The Inaugural Professor K. Dharmasena Memorial Lecture, delivered by Mr. K. M. Mahinda Siriwardana, Secretary to the Treasury, and Ministry of Finance, Economic Stabilisation and National Policies at the University of Kelaniya on 30th January 2024

I am honoured to be invited to deliver this inaugural Professor K. Dharmasena memorial lecture today. I am indeed thankful to Professor Ajith Disanayake and Professor Gunathilaka of the Department of Economics for inviting me to this memorable occasion. I am also delighted to come back to the University of Kelaniya, my alma mater, after 40 years, where I obtained my Bachelors (Honours) Degree in Economics in 1990. Although I entered the university in 1983, I had to stay at home for about two years without sitting for my final examination due to the 1987–1989 youth insurrection. I joined the Central Bank of Sri Lanka (CBSL) in 1991. I served at the General Treasury from 2010 to early 2015 on the secondment basis and served in the Executive Board of the International Monetary Fund (IMF) as the Alternate Executive Director, representing the constituency comprising Bangladesh, Bhutan, India and Sri Lanka from July 2017 to November 2019. These professional engagements outside the CBSL gave me an important opportunity to see the world and improve my understanding of the subject of Economics in various aspects, including political, social and global dynamics. I am grateful to Professor K. Dharmasena, along with the other lecturers at the Department of Economics, who provided me with the necessary knowledge and initial training on the subject of Economics, which I was able to build upon and reach where I am today. I am certain that he would be happy to see the progress that has been made one of his students. In fact, it was a long and tough journey for someone who entered the university from a very remote area like Nuwara Eliya in 1983. It also reflects the long way you all, as students of Economics, can go in many years to come, with of course hard work, commitment and integrity.

I thought it is important to emphasize the importance of evidenced based policy making and decision making as many of you who are here one day will take such positions in the government as well as the private sector. As trained Economists, your duty will be to analyse situations and communicate to your higher authorities who take decisions and if you were a decision maker, to make conscious decisions. It is the duty of the higher authorities to listen to the recommendations that are coming through such analyses. If not, the result could be devastating as we experienced through this unprecedented economic crisis. Hence, I thought I would focus my speech today on these very important areas.

1. Introduction

All of us here today have experienced the devastating fallout of Sri Lanka's worst economic crisis in post-independence history. The Department of Census and Statistics recently published the results of a Survey[1] on the impacts of the crisis on households. The findings confirm the gravity of this crisis, where 60.5% of households have decreased their total household average monthly income, 91.0% of households experienced an increase in their total household average monthly expenditure, 22% of households are indebted, 7% of the total population changed their health treatment procedure and 54.9% of individuals' (aged 3-21) schooling has been affected by the economic crisis.

Whilst the worst of the economic crisis was experienced through the year 2022, and the country enjoys a degree of stabilisation at present, the crisis is far from over. In fact, it is also well understood that the reform measures implemented to address the causes of the crisis create additional stress on the citizenry. There has been substantial public debate on the impact of these remedial measures and what alternative options are available for consideration. In today's address, I want to focus on the policy reform path that has been adopted and also reflect on the alternative options that have been mooted in the public debate.

2. Origins of the economic crisis

In order to arrive at the appropriate solution to a problem, it is first necessary to understand the causes. With regard to Sri Lanka's economic crisis, there have been various causes attributed to the crisis in public discussion. These include corruption and mis-governance, ISB borrowings, declining economic growth rates, and the declaration of a moratorium on debt service payments (Debt Standstill) in April 2022, among others.

In reality, the causes of the crisis are more nuanced than a single issue that happens to fit a particular ideology. I do no doubt that your university education would have reinforced the importance of adopting a scientific, rational method in arriving at a conclusion, and to avoid examining a problem through an ideological lens. We must do the same when it comes to understanding the root causes of the economic crisis as well.

There have been long-standing structural weaknesses in the Sri Lankan economy which have been neglected for many decades given the pain associated with remedying these issues. The weaknesses include fiscal sector imbalances, inadequate external policy

[1] "*Household Survey on Impact of Economic Crisis – 2023*", Department of Census and Statistics, Ministry of Finance, Economic Stabilization and National Policies: http://www.statistics.gov.lk/WebReleases/HECS_Bulletin_Final

buffers, financial and monetary sector vulnerabilities, deficiencies in governance, and shortcomings in the legal and institutional framework in the country. The recent external shocks faced by the country, including the Easter Sunday attacks, the COVID-19 pandemic, the Russia-Ukraine conflict, coupled with significant domestic policy errors, exposed these macroeconomic vulnerabilities and triggered the prevailing economic crisis.

3. Twin deficits

In macro-economic terms, the crux of the problem has been persistent twin deficits – budget deficits in the fiscal account and current account deficits in the balance of payments (BOP) accounts.

