SUMMARY

1. Sri Lanka has a fairly open and transparent trade regime, characterized by reliance on price-based measures and scant use of non-tariff measures and, in general, relatively low tariffs. Trade reforms since the last Review have proceeded at a mixed pace: transparency has been enhanced, but average tariff protection has increased. Also, Sri Lanka has made substantial use of import surcharges and other charges falling solely or mainly on imports. These measures have been taken mostly for revenue purposes and, in this sense, high economic growth and the end of the armed conflict in May 2009 provide the opportunity to lower the burden on imports as well as to step up economic, trade and institutional reform. In June 2010, the Government announced an overall reduction in tariffs, lowering many rates to zero, and eliminated a 15% import surcharge applied on most imports.

2. The incentives programmes have been streamlined somewhat but continue to be complex; the authorities consider that they have been necessary to offset the disincentives created by the internal strife. Further rationalization of the incentives regime could help improve resource allocation and overall economic efficiency, hence increasing Sri Lanka's international competitiveness. It could also help to eliminate distortions and diversify production and trade, which remain concentrated in a few products and markets. In this respect, and in tandem with measures to liberalize trade, the Government intends to deepen the process of reform and modernize the business environment by unifying and further reforming its incentives regime and introducing comprehensive competition policy legislation. The authorities consider that Sri Lanka has the potential to expand its industrial base by focusing on industries with higher value added. This will, however, require investment in new technologies and in human capital.

(1) ECONOMIC AND INSTITUTIONAL ENVIRONMENT

3. The performance of Sri Lanka's economy during the period under review (2004-09) was strong, despite the internal conflict, the effect of a tsunami, and external shocks such as higher oil and food prices and the global financial crisis. GDP expanded by a solid 6% per year in real terms during the period, supported mainly by strong domestic demand, allowing GDP per capita to double between 2004 and 2009 to reach US$2,053. However, although the global financial crisis has had a limited impact on economic growth, it has had a strong impact on Sri Lanka's external trade, particularly owing to a drop in demand from its major trading partners, the European Union and the United States. Foreign direct investment inflows, on the other hand, were not severely affected by the internal conflict or the crisis.

4. Sri Lanka's response to the global economic crisis included adopting a number of fiscal measures to increase taxes falling mostly on imports, as well as measures to support export-oriented industries. The Central Bank made active use of monetary policy from 2008 to ensure an adequate level of liquidity, through measures including the reduction of the statutory reserve ratio and lower policy interest rates, while the exchange rate was allowed to float more freely. Inflation, which had peaked in June 2008, fell to below 5% by end 2009, aided by tighter monetary policy and the easing of international commodity prices. However, fed by strong domestic demand inflation picked up some strength in the first half of 2010, albeit staying at single-digit levels.

5. Sri Lanka's balance of payments is characterized by a structural current account deficit, which increased substantially between 2005 and 2008, to 9.5% of GDP. Together with a sharp outflow of capital resulting from the global financial crisis, this led to a substantial loss in foreign exchange reserves. This loss prompted the authorities to adopt measures to bolster liquidity, increase foreign

exchange inflows and strengthen the balance-of-payments position, and to seek IMF financing, resulting in a Stand-by Arrangement signed in mid 2009 for a total of US$2.6 billion. Under the arrangement, Sri Lanka committed to trim the budget deficit and eliminate losses in two major state utilities, among other targets. A dramatic (27.6%) decline in merchandise imports, partly due to lower GDP growth and partly to price-based measures taken to contain imports, such as new and higher import charges, as well as temporary deposits in the Central Bank for import operations, contributed to a substantial reduction of the current account deficit in 2009, to an estimated US$214 million, or 0.5% of GDP.

6. The end of the internal armed conflict in May 2009 offers new growth opportunities, particularly in the short- and medium-term, because economic expansion may be boosted by the reconstruction effort. However, to ensure sustained growth, the authorities would need to maintain and reinforce macroeconomic stability and complete the pending structural reforms, including tax reform, the restructuring of state-owned enterprises, investing in education and research and development, and reforming the labour market to make it more flexible.

