Sri Lanka
State of the Economy Report 2016

Chapter 5
Promoting Exports and FDI under Financing Constraints

by
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5. Promoting Exports and FDI under Financing Constraints

5.1 Introduction

In the late 1970s, with reforms aimed to liberalize the foreign trade regime, Sri Lanka was seen as the first South Asian country to significantly open its borders to trade and FDI. In the decades that followed, trade in goods and services increased to nearly 90 per cent of GDP in 2000, with tea and apparel exports leading the way. However, trade openness began to decline steadily - at a time when the rest of the world was integrating more strongly and global trade was accelerating - to reach 36 per cent of GDP in 2015. Even at present, FDI remains below 2 per cent of GDP, five years after the end of the armed conflict. The decline in openness and stagnating FDI is reflected in a shrinking world market share to levels last seen in the 1980s, accompanied by a steady decline in exports and an export basket that has remained largely unchanged in a context of rising production costs and weakening demand in some of its main markets (Europe and the Middle East).

Sri Lanka has set itself an ambitious target of US$ 20 billion exports by 2020; achieving this target will require an increase in exports of nearly 80 per cent during 2016-2020. Meanwhile, the government has also placed significant emphasis on driving FDI, with a target of US$ 5 billion within the next three years from current levels of US$ 970 million in 2015. Hence, stronger export and FDI promotion efforts will be needed to achieve Sri Lanka's export and FDI targets in the years to come.

Given the country's unsatisfactory fiscal performance, efforts to channel state funds to incentivize exports and FDI will be difficult. This calls for alternative approaches towards promoting exports and export-oriented FDI without drawing upon dwindling state funds. In this light, export and FDI promotion agencies need to play a stronger role in facilitating export and export oriented-FDI amidst a challenging macroeconomic setting. This chapter will examine the role of key export and FDI promotion agencies in Sri Lanka with the aim of analysing the existing export and FDI promotion programmes in place. The chapter will focus on identifying ways of maximizing

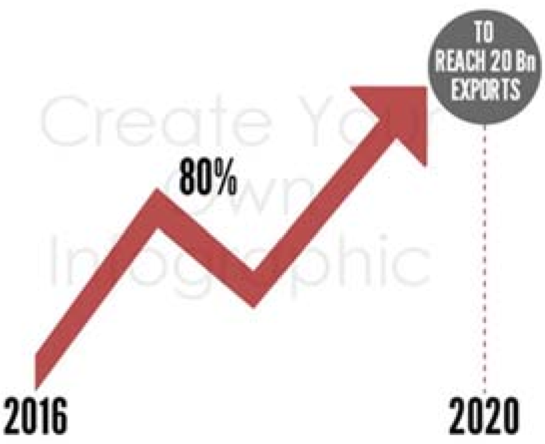
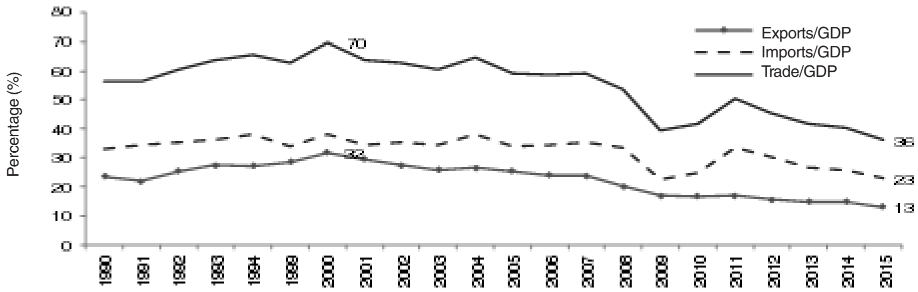


Figure 5.1
Sri Lanka's Trade Performance, 1990-2015



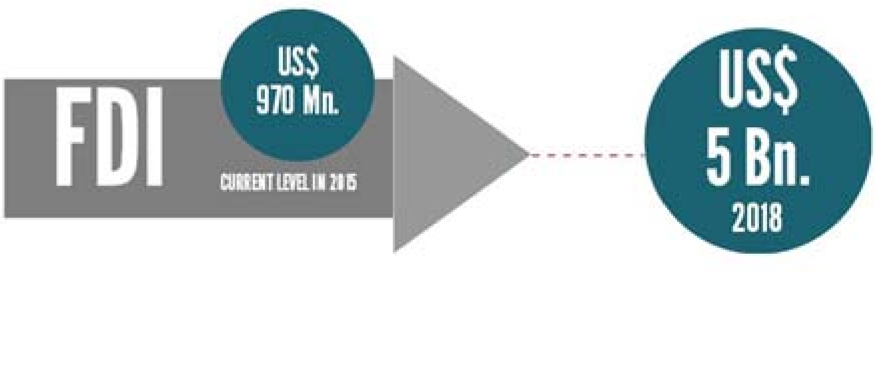
Source: WITS and WDI databases.

gains from export and FDI promotion efforts currently in place, and examine some alternative ways of financing exports and FDI, given current budgetary constraints.

5.2 Trade and Investment Performance

Sri Lanka's trade performance has shown a weakening trend over the years, with exports as a share of GDP dipping down to just 12.8 per cent in 2015 compared to 24 per cent in 1990 (Figure 5.1). Meanwhile, imports have grown faster than exports but are lower compared to the 1990s. An unfavourable external environment following the global financial crisis of 2008, though impacting Sri Lanka's trade performance, has not been the only factor at play. The lack of diversification of exports, lack of an enabling environment for trade caused by destabilizing macroeconomic environment, increasing levels of protection, etc., can also be blamed for the country's poor trade performance despite various export measures and a dedicated institution in place to promote exports, calling into question their effectiveness. However, it is important to note that revenue generated from trade has increased over time and continues to remain an important source of revenue for the government (Box 5.1).

Despite numerous fiscal incentives, FDI flows have also been disappointing. Inflows remain below 2 per cent of GDP, five years after the end of the armed conflict; FDI flows are low compared to countries in the Asia-Pacific (Figure 5.2). Moreover, FDI inflows have been concentrated in infrastructure projects, with little or no FDI going into industries associated with global production networks either in manufacturing or services sectors. In 2015, Sri



Box 5.1
Revenue and Expenditure Generated from Trade

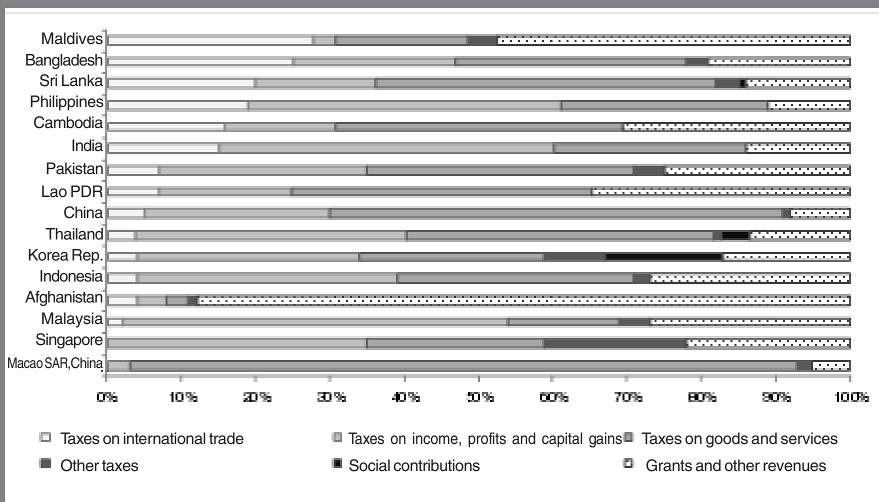
In 2014, Sri Lanka Customs (SLC) collected about 51 per cent of national tax revenue. This is a reduction from 61 per cent collected a decade ago. In fact, Sri Lanka collects more from taxes on trade than its neighbours in the region as seen below.

