AMERICAN TAX POLICY AND THE SRI LANKAN ECONOMY: IMPACTS AND FUTURE CHALLENGES

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Abstract

The United States has imposed a 20 per cent tax on the imports of Sri Lankan exports in 2025, which has presented a major external shock to the Sri Lankan export-based economy. More recent attention has focused on the impact of the current American tax policy changes on the main export industries, foreign exchange earnings, jobs and macroeconomic stability in Sri Lanka. The US tariffs may reduce the competitiveness of Sri Lankan exports, which has placed a strain on the level of exports, foreign exchange inflows and employment, especially with regard to the apparel industry. Even though there is some resiliency that can be seen in export diversification and moderately good performance in terms of growth, the long-term economic stability and momentum in terms of reform are at stake, even when the IMF-steered recovery goes on. It can thus be suggested that some significant policy implications whereby diversification of export markets, value addition production, improved foreign exchange management, and favourable industrial and trade policies are needed. Reform initiatives and active participation in trade are necessary to boost resilience in case of external trade shocks and the achievement of sustainable economic development.

JEL: *H20, J21, J62, L11, O24*

Keywords: *US Trade Policy, Sri Lankan Economy, Export Competitiveness, Foreign Exchange, Economic Resilience*

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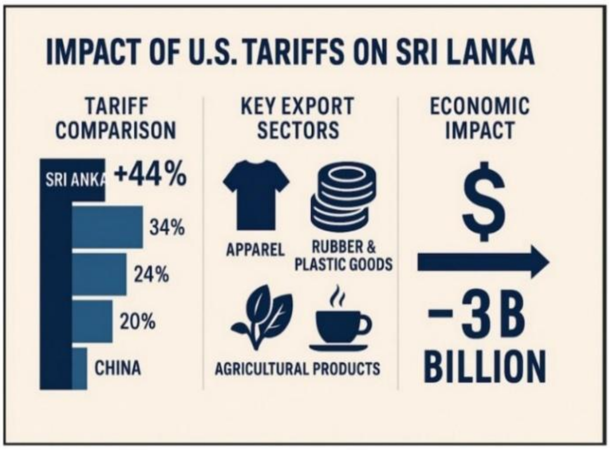
INTRODUCTION

On August 1, 2025, the United States started a 20% tax on Sri Lanka's import resources. This has become a serious challenge for the Sri Lankan economy. Major export sectors such as clothing, rubber, coconut products, tea, and other agricultural and industrial products are particularly affected because they account for an important part of Sri Lanka's export earnings (Reuters, 2025). The garment industry, a centre of the export economy, has increased competition due to the new taxes. As the US covers more than 40% of Sri Lanka's clothing exports in volume, these new taxes will affect local clothing competitiveness, risking export volume and declining revenue (Reuters, 2025). Declining export earnings also reduce foreign exchange income, putting pressure on Sri Lanka's payment interview administration and affecting the ability to pay international financial bonds (ISAS, 2025). Furthermore, the International Monetary Fund predicts that if the United States reimposes a 20% tax on Sri Lankan exports, Sri Lanka's total domestic production income (GDP) could decrease to 1.5%, with lower taxes on competing countries (Xinhua News, 2025). It is given in the following Figure 1.

Figure 1a and 1b: The Impact of Traffic in the United States on Sri Lanka



Sources: ISAS (2025)

In response to these challenges, the Sri Lankan government has set up a committee to evaluate the effects of US import taxes and try to find strategies to minimise the unfortunate effects. These tactics include making trade protest demands and diversifying into new markets. Furthermore, the US tax policy in effect in 2025 will cause major disruptions to the profits that make Sri Lanka's exports central to the economy. Efficient planning, which includes market diversification and targeted policy revisions, reduces the unfortunate effects and makes economic growth critical for survival.

AMERICAN TAX POLICY

In 2025, the US government took a huge step in increasing import taxes on Sri Lankan products, raising taxes to 20%. This policy expresses the broad purpose of adjusting economic disparities in the US economy and protecting domestic industries. Although this action could benefit American manufacturers by increasing the price of imported goods and promoting domestic use, it would produce significant results for Sri Lanka, which exports heavily to the US market. Goods that the Sri Lankan export business supplies to the American market include clothing, rubber, tea, and other agro-industrial goods. These commodities have historically provided large returns in foreign exchange income and job creation. Accordingly, higher taxes are a major economic challenge, as they affect both macroeconomic stability and the livelihoods of people engaged in the export sector.

