

# 2027



## FISCAL STRATEGY STATEMENT

**Anura Kumara Dissanayake**  
Minister of Finance,  
Planning and Economic Development  
June, 2026





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# Content

## Page No.

### **PART I – Fiscal Strategy Statement 2027**

1.	Introduction	01
2.	Fiscal Goals and Priorities of the Government	02
3.	Consistency of the Fiscal Strategy with the objectives of Responsible Fiscal Management	06
4.	Assessment of Performance against the Fiscal Strategy	07
4.1	Forward-looking Assessment of the Fiscal Strategy over the Medium-Term	07
4.2	Assessment of compliance with the fiscal targets for the preceding financial year	08
4.3	Assessment of Expected compliance with the fiscal targets in the financial year 2026	09
4.4	Assessment of Expected compliance with the fiscal targets for the next financial year and the four succeeding years	11
4.5	Assessment of non-compliance with the fiscal targets for the current financial year and the next financial year	13
5.	Macroeconomic impact of fiscal decisions taken over the past three years	14
5.1	Fiscal Consolidation and Debt Reduction	14
5.2	Revenue Mobilisation and its Macroeconomic Effects	14
5.3	Expenditure Management and its Macroeconomic Effects	14
5.4	Macroeconomic Stability and Confidence Restoration	15
5.5	Near-Term Risks and the Impact of Unanticipated Shocks	15

### **PART II – Fiscal Risk Statement 2027**

1.	Introduction	19
2.	Fiscal Risks	19
3.	Anticipated Fiscal Pressures	20
4.	Main Sources of Fiscal Risks	21
(A)	Fiscal Risks Arising from Macroeconomic Uncertainty	21
(B)	Fiscal Risks Arising from State-Owned Enterprises (SOEs)	27
(C)	Fiscal Risks Arising from Public Debt, Guarantees and On-lending	31
(D)	Fiscal Risks Arising from Natural Disasters and Climate Change	36
(E)	Fiscal Risks Arising from Public-Private Partnerships (PPPs)	39
(F)	Fiscal Risks Arising from Financial Sector	42
5.	Conclusion	44
	Annexure I	45
	Annexure II	46
	Annexure III	48
	Annexure IV	50
	Annexure V	51

# List of Acronyms

<b>BBB</b>	Build Back Better
<b>BOO</b>	Build, Own and Operate
<b>BOT</b>	Build, Operate and Transfer
<b>CAR</b>	Capital Adequacy Ratio
<b>CCBP</b>	Combined Cycle Power Plant
<b>CEB</b>	Ceylon Electricity Board
<b>CECB</b>	Central Engineering Consultancy Bureau
<b>CICT</b>	Colombo International Container Terminals
<b>CPC</b>	Ceylon Petroleum Corporation
<b>DBF</b>	Design, Build and Finance
<b>DBFOM</b>	Design, Build, Finance, Operate and Maintain
<b>DBFOMT</b>	Design, Build, Finance, Operate, Maintain and Transfer
<b>DSA</b>	Debt Sustainability Analysis
<b>EOI</b>	Expression of Interest
<b>FATF</b>	Financial Action Task Force
<b>FRS</b>	Fiscal Risk Statement
<b>FSS</b>	Fiscal Strategy Statement
<b>GDP</b>	Gross Domestic Product
<b>GFN</b>	Gross Financing Need
<b>HCT</b>	Health Check Tool
<b>IMF</b>	International Monetary Fund
<b>IVF</b>	In Vitro Fertilization
<b>Jet A-1</b>	Aviation Turbine Fuel (Jet A-1)
<b>JV</b>	Joint Venture
<b>KPI</b>	Key Performance Indicators
<b>LNG</b>	Liquefied Natural Gas
<b>LSCL</b>	Lanka Sugar Company (Private) Limited
<b>MOU</b>	Memorandum of Understanding
<b>MSME</b>	Micro, Small and Medium Enterprises
<b>MTDS</b>	Medium-Term Debt Management Strategy
<b>MTFF</b>	Medium-Term Fiscal Framework
<b>MTRS</b>	Medium-Term Revenue Strategy
<b>NITF</b>	National Insurance Trust Fund
<b>NWSDB</b>	National Water Supply and Drainage Board
<b>OPR</b>	Overnight Policy Rate

<b>PDMO</b>	Public Debt Management Office
<b>PDNA</b>	Post-Disaster Needs Assessment
<b>PFMA</b>	Public Finance Management Act
<b>PIT</b>	Personal Income Tax
<b>PPA</b>	Power Purchase Agreement
<b>PPP</b>	Public-Private Partnership
<b>RDA</b>	Road Development Authority
<b>SACLH</b>	South Asia Commercial and Logistics Hub
<b>SAGT</b>	South Asia Gateway Terminals
<b>SLA</b>	SriLankan Airlines
<b>SLDIF</b>	Sri Lanka Deposit Insurance Fund
<b>SLPA</b>	Sri Lanka Ports Authority
<b>SLSPC</b>	Sri Lanka State Plantations Corporation
<b>SLTB</b>	Sri Lanka Transport Board
<b>SOEs</b>	State-Owned Enterprises
<b>SPC</b>	State Pharmaceuticals Corporation
<b>SSCL</b>	Social Security Contribution Levy
<b>UHKDU</b>	University Hospital Kotelawala Defence University
<b>USD</b>	United States Dollar
<b>VAT</b>	Value Added Tax
<b>WCT-I</b>	West Container Terminal – Phase I



# **PART I**

## **Fiscal Strategy Statement 2027**



# Fiscal Strategy Statement 2027

## 1. Introduction

The Public Financial Management Act, No. 44 of 2024 (PFMA) requires the Minister of Finance to prepare the Fiscal Strategy Statement (FSS). The objectives of the FSS are to: (i) provide the Parliament and the public with a formal statement of the Government's fiscal strategy prior to the preparation of the annual budget; (ii) provide strategic guidance for the upcoming annual budget; (iii) establish the basis upon which fiscal performance shall be evaluated objectively; (iv) strengthen Parliamentary oversight of performance against the Government's fiscal strategy; and (v) enhance fiscal transparency and accountability.

The FSS must be submitted to the Cabinet of Ministers for approval. It shall set out the Government's fiscal targets and policies, the proposed timeframe for the reduction of public debt to a sustainable level, a medium-term fiscal framework, an assessment of performance against the fiscal strategy, main sources of fiscal risks and macroeconomic impact of fiscal decisions. Once the Cabinet has approved the FSS, the Minister of Finance is required to announce it in Parliament on or before 30<sup>th</sup> of June of each year. In line with the PFMA, Annual Budget 2027 shall also be prepared based on the FSS. Upon the Minister's announcement, the FSS is required to be published on the Ministry of Finance website.

### Economic Context

Resilience in responding to shocks on both domestic and external fronts has been demonstrated in addressing the socio-economic ramifications of Cyclone Ditwah and the Middle East conflict. The ongoing conflict exacerbates macro-fiscal risks by triggering price spikes in fuel, electricity, cooking gas, transport and other essential food and intermediate commodities, including fertilizers amid tightening global

financial market condition. Elevated oil prices drove up the cost of the import bill by 25.2 percent to USD 8.2 billion in the first four months of 2026. Exchange rate depreciated sharply to 5.4 percent to year to date at end-May 2026. In April 2026 alone, fuel imports increased notably by 149.9 percent on a year-on-year basis to USD 886 million. Consequently, during January-April 2026, the trade deficit widened to USD 3.7 billion from USD 2.3 billion in the same period of 2025. Headline inflation rose to 5.5 percent in May 2026. Inflows from tourism dropped by 5.1 percent to USD 155.7 million in May, 2026. However, workers' remittances increased by 26.0 percent in the first five months of 2026.

To respond to these external developments, the Government introduced a relief package of Rs. 100 billion. In addition, a tight monetary policy stance was adopted on May 26, 2026, with the Overnight Policy Rate (OPR) raised by 100 basis points to 8.75 percent. This marks a significant shift from the accommodative monetary policy stance maintained since May 21, 2025. The economy was stabilised in 2025 underpinned by broad-based growth of 5 percent in both 2024 and 2025 with per capita GDP surpassing the USD 5,000 threshold in 2025. Lower interest rates in 2025 supported the recovery of construction, manufacturing, transportation, and other economic activities. Strong performance in rice, vegetable, and milk and dairy production, a recovery in the tourism sector, and increased external sector activity contributed to this growth.

The unemployment rate fell to 3.9 percent in 2025 from 4.4 percent in 2024. The current account in the external sector recorded a surplus of USD 1.7 billion in 2025 from USD 1.2 billion in 2024, marking a surplus for the third consecutive year. However, in the first four months 2026, the current account recorded a deficit of USD 0.9 million, compared to a surplus of USD 1,124.4 million in the same period of 2025.

As Sri Lanka enters the next phase of its reform journey amid heightened global uncertainty, the Fiscal Strategy Statement 2027 (FSS 2027) provides a clear roadmap for safeguarding macroeconomic stability. Reflecting the hard-won gains in macroeconomic stability, fiscal aggregates in 2025 surpassed their annual estimates. However, this momentum is expected to be temporarily disrupted in 2026 due to the fiscal impact of Cyclone Ditwah, which necessitates an additional allocation of Rs. 500 billion. As a result, the primary balance is projected to reach 2.1 percent of GDP in 2026, while primary expenditure is expected to increase to 13.7 percent of GDP, exceeding the 13.0 percent ceiling stipulated under the PFMA. This disruption is expected to be resolved from 2027 onwards as fiscal consolidation continues in line with the medium-term fiscal targets.

The FSS 2027 is anchored on pursuing sustained debt reduction over the medium term, targeting a primary surplus of at least 2.6 percent of GDP, increasing Government revenue to above 15 percent of GDP, and rationalising public expenditure while enhancing public investment to accelerating future growth.

The fiscal responsibility provisions enacted under the PFMA establish specific requirements regarding the content of the FSS and Medium-Term Fiscal Framework (MTFF). The minimum content of the FSS as specified by the PFMA is summarised in Annexure I.

## 2. Fiscal Goals and Priorities of the Government

The main goal of fiscal policy for 2026–2031 is to bring public debt to a sustainable level. This will be achieved by enhancing domestic revenue mobilisation, rationalising recurrent expenditure and reducing gross financing needs, while maintaining macroeconomic stability and rejuvenating economic growth. Planned debt reduction targets will be ensured through consistent and determined policy action over the years ahead.

Fiscal policy is guided by the Government's Medium-Term Fiscal Framework covering 2026–2031 and extended further by the commitments under the Extended Fund Facility Programme of the International

Monetary Fund (IMF-EFF), while also reflecting commitments to other development partners, including the World Bank and the Asian Development Bank.

Under the PFMA, the Government is required to adhere to responsible fiscal management principles, encompassing debt sustainability, the maintenance of fiscal buffers, prudent fiscal risk management, discipline, transparency and accountability in fiscal management, medium-term fiscal planning through an annual fiscal strategy statement and rolling five-year fiscal frameworks, and effective scrutiny of fiscal performance.

The FSS serves as the Government's principle instrument for communicating its fiscal objectives and priorities. Under the PFMA, the FSS must establish measurable targets for key fiscal indicators, including: (i) **a debt reduction objective**— comprising public debt reduction path and timeline to maintain debt at sustainable levels; (ii) **primary balance targets** for the budget year and the succeeding four years to facilitate debt reduction; and (iii) **a primary expenditure ceiling** consistent with these objectives. The PFMA further requires primary expenditure to remain below 13 percent of GDP during the first five years of implementation, except in cases of unforeseen emergencies or natural disasters that necessitate temporary and targeted additional spending to safeguard national security, economic security, public health or public safety.

Sri Lanka's 2022 economic crisis rooted in fiscal indiscipline, highlighted the need for a rules-based fiscal framework built around clearly defined targets. The three chosen fiscal aggregates—a debt reduction objective, a primary balance target, and a primary expenditure ceiling—represent an internationally recognised set of fiscal tools designed to collectively address the country's longstanding fiscal vulnerabilities including unsustainable debt accumulation, persistent primary deficits, and uncontrolled and unproductive expenditure growth.

Together, these aggregates form the operational core of the PFMA's fiscal responsibility framework, providing structured and transparent pathway toward fiscal sustainability and restored public confidence.

The strength of the framework derives not only from each aggregate individually, but from their interlinkages, ensuring that fiscal policy is guided by a unified set of objectives directed toward long-term macroeconomic stability.

### Debt Reduction Objective: Accelerating the path to fiscal sustainability

The debt reduction objective remains the foundational anchor of the fiscal framework, establishing a clear and long-term commitment to reducing public debt to sustainable levels. High levels of public debt constrain economic growth, elevate borrowing costs across the economy, divert scarce budgetary resources toward debt servicing, and narrow future policy space. The Government's commitment to debt reduction is therefore not merely a fiscal target, it is a prerequisite for restoring economic resilience and sovereignty over its own policy choices.

#### Progress to Date

Tangible and accelerating progress in debt management has been made since the commencement of the IMF-EFF programme. Public debt as a percentage of GDP declined from 103.2 percent in 2024 to 98.3 percent in 2025, recording a reduction of 4.9 percentage points in a single year, as per the Public Debt Management Office (PDMO). This trajectory reflects the combined impact of sustained revenue-based fiscal consolidation, successful debt restructuring, and the restoration of macroeconomic stability.

The IMF-EFF programme established a quantitative milestone of reducing public debt to below 95 percent of GDP by 2032. The latest IMF projections, reflecting the near completion of debt restructuring, point to a further decline, providing a prudent buffer against the inherent uncertainty associated with long-term fiscal projections.

#### A Trajectory Ahead of Schedule

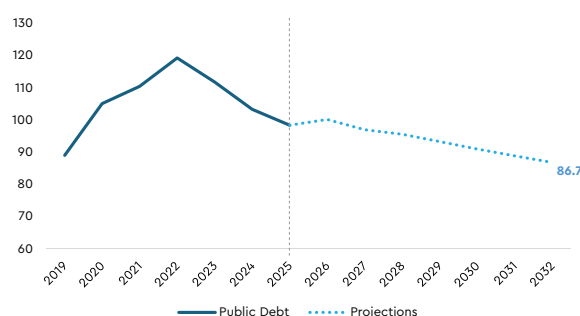
The recent pace of debt reduction indicates that the interim public debt target of below 95 percent of GDP by 2032 could be achieved earlier than anticipated, provided that current fiscal policies and reform implementation are maintained consistently. However, easing fiscal discipline prematurely in response

to favourable near-term outcomes would jeopardise the progress achieved to date. Accordingly, the Government will retain the 2032 debt interim target of below 95 percent of GDP as the binding fiscal anchor. However, these projections are based on the baseline macroeconomic scenario and remain subject to risks and uncertainties, particularly those arising from developments in the Middle East and their potential impact on the global and domestic economic outlook.

#### The Long-Term Horizon

While reducing public debt to below 95 percent of GDP by 2032 represents an important milestone, it is not the destination. Restoring adequate fiscal buffers and resilience requires bringing public debt below 60 percent of GDP, a threshold currently projected to be reached only in the early 2040s. This underscores that the debt reduction is a generational commitment extending well beyond any single programme, budget cycle, or government.

**Figure 1 | Public Debt**  
(As a percentage of GDP)



Sources: Central Bank of Sri Lanka (data: 2019 – 2023), Public Debt Management Office (data: 2024–2025), IMF 5<sup>th</sup> and 6<sup>th</sup> Reviews (data 2026–2032)

#### Institutional Arrangements

The Ministry of Finance is strengthening its capacity to undertake and publish Debt Sustainability Analysis (DSA) in line with the PFMA, providing a sound foundation for fiscal strategy formulation. To strengthen fiscal risk management, the Government has reduced the statutory ceiling on government guarantees from 15 percent to 7.5 percent of GDP, and introduced a new framework for their issuance and monitoring, thereby mitigating contingent liability risks.

The significant 4.9 percentage-point reduction in public debt achieved in 2024/2025 reflects in the success of critical reforms implemented under the IMF-EFF programme and the Government's commitment to restoring fiscal discipline. However, ensuring debt sustainability ahead remains substantial key priority, requiring the debt reduction objective to continue serving as the overarching anchor guiding primary balance target, primary expenditure ceiling and all revenue, expenditure, and borrowing decisions.

### Primary Balance Target: The Bridge between Debt Reduction Objective and Annual Budgeting

The primary balance serves as the key operational link between the Government's debt reduction objective and annual budget decisions. By setting primary surplus target for the budget year and the succeeding four financial years, the Government translates its longer-term debt sustainability agenda into actionable annual commitments, ensuring fiscal discipline is maintained across different planning horizons.

Under the PFMA, the Government is obliged to monitor compliance with this target, notify Parliament of any risks to its achievement and, implement remedial measures where necessary. In the event of major unforeseen shocks, recalibration of the Medium-Term Fiscal Framework (MTFF) and the primary balance target may be required to maintain alignment with the debt reduction objective.

The primary balance has improved significantly in recent years due to sustained revenue-based fiscal consolidation since the onset of the economic crisis. The primary surplus increased from 2.2 percent of GDP in 2024 to 5.4 percent of GDP in 2025, reflecting the strong impact of ongoing structural reforms.

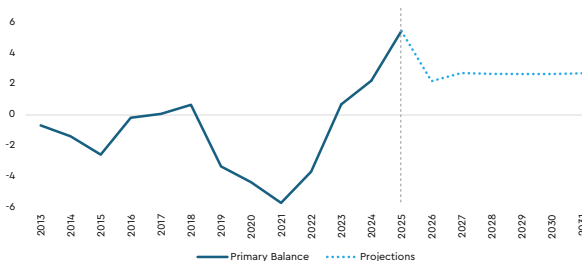
The Government has set a primary surplus target of 2.6 percent of GDP from 2027 onwards and will maintain at least this level through the MTFF period up to 2031. According to the latest DSA published in the Fifth and Sixth Review of IMF-EFF, sustaining a primary surplus of at least 2.3 percent of GDP over the 2027–2031 is sufficient to support

reducing public debt below 95 percent of GDP by 2032.

While the strong primary surplus outturn of 2025 marks a historically significant achievement, the Government's focus for the period ahead is on consolidating and institutionalising these gains, on a durable basis, supported by structural revenue measures and expenditure rationalisation, rather than one-off or temporary measures.

The primary balance target will continue to serve as the **main fiscal guardrail** until debt sustainability is fully restored, providing a transparent and measurable benchmark for assessing fiscal performance by Parliament, the public, and international partners.

**Figure 2 | Primary Balance**  
(As a percentage of GDP)



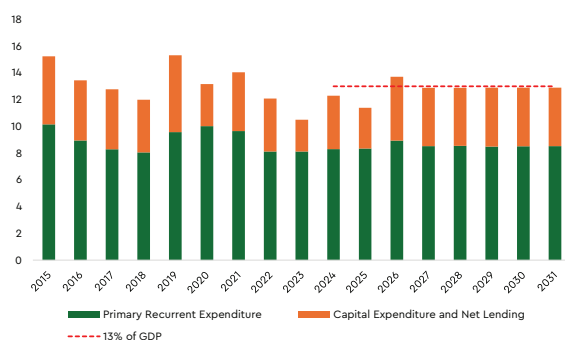
Source: Department of Fiscal Policy

### Primary Expenditure Ceiling: Operationalising Fiscal Discipline

The primary expenditure ceiling, capping at no more than 13 percent of estimated GDP during the first five years, is the most direct instrument for maintaining fiscal discipline. It translates the debt reduction objective and the primary balance target into a binding operational constraint governing budget formulation and execution, thereby supporting expenditure control and progress toward the debt reduction sustainability.

The primary expenditure ceiling for Budget 2027 is set at 12.9 percent of GDP, consistent with the primary balance target and the revenue projection of 15.5 percent of GDP, translating to a nominal value of Rs. 5,064 billion. For 2027–2031, the indicative ceiling is maintained at less than 13 percent of GDP. This ceiling must be observed at all stages of budget planning, formulation and execution.

**Figure 3 | Primary Expenditure**  
(Percent)



Source: Department of Fiscal Policy

The primary expenditure ceiling for future years shall be revised annually through the FSS update process, incorporating the latest economic data and updated macroeconomic and fiscal projections guided by a formal compliance assessment against the established MTFF targets.

### Additional Fiscal Targets

In addition to its core PFMA obligations and IMF-EFF commitments, the Government has established complementary fiscal targets

in support of its broader debt reduction and fiscal sustainability objectives. These include increasing government revenue to above 15 percent of GDP from 2026 onwards, rationalising expenditure to manageable levels, increasing public investments to above 4 percent of GDP from 2027 onwards, and reducing the budget deficit to below 5 percent from 2028 onwards.

### Medium-Term Fiscal Framework (MTFF)

As per Section 12 of the PFMA, the preparation of the MTFF for the upcoming financial year and for the four succeeding financial years and its publication within the FSS, is required. Table 1 below presents the MTFF for the period 2026–2031, outlining key parameters for the upcoming Budget 2027 and providing the most recent projections extending through to 2031.

