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Indo-Sri Lanka Economic Cooperation:

Facilitating Trade Expansion through a Reciprocal Preference Scheme

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(UNU/WIDER)

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UNU World Institute for Development Economics Research (UNU/WIDER)
A research and training centre of the United Nations University

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Indo-Sri Lanka Economic Cooperation: Faciliting Trade Expansion through a Reciprocal Preference Scheme

Report of a Study Group of the UNU World Institute for Development Economics Research (UNU/WIDER), Helsinki, Finland

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Helsinki, Finland

* The members of the Study Group have participated in its work in their personal capacities.

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PREFACE

South Asian countries belonging to the South Asian Association for Regional Cooperation (SAARC) are all currently engaged in implementing major economic reforms in order to accelerate economic growth, increase employment, and raise the living standards of their populations. Central to the success of the ongoing reform process is the need for rapid expansion of markets, both domestic and foreign, substantially above rates of expansion in the past. There is a growing recognition that the countries of the region cannot rely exclusively on their traditional markets in OECD countries for fast export growth. The economic and trade environment which in the past provided a strong magnet for imports into these countries from developing countries has deteriorated, while competition to supply these markets has increased. If a substantial increase in trade growth is to be accomplished, it follows that South Asian countries need to diversify their export markets particularly to East Asia, and within South Asia itself. With a population of over one billion people, South Asia itself has the obvious potential of providing a growing regional market that transcends national boundaries. What is clearly needed is for countries of the region to look more closely than ever before at the trade potential of the regional market to speed up the processes of growth and expansion of their economies, and at the steps to be taken to realize that potential.

Reflecting the increasing interest in regional cooperation in recent years, senior officials of the Governments of India and Sri Lanka requested the support of UNU/WIDER in the preparation of independent studies that would provide objective advice on the practical steps needed to promote closer economic cooperation and integration between the two countries. In response to that request, a Report entitled 'Indo-Sri Lanka Economic Cooperation: An Operational Programme', was prepared by a Study Team led by Dr. V.R. Panchamukhi, Director of the Research and Information System for the Non-Aligned and Other Developing Countries, New Delhi, and composed of staff of the Institute. Their Report is being issued as No. 8 in the WIDER Study Group Series.

This 9th WIDER Study Group Report complements, and carries forward, the work of its predecessor in respect of one of its key recommendations - namely the need to evolve an institutional mechanism involving trade preferences to facilitate trade expansion, both ways, between the two countries. It was decided to approach the subject from a Sri Lankan perspective as trade liberalization on a non-discriminatory basis was initiated earlier in Sri Lanka, and has advanced further than in India. The Report examines the rationale for trade preferences between the two countries, and specifies ten key elements or principles governing the design of a possible bilateral preferential arrangement consistent with outward oriented policies. Basic to the design is the shift from a traditional focus on *individual commodities* for which each country might grant preferences to the other, to a focus on granting reciprocal preferential treatment *across-the-board*, to all commodities, except for a small limited exclusion list of sensitive items.

What is envisaged is the rapid, though phased, removal of barriers to trade between the two countries, subject to suitable safeguards, in a manner aimed at maximizing trade creation between the two countries, and minimizing any possible trade diversion from third countries. The objective, in other words, is the creation of a 'fast track' for enhancing mutual trade between the two countries within the overall process now under way in SAARC. The underlying premise is that at the political level there is no impediment whatever to enhanced cooperation between the two countries for mutual benefit. In particular, reciprocal trade preferences would make a major contribution to the political and economic stability of Sri Lanka regarding which India has a major stake; they would, at the same time, support India's economic reform process by providing an export platform in Sri Lanka for joint ventures involving foreign investment (including Indian investors), serving both the joint Indo-Sri Lankan market and the outside world.

I am pleased that UNU/WIDER is able to bring the ideas contained in this Report to the attention of the Governments of India and Sri Lanka. I hope the Report will make a contribution to enhancing their mutual economic cooperation, and would be of some assistance in launching the political processes needed. Indeed, the substantial reduction in tariffs for all categories of commodities in the budget of the Government of India for 1993, materially strengthens the case for making rapid progress in implementing a reciprocal preferential arrangement along the lines suggested in this Report.

The linkage between economic reform in both countries, and the creation of a reciprocal preferential arrangement, was of particular interest to the late Chairman of the UNU/WIDER Board, Dr. Saburo Okita. He took a very personal interest in the evolution of this Report, arranged several meetings for me in connection with it in Tokyo, and gave freely of his advice and wisdom. It was part of Dr. Okita's grand vision for world development that South Asia should equip itself to benefit from the dynamic influences emanating from Japan and East Asia, and that a joint Indo-Sri Lankan economic space linked to economic reform in both countries would be a vital first step. With the tragedy of his passing away a bare two weeks ago the world has lost a man of truly gigantic moral stature, someone from the North who empathized more than most Southerners with the problems of the South, and a powerful *eminence grise* for global good behind Japan's international policy making. His support and guidance was crucial to the building up of UNU/WIDER as an outstanding world think-tank on development issues. He also served as Chairman of UNU/WIDER's first two Study Groups that, jointly with Dr. Arjun Sengupta, now Ambassador of India to Belgium and Luxemburg and to the European Communities, and myself, developed influential ideas on the recycling of Japan's surplus - collectively known as the Okita Plan.[1] It is

[1] Saburo Okita et al. *The Potential of the Japanese Surplus for World Economic Development*, UNU/WIDER Study Group Series, Report No. 1, Helsinki, 1986; Saburo Okita et al. *Mobilizing International Surpluses for World Development: A WIDER Plan for a Japanese Initiative*, UNU/WIDER Study Group Series, Report No. 2, Helsinki, 1987.

therefore entirely appropriate that this final 9th Study Group Report prepared during my tenure as Director of UNU/WIDER, is dedicated to Dr. Okita's memory.

I would like to express my gratitude to Mr. V. Narasimha Rao, Prime Minister of India, Dr. Manmohan Singh, Minister of Finance of India, and to Mr. Ranil Wickremasinghe, Minister of Industries, Science and Technology of Sri Lanka for receiving me in January 1993 in connection with the preparation of this Report. I would also like to thank Mr. J.N. Dixit, Foreign Secretary, Ministry of External Affairs, India, Mr. Montek Singh Ahluwalia, Secretary, Department of Economic Affairs, Ministry of Finance, India, Mr. A.V. Ganeshan, Commerce Secretary, Ministry of Commerce, India and Mr. A. S. Jayawardena, Secretary, Ministry of Industries, Science and Technology, Sri Lanka, for the time they gave me for discussion of matters relating to this Report. The members of the Study Group are also in the debt of a large number of persons in India, Sri Lanka, and Japan, including senior government officials, and those in the academic, business, industrial, and banking communities, who have been consulted in the course of preparing this Report. The Group owes a special debt of gratitude to Dr. V. R. Panchamukhi, Director of the Research and Information System for the Non-Aligned and Other Developing Countries, New Delhi who has been the principal point of liaison in the numerous discussions in India, and to Professor S. K. Goyal, Director, Institute for Studies in Industrial Development, New Delhi.

Lal Jayawardena
Director, UNU/WIDER

EXECUTIVE SUMMARY

A substantially higher rate of growth of exports is crucial to ensure success of the major outward-oriented, 'market friendly' economic reforms being pursued in India and Sri Lanka. The international economic and trade environment, however, is far less conducive than before to achieve that objective. While efforts have to be made to increase the pace of exports to traditional markets, the two countries also need to look at the possibilities for development of new markets including the trade potential of the regional market. In this regard, Sri Lanka should focus to a much greater extent than before on ways to increase exports to India as the current economic reform process in India unfolds.

The expansion of Indo-Sri Lanka trade is constrained by significant barriers to trade. These have been falling in both countries and have been reflected so far in a large increase in exports from India to Sri Lanka but not the other way. Barriers remain high in India, by far the largest economy in the region and the pivot around which a regional market could develop. Further declines in barriers to imports into India on a non-discriminatory basis can be expected but will take time before they have a significant effect on exports from Sri Lanka to India. The growth of Indo-Sri Lanka trade could best be stimulated by a 'fast track' dismantling of barriers to trade with each other, but not necessarily with third countries, while pursuing the process of more general liberalization of trade on a non-discriminatory basis. Making trade freer between the two countries on a preferential basis could pave the way for the rest of the countries of the region to follow in developing a regional market, and obtaining benefits in terms of trade and economic growth.

A reciprocal preferential scheme should be designed so as to have a substantial trade effect, and at the same time be consistent with the outward-oriented policies being pursued in the two countries. Bearing in mind these objectives, the following principles are suggested as a basis for intergovernmental consideration of a preferential arrangement between India and Sri Lanka:

1. All trade should be included except for a small exclusion list of sensitive items.
2. Non-tariff barriers such as prohibitions, quantitative restrictions and licensing should be abolished for trade with each other except for items on the exclusion list.
3. Tariffs should be reduced across-the-board for all items.
4. Tariff reduction should be based on the principle of equivalence of tariffs across-the-board for all items except for those on the exclusion list. The level of tariffs should be the lower rate prevailing for each item in either country.
5. Each country should give the other a minimum 30% preference for each product over third countries except where the non-discriminatory rate is zero.

6. Deeper reductions in tariffs, over and above the rates derived on the basis of the equivalence principle and the preferential margin, should be permitted for selected items such as products of joint ventures, including specific consumer durables.
7. Rules of origin for preferences to be granted on imports from each other should be liberal. A relatively low - 35% to 40% - cumulative value added test should apply for products to qualify for preferential treatment.
8. The provisions of the reciprocal preferential scheme should be phased in automatically over a two to three year period.
9. A dispute settlement mechanism should be established.
10. The substantial Indian market should be perceived as the 'motor' to speed up the process of economic growth and expansion in the framework of the bilateral preferential scheme.

The success of a reciprocal preferential scheme for Sri Lanka will depend to a substantial extent on the flow of investment from India and third countries to Sri Lanka, to take advantage of the market openings in India following the adoption of the scheme. The scheme should be complemented by the removal of the restrictions in India to the flow of investment to Sri Lanka. Investment in joint ventures in Sri Lanka would be facilitated if a revolving fund, subscribed to by the two countries, and by third countries interested in promoting South Asian regional cooperation and integration in a practical manner, is established. The objective would be to facilitate sourcing within the two countries of a generous proportion of the capital goods requirements for joint ventures, and thereby promote regional trade and investment.

I BASIC RATIONALE FOR EXPANDED INDO-SRI LANKA ECONOMIC COOPERATION IN THE CONTEXT OF THE CHANGING WORLD TRADING ENVIRONMENT

Although there are wide differences between India and Sri Lanka in the structure of their economies, economic resources, capabilities and population, the basic changes in economic policies in the two countries that have been, and are, taking place are similar. The reform process was initiated earlier in Sri Lanka - in the budget of 1977 - and it has advanced further than in India. In both countries, these reforms are directed towards the integration of their economies into the world economy after a prolonged period as controlled, inward-looking economic regimes. The changeover to a more outward-oriented, export-driven liberal economic system in both countries involves greater monetary and fiscal discipline, the deregulation of the domestic economy, reducing subsidies, liberalization of foreign trade, competitive exchange rates and currency convertibility, privatisation of state enterprises where appropriate, and an 'open door' policy to foreign investment.

The rationale underlying the sea-change in policies in both countries is the acceleration of economic growth. In Sri Lanka's case the declared objective of the Government is to achieve the status of a newly industrializing economy (NIE) by the year 2000. The implications are clear. The experience of the NIEs is one of phenomenal economic growth in the 1980s, and for the more advanced among them (Republic of Korea, Hong Kong, Taiwan and Singapore) in the 1970s as well. In these economies, unlike in South Asia, the processes of import substitution and export promotion went hand in hand, and reinforced each other.[2] Trade and production growth were closely linked; export growth was associated with a fast pace of industrialization; the expansion of both were higher than GDP growth rates; and domestic savings and capital formation were high. Export growth brought about increases in foreign exchange availability (from exports and foreign direct investment) which financed the expansion of import capacity. Higher imports (of machinery, equipment and intermediate goods) led to higher fixed capital formation, further production expansion and higher exports, thus completing a 'virtuous circle'.

