The Island Online

Role of Imports in the Sri Lankan Economy

August 29, 2010, 12:00 pm

Address by Dr. Saman Kelegama, Executive Director, Institute of Policy Studies of Sri Lanka at the AGM of the Import Section of the Ceylon Chamber of Commerce, 3 August 2010:

"It is an honour to be the Chief Guest at the AGM of the Import Section of the Ceylon Chamber of Commerce. I thought that it will be appropriate to share some of my views of the import sector of Sri Lanka so as to identify its current role in the Sri Lankan economy and its role in the future. Accordingly, I will deal with four broad issues relevant to the import sector in Sri Lanka, viz., (1) the positioning of imports in the Sri Lankan economy, (2) imports as a value adder to the Sri Lankan economy, (3) imports as a revenue earner to the economy, and lastly, (4) imports as a growth facilitator in the economy.

Let me start with import positioning in the Sri Lankan economy. In the Sri Lankan economy today, imports (of goods) roughly amount to US$ 12 billion and exports (of goods) amount to US$ 8 billion. This roughly boils down to imports amounting to 30% of GDP and exports amounting to 20% of GDP. Basically, exports of goods finances 63% of the imports of goods. If we add remittances which amount to approximately US$ 3 billion or 7.5% of GDP, then 92% of the goods import bill is financed by goods exports and remittances. Thus, the country is in a position to support its import (goods) flows as long as the foreign reserves are in a healthy position.

If Sri Lanka could sustain its reserves above US $ 3 billion, then the country will be in a comfort zone where it could finance 3 months and above of imports. Sustaining reserves above US $ 3 billion when the import bill is escalating will be a challenge. Sri Lankan remittances in recent years have been covering the oil import bill – this is also a noteworthy feature of the import sector.

The largest source of imports is India (accounting for 25% of total imports), followed by China (includes Hong Kong). But if we consider EU as a single source, then it is the second largest source of imports to Sri Lanka and not China. Sri Lankan imports as a percentage of global imports amount to meager 0.1%.

One can note that if the Sri Lankan economy is growing above 5%, it is normally supported by growth in imports above 10%. Sri Lanka's growth is such that it is an import-intensive growth. Take for instance, the growth of our industrial sector and services sectors – the two fast growing sectors in the economy. Industrial growth is mainly driven by export industries like ready-made garments, gems and jewellery, leather products, etc., and they are all import intensive. Two export items that grew under the India-Sri Lanka Bilateral FTA were Vanaspathi and Copper — they too were import intensive with palm oil imported for vanaspathi production and raw iron imported for copper production. In services, growth sectors like wholesale/retail trade, tourism, telecommunication, etc., all are import intensive.

In any country in the early stages of development this is what we observe, an import-intensive growth. In Sri Lanka, the import composition statistics further provides evidence of this. Consumer imports amounted to 50% of overall imports at the time of Independence. Today, they amount to only 19% of overall imports. On the other hand, intermediate goods used for industries and services that accounted only for 11% of overall imports at the time of Independence, have doubled its share to 22% of overall imports today, clearly indicating that the input of imports in Sri Lankan production has increased.

Sometimes, when there is a call for depreciation of currency by exporters there is also the concern of the impact on the import-intensive exports and import-intensive services and thus the overall growth trajectory, as imports will become more expensive. That is why calls for depreciation take time for full consideration by the policy making apparatus in this country.

These are some of the noteworthy characteristics of Sri Lanka’s import sector.

I now come to my second topic of imports as a value adder to the economy. Import liberalization can also be a source of value addition. Take for instance, assembly operation from Completely Knocked Down importations. One can import components of a motor vehicle, three wheeler or refrigerator and assemble them with some value addition to sell in the domestic market. The value addition will be small but if the operation takes place in a large scale the value addition will also be bigger. Let us now take a higher value addition case with the example of the gem and jewellery industry. There was a call in the early 1990s to liberalize the importation of gem stones. After some initial hesitation, we did liberalize, and as a result, variety and jewellery products were manufactured in Sri Lanka using a variety of stones. One can easily say that the import liberalization in this case certainly increased the value addition to the economy.

