

Crisis to Recovery: Sri Lanka's Economic Collapse and Pathways to Renewal

Nirupama Singh

Independent Scholar, E-mail: nirupamasingh52@gmail.com

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Abstract: Sri Lanka, an island nation rich in natural resources, faced severe economic crisis in the recent history. In 2022, these vulnerabilities triggered a series of interconnected crisis, marked by the decline in budget, increase in debt, and inflation, in addition to a significant sociopolitical upheaval when it defaulted the external debt payments. This study attempts to explore the multifaceted causes that led to these long-standing economic vulnerabilities, which included resource mismanagement, political instability, and global economic conditions. The discussion also touches on the prospects for recovery with emphasis on both immediate and long-term measures. The primary cause of economic crisis in Sri Lanka was the country's long-running, budgetary shortfalls, which were exacerbated by unmanageable national debt, especially from external commercial loans. The effect of the crisis on different sectors of society, including poverty, unemployment, and public services, is examined. For Sri Lanka's medium-term recuperation, stability, and long-term growth, key measures would include significant debt reduction and reprofiling, restructuring of both national and international debt to achieve debt sustainability, and implement significant fiscal policy reforms focused on increasing revenue and optimized expenditures to mitigate the budgetary deficit. In addition ambitious structural reforms aimed at growth are also required.

Keywords: Sri Lanka, Economic crisis, Debt Restructuring, Debt-trap Diplomacy, Policy, Recovery

Introduction

Sri Lanka, after gaining independence in 1948, entered the world with a promising foundation. The country inherited an open economy, had high standard of educational system, reliable and good infrastructure, enhanced foreign exchange

earnings, higher standard of living, and administrative apparatus. In 1950s Sri Lanka was the most prosperous Asian countries with the growth rate of 4.6 percent. The Six Year Plan of Development, combined with the “Korean Boom” (resulting from Korean War in 1949) made the country less dependent on the imports of food and manufactured items. There was also emphasis on the self-sufficient production of food by giving impetus to agricultural co-operatives. By the late 1960s the achievements of Sri Lanka remained constant and impressive in the field of adult literacy, life expectancy, infant mortality etc. However, the growth rate that has averaged 3.9 percent between 1960-1970 dropped to 2.9 percent between 1971-1974. The increase in the number of Indian repatriates since the Indo Ceylon Agreement of 1964 also resulted in fall in the rate of population growth (Central Bank of Ceylon, 1975). In 1972, the government issues a Five-Year Plan aimed at achieving the goal of socialist democracy with a mixed economy framework where state had increased ownership and cooperatives developed. For reducing economic and social inequalities policies like ceiling on land ownership, income and residential property along with income redistribution was practised. While these welfare-oriented schemes were noble in intent, they eventually backfired and left the economy in shambles. Foreign exchange was deteriorating as the country’s external trade was declining over the years. Additionally, by the mid-1970s, Sri Lanka was facing high rate of unemployment, escalating living costs, and looming food crisis (Balakrishnan, 1973).

In 1973, the Agricultural Lands Law provided the establishment of Agricultural Tribunals for adjudication of legal disputes. In 1974, higher yields were obtained by increasing the use of fertilizer and better agricultural practices. The government allocated 15 percent of total capital expenditure on agriculture and irrigation, including the plantation (Central Bank of Ceylon, 1975). The schemes adopted during this time were centralised and dominated by public sector. The social objectives were reached through administrative control over pricing and rationing. In 1977, a dramatic shift occurred as the government-initiated liberalization. The new approach focused on export-oriented industries, promotion of private enterprise, and Foreign Direct Investment causing a decline in many domestic industrial centres. The government’s tax and policy incentives to promote local diversification were not effective as there was an urban bias with 80 percent of the industries set in the capital of the country. However, the liberalization promoted industrial development in private sector especially in field

of textiles, food, beverage, plastics, wood products, and other consumer goods (Wijenayake, 2021).

Sri Lanka saw second wave of liberalization from 1989-2005, fiscal and monetary policies were tightened, and expenditure was reduced. Subsidies were phased out on fertilizers, rice, and flour in mid-1990's. In the third quarter of 1990 GDP grew due to liberalization and privatisation of small manufacturing enterprises, state-owned bus company, ocean freight, and airline services. Foreign exchange allocation was increased for education and travel. Though Sri Lanka retained structural impediments of 1980's and liberalisation bypassed the public enterprise and remained largely inefficient (Karlik et al., 1996).

