POLICY BRIEF

ADVOCATA

Unshackling Markets: The Case Against Import Controls and Price Controls

Sri Lanka has a long history of price controls that dates back to the 1970s, and despite all evidence to the contrary, these measures are still widely accepted as a solution to high prices. Proponents of price controls advocate for such measures because they do not fully appreciate the complex role prices play in determining the allocation of scarce resources. Abnormally high prices are merely a symptom of an underlying issue. Therefore, it makes more sense to resolve the underlying cause than impose price controls. This policy brief will examine how trade barriers and market structures impede competition. It will demonstrate how trade and competition policies, rather than price controls, can be used to stabilize prices, by examining three products in the construction industry: cement, tiles and aluminum.[1]

Issues in the construction industry

1: Market structures and competition

The domestic market for construction materials such as tiles, cement, and aluminum exhibit a high degree of concentration in terms of the number of players operating in the sector. This concentration can be attributed to various factors, including economies of scale, barriers to entry, and established market dominance.

The cement, tile, and aluminum industries are characterized by either an oligopolistic or duopolistic market structure. The cement industry is dominated by three domestic players,[2] the tile industry by four players (which are owned by two firms),[3] and the aluminum industry by four players.[4] The limited number of players in each market has restricted the degree of competition that domestic players face. This lack of competition limits the scope for competitive pricing as each individual firm has significant control over the market. Competition from international players is also limited due to import restrictions and high import tariffs.

2: High tariffs and trade restrictions

Numerous import restrictions and tariff increases have been imposed on construction materials from time to time. These tariff increases include the use of para-tariffs like the CESS and Port and Airport Development Levy (PAL), which have raised cumulative tariff rates.

For instance, in the case of domestically produced cement, the cumulative tariff on the raw material used in production, clinkers, ranged between 16% and 25% from 2014 to 2021. By contrast, importers of bulk and bag cement, the direct competitors to domestic manufacturers, faced an additional para-tariff (CESS) of between 8% and 14% during the same period.[5] This difference creates an uneven playing field, giving domestic manufacturers a distorted advantage over importers.

A similar situation can be observed in the tile market, where the total tariff rate on imported tiles ranged between 79% and 89.5% from 2013 to 2021. In comparison, domestic manufacturers do not face any tariffs other than VAT for the raw materials and other inputs that go into the making of a tile.[6] In addition to the high tariffs at the border, quantity restrictions have also been utilized to limit imports.

These restrictions were observed predominantly in relation to the sweeping import restrictions imposed in April 2020, owing to the foreign exchange shortage brought on by the COVID-19 pandemic. The quantity restrictions reduced the quantity of bag cement being imported by 65% and the quantity of tiles imported by 87%.

Impact on consumer welfare

An argument used to support the protection of domestic industries is that of achieving self-sufficiency. The premise of this argument is that, by restricting foreign competition through protectionist trade policies, domestic producers will become the sole suppliers to the market, eventually leading to self-sufficiency. However, this argument tends to overlook an important consideration – the capacity of domestic producers to effectively meet domestic demand, especially in the short to medium term, and provide consumers with a range of comparable products at cheaper prices than would have been available through imports. Failing to address this capacity issue can result in significant drawbacks for consumers, including severe shortages, price hikes, and limited choice. Ultimately, it is the consumers who bear the costs associated with these consequences.

In the tile market, for instance, customers faced price increases of 93-123% during the period April 2020 to August 2022, and recorded waiting times of over a year to receive goods.

While most of these restrictions were placed with the intention of “protecting” domestic producers, the inconsistent way in which these policies have been applied have disproportionately benefited large players in the market. In these circumstances, importers often find it difficult to compete and are sometimes driven out of the industry.

Lack of competition reduces the incentives for large domestic manufacturers to be efficient, competitive and innovative, particularly given the market structures that these firms operate in. This lack of competition leads to higher prices, products of poorer quality, less choice and limited availability of goods.

