Frustration spikes as there’s yet *another* powercut, leading to a flurry of complaints (and expletives) via social media and group chats across the country. The hashtag, [#PowercutLK](https://twitter.com/search?q=%23PowerCutLK&src=trend_click&vertical=trends) trends, along with outspoken worry about the Sri Lankan economy [as prices of essential goods increase exponentially – all while there are massive shortages in others.](https://www.sundaytimes.lk/220102/news/eye-watering-prices-of-essentials-shortages-set-to-worsen-467682.html) The lack of food, gas, and fuel has made everyone feel that the economy ‘isn’t doing too well’.

These day-to-day struggles and economic issues are the consequences of a number of economic policies. Understanding the roots of these requires a little digging as to what happened to the Sri Lankan economy over the last decade. Consider this a background story for the frequently asked question:
*How did we get here and how did things get so out of hand?*

**A brief look at Sri Lanka’s economy and growth**

Soon after the three-decade long conflict which ended in 2009, Sri Lanka recorded high economic growth rates. This means, goods and services produced in the country expanded at a substantial rate. [In 2010, the Sri Lankan economy grew by 8.0%](https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2020/en/16_S_Appendix.pdf). This growth followed 2011 and 2012, as the country recorded growth rates of 8.4% and 9.1% respectively.

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However, this was largely a result of an expansion of domestic economic activities such as construction and retail trade. The growth in construction was due to both government and private sector infrastructure development; such as expressways, airport and ports, plus the high-rise buildings in Colombo. For a bit of context, the first part of the Southern Expressway was constructed at a cost of [approximately USD 740 million](https://theleader.lk/images/PDF/2014-m-01-real-cost-of-highway-development-in-sri-lanka.pdf), and was [declared open in 2011](http://www.exway.rda.gov.lk/index.php?page=expressway_network/e01). Our second expressway – the Colombo-Katunayake one – was declared open in 2013. Clocking in at a cost of [USD 292 million](https://www.currencyconverterx.com/USD/INR/292000000), this was made possible thanks to a loan from China EXIM Banks. This continued as successive Sri Lakan governments extended the Southern Expressway, constructed the Outer Circulation Highway (OCH), and started on the construction of Central Expressway in 2015 as well.

Economists identify these sectors as non-tradable sectors; because goods and services related to these sectors cannot be traded internationally. Thus, growth from these sectors are constrained by the size of the country’s population and purchasing power (which is the average person’s ability to buy things). Therefore, any country’s economic growth driven by such non-tradable sectors is often short-lived. This is more relevant to a country like Sri Lanka which has a population of only 22 million.

**2013 onwards: a steady decline**

In 2013, Sri Lanka’s economic growth rate began to decline from 3.4%. This downward spiral continued and eventually hit [2.3% in 2019](https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2020/en/6_Chapter_02.pdf). This is the lowest recorded economic growth rate since 2001. This can be pinned down to two main reasons: not being able to expand sectors like retail and construction, due to Sri Lanka’s small population; and the failure to increase exports.

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**What are we selling?**

Let’s first look at Sri Lanka’s export performance, which started to worsen from 2000. Let’s clarify this: in absolute terms, export performance improved over time - a point used to drive optimistic rhetoric..

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However, the export of goods and services as a share of the [GDP was 39% in 2000](https://data.worldbank.org/indicator/NE.EXP.GNFS.ZS) – this dropped to 20% by 2015. While global trade moved towards producing parts and components, [Sri Lanka continued to rely on traditional exports](https://onlinelibrary.wiley.com/doi/abs/10.1111/twec.12039) such as textiles, garments, tea and rubber. This became problematic as lower-income countries such as Bangladesh and Kenya started to manufacture products like textiles and tea at a cheaper cost. This made it difficult for Sri Lanka to expand its market share on both textiles and tea; both which account for more than half of the country's export earnings, which is the largest source of foreign currency inflow to Sri Lanka.

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Why does this matter? Looking at exports against the GDP indicates what percentage of our national income is earned in foreign currency earnings, by selling goods and services to global markets. As you can see in the chart above, that percentage has been steadily declining.

What’s worse is that by 2019, approximately 46% of foreign currency earnings were through exporting goods (in the same year, 14% foreign currency earnings came from tourism and 26% were from workers remittances). This meant that while the economy kept improving in absolutes and rupees, Sri Lanka was failing to increase foreign currency inflows to the country. If the electricity crisis has taught us one thing, it’s [how critical having dollars on hand are to a small country like ours](https://ceylontoday.lk/news/dollar-crisis-hits-power) that needs to import things like fuel and food.

