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Sri Lankan Economic Crisis: Factors Responsible for Economic Failure

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ABSTRACT

For the first time, the Island Country of Sri Lanka is experiencing the worst economic crisis ever. This type of economic chaos in Sri Lanka can be said to be the consequence of the poor decisions taken by the government, due to which Sri Lankans from all walks of life are struggling since there is not enough money, fuel, or food available. This type of poor governance has a domino effect that paralyses all the important and key economic sectors. The first and foremost reason is the Large-scale borrowings at high-interest rates with stringent restrictions from international financial organisations. Then the nationwide ban on chemical fertilisers served as the second justification. The third one resulted in significant revenue loss for the government due to the enormous increase in the annual income threshold for personal income tax waivers and the reduction of Value Added Tax rates. The fourth was the government's nationwide adoption of the organic farming policy, which had a significant negative impact on yield. The fifth was that the tourism sector is experiencing severe problems, and fewer foreigners are visiting the island nation regularly due to the impact of the Covid-19 pandemic.

Keywords: Foreign Reserve, Agricultural, Tax Reduction, Covid-19.

I. INTRODUCTION

Formerly known as Ceylon, Sri Lanka is one of the most stunning islands in the entire globe, with 2.15 crore people living in Sri Lanka as of 2022². The Central Bank of Sri Lanka issues the Sri Lanka rupee as the country's unit of exchange; the currency code for the rupee is often LKR³. Compared to the majority of its Asian neighbours, Sri Lanka's economy was much more thriving when it gained independence in 1948, but the economic growth and long-term stability of the nation have both been severely hampered by political unrest there and according to Sri Lanka's history, it can be adequately established that the "Twin Political Strife" is what has led to the country's ongoing conflict and hindered growth⁴. The conflict between the Tamil

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² "Dr. M. Nazeeruddin" & "Mr.M.Jafarullah Baig", Sri Lanka's Economic crisis- An Eye Opener, Research Review International Journal of Multidisciplinary, (Apr. 2022).

³ *Id.*

⁴ Raagini Sharma, Sri Lanka Crisis 2022: The Biggest Economic Debacle & Political Turmoil Since 1948, Research Institute for European and American Studies, (3 May 2022).

separatists in the north and the Sinhala youth revolt in south Sri Lanka⁵. From the 1950s through the late 1970s, Sri Lanka had a closed, inward-looking economy with very little growth, which resulted in a significant fiscal deficit. The 21.8 million-strong population afterwards through a horrific civil war from 1983 to 2009, which resulted in tens of thousands of deaths, after the protracted civil war, the nation struggled to maintain stability and progress during the past ten years⁶. Now, with the economy in freefall and no foreign reserves to import necessities, the nation is once more dealing with street violence and political upheaval. With this population and a GDP per capita of USD 3,852 (2019), Sri Lanka is a lower-middle-income nation⁷. The power battle between President Gotabaya Rajapaksa and the Sri Lankan Parliament has been the cause of the ongoing political unrest in the nation since April 3, 2022. The nation's general morale and status have been devastated and decimated by a number of causes, including the downturn in the economy, the soaring debt, the decline in foreign reserves, and the residents' inability to afford basic needs. These 22 million people living in the island nation of Sri Lanka, are experiencing a severe economic crisis and political unrest as a result of widespread public protests. The nation is currently experiencing its first economic crisis since obtaining independence in 1948. As a result of the crisis, the government's coffers are empty and the public lacks the funds to purchase necessities like food and medicine. Sri Lanka's economy has been significantly impacted by the pandemic, rising energy costs, and populist tax cuts. There are severe shortages of essentials like fuel and medicines as a result of a continuous scarcity of foreign currency and increasing inflation.

