Enhancing competitiveness in Sri Lanka

June 2016

Foreword

While growth in Sri Lanka has been high over the past few years, is has stemmed from non-tradable sectors (mainly construction and real estate) and is thus both unsustainable and unequitable. At the same time economic activities have been mainly focused on domestic demand. While Sri Lanka was one of the most open Asian economies in the 1970s, restrictive trade policies over the past decades have created an anti-export bias, which has reduced the incentives of local firms to export. The existing exports basket has been stale and is highly concentrated in garments and labor-intensive activities.

Shortcomings in the investment climate have limited the growth potential of established firms, while creating strong incentives for informality - which in turn has stunted private sector growth and poses a drag on competitiveness of the Sri Lankan economy. At the same time, Sri Lanka has attracted a much lower volume of FDI (as a proportion of GDP) than peer economies, reducing the ability of the country to enhance trade and improve production processes. In turn, the disappointing FDI trends stem from a host of factors, including legal and procedural obstacles for foreign investors, lack of predictability in laws and regulations, and deficiencies in mechanisms to attract, retain and integrate foreign investment.

In spite of shortcomings in the enabling environment, Sri Lanka has a vibrant, but nascent sector of highly innovative startups and export-oriented SMEs. Unleashing the potential of these enterprises requires not only addressing the investment climate obstacles, but also putting in place mechanisms to support entrepreneurship, technology adoption and better align the R&D system to respond to the needs of the private sector.

Going forward, as Sri Lanka aspires to become a higher middle income economy driven by higher added value exports, major reforms will be required in its investment climate; investment, innovation and trade policies and the efficiency of the institutions governing the activities of domestic and foreign firms.

In order to identify the most important obstacles to competitiveness in the areas mentioned above, the World Bank Group has conducted various pieces of diagnostic and just-in-time technical assistance aimed at providing details on specific reforms needed in laws, regulations and institutional arrangements. This note summarizes the main findings of this work and outlines options for implementation of reforms needed.

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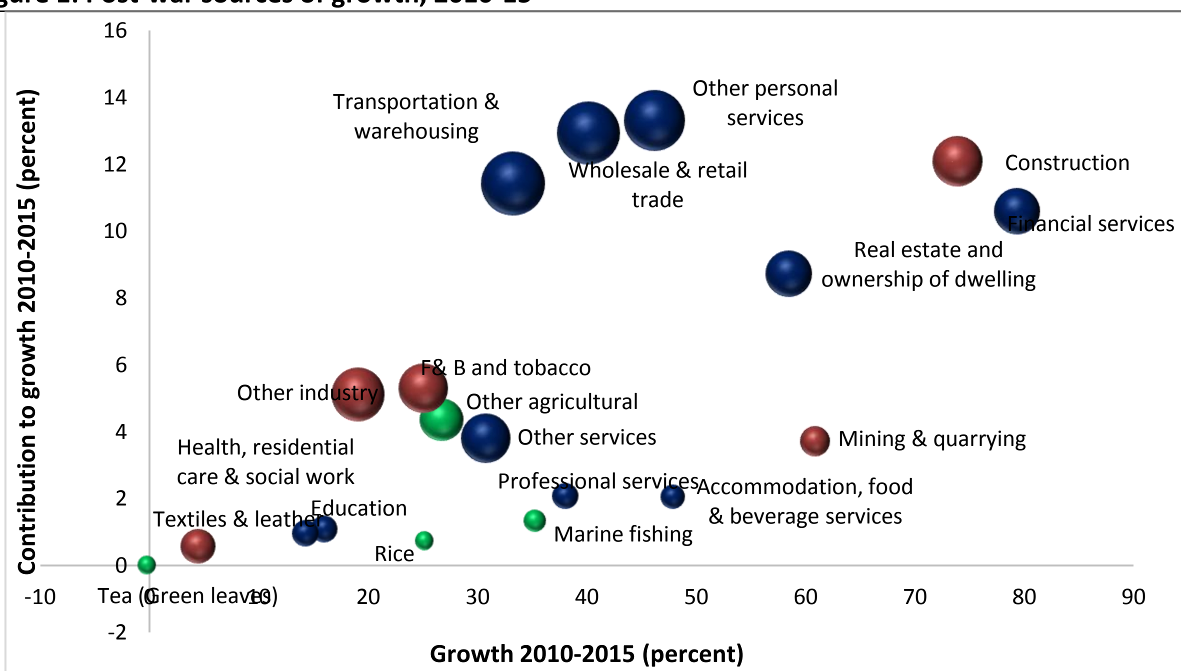
Table of contents

Introduction. Enhancing competitiveness in Sri Lanka

Sri Lanka needs to address new challenges if it is to sustain its strong record of economic growth and poverty reduction. The country has in many respects been a development success story, with average growth exceeding 6 percent and a threefold decline in poverty using the national poverty line over the past 10 years[1]. However, low productivity, high reliance on non-tradable sectors and a stale export basket highlight the need to enhance private sector competitiveness as a way to create one million new jobs.

The GoSL has recognized the need to adopt a policy agenda that strengthens the competitiveness of the country's private sector in order to achieve inclusive and sustainable growth. Recent government vision statements[2] have identified the need for a revision of trade and investment policies coupled with reforms that promote innovation, entrepreneurship and skills formation, as needed to propel Sri Lanka to upper-middle-income status. The Government's vision recognizes that while the economy has grown rapidly in the last decade, the dominance of non-tradable sectors as drivers of economic growth is unlikely to remain adequate for inclusive and sustainable growth in the coming decade. Authorities have identified the need to strengthen competitiveness not only in traditional sectors such as apparel, natural resources transformation, and tourism but also to establish the necessary conditions for a thriving knowledge economy, the integration of productive local companies in global value chains, and the attainment of higher value addition in the manufacturing sector.

Figure 1: Post-war sources of growth, 2010-15

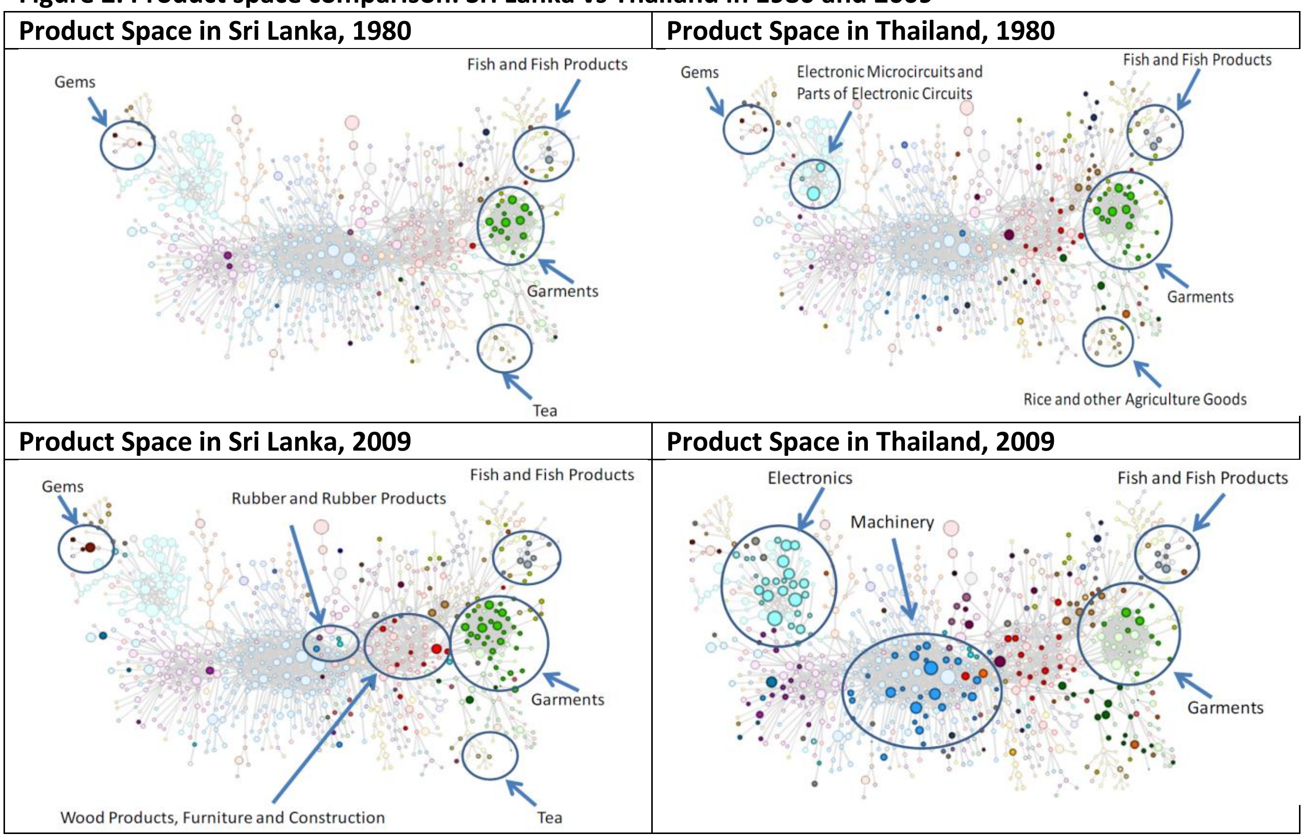


Note: Size of bubble indicates gross value added of each sector in total gross value added.
Source: DCS, staff calculations

[1] Source: World Bank, Systematic Country Diagnostic
[2] Including the Prime Minister's vision speech in November 4, 2015 as well as the speech by the Minister of Finance during the presentation of the national budget to Parliament on November 20th, 2015.

The new Government has emphasized the need to realize Sri Lanka's trade potential as a way to accelerate the transformation of the economy and generate new and more attractive opportunities for Sri Lanka's labor force. While many Asian economies benefitted from the opportunities created by trade, FDI and regional integration, Sri Lanka has largely failed to capitalize on similar opportunities. In the last few years Sri Lanka experienced significant growth in some export-oriented industries (notably garments, where the industry has moved from a commodity exports model to higher-value added production) and there are high growth companies in the nascent service sector (including information and communication technology, ICT). The dynamism of these sectors demonstrates the potential to successfully access and compete in foreign markets, but success stories remain few and relatively isolated. Exports are mainly generated by a handful of industries and there has been little change over time compared to many other Asian countries (figure 2). Moreover, Sri Lankan exports remain largely linked to low added-value labor and resource-intensive products. Exploiting the value of Sri Lanka's natural resources (both in manufacturing and services) has proved elusive: tea and rubber remain commodity industries; fisheries suffer from lack of adequate value addition capacity and mismanagement of stocks; and tourism remains a low-added value sector hampered by lack of skills and investment. The Government is seeking to shift towards greater outward orientation, particularly through the creation of an agency to develop a new trade policy (Agency for Development) and negotiating a deeper trade agreement with India while negotiating a free trade agreement with China.

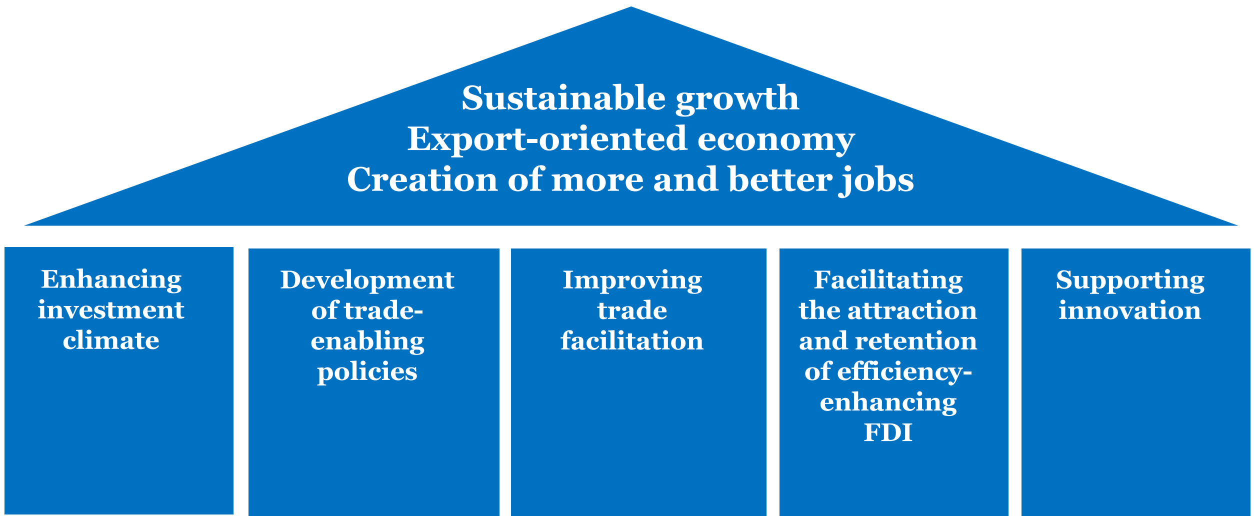
Figure 2. Product space comparison: Sri Lanka vs Thailand in 1980 and 2009



Source: Atlas of Complexity

Unleashing the competitiveness potential of Sri Lankan enterprises will require addressing a wide range of factors. These factors include basic foundations such as macroeconomic sustainability, a well-functioning financial sector; strong governance and an education system that produces the degrees and skills that in demand. Beyond those basic foundations, this note focuses on opportunities to improve areas directly impacting the competitiveness of the private sector, including streamlining the regulations governing the activities of the private sector to reduce the cost of doing business; strengthening trade policies to eliminate biases against exports; enhancing trade facilitation to reduce the costs and time it takes to export; enhancing the ability of the country to attract, retain and integrate FDI; enhancing innovation and entrepreneurship and strengthening accessibility to financial services.

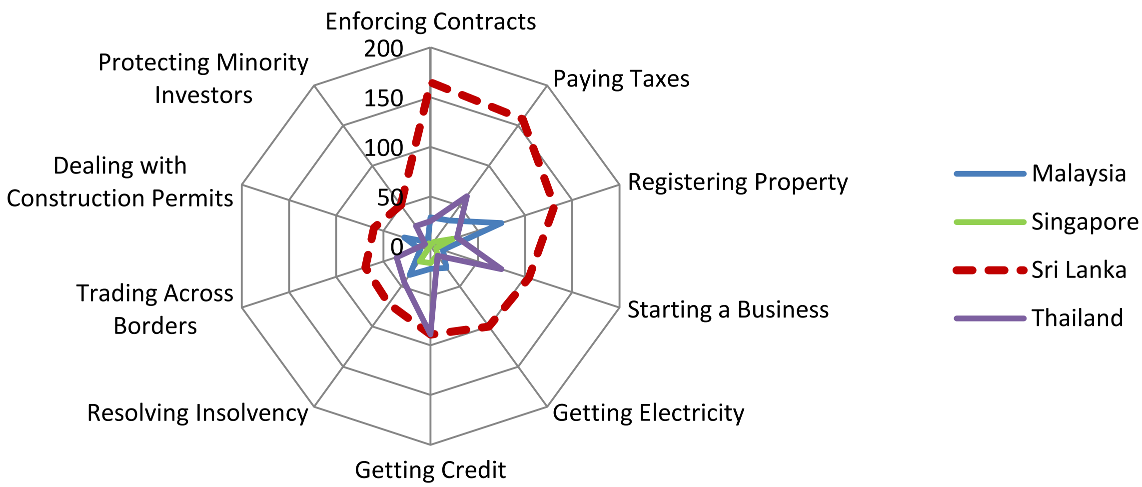
Figure 3. Factors enabling private sector competitiveness



1. Enhancing the investment climate[3]

A more conducive investment climate would help to increase the competitiveness of Sri Lanka's private sector. At the present time, the investment climate in Sri Lanka compares unfavorably to that of other economies in the region. While Sri Lanka has implemented some reforms in recent years, the pace of reform has been slower than among peers and the country lacked a clear vision with regards to investment climate as well as strategic direction to guide reform priorities.