The government then resorted to the easy option of borrowing from foreign sources. This included the borrowings from international capital markets through issuing International Sovereign Bonds (ISBs). This gave the illusion that Sri Lanka’s economy was booming. Meanwhile, expressways were also constructed, adding to the illusion. The road networks were upgraded. The country got a new international airport. High-rise buildings started to become the norm in Colombo and its suburbs. Amidst these developments, deteriorating export performances and piling up of foreign loans were conveniently ignored.

**Economic growth and Income Inequality**

As mentioned earlier on, Sri Lanka’s high economic growth rates during post-conflict were largely due to the public infrastructure and private constructions such as apartments and hotels. These had very little trickle down effect – meaning Sri Lanka’s economic growth during the post-conflict era did not benefit the poor much. Most benefits of the country’s economic growth were enjoyed by the rich. This is why indicators like GDP are misleading; growing the size of the pie doesn’t necessarily mean that everyone gets a bigger share. It means that sometimes, the rich get rich and the poor get poorer.

This is clearly reflected in the Gini coefficient. Gini is a measure of the dispersion of wealth; that is, it captures the income distribution in an economy. The lower it is, the more evenly distributed the wealth is.

[Estimates from the Department of Statistics](http://www.statistics.gov.lk/IncomeAndExpenditure/StaticalInformation/HouseholdIncomeandExpenditureSurvey2019FinalResults) shows that while Sri Lanka’s GDP per capita rose, Sri Lanka’s Gini coefficient remains almost unchanged.

Look at these numbers assessing Gross National Income (GNI) change from 2016:

| **Region/sector** | **2016** | **2019** | **Change** |
| --- | --- | --- | --- |
| **Sri Lanka** | 0.45 | 0.46 | -0.01 |
| **Sector** |  |  |  |
| Urban | 0.48 | 0.49 | -0.01 |
| Rural | 0.44 | 0.44 | 0 |
| Estate | 0.36 | 0.36 | 0 |
| **District** |  |  |  |
| Colombo | 0.46 | 0.47 | -0.01 |
| Gampaha | 0.42 | 0.44 | -0.02 |
| Kalutara | 0.44 | 0.41 | 0.03 |
| Kandy | 0.42 | 0.45 | -0.03 |
| Matale | 0.42 | 0.42 | 0 |
| Nuwara Eliya | 0.41 | 0.38 | 0.03 |
| Galle | 0.43 | 0.44 | -0.01 |
| Matara | 0.39 | 0.39 | 0 |
| Hambantota | 0.43 | 0.44 | -0.01 |
| Jaffna | 0.44 | 0.44 | 0 |
| Mannar | 0.42 | 0.34 | 0.08 |
| Vavunia | 0.41 | 0.37 | 0.04 |
| Mullaitivu | 0.42 | 0.47 | -0.05 |
| Kilinochchi | 0.37 | 0.38 | -0.01 |
| Batticaloa | 0.45 | 0.39 | 0.06 |
| Ampara | 0.39 | 0.45 | -0.06 |
| Trincomalee | 0.42 | 0.4 | 0.02 |
| Kurunegala | 0.45 | 0.45 | 0 |
| Puttalam | 0.47 | 0.43 | 0.04 |
| Anuradhapura | 0.46 | 0.44 | 0.02 |
| Polonnaruwa | 0.46 | 0.41 | 0.05 |
| Badulla | 0.46 | 0.53 | -0.07 |
| Moneragala | 0.43 | 0.43 | 0 |
| Ratnapura | 0.41 | 0.38 | 0.03 |
| Kegalle | 0.41 | 0.39 | 0.02 |

As you can see, the change is miniscule. While GDP per capita has grown, most people have not seen the benefit of that growth.

Let’s look at these numbers comparing 2016 and 2019, this time in rupee values::

| **2019** | First quartile | Second quartile | Third quartile | Fourth quartile | Fifth quartile |
| --- | --- | --- | --- | --- | --- |
| Mean household income per month (Rs.) | 17,572 | 36,290 | 53,522 | 78,431 | 196,289 |
| Share of income (%) | 4.6 | 9.5 | 14 | 20.5 | 51.4 |
| Cumulative share of income (%) | 4.6 | 14.1 | 28.1 | 48.6 | 100 |
|  |  |  |  |  |  |
| **2016** |  |  |  |  |  |
| Mean household income per month (Rs.) | 14,843 | 30,008 | 43,713 | 64,570 | 158,072 |
| Share of income (%) | 4.8 | 9.6 | 14 | 20.7 | 50.8 |
| Cumulative share of income (%) | 4.8 | 14.4 | 28.5 | 49.2 | 100 |
|  | Bottom 20% |  |  |  | Top 20% |

In 2016, people at the bottom 40% of earnings owned 14.1% of the income in the country; the top 20% owned 50.8%. Fast forward to 2019, and the top 20% own 51.4% of income; everyone else has fallen slightly. The median household income at the top is 196,289 rupees; at the bottom it’s 17,572.