Sri Lanka has been experiencing imbalances in the fiscal sector over many years. However, the situation deteriorated significantly recently. Sri Lanka's government revenue as a percentage of GDP stood as low as 8.3 percent in 2021. This is a historically low figure for our country and it is one of the lowest revenue levels in the world. While government revenue was substantially low, government expenditure was around 20 percent of GDP in 2021, making government revenue grossly inadequate even to meet day-to-day expenses of the Government, i.e. the recurrent expenditure.

A major fiscal challenge is that recurrent public expenditure is largely non-discretionary in nature and cannot easily be reduced in the short term. Expenditure on public sector salaries, pensions, essential welfare payments, and interest cost alone easily exceed revenues. Reducing these in the short term is not practically feasible. Furthermore, public expenditure of around 20% of GDP is quite low by global standards, and on par with some peer countries. There are in fact several areas where Sri Lanka needs to spend more – including health, education, public transport, and digitalization, among others.

In parallel, Sri Lanka also had persistent current account deficits in the BOP as consumption in the economy typically exceeded savings. The low savings levels were influenced by the high public dis-savings as evidenced in the fiscal deficits, but private savings were also low. The latter was influenced by consistent low real interest rates as inflation was high compared to nominal interest rates. Interest rates were often suppressed through monetary financing.

Therefore, Sri Lanka has been continually running current account deficits, and 2023 will be the first year that a current account surplus will be recorded since 1977. The country has also run fiscal deficits for many years largely due to inadequate government revenue. Since independence, Sri Lanka has had a primary budget surplus in only 5 years, 1954, 1955, 1992, 2017, 2018, and I am pleased to share that 2023 was the sixth occasion that a primary surplus was achieved.

These twin deficits had to be financed by borrowings which gradually accumulated into ever increasing public debt, both domestic and external. Debt was also parked outside the government balance sheet, particularly in state owned enterprises such as the Ceylon Petroleum Corporation (CPC), Ceylon Electricity Board (CEB), and Sri Lankan Airlines (SLA). The CPC and CEB in particular have accumulated large volumes of debt due to persistent under-pricing of energy below cost levels. The resultant losses built up over time with CPC having over Rs. 1 trillion of debt on its balance sheet. These SOE losses were in turn funded by the state banks. The regulations on lending by state banks to SOEs were relaxed to allow large exposures which went against prudent risk management practices.

4. Unsustainable debt

It was possible to fund this debt through concessional foreign financing whilst Sri Lanka was a low income country. However, since 2006 when Sri Lanka's per capita GDP crossed the middle income threshold, access to concessional financing diminished gradually. With less access to cheap financing, the country should have changed its practices to reduce its deficits and borrowing requirements, however it did not happen. Since 2007, the country shifted to commercial borrowings, primarily in the form of international sovereign bonds (ISBs). Most of these bonds have up to 10 year maturity periods, so until around 2019, Sri Lanka did not face much difficulty in terms of repayment pressures for external debt.

When middle income countries take on commercial borrowings in the international bond market, they typically would refinance the capital portion of maturing debt while servicing interest. In order to regularly refinance debt, it is essential to maintain the confidence of markets through good credit ratings based on sound macroeconomic management. By 2019, Sri Lanka already had elevated central government debt at 82% of GDP. However, the country had a credit rating of B and being in an IMF programme with two successive years of primary surpluses, enabled Sri Lanka to access global capital markets to successfully re-finance debt maturities in 2019.

5. Were ISBs the cause of the debt crisis?

In fact, the government at the time made a conscious decision to raise additional funds amounting to USD 2.4 billion in long term ISBs to ensure Sri Lanka would have sufficient reserve buffers to get through a period of volatility amidst the election cycles of 2019 and 2020. There have been claims that this increase in ISB borrowings was a cause of the debt crisis – however in reality, it was the additional reserve buffers created by those ISBs that enabled the government to avoid a crash in the economy during the worst of the COVID-19 pandemic.

The government maintained primary surpluses in 2017 and 2018, indicating that the ISB borrowings were not driven by budget deficits, but in order to build up reserves and to improve the quality of reserves by converting maturing short term debt into longer term stable instruments such as ISBs and syndicated loans. The fundamental drivers of the economic crisis were fiscal and debt unsustainability, whereas ISBs were just one of many financing instruments.

6. Tax cuts and rating impact

Following the change in government in November 2019, the new administration implemented significant tax reforms with sharp reductions in VAT and income tax rates and large increases in tax free thresholds. On 18th December 2019, Fitch revised Sri Lanka's credit rating outlook to negative. In Fitch's estimate, the VAT change and scrapping of NBT alone would shave off tax revenue equivalent to 2% of GDP. It is worth noting the following extracts from the Fitch rating review in response to the tax changes;

- *"Following the tax cuts, Fitch projects that gross general government debt, currently at about 85% of GDP, will be on an upward trajectory over the medium-term"*
- *"The outlook for the completion of the seventh and final review under the Extended Fund Facility (EFF) arrangement with the IMF now seems uncertain"*
- *"We believe the initial evidence of a roll-back of the revenue-driven fiscal consolidation path is negative for the sovereign's creditworthiness."*

It was not just Fitch ratings that indicated such risk. Standard & Poor (S&P) followed with a negative rating outlook revision on January 14th 2020. Highlights from the S&P review are as follows;

- *"We believe that the tax cuts introduced by Sri Lanka's Cabinet risk undermining fiscal and debt sustainability"*

- *"The negative outlook reflects our view that a larger-than-expected fiscal deficit will increase the government's financing needs and concerns over debt sustainability."*

It was in this context that the COVID-19 pandemic hit the country. The pandemic induced lockdowns and freezing of economic activity caused government revenues to further crash and the budget deficit ballooned to double digit levels. With the credit rating downgrades, Sri Lanka was locked out of global capital markets and was not able to raise external financing to fund the rising budget deficits. As the government continued to service external debt service obligations in the absence of fresh financing inflows, foreign exchange reserves began to diminish.