Figure 4: Doing Business benchmarks 2016 (higher ranking implies lower comparative performance)



Source*:* World Bank Doing Business 2016

The government of Sri Lanka has recognized these limitations and identified regulatory barriers as key factors for a floundering private sector. The GoSL recognizes that entrepreneurs constantly highlight high transaction costs in in compliance of regulations, creating incentive for them to conduct business informally. This is consistent with the findings of the World Bank's Systematic Country Diagnostic for Sri Lanka, which identified governance as a cross cutting challenge noting that *the most prominent manner in which governance acts as a constraint is in how the state carries out regulatory functions for the economy*.[4]

In Sri Lanka the dense web of business regulations have multidimensional effect on business growth. High transaction costs involved with regulatory compliance discourage the creation of new firms and limit the growth of exiting firms. When the entry barriers to the market are extremely high

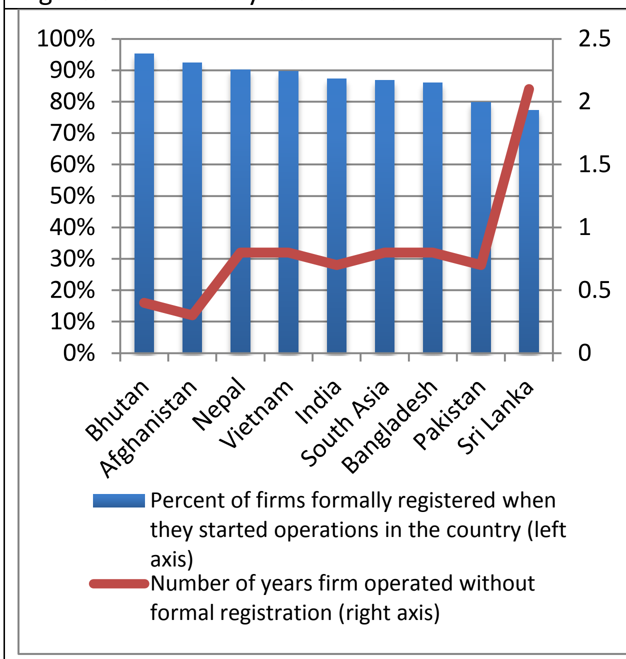
[3] This section draws from the Doing Business Reform Memorandum (2015) led by Sylvia Solf (Global Lead, Investment Climate) and Karim Belayachi (Senior Private Sector Development Specialist) and ongoing technical assistance provided by the World Bank Group.

[4] In particular, the SCD identifies systemic issues in tax and land regulation as the top governance constraints

entrepreneurs are induced to operate informally which leads to unfair competition. Informality further reduces the ability for firm growth and undermines productivity due, inter alia to limited investment, limited access to finance and inadequate business processes. On the other hand, the government too incurs high monitoring costs in its attempt to police market actors. This further leads to irregularities in the written law and its application as it will enhance government officials and politicians discretionary power with regards to market related decisions thereby paving the way for waste and corruption.

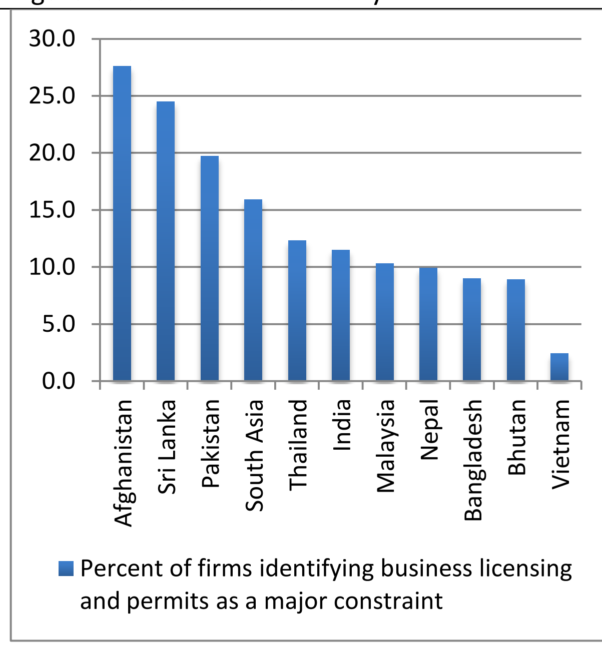
Regulatory issues created incentives for informality and affected firm productivity. According to firms surveyed[5], this is due to a large extent to difficulties in complying with regulations, fees, transaction costs and lack of confidence on regulatory agencies. This is consistent with the findings of the World Bank's Systematic Country Diagnostic, which highlighted the fact that regulatory issues have stunted the growth of Sri Lanka's formal sector, which have in turn has been a drag on firms' productivity. Indeed, informality is a major obstacle in itself for businesses' growth (for example by reducing informal businesses' ability to obtain financing). But it also has a negative impact on the economy as a whole: the growth of formal businesses is hampered by unfair competition with informal ones. In Sri Lanka, formal firms surveyed identified informality as the single most important factor constraining their growth.

Figure 5. Informality in South Asia



Source: World Bank Enterprise Surveys

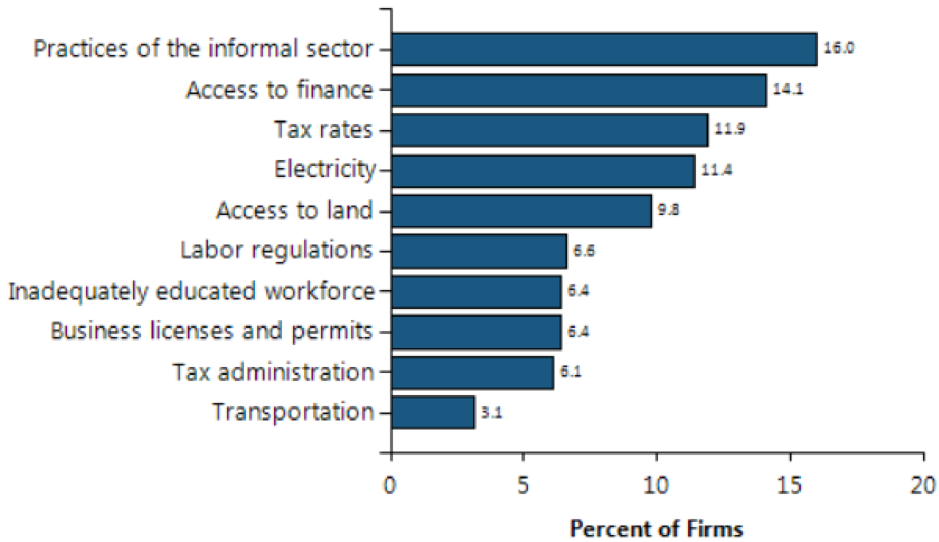
Figure 6. Obstacles to formality



Source: World Bank Enterprise Surveys

[5] Source: World Bank Business Environment Enterprise Surveys (www.enterprisesurveys.org). The latest countrywide survey was conducted in 2011. Recent consultations with chambers of commerce and private sector confirm that the findings of the survey remain relevant.

Figure 7. Major obstacles to growth



Source: World Bank Enterprise Surveys

Box 1. New license and closure fees a major step in the wrong direction

The recent introduction of Annual License Fees for private companies together with the introduction of business closure fees significantly increase the level of difficulty of the investment climate in Sri Lanka and have the potential to create major negative effects throughout the economy and significantly enhance incentives for informality.

These new fees are as follows: A) Every company registered with the Registrar of Companies (RoC) will be subject to an Annual License Fee of Rs. 60,000 for private companies, Rs. 500,000 for Publicly Quoted Companies and Rs.100,000 for other companies. B) A fee of Rs. 250,000 would be levied by the RoC for the voluntary cancelation of business registration or liquidation.

The introduction of these charges is a move in the opposite direction of that followed by the countries with the best investment climate, which have sought to reduce the costs of regulatory compliance. These fees will likely increase incentives for informality and discourage entrepreneurship in the country.

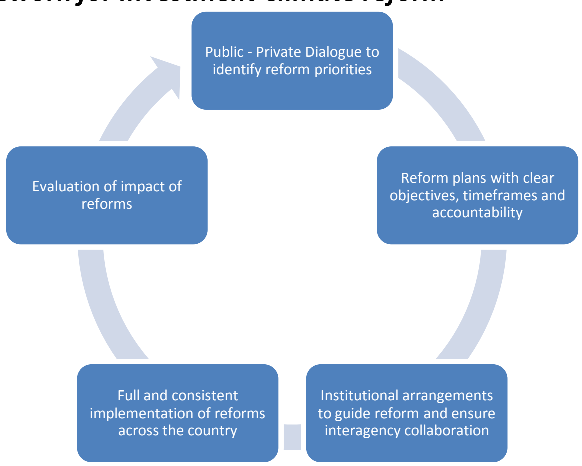
Going forward as the country seeks to improve its investment climate it will be necessary to ex ante the adverse impact to enterprises of further regulatory changes.

The way forward: An investment climate reform agenda

Enhancing the investment climate in Sri Lanka will require addressing a wide range of shortcomings across all areas of business regulation. A recent diagnostic undertaken by the World Bank[6] identified numerous areas of business regulation that currently represent unnecessary obstacles for new firms to be established and for existing ones to grow. Annex 1 includes a table summarizing suggested reforms to improve Sri Lanka's ease of Doing Business.

Addressing these obstacles will require a well-defined program of reforms with an adequate sequencing of actions and an institutional framework in place in order to lead reforms going forward. Beyond the specific recommendations, success in strengthening the business environment in the country will likely require a number of factors outlined in Figure 8 below and discussed subsequently.

Figure 8. A framework for Investment Climate reform



First, effective investment climate reform in Sri Lanka needs to be a continuous process responds to the priorities identified by entrepreneurs. While Doing Business rankings provide a useful comparative overview, it does not cover all areas of the investment climate that are challenging to enterprises. As the Government of Sri Lanka embarks in strategies aimed at facilitating the economic transformation of the country, it will be essential to develop Public-Private Dialogue to involve the active participation of the private sector in identification of the most significant obstacles to their operations as a way to prioritize reforms.

Second, investment climate reform will require the inception of well-defined plans that clarify the objectives of the GoSL, timeframe for expected results and accountability. Reforming the investment climate is a complex task as it involves revaluation of policies and procedures affecting a wide spectrum

[6] In response to GOSL's renewed interest in investment climate reforms the WBG conducted a diagnostic by identifying obstacles faced by entrepreneurs and provided a detailed set of recommendations for reforms. These recommendations covered all areas of the *Doing Business* report. This diagnostic aimed at identifying the major obstacles faced by SMEs.

of governing bodies and require inter coordination among numerous implementing institutions. Therefore, careful planning is necessary as it has the potential either to create positive synergies among stakeholders or run the risk of creating silos due to the conflicting nature of interests in some of the agencies involved**.** An ideal action plan would provide defined objectives for each identified recommendation, with specific timelines, milestones and targets[7]. Time bound objectives create a sense of urgency while providing adequate time to assess reform improvements. There are many factors in the external environment as well as in the internal environment that could affect the expected time lines of reform recommendations. Limitations pertaining to the agent's capacity such as technology barriers or limitations in human resources would not be as complex in nature in comparison to political, social or cultural factors. Therefore, the strategic action plan should aim to identify these issues and challenges in a timely manner and prepare for contingencies whenever possible. Further, responsible entities for each reform area should be identified thus creating clear accountability mechanisms. It is also essential to widely communicate the commitment of authorities towards the action plan as a mean of creating credibility for defined actions among the stakeholders.

Third, adequate institutional arrangements will be required in order to ensure inter-agency coordination. There are numerous ways to define institutional arrangements to organize reforms. However, some common characteristics and functions are evident in most of the successful reforms programs worldwide (see Box 2). Technical working groups consisting of key focal points from the public agencies related to each one of the investment climate area together with professional experts from the private sector will be responsible for developing and implementing detailed action plans by bringing in expertise where needed. These working groups will operate at a granular level by identifying feasible timelines and milestones for each reform activity. Appointment of an overall leading agency is also important who will be in charge of pursuing the reforms and formally accountable for results. This layer would be responsible for determining overall reform priorities and setting key performance indicators while having direct link to the prime minister or the president to unblock implantation barriers, obstacles and delays in a timely manner. Another very crucial element binding these two institutional arrangements together are the secretariat or delivery units consisting of technical staff of relevant reform climate areas that would also have direct reporting lines to the Prime Minister. This layer would liaise among the technical level working groups, steering committee and the Prime Minister and would ensure the timely delivery of day to day reform activities across all areas by providing quick solutions for obstacles faced by the technical level working groups and also by escalating other issue to the responsible parties as and when needed.

Finally, evaluation of results will be necessary in order to assess the implementation quality of the reforms pursued by the government. After reforms take place in paper, the full and consistent implementation of reforms across the country is essential in order to ensure equal opportunities for entrepreneurs in all regions. In this regard, it will be important to assess the impact of reforms in order

[7] Evaluation mechanisms will also be useful to determine the extent to which the reforms intended are on track as per the objectives laid down by the GoSL by reviewing the progress against milestones in the strategic plan. Early identification of delays by the decision makers will ensure that corrective actions are taken where necessary to address sources of delays and ensure that resources are used in the most effective and efficient manner.

to ensure that they have achieved the objective expected. Engagement of the private sector in assessing the impact of reforms will also be necessary in order to ensure that reforms have the impact intended and that their benefits are visible to enterprises and entrepreneurs.

Box 2. International experience in investment climate reform

International experience shows that countries that have successfully implemented business regulatory reform programs across a number of areas have several features in common: strong leadership, clear accountability mechanisms, an inclusive institutional setup, detailed implementation plans with measurable goals which are monitored, private sector involvement and effective communication with relevant stakeholders.

A number of governments have established high-level oversight committees that set the strategic vision and priorities for reform, maintain reform momentum, and provide the political weight for reform implementation. Technical working groups then lead implementation at the agency level. These working groups generally designate a point person and ministry to take responsibility for and lead coordination of the efforts of each group. The most successful technical committees have representatives from all key agencies involved in a particular area, as well as knowledgeable members of the private sector. The table below illustrates such different models and how responsibilities and accountabilities can be assigned at different levels.

