# SRI LANKA DEVELOPMENT UPDATE

## BETTER SPENDING FOR ALL

OCTOBER 2025

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## Preface

The Sri Lanka Development Update (SLDU) has two main aims. First, it reports on key developments over the past 12 months in Sri Lanka's economy, places these in longer term and global contexts, and updates the outlook for Sri Lanka's economy. Second, the SLDU provides a more in-depth examination of selected economic and policy issues. It is intended for a wide audience, including policymakers, business leaders, financial market participants, think tanks, non-governmental organizations and the community of analysts and professionals interested in Sri Lanka's evolving economy.

The SLDU was prepared by a team consisting of Shruti Lakhtakia (Economist, Economic Policy Department (EP)) and Udahiruni Atapattu (Research Analyst, EP), with inputs from Richard Walker (Senior Economist, EP), Anthony Obeyesekere (Senior Economist, EP), Namoos Zaheer (Senior Financial Sector Specialist, Finance, Competitiveness and Innovation (FCI)), Tatsiana Kliatskova (Senior Financial Sector Economist, FCI), Niroshi Perera (Analyst, FCI), Marta Schoch (Economist, Poverty), Nandini Krishnan (Lead Economist, Poverty), Patrick Kirby (Senior Economist, South Asia Regional Chief Economist's Office), Gautam Mehta (Associate Operations Officer, Country Advisory & Economics SA), and Gregory Smith (Manager, Country Advisory & Economics SA).

The Special Topic is based on Chapter 3 of the 2025 Public Finance Review for Sri Lanka, titled "Towards a Balanced Fiscal Adjustment". The Special Topic was prepared by Anthony Obeysekare (Senior Economist, EP), with inputs from Shruti Lakhtakia, Richard Walker, Felipe Dizon (Senior Economist, Agriculture and Food Practice Group South Asian Region 1), and Anne Christelle (Food and Agriculture Organization).

The team thanks David Sislen (Division Country Director for Maldives, Nepal and Sri Lanka), Gevorg Sargsyan (Country Manager, Maldives and Sri Lanka), Shabih Ali Mohib (Practice Manager, EP), Ximena del Carpio (Practice Manager, Poverty), and Arvind Nair (Acting Lead Country Economist, Prosperity) for their guidance and comments on the report. Tracey Ann Plunkett and Yasindu Amarasinghe provided administration support. Ruwani Rajapakse was responsible for the layout, design, and typesetting. Buddhi Feelixge and Samitha Senadheera led external outreach efforts. For questions, please contact: infosrilanka@worldbank.org

The report is based on published data available on or before September 15, 2025.

This report, additional material and previous reports can be found at:

- www.worldbank.org/sldu

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- March 2023: Time to Reset
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- October 2022: Protecting the Poor and Vulnerable in Time of a Crisis
  https://thedocs.worldbank.org/en/doc/6c87e47ca3f08a4b13e67f79aec8fa3b-0310062022/original/Sri-Lanka-Development-Update-October-2022-final.pdf
- April 2021: The Economic and Poverty Impact of COVID-19
  https://openknowledge.worldbank.org/handle/10986/35833
- February 2019: Demographic Change in Sri Lanka,
  https://openknowledge.worldbank.org/handle/10986/31261
- June 2018: More and better jobs for an upper middle-income country,
  https://openknowledge.worldbank.org/entities/publication/6d0c157e-cd50-5997-b81c-d271b07a3c2d
- November 2017: Creating opportunities and managing risks for sustained growth,
  openknowledge.worldbank.org/handle/10986/28826
- June 2017: Unleashing Sri Lanka's trade potential
  https://openknowledge.worldbank.org/entities/publication/8807de61-f5cc-54af-ba1f-83dba2883fd7
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# Abbreviations

| | |
|---|---|
| **CCPI** | Colombo Consumer Price Index |
| **EFF** | Extended Fund Facility |
| **EMDEs** | Emerging Market and Developing Economies |
| **FX** | Foreign Exchange |
| **GDP** | Gross Domestic Product |
| **HR** | Human Resources |
| **ID** | Identification Number |
| **IMF** | International Monetary Fund |
| **ISB** | International Sovereign Bond |
| **LFP** | Labor Force Participation |
| **LMIC** | Lower-Middle Income Country |
| **MOF** | Ministry of Finance |
| **MSMEs** | Micro, Small, and Medium Enterprises |
| **NPD** | National Planning Department |
| **NPLs** | Non-Performing Loans |
| **PFM** | Public Financial Management |
| **PIM** | Public Investment Management |
| **PPG** | Public and Publicly Guaranteed Debt |
| **PPP** | Purchasing Power Parity |
| **RMG** | Ready-Made Garments |
| **SLDU** | Sri Lanka Development Update |
| **SOEs** | State-Owned Enterprises |
| **T-bill** | Treasury Bill |
| **U.S.** | United States |
| **y-o-y** | Year-on-year |

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# Executive Summary

## A. Macroeconomic Developments

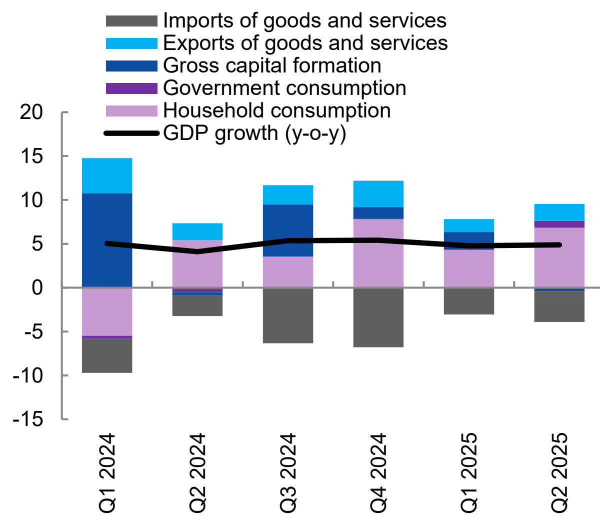
**Sri Lanka's economic recovery continues in 2025 with a growth of 4.8 percent (year-on-year, y-o-y) in H1 2025.** Growth has been driven by continued industrial rebound and steady gains in the service sector. On the demand side, private consumption and investment have led the recovery (Figure 1). Headline inflation, which was in deflation since September 2024, turned positive in August 2025, and has remained in the low single digits. The longer-than-expected deflation allowed for further easing of monetary policy, resulting in a sustained downward adjustment of lending and deposit rates and a marked increase in private sector credit growth to 19.6 percent (y-o-y, July 2025). The current account remains in surplus, supported by service exports and remittances, even as the merchandise trade deficit widened and debt servicing resumed. This has kept the gross usable reserves broadly stable at US$4.7 billion (about three months of imports) for most of the year. Robust revenue collection and weak capital expenditure strengthened the primary balance while the fiscal deficit contracted.

**Although progress has been made, the recovery is unfinished and has not translated into widespread improvements in welfare.** Real output remains below 2018 levels. Although poverty is projected to decline in 2025, it remains double the 2019 levels. Vulnerability remains high with an additional 10 percent of the population living just above the poverty line. Malnutrition continues to be elevated (Figure 2). The labor market recovery is slow with real wages and labor force participation well below 2019 levels.

**Despite strong recent performance, medium-term growth prospects remain modest, around 3.1 percent, in the absence of growth-enhancing reforms.** After its initial rebound post-crisis, growth is expected to revert to potential medium-term levels and be consumption-led with limited contribution from investment and exports. Inflation is projected to remain moderate in 2025 and then converge gradually toward the central bank target. In the medium-term, the current account is projected to be moderately in surplus while the primary balance surplus is expected to average 3 percent of gross domestic product (GDP). However, reserve accumulation is expected to slow, as debt servicing obligations increase.

**Figure 1: Growth is being driven by household consumption and investment**

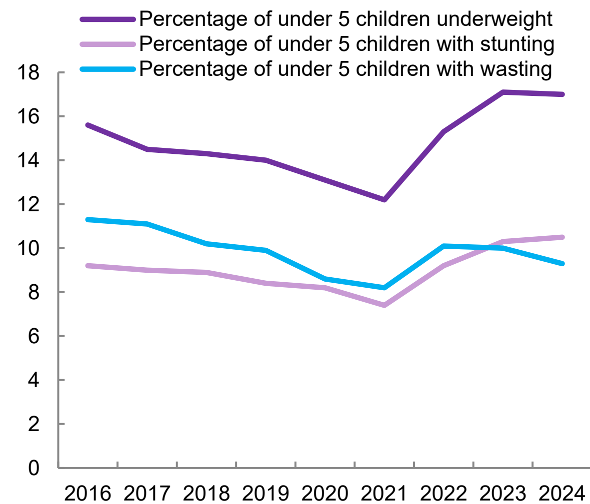
*(Percent, y-o-y, and Percentage point contribution)*




Source: Department of Census and Statistics, World Bank calculations.

**Figure 2: Malnutrition continues to be elevated**

*(Percent)*




Source: Family Health Bureau, Sri Lanka.

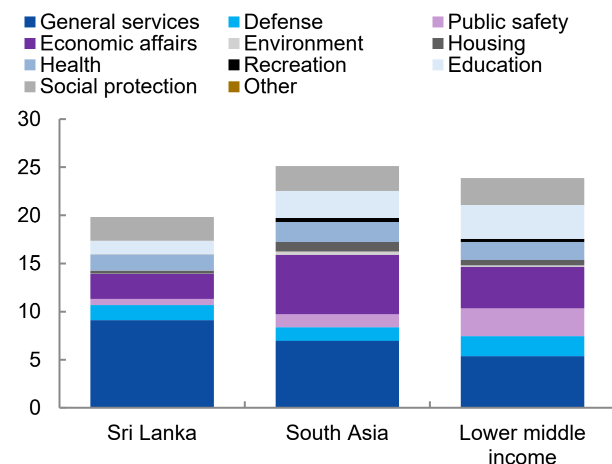
**To boost growth prospects, it is critical to maintain stability, policy consistency, and coherence while urgently implementing structural reforms.** Structural reforms that ease barriers to trade, reduce trade costs, improve investment climate, modernize tax administration, and alleviate rigidities in land, labor, and capital markets could stimulate private sector investments and help boost growth and attract fresh, non-debt-creating capital inflows, given limited fiscal space. These reforms are also critical to revitalize private sector-led job creation, as rigidities in labor regulation and reliance on public sector employment have constrained labor market dynamism and recovery in labor incomes. Higher growth that creates jobs and increases labor incomes will contribute to sustained poverty reduction and increase households' resilience to shocks. Finally, increasing the reliance on direct taxes, modernizing and digitizing tax administration, and focusing on taxpayer engagement to improve tax morale will support sustainable and equitable revenue mobilization, essential for stability and growth.

## B. Better Spending for All

**Sri Lanka's public expenditure is relatively low and highly rigid by international standards.** Sri Lanka's recent economic crisis was partly triggered by weak fiscal management as spending considerably exceeded revenues. However, at an average of just 19.7 percent of GDP over 2017–2023, overall spending is below the averages for lower-middle income countries (LMICs) and South Asian neighbors. Likewise, spending on public wages and capital projects and on sectors such as health, social protection, and education are all comparatively low (Figure 3). Changing spending patterns in Sri Lanka is difficult as 82 percent of spending is 'rigid,' that is, spent on outlays such as public wages, welfare benefits, and interest payments, which are difficult to cut. While high expenditure rigidity limits options to reduce expenditure, the government can focus on increasing the efficiency of its spending, that is, better targeting spending to boost its impact.

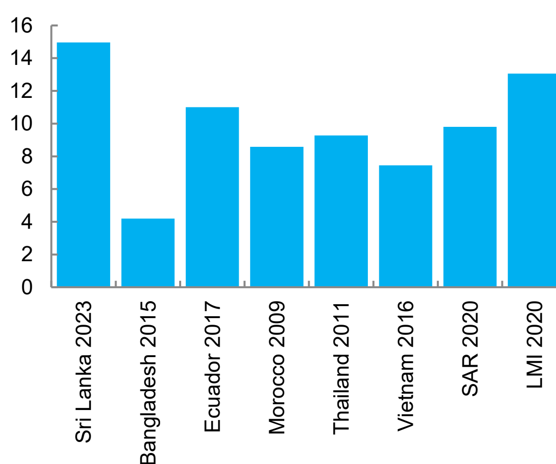
**Looking ahead, Sri Lanka does not have room to significantly increase public expenditure and therefore, could focus on maximizing the development outcomes from its existing levels of public spending.** Comprehensive reforms are required to enhance the efficiency and effectiveness of every rupee spent. The public wage bill and capital expenditures are good places to start. Other aspects of spending, including subsidies and transfers, are discussed in more detail in World Bank (2025).

**Figure 3: Central government expenditure, functional classification 2021-23 average**
*(Percent of GDP)*




Source: Ministry of Finance, World Bank calculations.

**Figure 4: Public service as a share of total employment 2023**
*(Percent)*




Source: Ministry of Finance, 2023 Public Service HR Information Database - Management Services Department, Labor Force Survey 2022, and Worldwide Bureaucracy Indicators, World Bank calculations.

**Reforms to the public wage bill can support fiscal sustainability, fairer public sector pay, better service delivery, and improved long-term planning of the public sector workforce**. At 5 percent of GDP, Sri Lanka's public wage bill is modest compared to its international peers. However, this pays for about 15 percent of all national employment, substantially higher than peers (Figure 4). The result is low wages and difficulties recruiting and retaining key talent. Real public sector wages declined by 33 percent over 2020-2023 due to inflation. In response to low base salaries, ad hoc allowances have proliferated—comprising up to 60 percent of total compensation for specialized roles and complicating remuneration structures across agencies. The overall system is also hampered by decentralized, outdated payroll management and weak data practices. The government could begin tackling these issues by establishing a commission to benchmark and restructure compensation away from ad hoc allowances, implementing gradual workforce attrition while preserving frontline health and education staff, and modernizing payroll and human resource management systems.

**Reforms to public capital expenditure can ensure better return on investment, alleviate critical bottlenecks in the economy, and boost long-run economic growth.** Sri Lanka's long history of low public investment has meant that the public capital stock, as a share of GDP, ranked 143rd out of 166 countries in 2019. Central government public capital expenditure continues to be low, at just 3.4 percent of GDP in 2023, and this limited spending is not well allocated, with the transport sector typically overemphasized. Even when budgeted for, capital spending execution has averaged less than 80 percent (2017-2023) due to challenges in planning frameworks, project appraisal processes, and monitoring systems. In 2025, capital spending as of July was only 27 percent of the planned annual expenditure. Finally, once infrastructure is built or acquired, maintenance has been inadequate, risking future repair or increase in replacement cost. The government could begin tackling these issues by fast-tracking near-complete projects and redirecting resources from stalled projects, strengthening project appraisal procedures and focusing review on larger projects, introducing unique project IDs and integrated project-cycle tracking, and substantially increasing spending on routine maintenance.

