

TRADE POLICY REVIEW

SRI LANKA

Report by the Secretariat

This report, prepared for the first 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.

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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. Until the late 1970s, Sri Lanka's economic development centred on import-substituting activities performed mainly by State-owned firms. The results were disappointing, and economic expansion lagged significantly behind other countries in the region. Encouraged by strong export-driven growth in east and south-east Asian economies, economic and trade reforms were initiated in 1977. Their initial focus was on export expansion in manufacturing, particularly clothing, although emphasis has shifted recently to broader-based liberalization. The pace of change has varied over time, *inter alia*, because of difficulties in macroeconomic management and a severe balance-of-payments crisis in the late 1980s.

2. Sri Lanka's economic ascent has relied heavily on labour-intensive export industries, principally clothing and gem finishing, that take advantage of the country's low-cost, relatively well educated labour force as well as generous tariff exemption schemes. While the internal supply links of these industries remain weak, ongoing economic liberalization and deregulation may help to promote greater domestic content.

3. Despite civil war in parts of the country, the economy has responded well to recent reforms, with real GDP growth of about 5 per cent (1990-94), mounting foreign exchange reserves and increasing shortages of certain skills. However, Sri Lanka's trade balance has remained in substantial deficit in goods and services combined, amounting to US\$1.1 billion or around 10 per cent of GDP in 1993. Remittances from Sri Lankans working overseas and government-to-government grants cover more than half of the deficit.

4. Formidable challenges remain. Persistent budget deficits tend to drive up real interest rates and hamper long-term private

investment decisions. Fiscal retrenchment has proved difficult in view of a narrow tax base, the fiscal drain of civil war and, more recently, substantial consumer subsidies on socially sensitive items, in particular bread. Traditional public sector activities have been curbed and restructured; however, significant investment is needed to upgrade the country's infrastructure, in particular transport and electricity, and ease bottlenecks to further economic expansion. A value-added tax, scheduled for introduction in late 1995, may contribute to reducing the share of the budget deficit in GDP.

(2) Sri Lanka in World Trade

5. Traditionally, Sri Lanka's merchandise exports were dominated by tea and tea products, while rice and other food items were the main imports. Since the late 1970s, the tea sector has maintained its share in world production and trade, relying on countries in the Middle East as the principal outlet. The share of rice, the main food crop, in total imports has declined as domestic production has expanded.

6. Since 1980, the clothing industry has emerged as the country's main export earner. Substantial foreign investments, including from countries facing quotas under the Multifibre Arrangement (MFA), created a strong production base and eased access to international marketing channels. The ascent of the clothing industry is reflected in a reorientation of imports towards textile suppliers in east and south-east Asia, such as Hong Kong, Chinese Taipei and the Republic of Korea. Clothing exports have expanded rapidly, while now also subject to quotas on certain items in main markets, including the United States and the European Union. At present, the share of clothing in merchandise exports is close to 50 per cent, with almost two thirds destined for the United States.

7. Semi-precious stones contribute some 10 per cent of merchandise exports; shipments of processed gems have expanded particularly rapidly since 1990. Despite specific incentives for the electronics industry, its share in production and exports has remained limited.

8. Mirroring developments in manufacturing, services sector growth initially relied on areas contributing directly to foreign exchange earnings, such as trans-shipment and tourism. While the tourist sector has suffered from uncertainties related to the civil war, arrivals recently picked up again to reach 400,000 in 1994. Although no detailed data are available, the geographical distribution of both imports and exports of services appears dominated by trading partners outside the region.

(3) Legal and Institutional Framework

9. Sri Lanka's present Constitution, promulgated in 1978, provides for a strong executive President who is elected for a six-year term. The current President holds several portfolios, including those of Finance, Planning and Defence.

10. Policy competence in main trade-related areas lies with the Minister of Finance and the Minister of Internal and External Trade, Commerce and Food. While the Minister of Finance is in charge of revenue-related aspects, including tariffs, surcharges, subsidies and government procurement, responsibilities of the Minister of Trade include the administration of import and export licensing and intellectual property legislation. The Board of Investment (BOI), under the Minister of Finance, is mandated to approve, administer and facilitate inward foreign investment.

11. Since the late 1970s, three Presidential Tariff Commissions have tabled reports on the impact of alternative trade policy options, preparing the ground, inside and outside Government, for subsequent liberalization initiatives.

(4) Trade Policy Features and Trends

(i) International obligations

12. Sri Lanka has been a contracting party to the General Agreement on Tariffs and Trade (GATT) since 1948. It ratified the Marrakesh Agreement in June 1994 to become a founding member of the World Trade Organization (WTO).

13. Like other WTO Members, Sri Lanka has bound all tariffs on agricultural products. Although well above applied rates, the bound rates - 50 per cent - may constrain the use of surcharges during harvest seasons. The scope of tariff bindings in the industrial sphere has remained small, with the same ceiling rates as in agriculture. Sri Lanka's commitments under the General Agreement on Trade in Services (GATS) are limited to tourism, although access conditions have, in practice, also been improved in other areas such as banking. Amendments are in preparation to align domestic legislation with the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS).