Role	Features	Responsibilities
Steering committee	- Often public-private - Relevant ministries for investment climate reform agenda - Direct periodic reporting PM or President (e.g. monthly, every 3 months)	- Determine overall priorities - Setting Key Performance Indicators (KPI's) - Unblocking implementation obstacles/delays together with PM / President
Secretariat/ Delivery unit	- Technical staff - Direct reporting line to PM - Liaise between technical level working groups and steering committee or PM - Escalate key issues to steering committee or PM for action	- Day-to-day oversight of reform program across all areas - Monitoring of reform road-map and KPIs/ setting KPIs - Ensure agenda setting, minutes, follow-up items, timelines - Escalating issues
Technical working groups	- Key stakeholders from public agencies (e.g. focal points of relevant line ministries) - Private sector; professional experts (lawyers, IT, accountants, architects, etc.) - Frequent structured meetings (e.g. bi-monthly)	- Develop and implement detailed action plans bringing in expertise where needed (e.g. legal assessments, proposals for legal amendments, IT assessments, budget proposals) - Develop timelines and milestones; clarify responsibilities

2. Establishing trade-enabling policies[8]

Trade can be an engine of economic growth, job creation, and poverty reduction, particularly for a small economy like Sri Lanka. Sri Lanka was a pioneer in trade liberalization among South Asian countries, where export-oriented jobs were strong contributors to poverty reduction and inclusion.

Sri Lanka is less open to trade today than it was for most of the last 30 years. Before 1977, Sri Lanka's development strategy, based on import substitution, aimed to create a comprehensive welfare state. Post-1977, reforms aimed to liberalize the foreign trade regime and Sri Lanka was seen as the first country in South Asia to significantly open its borders to trade and foreign direct investment. In the decades that followed, trade of goods and services increased to 89 percent of GDP in 2000, with tea and high-end apparel exports leading the way. After the beginning of the new millennium, however, trade steadily declined to 54 percent of GDP in 2013. The decline in openness and stagnating FDI took place when the rest of the world was integrating more strongly and global trade was accelerating. Sri Lanka's world market share has consequently declined to levels last seen in the 1980s.

Overall export performance is mainly in unsophisticated product lines, notwithstanding the success of some niche companies. Sri Lanka's exports of manufactured goods per capita are only one-third and less than half of other regional Middle Income Countries. Only around one-tenth of the exports are for skill- and capital-intensive production with the rest being low-added value skills and resource intensive products. IT exports tripled between 2007 and 2014, but still make up less than 4 percent of total exports. Sri Lanka's export performance highlights the huge untapped potential in the tradable sector. It also implies that there are significant barriers holding back private creativity to realize the economic potential of Sri Lanka's relatively educated labor force. Additionally, the export product categories have remained largely the same over two decades.

While there are many factors at play, inadequate trade policies have had a major impact on limiting Sri Lanka's trade competitiveness. First, stagnating product diversification and weak export performance has come on the back of an industrial policy orientation in the past decade that does not promote competition and aims to protect domestic industry (including promotion of domestic agriculture through generous subsidies and guaranteed prices; and support for domestic industries with specific tax breaks and tariff protection). Second, a high increase in para-tariffs has created a major anti-export bias by significantly increasing nominal protection and prices of imports while; adding to trade policy complexity (the combined system of the MFN applied tariff rate and the para-tariffs has made the present import regime one of the most complex and protectionist in the world); leading to prices that distort production and consumption patterns; creating incentives for producers to focus on domestic markets rather than exports; and reducing potential for producers to join global value chains. Third, the government has been interventionist, "tilting the playing field" in many areas through a web of tax and trade policy incentives for a large number of domestic sectors and actors. Fourth, inadequate policies

[8] This section was prepared by Sanjay Kathuria (Lead Economist, Trade & Competitiveness) and Priya Mathur (Consultant, Trade & Competitiveness).

have failed to achieve objectives, while having significant negative impact. This is the case of introduction of high taxes on exports of raw materials (cesses) with the intention to incentivize value addition (with revenues from cesses supposed to be then invested in R&D for the corresponding sectors). While positive results of cesses have not been identified, they are largely deemed as having contributed to stifle exports.

Opportunities for revitalized trade

Sri Lanka is strategically located and can leverage its locational advantage of geographical proximity to the powerhouses in the world economy, and plug into their growth in order to fully unleash its own growth potential.

Sri Lanka can leverage new opportunities, as well as address fresh challenges, emerging in global trade. It is crucial for Sri Lanka to recognize the importance of harnessing regional synergies and regional value chains toward unleashing its own growth potential. This is particularly important given the slow-down in world trade and Sri Lanka's traditional export markets – the US and EU. At the same time, South Asia is now the fastest-growing region in the world, and presents a vast untapped opportunity for Sri Lanka, and other countries in the region. The new trade policy framework needs to address how Sri Lanka can best leverage opportunities provided by regional synergies, and the role that Preferential Trade Agreements (PTAs) will play in that process.

Rethinking trade policy: Reform Priorities

Exports and imports are an outcome of cross-cutting policies, including tariffs, logistics, border clearances, infrastructure and skills among others. Some of the key considerations in successful trade reform are outlined below.

Tariffs are one of several instruments that affect the trade openness of the economy. Trade policy reforms are more effective when other trade facilitation reforms - such as regulatory reforms for reducing restrictiveness of trade-related regulations and minimizing non-tariff barriers to imports, improving logistics services and reducing port clearance times - are also implemented. Welfare gains will be maximized when structural transformation (implying growth of some sectors and relative decline of others) is possible, which also requires mobility of capital and labor.

The objectives of the new trade policy should primarily consist of reducing its anti-export bias and focusing on a more neutral regime across sectors/products. The introduction of para-tariffs during the last decade has effectively doubled the protection rates (from an average MFN tariff rate of 13% to average total nominal protection rate of 28% in 2013), making the present import regime one of the most complex and protectionist in the world. Additionally, the para-tariffs' dispersion leads to prices that distort production and consumption patterns. Higher rates of protection on final products than on inputs used in their production has created an anti-export bias, since producers have strong incentives to sell goods domestically. This is particularly worrying for the agricultural sector, where high protection of import-competing crops along with fertilizer subsidies have created strong disincentives for crop and export diversification. On the one hand, the protection afforded to agriculture encourages expansion of production of import-competing crops (rice, maize). Similarly, the introduction of high export taxes (‘cesses’) on raw materials such as tea, rubber, cinnamon, coconut and spices, with the notion that this would increase value addition of exports, discourages the production of “exportables”. Trade barriers also make it difficult for firms to access world-class inputs at competitive prices, thus reducing the ability of firms to compete and integrate into Global Value Chains (GVCs) and Regional Value Chains (RVCs).

Trade policy reforms can be devised with potential revenue neutrality or even gains if imports (and exports) increase due to reforms. Sri Lanka’s low and declining tax-to-GDP ratio (10.1% in 2014) and its heavy reliance on trade taxes (49% share of import-based taxes and 18% share of protective duties in total tax revenue) complicates trade reform. However, if Sri Lanka’s trade-to-GDP ratio increased back to what it was in 2000 (89%) or even more to 160% (as in the case of Vietnam), even low tariffs could yield significant import revenues. Thus, the new trade policy, while being mindful of the impact of tariff reform on revenue and balance of payments, needs to incorporate a gradual but firm liberalization schedule, allowing time for adjustment, with a fixed phase-out schedule (sunset). It is clear that para-tariffs need to be consolidated, reduced in magnitude, and eventually eliminated, as they are non-transparent in nature and their ad-hoc imposition as an easy “go-to” for revenue generation takes away predictability, which is critical for production and investment decisions. Similarly, export taxes on agricultural commodities need to be revisited as the rationale behind them is no longer clear.

Trade policy reform needs to be complemented by improved trade facilitation. Poor trade facilitation can add significantly to costs of trading (see section 3 below). Efficient trade facilitation, along with low tariffs, is a crucial enabler to plug into global value chains, which have increasingly become the driver of global trade.

Linkages between Sri Lanka’s trade competitiveness and the country’s ability to attract and retain efficiency-seeking FDI must also be identified and exploited. In addition to boosting investment necessary for growth and providing long-term balance of payments financing, FDI can help to enhance the sophistication of Sri Lankan products and exports through introduction of new technologies and production processes. It can also give rise to positive spillovers to the rest of the economy through diffusion of better skills, technology and management practices. Finally, FDI can enhance access of Sri Lankan producers to global production networks and facilitate the development of new activities within existing value chains. Poor FDI performance has reinforced poor trade outcomes given the strong trade-investment nexus. Enhancing the ability of Sri Lanka to attract and retain FDI will require addressing a number of obstacles (See section 4 below).

Sri Lanka can use PTAs as an instrument of its trade policy, and pursue them strategically to maximize benefits to itself. While Sri Lanka is committed to multilateralism and needs to remain engaged in the WTO to safeguard its interests, it cannot ignore the fact that nearly 50% of global trade now takes place through regional, plurilateral, and bilateral trade agreements. Given that it will have to increasingly depend on the growing markets of Asia – China, India, and ASEAN – for export growth, PTAs with Asian countries like China and India need to be viewed as opportunities rather than threats, while carefully evaluating the costs and benefits to Sri Lanka from each PTA. Also, in negotiating new PTAs, Sri Lanka needs to be mindful of the lessons from existing PTAs – viz., non-tariff barriers are as important to address as tariff barriers, Mutual Recognition Agreements are critical for trade facilitation, widespread awareness campaigns are vital for information dissemination, and an effective communication strategy is essential to dispel concerns regarding PTAs.

Sri Lanka's new trade policy framework will also need to address fresh challenges emerging in global trade, such as exclusion of Sri Lanka from Trans-Pacific Partnership (TPP) and threat of re-shoring based on geographic proximity.

Given the above, it will be critical for Sri Lanka to enhance its institutional framework to meet 21st century trade challenges. The strategic trade policy framework in itself will enhance predictability of trade policy by setting the agenda for the medium term, and ensuring that the more detailed policy guidelines do not deviate from it. Beyond that, capacity building in the Government will be essential to enable Sri Lanka to effectively meet WTO requirements and negotiate trade agreements to maximize benefit to the country. A coherent and synergistic approach on trade policy will require effective leadership and coordination among the different agencies involved in trade.

Finally but not least, it would be important for the government to communicate early on about the scope, timing and sequencing, and objectives of reforms to inform stakeholders, to manage their expectations and to avoid unjustified resistance. Like for any policy reforms, the GoSL should recognize that the trade policy will lead to winners and losers, and should be prepared to listen to potential losers and to mitigate the negative impact by focusing on the welfare of workers (see box 3 below).

Box 3. A humane approach to reforms

Reforms have a differentiated impact on different segments of the economy. *Policy reform will lead to gains, which are often dispersed over time and space, as well as losses, which can be immediate*. There will be sectors, firms, and workers that will succumb to competition unleashed with the opening up of the economy and declining protection for domestic industries. However, it is important to focus on the fact that the costs will be far outweighed by the overall benefits to the Sri Lankan economy. Firms and exporters will gain access to world class inputs at competitive prices, and thus be able to breach new markets. Since trade and investment complement each other, trade liberalization will also bring FDI, which, in turn, will bring skills, technology, and foreign capital as well as access to GVCs and new markets. Most importantly, Sri Lankan consumers, whose welfare has to be given due consideration, will gain – they will have access to goods of greater variety, better quality, and at cheaper prices.

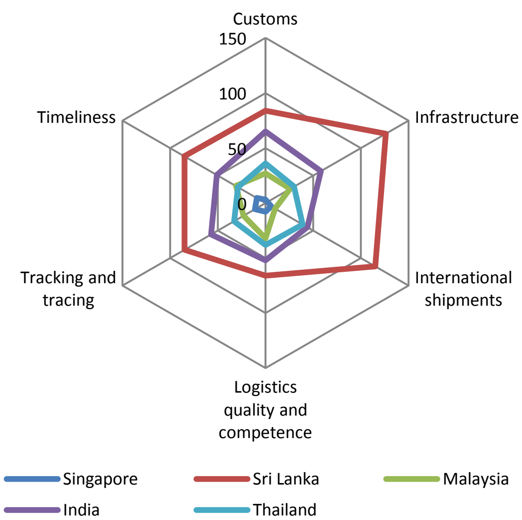
The role of the Government during the reform process will be to ensure that those who are negatively affected by reforms are not forgotten. Keeping that in view, reforms should be carefully sequenced and calibrated, but with a finite schedule, to allow time for adjustment. The phasing in period will also allow the opportunity to address cross-cutting competitiveness issues which hamper firm productivity. It will also be important to design appropriate retraining programs to facilitate movement of workers out of the affected firms and sectors. Similarly, it will be important to ensure there are business support programs that help firms, for instance, to negotiate new markets by supplying the requisite market information. Through all of this, Sri Lanka will need to be mindful that its aspiration to become a prosperous and competitive MIC, and its development vision, which entails creation of one million new and better jobs in the medium term, can be achieved only by looking outward and harnessing trade as an engine of growth, job creation and poverty reduction. The new strategic trade policy framework shall be framed with that underlying objective.

3. Improving trade facilitation[9]

The competitiveness of Sri Lanka's firms depends on their ability to get products to foreign markets in a timely and cost-effective way. Improving access to enabling infrastructure and cutting costly and burdensome trade-related procedures are essential in this regard. The Government of Sri Lanka has said that trade facilitation is a priority and that the country has the potential to reduce the gap compared to best practice countries such as Singapore. Many agencies have undertaken reforms and investment has been focused on improving infrastructure.

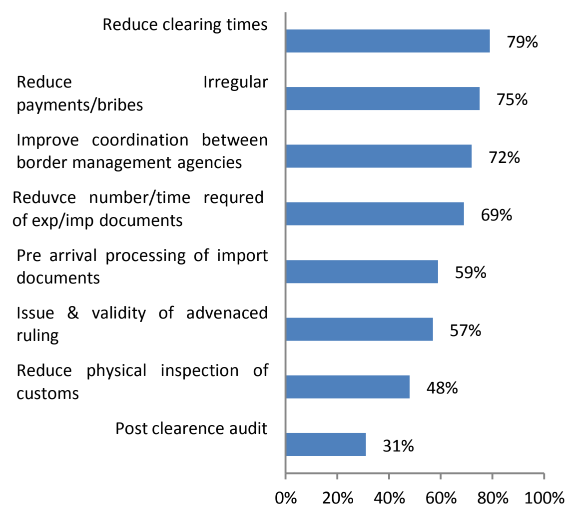
There are significant gaps between trade facilitation practices in Sri Lanka and benchmark countries in Asia. The comparison of all areas related to trade facilitation (see below) highlights the need for improvements not only in infrastructure, but also on regulatory processes that cause unnecessary delays for traders and erode the competitiveness of local producers relative to exporters in neighboring countries. Elimination of some regulatory and procedural hurdles would be a cost-effective way to quicken Sri Lankan producers' access to foreign markets.

