

Sri Lanka's Reform Drive: Response to Economic and Political Crisis

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Summary

To support Sri Lanka's economic policies and government-led reform programme, the International Monetary Fund approved a 48-month extended arrangement of approximately US\$3 billion (S\$4.06 billion). This paper discusses Sri Lanka's historical tax regime, characterised by low government revenue and inconsistent tax policies, as structural features that contributed to the economic crisis. Furthermore, the adoption of populist tax cuts and relief measures during the COVID-19 pandemic exacerbated the budget deficit, thereby worsening the economic crisis. This paper further explores the government's efforts towards revenue-based fiscal consolidation and the strengthening of social safety nets. It also analyses the extreme concentration of power within the executive presidency as one of the primary causes of the crisis. The findings emphasise the importance of addressing tax regime inconsistencies, implementing responsible fiscal policies and reducing executive power concentration to promote sustainable economic growth and political stability in Sri Lanka.

Introduction

On 21 March 2023, the International Monetary Fund (IMF) approved a 48-month extended arrangement of about US\$3 billion (S\$4.06 billion) to support Sri Lanka's economic policies and government-led reform programme.¹ This was in response to Sri Lanka's economic crisis in 2022, caused by a failure in governance due to long-term economic mismanagement and, in the more immediate term, accelerated by the ill-advised populist policies of the Gotabaya Rajapaksa government and recent global events such as the COVID-19 pandemic and the Russia-Ukraine war.²

The current government's reform programme prioritises five main policy provisions. The first is a focus on revenue-based fiscal consolidation alongside measures to strengthen social safety nets, improve fiscal institutions and introduce energy pricing that promotes cost recovery. Second, public debt sustainability is to be restored through measures such as debt restructuring. The third is for the government to prioritise strategies to restore price stability and rebuild reserves, particularly protecting the poor from the impact of inflation. The fourth is policies safeguarding financial sector stability to promote investment and growth. Finally, the government will address corruption and advance structural reforms to

¹ "Transcript on IMF-supported EFF program Press Briefing for Sri Lanka", International Monetary Fund, 21 March 2023, <https://www.imf.org/en/News/Articles/2023/03/21/tr032123-transcript-of-sri-lanka-press-briefing>.

² Chulanee Attanayake and Shavinyaa Vijaykumarr, "Sri Lanka's economic meltdown sparks political crisis", ISAS Brief No. 923, 14 April 2022, <https://www.isas.nus.edu.sg/papers/sri-lankas-economic-meltdown-sparks-political-crisis/>.

enhance growth prospects. As of May 2023, Sri Lanka was engaged in discussions with foreign and domestic creditors in their efforts to craft a sustainable debt restructuring framework. While the IMF commented that the negotiation process is going well, it also stressed that “achieving timely restructuring agreements with creditors in line with the [programme] targets by the time of the first review is essential to restoring debt sustainability”.³ The IMF expects the restructuring exercise to be completed by the first review of the programme in September or October 2023.⁴

Economic Reforms

Historically, Sri Lanka has had an unhealthy and inconsistent tax regime. Low government revenue, due to the low tax revenue to gross domestic product (GDP) ratio, has been a structural feature since the late-1990s.⁵ The adoption of populist tax cuts and relief measures during the COVID-19 pandemic, which further increased the budget deficit from 9.6 per cent of the GDP in 2019 to 12.2 per cent of the GDP in 2021, was among the main reasons for the 2022 economic crisis which engulfed the country.

Comprehensive tax reforms are, therefore, an essential component of the IMF bailout agreement. The tax reforms under the programme aim to be progressive, with higher-income earners and the wealthier segment of the population making more significant contributions.

In October 2022, the government implemented an increase in value-added tax from 12 per cent to 18 per cent and increased corporate income tax from 24 per cent to 30 per cent. In 2023, income taxes were hiked to 36 per cent, and power tariffs were raised by two-thirds.⁶

In response to these measures, several thousand public workers and trade unions in Sri Lanka took to the streets in protest. The protesters demanded a fairer tax regime, which could be borne by workers commensurate with wages and the rate of inflation in the country. Given past governments’ economic mismanagement, which had led to the

³ “IMF Staff Concludes Visit to Sri Lanka”, International Monetary Fund, Press Release No. 23/167, 23 May 2023, <https://www.imf.org/en/News/Articles/2023/05/22/pr23167-sri-lanka-imf-staff-concludes-visit-to-sri-lanka>.