While total revenue collection by SLC has increased over time, the contribution of various border taxes has changed. Customs duty (CD) has been one of the main measures of border taxes and currently raises about 17 per cent of tax revenue from international trade. However, its contribution has fallen over time with the growing importance of other tariffs like Excise duty and VAT on imports. The relative decline in revenue from CDs owing to trade liberalization and a gradual reduction of duties, was off-set by an increase in revenues from other charges like the PAL, CESS, SCL, Excise, VAT (on imports) and NBT in the last decade.

The introduction of a number of border taxes from time to time has enabled SLC to maintain its important position as a collector of revenues for the government. However, the proliferation of para-tariffs has resulted in a shift towards protectionism, making the current import tariff regime complex and more 'protectionist' over time. Moreover, an escalating tariff structure with higher rates of protection on final goods than on inputs used in production leads to higher effective rates of protection and an anti-export bias.

Sri Lanka also imposes border charges on certain exports (vein quartz) as well as an export CESS on some raw materials (cashew nuts with shells, raw hides and skins, metal scraps, natural rubber, coconut products and tea) for various reasons, from discouraging export in raw form to ensuring local supplies and generating funds for cultivation. Revenues from the CESS are supposed to be ploughed back into the respective industries to encourage value addition but this has not happened. It is yet to be seen whether an export CESS has any impact on boosting value added exports of these products.

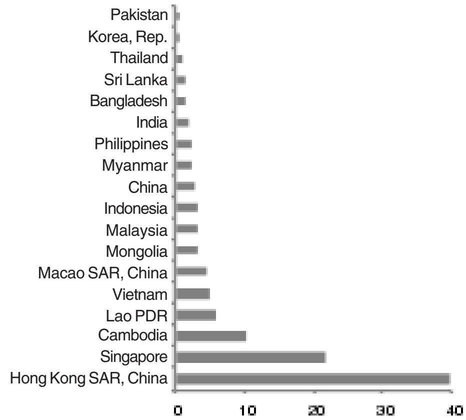
Composition of Government Revenue, Asia-Pacific, 2013



Source: World Bank, "World Development Indicators"; SLC (2014); "Customs Performance Report 2014", Sri Lanka Customs, Colombo.

Lanka received a total FDI flows of US$ 969.7 million, of which 46.7 per cent went into infrastructure, followed by manufacturing (26.5 per cent), services (26.3 per cent) and agriculture sector (0.5 per cent).[1] The need for Sri Lanka to increase FDI in place of debt financing is critical; a revamped role for the Board of Investment (BOI) - the central facilitation point for investors - will be significant in this regard. The soon to be established Agency for Development has the mandate to revamp the BOI (Box 5.2).

Figure 5.2
FDI as % of GDP, 2013



Source: World Bank, World Development Indicators.

Box 5.2
Development Bill

Agency for Development

Under the proposed Development (Special Provisions) Bill, an Agency for Development will be established soon with the twin objectives of stimulating growth, expansion, and development of the Sri Lankan economy; and reporting on key competitiveness issues facing the economy with the required policy action. Towards this end, the Agency will draft plans, programmes, schemes while being responsible for their implementation and coordination with relevant department/state institution/authorities (including the BOI). The Agency will have powers over economic development areas, demarcate special areas for development, and give directives to specified institutions to ensure the effective implementation of plans/programmes/schemes.

In terms of FDI, the Agency will be given the task of attracting more investments into the country and alleviate the problems faced by foreign investors by expediting the approval process. The Bill promises to remove other obstacles facing potential investors including ownership of buildings and land (i.e., Land Restriction and Alienation Act) and offer tax incentives to foreign and local companies that will locate in economically depressed rural areas in the country. The Agency for Development seeks to insert Sri Lanka into global value chains and enhance the competitiveness and value of the country's exports of goods and services while generating employment and increasing people's incomes/welfare.

Agency for International Trade

The proposed Development Bill also aims to establish an Agency for International Trade, with the objective of promoting international trade and creating an environment to facilitate export trade. Specifically, the Agency will recommend measures to the government to increase exports, and change import policies of the country. The Agency will also represent the Government of Sri Lanka during negotiations of regional and multilateral trade agreements, and liaise with OECD, UNCTAD, ASEAN, APEC, BIMSTEC, and SAARC. The Agency will also have the authority over institutions relating to international trade including the Sri Lanka Export Development Board (EDB), the BOI, Department of Commerce, the Department of Import and Export Control, the Sri Lankan Tea Board, etc.

[1] CBSL, *Annual Report 2015*, Central Bank of Sri Lanka, Colombo.

5.3 Export Promotion

Promoting exports ranks as a priority in both developed and developing countries in view of the suggested strong relationship between exports and economic growth. Export promotion has been defined in various ways, based on different ideological schools of thought. At one extreme is a narrow definition of export promotion as the adoption of a neutral trade policy, maintaining an effective exchange rate,[2] or one in which the effective exchange rate of exports equals the effective exchange rate of imports; this gives producers equal incentives to sell domestically and to export.[3] A broader definition such as that of OECD includes a set of 'specific measures that generally amount to the government bearing a portion of the private cost of production of export'.[4]

Generally speaking, it includes a set of measures/programmes which aim at assisting current as well as potential exporters to penetrate markets abroad through export subsidies, reduced tax rates on exporting firms' earnings, favourable insurance rates, advantageous financial conditions, or effective exchange rates.[5] It can also include removing domestic regulations (i.e., export licences), infrastructure or human resource constraints which hinder export expansion.

Economic justifications for government intervention in trade are usually related to the existence of market failures pertaining to externalities/infant industry protection; information problems, coordination problems, credit and other market imperfections; comparative advantage discovery; spillovers and learning by doing; production of knowledge goods and R&D spillovers.[6] The theory of international trade suggests that when perfect competition prevails in markets, free trade is

Export promotion is widespread and most governments intervene, ranging from providing infrastructure support to direct export subsidies, though the latter is currently limited by WTO rules.

[2] Effective exchange rate includes currency earned at parity and also any export subsidy, tax credits, and special credits.