II. FACTORS RESPONSIBLE AND CONSEQUENCES OF CRISIS IN SRI LANKA

“Citizens of Sri Lanka's debt-ridden nation are being urged to send money home. 13 banks in Sri Lanka have had their ratings put on hold. External debt of 51 billion dollars is not repaid by Sri Lanka. The beautiful island is not without problems. No food is available. In the past few months, at least 500,000 Sri Lankans have fallen into poverty. According to the doctors, the economic crisis may kill more long-time fans than COVID because there is no fuel, no medicine, and vital surgeries are being postponed. Daily power outages and protracted street demonstrations. More than an economic catastrophe, Sri Lanka is currently experiencing a humanitarian crisis. The question is: How did Columbo manage to lose every last penny?”⁸

There are various reasons for the Lankan crisis, including a problem with the country's policies,

⁵ *Id.*

⁶ *Id.*

⁷ *Id.*

⁸ Explained: Sri Lankan Economic Crisis, Gravitas Plus, May 2022.

political circumstances outside of Lanka's control that some like to refer to as fate, and China, which is the main factor in many issues in Sri Lanka and abroad. What's taking place right now is the outcome of years of poor management. Sri Lanka has a basic issue since it imports more than it exports, spends more than it makes, and has a budget imbalance in addition to a trade deficit. This additional debt is a surefire prescription for catastrophe.

Sri Lanka's response to this catastrophe has been terrible; rather than attempting to reduce the deficit, the nation increased its debt by borrowing recklessly without taking into consideration its future consequences. Colombo took out a lot of loans from nations and organizations. At 111%, Sri Lanka's debt to GDP-ratio indicates that it now consumes more than it generates. This shows the dependency of Sri Lanka on other nation states even to fulfill its basic needs. The Asian Development Bank raised this issue in 2019, noting that the nation's national expenditures exceeded its national revenues and that it produced insufficient amounts of tradeable commodities and services.

(A) Foreign Reserve Crisis: -

Due to a decrease in foreign reserves, Sri Lanka is currently experiencing a severe economic crisis. Foreign reserves have been declining since August 2020, but in November 2021 they reached a perilous level. It was hard enough to cover the import for one month⁹. A minor increase occurred a month later, but even that was insufficient for two months' import. According to reports, the gross foreign reserves decreased by another 24% to US\$ 2.3 billion in January 2022¹⁰. The lack of foreign reserves has raised questions about the Sri Lankan government's capacity to pay for the import of necessities and debt repayment but the Sri Lankan government has acknowledged that the lack of dollars is making it harder for them to pay their import costs, especially when it comes to importing petroleum for daily needs, but even after the current economic crisis, the government and the Central Bank of Sri Lanka (CBSL) remain confident that Sri Lanka will not default on its debt obligations¹¹. Since Sri Lanka's independence, its imports have always been more than its exports. This country has been dependent on other nations even for its necessities such as food, pharma, fuel, etc. Thus, the foreign exchange that is been earned by the country is utilized to clear the import bill dues

⁹ Economic Research Department, Central Bank of Sri Lanka, External Sector Performance - December 2021, (Feb. 11, 2022), [press_20220211_external_sector_performance_2021_december_e.pdf](https://www.cbsl.gov.lk/press_20220211_external_sector_performance_2021_december_e.pdf) (cbsl.gov.lk).

¹⁰ Sri Lanka foreign reserves drop to US\$2.3bn in Jan 22, *Economy Next*, (Feb. 7, 2022) [Sri Lanka foreign reserves drop to US\\$2.3bn in Jan 22 | EconomyNext](https://www.economynext.com/sri-lanka-foreign-reserves-drop-to-us2.3bn-in-jan-22/).

¹¹ Central Bank of Sri Lanka, Reiteration of Sri Lanka's Commitment to Service Forthcoming Debt Obligations, (Feb. 9, 2022), [Reiteration of Sri Lanka's Commitment to Service Forthcoming Debt Obligations | Central Bank of Sri Lanka](https://www.cbsl.gov.lk/reiteration-of-sri-lanka-s-commitment-to-service-forthcoming-debt-obligations/) (cbsl.gov.lk).

for years.