7. IMF Rapid Financing Instrument

In April 2020, the government wrote to the IMF requesting a Rapid Financing Instrument (RFI), which was a financing instrument without policy conditionality that was introduced to support liquidity needs of countries affected by the pandemic. The IMF's lending rules and risk management practices prevent the institution from providing financing to country's whose debt is considered to be unsustainable. With Sri Lanka's change in fiscal trajectory since end 2019 which placed the country on a path of rising public debt, the country's debt was no longer considered sustainable.

The IMF's lending rules require that a country with unsustainable debt must demonstrate a credible process of restructuring its debt in order to restore debt sustainability in order to become eligible to receive financing once again. Therefore, for Sri Lanka to be eligible for the RFI, it would have had to embark on a debt restructuring process in a proactive manner, before running into a major crisis.

The government at the time had a clear choice to make. It could either;

i) Proactively restructure its debt in order to restore debt sustainability and commence an IMF programme, allowing it to eventually regain access to external financing and prevent a situation of possible serious economic collapse.

ii) Continue without IMF engagement and without sufficient external financing to meet external liabilities, thereby running down reserves and accepting an elevated risk of serious economic collapse.

8. Home grown solution

The second option was selected. Instead of resuming a strategy of macroeconomic reforms to restore fiscal and external buffers supported by the IMF, the government opted for a "*home grown solution*". Over the next two years, the government continued to fund the double-digit budget deficit through domestic financing with a significant component of monetary financing. Given the lack of corrective measures to address the tax policy reductions, credit ratings continued to deteriorate. By September 2020, Moody's had downgraded Sri Lanka to Caa1, Fitch downgraded Sri Lanka to CCC by November 2020, and S&P downgraded Sri Lanka to CCC by December 2020.

In the absence of foreign financing, it was not possible to roll-over maturing external debt. Therefore, the country's foreign exchange reserves were used to settle maturing debt. Foreign exchange reserves began to gradually diminish from around USD 7.6 billion at the end of 2019.

The decision to peg the currency at an overvalued level of Rs. 203/USD also contributed to the continued weakness of the current account of the BOP, as it made imports relatively cheap and exports relatively uncompetitive.

9. Economic crisis sets in

In the second half of 2021, as official foreign exchange reserves had declined below USD 3 bn, the shortages of foreign currency liquidity in the banking sector began to translate into shortages of essential imported commodities. Long queues began to form for products such as fuel and cooking gas. The situation continued to escalate as the government found it impossible to raise external financing due to the weak credit rating of CCC or below.

By early 2022, the forex shortages reached extreme proportions. There were several defaults in the inter-bank foreign exchange market and defaults on letters of credit. External financing lines to the banks came to a halt and the inter-bank market all but froze as well. Opening LCs was no longer an option to fund essential imports.

Shortages of fuel reached such an extent that people had to queue for four to five days to obtain 10 litres of petrol or diesel. Power cuts ran up to 13 hours. Essential medicines were in short supply. Tourist arrivals began to decline as shortages of fuel and power cuts significantly disrupted travel. The crippling supply chain disruptions upended the manufacturing and agricultural sectors which was already in trouble due to the lack of fertilizer.

Inflation began to accelerate as supply chain disruptions were the fuel added to 2 years of extensive monetary financing that led to significant demand pressures. As prices spiralled, the real income and wealth of the citizens, particularly the poor and vulnerable, was eroded day by day. Eventually, inflation peaked at a Sri Lankan record of 70% in September 2022.

There were significant disruptions to current account inflows (manufacturing exports, tourism, remittances) towards the latter part of 2021, alongside the lack of financial account inflows due to the weak credit ratings. At the same time, external liabilities continued to be settled. On a net basis, reserves were being eroded day by day, with no clear solution in sight. In this context, even by mid-2021, it was evident that it was a matter of time before the country ran out of reserves and would end up in serious economic collapse. I still remember the way I predicted a dire situation in the country and apprised the Monetary Board of the CBSL in mid-2021 using my knowledge, experience, and judgement. These early warnings were not heeded appropriately and no serious effort was taken by the Monetary Board to actively intervene and convince the government on the need for changing the course of action and adopt an alternative path, which was mainly woven around seeking the assistance of the IMF to better manage the dire situation.