[3] Bhagwati. J.N. (1988), “Export-promoting Trade Strategy: Issues and Evidence”, *The World Bank Research Observer*, 3(1).

[4] OECD (1984), *Competition and Trade Policies: Their Interaction*, OECD, Paris.

[5] Belloc. M. and M. Di Maio (2011), “Survey of the Literature on Successful Strategies and Practices for Export Promotion by Developing Countries”, Working Paper, International Growth Centre, London.

[6] *Ibid.*

better than protectionism. However, when one or more conditions required for the well-functioning of markets are missing, government intervention aimed at correcting the distortions may be welfare enhancing.

Nowadays export promotion is widespread and most governments intervene in one way or another, ranging from providing infrastructure support to offering direct export subsidies, though the latter is currently severely limited by

Box 5.3
Transformational Export Promotion Policies of South Korea: The Role of Institutions

South Korea, an underdeveloped war-torn desolate economy until the 1960s, with a per capita income of around US$ 87 in 1962 (similar to that of the poorest parts of Africa), has seen a sea change in development since the country adopted export-based industrialization in 1961 with the commencement of Park Jung-hee's regime. Today, South Korea is ranked as an advanced economy with a per capita income of around US$ 30,000 and is one of the world's top ten exporters. South Korea has been coined as the only country that has so far managed to go from being the recipient of development aid to being rich within a working life. Much of Korea's seemingly miraculous growth has been the consequence of aggressive export promotion policies pursued since the mid-1960s.

The provision of state subsidies to promote export industries (high value added industries since the 1970s) was a common feature of Korea's aggressive export promotion period witnessed during 1960s to 1980s. Since 1964, tax benefits such as 80 per cent reduction of profit tax were provided to profits arising from exports, while imported raw materials that were used to produce export products (within thirteen months from import) qualified for duty drawback under the Special Act for Duty Drawback in Korea until 1997. Other common export promotion tools include special rates of depreciation targeting export industries, income tax exemptions in special investment zones, establishment of FTZs, the provision of policy loans and export financing through state-owned banks, etc. Korea's success story goes beyond having the right export promotion policies in place and makes a strong case for the importance of the institutional set-up in effectively implementing such policies.

Design and implementation of export promotion policies in Korea was supported by a strong institutional set-up. The Economic Planning Board of Korea (EPB), set up in 1961 was a unique organization that initiated longer-term policy planning, consisting of various consistent five-year plans. Having a systematic longer-term plan makes the planning process more methodical and helps avoid imbalances that come about from ad hoc policy changes. Additionally, heavy pressure was exerted on bureaucrats belonging to various state-owned enterprises to complete projects based on targets. For example, the Ministry of Commerce and Industry set annual export targets for officials connected with export administration; if targets were not fulfilled, the administrative process was expedited to strengthen existing export-support schemes to innovate new subsidy measures. These additional checks and balances have been noted to be unique features of Korea's institutional set-up that aided trade promotion. Moreover, a host of institutions such as the Korea Development Bank, the Export-Import Bank, the Technology Development Corporation, and the National Investment Fund, etc., were among some of the other institutions that supported the implementation of export promotion efforts in Korea.

Source: *The Economist* (2011), “South Korea’s Economy: What Do You Do When You Reach the Top?”, available at http://www.econo mist.com/node/21538104; Mah., J.S. (2010), “Export Promotion Policies, Export Composition and Economic Development of Korea”, paper presented at Law and Development Institute Inaugural Conference, Sydney, Australia; Kim. S.K. (1991), “The Korean Miracle (1962-1980) Revisited: Myths and Realities in Strategy and Development”, Working Paper No. 166, Kellogg Institute for International Studies, Paris.

WTO rules.[7] In fact, export promotion through government intervention has been an important contributor to the impressive export performance of East Asian countries led by Japan, and followed by the four Asian Tigers (Hong Kong, the Republic of Korea, Singapore, and Taiwan), and much later by Southeast Asian countries such as Indonesia, Malaysia and Thailand. Selective interventions in the form of provision of protection, subsidized credit, tax benefits, export processing zones (EPZs) to attract FDI, etc., have played a key role in setting up export-oriented manufacturing bases that boosted growth in these countries. However, there is little evidence to suggest that export promotion has been the only factor for their success.

The overall context or environment within which export promotion took place in these countries is noted to be as important to their success, as the policy interventions themselves. It has been argued that export promotion will have greater success if they take place where there are good fundamentals (low inflation, competitive exchange rates, human capital, secure financial systems, etc.), and strong institutions to implement them (Box 5.3).[8] This is particularly evident when comparing the experience of export promotion in Latin America with that of East Asia. A range of export promotion measures like tax refunds, duty drawbacks, temporary admission and EPZs have been used to increase exports in Latin America. However, they have been found to be less effective in driving export growth compared to the experience of East Asia due to the context in which they were implemented - macroeconomic stability, government intervention, high quality of bureaucracy, and high quality of institutions.[9]

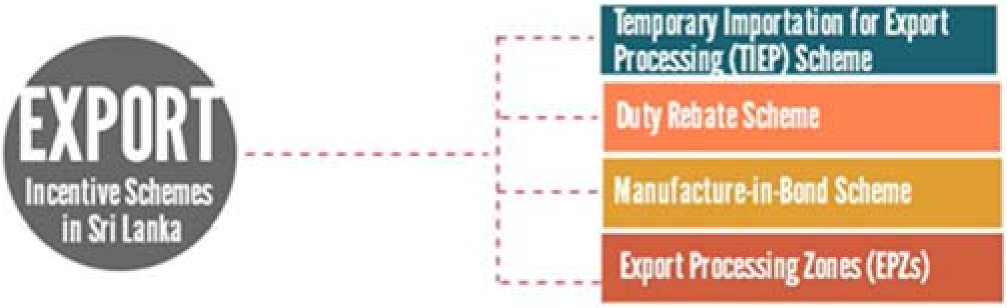
In the case of Sri Lanka, successive governments have promoted exports through various incentives/measures. These include a duty rebate (drawback) scheme, a temporary importation for export processing (TIEP) scheme, a manufactured-in-bond scheme, as well as tax incentives administered through

Export promotion will have greater success if they take place where there are good fundamentals and strong institutions to implement them.

[7] Export subsidies and subsidies for the use of domestic inputs are now prohibited for all non-LDC countries. Local content requirements and quantitative restrictions on imports are also banned.

[8] See World Bank (1993), *The East Asian Miracle: Economic Growth and Public Policy*, World Bank, Washington D.C. and Oxford University Press; Weiss. J. (2005), "Export Growth and Industrial Policy: Lessons from East Asian Miracle Experience", ADB Institute Discussion Paper No. 26, Asian Development Bank Institute, Tokyo.

[9] Elson, A. (2006), "The Economic Growth of East Asia and Latin America in Comparative Perspective: Lessons for Development Policy", *World Economics,* 7(2).



