

BUDGET - 2007

PROPOSALS TO THE GOVERNMENT OF SRI LANKA ON BUDGET 2007 BY THE CEYLON NATIONAL CHAMBER OF INDUSTRIES

As the premier Chamber representing the Industrial Sector of this country, each year The Ceylon National Chamber of Industries presents its proposals to the Director Fiscal Policy of the Ministry of Finance for consideration in formulating the country's Annual Budget Proposals. It is in the best interest of Business and Industry and the well being of the economy as a whole that we voice our views on the budget formulation.

As in the previous years we sought the views of larger cross section of entrepreneurs, leading personalities of Trade Chambers, Business and Industry, Economists and from the general public in preparing the proposals for 'Budget - 2007'.

Theme of our proposal this year is broadly based on two aspects -

- **Increased Productivity and**
- **Competitiveness**

1. *Overall Economy*

- 1.1 It is the Chamber's hope that the Government will give priority to sustain the 8% growth reported to have been achieved in the first quarter of this year. Though 8% is commendable compared to the 6% of last year, the need however is for a higher growth if the poverty is to be reduced substantially.
- 1.2 Meteoric escalation of oil price in the world market, resumption of war with LTTE worsening law and order situation in the country, *escalating inflation and slowing down of investments* are adverse factors to contain with. The Government face a major task to bring forth budget proposals leading to sustainable quality economic growth while being sensitive to the escalation of commodity prices and to keep them under control.
- 1.3 Notwithstanding these the need for political stability, progress of Peace Process, strengthening of macro and *micro* economic management, the speed and effectiveness of implementing structural reforms, development of infrastructure facilities, particularly the Power and Transport and effective utilisation of foreign donor assistance has to be emphasized even to sustain the 8% growth level.
- 1.4 The Chamber wish to stress the need for a comprehensive plan for improvement of productivity too because a substantial part of economic growth can come from such an effort, since there is enormous potential for it, especially in public sector activities. In addition the emphasis should be on creation of productive jobs, especially in manufacturing and services rather than the growth rate itself.

Importance of this can be highlighted from a recent report that Sri Lanka is rated among the 10 countries in the world with lowest productivity.

2. *Government Revenue*

It is noted that Revenue due to the Government by way of all forms of Taxation, which accounts for 85% approximately of the total Revenue is still not recovered fully. Whilst the Government machinery should be made more effective in the collection of Taxes, it is proposed that the need for all to contribute towards the National Income should be inculcated as a National responsibility of each individual.

Accordingly, the measures should be taken to,

- 2.1 Emphasise the National Responsibility towards National Development at school level itself and the need for ethnic harmony and law and order for the purpose. Children also should be taught the basics of conflict resolution, economic development and the need for hard work, thrift and honesty at some stage.**
- 2.2 Remove the Tax exemption on State employees and members of Parliament to make them awaken to the National Responsibility and also to bring about equity even though this measure may not have a significantly favourable impact on Government Revenue as almost 95% of the state employees wages are below the level of taxable income.**
- 2.3 Grant Preferential Treatment to Tax payers without extending such incentives in general thus allowing the Tax defaulters too to enjoy such incentives**
- 2.4 Bring those who avoid Taxes into the tax net by the following measures,**
 - i.) Company Registration to be made invalid automatically if the company does not file Tax returns for a specified period, eg. three consecutive years.**
 - ii.) Proof of Tax file number be made a pre requisite in the Registration of a new company.**

Registrar of Companies to issue the Certificate of incorporation only after the company Directors and major shareholders submit the respective Tax file numbers.

Monitoring system should be in place to prevent Businesses being set up and closed with the aim of avoiding Tax payments.

- iii.) The same should apply to Partnerships and Sole Proprietorships. Business Registration/Trade Licences issued to partnerships and Sole Proprietorships to be renewed after every 5 years on submission of Tax clearance certificates.

Different Registration procedures may be adopted devoid of the above stated requirements in the case of small and micro businesses.

- iv.) Submission of Tax file number/Tax clearance certificate should be made compulsory to the,
- Registration/Transfer of motor vehicle including commercial vehicles
 - Registration/Transfer of Land/Property
- These may be subject to minimum standard values.
- v.) In the case of Tender procedures to supply goods and services to the state sector organisations, the private sector suppliers should be made required compulsorily to submit their Tax clearance proof to qualify for the Tender.

Higher the value of supply this requirement should be strictly enforced.

- vi.) Introduce and publicise a Reward Scheme for information on Tax dodgers.
- vii.) Professional accounting/auditing companies should be advised to refrain from certifying the annual accounts of companies, which do not have Tax Clearances.
- viii.) Accountancy/Audit firms must be charged with the responsibility of issuing certificates of correct Tax assessment and payments by their clients. Department of Inland Revenue could monitor this by sample checking of client's files.
- ix.) The Inland Revenue Department should be strengthened with adequate manpower and modern technology to track Tax defaulters and bring them into the Tax net.
- x.) Revise all fines for breaking laws of the land in line with the cost of enforcing such laws.

