Verité insights

Sri Lanka's Trade Liberalisation: What you see is NOT what you get

DailyMirror – 8th January 2014

Sri Lanka's 2014 Budget claims a continuous commitment by the government to maintain a liberal, consistent and simple trade regime. The budget speech puts it this way: "A four band tariff structure presently in place is further consolidated aligned with simplicity to facilitate production and trade".

In support of this claim, the budget provides the simplified import duty structure in Exhibit 1. But this is a case of misleading with facts. It is true that the import duties are being simplified; but the claim is nevertheless false. This insight shows that import duties are only one of the many taxes imposed, and overall import taxes are increasing, becoming more complex and less predictable and are harming trade.

Exhibit 1: Import Duty Structure of Sri Lanka

Classification	Customs Duty (%)	No. of Tariff Lines
Essential inputs, not manufactured locally	0	3,376
Raw materials & semi raw materials	7.5	184
Intermediate goods	15.0	1,605
End user products	25.0	1,412

Source: Budget Speech 2014

The past and the present

Sri Lanka was the first South Asian country to liberalise its trading economy; that was in 1977. Since then, for 22 years, till 1999, Sri Lanka's trade regime remained amongst the most liberal in the region. The dominant view amongst economists is that the Sri Lankan economy, by and large, benefited from its openness. But since 2000 and especially in the last six years, this reality is being reversed, albeit not transparently. In public statements, as in the budget, the government continues to make pledges and commitments in the direction of a liberal trade regime. However, its actions follow the opposite direction.

Up to 1999, import duty was the only tax on external trade. Since the turn of the century in 2000, the government has introduced a number of additional tariffs on international trade and over 90 percent of these taxes are imposed on imports. These are mainly the Cess, Port and Airport Development Levy (PAL) and the Special Commodity Levy (SCL).

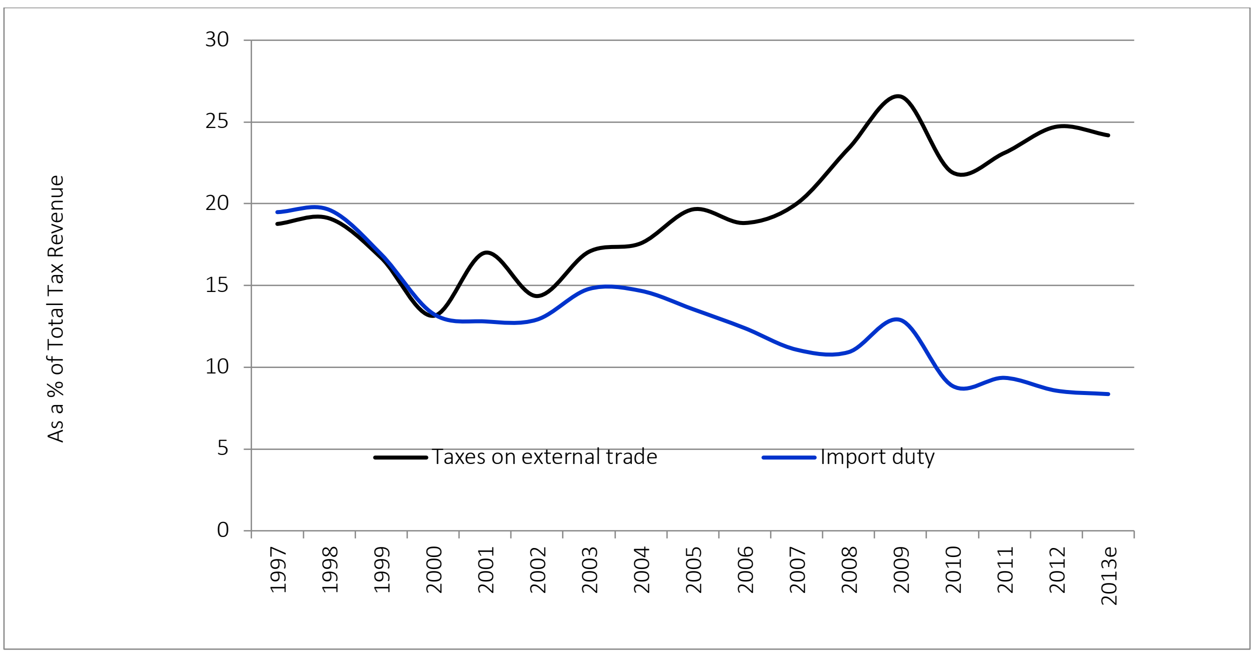
Taxes on imports on the rise

Sri Lanka still has the lowest import duty protection in the region and the structure of import duties is uncomplicated. However, with each year, the rate and product coverage of the additional taxes has been on the rise.

For example, the Fiscal Management Report of 2013 and 2014 both state that the increased revenue collected from SCL is the result of increases in the number of items coming under the levy and of increasing rates. This is the case for the Cess as well, which is implemented in a manner that violates both statutory provisions and policy promises: see Verité Insight titled "'Cess'. End the deception and build the 'street lights'".