EPZs (Box 5.4). Dedicated institutions such as the Export Development Board (EDB), Sri Lanka Export Credit Insurance Corporation (SLECIC) and Board of Investment (BOI) have been set up with the aim of increasing the sales of domestically produced goods and services abroad through provision of better knowledge of foreign markets, access to credit, and attracting FDI to support export growth, respectively. The remainder of the chapter will identifying ways of maximizing gains from export and FDI promotion efforts currently in place through these institutions, and examine alternative ways of financing export and investment promotion, given current budgetary constraints.

5.3.1 Strengthening Institutions for Export Promotion

Trade promotion organizations (TPOs) such as the EDB are important instruments for export promotion, with governments in both developed and developing countries establishing TPOs to facilitate and encourage exports.[10] TPOs aim to reduce the problems of imperfect information on the part of local exporters/potential exporters about foreign markets on one side, and foreign customers about domestic products/firms on the other side and thereby increase and diversify exports. TPOs provide a number of services including: (i) dissemination of information on export markets; (ii) assistance in export marketing; (iii) packaging and labelling; (iv) quality standards management; (v) general training about export activity; (vi) legal assistance; (vii) assistance in obtaining export financing; and (viii) trade missions and trade fairs.

In several cases, TPOs had a positive impact in terms of increasing both export volumes and export products' diversification. Lederman *et al.* (2010), using survey data on TPOs from 104 developed and developing countries, found that export promotion agencies have a strong and statistically significant impact on the countries' total export volumes; an additional dollar spent on export promotion increases exports by about US$ 40. However, the magnitude of this positive effect is found to change across regions, and the marginal impact to decrease with GDP and with the amount of expenditure. TPOs have also proved to be more effective when focused on solving specific needs of firms. In most cases, support and assistance provided to exporting

[10] Lederman, D., M. Olarreaga, M. and L. Payton (2010), "Export Promotion Agencies: Do they Work?", *Journal of Development Economics*, 91(2).

firms is not considered enough by domestic entrepreneurs. Nevertheless, some early studies have a negative assessment of TPOs in developing countries; for example, arguing that TPOs in developing countries are inefficient because of weak leadership, inadequate funding and inefficient bureaucracy.[11]

In the case of Sri Lanka, the apex state organization for promoting and developing exports is the EDB. Established in 1979 under the Sri Lanka Export Development Act No. 40, the EDB functions as the executive arm of the Export Development Council of Ministers (EDCM), known as EDB's policy-making body.[12] EDB's role in export promotion has diluted from being a provider of direct export assistance to more of a facilitator of exports over the years. EDB does not currently provide any direct supply development assistance,[13] and its activities are considered by the exporters to be minimal or basic.[14] Its scope in export promotion is limited to that of a policy adviser, formulating, implementing and monitoring export development activities, and as the focal point for all export related issues, including as a knowledge provider to exporters.

From an institutional perspective, EDB's key weaknesses in the past included lack of a strategic vision for export promotion; inadequate resources for export promotion; weak monitoring of export promotion activities; and poor targeting of beneficiaries for export promotion programmes. Some of these weaknesses have been addressed during the last one year.

Strategic vision for export promotion: EDB lacked a systematic national export promotion strategy which lays out a detailed plan for export promotion in the country. This is vital to achieve export competitiveness. Meanwhile, the EDCM has been inactive for a long time and has not met since 1992.[15] Implementing a systematic export promotion policy, with strong commitments from key trade promotion organizations like EDB, is vital to achieve export expansion. A systematic export policy will ensure that the country not only prioritizes export promotion at a national level, but that it will also detail the relevant commitments and actions needed at various tiers for export promotion. It will also ensure that the country has a strategic roadmap and a holistic export promotion drive (free of ad hoc policy changes) for synergizing export promotion efforts to gain maximum returns.

In this regard, it is promising that the EDB has already undertaken efforts to develop a National Export Development Plan (NEDP) for Sri Lanka. However, the success of the NEDP will depend largely on the commitments of relevant state and non-state agencies for export promotion. Hence, a stronger focus at a national level is needed for export promotion in order to push the NEDP forward with support from

[11] Keesing, D. B. and A. Singer (1991), "Development Assistance Gone Wrong: Failures in Services to Promote and Support Manufactured Exports: The Role of Support Services in Expanding Manufactured Exports in Developing Countries", Economic Development Institute, World Bank.

[12] Headed by the President and consisting of Ministers in charge of trade, shipping, industries, agriculture, plantation industries, textile industries, fisheries, finance, foreign affairs, planning and rural industries.

[13] Some of the supply development schemes previously carried out by EDB included establishing agro export zones, and capacity building and quality upgrading programmes.

[14] Key Informant Interviews (KIIs) with exporters.

[15] KIIs and EDB (2010), *Annual Report*, Export Development Board, Colombo.

Box 5.4
Export Support Schemes and their Effectiveness

Temporary Importation for Export Processing (TIEP) Scheme: is a scheme under which direct and indirect exporters in Sri Lanka can import inputs for the production of exports, without having to pay import duties and taxes. The scheme consists of two sub-schemes: TIEP-1 for importation of raw material, components, parts and packaging material exempt from duty; and TIEP-4 for whole or partial exemption of duties for importation of capital goods, intermediate materials, etc. Approval for the scheme is granted by SLC and a bank guarantee (with the type of guarantee depending on the proven track record of exporters) is mandatory in order to access the scheme. At the end of 2014, there were 1,055 operators under TIEP-1 and 534 operators under TIEP-4. However, small and medium exporters in the country feel that the cost of compliance to the scheme is too high, and that it is also not appropriately designed to accommodate multi-product exporters.

Duty Rebate Scheme: is a scheme under which duties paid are fully or partially refunded or rebated for imported raw materials and intermediate inputs used to manufacture exports. Products that are eligible for this scheme are gazetted annually by the Ministry of Finance; only Customs duties and import surcharges are applicable under this scheme. The rate of rebate is decided by SLC upon approval of cost statements, and registration is required for each export shipment. The management of the scheme is quite difficult, especially for developing countries. In most cases they have not worked efficiently and their effects have been negligible. However, in countries such as Dominican Republic, Colombia and Chile, simplified schemes were implemented; these are considered to be effective in the absence of costly bureaucratic processes. In Sri Lanka, reimbursement of duties has been subject to delays and exporters have been critical of the bureaucratic process, excessive documentation required and the many agencies that need to be contacted for an application.

Manufacture-in-Bond Scheme: exporters are provided the facility of manufacturing-in-bond warehouses in which production processes can be conducted free of duties. Imported goods can be stored up to six months without payment of taxes and extended up to two years or more under special circumstances. There are currently six manufacture-in bond warehouses operating in the country. Their impact on export performance depends on a number of factors such as the political environment, the administrative capabilities to distribute and monitor usage. Thus, assessing the effectiveness of such schemes is difficult.