3. *Rationalisation of Government Expenditure*

Following are some of the proposals the CNCI wish to make in the Rationalisation of Government expenditure.

- i.) **Subsidies on consumer items should be clearly targeted rather than allowing it across the board. Items on which the subsidies cannot be removed should be frozen at current levels.**

The adverse effects on the low-income groups on whose benefit the subsidies are made should be cushioned by increasing the "Samurdhi" payments on a well-targeted basis.

- ii.) **Rationalise the functions of the Government Institutions/Departments which are either duplicated or could be carried out by other Departments/Authorities and close down any redundant Institutions/Departments.**

Eg. Transfer of functions from the Central Government to the Provincial Councils along with the related staff for greater efficiency, convenience of the public and avoid duplication of work. This would also ease up traffic congestions when lesser number of people travelling to Colombo, the Administrative Capital.

- iii.) **Legislation be passed to limit the expenditure on State institutions to a percentage of the Total National Revenue; they should be closed down or divested if they cannot be self financing. The employees losing jobs in such an eventuality should be compensated generously or transferred to understaffed agencies after a re-training.**
- iv.) **If privatisation is not an option for the Government, alternatively it is suggested that the management of the State organisations be leased or contracted to the private sector on a long-term lease. This would eliminate the drain of financial resources of State, by not having to offset the losses.**
- v.) **It is proposed that productivity improvement of all State sector organisations be introduced. Funds allocated for staff remuneration, premises upkeep, travelling, transport etc. should be progressively curtailed by a certain percentage every year and the management of the organisation be called upon to meet such reductions by productivity improvements to provide the same level of quality service they are meant to provide.**

- vi). It is imperative that the Transport system in a country should be made efficient in order for the economy to grow. Long delays experienced by the workforce and industry due to poor road network, lack of alternate ring roads, flyovers, etc. especially in the main cities and suburbs result in colossal loss of man-hours and extra fuel consumption due to traffic congestions. Production and marketing of produce in rural areas could be improved significantly by accelerating infrastructure development in such areas as well.

As the country does not have the necessary financial resources presently for road development, it is proposed that the restriction on import of motor cars be introduced. A System of auctioning the permits as practiced in Singapore when one need to replace a vehicle may be introduced in Sri Lanka. The same system should apply to Diesel powered motor vehicles too.

- vii) *Avoid Adhoc salary revisions in public sector*

Whilst it is important to satisfy the work force by offering salary/wage increases mainly on the basis of improvements in productivity and removing salary anomalies to avoid work stoppages, it is our view that ad hoc salary increases should be avoided. For this purpose it may be necessary for every ministry to introduce a mechanism to resolve the grievances of workers before such discontentment leads to strike action on the basis of a national policy and mechanism on such issues.

- viii) Wastage of public funds by Ministries and Departments on various ceremonies, paper supplements etc. has to be minimised if not eliminated.

4. *Industrial environment*

4.1. Competitiveness

Global trade today is based on competitive pricing. Thus if Sri Lankan Industries are to survive, leave alone exporting, it has to be competitive with the industries in other countries. Unfortunately a series of factors in the county retards them from being competitive. This may be evident from the following.

- i) Indian Finance Minister speaking on Indo -Sri Lanka FTA is reported to have said "some quotas are not being used and we urge Sri Lankan Industry to utilize these quotas. He attributed these to various constraints on the part of Sri Lankan Government." He is further reported to have said that duty concessions allowed have not been used by the Sri Lankan Industries.

- ii) The CNCI is involved in a project to promote industries in Sri Lanka to become suppliers of components, accessories and spares for the motorcar industry in India. However, it was surprising to learn that the purchase price of the components and accessories were much lower than what the local industrialist could produce at and in some instances below the raw material costs.
- iii) This was further highlighted by the garment industrialist who sought relief from the Government to offset their high cost of production.

Thus signing of Free Trade agreements with other countries alone is not sufficient for a win-win situation for Sri Lankan businesses unless the necessary macro and other policy decisions are also put into place. In the case of Indian FTA undoubtedly some progress has been made by the Sri Lankan industries in exporting but far short of expectation. On the other hand India has now become the largest supplier of goods to Sri Lanka.

4.2. Productivity and Competitiveness

THE CHAMBER IS DISMAYED THAT THE COUNTRY HAS NOT AND DOES NOT APPEAR TO FOCUS ON THE URGENT NEED TO BECOME A PRODUCTIVE AND COMPETITIVE NATION. THIS HAS TO BE A NATIONAL PRIORITY AND CANNOT BE IGNORED ANY LONGER AS THE NATION IS PAYING A HIGH PRICE DUE TO UN-COMPETITIVENESS ARISING OUT OF INACTION.

