"Government Borrowing and Debt Sustainability: Lessons from Sri Lanka's Crisis and Path to Recovery"

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Government Borrowing: Balancing Public Needs and Market Inefficiencies

Debt accumulation by governments often sparks heated debates, with some considering it a crisis and others a necessity. However, it is essential to recognise that governments operate fundamentally differently from private sector entities or individuals. While firms and households prioritise profitability or personal gains, governments serve broader societal objectives that transcend market efficiencies.

In a perfectly competitive market, private entities prioritise activities that generate profits. This profit driven focus often excludes the provision of goods and services with significant non-monetary or long-term societal benefits, such as public infrastructure, healthcare, and education. These are typically non-marketable goods where direct cost recovery is impractical, yet their social returns, often spanning generations, are substantial.

Governments act as facilitators, stepping in to provide goods and services that address market inefficiencies. To fund these public goods, they primarily rely on taxation, which redistributes resources within the economy. However, tax revenues often fall short of meeting the full spectrum of public needs. When expenditures exceed revenues, governments face two primary options: reduce the deficit by cutting spending or increasing revenue, or finance the shortfall through new borrowing, which adds to the stock of public debt.

Borrowing: A Necessity, Not a Stigma

Zero public debt, or a situation where a country has no national debt, is theoretically possible but highly uncommon and difficult to achieve or sustain in modern economies. Governments typically require some level of borrowing to address the need for investment, maintain economic flexibility, and respond effectively to economic cycles.

Borrowing by governments should not be viewed as inherently negative. It serves as a mechanism to pool society's collective resources, enabling investment in critical areas such as infrastructure, social welfare, and other initiatives that benefit both present and future generations. Public borrowing fulfils several vital purposes. It allows governments to smoothen the time profile of expenditures, improving spending efficiency and minimising distortions caused by abrupt tax changes. Additionally, borrowing facilitates countercyclical policies by enabling governments to increase spending during economic downturns and vice versa. Such borrowing is generally expected to be temporary, with repayments occurring during economic expansions. However, sustained borrowing can support long-term public investments critical for growth and development. Investments in infrastructure, education, and healthcare, for instance, are expected to yield returns that enable future debt repayment, provided the borrowed funds are used effectively (Beddies et al., 2009).

When used wisely and in moderation, borrowing can enhance welfare by fostering economic growth and development. Yet, imprudent and excessive borrowing can lead to financial turmoil, resulting in severe economic consequences. Debt, therefore, is a double-edged sword (Cecchetti & Zampolli, 2011). High levels of public debt increase vulnerability to economic shocks, exacerbate the risk of banking crises, and divert resources from productive uses to debt servicing

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obligations (Raga, 2024). Effective borrowing must be accompanied by sound fiscal management to ensure that the economy is resilient enough to handle debt repayments. Many governments experiencing debt crises have failed to plan adequately for debt servicing. As such, long-term fiscal planning is critical to balance the benefits of public investments with the need to avoid unreasonably overburdening future generations.

What is debt Sustainability

Public debt is considered sustainable if a government can meet its current and future payment obligations without requiring exceptional financial assistance or defaulting (Hakura, 2020). The International Monetary Fund (IMF) defines public debt sustainability by considering solvency and liquidity factors, as well as the political and economic feasibility of policies needed to stabilise the debt-to-GDP ratio, minimize rollover risks, and avoid restructuring or exceptional bilateral support, even with IMF financing (International Monetary Fund, 2022). Similarly, the European Commission defines sustainable debt as one where fiscal policy can remain unchanged over the post-forecast horizon without altering public spending or taxation to affect the primary balance while preventing public debt from continuously rising as a share of GDP (European Commission, 2016).