(2) TRADE AND INVESTMENT REGIME

7. Sri Lanka has been an active participant in the Doha Development Agenda, having tabled, together with other countries, proposals on areas such as: technical barriers to trade; geographical indications; labelling of textiles, clothing, footwear, and travel goods; preferences erosion; and trade facilitation. During the period under review, Sri Lanka has not been involved in any dispute under WTO rules.

8. Sri Lanka's main trade-policy thrust continues to be aimed at achieving greater integration into the world economy. In particular, Sri Lanka is seeking to foster foreign direct investment into the country to expand output and employment, and to enhance foreign market access for its products. These objectives have been pursued through multilateral, regional, and bilateral trade negotiations, through an incentives regime geared at encouraging exports and investment, and through a number of development programmes to enhance productivity and improve infrastructure.

9. Sri Lanka participates in two regional trade agreements: the South Asian Free Trade Area (SAFTA) Agreement, and the Asia-Pacific Trade Agreement (APTA); as well as in two bilateral agreements: the Indo-Sri Lanka Free Trade Agreement (ISFTA), and the Pakistan-Sri Lanka Free Trade Agreement (PSFTA). Among those preferential partners, only trade with India and China is significant.

10. Sri Lanka's foreign investment regime is relatively open, with a few exceptions where investment is either subject to non-automatic approval or is reserved for Sri Lankan nationals. In areas where foreign investment is permitted, foreign investors receive national treatment and may benefit from the wide range of incentives provided by the Board of Investment of Sri Lanka (BOI) or from the Treasury. Full foreign ownership is allowed in most industries and in a number of services activities (including banking, insurance, finance, construction, mass transportation, telecommunications and information technology, and petroleum distribution).

11. Sri Lanka received total of US$1.77 billion in assistance in aid-for-trade between 2004 and 2008. Japan and multilateral donors have been the major providers. Sri Lanka's Ten-Year Horizon Development Framework 2006-2016 (TYHDF) aims to accelerate economic growth with special consideration given to pro-poor growth strategies. Trade is included as a macroeconomic strategy to achieve development.

(3) TRADE POLICY BY MEASURE

12. Sri Lanka's trade reform efforts since its last Review have proceeded at a somewhat mixed pace; they have included steps to enhance transparency, but have also resulted in the introduction of new border charges, which have, on average, increased protection. Sri Lanka's trade policy has relied mostly on price-based measures rather than on non-tariff measures, of which it has made relatively scant use. Trade policy has been guided to a large extent by revenue considerations. In 2010, with the end of the armed conflict and high GDP growth rates expected, Sri Lanka started to undertake steps to reduce tariffs and other charges on imports.

13. Sri Lanka introduced major changes to its tariff schedule in 2007 and in 2010. The simple average applied MFN tariff was 11.5% in 2010, up from 9.8% reported in Sri Lanka's Review for 2003, but lower than the 12% posted in 2009. Tariff rates for most products range from 0 to 30%, with a few peaks, mainly for tobacco products. Despite the increase in the average rate, the proportion of duty-free lines rose from 10% of the total in 2003 to 44.4% in 2010, mainly through the elimination of the 2.5% tariff rate and its replacement with duty-free access. Bound tariff lines account for only 36.4% of the total, at rates ranging from 0% to 75%. In general, bound rates greatly exceed applied rates, with an average bound tariff of 32.7%. However, in June 2010, some 103 HS applied tariff lines exceeded their bound rates, affecting mostly tobacco products, textiles, carpets, ploughs, and switches. As part of their strategy to liberalize trade and tariffs and other charges on imports, the authorities may wish to consider enhancing the scope and level of their bindings; this would add predictability to the trade regime and would help to improve the business environment, which is one of the Government's goals.

