

WADING THROUGH MURKY WATERS

A Case Study of Regulatory Ineffectiveness in Sri Lanka's Import Tax Exemption Schemes

The predictability, efficiency and openness of regulatory procedures are critical to enhance their effectiveness. In the absence of these features, procedures will fail to generate expected outcomes. Such opaque processes are also prone to abuse. This policy brief highlights and examines this problem by analysing the mechanisms that currently govern import tax exemption schemes for selected product categories.

SUMMARY

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KEY FINDINGS

Import taxes are a critical source of government revenue. Depending on the product, importers may need to pay five different taxes at the point of import: import duty, import cess, Port and Airport Development Levy (PAL), Nation Building Tax (NBT) and Value Added Tax (VAT). The tax exemption schemes that provide relief from these taxes can therefore be a significant cost saving to most businesses. To prevent misuse of the exemptions to evade taxes, the government requires businesses to follow a certain process to demonstrate eligibility.

This policy brief finds three problems with the current process that diminishes the effectiveness of the scheme in terms of achieving expected benefits and increases the potential for it to be misused. This brief analyses these shortcomings by looking specifically at the tax exemptions in place for agricultural equipment such as green houses, drip irrigation systems and polytunnels, vital to enhance sector productivity.

1. Opaque process

Businesses are required to obtain letters of approval from several agencies to be eligible for the exemptions. The

procedure in place to obtain these approvals however, is neither documented nor publicly available. As a result, businesses must rely on verbal instructions provided by the agencies and visit these organisations in person to obtain instructions. Research by Verité Research (VR) finds that verbal directives provided by different officers in different agencies are often inconsistent, making such instructions unreliable. Research also revealed that lack of a documented procedure favours incumbent businesses with access to high level bureaucrats at a personal level that can guide them through the opaque system over new businesses that do not have the same level of access.

2. Decisions subject to undue official discretion

The criteria by which exemptions are approved by the relevant government agency are neither documented nor made publicly available. Additionally, the legislation that lists the eligible products identify them by product name and not by HS code.¹ As a result, the determination of the applicant's eligibility and the product for exemption is subject to undue discretion on the part of the officer-in-charge. This state of affairs reduces the predictability of the outcome and leaves room for misuse and corruption.

3. Schemes prone to abuse

The current approval process is also prone to abuse by tax evaders who can import products other than those eligible under these schemes in collusion with officials. Import statistics may potentially help assess impact of the schemes on targeted beneficiaries and detect instances of such misuse. The absence of such data further increases the possibility of abuse.

RESEARCH OVERVIEW

Encouraging modern agricultural practices and increasing commercial agriculture is a long-standing policy priority of the government. For example, the 2017 Budget proposed a 50% interest subsidy to farmers, farmer organisations and agro-processing establishments for sector upgrades through the infusion of productivity enhancing technologies and practices.² These measures are designed to encourage the uptake of technologies which are otherwise too costly for growers to adopt. With small farms, large fixed costs can be a constraint to technology adoption especially if this requires a substantial amount of initial set-up cost.³ In Sri Lanka, multiple import taxes further heighten the costs of imported technology.

Using modern agriculture equipment clearly benefits growers. The limited application of modern technology is a key problem that affects both agricultural productivity and the sector's ability to resist the effects of climate change.⁴

To encourage the uptake of modern agricultural technologies, selected agricultural equipment are exempt from Customs Duty, Import Cess, and VAT (refer Table 1). Depending on the HS code of the product, the cumulative effect of these taxes can exceed 50% of the import value, underscoring the strong incentive for businesses to apply for these exemptions.

The government's eligibility verification process requires businesses to obtain approval by respective government agencies. This process applies not only to agricultural equipment but also for other products eligible for exemptions. Table 1 shows the eligible agricultural equipment and approvals necessary pursuant to the relevant exemptions legislation.

