with one of the lowest revenue-to-GDP ratios in the world, and the tax cuts drove Sri Lanka closer to the bottom of this list.

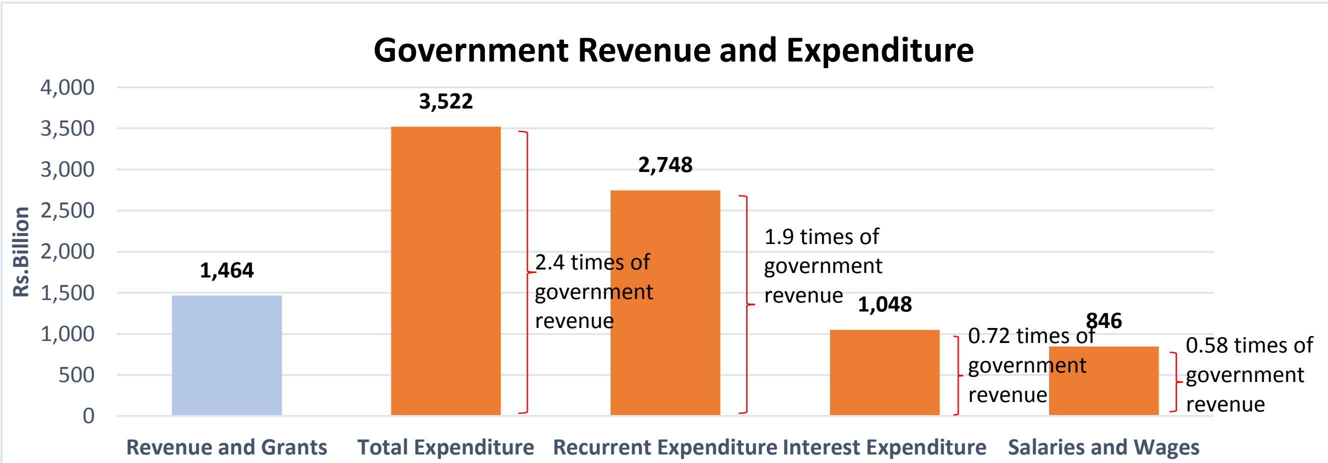
Chart 1



Source: Ministry of Finance

The magnitude of the Sri Lankan Government's revenue condition is displayed below (Chart 2). The Government's total expenditure was 2.4 times of Government revenue in 2021. Recurrent expenditure, i.e., expenditure on the Government's day-to-day operations, was 1.9 times of Government revenue in 2021. Interest expenditure absorbed 72 per cent of Government revenue—one of the highest such ratios in the world—while salaries and wages amounted to 58 per cent of Government revenue. Government revenue is insufficient to meet the recurrent expenditure such as interest payments, salaries and wages, and pensions. The continued decline in Government revenue to GDP ratio in Sri Lanka over a period of about 30 years is an immediate concern that needs to be addressed to improve the overall fiscal performance of the country.