# A. Macroeconomic Developments

## 1. Context

***Sri Lanka has restored stability through the implementation of key policy reforms after a severe and unprecedented economic crisis in 2022 and 2023. The economy is growing, and poverty has begun to decline.***

1. **In 2022, a balance of payment crisis and sovereign default plunged Sri Lanka into its worst economic crisis post-independence.** Long-standing structural weaknesses, in conjunction with fiscal and monetary indiscipline, exacerbated by exogenous shocks, led to this crisis. The loss of access to international financial markets led to a rapid depletion of usable official reserves (to less than two weeks of imports by end-2022), severely constraining foreign exchange (FX) liquidity and resulting in an acute shortage of essential goods such as fuel, medicine, and cooking gas. At the height of the crisis, real GDP contracted, inflation surged to 69.8 percent, and public and publicly guaranteed (PPG) debt to GDP ballooned to 119.2 percent. The crisis also had a profound social impact: poverty doubled from 13.1 percent in 2021 to 25.9 percent in 2023 (at US$3.65 per capita, purchasing power parity, PPP), effectively undoing a decade of poverty reduction in Sri Lanka. In March 2023, the country entered into a 48-month International Monetary Fund (IMF) Extended Fund Facility (EFF) program.

2. **Amid the crisis, the government started implementing both macro-fiscal stabilizing and structural reforms.** The macro-fiscal stabilization was underpinned by the implementation of cost-reflective utility pricing, new revenue measures, prudent monetary policy, and enactment of legislation on public debt and public financial management. In parallel, structural reforms were initiated to address long-standing growth-constraining issues in the economy, such as a challenging investment and trade environment, high exposure of the financial sector to the sovereign, and labor market rigidities, among others. The government commenced discussions to restructure its external debt in 2022, and domestic debt was restructured in 2023.

3. **Following the implementation of reforms, the economy stabilized by mid-2023 and started recovering in 2024.** The economy expanded by 5 percent (year-on-year, y-o-y) in 2024, following a cumulative

contraction of 9.5 percent between 2021 and 2023. Headline inflation returned to single digits in mid-2023 and remained negative between September 2024 and July 2025. Usable reserves grew to US$4.7 billion by end-2024 (compared to US$500 million by end-2022), covering three months of imports. The primary balance reached 2.2 percent of GDP in 2024 (compared to -3.7 percent in 2022), and PPG debt-to-GDP fell to 103.9 percent by end-2024. However, the economic recovery did not translate into widespread welfare improvements. Poverty continues to be twice the 2021 level, despite improvements in 2024, and the labor market recovery has been weak.

# 2. Recent Economic Developments

***Sri Lanka's recent economic performance remains strong, supported by a recovery in consumption and investment, robust remittances and tourism inflows, and significant revenue improvements. Poverty has started to decline, but vulnerability of households remains high.***

## The recovery continues through the rebound in industry and steady growth in services

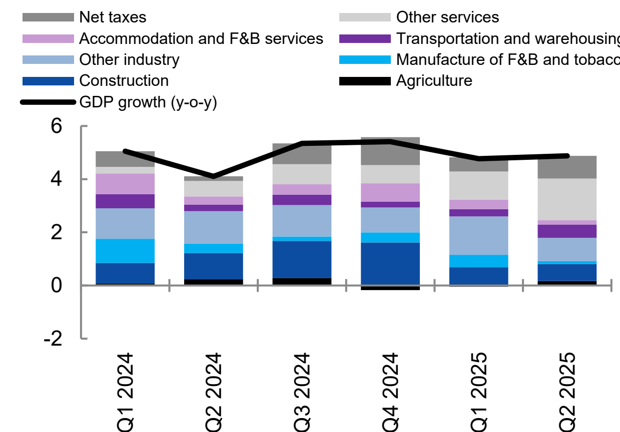
4. **GDP grew at 4.8 percent (y-o-y) in H1 2025, marking eight quarters of expansion.** Growth was led by the continued rebound in industry (7.9 percent, y-o-y) and steady growth in services (3.3 percent, y-o-y) (Figure 5). The industrial rebound was driven by expansion in textiles and apparel (as production ramped up ahead of tariff deadlines), pick-up in construction (as new small-scale projects took off amid the economic recovery), and growth in food and beverage manufacturing (supported by tourism and the recovery in consumption). Strong performance in financial and tourism-related services, such as accommodation and transport, underpinned service sector growth. The agricultural sector grew by 0.6 percent (y-o-y), as the production of several key crops declined, reflecting inclement weather conditions.

5. **High frequency indicators show continued improvements, reflecting the expansion in industry and services in H1 2025.** The Index of Industrial Production expanded in the first five months of 2025, while electricity sales to industries and cargo and container handling also grew marginally. Total cement consumption increased by 10.1 percent (y-o-y) over the same period, reflecting the moderate pick-up in the construction sector. However, cement consumption remains below pre-crisis levels, reflecting the limited availability of larger-scale projects (Figure 6). Despite the seasonal dip in April in line with the annual holiday period, the Purchasing Managers' Index for manufacturing, services, and construction continues to show an uptick in activity.

6. **Since late 2024, household consumption and investment have led growth.** Household consumption grew at 7.7 percent (y-o-y) in Q1 2025, contributing to 90 percent of growth, amid deflation, recovering wages, increased credit growth, and a broadly stable rupee. Investment spending (5.9 percent, y-o-y) remained high, with gross fixed capital formation in Q1 2025 reaching its highest level since Q1 2022,

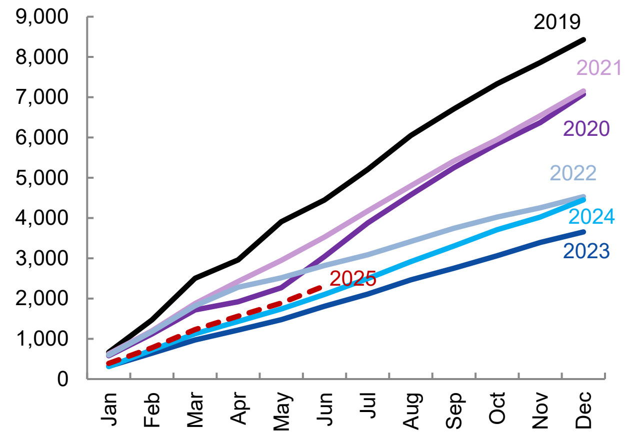
reflecting the rebound in the industrial sector. The contribution of the net external balance (exports minus imports) and government consumption to growth remained low.

**Figure 5: GDP growth continues to be driven by industry and services**
*(Percent (y-o-y) and Percentage point contribution)*




Note: 'Other industry' includes manufacture of textiles and apparel, chemical and chemical products, rubber and rubber products, among others. 'Other services' include financial services, wholesale and retail trade, education, among others.
Source: Department of Census and Statistics, World Bank calculations.

**Figure 6: Total cement consumption has increased but remains below pre-crisis levels**
*(Total MT'000)*




Source: Central Bank of Sri Lanka.

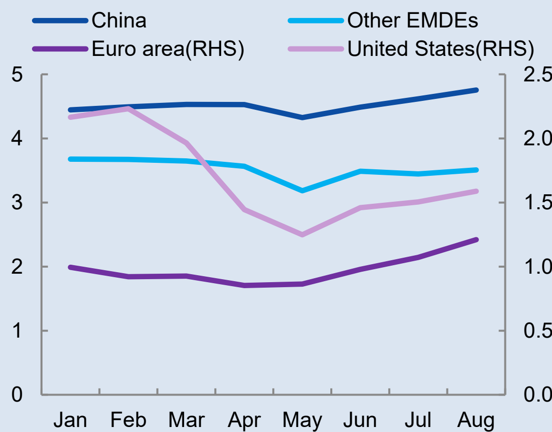
## Box 1: Global economic developments

**Global growth is showing early signs of strain from rising uncertainty over tariffs and trade policy.** Forecasts for 2025 growth rates of major economies dipped in April after major economies announced new tariffs. Except for the United States (U.S.), the forecasts recovered after tariff implementation was delayed and moderated (Figure 7).

**Global trade policy uncertainty has retreated from its April high but remains elevated by historical standards.** This largely reflects changing U.S. import tariffs, which have been introduced, delayed, and adjusted frequently in recent months. The net effect has been that U.S. tariffs, averaged using their 2024 weight in the U.S. import basket, have risen to their highest level in nearly a century, from 2.4 percent in 2024 to 17.4 percent in September 2025 (Figure 8). The effects of changing trade policy are apparent in some categories of trade, such as bilateral merchandise trade between the U.S. and China, with the trade volume between the two countries having fallen by about a quarter since April. However, aggregate global trade volumes have remained resilient so far, growing 3.1 percent in the 12 months ending in June, as companies increased production and stockpiled imports prior to the imposition of new tariffs. Similar trends were seen in Sri Lanka.

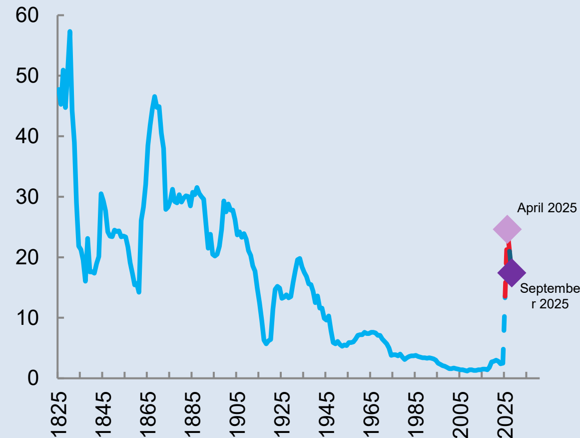
**Central bank decisions around the world have been highly synchronized since the pandemic but are now becoming more varied as inflation dynamics become more country specific.** Inflation remains close to central bank targets in most countries, but it has been trending up in 2025. Import prices are being pushed up in some countries by tariffs and pushed down in others by the falling price of goods coming from China and currency appreciation against the U.S. dollar. Commodity prices have been volatile without a clear trend. Borrowing costs for both sovereigns and corporates remain above their pre-pandemic average, even as spreads over U.S. Treasury yields have generally been small. Credit ratings for emerging market and developing economy (EMDE) sovereigns have been improving. The majority of central banks are still easing policy, often at a very gradual pace. Central bank communications are increasingly expressing caution about moving too quickly in an environment of elevated uncertainty.

**Figure 7: Evolution of consensus forecasts, 2025**
*(Percent) (Percent)*




Note: "Other EMDEs" includes 45 economies. The horizontal axis shows the months of 2025 in which the forecast was prepared.
Source: Consensus Economics.

**Figure 8: U.S. tariff history**
*(Percent)*



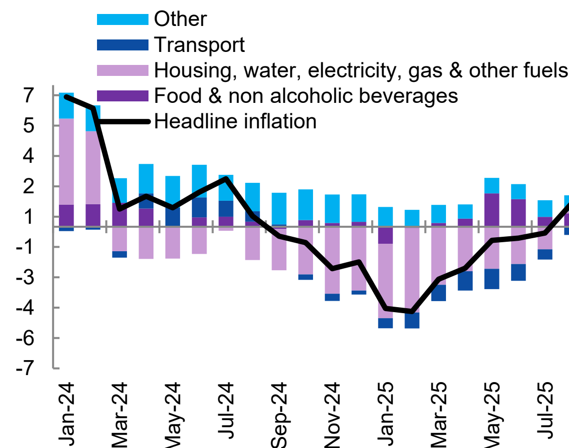

Note: Values prior to 2025 are from Tax Foundation. 2025 values are average trade-weighted tariff rates estimated by the Budget Lab at Yale.
Source: Budget Lab at Yale; Tax Foundation.

Source: South Asia Regional Chief Economist Office.

## Inflation picked up after eleven months of deflation

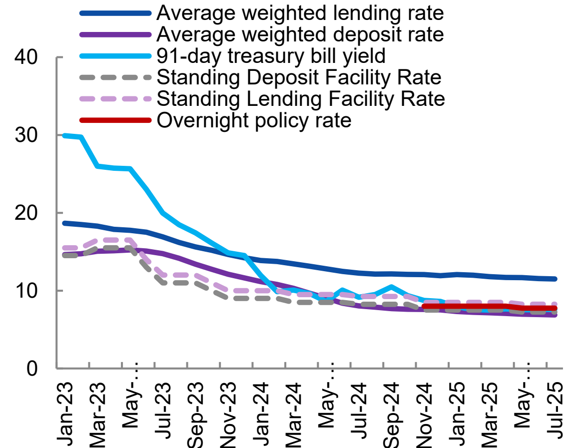
7. **Headline inflation, as measured by the Colombo Consumer Price Index (CCPI), turned positive in August 2025 (1.2 percent, y-o-y), driven by the base effect.** Deflationary conditions persisted since September 2024, reflecting repeated downward adjustments in utility prices (including petroleum, electricity, and water), better supply conditions, lower global oil prices, an appreciating rupee (until end-2024), and the phase out of monetary financing. After falling to -4.2 percent (y-o-y) in February 2025, deflationary conditions began to ease, and inflation returned to positive territory in August 2025 (Figure 9). This increase was driven by the base effect—led by fluctuating food inflation (given recovering demand and agricultural shortages) and a rebound in administered energy prices (given upward revisions to fuel prices and electricity tariffs in Q2 and Q3 2025)—amid rupee depreciation. Core inflation (which excludes volatile food, energy and transport prices) has remained positive throughout, with the recovery in demand. The National Consumer Price Index followed a similar trend to the CCPI but turned positive earlier, in May 2025.

**Figure 9: Deflationary conditions began to ease in early 2025**
*(Percent (y-o-y) and percentage point contribution)*




Source: Department of Census and Statistics, World Bank calculations.

**Figure 10: Market rates have trended downward**
*(Percent)*




Source: Central Bank of Sri Lanka.

