How Open Has the Sri Lankan Economy Become?
Trends in Trade and Trade Taxes: 1977-93

Dushni Weerakoon
and
Howard White

Research Studies
Macroeconomic Series No.9



INSTITUTE OF POLICY STUDIES
99, St. Michael's Road, Colombo 3, Sri Lanka
December , 1995

INSTITUTE OF POLICY STUDIES

How Open Has the Sri Lankan Economy Become?
Trends in Trade and Trade Taxes: 1977-93

Dushni Weerakoon and Howard White

© Institute of Policy Studies 1992
ISBN 955-9122-44-4

CONTENTS

1. Introduction 1

2. Tariff Liberalisation Post-1977 2

3. The Openness of the Sri Lankan Economy 7

4. Trade Taxes in Sri Lanka 14

5. Conclusions 19

How Open Has the Sri Lankan Economy Become? Trends in Trade and Trade Taxes: 1977-93

Dushni Weerakoon and Howard White

1. Introduction

In 1977, the newly elected government of the United National Party (UNP) introduced a package of economic reforms aimed at opening up the Sri Lankan economy to external trade and investment. This policy was a sharp deviation from the development strategy adopted during the 1960s which, as in many other contemporary developing countries, was more in keeping with an import substituting industrialisation (ISI) strategy. On the eve of the 1977 election the Sri Lankan trade regime was characterised by a system of stringent exchange and import controls and the existence of a dual exchange rate. Quantitative restrictions on trade were more prevalent than at any previous time of its economic history with an estimated 6,000 consumer items under price control measures by 1977.

The package of reforms introduced in 1977 included the liberalisation of import trade and exchange payments; the abolition of most price controls; promotion of private enterprise; and liberalisation of the financial sector. While all these factors were major aspects of the process of opening up of the economy, the focus of this paper is confined to trade barriers. Accordingly, this paper presents data on the nature and extent to which the liberalisation of the trade regime took place. We find that beyond the initial changes of 1977-78, the Sri Lankan economy does not appear to have opened up to external trade as much as policy rhetoric would lead one to believe.

Import liberalisation and a special package of incentives to promote non-manufactured exports were intended to remove the existing "anti-export" bias. Studies of trade bias in the Sri Lankan manufacturing sector in the post-1977 period have concluded that the system of trade incentives has been "pro-export" biased (Athukorala, 1986; and Kelegama and Wignaraja, 1991). This conclusion conflicts with the evidence provided by studies of effective protection which have shown that the effective rate of protection has been higher

in the 1980s than in 1978 (Cuthbertson and Athukorala, 1991; Abeyratne, 1993; and Weiss and Jayanthakumaran, 1995). The introduction of a cascading tariff rate structure (as in Sri Lanka) could result in constant or increasing rates of effective protection even if all nominal tariff rates are reduced. However, effective protection data are sporadic and frequently incomparable. Our study analyses changes in the implicit level of taxes on exports and imports as measured by duty collections. We show that despite continued reductions in nominal tariff rates, the average rate of import duty has actually been rising since the early 1980s. Changes in average duty may be the result of either increased duty or changes in the composition of imports, and we present a decomposition approach to distinguish between these effects.

The structure of the paper is as follows. Section 2 presents an overview of the major tariff reforms implemented by the UNP in the post-1977 period. Despite the formal lowering of tariff bands, we find government policy to have been inconsistent with the original goal of import liberalisation. Section 3 looks at the evolution of the usual measure of an economy's openness: that is the ratio of exports plus imports to GDP. However, since this ratio is commonly calculated using nominal series it is important to distinguish price effects as a result of changes in the nominal exchange rate and the terms of trade from changes in volume. Import liberalisation in 1977 was also accompanied by a significant nominal devaluation of the rupee. Thus, the change in the value of the currency would also have exerted a significant influence on the nominal value of exports and imports in the aftermath of liberalisation. Section 4 presents a model for the decomposition of trade taxes in Sri Lanka to explore the hypothesis that trade liberalisation was in fact rather limited. We present data on implicit trade taxes (which are calculated by dividing revenue by the taxable flow). Section 5 concludes.

2. Tariff liberalisation post-1977

The re-orientation of economic policy that took place in 1977 can be considered to have been quite momentous. The new government heralded in an "open economy", giving immediate priority to trade liberalisation. The trade reforms introduced in 1977 included specific measures aimed at promoting manufactured exports and tariff liberalisation. The Government opted to rely on tariffs as the principle restraint on imports, replacing the

existing quantitative restrictions by a six-band tariff structure. The duty system for classification set out in the Budget of 1977 was as follows:

(i) zero per cent on the price of essential goods;
(ii) 5 per cent on most raw materials, spare parts and machinery;
(iii) 12.5-25 per cent on most intermediate goods;
(iv) a common revenue rate of 50 per cent on goods that are neither "essential" nor "luxury"";
(v) a common protective rate of 100 per cent on goods being produced domestically and; (vi) a prohibitive rate of 500 per cent on goods considered to be "luxury" consumer items.

The virtual dismantling of quantitative restrictions and the introduction of a multi-band tariff structure constituted a substantial shift from the pre-1977 period. While the tariff rates introduced were generally quite high, the removal of the scarcity premia attached to quantitative restrictions in itself was expected to hold beneficial effects in reducing the levels of nominal protection. There were deficiencies in the new system -- one of the most significant being the wide disparity that existed in the tariff rates, ranging as it did from zero to 500 per cent.

The tariff reforms were followed by the setting up of the Tariff Reform Commission (transformed to the Presidential Tariff Commission in 1980) to look into the structure of tariffs and to recommend changes required for a "rational" tariff structure. The PTC was required to keep in mind the government's economic and social priorities. These included the need to (i) encourage local industry through some form of protection; (ii) meet both the revenue requirements of the government and consumer interests; and (iii) safeguard employment.

Technical and political factors favoured an easing up on the rate of reform. There were voices of dissent from local entrepreneurs against the policies themselves and the speed of the initial liberalisation episode. The Ceylon National Chamber of Commerce, for example, argued against what it saw as wholesale import liberalisation, on the grounds that "export industries can only be built up on the strong base of servicing the domestic market" and it appealed to the government "not to attempt to turn us into exporters while leaving the domestic market open for dumping of imported consumer products from countries which heavily subsidise exports" (Wijesekera, 1982, p.11).

It soon became apparent that State Owned Enterprises (SOEs) were also very vulnerable to foreign competition and big losses would make heavy demands on the budget. By 1980, the government budget and current account deficit of the balance of payments peaked at approximately 25 and 16 per cent of GDP respectively, while the rate of inflation peaked at 26 per cent. In 1980, there was therefore already some backtracking with an across the board levy of 10 per cent on all items dutied at 50 per cent or over. Its purpose was ostensibly to make available funds for export development. The outcome of its imposition, however, was to formally raise the level of protection on import substituting industries. Again in 1982, prompted by revenue purposes, the government introduced substantial selective increases on certain items already dutied at high rates. These included such items as carpets, toothpaste, cosmetics, batteries, paints and tyres, strengthening their already existing protected status.