Chart 2

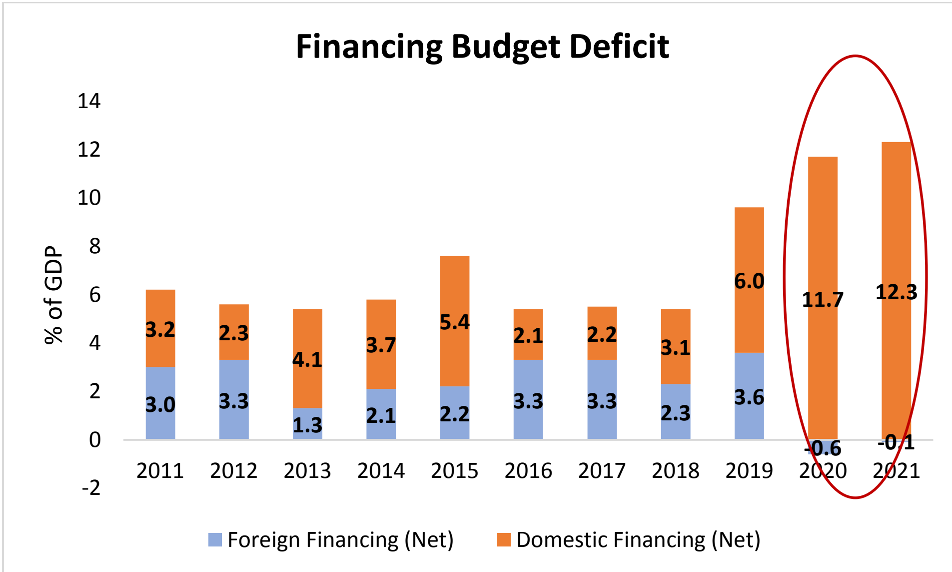


Source: Ministry of Finance

While Government revenue as a percentage of GDP has declined to single digits (9.1 per cent in 2020 and estimated 8.7 per cent in 2021), the budget deficit as a percentage of GDP has widened to double digits over the past two years (11.1 per cent in 2020 and estimated 12.2 per cent in 2021) which has resulted in significant macroeconomic imbalances.

With the deterioration of fiscal and macroeconomic conditions, Sri Lanka's credit ratings were successively downgraded resulting in Sri Lanka's access to international financial markets being severely constrained. This led the Government to depend on domestic borrowing to finance the increased budget deficit (Chart 3). Domestic financing has been largely from the banking system. Within the banking system, financing from the Central Bank, which is commonly referred to as "monetary financing" (or loosely termed as money printing), has risen to an alarmingly high level, leading to an unprecedented deterioration of the Central Bank's balance sheet and causing inflationary and balance of payments pressures.

Chart 3



Source: Central Bank of Sri Lanka

Meanwhile, the demand for public resources is growing fast due to the day-to-day difficulties faced by the people at present. However, the Government's ability to intervene remains very limited due to the lack of fiscal space, primarily because of the very weak revenue position. The present situation is such that the maintenance of Government operations requires continued monetary financing to some extent until the revenue base is enhanced and some foreign financing is received.

The issues in the fiscal sector have spilled over to the other sectors of the economy. Inflation has increased significantly, which is perceived as one of the primary causes of the current social and political unrest. Interest rates have already increased significantly, partly reflecting the increased financing needs. The exchange rate has depreciated reflecting the country's adverse balance of payments situation, affecting financial transactions of the Government, public corporations, and contributes to higher cost of living for citizens. Foreign reserves have declined to critically low levels due to fulfilling of the Government's financing needs in terms of loan repayments as well as the country's financing needs in terms of essential imports. As the country struggles to meet foreign exchange liabilities, restructuring of its foreign currency debt became essential, in order to build some space to finance essential expenses, and eventually re-enter international capital markets. Growing fiscal risks could also create transmission impacts on the financial sector, putting pressure on firm-level growth and private sector job creation.

The government's unsustainable fiscal operations have led to repeating cycles of stop-go policies resulting in an uncertain and unpredictable investment climate, which has adversely affected long term investment and hindered economic growth. Sustained growth is not possible without macroeconomic stability. Hence, strong corrective measures are imperative to improve the fiscal performance in the near to medium term. The time has come to put the "*house in order*" and revamp the Government's fiscal operations to facilitate growth and macroeconomic stability in the medium to long term.

The Government's decision to seek the assistance of the International Monetary Fund (IMF) will be a starting point and a catalyst to implement these critical reforms with the support of Sri Lanka's citizens and other stakeholders. The foundation needs to be laid for a strong fiscal sector that would support future generations with the macroeconomic stability required to facilitate growth and improve living conditions of the people. The support of the private sector, the public and international agencies is crucial in implementing fiscal reforms, with a strong social protection network to support the poor and vulnerable. The current situation in the country demands responsible and disciplined fiscal management, transparent and robust institutions, and committed delivery of public services among others. The decision to work with the IMF is expected to help restore credibility with global markets and institutions as well.

Sri Lanka has approached the IMF 16 times in the past to correct fiscal and balance of payments difficulties. As a global lender, IMF financing is made available based on reforms that can ensure debt sustainability and improvements to macroeconomic conditions and institutional frameworks. However, it is unfortunate that Sri Lanka has not been able to fully utilise the past 16 programmes with the IMF given the failure to undertake comprehensive and sustained macroeconomic reforms to facilitate economic growth and stability. If the required fiscal and institutional reforms had been implemented in an uninterrupted manner, Sri Lanka could have maintained the economic strength and stability to absorb the economic shocks associated with the COVID-19 pandemic, as was the case with many other countries. Moreover, at this point, it is important to note that the IMF will not engage a country unilaterally, but it is Sri Lanka which has sought the assistance of the IMF due to the country's inability to manage the economy prudently over many years. While the process of ensuring debt sustainability and securing IMF assistance is more difficult than ever on this occasion, the country and its citizens will need to go through a period of difficulty in the process of building a better country for future generations, devoid of the shocks experienced in the last few months.