Figure 9: logistics Performance Index (2013)



Source: World Bank Logistics Performance Index.

Figure 10: high priority areas related to rules/procedures for imports/exports



Source: IPS Survey (2014).

Bureaucratic bottlenecks give rise to high trade transaction costs. Policy induced barriers account for nearly 70 percent of the total time spent on exporting or importing goods. The preparation of documents is the most significant component, absorbing more than 50 percent of the time spent on import or export procedures. Traders and agents face critical delays as round-the-clock processing of documentation and clearing of goods is yet to be implemented. This results in scheduling conflicts and

[9] This section draws on the report "Sri Lanka–WTO TFA Validation and Reform Map" prepared by the World Bank Group in September 2015.

costs are exacerbated owing to penalties charged for demurrages and changes to logistics scheduling. Reform efforts have met with resistance.

Inter-institutional linkages are weak, leading to processing delays. The introduction and upgrade of the ASCYUDA system at the Sri Lanka Customs Department has been an important though delayed step towards reducing transaction costs and processing times. The failure to fully integrate the 30 government agencies involved in trade facilitation into a single window facility undermines the reforms undertaken as delays and manual processing still occur upstream, i.e. before traders and agents submit the final documentation electronically to the Customs Department.

The regulatory framework governing the trade regime in Sri Lanka is complex and has a significant anti-export bias. The existence of separate processes for Board of Investment companies and non-Board of Investment companies, onerous documentation requirements, and the failure to update customs ordinance, increase the complexity of the regulatory framework governing trade.

There are also significant shortcoming in trade regulation and border management. The proper management of goods passing through borders is critical for trade facilitation as it eliminates avoidable delays and enhances predictability in border clearance.[10] However, in Sri Lanka there are significant shortcomings affecting the effectiveness of border management, including lack of sufficient coordination between government bodies. At the same time, measures put in place at the time of the armed conflict, requiring review of 100 percent of shipments are still in place, further adding to delays and costs. The implementation of a risk-based approach to border management would likely result in significant increase in efficiency.

The lack of automation of border management systems reduces the efficiency of trade facilitation. At the present time, many of the trade-related processes remain manual and paper-based, with significant duplication of documentation required by different agencies. Systems automation and the use of IT in import and export processes can lead to reductions in paperwork and rent seeking opportunities. While *automation* has been introduced by Customs through implementation of ASYCUDAWorld[11] as its Customs processing system, all the various agencies that are involved in import and export processes are not connected to the system. Similarly, establishment of a single window facility and electronic data interchange (which would reduce the delays associated with the preparation of documentation by cutting the number of documents required and streamlining interagency transfers)[10] has been identified as a significant need.

[10] World Bank (2014) *Logistics Performance Index Report*, World Bank.

[11] ASYCUDA is a computerized customs management system which covers most foreign trade procedures. The system handles manifests and customs declarations, accounting procedures, transit and suspense procedures. The ASYCUDA software is developed by UNCTAD.

[10] de Mel S etal (March 2011)"What is the Cost of Formality? Experimentally Estimating the Demand for Formalization", presented at the World Bank Conference on "New Ideas in Business Growth: Financial Literacy, Firm Dynamics and Entrepreneurial Environment".

The dissemination of information related to new procedures needs to be improved. The majority of customs procedures are lodged manually, despite the availability of an electronic system.[12] Creating awareness among traders and agents of the electronic system in place is critical. Training, help desks and the gradual introduction of new procedures are needed to the smooth the transfer from manual to digital procedures.

Towards a long-term reform agenda for trade facilitation

The GoSL has recently adopted a commitment towards a long-term agenda for trade facilitation. In May 2016 the GoSL ratified their commitment to the World Trade Organization Trade Facilitation Agreement (WTO TFA), a major step in setting up a foundation for trade facilitation reform. The WTO TFA provides a framework for the implementation of simple, transparent trade procedures that enhance trade facilitation, and its ratification will signal to domestic and international stakeholders the GoSL's strong commitment to the reform and modernization of its trade facilitation regime The TFA sets forth a series of measures for expeditiously moving goods across borders inspired by the best practices from around the world. Once implemented[12] the TFA is expected to reduce total trade costs by more than 14 per cent for low-income countries and more than 13 per cent for upper middle-income countries by streamlining the flow of trade across borders[13]. Inefficiencies in areas such as customs are roadblocks to developing countries' integration into the global economy and may severely impair export competitiveness or inflow of foreign direct investment.

The ratification of the WTO TFA can be an effective platform for a first wave of reforms that target core bureaucratic bottlenecks. The WBG recently conducted a diagnostic, which identified specific areas for improvement in trade facilitation in Sri Lanka. The diagnostic analyzed key elements of Sri Lanka's trade facilitation environment on the basis of an evaluation of its alignment with the articles of the WTO TFA. The diagnostic covered a number of areas including institutions; processes, procedures, and operations; laws and regulations; information technology and automation; capacity building, training, and human resources; facilities; analytical areas; information dissemination and communication and; strategy and policy. Within each one of these areas, the diagnostic provides specific recommendations for reform (see Annex 2 for a summary of reforms).

[12] Weerakoon D and Perera N (2014), "The Role of Sri Lanka in Enhancing Connectivity between South Asia and Southeast Asia", ADBI Working Paper Series, ADBI.

[12] The Trade Facilitation Agreement was adopted by the General Council in November 2014 to bring the TFA into the WTO's legal framework. The Agreement will enter into force when two-thirds of WTO members ratify the TFA and deposit their instruments of acceptance with the WTO Secretariat.

[13] The United Nations Conference on Trade and Development (UNCTAD) estimates that the average customs transaction involves 20–30 different parties, 40 documents, 200 data elements (30 of which are repeated at least 30 times) and the re-keying of 60–70 per cent of all data at least once. With the lowering of tariffs across the globe, the cost of complying with customs formalities has been reported to exceed in many instances the cost of duties to be paid. In the modern business environment of just-in-time production and delivery, traders need fast and predictable release of goods. A study by Asia-Pacific Economic Cooperation (APEC) estimated that trade facilitation programs would generate gains to APEC of about 0.26 per cent of real GDP, almost double the expected gains from tariff reductions, and that the savings in import prices would be between 1–2 per cent of import prices for developing countries in the region. Source: WTO, https://www.wto.org/english/thewto_e/20y_e/wto_tradefacilitation_e.pdf

Beyond the specific reform recommendations, a significant improvement in trade facilitation will require well-defined institutional arrangements to guide reforms. In this regard, the Cabinet also approval the creation of a National Trade Facilitation Committee (NTFC) is a positive step in the right direction as it tasks the NTFC with overseeing and coordinating all trade facilitation matters in Sri Lanka including full and effective implementation of the WTO TFA[14]. Once fully operational the NTFC is expected to identify key bottlenecks and inefficiencies, provide key inputs into reform efforts to modernize trade facilitation policies, processes and reduce trade transaction costs. The NTFC will also be tasked with significantly enhancing inter-agency coordination on trade facilitation matters as well as improve dialogue between the government and the private sector.

The success of the NTFC and the overall reform agenda on trade facilitation will depend on a number of factors. First, a clear vision for trade facilitation needs to be articulated and communicated as a way to guide reforms. Second, the vision needs to be translated into a clear strategic action plan, with well-defined targets, milestones and responsibilities. The action plan needs to be drawn in full consultation with private sector representatives in order to ensure that it addresses the most critical obstacles and defines priorities accordingly. Third, the NTFC needs to have sufficient mandate to lead the reforms, which will require substantial coordination across agencies and ministries. Fourth, a monitoring and evaluation framework will be required in order to verify progress of reforms versus plans and implement corrective measures as needed.

The ratification of the WTO TFA and the formal establishment of the NTFC can be an effective platform for a first wave of reforms that target core bureaucratic bottlenecks. Reforms that can be achieved in the short to medium-term include the following:

i) Implementation of a *coordinated border management policy and strategy* that allows for a more coordinated approach to management of the import and export processes and related requirements by all involved government agencies.

ii) Full implementation of the ASYCUDAWorld system with electronic linkages to all relevant regulatory agencies

iii) Implementation of a national electronic single window facility for trade

iv) Adoption of a systematic and effective *risk management system* needs to be adopted,

v) Creation of a *single trade information portal* to help meet the informational needs of businesses more easily by aggregating all relevant requirements and processes from the more than 30 agencies are involved in import and export processes.

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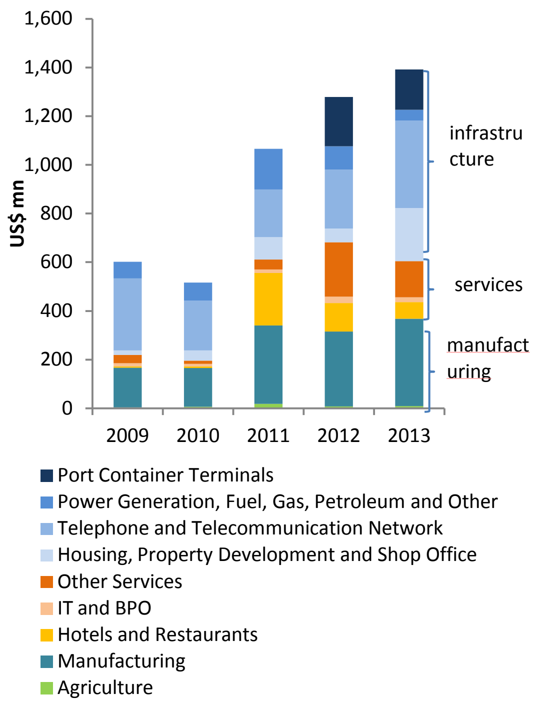
[14] As a WTO Member, Sri Lanka will be required to implement the WTO TFA once it comes into force (expected in early 2016). As per article 23.2 of the Agreement, Members must establish a National Trade Facilitation Committee to oversee and coordinate implementation of the Agreement. Article 23.2 states that WTO Members “shall establish a committee to establish and/or maintain a national committee on trade facilitation or designate an existing mechanism to facilitate both domestic coordination and implementation of the provisions of this Agreement”.

4. Facilitating the attraction and retention of efficiency-enhancing FDI[15]

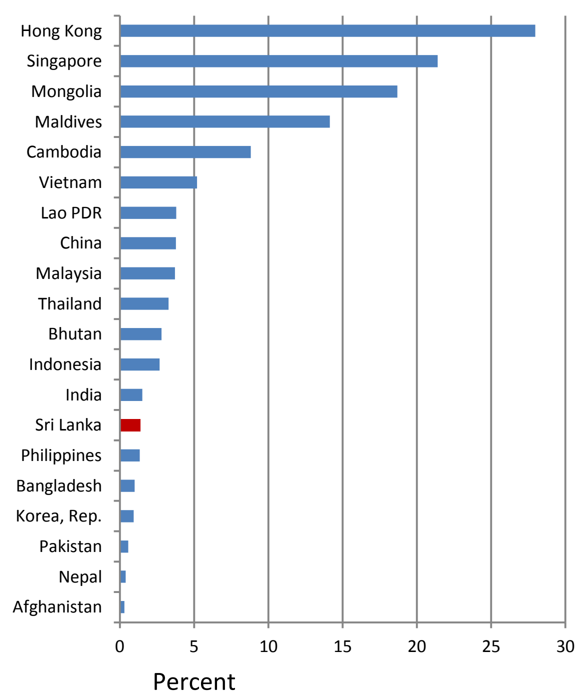
FDI into Sri Lanka has been lower than in peer countries despite its location and access to major markets. FDI inflows have been focused on infrastructure, with only a relatively small proportion reaching sectors of the economy that are associated with global production networks. Greater FDI into such sectors would enhance the access of Sri Lanka's producers to global production networks and facilitate the development of new activities within existing value chains, thereby increasing added value in production.

Figure 12: composition of FDI



Source: Board of Investment, World Bank.

Figure 13: FDI net inflows in 2013 (percent of GDP)



Source: World Bank WDI.

Attracting FDI is a necessary condition for the economic diversification that Sri Lanka aspires to achieve. FDI can be an important driver of the country's economic growth and diversification by bringing in new capital and new technologies, by creating new jobs and shifting the work force from lower into higher value added jobs; and by imparting skills and knowledge spillovers to the workforce and local firms. FDI is also an important vehicle for connecting the domestic economy with the international private sector by fostering a wide range of opportunities for local companies to integrate into global production value chains.

[15] This section draws on technical assistance provided by the World Bank Group led by Roberto Echandi (Lead Investment Policy Specialist) with input from Priyanka Kher, Ralph Van Doorn and Persephone Economou.

However, not all FDI is the same and their impact and spillovers in the economy vary significantly. There are broadly four types: natural resource seeking, market seeking, efficiency seeking and strategic asset seeking. They do not have the same potential for positive spillovers. For example, each type of investment generates different types of jobs. Natural resource seeking investment in agriculture tends to generate mostly small-scale household/informal or low skilled jobs, while efficiency seeking investment, such as that found in automotive and IT hardware, tends to generate high skilled/technology intensive jobs. When considering investment policy it is critical to acknowledge that the factors that motivate, dissuade and affect investors are vastly different depending on the business they are in and the markets they target.

Policies and instruments to attract FDI to Sri Lanka should be guided by a clear vision on the type of FDI that the country pursues. Countries often make the mistake of designing investment policies around the type of foreign investments that they already have. As opposed to that, authorities in Sri Lanka should instead tailor policies to suit the type of investment that they want to grow and the linkages with the local economy they want to develop. To do this, authorities need to identify the types of investors that are more likely to make a positive contribution to the domestic economy. In turn, the investment policy that is developed for the country should address the specific concerns of these types of investors and facilitate generation of linkages and spillovers in the domestic economy.

Investment attraction efforts are not enough in absence of a stable foundation. Investors seek macroeconomic and political stability in the host country.[13] Beyond that, they prioritize having access to qualified staff (see figure below). Factors such as the availability of infrastructure have substantially decreased in importance in recent years. The size of a domestic market has also become less important for foreign investors, relative to the premium they put on efficiency and links to global markets.

The views of global investors offer insights that can be used to determine the priorities for policies and investments aimed at attracting and retaining FDI. They also highlight the fact that the ability of Sri Lanka to become a destination of choice for efficiency-enhancing FDI will require much more than investment in infrastructure and incentives for investors.[14] Sri Lanka can leverage its economic and political stability, but additional factors will also need to be improved, including:

a) minimizing uncertainty and fostering investor confidence through certainty on policies and regulations;
b) eliminating unnecessary regulatory and policy obstacles to FDI;
c) investing in education to ensure that the population (and especially the youth) has the skills demanded by efficiency-enhancing enterprises (see below);
d) creating a level playing field that fosters competition and eliminates preferential treatment for specific public or private players; and

[13] Multilateral Investment Guarantee Agency (2013) *World Investment and Political Risk 2013*, Multilateral Investment Guarantee Agency.