But despite this backtracking, the general trend in published tariffs was still downwards. A tariff revision was introduced in November 1984 on the recommendation of the PTC and implemented with the budget proposals for 1985. Although it remained a six-band tariff structure, there were in effect 17 bands in operation as follows:

(i) zero per cent on essential goods;
(ii) 5 per cent on raw materials;
(iii) 10-50 per cent (9 rates) intermediate band;
(iv) a 60 per cent revenue band;
(v) 75-150 per cent (4 rates) protective band; and
(vi) 250 per cent prohibitive rate.

The implementation of these new bands constituted an apparently substantial tariff reform, the main features of which may be summarised as:

- a reduction of duty rates on certain items from very high levels of 500, 300, 150 and 100 to 60 per cent;
- the existing 5 per cent duty on chemicals and pharmaceuticals were abolished;
- an import duty of 7.5 per cent on machinery was reduced to 5 per cent and in instances where machinery was imported for use in an industry where at least 50 per cent of output is exported, no duties or turnover taxes were to be levied;

- to boost the agricultural sector, fertilizers were allowed in duty free (though still heavily subsidised) while duties on most agricultural machinery and raw materials were reduced at the same time; and
- certain items that had been taken off the license list were once again brought under specific import licensing to protect the domestic sector, while in other cases, items under such specific import licensing were liberalised under the Special License Scheme. These included importation of such items as potatoes, onions, chillies and all types of woven fabrics. The removal of the license control on textiles was subject to the imposition of a 100 per cent duty. This duty was reduced further to 60 per cent in 1987.

In the budget of 1988, the Government announced a further revision of the tariff structure - the adoption of a four band tariff system. The existing 17 tariff bands were rationalised and reduced to four bands. The rates were:

(i) 5 per cent on raw materials and capital goods;
(ii) 15 per cent on intermediate inputs including semi-finished items;
(iii) 35 per cent on chemicals required as inputs to industry; and
(iv) 50 per cent on finished goods.

New trade taxes were introduced on imports, particularly for revenue purposes, making the whole exercise inconsistent with the original goal of import liberalisation. Besides the 10 per cent cess imposed by the EDB in 1980, a turnover tax (TT), which had previously applied only to domestic manufactured products, was introduced for imports in 1984, with exemption granted for a few essential goods. The TT rates ranged from 2 to 35 per cent at the beginning and varied between 3 and 20 per cent in the late 1980s. In 1989, an additional temporary surcharge on import duty for revenue purposes was imposed. The surcharge was set at 5 per cent of the duty paid and was to be levied on all imports that were subject to a 5 per cent tariff rate, except for a few essential items.

With effect from 1990, the further rationalisation of the tariff structure led to an overall 30 per cent reduction in nominal rates, and removed all non-tariff controls except those on a limited range of strategic items. In 1992, for example, the average nominal tariff rate in Sri Lanka was only 35 per cent compared to a rate of 85 per cent in neighbouring India. The Budget of 1995 introduced further tariff cuts by way of the introduction of a three band duty structure of 10, 20 and 35 per cent. Some of the major changes included the reduction of import duties on textile fabrics and apparel from 50 to 35 per cent.

While the 1977 reforms drastically reduced the number of imports subject to licensing, they were not entirely eliminated. A limited list of 281 items continued to remain under import licensing.[1] However the numbers were gradually reduced - by the end of 1980 some 77 items had been removed,[2] with only two items finding their way back into the licensing list.[3] The rationalisation of the tariff structure in 1990 removed most of the remaining industrial licensing requirements. Existing controls on imports of plant and machinery were removed, as well as a substantial number of controls on imports of industrial raw materials, leaving only 12 categories of such items still under license for security and health reasons. A significant shift of previously non-tariff (QR) constrained imports into the category of imports subject to tariff would have an impact on the import duty rates. However, in the case of Sri Lanka, there was no major shift in the relaxation of import licensing in the post-1977 period.

In terms of export duties, while attempts were made to relieve the tax burden on non-traditional exports, duties on the traditional plantation export crops were raised in the immediate aftermath of liberalisation in 1977 to take account of the higher rupee value following the devaluation of the currency. Effectively, the higher rate was set to give government, rather than producers, the benefit of the devaluation. This move was presumably based on a belief in the limited supply response in the traditional sector, a belief rather undermined by the continued decline of the sector in the face of consistent adverse price movements (White and Kelegama, 1993). However, duty rates on these traditional exports were whittled down consistently and substantially removed over the next seventeen years.

Table 1 sets out the share of import and export taxes in GDP and total tax revenue for the period 1978-1993.[4] Between 1977-1978 both import and export taxes increased as a per cent of GDP, in part because of the devaluation. The data in Table 1 indicate that while total tax revenue as a percentage of GDP declined in the immediate aftermath of liberalisation, tax revenue on imports actually increased.

The increase in export taxes is accounted for by the decision taken to impose higher duties on the plantation exports following the devaluation of the rupee. Import taxes as a

---

1 .These included weapons, explosives, poisonous compounds, nuclear or radio transmitting devices, vehicles, jewels, minerals, fuels and oils, pharmaceutical products, textile yarn and fabrics, and tobacco.

2 Including licenses on fertilizer, primary plastic raw material and newsprint.

3 These were matches and plywood tea chest panels.

4 Net of import duty rebates.

percentage of GDP have indicated a significant increase in the period 1982-89 after a perceptible decline in the early 1980s. While liberalisation and reduced tariffs can be expected to see the volume of imports and hence import revenue increase, import duty as a percentage of GDP increased in the latter half of the 1980s when volume expansion reduced significantly (Table 2). The figures in Table 1 thus raise the possibility that tariff reform in Sri Lanka has been rather less than government policy rhetoric would lead one to believe. However, an alternative explanation for the increase in import revenue in the latter part of the 1980s might lie in the changing composition of imports during the post-reform period. Import duties can rise either because higher duties are being levied on the goods imported or because the structure of imports has shifted toward high-duty items. The following discussion will assess to what extent these alternative factors are accountable for the perceived trend in import and export tax policy.

