Verité insights

More of the Same: Budget 2016 increases protection and dependence on trade taxes

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Sri Lanka was amongst the early movers in trade and economic liberalization in South Asia.

Many portrayals of Sri Lanka's policies, including in the presentation of the Budget 2016, frame the country as maintaining this initiative.

This initiative was somewhat backtracked upon in the past 10 years. This insight points out that, despite the claims, the policies outlined in the Budget 2016 are continuing rather than reversing this trend of backtracking.

Verité's Insight titled 'Sri Lanka's trade liberalisation: what you see is not what you get' published after the Budget 2014 showed that despite highlighting the move to a simple four-band tariff structure, overall import taxes had increased in value-share and become more complex.

This was done by adding a menu of new taxes on trade, without using the term import duty. Furthermore, frequent revisions to these additional taxes made the trade regime unpredictable and more complex. These resulted in the government's dependence on taxes from trade (including VAT and NBTs on these items) increasing to 50 percent of total revenue.

The present Insight suggests that the Budget 2016 is continuing to nourish this mismatch between rhetoric and reality. The Budget Speech states a commitment to a simplified tariff structure by further reducing the number of tariff bands from four to three. However, the details reveal that the government has increased taxes on imports as well as the dependence of government revenue on trade taxes – reflecting more continuity than change with regard to trade liberalisation.

Import duties: A net increase, not a reduction

Prior to Budget 2016, Sri Lanka had a four-band tariff structure – zero duty, 7.5 percent, 15 percent and 25 percebt. Essential inputs not manufactured locally were imported duty free;

raw materials and semi-raw materials at an import duty of 7.5 percent; intermediate goods at 15 percent; and final end user products at 25 percent.

The Budget 2016 proposes to further simplify the tariff structure, by (a) removing the 7.5 percent band; and (b) increasing the 25 percent band to 30 percent. This would produce a 3-band import duty structure of zero, 15 percent and 30 percent. Only 3 percent of tariff lines (or about 184 tariff lines as per the Budget 2014) fall into the category of raw and semi raw materials. Meanwhile, final end user products - for which import duty has been increased from 25 percent to 30 percent account for 1,412 tariff lines or 21 percent of all imported products.

As far as total trade taxes are concerned this is a measure to increase taxes and revenues, because taking the 7.5 percent of a small number of products to zero is more than compensated by the increased tax on a much larger menu of items. Most of these upper tariff band products are also subject to higher rates of import cess between 15 percent and 35 percent, which have remained unchanged.

Additional taxes are also increased

While import duties are adjusted to present a picture of tax reduction and trade liberalization, the other taxes on imports and trade have been increased, making the reality quite different to what is presented. For example, the Port and Airport Development Levy (PAL) is a tax imposed on the Cost Insurance and Freight (CIF) value of all imports. The Budget increased PAL from 5 percent to 7.5 percent.

Exhibit 1 shows that with the revision in PAL and import duty 21 percent of tariff lines in the country will be subject to a tax increase of 7.5 percent. Another 76 percent of products will see tax on imports increase by 2.5 percent; while it is only a small number (3 percent) that will see a 5 percent reduction in taxes.

Under the new tax structure, since the cess has not changed (see Verité's previous Insight: 'Cess – End the deception and build street lights'), products in the upper band will be subject to tax rates of over 60 percent on CIF value.

Exhibit 1: Higher Taxes for Imports in 2016

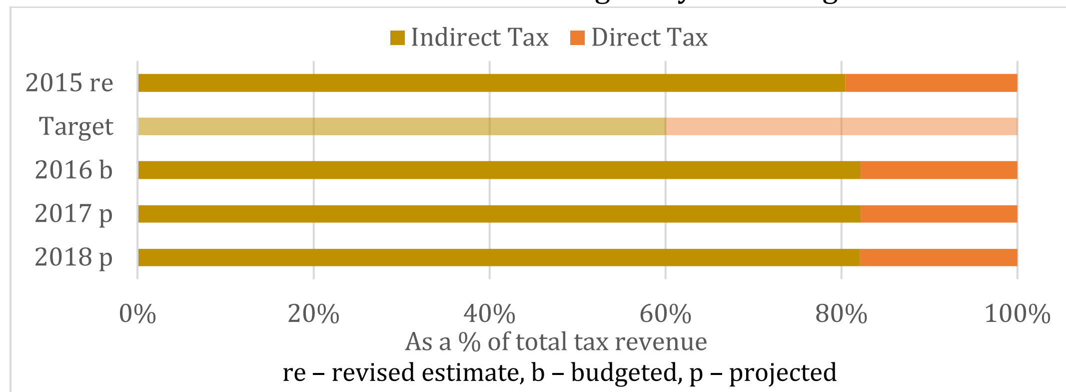
Classification	Number of Tariff Lines	2015 Customs Duty + PAL	Budget 2016 Revisions	2016 Customs Duty + PAL
Essential inputs, not manufactured locally	3,376	5	2.5↑	7.5
Raw materials & semi raw materials	184	12.5	5 ↓	7.5
Intermediate goods	1,605	20	2.5↑	22.5
End user products	1.412	30	7.5↑	37.5