Thus, the Sri Lankan crisis was the result of the long-drawn policy mistakes and the structural weaknesses of the government. The crisis has resulted in severe shortages of essential goods, widespread unemployment, and a substantial decline in living standards. This study aims to present an extensive examination of the crisis, focusing on its root causes, impact on society, and potential pathways to recovery.

The process of economic degradation is said to have set in motion since 2020 when the official reserves dropped, the access to international financial market was lost and the forex liquidity constraint led to shortage of essential goods (World Bank, 2024). Prior to these events, since 1948 Sri Lanka has maintained an untarnished image in external debt services. Thus, the Sri Lankan government has blamed the coronavirus pandemic and hostilities between Russia and Ukraine as affecting the fiscal position of the country (World Bank, 2024).

However, BBC's report has pointed out that this crisis was a disaster in the making since 2009. Since the civil war in 2009, economic mismanagement has caused a shortage of foreign currency, as the government concentrated on supplying commodities to the national market rather than promoting international trade. This led to a decline in export revenues, while the country imported more goods at higher rates. Additionally, the 2019's bomb attacks also frightened off the tourists and affected the tourist trade which was one of the biggest earners of foreign currency. Sri Lanka in 2019 experienced a huge decline from 7.6 billion dollars to 250 million dollars. In the same year the Rajapaksa government introduced huge tax cuts due to which the government lost more than 1.4 billion in revenues. The foreign currency shortage worsened in 2021 when the government prohibited the import of artificial and inorganic fertilisers and encouraged farmers to use domestically sourced natural fertilisers, which led to widespread harvest failure. The country thus had to

import food from abroad, which worsened the situation even further (Perera, 2023). In April 2022, the Sri Lankan government deferred payments on its external debt obligations for an interim period to allow for economic readjustment (Ministry of Finance, 2022).

The Sri Lankan economy declined to 9.5% in total during 2022 and 2023, the public debt also increased to 119.22% of Gross Domestic Product (GDP) in 2022 amid high inflation. During the same time the currency depreciated to 81.2%. As a result of this food security and malnourishment increased, poverty doubled, and inequality widened. The economic decline resulted in reduced work hours and job losses which affected almost 60 percent of the households who experienced a decline in income (World Bank, 2024).

Key Factors Contributing to the Crisis

The economic mismanagement, political instability, and global economic conditions were some of the key factors that led to the Sri Lankan crisis. Scholars like Saumya Bhowmick has highlighted six major factors that contributed to the Sri Lankan economic crisis: a) the 2019 reduction in tax rate, which weakened the domestic economy, b) repeated Balance of Payments crisis caused depletion of foreign exchange resources that posed difficulty in import of essential consumption goods; c) fall out of the International Monetary Fund's bailouts, d) a sudden shift to organic farming also caused disastrous impact on the food production capacity and economy of the country, e) the collapse of the tourism industry after the 2019 Easter Sunday bombings, and finally, f) the sharp rise in overseas debt (Bhowmick, 2022).

Economic mismanagement: The financial problem in Sri Lanka became evident from 2018 onwards when the GDP went down to 2.3 percent. In this environment, the bomb attacks on several Catholic churches and Colombo hotels on Easter Sunday in 2019 added to the economic losses. The bomb blast impacted the country's tourism industry and contracted the economy by 0.2 percent. The deficit and government debt increased to 9% and 82% respectively. It became worse due to the onset of coronavirus in 2020 when the country faced 30% (Rs. 518 billion) of loss of tax revenue. Rising prices of essential commodities, global inflation and global economic slowdown also reduced the demand for Sri Lankan exports. The Sri Lankan GDP also dipped to 2.8 billion in 2021. The Sri Lanka's International Sovereign Bonds yields rose from the 5 to 8 percentage range, reducing the country's access to external borrowing needed to cover the budget gap. At the, same time,

foreign exchange reserves dwindled. The outcome of all of this was that the fiscal deficit reached to 11.7% by the end of 2021 (Samarakoon, 2024).