Table 1: Taxes on International Trade: 1978-93
(as per cent of GDP)

Year	Imports	Exports	Total Revenue
1978	3.3	11.1	24.2
1979	4.1	8.4	21.0
1980	3.9	5.6	18.3
1981	3.2	4.4	16.1
1982	2.6	2.7	14.9
1983	3.3	2.8	16.4
1984	4.3	4.2	19.5
1985	5.0	1.8	18.7
1986	5.2	0.9	17.4
1987	5.6	1.0	17.9
1988	4.8	0.8	16.1
1989	6.0	0.6	19.0
1990	5.2	0.8	19.0
1991	5.0	0.3	18.3
1992	4.9	0.2	18.1
1993	4.2	...	17.6

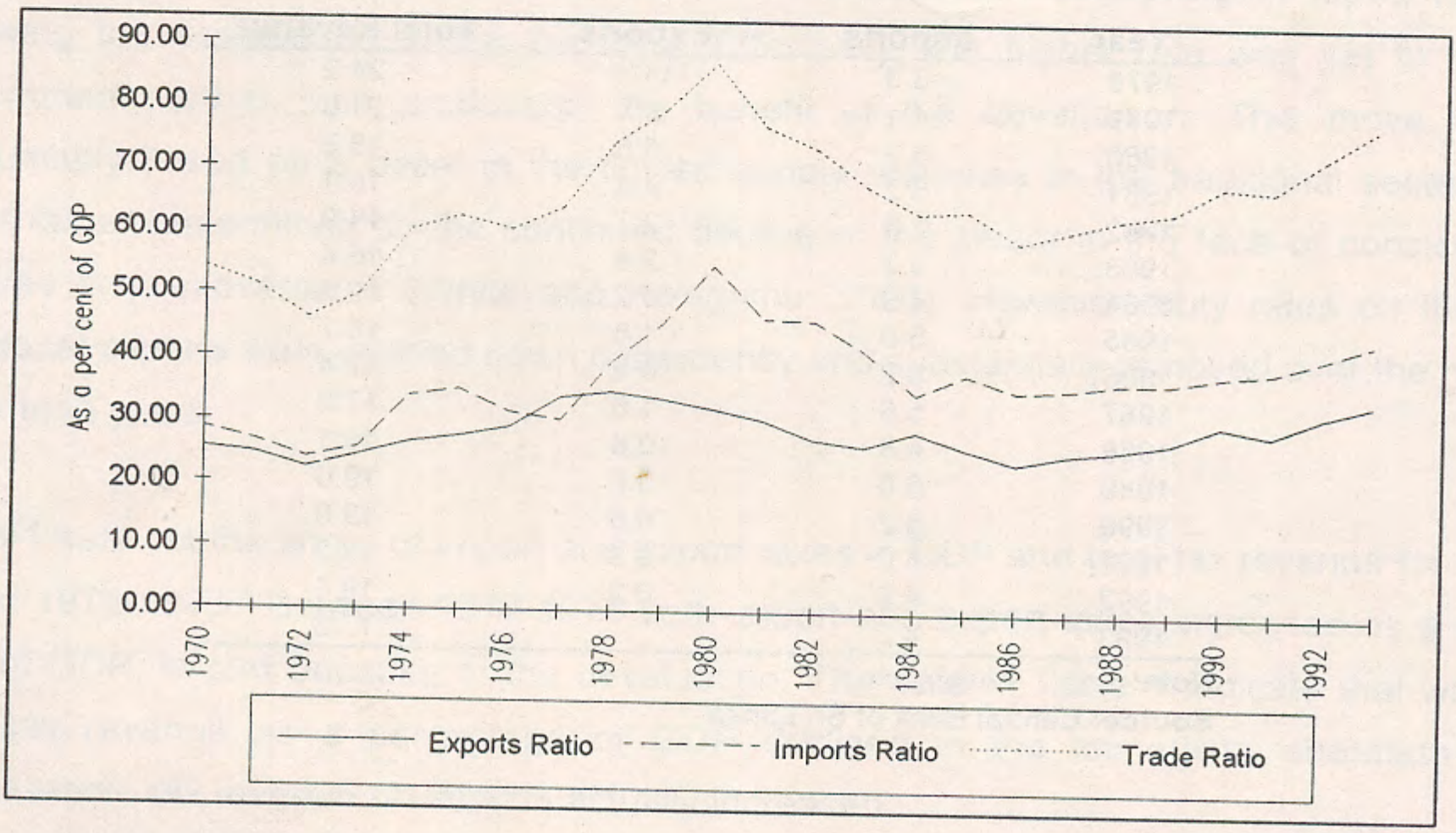
Note: ... = negligible
Source: Central Bank of Sri Lanka

3. The Openness of the Sri Lankan Economy

Figure 1 shows the ratio of the sum of nominal exports and imports of goods and non-factor services to GDP for the period 1970-1993, and the two component parts as separate ratios.

Overall, the changes are not as striking as one may have expected. The ratio of total exports plus imports to GDP rose rapidly in the immediate wake of the 1977 liberalisation. However, the growth faltered from 1980, so that the ratio fell until 1986. Since that time it has experienced a more modest rise. Comparing the pre-liberalisation period (1970-77) with the later period (1986-93), the ratio was 56.1 in the former period and 65.1 in the latter. Almost this entire difference comes from the import ratio (which rose from 29.4 to 37.5) as exports as a per cent of GDP barely moved (from 26.7 to 27.7 per cent). The initial increase in exports of goods and non-factor services in the post-reform period was largely on account of a significant increase in earnings from factors, in the form of labour services with the country earning migrant worker remittances. Merchandise exports have, however, continued to account for around 80 per cent of total earnings from exports of goods and non-factor services in the post-1977 period.

Figure 1: Trade Ratios: 1970-93
(as a per cent of GDP)



It is thus clear from Figure 1 that it is the changes in the import ratio which were driving the situation during 1977-84. During the period 1987-93, the export and import ratios have been moving more or less in parallel (with exports showing a marginal increase). Despite the recent rise in the export ratio, it is, by comparison with imports, more or less trendless throughout the period.

Table 2 : Import Growth: 1978-1993[a]

	1978-83	1984-89	1990-93
1. Total Consumer Goods	-1.5	1.3	9.0
Food and Drink	-14.2	5.2	5.9
Other Consumer goods	31.6	-4.3	13.4
2. Intermediate Goods	5.0	6.0	14.5
Petroleum	13.6	-2.2	3.3
Textiles	34.7	10.2	20.8
3. Investment Goods	20.1	-12.8	12.1
TOTAL	10.0	-1.8	10.1

Notes: a. Annual average growth in import volume calculated using trend line approach.

Source: Weerakoon, D. 1992, *Adjustment and Growth After Trade Liberalisation: Sri Lanka, 1977-1992*, PhD Thesis (unpublished), University of Manchester, UK.

The explosion in the import ratio may be explained by three factors: (i) an increase in imports following the abolition of quantitative restrictions in 1977 to meet pent-up demand; (ii) the increased demand from imports consequent upon the government-led, partly aid-funded investment boom; and (iii) a price effect from devaluation. These factors help explain why the Sri Lankan trade balance has followed a classic "J-curve" pattern.