It was claimed that engaging the IMF was avoided in mid-2020 in order to approach the IMF from a position of strength. This misjudgement continued in mid-2021 as well and resulted in the country having to approach the IMF in early March 2022 when the country had all but completely run out of foreign exchange – a position of unprecedented weakness.

A home-grown solution was adopted in order to preserve the country's sovereign decision making powers – but the resultant economic crisis led to an all but complete erosion of the country's economic sovereignty.

When negotiating with the IMF and creditors from a position of economic collapse, negotiating leverage is extremely limited, and the country no longer has the luxury of pursuing a reform agenda on its own terms. This situation would not have materialized if the IMF had been approached earlier, from a position of relative strength.

My personal assessment is that the crisis could have been managed far better if a decision was taken to seek the assistance of the IMF even at the very late stage in July/September 2021.

My strong belief is that this is a crisis that occurred due to the failure to take appropriate, timely decisions and failure to give due attention to the professional recommendations made by many, including the early warnings made officially at the highest level to the Monetary Board of the CBSL by me and other relevant CBSL officials/departments.

10. Was the COVID-19 pandemic to blame for the economic crisis?

It has been claimed that the depletion of Sri Lanka's foreign exchange reserves can be blamed entirely on the COVID-19 pandemic. However, if this was the case, other comparable regional peer economies would have also seen a collapse of reserves during this period. The evidence indicates otherwise. When comparing the percentage change in reserves between end 2019 and end 2021, countries like Bangladesh (41% growth), India (39% growth), Pakistan (33% growth), Philippines (24% growth), Malaysia (13% growth), all experienced significant reserve growth. Even countries dependent on tourism like Thailand (10% growth) and the Maldives (5% growth) experienced reserve growth during the pandemic. Sri Lanka on the other hand saw reserves collapsing with a 79% decline in foreign exchange reserves during the same period. Therefore, while the pandemic had an adverse impact on the Sri Lankan economy like the rest of the world, the collapse in reserves in Sri Lanka was inherently an endogenous problem that can be explained by the macroeconomic policy choices adopted at the time.

11. Was the interim debt service policy of April 2022 the cause of the crisis?

In March 2022, the steady trickle of protests gained momentum and spilled over into mass scale public protests. On the 18th of March 2022, Hon. President Gotabaya Rajapaksa officially wrote to the International Monetary Fund (IMF) with Request for an IMF Engagement in Sri Lanka. The Cabinet of Ministers resigned, as did the Governor of the Central Bank and the Secretary to the Treasury. A new Central Bank Governor was appointed and I was appointed Secretary to the Treasury on 7th April 2022 during the most critical and challenging period of Sri Lanka's macroeconomic management.

One of the first decisions that had to be made was the decision to temporarily suspend selected external debt service payments. This was not an easy decision and it had to be taken on a very urgent basis. The country's usable foreign exchange reserves had fallen to a critically low level. Whilst Sri Lanka had the willingness to pay, the liquid foreign exchange reserve position available was insufficient to meet the immediate debt service obligations and future liabilities.

Although gross official reserves, including proceeds of the People's Bank of China swap facility, stood at USD 1,889 million on 11th April 2022, liquid and usable reserves were as low as USD 24 million. At the same time, there was a government debt service obligation of USD 182 million on 18th April 2022. The near-term commitments that had already been made by the CBSL with respect to the importation of fuel, coal, and other essential items amounted to more than USD 500 million.

In addition, foreign currency debt service payments of the Government during the remainder of the year 2022 were estimated at about USD 4,330 million, excluding the liabilities arising from Asian Clearing Union (ACU) related payments and foreign currency liabilities of the CBSL. As such, it was abundantly clear that the available foreign exchange was insufficient to meet the liabilities maturing even within a few days from 12th April 2022, and all options for continued debt service had been exhausted.

In recent times, there have been claims that the announcement of the interim debt standstill was the cause of the economic crisis. However, in reality, the crisis had set in well before April 2022 and the debt standstill was in fact the first step in economic recovery. Until April 2022, amidst rapidly declining foreign currency reserves, the government gave priority to the service of external debt whilst forex resources available for essential imports such as fuel and medicines continued to decline, as evidenced by the steady increase in shortages of such products. By April 2022, foreign currency reserves eventually ran out and the government was not able to achieve either objective as it could no longer service external debt and there were no funds for essential imports.

The interim debt standstill was the first step in restructuring the country's debt, and freeing up foreign currency to pay for critical imports. Once debt restructuring is completed, Sri Lanka will once again be able to service debt on a sustained basis and also ensure there is sufficient foreign currency to finance import requirements of the economy.