VR's research finds three problems with the current process that undermines the ability of targeted businesses to benefit from the tax exemption schemes: (1) the process is opaque; (2) it is subject to undue official discretion and (3) is prone to abuse. These problems arise due to

Table 1: Agricultural equipment exempted from Customs Duty, Import Cess and VAT and the required approvals to obtain the exemption

Exemption	Equipment	Approvals required to obtain the exemption as outlined in the legislation
Customs Duty ⁵	<ul style="list-style-type: none"> ▪ Weather stations ▪ Green houses ▪ Poly tunnels ▪ Sprinkler/misting systems ▪ Drip irrigation systems ▪ Fertigation systems ▪ Hydroponic systems ▪ Mulch films ▪ Pond liner ▪ Shade for netting 	<ol style="list-style-type: none"> 1) Recommendation letter from the Secretary, Ministry of Agriculture 2) Approval from the Director General, Department of Customs
Import Cess ⁶	<ul style="list-style-type: none"> ▪ Weather stations ▪ Green houses ▪ Poly tunnels ▪ Sprinkler/misting systems ▪ Drip irrigation systems ▪ Fertigation systems ▪ Hydroponic systems ▪ Mulch films ▪ Pond liner ▪ Shade for netting 	<ol style="list-style-type: none"> 1) Recommendation from Secretary, Ministry of Agriculture 2) Approval from Director General, Department of Customs
VAT ⁷	<ul style="list-style-type: none"> ▪ Green houses ▪ Poly tunnels ▪ Materials for the construction of green houses 	<ol style="list-style-type: none"> 1) Recommendation from Secretary, Ministry of Agriculture 2) Approval from Director General, Department of Fiscal Policy

the lack of a documented, publicly available procedure, non-identification of eligible products by HS code and the lack of published import statistics by exemption scheme.

1. Opaque process

First-time or new importers face difficulties in finding relevant information on the process to obtain approval letters to qualify for tax exemptions. Information regarding (i) the eligibility criteria, (ii) the HS codes of the eligible products, and (iii) the documents required as proof are neither documented nor publicly available. The relevant gazettes and orders published by the respective agencies provide only the basic information on the products and the list of agencies from which approvals are required (as outlined in Table 1).

The three agencies responsible for approving requests (Ministry of Agriculture, Department of Fiscal Policy, Department of Customs) for exemptions under the scheme do not provide details of the documentation required, eligibility criteria or the relevant HS codes for exempt products. Importers must rely on the verbal guidelines provided by the officer in charge or other third parties such as clearing agents or customs house agents. The research conducted by VR revealed that this lack of clarity leads to the following adverse consequences.

1.1. Reliance on inconsistent and unreliable verbal instructions puts businesses at risk

Agricultural importers interviewed during the research provided inconsistent reports of the verbal directives they received from officers in different agencies. Some agencies stated that the approval of a second agency was not required for an exemption, while the latter organization insisted that its approval was necessary. This type of conflicting information is evidence of the difficulties importers face in finding accurate and reliable information. Moreover, since these particulars are received verbally, businesses are at considerable risk when they cannot validate the information if challenged by a third party

1.2. Increases the time and cost incurred

Since the pertinent information is not documented and made available through a web platform, businesses are compelled to visit the relevant government agencies in person to obtain the necessary information. Research by VR revealed that the absence of the relevant officer can

also cause delays since the other officers in the agency have limited ability to assist the importer given that the process is not documented. As a result, businesses can spend an unnecessary amount of time obtaining the required information and subsequently approvals. As all three agencies involved in this procedure are located in Colombo, the time and cost incurred will be greater for businesses located outside the Western Province.

2. Discretionary decisions

The lack of published eligibility criteria and applicable HS codes leaves considerable room for official discretion in determining the qualification of the applicant and the product for tax exemptions. This exposes businesses to undue harassment and leaves room for corruption. Decisions subject to a high degree of official discretion reduce the predictability of the outcomes. The research by VR also reveals that official discretion works in favour of incumbent businesses who are known to high level officials and are well networked as compared to new businesses.