Some of the major factors that are responsible for making the industry uncompetitive are

- i) Poor infrastructure facility, especially the lack of sufficient road network resulting in heavy traffic congestion
- ii) High Costs and less reliable of the Power supply.
- iii) Frequent policy and duty changes and outdated capital allowance retards the industries from keeping pace with fast advancing technology.
- iv) Low labour productivity due to too many holidays, difficulties in commuting, high cost of nutritional food and outdated labour laws
- v) Multitude and complicated systems of taxation, duties, government levies etc. all adding to unproductive cost in computing, documenting and making payment.
- vi) High transaction cost at port, customs etc.
- vii) Multitude of slow moving government agencies with which industry has to interact.

- viii) Numerous and complicated government procedures.
- ix) Law and order situation much to be desired.
- x) Lack of proper waste disposal facilities.
- xi) An educational system not attuned to the current requirement of industry and business.
- xii) Low investment on R & D.
- xiii) Lack of knowledge in English especially in the public sector.

5. *Infrastructure Development Needs*

As mentioned, the absence of basic infrastructure needs such as improved Road network, and low cost uninterrupted power supply at competitive rates are two main factors, which retards the country's economic growth.

5.1 Power Generation

Economic progress of the country over the years has been adversely affected due to unreliable and high cost power resources. The crisis in the generation of much needed electrical power has been and is presently the biggest crisis only second to the problem of peace the country faces today. The Ceylon National Chamber of Industries being the premier Industrial Chamber has always been very concerned about the situation and demanded urgent action. We thank H.E. the President and the Government for taking the bold step of initiating the construction work of Norochcholai Coal power Plant and the Upper Kotmale Hydro Power Plant.

Over dependence on thermal power has increased the cost of power generation and the industrial sector is compelled to pay high tariff rates which makes it uncompetitive with those in the Region. Exporters who have to compete in the global market have to overcome this handicap. The cost of production of the local industry too is therefore higher and their ability to compete with the imported products is adversely affected. The situation will be further aggravated if the price of oil continues to escalate the way it is happening now.

It is evident that the dependency on hydropower is no longer possible with the drastically changing weather patterns. Therefore, it should be re emphasised that alternate low cost power generation is a must. Accordingly, it is proposed that,

- **The Government speed up the work of coal power facility in Norochcholai, while making every effort to reduce environmental pollution by**

introducing the latest technologies for the purpose. This should be placed on a fast track, as a national priority.

- Speed up the Upper Kotmale Hydro power generation project; there too ensuring to minimize the environmental damage.
- Commence work on two other proposed coal power plants in Trincomalee & Hambantota and diversification of energy supplies by introducing cleaner power sources as well as natural gas and nuclear power as a part of long-term plan.

5.2 Road Network

Whilst we all agree on the urgent need for road network modernisation with flyovers and overhead bridges to ease the traffic congestions and help faster movement, we are cognizant of the fact that the limitations of funds available for such development remains a problem.

Lengthy acquisition procedure of Land for Road development also retards the process even when the much-needed funds are available.

Therefore, it is proposed that,

- The Government explores all possibilities of obtaining foreign aid for the improvement of the road network. The standards of maintenance and widening should also be improved substantially by strict supervision and removal of corruption, as all our roads are in a constant state of disrepair despite continuous and massive investment by the government. The ability of most local government institutions to undertake such tasks is questionable.
- Land acquisition for Road development should be made without any fear or favour and compensation payments should be expedited. Legislation should be brought in to fast track the land acquisition *and streamlining of procurement procedures* to prevent long delays in implementation of National Projects.
- To concentrate on one major development at a time rather than talk about many and not implementing any. The immediate need is to complete the Southern Highway the work on which has already commenced.
- Expedite the work on Katunayake/Colombo Highway too on BOT basis with part funding from the State, so as to make it a financially feasible proposition. In fact highway and railway development is more feasible for generating development than expressways as most villages and towns will be bypassed by the latter, which should be used only to connect major cities in order to reduce travel/transport times.

5.3 Rail Network

It is noted that the Government does not possess adequate resources to revamp the much needed Railway network. It needs urgent restructuring and improvement to make it a viable system and to largely supplement the country's transport needs.

As the stated policy of the Government does not have the option of privatisation, even having abolished the Railway Authority, the government needs to generate funds for the Railway development. It is therefore proposed that,

- **The Government explore the possibility of obtaining foreign aid/funding for the purpose AND/OR**
- **Explore possibility of generating the required funds by realising the value of many unused/idle assets belonging to Sri Lanka Railways eg. Large tracts of prime property.**
- **If complete privatization is not considered, at least part private funding/management be contemplated by persuading the recalcitrant stakeholders like the trades unions (on a give and take basis), as in the case of the SLT, which is considered a successful divestment.**

5.4 Sea Port Facilities

While recognising the improvements effected to the Port of Colombo, it is seen that its efficiency need be further improved to withstand the competition, Colombo would face once the proposed Indian Regional Development Plans are implemented. The development of the Galle or Hambantota ports also should be considered to complement the attractiveness of port of Colombo.