12. The recent Supreme Court decision (on the responsible economic management)

The Supreme Court decision on 14th November 2023 has significant bearing on Sri Lanka's macroeconomic management process. The Supreme Court ruled that government officials breached the public trust and violated Article 12 (1) of the Sri Lankan Constitution in their management of the economy. The bench ruled by a majority of 4-1, saying that the respondents were responsible for Sri Lanka's economic crisis between 2019-2022. The ruling stated, *"This situation brought in a total breakdown of economic and social life of the entire society. Such breakdown ultimately led to the collapse of the public order and the complete undermining of the rule of law*." The court found that the actions of the respondents directly contributed to the economic crisis. The court emphasized that the authorities should have been aware of and taken measures to address issues that negatively impacted the economy instead of exacerbating them. The judgment underscored that public officials hold a responsibility to act in the best interests of the public and are entrusted with significant powers to uphold public trust, requiring them to adhere to the directives of the constitution.

The respondents' attempts to attribute their actions to policy decisions were dismissed, as the Court emphasized that they possessed the authority and knowledge to prevent such an outcome but failed to act in the public interest. The cumulative actions and inactions of the respondents were identified as key contributors to the economic debacle. This underscores the importance of public officials acting in good faith, putting the interests of the country at the forefront, and always ensuring professional, objective advice and decision making.

13. Macroeconomic reforms towards economic stabilisation and recovery

Since April 2022, the government has embarked on a comprehensive macroeconomic reform programme with a view to addressing the fundamental causes of the crisis and long standing macroeconomic vulnerabilities. As outlined previously, the fundamental drivers of the crisis are unsustainable debt and fiscal imbalances, which require substantial fiscal reform.

Sri Lanka needs to boost government revenue from 8.3% of GDP to 15% of GDP in order to meet the primary budget balance targets in its debt sustainability roadmap. This in turn is required to obtain the support of creditors to restructure the country's debt and enable a normalisation of economic activity. In Sri Lanka, tax revenue accounts for around 90% of government revenue. In resource rich countries such as the Middle East, royalties such as oil or minerals can boost government revenue, easing the burden on tax. In countries like Sri Lanka, increasing tax revenue becomes the key source of government revenue to address fiscal deficits and thereby address the root cause of economic vulnerability. Regardless of the administration in power, this has to be done.

14. Will tax increases reduce growth and thereby undermine debt sustainability?

For many years, governments have tried to provide tax incentives to incentivise investment and economic activity. Similarly, tax exemptions have been used to provide relief for consumers by reducing the impact on prices. For instance, such exemptions characterised the VAT regime, which is why as of 2022 Sri Lanka collected just 1.9% of GDP from VAT revenue whereas most regional peers collect around 7.5% of GDP from VAT. The outcome has been a proliferation of such tax exemptions for various purposes which completely eroded the country's revenue base and ended up in the fiscal crisis.

There is also an erroneous perception that higher tax rates, particularly VAT, will result in inflation. However, in reality, it is the failure to collect sufficient tax revenue that has resulted in the necessity for monetary financing of the resultant budget deficits which has led to inflation. It is no surprise that Sri Lanka's lowest tax structure in recent history (2020-2022), culminated in Sri Lanka's highest ever inflation of 70% in 2022. Inflation is a far worse outcome for citizens than taxation, particularly for the poor and vulnerable who lack the assets to hedge against inflation.

It is evident that the result of these tax exemptions has been infinitely worse than the benefits that were intended. Tax policy should be seen purely as a means of financing public goods and services. Past usage of tax policy measures such as exemptions and preferential rates to achieve competing objectives, such as welfare and investment promotion, has led to macroeconomic collapse. Going forward, the government intends to address its welfare objectives through targeted cash transfers to the poor and the vulnerable as opposed to using tax concessions and exemptions. This is why the allocations for Aswesuma and related measures have been increased by over three-fold compared to pre-crisis levels in 2019.

Similarly, economic growth objectives need to be achieved by improving the ease of doing business, addressing bottlenecks in the supply side such as facilitating markets for land, labour, and capital. The recent budget has proposed many of these interventions. In the past, successive governments have been reluctant to implement the difficult structural reforms to drive productivity and growth, and have instead used tax incentives as an alternative. We have now seen the outcome of such misguided policies.

15. If corruption is eliminated, can tax reforms be reversed?

Corruption has become an endemic problem in Sri Lanka and it is evident across all aspects of government and indeed society. The present administration was the first in Asia to facilitate an independent diagnostic of governance lapses and corruption vulnerabilities with a view to implementing an evidence based process to address these gaps. However, even if one hundred percent of these governance gaps are eliminated, the gap in the budget deficit could not be filled.

As mentioned earlier, government expenditure largely comprises very rigid non-discretionary items such as public sector wages and pensions, interest cost, essential welfare payments. Just the interest cost and the salary bill alone easily surpasses government revenue. Therefore, even with zero corruption and perfect governance, tax revenue must still be enhanced in order to reduce the budget deficit and reduce borrowing requirements.

Some groups claim that *"the tax burden on the people can be relieved once stolen assets are recovered"*. I do not have the evidence to comment on such assets in Sri Lanka, but if we consider the experience of other countries, asset recovery takes an exceedingly long time.

Take the case of the Philippines, it took over 18 years for recovery of a small component of estimated ill-gotten gains since Ferdinand Marcos was ousted in 1986[2]. Unfortunately, in Sri Lanka's case, time is not a luxury that we have. When the Treasury has to pay salaries at the end of this month, we do not have the option of telling our teachers, doctors, lecturers and civil servants to please wait for a couple of decades and they will be paid eventually.