The decrease in competitiveness of Sri Lankan exporters can be considered a major effect of the increase in American taxes. With the increase in taxes, Sri Lankan commodity prices for American consumers and businesses will increase, and demand will decrease. As the clothing industry is an essential sector of Sri Lanka's export economy, this effect can be seen in particular. The United States has long been a large market for Sri Lankan clothing, and it has become an important part of export earnings. With the new taxes, Sri Lankan clothing now faces difficulties compared to goods from other countries that do not have low taxes, as goods from those countries can be offered at competitive prices. This situation can lead to lower export volumes, lower revenue capacity, and pressure on businesses to lower prices or incur additional costs, which reduces profits. Smaller manufacturers and suppliers face particularly severe risks because they have limited financial capacity to absorb these economically damaging effects. In severe cases, these pressures can lead to factory closures, workers losing their jobs, and more greenhouses in export-oriented communities. Comparing Sri Lanka with countries that export similar apparel products—such as Bangladesh, Vietnam, or Cambodia—is therefore justified. All these countries compete in the same market segments, serve similar international buyers, and rely on comparable labour-intensive production structures. Differences in export performance among these countries can be more accurately attributed to trade policies, tariff structures, labour costs, and infrastructure development rather than to differences in product type or market orientation.

The consequences of declining exports affect not only foreign exchange incomes but also the entire economy. Sri Lanka's foreign exchange earnings depend heavily on export earnings to maintain income stability and finance essential imports such as fuel, machinery, and technology. With the decrease in income from the American market, there is a risk of the country's foreign currency reserves being limited, which may also lead to a decrease in the value of the Sri Lankan rupee. The currency value recession causes the price of imported goods to rise, steep price increases, and the purchasing power of local consumers to decrease. The government will also have to make more efforts in fulfilling international debt payments, credit services, and external debt payments. These pressure conditions indicate the relationship between trade policies, monetary stability, and overall economic health, and how policy changes not understood by major trading sectors have long-term consequences.

In response to such challenges, Sri Lanka has had to reconsider its trade and economic policies. The US tax hike further accelerates the need to diversify trade partners and export goods. By finding alternative markets such as Europe, the Middle East, and Asia, risk can be distributed without relying on just one export destination. The success of this type of route requires strengthening bilateral and multilateral trade relations, actively engaging in trade negotiations, investing in trade market exploration, and participating in international trade forums. Thus, the public sector and private sector should resort to updated production processes. By adding modern manufacturing technologies, developing quality control standards, and increasing logistics efficiency, Sri Lankan goods will remain competitive even under higher taxes. These strategies match long-term economic effectiveness and the characteristic of building a resilient economic system.

Internal systems are also important, for example, tax increases, product distributions, resource management, and price stabilisation. Maintaining the same production level is a major challenge for Sri Lankan manufacturers, as consumer demand changes and foreign trade problems arise. Strengthening supply chains, developing warehouse management, and investing in employee training can reduce rare problems in projects and maintain product output. Government support, tax cuts, and financial assistance programs help exporters adapt to the new trading environment and maintain their position in the international market. This step is essential not only for the safety of individual businesses but also to maintain complete economic stability.

In full view, although current trade plan changes are essential, they bring a wider opportunity for economic transformation. The 2025 US tax increase indicated the need for Sri Lanka to build a more diverse and stronger export economy. By not relying solely on limited goods and markets, Sri Lanka can maintain stable economic growth despite external problems. This can include the discovery of new sectors such as high-value farming goods, the expansion of food processing exports, information technology, and modern fuel equipment. With that, the government and the private sector come together to increase production, exploration, and development.

IMPACT ON THE SRI LANKAN ECONOMY

Reduction in Imports

In 2025, the United States increased import taxes by 20%, and this had a major impact on Sri Lanka's export sector. Demand in the American market for major export goods, including clothing, rubber, leaflets, and other agro-industrial goods, declined.

Accordingly, the decrease in the total value of Sri Lanka's exports has raised challenges for producers to maintain competitiveness and has warned of wider economic growth concerns (Sri Lanka Business, 2025). Although these obstacles were significant, Sri Lanka's export sector showed resilience. In the first half of 2025, total export revenue was US$8.34 billion, an increase of 6.7% compared to the same period in 2024. Exports of manufactured goods saw a 5.86% increase, led by sectors such as clothing, tea, gems, and gold. This growth expresses the possibility that some industries will remain competitive even under adverse external conditions (Sri Lanka Business, 2025).

To mitigate the effects of US taxes, Sri Lanka has focused on efforts to diversify its export economy. This includes looking for alternative trading partners, investing in higher-value manufacturing processes, and strengthening international trade advertising strategies. These efforts are aimed at increasing revenue, strengthening trade relations and improving production status (Xinhua, 2025). While the US tax hike poses current challenges, it could also provide an opportunity for Sri Lanka to strengthen its economic resistance. By diversifying the market, increasing product competitiveness, and using modern manufacturing technologies, Sri Lanka can be well matched with global trade volatility and promote stable export growth.