The average annual real rates of growth of import volume for the period 1978-93 are set out in Table 2. In terms of consumption, intermediate and investment goods, the latter category saw the largest increase in the immediate post-liberalisation period. Imports of capital goods during this period was largely for the government's Accelerated Mahaweli Development Programme, made possible by the availability of substantial external finance in the form of grants, and the rehabilitation of existing capital stock in the state sector. In disaggregated terms however, textiles and luxury consumer imports saw the fastest growth. Imports of textiles grew from a very small base at an annual average of approximately 35 per cent during 1978-83; this growth being partly linked to the promotion of labour-intensive export industries. Luxury consumer goods had one of the highest growth rates. Increases in consumer imports are often argued to support the agricultural supply response through incentive goods effects. In the case of luxury goods, a similar argument might be made with respect to the rising entrepreneurial class, though whether these goods have been necessary to support the supply response of non-traditional manufactured exports must remain a question for further research. However, the category of consumer goods as a whole experienced a negative growth rate on average as imports of food fell, mainly on account of significant expansion in rice production.

In the latter half of the 1980s, there was a sharp deceleration in the growth of imports, with the most noticeable decline recorded in imports of investment goods. Economic activity in the country was hampered significantly in the latter part of the 1980s due to widespread civil unrest in the country. The continuing expansion of the garments industry, largely uneffected in the FTZs, was reflected in the growth of intermediate textile imports. Stagnant economic growth at around the 2 per cent mark and the consequent relative decline in the absorptive capacity of the economy, can be identified as a major factor in explaining the fall in the outlay on imports. After 1989, with further liberalisation of import trade and renewed economic activity, there was again a perceptible rise in imports, particularly in the investment and intermediate goods categories. However, non-essential consumer goods, at 13.4 per cent per annum, were growing faster than investment and almost as fast as intermediate goods.

Table 3: Composition of Imports (% value)

Period Average	Consumer	Intermediate	Capital
1970-77	47.1	36.2	16.7
1978-80	29.2	46.9	23.9
1981-83	18.0	56.6	25.4
1984-86	20.6	57.0	22.4
1987-89	25.0	57.8	17.2
1990-93	24.4	52.3	23.3

Source: Central Bank of Sri Lanka

The composition of imports has also changed. As can be seen from the data in Table 3, the share of capital goods peaked at just over 25 per cent in 1981-83, falling in subsequent years (but with a recovery in the most recent period). The share of intermediate imports also rose, before declining, as the rate of growth of textile imports slowed. The result has been a climb in consumer imports during the 1980s, bolstered by a significant increase in non-essential consumer imports, though the share to total consumer imports remains lower than it was in the 1970s.

The observed increase in import revenue in the latter half of the 1980s (Table 1) thus coincides with the slowing down of the rate of growth of investment imports in to the country. The tariff structure in the post-reform period was formulated in a manner that would impose low tariffs on imports of capital goods. This raises the possibility that the observed increase in import tariff revenue in the latter part of the 1980s is linked to the

change in the composition of imports - that is, to a significant reduction in the import of capital goods from around 1983/84.

As pointed out earlier, the explosion in the import ratio as shown in Figure 1 may also in large part be explained by a price effect from devaluation. It is important to distinguish between price effects stemming largely from changes in the nominal exchange rate and changes in volume.

The price effect may be disentangled from the other effects as follows. The trade ratio (TR) is given by:

$$TR = \frac{IMP + EXP}{GDP} \qquad (1)$$

where IMP and EXP are nominal imports and exports respectively. Equation (1) may be rewritten as:

$$TR = \frac{EP_m}{P_y} \cdot \frac{M}{Y} + \frac{EP_x}{P_y} \cdot \frac{X}{Y} \qquad (2)$$

where E is the nominal exchange rate, P_m and P_x the dollar import and export price indices respectively, P_y the GDP deflator, M and X import and export volume and Y output (or GDP).

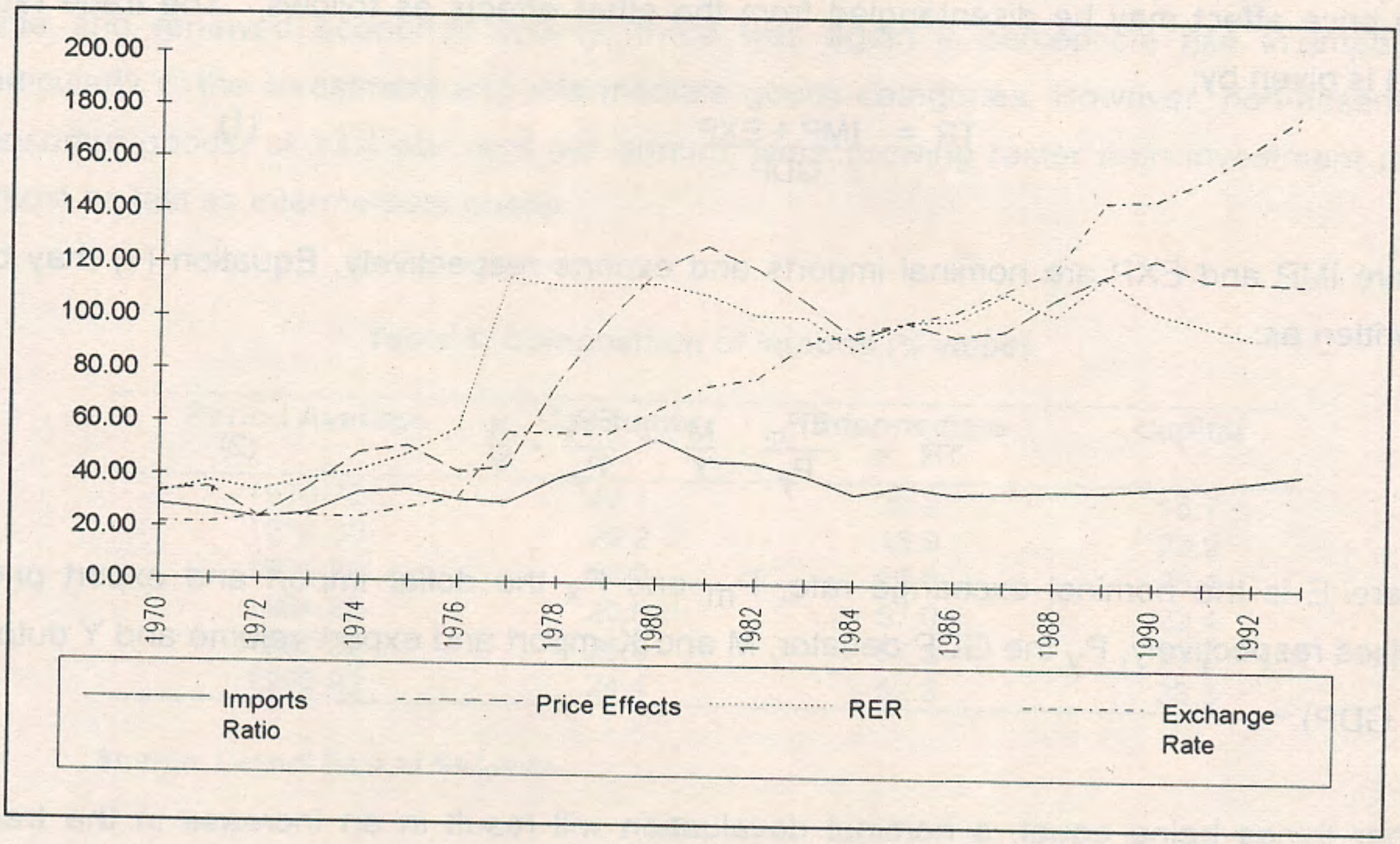
Other things being equal, a nominal devaluation will result in an increase in the trade ratio.[5] But even if the ratio in volume terms remains constant, the price terms further confuse the picture. In each case the exchange rate and price terms approximate to the real exchange rate (RER) - being the product of the nominal rate and the ratio of a foreign to a domestic price ratio. That is, the trade theory definition of the RER is typically of the form EP_T^*/P_N; where, E=nominal exchange rate; P_T^*= foreign price level of traded goods; and P_N=domestic price level of non-traded goods. The wholesale price index is employed as a proxy for the price of traded goods and the domestic consumer price index as a proxy for the price of non-traded goods. A depreciation corresponds to an increase in the index and an appreciation corresponds to a decrease.