[14] While many countries have sought to attract FDI through offering incentives to investors, research has demonstrated that incentives alone can be insufficient to attract efficiency-enhancing FDI, retention of FDI is low as incentives pose a significant fiscal strain and investors often switch investment destinations when incentives dry up, and fixing enabling environment deficiencies can be more effective than offering incentives to cover for such deficiencies.

e) establishing a well-functioning financial sector that can contribute to the development of local firms in the ecosystem around foreign enterprises.

Figure 14: main obstacles to FDI

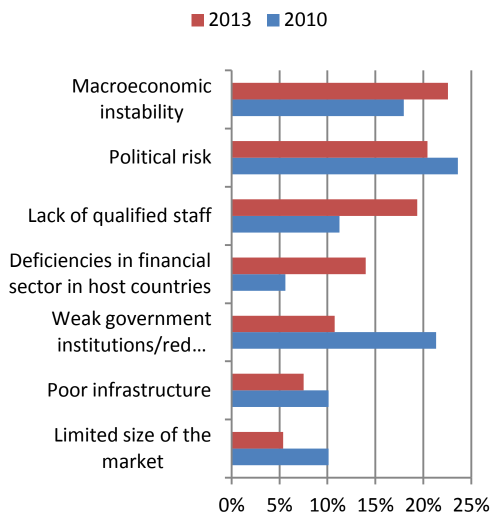
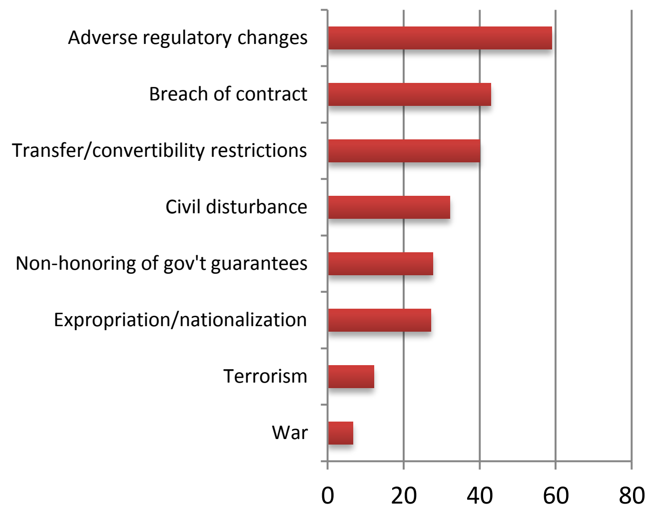


Figure 15: top Political Risks from 2012-2013



Source: MIGA (2013) World Investment and Political Risk Report, IBRD/World Bank.

Minimizing uncertainty and fostering investor confidence will support greater FDI into Sri Lanka. Governments have a major role in building investor confidence through ensuring predictability and consistency in regulations that govern the activities of foreign investors, as well as protecting investor rights and ownership. Arguably, this confidence is important in attracting efficiency-seeking investors, whose business models depend on productivity and reliability of production – which can be easily disrupted by regulatory changes – rather than on cheap access to natural resources. Actions such as the nationalization of private property[16] in 2011 and the passage of a Land Act forbidding the purchase of land by foreign firms and individuals with retroactive application[17] unnecessarily undermine investors' confidence in the country as an investment destination. Going forward, close consultation with the private sector will be necessary in order to minimize the negative impact and uncertainty from policy changes.

Eliminating regulatory and policy obstacles help to increase FDI. Although most countries in the world seek to attract foreign investment, very few countries maintain an entirely open investment regime. A country can close or protect a sector for legitimate security or cultural reasons, or instead, may use

[16] Through the Underperforming Enterprises and Underutilized Assets Act No. 43 passed in November 2011 the Government nationalized 37 enterprises many of which had foreign investment. The wording of the law provides for a 'competent authority' to administer 'underperforming' assets, although the criteria for definition of underperformance was considered vague.

[17] Land (Restrictions on Alienation) Act effective from 1st of January 2013 prohibited the acquisition of land by foreign individuals and companies with 50% or more foreign ownership. The Act created significant uncertainty to companies through two provisions: a) The Act stipulates that companies with less than 50% foreign ownership can acquire land, but must retain the shareholding mix by at least 20 years (within which term foreign ownership above 50% would make the land acquisition null). B) the Act has a retroactive effect for the 22 months before enactment, thereby affecting investments already undertaken.

protectionism as a substitute for regulation (see table below). These limitations damage the ability of the country to attract FDI, and especially efficiency-seeking FDI. Natural resource-seeking and market-seeking FDI can compensate for the cost of dealing with barriers by getting cheaper access to natural resources or increasing the product prices in local markets.

Table 1: typology of entry barriers to FDI

Typology		*Types of barriers*	*Examples*
***De Jure* Barriers** *Barriers in the legal framework*	**Substantive barriers** Policy decisions on FDI	Prohibition of foreign investment in certain sectors	A country may prohibit FDI in the retail sector by regulating that only companies owned and controlled by nationals can own supermarkets or department stores
		Restrictions on top managerial personnel	A country may restrict the appointment of foreigners to the board of directors and/or to executive-level positions
		Discriminatory licensing requirements	A foreign investor may be required to meet additional conditions in order to get a license to operate (in comparison to a domestic investor)
	Procedural barriers Processes and documentation requirements	Obtaining investment approval	A country may require several different agencies to sign off on investment approval, causing increased time and costs
		Registration or notification of investment	Registration or notification requirements may require detailed, forward-looking information that is time-consuming to prepare
		Obtaining a work permit or visa	Work permits applications may be onerous and lengthy, and may impose restrictions on staff mobility
		Opening a bank account in a foreign currency	Documentation required to open a bank account may be costly to collect and slow to process
		Miscellaneous procedures	A country may require that certain foreign documents be certified or notarized before they can be recognized for establishment
***De Facto* Barriers** *Barriers on the ground*		Lack of enforcement	Substantive laws and regulations of the country may be adequate; however, they may not be effectively implemented and enforced.
		Excessive discretion	Certain informal practices may creep into the system, increasing the costs to the private sector and reducing the efficiency of the FDI Entry Framework

Articulating an investment policy to guide the country's efforts

Sri Lanka needs to develop a well-articulated and coherent Investment Policy, clarifying how the country can use investment to better insert itself into a globalized economy and achieve the development goals of the country. At the present time investment, trade and other policies relevant for investment in Sri Lanka are not fully aligned and compatible. In addition, currently Sri Lanka does not have a modern umbrella legal framework clarifying in a single instrument the roles of the different agencies interacting with investors as well as the specific guarantees applicable to both domestic and foreign investors[18]. Further, the lack of a clearly defined and comprehensive monitoring and evaluation (M&E) framework prevents authorities from assessing whether policies being implemented actually reach the envisaged results.

Such Investment Policy could focus primarily on how to better attract, enable the entry, retain and link efficiency-seeking FDI with the domestic economy (that is, export oriented FDI using Sri Lanka as part of international production processes within global value chains). As part of this process, other types of FDI, such as market-seeking investment in certain services industries, key to enhance the competitiveness of the Sri Lankan economy should also be envisaged. Formulating such an Investment Policy through an internal consultation and collaborative process, could be an important tool for

[18] The BOI Act focuses predominantly on the structure, roles and responsibilities of BOI and does not explicitly address FDI

applying the Government's vision regarding FDI in a consistent manner and would help in streamlining institutional processes and linking the overall policy environment that impact investment.

An Investment Policy should be supported by a state-of-the-art investment legislation designed according to international best practices. Such legislation should clearly articulate the institutional structure, roles and functions of the relevant agencies as well as explicitly differentiate between two key different government functions: investment regulation on the one hand and investment promotion on the other. Further, it should level the playing field between foreign and domestic investors by providing the latter with the high level of protection provided by international standards. The Investment Law should be an instrument to enhance investors' confidence, while signaling the Government's renewed commitment to attracting and retaining investment.

The creation of the Agency for International Trade provides a good opportunity to lead investment policy related issues. Under the guidance of this agency, investment policy could be coordinated with other key government areas –for instance trade, labor and environment, in such a way that different ministries and agencies could better understand their specific roles, functions, obligations and lead to a more articulated investment policy implementation.

The effectiveness of the Investment Policy should be assessed through a monitoring and evaluation (M&E) framework. It is necessary to develop such M&E framework with clearly defined and monitored metrics and performance indicators. With an M&E framework, the Government would be in a position to undertake quantitative and qualitative analysis on the contribution of FDI to the country's economy and development objectives. Such M&E framework could measure whether reforms are actually leading to impacts on key policy objectives, for instance, investment generated, investment retained, the effectiveness of incentives and whether FDI is generating linkages and jobs.

Strengthening investment promotion

Investment promotion is undertaken by the Board of Investment (BOI), but its effectiveness may have been undermined by competing institutional tasks. BOI is a large institution with a wider range of functions than peer organizations in Asia. The size of its staff stems from the fact that BOI undertakes a wide range of functions including investment promotion; regulatory functions; management of economic zones and trade facilitation services. In other countries these functions would typically be found in separate specialized agencies. In turn, this multiplicity of roles appears to have undermined the BOI's focus on investment promotion – to which less than 1 percent of BOI's staff is dedicated.

The effectiveness of the BOI could be improved through streamlining of both its functions and structure. Streamlining the range of functions that the BOI currently delivers could help the institution to focus on FDI attraction as a strategic priority. Many of the BOI's existing functions could either be eliminated or reallocated to other more relevant government bodies. Specifically the streamlining of the current investment screening and approvals processes as described in the section of investment entry below, and the separation of regulatory and promotional functions, could be a major part of such rationalization. Reviewing BOI's staff resources and skills in the context of a new promotion strategy would help ensure that the promotion efforts are adequately staffed and can effectively deliver against agreed FDI goals.

Investment Agency	Total Staff	Functions
BOI Thailand	~ 300	Investment promotion and facilitation, administration of tax incentives, assistance to investors on the provision of visas and work permits, business Support Services (information, site visits, contacts. One stop shop investor center.
BOI Philippines	~220	Investment promotion and facilitation. Supplying knowledge-based market information, sector studies and business feasibility studies, linking investors to the services chain and matching them with foreign and local business partners. Coordinator of Invest Philippines (multi-agency initiative).
Invest Korea	~ 280	Foreign investment promotion, investor information services, aftercare services, one-on-one investor consultation services. Sector studies. One-stop Administrative Services Center.
BOI Sri Lanka	~ 1,300	FDI promotion; various regulatory functions; management of economic zones and trade facilitation services

An FDI promotion strategy should identify Sri Lanka's value proposition for foreign investors, as well as identifying clear sector priorities for proactive promotion, based on strong comparative and competitive benchmarking and new targeting methodologies. At the present time the GoSL has identified priority sectors for FDI. However, the list of priority sectors is very extensive and the articulation of what would make Sri Lanka a competitive location for investment in those sectors relative to competitor locations is not well articulated. In practice, having too many priority sectors is the same as having no priority sectors. In this context, a streamlined identification of sector priorities based on sufficient analysis will likely enhance the ability of the BOI to focus efforts and develop the required sector expertise.

Strengthening the BOI's investment promotion capacity will require strengthened institutional capacity.

More effective investment promotion efforts will require staff with relevant skills; enhancement of investment promotion processes through adoption of state-of-the-art techniques; strengthening the BOI's aftercare capacity to leverage existing investors in a way that promotes second and third generation investments; and a well-designed M&E system for investment promotion in order to assess the effectiveness of the FDI promotion efforts.

A review of the management and development of economic zones within the context of the national investment strategy can enhance their effectiveness. The model for managing and marketing the zones has remained unchanged over the recent decades despite significant changes in global markets and in the competitiveness of other countries' zones. Specifically, the lack of adequate and detailed market demand assessments, as well as a lack of assessment of supply side factors, such as availability of infrastructure, labor and utilities for each zone has made sector focus somewhat ad hoc and ineffective in many of the current zones. Similarly proactive sector-based investment promotion appears limited in marketing of the zones. A full market assessment as part of any plans to develop further zones is necessary in order to ensure that there is demand for them. Beyond that a detailed master plan to steer the development and marketing of economic zones is needed.

Streamlining investment entry processes

Discussions with the private sector[19] indicated that there are three main challenges affecting the establishment and entry of investors into the country: first, cumbersome and slow entry procedures; second, access to land and third, ownership ceilings to foreign investors in many sectors. These areas are further elaborated below.

First, even when companies decide to invest in Sri Lanka, the process for entering and establishing their operations in Sri Lanka is complex and can be very time consuming. First, the investment approval process is a key impediment. Investors investing under the normal laws of the country need to obtain an approval under Section 16 of the BOI Act and those seeking certain support measures need to obtain an approval under Section 17 of the BOI Act. While Section 16 investment approval entails a relatively short process, Section 17 process is longer and more time consuming - at times lasting several months.

De-linking the investment entry approval process from the granting of incentives can help streamline and simplify the entry process. At present, approval by BOI is required both for projects that benefit from support measures and for those that do not. However, 80% of countries[20] have eliminated entry approval process referred to as "screening" (except for certain national security related activities) and only a simple registration process exists. In Sri Lanka, eliminating investment approvals when support measures by BOI are not sought by investors, can help free up BOI's resources, reduce lead times for investment establishment and reduce transaction costs for both the government and investors. Where support measures are being sought by investors, Sri Lanka may consider further streamlining procedures to ensure that they are transparent and non-discretionary. The establishment of a One Stop Shop for foreign investors may help to reduce some of the regulatory difficulties for establishment of new investors in the country (see box 4).

Box 4. Addressing regulatory obstacles through a One Stop Shop for foreign investors

The GoSL established in May 2016 a One Stop Shop (OSS) to facilitate the establishment of foreign investment in the country. The OSS is expected to reduce lead times for investment approval by facilitating the interaction between investors and the regulatory agencies involved in approval of new investments[21]. This is a positive initiative given the fact that at present, foreign investors seeking to

[19] Based on interviews conducted by the World Bank during 2015 and 2016.
[20] Source: World Bank's Investing Across Borders Database, which benchmarks foreign investment legal and regulatory frameworks worldwide.
[21] Ministry of Provincial Councils and Local Government, Inland Revenue Department, Sri Lanka Customs Department, Colombo Municipal Council, Department of Immigration and Emigration, Central environmental Authority, Forest Conservation Department, Urban Development Authority, National Water Supply and Drainage Board, Ceylon Electricity Board, Sri Lanka

establish operations in Sri Lanka face high transaction costs and lead times to obtain all necessary approvals from multiple regulatory agencies when establishing operations in Sri Lanka[22]. In this context, a well-functioning OSS might facilitate the establishment of new investment by enhancing clarity in approval processes and timeliness of response from regulatory agencies.

One stop shops for investment entry can be an important mechanism to support investors by helping them understand requirements, navigate through procedures and institutions, and streamline those procedures. It is also an indication to potential investors of the government's interest in prioritizing and providing support.