It is noted that the rates charged by the Port are not competitive with those in the Region and this need to be rectified.

It must be ensured that work stoppages, go-slow action by Trade Unions that not only make the Colombo Port unpopular but also causes massive revenue losses are not allowed to occur.

Further, the security of the Colombo Port must be strengthened to an extent the terror attacks could be totally ruled out.

6. *Control of Rising Fuel Prices*

Frequently escalating fuel prices have pushed the prices of all consumer items, transport and every need of the people beyond unimaginable levels setting up galloping inflationary trends.

Whilst accepting the fact that ever rising fuel prices in the world has its effects on the domestic prices, CNCI wish to propose the following measures in order to minimize the frequent price hikes.

- a). Introduce a cap on VAT levied on Petrol, Diesel and Kerosine to avoid consumers having to pay additional VAT on every price hike.
- b). Initiate action to expand the oil refinery capacity and import more crude than ready to use fuel.
- c). Consider setting up oil refinery facilities in the East Coast and Southern Coasts along with the proposed Hambantota Port which would substantially minimize the distribution costs.
- d). **Explore the possibility of encouraging the mixing of petroleum with alcohol liberally produced in the country (initially it can be imported as it currently costs only around \$ 25 per barrel) thereby reducing the consumption of pure petroleum, which would lead to reduction in oil imports. It is said that up to 10% of alcohol could be mixed with Petroleum. Production or initial import of bio diesel also to be considered. These ventures will be a lucrative source of income to our farmers.**

The method would also lower the harmful emissions. Understandably it is being practiced in countries like India, Sweden and Brazil.

In the meantime a strictly supervised national energy conservation programme should be implemented.

7. *Setting up of Industrial Zones*

It is proposed that Industrial Zones be created in each district and in the suburbs of Provincial towns towards industrial development in the country.

The establishment of geographic clusters of like industries such as electronic goods and sports goods with all infrastructure facilities as well as backward and forward linkages in production and services, as in the case of the proposed apparel/textile cluster, should be developed by the government in consultation with sectors desirous of setting up such facilities, as individual Sri Lankan firms are too small to be competitive by world standards.

The contribution expected from the government is the required planning, provision of relevant specialized infrastructure facilities (physical and social infrastructure including research and training facilities) and amenities to attract skilled workers and professionals to live in such locations. It is cheaper and more feasible to develop selected existing urban centres as clusters, as location is of prime importance.

The prospective entrepreneurs should be attracted by,

- **Giving them a rebate on the VAT they pay**
- **Payment of EPF/ETF of the employees by the State and freeing them from rigidities of labour laws.**
- **Industries being relocated too be given enhanced capital allowances and write off of relocation expenses in the first year itself.**

8. *Taxes & Levies*

8.1 Multitudes of Taxes & Levies

PAYE, Withholding Tax, VAT, ESC, BTT, Income Tax payable to Inland Revenue or Provincial Councils as well as the Import Duty, Surcharges, CESS, PAL etc., on Imports/Exports by Sri Lanka Customs make things difficult to the respective authorities, the Importers/Exporters and Business Community as a whole. The enormous paper work, wasted man-hours on collection and monitoring of administrative expenditure could easily be minimised by proper planning.

- **Accordingly it is proposed to rationalize the multiplicity of taxes, simplify methods of payment of taxes and make the Inland Revenue Department a people friendly organization.**
- **The various cost incurred by way of charges at the port and customs should be reviewed to ensure that these charges are competitive with that of the other ports in the region.**
- **The corporate tax has been increased from 30% to 35%. While appreciating the need for revenue on the part of the government it is pertinent to mention that the corporate sector too is there by handicapped in finding funds for re-investments. Furthermore as stated under the earlier paragraphs the industrial sector operates with unnecessary drawbacks. Therefore we proposed this to be reviewed.**

9. *Sri Lanka Customs*

9.1 Under invoicing and need for MRP

Under invoicing of goods appears to be taking place on an alarming proportion. On one hand, it denies the state of its legitimate dues by way of taxes and on the other hand it affects competition of the local industries. Therefore it is reiterated that wherever possible the maximum retail price (MRP) should be marked by the manufacturer of the product before shipping it to Sri Lanka.

Sri Lanka Customs to introduce the following measures in order to safeguard the consumer and the local manufacturers from substandard and obsolete imported Consumer items.