---

5 In fact other things will not be equal since GDP is also affected by the devaluation. A devaluation from an initial trade deficit may increase the deficit, resulting in a reduction in GDP, thus accentuating the increase in the trade ratio.

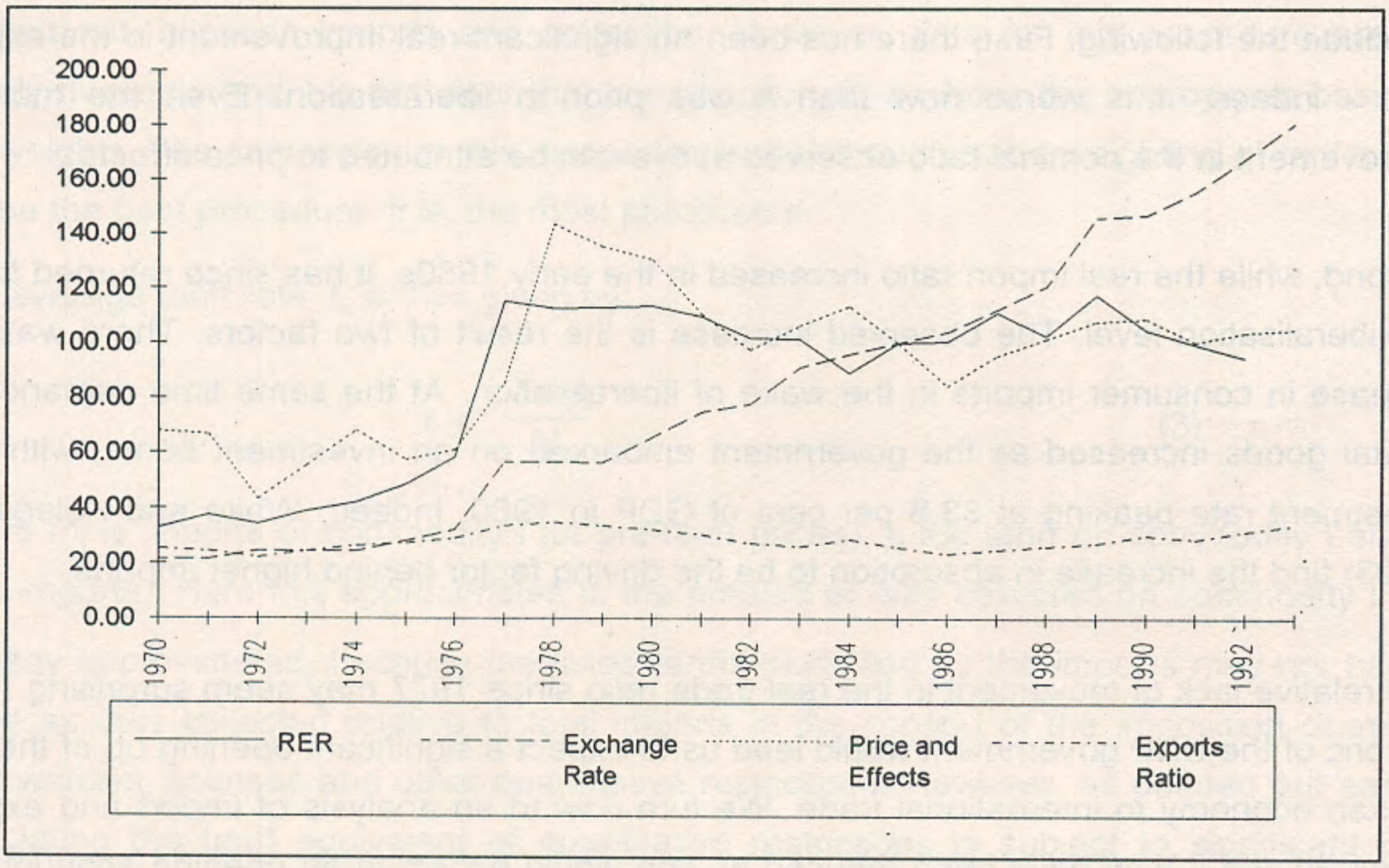
The difference in the proxy estimates of the RER calculated in Figures 2 and 3 are that instead of using the foreign wholesale price index and domestic consumer price index, in our example foreign prices are for imports and exports and the domestic index is the GDP deflator. Nonetheless, as Figures 2 and 3 show, these indices have behaved in a somewhat similar manner to the more conventionally defined RER.

Fig 2: Factors Underlying the Change in the Import Ratio



The devaluation and subsequent floating of the rupee in November 1977 led to a 42 per cent nominal devaluation. By the end of 1980 the rupee had devalued by over 100 per cent from its pre- November 1977 level. This very large nominal devaluation fed through to a real depreciation - both in the conventionally defined RER and in the two "pseudo" RERs shown in Figures 2 and 3. That is, both the export and import ratios increased as a result of price effects during this period. The price effect for the import ratio is particularly strong, as a result of the impact of the second oil shock. It is less marked for exports, as the export price index was falling from its 1976 boom.