(B) Tax Reduction & Money Creation

Gotabaya Rajapaksa ran for the presidential election in 2019 and participated in campaigning. Deep tax cuts were one of his political pledges. How will the country make money if it pays less in taxes? Later, neither the voters nor Gotabaya cared to ask. With more than 52% of the vote in November 2019, he won the election and took the position, followed by the tax cuts including the elimination of the Pay As You Earn (PAYE) tax, the imposition of the 2% "nation-building tax," which funded infrastructure development, the reduction of VAT to 8%, the reduction of corporate tax from 28% to 24%, and the increased tax-free thresholds, which reduced the number of taxpayers by 33.5%¹². Rating agencies eventually reduced the sovereign credit rating as a result of the significant decrease in tax revenue, making it more difficult to take on further debt. The rating companies indicated their worry which indicated worry that Sri Lanka's government coffers would soon be empty and the nation risked running out of money. Investors left Sri Lanka as a result, making it impossible for the government to access global markets. As a result, investors withdrew from Sri Lanka, making it impossible for the government to access international markets. But Gotabaya wasn't finished; he made a huge mistake that proved to be a game-changer in the economic condition of Sri Lanka.

(C) The Agricultural Crisis in Sri Lanka

Gotabaya outlawed all chemical fertilizers in April 2021, citing health benefits, but his critics scoffed and concluded that the underlying issue was a lack of funding¹³. The nation was out of its foreign reserves. The movie continued to show that Sri Lanka was killing agriculture output while saving foreign exchange by forbidding imported fertilizers under the guise of organic farming. The production of white rice, a staple food in Sri Lanka, decreased by 50% in the first year itself and for the first time in its history, Sri Lanka was compelled to import rice around June 2021¹⁴. The Tea industry in Sri Lanka too deteriorated and more bad news arrived in July as Sri Lanka barred the import of luxury items at a time when the nation was already struggling to save money. A country like Sri Lanka that is heavily dependent on other nations for its necessities and imports more than it exports, if it is out of its foreign currencies, there is nothing as devastating as this for a nation.

¹² A.S. Hovan George, A. Shaji George & T. Baskar, Sri Lanka's Economic Crisis: A Brief Overview (Apr.-June 2022), Partners Universal International Research Journal (PUIRJ), Partners Universal International Research Journal (puirj.com).

¹³ *Id.*

¹⁴ *Id.*

(D) Impact of Covid-19

Like other nations, COVID-19 has profoundly affected Sri Lanka's economy and way of life. As is the case in many nations battling the pandemic, Sri Lanka's economy shrank by 3.6 percent in 2020, its poorest growth result on record, and the fiscal situation also got worse as a result of rising expenses and declining revenues brought on by the pandemic¹⁵. According to an update on Sri Lanka's growth, the nation is currently on the road to recovery after experiencing an unprecedented economic downturn as a result of the pandemic. Numerous changes have been brought about by the COVID-19 pandemic in all facets of life. However, the economy and levels of poverty have been significantly impacted. Due to how the pandemic has impacted household income and work stability, the impact of COVID-19 on poverty in Sri Lanka has effectively halted major progress toward reducing poverty. There is a projected increase in the \$ 3.20 poverty rate from 9.2 percent in 2019 to 11.7 percent in 2021 is expected to be concentrated in metropolitan areas, among workers in the private sector and the informal economy¹⁶. As a result of job losses and income declines, poverty will considerably rise in 2020. It is anticipated that approximately 500,000 individuals have become impoverished as a result of this crisis.

(E) Sri Lankan Tourism Sector

The Easter explosions that occurred in Sri Lanka in 2019 had already caused a setback in the tourism sector of the country. The European tourists no longer visited the nation. Later in 2020, with the outbreak of the COVID-19 epidemic, the situation worsened and had a detrimental impact on Sri Lanka's tourism industry. The borders of nations were blocked, stopping visitors to come to Sri Lanka, which led to a drop in tourism-related income. The tourist sector of Sri Lanka accounts for 13% of the nation's GDP¹⁷. Tourists are moreover a source of foreign currency. In 2020, Sri Lanka only managed to receive 173,000 visitors whereas in 2018 there were 2.3 million people¹⁸.