The projections of the MTFF are required to comply with the Fiscal Responsibility Framework. The MTFF will be updated on an annual basis to sustain a rolling five-year horizon, with the PFMA placing an obligation

**Table 1 | Medium-Term Fiscal Framework: 2026–2031**

Indicator	As a percentage of GDP (Unless otherwise noted)						
	2025 Provisional	2026 Revised Estimates	2027 Estimates	2028	2029	2030	2031
<b>Total Revenue and Grants</b>	<b>16.7</b>	<b>15.8</b>	<b>15.5</b>	<b>15.5</b>	<b>15.5</b>	<b>15.5</b>	<b>15.5</b>
<b>Total Revenue</b>	<b>16.6</b>	<b>15.7</b>	<b>15.4</b>	<b>15.4</b>	<b>15.4</b>	<b>15.4</b>	<b>15.4</b>
Tax Revenue	15.4	14.4	14.2	14.2	14.2	14.2	14.2
Non-Tax Revenue	1.2	1.3	1.2	1.2	1.2	1.2	1.2
<b>Grants</b>	<b>0.1</b>	<b>0.1</b>	<b>0.1</b>	<b>0.1</b>	<b>0.1</b>	<b>0.1</b>	<b>0.1</b>
<b>Total Expenditure</b>	<b>19.0</b>	<b>21.4</b>	<b>20.0</b>	<b>19.8</b>	<b>19.5</b>	<b>19.2</b>	<b>19.0</b>
<b>Recurrent Expenditure</b>	<b>16.0</b>	<b>16.6</b>	<b>15.6</b>	<b>15.5</b>	<b>15.1</b>	<b>14.9</b>	<b>14.7</b>
Non-Interest Recurrent Expenditure	8.3	8.9	8.5	8.5	8.5	8.5	8.5
Interest Expenditure	7.6	7.7	7.1	6.9	6.6	6.3	6.2
<b>Capital Expenditure and Net Lending</b>	<b>3.0</b>	<b>4.8</b>	<b>4.4</b>	<b>4.4</b>	<b>4.4</b>	<b>4.4</b>	<b>4.4</b>
o/w Public Investments	3.1	4.8	4.4	4.4	4.4	4.4	4.4
<b>Primary Balance*</b>	<b>5.4</b>	<b>2.1</b>	<b>2.6</b>	<b>2.6</b>	<b>2.6</b>	<b>2.6</b>	<b>2.6</b>
<b>Budget Deficit</b>	<b>-2.3</b>	<b>-5.6</b>	<b>-4.5</b>	<b>-4.3</b>	<b>-4.0</b>	<b>-3.8</b>	<b>-3.5</b>
<i>Memorandum Items:</i>							
Nominal GDP (Rs. billion)	32,751	36,037	39,294	42,839	46,689	50,879	55,443
Nominal GDP (growth rate)	8.8	10.0	9.0	9.0	9.0	9.0	9.0
Real GDP (growth rate)	5.0	3.8	4.2	4.1	4.0	4.0	4.0
GDP deflator (per cent change)	3.7	6.0	4.6	4.7	4.8	4.8	4.8
Primary Expenditure (as a % of GDP)	11.4	13.7	12.9	12.9	12.9	12.9	12.9
Primary Expenditure (Rs. billion)	3,730	4,940	5,064	5,526	6,022	6,564	7,151

Source: Department of Fiscal Policy

\* Exclude interest

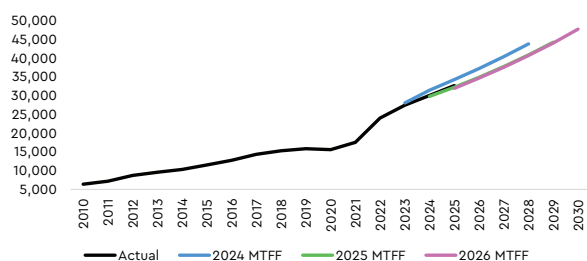
on the Government to undertake continuous monitoring of performance against the plan and to take corrective action in response to any actual or projected deviations.

### Macroeconomic Assumptions

The fiscal targets and projections within the MTFF are expressed as percentages of nominal GDP, derived by dividing key fiscal aggregates by projections for nominal GDP. The underlying macroeconomic assumptions on which these nominal GDP projections are based are presented in Table 1.

Figure 4 illustrates the nominal GDP projections used to prepare the 2024, 2025 and 2026 MTFF vintages. With each successive MTFF update, the macroeconomic projections are revised to incorporate the most recent actual economic outcomes and to reassess whether the assumptions underpinning the forward-looking projections remain appropriate. Nominal GDP projections have been revised downward across successive MTFF vintages, reflecting the deflationary conditions that prevailed in Sri Lanka between September 2024 and July 2025. For instance, the nominal GDP estimate for 2026 was revised downward from Rs. 34,951 billion in the 2025 MTFF vintage to Rs. 34,754 billion in the 2026 vintage. Despite these revisions, the close alignment between the two latest vintages indicates that the macroeconomic assumptions underlying the 2025 MTFF have been broadly validated by subsequent outturns. This highlights the importance of periodically updating macroeconomic projections to ensure fiscal planning remains aligned with the evolving economic conditions.

**Figure 4 | Nominal GDP**  
(Rs. Billion)



Source: Department of Census and Statistics (actual), Department of Fiscal Policy (Projections)

### 3. Consistency of the Fiscal Strategy with the objectives of Responsible Fiscal Management

The Government's fiscal targets and policies are in strong alignment with objectives of prudent fiscal management, as outlined below;

**(a) Debt Sustainability:** Sri Lanka recorded its **historically highest primary surplus of 5.4 percent of GDP in 2025**, driven primarily by strong revenue performance of **16.7 percent of GDP**, contributing to a significant reduction in public debt. Combined with near completion of debt restructuring the Government **remains committed** to sustaining the debt reduction trajectory to safeguard the country's fiscal stability and mitigate the burden on future generations.

**(b) Fiscal Buffers:** The critical importance of fiscal buffers has been demonstrated through two significant adverse events. The Government deployed funds to finance relief and reconstruction following Cyclone Ditwah, and further resources to mitigate the economic impact of the Middle East conflict. These two episodes highlight the indispensable role of fiscal buffers in enabling the Government to respond swiftly and effectively to unforeseen shocks without compromising its medium-term fiscal consolidation path. The Government will continue to make deliberate provisions for replenishing and maintaining such buffers, thereby strengthening the country's resilience to adverse events and reducing the need for disruptive corrective measures during periods of crisis.

**(c) Discipline, Transparency, Accountability and Scrutiny:** Sound fiscal management encompasses discipline, transparency, and accountability. The Government's fiscal targets and policies are clearly defined, supported by robust mechanisms for performance monitoring and public accountability. Adherence to transparent reporting standards and openness to independent scrutiny serve to enhance public trust and confidence in the management of public finances.

**(d) Long-Term Planning:** Through the annual publication of FSS and rolling five-year medium term fiscal frameworks, the Government is progressively extending its fiscal planning horizon, promoting stability, predictability, and the efficient allocation of public resources, with particular emphasis on sustaining an increase in public investment.

#### 4. Assessment of Performance against the Fiscal Strategy

##### 4.1 Forward-looking Assessment of the Fiscal Strategy over the Medium-Term

In line with the fiscal targets set out in paragraph 2 on Fiscal Goals and Priorities of the Government, the Government's fiscal strategy is directed towards achieving sustained primary surpluses to support public debt reduction and enhance economic stability and growth. The strategy primarily emphasizes the following priorities:

- **Reducing Public Debt:** The fiscal framework is aligned with the objective of lowering public debt to below 95 percent of GDP by 2032. According to the latest projections, under the baseline scenario, public debt is expected to decline to approximately 91 percent of GDP by 2030, representing early attainment of the target of below 95 percent by 2032.
- **Maintaining the Government Revenue Target:** In 2025, the Government's revenue target exceeded by 1.6 percentage points to 16.7 percent of GDP, mainly driven by higher revenue collections from motor vehicle imports, VAT on domestic activities, and taxes on external trade. The Government expects revenue to reach around 15.5 percent of GDP in the medium term. By maintaining revenue at or above this level, it is expected to enhance Sri Lanka's fiscal capacity, enabling the Government to finance a larger share of public services, operations, and investments while reducing dependence on borrowing.
- **Managing Government Expenditure:** Maintaining primary expenditure below the established statutory ceiling of 13 percent of GDP from 2025 onwards

reflects the Government's continued commitment to prudent expenditure management, the efficient allocation of resources, and expenditure discipline.

- **Increasing Public Investment:** Within the overall expenditure ceiling, the Government plans to maintain public investment at above 4 percent of GDP from 2027 onwards, underscoring the importance of infrastructure development and capital investment in supporting long-term economic growth and productivity improvements.
- **Maintaining Primary Surpluses:** Building on recent fiscal improvements, the Government expects to maintain a primary surplus of at least 2.6 percent of GDP from 2027 onwards. The historically highest primary surplus of 5.4 percent of GDP recorded in 2025, driven by strong revenue performance and slower than expected capital expenditure, highlights the importance of sustaining primary surpluses in restoring fiscal sustainability, reducing debt and rebuilding fiscal buffers.
- **Reducing Budget Deficits:** The Government aims to gradually reduce the overall budget deficit to below 5 percent of GDP from 2027 onwards. Notably, the deficit has already narrowed to 2.3 percent of GDP the lowest recorded since 1956—driven by improvements in Government revenue, containment of recurrent expenditure and lower execution of capital expenditure. Sustained reduction in the fiscal deficits is expected to contribute to debt stabilization, reduce borrowing costs and risk premiums, and strengthen investor confidence.

The Fiscal Strategy is anchored five core objectives: broadening revenue generation, ensuring prudent expenditure management, scaling up public investment, maintaining healthy fiscal balances, and sustaining primary surpluses. By pursuing these objectives, the Government aims to uphold sound public financial management, foster economic growth, and preserve long-term fiscal sustainability.

## 4.2 Assessment of compliance with the fiscal targets for the preceding financial year

The 2025 fiscal outturn significantly exceeded targets, recording the highest ever primary surplus of 5.4 percent of GDP— surpassing the 2.3 percent target by 3.1 percentage points and the 2024 outturn by 1.4 percentage points.

In 2025, the current account of the fiscal sector recorded a surplus of 0.7 percent of GDP— the first in Sri Lanka's history. The milestone was underpinned by robust revenue mobilisation, which exceeded initial projections, and disciplined recurrent expenditure management, reflecting the effectiveness of ongoing fiscal reforms and prudent management of expenditures.

The overall balance in 2025 recorded a deficit of 2.3 percent of GDP, markedly below the

budgeted deficit of 6.7 percent of GDP, and the 6.8 percent deficit recorded in 2024. Under the medium-term fiscal strategy, the overall budget deficit is projected to fall below 5 percent of GDP from 2028 onwards. Notably, the 2025 fiscal outcome represents an early attainment of this threshold, driven by a substantial increase in government revenue and lower-than-projected expenditure execution.

Nominal GDP growth of 8.8 percent in 2025 surpassed the forecast of 7.1 percent, supported by an uptick in inflation in early third quarter of 2025, a largely stable exchange rate and continuously declining interest rates. Real GDP growth of 5.0 percent likewise exceeded the Budget forecast growth of 3.5 percent, underpinned by stronger than expected expansion across Agriculture, Industry and Services, which grew by 1.4 percent, 7.8 percent and 3.3 percent, respectively.

**Table 2 | Performance Assessment 2025**

Indicator	Rs. Billion			As a % of GDP	
	2025 Budget	2025 <sup>(a)</sup>	Deviation with Budget	2025 Budget	2025 <sup>(a)</sup>
<b>Total Revenue and Grants</b>	<b>4,990</b>	<b>5,486</b>	<b>496</b>	<b>15.1</b>	<b>16.7</b>
<b>Total Revenue</b>	<b>4,960</b>	<b>5,449</b>	<b>489</b>	<b>15.0</b>	<b>16.6</b>
<b>Tax Revenue</b>	<b>4,590</b>	<b>5,049</b>	<b>459</b>	<b>13.9</b>	<b>15.4</b>
Taxes on Income and Profit	1,167	1,139	-28	3.5	3.5
Taxes on Goods and Services	2,772	3,198	426	8.4	9.8
Taxes on External Trade	651	712	61	2.0	2.2
<b>Non-Tax Revenue</b>	<b>370</b>	<b>400</b>	<b>30</b>	<b>1.1</b>	<b>1.2</b>
<b>Grants</b>	<b>30</b>	<b>36</b>	<b>6</b>	<b>0.1</b>	<b>0.1</b>
<b>Total Expenditure</b>	<b>7,190</b>	<b>6,230</b>	<b>-960</b>	<b>21.8</b>	<b>19.0</b>
<b>Recurrent Expenditure</b>	<b>5,886</b>	<b>5,232</b>	<b>-654</b>	<b>17.8</b>	<b>16.0</b>
<b>Non-Interest Recurrent Expenditure</b>	<b>2,936</b>	<b>2,732</b>	<b>-204</b>	<b>8.9</b>	<b>8.3</b>
Salaries and Wages	1,230	1,164	-66	3.7	3.6
Goods and Services	416	335	-81	1.3	1.0
Subsidies & Transfers	1,290	1,233	-57	3.9	3.8
<b>Interest Expenditure</b>	<b>2,950</b>	<b>2,501</b>	<b>-449</b>	<b>8.9</b>	<b>7.6</b>
<b>Capital Expenditure and Net Lending</b>	<b>1,304</b>	<b>998</b>	<b>-306</b>	<b>4.0</b>	<b>3.0</b>
o/w Public Investments	1,315	1,016	-299	4.0	3.1
<b>Current Account Balance*</b>	<b>-926</b>	<b>217</b>	<b>1,143</b>	<b>-2.8</b>	<b>0.7</b>
<b>Primary Balance**</b>	<b>750</b>	<b>1,756</b>	<b>1,006</b>	<b>2.3</b>	<b>5.4</b>
<b>Budget Balance</b>	<b>-2,200</b>	<b>-745</b>	<b>1,455</b>	<b>-6.7</b>	<b>-2.3</b>
<i>Memorandum Items:</i>					
Nominal GDP (Rs. billion)	33,000	32,751	(249)		
Nominal GDP (growth rate)	10.0	8.8	(1.2)		
Real GDP (growth rate)	3.0	5.0	2.0		
GDP deflator (percent change)	6.7	3.7	(3.0)		
Primary Expenditure (Rs. billion)	4,240	3,730	(510)		
Primary Expenditure (As a share of GDP)	12.8	11.4	(1.5)		

Source: Department of Fiscal Policy

<sup>(a)</sup>Provisional

\* Includes interest, excludes public investment and net lending

\*\* Excludes interest

Total revenue and grants in 2025 amounted to Rs. 5,486 billion, exceeding the Budget forecast of Rs. 4,990 billion by Rs. 496 billion, and representing 16.7 percent of GDP — 1.6 percentage points above the forecasted 15.1 percent. Tax revenue rose to 15.4 percent of GDP, the highest level since 1997 and 1.5 percentage points above the Budget forecast of 13.9 percent. This notable improvement was underpinned by tax policy reforms, enhanced tax administration, and a substantial recovery in economic activity.

Revenue from taxes on goods and services and taxes on external trade both outperformed their respective forecasts. The removal of temporary import restrictions on motor vehicles contributed to higher collections from Excise Duties, Value Added Tax, and Customs Import Duty. Income tax revenue was broadly in line with projections, achieving 97.6 percent of its Budget target. Total expenditure in 2025 amounted to Rs. 6,230 billion, well below the Budget forecast of Rs. 7,190 billion, representing 19.0 percent of GDP against the forecasted 21.8 percent. The underspending reflects several contributing factors, including disciplined expenditure control, lower capital expenditure execution due to procurement delays, and subsidy rationalization. Additionally, the passage of the Vote on Account on December 6, 2024 — covering only the first four months of 2025 — constrained expenditure execution by restricting new programme initiations and compressing the effective implementation period to seven to eight months, making it structurally difficult to achieve the originally budgeted expenditure targets. This is further evidenced by a 1.4 percentage point reduction in primary expenditure, which declined from 12.8 percent to 11.4 percent of GDP, largely attributable to lower capital expenditure execution.

#### **4.3 Assessment of Expected compliance with the fiscal targets in the financial year 2026**

The assessment of anticipated compliance with fiscal targets for the current financial year is based on the period January to April 2026. Building on the stronger-than-expected revenue and primary balance outcomes recorded in 2025, the Government entered

2026 with additional fiscal space. In response to the economic impacts of Cyclone Ditwah and the Middle East conflict, the escape clause under the PFMA was invoked, and part of this fiscal buffer was deployed to provide temporary and targeted support measures. Consequently, the primary balance target for 2026 was revised downward to 2.1 percent of GDP. The primary surplus for the first four months of 2026 is amounted to Rs. 863 billion, significantly ahead of the full-year target of Rs. 360 billion, driven by lower-than-anticipated execution of capital expenditure and elevated revenue collection from motor vehicle-related taxes.

The fiscal performance of the first four months indicates that the revised 2026 target remains achievable, and the Government is broadly on track to attain the medium-term primary surplus objective of 2.6 percent of GDP from 2027 onwards. In the first four months of 2026, growth across all major tax revenue categories exceeded budgeted growth rates by significant margins, resulting in a 34.6 percent increase in total revenue and grants over the period. Non-tax revenue, despite its relatively modest share of total government revenue, recorded a remarkable 73.3 percent growth, driven primarily by the receipt of Central Bank profits. Grants, which similarly occupy a marginal position within the overall revenue structure, contracted by 39.4 percent over the same period. With 36.9 percent of the 2026 annual revenue estimate achieved in the first four months of 2026, revenue performance remains on track to meet the full-year target of 15.8 percent of GDP, supported by anticipated higher collections in the remaining months. Total revenue and grants in the first quarter of 2026 amounted to 16.4 percent of quarterly GDP. Expenditure execution remains broadly contained, with total expenditure in the first four months of 2026 reflecting 24.5 percent of the annual estimate and primary expenditure accounting for 22.2 percent. Recurrent expenditure over the same period grew ahead of Budget estimates, driven by stronger-than-forecast growth in salaries and wages and in subsidies and transfers. Interest expenditure and capital expenditure are also tracking above budgeted growth rates.

The hard-won fiscal discipline maintained in recent years has strengthened resilience to

emerging headwinds and provided adequate fiscal space to respond to the impacts of Cyclone Ditwah and the Middle East conflict. Nevertheless, expenditure pressures may intensify in the remainder of the year should the Middle East crisis escalate further, potentially diluting the fiscal over-performance achieved in the first four months of 2026. The temporary easing of fiscal policy to accommodate post-cyclone recovery and relief measures and to cushion the spillover effects of higher fuel prices stemming from the Middle East conflict has necessitated a breach of the primary expenditure ceiling stipulated under the PFMA. Accordingly, a Supplementary Budget, financed through fiscal over-performance, has been allocated to support post-cyclone relief and reconstruction activities. As a result, primary expenditure is estimated to exceed the ceiling by 0.7 percentage points, reaching 13.7 percent of GDP in 2026. In addition, funds have been provided through the reallocation of 2026 budgetary expenditures,

with no impact on the expenditure ceiling, to address the adverse economic impacts of the Middle East conflict. Nevertheless, the prioritization of reconstruction expenditure in line with recovery needs and sectoral priorities outlined in the Post-Disaster Needs Assessment (PDNA) 2026 report is expected to facilitate a return of primary expenditure to the ceiling of 13 percent of GDP in 2027.

The overall budget balance in the first four months of 2026 recorded a surplus of Rs. 105 billion, compared to a deficit of Rs. 262 billion in the corresponding period of 2025 — an improvement of Rs. 367 billion within a single year. This remarkable turnaround reflects the combined effect of strong revenue performance, driven by heightened tax revenue collection particularly from motor vehicle-related taxes, and disciplined expenditure execution during the first four months of 2026.

**Table 3 | Performance Assessment 2026**

Indicator	Rs. Billion							
	2025		2026		Budgeted Growth %	Jan-Apr growth %	Achievement (As a % of Budget)	
	Budget	Jan-Apr	Budget	Jan-Apr <sup>(a)</sup>				
<b>Total Revenue and Grants</b>	<b>4,990</b>	<b>1,455</b>	<b>5,300</b>	<b>1,958</b>	<b>6.2</b>	<b>34.6</b>	<b>36.9</b>	
<b>Total Revenue</b>	<b>4,960</b>	<b>1,453</b>	<b>5,270</b>	<b>1,957</b>	<b>6.3</b>	<b>34.7</b>	<b>37.1</b>	
<b>Tax Revenue</b>	<b>4,590</b>	<b>1,349</b>	<b>4,910</b>	<b>1,777</b>	<b>7.0</b>	<b>31.7</b>	<b>36.2</b>	
Taxes on Income and Profit	1,167	274	1,210	310	3.7	13.2	25.6	
Taxes on Goods and Services	2,772	881	3,056	1,214	10.2	37.8	39.7	
Taxes on External Trade	651	194	644	253	(1.1)	30.2	39.3	
<b>Non-Tax Revenue</b>	<b>370</b>	<b>104</b>	<b>360</b>	<b>181</b>	<b>(2.7)</b>	<b>73.3</b>	<b>50.2</b>	
<b>Grants</b>	<b>30</b>	<b>1.4</b>	<b>30</b>	<b>0.8</b>	<b>-</b>	<b>(39.4)</b>	<b>2.8</b>	
<b>Total Expenditure</b>	<b>7,190</b>	<b>1,716</b>	<b>7,557</b>	<b>1,853</b>	<b>5.1</b>	<b>8.0</b>	<b>24.5</b>	
<b>Recurrent Expenditure</b>	<b>5,886</b>	<b>1,603</b>	<b>5,838</b>	<b>1,685</b>	<b>(0.8)</b>	<b>5.1</b>	<b>28.9</b>	
<b>Non-Interest Recurrent Expenditure</b>	<b>2,936</b>	<b>809</b>	<b>3,221</b>	<b>927</b>	<b>9.7</b>	<b>14.6</b>	<b>28.8</b>	
Salaries and Wages	1,230	361	1,323	415	7.6	14.8	31.3	
Goods and Services	416	102	401	95	(3.6)	(7.6)	23.6	
Subsidies & Transfers	1,290	345	1,497	418	16.0	20.9	27.9	
<b>Interest Expenditure</b>	<b>2,950</b>	<b>794</b>	<b>2,617</b>	<b>758</b>	<b>(11.3)</b>	<b>(4.6)</b>	<b>29.0</b>	
<b>Capital Expenditure and Net Lending</b>	<b>1,304</b>	<b>113</b>	<b>1,719</b>	<b>169</b>	<b>31.8</b>	<b>49.3</b>	<b>9.8</b>	
o/w Public Investments	1,315	115	1,730	161	31.6	39.4	9.3	
<b>Current Account Balance*</b>	<b>-926</b>	<b>-150</b>	<b>-568</b>	<b>273</b>				
<b>Primary Balance**</b>	<b>750</b>	<b>533</b>	<b>360</b>	<b>863</b>				
<b>Budget Deficit</b>	<b>-2,200</b>	<b>-262</b>	<b>-2,257</b>	<b>105</b>				
<i>Memorandum Items:</i>								
<i>Primary Expenditure (Rs. billion)</i>	<i>4,240</i>	<i>922</i>	<i>4,940</i>	<i>1,096</i>	<i>16.5</i>	<i>18.8</i>	<i>22.2</i>	

Source: Department of Fiscal Policy

<sup>(a)</sup>Provisional

\* Includes interest, excludes public investment and net lending

\*\* Excludes interest

#### 4.4 Assessment of Expected compliance with the fiscal targets for the next financial year and the four succeeding years

The Middle East conflict and Cyclone Ditwah present significant risks to Sri Lanka's economic outlook. Nevertheless, the strong fiscal performance of recent years demonstrates that projected fiscal indicators over the next five years remain largely on track, notwithstanding some notable deviations in fiscal aggregates in 2026 attributable to the Supplementary Budget allocated to address the adverse impacts of Cyclone Ditwah. Despite the notable improvement in fiscal indicators over the first four months of 2026, the attainment of fiscal targets for 2026 and expected compliance with targets for 2027 and the four succeeding years remain contingent upon the continuation of ongoing reforms and the effective management of both external and internal uncertainties, particularly those arising from the Middle East conflict.