The dynamics of economic growth in the NIEs show the heights which need to be scaled if Sri Lanka is to achieve NIE status by the end of the decade. Currently, economic growth, industrial output, fixed capital formation, and export expansion rates are well below those achieved by the NIEs. In the circumstances facing Sri Lanka (low national savings, low net foreign aid, and a small domestic market), the only way to grow is to obtain the foreign exchange needed to purchase the import of machinery and capital equipment to spearhead industrial expansion. This, in turn, needs higher exports

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2 Siddiq Osmani, *Growth and Poverty in South Asia: A Comparative Study,* WIDER Studies in Development Economics, Clarendon Press, Oxford, forthcoming.

through, *inter alia*, an infusion of foreign direct investment to compensate for domestic capital shortage, to facilitate the transfer of technology, improve competitiveness and secure export markets as well as an adequate level of foreign aid.

Higher export growth rates are central to achieving the economic growth objectives in both Sri Lanka and India. The international economic and trade environment, however, is far less conducive than before for countries such as India and Sri Lanka to emulate the export-oriented experience of the NIEs. Among the inclement factors are:

- a deceleration in the 1990s of economic growth in OECD countries, which are the main export markets for both India and Sri Lanka. Economic growth in OECD countries was 3.8% annually in the period 1965-1980, 3% in the 1980s, 2.5% in 1990, and 1% in 1991. The likelihood of continued sluggish economic expansion in these economies during the rest of the decade implies slower import growth in these markets than in the heyday of export expansion of the NIEs. Recession and/or measures to correct the fiscal and trade deficits in the three major economic centres, the United States, EEC and Japan are all likely to dampen growth of imports of manufactures to these markets from developing countries;

- increased competition among exporting countries to supply the slow-growing OECD markets. Increased competition for markets is in prospect because of the re-direction of trade of Eastern Europe to OECD countries, and the pervasive trend throughout the developing world of targeting supplies to OECD countries in the framework of export-oriented growth strategies;

- the intensification of protectionism in OECD countries to curb the surge of imports into their markets. Tariffs are not important barriers to exporting to these markets. The danger that lies ahead is the proliferation of non-tariff barriers such as anti-dumping actions and "voluntary" export restraint agreements to stem the inflow of imports, especially of labour-intensive categories of products for which developing countries have a natural and strong comparative advantage. The increased application of these barriers of administered protection (product standards, customs entry procedures, safeguard actions such as countervailing duties or other special charges) threaten the gains of negotiated tariff reductions;

- the emergence of trading blocs centred around the major world economic powers. The single EEC market is the most advanced in this regard. This market is being developed in a manner which would ultimately incorporate other European countries, including former Eastern European countries, in an enlarged European market. Agreement has also been reached to form the North American Free Trade Area between the United States, Canada, and Mexico (NAFTA). Although the effects for imports of manufactures to these and similar regional groups are uncertain, at the very least, they would place at a competitive disadvantage suppliers outside the grouping, such as India and Sri Lanka. The most wide-ranging impact over the longer-term of these arrangements of special interest to India and Sri Lanka may be on garment imports, a sector in which both countries have made impressive gains in exports, especially to North America. If, in addition to the enlarged European market, the concept of a free trade area which will embrace the continents of North and South America and of a cooperative grouping of countries of East and South East Asia centred around Japan were to be realized, the ambitious export objectives of India and Sri Lanka (both of which would be outside any of the preferential trading blocs) would be more difficult to achieve;

- stagnant or declining net foreign aid. Aid flows from OECD countries to developing countries have stagnated for a decade despite substantial growth of real output over the period. The waning global commitment to aid is evident in the ratios of aid flows to gross domestic product of individual OECD countries. For the preponderant majority of countries these ratios are far below the agreed United Nations target of development assistance equivalent to 0.7% of gross domestic product. There are now mounting pressures to cut aid budgets because of budgetary constraints, the collapse of communism and the consequent disappearance of the political motivation for aid, and the perceptible shift in the intellectual climate against foreign aid in OECD countries arising from failure to reach the objectives hoped for by the donors. In view of the role that foreign aid plays in import capacity expansion and fixed capital formation, particularly in Sri Lanka, 'aid fatigue' may act as a brake to economic growth unless offset by other flows of foreign exchange.

The developments mentioned above, particularly the deterioration of economic opportunities in OECD countries and the rise of new forms of protectionism in these economies, are 'warning signals' that the new more 'market-friendly' policies being pursued by India and Sri Lanka, however positive, cannot be relied upon exclusively to ensure sustained export-oriented growth. They hold important implications for India and Sri Lanka as they weigh policy options for related industrial and trade growth that is required to solve their mounting trade deficits and to accelerate economic growth. Within the policy framework currently adopted, there may be a need to move decisively in the direction of choosing the particular industrial sectors that are likely to succeed in world markets along the lines that have been pioneered by Japan and the East Asian NIEs. What is involved is a strategy of 'picking winners' through selective interventions in industrial policy, and the pursuit of an active trade policy including the targeting of markets.

With regard to the future export strategy of Sri Lanka and India, there can be little doubt that augmentation of the flow of trade with OECD countries has to be a clear policy goal in the period ahead, because these countries taken together offer a huge market and substantial effective demand. They will undoubtedly continue to provide the major market for industrial exports from Sri Lanka and India and be the immediate target for new export sales for the foreseeable future. Hence liberal access to these markets will remain important. At the same time, it appears unlikely that they would provide a strong magnet for imports from Sri Lanka and India in the same manner as in the expansionary phase of the NIEs in the 1970s and 1980s, when the

NIEs maintained a good export growth performance to these markets, especially the United States, even during the period of world recession in the early 1980s.

The rapidly expanding economies of East Asia (including China) and ASEAN too offer a possible new source of dynamism for additional Sri Lankan and Indian exports. However, even with a boost of exports to these markets, trade growth may still fall far short of what is needed to transform their economies and thereby provide increased employment and higher living standards. Sri Lanka and, to a lesser extent, India, consequently need to look more closely at the trade potential of the SAARC regional market of over one billion people to provide the indispensable additional stimulus needed to speed up the processes of growth and expansion of their economies. Opportunities for mutually beneficial trade between countries of the region which were absent before have opened up with the liberalization of their economies. Some expansion of trade can be expected through the normal operation of market forces depending on the extent to which trade barriers are reduced. The realization of the full potential of trade expansion between them arising from differences in comparative advantage of production, however, would require much more focused attention than has been given so far. This is particularly so with regard to exports from Sri Lanka to the Indian market, by far the largest in the region and the pivot around which a regional market can be developed. A necessary condition for the latter, however, is that India continues with its policies of economic liberalization in general, and more specifically trade liberalization *vis-a-vis* the other countries of the region, and as a result achieves a sustained high rate of growth over the next decade and beyond.

II CURRENT INDO-SRI LANKA TRADE

The past is a poor guide to current trends in Indo-Sri Lankan trade and to future potential. The dismantling of the highly regulated trade regime in Sri Lanka with its import control and licensing system has meant that it is market forces rather than administrative action that determines the nature and the sourcing of imports into Sri Lanka. A striking feature which has emerged in the 1990s following liberalization of trade has been the surge of imports into Sri Lanka from India which could not have been foreseen or predicted on the basis of past trends. After stagnating for the most part during the 1980s, Sri Lanka's imports from India doubled between 1989 and 1990, doubled again between 1990 and 1991 and has increased further in 1992 (by about one third) on the basis of preliminary estimates. In 1991, not only did imports from India to Sri Lanka increase at a faster rate than from any other origin but India also emerged as the second largest supplier of imports after Japan. Total imports from India of Sri Lanka Rupees (SLRs.) 9.1 billion in 1991 constituted over 7% of total Sri Lankan imports compared with about 4% of the total in 1980; the value of total imports over this period rose from SLRs 37.7 billion to SLRs 132.4 billion. In the first six months of 1992, imports from India rose to 9.5% of total imports of Sri Lanka. The dominant position of India is enhanced if concessional imports from Japan under Japanese ODA is separated from the total.

An important aspect of Sri Lanka's imports from India is its broad-based nature. Imports of consumer goods (including food), intermediate goods and capital goods are all substantial; within the total, manufactures account for about 60% of imports. The diversified nature of imports can be gauged by the fact that they fall into more than 1200 categories in the Harmonised Commodity Description and Code System (HS System).

In sharp contrast to Sri Lanka's imports from India, there has been a virtual stagnation of exports from Sri Lanka to India at SLRs 500 to 600 million per year. These exports are marginal (about 0.6%) in relation to Sri Lanka's total exports in 1991. The product range is very narrow, comprizing only some 30 categories in the HS system. What is also noteworthy is that in the context of a substantial increase of total exports of Sri Lanka (from SLRs 6.6 billion in 1977 to SLRs 81.4 billion in 1991), a steady shift in the proportion of its total exports from primary commodities to manufactures (which rose from 14.1% in 1977 to 60% in 1991) and an increasing diversity in the range of manufactures exported notwithstanding the heavy concentration of garments in the total, the bulk of Sri Lanka's exports to India consists of primary commodities (see Table 1).

TABLE 1

INDO-SRI LANKA TRADE IN 1991

	India to Sri Lanka (SLRs. million)	Sri Lanka to India (SLRs. million)	India to Sri Lanka (per cent)	Sri Lanka to India (per cent)
Primary Commodities				
Food and beverages*	2842	193	31	37
Intermediate products	863	215	9	41
Sub-total	3705	408	40	78
Manufactures				
Consumer goods	522	10	6	2
Intermediate goods	3097	91	34	18
Capital goods	1611	7	18	1
Sub-total	5230	108	58	21
Unclassified	170	6	2	1
Total	9105	522	100	100

Source: External Trade Statistics of Sri Lanka 1991, Sri Lanka Customs; UN classification of products by broad economic categories.

* Includes raw sugar classified as an intermediate product in UN classification

A broad conclusion that can be drawn from the divergent trends in Indo-Sri Lanka trade is that India's supply capability would seem to match well with Sri Lanka's demand for imports. The liberalization of the Sri Lanka trade regime, notably the elimination of most non-tariff barriers and the reduction in tariffs, provided a strong stimulus to import demand (and to major changes in its composition) for which India was among the best able to respond. In a year (1991) when total exports of India declined, Sri Lanka emerged as one of the fastest growing markets for Indian exports. Low transport costs was one factor. More important were perhaps the long established marketing structures and networks of traders of Indian origin. Moreover, price appears to be an important determinant of Sri Lanka's demand pattern, at least in the initial phase of liberalization. Indian goods have been extremely price-competitive, although quality may not always be of the same standard as compared with other suppliers. With the likely upgrading of the Indian industrial sector in all the broad economic categories (consumer goods, intermediate goods and capital goods) following economic reforms, and greater foreign collaboration in industry, there are good reasons to expect that India would have the ability to continue to expand exports and to raise its share of the Sri Lankan market further.

A second broad conclusion that one might be tempted to draw on the basis of Sri Lanka's exports to India, is that India and Sri Lanka have little reciprocal trade complementarity. The supply capability of Sri Lanka at first sight does not seem to match well with India's demand structure. It could be argued, on the basis of Sri Lanka's current flow of trade to India, that Sri Lanka's emerging manufacturing structure is 'competitive' rather than 'complementary' to India's industrial sector, and that whatever Sri Lanka can produce, India can also produce more cheaply. This view is, to some extent, reflected in the extra-regional orientation of Sri Lanka's entrepreneurs and exporters and their lack of interest in penetrating the Indian market. The absence of a strong lobby concerned with exports to India is noticeable.

It is difficult, however, to argue that there is a lack of reciprocal trade complementarity between India and Sri Lanka using various standard techniques. Past data cannot capture the potential for Sri Lanka's exports to India, just as it was not possible by evaluating past trends to envisage the impressive increase in Sri Lanka's imports from India. The reason is simple. India still has a highly restrictive trade regime relative to Sri Lanka. The nature of these restrictions for items of which Sri Lanka has a comparative advantage, particularly non-tariff restrictions, notwithstanding the wide-ranging trade policy changes in India, are discussed in the next Section.[3]

It would appear that trade barriers in India distort what would otherwise be the natural pattern of exports from Sri Lanka to India. It is only after the dismantling of these barriers, especially the non-tariff barriers, that it would be possible to assess whether it is the lack of complementarities or the existence of high trade barriers in India which has stifled exports from Sri Lanka to India. Moreover, even if it became evident that the emerging manufacturing structure in Sri Lanka was in large part 'competitive' rather than 'complementary' to India's industrial structure, experience elsewhere shows that such competitive manufacturing sectors are suited for increasing intra-industry trade provided there are no trade barriers. This type of trade is widespread among major industrial countries and permits even greater avenues of specialization and growth than the traditional inter-industry trade.

[3] The thrust of India's current reform process is progressively to reduce these restrictions and the Government's budget for 1993 represents a major step forward in this direction, which materially strengthens the case for rapidly implementing the kind of reciprocal preferential arrangement suggested in this Report.