The problem with price controls

Price controls are viewed as the solution to rising prices. However, a deeper analysis of price controls reveals a host of unintended consequences associated with the imposition and subsequent effects of regulated prices.[7] Prices act as a signal in the market, reflecting supply and demand dynamics and guiding the allocation of resources. When prices are distorted through price controls, resources are misallocated.

For example, imposing a price ceiling, which is below the price determined by market forces, leads to excess demand which cannot be satisfied with existing supply. Consumers demand more at artificially low prices, while suppliers are not incentivized to produce and supply more. This mismatch creates shortages and may even lead to a black market developing where these products are sold at much higher prices.

Furthermore, the process by which the Consumer Affairs Authority (CAA) determines price controls is completely shrouded in ambiguity. The CAA is authorized to regulate the price of any good or service considered essential to the community through a gazette notification by the relevant minister. However, it remains unclear whether any rational process is used to identify which goods and services qualify as "essential", or if it is determined at the discretion of the minister in charge. This issue becomes even more complicated when considering how the actual controlled price is determined. The CAA claims to consider production patterns, market conditions, international prices, and price trends when setting the controlled price. However, the presence of information asymmetries in the market raises questions about the accuracy of the controlled price.

The lack of transparency in the process, the uncertainty regarding the criteria for identifying essential goods and services, and the factors considered in setting prices, can lead to market inefficiencies and allow for corruption and rent-seeking to take place.

Policy recommendations

1: Remove trade barriers

Given these findings, the corrective course of action that should be taken by the government is to lower trade barriers and increase competition. Opening up markets will lead to a higher degree of competition and greater stability in prices. Lowering tariffs and removing trade restrictions will exert pressure on domestic manufacturers to become more efficient and improve product quality to be able to compete with imported goods. Additionally, this approach means that greater quantities of these goods can be imported, increasing supply and driving down prices.

2: Reform Sri Lanka's competition policy/authority

The CAA is mandated to promote competition, and has been dormant in this regard. It lacks the independence, institutional capacity, and financial and professional resources to do so. The governance structure of the CAA is inadequate for ensuring independence and preventing political interference, as the minister in charge holds the power to appoint and remove officials and determine wages. Additionally, it is dependent on state funding, with only a small portion of funding raised through fines. This reliance on state funding, coupled with limited financial resources, undermines regulatory independence, and impairs CAA's ability to attract skilled professionals. To address these issues, it is crucial to enhance the independence of the CAA and provide it with the necessary resources. By strengthening its independence and capacity, the CAA can effectively fulfill its mandate to promote competition and protect consumer interests.

Conclusion

In summary, import and price controls do not achieve what they set out to do and they also have perverse effects. Adopting the policy recommendations discussed would be a far better way to stabilize prices. Removing trade restrictions and lowering tariffs will be easier to implement than undertaking competition reform, which would require significant political buy-in and take time to implement. Therefore, if the government wishes to stabilize the price of goods, removing trade restrictions is a quick solution. In the long term, however, a more competitive market structure is needed.

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Endnotes

(1).The analysis in the “Issues in the construction industry”, “Impact on consumer welfare” and “Policy Recommendations” sections are drawn from the Impact of Anti-Competitive Practices in the Construction Industry on Affordable Housing in Urban Sri Lanka Report (Unpublished Manuscript, Advocata Institute, 2023)

(2).Mendis, S. and Majeed, N., Construction Sector Update: Setting Sights on a Residential Thrust, (Asia Securities, 2020)

(3).Royal Ceramics PLC Annual Report 2021, Alumex PLC Annual Report 2021 , Hayleys PLC Annual Report 2021 and Vallibel One PLC Annual Report 2021.

(4) Alumex PLC Annual Report 2021

(5) Import Data 2010-2021, Department of Customs, and Gazettes published by the Department of Customs

(6) JB Securities, Tile Industry Report 2021.

(7) The analysis in this section is drawn from the Price Controls In Sri Lanka: Political Theater Report (Advocata Institute, 2018)