Export Processing Zones (EPZs): there are 14 such zones administered by the BOI, comprising over 200 enterprises, and employing over 75,000 persons. Locating an enterprise in an EPZ entitles a company to tax holidays, duty-free imports, and concessionary land prices. Existing experience relating to EPZs underpin that the determinants of successful EPZs are economic and political stability, profitability of local production (and related exchange rate policies), trade facilitation, etc.

Source: Belloc, M. and M. Di Maio (2011), "Survey of the Literature on Successful Strategies and Practices for Export Promotion by Developing Countries", Working Paper, International Growth Centre, London; Hinkle, L., et al. (2003), "How Far Did Africa's First Generation Trade Reforms Go? An Intermediate Methodology for Comparative Analysis of Trade Policies', World Bank Africa Region Working Paper Series, World Bank, Washington, D.C.; KIIs.

relevant stakeholders. Reactivating the EDCM will help to gain support from state agencies and ministries in this endeavour.

The EDB with the Department of Commerce (DOC) are now directly reporting to the newly established Agency for International Trade (see Box 5.2). The new Agency is empowered to expedite plans and activities of the EDB and DOC. The exact role of this Agency will become clearer once legislation to establish it is passed in the Parliament.

Private sector engagement can be sought through PPPs to deliver export promotion programmes on a cost sharing basis. It can also help to address budgetary constraints faced by the EDB as well as introducing innovative export promotion programmes. In fact, TPOs of developing countries are increasingly utilizing PPPs to build exporter readiness; this has taken the form of collaborative arrangements with stakeholders in the private sector, universities and research institutes. For example, Go-Exports programme of Enterprise Mauritius is a three-time award winner at the TPO Network Awards.[16] The Go-Exports programme aims to build export capacity of SMEs by providing practical knowledge transfers with real-time simulations of activities. The programme is conducted in collaboration with industry experts from the private sector including factory managers, bankers, freight forwarders, marketing consultants, etc. Similarly, Chile's export promotion agency - ProChile - build SME exporters capacity through a systematic one year long training conducted in collaboration with private consultants.[17] It is encouraging that EDB has already introduced a host of innovative export promotion services through PPPs. Examples include ventures with the Sri Lanka Institute of Nanotechnology (SLINTEC) to enhance R&D access to exporters, and partnering with Sri Lanka Association of Professional Services (SLASSCOM) to develop the ICT/BPO sector, etc.

Targeting of beneficiaries for export promotion programmes: Exporters have expressed concerns about smaller firms lacking capacity to deliver large export orders being chosen for export promotion programmes such as trade fairs,[18] subsequent to which they have been noted to be incapable of meeting the large

Private sector engagement can be sought through PPPs to deliver export promotion programmes on a cost sharing basis.

[16] International Trade Centre (2014), “What Makes a Winner?”, available at: http://www.intracen.org/itc/events/tpo-network-world-conference-and-awards/.

[17] World Bank (2014), “Malaysia Economic Monitor: Boosting Trade Competitiveness”, available at http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2014/06/27/000350881_20140627082245/Rendered/INDEX/891020WP0P14640B00PUBLIC00MEM100web.txt.

[18] *Ibid.*

orders received during trade fairs. The selection of beneficiaries for export promotion is generally done in-house by the relevant export promotion officers and departments in charge but this appears to be not systematic.

In the case of ProChile for instance, training is used for targeting, whereby following a comprehensive training programme becomes a prerequisite or the first step to qualify for assistance. Training is also used to filter export ventures so that direct assistance will go towards building export readiness of the most viable ventures to ensure higher returns on assistance provided. Similar programmes can be observed in other countries including Costa Rica and Colombia to name a few. In the case of Sri Lanka too, targeting beneficiaries for existing export promotion programmes of EDB through training programmes could improve the efficient use of limited resources available.

Inadequate resources for export promotion: Under the Sri Lanka Export Development Act, export development activities are to be financed through the Export Development Fund, which draw from the proceeds of the Export Development Levy known as the Commodity Export Subsidy Scheme (CESS), while the remaining allocations are to be made through state budgetary provisions. Revenue collected from CESS, which was imposed with the objectives of protecting local manufacturers and channelling funds for R&D through the EDB, amounted to Rs. 46.3 billion in 2015.[19] Though proceeds of the CESS were initially ploughed back to exporters by way of financing export development services of EDB, their use for export development has been halted since the 1990s, with collected funds diverted to the Consolidated Fund of the Treasury for financing other national priorities. This has resulted in EDB experiencing financial constraints; the only source of financing available for EDB is now through budgetary provisions. Moreover, this problem has been compounded by a substantial portion of funds allocated to EDB being spent on administration, leaving very little for exporter assistance.[20]

Monitoring export promotion activities: Monitoring and evaluation efforts of export promotion programmes are noted to be fairly weak in the context of Sri Lanka. For example, it was noted that necessary follow-up mechanism for trade fairs could be improved further through evaluation tools such as surveys, which are important in assessing the usefulness of such programmes.[21] Moreover, the current setting lacks representation of local trade promotion organizations in foreign markets and this hampered the follow-up action in processing orders after trade fairs.

Many TPOs have systematic M&E mechanisms in place to ensure that programmes are meeting their objectives and achieving the targeted level of export promotion. These checks and balances ensure that financial assistance granted is being utilized to the fullest. For example, one of the outstanding characteristics of Go-Exports programme of Enterprise Mauritius is the systematic evaluation framework that the programme has adopted. M&E efforts are used to ensure that the financial assistance distributed yields the highest returns. Though

[19] CBSL, *Annual Report 2015*, Central Bank of Sri Lanka, Colombo.

[20] According to the latest published and publicly available information, more than a half of the total expenditure (55 per cent) of EDB was used up for administrative expenses (EDB *Annual Report 2010*).

[21] KIIs with exporters.

EDB has made some headway in this regard recently, further efforts to have systematic M&E processes in place like in the case of Mauritius could ensure better results from the limited programmes and budget it maintains.

5.3.2 Strengthening Export Financing in Sri Lanka

Another means of government support for the export sector is through export finance. Access to credit represents an important barrier to exports; imperfections in credit markets increase transaction costs faced by firms and limit access to credit, even in developed countries. These financial constraints may be the result of inefficiencies in financial sectors or lack of creditworthiness by private firms.[22] Export credits may be in the form of supplier credits or buyer credits.[23] In addition, export guarantees can be used to cover the risks of export credits (political or commercial) in the case of default by the borrower. Studies on the effects of credit and export guarantees highlight their positive role in increasing exports, especially that of SMEs.[24]

In most countries, governments intervene in credit financing by establishing specialized institutions like EXIM banks that provide special credit facilities to exporters. The prevalence of such credit facilities and credit institutions circumvent the need to finance exports through direct assistance, while motivating exporters to work towards utilizing the money borrowed in order to repay their loans. This in turn can guarantee higher returns on investments compared to direct subsidies.

While there is no state funded export finance bank in Sri Lanka, the Sri Lanka Export Credit Insurance Corporation (SLECIC) functions as the official state credit agency and is the only agency that insures exporters. The products and

Access to credit represents an important barrier to exports; imperfections in credit markets increase transaction costs faced by firms and limit access to credit.