- **All consumer items imported should have the following marked by its manufacturer on the product or the container of the particular product,**
 - **Shelf life of the product - at the time of import, shelf life should be for another year or at least 75% of the accepted shelf life**
 - **Maximum retail selling price of that product (MRP)**
 - **TIN number of the importer in Sri Lanka**
 - **All items should either comply with SLS standards or should be accompanied with quality reports from SLS accredited institutions in the originating country.**

9.2 TIEP & VAT deferment scheme

Yet another specific example of multiplicity of government agencies being involved in one exercise is the facility of duty free imports (TIEP scheme) and VAT deferment scheme offered to exporters and indirect exporters. Currently the scheme is being operated by the Sri Lanka Customs, Textile Quota Board, EDB, and Inland Revenue. These scheme could easily be operated either by Customs itself or by modifying the scheme whereby export and indirect export proceeds in US\$ are credited by the companies in designated accounts in the bank and payments from it could only be made for imports of raw materials in US\$ only. Such imports could be freed from duty and VAT, based on a certificate from the Bank that payment was made from the \$ receipts of exports or indirect exports.

9.3 VAT Refunds

The VAT deferment scheme as being implemented only passes the VAT reclaim from direct exporters to indirect exporters. Therefore it is proposed that the qualification requirement of 50% export sales be including the VAT component too along with the duty in the TIEP scheme.

9.4 Capital Allowance & Technology

Further due to fast changing Technology, Industry should be able to replace machinery with more modern ones more quickly perhaps in 3 or 4 years. Therefore the capital allowance on machinery should be increased from the present 12.5% to 25%. Also it should be free of import duty and VAT.

9.5 Disallowed Advertising Expenses

- It is noted that the disallowing 50% of advertising expenses for the purpose of computing taxable profit is not justified, as advertisements are an essential expenditure especially for those marketing consumer products.

9.6 Welfare of Senior Citizens

Since employees who retire from private sector jobs survive only from investing their EPF and ETF benefits in banks, the exemption limit from tax on interest obtained either from State owned banks or private banks should be raised from the present paltry Rs. 9000/- per month substantially to an equal level to all, especially senior citizens, without discrimination since spiralling inflation, especially on medicines has rendered it impossible to enjoy a decent living for a vast number of such people; statistics indicate the percentage of such senior citizens in this country is increasing significantly .

10. *Environmental Matters*

10.1 Encouraging systematic waste disposal

Encourage setting up of recycling plants/industries for recycling of polythene, paper and glass by extending tax concessions. Needless to say it will have the dual benefit of employment and environmental protection, *especially by minimising the countrywide garbage problem.*

Country is still to implement the Hazardous Industrial waste disposal system, for the location itself is still to be finalized. This needs to be fast tracked if the country is to avoid a greater cost by delaying it.

- Complete the waste disposal plants at Ekala and Ratmalana industrial zones on which construction was suspended after completing substantial work few years back due to lack of funds.

11. *Research and Development*

One of the major causes hampering the development of the industrial sector is the insufficient investment on R & D by the government and the private enterprises themselves. Cost of equipment for R & D being relatively high is a major factor deterring investment in R & D. We therefore advocate that industries be encouraged to invest on R & D by making the import of equipment duty and VAT free and allowing twice the cost of equipment to be claimed as capital allowance for tax purposes.

11.1 Productivity Improvement in Selected Sectors

It is encouraging to note the experimental projects undertaken by the Ministry of Industrial Development where about 10 Companies have been selected and steps taken to enhance their productivity. We suggest this programme be extended to more sectors.

11.2 Encouragement by the Government

The need to promote Sri Lankan products overseas needs no emphasis. This obviously has to be encouraged by the state. We therefore suggest that the state contributes twice the amount spent by the individual Companies with emphasis on selected sectors where the contribution has the potential to compete and capture greater market share globally.

- **Efforts should be made to step up the export of both products and services and human skills by strenuously emphasizing on improvement of productivity (reduction of costs and differentiation of products/ services on the basis of customer needs) to fetch higher prices both by the public and private sectors and improving standards of education and training. Differentiation can only be induced by offering incentives in the form of matching grants (part government, part private funding to get the firms committed to carry the project to a successful conclusion) supervised by reputed institutions for research for market and product development, training and adoption of superior technologies. Reduction of costs in the private sector can come from increasing scales of production either by larger firms or amalgamation of smaller firms. Therefore incentives should be offered for such efforts as well.**

The above proposals should not be viewed as those incurring revenue losses but as increasing or gaining new revenues for the future. These concessions are required to offset the additional costs that these industries have to bear and the difficulties they will have on recruiting quality staff.

12. *University Education*

It is acknowledged that the University education is purely academic and not job oriented. It was not long ago that the country was ably managed and administered by those who graduated even in Arts, Classics and Languages from our Universities and turned out to be eminent and capable Civil Servants. It is accepted that majority of the present day graduates are below the accepted standards. Therefore, it is high time that the relevant authorities' re-examine the areas of inadequacy in University Education and remedy the matters urgently.