The saga looks worse when you look further back. In [2009 - 2010, Sri Lanka’s gini-coefficent was 0.49.](http://www.statistics.gov.lk/IncomeAndExpenditure/StaticalInformation/HouseholdIncomeandExpenditureSurvey2009-2010FinalResults)  [2019, it remains high as 0.46](http://www.statistics.gov.lk/IncomeAndExpenditure/StaticalInformation/HouseholdIncomeandExpenditureSurvey2019FinalResults). To put it simply, in 2009 and 2010, the poorest 40% in the country earned 13.3% of total household income. By 2019, they had not even gone up a full percentage point.

Economic growth happened, but these numbers reflect how the poorest - and even the middle classes - did not actually benefit from this particular economic growth.

**Sri Lanka’s Taxation problem**

Let’s move on to the next problem. Although the Sri Lankan economy continued to grow, at least on paper, successive governments failed to create a substantial increase in tax revenues. Once again, absolute values show growth . . .

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But when considered as a percentage of the GDP, what we see is a continuous decline.

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This scenario iss not a mere post-conflict phenomenon. Sri Lanka’s tax to GDP ratio started to decline in the mid-1990’s. This trend continued during the post-conflict era despite the high economic growth recorded. [Sri Lanka’s tax to GDP ratio declined from 20.4% recorded in 1990 to 10.1%](https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2020/en/16_S_Appendix.pdf) in 2014, reaching an all time low since receiving independence in 1948.

Tax revenue increased marginally in 2015 thanks to short-term measures such as the introduction of [Super Gain Tax](https://www.treasury.gov.lk/api/file/5d61e421-b990-4289-9084-e0b541ae2830#:~:text=Super%20Gain%20Tax&text=year%20of%20assessment%20commenced%20on%20April%201%2C%202013%20of%20any,for%20such%20year%20of%20assessment.). In 2017, as a long-term solution to the issue, the [Inland Revenue Act 2017](http://www.ird.gov.lk/en/publications/Acts_Income%20Tax_2017/IR_Act_No._24_2017_E.pdf) was introduced to enhance revenue collection by focusing more on income tax. This legislation introduced a series of measures to increase the tax revenue and simplify the tax system, including an increase of individual as well as corporate tax rates.

However as a part of fulfilling the election pledges, the then-newly elected government led by the President Gotabaya Rajapaksa [provided massive tax reliefs](https://www.ft.lk/top-story/Tax-bonanza/26-690545). This included revising most of the tax changes introduced through IR Act 2017. These changes included reduction of the VAT to 8% from 15%, reducing income tax rates, abolishing the Pay As You Earn (PAYE) tax, and abolishing Withholding Taxes (WHT) from selected types of income – including what you earned from interest. These measures, coupled by the impact of COVID-19 on the economy resulted in a significant drop in tax revenue. [Sri Lanka’s tax to GDP ratio plunged to 8.4](https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2020/en/15_Appendix.pdf)%, surpassing the all-time recorded low in of 10.1% in 2014.

This trend indicates that while the average income of Sri Lankans have increased (as reflected by the increase of per capita income) over the years, and the rich have stayed rich, government tax revenues have deteriorated.

This remains an exception to the conventional development stories. Global evidence suggests that as a [country moves to a higher development status, tax to GDP ratio also increases](http://piketty.pse.ens.fr/files/CageGadenne2018.pdf). In Sri Lanka’s case, this was the exact opposite. Sri Lanka’s tax to GDP ratio declined as the per capita income increased. This indicates a serious failure in tax collection: money’s coming in, but it certainly isn’t going to the government. Going by the GNI, it isn’t going to the majority of the population, either.

As a result of worsening tax collection, the country’s budget deficit (the gap between government expenditure and government revenue) kept expanding. In spite of consistent reduction of government revenue, Sri Lanka’s expenditures continued to grow lavishly. The government continued to construct expressways through obtaining more and more loans.