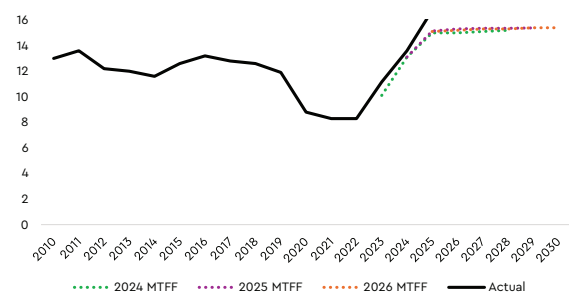
Accordingly, sustained revenue enhancement and disciplined expenditure management remain essential to achieving medium-term fiscal targets. However, the Middle East conflict has significantly darkened the global economic outlook, driven by disruptions to oil supplies resulting from the effective closure of the Strait of Hormuz and damage to critical production facilities. As a net oil importer, Sri Lanka remains highly vulnerable to these developments. The country's medium-term fiscal outlook will therefore largely depend on the duration and intensity of the conflict and its consequent impact on global energy markets and supply chains.

##### Revenue

The MTFF projects total revenue and grants to moderate from 16.7 percent of GDP in 2025 — the highest in two decades — to 15.8 percent of GDP in 2026, with this ratio expected to remain broadly unchanged through 2031. This projected decline primarily reflects the normalization of revenue following the one-off tax revenue gain associated with the resumption of vehicle imports in 2025.

The total revenue-to-GDP ratio had declined to 8.4 percent by the time of the 2022 crisis,

**Figure 5 | Total revenue to GDP (Percent)**



Source: Department of Fiscal Policy

among the lowest in the world. A series of tax policy and revenue administration reforms has since significantly strengthened the tax base, broadened the tax net, and reduced tax avoidance, leakages, and evasion. In addition, targeted legislative reforms — including amendments to the Strategic Development Projects Act and the Colombo Port City Economic Commission Act — have introduced rules-based criteria for granting tax incentives, contributing to a reduction in tax expenditures. Given the uncertainties on both the external and domestic fronts, sustaining this improvement in revenue performance will remain challenging.

The escalation of geopolitical tensions in the Middle East and the resulting disruptions to global trade and energy markets could adversely affect economic activity and fiscal outcomes. Nevertheless, revenue collection has demonstrated notable resilience, recording positive growth in both March and April 2026 despite the outbreak of the Middle East conflict on 28 February 2026. Furthermore, the recent uptick in inflation may provide some support to nominal revenue growth, particularly through consumption and income-linked taxes. While these factors may partially offset downside risks, the achievement of medium-term revenue targets will ultimately depend on the continued implementation of tax policy and revenue administration reforms, as well as the evolution of domestic and external economic conditions.

##### Expenditure and the Primary Expenditure Ceiling

Effective public expenditure management, combined with ongoing fiscal consolidation efforts, contributed to a gradual reduction in total expenditure from 20.4 percent

of GDP in 2024 to 19.0 percent of GDP in 2025. The MTFE projects total expenditure to increase to 21.3 percent of GDP in 2026, driven primarily by the allocation through a Supplementary Estimate to address immediate relief and reconstruction needs arising from Cyclone Ditwah. Thereafter, total expenditure is projected to decline to around 20 percent of GDP in 2027 and gradually stabilize at approximately 19.5 percent of GDP over the medium term, consistent with the Government's commitment to maintaining fiscal discipline while accommodating essential spending requirements.

Recurrent expenditure is projected to increase from 16.0 percent of GDP in 2025 to 16.6 percent of GDP in 2026, in line with the expenditure escalation associated with the Supplementary Estimate. It is thereafter expected to decline to 14.7 percent of GDP by 2031, driven primarily by the anticipated reduction in interest expenditure from 7.6 percent of GDP in 2025 to approximately 6.2 percent of GDP in 2031. Capital expenditure and net lending are projected to increase from 3.0 percent of GDP in 2025 to approximately 4.4 percent of GDP in 2031, reflecting post-cyclone reconstruction and rehabilitation needs alongside a sustained focus on long-term public investment.

Primary (non-interest) expenditure is projected to increase from 11.4 percent of GDP in 2025 to 13.7 percent of GDP in 2026. The allocation through the Supplementary Budget to provide transfers to cyclone affected households and firms and to rebuild public infrastructure has permitted primary expenditure to exceed the legislated ceiling. This is expected to return to 12.9 percent of GDP in 2027 and to be maintained at or slightly below the legislated ceiling of 13 percent of GDP throughout the first five years of the new fiscal responsibility framework.

### **Primary balance**

Based on the above projections for revenue and primary expenditure, the primary surplus target of at least 2.6 percent of GDP is set to be achieved and maintained from 2027 onwards. However, the MTFE projects a lower primary surplus of 2.1 percent of GDP for 2026, reflecting the activation of the escape clause under the PFMA and the allocation of

a Supplementary Budget to provide transfers to cyclone affected households and firms and to support the rebuilding of public infrastructure.

The MTFE projections for the primary surplus over the medium term slightly exceed the debt-stabilizing primary surplus of 2.3 percent of GDP, generating additional fiscal space to absorb downside risks associated with the near-term outlook for growth, inflation, and revenue. This is achieved by maintaining primary expenditure slightly below the level required to precisely meet the primary balance target. This built-in buffer increases the likelihood of achieving the intended fiscal outcomes. The size of this buffer may be adjusted in future years based on actual fiscal performance and emerging economic conditions. The MTFE projections indicate that the primary balance target is expected to be met consistently over the remaining IMF-EFF programme period through 2027 and the medium-term projection horizon through 2031. The Government intends to maintain primary surpluses of at least 2.6 percent of GDP throughout the medium-term horizon.

### **Overall Balance**

The overall balance narrowed significantly from -6.8 percent of GDP in 2024 to -2.3 percent of GDP in 2025, reflecting strong revenue performance, disciplined expenditure management, and lower-than-projected capital expenditure execution. Having achieved the 2028 fiscal threshold ahead of schedule in 2025, the overall balance is estimated to widen to -5.6 percent of GDP in 2026, owing to the increase in total expenditure to 21.4 percent of GDP arising from unplanned expenditure associated with Cyclone Ditwah. The MTFE projects the overall balance to reach below -5 percent of GDP from 2027 onwards. Sustaining the overall balance below this threshold over the medium term will be critical to preserving the hard-won fiscal stability achieved in recent years.

### **Public Debt**

The latest projections for public debt indicate a reduction from approximately 119.2 percent of GDP in 2032 to around 86.7 percent of GDP by 2032, consistent with the debt falling below the initial target of 95 percent of GDP

by 2032. Adherence to the primary balance target and primary expenditure ceiling will be instrumental in attaining this goal, provided no major external shocks materialize.

#### **4.5 Assessment of non-compliance with the fiscal targets for the current financial year and the next financial year.**

The assessment of non-compliance covers two instances of deviation from the fiscal targets established under the PFMA: the breach of the primary expenditure ceiling in the current financial year 2026, and the shortfall in the primary balance target, also in 2026. Both deviations are directly attributable to extraordinary and unanticipated fiscal demands arising from Cyclone Ditwah and the Middle East conflict, and are assessed as temporary in nature.

#### **Non-Compliance in the Current Financial Year 2026**

##### **Primary Expenditure Ceiling**

The PFMA stipulates that primary expenditure shall not exceed 13 percent of estimated GDP during the first five years of operation of the fiscal responsibility framework, unless unanticipated events or natural disasters threaten national security, economic security, or public health and safety, necessitating additional, temporary, and targeted expenditure beyond the contingencies provided for in the annual budget. Primary expenditure is estimated to reach 13.7 percent of GDP in 2026, exceeding the statutory ceiling by 0.7 percentage points. This deviation arose from exceptional and unanticipated expenditure allocations, with a Supplementary Budget approved to finance emergency relief, rehabilitation, and reconstruction activities necessitated by Cyclone Ditwah. This allocation was directed toward transfers to affected households and firms and the rebuilding of damaged public infrastructure, in line with the priorities identified in the Post-Disaster Needs Assessment (PDNA) 2026 report. A reallocation within the existing 2026 budgetary expenditures was approved to address the adverse domestic economic impacts of the Middle East conflict, including support measures to cushion the effects of elevated fuel prices on households and the

productive sector. As this reallocation involves no additional net budgetary allocation, it does not affect the expenditure ceiling.

The Government has activated the escape clause provided under the PFMA, which permits a temporary and targeted breach of the primary expenditure ceiling under such circumstances. Rigid adherence to the expenditure ceiling during a period of genuine national emergency, in the absence of this provision, would have imposed unacceptable social and economic costs.

##### **Primary Balance Target**

As a result of these expenditure pressures, the primary balance target for 2026 has been revised downward from 2.3 percent of GDP to 2.1 percent of GDP. The primary surplus over the first four months of 2026 is estimated at Rs. 863 billion, significantly ahead of the full-year target of Rs. 360 billion, largely reflecting lower-than-anticipated capital expenditure execution and strong revenue performance. This year-to-date outturn provides a reasonable basis for confidence that the revised 2026 primary balance target remains achievable.

##### **Remedial Measures and Path to Normalisation**

The Government is committed to returning to full compliance with both the primary expenditure ceiling and the primary balance target from 2027 onwards. The following measures underpin this commitment: The supplementary expenditure allocated in 2026 for Cyclone Ditwah reconstruction is temporary and non-recurring in nature. The prioritization of reconstruction expenditure in line with the sectoral priorities identified in the PDNA 2026 report is expected to facilitate a return of primary expenditure to 12.9 percent of GDP in 2027, within the legislated ceiling. Revenue performance has demonstrated resilience despite external headwinds from the Middle East conflict, recording positive growth in March and April 2026. The continuation of ongoing reforms is expected to support the achievement of the medium-term revenue projection of approximately 15.5 percent of GDP.

The strong fiscal over-performance of 2025, including the historically high primary surplus

of 5.4 percent of GDP, has generated sufficient fiscal buffers to absorb the 2026 deviations without compromising the medium-term debt reduction trajectory.

### **Non-Compliance in the Next Financial Year 2027**

Deviation from fiscal targets is not anticipated for the financial year 2027. The primary surplus target of at least 2.6 percent of GDP and the primary expenditure ceiling of 12.9 percent of GDP are both projected to be met, contingent upon the continuation of ongoing fiscal reforms and the absence of further major unanticipated shocks. The principal downside risk to this assessment remains the duration and intensity of the Middle East conflict and its consequent impact on global energy markets, domestic inflation, and revenue performance.

## **5. Macroeconomic impact of fiscal decisions taken over the past three years**

The fiscal decisions implemented over the period 2023–2025 have played a pivotal role in shaping Sri Lanka's macroeconomic trajectory. Following the unprecedented economic crisis of 2022 — which saw public debt reach approximately 119.2 percent of GDP, real GDP contract by 7.3 percent, foreign reserves fall to critically low levels, and inflation surge to historic highs a comprehensive programme of fiscal consolidation (Annexure II) anchored in the IMF-EFF programme. The macroeconomic outcomes observed over the subsequent three years reflect the direct and indirect effects of these fiscal decisions.

### **5.1 Fiscal Consolidation and Debt Reduction**

The most direct macroeconomic impact of the fiscal decisions taken over 2023–2025 has been the restoration of public debt sustainability. Through sustained revenue mobilization, disciplined expenditure management, and the successful near conclusion of external debt restructuring, public debt declined from approximately 119.2 percent of GDP in 2022 to 103.2 percent of GDP in 2024, and further to 98.3 percent of GDP in 2025 — a reduction of approximately 20 percentage points over three years. This trajectory places Sri Lanka firmly on track to achieve the IMF-EFF interim target of below 95 percent of GDP by 2032, and current projections suggest this

milestone may be reached ahead of schedule. The primary balance improved dramatically over this period, transitioning from chronic primary deficits prior to the crisis to a surplus of 2.2 percent of GDP in 2024 and reaching a historically high 5.4 percent of GDP in 2025. This improvement was driven by a combination of tax policy reforms, strengthened revenue administration, and the rationalization of subsidies and transfers. The achievement of sustained primary surpluses has been a critical factor in stabilizing the debt-to-GDP ratio and creating the conditions for its subsequent decline.

### **5.2 Revenue Mobilisation and its Macroeconomic Effects**

The revenue measures implemented over 2023–2025 — encompassing reforms to Value Added Tax, the Social Security Contribution Levy, income tax, and excise duties, as well as improvements in tax administration— produced a significant increase in the revenue-to-GDP ratio. Government revenue rose from approximately 8.4 percent of GDP at the trough of the crisis in 2022 to 16.7 percent of GDP in 2025, the highest level recorded in nearly two decades and among the most rapid revenue recoveries observed in any IMF programme in any country in recent years. The macroeconomic effects of this revenue recovery have been broadly positive. By reducing the fiscal deficit and the associated government borrowing requirement, higher revenue collections contributed to a significant easing of domestic interest rates. The reduction in financing pressure alleviated the crowding-out of private sector credit that had characterized the crisis period, creating space for private investment to recover. Lower interest rates also reduced debt service costs, reinforcing the fiscal consolidation process and freeing budgetary resources for more productive expenditure.

### **5.3 Expenditure Management and its Macroeconomic Effects**

Fiscal decisions on the expenditure side over 2023–2025 encompassed the rationalization of recurrent expenditure, containment of public sector salaries, reduction of generalized subsidies, and the introduction of the primary expenditure ceiling of 13 percent of GDP under the PFMA. Total expenditure

declined from 20.4 percent of GDP in 2024 to 19.0 percent of GDP in 2025, with primary expenditure falling to 11.4 percent of GDP — well within the statutory ceiling.

Real GDP growth reached 5.0 percent in 2025 for the second consecutive year, significantly exceeding the Budget forecast and reflecting broad-based expansion across the agriculture, industry, and services sectors. This outturn demonstrates that fiscal consolidation, when implemented within a credible medium-term framework and supported by complementary monetary and structural reforms, need not be incompatible with near-term economic recovery.

#### **5.4 Macroeconomic Stability and Confidence Restoration**

The cumulative effect of the fiscal decisions taken over 2023–2025 has been a substantial restoration of macroeconomic stability. Key indicators of this stabilization include:

**Inflation:** The implementation of fiscal consolidation, combined with monetary policy tightening by the Central Bank under the Flexible Inflation Targeting framework, contributed to a rapid and sustained decline in inflation from its crisis-period peak. This was followed by a period of deflation between September 2024 and July 2025.

**Exchange rate:** The exchange rate appreciated by over 10 percent in 2025, supported by the restoration of external confidence, the strengthening of foreign reserves through Central Bank market purchases, and the resolution of external debt restructuring. This appreciation contributed to the disinflationary environment and reduced the rupee cost of foreign currency debt service obligations.

**External sector:** Foreign reserves were progressively rebuilt over the programme period, strengthening Sri Lanka's external resilience and reducing vulnerability to external shocks. Exports expanded, tourism earnings recovered significantly, and workers' remittances remained robust, collectively contributing to a current account surplus of 1.6 percent of GDP in 2025.

**Investor confidence:** The successful near completion of external debt restructuring, the maintenance of the IMF-EFF programme on track, and the demonstrated commitment to fiscal consolidation contributed to a significant improvement in sovereign risk perceptions. This was reflected in improved access to concessional financing and in the terms of the restructured debt instruments, including the Governance-Linked Bond.

#### **5.5 Near-Term Risks and the Impact of Unanticipated Shocks**

The macroeconomic gains of the 2023–2025 fiscal consolidation period have been subject to two significant unanticipated shocks: Cyclone Ditwah in 2025 and the Middle East conflict in 2026. The fiscal response to these shocks, encompassing supplementary expenditure for cyclone recovery and budgetary reallocation for Middle East conflict mitigation, has temporarily interrupted the consolidation path in 2026. The macroeconomic implications of these fiscal decisions include a temporary increase in aggregate demand associated with reconstruction spending, upward pressure on inflation from higher fuel costs, and a near-term widening of the overall deficit to an estimated 5.6 percent of GDP in 2026. The fiscal policy measures implemented over the past three years have contributed significantly to restoring macroeconomic stability and strengthening the foundations for sustainable economic growth. The improvement in fiscal balances, moderation of inflationary pressures, stabilization of the external sector, and gradual recovery of economic activity collectively reflect the effectiveness of the Government's fiscal consolidation strategy. Notwithstanding the progress achieved thus far, maintaining fiscal discipline, strengthening revenue mobilization, enhancing expenditure efficiency, and advancing structural reforms remain essential to safeguarding macroeconomic stability and building resilience against emerging domestic and external risks. Continued commitment to these priorities will be critical to securing long-term debt sustainability, fostering investor confidence, and achieving inclusive and durable economic growth.



**PART II**  
**Fiscal Risk Statement 2027**



## 1. Introduction

Under Section 11(5)(f) of the PFMA, the FSS is required to specify the main sources of fiscal risks to achieving the objectives specified in Section 10, and to estimate their fiscal impacts. The Fiscal Risk Statement (FRS) 2027 is the second such statement published under this requirement, building on the framework established in the first FRS 2026.

The FRS is a central instrument of modern fiscal governance. Its purpose is to ensure that the Government, Parliament, and the public have a clear and transparent assessment of the risks facing the public finances, risks that, if they materialise, could cause fiscal outcomes to deviate from the targets and projections set out in the Medium-Term Fiscal Framework (MTFF) presented in the FSS. By identifying, assessing, and disclosing these risks, the FRS supports evidence-based policymaking, strengthens parliamentary oversight, and reinforces the Government's commitment to fiscal accountability and long-term sustainability.

The FRS 2027 assesses fiscal risks across six categories, with much broader coverage and analytical depth than that established in FRS 2026: (i) macroeconomic uncertainty; (ii) State-Owned Enterprises (SOEs); (iii) public debt, guarantees, and on-lending; (iv) Public-Private Partnerships (PPPs); (v) climate and natural disaster-related risks; and (vi) financial sector risks. Together, these categories capture the principal sources of risk that could cause fiscal outcomes to deviate materially from the Government's MTFF.

## 2. Fiscal Risks

Fiscal risks are factors that can cause the fiscal position to deviate from forecasts, encompassing potential shocks or events that could create unexpected costs, reduce revenues, increase expenditure requirements, or cause debt to differ materially from projected levels. In practice, fiscal risks may materialise through weaker-than-expected economic growth, exchange rate or interest rate movements, the realisation of contingent liabilities, or unplanned spending pressures. Recognising, assessing, and managing these risks is essential to maintaining fiscal discipline and protecting the integrity of the MTFF.

The fiscal position of Sri Lanka remains exposed to multiple risks of varying magnitude. Macroeconomic risks arise from structural weaknesses embedded in the economy, including a narrow export base, over-reliance on tourism and workers' remittances, and heavy dependence on imported energy, compounded by geopolitical tensions and elevated uncertainty in global energy markets, among other factors.

Fiscal risks arising from SOEs remain a critical and tangible concern. Vulnerabilities persist in the energy, water, and aviation sectors, where deteriorating conditions could generate recapitalisation needs or budget support obligations. In addition, debt, guarantees, and on-lending risks associated with SOEs remain material. The outstanding stock of government guarantees continues to represent a source of contingent liabilities.

Significant progress has been made in strengthening the institutional framework for PPPs through a dedicated PPP law and a centralised PPP unit. However, if not carefully managed, PPPs can give rise to fiscal risks through contingent liabilities embedded in PPP agreements. Separately, climate and natural disaster risks have been assessed in greater depth. Sri Lanka's regular exposure to floods, droughts, landslides, and cyclones generates material fiscal costs through reconstruction expenditure, relief spending, lost revenues, and SOE contingent liabilities.

Financial sector risks are assessed as a distinct category for the first time in FRS 2027, reflecting the fiscal implications of financial system stability.

A summary of the assessments in this statement is presented in the fiscal risk heat map below, organising risks by their assessed likelihood of realisation and potential fiscal impact. Accordingly, among the six categories of fiscal risk, the heat map finds that macroeconomic risks, and climate and disaster risks, pose potentially high fiscal impact with probable likelihood of occurrence. Risks emanating from SOEs carry higher potential fiscal impact with possible likelihood of realisation, while debt, guarantees, and on-lending pose medium potential fiscal impact and possible likelihood of realisation.

## Summary of Findings

		Likelihood of realization		
		Remote (<10%)	Possible (10–50%)	Probable (>50%)
Potential fiscal impact	High (>1% of GDP)		State-owned Enterprises	Macroeconomic Uncertainties Climate Change & Natural Disasters
	Medium (0.1–1% of GDP)		Public Debt, Guarantee & On-lending	
	Low (<0.1% of GDP)		Public-Private Partnerships	

financial system stability, including government guarantee obligations to state-owned financial institutions, the exposure of the financial sector to sovereign debt, and the potential fiscal costs of financial system stress.

### 3. Anticipated Fiscal Pressures

The Government faces a range of structural and emerging fiscal pressures that are expected to place sustained demands on public finances over the medium term. These pressures do not necessarily represent sudden shocks to the fiscal position. Rather, they reflect foreseeable obligations that, if not carefully managed, could affect the pace of fiscal consolidation and the ability of the Government to meet its primary surplus and debt reduction objectives.

Debt service remains one of the most significant fiscal pressures over the medium term. Despite the successful completion of debt restructuring and the reduction in interest expenditure as a share of GDP, Sri Lanka's public debt remains elevated, and debt servicing costs continue to absorb a substantial share of government revenues. Sustaining the primary surplus target and

managing the refinancing of maturing obligations will require continued fiscal discipline, leaving limited room for unplanned expenditure increases in other areas.

Social protection pressures are expected to remain elevated. According to the World Bank Sri Lanka Development Update (May 2026), around one-third of households experienced moderate or severe food insecurity in 2025, three times the level recorded in 2019. Although nominal wages have increased, real wages adjusted for inflation remain below pre-crisis levels, sustaining demand for targeted income support and social safety net programmes, including Aswesuma. These pressures are likely to persist over the medium term as the recovery in household incomes and living standards remains incomplete, particularly among the most vulnerable segments of the population.

Demographic pressures present a growing long-term fiscal challenge. Sri Lanka's population is ageing rapidly, driving increased demand for government pension payments, healthcare services, and elderly support programmes. Population ageing, combined with declining birth rates and outward migration of the working-age population, is

likely to place sustained upward pressure on recurrent expenditure while simultaneously constraining the growth of the revenue base over the longer term.