But we must note that import liberalization contributing to value addition is not straightforward. If there are competing products in the domestic market, import liberalization will not lead to value addition. In fact, import liberalization will lead to closure of industries if Sri Lankan products are not in a stage to face competition. That is why in the India-Sri Lanka Bilateral FTA (ISLFTA), all agriculture products and SMI (small and medium industries) products were kept on the negative list. Even in the SAFTA, APTA and the Pakistan-Sri Lanka Bilateral FTA (PSLFTA) those sensitive products of Sri Lanka have been put under the negative list.

Then there are cases of import liberalization for value addition where the arguments are not straightforward. In cases where Sri Lanka has a brand name like tea, the case for import liberalization is not straightforward because if import liberalization is done without a proper regulatory framework in place, import liberalization can dilute the brand name and reduce the domestic price for tea. Brand name can be diluted, for example, by mixing 10% Ceylon tea with 90% imported Indonesian tea and exporting as Ceylon tea. Tea traders will benefit, but tea manufacturers and exporters will have concerns on domestic price level and ‘Ceylon Tea’ brand name, respectively. That is why the liberalization of importation of tea has become a hotly debated topic. In such a case, value addition through imported tea should be done with supervision and extreme care. Some countries created special Export Processing Zones for enhanced supervision to get the best results from import liberalization. In cases like this, we have to be constantly vigilant on how global operations are taking place and accordingly adjust our strategy to be in line with global trends.

I now come to my third topic of imports as a source of revenue. At the time of Independence, import duties contributed revenue amounting to 6.2% of GDP, today it contributes close to 2% of GDP as revenue. Here, I am only referring to tariff revenue. When liberalizing an economy, we should not see import duties as a major source of revenue. From 1977 onwards, revenue from import duties fluctuated – from 2.27% of GDP in 1977 it increased to 4.1% of GDP in the late 1980s due to the increase in import volumes making up for the reduction in tariffs as a result of liberalizing the economy. But import duties declined to 3.3% of GDP in late 1990s and further to to 2.0% of GDP in the late 2000s. That is understandable because although the import volumes increased by the mid-1990s, WTO related tariff reduction, regional and bilateral agreements related tariff cuts further reduced revenue. For example, 1,208 product lines became duty free for India under the ISLBFTA and 102 product lines became duty free for Pakistan under the PSLFTA. It is estimated that there are 2,500 duty free lines (746 MFN duty free lines) out of the 6,500 tariff lines. Also, with the formation of BOI in 1992, duty free importation increased rapidly so much so that about 65% of imports now come under duty free or tariff free to Sri Lanka.

At the border however, it is not only tariffs that operate: there are a number of other taxes that have been imposed from time to time at the border, viz.: (a) surcharge on customs duty (was removed for most products on 1 June 2010); (b) VAT, (c) Excise Duty, (d) Commodity Export Subsidy Scheme (CESS), (f) a number of development taxes operating in the border – (1) Port and Airport Levy (PAL), (2) Social Responsibility Levy (SRL), (3) Regional Infrastructure Development Levy (RIDL), and (4) Nation Building Tax (NBT). Due to these taxes, the overall border tax contribution to revenue is close to 50%. This boils down to overall customs duties related revenue amounting to 8% of GDP. Now the question arises why are all these taxes in operation? Several factors have contributed to their evolution. One was to raise additional funds for the war at that time; second, to meet expenses on development activities – PAL, RIDL, etc.; third, to meet product development like the CESS – whether the CESS goes to the industry concerned, i.e., tea, rubber or coconut via the Consolidated Fund is another matter; and fourth, for protection on the basis of industrial lobbying – duty surcharge or CESS may have been imposed to fulfill aspiration of various lobbies.

This has made the border tariff structure highly complicated. These taxes are imposed on different tax bases at the point of importation making it further complicated. When designing the tariffs for the imports coming into Sri Lanka, there was a four band tariff structure: 2.5%, 6%, 15% and 28% and they were to cover the following: 2% for raw material, 6% for semi-processed raw material, 15% for intermediate goods, and 28% for final goods (of course there was the zero rate also). This structure has got complicated not only due to the development and other nuisance taxes, but also due to specific tariffs – extremely high duty on cigarettes, liquor, motor vehicles, etc.