⁴ “Transcript of IMF Press Briefing in Sri Lanka”, op. cit.

⁵ Under the Gotabaya Rajapaksa administration, the value added tax was slashed from 15 per cent to 8 per cent, along with other tax cuts such as Pay As You Earn tax, withholding tax on interest, debit tax on banks and financial institutes and Nation Building tax on household goods. For more, see Neshella Perera, “Sri Lanka gambles on tax hikes; downside risks seen”, *EconomyNext*, 17 October 2022, <https://economynext.com/sri-lanka-gambles-on-tax-hikes-downside-risks-seen-101245/>; and Vagisha Gunasekara, “Crises in the Sri Lanka economy: Need for national planning and political stability”, ISAS Working Paper No. 356, 23 November 2023, <https://www.isas.nus.edu.sg/papers/crises-in-the-sri-lankan-economy-need-for-national-planning-and-political-stability/>.

⁶ Uditha Jayasinghe, “Crisis-hit Sri Lanka’s public workers protest power tariff, tax hikes”, *Reuters*, 1 March 2023, <https://www.reuters.com/world/asia-pacific/crisis-hit-sri-lankas-public-workers-protest-power-tariff-tax-hikes-2023-03-01/>.

economic crisis in the first place, they also raised concerns on the lack of transparency in how taxes are being utilised, leading to suspicions of corruption and misuse of funds.⁷

Following widespread protests against the tax hikes, the Sri Lankan government responded by partially easing taxes on non-cash benefits. The new policy involves a 25 per cent tax on the value of non-cash benefits like housing, electricity and water provided by employers to workers earning less than LKR75,000 (S\$351.80) a month.⁸ Additionally, the tax exemption on cash allowances for uniforms, subsistence and attendance has been increased from LKR2,500 (S\$11.73) to LKR3,000 (S\$14.07) per month.⁹ This initiative is anticipated to provide some relief to public sector employees who had been protesting against the tax increases and higher electricity tariffs.

Another key criticism of the government's recent tax hikes was that several professional groups, such as doctors and lawyers, earned significant additional incomes but were adept at evading taxes.¹⁰ As a result, critics perceived tax reforms to continue to benefit the more well-off, due to the social and political capital these groups wielded. On 1 June 2023, the government issued a special gazette under the country's income tax law, which mandated 14 such professional groups to register under the income tax law.¹¹

Additionally, the Sri Lankan government has announced its plan to implement three new taxes, namely, the property tax, gift tax and wealth tax, by 2025.¹² The government is yet to disclose any specific information about the rates or thresholds for these taxes. These taxes are intended to target the more affluent sections of the public. The property tax will be levied on buildings and land, while the gift tax will apply to the transfer of property or assets without any consideration.¹³ The wealth tax will target individuals with a net worth exceeding LKR1 billion (S\$4.7 million).¹⁴ Although a wealth tax has the potential to generate significant revenue for the government, there are several challenges associated with its effective implementation, such as difficulties in valuing assets and the possibility of tax

⁷ Sirimal Abeyratne, "Taxpayers Inside, Beneficiaries Outside!", *The Sunday Times*, 22 January 2023, <https://www.sundaytimes.lk/230122/business-times/taxpayers-inside-beneficiaries-outside-508844.html>.

⁸ "Amid Protests, Sri Lanka Relaxes Taxes Partially On Non-Cash Benefits", *EconomyNext*, 8 February 2023, <https://economynext.com/amid-protests-sri-lanka-relaxes-taxes-partially-on-non-cash-benefits-111729/>.

⁹ Ibid.

¹⁰ Devan Daniel, "Sri Lanka's Ripped Income Tax Net", *Echelon*, 19 August 2016, <https://www.echelon.lk/sri-lankas-ripped-income-tax-net/>.

¹¹ "Sri Lanka Professionals, Vehicle Owners, Over 18s, to Register Under Income Tax Law", *EconomyNext*, 1 June 2023, <https://economynext.com/sri-lanka-professionals-vehicle-owners-over-18s-to-register-under-income-tax-law-122047/>.

¹² "Government Envisages Property Tax, Gift And Wealth Tax In 2025", *The Sunday Times*, 30 May 2023, <https://sundaytimes.lk/online/news-online/Government-envisages-property-tax-gift-and-wealth-tax-in-2025/2-1141230>.