But international experience over a number of decades indicates that it is very difficult to establish, and even more difficult to sustain successful OSSs. Many OSS have been set up worldwide but have subsequently failed due to a decline in political support, insufficient legal foundations, unclear operating procedures, a tendency for line agencies to take back their delegated staff and functions, lack of accessibility for both geographical or virtual one-stop shops. Lessons learned from global experience – including unsuccessful efforts – can inform Sri Lanka's efforts to establish a successful OSS. The following are some key considerations to enhance the effectiveness of the newly created OSS.

a) Clear strategic vision and mandate: Successful OSS have clearly identified objectives and sufficient mandate to achieve them. The mandate is a particularly important consideration given the fact that OSS usually need to interact with various regulatory agencies.
b) A well-defined legal framework: The operations of OSS often require a legal and/or regulatory foundations to operate.
c) A well-functioning operational process: rather than formalizing inefficient processes, successful OSS re-engineer processes to improve efficiency for both government and businesses.
d) Adequate institutional capacity: Successful OSS have institutional capacity (including staff and systems) commensurate with the scope and complexity of their task. Shortcomings in this capacity undermine the effectiveness of the OSS and often transform them into additional hurdles in the approval process.
e) A well-defined monitoring and evaluation framework: Successful OSS have clearly-defined key performance indicators (KPIs) that are constantly monitored versus actual results. KPIs are designed to fully reflect the expected results of the OSS. The monitoring and evaluation framework has also well-defined processes to identify and address deviations between expected and actual results.

Second, difficulties in gaining access to Land has been a critical constraint for further expansion by investors. Under the recent Land (Restriction on Alienation) Act 2014, a foreigner, foreign company or a company with 50% or more foreign shareholder is prohibited from owning land in Sri Lanka. Investors also reported that the process of leasing land in Sri Lanka is cumbersome since it involves multiple

Land Reclamation & Development Corporation, Import & Export Control Department, Land Commissioner General's Department, Department of Registrar of Companies.
[22] The World Bank conducted interviews with various foreign investors during diagnostic missions undertaken in 2015 and 2016.

government agencies, is time consuming (can take even up to a year or more) and requires payment of upfront 15% tax for the period of the entire lease.

Third, there are substantive restrictions on foreign investment which act as a deterrent to investors looking to invest larger volume of capital. For example under the BOI Act, foreign ownership in sectors such as education, freight forwarding, travel agency, shipping agency and mass communication is restricted to 40% and can be increased only upon approval by BOI. The rationale for these barriers should be revisited in light of the vision of the government for economic transformation.

Improving investment retention through enhancing investors' confidence

The lack of well-established mechanisms to address investors' grievances can have a negative impact on retention and expansion of existing investments. Investors both domestic and foreign[23], consistently report lack of regulatory transparency and excessive discretion as key constraints to their ongoing operations and investment expansion, suggesting low levels of implementation of investor protection principles provided in Sri Lanka's international investment agreements (IIAs). Consultations with the private sector further suggest that one reason for lack of implementation may be that many government agencies are not fully aware of the types of obligations they have towards investors under IIAs and other laws and regulations of the country.

The implementation of a Mechanism for Investment Retention and Confidence (MIRC) has the potential to effectively address investor grievances and enable retention and expansion of investment, as well as prevent investor-state disputes. At present, Sri Lanka does not have a mechanism (apart from legal recourse) that addresses investor grievances arising from adverse government actions. Neither does it provide aftercare services to investors. To resolve grievances private sector engages in *ad hoc* consultations with the relevant agencies. Apart from being costly for both investor and the government, legal recourse negatively impacts the relationship between the investor and the government and discourages investors from continuing with their investment in a country[24]. Retaining existing investors and encouraging them to expand operations is therefore a potentially important source of FDI for Sri Lanka that should be further leveraged. Content investors already in Sri Lanka can also be a source of good publicity for the country. Thus, a MIRC as well as general aftercare services would greatly benefit existing investors.

There is potential to strengthen the domestic legal and policy environment. Analyzing Sri Lanka's international investment commitments versus domestic laws governing FDI may reveal gaps in investor protection. A consolidated legal framework for investment can substantively upgrade the domestic legal framework by providing the same level of protection to both domestic and foreign investors. Furthermore, aligning domestic laws and regulations with the provisions of international investment agreements concluded by Sri Lanka and removing inconsistencies can help decrease Sri Lanka's exposure to the threat of international arbitration.

[23] Source: World Bank Enterprise Surveys 2011 and consultations conducted in 2015 and 2016.

[24] Anecdotal evidence suggests that certain foreign investors have cancelled expansion projects due to adverse government conduct.

Strengthening the efficacy of investment Incentives[25]

Investment incentives can be used to attract FDI to Sri Lanka. They are likely to be most influential when investors are wavering between similar options, and when a country already has a favorable investment climate. They can be used to compete for potential investors; to encourage certain business practices; and to attract investment into priority regions and priority sectors.

As Sri Lanka seeks to attract and retain more transformative FDI it will need to analyze the effectiveness and adequacy of incentives. Incentives can come at a significant fiscal cost and can disrupt market dynamics through, inter alia, the creation of an uneven playing field. The effectiveness and efficiency of tax and other financial incentives for FDI are affected by the presence of obstacles to foreign investment. Analysis of the efficiency of incentives in generating and retaining the type of investment that Sri Lanka seeks, and their effectiveness on fostering different policy objectives, can help to inform policies.

Table 2: modalities of tax and financial incentives

Tax incentives		Financial incentives	
Income tax	• Tax holiday or lower tax rate • Investment allowance • Accelerated depreciation • Special deductions • Exempted income • Exemption from withholding • Tax rebate/credit	Direct grants & cost-sharing schemes	• Cash grants on proof of start-up, or after x years of operation • Matching grants • Public sector equity participation
Value added tax (VAT)	• VAT zero rated goods • Exemption from import VAT • VAT exemption (domestic sales) • Remission from VAT	Reduced market values / direct provision of land	• Public land or buildings sold to investors at below market values
Customs duty	• Duty exemption • Duty remission	Low input prices from para-statal companies	• Reduced rates on public utilities (e.g. electricity, water) and transportation
		Lending instruments and guarantees	• Soft loans • Interest subsidies • Loan guarantees

Traditionally, Sri Lanka has relied on a variety of investment incentives to attract investment. In the past several years, the Government of Sri Lanka has adopted a number of changes to its incentives regime. Notably, in 2011, the Board of Investment (BOI) moved from providing a separate set of investment incentives to instead largely follow those offered by the Ministry of Finance under the 2006 Inland Revenue Act. Subsequently, in 2014, an amendment to the Inland Revenue Act discontinued granting new tax holidays for most investment undertakings. More recently, the 2016 Parliamentary Budget Speech made reference to new incentives to be offered including those to promote investment in lagging regions.

At the same time, Sri Lanka is facing a long-term decline in fiscal revenue, coupled with high public debt which reduces the ability of the country to continue foregoing revenue, prompting the need to rethink the role of investment incentive going forward. Tax revenue to GDP was 24% in 1978, declining to 15% in 2000 and reached 12% in 2013. Particularly in this current environment of changing incentive

[25] This section draws from findings of the technical assistance provided by Hania Kronfol (Investment Policy Officer).

policies and growing budgetary constraints, the Government of Sri Lanka has come under pressure to improve the governance of its incentives regime, and increase the cost-effectiveness of incentives in attracting investment and fostering different policy objectives. Under the recently agreed program with the IMF, the incentives under the Special Development Projects Act and the BOI Act have been suspended and will likely be derogated through amendments to these acts. The suspension of the current incentives framework presents a good opportunity to re-think the role of incentives and determine what incentives may be affordable to the country going forward and how to enhance their efficacy.

Sri Lanka's incentives regime is characterized by frequent changes to the design and types of incentives offered. Investors value predictability in a country's tax regime, particularly for establishing longer-term projections for business operations and profitability. In Sri Lanka, the incentives regime is a notably dynamic one, involving both minor and major changes over the past five years. There is a practice of updating the incentives regime on an annual basis based on priorities set out in the Parliamentary budget speech. Arguably, it is important for a country to periodically review its incentives regime based on cost-benefit considerations, a shift in government priorities, and/or changing market conditions. However, the frequency by which these changes occur in Sri Lanka, coupled with a lack of clarity, as well as of underlying economic rationale around the revisions, contribute to an unpredictable business environment for investors.

It is important to enhance the governance and administration of the incentives regime. A number of different actors may be involved in the governance and administration of incentives, without clear delineation of their roles and responsibilities. Although the Government has made efforts to unify the coordination of incentives under the sole purview of the Ministry of Finance, there remains some ambiguity regarding the role of BOI in granting distinct incentives. Notably, for example, the authority of BOI to grant tax holidays under the BOI Act and Regulation No. 2 of 2006 was never formally rescinded. Since August of 2015 (following uncertainty around the 2015 Budget), the BOI has been following these older 2006 provisions--in effect recreating an alternate incentives regime. Moreover, the BOI has traditionally played a role in developing tax packages for projects approved under the Strategic Development Projects (SDP) Act of 2008. Under this Act, projects designated to be of strategic importance to national interest, with Parliamentary approval, may receive preferential tax incentives, including tax holidays. Although the 2016 Budget Speech announced that no more projects will be approved under this Act, it is not clear whether these packages may be re-introduced at a later stage. It is important that investors are approached with a coherent incentives regime under a governance framework that supports clarity and transparency. These attributes should be codified in such a way that minimizes discretionary application, different interpretations, and frequent or arbitrary changes. While different agencies may be involved in attracting investment, their actions need to be aligned, and their roles, responsibilities and authority clearly delineated.

Similarly, the legal framework pertaining to investment incentives is complex. The Inland Revenue Act of 2006 involves a lengthy and expansive web of provisions, and includes an overlapping mix of procedural and substantive provisions. Numerous additions, deletions and amendments to the Act have made the text hard to follow and have largely obscured its original organizational tenets. Following international good practice, Tax Codes should be organized around key tax principles, and use plain and simple language, such that they are easy to understand and promote consistency in interpretation. Particularly if incentives are to attract investors, the legal details supporting these incentives (including the types of incentives offered, the eligibility criteria, and reporting requirements) should be easy to locate and comprehend.

The way forward: re-designing the incentives framework

Conducting the systematic calculations of tax expenditure, estimating the revenue foregone through the provision of tax incentives is a necessary first step. Currently these are not calculated systematically and regularly by the Government. International good practice suggests that a country's incentives regime should be reviewed periodically to include analysis of the cost and benefits of incentives. But without a coordinated system to accurately collect and review information on the revenue foregone (to include corporate income tax exemptions, Customs exemptions, and VAT exemptions), the Government will struggle to estimate the costs associated with these incentives – hampering further analysis on their effectiveness. This lack of systematic data collection in Sri Lanka is compounded by the practice in which firms receiving tax holidays are not required to file income tax returns.

Similarly, it is necessary to conduct analysis of the costs and benefits of incentives and the economic rationale for revisions to the incentives regime. While a number of changes have taken place over the past several years relating to Sri Lanka's incentives regime, these changes (and further suggested revisions) are not readily supported by an evaluation of the cost-benefit implications. As such, it is challenging to draw substantive conclusions on the extent and influence of Sri Lanka's incentives in attracting investment and fostering other policy objectives. Implications related to government revenue comprise an important part of such reviews, but it is equally important to address other objectives considered a priority by the Government, including for example, investment generated, job creation and export promotion. If Sri Lanka is to adopt a targeted and smart incentives regime that maximizes value for money, this type of cost-benefit assessment would be critical to underpin the design and application of their incentive instruments.

The Government may benefit from adopting a more targeted set of investment incentives. The Government has made efforts to limit the use of tax holidays, which are considered rather blunt instruments for attracting investment. A variety of other tax instruments, particularly those that are performance-based (e.g. linked to investment levels or jobs created) or those that promote skills or innovation may be more effective in achieving different goals across various sectors. Understanding firm-responsiveness across different activities and tailoring the incentives regime accordingly could help the Government increase their cost-effectiveness.

5. Enhancing innovation and entrepreneurship[26]

Sri Lanka is embarking on an ambitious journey of economic transformation and global integration, wherein innovation and entrepreneurship are key drivers of competitiveness. The focus of the Sri Lankan authorities is to rebalance its economic growth model to being more open, private sector-led, knowledge-intensive, and one that successfully develops and sells higher value goods and services in global and domestic markets. Three actions to enable this transition involve: (1) revitalizing export oriented small and medium enterprises (SMEs), (2) fast-tracking the formation and scaling of growth oriented start-up companies and (3) rationalizing and upgrading the research and development (R&D) sector in Sri Lanka. Each of these actions will require very distinct yet highly complementary set of initiatives to achieve the desired results. All three actions are essential elements of the economic modernization process Sri Lanka is undertaking to improve its competitiveness vis-à-vis its competitors in the global economy.

Sri Lanka's post-war economic performance is encouraging but the transition to upper middle-income status is not guaranteed. With the cessation of the protracted armed conflict, a new era of opportunity has dawned. The country's strategic geographical location, access to growing markets in Asia, high human development indicators, and human and environmental assets, position it well for the transition out of lower and beyond. However, the transition to middle-income status will be challenging. Sri Lanka is already competing against cheaper labor in neighboring low-income economies (e.g. Bangladesh, Cambodia and Laos) and with higher productivity, technologically sophisticated economies (e.g. Singapore, Malaysia and South Korea). The challenge is already apparent. Sri Lanka's exports to GDP ratio has halved in the last decade, the proportion of high value exports in total exports is very low, and the global market share of exports is declining.

Innovation and entrepreneurship offer potential for transformational impact on the Sri Lankan economy. The transformation to upper middle-income status essentially requires a transition from an economy largely driven by commodity products and relatively inexpensive inputs to production (e.g., labor) to a knowledge-intensive economy focused on developing and commercializing high value products and services. Innovation and entrepreneurship can be key in this transition as they are the source of the development and commercialization of these new products and services. This transformation would need to be driven by a growth oriented agenda that leverages:

- **Export oriented SMEs with strong growth potential**
- **Growth oriented start-up companies**
- **Industry-facing research and development capabilities**

[26] This section was prepared by a team led by Natasha Kapil (Senior Innovation and Entrepreneurship Specialist) and reflects the findings of the "Sri Lanka Innovation and Entrepreneurship Diagnostic" conducted by the World Bank in May 2016.

Enabling Export Oriented SMEs

Sri Lanka can strategically leverage its islands of excellence. Sri Lanka boasts a few important global brands, however these are relatively small islands of success within the island of Sri Lanka. The challenge is to leverage the vision, leadership, knowledge, and global networks of some of Sri Lanka's anchor firms and greatly expand the number of highly successful Sri Lankan firms selling high value added products and services globally. **One key area of focus is to enable export oriented SMEs to achieve greater success**. Traditional sectors and emerging industrial verticals could benefit from a combination of the following initiatives, including:

- Reintroducing incentives for technology adoption
- Developing channels for greater access to supply chains and international markets
- Strengthening the national quality infrastructure (NQI)
- Addressing technological skills gaps

Building linkages between the larger anchor enterprises and export oriented SMEs could be an important way to facilitate integration with global value chains and new markets. This approach enables SMEs to build their market knowledge, understand product, quality, and service requirements in international markets and pursue a growth strategy that involves both the use of existing technologies as well as development of new high value products and services.

