

Trade Policy Review Body

TRADE POLICY REVIEW

SRI LANKA

Report by the Secretariat

This report, prepared for the second Trade Policy Review of Sri Lanka, has been drawn up by the WTO Secretariat on its own responsibility. The Secretariat has, as required by the Agreement establishing the Trade Policy Review Mechanism (Annex 3 of the Marrakesh Agreement Establishing the World Trade Organization), sought clarification from the Government of Sri Lanka on its trade policies and practices. The Secretariat did not receive detailed comments or clarifications from the authorities on some parts of this report.

Any technical questions arising from this report may be addressed to Mr. Michael Daly (tel. 022-739 5077).

Document WT/TPR/G/128 contains the policy statement submitted by the Government of Sri Lanka.

Note: This report is subject to restricted circulation and press embargo until the end of the meeting of the Trade Policy Review Body on Sri Lanka.

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SUMMARY OBSERVATIONS**(1) ECONOMIC ENVIRONMENT**

1. Sri Lanka's real annual growth in GDP averaged 4% during the period under review (1996-03), despite political uncertainty owing to the internal armed conflict, lasting some 20 years, and related economic difficulties. Per capita GDP also rose to US\$872 in 2002, 9% higher than in 1996. Nonetheless, poverty remains widespread, especially in rural areas. The economy, which started recovering in 2002 because of the peace accord, remains fragile and its full recovery depends on the authorities' ability to ensure peace. Moreover, sustainable economic growth requires major macroeconomic and structural reforms to redress fiscal imbalances and clear the way for greater private-sector involvement in the economy, which would improve economic efficiency and thus competitiveness.

2. Fiscal imbalances continue to be a major problem in Sri Lanka. During the review period, the budget deficit averaged 9% of GDP; it reached its highest level in 2001 (10.8% of GDP), but declined to 8.9% of GDP in 2002 after greater fiscal discipline was adopted. Servicing the public debt, which exceeds GDP, has severely hampered growth. The Government's main macroeconomic policy objectives include reducing the budget deficit and tackling the debt crisis. Related structural objectives involve the sale of inefficient loss-making state-owned enterprises, and tax reform aimed at increasing tax revenue, especially through improved tax collection.

3. The Government is still involved in a number of loss-making commercial activities in many sectors. In particular, state-owned enterprises supplying, inter alia, electricity, petroleum and public transport, are highly indebted. State involvement in banking and transport remains important. Improving the soundness of the state banks, which dominate banking, is crucial to rehabilitating the financial system. In addition, escalating

power and energy costs, owing to inefficiency, penalize users. The electricity and petroleum subsectors are being restructured and the telecommunications and insurance subsectors privatized.

4. Sri Lankan exports remain concentrated in a few goods (clothing and tea) and markets (the United States and the European Union). Export performance has been poor because of unreliable domestic supply, security problems, and developments affecting Sri Lanka's main export products and markets. For instance, tea and garment prices have declined, and competition is increasing from low-cost clothing suppliers and from countries receiving trade preferences in major markets. Further structural and institutional reforms, including in areas of taxation, state-ownership, the financial system, and basic infrastructure, should improve Sri Lanka's international competitiveness and thus contribute to export growth and diversification. Policies aimed at further opening the Sri Lankan economy to trade and foreign investment can be expected to contribute to the success of these structural reforms.

(2) TRADE AND INVESTMENT POLICY FRAMEWORK

5. Sri Lanka's trade policy objectives include moving towards a more outward-oriented trade regime and improving market access for its exports. In recent years, however, the focus of its trade policy has seemingly shifted towards regionalism, which Sri Lanka considers a springboard for broader trade liberalization. Nevertheless, Sri Lanka recognizes that its long-term trade and other economic interests are best served by a stable and liberalized multilateral trading system that supports the needs of developing nations. Thus, Sri Lanka, an original Member of the WTO, continues to play an active role in the organization. It grants at least MFN treatment to all its trading partners.

6. The authorities stated that since the last review, policies have been aimed at

enhancing production and productivity through a continuous process of economic reform, with a view to promoting a more efficient allocation of resources, while improving the environment for private domestic and foreign investment. While Sri Lanka seems to be much more open than in 1995, trade barriers still impose unnecessary economic costs. Moreover, there have been some backward steps in the reform effort, as trade-related and other economic policies are changed frequently in an ad hoc manner, mainly because of political pressures, with detrimental effects on the transparency and predictability of Sri Lanka's trade policy regime.