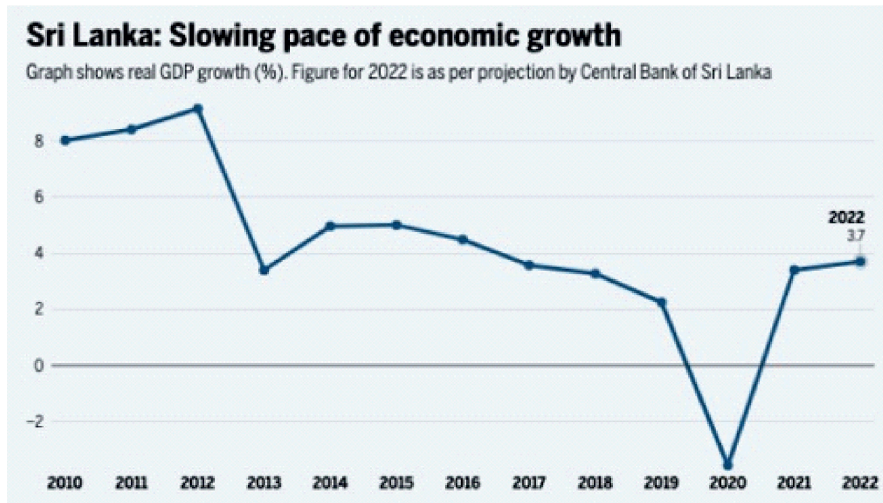


Figure 1: Sri Lankan Economic Growth (2010-2022), Source: The Times of India

The impending economic crisis on Sri Lanka was predicted by the economists who have warned the government about the unfavourable domestic and external shocks. However, the government downplayed the seriousness and high vulnerability of Sri Lankan economy which needed reforms. In Sri Lanka, falling revenues increased the cost of importing essential items, while a weakening currency, heavy reliance on imports, and hoarding pushed food prices higher. The Hambantota port, a project which was introduced to shorten the economic woes of the country also increased its debt problem and landed Colombo in “dragon debt trap” (Gupta, 2022). On 12th April 2022, Sri Lanka acknowledged it had run out of foreign funds when it halted all debt repayments without negotiation, signalling a sovereign debt default on foreign obligations (Samarakoon, 2024).

Political Instability: The outline of the macroeconomic conditions in Sri Lanka shows a 114% decline in the GDP, continuous rise in consumer inflation, and a 95% inflation on the food rate by September 2022. There were widespread protests, called *Aragalaya* (struggle), which began in March 2022 in reaction to the economic crisis, that included inflation and shortage of food, fuel, gas, and medicines. The protestors demanded resignation of the President and the entire parliament (Samarakoon, 2024). Large scale demonstrations were held at President’s personal residence; the protestors

also rallied to Colombo and made a temporary community called *Gotagogama* (Gota go village). The protestors also used social media to popularize their demand of the exit in which they succeed after three months. Gotabaya Rajapaksha resigned from the office and fled the country due to protests (Devapriya, 2022).

The frequent changes in the government and political instability impacted Sri Lanka's economic health significantly. It led to inconsistent economic policies and lack of long-term planning. Corruption and inefficiencies within both the public and private sectors diverted resources away from critical development projects. As a result, the country had to rethink its foreign policies. The government opted for currency swap with India, Bangladesh, and China. India additionally sent consignments of fuel, food, and medicine whereas China was blamed for throwing Sri Lanka into a debt-trap (Devapriya, 2022).

Additionally, by mid-April, Sri Lanka exhausted its foreign reserves, leading to the unilateral suspension of foreign debt payments in April 2022. As the protests intensified the Prime Minister resigned followed by the resignation of the President on July 15th, 2022. The five-month socio-political chaos ended with the election of new president on 20th July 2022. The new government requested aid from IMF, who agreed to provide three billion US dollar Extended Fund Facility (EFF) on 1st September 2022. On April 28, 2023, the IMF deal was ratified by the Sri Lankan Parliament (Samarakoon, 2024).