Climate adaptation and disaster reconstruction represent a significant category of anticipated fiscal pressure. The reconstruction needs arising from severe disasters place immediate and sustained pressure on the capital budget. More broadly, reducing exposure to climate and disaster risks over time will require sustained public investment in resilient infrastructure, coastal protection, early warning systems, and agricultural adaptation. The Government has identified the El Niño and La Niña cycles as an important driver of this risk, as these patterns tend to bring drier or wetter conditions than usual and can increase the likelihood of droughts or floods in a given year. As these cycles can often be forecast some months in advance, work is underway to make better use of this forecasting to anticipate years of elevated risk and plan budgets accordingly. These adaptation investments represent a structural increase in public expenditure requirements that will need to be accommodated within the primary expenditure ceiling set out in the FSS.

Infrastructure and public investment pressures extend beyond climate adaptation. The infrastructure deficit accumulated over years of underinvestment, compounded by crisis-related rationalisation of capital expenditure, requires sustained increases in public investment to support long-term economic growth and productivity. The target of maintaining public investment at above 4 percent of GDP from 2027 onwards reflects this priority, but meeting this target while also observing the primary expenditure ceiling will require careful management of the overall expenditure composition and continued efforts to crowd in private sector investment through PPPs and other mechanisms.

SOE restructuring and reform costs represent a further source of anticipated fiscal pressure. While the financial performance of major SOEs has improved, several enterprises continue to require financial support or face the prospect of significant restructuring costs. The ongoing reform programme, including potential restructuring of loss-making entities, may

generate one-off fiscal costs that need to be planned for within the MTF.

Collectively, these pressures highlight the importance of maintaining fiscal discipline and preserving the primary surplus target over the medium term. The fiscal strategy provides the framework within which these competing demands must be managed, prioritising expenditure carefully, continuing to grow the revenue base, and maintaining sufficient fiscal buffers to absorb shocks without derailing the debt reduction objective. Failure to manage these pressures proactively could compress the fiscal space needed to respond to unforeseen shocks and slow the pace of return to full fiscal sustainability.

#### **4. Main Sources of Fiscal Risks**

##### **(A) Fiscal Risks Arising from Macroeconomic Uncertainty**

The fiscal standing of a country is largely determined by its macroeconomic conditions, and changes in critical economic variables can significantly undermine the accuracy of fiscal forecasts. Volatility in global and domestic economic activity, exchange rates, and commodity prices may cause actual revenue and expenditure outcomes to deviate from their forecast values. In the event of a disaster or other exogenous shock, government revenue receipts may underperform relative to projections, while unforeseen expenditure pressures may escalate significantly owing to emergency response and recovery needs. In addition, fluctuations in key macroeconomic variables, including interest rates, inflation, and exchange rates, can affect borrowing costs and debt servicing obligations, thereby posing risks to overall fiscal sustainability. This exposure is reinforced by Sri Lanka's narrow export base and its reliance on tourism, remittances, and imported energy.

Such deviations can arise from several key factors, including the materialisation of unexpected extreme events not captured in budget forecasts, inherent errors and biases in economic forecasting models and policy assumptions, and subsequent policy decisions that were not incorporated into the original forecast. In recent years, Sri Lanka has experienced a series of significant adverse shocks, including the 2019 Easter

Sunday attacks, the COVID-19 pandemic, the foreign exchange crisis, Cyclone Ditwah, and the ongoing Middle East conflict. Against this backdrop, this section provides a critical assessment of the accuracy of the main economic and fiscal forecasts for Sri Lanka over the past decade, while also examining the fundamental sources of uncertainty that are expected to have a significant bearing on the country's projected fiscal performance over the medium term.

## Analysis of Forecast Performance

### Macroeconomic Forecasts Performance

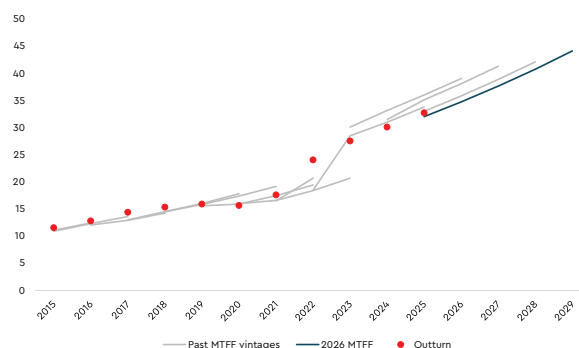
Forecast accuracy tends to be higher under stable economic conditions, and in the near term, projections generally prove more reliable than long-term ones, which are naturally subject to greater deviation. This was clearly evident during 2015 to 2019, a phase largely free from major adverse shocks, when nominal GDP forecasts were broadly accurate, with only minor underestimations. However, the period from 2019 to 2022 marked a sharp departure from this trend, as a series of unforeseen and compounding shocks, namely the Easter Sunday attacks, the COVID-19 pandemic, a severe foreign exchange crisis, and a broader economic recession, caused real GDP outturns to fall significantly below budget forecasts, with the 2022 contraction being unprecedented in scale, exceeding even the economic damage observed during the pandemic year of 2020. Adding further complexity, the sharp spike in inflation during 2022, driven by supply-side disruptions, global energy price hikes, rupee depreciation, and lagged monetary accommodation, resulted in a temporary upward distortion in nominal GDP growth, making projections from that period particularly difficult to interpret.

Benefiting from the implementation of a revenue-based fiscal consolidation path and a broad range of structural reform strategies undertaken in line with the IMF Extended Fund Facility (IMF-EFF) programme, the economy gradually turned towards a recovery phase. Real GDP growth rebounded to 5.0 percent in 2024, significantly exceeding initial expectations. The recovery was sustained in

2025, with growth remaining at 5.0 percent, supported by the gradual removal of import restrictions and a strengthening of domestic consumption. Nevertheless, negative inflation persisted from September 2024 through to July 2025, which unfavourably impacted the expected nominal GDP growth of the country, leading to successive downward revisions to medium-term projections. By the time Budget 2026 was announced, the country had reached a position of relative stability and measured optimism in its economic recovery trajectory, with consolidation gains beginning to take hold across key macroeconomic indicators.

However, the outlook was further complicated by a set of unforeseen developments that tested the resilience of the recovery. Cyclone Ditwah inflicted severe damage on both economic activity and the social fabric of the country, compelling the Government to repurpose existing 2025 budget allocations and make an additional provision of Rs. 500 billion to support rebuilding and recovery efforts, which are expected to be financed through the excess cash balances accumulated during 2026. Simultaneously, the escalating conflict in the Middle East has continued to worsen the country's macroeconomic conditions through upward pressure on global oil prices, disruptions to the tourism sector, possibility of reducing workers' remittances, and adverse impacts on key export destinations, all of which pose significant risks to the sustainability and pace of economic recovery going forward.

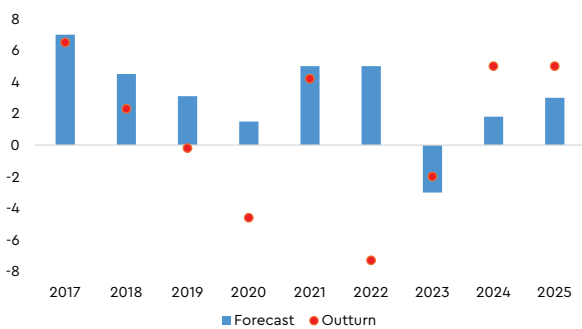
**Figure 6 | Nominal GDP – Projections vs Outturns**  
(Rs. Trillion)



Source : Department of Fiscal Policy (projections), Department of Census and Statistics.

**Figure 7 | Real GDP growth – budget year forecast vs outturn**

(As a percentage of GDP)



Source : Department of Fiscal Policy (projections), Department of Census and Statistics.

## Fiscal Forecasts

### Revenue

Medium-Term Fiscal Framework (MTFF) vintages from 2015 to 2022 consistently show that projected revenue levels exceeded actual outturns, as illustrated in Figure 8. However, this pattern should not be interpreted as a fundamental error in macroeconomic forecasting, but rather as a persistent failure to achieve the potential revenue levels that were anticipated at the time of budget formulation. Several factors contributed to this recurring shortfall, including unanticipated economic shocks that dampened revenue mobilisation, the non-implementation of certain planned tax policy measures, and gaps in tax administration that prevented the expected improvements in tax compliance from materialising.

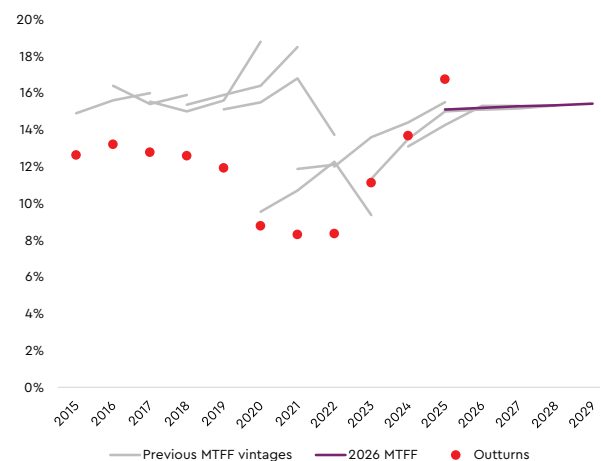
From 2023 onwards, this optimistic bias has been substantially corrected, with revenue outturns broadly in line with, or exceeding, budget forecasts. This marked improvement was primarily driven by the Government's decisive implementation of tax policy and administrative reforms, which together enabled a significant and sustained lift in the revenue-to-GDP ratio.

Total revenue and grants increased to 16.7 percent of GDP in 2025, marking the highest level in nearly two decades. This outcome reflected the ongoing impact of tax policy and administrative measures, reinforced by a surge in revenue from pent-up demand released upon the relaxation of motor vehicle import restrictions, which had been maintained for

almost half a decade. Supporting this strong revenue performance was the rapid recovery of the economy, with GDP growth reaching 5 percent in both 2024 and 2025, surpassing earlier, more conservative growth projections for both years. This stronger-than-anticipated economic expansion provided a broader tax base and meaningfully contributed to the sustained overperformance in revenue collection.

**Figure 8 | Total Revenue and Grants**

(As a percentage of GDP)



Source : Department of Fiscal Policy

### Expenditure

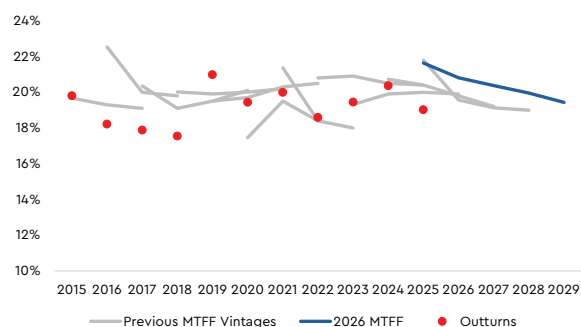
Expenditure forecasts have remained broadly stable over the years as a percent of GDP, reflecting a consistent and disciplined approach to public financial management. Compared to budgeted projections, actual outturns have generally been in line with or below forecast values, underpinned by the government's sustained efforts to rationalise expenditure while ensuring that essential spending requirements continue to be adequately prioritised. In periods where revenue performance fell short of expectations, the government took proactive and timely measures to curtail expenditure, thereby safeguarding fiscal sustainability and maintaining broad alignment with overall budget targets.

The under-execution of public investment relative to budget in recent years has been attributable to a range of factors, including delays in the approval of the budget, extended procurement processes, and other implementation constraints. On average,

the execution rate for public investment has been approximately 0.1 percent of GDP below the estimated value, highlighting the need for continued strengthening of public investment management systems to ensure more effective and timely delivery of planned capital spending.

**Figure 9 | Total Expenditure**

(As a percentage of GDP)

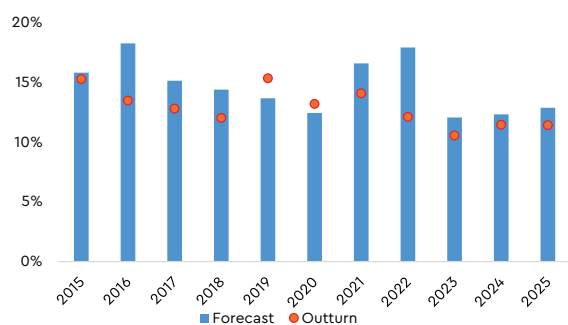


Source : Department Of Fiscal Policy

Primary expenditure has generally remained below budgeted levels over the past decade, reflecting a sustained commitment to fiscal discipline, with temporary overruns in 2019 and 2020 driven by exceptional social spending needs. The Public Financial Management Act, No. 44 of 2024, further strengthened this commitment by introducing a 13 percent of GDP ceiling on primary expenditure. Although it is expected that this ceiling will be temporarily breached in 2026 owing to reconstruction needs following Cyclone Ditwah and additional social support measures necessitated by the increase in global oil prices, the Government remains committed to preserving the fiscal consolidation path through the strategic reallocation of budgetary resources.

**Figure 10 | Primary Expenditure**

(As a percentage of GDP)



Source : Department of Fiscal Policy

## Ditwah – related Reconstruction and Rehabilitation Activities

For the year 2026, Parliament approved a supplementary allocation of Rs. 500 billion for Ditwah rehabilitation and reconstruction activities, in view of the exceptional circumstances arising from the disaster. However, given the scale and complexity of the rehabilitation programme, it may not be possible to complete all activities within the 2026 financial year. As there is no legal provision under the PFM Act to carry forward any unutilised balance of the 2026 supplementary allocation into 2027, the funding requirements for any outstanding activities will be determined following an assessment at the end of 2026. While part of any such requirement may be accommodated within the primary expenditure ceiling applicable to 2027, completion of the remaining activities may necessitate additional budgetary provisions, the magnitude and timing of which remain uncertain at this stage. In such circumstances, and subject to the provisions of the PFM Act, Parliamentary approval may be sought through a Supplementary Estimate in 2027, exclusively for expenditure relating to the completion of Ditwah rehabilitation and reconstruction activities commenced in 2026 under the supplementary allocation approved by Parliament.

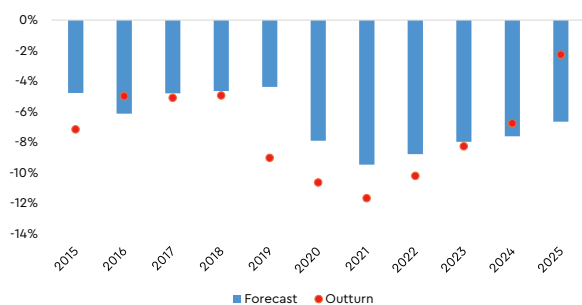
## Budget Balance and Primary Balance

The overall budget balance represents the net effect of revenue and expenditure, and its forecast is derived directly from the above projected revenue and expenditure figures. Over the past decade, the forecast error of the budget balance has, on average, remained within 1 percent of outturn values, reflecting a reasonable degree of fiscal forecasting accuracy. Deviations beyond this range have been limited to exceptional years in which the economy was subjected to adverse external or domestic shocks. Throughout the past decade, outturn values have generally fallen below forecast figures, with the exception of the period from 2019 to 2022, which was marked by a series of consecutive adverse shocks. The highest forecast error was recorded in 2019, which marked the onset of this unprecedented sequence of shocks. In 2025, a forecast error of over 4 percent was recorded, driven

primarily by a significant overperformance of revenue, reinforced by effective expenditure management and the under-execution of capital expenditure relative to planned levels, both of which contributed positively to the observed forecast error. The fiscal deficit in 2025, equivalent to 2.3 percent of GDP, reached its lowest level since 1956.

**Figure 11 | Fiscal Balance**

(As a percentage of GDP)

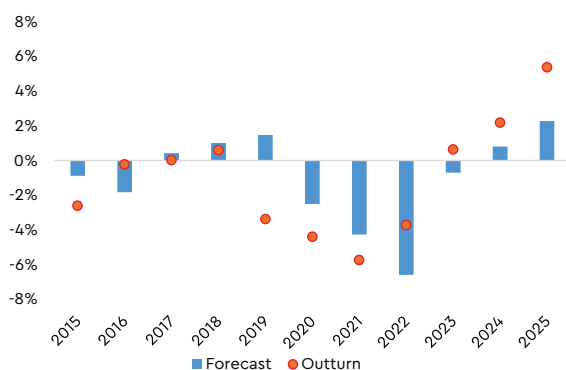


Source : Department of Fiscal policy

The primary balance serves as a key indicator of fiscal sustainability, as it captures the portion of the fiscal position within the Government's direct control. While the ten-year average forecast error for the primary balance tends to neutralise over time, with overestimations and underestimations broadly offsetting one another, a clear shift has been evident from 2022 onwards: outturns have consistently outperformed forecasts, reflecting increasingly prudent fiscal management. This improved discipline produced a primary surplus from 2023 onwards, reaching a historic high of 5.4 percent of GDP in 2025, the largest primary surplus ever recorded in Sri Lanka's fiscal history, and a milestone that underscores the Government's strengthened debt sustainability position.

**Figure 12 | Primary Balance**

(As a percentage of GDP)



Source : Department of Fiscal Policy

### Scenario and Sensitivity Analysis: Potential Sources of Risk and Uncertainty over the Medium-Term

As the foregoing analysis highlights, the fiscal outlook remains inherently susceptible to unpredictable shocks. On the domestic front, delays in executing the Cyclone Ditwah reconstruction programme noted above continue to weigh on both the fiscal position and the pace of economic recovery. The principal external risks that could further alter budgetary outcomes over the medium term are set out below.

The fiscal projections presented in the Budget are grounded in a central case scenario, carefully calibrated by weighing a broad spectrum of competing considerations and uncertainties. Among the many variables that shape the economic and fiscal outlook, several key factors are expected to play a particularly influential role over the next five years:

- Geopolitical instability:** The protracted uncertainty stemming from the ongoing Middle East conflict, alongside other regional and internal conflicts, poses a considerable risk to global economic stability, with potential ramifications for global growth trajectories, international capital markets, cross-border trade flows, and energy price dynamics.
- Trade policy issues:** Building on the trade policy risk noted in Section 2, a further complicating factor is the pace of domestic trade liberalisation, including the gradual removal of para-tariffs and the easing of foreign exchange management measures such as import restrictions. While necessary for economic liberalisation, this transition adds complexity to the external sector outlook, with potential pressure on export earnings, import costs, and foreign exchange reserves.
- Commodity Price Volatility:** The trajectory of global oil, food, and fertiliser prices over the medium term remains highly uncertain, posing significant risks to the economic and fiscal outlook of Sri Lanka. A sustained increase in oil prices would increase energy import costs,

pressure foreign exchange reserves, and fuel broader inflationary pressures, while escalating food prices could raise the cost of living and necessitate additional government spending on social assistance. Higher fertiliser prices would weigh on agricultural productivity and domestic food security. Collectively, continued volatility in global commodity prices could widen the current account deficit, weaken the exchange rate, and elevate borrowing costs, posing considerable risks to macroeconomic stability and fiscal sustainability over the medium term.

- **Demographic Change:** Beyond the expenditure pressures already noted in Section 3 (pensions, healthcare, and elderly support), demographic trends also pose a risk to the revenue base. If recent patterns of outward migration, declining birth rates, and lower population growth persist, they would shrink the size and productive capacity of the labour force, weighing on long-term growth and the tax base.

### Steps Being Taken to Manage Macro-Fiscal Risks

Building on the recovery described in Section 1, the Government's fiscal strategy, centred on revenue-based fiscal consolidation, remains firmly aligned with medium-term revenue targets that are anchored to debt sustainability objectives.

Notwithstanding this progress, the Government recognises the high likelihood of macro-fiscal risks emanating from the external sector, as outlined earlier. As an immediate response to this geopolitical risk, the Government has introduced a targeted relief package to support individuals and energy suppliers in mitigating the impact of rising energy costs. Concurrently, measures have been taken to raise policy interest rates to anchor domestic price stability, implement cost-reflective pricing in the energy sector, and introduce policies to manage the depreciation of the rupee against the US dollar while maintaining foreign exchange

reserves at sustainable levels, thereby safeguarding macroeconomic stability in the face of external headwinds.

Despite the notable fiscal performance recorded in 2025 and the first five months of 2026, the Government needs to further strengthen fiscal consolidation efforts to address recurring external and domestic vulnerabilities. To this end, maintaining primary expenditure at a level not exceeding 13 percent of GDP, alongside the formulation and implementation of the Medium-Term Revenue Strategy (MTRS), will be essential in ensuring continued fiscal sustainability. The Government remains committed to full execution of the public investment programme, with a strong emphasis on minimising implementation bottlenecks to unlock the economy's growth potential over the medium to long term.

The Government is actively pursuing broader structural reforms to create an enabling environment for private sector investment and sustainable economic growth. Key reform priorities include export diversification, attraction of foreign direct investment, digital transformation, energy sector reforms, and transportation infrastructure improvements. These reforms are expected to foster inclusive and broad-based economic growth, while ensuring that vulnerable segments of the population are adequately protected, thereby contributing to sustained macroeconomic stability over the medium term.

Recognising the critical importance of labour market development, the Government is introducing targeted policies to incentivise labour force participation and raise overall participation rates. These efforts are complemented by a knowledge-based economic growth agenda driven by a Key Performance Indicators (KPIs)-based reform framework, aimed at building the necessary institutional infrastructure and staff capacity to deliver on the Government's development objectives.

## Summary Assessment:

Probable, High Potential Impact.	Rating									
<p>Macroeconomic shocks are assessed to carry a greater than 50 percent likelihood of impacting the Sri Lankan economy within the coming five years. As an open economy, Sri Lanka remains particularly vulnerable to a range of external shocks, including global commodity price volatility, shifts in international capital flows, exchange rate pressures, and disruptions to key export markets and tourism receipts. The nature and severity of such shocks are difficult to predict, yet their fiscal implications could be material. These vulnerabilities are further compounded by ongoing geopolitical tensions in the Middle East, global trade policy uncertainties, and the risk of tightening global financial conditions, all of which could pressure Sri Lanka's foreign exchange reserves, borrowing costs, and debt servicing capacity. The Government is actively managing these risks through a range of mitigation measures, including significant debt reduction to enhance fiscal flexibility, building of policy buffers, and timely policy responses to ensure continued adherence to the fiscal strategy's targets and safeguard medium-term macroeconomic stability.</p>	<table border="1"> <tr> <td></td> <td></td> <td style="background-color: black;"></td> </tr> <tr> <td></td> <td></td> <td></td> </tr> <tr> <td></td> <td></td> <td></td> </tr> </table>									

### (B) Fiscal Risks Arising from State-Owned Enterprises (SOEs)

State-Owned Enterprises remain a cornerstone of the Sri Lankan economy, dominating strategic sectors like energy, aviation, and transport. However, they represent a double-edged sword: while they provide essential services, their structural and financial vulnerabilities create significant explicit and contingent fiscal risks for the Government.