14. Imports into Sri Lanka are subject to a number of other charges: excise duty, Export Development Board Levy (cess), value-added tax (VAT), Social Responsibility levy, the Ports and Airports Development Levy (PAL), the Nation Building tax, and port handling charges. These charges increase considerably the cost of importing into Sri Lanka, which in some cases may exceed 100%. Tobacco products and motor vehicles face the highest overall import charges. Most imports, with the exception of some basic goods, were subject to a 15% surcharge until June 2010, when it was eliminated. An Export Development Board (EDB) Levy (cess), ranging from 1% to 35%, is charged on imports under some 3,500 tariff lines covering a relatively large range of products. Excise duties are levied on tobacco products, oil products, aerated water, liquor, beer, motor vehicles, and certain household electrical items; they can be *ad valorem*, specific, or alternate. The highest rates are applied on automobiles and some machinery. Imports are also subject to the PAL at a rate of 5% and, since early 2009, to a Nation Building Tax, currently at 3%. The VAT is applied at a general rate of 12%, with some exceptions.

15. A Special Commodity Levy was introduced in 2007 on 11 essential food commodities, including milk powder, dhal, sugar, potatoes, and onions. This single composite levy replaced the various duties and taxes applicable in respect of essential food commodities with a view to controlling the price escalation of these products. Rates are adjusted periodically to reflect price and demand and supply developments; adjustments may be general or limited to specific products. The introduction of the levy has resulted in lower import duties for the products concerned.

16. Despite having raised tariffs and other charges on imports, Sri Lanka made substantial efforts during the period under review to enhance transparency. Information regarding applied tariff levels and all other import charges is easily available online. However, although orders modifying tariff and other import tax rates are published and available online, the frequent resort to this kind of practice adds discretion and creates confusion among importers; limiting the number of changes and converting specific

duties into *ad valorem* charges would help to further foster transparency. On the other hand, Sri Lanka must be commended for keeping and publishing figures with respect to revenue forgone due to tariff and other tax exemptions.

17. An important policy development since the last Review has been the implementation of the WTO Customs Valuation Agreement (CVA). However, Sri Lankan legislation grants the authorities the flexibility to depart from CVA rules when deemed necessary, in the interest of the national economy or for any other reason, allowing for the use of minimum values. During the period under review, minimum import prices were applied on imports of used cars.

18. Sri Lanka's use of non-tariff barriers is relatively limited, with the exception of non-automatic import licensing requirements, which are applied on some 500 tariff lines, covering goods including grains, chemicals, some textiles, petroleum, and motor vehicles. Sri Lanka does not have any provision in place to use contingency measures. Two bills containing provisions on anti-dumping, countervailing duties, and safeguard measures were *gazetted* in October and November 2005, but as at June 2010, still awaited the approval of Parliament. Sri Lanka's national standards and technical regulations generally follow international guidelines. Sri Lanka has 103 trade-related technical regulations; these have been notified to the WTO. The technical regulations cover a range of products included in the Imports (Standardization and Quality Control) Regulations 2006, which must conform to a Sri Lanka Standard (SLS), to be allowed for import. Sri Lanka has made 18 SPS notifications to the WTO.

19. Sri Lanka continues to apply policies to encourage exports of goods and services. Several incentive programmes, some of which have export requirements, are available to support exports. Three schemes are operated by Customs: duty rebate (drawback) scheme, the temporary importation for export processing scheme (TIEP), and the manufacture-in-bond scheme. Sri Lanka also has an Export Processing Zones (EPZs) scheme; there are 11 such zones, comprising some 220 enterprises, and employing over 75,000 persons. Locating an enterprise in an EPZ entitles a company to tax holidays, duty-free imports, and concessionary land prices. Exporters of non-traditional goods exporting at least 80% of their production also enjoy a number of tax concessions, including a preferential income tax rate on profits from these exports, and a full tax holiday for between three and seven years for new investments. These concessions are also extended to service providers that export at least 70% of turnover.

20. Sri Lanka imposes border charges on certain exports. Export duties are levied on value-added vein quartz and raw vein quartz, while an export cess is levied on cashew nuts, raw hides, metal scrap, natural rubber, coconut products, and tea.

