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What are the objectives of tariff reform in Sri Lanka?

With the 2018 budget aggressively addressing some of the low-hanging fruit in terms of tariff rationalization, now is a critical time to begin to develop a plan for what comes next. The first question to ask is: what are the objectives of tariff rationalization in Sri Lanka? Or in other words: what problem(s) does tariff rationalization seek to solve?

We encourage your working group to agree on the objectives of the rationalization effort before diving into questions of design. Here we provide our perspective on what is broken with the current system and what objectives that implies.

The problem

Our growth diagnostic research has identified Sri Lanka's current lack of export diversification, and the resulting slow growth of exports, as the binding constraint to stronger and more sustainable economic growth. This problem is deeply connected to Sri Lanka's lack of FDI in new industries. Our research, in collaboration with the Prime Minister's Policy Development Office (PDO) and the U.S. Millennium Challenge Corporation (MCC), has traced the export and export-oriented FDI problem to several important underlying causes. The current tariff structure, which an earlier draft of the new trade policy correctly identified as "non-transparent, complex and unpredictable," is one of these causes.

The structure of *import* duties is a problem for *exports*, in at least four critical ways:

- First, the extremely high effective rates of protection for some products create a bias against investments for other products. For those products that already have a presence in Sri Lanka and are able to lobby for protection, duties are generally low, para-tariffs are usually exempt, and rates are not subject to change. Much lower (or even negative) effective rates of protection for other products limit the space for investment in new economic activities.

- Second, the complexity and uncertainty faced by foreign investors interested in manufacturing a new product in Sri Lanka is extraordinary. Insiders can navigate the system but outsiders will see a complicated mix of para-tariffs and tariff changes announced by Customs on, at times, a weekly basis.

- Third, the exemptions available to exporters from import duties do not fully address the problem. Exporters may still be subject to paying para-tariffs on their imported inputs, which by themselves can be high by international standards.

- Fourth, the system of exempting exporters from some fees creates an artificial barrier between exporters and non-exporters. This creates a strong bias against the development of local supply chains, since exporters are incentivized to import the inputs they need versus buying from domestic producers.

In addition to this, it is consumers that ultimately pay the price for the system through higher prices on the things they buy, and government revenues remain reliant on this system as a fragile base for around half of tax revenues. Meanwhile, the inertia of the system further encourages rent-seeking and has locked Ministry of Finance resources into responding to industry requests for protection (and other industry requests for the removals of protection to their imports) on a case-by-case basis with a large degree of uncertainty over how changes to one tariff line will affect other industries.

Objectives for rationalization

Based on this understanding of the problem, the following objectives for rationalization are implied, all of which are consistent with the New Trade Policy. Designs for tariff rationalization might present tradeoffs between these objectives, but our basic review of your revenue data from 2015 and 2016 suggests that there could be designs that accomplish all of these objectives at once:

<u>Objective 1</u>: Reduce overall levels of effective protection (both customs duties and para-tariffs)

- to reduce input costs on production (incl. para-tariffs faced by exporters)
- to reduce prices for consumers

<u>Objective 2</u>: Lower the variance between levels of effective protection

- to remove bias against new industries (which tend to have lower levels of protection)
- to remove disincentive for backward linkages between exporters and non-exporters (resulting from the duty exemption for exporters)

<u>Objective 3</u>: Simplify the system as a whole (ideally into a few bands) rather than remove protections product-by-product

- to provide clarity, predictability and transparency to potential investors
- to change the political economy from industries arguing for exceptions to industries arguing for fairness (while also allowing for reasonable differentiation between products)
- to allow special tariff protection (exceptions to the few bands) visible, explicit and time-bound
- to make FTA negotiations and associated revenue implications much simpler

<u>Objective 4</u>: Provide a gradual but predictable path of rationalization (i.e. one plan phased in over several years rather than new plans announced every year)

- to address existing uncertainty, which has implications for investment
- to provide time for existing industries to adjust
- to allow trade adjustment measures to be based on objective criteria and to be administratively feasible
- to allow for revenue and balance of payment implications to be observed (and small adjustments to be made)
- to move in tandem with a broadening of the tax base

<u>Objective 5</u>: Make use of many degrees of freedom (number of bands, level of bands, removal of VAT/NBT exemptions, etc.) to manage revenue implications and perhaps be revenue-neutral or revenue-positive

- to also arrive at a system that is more robust and predictable in terms of revenues (note, for example, that a large share of revenue increases in the past couple years have come from increased oil imports, which cannot be assumed for future years)

<u>Objective 6</u>: Remove all para-tariffs

- as a necessary condition for a simple, transparent and predictable system
- to be WTO-compliant