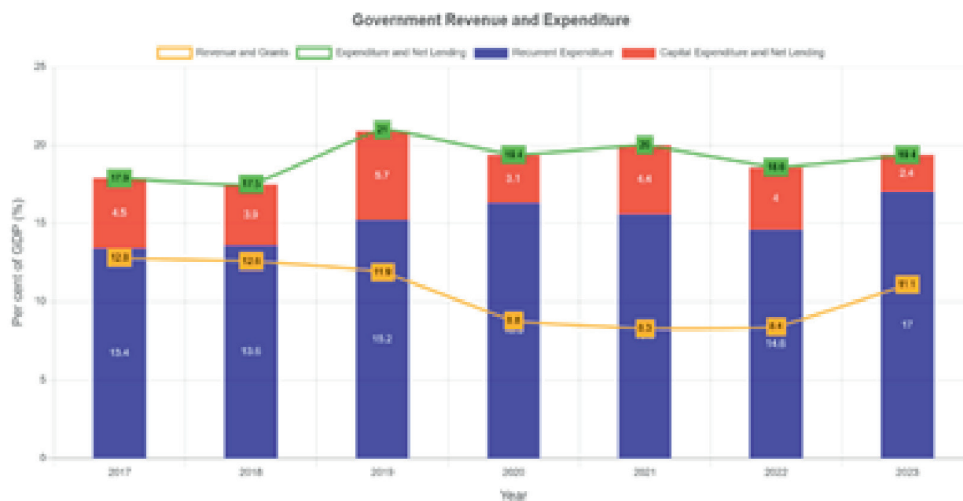


Figure 2. Revenue and Expenditure of Sri Lankan Government (2017-2023),
Source: Annual Economic Review 2023

A year after the *Aragalaya* (struggle) protests began, former president Gotabaya Rajapaksa fled the country in July 2022. Concerns over human rights persist under the current government of Ranil Wickremesinghe of Sri Lanka Podujana Peramuna (SLPP). As president, he has suppressed protests, postponed elections, and restricted the freedom of media and civil society activity. Additionally, the military continues to acquire land in north and east, where minority rights are being compromised. However, this government has also proposed some positive changes to law and order by introducing new measures such as the Anti-corruption Law (De Mel, Samaranayake, & Satkunathan, 2023). Under this bill, the government is now accountable for eradicating bribery and corruption and enhancing transparency in administration (Mallawarachi, 2023).

Global Conditions: Global Economic and political conditions also affected Sri Lanka. The economic slump experienced by all the countries due to COVID 19 also affected Sri Lanka. Its exports to European Union countries, United Kingdom, and United States were severely affected. The international trade of tea dropped by \$520 million and apparel sector also lost \$10 million. The pandemic had a severe impact on the GDP and employment in Sri Lanka (Deyshappriya, 2021). The pandemic also affected the tourism sector due to a series of bans on international and domestic tourism. Many European countries, including the UK, Russia, Ukraine, and Germany, were experiencing the ramifications of the pandemic, and by 2020 the influx of tourists from these countries had declined. That year, Russia and Ukraine still ranked among the top ten sources of tourists. Until 2022, Russia remained the second-largest source, with arrivals reaching 16,894, while Ukraine ranked fifth with 7,037 arrivals (Padmakumara, 2023). Before the pandemic in 2019, China was the second largest contributor to the tourism sector with more than fifty thousand tourists. In 2020 the rate of outbound tourists dropped to approximately 55% (Deyshappriya, 2021). Thus the condition of tourism sector did not improve till 2022 due to several domestic and global realities.

The decline in tourism also affected the export earnings and added strain on the exchange rate. Sri Lankans working in the Middle East, South Korea, and Italy experienced a drop in remittances after losing jobs due to the coronavirus pandemic. As a result, the Sri Lankan currency depreciated against the US dollar. In response, the Central Bank of Sri Lanka restricted imports of automobiles and other non-essential goods, and prohibited licensed banks from purchasing Sri Lankan international sovereign bonds. The Colombo Stock Exchange (CSE) fell

into its lowest in the year 2020. The conversion of many hotels and public places into the quarantine centres and providing for suspected patients added to the welfare expenditure of the government, which could not be compensated; this adversely affected the economy of the country (Deyshappriya, 2021).