Source: Budget Speech 2014 and Budget Speech 2016

Dependence on trade taxes is increasing

Taxes on imported consumption goods are an indirect tax, as opposed to a direct tax, which would fall on income rather than consumption. Exhibit 2 shows that in 2015, over 80% of the tax revenue is from indirect taxes and this trend is expected to continue- which is in the opposite direction of government policy targets.

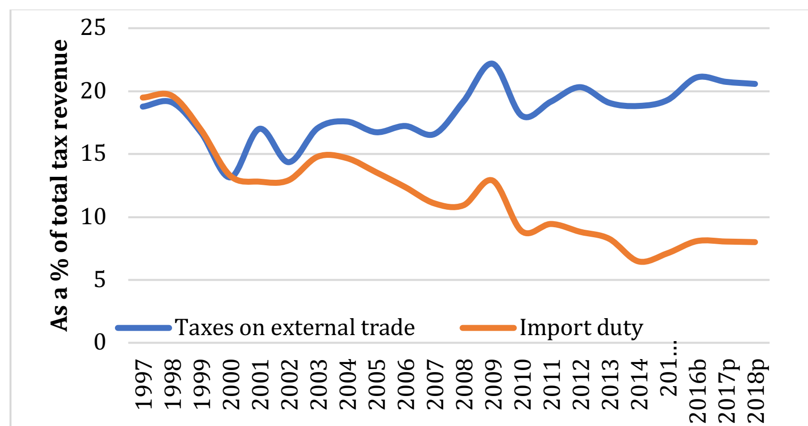
Exhibit 2: Direct and Indirect Taxes Moving Away from Targets



Sources: Budget Estimates 2016, Prime Minister's Economic Policy Statement (Nov 5th 2015)

Within indirect taxation, the dependence on trade tax is high and has been increasing significantly over the years (refer Exhibit 3). Projections indicate that the government expects this trend to continue in the next three years. Revenue from import duties alone is projected to increase by 28 percent in the next year, which, if achieved will be the highest annual growth in the last ten years.

Exhibit 3: Taxes on International Trade continue to be an important source of government revenue



Source: Central Bank Annual Reports and Budget Estimates 2016

This trend raises three concerns

First, higher taxes are sometimes used to unreasonably protect excess profiteering, or the inefficiency of a small number of suppliers, at the cost of a large and often poorer set of consumers. (See Verité's previous Insight: 'A bicycle ride through trade liberalisation').

Second, a revenue system that is highly dependent on imports creates an undesirable link between the fiscal deficit and the trade deficit. When the country takes non-taxation measures to reduce the trade deficit, it hits revenue and creates problems for managing the fiscal deficit – this pattern is evident in Sri Lanka's economic outcomes over a period.

Third, both the Prime Minister's economic policy statement and the Budget Speech indicate that trade agreement negotiations are planned with countries such as United States, China, South Korea, Singapore, Australia, South Africa and Japan. Several of these countries will ask Sri Lanka to match rhetoric with reality and remove the taxes on trade that are disguised under other names; making the current approach to taxing trade unsustainable.

One of the challenges that Sri Lanka faces in moving away from trade taxes is the weakness in its administration of domestic direct and indirect taxes. This weakness has trapped the government into high dependence on trade taxes which in turn have consequences on consumers and investors. This Insight shows that the extent of trade dependence for tax revenue is such that even when the government is presenting a policy front of reducing these taxes, they are in fact being increased.

(Verité Research is an independent think-tank based in Colombo that provides strategic analysis to high level decision-makers in economics, law, and media. Comments are welcome. Email publications@veriteresearch.org.)