Between 2021 and 2025, the SOE sector was characterised by persistent operational losses, high leverage, and severe liquidity constraints. These issues have forced substantial government interventions, including debt absorption (notably USD 2.46 billion for the Ceylon Petroleum Corporation) and recurring capital injections for loss-

making entities like SriLankan Airlines.

### Scope and Coverage of the Fiscal Risk Analysis

The analysis is based on a selected sample of twelve major non-financial SOEs, namely: Ceylon Electricity Board\* (CEB), Central Engineering Consultancy Bureau (CECB), Ceylon Petroleum Corporation (CPC), Lanka Sathosa Limited (Sathosa), Milco (Private) Limited (MILCO), National Water Supply & Drainage Board (NWSDB), Sri Lanka State Plantation Corporation (SLSPC), Lanka Sugar Company (Private) Limited (LSCL), Sri Lanka Transport Board (SLTB), SriLankan Airlines Limited (SLA), Sri Lanka Ports Authority (SLPA), and State Pharmaceuticals Corporation (SPC).

The analysis was conducted primarily on audited financial statements for 2021–2025 of these twelve major non-financial SOEs. It focuses on profitability, liquidity, leverage, and fiscal exposure, including Government guarantees, on-lent loans, and quasi-fiscal activities.

### Methodology for Fiscal Risk Assessment (IMF HCT-Based Approach)

The assessment used the State-Owned Enterprise Health Check Tool (SOE-HCT) of the International Monetary Fund. The tool evaluates SOEs using indicators grouped under four dimensions:

<b>Profitability</b>	Return on Assets, Return on Equity, and cost recovery.
<b>Liquidity</b>	Current Ratio, Quick Ratio, and working capital indicators
<b>Solvency</b>	Debt ratios and debt servicing capacity.
<b>Fiscal Exposure</b>	Guarantees, on-lent loans, foreign currency liabilities, and quasi-fiscal activities.

Each entity is assigned a risk rating ranging from very low to very high risk. The results are then reviewed collectively to identify systemic fiscal risks.

### SOE Fiscal Linkages and Government Exposure

- The selected twelve SOEs represent a substantial portion of the non-financial

\* As per the Sri Lanka Electricity (Amendment) Act, No. 14 of 2025, the Ceylon Electricity Board has been unbundled in to six state owned companies.

SOE sector, both in terms of asset base and fiscal exposure. Entities such as the CEB, CPC, and SLA are systemically important, with large-scale operations, significant borrowing requirements, and direct or implicit Government support mechanisms. The Government's fiscal exposure to these SOEs arises through multiple channels, including: Budgetary transfers and capital injections

- Treasury guarantees on domestic and external borrowings
- On-lent loans and debt restructuring arrangements
- Settlement of inter-SOE liabilities and accumulated losses

These linkages have, in recent years, translated into substantial fiscal costs, particularly during periods of macroeconomic stress.

### Key financial trends observed during 2021-2025

- **Weak Profitability:** Persistent losses in several SOEs due to operational inefficiencies, delays in cost-recovery pricing, and exposure to exchange rate depreciation.
- **Liquidity Constraints:** Cash flow pressures resulting in short-term borrowing, delayed payments, and reliance on Government support.
- **High Leverage:** Elevated debt levels, significant Government-guaranteed borrowings, and weak debt servicing capacity.
- **Foreign Exchange Exposure:** Vulnerability to exchange rate fluctuations, especially among entities with foreign currency liabilities.
- **Inter-SOE Liabilities:** Cross obligations among major SOEs, particularly in the energy sector, which increase systemic fiscal risk.

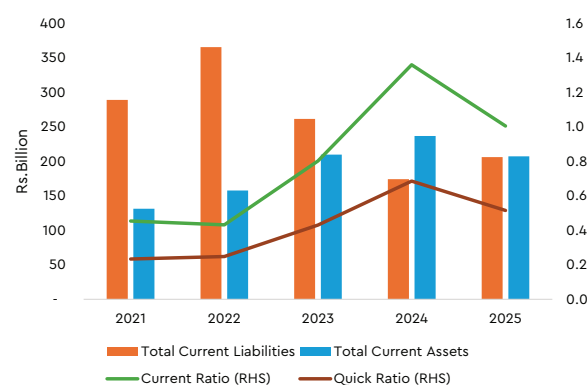
These weaknesses create several fiscal risks, including the possible realization of contingent liabilities, quasi-fiscal obligations, and direct financial burden on the budget.

### Examples for Fiscal Risk Realisation

The effect of fiscal risks within the SOE sector can be observed through several major entities that required significant Government intervention and financial support in recent years. These cases illustrate how operational weaknesses, foreign exchange exposure, pricing distortions, and high debt burdens may ultimately translate into direct fiscal costs, contingent liabilities, and broader pressures on public finances.

**SriLankan Airlines** has consistently needed repeated government support in the form of guarantees, restructuring efforts, and capital assistance, driven by ongoing operational losses and exposure to foreign currency fluctuations.

Figure 13 | Short-term liquidity Ratios – SLA

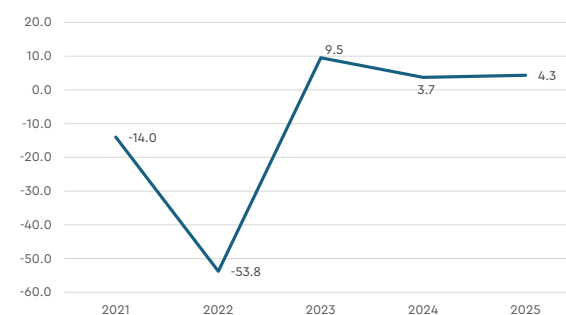


Source : Department of Public Enterprises

**Ceylon Petroleum Corporation** generated significant fiscal pressures during the 2022 crisis, leading to the transfer of approximately USD 2.46 billion of guaranteed debt to the Government. The introduction of a monthly cost-recovery pricing mechanism in May 2022, the enactment of the Petroleum Products (Special Provisions) (Amendment) Act, No. 27 of 2022, and the restructuring of CPC's balance sheet to improve financial sustainability and reduce fiscal risks.

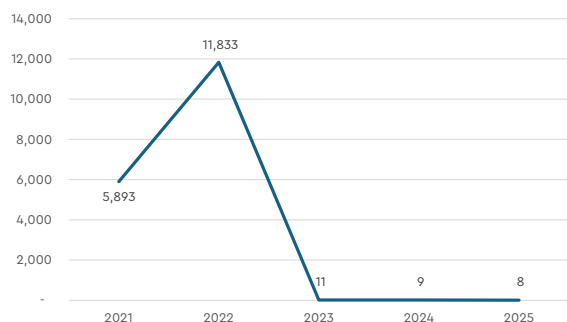
Figure 14 | Net Profit Ratio – CPC

(Net Profit Ratio (%))



Source : Department of Public Enterprises

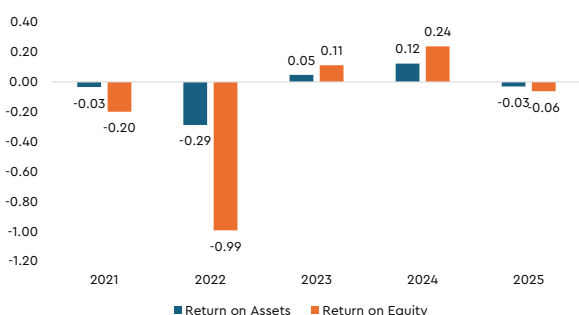
**Figure 15 | Loans & Borrowings – CPC**  
(Rs Million)



Source : Department of Public Enterprises

**Ceylon Electricity Board** reported significant losses in 2022, driven by tariff under-recovery and exchange losses. Although subsequent tariff adjustments and balance sheet restructuring have strengthened its financial standing, the entity remains systemically important and continues to require close oversight.

**Figure 16 | Rates on Return – CEB**



Source : Department of Public Enterprises

## Detailed Fiscal Risk Analysis

### Overall Risk Profile

**Figure 17| Overall Risk Rating**

	Overall Risk Rating
CEB	Low Risk
SLA	High Risk
NWSDB	Medium Risk
SLPA	Low Risk
CPC	Low Risk
SPC	Medium Risk
SLTB	Medium Risk
Sathosa	High Risk
MILCO	High Risk
LSCL	High Risk
CECB	Medium Risk
SLSPC	High Risk

The assessment reveals a varied risk profile among the selected SOEs. Following pricing reforms and operational adjustments, CEB, CPC, and SLPA now demonstrate comparatively stronger financial positions. In contrast,

SLA, Sathosa, MILCO, LSCL, and SLSPC continue to fall into the high-risk category driven by ongoing losses, poor liquidity, and heavy debt burdens.

### Profitability Risks

**Figure 18 | Profitability Risk Analysis**

	Return on Assets	Return on Equity	Cost Recovery
CEB	Very Low risk	Very Low risk	Low risk
SLA	Medium Risk	Very High risk	Medium Risk
NWSDB	Medium Risk	Medium Risk	Very Low risk
SLPA	Low risk	Medium Risk	Low risk
CPC	Very Low risk	Very Low risk	Medium Risk
SPC	Medium Risk	Medium Risk	Medium Risk
SLTB	Very High risk	High risk	High risk
Sathosa	Very High risk	Very High risk	High risk
MILCO	High risk	Medium Risk	Medium Risk
LSCL	Very High risk	Very High risk	High risk
CECB	Medium Risk	Medium Risk	Medium Risk
SLSPC	High risk	Medium Risk	Very High risk

A number of SOEs continue to post recurrent losses and low returns on assets and equity. The weakest performers are largely found in aviation, retail distribution, transport, and agro-based industries. Although profitability in CEB and CPC improved following cost-recovery pricing reforms, results remain vulnerable to external shocks.

Fiscal implication: Sustained losses may require budgetary transfers, capital injections, or debt restructuring.

### Liquidity Risks

A number of SOEs face cash flow constraints and limited capacity to meet short-term obligations. Entities such as SLA, Sathosa, NWSDB, and SLSPC exhibit particularly weak liquidity positions.

**Figure 19| Liquidity Risk Analysis**

	Current Ratio	Quick Ratio	Debtor Turnover Days	Creditor Turnover Days
CEB	Medium Risk	Medium Risk	Low risk	Low risk
SLA	Very High risk	Very High risk	Medium Risk	*
NWSDB	Very High risk	High risk	Very High risk	Very High risk
SLPA	Very low risk	Very low risk	Very High risk	Very low risk
CPC	High risk	Very High risk	Very low risk	Very low risk
SPC	Medium Risk	Very low risk	Very High risk	Medium Risk
SLTB	High risk	Low risk	Very low risk	Low risk
Sathosa	Very High risk	Very High risk	Very low risk	Medium Risk
MILCO	High risk	Very High risk	Very low risk	Very low risk
LSCL	Low risk	High risk	Very low risk	Very High risk
CECB	Medium Risk	Very low risk	Very High risk	Very High risk
SLSPC	Very High risk	Very High risk	Very High risk	Very low risk

Fiscal implication: Liquidity shortages can lead to requests for short-term Government support or additional guarantees.

\* The Financial Statements of SLA do not disclose the cost of sales; therefore, the Creditor Turnover Days cannot be calculated.

**Solvency and Debt Sustainability Risks**

High leverage and weak debt servicing capacity remain major concerns. SLA, Sathosa, MILCO, and LSCL demonstrate very high-risk ratings across several debt indicators.

Fiscal implication: These entities pose significant contingent liability risks, especially where borrowings are based on Government guarantees.

While CEB, CPC, and SLPA now demonstrate comparatively stronger financial positions following pricing reforms and balance sheet restructuring, caution is warranted in interpreting their low-risk ratings. In the case of CEB and CPC in particular, improved financial indicators are in part attributable to the absorption of accumulated losses and guaranteed debt by the Treasury, which represents a transfer of risk rather than its elimination. Both entities retain structural vulnerabilities, including dependence on administratively set pricing, foreign currency exposure in fuel and equipment procurement,

and sensitivity to commodity price shocks that could rapidly reverse recent gains in the absence of sustained reform implementation.

**Figure 20| Solvency and Debt Sustainability Analysis**

	Debt to Assets	Debt to Equity	Debt to EBITDA	Interest Coverage	Cash Interest Coverage	Debt Coverage
CEB	Low risk	Low risk	Medium Risk	Very low risk	Very low risk	Very low risk
SLA	Very High risk	Very High risk	Very High risk	Very High risk	Very High risk	Very High risk
NWSDB	Low risk	Low risk	Very High risk	Medium Risk	Medium Risk	High risk
SLPA	Very low risk	Very low risk	Medium Risk	Very low risk	Very low risk	Very low risk
CPC	Medium Risk	Very High risk	Very High risk	Very low risk	Very low risk	Very low risk
SPC	Medium Risk	Very High risk	Very High risk	Medium Risk	High risk	High risk
SLTB	Low risk	Low risk	Very High risk	Very low risk	Very low risk	Very low risk
Sathosa	Very High risk	Very High risk	Very High risk	Very High risk	Very High risk	Very High risk
MILCO	Medium Risk	Very High risk	Very High risk	Very High risk	Very High risk	Very High risk
LSCL	Medium Risk	Medium Risk	Very High risk	Very High risk	Very High risk	Very High risk
CECB	Medium Risk	Medium Risk	Medium Risk	Very low risk	Very low risk	Very low risk
SLSPC	Low risk	Low risk	Very High risk	Very High risk	Very High risk	Very High risk

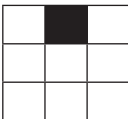
**Fiscal Risk Mitigation Strategies**

The Government's stated risk mitigation strategy rests on six pillars:

- i. **Targeted restructuring** of high-risk SOEs, including operational and financial restructuring plans
- ii. **Cost recovery and pricing reform:** building on the May 2022 monthly fuel pricing mechanism and electricity tariff adjustments, to prevent recurrence of large quasi-fiscal losses
- iii. **Fiscal discipline and borrowing controls:** limiting new guaranteed borrowing and enforcing borrowing ceilings
- iv. **Liquidity and financial management improvements:** strengthening cash flow management and reducing reliance on Government short-term support
- v. **Governance and oversight strengthening:** improved board accountability and performance monitoring frameworks

- vi. **Contingent liability management and fiscal transparency:** systematic disclosure and monitoring of guarantees and on-lent loans

**Summary Assessment:**

Possible, High Potential Impact.	Rating
<p>SOE-related fiscal risks are assessed to carry a greater than 50 per cent likelihood of materialising within the coming five years. As the primary provider of essential services including energy, water, transport, and aviation, Sri Lanka's State-Owned Enterprises remain a significant source of contingent fiscal exposure. The financial vulnerabilities of these entities including persistent losses, weak liquidity, high leverage, and foreign currency liabilities create multiple channels through which fiscal risks may be transmitted to the Government, including through the crystallisation of Treasury guarantees, demands for capital injections, settlement of inter-SOE liabilities, and absorption of quasi-fiscal losses. The nature and timing of such crystallisations are difficult to predict with precision, yet their fiscal implications could be material, as evidenced by the realisation of approximately USD 2.46 billion in CPC-related guaranteed debt during the 2022 economic crisis. These vulnerabilities are further compounded by the concentration of high-risk entities in commercially sensitive sectors, exposure to global commodity price and exchange rate fluctuations, and the risk of policy reversal on cost-recovery pricing mechanisms, all of which could rapidly erode recent financial gains and renew pressures on public finances. The Government is actively managing these risks through a range of mitigation measures, including targeted restructuring of high-risk SOEs, strengthening of cost-recovery and pricing frameworks, enhanced borrowing controls, and improved governance and oversight arrangements, with a view to reducing the contingent liability burden on the budget and safeguarding the medium-term fiscal consolidation path.</p>	

**(C) Fiscal Risks Arising from Public Debt, Guarantees and On-lending**

Fiscal risks arise when governments issue debt to finance recurrent deficits, fund public investment, or provide guarantees for loans raised by State-Owned Enterprises, provincial councils, and local authorities. The Government's overall level of indebtedness is a direct function of its historical fiscal performance, including instances where these risks have materialised. Governments make strategic borrowing decisions regarding the composition of their debt portfolios, including the term structure of debt, the choice between domestic and foreign currency borrowing, and the use of fixed or variable interest rate instruments, in line with the Medium-Term Debt Management Strategy (MTDS). These decisions are intended to balance borrowing costs against the associated risks and to promote debt sustainability over the medium term.

In addition, when governments borrow on behalf of or extend guarantees to, other public sector entities, they effectively assume contingent liabilities by committing to service or repay such obligations should the underlying entities be unable to meet their debt obligations.

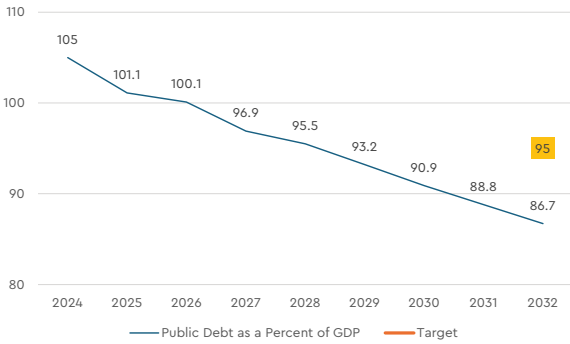
**Debt Reduction Objectives**

Reducing the risks and vulnerabilities associated with Sri Lanka's high public debt levels has been a central objective of the IMF-EFF programme, as outlined in the Fiscal Strategy Statement 2027 and related programme documents. The policy measures undertaken to restore macroeconomic stability, combined with the near-completion of public debt restructuring, have played a pivotal role in placing Sri Lanka's debt on a sustainable trajectory and strengthening long-term fiscal resilience.

**Debt Sustainability Targets**

The latest projections indicate that the objective of reducing public debt to below 95 percent of GDP by 2032 is well on track.

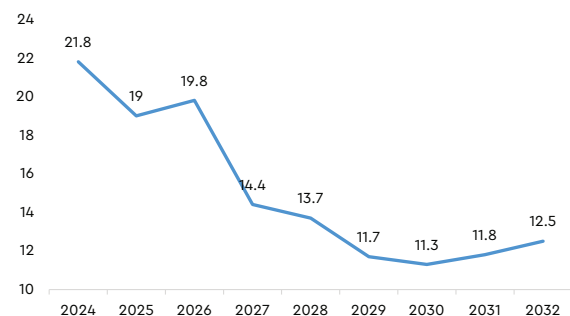
**Figure 21 | Public Debt**  
(As a percentage of GDP)



Source : Central Bank of Sri Lanka and IMF – EFF Programme

As outlined in the Fiscal Strategy Statement, achieving a durable reduction in public debt will require sustained fiscal consolidation over an extended period to bring debt to safer and more prudent levels, thereby restoring policy space and enhancing macroeconomic resilience. An IMF debt sustainability analysis has been conducted and updated regularly as part of the existing programme. In parallel, the Ministry of Finance is strengthening its internal analytical capacity to conduct debt sustainability assessments, with annual DSA reports expected to be published commencing in 2027. In addition to the objective of reducing public debt, one of the key targets relating to debt sustainability is maintaining annual gross financing need (broadly the amount of debt required to cover new borrowing plus refinancing) at manageable levels. Under the IMF-supported programme, Sri Lanka has committed to maintaining average annual Gross Financing Need (GFN) below 13 percent of GDP during the period 2027–2032. The latest projections indicate that this target is expected to be met, with average GFNs projected at 12.6 percent of GDP, marginally below the programme threshold.

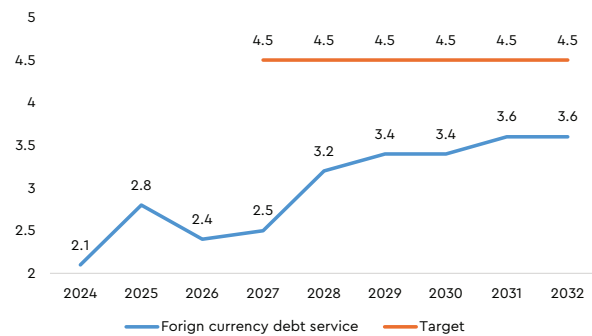
**Figure 22 | Gross Financing Needs**  
(As a percentage of GDP)



Source : IMF – EFF Programme

Another programme target relating to public debt focuses on limiting the debt portfolio's exposure to foreign currency risk. Specifically, the objective is to ensure that annual foreign currency debt service obligations do not exceed 4.5 percent of GDP in any year over the period 2027–2032. The latest projections indicate that this target is also expected to be met, with foreign currency debt servicing requirements remaining within the prescribed threshold throughout the projection horizon.

**Figure 23 | Foreign Currency Debt Services**  
(As a percentage of GDP)



Source : IMF – EFF Programme

### Reforms to Support Debt Sustainability

A range of institutional and policy changes have been implemented since the 2022 crisis to reduce vulnerabilities and strengthen risk management and oversight for the public debt portfolio. These include:

- Public Financial Management Act, No. 44 of 2024 and Public Debt Management Act, No. 33 of 2024: these landmark laws have modernised fiscal governance and public debt management in Sri Lanka, establishing a rule-based fiscal responsibility framework and providing the statutory basis for the Public Debt Management Office.
- Primary Balance Target: a primary surplus target of at least 2.3 percent has been established as the central fiscal anchor for debt reduction, with the 2025 outturn of 5.4 percent of GDP significantly exceeding this target and demonstrating the credibility of the fiscal consolidation effort.
- Debt restructuring: the near-complete restructuring of public debt has substantially concluded, including

arrangements with official bilateral creditors and the sovereign bond exchange. This has materially improved the outlook for debt sustainability and contributed to credit rating upgrades by major international rating agencies.

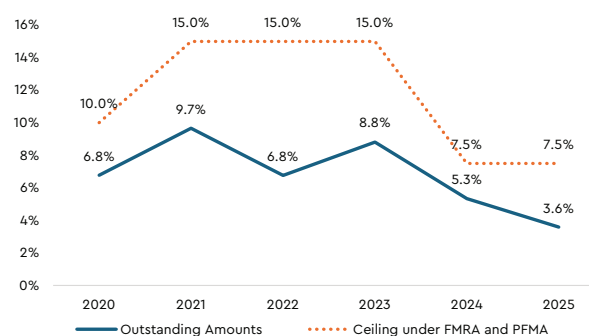
- **Public Debt Management Office:** established in December 2024 and now fully operational, the PDMO has assumed primary responsibility for government debt management functions previously conducted by the Central Bank of Sri Lanka, including the conduct of government security auctions.
- **Medium-Term Debt Management Strategy:** the MTDS, covering the current and four succeeding financial years, has been published and updated annually. The strategy guides portfolio composition decisions, with a focus on reducing reliance on foreign-currency-denominated debt and lengthening the average maturity of the portfolio to reduce refinancing risk.
- **Annual Borrowing Plan:** published to provide a forward-looking overview of the Government's borrowing programme for the upcoming financial year, including the planned composition of domestic and external borrowing, supporting predictability and transparency in debt management operations.
- **Transparency and reporting:** the PDMO publishes a Quarterly Statistical Debt Bulletin and Semi-Annual and Annual Debt Reports, providing regular and comprehensive information on the debt portfolio and debt management operations.