Steps to address corruption must be taken and they are being taken. One of the most important elements required for recovery of assets related to corruption is the legal framework. That is why the recent Anti-Corruption Act incorporates the key elements of the United Nations Convention Against Corruption (UNCAC). Key articles of the Anti-Corruption Act such as Article 109 and 114 (5)[3] give effect to asset forfeiture in relation to corruption related offences. However, the reality of fiscal management is that this is not a substitute for raising revenues to be able to meet essential day to day expenditure of the state.

16. Tax administration and compliance improvements

Whilst many groups claim that taxes can be reduced, there are no real alternatives that can boost government revenue in the short term. In the medium to long term, it is possible to reduce tax rates once tax compliance and tax administration is improved. Following the tax reduction measures in end 2019, Sri Lanka's already weak tax base was further diminished. The total number of tax payers crashed from 1.7 million to just 0.4 million by 2022. At present, there is a stringent effort by the government to introduce reforms to improve tax compliance.

Many of these measures were reflected in the recent budget, such as risk based audits and expanding Tax Administration Number (TIN) coverage, some of which have already commenced implementation. There are several other initiatives introduced over the last 21 months which are now beginning to show results. These measures mainly include the digitalisation, information sharing, and on time filing.

Whilst around 80% of uncollected taxes are due to legal disputes, the tax authorities are expected to make enhanced efforts to collect tax arrears that are not subject to dispute.

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[2] "*Stolen Asset Recovery (StAR) Initiative: Challenges, Opportunities, and Action Plan*", p.21, The International Bank for Reconstruction and Development / The World Bank, 2007. https://www.unodc.org/documents/corruption/StAR-Sept07-full.pdf

[3] "*Where a court convicts a person, the court may, for any offence under this Act, make order that any movable or immovable property found to have been acquired by the commission of such offence or by the proceeds of such offence, be forfeited to the State free from all encumbrances*".

Collection of such taxes will be monitored by strict targets and KPIs ensuring the ratio of uncollected taxes to revenue continues to decline. Some have claimed that taxes need not be increased if unpaid taxes are recovered. However, it is evident that the vast majority of such tax arrears are undergoing the judicial process, and the government must follow the law of the country in the process of recovering such taxes. It is unlikely that many would advocate undermining the rule of law to achieve this.

As a result of these ongoing measures, there has been an appreciable increase in tax compliance. The total number of registered tax payers as at end 2023 recovered to 1,002,029 from 437,547 in 2022. Government revenue also reached Rs. 3.1 trillion in 2023, approximately 11% of GDP. This shows that the reforms in place are beginning to work. As compliance continues to improve at revenue targets are met, it will be possible to reduce tax rates without compromising revenue outcomes.

17. Complex interactions in the crisis and reform process

Another key reform is the implementation of cost-reflective pricing of utilities, especially fuel and electricity. Due to persistent mis-pricing, the CPC and CEB consistently ran losses and by 2022, CPC's debt approached a trillion rupees and CEB debt approached Rs. 800 billion. By mid-2022, the state banks were no longer able to finance the working capital requirements of these two entities and supply of electricity and fuel would have come to a standstill until cost-reflective pricing for the two entities was implemented. A reversal of cost-reflective pricing will promptly return us to that situation.

The government is now in the process of restructuring the debts accumulated by these SOEs on the books of the state banks. When these debts are restructured, the banks may face large losses which have to be met by capital infusions from tax payer funds. In the 2024 budget, the government has allocated Rs. 450 billion of tax payer funds to recapitalise the state banks for this purpose. As state bank forex loans extended to SOEs like CPC are restructured, the banks face imbalances in the foreign exchange position of their balance sheets (negative net open positions), requiring banks to buy foreign exchange from the market. This in turn reduces the dollars available for the Central Bank to purchase from the forex market to boost reserves and meet their reserve targets. Measures are then required to restrict imports to protect forex reserves. Lower imports, especially high value items such as motor vehicles, lead to lower government revenues and hinders the budget deficit reduction efforts, which in turn undermines achievement of primary deficit targets in the debt sustainability framework.

The above example illustrates the deep inter-connections that are inherent in the prevailing economic crisis. It should be clear that managing this reform process requires careful planning, timely implementation, and robust risk mitigation strategies. The complexity of this problem should also make it evident that a mis-step in one of these reforms can cascade into other policy areas, which could easily snow-ball into a full-blown crisis far worse than what was experienced in 2022.

There are significant improvements in state-owned enterprises. Cost-reflective pricing and balance sheet restructuring has enabled the elimination of losses in key state owned enterprises such as the Ceylon Petroleum Corporation, and substantial reduction of losses in the Ceylon Electricity Board. The balance sheets of the key SOEs are also being restructured. Legacy foreign debt on the CPC and CEB balance sheet have to a great extent been addressed which reduces the future risk of forex losses for these entities. Further measures are being taken in terms of introducing competition in the petroleum retail sector and the steps to unbundle the CEB have commenced. Significant reduction in SOE losses has also helped in efforts to reduce wasteful expenditure and focus on better quality public spending.