Enabling and Scaling Growth Oriented Start-Ups

Another area of focus is to enable and scale growth-oriented start-ups in Sri Lanka. Growth-oriented start-ups are often the source of innovative business models, products and services that can have a transformative economic impact. Although Sri Lanka's progress in launching these types of start-ups is very limited, there are signs of progress and early indicators of success, particularly in the area of digital entrepreneurship and tourism.

Competitors are accelerating the innovation race by enabling their start-up communities through comprehensive ecosystem approaches. In January this year, India launched "Start-up India" program that provides three years of tax-free environment for newly formed start-ups (including an entire package of regulatory simplification and incubation activities specially tailored for start-ups). Just this month, Indian authorities announced an integrated national intellectual property rights policy to strengthen the confidence of foreign investors keen on manufacturing products with high value IP in India (a deterrent for multinationals that don't produce highly innovative products in China so as not to reveal sensitive intellectual property). Singapore, Korea, China, and many other Asian countries, have developed robust national innovation agencies that stimulate early stage innovation in start-ups via publicly funded schemes and establishment of shared infrastructure, and have also leveraged private angel and venture capital investors to finance the scaling of start-ups. If Sri Lanka wishes to attract and raise regionally or globally oriented startups it must focus on creating a simplified and enabling business environment with a supportive innovation and entrepreneurship policy mix.

Sri Lanka's policy and regulatory environment needs significant attention if it is to support the entry and scaling of growth-oriented start-ups. Actions to accelerate startup formation or improve their growth prospects include, but are not limited to:

- Eliminating the costs associated with starting up and closing an enterprise (Sri Lanka recently introduced a minimum Rs. 60,000 annual tax on enterprises and a Rs. 250,000 tax on enterprise closures that is creating substantial concern in the start-up community and could deter potential entrepreneurs from formalizing or starting altogether)
- Resolving payment gateway issues to enable swift electronic fund transfer from abroad, particularly important for new export-oriented firms with international clients
- Liberalizing labor laws to allow re-staffing of start-ups as they business models pivot
- Announcing the capital gains tax rate; uncertainty around the rate is causing consternation among start-ups and particularly their international investors
- Enabling access to early stage innovation finance, incubation or acceleration and shared infrastructure facilities
- Raising awareness around the distinct growth patterns and needs of start-ups among government agencies (e.g., Inland Revenue, Central Bank) as well as the banking sector to create a conducive environment in which the Sri Lankan start-up community can thrive.

The Sri Lankan start-up ecosystem has a globally connected heartbeat. Digital entrepreneurs typically tend to be the first movers in most nascent innovation ecosystems as the barriers to their formation and scaling tend to be lower. Sri Lanka's start-up landscape is dominated by digital entrepreneurs. Most of these start-ups are adapting proven business models to local circumstances and considering regional markets to scale. Going forward, it will be important for Sri Lanka to nurture start-ups beyond digital and enable those that are willing to take on both technology and market risk. A testament to Sri Lanka's potential is the impressive proportion of start-ups with diaspora or foreign co-founders. These start-ups are well versed with global technological trends, highly networked with investors globally and active in global markets. In short, they offer a fast track option to rebalancing the private sector landscape in Sri Lanka (beyond large anchor firms and SMEs). This is a unique opportunity for Sri Lanka to catch up with progressive countries in this important dimension of growth and take definitive actions to address the distinct needs of the existing and future start-up community.

Upgrading and Rationalizing the Research and Development Sector

For a middle-income country aspiring to embark on a knowledge based growth trajectory, Sri Lanka's expenditures on R&D are dismally low (0.16 percent of GDP), and enterprise R&D is insignificant. Sri Lanka's investment in R&D is substantially below other economies in the region (and dominated by public spend), particularly in comparison with countries like Vietnam (0.18 percent), Thailand (0.25 percent), Malaysia (1.0 percent) and India (0.81 percent). Low enterprise R&D investments put Sri Lanka at a severe disadvantage when attempting to compete with countries in the development of high value products and services, attracting R&D leaders and fostering foreign direct investment (FDI).

It's important to note, that there are small islands of R&D progress in Sri Lanka. Select private sector enterprises have demonstrated considerable success by harnessing R&D as part of their growth strategy and in order to avoid being eliminated by downward wage pressures or disrupted by global innovation trends (e.g., MAS Holdings). Further, institutions such as the Sri Lanka Institute of Nano Technology (SLINTEC) - a unique public-private partnership model that brings together an interdisciplinary set of anchor firms in Sri Lanka, Industrial Technology Institute (ITI), and the University of Moratuwa have all made considerable progress in developing R&D capabilities to deliver value to Sri Lankan enterprises. The Sri Lankan authorities would do well to celebrate the practices of these firms as examples of domestic success that can be emulated.

However, if the Sri Lankan research sector is to become relevant and provide timely innovation inputs to the private sector, the following major challenges need to be addressed:

- **Severe fragmentation of research institutions and inadequate policy environment**: There are around 44 research institutions and 17 universities in Sri Lanka. In general, there is little scientific research being conducted at global standards and incentives at the institutional and researcher level are not calibrated to incent either research excellence or relevance to societal or industrial needs. As a result, research programs are fragmented, supply driven and rapidly becoming irrelevant to private sector needs.
- **Severe underfunding of the R&D Sector***:* Given the severe fragmentation of the R&D sector and limited public funding for R&D, programs are generally unable to conduct research that is impactful. It is also increasingly difficult to attract and retain high quality research staff into these organizations and brain drain has become a major concern. Many of these institutions are already in decline and on a path to failure if the current trends continue.
- **Dominance of the Public Sector**: In most developed economies, the private sector accounts for well over half of R&D spending. In Sri Lanka, the public sector dominates R&D funding. Steps need to be taken to foster greater private sector investment in R&D and innovation more broadly. Given the limited fiscal space, Sri Lanka has a unique opportunity to reorganize its public resources to leverage firm level investments as well as public private partnership models within verticals (e.g. SLINTEC).
- **Weak Intellectual Property regime (IPR)**: There is no national intellectual property rights policy that would establish clear guidelines for the transfer of publicly funded research or create incentives for technology commercialization with the private sector. The National Patent Office also needs a complete overhaul in order to meet future demand from the private sector.

Towards a reform in innovation and entrepreneurship

Enabling innovation and entrepreneurship in Sri Lanka involves building and supporting an integrated system with many stakeholders and actors. When considering the establishment of an enabling environment, there are a number of initial steps that will be critical to success.

One of the first steps is to create a robust fast track environment for start-ups that fosters the development of enterprises focused on developing and commercializing innovative products and services based often on early stage technology emerging from public and private R&D operations. Key actions to be taken involve establishing a friendlier and more conducive IP policy, regulatory, tax and financing environment for start-up enterprises.

A second step is to enable vertical integration of SMEs in order to produce higher value products and services and facilitate access to international markets. Key actions to be taken involve enabling SME access to supportive R&D infrastructure and activities, supporting access to relevant technology available internationally, and fostering SME linkages with anchor firms and relevant global markets.

A third step is to rationalize and modernize the R&D sector in Sri Lanka. Key actions to be taken involve refocusing the R&D sector on creating value for society and the private sector (particularly in support of SME and start-up enterprise success), strengthening the IPR regime to foster the development and protection of high value technology, and consolidating the R&D sector as necessary to improve performance, increase cost-effectiveness, and build valuable relationships with the private sector.

Annex 1: Suggested reforms to improve Sri Lanka's ease of doing business

TOPIC	SHORT-TERM RECOMMENDATIONS (WITHIN SIX MONTHS)	MEDIUM- AND LONG-TERM RECOMMENDATIONS (MORE THAN SIX MONTHS)
Starting a business	• Complete computerization of records at RoC, and link database with Inland Revenue Department's tax registration database • Implement a one-stop shop (OSS) that allows new companies to register with the multiple entities involved in company registration	• Introduce a Single Identification for companies to be identifiable across databases at the different government entities • Approve and implement amendments to the Companies Act to simplify the requirements related to having an external company secretary and eliminate the requirement for a public notice of incorporation in the Gazette and newspaper • Introduce paperless online registration
Dealing with constructi on permits	• Implement full computerization of construction permitting records at CMC • Conduct comprehensive assessment of construction permitting procedures at CMC to identify current bottlenecks, and implement improved workflow	• Introduce fully operational system for electronic document submission • Introduce and fully implement risk-based inspections during construction • Implement workflow management system for filing, processing and tracking construction permit applications • Introduce service standards and accountability measures for Colombo Municipality officers • Assess potential introduction of reliable liability and insurance systems for the construction sector
Registerin g property	• Complete digitization of registration records and cadaster for Colombo, to allow for electronic records searching and encumbrances checking • Conduct an assessment to identify quality gaps in Sri Lanka's overall land governance regime	• Introduce standardized sale-purchase contracts (deeds of transfer), and consider changes to the role of notaries • Link databases related to land registration information at CMC and land registry, and introduce single window combining property transfer processes at the two locations • Make official statistics tracking property transfers available to the public
Getting	• Upgrade infrastructure at credit bureau to allow inclusion of non-financial data	• Develop credit scoring and provide it as an additional value-added service in credit

credit	(insurance, telecoms, utilities, retailers) in the longer-run
	• Approve and implement new Secured Transactions Act (2015) allowing for secured transactions in movable collateral, ensuring that it includes international best practices such as:
	  ○ Unified legal framework that extends to creation, publicity and enforcement of security interests in movable assets
	  ○ Allowing general description of assets, depts. And secured obligations
	  ○ Ensuring that the movable assets collateral registry is indexed by borrower and unified geographically, with an electronic database indexed by debtors' name searchable online
	  ○ Protecting secured creditors' rights by providing clear grounds for relief from stay and/or a time limit
		reports
		• Expand reach of credit bureau to include data from non-financial and microfinance institutions

Protecting minority investors		• Revise and amend the Companies Act of 2007 and other relevant regulations to strengthen minority shareholder rights and protections including:
		  ○ Allowing minority shareholders to access relevant company documents, and easing the requirements governing the identification of documents requested
		  ○ Requiring shareholders' approval for the issuance of new shares, and automatically granting shareholders preemption rights on new shares
		  ○ Barring CEOs from also serving as Chair of the board of directors
		  ○ Requiring that the

		compensation of individual managers be disclosed
Paying taxes	• Conduct a process-mapping exercise to simplify the current tax administration as a first step towards an efficient administration • Test run and evaluate RAMIS online taxpayer registration and filing system capabilities and gradually expend its application • Introduce periodic taxpayer perception and compliance surveys	• Simplify the Inland Revenue Act to facilitate the administration of the tax system and improve tax compliance • Simplify the VAT framework with the objective of establishing a single broad-based VAT legislation administered under a single implementation framework • Strengthen current audit practices with the objective of moving towards a functional risk-based audit system
Trading across borders	• Identify opportunities to streamline documentation requirements for export and import • Conduct a multi-agency review of trade information availability, and develop an online National Trade Portal Website • Update Customs Ordinance and other laws and regulations to allow for the implementation of best practices in processing and screening of traded merchandise such as risk management, pre-arrival processing and post-clearance audits	• Enable fully electronic, paperless submission of documents and payment to Customs and Port Authority • Fully implement best practices in processing and audits (such as risk management systems, pre-arrival processing and post-clearance audits) • Connect relevant agencies through an electronic single window
Enforcing contracts	• Develop comprehensive and verifiable court statistics to allow for the identification of causes for delays at the courts • Conduct an assessment of court processes and the legal framework to identify and address underlying causes of delays	• Use the data collected at the courts to introduce accountability measures and improve efficiency • Pass amendments to Civil Procedure Code to reduce delays for commercial disputes • Publish more detailed court data once data collection has been completed for at least a year, and make publicly available judgments in commercial cases • Introduce automated case management systems at courts • Implement good practices in use of electronic systems for filing of summons, service of process and payment of court fees such as electronic filing, electronic service of process, and electronic payment of court fees
Resolving insolvenc	• Revise and implement new Companies Act chapter to allow for restructuring of viable businesses	• Invest in the capacity of the institutions handling insolvency cases, and in regulations and training for practitioners

y	facing insolvency, and ensure that good practices for restructuring are implemented, such as: ○ Allowing the continuation of contracts supplying essential goods and services to the debtor; ○ providing for the possibility of the debtor or administrators to obtain secured and unsecured financing after commencement of insolvency proceedings, and assign priority to post-commencement credit; ○ Requiring that dissenting creditors in reorganization receive at least as much as what they would obtain in a liquidation; ○ Dividing the creditors into classes for the purposes of voting on the reorganization plan (with each class voting separately and with creditors in the same class treated equally).	• Introduce legislation strengthening creditors' rights in participating in insolvency proceedings • Explore establishing an expedited framework for SME insolvency

Annex 2: Recommendations on trade facilitation stemming from the Sri Lanka–WTO TFA Validation and Reform Map

TFA Article	Recommendations Short = < 1 year; Medium = < 3 years; Long = > 3 years Institutional (I); Processes, procedures, and operations (P); Laws and Regulations (LR); Information Technology and Automation (IT); Capacity Building, Training, and Human Resources (HR); Facilities (F); Analytical (A); Information Dissemination and Communication (C); Strategy and Policy (SP)
1.1 Publication	Short • Review all publications produced by border agencies and in consultation with the business community; identify and fill gaps in available information. (P) • In consultation with the business community, identify easily accessible points for obtaining publications dealing with processes, fees, penalties, and appeals. These points should typically be the enquiry points; see 1.3. (A, P) Medium • Ensure all laws, regulations, directives, and procedures involving all border agencies are published and made easily available to the public in Colombo and in other major towns. (I, P, F) • Review agency facilities and resources, including staff numbers and training, to successfully deal with increasing volumes of information requests. (F, HR) • Issue clear guidelines on time lines for publishing information and answers to queries. (L) • Clarify with the AG's office concerns over 1.d, e, and h, and articulate a clear plan of action to mitigate issues. (L, P)
1.2 Information Available through Internet	Short • Clarify and ensure legal requirements exist or promulgate the need to have all laws, regulations, orders, guides, and forms to be made available on the Internet. (SP) • Review the management, operation, and content of the Customs website to ensure that information is comprehensive, easily accessible, and current. (P, IT) • Develop and provide long-term support for a query-based, user-oriented trade information portal that contains all trade-related regulatory information. The decision to develop a national trade portal has not been made, and consequently the design has not yet been determined nor have the procedures, roles, and responsibilities of stakeholders been defined. It is recommended that design and implementation of any future national trade enquiry portal should be aligned with international best practices. (Background and additional guidance on the trade portal principle and benefits can be found at the World Bank's site under "Developing a

	Trade Information Portal." These have been implemented in the Lao People's Democratic Republic and Lesotho.) (I, L, P, IT, HR) Medium • Provide support to ICTA to further develop and implement e-government services in the trade-related agencies. (I, IT)