The institutional and policy framework established under the IMF-EFF programme provides a strong foundation for continued debt management beyond the programme period. Adherence to the fiscal targets set out in the PFMA and the Fiscal Strategy Statement will be essential to sustaining the debt reduction trajectory and restoring Sri Lanka's sovereign credit standing over time.

## Treasury Guarantees

The outstanding value of debt of SOEs that is guaranteed by the Government of Sri Lanka stood at approximately Rs. 1,080.18 billion at the end of 2025, or approximately 3.59 percent of the average GDP of the past three years (Figure 24). This balance is counted within total public sector debt for the purposes of the Government's debt reduction objective under the fiscal strategy.

**Figure 24 | Outstanding Loan Guarantees**  
(as a share of 3yr-avg GDP)



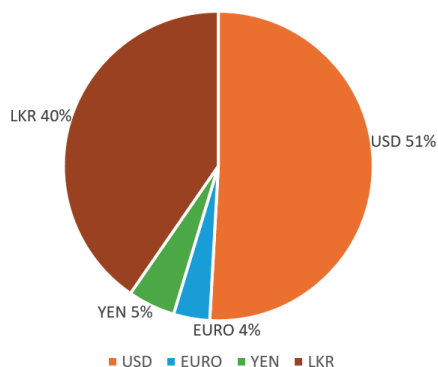
*Note: Guaranteed issued to the Public Private Partnership Projects are not included in the outstanding amount)*

*Source: Public Debt Management Office*

There is also a separate limit under the PFMA that restricts the outstanding stock of government guarantees to less than 7.5 percent of the average GDP for the relevant financial year and the preceding two financial years. In addition, a new policy framework has been developed to ensure appropriate scrutiny of requests for new loan guarantee on lending and an assessment of the financial health and creditworthiness of requesting entities, typically statutory bodies or SOEs.

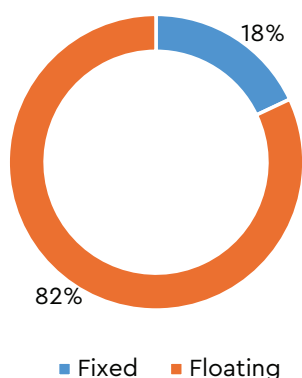
The largest outstanding loan guarantees are extended to the National Water Supply and Drainage Board (Rs. 237.69 billion), the Road Development Authority (Rs. 209.46 billion), and the Central Bank of Sri Lanka (Rs. 201.94 billion). Collectively, these arrangements account for approximately 60 percent of the outstanding guarantee portfolio.

**Figure 25 | Guaranteed Debt Outstanding by Currency**



Source : Public Debt Management Office

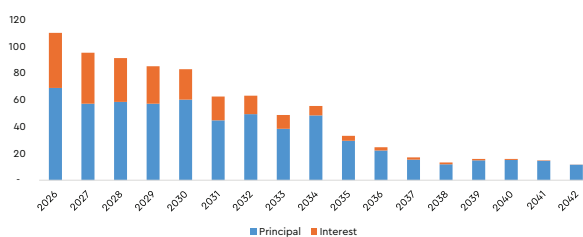
**Figure 26 | Guaranteed Debt Outstanding by Interest Type**



Source : Public Debt Management Office

At the end of the 2025 financial year, the government's portfolio of guaranteed obligations contains a significant share of foreign currency denominated obligations, accounting for around 60 percent of the total portfolio, of which approximately 51 percent is denominated in US dollars along with a substantial proportion of loans carrying floating interest rates.

**Figure 27 | Guaranteed Debt Exposure at Default/ Distress for next 16 Years (Rs Billion)**



Source : Public Debt Management Office

(a) Provisional;

(b) Principal and Interest forecasts of FX loan guarantees obtained from relevant SOEs, Principal and Interest forecasts of Domestic loan guarantees obtained from the Meridian debt management system based on the terms and conditions received from local banks excludes Principal/ interest arrears;

(c) Details of the guarantees provided to the financial SOEs, guarantees issued for the letters of credit, payment guarantees, and loan guarantees under restructuring, including Sri Lankan Airlines have been excluded.

In 2025, no new loan guarantees were issued by the Government. However, extensions were granted to the guarantee period of several existing SOE arrangements. The guarantee period of a payment guarantee issued on behalf of the Sri Lankan Airlines Limited, amounting to USD 11.6 million, was extended by one-year, while a guarantee issued on behalf of the Central Bank of Sri Lanka, amounting to USD 1,101.43 million for the Special Swap Agreement, was extended for 1.5 years and guarantee issued on behalf of Lanka Coal Company Pvt Ltd amounting to Rs. 2.2 billion was extended until 22.10.2026. Additionally, a loan guarantee of USD 5.38 million related to overdue amounts pertaining to interest and other costs accrued under two restructured loans of the Export-Import (EXIM) Bank of India obtained by the National Water Supply and Drainage Board was issued in 2025. Further, the guarantee periods of each restructured loan obtained from the EXIM Bank of India and China Development Bank were reissued in accordance with revised terms and conditions.

During 2025, the Treasury met guarantee obligations amounting to Rs. 18.1 billion on behalf of the State Engineering Corporation, North SEA Limited, the Ceylon Fisheries Corporation, Mihin Lanka PVT Ltd, Paddy Marketing Board, Lanka Sathosa Ltd, Techno Park Development Company Pvt Ltd, and National Paper Company Ltd.

**Risk Quantification:**

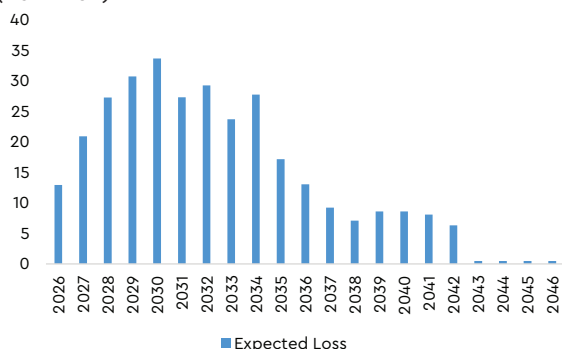
The overall fiscal risk assessment for the total guarantee portfolio has been conducted only for 13 non-financial SOEs out of 22, based on the availability of debt data and audited financial statements. Guarantees granted to four entities (Ceylon Shipping Corporation Ltd, State Engineering Corporation of Sri Lanka, Co-Operative Wholesale Establishment, and Lanka Coal Company (pvt) Ltd) have

been excluded from the analysis due to the unavailability of audited financial statements for 2023 or 2024, as well as draft financial statements for 2025.

Further, payment guarantees, guarantees issued for the letters of credit, and guarantees under restructuring and guarantees given to the National School of Business Management Limited (due to organizational restructuring) have also been excluded from the analysis.

Accordingly, the total outstanding of the portion considered in the analysis is Rs. 629.11 billion, which is 58 percent of the total guarantee portfolio and 1.9 percent of GDP. The present value of total expected loss is Rs. 169.04 billion, which is 0.52 percent of GDP. However, for some of the SOEs, such as RDA and NWSDB, the government has already undertaken the debt service payment of guaranteed loans through equity infusion or gap financing arrangements.

**Figure 28 | Expected Loss**  
(Rs Billion)



Source: Public Debt Management Office

### Risk Mitigation Mechanisms:

Guarantee fees will be set as a percentage of the total contractual amount or outstanding amount of guaranteed debt, in accordance with the Public Debt Management Regulations. The applicable rate will be determined based on the PDMO's credit risk assessment, with the objective of covering expected losses.

In addition to the guarantee fee, the PDMO will recommend additional risk mitigation measures or covenants as applicable.

### On-lending

The Government of Sri Lanka borrows on behalf of a range of public sector entities through on-lending arrangements, typically where this structure is preferred by development partners

for financing infrastructure development and other policy and investment programmes. This mechanism provides liquidity support for State-Owned Enterprises (SOEs) and other public institutions while enabling the implementation of development projects.

At the end of 2025, the outstanding stock of on-lending amounted to approximately Rs. 234.1 billion, equivalent to around 0.71 percent of GDP. The portfolio is primarily concentrated in infrastructure-related financing, with the Sri Lanka Ports Authority representing the largest single exposure at approximately Rs. 54 billion.

Around 87 percent of the on-lending portfolio relates to foreign-financed loans from multilateral agencies and development partners, while the remaining 13 percent is financed through domestic sources. During 2025, on-lending operations also supported the Micro, Small and Medium Enterprises (MSME) sector through disaster relief financing and ongoing recovery programmes, including disbursements under facilities initiated in 2024 to re-energise the MSME sector.

Overall, on-lending continues to serve as an important financing mechanism for development projects and SOE investment needs, while also creating contingent credit exposures for the central government that require careful monitoring within the broader fiscal risk framework.

### Summary Assessment:

Possible, Medium Potential Impact.	Rating									
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<p>There is a medium likelihood that risks may materialise over the next five years, potentially affecting the cost of servicing Sri Lanka's debt. In particular, fluctuations in exchange rates and interest rates remain key sources of risk. External shocks, including geopolitical developments such as conflicts in the Middle East, could contribute to heightened volatility in both exchange rates and interest rates.</p> <p>The potential impact of these risks is assessed as medium, taking into account the measures being implemented to</p>										

strengthen debt sustainability and enhance the resilience of the debt portfolio. These measures include efforts to reduce public debt levels, mitigate refinancing risks, particularly within the domestic debt portfolio, smooth the debt maturity profile through debt restructuring, and maintain prudent borrowing practices in line with the Medium-Term Debt Management Strategy.

In addition, regularise the mechanism for issuing loan guarantees and on-lending through financial viability analyses, the adoption of risk mitigation mechanisms, such as guarantee fees and on-lending premiums based on credit risk assessments, and the application of policy limits on the issuance of government guarantees, are expected to help contain potential fiscal risks and reduce the government's exposure to contingent liabilities.

#### **(D) Fiscal Risks Arising from Natural Disasters and Climate Change**

This assessment focuses on fiscal risk exposures arising from current natural hazards. While climate change is expected to alter the frequency and severity of these hazards over time, forward-looking climate scenario analysis is not included in the present assessment.

##### **Sri Lanka's exposure to climate and disaster-related risks**

Sri Lanka is exposed to chronic and acute climate and disaster risks. Acute hazards include floods, droughts, landslides, and cyclones, which are among the most significant regularly occurring events. Chronic hazards include gradual sea-level rise, saline intrusion into coastal aquifers and river systems, rising mean temperatures, and shifts in monsoon precipitation patterns. Climate change is projected to increase the frequency and intensity of extreme weather events while compounding the effects of slower-onset hazards over time.

These risks affect the country's economic development, population, and natural environment. Chronic and acute climate and disaster-related risks can reduce the productivity of economically important sectors, including agriculture and fisheries,

placing downward pressure on jobs, exports, and incomes. Agriculture, forestry, and fishing employ around a quarter of the workforce and contributed 8.4 percent of GDP in 2025; disruption to these sectors therefore feeds through to household incomes, food security, and export earnings. Rice yields could fall substantially by the 2060s under higher-warming scenarios, while tea productivity at low and medium elevations is also sensitive to changing rainfall patterns<sup>1</sup>. Agricultural production more broadly is threatened by more intense rainfall, deepening drought, and less predictable monsoon seasons, all of which can be influenced or amplified by El Niño-driven climate variability. Fisheries face projected declines in catch potential of around 20 percent by the 2050s, with further pressure from coral reef degradation and damage to coastal ecosystems<sup>1</sup>. Rising temperatures and changing precipitation patterns have broader implications for public health and labour productivity, for example, by expanding the range of climate-sensitive diseases such as dengue, and by increasing heat stress among outdoor workers.

Climate and disaster-related risks can also damage assets, including infrastructure systems on which economic activity depends. The road network of Sri Lanka is vulnerable to flooding, and damage to transport and utility infrastructure can disrupt supply chains and amplify losses across the broader economy. Saline intrusion driven by sea-level rise poses a threat to freshwater supplies that support both municipal water provision and irrigated agriculture in coastal districts. Drought conditions can affect the productivity of hydropower generation, increasing dependence on costlier thermal generation, thereby raising energy costs to the broader economy.

Economic impacts are material: third-party estimates of combined public and private losses from acute climate risks and disasters are approximately 1.5 percent of GDP<sup>2</sup>, rising to between 2.5 percent and 2.8–3 percent of GDP depending on the warming scenarios<sup>3</sup>.

1 <https://www.adb.org/sites/default/files/publication/653586/climate-risk-country-profile-sri-lanka.pdf>

2 <https://openknowledge.worldbank.org/server/api/core/bitstreams/5382c3b1-0c20-54d6-819c-6d7c562ab408/content>

3 <https://www.imf.org/-/media/files/publications/tar/2025/english/tarea2025085-source-pdf.pdf>

By way of illustration, Cyclone Ditwah (2025) resulted in an estimated Rs. 416 billion in losses and Rs. 1,022 billion in recovery needs, capturing both public and private sector impacts<sup>4</sup>.

### Climate and Disaster Risk: Fiscal Transmission Channels

Climate and disaster risks can affect the government's fiscal position through both short-term volatility caused by acute events and longer-term impacts on borrowing capacity. Many of the economic and humanitarian impacts of climate and disaster have consequences for tax revenues, government spending, public debt dynamics, and other relevant fiscal risk metrics.

Acute climate and disaster hazards can trigger contingent liabilities, generate unplanned spending, and lead to lost tax revenue. Public spending on relief and reconstruction can be significant. For example, Cyclone Ditwah caused damage to public transport assets worth an estimated Rs. 296 billion. Economic disruption caused by disasters will typically reduce tax revenues (though reconstruction activity by the private sector may partially offset this). Losses and damages incurred by State-Owned Enterprises (SOEs) may trigger liabilities for the central government. These include SOEs in climate-sensitive sectors such as energy, water, and ports.

Acute impacts could create volatility in Sri Lanka's financial system and external balance. The IMF notes that Sri Lanka faces fiscal risks from guarantees offered to the financial sector, which in turn has significant exposure to climate and disaster-related risks to credit quality. Climate-related pressures on commodity exports and tourism may adversely affect the cost of servicing foreign-currency-denominated debt.

The compounding effects of repeated acute events and adverse chronic trends may potentially reduce Sri Lanka's public borrowing capacity. Reduced output and investment, combined with greater public spending to manage acute risks, may increase the country's debt-to-GDP trajectory.

<sup>4</sup> [http://www.dmc.gov.lk/images/pdfs/PDNA\\_Executive%20Summary\\_Final\\_Published\\_on\\_%2021\\_May.pdf](http://www.dmc.gov.lk/images/pdfs/PDNA_Executive%20Summary_Final_Published_on_%2021_May.pdf)

### Climate and Disaster-Related Fiscal Risk Assessment

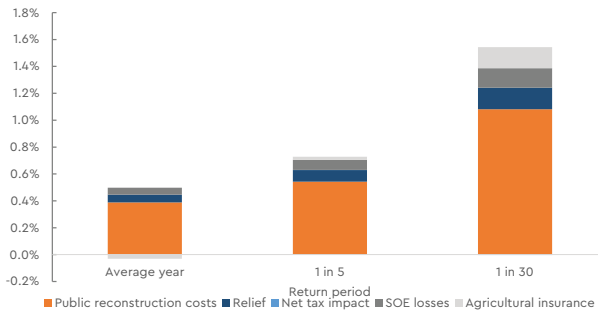
This assessment estimates the fiscal impact of Sri Lanka's current exposure to key climate hazards. The assessment covers cyclones, floods, landslides, and droughts, considering current climatic, socioeconomic, and fiscal conditions. It quantifies public reconstruction costs, relief expenditure, net tax revenue impact, and losses to SOEs and public agricultural insurance. The assessment is calibrated against Post-Disaster Needs Assessments (PDNAs) and World Bank (2021) probabilistic damage curves, and reflects current climate and economic conditions. These sources do not provide a basis to assess broader systemic impacts, nor do they offer a view of how risks will change as a result of future climate change, demographic change, or economic development. The assessment is not exhaustive in its coverage of sources of hazards, and does not include any assessment of chronic hazards such as sea-level rise.

Analysing fiscal risk exposures to key climate hazards is worth around 0.5 percent of GDP in an average year, 0.7 percent in a 1-in-5 year outturn, and increasing to more than 1.5 percent of GDP, or around ~8 percent of government expenditures (2025), in a 1-in-30 year outturn. Impacts are estimated for an 'average year' where disaster impacts are at their typical levels, a '1-in-5 year' outturn (where disaster impacts are at a severity expected in only one year in five), and a '1-in-30 year' outturn. Direct fiscal exposures are estimated at 0.45 percent of GDP in an average year, 0.63 percent in a 1-in-5 year outturn, and 1.24 percent of GDP in a 1-in-30 year outturn (net tax revenues being approximately neutral in all events, with lost taxes from economic disruption being offset by increased revenue from private-sector reconstruction)<sup>5</sup>. Further assessed fiscal risk exposure arising from losses in SOEs and agricultural insurance<sup>6</sup> is worth 0.02 percent of GDP in an average year, 0.1 percent of GDP in a 1-in-5-year outturn, and 0.3 percent of GDP in a 1-in-30-year outturn.

<sup>5</sup> Net tax impacts are zero for the average year, as they are already reflected in yearly tax revenue to GDP ratio which is used to estimate the losses.

<sup>6</sup> SOE losses and Agricultural insurance payouts are indirect exposures. They tend to affect public finances through recapitalisation needs and contingent liabilities, not through direct in-year spending. They are shown in grey to distinguish from direct fiscal channels (relief expenditure, net tax revenue impact). Assessed impacts of droughts on SOEs is based on historical subsidies from the Sri Lanka government to state-owned energy companies as reported in [World Bank \(2021\)](#).

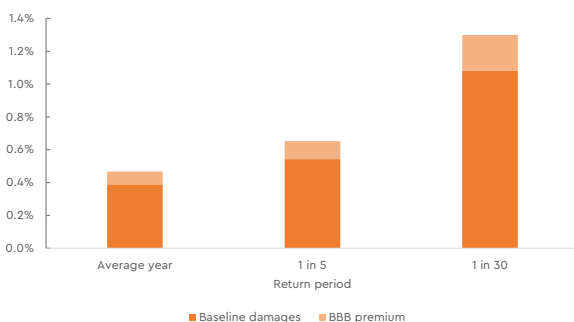
**Figure 29 | Fiscal Impact by Return Period**  
(As a percentage of GDP)



Sources: World Bank and Ministry of Finance, Planning and Economic Development

Analysing public reconstruction costs can be worth 1.1 percent of GDP in a 1-in-30 year event. Where an additional Build Back Better ('BBB') premium is applied, this can increase by 19 percent. Estimated fiscal costs of damages are concentrated in the transport and housing sectors (around 0.7 percent of GDP in a 1-in-30 year event). These numbers are based on the assumption that the government will fund 30 percent of damages to private housing and productive sectors, such as agriculture, commerce, and industry<sup>7</sup>. Increasing this figure to 50 percent would imply public construction costs (without BBB premium) are worth 1.3 percent of GDP in a 1-in-30-year event.

**Figure 30 | Public Reconstruction Costs by Return Period**  
(As a percentage of GDP)



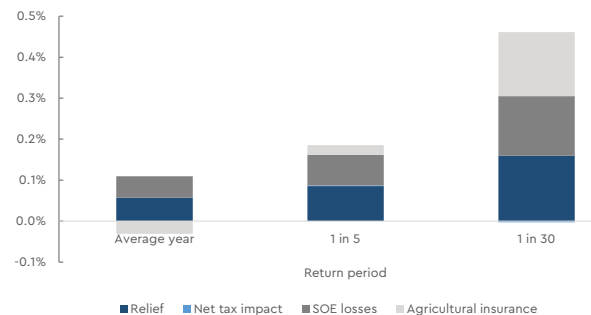
Source: World Bank, Ministry of Finance, Planning and Economic Development

Combined losses from relief spending and net tax revenue impacts are assessed at 0.16 percent of GDP in a 1-in-30 year event. Relief is primarily driven by spending on health and accommodation, or specific support to farmers during droughts. Losses to tax revenues from disruptions to economic

<sup>7</sup> The assumption of a 30% public share of housing reconstruction is approximately consistent with the experience of Ditwah.

activities in the agriculture, commerce, and industry sectors may be partially offset by tax revenue generated by private sector reconstruction activities, and the net fiscal impact will depend on the scale of the disaster, the pace of recovery, and the financing modality of reconstruction.

**Figure 31 | Losses by Channel and Return Period**  
(As a percentage of GDP)



Sources: World Bank and Ministry of Finance, Planning and Economic Development

Analysed losses to SOEs and net agricultural insurance payouts can reach 0.3 percent of GDP in a 1-in-30 year event. Losses to SOEs and state-provided agricultural insurance may create recapitalisation needs and budget support obligations for the government. The majority of analysed SOE losses are from the energy sector, while the analysis of state-backed agricultural insurance shows losses for 1-in-5-year and 1-in-30 year events.

## Managing Fiscal Risks from Natural Disasters

The findings of this assessment highlight the need for a more systematic approach to managing climate and disaster related fiscal risks, with particular attention to three broad areas: budgetary preparedness, the financial resilience of exposed institutions, and dedicated disaster risk financing instruments.

### Budgetary preparedness

Consistent with the direction set out in FRS 2026, the adequacy of existing budget contingencies and reserve allocations for disaster response should continue to be assessed, alongside more detailed planning for managing events of varying severity within the expenditure ceiling outlined in the FSS. Strengthening this area would reduce reliance on ad hoc reallocation from planned capital expenditure when disasters occur.

### **Institutional resilience**

Several State-Owned Enterprises in climate-sensitive sectors, particularly the energy sector, where drought conditions increase reliance on costlier thermal generation, have historically required budget support following climate shocks. Strengthening the financial resilience of these entities, including through cost-reflective pricing and the maintenance of adequate financial buffers to absorb shock-related costs, would reduce the likelihood that climate shocks translate into recapitalisation needs.