(F) China's Influence on Sri Lankan Economy

Sri Lanka has consistently resisted establishing deeper connections with India whereas the Rajapaksa family has always decided to ally themselves with China. Sri Lanka has thoroughly borrowed heavily from China. Concerning debt repayment, China has not yet released any

¹⁵ A S De Silva, Economic Crisis in Sri Lanka due to the COVID - 19 Epidemic, (Aug. 27, 2021), Economic Crisis in Sri Lanka Due to the COVID-19 Epidemic by Ashani De Silva :: SSRN.

¹⁶ *Id.*

¹⁷ A.S. Hovan George, A. Shaji George & T. Baskar, *supra* note.

¹⁸ *Id.*

formal statements. China received the 99-year lease as a result of commercial agreements between the two nations since Sri Lanka was unable to pay the financial capital loan¹⁹. The Dragon is in charge of the Hambantota International Port, the second-largest port in the country and one of the key components of the Chinese Belt and Road Initiative due to its strategic location (BRI), thus resulting in Sri Lanka falling prey to China's debt trap diplomacy in this blatant case²⁰. Then came the Wuhan virus when borders closed, tourists completely stop arriving and so did the revenue from tourism. Due to its inherent advantages, the tourist industry is thought to be one of the most significant drivers of economic growth and development in Sri Lanka, and as such, it is a major emphasis of the government's industrial policy²¹. But still, in June 2021, Bangladesh loaned Sri Lanka 200 million Dollars in February 2022 and India loaned 500 million dollars.

III. CONSEQUENCES

Tens of thousands of people have been forced to stand in line for hours outside gas stations since March 2022 due to a sudden increase in the price of essential commodities and a gasoline shortage. The average daily power outage lasts up to 12 to 13 hours. In February 2022, Sri Lanka saw food inflation of 25.7% and retail inflation of 15.1%, both among the highest in Asia and Sri Lanka since 2008. Inflation in March increased even further as a result of the rupee's depreciation against the US dollar. Food and fuel are examples of commodities that are either unavailable or extremely expensive (food inflation in March reached 30%, making basic staples out of reach for many average Sri Lankans)²².

IV. CONCLUSION

The Sri Lankan government is optimistic that the situation with regard to foreign exchange would soon improve as a result of the anticipated inflows from the bilateral partners as well as non-debt-producing foreign currency inflows in the next few days. The tourist industry's foreign exchange profits and remittances are anticipated to increase shortly. Despite the government's confidence, it is doubtful that Sri Lankans would see immediate economic respite. In my opinion, the economic crisis in Sri Lanka is mostly the result of foolish and poor policies. The government must now focus on increasing the income through the tourism sector which would eventually bring in foreign currency to the nation. Once the nation is slightly stable

¹⁹ Raagini Sharma, *supra* note 3.

²⁰ *Id.*

²¹ Ruwan Ranasinghel & Ravindra Deyshappriya, Analyzing the Significance of Tourism on Sri Lankan Economy; An Econometric Analysis, Department of Management Sciences Uva Wellassa University Badulla, Wayamba Journal of Management.

²² Sri Lanka Crisis: Children In Need, Unicef Sri Lanka, SRI LANKA CRISIS: | UNICEF Sri Lanka.

economically, the nation should try on decreasing its imports and reducing its dependency on other states by introducing several domestic measures promoting capital inflow. While dealing with the crisis, specific attention must also be given to regaining the trust of the investors as the nation is highly indebted and needs funds to pay back. The irony is that Sri Lanka has to repay several loans and the only way to repay is again by taking the support in form of loans itself. Currently, it is anticipated that this situation maybe healed by next three or four years.