[22] English, P. and L. de Wulf (2002), "Export Development Policies and Institutions", in Hoekman, B. *et al*. (eds.), *Development, Trade, and the WTO,* World Bank, Washington, D.C.

[23] Supplier credit is when credit is granted by an exporter to a foreign buyer; buyer credit is when an exporter enters into a contract with a buyer, financed through a loan agreement between a bank in the exporter's country and a bank in the buyer's country.

[24] Belloc, M. and M. Di Maio (2011), "Survey of the Literature on Successful Strategies and Practices for Export Promotion by Developing Countries", International Growth Centre, London.

services provided by SLECIC are export insurance, including insurance against non-receipt or delayed receipt of payments resulting from commercial and non-commercial risks, credit guarantee for exporters, etc.

However, the availability and utilization of export finance in Sri Lanka is found to be low, with the percentage of export transactions covered by export credit guarantee/insurance found to be around 2-4 per cent compared to an international average of 10-12 per cent.[25] These low levels are due to several weaknesses including institutional deficiencies and the limited portfolio of export finance instruments available in the market; low risk and static export structure; information gaps and asymmetries; limited role of institutions that facilitate export finance due to low level of policy focus; weak government support; and limited skills and capacity within related institutions.[26] Furthermore, given that there is no dedicated state funded development bank that provides export credit, exporters have to rely on commercial banks at commercial rates to obtain export credit.

Export finance has been an important instrument of export promotion as far back as two decades ago for most developing countries. Though there has been much discussion about setting up an EXIM bank in Sri Lanka over the years, progress in this regard to date has been slow. The importance of setting up a specialized export credit agency was underlined in the Budget 2016 with Rs. 50 million to be allocated as seed capital for the setting up of an EXIM bank jointly by the government and industry. The proposed EXIM bank is to be listed under the Colombo Stock Exchange (CSE).

EXIM banks around the world have adopted different operational models and include both state-owned and privately owned ones. In China, export finance facilities are provided by several state funded banks including the China Export-Import Bank (EXIMbank). It primarily offers overseas financing through a range of activities such as export credits (including export seller's credit and export buyer's credit), international guarantees, loans for overseas construction and investment, and official lines of credit. Whilst the bank mainly serves SOEs and foreign trade corporations, it also serves SMEs and is now the third largest Export Credit Agency (ECA) in the world. Similarly, the Export-Import Bank of Malaysia Berhad (EXIM Bank), was incorporated in 1995 as a government owned development financial institution and is a wholly owned subsidiary of the Ministry of Finance. It aims to promote reverse investment

25 Verite Research (2015), "Expanding Exports: Role and Relevance of Export Finance", available at http://www.veriteresearch.org/research-spreport-archives.cfm?category=economics

26 *Ibid.*

and export of strategic sectors, facilitate the entry of Malaysian companies to new markets, particularly to the non-traditional markets. The facilities provided by the bank include a host of services such as buyer credit, supplier credit, export credit refinancing, buyer credit guarantees, and buyer credit insurance, etc. Unlike most other EXIM banks, the Export Import Bank of Bangladesh Limited is a private initiative, incorporated in 1999 with its Initial Public Offering (IPO) held in 2004. It provides a host of export credit services for exporters including retail services, corporate banking, agri-banking, etc. While several models of EXIM banks are currently in place around the world, it is important for Sri Lanka to decide which model would best suit its context, including the budgetary costs and long-term sustainability.

5.4 Investment Promotion

Since Sri Lanka's initial bout of economic reforms in the late 1970s, FDI has been promoted as an important nexus for trade and development. The institutional structure created for this purpose was the setting up of the Greater Colombo Economic Commission (GCEC) in 1978 and the Board of Investment (BOI) as its successor in 1992. The BOI was to function as a one-stop shop for FDI, with powers to grant generous tax holidays, tax concessions and exemptions from Customs duty and exchange control laws, depending on criteria such as investment amounts and employment creation.

While FDI promotion is unambiguously associated with greater FDI flows, the effectiveness of investment promotion is likely to have the greatest impact in countries where other factors (investment climate, market size, level of development, etc.) that attract FDI are favourable.[27] There is a debate on the effectiveness of investment promotion centres on arguments that governments should work

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[27] Morriset, J. and K. Andrews-Johnson (2004), "The Effectiveness of Promotion Agencies at Attracting Investment", World Bank, Washington, D.C.

towards building a good investment climate and investors will automatically seek out opportunities; proponents of investment promotion highlight market failures due information gaps/misperceptions regarding investment climate and opportunities, and the need for investment promotions to influence FDI decisions.

Although there are no substitutes for having the 'right' basics, investment promotion and facilitation can play an important role. In fact, investment promotion and facilitation is identified to be a vital pull factor of investments to a country; studies have found a significant and positive correlation between investment promotion efforts and FDI flows to developing countries.[28] As such, dedicated investment promotion agencies (IPAs) have emerged at both national and sub-national levels to engage in investment promotion in many countries. Investment promotion covers a range of services, varying from investor outreach, facilitation, after care, and strategy. Of these, investment facilitation is widely seen as the most basic and cost effective activity supporting FDI promotion.[29]

More specifically, IPA services include four main types of activities: (i) image building; (ii) investment targeting/ generation; (iii) investment facilitation/servicing; and (iv) policy advocacy.[30] 'Image building' creates the perception of a country as an attractive site for international investment. Activities commonly associated with image building include focused advertising, public relations events, the generation of favourable news stories by cultivating journalists, and so on. 'Investor facilitation and investor services' refer to the range of services provided in a host country that can assist an investor in analysing investment decisions, establishing a business, and maintaining it in good standing. Activities in this area include information provision, 'one-stop shop' services aimed at expediting approval process, and assistance in obtaining sites, utilities, and so on. 'Investment generation' entails targeting specific sectors and companies with a view to creating investment leads. Activities include identification of potential sectors and investors, direct mailing, telephone campaigns, investor forums and seminars, and individual presentations to targeted investors. Investment generation activities can be done both at home and overseas. 'Policy advocacy' consists of the activities through which the agency supports initiatives to improve the quality of the investment climate and identifies the views of the private sector on that matter. Activities include surveys of the private sector, participation in task forces, policy and legal proposals, and lobbying.

The degree of importance of each activity however, may vary from country to country. According to a survey which measured the effectiveness of various functions of IPAs in attracting FDI, 'policy advocacy' was the most effective activity in attracting FDI followed by 'image building' and 'investor services'.[31] However, 'investment generation' was not

[28] Morisset, J. (2003), “Does a Country Need a Promotion Agency to Attract Foreign Direct Investment?”, available at http://elibrary.worldbank.org/doi/abs/10.1596/1813-9450-3028

[29] IFC (2015), “Investment Promotion”, available at https://www.wbginvestmentclimate.org/advisory-services/investment-generation/investment-policy-and-promotion/

[30] Piontkivska, I. and E. Segura (2003), “Survey on International Foreign Investment Promotion Practices”, The Bleyzer Foundation.