Debt sustainability can be evaluated using various debt and debt-service indicators relative to measures of repayment capacity, which can be assessed through GDP, export proceeds, or fiscal revenue (Beddies et al., 2009). GDP ratios indicate the size of the economy and its ability to support debt. Export ratios assess a country's capacity to generate sufficient foreign exchange to meet external debt obligations, while revenue ratios reflect the government's ability to mobilise domestic resources for debt repayment. The most relevant measure depends on the constraints most binding in a particular country. Debt stock ratios relative to repayment capacity highlight long term solvency risks, whereas the trajectory of debt service ratios indicates the likelihood and timing of potential liquidity challenges.

Assessing debt sustainability and determining the level of fiscal adjustment required to bring down the debt trajectory in the case of a distress situation is both a mechanical and a complex process. It can range from simple matrix-based approaches, using a handful of variables and straightforward extrapolations to sophisticated models that incorporate multiple variables, embedded scenarios, and rigorous stress-testing mechanisms.

IMF utilises two distinct frameworks to assess debt sustainability based on a country's borrowing characteristics. The *Sovereign Risk and Debt Sustainability Analysis (SRDSA)* is designed for countries with market access, focusing on assessing sovereign debt distress and sustainability under varying economic and financial conditions. In contrast, the *Debt Sustainability Analysis for Low-Income Countries (LIC DSA)* is tailored to low-income nations, where budget financing is primarily through concessional loans. These frameworks provide critical tools for evaluating debt sustainability, helping policymakers make informed decisions based on both baseline projections and stress-tested scenarios.

Managing Debt Dynamics: The Role of the Primary Balance

A country often accumulates debt to finance its annual budget requirements, which comprise two key components: the primary balance[2] and debt service payments. The primary balance reflects the discretionary fiscal policy decisions of the government, while debt service payments include interest expenditures and principal repayments on existing debt.

[2] *The primary balance refers to the difference between a government's total revenue and its non-interest expenditure within a given period.*

Without adjustments to the stock of debt, or in other words, without any debt restructuring effort, a government seeking to reduce its debt trajectory must focus on improving the primary balance within the framework of debt dynamics. The primary balance is the key lever under the government's direct control, and achieving this adjustment typically involves either increasing government revenue (through higher taxes or improved tax collection) or reducing government spending (by rationalising or curtailing public sector wages, subsidies, or social programs).

The behaviour of the interest expenditure may largely reflect the direction of monetary policy and other market dynamics, independent of the fiscal policy and principal repayments reflect the legacy of past budgetary decisions and are therefore less flexible in the short term.

By prioritising an improved primary balance, governments can exert a meaningful impact on the trajectory of public debt, ensuring fiscal sustainability over time.

Sri Lanka's Debt Conundrum: Lessons from the Crisis

Sri Lanka, has operated with persistent fiscal deficits over the past few decades, relying heavily on borrowing to bridge financing gaps. The sources of borrowing, whether domestic or foreign, bilateral, multilateral, or international capital markets have been shaped by various factors, including diplomatic relationships, policy orientations, economic strategies, etc.

Since independence, the country has faced structural fiscal challenges, primarily characterised by an inability to sustain adequate government revenue while controlling expenditure. The question also arises about the effectiveness of fund allocations and whether the prioritisation of funds have been successful in achieving intended objectives. Consequently, the overall fiscal balance has continued to widen, with the primary balance, a reflection of discretionary government policy, achieving a surplus only on six occasions over the past seven decades.

Until 2009, Sri Lanka largely relied on concessional financing from multilateral sources, benefiting from its low-income status as external financing. However, with the resolution of the civil conflict and promising growth rates, the country graduated to middle-income status. While this was a positive milestone, it restricted access to concessional external financing. Therefore, Sri Lanka shifted towards borrowing from international capital markets, which carried higher repayment obligations.

Despite this transition, it was apparent that the country failed to channel borrowed funds effectively to strengthen the economy to support its future dues. Therefore, investments that could have facilitated economic growth and enabled future debt repayment may have either been underutilised or misallocated. The significant increase in Sri Lanka's external debt failed to yield meaningful improvements in infrastructure or economic growth, with some newly constructed projects proving inefficient or unprofitable from an economic perspective (Sumanaratne, 2022). This failure set the stage for a vicious debt cycle, no later than a decade since 2009, where new external borrowing merely financed the rollover of existing external debt, a model that was unsustainable without a robust strategy to regain fiscal control.