14. Sri Lanka's involvement in regional trade agreements is limited. It is a signatory to the Bangkok Agreement and participates in the South Asian Preferential Trade Area (SAPTA), which is to become effective from November 1995. The scope of these arrangements is confined mainly to duty reductions and exemptions on a relatively small range of items; services are not covered. Consequently, Sri Lanka has not notified m.f.n. exemptions under Article II of the GATS.

(ii) Type and incidence of trade policy instruments

15. Past liberalization initiatives have reinforced the rôle of tariffs as the central instrument regulating Sri Lanka's merchandise trade. In turn, the tariff régime has become less distortive during subsequent rounds of reform. It currently relies on a three-pronged structure

with rates of 10, 20 and 35 per cent; the unweighted average is in the order of 20 per cent. Following the tariffication of most quantitative restrictions, apart from some remaining measures maintained for balance-of-payments reasons, remaining controls and licensing requirements are motivated mainly by health, safety and security concerns. Licences are issued only to Sri Lankan nationals or companies majority owned by them.

16. Although tariff escalation has been reduced over time, it is still considerable. Effective rates of protection currently exceed 100 per cent in areas such as paper and metal products. While further tariff reduction and harmonization would help to reduce economic distortions - the Government envisages introducing a uniform tariff of 15 per cent in the medium term - fiscal constraints may be an impediment. Revenue considerations have already led to the introduction, and subsequent increase, of a defence levy on all imports destined for domestic consumption; the current rate is 4.5 per cent. In addition, such imports are subject to a 2 per cent stamp duty on compulsory letters of credit.

17. With a view to insulating exporters from the direct cost of import protection, various schemes are used to provide access to traded inputs at close to world market prices. While export-processing zones were initially set up in specific geographic areas, the whole country was declared an export-processing zone in 1992. Although this may have encouraged export production in rural areas, in line with original intentions, it may also have facilitated leakages of duty-free imports into the domestic economy as movement of supplies for eligible companies is difficult to monitor. In addition, while promoting exports, such imports may have hampered the emergence of intermediate industries and, thus, of a broader industrial base.

18. Exports of a range of natural-resource-based products, as well as certain steel items, are subject to royalties, duties and cesses.

These are generally applied at moderate levels. The funds are destined for either the general budget or export promotion activities, including start-up subsidies for new exporters. Sri Lankan exports of certain textile and clothing items to the United States and of coconut products to Brazil have been subject to countervailing duty actions.

19. Gradual import liberalization, and the ensuing adjustment pressures, may have encouraged requests for temporary protection through import surcharges. Applications are decided by the Minister of Finance, who has considerable scope for discretion. No injury test is required. There were 17 cases in 1994, covering a range of products from onions to razor blades and bicycles; however, all measures have now expired. The authorities are considering new legislation to conform with the WTO Agreements on Safeguards, Anti-dumping, and Subsidies and Countervailing Measures.

20. Since the 1970s, foreign direct investment in export-oriented activities has been welcomed. Such investment played a particularly important rôle in the development of the clothing and tourist industries. Commitments up to an equity share of 40 per cent are generally given automatic approval, and investors receive national treatment. Larger commitments are examined case-by-case. Structural deficiencies in the insurance sector and the Government's preferential claim on certain funds, reflecting fiscal straits, appear to have delayed liberalization in this area. Partial reforms, allowing for minority foreign shareholdings, are, however, under consideration.

(iii) Sectoral policy patterns

21. Sri Lanka's plantation-based tea sector co-exists with significant levels of subsistence farming, predominantly of rice. Large-scale public investments in irrigation facilities benefited rice growers during the 1980s, and have contributed to Sri Lanka's high level of self-sufficiency. Today, emphasis is being

placed on cultivation of high value-added crops and related processing activities. Market-oriented seed improvement schemes, special credit facilities and the privatization of plantation management are major initiatives in this context. However, for social and regional policy reasons, rice farming is likely to attract strong continued policy attention.

22. External liberalization in manufacturing has been accompanied by internal deregulation and privatization, affecting a large number of State-owned companies. Exceptions are limited mainly to "security-sensitive" areas such as petroleum and gas production. The declining share of publicly-owned enterprises in manufacturing value added - from almost 60 per cent in 1981 to less than 15 per cent in 1991 - may be attributable both to these initiatives and to strong growth in the private sector, especially in clothing.

23. Access to a number of services sectors, including telecommunications and banking, has gradually been deregulated. While Sri Lanka Telecom (SLT) continues to operate as the exclusive provider of basic voice services, linked to its network monopoly, activities such as mobile telephony and data transmission are open to competition. Efforts are underway to rein

in internal cross-subsidization within SLT and further rationalize its tariff structure. Continued liberalization may encourage the development of outward-oriented services, underpin the competitiveness of user industries and reinforce their internal supply links.

(5) Trade Policies and Trading Partners

24. Sri Lanka's economic reforms were launched in response to widespread public dissatisfaction with poor industrial performance and rampant rent-seeking within a distorted incentive system. While there have been some slippages over time, strong growth in recent years has helped to broaden the internal political support for change. On the external front, the WTO Agreements have secured and widened the institutional framework for international market integration. The signs are thus positive for new initiatives aimed at exposing long-protected services sectors to competition, further reducing and harmonizing tariff protection, rationalizing duty drawback and exemption schemes and developing alternative, less distortive sources of government revenue. Given Sri Lanka's current export basket, it is essential that such efforts be supported by liberal and predictable access conditions to large export markets outside the region.