[31] Morriset, J. and K. Andrews-Johnson (2004), “The Effectiveness of Promotion Agencies at Attracting Investment”, World Bank, Washington, D.C.

associated with higher FDI flows.[32] The study recommends that IPAs should dedicate a larger portion of their resources towards policy advocacy to improve the country's business environment.

5.4.1 Strengthening Institutions for FDI Promotion

In Sri Lanka, the BOI has been the government entity responsible for FDI. It functions as a central facilitation point for foreign investors and manages a number of export processing zones (EPZs). BOI provides assistance and advice throughout the investment process from initial point of inquiry through project approval, implementation, monitoring and aftercare facilities.

From an institutional perspective, the effectiveness of BOI in its current form, as well as that of incentives offered to attract FDI, are two key areas of concern that need attention.

Effectiveness of BOI: Promoting and attracting investment is financially costly and public expenditures towards this end can be justified only if government agencies set up for these purposes are successful in attracting greater volumes of FDI. By this measure, the performance of the BOI is mixed; whilst the major constraint to FDI in the form of the armed conflict was extraneous, as noted previously, Sri Lanka's record in attracting FDI even five years after the conflict ended has not been promising. Aside from attracting FDI, its role as a 'one-stop shop' appears to be weak. Lack of authority to mandate relevant agencies and ministries, limited role in negotiating on behalf of BOI companies, lack of detailed and comprehensive investment-related information (other than in English), insufficient detailed and project specific information, inconsistency in the information provided, limited post-investment services, and weak monitoring are some organisational limitations that have been identified.[33]

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[32] *Ibid.*

[33] IPS (2016), "One-Stop-Shop Functions of the Board of Investment", Institute of Policy Studies of Sri Lanka, Colombo (unpublished); Jayaratne, S. and R. Ekanayake (2016), "Attracting Foreign Direct Investment to Sri Lanka: The Need for Proactive Investor Facilitation", available at http://www.ips.lk/talkingeconomics/2016/05/26/attracting-foreign-direct-investment-to-sri-lanka-the-need-for-proactive-investor-facilitation/.

A review of BOI's role as an investor promoter and facilitator suggests significant room for improvement in line with practices of top performing investor agencies around the world (Box 5.4). The most important elements are listed below:

- Give greater authority to the BOI to carry out its mandate. The limited power wielded by the BOI over other relevant agencies has made the BOI more of an 'intermediary' rather than a 'facilitator' of investments into the country. The BOI often refers investors to other ministries/ agencies undermining the concept of a 'one-stop-shop'. It is encouraging to note however that BOI has started a 'one-stop' from 2016 with officials from six different agencies (Inland Revenue Department, Registrar of Companies, Customs, CEB, CEA, and Ports Authority) housed within the BOI.
- Update BOI companies on changes to policy. This is identified as necessary by investors; there is no mechanism in place to do this at present, with firms having to resort to accounting and auditing firms for information. Relatedly, the BOI needs to provide detailed and comprehensive investment-related and project specific information, and maintain consistency in the information provided to investors.
- Improve post-investment services provided by the BOI. Currently, they are limited; the focus should extend beyond being a one-stop-shop to facilitate investments and include opinion surveys aimed to improve post-investment services of BOI.
- Strengthen supply of workers for companies. The BOI has a contractual obligation to provide employees to BOI companies. However, the BOI job bank is currently not functioning and as a result, companies have resorted to alternative sources like employment outsourcing companies to hire workers. According to companies, hiring workers is a challenge due to dearth of workers, new trends in youth employment (preference for temporary jobs compared to permanent jobs) and preference for desk jobs. The labour issue is highlighted as a major area of concern to existing investors, and one which can discourage new investors.
- Develop a promotional plan. The need for a well-researched promotional plan targeting investors and markets to use resources optimally is important. Improving the capacity of the promotions department within the BOI is also identified to be important, especially in terms of numbers and training.
- Adopt a more pro-active approach to attract potential investors. Currently, the system is more reactive than pro-active with officers following up with investors who take the initiative first and contact the BOI. However, there is no mechanism to be pro-active and identify potential investors and investments, and follow up with them to convince investors to come to Sri Lanka.
- Improve the capacity of BOI officers through training programmes. This is intended to ensure better understanding of the sensitivities, cultures and way of life of countries to be targeted for FDI.
- Improve monitoring mechanism of the BOI by maintaining comprehensive information on concessions provided, improve the evaluation procedure for duty free applications, reduce leakages, and ensure systematic and frequent monitoring of BOI projects and commitments.

Box 5.5
Fourteen Essential Practices of Top IPAs

The Global Investment Promotion Benchmark 2009 study assessed 219 IPAs in 181 countries and uncovered 14 essential practices for effective investment facilitation - practices which were evident among strong IPAs. The world's top performing IPAs distinguish themselves from weaker ones by fostering a private sector-minded culture, accumulating deep business knowledge, and implementing internal systems that ensure the agencies can provide foreign investors with the necessary information to influence their investment decisions.

Foster a Private Sector-Minded Culture

1. Build a staff with public and private sector experience.
2. Offer salaries and bonuses closer to private sector standards.
3. Secure operational freedom and high-level reporting channels.
4. Establish and concentrate efforts in a few priority sectors.
5. Coordinate facilitation with networks and partners sub-nationally and overseas.
6. Maintain English-speaking staff in sufficient numbers and with the full range of facilitation skills.
7. Continually train and develop staff, especially in soft skills.

Accumulate Deep Business Knowledge

8. Establish a minimum level of in-house research capacity.
9. Develop account managers into reservoirs of knowledge on particular sectors.
10. Ensure the accumulation of knowledge and its relevance.

Implement Internal Systems for Consistently Good Facilitation

11. Make facilitation a priority within the overall strategy, including by training and dedicating an adequate proportion of staff.
12. Maintain the equipment and practices to be easily reached and to quickly return calls and e-mails.
13. Demonstrate professionalism and dynamism through the Web site with frequent news updates of importance to investors.
14. Follow detailed guidelines on the content, style, timeframe, and quality assurance of inquiry responses.

Source: Investment Climate Advisory Services (2009), "Global Investment Promotion Benchmarking 2009: Summary Report", World Bank, Washington, D.C.

Finally, there needs to be a continuous evaluation and follow-up of investors from the point of expressing interest to invest in Sri Lanka. While there is an internal system of follow-up (i.e., progress report from officers) it is beneficial to have a system online, accessible to staff members to feed in information continuously.

Effectiveness of incentives: Despite a poor record of attracting FDI, Sri Lanka - like many countries at different points in time - offers significant incentives to promote inward investments. These can take the form of general investment promotion measures, or be directed at selected economic activities. Sri Lanka has tended to rely on the provision of incentives (corporate tax incentives, import duty exemptions, exemption tax on dividends, and exemption on exchange control) for FDI promotion subject to fulfilment of an investment threshold or any other specified requirements. These have been used extensively since 1978 to attract FDI and promote export-oriented industrialization.