It is proposed as short-term measures to,

- **Reintroduce viva for admissions**

- **Ensure English Language proficiency**

It is also proposed that,

- **The Teaching methods be reviewed and encourage reference/ case studies rather than lecture notes oriented examinations.**
- **University authorities interact with business and industry in order to direct the attention of University students for suitable employment compatible with their knowledge.**
- **Centres of excellence be established in critical areas such as S&T and Management as in India and China in collaboration with reputed foreign educational institutions to produce the higher creative skills that are essential to achieve a faster rate of growth. In the absence of such institutions, the waste of human resources of the large numbers of poor students who cannot be accommodated by the local universities (the standard of education of which do not satisfy the parents and students in any case) and the brain drain as well as the expenditure on foreign education by those few who can afford is enormous.**

In fact future enterprises will involve knowledge intensive operations and boosting the creation of higher creative skills demanded by them now itself will be a critical source of competitiveness.

13. Industry Specifics

13.1 Small industries

We endorse the Government Policy of encouraging the small industrial sector. It is seen that marketing is one of the drawbacks of this sector.

- **Therefore it is suggested that some of the procurement quotas of the State sector be reserved for the Small Industries or preference be given to this sector.**
- *The best solution is to legally empower them to solve such problems on their own by amalgamating operations of a number of small enterprises on a formal basis such as the formation of joint stock companies or co-operative societies so that they operate on a larger scale enabling cost reductions and differentiating their outputs by being able to command credit, the necessary expertise and technologies as other well run businesses. The State can help them until they can stand on their own feet. This is a solution that can be tried out on a pilot basis, especially in paddy farming.*

13.2 Micro Financing

Micro financing refers to a different method of giving the people of low-income group access to Financial Services. The target group of those who need financial assistance are spread mainly in the rural areas and they do not have access to Banks due to their low-income levels, limited education and non-availability of collateral for bank borrowing.

Today Micro Finance is a worldwide service and in Sri Lanka too there are over 200 such companies functioning formally as well as informally bringing benefits to a large rural population.

We understand that at recent times even the Asian Development Bank has stressed the need to change the Central Bank Policies and existing fiscal regulations to accommodate more private sector micro financing institutions.

Following are some of the benefits to be gained by regularising the MFI's.

- Increased Tax revenue through MFI's to the Government
 - Build confidence among rural communities and encourage them to save
 - Rural development would result in reducing the Government expenditure on Social Welfare
 - Help some rural unemployment through micro financing assisted self-employment projects.
 - Increased demand for industrial goods with rising rural incomes, enabling the setting up of more industrial and service projects, especially in the rural areas itself.
 - Reduction of poverty and associated *problems like malnutrition.*
- **Accordingly we propose that the Central Bank authorities should study the MFI scheme in depth and take measures to develop/regularise its operations.**

13.3 Textile and Apparel Sector

Frequent changes in policy are a major contributor for the collapse of certain industries. Sudden changes in policy without studying the implications they have on different sectors of industry in consultation with the stakeholders, results in either their collapse or becoming sick industries at great cost to the economy and to the stake holders. Recent example of this is the Textile Industry.

Potential investors in industry are either cautious or reluctant to adopt a short-term return basis. Result is the retardation of the industrial development in the country. The following real life example amply illustrates this situation.

- *Needless elaborating the importance of the Apparel Industry to the country's economy. But this sector is facing difficulties as the Industry is losing its competitive edge to China and the other competing countries from the time the quota system was abolished. The main reason for the down fall is the non availability a good fabric manufacturing base in our country to support the apparel industry. Due to the same reason the industry is unable to reap the maximum benefits from GSP + scheme extended to our country by the EU. It is not an easy task to set up a textile plant which could cater to the apparel industry overnight because of high investment cost. The cost of a state of the art textile dyeing and finishing plant would be around Rs 1 billion.*

The textile manufacturing base the country had, which catered mainly to the domestic market, has virtually collapsed after sudden removal of import duty for textiles. Removal of duty never helped the apparel sector too. Had the textile industry been developed to cater to the apparel sector instead of removing the duty, the apparel industry would have been on a better footing today. Still it is not too late to revive the local textile industry as the infrastructure facilities are still available and the skilled and trained workers other qualified and experienced personnel in this field are still around. If suitable environment is created for them to operate smoothly, definitely many will expand their activities to support the apparel sector.

*The main reason why the local textile industry cannot survive in a duty free environment is the adoption of under mentioned **unfair trade practices in very large scale** by the importers of textiles.*

- I. *Under invoicing.*
- II. *Dumping of factory rejects.*
- III. *Under stating of quantities.*

Although the legislations relevant to unfair trade practices were gazetted and now in the Parliament for approval, it may not be practical to curb these as almost every importer resorts to these practices. The textile factories do not operate at the full capacities and some were even closed due to this reason.