Therefore, while the import duty burden is easing, the overall tax burden on imports has been on the increase (see Exhibit 2). In numbers: import duties have fallen from about 13 percent of government revenue in 1999 to 9 percent in 2012; but overall taxes on imports have increased from 13 percent to 25 percent of government revenue by 2012.

Exhibit 2: Revenue collected from Taxes on External Trade and Import Duty



Lack of predictability, transparency and simplicity

The government claims a commitment to be consistent and maintain an uncomplicated tax regime on international trade and advertises this with a reduced import duty structure of four bands. But the additional tariffs negate and reverse this advertised reality. The net taxes suffer from a lack of predictability, transparency, and simplicity.

Predictability: Import duties are generally revised once a year, with the budget. However, the Cess and SCL have been adjusted several times a year, without a predictable schedule. A case in point is the Cess imposed on tea early in 2013. It took the industry by surprise and held up shipments.

Transparency: Furthermore, stakeholders are not being consulted or forewarned on rate revisions, often resulting in traders learning of extra costs only at the point of export. At a seminar organized by Exporters Association of Sri Lanka in October 2013, an exporter stated, "We are the first to comply but last to know about the revisions."

Simplicity: While import duties are kept at four bands, the net tax structure is made extremely complicated by the additional taxes imposed. As indicated by Exhibit 3 the Cess tariff structure on imports is extremely complex and has nearly 60 different tariff bands.

In terms of Value-Added taxes the lowest is 5 percent and the highest is 50 percent. Over 80 percent of tariffs are either unit taxes or combined taxes ranging from Rs. 4 per unit to Rs. 6000 per unit. In terms of tariff bands, unit taxes have 21 different rates and the combined taxes have 29 different rates.

Exhibit 3: *Import Cess Levy Structure*

Unit Tax bands (Rs. Per kg)	4, 10, 15, 20, 25, 30 , 50, 60, 75, 70, 80 175, 200, 250, 400, 500, 550, 600, 625, 1000, 6000 net weight
Ad Valorem (Value-Added) Tax bands (%)	5, 6, 8, 10, 15, 20, 35, 40, 50
Combined Tax bands	15% or Rs. 15/= per kg, 15% or Rs. 25/= per kg, 15% or Rs. 30/= per kg, 20% or Rs. 25/= per kg 15% or Rs. 30/= per kg, 10% or Rs.45/kg 15% or Rs.70/kg, 30% or Rs. 70/= per kg 30% or Rs.75/= per kg, 30% or Rs. 80/= per kg 30% or Rs. 90/= per kg, 20% or Rs.90/kg 30% or Rs. 100/= per kg, 35% or Rs. 100/= per kg 35% or 35% of 65% of MRP* or Rs. 100/= per kg 30% or Rs. 110/=per kg, 30% or Rs. 120/= per kg 35% or Rs. 125/= per kg, 25% or 25% of 65% of MRP orRs. 150/= per kg, 25% or Rs. 150/= per kg 15% or Rs.150/kg, 20% or Rs. 150/= per kg 10% or Rs.200 /= per kg, 35% or Rs. 200/= per kg

	30% or Rs. 225/= per kg, 35% or Rs. 275/= per kg 20% or Rs. 500 /= per kg, 30% or Rs.2,000 /= per kg

MRP - Maximum Retail Price; Source: Extraordinary Gazette Notification No. 1837/30 dated 21.11.2013*

Losing International Credibility

Sri Lanka is a member of the World Trade Organization (WTO) and a member of several bilateral and regional trade agreements. As a WTO member, Sri Lanka has made the commitment not to increase import duty on agricultural produce above 50 percent. The Cess applicable on agricultural products violates this commitment. While offering "import duty free" access under existing trade agreements, Sri Lanka has imposed new taxes on imports by other names, nullifying the substance of the promises.

Once a leader promoting trade as well as a regional integration within the South Asian Association for Regional Cooperation (SAARC), today, Sri Lanka has become possibly the most backward country within the regional grouping. For example, under South Asian Free Trade Agreement (SAFTA) Sri Lanka within SAARC attempted to reduce the negative list. While all other countries, including the least developed countries (LDCs) in the region such as Bangladesh, reduced the negative list by the agreed date, Sri Lanka failed to meet the deadline and took several months more to finalise the list of products.

Faced with depressed demand for its exports, Sri Lanka is seeking improved market access to markets through new bilateral trade agreements. But failing to honour commitments under current agreements reduces the confidence of potential partners, and this could be an impediment to securing favourable terms in new agreements.

Conclusion

Truth telling: "Saying what you do and doing what you say", is not only an important quality for persons, it is also important for countries. The lack of integrity leads to lack of confidence, and that affects economic activity as well as future potential.

Tinkering with trade taxes has not been sufficient to increase government revenue, which is steadily declining. However, the resulting decline in transparency, predictability and simplicity of the trading regime will be detrimental to promoting exports and investments; two critical factors that are essential to sustain higher rates of economic growth.

(Verité Research is an independent think-tank based in Colombo that provides strategic analysis to high level decision-makers in economics, law, and media. Comments are welcome. Email publications@veriteresearch.org.)