18. Debt restructuring

One of the most critical steps in the economic recovery has been the process of restructuring Sri Lanka's debt. Persistent fiscal weakness coupled with tax cuts implemented in end 2019 contributed to Sri Lanka's debt eventually being deemed unsustainable. The IMF rules do not allow it to lend to countries with unsustainable debt in the absence of a credible process of debt restructuring. Therefore, the first step in embarking on an IMF supported economic recovery programme was to restructure the country's debt. This entailed a very complex process given the short timelines and the diverse types of instruments and creditors (Paris Club, non-Paris club such as India and China, foreign currency bond holders, other external commercial creditors, domestic rupee creditors and domestic foreign currency creditors). Being a middle income country, Sri Lanka was not eligible for the Common Framework of debt restructuring, therefore had to chart its own course in navigating this complex process with inherent geo-strategic interests at play.

In spite of these challenges, within 9 months of IMF board approval which enables the launch of the technical negotiations with creditors, Sri Lanka was able to obtain Agreement in Principle on the terms of debt restructuring with all key official creditors. Steps are now underway to obtain similar agreement in principle with private creditors and it is expected that the overall debt operation can be concluded within the first half of this year. In 2023, the government completed the domestic debt restructuring process that enabled debt targets to be met without compromising the stability of the domestic financial system. Restructuring of provident funds, including the EPF, was limited to maturity extensions with no haircut and yields maintained in line with historic trends and inflation outlook.

19. Institutional reforms

I assumed duties as the Secretary to the Treasury and Ministry of Finance in April 2022, when the country was in chaos. When the country was in its deepest crisis and there was reluctance to take the leadership and address the burning issues. The country's solvency crisis translated into a major liquidity crisis with shortages of rupees as well as dollars. At the time it was a struggle to find rupees even to pay the salaries, and to find dollars to settle the next petroleum shipment. Meeting other expenditure was near impossible. Day to day operation of public services was extremely difficult.

Now, after 21 months, we increasingly see various complaints regarding the conduct of the Ministry of Finance. It is easy to forget the extreme challenges that were faced less than 2 years ago. Many of the prevailing issues are legacy issues that have been hindered the Treasury for many years if not decades. The tax administration weaknesses due to deep institutional shortcomings, legislative bottlenecks, gaps in human resources, weaknesses in the IT systems including Revenue Administration Management Information System (RAMIS) and Integrated Treasury Management Information System (ITMIS). These constraints have existed for many years and we have taken steps to address them, but the results won't materialize in just a few months.

It is also unfortunate that some critics only see part of the problem i.e. taxation only; and they don't see the role of tax in addressing the broader macroeconomic issues and fiscal structure. It is also important to look at the broader macroeconomic picture and understand the fact that crisis-time policies will be different to the policies that will be adopted under normal circumstances.

It took strenuous efforts to turn this around to the present situation under the guidance and the leadership of the Hon. President who is also the Minister of Finance who worked tirelessly. I am glad that we have been successful in these efforts to a considerable extent, and that we have seen stability in many areas. However, the deep crisis is not over and there is a long way to go.

There is no argument that the performance of the General Treasury should be improved. At the same time, it is important to understand that in the midst of a crisis, improving all these legacy issues, which were embedded to the system for many years, cannot be completed within a period of 21 months. The priority had to be given to stabilizing the economy to come out of a deep and complex economic crisis. This involved debt restructuring, a huge operation in which Sri Lanka had no experience in the past, improving revenue, inculcating disciplined fiscal management, structural reforms, legal reforms, cashflow reforms in an environment where usual monetary financing is not available any more, and many administrative reforms. It is a journey that should continue steadily with commitment to achieve the desired results. Furthermore, as Sri Lanka is under an Extended Fund Facility (EFF) programme, supported by the IMF, the liberty to introduce some policies is limited.

Even today, there are groups that threaten to go on strike since their expectations have not been fully met. Amidst great fiscal stress, the government has been able to incorporate a salary increase for public servants to the maximum level within the available fiscal space. This was done with great difficulty. It is easy to make such demands whilst forgetting that the country is still in a deep crisis. We all have to make some sacrifices, and some contribution in order to improve the situation. It is the collective sacrifices that we have made that enabled the country to come out of the period of queues, shortages, and power cuts to where we are today. I have no doubt that if we as a society maintain that discipline, we can continue to improve the situation of the country and achieve prosperity for all.

20. Reforming the General Treasury

The country cannot afford to another crisis as the people have already gone through severe pain. There is no room to repeat the mistakes that led to the crisis. The country, economy, key institutions and processes are being changed as a response to the crisis while considering the crisis as an opportunity to change. Sri Lanka's General Treasury is no exception. It has been observed that the General Treasury/Ministry of Finance of Sri Lanka has operated on largely the same structure for a prolonged period of time. Meanwhile, a series of comprehensive economic reforms are being implemented by the government to address issues in various sectors, dismantle the bottlenecks and facilitate higher economic growth, and improve living standards of the people.