Job Loss

In 2025, the US government increased import taxes by 20%, and this is expected to have an important impact on the Sri Lankan clothing industry. The Sri Lankan clothing sector has contributed greatly to the national economy over a long period of time, with around 350,000 people employed and significant foreign exchange income generated (Bandara, 2022). The United States is one of the largest export markets for Sri Lankan clothing, and the imposition of higher import duties may lead to reduced demand for these goods. A decline in demand suggests that producers are experiencing lower incomes, lower profits, and reduced competitiveness in the global market (Fernando & Jayasinghe, 2021). Small and medium-sized businesses are particularly vulnerable, and they may face the risk of worker cuts or factory closures due to limited financial capacity.

To minimise the disadvantages of US tax increases, the Sri Lankan government and industry stakeholders must look into alternative export destinations and make efforts to diversify goods. We can strengthen trade ties with the EU and UK by fully using trade concessions like GSP+ and bilateral agreements. In the meantime, relevant authorities should explore emerging markets in Eastern Europe and Latin America to reduce reliance on the US. A country can move from raw materials to value-added products (e.g., branded tea, packaged spices, ready-to-drink beverages). The exporters need to be encouraged to engage in processed agricultural products, such as coconut-based foods, herbal products, and Ayurveda items. Expanding trade links to the European Union and Asia-Pacific countries could help cover losses from the American market (Perera, 2023). Also, it is essential to update manufacturing technologies, invest in technology, increase staff skills, maintain competitiveness and ensure consistent growth. Industry associations and policymakers can work together and implement strategies to increase production efficiency and strengthen the overall resistance of the sector (Wijesinghe, 2022).

The increase in US import taxes was a more important challenge, but it also suited the Sri Lankan clothing industry and provided opportunities for innovation. Looking for new markets, increasing operational efficiency, and promoting value-added products will help not only to protect jobs but also to increase long-term economic stability. By taking active action, Sri Lanka can transform these external pressures into a promotion system for modernisation, market diversification, and steady industrial growth.

Decrease in Foreign Exchange

Once the US government raises import taxes in 2025, it is expected that Sri Lanka's foreign exchange earnings could be significantly affected. The United States has long served as a large market for Sri Lanka's exports, including clothing, rubber, tea, and other agro-industrial goods, making it a major source of foreign currency (Bandara, 2022). The sudden increase in import duties may reduce demand for these goods, reduce export earnings, and reduce foreign exchange inflows. Declining foreign exchange incomes can pose major challenges to the Sri Lankan economy, and problems may arise in fulfilling foreign debt obligations, financing imports, and maintaining monetary stability (Fernando & Jayasinghe, 2021). Declining foreign exchange leverage also affects investor confidence, leading to restrictions on new foreign direct investments (FDI) and reduced availability of international financial resources. With dwindling investor sentiment, financial stamina may decrease, and the government and private sector may face further difficulties in financing development projects or maintaining economic development (Perera, 2023). These economic pressures, affecting domestic markets as well, lead to reduced consumer purchasing power, price volatility, and cash-flow restrictions for businesses. Small and medium-sized businesses are particularly affected, as limited foreign currency receipts can reduce the ability to import and maintain production levels.

To mitigate these challenges, the Government of Sri Lanka, financial institutions, and industry stakeholders must implement objective strategies. Looking for alternative markets such as the European Union, Asia-Pacific countries, and emerging economic countries will help diversify export destinations and reduce reliance on the same market

(Wijesinghe, 2022). Increasing production efficiency, increasing value processing, and investing in technology can increase export competitiveness. Furthermore, strengthening the policy environment for attracting foreign investment and steady trade growth is essential to stabilise foreign exchange earnings and protect the national economy from external killer effects. Although the increase in US import taxes is an important challenge, Sri Lanka can also use it as an opportunity to diversify its economy, innovate export strategies, and resist international market volatility. By actively taking these measures, Sri Lanka can maintain economic stability, maintain foreign exchange funds, and reduce the long-term disadvantages of US tax increases.

ECONOMIC RESPONSES AND REFORMS

Economic Growth Forecasts

Amid these challenges, Sri Lanka's economic growth is set to reach 3.5% in 2025, according to the World Bank's forecasts. This growth is mainly based on monetary input, product export growth, and public and private investment. This brings a good perspective and is directly related to efforts to establish support structures, business activity expansion, and economic incentives. However, major US modern laws, particularly the 20% increase in import taxes on Sri Lankan products, bring a severe disruption to this growth journey. A serious decrease in incomes in clothing, rubber, and other basic export sectors can be expected. For companies heavily dependent on the US market, this translates into low incomes, low profits, reduced employment opportunities, and low investment potential. Declining export earnings result in a decline in foreign exchange access, which puts pressure on the exchange rate and calms overall economic prices. All these factors are tied together, and there is a risk of negative effects on the 3.5% growth forecast.