III A PROFILE OF PROTECTION IN INDIA FOR PRODUCTS OF EXPORT INTEREST TO SRI LANKA

1. Tariffs and Non-tariff Barriers in India for Products Currently Exported from Sri Lanka to India

Any survey of the nature and extent of tariff and non-tariff barriers in a country and their significance for trade is not an easy task because of difficulties arising from data, definitions, methodology and quantification. Important qualifications inevitably have to be made regarding the information and analysis of the trade control measures imposed by a country. The purpose of the information given below of the tariff and non-tariff measures applied by India on products of export interest to Sri Lanka, is to give a broad overview of the measures that restrict imports to India. All the changes in the structure of protection of India which have been introduced as a result of changes in trade policy since July 1991 may not necessarily be reflected in the information given. These, however, do not change the overall picture of protection for products of export interest to Sri Lanka.

The information on trade control measures focuses on major governmental measures implemented internationally for reasons such as revenue collection, domestic industry protection, and balance of payments and foreign exchange shortage. They are confined essentially to tariffs which consist of customs duties, and to non-tariff barriers relating to restrictive licensing, quotas, prohibitions, and canalization of imports through state trading agencies. There may be a number of other trade control measures such as para-tariffs (e.g. customs surcharges, stamp duty and other fiscal and financial charges on imports) which may restrict trade. Although involving simplification, the information is adequate to draw broad conclusions relevant for policy.

Current exports from Sri Lanka to India of over SLRs. 100,000 fall into 31 categories accounting for SLRs. 516 million out of the total exports to India in 1991 of SLRs. 522 million. The duties for each product category are set out in Table 2.

The rates of duty indicated are the sum of the basic and auxiliary duties. The realisable import duties include additional rates (see Annex for details).[4]

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[4] The basic duty is prescribed in the Customs Tariff Act. The auxiliary duty is prescribed in the Finance Act every year and is levied in addition to the basic duty. The additional duty is equal to the excise duty levied on similar goods when manufactured in India. The additional duty is charged on the value of goods as well as the sum of the basic and auxiliary duties. Consequently, the total will not be the sum of the three components. For example, if the basic duty is 60%, the auxiliary duty is 45% and the additional duty is 12%, the total duty will be 129.60% and not 117%. There appears to be, *prima facie*, an element of protection in the additional duties.

TABLE 2

IMPORT REGIME AND TARIFFS APPLICABLE IN INDIA FOR PRODUCTS EXPORTED FROM SRI LANKA TO INDIA IN 1991

		Value of exports (SLRs. million)	Tariffs (per cent)
Freely importable items			
1.	Ferrous waste and scrap	122.4	85
2.	Natural rubber	55.9	70
3.	Copper waste and scrap	29.2	10 (+IRs. 10500/mt)
4.	Glycerine products	23.7	90
5.	Glycerol	18.7	90
6.	'Camel back' strip for retreading tyres	14.9	110
7.	Radiators for central heating	10.4	110
8.	Unsorted waste and scrap or paper	5.2	20
9.	Methacrylic acid and its salts	4.8	110
10.	Drums, cans of iron and steel	4.7	110
11.	Black gram	4.5	10
12.	Containers of iron and steel	2.8	100
13.	Screws and bolts	2.5	110
14.	Waste of paper (unbleached kraft)	1.3	20
15.	Natural graphite	1.2	85
16.	Other knitted/crocheted fabrics	1.1	110
17.	Electrical apparatus for switching etc.	0.9	110
18.	Human hair	0.8	105
19.	Leather	0.3	0
Items under license			
1.	Pepper	71.1	110
2.	Black tea in bulk	67.7	10
3.	Cloves	44.1	47
4.	Resinoids	16.8	110
5.	Tea bags	2.9	10 (+IRs. 2/50 per kg)
6.	Plants in perfumery use	2.0	105
7.	Nutmeg	1.6	110
8.	Coconut oil	1.6	110
9.	Black tea less than 3kg	1.4	10 (+IRs. 3/25per kg)
10.	Brown crepe rubber	0.6	70
11.	Essential oils	0.5	110
12.	Cinnamon leaf oil	0.4	110

Source: External Trade Statistics, Sri Lanka Customs; BIG's Database, New Delhi; various sources.

Notes: Tariffs applicable in February 1993. Tariff rates shown are the sum of the basic and auxiliary duties. To obtain realisable duties add additional duties (see footnote 4 in the main text). See Annex for details.

TABLE 3

TARIFFS APPLICABLE IN INDIA FOR **FREELY IMPORTABLE ITEMS** OF SPECIAL EXPORT INTEREST TO SRI LANKA WHICH ARE NOT IMPORTED BY INDIA FROM SRI LANKA

	Item	Exports from Sri Lanka SLRs. million	Tariffs per cent
1.	Other wood products	625	105
2.	Activated carbon	553	100
3.	Nuts of iron and steel	327	110
4.	Interchangeable spanner sockets	248	105
5.	Glazed tiles (ceramics)	238	110
6.	Parts for automatic data processing machines	207	80
7.	Scrap crepe (rubber)	193	90
8.	Sails for boats	185	110
9.	Electrical machinery - plugs and sockets	141	70-110
10.	Artists brushes	110	110
11.	Wood charcoal of coconuts	100	105
12.	Board/panels for electrical control goods	71	70-110
13.	Quartz	51	110
14.	Variable resistors	51	80
15.	Ilemenite	45	90
16.	Steel rolled sheets	35	45 (+ IRs. 600/mt)
17.	Copper chain and parts thereof	35	110
18.	Stuffed toys	32	110
19.	Leather gloves other than for sports	30	110
20.	Wood tools, tool bodies, handles, etc.	29	105
21.	Other apparatus for electricity switching	27	70-110
22.	Rubber rods, tubes, shapes, discs, rings	25	110
23.	Footwear covering up the ankle	23	110
24.	Electrical transformers, static converters etc.	23	110
25.	Granite crude	21	110
26.	Printed circuits	20	80
27.	Leather - other parchment dressed	17	0
28.	Structures of iron and steel: frames, shutters etc.	17	85
29.	Fishing boats	13	0
30.	Leather - other tanned	13	0
31.	Leather - other blue chrome tanned	12	0
32.	Accumulators (electrical converters and inductors)	7	55-110
33.	Electric motors over 75kw less than 375kw	5	55
34.	Aluminium foil rolled	5	105
35.	Aluminium roll backed	5	105
36.	Water pump parts	5	40
37.	Electricity generating sets over 75kw less than 375kw	4	90
38.	Illuminated signs of plastic (parts)	4	110
39.	Rubber hygienic articles (excluding contraceptives)	3	110
40.	Articles of tin	3	105
41.	Water pumps	3	55

Source and notes: Same as Table 2.

The picture that emerges from the current trade regime in India is that, following the trade policy reforms that have already been implemented, licensing, quantitative restrictions, and administrative controls, have been removed for a large number of items featuring in the current flow of Sri Lankan exports. It is a qualitative change from the past and opens up possibilities for trade. Freely importable items cover so far about three-fifths of current exports from Sri Lanka to India. However, steep import duties continue to apply for most of these liberalized items. These duties are not easy to surmount. They constrain export expansion. The trade reforms so far do not appear to have had a significant trade effect.

For the current flow of Sri Lankan exports to India, non-tariff barriers apply primarily for agricultural or agricultural based products. India in the past applied a plethora of non-tariff barriers which were not always easy to identify. These have been simplified. The most common non-tariff instrument used to restrict imports is licensing. Their restrictive nature depends on the way they are applied. The licensing requirements can range from being liberal at one extreme and having the same effect as an outright prohibition at the other. In practice, licensing takes many forms. They include an open general license (i.e. free imports) for actual industrial users through Export Houses, advance licenses, limited permissible list, restricted list and imports based on a proportion of past imports conditional on export of equal value to that of the import license granted in the previous year.

Licensing for items currently imported into India from Sri Lanka is used in combination with relatively high tariffs. These items are the traditional exports of Sri Lanka to India. Many of them are items for which unrecorded trade ('smuggling') is reported to be substantial and highly lucrative because of wide price differentials in the two countries. Immediate benefits are likely to flow, in terms of volume and value of trade and customs revenues to governments, if these items such as spices become freely importable. At the same time, in India as elsewhere, agriculture is a sensitive sector where pressures from domestic interests are strong.

2. Tariff and Non-tariff Barriers in India for Other Products of Special Interest to Sri Lanka Which Are Not Exported from Sri Lanka to India

As noted earlier, the range of Sri Lanka's exports to India is extremely narrow. There have been no imports at all into India of the increasing diversity of exports from Sri Lanka to the world market. In part the absence of such trade reflects past constraints, when items which Sri Lanka was exporting to world markets in rapidly increasing volumes were not permitted to be imported into India from any source or faced severe restrictive licensing and high tariffs. These import restrictions, directly or indirectly, affected the volume and product structure of Sri Lanka's exports to India. This situation is bound to change as the trade liberalization process in India gathers momentum. Already there are a large number of new products exported from Sri Lanka to the world market which are also freely importable into India.

A number of problems, however, have to be dealt with if export expansion of both traditional and non-traditional export items from Sri Lanka to India is to be realized. One relates to the level of tariffs for items which are freely importable into India. Table 3 shows that a substantial number of Sri Lanka's export items are no longer subject to licensing or other non-tariff barriers. The tariffs, on the other hand, with one or two exceptions, are still high, often exceeding 100%. Export expansion of Sri Lankan goods to India cannot be expected until these tariffs are drastically reduced.

A second problem relates to non-tariff barriers in the form of licensing combined with high tariffs, often over 100%, for a large number of products which Sri Lanka has been able to export competitively to world markets. Licensing has generally meant no import at all of these items from any source. Table 4 shows an illustrative list of these items and the tariffs currently applied in India. Several of the items such as garments, diamonds, footwear, leather products and coir products are major exports from India, too. As India is as competitive as Sri Lanka with regard to these products, if not more so, there appears to be scant need for protection (other than value-added safeguards) from imports from Sri Lanka. Others, especially consumer durables, are produced for the home market and the restrictions reflect protection for domestic producers although output in Sri Lanka for most items is small in relation to their consumption in India. Specialization in the two countries for items currently under license is contingent on the elimination of licensing requirements and the reduction of tariffs.

A third problem relates to items currently not exported to any destination from Sri Lanka which have been targeted for export development and promotion. These are mainly consumer durables and other consumer goods (see Table 5). India has so far not liberalized, except perhaps marginally, imports of consumer goods and duties although high are notional.

TABLE 4

TARIFFS APPLICABLE IN INDIA FOR ITEMS OF SPECIAL INTEREST TO SRI LANKA WHICH REQUIRE **A LICENSE** AND ARE NOT IMPORTED INTO INDIA FROM SRI LANKA

	Item	Exports from Sri Lanka (SLRs. million)	Tariffs (per cent)
1.	Made-up textiles	32500	110
2.	Diamonds	2805	85-105
3.	Precious stones	2302	105
4.	Coir fibre	594	85
5.	Solid tyres	448	110 *
6.	Statuettes etc. of porcelain/china	403	110
7.	Sports footwear	313	110
8.	Ceramic tableware, kitchenware etc	287	110
9.	Brooms and brushes	283	110
10.	Rubber clothing and apparel accessories	271	110
11.	Leather gloves for sports use	235	110
12.	Artificial flowers	230	110
13.	Other articles of vulcanised rubber	195	110
14.	Fluorescent hot cathode lamps	190	110
15.	Surgical gloves (rubber)	150	110
16.	Parquet panels	119	105
17.	Rubber floor coverings and mats	113	110
18.	Instant tea	113	110
19.	Block rubber	106	90
20.	Sole crepe (rubber)	103	90
21.	Leather apparel accessories	102	110
22.	Coconut fibre floor coverings	64	110
23.	Razor blades	42	110
24.	Other rubber gloves (non-surgical)	39	110
25.	Other footwear rubber/plastic outer soles	30	110
26.	Non-electric lamps and light fittings	27	110
27.	Imitation jewellery	27	110
28.	Other footwear with textile uppers	19	110
29.	Footwear with upper straps	16	110
30.	Other articles of copper	10	110
31.	Electric light fittings - chandeliers	6	110
32.	Chocolates in blocs, slabs, bars filled	5	110

Source and notes: Same as in Table 2.

* Item as consumer good is subject to license and as industrial good is freely importable.