Fig 3: Factors Underlying the Change in the Export Ratio



Over the period 1980-84 the RER appreciated as high rates of domestic inflation, partly fuelled by higher capital inflows, more than offset the continuing depreciation of the nominal rate. The large inflow of foreign aid in the aftermath of liberalisation acted as an external shock, inducing a typical "Dutch disease" effect (Lal and Rajapathirana, 1989; White and Wignaraja, 1992; and Athukorala and Jayasuriya, 1991). Over this period the export price index also rose for a mini-boom in commodity prices, which peaked in 1984 (the f.o.b. price of tea more than doubled between 1982 and 1984). Import prices grew less fast, in the face of world recession and falling oil prices. This real appreciation thus plays a part in the reduction in the import and export ratios which can be observed during this period.

Some real depreciation was achieved in the latter part of the 1980s, but this movement has not been preserved into the 1990s. The trend towards a concerted real depreciation was not a strong one, and price effects are less important in this later period.

These price effects do not, however, explain the whole change in the trade ratio - for that to be the case M/Y and X/Y would have to be constant throughout the period. The use of volume series over long periods can be problematic because of the difficulty in defining

appropriate deflators in the presence of marked changes in the composition of imports or exports (such as has been observed in Sri Lanka). Nonetheless, we may still tentatively conclude the following. First, there has been no significant real improvement in the export ratio - indeed, it is worse now than it was prior to liberalisation. Even the modest improvement in the nominal ratio observed above can be attributed to price effects.

Second, while the real import ratio increased in the early 1980s, it has since returned to its pre-liberalisation level. The observed increase is the result of two factors. There was an increase in consumer imports in the wake of liberalisation. At the same time demand for capital goods increased as the government embarked on an investment boom, with the investment rate peaking at 33.8 per cent of GDP in 1980. *Indeed, White and Kelegama* (1993) find the increase in absorption to be the driving factor behind higher imports.

The relative lack of movement in the real trade ratio since 1977 may seem surprising. The rhetoric of the UNP government would lead us to expect a significant opening up of the Sri Lankan economy to international trade. We turn now to an analysis of import and export duties, to see if they have been reduced as one would expect in an opening economy. If they have not been reduced, this fact is a likely contributory factor to the lack of trend toward greater openness.

4. Trade taxes in Sri Lanka

There are a number of ways of reporting levels of duty. The obvious route would appear to be to take an average of all prevailing duties. In using this approach we are confronted with the problems of what weights to apply as we do not want to accord equal weight to the tariff on an item of little importance as we do for a major import. The most usual practice is to use trade- weights; for example, for import tariffs we weight by the share in total imports. There are some problems here. One is the continuing presence of non-tariff barriers, such as quantitative restrictions. Theoretically one could calculate the tariff equivalent of the quota, but such a procedure requires knowledge of the supply and demand curves and so is rarely carried out. Another problem is if a tariff is so high as to be prohibitive, as there are no imports the tariff will attract a weight of zero. Moreover, an additional problem is to determine whether fixed weights should be used or whether they should be allowed to change annually to reflect changing import composition. The latter has the attraction of giving the annually applicable average rate, but conflates changes in duty with changes in import composition.

One might alternatively weight by domestic consumption. Consumption weights can be more meaningful than import weights since there is likely to be an inverse relationship, as pointed out, between imports and protection. However, data for this procedure are not readily available and it is not clear that consumption is, anyhow, the appropriate basis for the weights. The conclusion of this discussion is that though trade weighting of tariffs may not be the best procedure, it is, the most practicable.

The average tariff rate, t, is thus given by:

$$t = \frac{\sum m_i t_i}{M} \qquad (3)$$

where m_i is imports of commodity i (at pre-tariff prices), t_i the tariff on commodity i and M total imports. Here $m_i t_i$ approximates to the amount of duty collected on commodity i (d_i). We say approximated, because the listed tariffs multiplied by the imports may not be the same as duty collected relative to total imports in the context of the imposition of import duty waivers, licenses and other quantitative restrictions. However, as pointed out earlier, calculating the tariff equivalent of quantitative restrictions is subject to significant data constraints. For the purposes of the present analysis, therefore, $m_i t_i$ is approximated as the amount of duty collected on commodity i (d_i). Hence:

$$t = \frac{\sum d_i}{M} = \frac{D}{M} \qquad (4)$$

where D is total import duty. That is the trade weighted average tariff may be calculated simply by dividing total duty by total imports. The weights being used are, implicitly, imports in the current year at pre-tariff prices. The use of pre-tariff prices is appropriate. On the other hand, we noted above that is not clear if the weights should be fixed or change annually to reflect changing import composition. Formula (4) dictates that in order to apply the decomposition we must allow the weights to change each year. Moreover, the formula also requires that we use trade shares, rather than consumption weights.

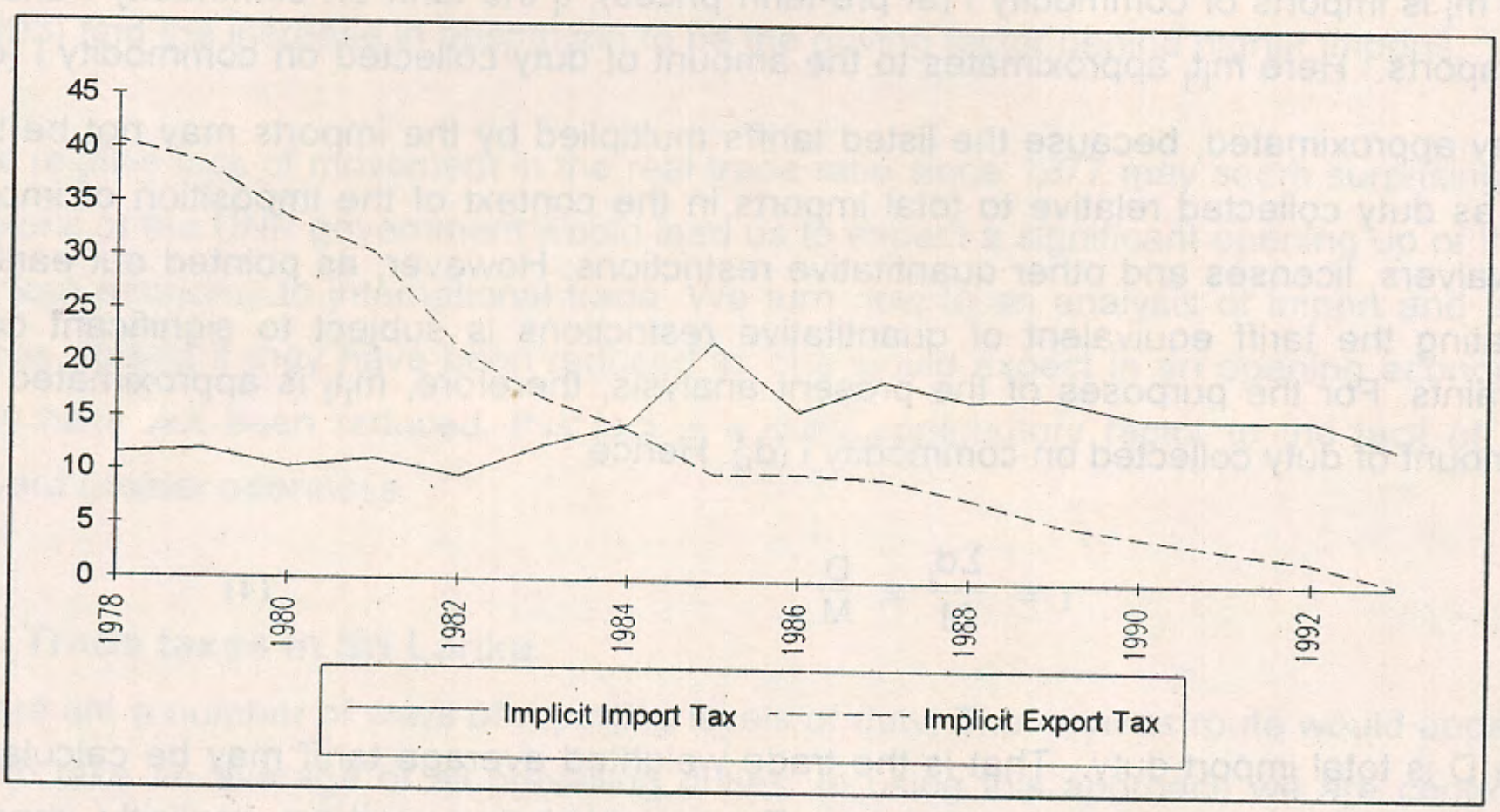
In our analysis of imports below we will distinguish between consumer, intermediate and capital imports (m_c, m_i and m_k respectively). Going back to equation (3) we know that t can