8. **With inflation well below target, the central bank maintained an accommodative monetary policy stance.** In May 2025, the central bank reduced policy rates by a further 25 basis points, bringing the overnight policy rate (OPR) to 7.75 percent, following a cumulative reduction of 825 basis points since 2023. Combined with the improved liquidity in the market, market rates trended downward (Figure 10). Treasury bill (T-bill) yields continued to decline, supported by lower policy rates and improved investor sentiment. Real interest rates stayed higher than nominal rates as deflation persisted. Domestic liquidity remained in surplus, driven by the FX purchases of the central bank, although overnight liquidity has moderated (compared to January 2025), as the central bank discontinued reverse repo auctions. Both reserve money (M0) and broad money supply (M2b) continued to expand by 16 and 10 percent (y-o-y), respectively, in July 2025 (Figure 12).

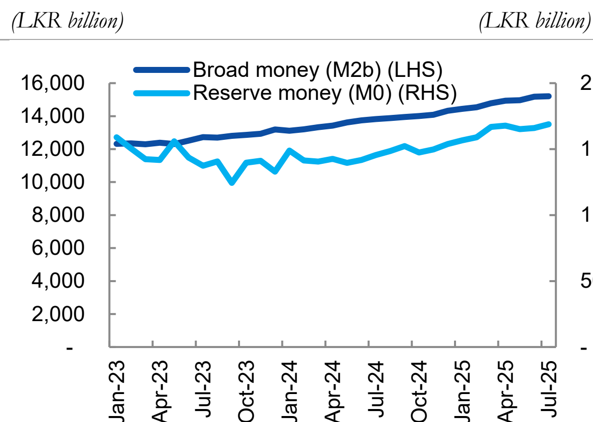
### The financial sector continues to recover amid lower rates and improved economic conditions

9. **Private sector credit grew, buoyed by monetary policy easing and the economic recovery**. Accommodative monetary policy, combined with improved market liquidity, contributed to a downward adjustment in lending and deposit rates. The average weighted new lending and deposit rates declined to 10.4 and 6.2 percent, respectively, in July 2025 (from 25.8 and 22.2 percent in January 2023). Lower interest rates and an increased lending appetite of the banking sector resulted in a sharp increase in private sector credit growth during the year (19.6 percent, y-o-y, July 2025).[1] Credit to the private sector reached its highest level in nominal terms, although it remains below pre-crisis levels as a percentage of GDP (Figure 11).[2] Net credit to the government from the banking system also increased by 4.7 percent (y-o-y, July 2025). Exposure of commercial banks to the sovereign (including via higher government securities holdings) increased in nominal terms but fell as a share of total banking sector assets (from 33.6 percent in June 2024 to 30.7 percent in June 2025) due to growth in total banking sector assets. However, commercial banks' credit to state-owned enterprises (SOEs) contracted 10.2 percent (y-o-y) in July 2025, as net repayments were made by large SOEs.

10. **The stability of the banking sector is improving, amid supportive macroeconomic conditions, but asset quality pressures remain high.** Stronger net interest margins (4.6 percent in Q1 2025, compared to 3.8 percent in Q1 2024), among others, contributed to a modest improvement in banks' profits. Financial soundness indicators, such as the Capital Adequacy Ratio, saw a significant improvement in Q1 2025 to 19.3 percent, from crisis lows of 15.1 percent in Q1 2022, mainly due to higher growth in regulatory capital. Non-performing loans (NPLs) saw a slight uptick to 12.7 percent in Q1 2025 from 12.3 percent in end-2024.[3] NPLs of micro, small, and medium enterprises remained unchanged at 19 percent by end-2024 (similar to end-2023), with the highest ratio recorded in the tourism sector (32 percent) followed by construction (26 percent). With the lifting of government restrictions on the execution of *parate* rights in March 2025,[4] the potential *parate* recovery and restructuring are expected to result in a gradual reduction in NPLs, further supporting credit growth.

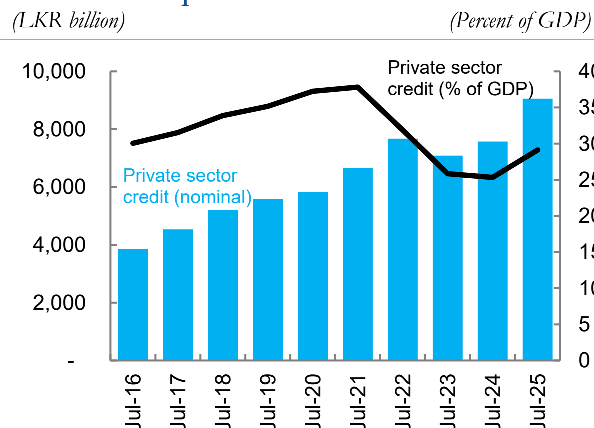
[1] In 2024, lending to both corporates and individuals grew by 10 and 11 percent, respectively, while the loan stock of the MSME sector increased by 3 percent.
[2] Private sector credit was 29.1 percent of nominal GDP (July 2025), compared to 31.9 percent (July 2022) and 37.8 percent (July 2021).
[3] Calculated as a percentage of total loans and advances.
[4] With exemptions provided to MSMEs which approached banks to discuss restructuring prior to March 31, 2025.

**Figure 11: Money supply continues to expand**




Source: Central Bank of Sri Lanka, World Bank calculations.

**Figure 12: Private credit has increased sharply but remains below pre-crisis levels as a share of GDP**




Source: Central Bank of Sri Lanka, Department of Census and Statistics, World Bank calculations.

## The external sector remained resilient amid unprecedented trade uncertainties

11. **Despite trade uncertainties (Box 2), the current account balance remained in surplus during the first seven months of the year, anchored by tourism and remittances.** The merchandise trade deficit widened from US$3.1 billion to US$3.9 billion during January–July 2025 (a 22.5 percent increase, y-o-y), as imports picked up faster than exports. The removal of restrictions on vehicle imports in February 2025 resulted in a 13-fold increase (y-o-y) in personal vehicle imports to US$506.1 million by July, surpassing the cumulative vehicle imports over the past five years (2020–24). The increase in imports of vehicles and general consumer goods (reflecting improved household consumption) more than offset the decline in fuel imports (as global oil prices fell and domestic supply of renewable energy increased),[5,6] leading to a 11.8 percent (y-o-y) increase in the import bill during the first seven months of 2025 (Figure 13).[7] Services exports increased by 5.8 percent (y-o-y) to US$4.2 billion over the same period, through steady growth in tourism and transport. Earnings from tourism reached US$2 billion with 1.4 million tourist arrivals by July 2025 (a 14.2 percent increase, y-o-y). While arrivals have nearly recovered to 2018 levels, tourism earnings remain notably lower compared to the same period (Figure 14). Remittances reached historic highs of US$5.1 billion between January and August 2025 (a 19.3 percent increase, y-o-y), aided by the high levels of emigration in recent years. Together, these inflows kept the current account in a continuous surplus (US$1.7 billion by July 2025).

### Box 2: Impact of U.S. Tariffs on Sri Lankan Exports

**The U.S. imposed a 'baseline' tariff of 20 percent on all imports from Sri Lanka in July 2025.** On July 31, 2025, the U.S. imposed a 20 percent tariff on Sri Lankan exports, which took effect on August 7. This is a reduction from the higher tariff rates of 44 percent and 30 percent announced in April and July 2025, respectively. The 20 percent tariff would be stacked on top of the Sri Lankan Most Favored Nation rate of 16.8 percent (with slight variation depending on the product). The terms of the negotiations with the U.S. are not public. The U.S. is Sri Lanka's largest single-country export destination, accounting for US$3.2 billion worth of exports in 2024 (22 percent of total exports and 3.2 percent of GDP). The export basket to the U.S. is primarily composed of ready-made garments (RMG), rubber products, and tea, with RMG alone accounting for 56 percent of Sri Lankan exports to the U.S. (Table 1). Notably, over 40 percent of Sri Lanka's

[5] Domestically, fuel and coal-based electricity generation fell by 34.7 percent, y-o-y, while electricity generated through renewable sources rose by 39.4 percent, y-o-y, during January to May 2025. The latter was mainly due to the good rains in this period.

[6] Only includes the electricity generated by the Ceylon Electricity Board, which is responsible for generating over 75 percent of the country's total electricity supply.

[7] Restrictions on private vehicles were introduced in early-2020, as part of efforts to conserve FX during the COVID-19 pandemic.

total garment exports in 2024 were to the U.S. The apparel industry overall is a key contributor to the economy (6 percent of GDP in 2024) and an important source of jobs (estimated at 350,000).

**Table 1: Profile of Sri Lanka's Exports to the U.S.**

| Export Category | Total Exports to the US in 2024 (US$ million) | Share of exports to the U.S. (percent) | Share of GDP (percent) |
|---|---|---|---|
| RMG | 1,777.6 | 56 | 1.9 |
| Rubber and articles | 342.4 | 11 | 0.3 |
| Precious stones | 246.7 | 8 | 0.2 |
| Machinery and mechanical appliances | 102.3 | 3 | 0.1 |
| Tea | 82.6 | 3 | 0.1 |
| Other | 607.6 | 19 | 0.6 |
| **Total** | **3,159.0** | **100** | **3.2** |

**Source: International Trade Centre, trademap.org.**

**The parity in tariff rates with competitors suggests limited possibility for trade diversion of RMG.** Sri Lanka's tariff rates are comparable to that of the major competitors—Viet Nam, Bangladesh, Cambodia, and Indonesia. The industry believes that the parity in tariffs with major competitors would reduce the possibility of trade diversion, especially given that markets with a high degree of complementarity in export bases (such as Viet Nam and Cambodia) have similar tariff rates. Conversely, given the limited overlap with India's export base, it is unlikely that Sri Lanka might benefit from the impact of the 50 percent tariff on India (as of August 27, including an additional 25 percent tariff imposed because of India's purchase of Russian oil).

**The composition of Sri Lankan apparel exports makes them relatively resilient compared to competitors.** Sri Lanka's primary exports to the U.S. are undergarments, performance wear, and higher-end clothing, which are relatively price inelastic. According to industry experts, Sri Lanka does not compete on price but rather on quality, better labor standards, sustainability, traceability, and compliance, suggesting that buyers of Sri Lankan exports may be less price sensitive. Even so, manufacturers operate on very thin margins (2–5 percentage points) and would be unable to absorb the entire additional 20 percent tariff.

**Despite its resilience, the RMG sector still faces structural challenges, which can be addressed through product and market diversification.** The small size of Sri Lanka's labor force, especially the low female labor force participation (relative to East Asia), and lack of domestically produced raw materials and intermediates pose challenges to the sector. Other structural challenges, including high construction costs and electricity prices, also affect export competitiveness. Beyond addressing these structural competitiveness challenges, diversification of markets and products can help the RMG industry become more competitive. Improving market access to Japan, Australia, and Korea through preferential trading arrangements and shifting with evolving consumer preferences from natural fibers to man-made fibers can aid diversification efforts. In the medium-term, shifting toward innovative, higher-value categories, such as performance, athleisure, and shapewear, where brand stickiness and compliance command high premiums, could help Sri Lanka absorb the tariff impact and sustain growth in the sector.

**Unlike RMG, rubber product exports could see trade diversion because of the tariff differential with Mexico.** Exports of rubber products to the U.S. could see an estimated 42 percent decline, driven in part by the possibility of significant trade diversion for value-added segments such as solid tires, gloves, and industrial

components.[8] Sri Lanka exported US$342 million worth of rubber products to the U.S. in 2024. While domestic value addition of rubber product exports is high, an estimated US$100–150 million worth of exports overlap with those from Mexico to the U.S. As these Mexican exports (that are compliant with the U.S.-Mexico-Canada Agreement, USMCA) are exempt from tariffs, the tariff differential could lead to processing and value addition migrating to Mexico over time.

**Table 2: US imports of select rubber products: Sri Lanka versus Mexico (2024)**

| Products (US$ million) | Sri Lanka | Mexico |
|---|---|---|
| Used pneumatic rubber tires, threads, flaps etc. | 169 | 96 |
| New pneumatic rubber tires | 63 | 2,214 |
| Articles of vulcanized rubber | 31 | 1,095 |
| Plates, sheets, strips, rods etc. of vulcanized rubber | 11 | 31 |

**Source: International Trade Centre, trademap.org.**

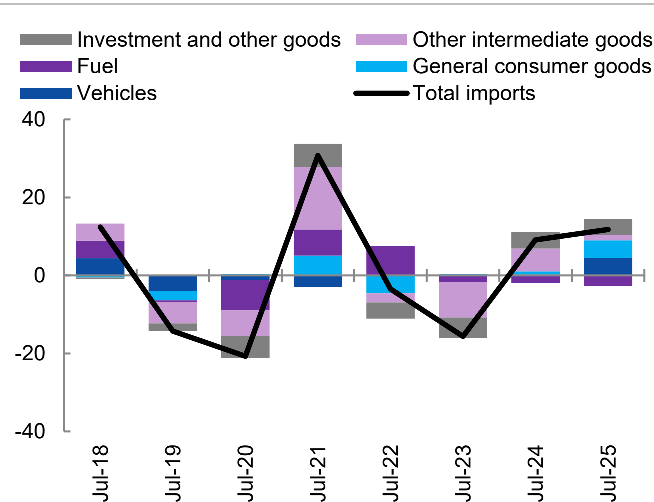
**The impact on the current account is manageable, but low-skilled workers are highly vulnerable.** It is estimated that the 20 percent tariff could decrease Sri Lanka's RMG exports to the U.S. by ~12 percent (~US$220 million compared to the baseline).[9] The impact on employment, which would disproportionately affect unskilled workers and women, is estimated to be 16,000.[10] Assuming 40–50 percent domestic value addition (in line with industry estimates), the impact on the current account would be approximately US$110 million-130 million (~0.1 percent of GDP). A similar decline of US$110 million–120 million (~0.1 percent of GDP) may be expected in exports of rubber products (relative to the baseline). While the overall impact of the tariff structure (if it remains unchanged) on the current account (~0.2 percent of GDP) is currently manageable, given the robust inflows in other sectors, second-order effects from a global slowdown could be high, and the impact on private consumption from job losses remains a key risk.

Source: International Finance Corporation.

12. **Despite the strong current account surplus and net purchases of FX by the central bank, reserve accumulation has slowed, and the rupee began to depreciate.** The strong current account surplus and continued inflows from development partners (including the disbursement of two tranches from the IMF EFF in March and July) contributed positively to the balance of payments. However, the government's external debt servicing needs were high, at US$1.4 billion in H1 2025 alone. The central bank continued to purchase FX totaling US$1.2 billion, albeit at a slower pace (38.8 percent reduction, y-o-y) compared to the first eight months of 2024. As a result, gross usable reserves (excluding the swap with the People's Bank of China) were at US$4.8 billion by end-August 2025, similar to levels prevailing at end-2024. However, reserves in terms of import cover fell to 2.5 months in July 2025, lower than 3 months at end-2024. The net foreign assets of the overall banking system, which turned positive in May 2024, broadly strengthened and then began to decline since April 2025, reaching US$2.9 billion in July 2025. Accordingly, the rupee depreciated (3.1 percent, year-to-date), following a cumulative appreciation of 19.4 percent in 2023 and 2024.