7. Sri Lanka's institutional and legal framework has remained largely unchanged since 1995. The Government has attempted to facilitate private sector development with less reliance on control and regulation. Nonetheless, Sri Lanka's Government is, in per capita terms, one of the biggest in the world, employing around one million public servants. The executive comprises 57 ministries, some 37 of which are cabinet rank. The large number of ministries contributes to overlapping jurisdictions in trade and trade-related policies leading to a certain lack of coherence in their formulation and implementation. This tends to undermine the cost-effective implementation of policy measures and delivery of government programmes.

8. Undue political influences, which give rise to ad hoc policy developments and unsatisfactory governance practices, would seem to have had a negative impact on the reform process and economic performance. Transparency of the regulatory system also appears to be somewhat lacking. While Sri Lanka's legal system appears to be well developed and laws covering, inter alia, taxes, exchange controls, customs, standards, and intellectual property rights are in place, foreign and domestic investors often complain that the regulatory system allows for too much bureaucratic discretion. Enforcement mechanisms are also weak and coordination

problems are common between the relevant agencies.

9. Sri Lanka's investment regime has not undergone major changes since 1996. Foreign equity restrictions were relaxed in key services, such as finance, mass transport, telecommunications, and professional services. Incentives are still available to national and foreign investors. Nevertheless, foreign inflows have remained subdued, probably due in part to the civil conflict, but also to other factors including obstacles to clearing products through customs, lack of access to land to build factories, and inadequate infrastructure (e.g. poor transportation facilities and unreliable power and water supplies).

(3) TRADE AND TRADE-RELATED POLICIES AND MEASURES

10. At the time of its previous Trade Policy Review in 1995, Sri Lanka had made substantial progress in liberalizing trade as a part of its extensive economic reform programme introduced in the late 1970s. Since then trade liberalization efforts have slowed and economic reform in general has received less attention as efforts have concentrated on ending the long drawn out civil conflict.

11. The tariff, which involves 11 rates, remains a major instrument of trade policy and source of government revenue. A planned two-band tariff system has not been attained mainly because of revenue considerations and political pressure from protected producers and other interest groups. Reflecting these pressures, the tariff lacks predictability; rates have been raised and lowered frequently in an ad hoc manner during the period under review. The current average applied MFN tariff (as of March 2003) is 9.8%, up from 9.2% in 2001. Furthermore, in 2001, an import surcharge of 40% based on the c.i.f. value and the import duty (i.e. c.i.f. value times import duty) was introduced to increase tax revenues, but then lowered to 20% in 2002 (and extended indefinitely beyond its original

end date in 2003). Tariff exemptions are common; indeed, it has been estimated that some 70% of all imports enter duty free, which seems to be in conflict with revenue objectives. Their elimination could add transparency to the tariff and compensate for the possible decline in tariff revenue from the planned across-the-board tariff reduction. Non-tariff barriers, especially licences affect a substantial number of goods. Moreover, as in the case of tariffs, licences are removed and restored easily, and often used interchangeably with tariff increases. Sri Lanka does not have any provisions in place to use contingency measures, although anti-dumping legislation has been drafted. Standardization is aimed at ensuring the quality, safety, and performance of products and services. Sri Lanka's national standards and technical regulations follow international guidelines whenever possible.

12. Export policies also suffer from inconsistencies. In order to promote exports, procedures have been streamlined; nevertheless, they continue to be regulated by a myriad of laws. Several incentive programmes (e.g. duty exemptions, drawbacks, export-processing zones), some of which are contingent on export performance, are available to support exports. According to the authorities, export duties have been phased out in all sectors, although they may be restored if the Government feels that there is a need to promote further processing of local materials. Traditional exports are still subject to export cess; apparently these cesses are earmarked to finance specific activities (e.g. R&D, export promotion, and to support small-scale land holders). In addition, a few items are subject to export licensing. Export competitiveness would benefit from the implementation of more coherent and predictable trade policies.

13. Tax and non-tax incentives remain in place to promote the establishment of export-oriented industries, industrial diversification, and industrialization in specific regions. These have had limited success, however. Sri Lanka continues to export only a few goods;

manufacturing depends heavily on the production of textiles and clothing, and most industries are still located close to Colombo.

14. Government intervention through regulation and ownership of enterprises remains important. Privatization has been slow, and loss-making state-owned enterprises remain a heavy budgetary burden. The main objective of privatization has been to raise revenues rather than to improve the economic efficiency of the enterprises and sectors involved. As a result, in some sectors, private monopolies have replaced public ones; a new competition law was passed by Parliament in January 2003, but it remains to be seen whether the new law addresses this and other weaknesses of the former competition regime.

15. While new statutes have been drafted to govern the protection of intellectual property rights (IPRs), it is not clear when these will come into force. In any event, no data are available to determine whether existing IPR laws are being enforced in Sri Lanka.