It has already been observed that the prevailing structure lacks some elements of dynamism and agility to respond to the emerging challenges and opportunities of the contemporary economic environment. New institutions are being established, including the Debt Management Agency and Revenue Authority, while changes are taking place in State Owned Enterprise sector and Public Private Partnerships (PPPs), green financing opportunities are being explored, new laws are being introduced along with the need for further improving fiscal and economic policy analyses etc. has been clearly identified by now. Important measures are being implemented to address corruption and governance related issues. Procurement related improvements are also being introduced. In terms of human resources, it is critically important to allow the officials to express their views freely and undertake quality work with their utmost contribution as against some of the past practices and to build up certain specialist skill sets within the General Treasury to effectively facilitate the private sector economic activities during the post reform era. I should emphasize that we are in the process of addressing legacy issues spanning decades, and these institutional changes will take time to implement and yield the desired results.

Hence, the General Treasury must be aligned to the new developments and have the agility to meet the evolving situation. I have often been asked questions such as; How does the Treasury deliver its responsibility more effectively to the Executive, Parliament, and the general public? Why can't the Treasury be more considerate of the needs of the public? Shouldn't the treasury move out of its comfort zones? Doesn't the Treasury needs a very well trained, skilled and knowledgeable team with expertise in different disciplines/subject areas to deliver a better and high quality service?

All these changes/requirements have necessitated the need for revisiting the structure of the General Treasury itself, which is now being discussed internally. In this context, I have already proposed to review the current structure of the General Treasury to improve agility, better support the post reforms economy and create a conducive environment to improve the integrity, excellence and contribution to the nation. I even have proposed to change the name of the General Treasury to *"National Treasury"* considering the fact that the Institution manages the people's money and such monies should be utilised by everyone involved with utmost care and responsibility to the entire nation.

21. Legal and other key reforms

Whilst many reforms have been implemented, it is important that these are also built into the country's legislative framework. Landmark economic legislation reforms, including the Central Bank Act, Anti-corruption legislation have been implemented. Tax and tax administration reforms have already been completed, and the Public Finance Management Bill, Public Private Partnership Law, Debt Management Law and Investment Law are in the final stages of drafting. These legislative measures intend to help lock-in the progress made in fiscal management and economic reform.

Substantial steps are being taken to revamp investment policy in the country. We are in the process of setting up key institutional reforms and drafting new legislation to establish a new trade and investment facilitation and promotion regime.

The government is also taking steps to address key supply bottlenecks in the economy. Comprehensive reforms are being put in place to address factor markets in land, labour, and capital. For example; under-utilised state owned land is being ear marked for commercial use. A new labour law that is being drafted will address a number of existing rigidities in the labour market. New legislation is being developed to address bankruptcy resolution in capital markets as well.

22. Concluding remarks

Today, Sri Lanka is in the process of pulling itself out of the deepest and most complex economic crisis it has experienced in post-independence history. This is a long and difficult journey. In the past, we have attempted many short cuts, but these are no longer options. Considering the period between April 2022 and January 2024, an objective assessment of the evidence so far indicates that the reforms being implemented are working. This is not to say that the reforms are not associated with pain and economic stress for the citizenry. However, the alternatives are far worse.

There have been various theories as to what caused the economic crisis, including the COVID-19 pandemic, ISB borrowings, the Debt Standstill policy. However, it is clear that the fundamental cause has been long standing macroeconomic vulnerabilities and domestic policy errors. There have also been various alternative proposals and theories as to how the country can recover without the citizens having to bear a burden. But, we have seen today that measures such as asset recovery, collection of taxes in arrears, elimination of corruption, while all being essential actions, do not serve as an alternative to the macroeconomic reforms being implemented today. Those are reforms that were known to all of us for years if not decades. But, those much needed reforms were delayed mainly due to political reasons. In the past, and up to now, the present generation lived a better life by borrowings thereby sacrificing the lives of the future generations. However, it is critical to understand that now we have come to a situation where the present generation should make sacrifices for the betterment of the lives of the future generations.

The academic training you have received at University is not only to help you seek employment and professional success. Those disciplines should also be deployed when scrutinising public policy decisions. When a politician or political group makes a promise to provide relief through various means, you must ask the question as to how this can be done without undermining the fragile economic recovery we are embarking on. For too long we as a society have failed to engage in a robust critique of public policy decisions that affect us. When taxes were reduced in end 2019, nobody questioned as to how public services will be funded. The result was an unprecedented escalation in debt leading to this economic crisis. You are the future of this country, and you are blessed with education and opportunity to actively engage in public policy debate. At the same time, I wish to warn you that the analyses should not be bias in terms of politics, social or any other considerations and fully consistent with the actual and potential developments. Hence, the best way for society to help is to drive policy actions based on objective, rational, and evidence based measures, as opposed to policy based on ideology and misplaced beliefs that can end up in disaster for the entire country.

Thank you.