More recently, the global political unrest and wars in Russia and Ukraine have affected the economic condition not only in Sri Lanka but all over the world. The prospect of global economic recovery after the pandemic has been dwindling due to the rising inflation and unrest in Europe. Prices of crude oil, cereal, fertilisers, minerals, iron and steel which Russia and Ukraine export have been increasing. In 2020, Sri Lanka's imports from these two countries accounted for 2% of total imports, while exports to them represented 2.2% of total exports. Russia and Ukraine import 18% of Sri Lanka's fermented black tea and export products such as asbestos, copper, iron, steel, soybeans, sunflower oil, seeds, peas, and potassium chloride for fertiliser. Therefore, unless the Russia-Ukraine crisis is resolved, fuel and commodity prices are likely to rise further in Sri Lanka. Additionally, supply chain bottlenecks in Europe have reduced demand for Sri Lankan exports (Wijesinghe, 2022).

Since Russia is Sri Lanka's second-largest market for tea products, its war in Ukraine has significantly disrupted Sri Lanka's economic recovery. In response, Sri Lankan government focused on stockpiling grains and raw materials. They addressed input shortages, including fertilisers, to sustain domestic production and tackling the ongoing foreign exchange crisis by securing the dollar inflow from multilateral institutes to regain the ability to trade swiftly (Wijesinghe, 2022).

Regional Powers: Debt Trap and Economic Diplomacy

Sri Lanka's heavy reliance on imports led to chronic fiscal deficits. From the early 2000s, the government pursued infrastructure-led growth, financed mainly through foreign commercial loans, especially from China under the Belt and Road Initiative. Chinese banks like EXIM and the China Development Bank provided funding, and Chinese state-owned enterprises became key contractors. In 2004, EXIM financed Sri Lanka's first coal power plant. After Mahindra Rajapaksa became President in 2005, he launched major projects, including a port at Hambantota, various expressways, and the airport at Mattala. To strengthen his political position and fulfil populist promises. Following the defeat of the LTTE in 2009, he pledged further development in the conflict affected Northern and Eastern Provinces. The post-2010 period saw continued debt fuelled construction, sparking the "Chinese

debt trap” narrative both at home and abroad (Fernando & Moramudali, 2024).

Between 1980 and 2000, China did not invest in Sri Lanka, but afterwards it funded high-profile projects such as the coal power plant at Puttalam, port and cricket stadium at Hambantota and the airport at Mattala. This foreign direct investment caught international attention, especially given Sri Lanka's strategic location near India, raising geopolitical concerns (Fernando & Moramudali, 2024). Chinese infrastructure investments especially in ports and roads create markets for Chinese goods, shrinking India's economic space. Strategic sites such as Hambantota Port, while currently barred from military use, could serve Chinese military purposes under a future pro-China government. Another important port, Colombo Port handles more than 30% of India's container cargo, and any disruption there could hit Indian trade. In response, India has provided Sri Lanka with about approx. four billion dollars in 2022 through loans, currency swaps, and essential supplies, to strengthen trade and infrastructure ties. This is both a reaffirmation of historic bonds dating back 2,500 years and a counter to China's influence. The other QUAD (Quadrilateral Security Dialogue) members, such as the US, Australia, and Japan, have also extended varying degrees of assistance (Nair, 2022).

By 2017, the debt trap narrative gained traction when the port at Hambantota was leased to China Merchants Port Company for ninety-nine years to ease repayment pressures. Reports, including from The New York Times, linked the lease directly to unpaid Chinese loans. From 2018, China faced growing accusations of “debt-trap diplomacy” (Fernando & Moramudali, 2024). While intended to boost growth, projects like Hambantota Port generated little revenue but increased debt servicing burdens. After 2010, Sri Lanka's debt profile shifted towards high-interest, short term commercial loans, with 36% from International Sovereign Bonds, 20% from China, 15% sourced from the Asian Development Bank, 10% contribution from the World Bank, 9% from Japan, 2% from India and 10% from other sources (Fernando & Moramudali, 2024).

Scholars such as Y. Fernando and U. Moramudali (2024), reject the Chinese debt trap theory, arguing that Chinese loans were not the main cause of Sri Lanka's national debt. When the country failed to meet its debt obligations in April 2022, China held just twenty percent of its foreign debt. In contrast, analysts like V.S. Ranade (2024) contend that China ensnared Sri Lanka in over seven billion dollars of debt, following a pattern of financing large infrastructure projects with conditions that allow it to take control of assets when borrowers default. This according to Ranade

(2024) is done with strategic goals in mind. This approach, is seen in Sri Lanka, Pakistan, Maldives, several African nations, and other Belt and Road participants. This strategy is compared to the board game *Wei Qi*, where players try to surround more territories. India's humanitarian and strategic support to Sri Lanka has helped counterbalance Chinese influence and strengthen regional cooperation.