*We give below the import statistics of textiles and yarn to the **domestic market** for the last two years, which illustrates the futility of Fabric Manufacture locally.*

2004 imports

	<u>Qty (kgs)</u>	<u>Value (Rs)</u>	<u>Average unit price Per kg (Rs)</u>
Yarn	9.5 million	2,622.4 m	276.15
Fabric	41.7 million	12,858.2 m	308.47

2005 imports

	<u>Qty (kgs)</u>	<u>Value (Rs)</u>	<u>Average unit price Per kg (Rs)</u>
Yarn	10.7 m	2,977.8 m	278.16
Fabric	47.6 m	12,756.0 m	267.91

(Courtesy Sri Lanka Customs)

Please note that quantity of fabric is available only in weight (kgs) in Sri Lanka Customs, which makes the task of comparisons easier.

It is noted from the above statistics that difference between the average yarn price and the fabric price is marginal in 2004. The startling revelation in 2005 is that the average price of finished goods (fabric) is much lower than the average price of raw material (yarn). The imported quantities of fabrics have increased from 2004 to 2005 but the total value of same has reduced. This is a clear evidence of adoption of unfair trade practices in large scale. The actual average fabric price should have been more than Rs 400 per kg. The fabric imports to the local market had been under invoiced by an average of Rs 132 per kg (Rs 400 – Rs 268) and for total imported quantity of 47.6 m kgs of fabrics during 2005 the value had been under stated by Rs 6283.2 m. **Therefore the loss of VAT income for the State had been (Rs 6,283.2 m @ 15%) a staggering amount of app. Rs 942.5 million for the year 2005.** The total quantity of fabric imported to the country including for both BOI and non BOI sectors in 2005 were 191 m kgs and the values were Rs 162,650 m. **The av. price per kg is Rs 851.**

Presently 10% of import duty for textiles can be imposed, which is the bound rate as per the WTO agreement. This could not be done earlier due to the complication of the MOU signed with EU to get quota benefits for apparels. Since the quota system is no more, there is no validity in the MOU signed with the EU but by imposing this duty the issues of under invoicing, under stating of quantities and dumping cannot be curtailed and ideal solution would be a unit rate for a kg of fabric as a levy equivalent to the 10% allowable bound rate of duty. The weight of fabric consignments cannot be under stated, as it is the physically checked quantity.

Therefore in order to overcome the above-mentioned issues and to revive the industry we give below our proposals.

- To impose a levy of Rs 50/= per kg of fabric imports to the local market. This is 6% of the average price of Rs 851 of the total imports of the fabric. This is a justifiable amount as 10% is the bound rate for textiles as we have mentioned earlier. This would help the Government save the losing revenue due to unfair trade practices and protect the local industry. The Expected income for the Government from this levy is estimated to be more than Rs 2000 m.
- Exempt yarn and fibers from VAT (this benefit has already been given to the handloom sector). Textile producers to pay VAT only on the value addition. Example:- If the Sales proceeds for the month is Rs 10 million and yarn purchase is Rs 6m, to pay VAT only on the net amount of Rs 4 m (Rs10m-Rs. 6 m). This would drastically reduce the cost of production of fabric and local products could be able to compete with low priced imported products. Expected loss of income for the Government from exemption of VAT would be app Rs 450 million. This loss can be set off against income expected of Rs 2.0 billion from the suggested levy for textile imports.
- The suggested proposals for a levy for import of textiles would no way affect the apparel industry as they can import their fabric requirement free of taxes and levies using the same method similar to VAT deferment scheme. In order to assist the apparel sector further we suggest to have dedicated counters, which should be green channels in Sri Lanka Customs to expedite imports and exports. Statistics section of Sri Lanka Customs can monitor the imports and exports of the apparel sector by comparing the weight and value of the imported and exported consignments from already available statistics
- Any changes in Government policy should therefore be studied in detail, its impact on the different sectors of the industry examined, views of the Industrial Chambers obtained and the policy changes effected.
- No changes in duty structure should be effected unless it has been studied and agreed upon by the Tariff Commission.

13.4 Financial Services Sector

13.4.1 *VAT on the supply of Financial Services*

In accordance with the current tax legislation, The Financial Institutions are required to pay VAT on the supply of Financial Services at the rate of 20% on value attributable to financial services rendered on monthly basis. However, this is totally disallowed in the computation of income tax with effect from year of assessment 2005/06. Since the current corporate tax rate is 35%, financial institutions pay more than 55% of its net earnings as direct taxes. This is a substantial outflow for the financial institutions. Further it impairs the business growth and development directly.

- **Hence we request the Government to consider the VAT on financial services as deductible expenses in the income tax computation and to reduce the current VAT on financial services tax rate to a bearable level.**

13.4.2 Non – recoverability of Input VAT

It was experienced that VAT refunds are being accumulated due to irregular or less availability in the taxable (VAT liable) supply in some particular months. There are substantial delays in recovery of such input VAT.