TABLE 5

IMPORT REGIME AND TARIFFS IN INDIA FOR ITEMS CURRENTLY EXPORTED IN SMALL OR NEGLIGIBLE QUANTITIES FROM SRI LANKA AND TARGETED FOR EXPORT EXPANSION IN SRI LANKA

	Item	Import regime (Licensed or free)	Tariffs (per cent)
1.	Refrigerators	Licensed	110
2.	Air conditioners	Licensed	110
3.	Batteries	Free	110
4.	Sewing machines (household)	Licensed	110
5.	Electrical cables and conductors	Free	110
6.	Motor spares (radiators etc)	Licensed *	110
7.	Electric table, floor/desk lamps	Licensed	110
8.	Spectacle frames	Licensed *	110
9.	Rubber belting - conveyor/transmission	Free	70
10.	Rubberised textile fabrics	Free	110
11.	Soaps	Licensed	110
12.	Detergents	Free	100-110
13.	Bicycle tyres	Licensed	110
14.	Conveyor belts	Free	85
15.	Rubber automotive components	Free	80
16.	V belts of vulcanized rubber	Free	70
17.	Ceramic sanitary ware (porcelain)	Licensed	110
18.	Glass tableware	Licensed	110
19.	Graphite crucibles	Free	100-110
20.	Granite slabs	Free	110
21.	Steel metal furniture	Licensed	110
22.	Metal tools, dies and moulds	Free	70

Source: BIG's Database, New Delhi. Notes same as in Table 2.
* Item as consumer good subject to license and as industrial good is freely importable.

The conclusion that can be drawn from the information presented above is that in the past Sri Lankan exports to India were severely constrained by high and widespread barriers to trade. Tariffs were very high and non-tariff barriers overwhelming. Protection was substantial for products where Sri Lanka had the greatest potential (including consumer durables and other consumer goods), and where Sri Lanka was progressing up the 'ladder of comparative advantage', moving from export of primary commodities to manufactures. The restrictions, applied on a non-discriminatory basis to all countries, reflected the general inward-looking policies pursued by India. In so far as imports from Sri Lanka were concerned, they were scarcely imposed for customs revenue, balance of payments reasons or even, for the most part, for the protection of domestic industry, given the small supply capability of Sri Lankan exporters in relation to production in India.

Economic reforms in India have brought about significant changes in its trade regime relating to the import of capital goods and intermediate goods. The direction is towards the further relaxation of barriers to imports by extending the range of freely importable goods and by a greater reliance on tariffs to regulate imports. Sri Lanka has better opportunities to export to India than ever before. However, tariffs are still too high for products of special interest to Sri Lanka to enter the Indian market in a significant way. In addition, India is still a closed market for many items Sri Lanka exports to the world and for consumer goods, especially consumer durables, which Sri Lanka has targeted for expansion of production and exports. It follows that the issue posed by these barriers needs to be addressed, so that tariff and non-tariff barriers are reduced simultaneously if Sri Lanka's exports to India are to expand.

IV FACILITATING TRADE EXPANSION BETWEEN INDIA AND SRI LANKA

1. The Case for Trade Preferences

Both India and Sri Lanka face major challenges in reshaping their economies in the period ahead. Both countries are striving hard to bolster exports, and attract foreign direct investment in a global environment which is at best uncertain. Boosting exports requires, *inter alia*, diversification of markets. In this regard, now, more than ever before, expanding Indo-Sri Lanka trade seems achievable. There is a growing convergence in economic objectives and policies and, more generally, interests that embrace political and economic matters. Moreover, both countries are firmly committed to building regional trading links which is reflected in their active support for SAARC initiatives in the area of trade. Geographical proximity is an added advantage to strengthening trading links.

The spur to enhanced trade cooperation with India from Sri Lanka's viewpoint is its burgeoning trade deficit with India which is rising inexorably. The perception currently prevails in Sri Lanka that there is a lack of a 'level playing field' in trade relations between the two countries, that India was enjoying a 'free ride' in the liberalized Sri Lankan market; and that mutual trade relations could not be built up when one side was obtaining all the benefits.

While the continuing general trade problems confronted by Sri Lanka, and its huge trade deficit with India, are in themselves grounds to find ways to promote Indo-Sri Lanka trade, the rationale for trade cooperation between the two countries can be advocated more generally on the basis of the standard theory of international trade. The theory of trade posits that there are gains to be realized from trade between countries where the relative cost of producing different goods in one country differs from the relative cost of producing the same goods in the other country, arising from the differences in the relative endowment of resources, and differences in production capabilities.

The trade potential, however, can be realized only where there are no barriers to mutual trade. Currently, Sri Lanka is a relatively open market for Indian goods but the reverse does not apply. The welfare gains to India have arisen so far from market expansion and the benefits therefrom, and for Sri Lanka from the supply of Indian goods which are cheaper than could be produced domestically or obtained from elsewhere.

Likewise, there are welfare gains to be obtained by both countries from a reduction in Indian barriers. For Sri Lanka it would increase market size and access for its exports. Gains from trade would arise from specialization in production in which Sri

Lanka has a comparative advantage. India, in turn, will obtain internationally competitive Sri Lankan goods reflecting complementarities which exist and the emerging production capabilities of the liberalized Sri Lankan economy. Moreover, increased competition from Sri Lankan firms, albeit limited in scope and intensity, can be expected to improve business efficiency and industrial productivity of Indian firms without disrupting their domestic market.

It is therefore as much in India's interest to respond positively to market openings in Sri Lanka, and to consolidate and 'lock-in' its new found success in the goods market in Sri Lanka as it is in Sri Lanka's interest to expand exports to India. There is thus a distinct reciprocity of interest in promoting mutual trade.

While there may be acknowledgement that there are gains to both countries from trade expansion between them, attention has yet to focus on concrete measures to achieve this end. It may be argued that in keeping with the broad approach underlying economic reforms, the gains from trade are best realized through the normal operation of market forces in the context of the on-going liberalization processes in both countries. Sri Lanka's liberalization which is relatively advanced has shown that market openings on a non-discriminatory basis, generally known as Most Favoured Nation (MFN) treatment, to all suppliers provides opportunities which the business sector in India had been quick to seize. It may be argued that a similar result would follow if India liberalizes on a MFN basis imports of products of export interest to Sri Lanka. The business sector in Sri Lanka would then be in a position to take advantage of the opportunities offered.

The flaw with this approach is that India seems unlikely to make substantial reductions in import barriers rapidly on a MFN basis as part of its programme of economic reform, including for those items in which Sri Lanka has a comparative advantage - mainly domestic resource based intermediates and consumer durables - for balance of payments reasons and/or the pressures to protect domestic industry from external competition.[5] The benefit likely to accrue to Sri Lanka from the pace of liberalization of trade set in India on an MFN basis would be long-term, and at best uncertain. Even under the most favourable assumptions, barriers to imports in India are likely to remain significantly higher than in Sri Lanka. If liberal access to create a 'level playing field' in trade exchanges, albeit on an MFN basis, to the Indian market for the existing and developing capabilities of Sri Lanka is not in prospect, increased Sri Lankan exports to India can best be achieved in the framework of trade preferences granted by India to Sri Lanka. As one way trade preferences from India to Sri Lanka are not a realistic option, expanding bilateral trade would require arrangements for reciprocal preferences between India and Sri Lanka that would entail special advantages to each other which would be absent in their dealings with third countries.

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[5] The Tax Reform Committee appointed by the Government of India has recommended a substantial reduction in average tariffs to 25% by 1997-1998. It has recommended that import duties should come down by 1997-1998 to a maximum of 30% except for non-essential consumer goods allowed to be imported which should attract a duty of 50%.

Closer market integration of Sri Lanka and India through the extension of reciprocal trade preferences can be expected to lead to some welfare gains from trade creation based on existing static comparative advantages. Sri Lankan industry, for example, will be enabled to extend the pure domestic market-oriented import substitution or establish new manufacturing industries to compete in the combined Indo-Sri Lanka market before facing the stiffer competition involved in trying to enter the markets of the rest of the world, particularly developed countries. The major benefits, however, will depend on the development of dynamic comparative advantages, and their effect in raising the trend rate of economic growth. For Sri Lanka, the exploitation of economies of scale in production, specialization, efficiency improvements, greater product variety, the increased flow of foreign investment and technology transfer are all potential and beneficial by-products of a larger Indian market. Equally important is that the larger Indo-Sri Lanka market would provide a spring board for the expansion of competitive exports from Sri Lanka to the world market. It would serve as an intermediate stage at the regional level for export development before competing internationally. It would provide an incentive for the attraction of foreign investment based upon assured access to a joint market with a large potential for growth as the current economic reform process in India unfolds.

The possible adverse effects of reciprocal trade preferences between India and Sri Lanka seem minimal. Whether integration of markets through trade preferences is in the economic interest of participants depends, as trade theory states, on the extent of trade creation as opposed to trade diversion. While the scope for trade creation between India and Sri Lanka is evident even leaving aside the potential from the development of dynamic comparative advantages, the economic structures and trade regimes of the two countries would seem to limit the scope for trade diversion, notwithstanding the fact that bilateral trade forms a small proportion of total exports of each country. Sri Lanka's trade restrictions are relatively low, especially for intermediate and capital goods. India is price competitive in a wide range of goods imported into Sri Lanka. Consequently little diversion from third countries to high cost imports from India seems likely. Where India is not price competitive - generally in high quality goods - price is not generally the important factor in Sri Lanka's imports of those goods. It is therefore unlikely that trade preferences would divert imports to less competitive Indian goods. Likewise, India's opening of its market to Sri Lanka would have little harmful trade diversion effects as probable imports from Sri Lanka into India would not have been imported from any source previously. Imports from Sri Lanka being a new flow of trade would be trade creating. In sum, any discriminatory elements are likely to be globally insignificant. The positive net effects globally will be increased in the longer term to the extent that growth is accelerated in the enlarged market. Higher growth can be expected to increase their trade exchanges with third countries in absolute terms.

A concern which might be expressed in both countries, especially in the context of the large overall trade deficits confronted by them, is that trade preferences may cause a flood of imports and aggravate their balance of payments problems. In order that a dynamic process of integration could proceed apace even when trade imbalances are accentuated it would be necessary to foster an environment which would facilitate longer term investment flows, especially foreign direct investment, and make possible credit availability from international capital markets and/or multilateral institutions.

Safeguards can also be built-in to prevent market disruption from 'dumping' or other unfair marketing practices by exporters in the bilateral partner.

Both countries would also wish to make certain that closer integration of their markets does not run counter to the liberalization processes of their economies, and their efforts to integrate their economies more closely to the world market. Global markets are immensely important to both countries. Neither would wish closer integration with each other to sacrifice global markets. Closer integration thus could not be accompanied by a 'fortress' mentality that leads to an increase in protection than would otherwise apply. Both countries are likely to view bilateral lifting of trade restrictions as a 'stepping stone' to the further liberalization of their trade regimes when conditions were felt appropriate, consistent with their outward-oriented policies.

It is evident that the purely economic benefits of closer integration through trade preferences for India and Sri Lanka would not be equal. Sri Lanka has more to gain by access to the currently largely closed Indian market than India which already obtains the benefit of a relatively liberalized Sri Lankan market. The purely economic benefits to India, though not insubstantial over the longer term, may well be perceived as a weak motivation to agree to reciprocal trade preferences with Sri Lanka. The rationale for building bilateral trade linkages could be viewed differently, if indeed it was deemed necessary, if the wider dimensions of closer integration were also taken into account. Closer integration of SAARC markets offers substantial economic benefits to India as well as to other countries of the region; the gross domestic product (GDP) of SAARC countries other than India is about 25% of GDP of India and their combined population about one-third of that of India. A bilateral preference scheme of significance between India and Sri Lanka would be a first step in that direction. A strengthened motivation also may well lie in the contribution that reciprocal trade preferences would make to the political and economic stability of Sri Lanka regarding which India has a major stake. It would be an example for the rest of the countries in the SAARC region to emulate in fashioning a partnership with India.

2. Possible Forms of Reciprocal Trade Preferences between India and Sri Lanka

The pursuit of bilateral integration efforts between India and Sri Lanka as part of a broader process towards trade liberalization still leaves open the question of what kind of arrangement makes most sense and, how best to design such an arrangement. The possible forms of reciprocal trade preferential arrangements have traditionally varied. Two of them widely adopted in different regions, involving preferences but not a common commercial policy, are preferential trade arrangements and free trade areas. Although there are legal aspects arising from GATT articles which differentiate them, the essential distinction between them relate to the scope and depth of integration sought. Preferential trade arrangements, such as those formed in Africa and ASEAN, consist of concessions on individual products following a negotiating process involving requests and offers of concessions on a product-by-product basis by participating countries; selectivity of lists of products for trade preferences; and periodic negotiating rounds. Free trade areas in order to be consistent with GATT should cover substantially all trade; eliminate, across-the-board, tariffs and non-tariff barriers within a specific period; and involve an automatic process rather than rounds of negotiations. Examples of free trade areas include the Canada-United States Free Trade Agreement, the North American Free Trade Agreement among United States, Canada and Mexico, the Australian-New Zealand Closer Economic Relations Trade Agreement and the European Free Trade Association (EFTA).