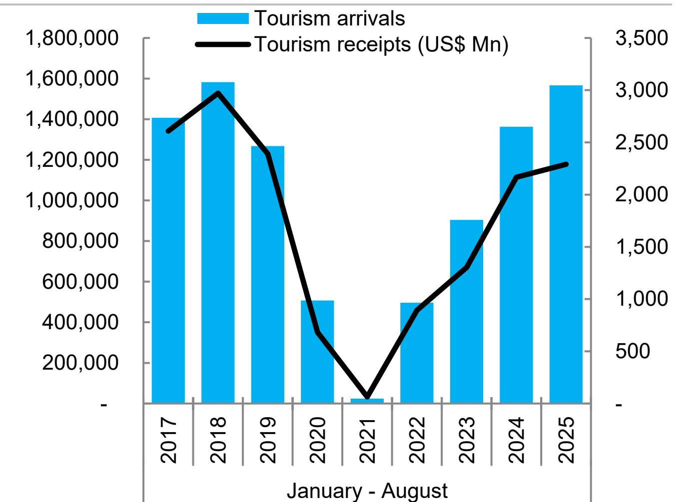
[8] https://www.themorning.lk/articles/2TKnfqOAOTZlgVXQfCvf
[9] https://www.ips.lk/talkingeconomics/2025/08/14/economic-cost-of-the-us-tariffs-on-sri-lanka/
[10] Ibid

**Figure 13: Import growth has been driven by vehicles and other consumer goods**
*(Percent y-o-y and percentage point contribution)*




Source: Central Bank of Sri Lanka, World Bank calculations.

**Figure 14: Tourism earnings remain below pre-pandemic levels.**
*(Arrivals)* *(US$ million)*




Source: Central Bank of Sri Lanka.

## Fiscal buffers have strengthened to unprecedented levels

13. **Revenue overperformance and weak capital budget execution led to a strengthening of the primary balance surplus over January-July 2025 (Figure 15).** Total revenue increased by 26.5 percent, mainly driven by taxes on imports (such as value added tax on imports, excise taxes on motor vehicles, and trade taxes) as vehicle imports gained momentum. Primary expenditure (expenditure minus interest payments) rose by 7.2 percent (y-o-y), as a result of a higher wage bill—due to resumed public sector hiring and implementation of the salary increases proposed in the 2025 national budget—and increased welfare costs.[11,12] However, this was partially offset by the higher-than-usual under-execution of the capital budget, with just 22.2 percent of the annual budgeted amount spent by July 2025 (a 19.8 percent decline, y-o-y, over the January-July period) (Figure 16). Capital execution remained slow on account of the passage of the appropriation act only in March 2025 and slower-than-expected recommencement of bilateral projects post-restructuring.[13] As a result, the primary surplus increased by 87.5 percent (y-o-y) over January-July 2025. The fiscal deficit fell by 36.3 percent (y-o-y), despite a 9.9 percent (y-o-y) increase in interest payments over the same period. The deficit was primarily financed domestically. The outstanding stock of T-bills remains high (approximately 12.3 percent of GDP at end-August 2025) and is being gradually rolled over into Treasury-bonds with longer maturities. The share of PPG debt stayed roughly stable at 103.6 percent of GDP in H1 2025, compared to 103.7 percent at end-2024.

14. **The restructuring of international sovereign bonds (ISBs) was largely completed in December 2024, and official debt restructuring is progressing steadily.** Bilateral agreements with several official creditors (including France, Japan, Hungary, the United Kingdom, the Saudi Fund for Development, and the Export-Import Bank of India) were finalized in H1 2025. The debt exchange with bondholders was largely completed in December 2024 (with a 98 percent participation rate). As a result, Sri Lanka's foreign currency

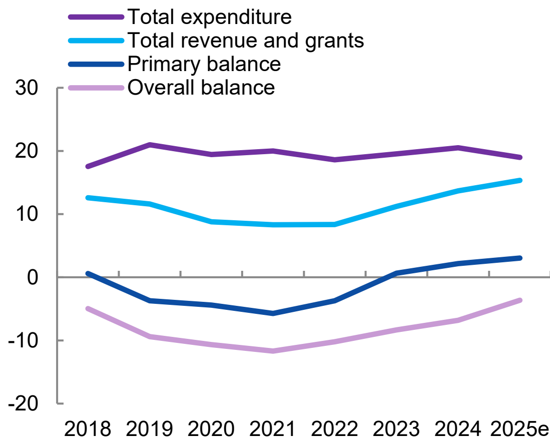
[11] The 2025 national budget proposed a three-phase salary increase for public sector employees, raising the minimum basic salary from LKR 24,250 to LKR 40,000 over 2025 to 2027. Under the first phase, implemented in April 2025, employees will receive LKR 5,000 plus 30 percent of the remaining increase.

[12] In March 2025, the cabinet approved an increase in monthly allowances for persons with disabilities, chronic kidney disease of unknown etiology, and for elderly citizens effective April 2025, alongside other revisions to the scheme.

[13] https://www.themorning.lk/articles/9vVausdXkmu9ryLCR5i8

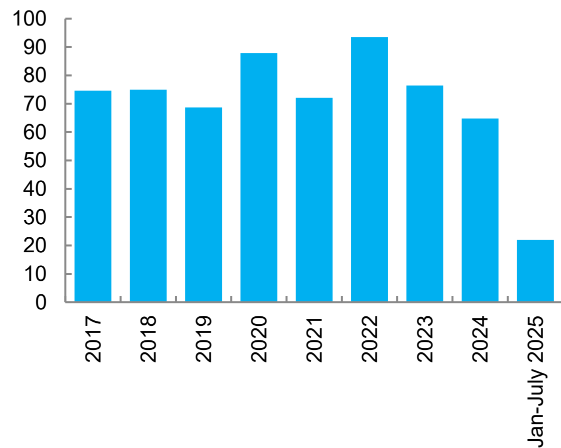
sovereign credit ratings were upgraded by credit rating agencies, including Moody's and Fitch. Payments in relation to restructured ISBs have commenced, including interest payments on restructured ISBs and the first repayment on the *past due interest* (PDI) bond. Discussions to restructure US$175 million worth of guaranteed bonds of Sri Lankan Airlines are ongoing. Domestic debt restructuring was concluded in September 2023.

**Figure 15: Fiscal indicators continue to overperform**
*(Percent of GDP)*




Source: Central Bank of Sri Lanka, World Bank calculations.

**Figure 16: Capital budget execution has remained low in recent years**
*(Percent of original budget)*




Note: 2024 figures are provisional, and the capital budget excludes the allocation made for bank recapitalization in the original budget. The 2025 capital budget execution figure includes net lending.
Source: Ministry of Finance, World Bank calculations.

## Poverty is falling again, though vulnerability remains high, and the labor market recovery is slow

15. **Poverty is projected to decline in 2025, supported by economic growth, higher wages, and low inflation, even though food prices remain high**. The poverty rate is projected to decrease from 24.9 percent in 2024 to 22.4 percent in 2025 (US$4.20 poverty line, 2021 PPP). However, vulnerability to falling into poverty remains high, with another 10 percent of the population living just above the poverty line.[14] Transport and energy-driven deflationary conditions are expected to have a positive impact on households with the reduction of non-food costs. Lower energy costs are likely to benefit poorer households more, while lower transport and oil prices will likely have a larger impact for households in the upper end of the income distribution. However, these may potentially spill over positively to workers via higher wages if the lower prices translate into lower costs of production. Nonetheless, the continual rise in food prices raises significant distributional challenges, as lower-income households allocate approximately three times more of their expenditures to food than wealthier households, and food insecurity remains elevated (Figure 17).[15] Likewise, ongoing inflationary pressures in health and education threaten the affordability of essential public services. Although wages are improving in both the public and private sectors, real earnings remain below those recorded pre-2022, and household purchasing power has yet to recover to pre-crisis levels.[16]

[14] The poverty rates for Sri Lanka are expressed at the new international poverty line of US$4.20 per person per day (2021 PPPs), typical of LMICs at similar levels of development. The new LMIC international poverty line is expressed in 2021 PPPs. The latest official poverty rate for Sri Lanka is based on the 2019 Household Income and Expenditure Survey and results in a poverty rate of 14.3 percent when calculated at the national poverty line of LKR 6,966. For the same year, the international poverty rate at the LMIC line was 11.5 percent. Vulnerability to falling into poverty is calculated as the share of the population living on a budget only 20 percent higher than the poverty line.

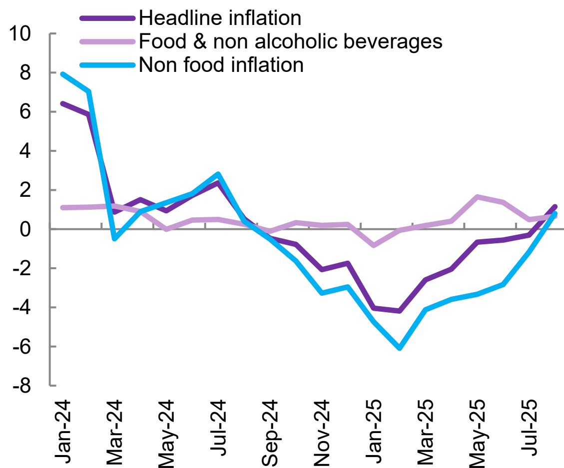
[15] https://docs.wfp.org/api/documents/WFP-0000166873/download/?_ga=2.238117376.1285793593.1750933835-462821477.1740843917

[16] The real wage index for the informal private sector is only reported since 2019: https://www.cbsl.gov.lk/en/statistics/statistical-tables/real-sector/prices-wages-employment

16. **Notwithstanding improvements, the crisis is expected to have reversed a decade of progress in monetary and non-monetary poverty alleviation**. Limited affordability of essential goods and public services is particularly concerning in an environment where the gains in human capital, that were achieved during the post-conflict decade, risk being undermined by prolonged economic hardship. The international poverty rate, which stood at about 20 percent in 2012-13, is likely to remain at higher levels until 2027. Other measures of deprivation show similar setbacks. In 2024, 17 percent of children under five were underweight—a marginal improvement over 2023 but still above pre-crisis levels—and stunting rates among young children have continued to rise.

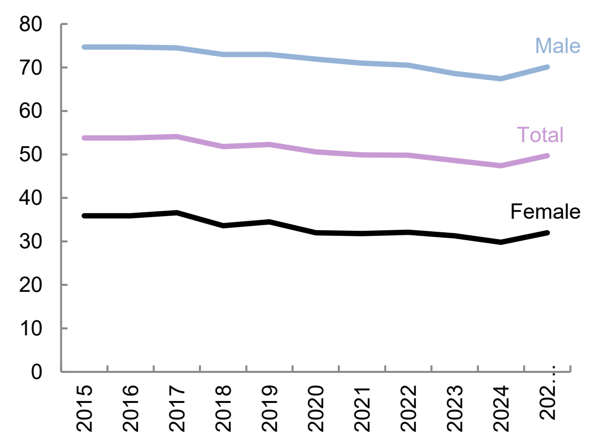
17. **Economic recovery drove an improvement in labor force participation (LFP) in Q1 2025, but participation rates remain below their pre-crisis levels, especially in urban areas and among women**. LFP began to recover in 2025, after a decline of 4.9 percentage points between 2019 and 2024 (Figure 18). The decline between 2019 and 2024 accelerated a trend that pre-dated the crisis—LFP had already declined from 53.8 percent to 52.3 percent between 2015 and 2019. Participation rates among women and in urban areas also fell—from 34.5 percent in 2019 to 29.8 percent in 2024 among women, and from 50.2 percent in 2019 to 44.3 percent in 2024 in urban areas. Improvements were registered in Q1 2025, with the broader economic recovery, as the LFP and participation in urban areas increased to 49.7 percent and 47 percent, respectively, in line with an increase in employment in services and industry—up from 48.5 percent to 50.3 percent and from 25.6 percent to 26.2 percent between 2024 and Q1 2025, respectively. Female LFP also increased to 32 percent in Q1 2025.

**Figure 17: Food prices have remained high**
*(Percent)*




Source: Department of Census and Statistics, World Bank calculations.

**Figure 18: LFP has remained low until recently**
*(Percent)*




Source: Department of Census and Statistics.

# 3. Outlook and Policy Priorities

***While the short-term outlook has improved, medium-term growth prospects are muted. Downside risks are high given global headwinds and scarring effects of the crisis. Medium-term growth and poverty prospects depend critically on continued macro stability and the implementation of structural reforms that boost trade, investment, and enhance non-debt-creating flows.***

## Sri Lanka's path toward sustainable economic growth remains narrow

18. **Medium-term growth prospects are modest.** Growth in 2025 and 2026 is expected to be supported by the continued recovery in industry and steady gains in services. However, medium-term growth is projected to remain around 3.1 percent—in the absence of growth-enhancing reforms—reflecting the scarring effects of the crisis, structural impediments to growth, and significant global economic uncertainties. This growth is expected to be primarily consumption led, with limited contribution from investment and exports. As a result, Sri Lanka is expected to regain 2018 levels of real output only by 2026. Inflation is projected to remain below the central bank's target of 5 percent in 2025 and gradually converge toward the target in the medium-term as demand recovers. Further monetary easing needs to be carefully managed to avoid overheating the economy and creating external pressures.

19. **A shift to a current account deficit is expected in the medium-term.** The current account balance is projected to remain in surplus in 2025, supported by tourism-led increases in services exports, strong remittance flows, and falling global oil prices. In the absence of any fundamental trade and investment reforms, the current account will moderate thereafter—as falling global oil prices and robust service exports and remittances are expected to counteract the trade-related disruptions—before turning negative in the medium-term. The accumulation of reserves is projected to continue in the short-term, albeit at a slower pace, on the back of a favorable current account and inflows from development partners.

20. **The fiscal consolidation is expected to strengthen further.** The primary balance surplus is projected to widen due to continued revenue overperformance and a slow recovery in public investment. However, the high reliance on value-added and trade taxes (primarily through imports) could hinder the recovery in consumption, adversely affect equity, and restrict export growth. The projected increase in recurrent expenditure over the medium-term—reflecting the proposed increases in salaries, pensions, and transfers—is

needed to protect service delivery but must be carefully managed to avoid crowding out capital expenditure (given the government's primary expenditure ceiling of 13 percent of GDP). As discussed in Part B, a better expenditure policy within a constrained overall envelope is needed to deliver stronger development outcomes and medium-term growth.