To respond to such risks, the Government of Sri Lanka may take proactive policy measures. Financial assistance, tax breaks, and capacity-building programs can be used to improve competitiveness in export industries. Not only traditional markets, but also maintaining trade relations with new emerging economic markets can reduce reliance on only one market. It can be argued that supporting export-led industries is not a cost; it is an investment that protects public revenue inflows. Furthermore, preventing job losses through the provision of tax concessions is cheaper than financing unemployment and social assistance later (ITA, 2023). In addition, introducing favourable policies for investment and establishing a stable business environment can further strengthen economic capabilities by attracting foreign investment. Successful implementation of these measures will enable the government to ensure long-term economic growth, keep foreign exchange inflows stable, and maintain investor and business confidence. Implementing the above policies will enable Sri Lanka to overcome external challenges in 2025 and continue economic development.

IMF Support

The provision of this $2.9 billion loan facility by the International Monetary Fund (IMF) provides essential support to Sri Lanka in implementing the Economic Amendment Program. This monetary protection plays a major role in strengthening the domestic monetary system by contributing to increased liquidity, establishing fiscal balance, and increasing confidence in the banking system. It also helps to promote domestic and foreign investment by pointing out that the government is committed to managing the economy so that it is clear. Furthermore, this credit facility provides the necessary capital resources for the efficient management of public expenditure, enabling the government to provide finance to key sectors such as infrastructure, social services, and industrial development.

However, external challenges threaten the effectiveness of this type of revision process. Heavy import duties, especially on Sri Lanka's products such as garments, rubber, and other exports, imposed by the United States of America, are likely to drastically reduce foreign exchange earnings. A decline in foreign exchange income leads to a decline in the value of the Sri Lankan rupee and an increase in the risk of exchange rate fluctuations, creating serious uncertainty at both the business and domestic levels. By changing the value of the rupee in this way, price instability occurs in the local market, making it difficult to maintain economic stability in the long run.

Legal and practical policy measures are needed to preserve the success of the amendment program by addressing the above challenges. The impact of external side effects should be reduced through processes such as increasing export competitiveness, diversifying trade selling destinations, and attracting foreign investment. At the same time, maintaining fiscal incentives and efficient money management are fundamental to sustainable growth by stabilising prices. By accepting a complete and shaping model, Sri Lanka can achieve the maximum benefits of IMF support to strengthen the economy, maintain further sustainability, and achieve long-term economic stability during external market pressures**.**

FUTURE CHALLENGES AND RESPONSES

Foreign Exchange Policy

The increase in US import duty brought a severe challenge to Sri Lanka's foreign exchange policy. Due to the decrease in export earnings and foreign investment, the weaknesses of the existing system have been clearly revealed. It is essential to prepare and strengthen it. Efficient management of foreign exchange savings, measures to stabilise monetary value, and the use of technologies to diversify the export market are essential to maintaining financial stability.

Economic Amendments

Long-term economic growth and stability will be essential through full revision processes. The main categories include efficient tax policy amendments, the promotion of domestic and foreign investment, and strong foreign exchange management. Also, policies should be applied to increase the competitiveness of export-based industries and stabilise domestic prices.

CONCLUSION

In 2025, the US government charged an import tax of 20% on Sri Lankan products. The move, aimed at solving America's economic and trade problems, had a direct impact on Sri Lanka. Declining demand in export-based sectors such as the textile, rubber, and other manufacturing industries has reduced sales and export earnings. As a result, the World Bank's forecast of 3.5% hints that economic growth may fall short of expectations. Job losses are a serious risk to economic stability. Sri Lanka's manufacturing sector, particularly the apparel and textile industry, plays a crucial role in employment generation and foreign exchange earnings. The sector directly employs approximately 350,000 workers, making it one of the country's largest industrial employers (International Trade Administration (ITA, 2023). However, declining exports to the United States, Sri Lanka's largest apparel export destination, have increased vulnerabilities within the sector due to rising tariffs and reduced competitiveness, thereby placing many of these jobs at risk (Asian Development Bank, 2024). A sustained reduction in export earnings weakens foreign exchange inflows, which contributes to currency instability, price volatility, and broader macroeconomic instability in Sri Lanka (United States Department of Commerce, 2023).

Declining foreign investment and challenges in paying off foreign debt further limit domestic economic activity. The USD 2.9 billion IMF loan received in relevant cases provides important support for strengthening the domestic monetary system, promoting investment, and enabling prompt control of public expenditure. However, the US tax increase and declining foreign incomes bring challenges to implementing the amendments. Economic instability and monetary value variation should be restored, taking into account local and international conditions. In response, Sri Lanka should implement policies based on economic revision, foreign exchange management, and investment promotion. The right and timely steps taken at this time will help Sri Lanka reduce the negative effects of US tax policy and maintain long-term economic stability.

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