¹³ Rebecca S. Rudnick and Richard K. Gordon, "10 Taxation of Wealth", In *Tax Law Design and Drafting*, Volume 1, International Monetary Fund, <https://www.elibrary.imf.org/display/book/9781557755872/ch10.xml>.

¹⁴ Ibid.

evasion.¹⁵ Alternatively, the government could focus on improving tax administration, reducing tax exemptions and expanding the tax base to increase revenue collection.¹⁶

Tax reforms should be implemented to promote economic growth while safeguarding the most vulnerable sections of the population. The IMF too appears to recognise the challenges faced by the lower-income community due to the current economic crisis, particularly the adverse impact on the poor and vulnerable population.¹⁷ However, no new social safety net measures or reforms have been introduced yet by the government to assist the vulnerable sections of the public.

The government should also consider simplifying the tax system and making it more transparent and accountable, ensuring that tax revenue is utilised effectively and equitably to benefit the citizens of the country.¹⁸ Being open and accountable about tax collection and expenditure would contribute towards improving public trust and reducing its democratic deficit.¹⁹ Ultimately, a fair and efficient tax system that benefits the citizens is essential for a functioning democracy and a prosperous economy.²⁰

Governance-oriented Reforms

The 2022 people's protest demanded that elected representatives and public officials be more transparent and accountable in the use of public finance and the operation of state institutions. Sri Lanka has been consistently ranked poorly in the Corruption Perceptions Index and the Ease of Doing Business Index.²¹ To date, there have been minimal efforts to address the structural issues of the politicisation of state institutions, political corruption and political clientelism.

The IMF too has emphasised the importance of prioritising anti-corruption and governance reforms as conditions alongside the bailout programme so that any progress achieved through reforms is distributed equitably among the citizens of Sri Lanka.²² It highlighted that the Sri Lankan authorities have committed to significantly enhancing public financial management and reinforcing the anti-corruption legal framework, aligning with the standards of the United Nations Convention against Corruption.²³ Aligned with this priority, the IMF will be carrying out a thorough governance diagnostic exercise to evaluate

¹⁵ Sathya Karunaratne, "Is Wealth Tax The Solution To Sri Lanka's Low Tax Revenue Collection", Advocata, 9 November 2021, <https://www.advocata.org/commentary-archives/2021/10/09/is-wealth-tax-the-solution-to-sri-lankas-low-tax-revenue-collection>.

¹⁶ Ibid.

¹⁷ "Transcript on IMF-supported EFF program Press Briefing for Sri Lanka", op. cit.

¹⁸ Sirimal Abeyratne, "Taxpayers Inside, Beneficiaries Outside!", *The Sunday Times*, op. cit.

¹⁹ Ibid.

²⁰ Ibid.

²¹ "Sri Lanka Country Data", Transparency International, 31 January 2023, <https://www.transparency.org/en/countries/sri-lanka>; and "Ease of Doing Business Rank (1=Most Business-Friendly Regulations) - Sri Lanka", The World Bank, 2019, <https://data.worldbank.org/indicator/IC.BUS.EASE.XQ?locations=LK>.

²² "Transcript on IMF-supported EFF program Press Briefing for Sri Lanka", op. cit.

²³ Ibid.

corruption and governance vulnerabilities in Sri Lanka and offer recommendations, which will prioritise and seek to address these issues. Sri Lanka is the first Asian country to undergo such an assessment by the IMF. This governance diagnostic exercise is designed to engage, consult and collaborate with stakeholders and civil society organisations about critical reforms in this area.

Currently, the government has been pursuing a reform programme to tackle corruption. In April 2023, Sri Lanka gazetted a new anti-corruption bill, which aims to address corruption vulnerabilities in governance.²⁴ The bill seeks to establish an independent commission with a mandate to conduct inquiries and investigations and to prosecute against bribery, corruption, and associated offences. The bill also includes a clause that imposes penalties on individuals who make false allegations of corruption against public officials. While supporters of the clause believe it will prevent false accusations and protect officials from baseless claims, critics argue that it will deter whistle-blowers and limit freedom of speech.²⁵ There are also concerns about the effectiveness of the bill in addressing corruption, given Sri Lanka's history of weak enforcement of anti-corruption laws.