The taxes businesses are liable to pay are published by the government by HS code. Using HS codes to identify the specific products exempt from taxes at the point of import allows businesses to make decisions with more precision. Businesses can calculate the taxes if they were not to receive an exemption, the actual monetary benefit of the exemption and make decisions about whether to import. Further, knowing the HS code of the product in advance enhances the predictability of outcomes and prevents lengthy disputes with Customs officials at the point of import about the eligibility of the product for exemptions.

Finding the relevant HS codes of the listed products in Sri Lanka has proven difficult. For example, attempts by VR to find the relevant HS codes of the eligible products, using the online HS code search facility provided by Sri Lanka Customs (SLC) failed to generate any meaningful results.⁸ Efforts made to obtain the list of products by HS code by contacting the appropriate officials of the applicable government agencies (e.g. Ministry of Agriculture, Ministry of Finance and SLC) also failed. A similar search by product description, in relevant Customs data bases in a selected few countries, however, generated meaningful results (Table 2). The absence of national level HS codes to identify specific products exempted, leaves it up to the officer in charge to decide whether a product is eligible under the scheme. This flexibility is susceptible to abuse.

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Table 2: Examples of national level HS codes assigned to identify selected agricultural products by other countries

Country	Product Description	HS code
India ⁹	Green houses in ready to assemble sets	9406.00.11
	Green houses other	9406.00.19
	Appliances for agricultural/horticultural work	8424.81.00
Thailand ¹⁰	Drip irrigation systems	8424.82.10
	Greenhouses fitted with mechanical or thermal equipment: Of plastics	9406.00.11
	Greenhouses fitted with mechanical or thermal equipment: Other	9406.00.19
Pakistan ¹¹	Plastic covering and mulch film	3920.10.00 3926.90.99
	Prefabricated green houses	9406.10.10 9406.90.10
	Anti-insect net	5608.19.00
	Shade net	5608.90.00
USA ¹²	Agricultural or horticultural irrigation equipment, Self-propelled, center pivot	8424.82.10
	Greenhouses	9406.90.00
Vietnam ¹³	Greenhouses fitted with mechanical or thermal equipment	9406.10.10
	Drip irrigation systems	8424.82.10
	Agricultural or horticultural sprayers	8424.20.21
Japan ¹⁴	Agricultural greenhouse	9406.00.09
	Agricultural or horticultural sprayers	8424.41.00

Source: Relevant government agency websites of the countries

3. Schemes prone to abuse

In the absence of a documented procedure, official discretion is a key factor that determines the probability of a request for tax exemptions being approved. Such processes which is opaque, unreliable and time consuming incentivises importers to circumvent it by leveraging personal reputation/influence and relationships with senior public officials. Further, the savings an importer can make by getting their product to be exempted from import taxes is high. Greenhouses according to interviews with importers falls under a broader product group called “pre-fabricated structures”, which includes other products other than greenhouses. Absence of a documented procedure and oversight creates in such in-

stances an incentive for parties other than the intended beneficiaries to misuse the scheme by importing other products under the schemes.

It is difficult to detect misuse due to the absence of import statistics published by exemption scheme. The response received from SLC to the Right to Information (RTI) application submitted requesting import statistics raises doubts as to whether they maintain statistics pertaining to imports under tax exemption schemes. The RTI referred to the exemption scheme and provided product names as listed in the relevant gazette notification. The SLC in its reply to the RTI application¹⁵ stated that it is unable to provide the information as the request did not include the HS codes of the products listed. As

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mentioned in the preceding discussion, at present, the exempted product list is only available to the public by name and not by HS code. The approving authorities (the Ministry of Agriculture and the Department of Fiscal Policy) are also not aware of these HS codes. Hence, SLC that finally decides whether a product imported is eligible for tax exemptions at the point of import is the only authority that has information of the relevant HS codes of the products imported into the country under the prevailing tax exemption schemes.