Way forward

The required policy measures and structural reforms to improve the fiscal performance are well known. Hence, it is now time to operationalise these measures to build the credibility of the economy on a sustained basis. This has to be a holistic national effort, with the participation and ownership of all stakeholders including citizens, political entities, the civil service, and private sector, among others. It is important to recognise that IMF assistance will not be a panacea for all the problems accumulated in the economy over many years. A programme with the IMF will be helpful to restore credibility of the country's economic programme, but the reform measures undertaken must have the ownership and commitment of all Sri Lankans. The required reforms to restore fiscal sustainability, institutional capacity, and macroeconomic stability must be sustained beyond an IMF programme, and this requires broadbased ownership of such reforms.

The immediate priority of the Government is to regain debt sustainability. This will have to be done through a two-pronged approach, which includes a) Reprofiling the debt stock with technical expertise from legal and financial advisors, and b) Fiscal consolidation measures underpinned by an IMF programme. Given Sri Lanka's current debt profile and its extreme vulnerability, negotiations with Sri Lankan creditors (commercial, bilateral), while working towards a macroeconomic programme, supported by the IMF, is vital.

With regard to fiscal consolidation, revenue enhancement is key, as is rationalising of non-priority and non-urgent expenditures, whilst prudently managing expenditure by line Ministries. A new framework for fiscal consolidation, based on revenue enhancement and expenditure rationalisation, would be an essential prerequisite to successfully negotiate with the IMF for its assistance. Whilst such fiscal tightening measures will create some headwinds for economic activity and livelihoods, these measures will have to be carefully sequenced and structured so as to minimize adverse impacts on vulnerable communities and ensure equitable outcomes. These challenging measures are an essential building block for macroeconomic stability that is required to prevent repetition of the adverse economic imbalances that have been experienced in recent months.

Urgent short-term financing, from both domestic and foreign sources, need to be secured for day-to-day operations until a longer-term solution is reached. The approach here will need to be three-fold: a) Reducing the fiscal deficit to an optimal level, b) Engaging bilateral and multilateral lenders to secure bridge financing, and c) Minimising Central Bank financing while mobilising other domestic resources within an appropriate real interest rate environment.

Cost-based pricing for public utilities and the energy sector will have to be implemented, with social safety nets to support vulnerable segments of society. Persistent losses of related state-owned business enterprises (SOBEs) add to the burden of the fiscal sector through contingent liabilities and loss of revenue while also creating significant financial pressures on the financial sector. Given the financial situation of the country, divestment of underutilised and non-strategic state assets, including unproductive SOEs, will also be required.

Given the tighter fiscal and monetary conditions, along with more market-based pricing, robust social safety nets must be designed and implemented. All social security payments must be based on objective criteria and made in a transparent manner using digital processes. Digital technology will be crucial in revenue enhancement and expenditure rationalisation measures as well.

Clear communication with the public, business and investor communities on all these measures will be important to ensure a sustained reform process. It is also important to foster the understanding that government expenditure on public services and welfare comes at the expense of higher levels of taxation or continued borrowings. Sri Lanka can no longer afford to run high budget deficits, and whilst there is a requirement for greater investment in sectors such as education, healthcare, public transport, and service delivery, and there are several aspects of government expenditure that require rationalization. It is observed that a culture of unproductive government subsidization and handouts is no longer viable. Instead, a stable macro-economic environment which empowers citizens to thrive along with the necessary social protection mechanisms, would result in a more stable and sustainable economic outcome.

Failure to implement required policy reforms at this critical juncture will be extremely costly. In recent months, Sri Lanka has already experienced the adverse outcomes of failing to implement these reforms in the past. Hence, it is vital that Sri Lanka uses this turbulent situation as an opportunity to undertake difficult but much needed reforms to address the long-standing macroeconomic issues and lay a strong foundation to create a modern and robust economy for future generations to come.