be expressed as a weighted average of the duty on these three types of import. Hence changes in the average tariff from one year to the next may be broken down as follows:

$$\Delta t = \frac{M_c}{M}\Delta\left(\frac{d_c}{M_c}\right) + \frac{M_i}{M}\Delta\left(\frac{d_i}{M_i}\right) + \frac{M_k}{M}\Delta\left(\frac{d_k}{M_k}\right) \qquad (5)$$
$$+ \frac{d_c}{M_c}\Delta\left(\frac{M_i}{M}\right) + \frac{d_i}{M}\Delta\left(\frac{M_i}{M}\right) + \frac{d_k}{M_k}\Delta\left(\frac{Mk}{M}\right)$$

where the first three terms are the duty effect and the second row the composition effect.

Fig 4: Implicit Trade Taxes (per cent)



Turning to the Sri Lankan data, Figure 4 shows the average export and import duty rates. Duty rates on plantation export crops have been scaled down progressively. However, the reduction in the export tax rate can be misleading in the case of tea, given that Sri Lanka is a significant supplier to the world market. For such commodities, as export duty comes down, supply may expand significantly to effect world market prices and lead to lower export revenue.

In the case of imports, the average import duty rate has been on an upward trend since 1982. It began to decline in 1992 as a result of the lagged effects of tariff reforms in 1990. Table 4 gives the disaggregated average import duty rates for consumer, intermediate and capital imports for the period 1978-93. There are no readily available data on duty rates disaggregated into consumer, intermediate and capital imports. The data in Table 4 have

been estimated using adjusted annual figures from customs data, where import revenue was classified into these three categories for the purposes of the present study.

Table 4: Calculated Import Duty Rates (per cent)

Year	Consumer	Intermediate	Capital
1978	9.2	9.1	17.0
1979	14.3	8.9	13.8
1980	8.9	8.3	14.2
1981	10.5	8.0	17.1
1982	13.9	6.8	12.3
1983	13.9	10.3	14.7
1984	19.0	11.0	17.7
1985	24.5	15.6	17.6
1986	25.0	10.8	16.9
1987	22.9	18.8	15.9
1988	20.5	16.0	15.7
1989	18.3	15.7	19.2
1990	12.5	15.3	18.6
1991	16.2	14.4	17.0
1992	23.2	11.6	17.5
1993	20.0	9.4	15.7

Source: Estimated from Customs data.

There has been little change in the duty rate on intermediate and capital goods between 1978 and 1992, in each case recording a slight increase. But the rates have not been constant in the intervening period. The average duty on intermediates initially fell steadily from 9.1 per cent in 1978 to 6.8 per cent in 1982. It then escalated to 18.8 per cent, double its 1978 level, in 1987, before drifting back down to the current level of 9.4 per cent. The initial fall in the rate on capital goods was of a similar proportion - falling from 17.0 per cent in 1978 to 12.3 per cent in 1982. Unlike the case of intermediates, the duty on capital goods then fell only slightly before peaking at 19.2 per cent in 1989, and falling again thereafter. As in the case of the other two categories, the average duty rate on consumer imports fell between 1992 and 1993, but the rate on consumer imports remains at a much higher level than that in 1978. There was no initial liberalisation for consumer imports (though the 1980 rate was slightly below that for 1978), and the rate climbed steadily to 25.0 per cent in 1986 (compared to only 9.2 per cent in 1978). It declined, with some fluctuations, thereafter, being 20.0 per cent in 1993.

The decline in average duty rates on intermediates after 1987 can be linked to the substantial increase in the growth of textile imports (as can be seen from Table 2), where textiles as a percentage of intermediate imports, increased from 23 per cent to 40 per cent between 1989 and 1993. Given that much of the textile imports are for export production

of garments under the incentive package for FDI, carrying a zero rate of duty, average duty on intermediate imports can be expected to indicate a decline.

Table 5: Decomposition of Export Duty

Year	Total Change	Duty Effect	Composition Effect	Residual
1979	-2.1	-1.0	-0.7	-0.3
1980	-5.1	-5.9	1.1	-0.4
1981	-3.2	-2.5	-0.7	-0.0
1982	-8.9	-8.2	-1.1	0.5
1983	-4.5	-4.7	0.3	-0.1
1984	-2.8	-1.9	-0.2	-0.7
1985	-4.3	-4.3	-0.1	0.1
1986	0.1	0.2	-0.1	0.1
1987	-0.5	-0.5	0.0	0.0
1988	-1.7	-2.0	0.1	0.1
1989	-2.3	-1.4	-0.7	-0.1
1990	-1.2	-0.3	-0.9	-0.6
1991	-1.1	-1.0	-0.2	0.0
1992	-0.9	-1.1	0.4	-0.2
1993	-2.1	-2.1	-0.3	0.2

Source: Estimated from data available from the Central Bank, Annual Reports

As we saw from the figures in Table 3, the composition of imports also began to change from the mid 1980s with a marked decline in imports of capital goods. What is of interest here is to determine to what extent the changes in export and import duty rates are the result of changes in duty and to what extent from changes in import composition.