1.3
Enquiry Points
	Short
	• A feasibility study should be undertaken to ascertain the following (A):
	  ○ If it would be appropriate to expand the One-Stop Shop representation to include more border regulatory agencies
	  ○ If the current enquiry points have the capability to adequately provide trade information
	  ○ The need to provide more enquiry points both in Colombo and in the regions (single versus multiple enquiry points, agency or agencies to host and participate, staffing needs, modes of operation, information to be provided)
	• Publish guidelines and time frames for provision of information in response to enquiries from the public or business community
	Medium
	• Enhance the number, motivation, and training of staff dealing with enquiries in all agencies to deal with a wide range of information in a timely manner. (I, HR)
	• Define required procedures, and roles and responsibilities for collection and coordination of information and operation of the enquiry point. (P)
	• Provide IT and material support as required. (F, IT)
	• Provide training and public outreach (HR, C)
	Long
	• In the long term, establish a South Asian Association for Regional Cooperation (SAARC) enquiry point that would be capable of giving trade informational for all its members. (I, F, HR, L, SP)

2.1 **Opportunity to Comment and Information before Entry into Force**	Short • Develop standard operating procedures (SOPs) for obtaining stakeholder comments and input on government proposals which will apply to all agencies. (P, I, C) Medium • Implement a legal requirement to mandate a statutory period for consultation with stakeholders and information on any changes prior to their entry into force. (L) • Implement a legal requirement to mandate government to allow a specified grace period between the passage of laws, regulations, and policies and their entry into force. Publish new or amended laws and regulations of general application as early as possible before their entry into force. (L)

2.2 Consultations	Short • Develop SOPs for consultative fora. (P) • Review the membership, terms of reference, and key agenda items of the National Trade Facilitation Committee (NTFC). (P, I) • Publicize the terms of reference and information for the NTFC within the business community. (C) Medium • Provide the necessary legal requirement for regular consultations with stakeholders. (L)
3. Advance Rulings	Short • Develop an advance ruling system for determining the origin of imported goods. (P) • Ensure appropriate staffing and equipment for staff who provide advance rulings, and provide them with suitable training. (HR, F) • Develop a communications strategy to ensure the business community is aware of the advance ruling process and the benefits it provides. (C) • Support allowing rulings on all matters covered under paragraph 9(b) of the article. (SP) Medium • Include the provisions of this article in any revision or amendment to the Customs Ordinance. (L)
4. Procedures for Appeal or Review	Short • Ensure there is a legal basis for Customs appeals in line with international best practice—within the agency, through an independent tribunal, and through judicial review (L). Medium • Review appeals procedures for other border agencies, in consultation with the business community, to ensure procedures are fair and effective. (A, C, P) • Ensure there is legal basis for appeals in all other agencies. (L)
5.1 Notifications for Enhanced Controls of Inspections	Medium • Implement a common risk-based methodology across all related agencies in regard to the issuance of notices for controls and inspections. (I, SP, P) • Ensure all enhanced controls are included and removed from the risk management system promptly. (I, LR, P) • Develop and implement a system for issuing and canceling special (enhanced) alerts. (IT) • Develop connectivity between border control agencies, and enable the issuance of notifications and alerts under any single-window project. (IT, P, HR)
5.2	• Program ASYCUDAWorld to include a “detention notice” that will indicate that the

Detention	goods are being detained and the reasons for detention. (IT) • Formalize the process and procedure for communication to importers of the detention of imported cargo. (P, C) • Ensure all government agencies have appropriate legislation in place authorizing the detention of cargo. (LR)
5.3 **Test Procedures**	Short • Identify any legal gaps on second tests in all border agencies conducting tests. (L) • Put in place procedures to ensure that independent testing is available in the event of appeals. (P) • Ensure that the "right to a second test" procedure, the list of laboratories, and other information is made publicly available through the trade portal. (IT) • Review all aspects of the availability, legal provisions, procedures, publication, and accreditation of laboratory testing for imports and exports, with a particular focus on the provisions for appeals and second tests. (A, L, P)
6.1 **General Disciplines on Fees and Charges**	Short • Review all fees to ensure compliance with the WTO; i.e., limited to cost recovery and not ad valorem. Eliminate any fees that are no longer necessary. Implement recommendations from the review. (I, L, P, A) • List and publish all fees and charges in one consolidated document that is made easily accessible on the Internet and the trade portal. (IT)
6.2 **Specific Disciplines on Fees and Charges**	Short • Ensure fees are charged only for services provided. (L) • Review all Customs fees to align them with the requirements of the article. (L) • Consider reviewing the fees of other agencies, including the SLSI. (SP, P)
6.3 ***Penalty Disciplines***	Short • Ensure all penalty schedules, guidelines, and procedures are published on agency websites and available in print from enquiry points. (C) Medium/Long • Review the penalty system to ensure it is in line with TFA obligations and best practice. There are implications for overall institutional reform (see cross-cutting issues). (P, L, I) • Introduce legislation to support the current Customs administrative penalties regime (support would be required). (LR) • Review the current Customs ordinance and update the provisions to reflect WTO and other international standards, to remove inconsistencies, and to ensure that penalties are imposed only on those responsible for a breach. (LR) • Abolish the current reward schemes and/or replace them with others that comply with the TFA requirement. (LR, I, HR)
7.1 ***Pre-Arrival***	Short • Formulate proper legal provisions to address pre-arrival processing. (L)

Processing	• Revise relevant laws and procedures to eliminate the dependency on original bills of lading and delivery orders to initiate processing and clearance. (L, P) • Develop SOPs for Customs' use and guidelines for traders' use to ensure consistent application of pre-arrival processing procedures. (P) Medium • Undertake consultations with all stakeholders in the border agencies and the business community to ensure the system is implemented effectively and provides for the advance issue of import permits. (I, C) • Undertake a sensitization program to ensure the business community has a greater understanding of the benefits of the process. (C)
7.2 Electronic Payment	Short • Accommodate multiple private sector banks in the electronic payment system. (L, P, I) Medium • Develop policy and/or legislation to allow payment of duties, taxes, and fees online and/or by credit and debit cards. Consider amalgamating clearance-related charges into a single payment (for example, through Customs). (I, SP) • Ensure that the legislation for all border regulatory agencies clearly allows for the electronic payment of all fees and charges related to international trade. (L) • Mandate that all border agencies implement electronic payments for fees and charges collected for international transactions. (L, P, I, IT)
7.3 Separation of Release from Final Determination	Medium • Include the provisions of this article in any revision/amendment to the Customs Ordinance. (L) • Ensure that policy and procedures are consistent with the Revised Kyoto Convention. (SP, P) • Develop SOPs for the use of Customs officials. (P) • Develop guidelines for importers outlining the procedures to be followed, and make them available through the Internet and hard-copy publication. (IT)
7.4 Risk Management	Short • Prepare the legislation necessary to fully implement risk management. (A) • Include the provisions of this article in any revision/amendment to the Customs Ordinance. (L) • Lobby the government to adjust policies and legislation that currently prevent the effective application of risk management. (C) • Eliminate the mandate to examine 100 percent of shipments. (L) • Establish a risk management compliance policy and guidelines. (SP) • Develop a risk management policy, strategy, procedures, and SOPs. (SP, P) • Conduct a training needs assessment for risk management to significantly enhance the human resource capacity within the Customs risk management

	team. (A) Medium • Introduce intelligence-based risk profiles. (P) • Fully implement the ASYCUDAWorld selectivity module. (IT) • Significantly enhance the human resource capacity within the Customs risk management team. (HR) • Allocate dedicated resources within each border agency, in addition to those in Customs, to undertake risk analysis using a range of resources, while obtaining continuous feedback on results, to create more timely and accurate profiles. (HR, IT, C) • Guide and assist other agencies to introduce and apply risk management. (P)
7.5 Postclearance Audit	Short • Include the provisions of this article in any revision or amendment to the Customs Ordinance, and in particular address all kinds of audits. (L) • Develop a PCA policy, manual, and procedures, and instructions at Customs. (SP, P) Medium • Review the issues that are creating staff turnover in PCA, and introduce measures to encourage retention and development of staff. (I, HR) • Provide enhanced training in audit skills, including in the analysis of electronic accounting systems. Provide IT tools to staff. (IT, HR)
7.6 Establishment and Publication of Average Release Times	Short • Develop a formal government requirement to conduct time release studies on a scheduled basis. (P, L) • Conduct further time release studies involving all stakeholders (public and private). (P) • Publicize the results of the studies on agency websites and eventually on the trade information portal. (C, IT) Long • Develop the internal capacity to conduct and analyze time release studies. (HR)
7.7 Measures for Authorized Operators	Short • Include the provisions of this article in any revision/amendment to the Customs Ordinance. (L) • Enhance the Authorized Operator (AO) program to be in line with the TFA and international best practice. Develop a manual of procedures and instructions. (SP, P) Medium • Continue to develop the program and increase the number of businesses within the AO scheme, including consulting the business community about what would encourage businesses to participate. (P) • Build understanding and training of staff within Customs to ensure they fully understand and participate in the effective operation of the AO process. (HR)

	• Enhance the business community's awareness and understanding of the scheme and their need to comply with the criteria, including that related to supply chain security. This can be undertaken through proactive publicity campaigns and information sessions. (C) • Review the involvement of other border agencies within the AO process and develop a system for incorporating their regulatory needs in the process, with appropriate benefits for compliant businesses. (SP, P, I)
7.8 **Expedited Shipments**	• Clarify and streamline the de minimis concession to be simple, transparent, and fair to the private sector and easy to apply for Customs. (SP, P) • Ensure instructions and orders are published including online and enquiry points are trained to deal with questions and complaints. (SP, P, HR) • Implement ASYCUDA at the airport. (IT) • Ensure the clearance processes for expedited shipments are streamlined across all agencies. (P)
7.9 **Perishable Goods**	Medium • Ensure that the proposed amended Customs Ordinance and amendments to other acts and regulations require priority be given to examination and release of perishable shipments. (L) • Develop and implement a common set of procedures across the border agencies for the clearance of perishable goods. (P) • Develop and implement a coordination mechanism among border agencies and the appropriate elements of the private sector, potentially through a working group under the NTFC. (I) • Assess the need of government agencies to establish storage facilities for perishable shipments pending their release, and develop a strategy based on the analysis of gaps and constraints in the sector. (A, SP, F)
8 **Border Agency Cooperation**	Short • Entrust the NTFC to be the key avenue to develop, strengthen, and formalize border agency coordination. (I) Medium • Identify and develop MOUs and SOPs for key activities that require interagency coordination; for example, joint inspections, dealing with rejected goods, working hours. (I, HR, L) • In the medium term, consider developing a coordinated border management strategy or policy that incorporates the above elements. (I, SP, LR)

9 **Movement of Goods Intended for Import under Customs Control**	• No recommendations
10.1 **Formalities and Documentation Requirements**	Short • Review all documentation requirements for imports and exports across all agencies, with a view to reducing the number of documents and increasing use of electronic submission of documents. (L, P, A) • Enable through law or regulation the requirement to review documents and formalities on a regular and periodic basis. (L) Medium • Review the need for multiple registrations across numerous agencies. This would require automation and electronic links between agencies to enable data sharing. This may also require legal amendments. (A, L, IT, P) • Clarify the roles of all officers in respect to document inspection and control to ensure a risk-based clearance process is implemented. (I, HR) • Enable delegation of roles on a legal basis for agencies that carry out same or similar tasks that result in additional costs to businesses. (L, P) • Create a port action plan to deal with issues of ingress and egress, dwell time, system redundancy, and operational efficiency. (SP, P, LR)
10.2 **Acceptance of Copies**	Short • Conduct a thorough review of current legislation and data standards relevant to the acceptance of copies and electronic sharing of information across all border related agencies, with a view to rationalization and standardization. (A, LR) • Resolve the legal ambiguity over the acceptance of copies of documents across all border agencies. This effort could be conducted through the NTFC. (L, A) • Conduct a data harmonization assessment to prepare for the upcoming electronic environment as part of the ESW blueprint. (A) Long • With the proposed development of the single window and Customs' electronic clearance system, ensure maximum uptake of electronic documentation by all agencies and the business community. (SP, P) • Develop training for and understanding of all border staff of the use and benefits of electronic documents. (HR) • Sensitize the business community to the benefits of electronic documentation and processes. (C)
10.3	Short

Use of International Standards	• Revise and modernize the Customs Ordinance. The new law will require subsidiary regulations. (L) • Conduct a gap analysis on the implementation of the other international standards, conventions, and frameworks acceded to by Sri Lanka (for example, IPPC, OIE, Codex Alimentarius) to identify legal, institutional, facility, training, and other resource gaps. (A) Medium • Increase the business community's comprehension of and compliance with international standards. (C)
10.4 **Single Window**	Short • Establish a single-window steering committee with a legal mandate, potentially under the NTFC. (I, L) • Prepare a blueprint for ESW implementation that includes a legal action plan, business process model, functional and technical architecture, operational and governance model, fee model, capacity building plan, change management plan, risk management model, procurement plan, and implementation plan (see the WBG guide to ESW). (A, P, I) • Ensure the ESW plan is integrated with an e-government strategy and leverages the ICTA experience. (I) • Review and develop stakeholder understanding, equipment, and human resource capacity to implement the single window effectively. (I, C) Medium • Implement the national single window based on the plan developed through the blueprint. (IT, F, HR)
10.5 **Preshipment Inspection**	• Customs should investigate other ways to establish the value for duty of imported used vehicles that are consistent with the TFA and the WTO Valuation Agreement. Once a methodology is agreed upon and officers trained in its use, the PSI report should not be used for Customs valuation purposes. (LR, P, HR)
10.6 **Use of Customs Brokers**	Medium • Consider the possibility of allowing legal entities (such as companies) to clear goods on their own behalf using their own employees without requiring the employee to hold a license. (L) • Review Customs house agent licensing rules to ensure that all licensing criteria are appropriate. (A,L)
10.7 **Common Border Procedures and Uniform Documentation Requirements**	No recommendations

10.8 **Rejected Goods**	Short • Establish MOUs between agencies and SOPs for the control and safe handling of rejected goods that may be dangerous. (SP, P) • Review the imposition of the fee by Customs to determine if there is a method of applying a fee that is consistent with article 6. (L, SP)
10.9 **Temporary Admission of Goods and Inward and Outward Processing**	• No recommendations
11 **Freedom of Transit**	• No recommendations
12 **Customs Cooperation**	Short • Develop and implement a voluntary compliance regime as described in the article. (L, SP, P) Medium • Issue directives to traders regarding the voluntary compliance regime so that they are aware of their rights and obligations. (C) • Review Sri Lanka's commitments under the Nairobi Convention with a view to accepting more annexes. (A, SP) • Develop and implement operational guidelines to give effect to additional commitments made respecting the Nairobi Convention (if any). (P)
23.2 **National Committee on Trade Facilitation**	Short • Review the current structure, membership, and terms of reference of the NTFC in line with recommended actions in the report. (I) • Establish a legal mandate for the NTFC. (L)