The differences between arrangements relating to free trade areas and preferential trade can be wide or narrow. The Latin American Free Trade Area's programme was based on product-by-product, regional and bilateral negotiations which, in some aspects, was not dissimilar to traditional preferential trade arrangements. The elimination of barriers was also never carried out as scheduled notwithstanding repeated efforts. The current proposals of ASEAN for a free trade area envisage a transition period of 15 years and allows for tariffs of up to 5% on any item at the end of the period. Another feature in practice in most free trade areas, including those involving industrial countries, is that the coverage and scope vary. Agriculture is often excluded and many also exclude other sensitive sectors such as textiles and clothing, leather products and steel. The ASEAN Free Trade Area, for example, which came into operation at the beginning of 1993, has clauses which allow exemptions from regional trade liberalization. Hundreds of products have been excluded by different member countries at the initial stage of the free trade area.

Although there are differences, and a conceptual distinction, between free trade areas and preferential arrangements, they blend into one another and overlap in practice. It is evident that during the long transition period in free trade areas, the arrangements in practice comprise reciprocal trade preferences for participating countries. As in the case of free trade areas, preferential trade areas too could, in principle, cover substantially all trade of participating countries, exclusion lists of sensitive products and provide for an automatic timetable of tariff and non-tariff reductions. The decision to call this form of reciprocal trade preferences, a preferential trade area or a free trade area should thus be a practical one, depending on the final objectives, the legislative processes in the countries concerned and the legal and political dimensions relating to the terms used.

In practice, the commitment to trade liberalization has been much greater in free trade areas than under a preferential trade arrangement. The traditional concept of a preferential trade areas has proved a failure to achieve growth oriented market integration. The results of preferential areas have been too meagre to impart dynamism to trade flows between participating countries. The Bangkok Agreement and the Global System of Trade Preferences among Developing Countries are examples of insignificant results, so far, in relation to the negotiating efforts and the objectives sought. Invariably undue selectivity results from a product-by-product approach in building a preferential trade area. In part, this reflects the pressures that vested interests in import competing industries can exercise in this form of negotiation. There is a tendency for most items to be regarded as 'sensitive' items and be excluded from trade concessions. The influence of vested interests also tends to bias the selection of products in favour of those with limited potential for trade expansion. The vision of negotiators is thus focused on the pros and cons of concessions on individual products rather than in netting the overall gains and losses of the removal of barriers. Another shortcoming, widely noted, is the lack of an automatic timetable for the removal of barriers to trade which results in time-consuming rounds of negotiations over a long period. These drawbacks lead to uncertainties whether, and how far, trade barriers would be removed under preferential trade arrangements. Uncertainty of this kind is counter-productive to the objectives sought and does little to improve the investment climate, a key factor in beneficial trade creation through preferences.

Experience of preferential agreements shows that the across-the-board approach is best as a way of promoting trade among member countries and best as a way of avoiding efficiency reducing trade diversion; the product-by-product concessions or sectoral preferences have not proved to be conductive to a rapid increase in intra-trade of members of preferential groupings. For all the above reasons, a preferential arrangement between India and Sri Lanka which makes most sense would need to be based on across-the-board reductions in tariff and non-tariff barriers leading to a largely free combined market. Such an approach would confirm the seriousness of the liberalization commitment of both countries for their mutual trade.

3. Possible Elements of a Reciprocal Preference Scheme between India and Sri Lanka

The principle of extending preferences by India and Sri Lanka to each other is nothing new. Tariff concessions have been granted by each country to the other in a multilateral framework such as in the Bangkok Agreement and the Global System of Trade Preferences among Developing Countries. The scope of these preferences so far has not been substantial. If closer integration of the two economies is a policy goal, the Governments of India and Sri Lanka have to consider how best to construct a meaningful preferential scheme; how to foster an environment to take advantage of the new opportunities that would be created; and how to make the necessary economic adjustments in each country to improve the competitive position of their industries. The following principles are suggested as a basis for intergovernmental consideration of a bilateral preferential arrangement. Its purpose is to draw attention to some basic issues in the designing of a preferential scheme and the choices that will have to be made.

First, the scheme should cover all trade, subject to the caveat of a small exclusion list of items the value of which should be limited to a ceiling of 10% to 15% of total imports. Both India and Sri Lanka have sensitive sectors or industries where it would not be possible to remove or reduce barriers, or where substantial liberalization could need to be carried out over a long period of time. This problem could be overcome by providing for an exclusion list of items, different for each country, relating to which no concessions would be given initially. Ideally, the number of products in the exclusion list should be small, and concessions on these items should be phased in over time.

Second, non tariff barriers such as prohibitions, quantitative restrictions and licensing should be abolished for trade with each other (though not necessarily for trade with third countries), with the exception of items on the exclusion list of each country. Past experience of Indo-Sri Lanka trade shows that non-tariff barriers are the biggest block to trade between the two countries. The effects of tariff reductions would not materialise until non-tariff barriers are relaxed. A 'standstill' of these barriers would have little impact on trade. A significant 'roll-back' of non-tariff barriers is what is required for trade growth. The removal of non-tariff barriers should be carried out progressively over a period of two to three years.

Third, tariffs should be reduced in an uniform manner for all items, across-the-board, except for items in the exclusion list. Several tracks for tariff reductions will weaken the scheme and reduce the benefits (see, however, the sixth point below).

Fourth, consistent with the concept of a largely free combined market, tariff reductions should be based on the principle of an equivalence of tariffs, across-the-board, for all items in India and Sri Lanka except for those in the exclusion list. The level in both countries should be the lower rate prevailing in either country. It follows that where Sri Lankan tariffs are higher than Indian tariffs for a specific product it will have to be reduced to the Indian level (though not to third countries) and vice versa. (see, however, the fifth point below). The convergence of tariffs based on the principle of equivalence of tariffs should be phased in over a two to three year period.[6]

Fifth, each country should give the other a minimum 30% preference for each product over third countries except where the MFN rate is zero; the maximum preferential margin under the equivalence principle indicated in point four could be much higher. For example, if India has a MFN duty of 50% for product A, and Sri Lanka has a MFN duty of 10% for the same product, under the equivalence principle the tariffs in both countries should be 10% for imports from each other, and 50% in India and 10% in Sri Lanka respectively for third countries (MFN rate). However, under the principle that each country should enjoy at least a 30% preferential margin, Sri Lanka would have to reduce tariffs for imports from India for product A to 7% in order to give India a preferential margin of 30% (10% less 30% of 10% = 7%). It also follows that India would have to reduce the tariff for the import of product A from Sri Lanka to 7% to conform with the equivalence principle.

Sixth, in addition to the basic equivalence principle referred to in point four and the preferential margin referred to in point five, each country would be permitted to make deeper tariff cuts (and thereby provide higher preferences than required under the equivalence and preferential margin principles) for individual products or categories of products. The purpose would be to facilitate selected exports to the partner country from Indo-Sri Lanka joint ventures or in relation to which the country has an overwhelming comparative advantage. The

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[6] The importance of the principle of equivalence should not be under-rated. It is a *sine qua non* for market determined intra-industry trade and specialisation in production in which either partner has a comparative advantage.

items for which deeper cuts would be made need not necessarily be the same for each country. For example for product A referred under point five above, Sri Lanka could agree to charge a duty of 5% instead of 7% preferential rate under the equivalence principle and preferential margin concept (which will continue to apply in India) and 10% MFN duty. This additional preferential margin could, for example, be extended to all capital goods imports from India. Likewise, India might wish to extend a similar additional preferential margin over and above the rate applicable under the equivalence and preferential margin principles for products of Indo-Sri Lanka joint ventures operating in Sri Lanka, or for certain specified products, such as consumer durables and intermediate goods in which Sri Lanka has a dynamic comparative advantage. The difference from the equivalence principle is that both countries will not be applying the same tariffs for the same products which fall into this category.

Seventh, the rules of origin[7] for preferences to be granted on imports should be liberal. Under preferential schemes, rules of origin are aimed at preventing third country exporters using the low tariff country to set up 'screw driver' industries as a back door through which to enter the highly protected country. In many preferential schemes a 50% cumulative value added requirement is specified to qualify for preferences.[8] In the proposed ASEAN Free Trade Area a 40% value added criterion is required to qualify for preferential treatment. In a growth-oriented preferential scheme as envisaged between India and Sri Lanka there are advantages in setting a relatively low - 35% to 40% - cumulative value added requirement for two reasons. One is that it would give an incentive to the flow of foreign direct investment from third countries, particularly to Sri Lanka, to supply the large combined market. The second is that it would inject an element of competition, for example, to the consumer goods market in India from relatively low value added imports from Sri Lanka. Safeguards could be introduced to 'bind' the gains and minimise the losses which can arise from a flood of low value-added imports from the bilateral partner. One safeguard would be to raise the value added requirements gradually to, say, 50% over a ten year period *pari passu* with the improvement of the competitive position of the industry. This would also have the effect of providing an incentive for the development of import substitution industries and to source a greater proportion of inputs from production in the two countries. The other safeguard is to establish a preferential quota for low value added items for which India or Sri Lanka operates a system of licensing, quantitative restrictions or prohibition. Such a preferential quota would be a move towards trade liberalization and in line with the economic reform process being pursued by both countries. This

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7 Rules of origin are laws, regulations and administrative practices which are used to identify the country of origin of internationally traded goods. Approaches to define a product's country of origin vary. Only the value added concept which gives a high degree of certainty is referred to in the text. Under preferential arrangements, rules of origin are needed because participating countries treat their imports for tariff purposes differently depending on their origin.

8 Cumulation involves the addition of parts of the production process in more than one country, provided they are all eligible for preferential treatment or that the final product includes components made in any country in the preferential area.

may enable, for example, the setting up of consumer durable goods industries in Sri Lanka with a guaranteed market in India. Such a guaranteed market might be sufficient for Sri Lanka to export the same goods competitively to the world market too. It would also have the effect of adding an element of competition to the Indian industry concerned, and thereby provide an incentive for it to be more productive and efficient, while at the same time buying sufficient time to prepare it for the rigours of international competition.

Eighth, a timetable should be adopted to reach the goals listed above and the phasing in of changes should be automatic. This would combine realism and confidence, two aspects which are important to the market and investors. A possible scenario would be to adopt:

(i) A 30% tariff preference across-the-board from the outset for all items except for those in the exclusion list. The implementation of the equivalence principle could be phased in automatically over a two to three year period so that tariff equivalence would be reached by the end of the transition period.

(ii) An initial 30% reduction in the number of items (except for those in the exclusion list) still subject to an agreed list of non-tariff barriers. In addition, there would be agreement on a time table for the elimination of the remaining non-tariff barriers over a two to three year period.

Ninth, a dispute settlement mechanism should be established. Interpretation of the preferential scheme on issues such as safeguards against market disruption from imports from the partner country, or unfair marketing practices, should be dealt with by this dispute settlement mechanism.

Tenth, the substantial Indian market should be perceived as the 'motor' to speed up the processes of economic growth and expansion in the framework of the bilateral preferential scheme; and as the core around which a dynamic regional market based on preferences would be developed.

4. Benefits and Costs

An analysis of the benefits and costs of a reciprocal trade preference scheme between India and Sri Lanka would have to be based on the detailed content of the arrangement. Even so, a large number of assumptions would have to be made in order to quantify the net gains and losses to each country from the arrangement. The results inevitably would be open to question. They could arise, for example, because of under-estimating or over-estimating the gains from improved micro-economic efficiency and/or the indirect dynamic effects following the exchange of trade preferences. Whatever the difficulties of quantification may be, there can be little doubt that both countries would increase exports to each other's markets if a scheme along the lines proposed is implemented. A 30% preferential market for Indian goods in the Sri Lankan market will improve the competitive edge it already enjoys over a wide range of goods in that market. Likewise, the opening of the Indian market, especially the removal of non-tariff barriers for items where the tariffs are relatively low, can be expected to give an immediate boost to Sri Lankan exports to India.