By 2020/21, the situation had deteriorated further due to a series of policy missteps within the fiscal front, including several tax reductions, reforms and exemptions, which sharply reduced government revenue. These challenges were compounded by the economic disruptions of COVID-19, which necessitated the allocation of government resources towards healthcare, pandemic control measures, and providing essential support for affected communities. Additionally, COVID-19 related disruptions led to a decline in foreign inflows. Sovereign credit downgrades, driven by worsened fiscal and external vulnerabilities, further restricted access to international financial markets.

Faced with limited options, Sri Lanka relied on its reserves to meet debt obligations until reserve levels became critically low. Eventually, the country declared a debt standstill for certain external creditors, including International Sovereign Bond (ISB) holders and bilateral lenders, initiating restructuring negotiations alongside the support of an economic reforms program under the Extended Fund Facility (EFF) of the IMF.

Sri Lanka's Path to Debt Sustainability: A Dual Approach

One of the core objectives of the EFF supported program is to restore the debt sustainability of the country. Debt sustainability analyses (DSAs) are critical tools for evaluating whether economic stress can be alleviated through a Fund-supported program, which typically involves fiscal adjustment and new financing, or if exceptional measures such as debt restructuring are necessary to achieve medium-term sustainability.

For Sri Lanka, the IMF's *Sovereign Risk and Debt Sustainability Analysis (SRDSA)* framework is particularly relevant. According to the IMF Staff Report (June 2024), Sri Lanka's economy remains highly vulnerable, with its path to debt sustainability described as "knife-edged." The required improvement in the primary balance to manage the situation without external intervention via a debt restructuring adjustment is deemed too severe with an even more stringent primary surplus target, imposing substantial social and economic costs in the short term exacerbating further economic hardships. Thus, a purely fiscal adjustment approach is insufficient, necessitating a dual approach involving:

1. **Macroeconomic adjustments** across fiscal, exchange rate, monetary, and structural policies to stabilise the economy.
2. **Debt restructuring** to address the unsustainable debt stock and achieve realistic fiscal targets by supplementing the much needed improvement in debt dynamics

The proposed adjustments collectively aim to place the debt trajectory on a sustainable path, targeting the achievement of debt sustainability benchmarks outlined under the EFF program. These benchmarked targets include: (i) reducing the public debt-to-GDP ratio to below 95 per cent by 2032, (ii) lowering the central government's average annual gross financing needs to below 13 per cent of GDP during 2027–2032, (iii) ensuring that the central government's annual foreign currency debt service remains below 4.5 per cent of GDP in each year of 2027–2032, and (iv) addressing the external financing gap over the EFF program period.

As outlined in the debt sustainability analysis, the adjustment from discretionary fiscal policy primarily operates through the primary balance. The target is to achieve and maintain a positive primary balance of 2.3 per cent of GDP annually from 2025 onward, serving as the fiscal policy anchor for stabilising debt dynamics. This adjustment corresponds to an annual debt reduction of 2.3 per cent of GDP from the fiscal side, which is crucial for bringing debt levels below the targeted threshold of 95 per cent of GDP by 2032.

However, the above adjustment alone is insufficient to bring debt levels to acceptable targets. Therefore, an additional adjustment is expected through the restructuring of debt repayments to ease pressure, along with some level of debt forgiveness in the form of a haircut, to complement the efforts of fiscal consolidation.

Progress and Challenges

Given the country's unfavorable track record in sustaining fiscal sustainability, maintaining a primary balance of 2.3 percent of GDP is undoubtedly a significant challenge. Since 2022, the government has embarked on an ambitious policy reform package that frontloaded measures across all possible tax avenues to enhance revenue collection alongside policy directions on rationalising the expenditures to curb unnecessary spending.