Rising global commodity prices and inflation worsened Sri Lanka's economic crisis, making imports costlier and depleting foreign exchange reserves. The healthcare sector was pushed to the brink, with severe shortage of essential medicines and equipment, compounded by crippling power cuts. Routine surgeries were halted, diagnostic testing reduced, and state-run hospitals ran out of life-saving drugs. Facilities faced shortages of endotracheal tubes for new born and children, prompting doctors to appeal to overseas Sri Lankans for donations. The Sri Lanka Medical Association (SLMA) reported that hospitals had lost access to imported medical supplies entirely, while rural doctors were forced to treat injuries without light. Emergency drugs for heart attack treatment were also in critically short supply (George, George, & Baskar, 2022).

India's response to Sri Lanka's crisis combined humanitarian aid with strategic engagement. Between 2020 and 2022, New Delhi supplied vaccines, medicines, oxygen, fertiliser, test kits, and essential food items, alongside major financial support. In 2022 alone, India extended about four billion through credit lines, currency swaps, and deferred payments, covering fuel, food, medical imports, and foreign reserve stabilisation. Key measures included a \$500 million credit line for petroleum, \$1 billion for essential commodities, \$400 million in currency swaps, and the provision of urea, kerosene, and dry rations. This assistance, rooted in India's *Neighbourhood First* policy, strengthened its economic and strategic position in the Indian Ocean while addressing urgent needs during COVID-19 and the 2022 economic collapse. India maintains that its ties with Sri Lanka are autonomous and multidimensional, not dependent on Colombo's relations with China (Nair, 2022; Singh, 2024). However, anti-Indian sentiment and political instability in Sri Lanka continued to challenge deeper integration.

India's support to Sri Lanka during its worst financial crisis is now paying off diplomatically, shielding it in the new tariff dispute triggered by Donald Trump. Harsha De Silva, former minister for economic reforms and a senior member of the Samagi Jana Balawegaya (SJB) party, emphasized the vital role India played in supporting Sri Lanka. In 2016, India helped launch the island's national ambulance

service, and during the crisis it delivered 3.3 tonnes of medical supplies to keep it running. Its help went well beyond mere emergency relief, amounting to nearly \$5 billion in credit lines, grants, and loans. This support included a \$400 million currency swap arranged through the Reserve Bank of India, the deferment of \$500 million in trade liabilities, and \$3.1 billion in credit facilities for critical imports such as food, fuel, and medicines. Additionally, India supplied petroleum products, locomotives, and buses, while funding grant projects worth hundreds of millions of dollars to support infrastructure development, digital ID systems, solar electrification initiatives, and housing of plantation workers. By converting some loans into grants, lowering interest rates, and offering concessional credit lines, India eased Sri Lanka's debt load, strengthening its position in deliberations with the International Monetary Fund (IMF) and other creditors. This helped Colombo avert a more severe sovereign default (Patra, 2025).

In 2022, Ranil Wickremesinghe, the then President, spoke at the 31st All India Partners Meet in Colombo, acknowledging that Sri Lanka had survived two difficult years, possibly because India had given a loan of \$3.5 billion, all of which will be repaid (PTI, 2024). The current President, Anura Kumara Dissanayaka, also thanked Narendra Modi, Indian Prime Minister for India's unparalleled, multi-pronged succour in stabilising Sri Lanka's economy, from emergency financing and foreign exchange assistance to an important role in debt restructuring as co-chair of the Official Creditor's Committee. He highlighted India's \$ 20.66 million grant to settle project related dues, easing the debt burden at a critical moment. Both leaders are committed to finalising a debt restructuring MoU and advancing socio-economic initiatives, including housing and healthcare services for the Indian-origin Tamil (IOT) community, development in the Eastern Province, and solar electrification of holy sites. They agreed to reopen the Nagapattinam – Kankesanthurai ferry, explore a Rameshwaram – Talaimannar link, and expand energy cooperation through the Sampur solar project, LNG supply, a high voltage electricity transmission link, an India–UAE–Sri Lanka multiproduct pipeline, and joint offshore wind power development in the Palk Straits, with Trincomalee as an energy and industrial hub (Ministry of External Affairs, 2024).