Two sets of effects are normally estimated when quantifying rigorously the gains and losses of preferential schemes. One set relates to the short-term or static effects. These stem from the re-allocation of existing factors of production and associated trade creation and diversion and from the consumption effects associated with changes in prices. Trade creation would occur when, for instance, India replaces high cost goods produced domestically before preferences with goods imported from Sri Lanka at a lower cost or meets the growth in domestic demand for these goods from cheaper priced Sri Lankan goods. Resources are then re-allocated and consumers gain from lower prices and more diversified products.

Trade creation under an Indo-Sri Lanka trade arrangement would be greater the more responsive supply and demand conditions are in Sri Lanka and India to changes in prices induced by reciprocal trade preferences. In practice, in a bilateral preferential scheme, trade creation would reflect differences in resource endowments, differentials in labour productivity in different sectors and industries, the size and strength of industries in the two countries, and the ability of industrialists in each country to seize the opportunities open to them. It can also be expected that given the broadly similar *per capita* incomes, there would be overlapping demand structures, and that exporters in each country would establish market niches in similar goods in one another's markets. Although there would be trade creation overall both ways, there would be gainers and losers in various sectors of manufacturing industry in both countries. This would, in essence, be no different from the effects of unilateral trade liberalization in both countries carried out so far and in prospect. Although sectoral concerns are bound to be raised in opposition to the implementation of substantial across-the-board preferences, it seems unlikely that the costs of trade preferences would be high in terms of lower industrial output and employment in any sector in either country arising from competitive imports from the other. At the same time welfare gains from the static effects of trade creation (unless the preferences are substantial) may also not be high.

The trade diversion effect on third countries, as noted earlier, will probably be insignificant in view of the relatively high protection in India and low imports of consumer goods, the relatively low protection in Sri Lanka and the outward orientation of both governments in their development strategies.

The second set of effects of a preferential scheme is the longer-term development of dynamic comparative advantages leading to changes in the trend-rate of economic growth of each country as a result of bilateral trade liberalization. These may not amount to very much for the large Indian economy but could be substantial for Sri Lanka. The most promising gains for Sri Lanka would arise from economies of scale, capital mobility (particularly from third countries such as Japan), specialization, transfer of technology and technological change. Much depends in Sri Lanka's case on the flow of foreign direct investment to take advantage of the opportunities to export to India. With liberal access to the Indian market, Sri Lanka appears to be in a good position to increase exports to India of a wide variety of primary commodities including tea, coconut oil, cloves and other spices, as well as to expand productive capacity in the natural rubber products, wood panel, metal work and the ceramic industries and in consumer durables to supply the liberalized Indian market. The biggest gains for India are likely to be in the export of capital goods to Sri Lanka; given the broad-based nature of Indian industrial production, other sectors including pharmaceuticals can also be expected to make further inroads in the Sri Lanka market.

Efforts to estimate the dynamic effects *ex ante* are even more speculative than estimating the static effects. The result of even the *ex post* econometric studies on free trade areas and customs unions in developed regions yield inconclusive or widely differing results. The reasons are that they are highly sensitive to the theoretical model used.

While trade preferences between the two countries seem a necessary condition for trade expansion in both directions they are not sufficient, by themselves, to achieve sustained trade growth. For the gains from trade creation to be maximised, the physical, administrative and financial infrastructure for trade expansion between the two countries, including the specialized support services, would need to be improved. These range from better marketing channels and networks; product quality and prompt delivery; after-sales servicing; export financing; improvements in sea and air cargo transport; communication channels; and trade information links. Harmonisation of customs formalities and procedures as well as other trade facilitation measures are another area which needs to be addressed. Likewise private sector cooperation in trade and collaboration in industry need to be actively encouraged. These measures would provide a supportive enabling environment for trade between the two countries. For the full potential of trade growth to be realized as soon as possible, there is merit in targeting the growth of specific sectors, industries and products to supply the combined market of the two countries. This, in turn, requires undertaking detailed feasibility studies, the encouragement of investment in targeted areas and supportive trade promotion efforts.

V INDO-SRI LANKA TRADE PREFERENCES, GATT OBLIGATIONS AND THE SOUTH ASIAN PREFERENTIAL TRADE AREAS (SAPTA)

India and Sri Lanka are both members of the GATT. Any exchange of bilateral trade preferences between them would naturally need to be without prejudice to the rights and obligations of the two countries under the GATT, its agreements, understandings and other instruments. However, GATT obligations are unlikely to be a problem in establishing bilateral preferential trade arrangement between the two countries. There are no clear-cut rules and guide-lines 'cast in concrete' to be observed rigorously with regard to the various types of preferential trade arrangements. In part this is due to the way that the GATT has dealt with the issue of regional trade arrangements up-to-date.

The principle of non-discrimination is a cornerstone of GATT and embedded in Article 1 of its Agreement. In principle, therefore, all bilateral and plurilateral trade arrangements involving preferences run counter to the basic principle of the GATT to grant non-discriminatory treatment (MFN treatment) to all other members of the GATT Contracting Parties. The GATT, however, has recognised from the time of its inception, regional trade arrangements as a means which would permit 'fast track' liberalization in the general movement to universal free trade. This departure from the principle of non-discrimination is enshrined in Article XXIV of the GATT Agreement on customs unions and free trade areas.

The GATT has dealt with regional trade agreements in two ways or, more precisely, under two provisions. One relates to customs unions and free trade areas which are covered under Article XXIV of the GATT Agreement. This Article states that departures from non-discriminatory (MFN) obligations are permitted provided (i) other GATT members are notified of the details of the preferential agreement, (ii) the agreement includes a plan and schedule for the formation of a customs union or free trade area within a reasonable period of time, (iii) the agreement covers substantially all trade between preference giving countries, (iv) the agreement does not raise barriers to the trade of other Contracting Parties. For customs unions, the current rules simply say that tariffs must be no higher on average.

A separate provision relates to trade arrangements involving preferences among developing countries, *inter alia,* in respect of tariffs and, under certain conditions, non-tariff preferences. These are covered under an 'Enabling Clause' (Decision of the GATT Contracting Parties of 28 November 1979 on differential and more favourable treatment, reciprocity and fuller participation of the developing countries, generally known as the Enabling Clause). The Enabling Clause is substantially less demanding than Article XXIV. It does not contain any of the conditions spelled out in Article XXIV mentioned above, particularly that relating to barriers being removed on substantially all trade. It is also less demanding in terms of notification and consultation.

The provisions of Article XXIV and the Enabling Clause have never been adhered to strictly. For example, under some free trade area agreements, including the United States-Canada Agreement, several non-tariff barriers on sensitive sectors such as agriculture may be exempt from obligations altogether. In several other free trade area agreements among developing countries deadlines were repeatedly postponed and commitments reversed. Up-to-date over 70 trading arrangements involving preferences have been notified to GATT. Only four have been deemed by consensus to be compatible with GATT. The EEC, EFTA and the United States-Canada Free Trade Area do not feature among them. No trading arrangement has been declared to be incompatible with Article XXIV of GATT. The lax implementation of Article XXIV was highlighted in a report commissioned by GATT as follows '... exceptions and ambiguities have been permitted ... (which) have set a dangerous precedent for further special deals, fragmentation of the trading system, and damage to the trade interests of non-participants[9] Likewise, according to Patterson, a former Deputy Director General of GATT, of all GATT articles, (Article XXIV) was one of the most abused, and those abuses were among the least noted.[10]

Many preferential arrangements among developing countries such as the Latin American Integration Agreement (LAIA), GSTP, ASEAN PTA, have been reported to GATT under the Enabling Clause. The Latin American Integration Agreement provides an umbrella within which a wide variety of bilateral and plurilateral preferential agreements, including free trade areas covering two or more countries, relating to both tariffs and non-tariff barriers can be and have been negotiated. These include the Agreement on Argentine-Brazilian Integration of 1986 which involve a series of sectoral protocols, MERCOSUR (Southern Common Market) of 1991 among Argentina, Brazil, Paraguay and Uruguay and the Agreement of Economic Cooperation between Mexico and Chile in 1991. The Latin American Integration Agreement, justified by its members under the Enabling Clause, has provided for two methods of trade liberalization: regional scope (preferential) agreements applying to all members of LAIA and partial scope (preferential) agreements negotiated bilaterally or plurilaterally which bind only the signatories. The Chile-Mexico Agreement involving preferences falls into the latter category. In the GATT, some developed countries have attempted to discuss MERCOSUR, established to create a common market, under Article XXIV. This has been opposed by members of MERCOSUR who maintain that it should be covered under the Enabling Clause. The matter is pending.

The conclusion that can be drawn from the brief discussion above is that a preferential trade arrangement between India and Sri Lanka, on the lines suggested earlier, could be established without prejudice to GATT obligations and its agreements, understandings and other instruments. The requirement is that it should not be inconsistent with the GATT. There are precedents for bilateral preferential

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9 Leutwiler et al. *Trade Policies for a Better Future: Proposals for Action*, Geneva, 1985.

10 Patterson, *Implications for the GATT and the World Trading System in Free Trade Areas and U.S. Trade Policy*, Institute for International Economics, Washington, D.C., 1989.

arrangements such as the one suggested between India and Sri Lanka. A provision that would make it doubly certain that an Indo-Sri Lanka bilateral arrangement was intended to be regional in character would be one which leaves open the enlargement of the arrangements to neighbouring countries in the region through negotiations. An alternative would be to have a third regional country such as Bhutan as a full member of the preferential arrangement from the outset.

No prior clearance of free trade areas or preferential arrangements is required by GATT. On the basis of past experience, the two Governments would be ill-advised to speculate on the attitude that would be taken in GATT by the other Contracting Parties of GATT to a bilateral preferential agreement between them or be overly concerned about consistency with GATT provisions on regional arrangements in designing the bilateral arrangement between them. Once the preferential scheme has been adopted by the two countries, the GATT should be notified under Article XXIV or the Enabling Clause as decided by the two Governments. Follow-up, if any, would then be in accordance with GATT procedures for consideration of such an arrangement.

There are advantages as a signal of future direction of an Indo-Sri Lanka arrangement if the longer-term aims of the two governments (i.e. free trade area or a preferential area) are indicated in the bilateral agreement itself. This would also help to clarify it in relation to GATT. A reciprocal preferential scheme on the lines outlined earlier would be more akin to the free trade areas that have been established than the existing preferential trade arrangements. There is some advantage for Sri Lanka and India to set, as a long-term objective, the creation of a free trade area between the two countries if a scheme on the lines suggested is pursued, whether it is notified to GATT under Article XXIV or the Enabling Clause. However, if such an objective was deemed to be premature, the Indo-Sri Lanka arrangement could be notified under the less demanding Enabling Clause. The trend towards the 'tariffication' of the trade regimes of the two countries simplifies the task. The Enabling Clause clearly permits tariff reductions among developing countries. A distinction is made in respect of non-tariff barriers but the language has never been tested. Reduction of non-tariff barriers within a preferential arrangement is unlikely to be seen negatively by the Contracting Parties of GATT provided it is clearly evident that it was a move towards freer trade universally rather than introducing new non-tariff barriers against other Contracting Parties.

A preferential trade area between India and Sri Lanka would also need to be consistent and supportive of the ongoing product-by-product negotiations on the South Asian Preferential Trade Area (SAPTA). Negotiations for a bilateral preferential scheme might be seen by other SAARC countries as an attempt on the part of India and Sri Lanka to shift away from a regional approach to trade liberalization among SAARC countries. The concerns need to be allayed. It would be readily recognised that neither India or Sri Lanka can solve the problem of their large trade deficits, let alone achieve dynamic overall export growth, purely by exporting to each other. They have a vital interest in making progress in improving access to global markets including access to increase their export opportunities to regional markets. Indo-Sri Lanka preferences should thus be seen as complementary to the SAPTA process and in no way an alternative to it. In fact, a bilateral preferential arrangement between the two countries could be designed in a manner to hasten the SAARC process which otherwise might tend to be determined by the least willing SAARC country engaged in the negotiations. The wider regional approach would be facilitated if a 'fast-track' bilateral preferential arrangement between India and Sri Lanka keeps open the possibility for other SAARC countries to join the arrangement through negotiation. In this regard SAARC countries may wish to examine the relevance for SAARC of the flexible framework of the Latin American Integration Agreement. As noted earlier, this Agreement conceives the integration process in the region in terms of a series of bilateral trade and other preferences as well as regional scope trade and other preferences.

VI THE PROMOTION OF INVESTMENT TO COMPLEMENT A RECIPROCAL PREFERENCE SCHEME BETWEEN INDIA AND SRI LANKA

As was pointed out earlier, while an outward oriented reciprocal preferential scheme which reduces barriers substantially would be a necessary condition for two-way trade expansion between India and Sri Lanka, it may not be a sufficient condition to bring about production and trade growth. There is a need insofar as Sri Lanka is concerned, to acquire the capacity and capability to export to the liberalized Indian market. This, in turn, needs specialization at the industry, sector and product level to supply the needs of the combined regional market. Investment is the key to create the new productive capacity.