Key tax reforms have included increasing Value-Added Tax (VAT) rates, lowering registration thresholds, and eliminating exemptions. Revisions were also made to the personal income tax structure, including adjustments to the tax-free threshold, rates, and brackets. Additionally, the standard corporate income tax rate was increased, a new Social Security Contribution Levy (SSCL) was introduced, and excise duties on liquor and cigarettes were revised multiple times as per the inflation-adjusted indexation. These measures are being supplemented by administrative improvements to enhance tax collection efficiency.

On the expenditure side, the government implemented a rationalisation drive to contain spending growth, avoiding the patterns of past fiscal expansions. Reforms in State-Owned Enterprises (SOEs) alongside the introduction of cost-reflective pricing mechanisms have also begun to ease the indirect fiscal pressures these entities traditionally had on government finances.

Deficit financing also assumes an increased issuance of long-term Treasury bonds in the domestic market, aligned with historical patterns, to ease pressures on immediate gross financing needs. Simultaneously, ongoing debt restructuring efforts have begun to enhance sovereign ratings, thereby improving access to external financing in the medium to long term. In the near term, reliance on multilateral financing remains essential for addressing funding gaps.

The successful completion of the Domestic Debt Optimisation (DDO) in 2023 significantly alleviated immediate debt service payment pressures by reducing the gross financing needs. Marking another significant step, the government successfully completed its external debt restructuring process by the end of 2024, with only a small portion remaining, prompting two major rating agencies to upgrade the country's sovereign rating thereby reducing the risk premium. These milestones represent a commendable achievement, serving as a critical component in supporting fiscal consolidation efforts aimed at achieving debt sustainability, an outcome that would have been unattainable without these measures.

The way forward

Sri Lanka has made significant progress on the fiscal front, in its fiscal consolidation efforts, policy reforms and debt restructuring. While these efforts have provided critical relief in the short term, it is important to recognise that this is not a quick fix but part of a long-term strategy that requires consistent policy alignment across successive governments, irrespective of political representation. Therefore, it is a necessity that the reforms introduced thus far must continue without interruption. Policymakers must resist the temptation to adopt short-term populist measures that jeopardise long-term stability.

Economic strategy should also focus on diversifying industries and enhancing productivity to generate sufficient foreign exchange inflows with necessary structural reforms across key sectors to create a resilient economy capable of meeting debt obligations without disruptions.

Ensuring debt sustainability is essential for the country’s economic stability and citizen welfare and must be pursued as a national priority rather than merely a condition of the IMF’s Extended Fund Facility (EFF). The success of Sri Lanka’s long-term debt strategy hinges on sustained political commitment. Given the country’s history of populist decisions prioritising short-term

gains over economic stability, a paradigm shift in political culture is necessary. Policymakers must recognise that the leeway for error is minimal, and any misstep could quickly push the country back into a crisis.

For instance, borrowing from international markets again amidst the improvements in sovereign ratings well within the reach in few years' time, must be carefully managed to avoid unsustainable debt accumulation and instead serve as a strategic tool for financing productive investment.

The economic crisis of 2022 was a stark reminder of the severe consequences of unsustainable borrowing practices, with widespread socioeconomic repercussions felt by all citizens. To prevent a recurrence, policymakers, politicians, and the public must develop a broader understanding of the critical importance of maintaining debt sustainability. Slippages in reforms, often driven by populist policies, may offer immediate relief but pose grave long-term risks. Such deviations could lead to a second debt default, plunging the country into an even deeper crisis that would be far harder to recover from.

In conclusion, borrowing, when managed prudently, is not inherently detrimental. It serves as a strategic tool to address immediate needs while fostering long-term growth. For Sri Lanka, the focus must remain on transparent policies, efficient use of resources, and a forward-thinking repayment strategy. By balancing immediate societal needs with sustainable fiscal practices, Sri Lanka can navigate its debt responsibly and build a stable foundation for economic prosperity.

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