21. **Poverty is expected to decline slowly.** With the economic recovery, poverty (below US$4.20 per person per day, 2021 PPP) is projected to continue its declining trajectory that began in 2024 but will still remain above 20 percent by 2027. Restoring income growth at the bottom of the distribution is critical for long-term growth and sustained poverty reduction. This requires a more equitable fiscal adjustment, robust labor market recovery, more private sector job creation through addressing rigidities in labor regulations and the reliance on public sector employment, and finding fiscally sustainable options to tackle public sector wage issues (see Part B).

22. **Despite the gradual buildup of buffers, downside risks remain high.** Decelerating global growth amid trade-related distortions, uncertain global trade and monetary policy, inequitable fiscal consolidation, and limited investments and external financing support are key risks to maintaining stability, sustaining growth, and building necessary external and fiscal buffers. Further, the recalibration of global trade could dampen export demand, deter investment, and result in potential trade-related job losses. Sound debt management is critical to managing the elevated gross financing needs. The ongoing reliance on regressive indirect taxes could worsen the poverty outlook, while the significant dependence of revenue gains on motor vehicle taxes necessitates strong contingency planning. Medium-term scarring effects of the crisis are potentially high due to the loss of jobs, ongoing depletion of human capital, shortages of frontline workers due to record levels of outmigration, and the impact of food insecurity and lower spending on health and education on future human capital. The continued under-execution of the capital budget poses risks to long-term growth. On the upside, a strong and sustained implementation of the structural reforms—particularly in trade and investment—could boost confidence and attract fresh capital inflows. Tourism and remittances could provide further upsides.

### Preserving macroeconomic stability is key to continued economic recovery

23. **Maintaining fiscal discipline while rebalancing fiscal policy is key to continued recovery**. The gains in domestic revenue mobilization need to be sustained, in a progressive manner, to maintain a primary balance surplus while supporting growth and equity. This entails a focus on tax administration reforms to strengthen tax compliance and broaden the tax base and shift focus to more progressive direct taxation from indirect taxes. Improved transparency, through a formal tax expenditure management framework—which includes a mandatory cost-benefit analysis for current and new incentives—will also enhance accountability and tax progressivity. Following the full establishment of the Public Debt Management Office, improved debt management and transparency practices can contribute to better borrowing decisions and help ensure that debt remains sustainable. Monitoring fiscal risks associated with SOEs remains critical for stability, including the continued enforcement of cost-reflective utility pricing to further improve the financial position of SOEs. Moving forward, fiscal policy needs to strike a balance between debt sustainability, economic growth, and equity to support stronger and more inclusive longer-term growth (see Part B).

24. **Monetary and financial sector policies need to continue to support macroeconomic stability**. While the elimination of monetary financing and enactment of a new Central Bank Law contributed to economic stability, monetary policy should be carefully calibrated to mitigate against inflationary pressures and unsustainable growth in private sector credit. Financial sector risks need to be carefully monitored as NPLs and exposure to the sovereign remain elevated. Continued reforms, including strengthening the governance and oversight of state-owned banks, are critical to deepen financial intermediation to the private sector and support broader economic growth. Exchange rate flexibility is essential to facilitate external adjustments and continue to rebuild international reserves.

## Structural reforms are required to address the root causes of the crisis

25. **In addition to maintaining macroeconomic stability and the current macro-fiscal-financial reforms, deep structural reforms are needed to enhance growth prospects**. These include reforms to:

- **Boost competitiveness and enable private sector-led growth,** through measures to streamline trade policy, such as phasing out para-tariffs; enhance customs administration; and modernize the current overarching legal, institutional and regulatory framework for investment. Investment, including foreign direct investment, is central to economic growth, as it mobilizes much-needed private capital and infuses new technologies into the economy.

- **Improve the oversight and management of SOEs** to address the fiscal, financial stability and governance-related risks posed by SOEs as well as boost the country's competitiveness. This includes fostering competition in key sectors, to support better pricing and services to consumers; improving governance frameworks, accountability, and transparency mechanisms; and exploring opportunities to increase private participation in SOEs engaged in commercial activities.

- **Enhance the functioning of factor markets, including updating Sri Lanka's labor legislation and improving the management and use of state land**. Formal sector firms in Sri Lanka pay among the highest severance pay rates globally and often need to obtain approval by labor courts when dismissing staff. These restrictions lead firms to be cautious in hiring and, ultimately, hinder the creation of jobs. State land covers about 80 percent of Sri Lanka. Overlapping mandates and poor coordination among agencies do not facilitate effective and transparent state land management. This hinders investments (both agriculture and non-agriculture), reduces agricultural productivity, and disincentivizes sustainable land management and conservation practices.

**Table 1: Key Economic Indicators (annual percent change unless indicated otherwise)**

| Recent history and projections | 2022 | 2023 | 2024 | 2025e | 2026f | 2027f |
|---|---|---|---|---|---|---|
| **Real GDP growth, at constant market prices** | -7.3 | -2.3 | 5.0 | 4.6 | 3.5 | 3.1 |
| Private consumption | 1.2 | -1.9 | 4.0 | 3.8 | 3.7 | 3.6 |
| Government consumption | 1.4 | -5.4 | -1.8 | 0.6 | 0.8 | 1.0 |
| Gross fixed capital investment | -24.6 | -8.8 | 19.3 | 10.9 | 7.5 | 3.2 |
| Exports, goods and services | 9.8 | 13.2 | 12.5 | 6.2 | 0.5 | 1.9 |
| Imports, goods and services | -19.9 | 8.9 | 22.5 | 8.3 | 4.0 | 2.4 |
| **Real GDP growth, at constant factor prices** | -7.0 | -2.6 | 4.6 | 4.6 | 3.5 | 3.1 |
| Agriculture | -4.1 | 1.6 | 1.2 | 1.4 | 1.3 | 1.2 |
| Industry | -16.0 | -9.2 | 11.0 | 9.4 | 5.4 | 4.0 |
| Services | -2.6 | -0.2 | 2.4 | 2.8 | 2.9 | 2.9 |
| **Employment rate (% of working-age population, 15 years+)** | 47.5 | 46.8 | 47.3 | 47.3 | 47.3 | 47.3 |
| **Inflation (consumer price index)** | 46.4 | 17.4 | 1.2 | -0.2 | 3.7 | 4.1 |
| **Current account balance (% of GDP)** | -2.0 | 1.7 | 1.2 | 1.1 | 0.5 | 0.4 |
| **Net foreign direct investment inflow (% of GDP)** | 1.2 | 0.8 | 0.7 | 0.5 | 0.6 | 0.7 |
| **Fiscal balance (% of GDP)** | -10.2 | -8.3 | -6.8 | -4.5 | -3.2 | -2.8 |
| **Revenues (% of GDP)** | 8.4 | 11.2 | 13.7 | 15.3 | 15.6 | 16.0 |
| **Debt (% of GDP)[1]** | 114.2 | 104.7 | 99.1 | 98.2 | 96.0 | 93.5 |
| **Primary balance (% of GDP)[2]** | -3.7 | 0.6 | 2.2 | 3.0 | 3.0 | 3.1 |
| **International poverty rate ($3.00 in 2021 PPP)[3]** | 8.4 | 10.7 | 9.3 | 7.8 | 7.4 | 7.1 |
| **Lower middle-income poverty rate ($4.20 in 2021 PPP)[3]** | 23.1 | 27.5 | 24.9 | 22.3 | 21.3 | 20.4 |
| **Upper middle-income poverty rate ($8.30 in 2021 PPP)[3]** | 67.8 | 70.9 | 69.2 | 67.5 | 66.5 | 65.7 |
| **GHG emissions growth (mtCO2e)** | -5.6 | -3.9 | 4.3 | 5.0 | 5.6 | 4.9 |

Source: World Bank, Poverty and Economic Policy Global Departments. Emissions data sourced from CAIT and OECD.
Notes: e = estimate, f = forecast. Data in annual percent change unless indicated otherwise.
1/ The series uses central government debt figures.
2/ The primary balance excludes interest payments received.
3/ Calculations based on SAR-POV harmonization, using 2019-HIES. Actual data: 2019. Nowcast: 2020-2024. Forecasts are from 2025 to 2027.

# B. Better Spending for All

## 1. Introduction

26. **Public expenditure—how much governments spend and what they spend it on—is a fundamental dimension of fiscal policy.** It encompasses the delivery of public goods and services, the financing of welfare and safety nets, and the development and maintenance of public infrastructure. When well-designed and executed, public spending promotes better development outcomes and can catalyze higher long-run economic growth. However, when mismanaged, it can also be a source of risk, instability, and crisis.

27. **Sri Lanka's recent economic crisis was, in part, triggered by poor fiscal management.** Spending, while not high by most standards, far exceeded collected revenues. Risky borrowing practices generated large interest commitments. The limited discretionary spending went toward large public investments with low returns, poorly targeted subsidies, loss-making SOEs, and a relatively large civil service. Efforts are underway to address or mitigate these, including through the enactment of new legislation on public debt and financial management. Moving from legislation to implementation will also require strengthened public sector capacity, thus making this challenging.

28. **Following the crisis, as the government seeks sustainable finances but faster economic growth, the envelope for new spending is limited and thus warrants a close review of existing public spending.** The government must now spend within its means. In the short-to-medium term, high public debt levels will mean that interest payments dominate public spending outlays. At the same time, non-interest spending is already at historically low levels, and further reductions may compromise the delivery of basic government functions and longer-term economic growth. Thus, until debt repayments and economic growth ease the overall debt burden and revenue reforms lock-in substantive new fiscal space, fiscal sustainability will require the government to exercise restraint in new spending plans. In the meantime, it is worth exploring opportunities to improve the efficiency, effectiveness, and equity of existing non-interest government spending.

29. **Better expenditure policy within a constrained overall envelope can still deliver better development outcomes and stronger medium-term growth.** Raising the quality of public infrastructure investments can improve the business environment and unlock growth by addressing critical bottlenecks in the country. Reforming outdated and inefficient public sector remuneration schemes among one of South and Southeast Asia's largest public sector workforces can ease the wage burden, while improving worker incentives, attracting and retaining talent, and boosting service quality. More efficient and effective public spending on health, education, and social protection can safeguard human capital investments and reduce the use of detrimental coping strategies by hardship-stricken households (for example, cutting back on private schooling and medical spending).

30. **This special topic chapter discusses critical public expenditure issues, based on a recent World Bank report.** The World Bank just completed a Public Finance Review for Sri Lanka. This flagship report—launched in September 2025—comprises in-depth chapters on the country's macroeconomic and fiscal framework, public revenues, and public expenditures. This SLDU chapter draws on the findings from Chapter 3, More Efficient, Equitable, and Growth-Oriented Government Expenditure.

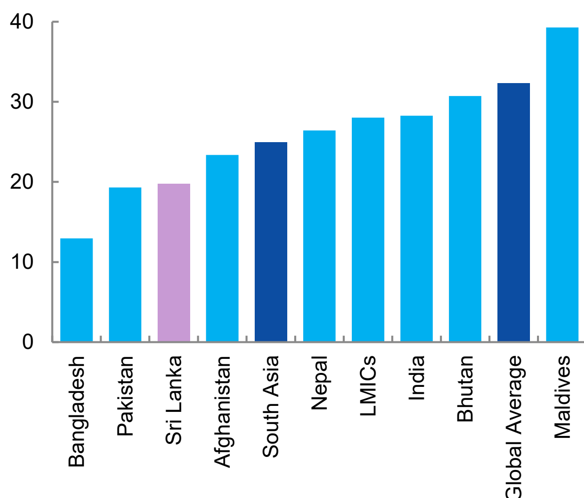
31. **The remainder of the chapter is structured as follows.** The next section offers an overview of public expenditure in Sri Lanka, including recent developments, trends, and challenges. This is followed by deep dives into the public wage bill and public capital expenditure—important areas where reforms are needed to progress Sri Lanka's ongoing public finance transformation. Finally, the last section summarizes and concludes.

## 2. An Overview of Public Spending

32. **Sri Lanka's public spending is relatively low by international comparison.** General government expenditure in 2023 amounted to LKR 5.4 trillion, equivalent to 19.5 percent of GDP and broadly in line with the average over 2017-23 of 19.7 percent. This is on the low side, with LMICs and South Asian neighbors tending to spend more (Figure 19).

**Figure 19: General government expenditure, selected countries and regions**

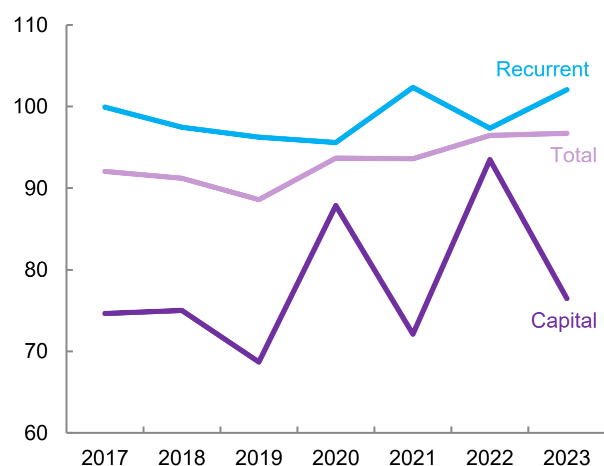
*(Percent of GDP) (average 2017-23)*




Source: IMF World Economic Outlook Database April 2025. Sri Lanka data based on World Bank calculations.

**Figure 20: Sri Lanka budget execution rates**

*(Percent of original budget)*




Source: Ministry of Finance, World Bank calculations.

33. **Public spending has become increasingly rigid and dominated by interest payments.** Rigid public expenditures are those that tend to be difficult to cut, especially in the short run. They include interest payments, the wage bill, and transfers such as welfare benefits. Rigid spending was equal to 15.8 percent of

GDP in 2023—around 82.1 percent of total government outlays in that year. This is markedly up from 68.4 percent in 2017, particularly as interest payments have risen. The largest component of government spending is now interest payments on domestic and foreign debt. Interest payments surged to 9 percent of GDP in 2023, from an average of 5.8 percent over 2017–22, due to crisis-related increases in domestic interest rates. By contrast, the public wage bill declined to 5.0 percent of GDP (from 7.2 percent in 2020), underpinned by below-inflation wage growth and a public sector hiring freeze during the crisis.