Sri Lanka, with a shortage of domestic capital, may find it difficult to mobilise the necessary investment to set up new industrial plants to take advantage of market openings through a bilateral preferential arrangement. Consequently, there is a need to create a supportive environment to make possible foreign investment flows, particularly to Sri Lanka from India and from third countries such as Japan, to complement the exchange of reciprocal trade preferences between the two countries. Experience, particularly in East Asia, shows that the engine that forces the pace and degree of economic interdependence between countries, and propels trade, is the flow of investment. The inflow of foreign direct investment is the glue that would bind an Indo-Sri Lanka preferential arrangement and determine its success.

The policy towards foreign direct investment needs to be directed in particular towards the setting up of joint manufacturing ventures between Indian entrepreneurs and Sri Lankan partners, primarily oriented for export of output to the Indian market. The scale of finance required, as well as weak technological development in Sri Lanka, are factors which point to the need for the active encouragement of joint ventures in the manufacturing sector between Sri Lankan entrepreneurs and Indian partners. In addition, such joint ventures would weaken, if not eliminate, the possible opposition of Indian industry to market opening measures in India for imports from Sri Lanka. However, in view of the alternatives for Indian foreign direct investment in several other locations, there is some advantage for the participation of partners from third countries such as Japan and other East Asian countries in establishing joint ventures to be encouraged. Their contribution could include capital, appropriate technology for efficient production and marketing skills. The case for joint ventures involving foreign direct investment from third countries is stronger in as much as the objective of joint ventures would not be production exclusively for the combined Indo-Sri Lanka market but also for increasing exports to third countries in a systematic way.

In the past, Sri Lanka has been a country with one of the largest concentrations of Indian joint ventures. The total capital involved has been small. In part, the small size of investments reflected the restrictions relating to the outflow of capital from India, and their limitation to the cost of plant and equipment. More fundamentally, all the joint ventures were oriented towards the small, relatively highly protected, domestic Sri Lankan market. None of the joint ventures were able to export their products to India because of the high tariffs and, in many cases, non-tariff barriers. India has, as of November 1992, substantially relaxed the conditions relating to foreign direct investment from India. Indian investment abroad up to US$ 2 million, of which up to US$ 0.5 million could be in cash, and the balance through the capitalization of plant and machinery, is virtually granted automatically. Proposals for investment of larger sums have still to be approved by an inter-ministerial committee on a number of criteria such as viability of the investment, benefit to the country through foreign exchange inflow, and technology transfer.

These changes, by themselves, seem unlikely to boost Indian investment in Sri Lanka in any substantial way. At best it may lead to some further investment in import substitution industries. Any major increase in inflows of Indian investment into Sri Lanka require two conditions to be fulfilled. One is the total elimination of all restrictions to the flow of investment into Sri Lanka. The second is the elimination of all barriers to import into India of production of joint ventures. Indian industrialists, with or without partners from Sri Lanka and third countries, would then be able to decide to set up their factories in India or in Sri Lanka exclusively on the basis of such factors as raw materials, location, availability of the required skills and profitability. Experience elsewhere, such as between the United States and Mexico, suggest that bilateral accords prompt a sharp growth in bilateral trade and investment based on intra-firm transactions. A similar development between parent companies in India and their subsidiaries in Sri Lanka could be envisaged. There may be an advantage in also encouraging trade between subsidiaries, located in Sri Lanka and India respectively, of a parent company in a third country such as Japan, with adequate safeguards taken to prevent Sri Lanka becoming an export platform for third country manufacturing firms to enter the Indian market with low value added goods.

The freeing of trade restrictions and of capital flows between the two countries, and a national treatment obligation under which India and Sri Lanka agree to treat each others' investors in the same manner as local investors in each country (except for sensitive sectors), would provide an incentive to increase substantially the flow of investment at least initially. The low availability of finance for Indian foreign direct investment in the manufacturing sector and high market interest rates in both countries may still remain a problem to be overcome. An additional inducement to accelerate the establishment of joint ventures would be to set up a revolving fund to aid Indo-Sri Lanka joint ventures. Finance could be subscribed to by the two countries, as well as by third countries such as Japan which are interested in promoting South Asian cooperation. Such a revolving fund could be operated by existing financial institutions in the subscribing countries concerned.

The objective of the revolving fund should be to provide cheap finance to source a generous proportion of the capital goods required for joint ventures within the two countries, and thereby promote regional trade and investment expansion. In order to keep the cost of finance as low as possible, it might be necessary to create innovative financial instruments such as convertible bonds (convertible to equity) tradeable in financial markets, rather than the fund extending loans at market interest rates so as to hasten the setting up of joint ventures to take advantage of market openings as a result of the preferential arrangement. India has already some experience in establishing a revolving fund along these lines. It has set up a special revolving fund of IRs. 200 million to aid (by extending term loans) joint ventures by Indian entrepreneurs with partners in Mauritius. The idea of a revolving fund to support closer economic integration of India and Sri Lanka merits detailed study.

VII AN AGENDA FOR SUBSTANTIVE FOLLOW-UP

The negotiation of preferential agreements even among developed countries has always been a complex task. If, after due consideration, a broad consensus emerges between the two countries on the need for a reciprocal preferential arrangement along the lines suggested above, the first step would clearly have to be an announcement of a joint intention, to work out the details of a scheme with a view to reaching agreement on it. Adapting from the experience of the preparatory process for similar types of agreements elsewhere, a possible model would be to create two technical Groups, one to deal with broad categories of issues relating to the preferential arrangement, and the other to deal with the promotion of investment flows. The issues for consideration of each Group are listed below:

Technical Group 1

(i) Market access:
  * Tariffs - across the board reductions, the principle of equivalence, minimum preferential margin, list of products departing from equivalence principle, exclusion list;
  * Non tariff barriers - list of agreed non-tariff barriers, listing of non-tariff barriers into categories for sequencing their elimination, exclusion list;
  * Rules of origin.

(ii) Trade rules - safeguards, standards (health and safety, industrial).

(iii) Dispute settlement mechanism for reciprocal preference scheme.

(iv) A time-table to ensure automaticity in phasing in the provisions of the scheme.

Technical Group 2

(i) Promotion of investment flows between India and Sri Lanka and foreign direct investment from third countries to underpin the bilateral preference scheme.

(ii) Elimination of restrictions affecting investment flows.

(iii) The examination of the feasibility of a revolving fund to assist joint ventures directed primarily to expand bilateral trade.

ANNEX

Annex Table 1	Import regime in India in February 1993 for Sri Lankan exports to India in 1991
Annex Table 2	Import regime in India in February 1993 for Sri Lankan exports to the world which are not imported into India from Sri Lanka
Annex Table 3	Import regime in India for selected list of items targeted in Sri Lanka for export development.

ANNEX TABLE 1

IMPORT REGIME IN INDIA IN FEBRUARY 1993 FOR SRI LANKAN EXPORTS TO INDIA IN 1991

No	Code HS	Description		Exports SLRs.mill.	Duties/per cent Basic	Aux.	Addl.	Total
1	720429	Ferrous waste/scrap *	(F)	122.0	40	45	IRs.460/mt	85.0
2	090411	Pepper	(L)	71.0	65	45	0	110.0
3	090240	Tea	(L)	68.0	10	0	*	10.0
4	4001	Natural rubber	(F)	56.0	25	45	0	70.0
5	090700	Cloves *	(L)	44.0	12	45	0	57.0
6	740400	Copper waste/scrap	(F)	29.0	10	0	11.5	*
7	152090	Glycerine other	(F)	24.0	45	45	17.2	122.8
8	152010	Glycerol	(F)	19.0	45	45	17.2	122.8
9	330130	Resinoids	(L)	17.0	65	45	23.0	158.3
10	400630	'Camel back' rubber *	(F)	15.0	65	45	IRs.12.60	110.0
11	732399	Radiators (not electric)	(F)	10.0	65	45	17.2	146.2
12	470790	Paper/waste, scrap	(F)	5.0	15	5	0	20.0
13	291613	Methacrylic acid	(F)	5.0	65	45	17.2	146.2
14	071310	Black gram	(F)	5.0	10	0	0	10.0
15	731029	Steel drums, etc.	(F)	5.0	65	45	23.0	158.3
16	090230	Tea bags	(L)	3.0	10	0	*	10.0
17	731100	Container for gas	(F)	3.0	55	45	23.0	146.0
18	731819	Screws bolts, etc.	(F)	2.0	65	45	23.0	158.3
19	121190	Plants for perfumery	(L)	2.0	60	45	0	105.0
20	090810	Nutmeg	(L)	2.0	65/57.5	45	0	110.0
21	151311	Coconut oil	(L)	2.0	65/55	0	17.2	100.0
22	090240	Black tea <3kg packs	(L)	1.0	10	0	*	*
23	470710	Waste paper (kraft)	(L)	1.0	15	5	0	20.0
24	250490	Natural graphite	(F)	1.0	40	45	0	85.0
25	600299	Fabrics KOC	(F)	1.0	65	45	*	110.0
26	853669	Electrical switching	(F)	1.0	25-65	0	45.0	Bas+Addl
27	050100	Human hair	(F)	1.0	60	45	0	105.0
28	400129	Brown crepe rubber	(L)	1.0	25	45	0	70.0
29	330190	Essential oil	(L)	0.5	65	45	23.0	158.3
30	330190	Cinnamon leaf oil	(L)	0.4	65	45	23.0	158.3

Source: External Trade Statistics, Sri Lanka Customs 1991: BIG's Database, New Delhi; various sources.

* Please refer to notes on individual items on page 37.

Abbreviations:

HS - Harmonised Commodity Description and Coding System, Customs Cooperation Council, Brussels. For all complete descriptions of code numbers, refer to the document with this title issued by the Council.
F - freely importable
L - license is required
Exp - exports
Aux - auxiliary
Addl - additional
SLRs.mill. - Sri Lanka Rupees million
IRs. - Indian Rupees
mt - metric ton
kg - kilogram
KOC - knitted or crocheted.

Notes:

Regarding duties see footnote 4 of the main text.
Export figures generally rounded to the nearest whole number.

Item 1	-	Total = 85% plus additional duty.
Items 3, 16 & 22	-	An additional duty of IRs. 2.50 per kg is applied for small packages of 25 grammes or less. For packages between 25 grammes and 20 kg. the duty is IRs. 3.25 per kg. An additional charge of 5% on the above duties is charged as a special excise tax. Imported tea for blending and re-exports is not levied a duty.
Item 5	-	Imports conditional on export of spices of 150% of the value of import license granted in previous year. Quantitative restrictions permit imports equal to 10% of volume of imports of the best year's imports during 1983/84 to the preceding licensing year.
Item 6	-	Basic = 10%+ IRs. 10500 mt; total = 11.5% plus basic duty.
Item 10	-	Total =110 plus IRs. 12/60 per kg.
Item 25	-	Additional duty on knitted or crocheted fabrics of man-made textile material is 53 paise to IRs. 1.30 per square metre, total =110% plus addl. duty.