21. Although the Consumer's Affairs Authority may investigate the effects on consumers of anti-competitive practices, Sri Lanka's legislation does not confer it the power to conduct investigations on the existence of monopolies *per se* or to examine mergers or acquisitions that have already taken place. There are no provisions that make pre-merger notification mandatory. As a result, investigations on the effects of mergers may only be undertaken for utilities, which fall under the purview of the Public Utilities Commission, or for companies listed in the Colombo Stock Exchange, which may be reviewed by the Securities and Exchange Commission of Sri Lanka. The Government is in the process of drafting new competition policy legislation to address most of these issues, including the mandatory examination of mergers across the board.

22. Sri Lanka has not made any notifications to the WTO with respect to state-trading enterprises under Article XVII of the GATT 1994. Sri Lanka launched a programme of public enterprise reform and privatization in 1990, reinforced with the

establishment, in 1996, of the Public Enterprises Reform Commission (PERC), which completed some 50 privatization operations before it was closed in 2007 and the legal basis to privatize was repealed. The Government's current policy on public enterprises is not to privatize, but to restructure and improve performance and invite private-sector minority participation. State-owned enterprises are required to enter into performance agreements with the Treasury and to aim at being profitable.

23. Sri Lanka offers a wide range of tax incentives, notably tax holidays, primarily for investment purposes. The two main investment incentive regimes are under the Board of Investment (BOI) Act, and under the Inland Revenue Act. Investment under the BOI Act scheme is subject to a number of requirements, including export requirements. The duration of the tax holiday depends on the amount invested. Under the Inland Revenue Department (IRD) incentives regime, income tax exemptions are provided usually for five years or in some cases for three years. Effective tax rates can vary substantially by firm and sector and there have been discussions about merging the two systems. Sri Lanka's current system of tax incentives may result in duplication and overlapping of beneficiaries if not of benefits, and may cause distortion in the allocation of resources by artificially placing some firms and sectors in a more advantageous position than others. The authorities consider that these incentives are necessary to offset the disincentives created by the internal strife, and by domestic bottlenecks. In this respect, the end of the conflict and the high economic growth rates achieved in recent years offer the opportunity to step up economic, trade, and institutional reform.

24. During the period under review, efforts were made to streamline and clarify procurement guidelines and to make the process more efficient and transparent. However, government procurement continues to be used to promote domestic suppliers and products. Sri Lanka grants price preferences for locally manufactured goods to promote value added to local raw materials and domestic bidders. The margins of preference for domestic bidders for works and contracts are 7.5% for contracts funded by international donors and 10% for contracts funded by the Government; the margins for domestically manufactured goods are 15% and 20%, respectively. Sri Lanka does not participate in the WTO Plurilateral Agreement on Government Procurement (GPA), nor is it envisaging participating in the near future.

25. Sri Lanka introduced new, comprehensive intellectual property legislation in 2003, aimed at ensuring compliance with the TRIPS Agreement. The new Act covers copyright and related rights, industrial designs, patents, marks and trade names, layout designs of integrated circuits, unfair competition and undisclosed information, and geographical indications. The new Act has also extended the term of copyright protection, from life plus 50 years, to life plus 70 years. Although enforcement of IPRs was reinforced during the review period, counterfeiting and piracy remain a problem. Stricter legal provisions to fight piracy have been introduced in recent years, but their enforcement appears to remain somewhat weak. The Sri Lankan authorities are intent on making every effort to enforce intellectual property rights by strengthening enforcement agencies, training officers, and building public awareness.