### **Disaster risk financing**

A more systematic approach to disaster risk financing, developed with the support of development partners, would help manage the budget volatility caused by major events. This could include contingent financing tools, such as the World Bank's Catastrophe Deferred Drawdown Option, which provides quick access to funds when a disaster is declared. It could also include a review of how affordable and available insurance and reinsurance options are, as a way of shifting some of the financial risk away from the government. Different tools may be better suited to different types of events. For example, routine budget contingencies could cover smaller, more frequent disasters, contingent credit could cover moderate events, and insurance could cover the most severe and costly events. Using a combination of these tools, matched to the scale of the event, is one option worth considering.

Looking ahead, future editions of the Fiscal Risk Statement are expected to progressively expand this assessment, including chronic climate risks and climate scenario analysis. Integrating Build Back Better principles into the public investment framework represents an area for further consideration, ensuring that post-disaster reconstruction enhances resilience and future vulnerabilities rather than merely restoring previously exposed assets. Progress against these areas will be reported in subsequent Fiscal Risk Statements.

### **Summary Assessment:**

<b>Probable, High Potential Impact<sup>8</sup></b>	<b>Rating</b>												
<p>There is a high likelihood of Sri Lanka experiencing material impacts from natural disasters such as cyclones, floods, landslides, and drought within the medium-term planning horizon. While the severity of any individual event is difficult to predict, analysed fiscal risk exposures in this statement are worth around 0.5 percent of GDP (can increase by 15.0 percent if a BBB premium is applied for public reconstruction) in an average year, accounting for both direct impacts on relief and reconstruction expenditure and impacts on SOEs and insurers. In a 1-in-5-year event, this figure increases to 0.7 percent (can increase by 13.7 percent if a BBB premium is applied for public reconstruction). Further, this figure increases to more than 1.5 percent of GDP, approximately 8 percent of government expenditure (2025 terms) (can increase by 13.6 percent if a BBB premium is applied for public reconstruction), in a 1-in-30-year outturn, with more costly events also possible. Recent experience, including Cyclone Ditwah (2025), highlights the scale of reconstruction and relief obligations that severe events can place on the budget.</p>	<table border="1"> <tr> <td></td> <td></td> <td style="background-color: black;"></td> </tr> <tr> <td></td> <td></td> <td></td> </tr> <tr> <td></td> <td></td> <td></td> </tr> <tr> <td></td> <td></td> <td></td> </tr> </table>												

### **E. Fiscal Risks Arising from Public-Private Partnerships (PPPs)**

Public-Private Partnerships (PPPs) are a key modality through which the Government mobilizes private sector capital and expertise for infrastructure and service delivery. While PPPs can reduce the immediate budgetary cost of public investment, they give rise to contingent fiscal obligations that require careful identification and ongoing monitoring. Past experience, both in Sri Lanka and internationally, shows that poorly structured

<sup>8</sup> Assessed as 'High' on the basis that the 1-in-30 year fiscal exposure identified in this assessment (1.5% of GDP) already exceeds the threshold for High potential impact, before accounting for additional likely impacts not covered in this analysis; from hazards such as extreme heat and sea-level rise, and from future changes in hazard frequency and severity due to climate change.

PPP agreements or unsolicited proposals can create long-term fiscal exposures that materialise well after a project is signed.

The principal fiscal risks arising from PPPs include explicit contingent liabilities such as government guarantees, minimum revenue guarantees, and termination compensation obligations embedded in contracts; implicit contingent liabilities arising from pressure to support distressed or renegotiated projects; availability payment and offtake commitments under government-pay structures; and exposures arising from project failure, early termination, or renegotiation.

While line ministries and implementing agencies identify and quantify project-level fiscal exposure for each PPP project, consistent with established procurement and reporting procedures, the Public-Private Partnership Unit (PPPU) maintains a portfolio-level overview, coordinates across agencies, and identifies risk categories that warrant further assessment.

### Government Support, Guarantees, and Contingent Liabilities

Government support across the PPP portfolio takes several forms: provision of land, implementation agreements, regulatory facilitation (including permits, grid access, and offtake arrangements), and, in certain cases, explicit financial guarantees.

- **Land provision:** the most common form of government support, applicable to projects across the energy, port, urban development, health, and hospitality sectors.
- **Implementation agreements:** apply particularly to power sector Build-Own-Operate (BOO) projects, granting contractual protections and risk allocations on private partners.
- **Offtake commitments:** primarily Power Purchase Agreements (PPAs) with the Ceylon Electricity Board (CEB), representing a significant category of contingent fiscal exposure for operational and awarded power projects.

- **Explicit financial guarantees:** currently include a sovereign-backed guarantee for National Thermal Power Corporation Limited's (NTPC) equity contribution in the Trincomalee (Sampur) 50MW Solar Power Joint Venture. This guarantee has been called.
- **Tax concessions:** apply to certain port sector projects, including the South Asia Gateway Terminal and the Colombo International Container Terminal.

### PPP Portfolio

The PPP portfolio comprises 36 projects across six responsible ministries, spanning energy (power and petroleum), health, ports and civil aviation, transport and urban development, industry, and defense. Of these, 25 projects have estimated total project costs, together valued at approximately USD 6.1 billion<sup>9</sup>. The remaining 11 projects are at early stages; proposal, expression of interest, or feasibility, where costs have not yet been estimated.

It is important to note that total project cost reflects the overall scale of investment, the majority of which is privately financed, and does not represent the Government's fiscal exposure. The Government's actual fiscal risk arises only from the specific contingent obligations; guarantees, offtake commitments, and similar instruments, and not from the portfolio's total value.

The energy sector accounts for the largest share of quantified portfolio value (USD 4.1 billion, around two-thirds of the quantified total), reflecting the capital intensity of power generation projects. Six projects, with a combined value of approximately USD 1.7 billion, are already operational, including major port terminal concessions. The full portfolio, including project-level cost estimates and current status, is provided in Annexure III.

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<sup>9</sup> Project costs are presented in USD as reported for each project. One project (Embilipitiya Paper Mills Recommendation) was reported in Sri Lankan Rupees and has been converted to USD at a rate of Rs. 330 per USD for the purposes of this aggregate figure.

## Legal, Institutional, and Organizational Arrangements

Consistent with the commitments set out in FRS 2026, the Government has established the PPP Unit as the central coordination body for PPP development, appraisal, and facilitation, and has progressed a dedicated PPP Bill. Once enacted, the Bill is expected to provide a comprehensive statutory framework governing PPP procurement, risk allocation, fiscal commitment recording, and contingent liability management, addressing a gap identified in the previous Fiscal Risk Statement.

Pending enactment of the Bill, PPP projects continue to be implemented under a framework combining sector-specific legislation, Cabinet-approved procurement processes, and project-level implementation agreements. Individual line ministries retain responsibility for project implementation and contractual management, while the PPP Unit coordinates with line ministries to consolidate portfolio-level data, including for the purposes of fiscal risk reporting.

## Fiscal Risk Types and Observed Materialization

Several categories of fiscal risk have been identified across the PPP portfolio, four of which have already materialised and are described below alongside the specific projects involved.

- **Government guarantees:** a sovereign-backed guarantee for the NTPC's equity contribution in the Trincomalee (Sampur) 50MW Solar Power Joint Venture has been called, representing the materialization of an explicit contingent liability.
- **PPA renegotiation:** the Power Purchase Agreements for the 350MW LNG Sobadhanavi and Sahasdhanavi power plants have been renegotiated. Renegotiations of this kind may involve revised payment terms, extended concession periods, or other fiscal commitments arising from the new contract terms.

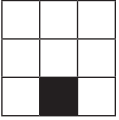
- **Infrastructure contract renegotiation:** the PPP contracts for the Union Place and Abdul Carder Mawatha multi-storied car park projects have been renegotiated, with potential fiscal exposure arising from the revised terms.
- **Early termination:** the South Asia Commercial and Logistic Hub (SACLH) project was discontinued through an early settlement arrangement.
- **Implicit and pipeline exposures:** beyond the materialised risks above, the portfolio contains implicit contingent exposures arising from government support; land, regulatory facilitation, and offtake arrangements, committed to projects still in the pipeline across the energy, ports, and urban development sectors, not yet quantified as contractual terms remain unfinalized. Separately, several projects across the health, industry, and defense sectors remain at early stages with no cost estimates finalized, representing potential future fiscal commitments that cannot yet be assessed.

## Mitigation Measures

To manage the fiscal risks identified above, the PPP Unit promotes risk allocation frameworks within PPP contracts that limit direct government financial exposure, favoring user-pay models where feasible, and carefully assessing the risks involved before any government guarantee or availability payment commitment is made.

As the legal and institutional framework for PPPs is strengthened through the enactment of the PPP Bill, the PPP Unit will work with the Department of Fiscal Policy and the Department of National Budget to develop standardized processes for recording, provisioning, and disclosing PPP-related contingent liabilities in the annual budget and future Fiscal Risk Statements.

## Summary Assessment:

Possible, Low Potential Impact.	Rating 
<p>Current PPP portfolio comprises 36 projects across six sectors, with an estimated total project value of approximately USD 6.1 billion, the majority of which is privately financed and does not represent direct fiscal exposure to the Government. Within this portfolio, several instances of fiscal risk have materialised, including a called government guarantee, renegotiation of Power Purchase Agreements, renegotiation of infrastructure contracts, and the early termination of a major port project. The fiscal impact of these events is yet to be quantified by the relevant line ministries.</p> <p>The potential impact of contingent liabilities being realized under existing PPP contracts is considered relatively low, reflecting the still-modest scale of direct government guarantees and availability payment commitments to PPPs, relative to the overall economy. However, this assessment should be revisited once project-level fiscal impacts are quantified. Risk management measures include the enactment of the PPP Bill, strengthening of risk allocation frameworks in new contracts, and the development of standardised processes for recording and disclosing PPP-related contingent liabilities.</p>	

## F. Fiscal Risks Arising from Financial Sector

### Potential Fiscal Risks arising from Banking and Finance Companies Sectors and Risk Mitigation Strategies

Banking and Finance Companies sectors recorded healthy growths in terms of their asset bases and credit portfolios, while maintaining sufficient liquidity and capital buffers. However, unexpected economic shocks, such as natural disasters, conflicts, or downturns, could increase stage 3 loans and weaken financial sector health. Although stage 3 loans of the sector have declined since the recent crisis, their outstanding level remains

elevated. To address this, banks, especially state-owned ones, should strengthen their capital positions and continue with planned recapitalisation efforts under the Central Bank and Ministry of Finance's recapitalisation framework. In addition, the Central Bank supports stability through monitoring risks and applying prudential rules, while crisis management arrangements are in place to respond if needed.

State-owned banks are heavily reliant on lending to the Government and state-owned entities, meaning a considerable share of their funds is tied to the public sector. If these borrowers fail to repay, the Government may have to step in, especially since many of these loans are backed by state guarantees. In addition, banks hold a significant amount of government securities, and any fall in their value or rise in interest rates could lead to losses, reducing profits and weakening banks' financial strength. This creates a risk that financial problems in these banks could translate into a burden on public finances. To manage this, it is important to limit over-reliance on a few borrowers, strengthen oversight, ensure proper safeguards for lending, and diversify investments.

Although overall liquidity remains strong, banks face risks due to their limited access to foreign currency funds, which suggests that they may find it difficult to meet foreign currency payment needs during periods of stress. Differences between foreign currency inflows and outflows can also create imbalances, leaving banks exposed to exchange rate movements. If the currency weakens or market conditions change suddenly, these pressures could increase and affect financial stability. Such pressures may also create fiscal risks, as the Government could be required to provide support, either directly or through the Central Bank, if banks encounter severe foreign currency shortages. To manage these risks, banks need to closely monitor their foreign currency positions, maintain adequate buffers, and comply with liquidity regulations, while the Central Bank can provide temporary support if needed.

As banking becomes more digital, risks from system failures, fraud, and cyberattacks are rising. Problems such as hacking, service outages, or weak internal controls can lead

to financial losses and damage public trust. These risks are higher in banks that rely on outdated systems, as they are more vulnerable to attacks and disruptions. Cybersecurity is critical because banks are frequent targets and handle sensitive data and large financial transactions. In serious cases, such losses can weaken banks and create fiscal risks, as the Government may need to step in to support state-owned institutions. To reduce these risks, banks need stronger internal controls, better cybersecurity measures, and modern technology systems, since operational problems often arise from failures in processes, people, or systems.

Deposit insurance helps protect people's savings and maintain confidence in the banking system. However, available funds set aside for this purpose are currently inadequate compared to the size of deposits in the banking system. This means that, in a crisis, raising enough money to support troubled institutions could be difficult and may place additional pressure on public finances. Efforts are therefore being made to strengthen the Sri Lanka Deposit Insurance Fund (SLDIF) and improve its capacity to handle potential crises. If the funds set aside to protect depositors run low, the Government may need to step in quickly to provide additional support. Since the available fund is much smaller than the total deposits it covers, any major bank failure could require urgent government financing. This creates fiscal risks, as delays or difficulties in activating this support could worsen the situation and put pressure on public finances. To manage this, it is important to have clear procedures, strong coordination, and readiness to act quickly when needed.

Sri Lanka's Financial Action Task Force (FATF) mutual evaluation began in early 2026 and includes an on-site assessment in later 2026, with the final results expected to be released in early 2027. If a country does not meet international standards to prevent money laundering, it can be placed on the FATF "grey list," meaning it will face closer monitoring by global financial institutions. Being grey-listed can harm the economy by making international transactions more difficult and expensive, reducing foreign investment, and weakening relationships with overseas banks. It can

also disrupt trade and damage the country's reputation. This can slow economic growth, reduce government revenue, and create fiscal pressure, as weaker economic activity and increased costs affect public finances. To avoid these risks, it is important to strengthen systems for preventing financial crimes and ensure they are effectively implemented.

Financial Soundness Indicators of the Banking and Finance Companies sectors are given in Annexure IV.

### **Fiscal Risks arising from the Insurance Sector**

An analysis on material fiscal risks arising from the insurance sector (e.g., fiscal risks arising from state-owned insurance providers, underlying exposures for the Government arising from provision of reinsurance by NITF, including implicit risks if the private insurance market is found to be unable to cope with extreme events).

The underlying exposures for the Government arising from the provision of reinsurance by NITF, including implicit risks should the private insurance market be unable to cope with extreme events, are summarised below:

- NITF presents significant fiscal risks, primarily driven by persistent solvency weaknesses. Its reinsurance business segment has continued to maintain a Capital Adequacy Ratio (CAR) below the regulatory minimum, alongside asset inadequacy, where available financial assets are insufficient to meet insurance contract liabilities.
- These vulnerabilities are further exacerbated by the negative equity position of the Agrahara scheme, increasing the likelihood of fiscal pressure due to a potential inability to meet policyholder obligations.
- In response to political or policy considerations aimed at maintaining affordable premiums, the state-owned insurer may adopt pricing practices that do not fully reflect the underlying risk profile. Consequently, reserves accumulated over time may be inadequate to meet large-scale claims, particularly under stressed conditions.

- The private insurance market is legally required to cede 30% of its general reinsurance liabilities to NITF. However, since February 2023, NITF has operated without retrocession cover. As a result, 100% of this concentrated domestic risk remains on NITF's balance sheet without transfer to the global reinsurance market, increasing systemic dependence on NITF's capacity to meet obligations during stress events.
- Given NITF's weak capital position and absence of retrocession, there is a heightened risk that it may be unable to honour claims in an extreme scenario. This could trigger a domino effect across the insurance sector, where private insurers face solvency pressures due to unrecovered reinsurance receivables.

Financial Soundness Indicators of the Insurance Sector are given in Annexure V.

## 5. Conclusion

The Fiscal Risk Statement 2027 presents a comprehensive assessment of the principal risks facing Sri Lanka's public finances, spanning macroeconomic uncertainty, State-Owned Enterprises, public debt, guarantees and on-lending, Public-Private Partnerships, climate and natural disaster-related risks, and financial sector risks. Taken together, these risks underscore that the fiscal position, while considerably strengthened since 2022, remains exposed to both cyclical shocks and structural vulnerabilities. Macroeconomic risks, together with climate and disaster-related risks, are assessed as carrying the highest combined likelihood and fiscal impact, reflecting Sri Lanka's continued exposure to external volatility and recurrent natural hazards. Risks emanating from SOEs, although moderated by recent reforms in the energy and ports sectors, remain significant given persistent operational losses and contingent liabilities in aviation, water, and agro-based enterprises. Debt, guarantee, and on-lending risks, alongside financial sector risks introduced for the first time in this year's assessment, carry medium potential fiscal impact but warrant sustained monitoring as

the debt restructuring process concludes and as linkages between sovereign and financial sector exposures evolve.

Beyond these categorised risks, the Government faces a set of foreseeable fiscal pressures over the medium term, including elevated debt servicing obligations, social protection needs, demographic ageing, climate adaptation and disaster reconstruction, infrastructure investment requirements, and the costs of ongoing SOE restructuring. These pressures are compounded by external uncertainties, including geopolitical instability, the pace of trade liberalisation, volatility in global commodity prices, and demographic trends affecting the labour force and revenue base. While none of these pressures represents a sudden shock in isolation, their cumulative effect could, if not carefully managed, constrain the pace of fiscal consolidation and test the Government's ability to meet its primary surplus and debt reduction objectives.

Notwithstanding these risks, the institutional and policy reforms implemented since 2022, including the legal and operational strengthening of fiscal and debt management frameworks, the establishment of the Public Debt Management Office, and the introduction of a rule-based fiscal responsibility framework, have materially enhanced the Government's capacity to identify, monitor, and respond to fiscal risks as they emerge. Sustained adherence to the fiscal targets set out in the PFMA and the Fiscal Strategy Statement, supported by continued reform momentum under the Medium-Term Revenue Strategy and prudent debt management under the MTDS, will remain essential to consolidating recent gains and safeguarding fiscal and debt sustainability over the medium to long term. The Government remains committed to strengthening its risk management capabilities further, including through the planned publication of independent Debt Sustainability Analyses from 2027 onwards, to ensure that emerging risks are addressed proactively and that fiscal outcomes remain aligned with Sri Lanka's long-term development and stability objectives.

## Annexure I: Required contents of the FSS

The PFMA specifies the minimum content of the FSS, which includes:

- I. Government's fiscal targets and the policies being implemented to ensure achievement of such targets;
- II. Proposed timeframe for the reduction of public debt to a sustainable level;
- III. Government's strategic priorities to ensure responsible fiscal management
- IV. Explanation of how the Government's fiscal targets and policies are consistent with the objectives of responsible fiscal management;
- V. The medium-term fiscal framework;
- VI. An assessment of performance against the fiscal strategy, including
  - an assessment of compliance with the fiscal targets for the preceding financial year, including an explanation of any non-compliance with such targets;
  - an assessment of expected compliance with the fiscal targets for the current financial year;
  - an assessment of expected compliance with the fiscal targets for the next financial year and the four succeeding years; and
  - an assessment of risks of non-compliance with the fiscal targets for the current financial year and the next financial year;
- VII. The main sources of fiscal risks against the attainment of the objectives underlying responsible fiscal management; and
- VIII. The macroeconomic impact of fiscal decisions taken over the past three years.

## Annexure II: Specific Policy Measures to Support Enhanced Fiscal Sustainability

### 1. A New Legal Architecture for Fiscal Discipline

- Enactment of the Public Debt Management Act, No. 33 of 2024.
- Enactment of the Public Financial Management Act, No. 44 of 2024.
- Establishment of the Public Debt Management Office (PDMO).
- Publication of the Tax Expenditure Statement as part of the annual fiscal reporting framework.
- Operationalization of fiscal rules, medium-term fiscal strategy requirements and enhanced fiscal risk reporting under the Public Financial Management Act.
- Strengthening debt management governance, debt recording and debt sustainability assessment frameworks.
- Strengthening transparency and accountability of tax incentives through mandatory estimation and disclosure of tax expenditures under Strategic Development Projects and Colombo Port City incentive regimes.

### 2. Major Tax Policy Reforms:

#### *In 2022/2023;*

- Increase the standard Value Added Tax (VAT) rate from 8 percent to 12 percent and then to 15 percent with effect from August 01, 2022 and September 01, 2022 respectively.
- Introduce the Social Security Contribution Levy (SSCL) at the rate of 2.5 percent with effect from October 01, 2022.
- Reintroduce a progressive Personal Income Tax (PIT) structure with marginal tax rates ranging from 6 percent to 36 percent with effect from January 01, 2023.
- Reduce the personal income tax-free threshold from Rs. 3 million per annum to Rs. 1.2 million per annum with effect from January 01, 2023.
- Increase the standard Corporate Income Tax rate from 24 percent to 30 percent with effect from January 01, 2023.

#### *In 2024;*

- Increase the standard Value Added Tax (VAT) rate from 15 percent to 18 percent with effect from January 01, 2024.
- Remove the majority of VAT exemptions applicable to the supply and import of goods and services with effect from January 01, 2024.
- Reduce the VAT registration threshold to Rs. 60 million per annum from Rs. 80 million per annum with effect from January 01, 2024.
- Reduce the Social Security Contribution Levy (SSCL) registration threshold to Rs. 60 million per annum from Rs. 120 million per annum with effect from January 01, 2024.
- Increase excise duty on all excisable articles by 14 percent based on the annual inflation-adjusted indexation with effect from January 01, 2024.
- Increase excise duty on all varieties of liquor by 14 percent based on the annual inflation-adjusted indexation with effect from January 01, 2024.

#### *In 2025;*

- Increase excise duty on all excisable articles by 5.9 percent based on the annual inflation-adjusted indexation with effect from January 11, 2025.
- Increase excise duty on all varieties of liquor by 5.9 percent based on the annual inflation-adjusted indexation with effect from January 11, 2025.
- Increase personal income tax relief from Rs. 1.2 million per annum to Rs. 1.8 million per annum with effect from April 01, 2025.
- Revise the tax bands applicable to taxable income of individuals, while maintaining the progressive tax structure with effect from April 01, 2025.

- Increase the Corporate Income Tax rate applicable to liquor, tobacco and gaming businesses from 40 percent to 45 percent with effect from April 01, 2025.
- Repeal the Simplified Value Added Tax (SVAT) scheme and introduce a risk-based VAT refund Scheme (RBRS) with effect from October 01, 2025.