ANNEX TABLE 2
IMPORT REGIME IN INDIA IN FEBRUARY 1993 FOR SRI LANKAN EXPORTS TO THE WORLD WHICH ARE NOT IMPORTED INTO INDIA FROM SRI LANKA

No	Code HS	Description		Exports SLRs. mill.	Duties/per cent Basic	Aux.	Addl.	Total
31	*	Garments	(L)	32484	65	45	0	110.0
32	710349	Precious stones unset	(L)	1958	60	45	0	105.0
33	710239	Diamonds cut/polished	(F)	1850	60	45	0	105.0
34	710231	Diamonds/non-industrial	(L)	839	40	45	0	85.0
35	442090	Wood products/other	(F)	625	60	45	0	105.0
36	380210	Activated carbon *	(F)	553	55	45	17.2	130.0
37	401290	Rubb.solid tyres	(F/L)	448	65	45	*	110.0
38	691310	Statuettes etc./ceramics	(L)	403	65	45	0	110.0
39	731816	Iron/steel nuts	(F)	327	65	45	23.0	158.3
40	640411	Footwear/sports	(L)	313	65	45	*	110.0
41	711319	Jewellery	(L)	296	60	45	*	105.0
42	691110	Tableware etc./ceramics	(L)	287	65	45	*	110.0
43	960310	Brooms/brushes	(L)	283	65	45	0	110.0
44	401590	Rubb.access. clothing	(L)	271	65	45	17.2	146.2
45	853669	Interchange.sockets	(F)	248	60	45	11.5	128.5
46	690810	Glazed tiles/ceramics	(F)	238	65	45	57.5	230.7
47	420329	Leather sports gloves	(L)	235	65	45	0	110.0
48	670290	Artificial flowers	(L)	230	65	45	11.5	134.1
49	530511	Mattress fibre (not twisted)	(L)	216	40	45	13.8	110.5
50	837330	Parts/automatic data processing machines	(F)	207	50	30	17.2	111.0
51	401699	Vulcanized rubber, other articles	(F/L)	195	65	45	17.2	146.2
52	401290	Rubb./scrap crepe	(F/L)	193	45	45	*	90.0
53	853931	Flourescent hot cathode lamps *	(L)	190	65	45	10-15	110.0
54	630631/39	Sails for boats	(F)	185	65	45	13.8	138.9
55	401511	Rubb./surgical gloves	(L)	150	65	45	17.2	146.2
56	853669	Electric plugs/sockets *	(F)	141	25-65	45	17.2	70.0
57	441830	Parquet panels	(L)	119	60	45	0	105.0
58	710221	Diamonds/industrial	(F)	116	40	45	0	85.0
59	401691	Rubb.floor coverings	(L)	113	65	45	17.2	146.2
60	210120	Instant tea	(L)	113	65	45	17.2	146.2
61	960330	Artist brushes	(L)	110	65	45	0	110.0
62	401290	Block rubber	(L)	106	45	45	0	90.0
63	401290	Sole crepe	(L)	103	25	45	0	70.0

* Please refer to notes on individual items on page 41.

ANNEX TABLE 2 (continued)

No	Code HS	Description		Exports SLRs. mill.	Duties/per cent Basic	Aux.	Addl.	Total
64	420310	Leather clothing accessories	(L)	102	65	45	0	110.0
65	440200	Coconut charcoal	(F)	100	65	45	0	105.0
66	530511	Mixed coir fibre twisted	(L)	81	40	45	13.8	110.5
67	530511	Mattress fibre twisted	(L)	80	40	45	13.8	110.5
68	853810	Boards for electric controls *	(F)	71	25-65	45	17.2	70.0
69	530511	Bristle fibre not twisted	(L)	66	40	45	13.8	110.5
70	530519	Other coir fibre	(L)	65	40	45	13.8	110.5
71	570220	Coconut fibre floor cov.	(L)	65	65	45	0	110.0
72	853340	Variable resistors (electric)	(F)	51	50	30	23.0	121.4
73	250610	Quartz	(F)	51	65	45	0	110.0
74	261400	Ilemenite	(F)	46	45	45	0	90.0
75	821220	Safety razor blades	(L)	42	65	45	17.2	146.2
76	401519	Rubb.other gloves	(L)	39	65	45	17.2	146.2
77	741910	Copper chain etc.	(F)	35	65	45	17.2	146.2
78	780824	Steel roll sheets<.5mm	(F)	35	*	45	11.5	45.0
79	950341	Stuffed toys	(F)	32	65	45	0	110.0
80	530511	Matt fibre	(L)	31	40	45	13.8	110.5
81	420329	Leather other gloves	(F)	30	65	45	0	110.0
82	640419	Sports other footwear	(L)	30	65	45	*	110.0
83	441700	Wood tools, etc.	(F)	29	60	45	0	105.0
84	940550	Non-electric lamps, etc.	(L)	27	65	45	17.2	146.2
85	711719	Imitation jewellery	(L)	27	65	45	0	110.0
86	400690	Rubb.rods, disks, rings, etc.	(L)	25	65	45	17.2	146.2
87	640192	Other footwear	(F)	23	65	45	*	110.0
88	850431	Electr. transformers etc.	(F)	23	25	45	23.0	109.1
89	261611	Granite crude	(F)	21	65	45	0	110.0
90	853400	Printed circuits	(F)	20	50	30	17.2	111.0
91	520812	Cotton fabrics	(L)	20	65	45	*	110.0
92	530510	Coir yarn	(L)	19	60	45	13.8	133.2
93	640520	Other footwear	(L)	19	65	45	*	110.0
94	730890	Household reinforcement steel	(F)	17	40	45	*	85.0
95	410439	Leather, other parchment	(F)	17	0	0	0	0.0
96	640220	Footwear with upper strap	(L)	16	65	45	*	110.0
97	261612	Granite cut	(L)	14	65	45	0	110.0

ANNEX TABLE 2 (continued)

No	Code HS	Description		Exports SLRs. mill.	Duties/per cent Basic	Aux.	Addl.	Total
98	410421	Leather-other tanned	(F)	13	0	0	0	0
99	890200	Fishing boats	(F)	13	0	0	0	0
100	410421	Leather other blue chrome	(F)	12	0	0	0	0
101	500710	Fabrics of noil silk	(L)	9	65	45	0	110.0
102	850422	Accumulators *	(F)	7	25-65	30-45	0-23	55-110.0
103	940510	Electric light fittings	(L)	6	65	45	28.7	170.4
104	850133	Electric motors >75kw<375kw	(F)	5	25	30	0	55.0
105	760711	Aluminium foil rolled	(F)	5	60	45	28.7	163.9
106	760720	Aluminium foil backed	(F)	5	60	45	28.7	163.9
107	841590	Parts for air conditioners *	(F/L)	5	65	45	25-65	110.0
108	841391	Water pumps-parts	(F)	5	10	30	0	40.0
109	500911	Cotton fabric/unbleached	(L)	5	65	45	*	110.0
110	520921	Cotton fabric bleached	(F)	5	65	45	*	110.0
111	940592	Illuminated signs/plastic parts *	(F)	4	65	45	17.2	146.2
112	850212	Electric. gen. sets>75kw<375kw	(F)	4	45	45	17.2	122.8
113	800700	Other articles of tin	(F)	3	60	45	17.2	140.4
114	720824	Steel rolled sheets<3mm	(F)	3	*	45	11.5	56.5
115	870899	Iron/steel springs etc. (parts)	(F)	3	35	45	23.0	121.4
116	841370	Water pumps	(F)	3	25	30	0	55.0
117	401490	Rubb. hygienic articles *	(F)	3	65	45	17.2	146.2
118	180610	Chocolates in slabs/blocks	(L)	3	65	45	28.7	170.4
119	500720	Other 85% silk fabrics	(L)	3	65	45	0	110.0
120	850710	Electric accumulators (lead)	(F)	2	65	45	*	110.0
121	850619	Non-mang, diox, batteries	(F/L)	2	65	45	*	110.0
122	940599	Non-plastic illuminated signs *	(F)	2	65	45	17.2	146.2
123	854420	Electric cables etc. co-axial	(F)	2	65	45	34.5	182.4
124	940540	Other lighting sets	(L)	2	65	45	17.2	146.2
125	180631	Chocolate bars filled etc.	(L)	2	65	45	28.7	170.4

ANNEX TABLE 2 (continued)

No	Code HS	Description		Exports SLRs. mill.	Duties/per cent Basic	Aux.	Addl.	Total
126	240699	Rubberised textile fabrics	(F)	1	65	45	*	110.0
127	401693	Rubb.gasket, washers, seals	(F)	1	65	45	17.2	146.2

Source: See source for Annex Table 1.
Notes: See notes for Annex Table 1.
Additional abbreviations:
F/L - as consumer good is subject to license (L) and as industrial good is freely importable (F).

Item 31	-	Includes code numbers in HS chapters 61 and 62, HS 6302 total duties 138.98% and HS 650590 total duties 134.15%.
Item 37	-	(Solid tyres) additional duty: two-wheelers IRs. 25 to IRs. 32, three-wheelers IRs. 95, saloon cars IRs. 210 to IRs. 265, other motor vehicles IRs. 890 to IRs. 2625, tractor tyres IRs. 120 to IRs. 485, trailers IRs. 220 to IRs. 440.
Item 40	-	(Footwear-sports) additional duty on footwear other than footwear with outer soles or upper of plastics 17.25%, others 23%.
Item 41	-	Jewellery add 15% special excise duty.
Item 42	-	Additional duty on toilet articles is 40%, tableware 20%, waterfilters not exceeding 40 litres nil, otherwise 30%. Add 15% on these duties for special excise duties.
Item 52	-	Additional duties not available.
Item 53	-	Fluorescent hot cathode lamps total duties = 110% plus additional duties; add 10% for special excise duty.
Item 56	-	Total duties vary, depending on basic duties levied.
Item 78	-	* = Basic duty: Hot rolled coils<6% carbon by weight of not less than 0.5mm thickness and width>500mm and weight less than 500kg/piece IRs. 1100/mt. Others 25%+IRs. 2500/mt.
Items 82 and 87	-	See footnote for Item 40.
Item 91	-	Additional duty varies from 20 paise per sq.metre to 20% depending on the fabric and value.
Items 93 and 96	-	See note for Item 40.
Item 94	-	Additional duty on doors windows and their frames and thresholds for doors 5%, others 17.25%.
Item 102	-	Includes 850432/33/34/40/50/90.
Item 107	-	Effective additional duty on air conditioners varies from IRs.12000 for<1.5mt to IRs.74000 per piece for 10-15/mt, parts and accessories 40%.
Items 109 and 110	-	See Item 25.
Item 114	-	Basic rate IRs. 600/mt, total rate basic plus 56.50%.
Item 117	-	Same duties and free imports applies to code 401410 - sheath contraceptive.
Items 120 and 121	-	Additional duty on dry cell batteries under 8596 = 30%, others 35%, add 15% for special excise duties.
Items 111 and 122	-	Additional duty of articles of glass under 9405 = 35%, others 15%. Add 10% for special excise duties.
Item 126	-	Additional duties 13.8%.

ANNEX TABLE 3

IMPORT REGIME IN INDIA FOR SELECTED LIST OF ITEMS TARGETED IN SRI LANKA FOR EXPORT DEVELOPMENT

				Duties/per cent			
No.	Code HS	Description		Basic	Aux.	Addl.	Total
128	841810	Combined refrig./freezer *	(L)	65	45	46.0	206.6
129	841821	Refrigerator household	(L)	65	45	46.0	206.6
130	841830	Freezers	(F/L)	25	30	0	55.0
131	841510	Window/wall air conditioners	(L)	65	45	*	110.0
132	850611	Batteries manganese dioxide	(F/L)	65	45	*	110.0
133	845210	Sewing machines, household	(L)	65	45	0	110.0
134	845221	Sewing machines, automatic	(F)	25	30	0	55.0
135	870891	Radiators-motor spares	(F/L)	65	45	23.0	158.3
136	870892	Silencers/exhaust pipes	(F/L)	65	45	23.0	158.3
137	940520	Electric table/desk/floor/lamps	(L)	65	45	17.2	146.2
138	900311	Spectacle frames/plastic/other	(F/L)	65	45	0	110.0
139	401010	Rubber belting/conveyor/trans	(F)	40	30	34.5	128.6
140	340111	Soaps	(L)	65	45	*	110.0
141	340211	Detergents *	(F)	65/55	45	34.5	182.4/169
142	400211,19,31	Leather goods	(L)	65	45	*	110.0
143	401150	Bicycle tyres	(L)	65	45	0	110.0
144	401110	Automobile tyres	(L)	65	45	0	110.0
145	591000	Conveyor belts	(F)	40	45	0	85.0
146	870899	Rubber automotive components	(F)	35	45	23.0	121.4
147	401010	Rubber V belts	(F)	40	30	34.5	128.6
148	691010	Ceramic sanitary ware	(L)	65	45	46.0	206.6
149	691090	Ceramic sanitary ware	(L)	65	45	11.5	134.1
150	701321+329	Glass tableware *	(L)	65	45	17.2	146.2
151	681510	Graphite crucibles	(F)	65/55	45	0	110/100
152	940310/20	Steel metal furniture	(L)	65	45	28.7	170.4
153	846210	Tools/dies/moulds all code nos	(F)	25	45	17.2	99.3

Source: BIG's Database, New Delhi.

Notes: See notes for Annex Tables 1 and 2.

Item 128 - Non-household type equipment duty is 25% basic and 30% additional.

Item 131 - See note for Item 107.

Item 132 - See note for Items 120 and 121.

Item 140 - Additional duty of 5%-25% depending on value per mt.

Item 141 - Same duties apply HS 340212, 340213, 340229, 340220, 340290.

Item 142 - Additional duty applicable on vanity cases, executive cases brief cases and vanity bags. Others exempt.

Item 150 - Glass by mouth blown process 15%; tableware of glass other than those of crystal 15%; others 25%. Add 15% for special excise duties.

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