This meant two things. One is the continuous expansion of the budget deficit. We don’t have money coming in, and we keep spending. The other is the massive increase of public debt as successive governments borrowed money every year to stay on their spending sprees.This is what growth without reforms looks like.

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**Where are we now ?**

Sri Lanka has been grappling with serious economic issues for decades while failing to carry out reforms or sustain reforms to address any of them. Our economy’s vulnerability is evident through the reduction of tax ratio, deteriorating export performances, rising inequality, and lack of fiscal discipline.

Currently, the Sri Lankan economy is a little like an old building that has fallen into disrepair. We’ve spent on some very expensive tile, but completely ignored the fact that the roof is leaking and the walls are wobbling. It’s evident that the building will collapse sooner rather than later unless these repairs are immediately taken care of. Now, especially as COVID-19 hit the globe, Sri Lanka’s economic vulnerabilities are severely exposed. The cracks and gaps are widening, leading to a very shaky situation - and everyone is deeply worried that the country, much like an uncared-for-building, will soon collapse.

**Explainer of terms**

1. [**Gini-Coefficent**](https://www.census.gov/topics/income-poverty/income-inequality/about/metrics/gini-index.html)- This is the mostly used indicator to measure income inequality. It measures how income is dispersed amongst different levels of income groups in a given country (for example, 60% of total income of a country is earned by top 20% income earners and 05% of total income of the country is earned by poorest income earners). It ranges from 0 to 01, with 0 meaning that income is distributed equally amongst the population. Gini-Coefficent of 01 means that one person receives all the income while everyone else receives none.
Therefore, ***higher gini-coefficent means higher income inequality***.
2. **Gross Domestic Product (GDP)** - This indicates the [monetary value of goods and services produced within a country](https://www.imf.org/external/pubs/ft/fandd/basics/gdp.htm) during a given year. GDP estimates do not include unpaid work such as housework and black market activities.
3. **Per Capita Income** - This is used to assess the average income level of a country. [GDP per capita is **Gross Domestic Product (GDP) divided by midyear population**. Generally GDP reflects the total income of a country.](https://databank.worldbank.org/metadataglossary/world-development-indicators/series/NY.GDP.PCAP.KN#:~:text=GDP%20per%20capita%20(constant%20LCU,the%20value%20of%20the%20products.) Therefore, GDP per capita reflects the average income of the country. This indicator does not capture the income inequality of a country.
4. **Economic Growth Rate** - This indicates by what percentage a country’s GDP has increased compared to the GDP recorded in the year before. The growth rates reflect what percentage of goods and services produced within a country in a given year have increased, compared to the production during the previous year.

**Tax explainer**

* Personal Income tax - Individuals who earn more than Rs.3 Million per year are required to pay an income tax. Higher the income, higher the tax rate is. Maximum tax rate is 24%.
* Corporate Income Tax - Companies pay taxes on the profit. There are four tax rates applicable based on the nature of business. These tax rates are 14%,18%, 24% and 40%.
* Value Added Tax (VAT) - Any business that earns over Rs.300 million in annual sales is required to pay 8% of VAT on the items that are liable for VAT. This tax is often transferred to the consumer by the sellers. Higher VAT means higher price.
* Custom Import Duties - Most imported goods are taxed at customs prior to release. Not all gods are subject to Custom Import Duties. List of items that are liable for [Custom Import Duties are available here](https://www.customs.gov.lk/customs-tariff/).
* Ports and Airports Development Levy (PAL) - An additional tariff imposed on imports. Not all gods are subject to PAL. The list of [items liable for PAL are here](https://www.customs.gov.lk/customs-tariff/)
* Cess - Another tariff on imports to discourage said imports and support local industries. Not all gods are subject to PAL. The list of [items liable for PAL are here](https://www.customs.gov.lk/customs-tariff/). Given that cess and PAL are additional tariff on imports, they are termed as para-tariffs.
* Special Commodity Levy (SCL) - This tax is applied for a few selected essential items such as rice, potato and onions. It is a consolidation of Custom Import Duty, Cess and PAL. Having one consolidated tax allows the government to change the tax at one go instead of changing a few taxes.
* Excise Duty - Taxes imposed on vehicles, liquor and cigarettes. Rates depend on the good.
* Special Goods and Services Tax (SGST) - The tax is yet to be implemented, as the [Bill was gazetted](http://www.documents.gov.lk/files/bill/2022/1/162-2022_E.pdf) just recently. This tax is supposed to consolidate all taxes imposed on vehicles, liquor, cigarettes, betting and gaming, and telecommunication.