To maintain growth and development in Sri Lanka, India has agreed to assist in rolling out its Unique Digital Identity (SLUDI) project, UPI payments, DigiLocker, and other digital platforms, alongside collaboration in agriculture, aquaculture, health, research, education, start-ups, and trade expansion under India-Sri Lanka

Free Trade Agreement (ISFTA). Security and defence ties have been deepened through joint training, maritime surveillance, and disaster relief support, including the gift of an Indian Navy Dornier 228 aircraft and establishment of a joint Maritime Rescue and Coordination Centre (MRCC). President Dissanayaka has appreciated India's role as a 'first responder' disaster relief and stated that the two countries will collaborate on hydrography, and maritime domain awareness. Both sides are working to strengthen cultural, tourism and fisheries cooperation with plans for more flights, harbour upgrades, and measures to protect fishermen's livelihoods through enhanced regional cooperation under the Indian Ocean Rim Association. Sri Lanka backed India's bid for a non-permanent seat on UN Security Council for the 2028-2029 term, underscoring stronger regional coordination (Ministry of External Affairs, 2024).

India stands as Sri Lanka's leading partner in trade and investment. This makes economic integration between the two countries vital not only for mutual growth but also for strengthening regional cooperation through notable organisations like the South Asian Association for Regional Cooperation (SAARC) and the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC). As India is expected to become third largest economy of the world by 2030, and Sri Lanka works to restore stability and expand its economy, the scope for deepening bilateral economic ties is significant. The Free Trade Agreement (FTA) signed in 2000 remains a cornerstone for collaboration in trade, investment, energy, tourism, and connectivity. Shared objectives of sustainable growth and regional stability further highlight the importance of closer cooperation. This partnership reached a defining moment in 2022, when India was the only nation to extend support to Sri Lanka during the most severe phase of its prolonged economic crisis (Talal, 2025).

Through the Economic and Technical Cooperation Agreement, India and Sri Lanka aim to broaden trade and strengthen services export growth for both economies (Ministry of External Affairs, 2024). For Sri Lanka, which faces an urgent need for large-scale foreign investment and carries foreign currency debt equal to half its GDP, India is a natural partner, especially as major economies like the US and China prioritise other regions. India has already invested in Colombo Port and expressed in developing Trincomalee, the world's fifth-largest natural harbour, into an industrial port. Colombo, already the busiest intermediate port for Indian trade, offers competitive pricing and a strategic location, while Trincomalee holds long term strategic value. As India's economy grows, its demand for port capacity will increase,

making further investment in Sri Lanka's ports mutually beneficial. Although Sri Lanka's recovery ultimately depends on domestic policy, closer economic ties with India will help accelerate progress. Tourism adds another dimension to the growth. India is Sri Lanka's largest source of tourists, and attracting even a fraction of India's rapidly growing middle class could significantly boost Sri Lanka's foreign currency earnings (Talal, 2025).

Prospects of Recovery, and Reform

Sri Lanka is emerging from its economic crisis, it recorded growth of 1.6 percent in the third quarter of 2023. Inflation has moderated significantly, and economic indicators such as manufacturing and services has shown signs of recovery. In 2022, Sri Lanka turned to IMF for sustainable and inclusive growth. At that time, the country's spending was twice higher than its revenue. The IMF's monetary support bought time for reforms to take hold, it drew in additional multilateral and bilateral financing, and signalled to creditors that Sri Lanka could rebuild its debt repayment capability. Furthermore, the IMF Governance Diagnostic Report contributed to reducing losses from corruption, excessive tax exemptions, and non-competitive procurement, for the benefit of everyone (Srinivasan & Breuer, 2024).