(4) TRADE POLICIES BY SECTOR

26. Despite its relatively modest share of GDP (12.6% in 2009), agriculture has an important role in Sri Lanka's economy: it employs and provides the livelihood of a high percentage of the population, and is an important foreign exchange earner. Government intervention in agriculture, including border protection and domestic support, remains significant. Support is provided in the form of subsidized inputs, price support, and concessionary credit, among others. Nevertheless, productivity in domestic food crops remains low, and Sri Lanka continues to be a net food importer. Tariff

protection for agricultural products increased during the review period, and the use of ad hoc duty waivers and tariff changes may have resulted in distortions in agricultural commodity markets and domestic production. Development in the sector has been hampered by low levels of investment and credit, lack of quality inputs, inadequate transportation and marketing systems, lack of storage facilities, insufficient technological development, and land use restrictions. Reducing import protection, rationalizing domestic support, and implementing a more consistent trade policy would allow a more efficient allocation of resources, thus increasing productivity and farmers' incomes. In addition, a more functional land market would help attract higher investment levels and promote the introduction of modern agricultural technologies.

27. Sri Lanka produces about half of its energy needs, but imports all its oil and oil product requirements. The petroleum sector was reformed in 2003, most notably by putting an end to the state-run Ceylon Petroleum Corporation's (CPC) monopoly to import and distribute oil and petroleum products, and by some adjustments to the pricing system. Nevertheless, the CPC remains a dominant player, and a leading retailer with influence over local market prices. An amendment to the CPC Bill aimed at improving the sector's regulation is under consideration.

28. The electricity sector is dominated by another state-owned enterprise, the Ceylon Electricity Board (CEB), which has run at a loss for many years as electricity tariffs have been kept below generation costs. At the same time, cross-subsidization in favour of certain consumers has led to high electricity costs for industrial users, potentially weakening their competitiveness. Under the recent Sri Lanka Electricity Act (2009), the CEB retained its monopoly in transmission, but it must now purchase electricity through competitive tenders. The new Act also provides for some degree of tariff reform, but falls short of more ambitious and long-discussed initiatives to fully re-structure the electricity industry.

29. Sri Lanka's industrial policy aims at diversifying its manufacturing base and promoting regional industrialization. In order to encourage investment in the manufacturing sector, the Government has offered a wide range of tax incentives, concessionary tax rates and other types of assistance. The sector remains an important contributor to economic growth, accounting for 18.1% of GDP and 17.7% of total employment. However, it is highly concentrated in a few products and export markets, and relies heavily on imported inputs, making it vulnerable to external economic cycles and price fluctuations.

30. The apparel industry, the main foreign exchange earner, has faced significant challenges over the past few years, affected by increased competition from other exporting countries and weak demand in the United States and the European Union, which receive about 90% of its exports. The industry has responded by adopting new technologies, improving quality, and encouraging product differentiation. Growth in the manufacturing sector as a whole would be enhanced by upgrading infrastructure (e.g. electricity and transport) so as to reduce production costs, improving productivity, diversifying export markets and products, and addressing labour market rigidities. In addition, rationalizing the incentives regime could help enhance resource allocation and efficiency.

31. The services sector, which accounts for 58% of GDP and 42% of employment, remains the main driver of economic growth, expanding by an average 6% annually in real terms between 2004 and 2009. Following privatization and liberalization measures in the early 2000s, Sri Lanka's service sector is relatively open. Full foreign ownership is permitted in banking, insurance, and telecommunications. Nevertheless, state intervention remains strong in key areas. For example, in the banking sector, the two largest commercial banks are state-owned and hold about a third of total banking assets. Moreover, the Government's position as the largest borrower has limited the ability of state banks to provide much-needed funds to the

private sector, although there are signs that this situation is changing. In telecommunications, the partially state-owned incumbent operator retains considerable influence in the market, while the sector's regulator faces capacity constraints to enforce pro-competitive reforms.

32. In transport services and infrastructure, although domestic and foreign investment has been encouraged, the State keeps a strong presence: the majority government-owned national carrier dominates the air services industry, another state-run company retains the monopoly to develop and manage airports and airport services, and a government agency is in charge of all cargo handling and port services, with the exception of a terminal at the Colombo Port. Further efforts to advance regulatory reform so as to strengthen competition, increase private-sector participation, and establish a level playing field for new entrants would contribute towards modernizing Sri Lanka's services sector, hence improving the country's productivity and external competitiveness.