Since the import statistics are not available and products are not identified by HS code, it is not possible to detect if and to what extent misuse takes place. This inability to detect possible violations is a major shortcoming in a system that was put in place to constrain misuse. In addition, the existing system does not provide equal access to tax exemptions by its targeted beneficiaries, specially the growers who are unable to afford costly equipment. ■

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ENDNOTES

¹ Harmonized System of Classification (HS) codes – The Harmonized System of classification was developed by the World Customs Organization to assess the product concentration and composition of exports. The level of detail in the classification of products depend on the HS level specified. For example, a product classified at 4-digit level is more specific than product classified at 2-digit level. For example, dairy products would be classified at 2-digit level at HS 04, while Concentrated Milk would be classified as 0402 at 4-digit level. Imports are identified by a code as per the Harmonized System. The international classification goes up to 6-digits and countries can further subdivide by adding 2 or 4 digits at the national level.

² Ministry of Finance, Budget Speech 2017.

³ I. Abara and S. Singh., 'Ethics and Biases in Technology Adoption: The Small Farm Argument', 1993, Technological Forecasting and Social Change, Vol. 43, pp. 289-300.

⁴ Athukorala, Premachandra, et al., eds. 'The Sri Lankan Economy: Charting A New Course', Asian Development Bank, 2017, available at: <https://www.adb.org/sites/default/files/publication/373316/sri-lankan-economy.pdf>, [accessed on: 27 March 2018].

⁵ Annex II of the Revenue Protection Order, No. 02/2017 under the Revenue Protection Act, No. 19 of 1962, Extraordinary Gazette 2006/42 of 16 February 2017, available at: <http://www.treasury.gov.lk/documents/10181/46038/2006-42+Revenue+Protection+Order+No.+022017/ff23cb72-3bbd-4667-bd03-b87c31f30b47?version=1.0>, [accessed on: 27 March 2018].

⁶ Sri Lanka Customs, Order under Section 14 of the Sri Lanka Export Development Act, No. 40 of 1979, 28 November 2017, available at: <http://www.customs.gov.lk/public/files/tariff/cess2018.pdf>, [accessed on: 27 March 2018].

⁷ Inland Revenue Department, Value Added Tax (VAT) - Schedule of Exempt Goods and Services, 01 November 2016, available at: <http://www.ird.gov.lk/en/Lists/Latest%20News%20%20Notices/Attachments/92/Schedule%20of%20Goods%20or%20Services%20Exempted%20from%20VAT.pdf>, [accessed on: 27 March 2018].

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¹⁰ Thai Customs, Integrated Tariff Database, available at: http://igtf.customs.go.th/igtf/en/main_frame.jsp?lang=en&left_menu=menu_integrated_tariff_search, [accessed on: 27 March 2018].

¹¹ PkRevenue.com, FBR updates customs duties on import of goods by agri sector, available at: <http://www.pkrevenue.com/customs/fbr-updates-customs-duties-on-import-of-goods-by-agri-sector/>, [accessed on: 27 March 2018].

¹² U.S. International Trade Commission, U.S. International Trade Commission, available at: <https://hts.usitc.gov/?query=8424>, [accessed on: 27 March 2018].

¹³ Vietnam Customs, Tariff Database, available at: <https://www.customs.gov.vn/SitePages/Tariff-Search.aspx?language=en-US>, [accessed on: 27 March 2018].

¹⁴ Japan Customs, Japan's Tariff Schedule as of 01 January 2018, available at: http://www.customs.go.jp/english/tariff/2018_1/index.htm, [accessed on: 27 March 2018].

¹⁵ Sri Lanka Customs, Response received to information requested by Verité Research regarding imports of agricultural equipment under the tax exemption schemes for Customs import Duty, VAT and Import Cess, 08 December 2017.