Additionally, the Ministry of Finance recently gazetted an amendment to the Monetary Law Act of 1949, which reinforces the central bank's legal independence.²⁶ The Central Bank of Sri Lanka is legally designated as an independent authority but has faced challenges in maintaining its independence in practice, particularly in the political appointment of key officials. While legal frameworks are important, ensuring the independence of the central bank in practice has been argued by proponents of this reform as crucial for promoting economic stability and growth in Sri Lanka. Critics of the attempts to reinforce central bank independence, however, argue that what is required is more accountability and restraint rather than independence from a democratically-elected government.²⁷

Linked to governance and democracy, the IMF also addressed allegations that it influences and intervenes in Sri Lanka's electoral governance processes. The Sri Lankan government had announced that local government elections must be postponed due to a lack of funding. The IMF clarified that "the question of election is a matter for Sri Lankan Government and the Sri Lankan people" and that it has "never recommended postponing local elections in Sri Lanka".²⁸

²⁴ Himel Kotelawala, "Sri Lanka's new anti-corruption bill sparks debate over false allegations clause", *EconomyNext*, 12 April 2023, <https://economynext.com/sri-lankas-new-anti-corruption-bill-sparks-debate-over-false-allegations-clause-117984/>.

²⁵ Ibid.

²⁶ Sirimevan Colombage, "Central Bank already an independent authority since inception by law, but not in practice", *DailyFT*, 21 March 2023, [https://www.ft.lk/columns/Central-Bank-already-an-independent-authority-since-inception-by-law-but-not-in-practice/4-746548#:~:text=E%2DPaper-Central%20Bank%20already%20an%20independent%20authority%20since,law%2C%20but%20not%20in%20practice&text=The%20Ministry%20of%20Finance%20gazetted,Act%20\(MLA\)%20of%201949.](https://www.ft.lk/columns/Central-Bank-already-an-independent-authority-since-inception-by-law-but-not-in-practice/4-746548#:~:text=E%2DPaper-Central%20Bank%20already%20an%20independent%20authority%20since,law%2C%20but%20not%20in%20practice&text=The%20Ministry%20of%20Finance%20gazetted,Act%20(MLA)%20of%201949.)

²⁷ "Sri Lanka's central bank needs accountability and restraint, not independence: Bellwether", *EconomyNext*, 1 June 2022, <https://economynext.com/sri-lankas-central-bank-needs-accountability-and-restraint-not-independence-bellwether-95009/>.

²⁸ "Transcript on IMF-supported EFF program Press Briefing for Sri Lanka", op. cit.

Political and Administrative Reforms

On 21 October 2022, the parliament passed the 21st amendment constitutional amendment aimed at “trimming presidential powers, beefing up anti-corruption safeguards and helping to find a way out of the country’s worst financial crisis since independence.”²⁹ Justice Minister Wijeyadasa Rajapakshe stated that besides the move addressing the demands of the *Aragalaya* (struggle) or system change, which included constitutional reform, it would also help to secure the IMF bailout loan.³⁰

Critics, however, were quick to point out that the changes were tokenistic and that “the amendment would still allow the president to prorogue parliament at any time while other powers, including the ability to remove cabinet ministers, would be curtailed only in the next presidential term.”³¹ Abolishing the executive presidency, or significantly reducing presidential powers, was among the key demands of the *Aragalaya* last year, as an extreme concentration of power within the executive presidency was perceived to be among the leading causes of the crisis.

The switch to a semi-presidential system in 1978 brought many key ministries under the executive president, particularly the management of the country’s defence. For the past four decades, the law was used to centralise power in the executive branch, providing the president immense powers and impunity.³² While some previous amendments to the constitution have aimed to lessen the president’s powers, they failed to change the president’s protection in the face of the law.

The 17th and 19th amendments to the Sri Lankan constitution were aimed at enhancing democracy and limiting executive power. The 17th amendment established independent commissions to oversee key areas such as elections, public service and police, while the 19th amendment curtailed the power of the president and restored term limits for the presidency.³³ However, the subsequent 18th and 20th amendments saw a regression of these reforms, with the 18th amendment removing term limits for the presidency and increasing executive power and the 20th amendment reversing some of the gains made by the 19th

²⁹ Uditha Jayasinghe, “Sri Lanka Passes Constitutional Amendment Aimed At Trimming Presidential Powers”, *Reuters*, 21 October 2022, <https://www.reuters.com/world/asia-pacific/sri-lanka-passes-constitutional-amendment-trim-presidential-powers-2022-10-21/>.