34. **With post-crisis fiscal consolidation underway and high expenditure rigidity limiting options, capital expenditures have faced the brunt of recent expenditure cuts.** Capital expenditure, a major category of non-rigid expenditure, has fallen as a direct consequence of the debt restructuring, and as the government looks to maintain spending control amid a tight spending envelope. Nearly 72 percent of the spending adjustment between 2019 and 2023 was driven by cuts to capital spending. This can be detrimental as preserving capital expenditure during fiscal consolidations can improve a country's medium- and long-term growth prospects.[17]

35. **Sri Lanka's public expenditure is also consistently lower than budgeted, driven by under-execution of capital spending.** Over the past seven years, actual annual spending has consistently remained below its allocated budget (Figure 20). In general, execution rates of recurrent expenditure are much closer to full execution than those of capital expenditure. Under-execution hinders fiscal planning and may also mean foregoing development outcomes—such as better public services or infrastructure—that the government seeks to deliver.

36. **Based on a functional classification,[18] government spending is dominated by general services, and less is spent on investments in human and physical capital than in peer countries.** General services accounted for 11 percent of GDP in 2023, after averaging 7.9 percent of GDP over 2017–22. At more than half of total government spending, this is high by international standards and primarily comprises of interest payments, discount payments, and equity contributions.[19] By contrast, Sri Lanka's public spending on the public sector wage bill and capital projects, and on sectors such as health, social protection, and education, is comparatively low.

37. **Sri Lanka's spending efficiency[20] tends to be higher than among its peers, especially in areas central to human development objectives.** Despite relatively lower spending on health, social protection, and education, Sri Lanka nonetheless achieves impressive human development outcomes in many areas. This 'efficiency' is reflected in higher output delivered per unit of spending (Figure 21 and Figure 22) and is partly attributable to low input costs (such as wages). However, the long-term sustainability of such a model is questionable, especially as advanced economies around the world increasingly contend with ageing workforces and skills shortages and seek to attract skilled migrants from less well-paid countries. High flows of skilled outmigration in recent years have already started to strain Sri Lanka's public service delivery, particularly in the health sector. Several other areas where public spending efficiency can be improved remain, such as in subsidies and transfers. Box 3 discusses opportunities to improve spending on agricultural fertilizer support.

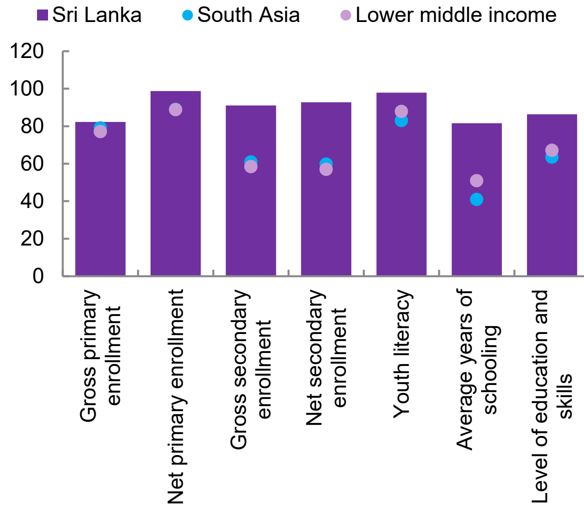
[17] IMF (2020).

[18] That is, according to the Organisation for Economic Co-operation and Development Classification of the Functions of Government (COFOG).

[19] Discount payments are the difference between the amount received by the government when it issues a debt instrument and the face value it pays upon that instrument's maturity. Equity contributions refer to government capital injections into other entities, including SOEs, which increase the value of the government's ownership holding in those entities.

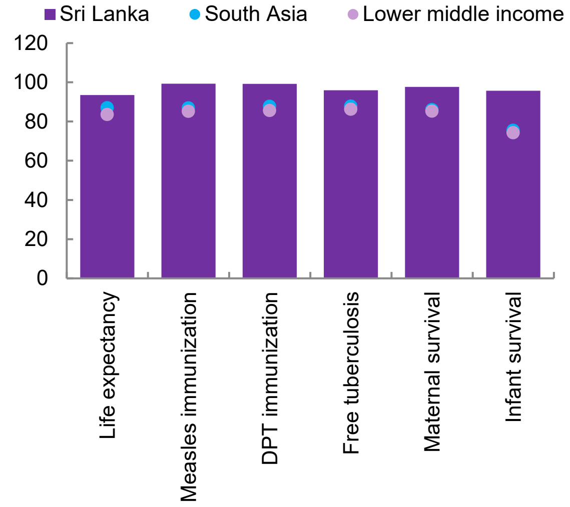
[20] Spending efficiency refers to the level of output generated from a given level of spending. Outputs may be quite broadly defined. Outputs relevant to human development include school enrolment rates, literacy rates, life expectancy, vaccination rates, etc.

**Figure 21: Output oriented indicators of selected education indicators**
*(Percent of the frontier (100), average, 2010-2020, all countries)*




Source: World Bank calculations.

**Figure 22: Output oriented indicators of selected health indicators**
*(Percent of the frontier (100), average, 2010-2020, all countries)*




Source: World Bank staff calculations.

## Box 3: Rethinking Fertilizer Policies in Sri Lanka

**Sri Lanka has a long and complex history of fertilizer support policies.** Fertilizer subsidies were introduced in 1962 to support the green revolution, resulting in the tripling of total nutrient use per hectare of cropland (from an average of 52.4 kg between 1961 and 1965 to an average of 149.6 kg between 2006 and 2010).[21] Over time, there have been multiple policy changes. Fertilizer subsidies were replaced by a cash grant in 2016, followed by a return to the subsidy scheme in 2019, a full subsidy scheme in 2020,[22] an import ban in 2021,[23] and the reversal of the ban and eventual return to a cash grant system between 2022 and 2023.

**Despite the frequent changes in policy, there has been a quasi-constant price support for fertilizers, entailing high public expenditures.** Expenditures on fertilizer subsidies/grants amounted to 1.3 percent of total government expenditure on average between 1998 and 2022, peaking at 2.7 percent of total expenditure in 2008, and decreasing to 1.2 percent in 2016, the year the cash grants were introduced. A recent agriculture public expenditure review by the World Bank (*forthcoming*) found that fertilizer subsidies/grants have been the second largest area of agriculture spending from 2017 to 2022, ranging from LKR 23 billion in 2021 (approximately US$115 million) to LKR 75 billion in 2022 (approximately US$232 million), over a quarter of total agrifood expenditures in the assessed period. Fertilizer subsidies/grants accounted for 26 percent of total agrifood expenditure[24] (2017–22) and 53 percent of spending by institutions with core mandates on crop and livestock.[25]

**In the absence of an overarching agriculture policy or fertilizer subsidy strategy, fertilizer policies are driven by multiple, sometimes competing, considerations.** The fertilizer policies and subsidies seem to, de facto, prioritize the objectives of productivity and paddy self-sufficiency, at the expense of other pressing objectives, such as improving export revenues, nutrition, and climate resilience. However, the

[21] Food and Agriculture Organization Statistics. 2025. *Fertilizers by Product*. https://www.fao.org/faostat/en/#data/RFB. Accessed May 10, 2025.

[22] Fertilizers provided free of charge.

[23] The complete ban on the import of chemical fertilizers and agrochemicals in May 2021 had devastating effects on agricultural sector productivity. The resulting food security crisis led to over 6.2 million people becoming moderately food insecure and 66,000 people becoming severely food insecure.

[24] Including agriculture, land, irrigation, fisheries, livestock and rural development, as defined in the Public Expenditure Analysis in the Monitoring and Analyzing of Food and Agriculture Policies methodology.

[25] World Bank. 2025. Data Bank: World Development Indicators. Accessed March 12, 2025. License: CC BY 4.0 https://databank.worldbank.org/reports.aspx?source=2&Topic=21

relationship between fertilizer use and productivity has become less evident over time, indicating that fertilizer is not the primary driver of yield trends and highlighting the need for a broader policy mix to increase productivity. Further, targeting fertilizer price support based on land size is regressive. In 2022, 68 percent of fertilizer benefits are estimated to have accrued to the top 60 percent of households in the income distribution.

**An assessment of fertilizer policies in Sri Lanka concluded the need for the following reforms:**

- **Follow a long-term and evidence-based strategy.** Fertilizer policy should be developed in the context of a coherent agriculture and rural development strategy. Define measurable outcomes for fertilizer policies, beyond fertilizer use. Develop adequate monitoring and evaluation systems for these policies. The development of integrated digital platforms such as *Geogoviya* could support efficient data collection.
- **Create an environment where private sector actors compete based on prices and/or product differentiation.** The shift away from subsidies to a cash grant system is a step in the right direction, as it allows for price-based competition among fertilizer suppliers. Further, the government could invest in lowering access costs[26] for fertilizers and easing the regulatory burden on new product approvals, allowing firms to compete based on product and service differentiation.
- **Empower farmers to make informed decisions for agricultural production.** The possibility that cash grants are not systematically spent on fertilizers creates opportunities to empower producers to make effective decisions. Further, producers can be supported in accessing necessary information for optimal fertilizer use, for example, via agronomic recommendations that focus more on profit, rather than yield, maximization, including details on fertilizers available in the market and findings from recent soil testing.
- **Consider targeting the cash grants to free up public resources.** To optimize public spending, the government could consider targeting the cash grants better, based on development goals and using metrics that minimize leakages.

## 3. A Closer Look at the Public Sector Wage Bill

38. **The public sector wage bill is one of the most consequential components of government expenditure.** It directly impacts fiscal sustainability, service delivery quality, and macroeconomic stability. The wage bill encompasses basic salaries for civil servants, teachers, healthcare workers, and other public employees, as well as allowances, pensions, and other benefits.[27] It is rigid expenditure that tends to be politically difficult to cut or reform. But it also determines the government's ability to attract and retain talent, incentivize high performance, and deliver better outcomes for Sri Lankans. This section briefly reviews the current state of public wage bill spending in Sri Lanka, discusses several key challenges, and proposes recommendations for the way forward.

39. **Sri Lanka's public sector wage bill is relatively low.** At 5 percent of GDP in 2023, it broadly aligns with South Asian peers but is considerably lower than the average for LMICs (Figure 23). This is down from 7.2 percent in 2020, under pressure from inflation-driven real wage erosion and a public sector hiring freeze. Around 50 percent of the wage bill is spent on base salaries. The rest is made up of different types of salary

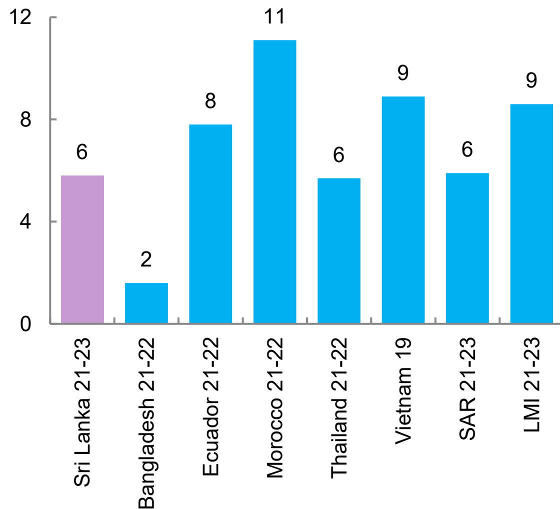
[26] As per the Monitoring and Analyzing of Food and Agriculture Policies methodology, access costs refer to the costs incurred to bring a commodity from one point in the value chain to another. In this case, they refer to the difference between the imported cost, insurance, and freight price and the price paid by producers, taxes included.

[27] Spanning central and provincial governments, and government-funded public institutions, the public sector wage bill includes salaries and wages, overtime and holiday payments, other allowances, retirement benefits, public institutions, property loan interest to public servants, and grants to provincial councils (personal emoluments). Figures in this section may not match those under other classifications.

supplements, such as overtime payments, other allowances, and the non-contributory public sector pension scheme (that is, retirement benefits).

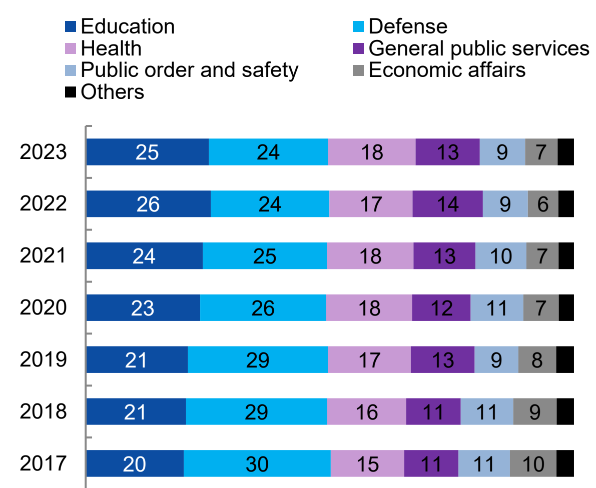
**40. The composition of the wage bill has been shifting toward larger shares of education, health, and general services (Figure 24).** While Sri Lanka's public spending on education and health is low by international standards, the public wage bill in these sectors has been growing strongly in nominal terms lately. The wage bill for general services has also seen similar performance. Together, these three sectors accounted for 56 percent of wage bill spending in 2023 (excluding retirement benefits), up from 46 percent in 2017. These increases have been mirrored by notable contractions in the defense sector's share of the wage bill, down from 30 to 24 percent, and that of public order and safety, down from 11 to 9 percent.

**Figure 23: Wage bill comparison with peers**
(*Percent of GDP*)




Note: 2021–23 averages of available data. SAR: South Asia Region. LMI: Lower Middle-Income Countries.
Source: IMF World Economic Outlook October 2023 Database; World Bank calculations.

**Figure 24: Composition of wage bill excluding retirement benefits, functional classification**




Note: 2021–23 averages of available annual data. SAR: South Asia Region. LMI: Lower Middle-Income Group.
Source: IMF World Economic Outlook October 2023 Database; World Bank calculations.