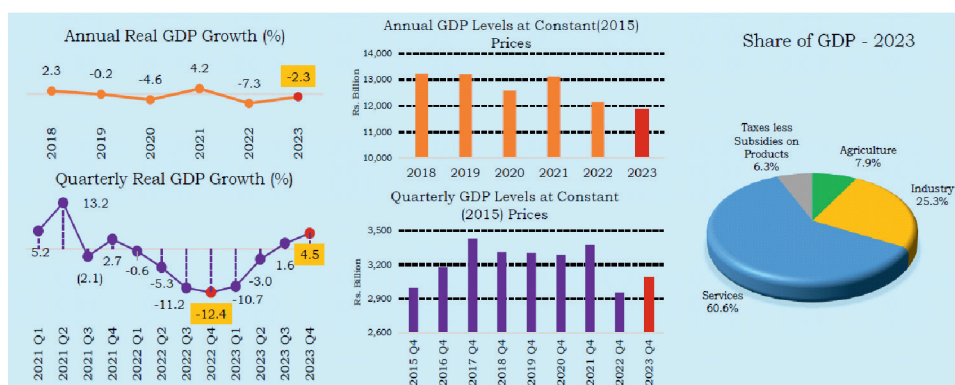


Figure 3: Sri Lanka's GDP Growth Rate (2018-2023), Source: Department of Census and Statistics, Central Bank of Sri Lanka.

Sri Lanka's ongoing IMF-backed reform program focused on fiscal and economic restructuring but gives little priority to broader governance reforms. In March 2023, the IMF sanctioned \$3 billion bailout under its Extended Fund Facility (EFF) to stabilise the economy, contingent on measures like tax increase, reduced

subsidised, cost-recovery energy pricing, debt restructuring, and anti-corruption commitments. Public debate, however, has centred almost entirely on tax hikes and fears of austerity. Since August 2022, the government has launched sweeping tax reforms to address chronic revenue shortages. Changes included raising VAT from 8% to 15%, lowering the VAT threshold to bring more business into the tax net, and sharply increasing personal and corporate income tax rates, while reversing many exemptions introduced in 2019-2020. The goal is to rebalance Sri Lanka's reliance on indirect taxes, expand the tax base, and restore fiscal sustainability (Fernando & Moramudali, 2024).

These moves have triggered strong backlash, especially from middle and upper-middle class professionals, like doctors, engineers, academics, and finance workers, who enjoyed the advantages of low tax rates on income. Opposition parties across the political spectrum also criticized the reforms, often appealing to middle-class voters. Trade unions formed alliances, staged strikes and proposed alternative tax plans. The government refused to reverse the changes, arguing they were essential for IMF support. Although the new personal income tax affects only about 20% of earners, resistance has been intense among those newly brought into the tax net. Critics link the unwillingness to pay higher taxes to distrust in government, fuelled by perceptions of corruption, inefficient public spending, and persistent overspending on defence despite post-war conditions. Many argue tax hikes must be matched by expenditure reforms, especially to improve social services (Fernando & Moramudali, 2024).

For the first time in years, taxation debates have pushed issues of accountability and public service quality into the political mainstream. Some taxpayers now demand better infrastructure, efficient state-owned enterprises, and measurable performance indicators for ministries. Increased taxes have also driven more people to use deteriorating public services, reinforcing calls for improvement. The success of Sri Lanka's fiscal reforms and its ability to rebuild a "fiscal social contract" will depend not only on revenue generation but on whether the state can convince citizens their taxes are funding equitable, high-quality public goods. Without this link between taxation, expenditure, and trust, both the IMF program and long-term governance reforms risk flatterring (Fernando & Moramudali, 2024).

Conclusion

The economic crisis faced by Sri Lanka stemmed from decades of fiscal mismanagement, weak revenues and excessive reliance on short-term foreign

borrowings, which was compounded by political instability and policy missteps. External shocks like the 2019 Easter attacks, the COVID-19 pandemic, and the Ukraine war exposed deep structural flaws, leading to a sovereign default, soaring poverty, and the collapse of essential services. While China's loans shaped parts of the debt profile, the immediate crisis beyond its means to control. Recovery depends on three priorities: credible debt restructuring, durable fiscal reforms to rebuild the revenue base and control spending; and institutional repair to strengthen governance, transparency, and central bank independence.

Long-term stability will require a shift from debt fuelled infrastructure spending toward export led growth, productivity gains, and better integration into regional and global markets, particularly with India. Key measures include restoring agricultural productivity, reforming state-owned enterprises, diversifying energy sources, and improving trade facilitation. Above all, success hinges on rebuilding the fiscal social contract i.e., better services and honest communication about economic trade-offs. The path to recovery is clear, but it demands consistent execution, transparency, and public trust to break the cycle of crisis.

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