### 3. **Tax Administration and Institutional Re-tooling**

#### ***Sri Lanka Inland Revenue***

- Establishment of the Criminal Investigation Unit.
- Expansion of the Risk Management Unit.
- Introduction of a simplified Individual Income Tax Return for taxpayers with employment and interest income.
- Establishment of an Exporter Refund Unit to expedite VAT refunds following the repeal of the SVAT scheme.
- Establishment of an Internal Affairs Unit.
- Expansion of digital tax administration systems and risk-based compliance management.
- Strengthening taxpayer registration, filing and compliance monitoring systems.

#### ***Sri Lanka Customs***

- Launch of the Strategic Plan 2024–2028.
- Establishment of an Internal Affairs Unit.
- Implementation of the "80-Day Excellence" programme with weekly KPI scorecards.
- Revamping risk management rules and container examination processes.
- Implementation of the ASYHUB system.
- Strengthening post-clearance audit, intelligence, and risk-based customs controls

#### ***Excise Department of Sri Lanka***

- Initiation of activities required for the implementation of the Revenue Administration System.
- Enhanced supervision of licensed excise premises.
- Implementation of a 100-Day special enforcement programme to improve revenue collection.
- Launch of the 24-hour hotline 1913.
- Establishment of a Central Laboratory.
- Establishment of a Risk Management Unit.
- Establishment of a Financial Intelligence Unit.
- Introduction of a mobile application to identify legally manufactured alcoholic beverages through a secure labelling system

## Annexure III: List of PPP Projects

No.	Project Name	Responsible Ministry / Entity	Type	Total Project Cost	Project Status
1	350MW LNG Sobadhanavi CCPP, Kerawalapitiya	Ministry of Energy	BOO	USD 212 Mn	Completion
2	350MW LNG Sahasdhanavi CCPP, Kerawalapitiya	Ministry of Energy	BOO	USD 290 Mn	Awarded
3	Trincomalee (Sampur) 50MW Solar Power Project (Phase I)	Ministry of Energy	JV	USD 42.9 Mn	PPA Signed / Procurement
4	50MW Wind Power Plant, Mannar (Thambapawani Stage II)	Ministry of Energy	BOO	USD 65 Mn	Contract Awarded / PPA Signed
5	Mullikkulam 100MW Wind Power Project	Ministry of Energy	BOO	USD 136 Mn	Contract Awarded / PPA Signed
6	Siyambalanduwa 100MW Ground Mounted Solar Park	Ministry of Energy	BOO	USD 300 Mn	PPA Signed
7	Sapugaskanda Oil Refinery Expansion / New Refinery	Ministry of Energy	BOT	USD 3,000 Mn	EOI Evaluation
8	China Bay 61-Tank Upper Tank Farm, Trincomalee	Ministry of Energy	BOT	USD 67.7 Mn	Procurement Under Review
9	Mixed Development Housing — Anuradhapura Post Office	Ministry of Health & Mass Media	DBFOM	Not yet estimated	Under Discussion
10	Conservation & Redevelopment — Galle Fort Post Office	Ministry of Health & Mass Media	DBFOM	Not yet estimated	Under Discussion
11	Hemodialysis Services Expansion — Selected Hospitals	Ministry of Health & Mass Media	BOO	USD 0.58 Mn	Proposed — Cabinet Approval Granted
12	Performance-Based Equipment Hiring Framework	Ministry of Health & Mass Media	BOO	Not yet finalized	Proposed — Feasibility Study Ongoing
13	Ayurvedic Treatment & Healthcare Tourism — Pottuvil	Ministry of Health & Mass Media	BOO	Not yet estimated	Proposed — Feasibility Study Ongoing
14	Airport Hotel — Bandaranaike International Airport	Ministry of Ports & Civil Aviation	BOT	USD 12 Mn	Operational
15	Jet A1 Fuel Supply & Storage Facility	Ministry of Ports & Civil Aviation	BOT	USD 15 Mn	Awarded
16	South Asia Gateway Terminal (SAGT)	Ministry of Ports & Civil Aviation	BOT	USD 241.2 Mn	Operational
17	Colombo International Container Terminal (CICT)	Ministry of Ports & Civil Aviation	BOT	USD 500 Mn	Operational
18	West Container Terminal — I (WCT-I)	Ministry of Ports & Civil Aviation	BOT	USD 762 Mn	Operational (Partial Completion)
19	South Asia Commercial & Logistic Hub (SACLH)	Ministry of Ports & Civil Aviation	BOT	USD 280 Mn	Not in Progress (Early Settlement)

No.	Project Name	Responsible Ministry / Entity	Type	Total Project Cost	Project Status
20	Middle Income Housing — Millagahawatta, Wattala	Ministry of Transport, Highways & Urban Dev.	DBF	USD 25.15 Mn	Procurement
21	Middle Income Housing — Orchardwatta, Nittambuwa	Ministry of Transport, Highways & Urban Dev.	DBF	USD 4.44 Mn	Procurement
22	Mixed Development — Sri Jayawardenapura Kotte	Ministry of Transport, Highways & Urban Dev.	DBF	USD 24.85 Mn	Preparation
23	Mixed Development — Kaduwela	Ministry of Transport, Highways & Urban Dev.	DBF	USD 12.07 Mn	Proposed
24	Middle Income Housing — Thuduwegoda, Hikkaduwa	Ministry of Transport, Highways & Urban Dev.	DBF	USD 17.67 Mn	Proposed
25	Middle Income Housing — Athurugiriya	Ministry of Transport, Highways & Urban Dev.	DBF	USD 12.63 Mn	Proposed
26	Multi-Storied Car Park & Mixed Dev. — Union Place, Colombo 02	Ministry of Transport, Highways & Urban Dev.	DBFOM	USD 5.10 Mn	Operational (Mixed Dev. Under Construction)
27	Multi-Storied Car Park & Mixed Dev. — Abdul Carder Mawatha, Colombo 11	Ministry of Transport, Highways & Urban Dev.	DBFOM	USD 10.80 Mn	Under Construction
28	Electronic Toll System — National Expressway Network	Ministry of Transport, Highways & Urban Dev.	BOT	USD 25 Mn	Procurement
29	Kahatagaha Graphite Mine — Integrated PPP Development	Ministry of Industry & Entrepreneurship Dev.	DBFOMT	Not yet estimated	EOI Stage
30	Kurunchathivu Saltern Rehabilitation	Ministry of Industry & Entrepreneurship Dev.	DBFOMT	Not yet estimated	EOI Extended / Under Review
31	Lanka Mineral Sands — Value Addition Project	Ministry of Industry & Entrepreneurship Dev.	TBD	Not yet estimated	Project Committee Stage
32	Paranthan Caustic Soda / Chlorine Project	Ministry of Industry & Entrepreneurship Dev.	TBD	Not yet estimated	Pending Decision on Modality
33	Embilipitiya Paper Mills Recommencement	Ministry of Industry & Entrepreneurship Dev.	Lease & Impl. Agreement	LKR 260 Mn	Ongoing
34	Medical Tourism MOU — UHKDU / MGM Healthcare	Ministry of Defence	MOU	Not yet finalized	Proposed — Awaiting Approval
35	IVF & Andrology Unit — UHKDU	Ministry of Defence	MOU	Not yet finalized	Awaiting EOI
36	Healthcare MOU — UHKDU / Apollo Hospital	Ministry of Defence	MOU	Not yet finalized	Proposed — Awaiting Approval

## Annexure IV: Financial Soundness Indicators – Banking & Finance Companies

### Table 01: Financial Soundness Indicators of the Banking Sector

Soundness Area	Indicator	2024 (%)	2025 (%) <sup>a</sup>
Asset Quality	Stage 3 Loans Ratio <sup>b</sup>	12.3	9.7
	Impairment Coverage for Stage 3 Loans	54.1	58.3
	Impairment Coverage for Total Loans <sup>1</sup>	8.5	7.2
Liquidity	Rupee Liquidity Coverage Ratio	349.9	283.3
	All-Currency Liquidity Coverage Ratio	313.8	249.7
	Net Stable Funding Ratio	164.8	154.1
Profitability	Net Interest Margin	4.4	4.3
	Return on Assets (Before Tax)	2.6	2.4
	Return on Equity (After Tax)	17.4	16.6
Capital	Common Equity Tier 1 Capital Adequacy Ratio	16.4	14.5
	Tier 1 Capital Adequacy Ratio	16.7	14.6
	Total Capital Adequacy Ratio	20.3	17.9

a. Provisional

b. Including undrawn amounts.

Source: Central Bank of Sri Lanka

### Table 02: Financial Soundness Indicators of the Finance Companies Sector

Soundness Area	Indicator	2024 (%)	2025 (%) <sup>a</sup>
Asset Quality	Stage 3 Loans Ratio <sup>b</sup>	11.5	6.1
	Impairment Coverage for Stage 3 Loans	43.4	47.8
	Impairment Coverage for Total Loans	6.6	4.1
Liquidity	Liquid Assets to Total Assets	11.5	8.2
	Liquid Assets to Deposits	20.9	17.9
	Liquid Assets to External Funds <sup>c</sup>	16.2	10.7
Profitability	ROA	5.8	6.3
	ROE	12.8	16.3
	NIM	10.9	10.6
Capital	Tier 1 Capital Adequacy Ratio <sup>d</sup>	20.5	17.3
	Total Capital Adequacy Ratio	21.3	18.7
	Net NPLs to Tier-1 Capital after Adjustments	28.9	18.0

a. Provisional

b. Gross Stage 3 Advances to Total Advances

c. Total Deposits and Borrowings

d. Tier 1 Capital after Adjustments to Risk Weighted Assets

Source: Central Bank of Sri Lanka

## Annexure V: Insurance Sector Financial Soundness Indicators (FSIs) – as at end Q4 of 2025

### Table 01: Assets, Liabilities and Equity (Rs. million)

Indicators	2024 Q4			2025 Q4			% Change (Y-o-Y)		
	Life Insurance	General Insurance	Reinsurance	Life Insurance	General Insurance	Reinsurance	Life Insurance	General Insurance	Reinsurance
Total Assets	924,409	286,880	11,743	1,059,612	359,950	12,644	14.63%	25.47%	7.67%
Total Liabilities	750,696	161,642	10,526	870,205	225,787	23,730	15.92%	39.68%	125.44%
Equity Capital & Reserves	173,713	125,238	1,217	189,407	134,163	12,644	9.03%	7.13%	939.09%

### Table 02: Regulatory Capital (Rs. million)

Indicators	2024 Q4			2025 Q4			% Change (Y-o-Y)		
	Life Insurance	General Insurance	Reinsurance	Life Insurance	General Insurance	Reinsurance	Life Insurance	General Insurance	Reinsurance
Total Available Capital	377,431	110,821	1,265	428,503	115,272	(10,299)	13.53%	4.02%	-914.06%

### Table 03: Asset Quality (Rs. million)

Indicators	2024 Q4			2025 Q4			% Change (Y-o-Y)		
	Life Insurance	General Insurance	Reinsurance	Life Insurance	General Insurance	Reinsurance	Life Insurance	General Insurance	Reinsurance
Invested Assets	837,405	184,586	7,693	967,948	196,830	9,520.67	15.6%	6.6%	23.8%
Investments in Government Debt Securities	495,085	113,757	7,693	550,842	110,680	9,521	11.3%	-2.7%	23.8%

### Table 04: Earnings and Profitability (Rs. million)

Indicators	2024 Q4			2025 Q4			% Change (Y-o-Y)		
	Life Insurance	General Insurance	Reinsurance	Life Insurance	General Insurance	Reinsurance	Life Insurance	General Insurance	Reinsurance
Earned Premium	176,401	110,816	3,832	218,436	118,048	3,819	23.83%	6.53%	-0.34%
Investment Income	101,134	20,691	655	102,064	18,428	702	0.92%	-10.94%	7.25%
Profit before Tax	32,521	22,983	1,538	32,315	20,715	(11,776)	-0.63%	-9.87%	-865.82%

### Table 05: Solvency (Percent)

Indicators	2024 Q4			2025 Q4			% Change (Y-o-Y)		
	Life Insurance	General Insurance	Reinsurance	Life Insurance	General Insurance	Reinsurance	Life Insurance	General Insurance	Reinsurance
Capital Adequacy Ratio (%)	338%	322%	36%	327%	231%	-161%	-3.25%	-28.26%	-547.22%
Capital to Total Assets	0.19	0.44	0.10	0.18	0.37	-0.88	-5.26%	-15.91%	-980.00%
Capital to Technical Reserves	-	1.44	0.13	-	1.10	-1.14	-	-23.61%	-976.92%
Technical Reserve Ratio (%)	-	131.55	43.50	-	106.14	38.40	-	-19.32%	-11.72%

**Table 06: Liquidity (Percent)**

Indicators	2024 Q4			2025 Q4			% Change (Y-o-Y)		
	Life Insurance	General Insurance	Reinsurance	Life Insurance	General Insurance	Reinsurance	Life Insurance	General Insurance	Reinsurance
Liquidity Ratio	0.80	0.92	0.85	0.80	0.69	0.47	0%	-25%	-45%
Loss Ratio (%)	47.46	56.62	54.79	47.93	58.26	405.88	1%	3%	641%

**Table 07: Earnings and Profitability (Percent)**

Indicators	2024 Q4			2025 Q4			% Change (Y-o-Y)		
	Life Insurance	General Insurance	Reinsurance	Life Insurance	General Insurance	Reinsurance	Life Insurance	General Insurance	Reinsurance
Profitability Ratio (%)	17.68	16.47	38.72	14.23	13.12	-315.14	-20%	-20%	-914%
Underwriting Ratio (%)	-	21.17	30.61	-	19.32	-320.50	-	-9%	-1147%
Return on Assets (ROA) (%)	3.73	7.79	13.99	3.26	6.41	-96.57	-13%	-18%	-790%
Return on Equity (ROE) (%)	18.28	16.41	154.49	17.80	15.97	238.64	-3%	-3%	54%
Net Combined Operating Ratio (%)	88.94	102.88	78.07	89.12	104.24	429.17	0%	1%	450%
Investment Yield Ratio (%)	12.78	10.77	1.88	11.31	9.43	8.16	-12%	-12%	334%
Premium Stability Ratio (%)	20.39	11.65	51.08	23.47	13.10	-5.90	15%	12%	-112%

**Table 08: Reinsurance (Percent)**

Indicators	2024 Q4			2025 Q4			% Change (Y-o-Y)		
	Life Insurance	General Insurance	Reinsurance	Life Insurance	General Insurance	Reinsurance	Life Insurance	General Insurance	Reinsurance
Retention (Reinsurance) Ratio (%)	95.90	81.87	100.00	96.63	82.13	100.00	0.76%	0.32%	0.00%

**Table 09: Asset Quality (Percent)**

Indicators	2024 Q4			2025 Q4			% Change (Y-o-Y)		
	Life Insurance	General Insurance	Reinsurance	Life Insurance	General Insurance	Reinsurance	Life Insurance	General Insurance	Reinsurance
Invested Assets to Total Assets	0.91	0.64	0.66	0.91	0.55	0.75	0.84%	-15.01%	14.94%

The financial performance of the insurance sector in Q4 2025 indicates a moderate softening compared to Q4 2024, with both life and general insurance segments experiencing pressure on profitability and returns, despite some improvements in operational aspects. The profitability ratio declined in both sectors, with life insurance decreasing from 17.68% to 14.23% and general insurance from 16.47% to 13.12%, reflecting a contraction in overall earnings.

Returns also weakened during the period, with Return on Assets (ROA) declining from 3.73% to 3.26% in life insurance and from 7.79% to 6.41% in general insurance. Similarly, Return on Equity (ROE) recorded slight reductions in both sectors, indicating lower returns to shareholders compared to the previous year

Investment performance followed a downward trend, as reflected by the decrease in investment yield ratios from 12.78% to 11.31% in life insurance and from 10.77% to 9.43% in general insurance, likely influenced by prevailing market conditions.

Despite these challenges, premium stability improved across both sectors, with the ratio increasing from 20.39% to 23.47% in life insurance and from 11.65% to 13.10% in general insurance. This suggests stronger consistency in premium growth and business retention.

Overall, while the sector remains stable, the decline in profitability and returns highlights the need for continued focus on underwriting discipline, cost management, and investment optimization to sustain long-term performance.

### **Profitability**

The earnings and profitability analysis for the life insurance and general insurance sectors reveals distinct trends and challenges. Both the life and general insurance sectors demonstrated strong growth in earned premiums and maintained profitability despite slight declines in some profitability ratios. The general insurance sector, while showing growth in earned premiums, faced significant challenges in investment income and profitability. The Net Combined Operating Ratio (NCOR) of the general insurance sector increased slightly from 102.88% to 104.24%, remaining above the breakeven level and meanwhile, the life insurance sector maintained relative stability in operational efficiency, with its NCOR marginally increasing from 88.94% to 89.12%.

The premium stability ratios for both sectors improved, reflecting positive stability and predictability in premium income. Despite the challenges, the industry continues to generate positive returns and retains a stable earnings base, supporting long-term capital formation.

### **Liquidity**

The life insurance sector's liquidity ratio remain stable at 0.80, while its loss ratio also remain stable at 47%, reflecting better risk management and claims handling. The general insurance sector saw a decreased in its liquidity ratio from 0.92 to 0.69, and its loss ratio also deteriorate from 56.62% to 58.26%. The reinsurance sector's liquidity ratio dropped significantly from 0.85% to 0.47%, and its loss ratio increased from 54.79% to 405.88%, indicating a substantial Worsening in liquidity and risk management.

### **Solvency**

The insurance sector maintained strong capital adequacy in Q4 2025, with life insurers recording an average Capital Adequacy Ratio (CAR) of 327% and general insurers at 231%, both significantly exceeding the regulatory minimum requirement of 120%. This highlights strong capital buffers and effective risk management, positioning the industry to withstand adverse market conditions and sustain long-term policyholder obligations.

### **Asset Quality**

The life insurance sector recorded a 15.6% increase in invested assets, reaching Rs. 967,948.19 million, with investments in government debt securities rising by 11.3%. This reflects a robust and growing asset base, contributing to reduced market volatility exposure. The general insurance sector also recorded 6.6% improvement in invested assets to Rs. 196,829.74 million. However, its investments in government securities dopped by 2.7%, indicating a pretty decrease in preference for stable, low-risk instruments. The Reinsurance sector demonstrated significant growth, with invested assets increasing by 23.8% to Rs. 9,520.67 million. Notably, all investments of the Reinsurance sector were directed into government debt securities, underscoring improved capital deployment and risk mitigation strategies.

## Earnings Profile and Interest Rate Sensitivity

The sector's reliance on fixed-income instruments aligns with its long-term liability structure, however it highlights sensitivity to interest rate movements. Any fluctuation in investment income may limit the buffer capacity for underwriting volatility, particularly under changing macroeconomic conditions. Nevertheless, the industry's current positioning offers reasonable insulation against market disruptions.

## Performance and Stability Concerns / Risks / Vulnerabilities

### Financial Soundness

Insurers are generally expected to maintain adequate levels of capital and liquidity to support their operations. Key financial soundness indicators include the Risk-Based Capital (RBC), Capital Adequacy Ratio (CAR), and liquidity ratios. These metrics are used to assess the sector's ability to absorb shocks and meet obligations under normal and stressed conditions.

### Key Risks / Vulnerabilities

- **Solvency Concerns** – A few insurers operate close to the minimum CAR threshold, with delays in capital infusion and weak earnings retention contributing to solvency pressures. Enhanced reporting and supervisory engagement have been initiated for these entities.
- **Investment Risks** – Investment risk remains moderate due to high allocation to government securities. However, interest rate fluctuations, limited diversification, asset-liability mismatches, and foreign currency exposure can affect financial performance.
- **Underwriting Risks** – Rising claim ratios in motor, medical, and life insurance segments could impact profitability and capital adequacy if not addressed through pricing and reserving strategies.
- **Reinsurance Risks:** Dependence on external reinsurers exposes insurers to counterparty credit, treaty changes, and regulatory challenges.
- **Operational / Governance Risks** – Includes IT vulnerabilities, controls, cybersecurity threats, weak board oversight, inadequate risk management frameworks, and poor compliance culture.
- **Market Concentration** – The two largest life insurers account for 53% of total assets and the three largest general insurers account for 52%, limiting competitive resilience.
- **Climate and Catastrophe Risk** – Exposure to floods, cyclones, and climate events may trigger correlated claims and stress reinsurance coverage.
- **Macroeconomic Impact** – Exchange rate fluctuations, inflation, and economic slowdown affect premium collection, investment returns, and overall resilience.

## Mitigation Measures Taken / To Be Taken to Address Risks / Concerns

### Supervisory Framework and Risk-Based Approach

- IRC SL applies a risk-based approach to allocate supervisory resources according to insurer risk profiles.
- Both off-site and on-site inspections are conducted comprehensively or in focused areas based on insurer risk level.
- Enforcement actions include issuance of Directions, Determinations, and Circulars.

### ***Risk Profiling and Monitoring Tools***

- Structured risk profiling is conducted using statutory returns and other available data, covering key areas such as capital adequacy, asset composition, profitability, market share, governance, and compliance. Enhanced monitoring and close supervisory reviews are applied to high-risk entities, with greater emphasis placed on identified risk exposures and instances of non-compliance.
- Early warning ratios and risk matrices (life/general) integrate quantitative and qualitative indicators.
- Continuous monitoring of earnings and profitability, solvency, liquidity and financial position.

### ***Solvency and Capital Monitoring***

- Monthly RBC reporting under Determination 01 enables early detection of capital deteriorations.
- Insurers near the minimum CAR threshold are subject to intensified monitoring and follow-up.

### ***Investment Oversight***

- Supervisory reviews ensure compliance with investment Directions and prudent asset-liability management.
- Focus areas include asset quality, diversification, and avoidance of excessive concentration.

### ***Reinsurance Regulation***

- Compliance with Section 31(1) of the RII Act is enforced, and insurers must place reinsurance only with authorised, creditworthy entities.
- Annual reporting and treaty submissions are mandatory.

### ***Governance and Internal Controls***

- Evaluations cover board composition, independence, audit and risk committee effectiveness
- IT/cybersecurity infrastructure.
- Sound governance practices are required according to insurer scale and complexity.

### ***Macroeconomic Risk Integration***

- Supervisory assessments incorporate inflation, exchange rate movements, and GDP trends.
- Stress testing, early warning systems, and sector-wide risk evaluations enhance resilience under adverse conditions.

### ***Policies That Had or May Have an Impact on Financial System Stability***

IRCSL is revising the Solvency Margin (RBC) Rules introduced in 2015 to align with evolving market conditions, international standards, and emerging risks. The revised RBC framework is expected to strengthen capital adequacy assessments and improve the sector's ability to absorb shocks, contributing to long-term financial system stability.