(4) SECTORAL POLICIES

16. Agriculture remains an important sector in Sri Lanka with a third of the population engaged in agricultural or related activities; it contributed some 20% to GDP in 2002. The sector is also a major source of raw materials and earner of foreign exchange. During the period under review, the provision of different subsidies (e.g. consumer, producer, and export subsidies) and other forms of assistance have failed to improve the sector's growth and productivity, which have remained low. This poor performance may be attributed, *inter alia*, to low levels of investment, lack of quality inputs, heavy dependence on regular rainfall, traditional cultivation practices, lack of credit, inadequate infrastructure (notably transportation), weaknesses in the marketing system, state control of land, and inconsistent trade policies. Government intervention in agriculture, as in other sectors, remains substantial. Less protection on agricultural

goods and other forms of assistance together with the adoption of a more predictable trade policy regime could lead to a better allocation of resources, thus raising productivity and increasing living standards. In addition, the establishment of a transparent land tenure system might make farmers more willing to invest and to adopt modern farming technologies.

17. Industrial policy throughout the years has aimed at diversifying the industrial base; regional industrialization has also been promoted. To this end, attempts have been made by the Government to create an environment conducive to investment, with incentives to encourage both domestic and foreign investment. Nevertheless, manufacturing, which contributed some 16% to GDP and accounted for 17% of employment in 2002, remains heavily concentrated in textiles and apparel, the leading net foreign exchange earner. However, Sri Lankan textile and apparel exports have lost competitiveness; the costs of production have risen as energy, telephone, and other utility prices have increased, and labour productivity has declined. The apparel industry faces additional challenges, notably the expected end to the quota system in 2005, and increasing competition from low-cost manufacturers in other countries and from exports under preferential trading arrangements.

18. State intervention in the oil sector is declining. The Ceylon Petroleum Corporation (CPC), a state-owned enterprise, which until recently was the exclusive importing and marketing agency for petroleum and petroleum products, is being reformed. The liberalization of oil product prices also seems to be under way.

19. The electricity sector went through a severe crisis in 2001 and part of 2002, when there were prolonged power cuts, which had an adverse impact on the country's output and productivity. In addition, high electricity tariffs, by raising business costs, have potentially weakened Sri Lanka's external

competitiveness. Investment in the electricity sector has been marginal in recent years; as a result, there have been delays in repairing existing plants and in establishing new power generation capacity. Sri Lanka is therefore likely to continue to face severe power shortages in the future. The Ceylon Electricity Board (CEB), a state-owned monopoly, and its subsidiary Lanka Electricity Company (Pvt.) Ltd. (LECO), are still in charge of the generation, transmission, and distribution of electricity in Sri Lanka. However, the Electricity Reforms Act passed in 2002 stipulates the re-structuring of the electricity sector; it calls for the separation of the generation, transmission, and distribution operation of the CEB, while paving the way for greater private sector participation.

20. The contribution of services to real GDP increased from 55% in 1996 to 62% in 2002. Tourism, one of Sri Lanka's largest foreign exchange earners, was severely affected by the domestic armed conflict; however, it rebounded following the peace initiative, and offers considerable potential. Nonetheless, the inefficient delivery of key services, such as telecommunications, financial services, and transport, has burdened the economy as whole. The modernization of the services sector is essential to improving the economy's productivity and thus its international competitiveness. The Government has taken some steps to reduce direct state involvement in the sector and raise private, including foreign, participation. For instance, in financial services, foreign investment limits have been relaxed; full foreign ownership in insurance and banks is now allowed. Since the last Review, privatization has been concentrated in the telecommunications and insurance subsectors. The state monopoly on basic telecommunications has ended. Moreover, the state-owned insurance company has been fully privatized. However, state involvement in banking remains important. The banking system in Sri Lanka is weak, despite efforts to upgrade prudential supervision. Banks have a high level of non-performing loans, and the two dominant

banks, which are state-owned, are particularly weak and in need of major restructuring. State intervention in transportation remains substantial. The provision of air services is still dominated by the majority state-owned national carrier, Sri Lankan Airlines (SLA). Another state-owned company has the monopoly on airport services. Some private-sector involvement was allowed in the provision of port services in 1998, but there have been few reforms since then.

(5) OUTLOOK

21. Sri Lanka's economic prospects appear favourable, provided that peace and

political stability are maintained and economic reforms, particularly those aimed at reducing government intervention, are continued. On the macroeconomic front, continued efforts are needed to ensure further fiscal consolidation. Additional structural reforms, including in the fields of trade, investment, and institutions, should help raise the economy's productivity and growth prospects. These reforms could also help boost investor confidence and promote inflows of foreign investment, which are essential to Sri Lanka's future growth.