³⁰ Ibid.

³¹ Uditha Jayasinghe, “Sri Lanka Eyes Trimming Presidential Powers Amid Unrest Over Economic Crisis”, *Reuters*, 30 June 2022, <https://www.reuters.com/world/asia-pacific/sri-lanka-eyes-trimming-presidential-powers-amid-unrest-over-economic-crisis-2022-06-30/>.

³² Siri Gamage, “Democracy in Sri Lanka: past, present and future”, *Asian Studies Review*, Volume 17, 1993, Issue 1, 110.

³³ Ministry of Justice, “Seventeenth Amendment To The Constitution”, *Lawnet*, 3 October 2001, [https://www.lawnet.gov.lk/seventeenth-amendment-to-the-constitution-2/#:~:text=\(1\)%20The%20appointment%2C%20promotion,Service%20Commissions%20established%20by%20law](https://www.lawnet.gov.lk/seventeenth-amendment-to-the-constitution-2/#:~:text=(1)%20The%20appointment%2C%20promotion,Service%20Commissions%20established%20by%20law;); and Parliament Of The Democratic Socialist Republic of Sri Lanka, “Nineteenth Amendment To The Constitution”, 15 May 2015, <https://www.parliament.lk/files/pdf/constitution/19th-amendment-act.pdf>.

amendment.³⁴ These amendments demonstrate that progress in constitutional reform is contingent on political interests and can be easily reversed.

The 21st amendment also fails to address pertinent questions on “minority rights and the devolution of power”.³⁵ While the ethnic issue was not entirely castaway in the political discourse of the current crisis, it was side-lined in the name of a more immediate political and economic crisis. Institutional and administrative reforms, without acknowledgement of the state’s majoritarian and ethnocratic political structure, will continue to be superficial and limited in addressing the structural causes of the current crisis.

Finally, the government gazetted the Anti-Terrorism Bill on 22 March 2023. The proposed bill in Sri Lanka has been postponed due to opposition by civil society and political opposition.³⁶ The bill claims to address gaps in the previous anti-terror legislation – the Prevention of Terrorism Act of 1979 – and to introduce measures to prevent radicalisation. However, critics of the proposed legislation point out that the bill grants the state excessive powers to suppress dissent and target individuals or groups based on vague definitions of terrorism. The lack of adequate safeguards for human rights, such as provisions for fair trial and due process, is another major concern. The bill was also introduced without sufficient public consultation or scrutiny, raising questions about its legitimacy and effectiveness in countering terrorism. There is a need for a comprehensive approach to counterterrorism that addresses underlying social and political grievances rather than relying solely on punitive measures.

Conclusion

Sri Lanka is undergoing a series of reforms to address various structural vulnerabilities in the country, to which the current crisis has been broadly attributed to. Closing a bailout agreement with the IMF has necessitated certain economic, political and administrative reforms. Some economic reforms have been implemented, but concerns remain over the transparency of public finance, the impact on vulnerable communities and threats to political stability in the face of future economic reforms being implemented. Governance and administrative reforms also face the challenges of a public trust deficit, that is, there is popular mistrust of reforms being used by the government to further consolidate power and undermine democracy and power sharing. The government must ensure comprehensive reforms which are transparent and accountable effective, and address growing social inequality and poverty. This will foster a healthier democracy and a more sustainable governance and development regime in Sri Lanka.

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³⁴ Parliament Of The Democratic Socialist Republic of Sri Lanka, Twentieth Amendment To The Constitution, 29 October 2020, <https://www.parliament.lk/uploads/acts/gbills/english/6176.pdf>; and The Constitution Of The Democratic Socialist Republic Of Sri Lanka, Eighteenth Amendment to the Constitution, 9 September 2010, <https://www.parliament.lk/files/pdf/constitution/constitution-upto-18th.pdf>.

³⁵ Sakuntala Kadirgamar, “21st Amendment: A Way Out Of Sri Lanka’s Multiple Crises?”, *Groundviews*, 30 April 2022, <https://groundviews.org/2022/04/30/21st-amendment-a-way-out-of-sri-lankas-multiple-crises/>.

³⁶ Ambika Satkunanathan, “Anti-Terrorism Bill: The Good, Bad and the Ugly”, *Groundviews*, 26 March 2023, <https://groundviews.org/2023/03/26/anti-terrorism-bill-the-good-bad-and-the-ugly/>.

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