Currently, various exemptions under the Inland Revenue Act, Port and Airport Development Levy Act, Value Added Tax Act, and Strategic Development Project Act are available for BOI approved companies. In addition, BOI provides duty free facilities and exchange control exemptions for projects approved under BOI. For example, companies that export more than 90 per cent of goods produced (with the exception of apparel and ceramic) or services (with 70 per cent turnover in convertible foreign currency) can benefit from zero Customs duty on capital goods and raw materials. Similarly, non-export oriented companies are entitled to import project related capital goods free of Customs duty during the project implementation period. In addition, exchange control exemptions are granted in the form of operating Foreign Currency Banking Unit (FCBU) accounts in any commercial bank in Sri Lanka.

These incentives to promote investments have eroded Sri Lanka's tax base and this is particularly important in the context of rising fiscal imbalances. Moreover, tax exemptions have made tax administration more difficult, discouraged tax compliance, and created demand for new exemptions.[34] Although the types of benefits that stem from additional investments as a result of incentives (flow of capital, job creation, transfer of skills, knowledge and technology) are difficult to estimate/quantify to do a cost-benefit analysis, the approximate cost of BOI incentives have been estimated to be about 1 per cent of GDP per annum.[35] In this context, and given that investor competing countries such as Vietnam have been able to attract more FDI with less generous incentives, there is a need to reconsider the incentives currently offered by the BOI for attracting projects.

The effectiveness of incentives in promoting investment has been extensively debated; incentives might not be the most effective means of attracting investments, especially 'efficiency seeking' (export-oriented) ones compared to 'market-seeking' (tariff jumping) investments as long as other factors (political stability, geographical location and

[34] World Bank (2015), "Sri Lanka – Ending Poverty and Promoting Share Prosperity: A Systematic Country Diagnostic", World Bank, Washington, D.C.

[35] GOSL, "Presidential Taxation Committee Report 2010", Government of Sri Lanka.

Effectiveness of incentives in promoting investment has been extensively debated; incentives might not be the most effective means of attracting investments.

infrastructure) remain favourable.[36] While incentives have been used to compete for potential investors, and attract investment into priority sectors/areas, international experience suggest an investor's decision on where to locate is based on various factors including market size, political and economic stability,[37] liberal policies/regulations,[38] natural resources, infrastructure, and availability of skilled labour. Investment incentives tend to be of marginal importance in investment making decisions. In fact, incentives alone are insufficient to attract FDI, while retention of FDI is low as investors switch between destinations when incentives dry up. While some insist on the importance of maintaining incentives to attract FDI, others argue that other forms of incentives which would place a less fiscal burden should be considered,[39] while fixing deficiencies in the enabling environment can be more effective than offering incentives to cover up the deficiencies.

In this context, Sri Lanka has to review the prevailing incentives structure.[40] Under the 2015 Budget proposals, the BOI is no longer able to grant any new tax holidays other than facilitating and implementing concessions. Currently, the granting of tax concessions for any investment is under the supervision and monitoring of the Ministry of Finance. Given that Sri Lanka is competing with other FDI destinations in the South and Southeast Asian region, the abrupt withdrawal of tax incentives could have an adverse impact on FDI attraction and the full implication will be seen in the coming months. A better policy would have been to gradually de-emphasis tax holidays and move towards other incentives like approved investment relief, investment tax credits/ allowances, accelerated depreciation allowances, and non-tax incentives like concessionary land, as recommended by the Presidential Tax Commission Report of 2010.

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36 Athukorala, P. (2012). "Sri Lanka's Trade Policy: Reverting to Dirigisme?," *The World Economy*, 35(12).

37 Macroeconomic stability determined by a mix of monetary, fiscal and exchange rate policies.

38 A business-friendly environment, including protection of investors, attractive tax rates, ease of trading across borders, contract enforcement, rule of law, etc.

39 Stakeholder interviews and GOSL, "Presidential Taxation Committee Report 2010", Government of Sri Lanka.

40 See IPS (2015),"Reforming Sri Lanka's Trade and Investment Policies for Export Growth" in *Sri Lanka: State of the Economy,* Institute of Policy Studies of Sri Lanka, Colombo.

The above mentioned alternative incentives benefit the companies ex-post - i.e., only after a project is implemented - and not ex-ante. Also these incentives minimize the need for frequent monitoring to ensure that conditions stipulated by the investment agreements have been fulfilled, reducing administrative burdens. In fact, many countries have moved away from offering blanket tax holidays towards these other types of incentives. For example, Malaysia and Brazil are using tax relief for investment in higher technology sectors, while Vietnam is using accelerated depreciation allowances for investment in difficult areas, etc.[41]

5.5 Conclusion

Despite numerous measures (TIEPs, duty drawbacks, manufacture in bond, tax incentives) and dedicated institutions like the EDB and BOI in place to promote exports and FDI, Sri Lanka's world market share in trade has declined to levels last seen in the 1980s while FDI remains below 2 per cent of GDP even after the end of the war. This poor performance highlights the dire need for renewed efforts to incentivize exports and FDI attraction, although the scope for additional state support is limited given budgetary constraints. In this context, Sri Lanka needs to re-examine and rationalize these measures to improve efficiency in the delivery of services of these institutions whilst engaging the private sector to explore how it could too contribute to trade and investment promotion as discussed in previous sections.

However, improving the existing institutional set-up and incentives for trade and FDI promotion will only deliver desired outcomes if they happen in the context of sound economic fundamentals and strong institutions. As highlighted by the experience of East Asia, the overall environment within which export and FDI promotion takes place is as important to the success of these countries, as the policy interventions themselves. Thus, creating an enabling environment for trade and FDI should remain the primary objective of the government in promoting trade and investment.

A prerequisite is to reduce/eliminate ad hoc policy changes. Towards this end, a systematic trade policy framework, which sets out policy guidelines and identifies principal areas of action to strengthen different aspects of Sri Lanka's export competitiveness is crucial. Here, rising levels of protection and complexity in the tariff structure witnessed over the past decade need to be addressed, and efforts made to improve trade facilitation measures.[42]

Overall, Sri Lanka also needs to streamline business procedures and undertake urgent reforms to improve the country's business climate to attract large volumes of FDI. In addition, minimizing policy uncertainty and fostering investor confidence through consistent and predictable policies and regulations is vital. The powerful signalling role that clear coherent government policy direction plays cannot be underestimated.

Whether the newly established Agency for Development and Agency for International Trade could address these anomalies remains to be seen.

[41] Wijesinha, A. and R. Ekanayake (2013), "Incentivizing Foreign Investment in Sri Lanka and Role of Tax Incentives", Working Paper Series No. 17, Institute of Policy Studies of Sri Lanka, Colombo.

[42] See IPS (2015),"Reforming Sri Lanka's Trade and Investment Policies for Export Growth" in *Sri Lanka: State of the Economy,* Institute of Policy Studies of Sri Lanka, Colombo.