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Reforming Sri Lanka’s trade and investment policies for export growth

2015-11-11 18:30:00 619 0

Sri Lanka’s recent trade performance has been far from satisfactory especially since 2000, marked by a decline as share of the country’s GDP as well as of world trade.

While the negative external environment has been blamed for the poor performance, many competing countries have achieved higher rates of growth, pointing to Sri Lanka’s lackluster performance being fundamentally ‘homegrown’. Lack of diversification of exports and markets also remain a cause of concern, with textile and garments (T&G), and US and EU markets accounting for a substantial share of Sri Lanka’s total exports.

Improving the competitiveness of exports to deepen integration with the world economy, attract the right kind of FDI and create a more enabling environment for trade is a must to broaden the sources of Sri Lanka’s growth. Reform efforts to improve export competitiveness will require addressing constraints on multiple fronts. These include: (i) tackling supply-side (ii) addressing weaknesses in the business; and (iii) strengthening demand-side conditions.

This Policy Insight focuses on four key reforms relating to the trade tariff structure, trade and transport facilitation, FDI promotion and existing trade agreements towards increasing Sri Lanka’s competitiveness and improving its external trade.

Trade tariff structure

Sri Lanka's unilateral trade liberalization process was initiated in 1977, ahead of her neighbours, in response to poor economic outcomes due to protectionist, import-substitution trade policies.

Although the country remained 'committed' towards greater integration into the world economy, the pace of trade reforms proceeded at a 'mixed pace'. However, the policy stance appears to have reversed in the last decade in terms of its tariff policy regime, with the introduction of a number of border charges in addition to customs duty, increasing levels of protection and insulating domestic producers from import competition.

Sri Lanka's openness to international trade has drastically declined since 2000, with a level of openness close to that seen during the import-substitution era. This was not due to poor GDP growth, which has been quite decent, but largely due to slow growth of trade, consistent with a return of more activist forms of import substitution and increased protectionism.

Generally speaking, Sri Lanka has an escalating tariff structure – most basic raw materials and essential items are duty free, or enjoy low duties in the case of semi-processed products, while many processed goods or finished products including goods that the government wishes to protect are taxed at a higher rate. The general practice has been to impose tariffs on an ad valorem basis. However, some goods attract specific duties. In addition to Customs Duty, imports into Sri Lanka are subject to a number of Para-tariffs, which have proliferated in the last decade.

Despite recent simplifications, the trade regime remains non-transparent, complex and unpredictable. This calls for simplification and rationalization of the tariff regime by limiting the number of rates and allowing for few exceptions; amalgamation of Para-tariffs into one overall tax with fewer rates; streamlining computation of various border taxes; conversion of specific duties into ad valorem to enhance transparency; and passing WTO consistent trade remedial measures such as anti-dumping, counter-veiling and safeguard measures without resorting to use of Para-tariffs. Several of these recommendations have been made by the 2010 Presidential Tax Commission, but remain to be implemented.

Trade and transport facilitation

Trade facilitation focuses on improving the efficiency of trading across borders by reducing transactional costs, increasing transparency and predictability. With progressive reduction of tariffs at the multilateral level, there is increasing attention on reducing constraints and costs that affect transactions at border points and increasing efficiency of supply chains.

While Sri Lanka's performance is commendable in comparison to other South Asian countries, outperforming its neighbors in several logistics performance indicators, more needs to be done to facilitate trade. This requires reforms to: improve publication and administration of policies related to trade; streamline rules and procedures for imports and exports; increase usage of ICT for trade; and strengthen trade related infrastructure. Specific reforms include: strengthening inquiry points; eliminating irregular payments; setting up of a single window and fully automating the trading system; extending pre-arrival processing to more products; and improving infrastructure facilities at both the port and airport.

Foreign Direct Investment

The ending of the armed separatist conflict removed one of the biggest impediments to FDI. However, Sri Lanka failed to capitalize on this, evident from the relatively poor performance of FDI inflows post-2009 averaging around 1.5 per cent of GDP. Various policy measures have sent mixed signals to both local and foreign investors, deterring investments into manufacturing and high value added services industries.

No major Multinational enterprise (MNE) has set up operations in Sri Lanka's manufacturing sector over the last decade. More recent FDI flows into the country have been heavily concentrated in infrastructure development, tourism and mixed development projects – not the kind of FDI that the country requires to boost exports and link Sri Lanka to markets abroad.

It is critical at this juncture of Sri Lanka's economic development to attract efficiency-seeking FDI and enter the fast-growing markets for made-to-order manufactured goods, and component production and assembly within vertically integrated production systems. Towards this end, there is a need: to formulate a national trade and industrial policy which would spell out the role of FDI to provide investors a credible and coherent indication of future policy direction; to enhance the effectiveness of BOI as a 'one-stop shop' for foreign investors and offers a range of services; to gradually phase-out of tax holidays and switch to other forms of incentives like investment tax credits/allowances, accelerated depreciation and non-tax incentives; to review existing laws affecting FDI to ensure that there is policy coherence to signal consistency in FDI and related policies; to streamline business procedures and undertake reforms to improve the overall business climate and the country's attractiveness as an FDI destination.

Accessing markets through trade agreements

Sri Lanka has lagged behind in pursuing Preferential Trade Agreements (PTAs) in recent years, especially in relation to neighbouring countries in South and Southeast Asia. At the moment, Sri Lanka has only four PTAs in force – the India-Sri Lanka Free Trade Agreement (ISFTA), the Pakistan-Sri Lanka Free Trade Agreement (PSFTA), the South Asian Free Trade Agreement (SAFTA) and the Asia-Pacific Trade Agreement (APTA). Whilst the provisions made under the bilateral agreements are much more liberal and favourable to Sri Lanka, only the ISFTA can be said to have had some economic gains.

In this context, Sri Lanka must take a more strategic approach in future trade agreements, whilst addressing shortcomings in existing PTAs. Sri Lanka should be mindful in its approach to future trade negotiations considering the lessons learnt from the existing FTAs and PTAs. Namely Non-Tariff Barriers (NTBs) should be identified at the onset and addressed along with tariff reductions/eliminations; Mutual Recognition Agreements (MRAs) should be signed together with the trade agreement specifying the mutually recognized or agreed standards between the signatory countries; widespread awareness campaigns are a vital to disseminate information effectively, especially to SMEs; the CEPA with India needs to be revisited as a priority. While Sri Lanka has shown an interest in exploring a bilateral trade agreement with China, the agreement needs to be prepared carefully taking into account the asymmetric relationship between the two economies, with a rational negative list and a longer phase-out liberalization schedule to protect local producers and manufacturers.

(This Policy Insight is based on the comprehensive chapter on "Reforming Sri Lanka's Trade and Investment Policies for Export Growth" in the 'Sri Lanka: State of the Economy 2015 Report' - SOE 2015)

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