



# SUSTAINABILITY OF SRI LANKA'S PUBLIC DEBT

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## **Abstract**

This study shows that the accumulated debt of government over the years has reached very high proportions to the extent that debt servicing has become a major challenge to government. Sustainability of the public debt is an issue that involves macroeconomic variables and in finding a durable solution it is necessary to address the issue at the macro level. Any attempts to reduce the deficit by raising taxes to levels that are intolerable or cutting down on capital expenditure are ill- advised as this only jeopardizes future growth prospects of the economy. The primary thrust in the short term should be on curtailing government expenditure and eliminating waste while the long term focus should be on creating an environment conducive to high and sustained growth.

## **Introduction**

This article addresses a critical issue which affects the economic well-being of Sri Lankan citizens. The total outstanding government debt which is termed the Public Debt and the way it is financed have implications for the welfare of Sri Lankans belonging to the present as well as future generations. Since the country's independence in 1948, successive governments have implemented deficit financing policies whereby governmental expenditure has been made to exceed the revenue collected through taxes. In no year since independence has government run a surplus budget except for the years 1954 and 1955 (CBSL Annual Report, 2006). More serious is the fact that after 1987, successive governments have run current account deficits- a situation where government revenue has been insufficient to meet even the recurrent expenditure. Clearly, the government has been living beyond its means and a stage may soon be reached where government would have no option but to incur additional debt to re-pay the existing debt.

The article first describes the adverse implications that arise due to high and unsustainable debt levels and then presents the guidelines regarding prudential debt management. With respect to the country's debt problem, the article moves logically from problem analysis to problem diagnosis and then to problem resolution.

This study relies on publications issued by the Ministry of Finance and Planning and the Central Bank. For purposes of the study, discussions were also held with officers attached to banks and other financial institutions and business practitioners .



## **Implications of high debt and rationale underlying debt sustainability indicators**

A high level of public debt and high debt servicing costs have several adverse implications for the economy.

1. High debt servicing costs which arise as a result of the debt stock accumulated over the years tend to reduce investment in vital areas of the economy.
2. Government competes with the private sector for the limited pool of savings available in the economy. If government wants to borrow by selling gilt-edged securities, it has to offer an attractive interest rate to induce the public to buy the extra debt. This in turn raises interest rates and “crowds out” private sector investment by making it more expensive for firms to borrow or raise funds on the capital market through new issues of corporate bonds and shares (Layton et al. 2005: 523)
3. Financing budget deficits by following the easy route of printing money leads to inflation which erodes the living standards of people. It also introduces uncertainty into the economy which encourages short term planning at enterprise level. This is inimical to long term growth.
4. Recourse to foreign borrowing and re- payment of foreign debt places burdens on future generations.
5. Accumulation of high public debt can lead to a reduction in the credit rating of a country. Any new debt would then have to be raised at higher interest cost in the future leading to higher debt servicing cost.

## **Benchmarks on debt sustainability**

Debt sustainability is defined as “the ability of a country to service its borrowings, both foreign and domestic, short term and long term, without compromising its long term goals” (Kappagoda, 2004; Daseking, 2002: 12). Debt sustainability includes two categories of indicators - one relating to “liquidity” and the other to “solvency”. Liquidity is the ability of a government to repay on- time the maturing debt, with interest, from its cash inflows. Solvency refers to the non-accumulation of excessive debt in comparison to GDP and the ability to raise new debt at a reasonable cost. A determination has to be made whether a country needs to reduce its debt as in the case of solvency, or re-schedule and re-structure debt to make it sustainable.

The set of indicators to measure liquidity and solvency of the domestic and external debt are indicated in Table 1.



**Table 1. Indicators to Measure Liquidity and Solvency of Domestic & External Debt**

**Source: IMF & World Bank, 2001; Debt Relief International, 2004; UNESCAP, 2005**

In view of the adverse consequences that arise from high and unsustainable debt, international agencies such as the IMF and the World Bank have laid down certain threshold ranges for debt sustainability (Table 2). By the Maastricht Treaty (1991), for example, EU members agreed to abide by the rules pertaining to price stability, low long term interest rates, stable exchange rates and sound public finances where the budget deficit should not exceed 3% of GDP and government debt should not exceed 60% of a year's GDP (Carbaugh, 2005:273). Governments that run excessive budget deficits and do not attempt to solve this problem are liable to be fined. Sri Lanka, on the other hand, has not been able to achieve the targets set by international agencies and all indicators have exceeded the upper limits of the thresholds (Table 2). If this situation continues the country will fall into a serious debt trap and would not be able to raise funds in the future from domestic and external sources at a reasonable cost.

**Table 2. Threshold ranges of debt sustainability indicators and applicable values for Sri Lanka**

**Source: Debt Relief International, 2004**