- **This could be avoided if the Department of Inland Revenue allows the companies to utilise these Vat refunds against VAT payables in subsequent months having duly filed VAT Returns.**

It was further conversant that the input VAT on general supply in case of financial institutions is not being recoverable since the financial institutions' taxable supply (output tax) is not significant. This is mainly due to availability of substantial non-taxable supply (i.e. interest income). Hence the financial institutions are not in a position to recover substantial portion of input tax. Input tax of 15% incurred on expenses like administration and establishment, communication, information technology, professional services etc. becomes a part of operating cost.

Therefore in addition to 20% tax as VAT on financial services, the financial institutions have to bear 15% input VAT charged on overheads (i.e. inputs).

13.4.3 Withholding tax on Investment Income on Corporate Debt

It was observed that, once the corporate debt (Commercial papers, Promissory notes, Securitized papers etc.) is issued (primary issue), the issuing company is liable to deduct the withholding tax at the rate of 10% on gross interest at the time of issuance (upfront) and certificate should be submitted to the investor. However in order to claim the withholding tax on interest, the related withholding tax certificate should be submitted to the Department of Inland Revenue by the investor.

In case of secondary market transactions, the investors are unable to claim the withholding tax, which they are entitled to claim for the tenor held since they don't have the withholding tax certificate. The initial investor is having the WHT certificate, which is not transferable. This has become a barrier to active secondary market transactions, which situation should be remedied.

Apart from the above, it was noted that in case of companies which are engaged in trading of corporate debt securities as a major (core) business, are not in a position to set off the withholding tax (WHT) paid against the income tax liability at the end of year. **The WHT paid on behalf of corporate debt**

securities are always higher than the income tax liability due to lower net interest margin and substantial volume of operating overheads, which are deductible for the income tax purpose. Hence WHT recoverable balance is being accumulated for a long time (annually). On the other hand this leads to impair the companies' liquidity position because substantial portion of cash flow is tied up as WHT recoverable for a long period.

This can be illustrated as follows (based on the prevailing market conditions);

	<u>Rs.</u>
Interest income on Commercial Papers for a particular year (Gross)	1,000,000
Less: Interest expenses (82.75% of the interest income)	<u>(827,500)</u>
Net interest income	172,500
Less: Operating expenses (10% of the income, assumed to be allowable expenses entirely)	<u>(100,000)</u>
Profit before tax	72,500
Income Tax @ 35%	<u>(25,375)</u>
Profit after tax	<u>47,125</u>
WHT on the interest income @ 10%	100,000
Excess Tax Paid/Tax Recoverable (i.e. Rs. 100,000 -25,375)	74,625

In accordance with the above scenario, the company should have a taxable income of Rs. 285,714.28/- (i.e. Rs. 100,000/0.35) for the year in order to claim the entire WHT paid except the effect of ESC.

- **Therefore it is proposed that the Government re-consider the ability to reduce the percentage of WHT on interest income on corporate debts to lower rate (i.e. around 2.5%) or to abolish the same.**

13.5 Pharmaceuticals Industry

The local pharmaceuticals industry has to compete with duty free imports. Obviously they cannot be competitive unless they too enjoy the various types of duty free inputs. They have been given the facility of importing their raw materials duty free but this does not cover *the machinery*.

- **It is suggested they be given the facility of buying machinery duty free as granted for their packaging material duty free by the 2006 budget.**

13.6 Packaging Sector

Chamber acknowledges the recognition given for the packaging sector in the last Budget. Chamber proposes,

- **The capital allowance of 25% on machinery import be extended for a further period of one year thus giving the industry 2 years to modernise.**

- Paper for making corrugated cartons is a raw material and hence the duty on it be reduced to what is applicable to raw materials. This was unfortunately missed last time.
- Stipulating that the annual export or deemed export sales should exceed 50% is too high for the packaging industry operating in a limited market. Suggest that it be lowered to 25%.
- TIEP scheme to include VAT too as it was with GST.

14. *Other*

14.1 Banking and Debt Recovery Legislation

- Debt recovery legislations be strictly enforced to punish those unscrupulous persons engaged in fraudulent transactions and cheque frauds. Banks too be advised to exercise care when opening current accounts without adequate references.
- Early steps be taken to effect changes to the Recovery of Loans by Banks (special Provisions Act No. 4 of 1990) in keeping with that of what is prevalent in USA where foreclosure is the last resort.

14.2 BOI Approval for New Industries

- We propose that BOI when granting approval for new industries should do so without denying the limited local raw materials to existing industries.

15. *National Identity Cards*

- Introduce the National Identity Card number as the identification number for all contributors of EPF and ETF. This will enable seasonal, temporary workers etc to claim their benefits which is now very often lost. It will also have the added advantage of keeping a track of benefits such as Samurdhi being claimed by those already employed.

Upali Samarasinghe
Secretary General/CEO

5th September 2006