Table 5 shows the results of the decomposition exercise on export duty rates -- that is, the year on year changes in average duty on plantation crops and other agricultural exports and the amount attributable to each of the two effects. Thus, the first column of figures indicates the percentage total change of duty and columns two and three indicate the shares attributable to the duty and composition effects. The decomposition analysis on plantation crops and other agricultural exports appears to suggest that duty effects have exerted the dominant influence on export duty rate changes since liberalisation. The duty effect is larger than the composition effect in all years but are, usually several times so.

Table 6 shows the year on year changes in average duty on imports and the amount attributable to duty changes and changes in the composition of imports. As the figures indicate, the decomposition analysis shows that the composition effects for imports are weak. The absolute value of the duty effect is greater than that of the composition effect

(usually several times so) in all years but one. The driving force behind the implicit import duty rates appears to be changes in duty rather than changes in the composition of total imports. The data for the years 1983-85, in particular, indicate significant change in import duty. The imposition of a 10 per cent cess by the Export Development Board in 1980, the introduction of selective increases in duty on imports in 1982, and the imposition of Turnover Tax on imports in 1984, may have some bearing on this observed increase. Again, the upsurge in import duty in 1989 can be linked to the imposition of an additional surcharge strictly for revenue purposes.

Table 6: Decomposition of Import Duty

Year	Total Change	Duty Effect	Composition Effect	Residual
1979	0.4	0.6	0.2	-0.4
1980	-1.6	-1.5	-0.2	0.1
1981	0.8	1.1	-0.2	-0.1
1982	-1.5	-1.2	-0.0	-0.3
1983	2.9	2.6	0.5	-0.2
1984	2.1	2.4	-0.1	-0.1
1985	7.6	7.9	0.1	-0.4
1986	-6.4	-6.5	0.4	-0.4
1987	3.0	3.0	-0.4	0.4
1988	-1.7	-1.9	0.2	0.0
1989	0.2	0.3	0.0	-0.1
1990	-1.8	-1.8	-0.1	0.1
1991	-0.0	-0.0	0.1	-0.1
1992	0.0	-0.0	0.0	0.0
1993	-2.6	-2.3	-0.3	0.0

Source: Estimated from data available from the Department of Customs.

The observed increase in import duty rates in the latter part of the 1980s appears therefore to be very much a result of duty changes rather than a consequence of the coincidental change to the composition of imports during this period. Thus the decomposition analysis for imports at least, seems to suggest that after the initial shift from quantitative restrictions on imports to a system of tariffs, and subsequent tariff reforms, the formal policies put in place to open up the economy to external trade have had less than expected results.

5. Conclusions

The main purpose of this paper was to examine to what extent government policy reforms aimed at opening up the Sri Lankan economy through tariff liberalisation had been a

reality. A description of the policy regime since 1977 would seem to suggest that there has been substantial opening up of the Sri Lankan economy. But we have shown that the export ratio has been stagnant, the higher trade ratio resulting from the increase in imports as a per cent of GDP. Moreover, we find that, depite reductions in nominal import tariffs, the average rate of duty has risen. We demonstrate that the rising duty collections are not the result of a change in the composition of imports toward higher duty goods, suggesting that the effects of nominal tariff reductions have been offset by other means of levying duty, and confirms the sporadic evidence that the effective rate of protection has risen since 1977. In general, while there was no reversal of import liberalisation, the speed of implementation of tariff reforms slowed down after the initial reforms in 1977. Having embarked on a rapid liberalisation, where the Government failed to capitalise on its performance was in failing to persist with the tariff reforms to reduce effective protection levels across the broad spectrum of industry. Following the implementation of the major revision of the tariff structure in 1977, political considerations played a part in compelling the government to make periodic adjustments to the duty structure in response to appeals by domestic entrepreneurs.

Formal statements about band changes and tariff band rates may not necessarily be an indication of what is actually taking place. Average rates may still remain high despite "rationalisation" and a sharp decline in the maximum rate. The Sri Lankan experience seems to suggest that there was indeed a lot of redundancy in the band structures. The most probable explanation for the perceived lack of openess apparent from the study may lie in the fact that while the listed tariffs have been reduced and quantitative restrictions removed, others have been put in their place. Thus, despite evidence of across-the-board reductions in nominal tariff rates since the implementation of reforms in 1977, the message that comes from our analysis is that there has been in practice little opening up of the economy by way of significant tariff reductions. Nominal reductions in import tariffs appear to have been substituted by other means of levies and surcharges to maintain a steady source of revenue for a resource starved government. Given such constraints, the effect of the tariff reform policies in opening up the economy has been much less than expected.

References

Abeyratne, S. (1993) "Anti-Export Bias in the 'Export-Oriented' Economy of Sri Lanka", Amsterdam: VU University Press.

Athukorala, P. (1986), "The Impact of 1977 Policy Reforms on Domestic Industry", *Upanathi*, vol.1, No.1, Journal of the Sri Lanka Association of Economists, Colombo.

Athukorala, P. and S. Jayasuriya (1991), "Macroeconomic Policies, Crises, and Growth in Sri Lanka, 1960-1990", World Bank Comparative Study (mimeo).

Cuthbertson, A.G. and P. Athukorala (1991), "Sri Lanka", in Papageorgiou, D., M. Michaely, and A. M. Choksi (eds.), *Liberalizing Foreign Trade*, vol. 5, Oxford: Blackwell.

Kelegama, S, and G. Wignaraja (1991), "Trade Policy and Industrial Development in Sri Lanka", *Marga Quarterly Journal*, vol. 11, No.4.

Lal, D. and S. Rajapathirana (1989), *Impediments to Trade Liberalization in Sri Lanka*, Trade Policy Research Centre, London: Gower.

Weerakoon, D. 1992, *Adjustment and Growth After Trade Liberalisation: Sri Lanka, 1977-1992*, PhD Thesis (unpublished), University of Manchester, UK.

Weiss, J. and K. Jayanthakumaran (1995), "Trade Reform and Manufacturing Performance: Sri Lanka, 1978-89", Development Policy Review, vol. 13, No.1.

White, H. and S. Kelegama (1993), "External Shocks, Adjustment Policies and the Current Account: The Case of Sri Lanka, 1971-1991" *Institute of Policy Studies Macroeconomic Research Series 7*, Colombo: IPS; also published as *ISS Working Paper No.138*, The Hague: ISS.

White, H. and G. Wignaraja (1992), "Aid, Trade Liberalisation and the Real Exchange Rate: the case of Sri Lanka", *World Development*, vol.20, pp 1471-1480.

Wijesekera, A. (1982), "Wither Local Industry?", The Ceylon National Chamber of Commerce, Colombo (unpublished mimeo).