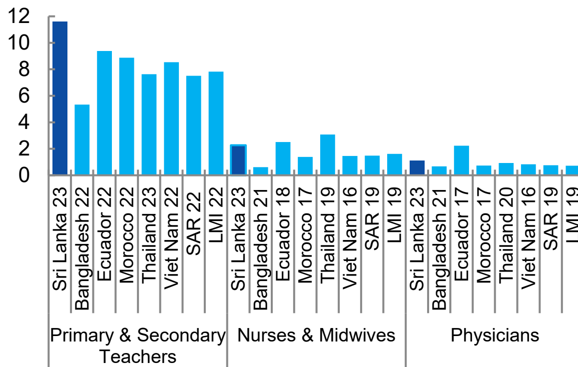
**41. Sri Lanka's public sector headcount—a fundamental determinant of the wage bill—is large relative to peers.** Public sector employment remains substantially higher than in peer countries,[28] partly reflecting occasional recruitment surges[29] that are politically hard to unwind. The public sector's headcount grew by 12 percent between 2013 and 2020, reaching a peak of 1.27 million civil servants. It then declined to 1.21 million workers in 2023, following a public sector hiring freeze and heavy crisis-time emigration. Of this, SOEs and government-funded public institutions accounted for roughly 212,000 workers. Despite the lower headcount in recent years, the public service accounted for around 15 percent of total nationwide employment, above the averages for South Asia (10 percent) and LMICs (13 percent).[30]

**42. High staffing of public health workers and teachers has proved beneficial, but staffing in some areas is larger than in peer countries.** A comparatively large, specialized health and education workforce (Figure 25) has contributed to the country's good record on related development outcomes in the past (see

[28] Disparities in the size of public sector employment between Sri Lanka and peer countries remain high even when controlling for differences in labor force participation.
[29] For instance, 20,000 new hires in 2014; 19,000 in 2015; 32,000 in 2016; and 65,000 in 2020.
[30] Sri Lanka's share is for 2023, while South Asia and LMICs' averages are based on latest data from 2020.

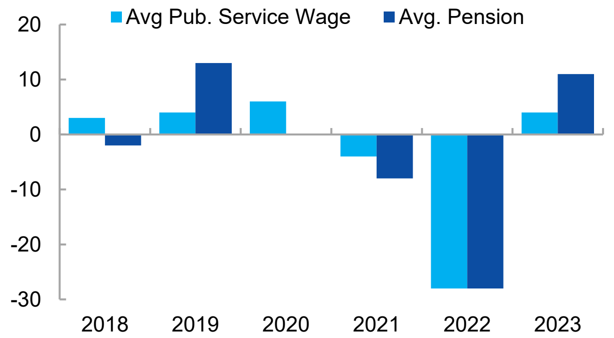
discussion in the previous section).[31] The Sri Lankan security sector also represents a substantially larger share of employment than in peer countries. On a per capita basis in 2023, Sri Lanka had over three times more armed forces personnel than the averages for South Asia and LMICs.

**Figure 25: Teachers and health professionals per thousand inhabitants**




Note: Data for Sri Lanka is from 2023. Data for other countries are the latest available year between 2016 and 2023.
Source: 2024 Approved Budget, Management Services Department 2023 Public Service HR Information Database, World Development Indicators, and World Bank calculations.

**Figure 26: Year-on-year change in real average effective wages/pensions**
*(Percent, 2017=100)*




Note: Figures for average pensions in 2023 are estimated based on an extrapolated number of pensioners.
Source: Ministry of Finance, 2022 Annual Report and World Bank staff calculations.

43. **Public sector wages and pension benefits, in real inflation-adjusted terms, have declined significantly in recent years.** High nominal growth in public sector wages and pensions in recent years has been more than offset by even higher consumer price inflation. Consequently, government employees have suffered a substantive erosion in their real incomes, with average real wages and pensions down 33 and 26 percent, respectively, from 2020 to 2023 (Figure 26). The decline in real incomes was largest for public sector workers in the bottom 30 percent of households by income distribution.[32] In contrast, the decline in earnings of private sector employees in the bottom three household deciles was less than that of their public sector counterparts and also less severe than for private sector employees in higher-income deciles.

44. **Public sector wages have also not kept pace with GDP per capita.** Between 2020 and 2023, average public sector wages—excluding non-contributory retirement benefits—decreased from 88 to 62 percent of GDP per capita. Even after including set-asides for future pension payments, rough estimates suggest a similar trend: total remuneration declined from 116 to 87 percent of GDP per capita. As of 2024, it is estimated that public sector wages (excluding non-contributory retirement benefits) for around 90 percent of civil servants were less than GDP per capita.

45. **Public sector remuneration heavily comprises of ad hoc allowances, which complicate wage bill management and result in horizontal inequity across job roles and agencies.** Allowances account for a large share of civil servants' total pay. This reflects a proliferation of *ad hoc* salary supplements that have arisen—to attract and retain staff—in specific professions, especially the most specialized**.** Preliminary analysis suggests that allowances, which are pensionable, account for 30 to 60 percent of final take-home pay, depending on the sector and profession. The largest shares tend to be among the most specialized, highly remunerated

[31] For every 1000 inhabitants, Sri Lanka has an average of 11.6 primary and secondary teachers (compared to 7.5 for South Asia Region and 7.8 for LMICs), 2.3 nurses and midwives (1.5 for South Asia Region, 1.6 for LMICs), and 1.1 physicians (0.8 for South Asia Region and 0.7 for LMICs).

[32] Based on labor force survey data between 2019 and 2022.

professions, such as executives and physicians.[33] More than 30 different types of allowances are in the health sector alone. The ad hoc nature of these allowances results in highly inconsistent remuneration structures across job types and government agencies, leading to potentially unfair differences.

46. **Wage bill management is decentralized and poorly documented, limiting the government's ability to monitor and understand changes, forecast spending, and analyze the implications of new policies.** The government operates a decentralized payroll management system dating back to 1985, whereby each agency maintains its own separate database of basic personnel and salary records. At budget time each year, agencies are required to submit individual-level salary payment records. However, submissions lack key data fields needed for wage bill forecasting and, in many cases, are submitted as physical paperwork. This outdated approach is an impediment to prudent, transparent, and professional wage bill management. The challenge is compounded by unreliable data on staffing levels, whereby the structure of the main consolidated dataset does not fully match the chart of accounts. Moreover, for a subset of agencies, data are either not collected or are inconsistent with other key sources.[34] Headcounts are aggregated at the salary code level (without individual-level records) and thus lack age data required for retirement and pension forecasting. Salary codes are also often inconsistently codified or not reported for certain jobs.

### *Recommendations to government*

47. **Avoid further erosion in real inflation-adjusted terms of the overall public wage bill and focus on improving the efficiency, effectiveness, and sustainability of remuneration structures.** Civil servants have suffered a considerable loss of purchasing power since 2020. Further erosion of real wages will only exacerbate the public sector's challenges in attracting and retaining talent and delivering a respectable quality of public services. At the same time, substantial increases in remuneration will be infeasible given the government's tight fiscal envelope and the large size of the civil service workforce. Thus, amid a constrained funding envelope, there is a need to restructure and simplify remuneration, improve performance incentives, and fill talent gaps while improving fiscal sustainability.

48. **Establish a pay commission to examine the structure of public sector compensation.** A central body, akin to a pay commission, could be appointed to conduct periodical reviews of compensation across public sector occupations.[35] This commission could be tasked with three core functions: (i) periodically review the equity and competitiveness of public sector compensation, including in comparison with the private sector; (ii) advise and oversee the job evaluation system so that compensation is linked to job complexity; and (iii) advise on performance incentives and supplements in remote or hardship locations. The recommendations could help restructure remuneration packages away from the overreliance on ad hoc allowances while increasing the attractiveness of public sector jobs for highly skilled professionals. It could also consider how best to institute cost-of-living adjustments to salaries, to avoid a future resurgence of allowances and top-ups.

49. **Implement targeted workforce attrition policies over the medium-to-long term to gradually reduce the public sector's employment footprint.** The system is currently strained by the crisis-time hiring freeze and the large outflow of skilled staff who sought opportunities overseas. Any further sharp reductions in public service headcounts over the next 2–3 years may compromise service delivery. The rightsizing of overstaffed sectors and professions could be conducted gradually by recruiting new workers at a slower pace than new retirements. However, such reforms should seek to preserve the existing availability of frontline

[33] The main civil service allowances have been modelled as part of this exercise including top ups paid to health workers, executives, secretaries, and workers in the judicial sector.

[34] World Bank estimates point to an unexplained discrepancy of 53,000 employees in 2023.

[35] Sri Lanka has made attempts at this before. A National Salaries and Cadre Commission was established in 2016. It was subsequently dissolved and replaced by a new Salaries and Cadre Commission in 2020. This latter commission was dissolved in 2023, and its responsibilities were assumed by the Department of the Establishments Division in the Ministry of Public Administration and the Department of Management Services in the Ministry of Finance. In other countries, the Central Pay Commission in India is a good example, as are the independent pay commissions in Kenya, Ireland, Greece, and Japan.

workers in health and education to safeguard Sri Lanka's reasonably good performance in human development outcomes.

**50. Undertake a comprehensive functional review of the government and quasi-government sector to guide workforce planning and the gradual downsizing of the public sector headcount**.[36] Revised staffing structures from such a review could serve as the basis for adjustments to the public sector cadre, establishing medium-term targets for staff levels through attrition. To ensure ownership of the process and its outcomes, the exercise could be conducted by each ministry, department, or agency under the coordination of the agencies that hold a mandate for approving the public sector cadre (that is, the Department of Management Services and Department of the Establishments Division). This would establish a bottom-up framework for the adjustment of the public sector workforce while preserving flexibility to selectively increase staffing in priority institutions or cadres.

**51. Improve the management and consolidation of human resources (HR) and payroll data to ensure efficient wage bill budgeting and forecasting and evidence-based policies.** In the short term, develop a new business process at the National Budget Department to ensure that individual payroll records collected through the annual budget call circular are consolidated across the public sector and incorporate essential information for wage bill projections (for example, dates of birth and appointment).[37] Over the medium-to-long term, the government could consider implementing a modern centralized payroll system—potentially building on the e-payroll system in the Ministry of Finance (MOF)—or a full human resource management information system. These systems would increase the transparency and traceability of payroll expenditures, improve the accuracy of wage bill budgeting, and enable improved HR planning.

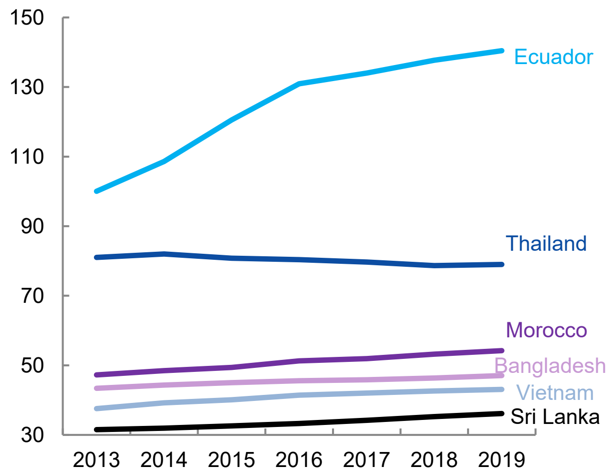
# 4. A Closer Look at Public Capital Expenditure

**52. Public capital expenditure can boost public sector service delivery, bolster the productive capacity of the economy, and unlock private sector growth.** It involves building, maintaining, and upgrading key assets such as roads, railways, ports, hospitals, schools, utilities, and public spaces, as well as machinery, equipment, and vehicles. Such public assets are essential for delivering government services and helping to create a business environment attractive to investment. However, to increase spending effectiveness, scarce budgetary resources designated for capital spending would need to be allocated to the sectors and projects with the highest public benefits in an efficient way that ensures spending is converted into assets. This section briefly reviews the current state of public capital spending in Sri Lanka, discusses several key challenges, and proposes recommendations for the way forward.

**53. Sri Lanka has relatively less, and a poorer quality of public capital compared to its peers.** Despite rising from 31.5 percent of GDP in 2013 to 36.1 percent in 2019 (Figure 27), the public capital stock is low, placing Sri Lanka 143rd out of 166 countries in 2019.[38] The quality of infrastructure—including trade-related, transport, electricity production, and internet connectivity infrastructure—is broadly comparable with South Asian peers but lags similar emerging economies outside this region, such as Ecuador, Thailand and Viet Nam (Figure 28). Inadequate infrastructure in power, logistics, telecommunications, and water supply and sanitation weighs on economic performance. Moreover, while national roads are in fair shape, only two thirds of provincial roads and 13 percent of rural roads are paved and in good condition.[39]

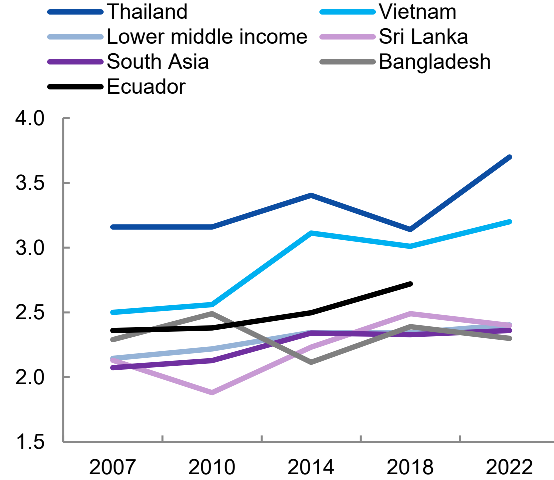
[36] See reviews of similar exercises conducted in other countries: World Bank (2004), World Bank (2010), and World Bank (2020).
[37] The new process could be facilitated through an Excel tool that automates some of the most onerous data consolidation tasks.
[38] IMF Investment and Capital Stock Dataset.
[39] World Bank (2021).

**Figure 27: Public capital stock**
*(Percent of GDP, constant 2017 PPP$)*




Source: IMF Investment and Capital Stock Dataset , World Bank staff calculations.

**Figure 28: Quality of trade and transport-related infrastructure, (1=low to 5=high)**




Source: World Development Indicators, World Bank staff calculations.

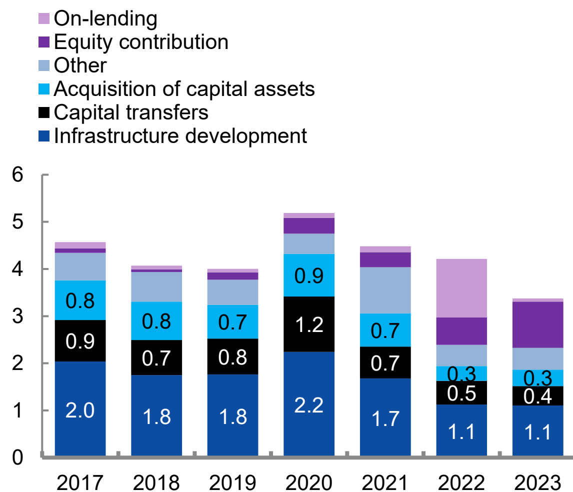
54. **As Sri Lanka recovers from its deep crisis and looks to accelerate growth, it would benefit from the growth-enhancing impacts of public capital expenditure.** New estimates for developing countries reaffirm the growth-boosting impact of public investment and suggest that it is larger in countries that have a lower capital stock.[40] Sri Lanka's capital stock is below the median of EMDEs. Specifically, for countries with capital stock below the EMDE median, the estimates suggest that each additional dollar of public investment raises output by US$2.3 on average. In addition, several studies suggest that the growth impacts of public investment may be larger than that of public consumption spending (Hlaváček and Ismayilov, 2022; Gechert and Rannenberg, 2018).