The time has come to simplify this process – get rid of these ‘add-on’ taxes and keep the same level of protection by adjusting the import duties. This is a very important area that the Presidential Taxation Commission has been asked to look into and all of you will be able to see the Commission’s recommendations by early September.

My final topic is imports as a facilitator of growth: ‘Mahinda Chintana Idiri Dakma’ aims for a 8% growth rate. This can come by improving the ‘doing business’ environment in Sri Lanka and bringing down the ICOR (Incremental Capital Output Ratio) from 5 to 4 and increasing investment to 32% of GDP. Currently, investment per GDP is at 24% of GDP and thus an 8% GDP increase of investment is required —- 4% will have to come from FDI and the remaining 4% GDP increase in investment from the domestic private sector. If investment cannot meet these targets, we will have to look at a combination of consumption-led growth and investment-led growth.

Most of the consumption-led growth is import intensive. The increased sale of motor vehicles and electronic goods after the import duty was lowered was consumption-led. It is a consumption-led growth that is giving a new lease of life to the leasing industry and electronic good importers. Take for example meeting the challenge of the tourism sector — 15,000 new rooms are required by 2016. It has been estimated that the per room cost will be close to Rs.10 million, and more than 60% of this will be on import expenditure – carpeting, curtaining, air conditioning, TV, DVDs, etc.

Even investment-led growth will be import intensive. Take for instance, North-East rehabilitation and reconstruction – that will also be quite import intensive. Take for instance, the five hubs articulated in Mahinda Chintana: Aviation, Shipping, Energy, Knowledge and Commercial — which will become major growth poles. Can hubs be developed by cutting off Sri Lanka from the rest of the world ? – No, they can be developed only by further opening up the economy and welcoming imports of not only goods but also services.

Singapore is an oil hub —- does it produce any oil ? - no. But, it liberally imports oil and is engaged in value addition. Singapore, blessed by its strategic location by a major sea route for oil tankers, is one of the major energy hubs in the world for oil refining and exporting. In addition to the Singapore Petroleum Company Limited, the world's largest energy multinational companies such as ExxonMobil, Royal Dutch Shell, Chevron, BP, Total, Marubeni and, Mitsui have invested in Singapore's oil industry. Singapore produces 8.3 million oil barrels a day, which is nearly a 10% of world oil consumption, but 10 times Singapore's own consumption. The point I am trying to make is that Sri Lanka need not be an oil producer to become an energy hub.

Let us look at the 5 hub areas from Sri Lanka's regional perspective: Aviation – today close to 42 % of revenue of Sri Lankan Air Lines comes from flights to India with 90 to 100 weekly flights. Shipping – today close to 71% of transshipment in the Colombo port comes from India. Energy – today close to 35% of our oil imports comes from India – Lanka IOC. Knowledge: IT, Biotech, Nanotech, Ayurvedic and Indigenous medicine —— all these areas we share closely with India. We have to seriously take cognizance of these issues when talking about making Sri Lanka a regional hub. The point I am trying to make is that these hubs will be difficult to develop by trying to by-pass India. It is in this context that the proposed frameworks such as CEPA have to be looked at seriously.

Always there will be views in favour of and against CEPA. Even in the EU there are the Euro-files and Euro-sceptics and this is particularly seen in the UK where the debate is still going on whether UK should be a part of Euro or remain outside it. But unlike in Sri Lanka, these debates are kept at a very professional level and not at a personal level or 'patriot versus traitor' level, as it is sadly the case in Sri Lanka. As a result, many are reluctant to openly come out and debate the subject of CEPA.

Be that as it may, imports are going to play a vital role in the Sri Lankan economy in the coming years. Sri Lanka has to clean up the border taxes and make the import tax regime simple and transparent while strengthening the regulatory framework to ensure that dumping of unwanted imports do not take place. Imports will play a vital role as a growth generator and a value adder to the economy in the coming years."