55. **Rather than rising to address critical gaps in public assets, capital expenditure has been falling.** Central government capital expenditures averaged 4.1 percent of GDP over 2017–2022 but declined markedly to 3.4 percent of GDP in 2023, as post-crisis fiscal consolidation got underway (Figure 29). Even as a share of total outlays, capital expenditure has also been steadily decreasing, from 24.8 percent in 2017 to 17.1 percent in 2023—partly owing to high rigidity in other areas of spending, as discussed earlier (Figure 30). Even more starkly, if on-lending and equity contributions are excluded, capital expenditure accounted for just 11.4 percent of total expenditure in 2023.

56. **The public investment that is taking place is not strategically allocated to address the country's most critical bottlenecks.** From a sectoral perspective, there has been an excessive focus on transport infrastructure. From 2017 to2023, an average of 35.5 percent of all capital expenditure[41] was designated for the transport sector. This was more than the combined value designated to the agriculture, water supply, health, education, environmental protection, and energy sectors. When budgets are tight, every rupee counts, and this bias toward the transport sector has likely meant that comparatively high-impact investments in other sectors are being overlooked.

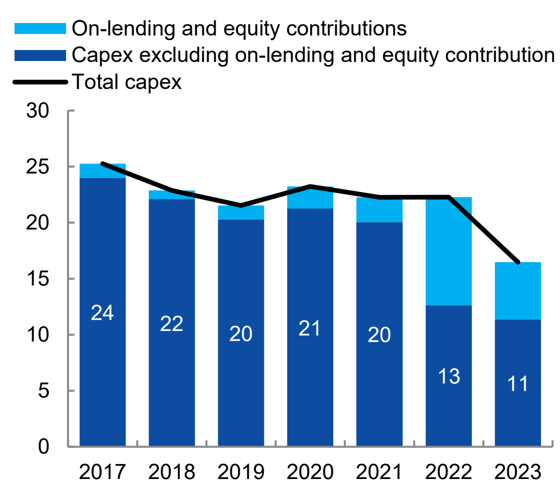
[40] See discussion in Chapter 3 and Annex 3.3 of World Bank (2025).
[41] Excluding equity contributions and on-lending.

**Figure 29: Capital expenditures by type**
*(Percent of GDP)*




Source: Ministry of Finance, World Bank staff calculations.

**Figure 30: Capital as a share of total expenditure**
*(Percent of total expenditure)*




Source: Ministry of Finance, World Bank staff calculations.

57. **A sizeable share of what is budgeted for capital expenditure each year is not eventually spent.** As noted earlier, budget execution rates for capital expenditure have been consistently low in Sri Lanka, with an average execution rate of around 78.3 percent over 2017-23. Infrastructure development, a subcomponent of capital expenditure, tended to be the largest source of this under-execution. Between 2019 and 2023, infrastructure underspending averaged 0.5 percent of GDP each year, largely in the transport and highways sector.

58. **Under-execution of the capital budget stems from challenges at both the upstream and downstream stages of the life cycle of government projects.** Large government projects can be complex multi-year undertakings. In 2023, 209 'mega' public projects were being implemented (projects with a total cost of over LKR 10 billion). Their average time under implementation was 5.8 years. In 'normal' times, complications, restructurings, and basic delays in getting things done can contribute to capital spending under-execution. These issues can be further compounded during economic crises—as was Sri Lanka's recent experience—with project cost escalations due to high inflation and currency depreciation, and stalled bilateral projects due to debt restructuring. The public sector's weak systems and processes, and gaps in technical expertise have also contributed to a host of issues across the project life cycle. Challenges can arise upstream, such as at the time of project planning, appraisal, selection, and consultation, as well as downstream when procuring, managing costs, monitoring, and carrying out ex-post evaluation.[42]

59. **Upstream, the planning framework, screening and appraisal processes, and consultation approach are all weak.** The absence of a proper macro-economic framework, lack of integrated planning, and frequent changes in national policy hinder the preparation of three-year rolling public investment programs. No systematic cost-benefit analysis or risk assessment is undertaken, aside from foreign-funded development partner projects. Line agencies are not effectively supported in project preparation, and there is inadequate staff training in project appraisal. The National Planning Department (NPD), which receives and must review all proposals for projects valued at over LKR 10 billion, can become overburdened with the heavy volume, distracting scrutiny away from the most critical high-value projects. This can result in approved projects with questionable net benefits and a lack of readiness. Moreover, stakeholder consultations are not mandated, and the government is not required to publicly disclose any prepared analyses.

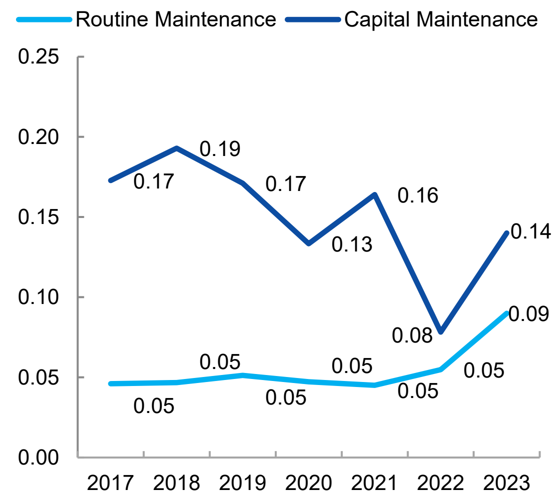
[42] The analysis draws on IMF (2018) and is updated with findings from ongoing World Bank engagements with the MOF.

60. **Downstream, multi-year budgeting is constrained, monitoring is limited to only the largest projects, funding priorities are not informed by project data, and evaluations are not undertaken.** Budgeting rules prevent unused capital expenditures from being carried over from one annual budget cycle to the next. This forces line ministries, the cabinet, and the MOF into annual negotiations for project-specific budget allocations, taking up time, reducing project certainty, and risking disruption of priority projects. While mega projects have some monitoring, others (including large or medium ones) are not monitored centrally. Currently, projects are not assigned a unique ID. They cannot be easily tracked over the project lifecycle, limiting clarity of their status and their eventual achievement of objectives and results. Even for mega projects that are monitored, there is limited evidence that this informs future budget allocation decisions; for instance, to reprioritize budget away from cost-overrun and time-overrun projects. Rigorous ex-post project evaluation is not undertaken, even for large projects, making it difficult for the government to learn lessons and improve future project selection, execution, and asset management.

61. **Maintenance of the existing capital stock is just as important as building new assets, but it is neglected in Sri Lanka.** Once assets are up and running, they need to be maintained. As public assets vary considerably in their type and use, there is no simple benchmark for good levels of maintenance spending. For active assets such as pumps, motors, and generators, annual maintenance spending of around 2 to 5 percent of the asset's full replacement value is considered appropriate, while for longer-life assets, it is less clear.[43] Another rough comparator is the average annual recurrent costs (that is, operations and maintenance) of development partner projects, which in one study averaged 3.9 percent of total investment costs (World Bank, 2002).[44] Applying either of these rates to Sri Lanka's public capital stock implies required spending of 0.7 to 1.8 percent of GDP and 1.4 percent of GDP, respectively. However, over 2017–2023, Sri Lanka's combined routine and capital maintenance spending was only around 0.2 percent of GDP.[45]

62. **Routine types of maintenance need to be strictly prioritized to lower lifetime asset costs.** There are two main types of maintenance activities. Routine maintenance ensures that infrastructure assets operate as initially intended in a long-lasting manner. Capital maintenance rehabilitates or renovates assets to extend their lives and capacity.[46] Sri Lanka tends to spend around three times as much on capital maintenance as it does on routine maintenance (Figure 31). However, capital maintenance is generally much more costly, and it may also be needed sooner when preventative routine maintenance is neglected. For example, for road infrastructure, when minor defects are neglected, an entire road section may eventually fail completely and require three times the cost to fix.[47]

**Figure 31: Maintenance expenditure**
*(Percent of GDP)*




Source: Ministry of Finance, World Bank calculations.

[43] Pacific Region Infrastructure Facility (2021).
[44] Based on a set of 167 Asian Development Bank and World Bank capital projects.
[45] Poor and inconsistent classification of public spending can make this number unreliable. For instance, from 2017 to 2022, major maintenance spending on roads and bridges was incorrectly classified as infrastructure development instead of maintenance.
[46] Blazey, Fabien, and Stokoe (2020).
[47] Burningham and Stankevich (2005).

***Recommendations to government:***

63. **Review the overall capital budget and the approved pipeline of investments, giving careful regard to infrastructure constraints and opportunities to mobilize private co-financing.** Establish clear prioritization criteria to guide the capital budget allocation as part of the annual budget process. These criteria can consider: (i) the severity of existing infrastructure gaps, and (ii) the absorptive capacity for further investment. Further, the potential role of public-private partnerships in mobilizing additional private resources could also be explored. To support such efforts, an overarching public-private partnerships law and policy framework will be important, as will be the management of public-private partnerships related fiscal risks.

64. **Within each sector, implement performance-based funding reallocations across projects to improve the sector's portfolio quality and ensure spending translates into assets**. In the short term, consider fast-tracking projects—both foreign-financed and domestically-financed—that are close to completion by increasing their budget allocations in line with required resources and absorptive capacity.[48] Additional capital spending of around 0.6 percent of 2023 GDP is needed to finish ongoing projects that are nearing completion. This could be financed by shifting the budget away from slow-progress or off-track projects that are far from completion.[49] About 0.4 percent of 2023 GDP can be reprioritized in this way.[50]

65. **Establish more rigorous appraisal procedures for the approval of projects, particularly for high-value projects.** In the short term, increase the threshold criteria for compulsory intensive appraisal and review to a project value of LKR 1,000 million. This would focus NPD's intensive review activities on the largest prospective projects (down from over 100 projects to around 20 per annum) but still cover a large majority of the total new pipeline value.[51] A light-touch appraisal would still be warranted for the remaining smaller project proposals.

66. **Improve data flow, systems, and regulations, and fully implement Sri Lanka's new Public Financial Management (PFM) Act.** The new PFM Act, enacted in August 2024, provides a sound basis for the management of public investments, including public-private partnerships. The implementation of the changes will be a complex task, requiring action on several fronts:

- ***Address the misclassification of project spending.*** Undertake a review to address misclassifications of long-running recurrent spending and asset maintenance as capital spending.

- ***Improve coordination between departments and agencies.*** Several MOF departments are vested with responsibilities for different aspects of the project cycle. The departments tend to operate in silos with limited data sharing. No agency maintains a joined-up view across the public investment management (PIM) cycle, on new and ongoing projects, and across all sources of funding. The PFM Act now provides a framework for better coordination and will require: (i) development of information systems and (ii) interoperability across systems to share relevant data.

- ***Update the regulatory framework.*** To fully operationalize the new PFM Act, further regulatory steps are required. These include new financial regulations, appraisal guidelines, sectoral appraisal manuals, and guidelines for tracking and reporting on project performance.

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[48] Projects with physical progress over 80 percent, and financial progress of 50-100 percent.

[49] Additional filters for prioritization can also be used.

[50] That is, by reprioritizing new funding away from projects which have either (i) financial progress less than the median (44.2 percent) and time under implementation greater than the median (5.8 years), or (ii) overrun their total estimated cost while their time under implementation is less than the median (5.8 years).

[51] Currently, the threshold for NPD screening and appraisal is just LKR 10 million. Moreover, among all project submissions, around 90 percent of project value is accounted for by less than 20 percent of projects.

- ***Implement a unique project identification number (ID) and create a database of capital projects.*** A key enabler of public investment management, especially for multi-year capital projects, is a unique project ID. It can link and organize data across the full project lifecycle, spanning relevant agencies and diverse information technology applications, and thus supports monitoring of progress and financial performance. The ID can be used to establish a capital project database. This will improve budget decision-making by enabling the performance of multi-year projects to be considered during budget formulation.

- ***Build an integrated PIM information system over time***. Eventually, the capital projects database can be transformed into a more advanced single PIM information system, which integrates the entire project cycle from project submission to appraisal, budgeting, monitoring, and evaluation, and includes both investment and maintenance spending. Such a system could interface with other core Treasury systems.

67. **Increase budget allocations for capital asset maintenance, particularly routine maintenance, and implement better tracking of the quality of these assets.** Asset maintenance can be prioritized better in annual budget allocations to avoid much higher repair and replacement costs later on. However, maintenance spending should be linked to the condition of assets, and the tracking of asset conditions is limited across much of government. Efforts are being made by the Road Development Authority with the development of a web-based Road Asset Management System that monitors national road conditions, estimates maintenance, rehabilitation and improvement needs, and helps formulate a prioritized work plan. The provincial and rural road networks do not have a similar system in place. More generally, the Comptroller General's Office has been developing an online system with a central database to record and track all non-financial assets.

## 5. Concluding Remarks

68. **To boost economic growth while adhering to a tight fiscal envelope, Sri Lanka could maximize the development outcomes from its existing levels of public spending.** The analysis in this chapter, with a focus on the public sector wage bill and public capital expenditure, reveals several challenges in how existing resources are used and managed. The public sector wage bill, despite being relatively modest by international standards, suffers from structural inefficiencies, including an oversized workforce, unsustainable real wage erosion, and excessive ad hoc allowances that undermine both fiscal discipline and service quality. Meanwhile, capital expenditure—important for long-term growth prospects—has fallen markedly while still suffering from poor project selection and monitoring, low budget execution, and inadequate maintenance.

69. **Comprehensive institutional reforms are required to enhance the efficiency and effectiveness of every rupee spent.** Priorities include establishing a pay commission to review and restructure public sector compensation, implementing workforce rightsizing through strategic attrition, developing modern payroll and project management systems, and improving capital project appraisal and execution processes. The government must ensure that limited resources are directed toward investments with the highest net social benefits. Many of these reforms will require strengthening public sector capacity. The time to act is now, as the country emerges from its recent economic crisis and with a government that has a strong reform mandate and appetite for change.

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