SUMMARY

1. Sri Lanka, a middle-income economy, has performed relatively well since its last review in 2010. Its economy has shown resilience in the aftermath of the global financial crisis and following the resolution of the internal conflict, with an average annual growth rate in real GDP of 6% during the review period. Growth was mainly driven by the construction, wholesale and retail trade, and financial services sectors. The main risks to growth sustainability and development result from the weak fiscal position – the fiscal deficit increased from 6.5% of GDP in 2011 to 7.5% in 2015, well above the government target of 4.4%; the declining revenue collection – revenue collection as a proportion of GDP declined to around 13% in 2015; and the resulting public debt overhang. The Government's reform agenda for the next three years plans to address these risks by introducing fundamental changes to tax policy and administration, encouraging stronger revenue performance, and reforming state-owned enterprises (SOEs). With inflation declining from 7.5% in 2012 to less than 1% in 2015, the Central Bank pursued an accommodative monetary policy from 2012, in part to spur economic growth, however, as credit and monetary aggregates expanded, the Central Bank commenced tightening monetary policy gradually towards the end of 2015. Economic activity is dominated by the services sector, which accounts for 60% of GDP, followed by manufacturing at 20%, and agriculture at 9% of GDP.

2. Trade played an important, albeit declining role in the economy during the review period, as trade in goods and non-factor services declined from the equivalent of about 55% of GDP in 2011 to 49% in 2015. While exports and imports grew in absolute terms over the review period, the merchandise trade deficit widened as imports increased more rapidly from US$12 billion to nearly US$19 billion, and exports from US$8 billion to US$10 billion. Sri Lanka's merchandise exports remain heavily concentrated with agriculture and clothing accounting for over 70% of 2015 total exports, while imports remain more diversified. Services trade exhibited strong growth, both in imports and exports, thus contributing to a reduction of the current account deficit during the period from US$4.6 billion in 2011 to US$2 billion in 2015. Receipts more than doubled due to large increases in transport and travel services, reflecting a significant increase in tourism.

3. In term of policy, Sri Lanka has been focusing on long-term strategic and structural development since the end of its internal conflict, as it strives to become an upper-middle-income country. Since its last review, the Government has been guided by its 2010 "*Mahinda Chinthana* – Vision for the Future" which sets out specific targets, e.g. for GDP and export growth, and also for structural change to reduce the reliance on agriculture in order to focus on development of the services and industrial sectors. There are also broad mandates for trade and investment policies, including pursuing preferential trade negotiations, revising tariffs under reciprocal trade agreements, and reviewing import tariff policies and border measures. Key priorities are to review and renegotiate existing trade agreements, adopt an export promotion strategy, encourage more foreign direct investment, and promote the diversification of exports.

4. Sri Lanka's preferential trade regime has remained unchanged during the review period and it continues to provide long-standing reciprocal preferences pursuant to two bilateral agreements with India and Pakistan, and two regional trade agreements – the Asia-Pacific Trade Agreement (APTA), and the South Asian Free Trade Area (SAFTA) Agreement. Sri Lanka receives GSP benefits from a number of countries and participates in the Global System of Trade Preferences among Developing Countries (GSTP). Developments during the review period included the launch of free trade negotiations with China in September 2014, and deepening of the bilateral relationship with India through the launch of negotiations on a new Indo–Sri Lanka Economic and Technology Cooperation Agreement. Trade under reciprocal preferential agreements for Sri Lanka is minimal, amounting to 3.4% of 2014 imports; this is in part attributed to overlapping trade concessions with the same trading partners through different preferential regimes.

5. Sri Lanka recognizes the importance of attracting foreign direct investment, in particular to rebuild the country after the internal conflict, as FDI levels remain relatively low. Despite a general increase over the period, FDI inflows declined in 2015 and stood at about 2% of GDP, below the Government's target of 3% of GDP. The telecommunications sector has been the largest recipient of foreign investment followed by manufacturing. Sri Lanka has a long-standing policy of offering incentives to attract investment, mostly through tax concessions and import duty exemptions, and has also specifically targeted certain sectors. The incentives have been modified and scaled back during the period and, since October 2014, no new fiscal incentives have been offered. As of June 2016, the Government was formulating a new incentive scheme in which it planned to focus on

facilitating investments and improving the ease of doing business. Despite efforts to encourage investment, there have been no changes in the long-standing investment restrictions, some of them applied in many strategic sectors, and more restrictions have been put in place such as prohibiting the sale of land to foreigners. Also to encourage investment, Sri Lanka maintains a number of specialized zones, in particular export processing zones which offer customs facilities and bonded facilities to attract potential investors.

6. In terms of the multilateral trading system, Sri Lanka granted at least MFN treatment to all its trading partners, made proposals to the DDA and participated in the regular work and Committees of the WTO, and has not been involved in any disputes under the WTO Dispute Settlement Mechanism during the review period. Sri Lanka made many WTO notifications during the review period that pertained mainly to customs valuation, agriculture, import licensing, SPS, TBT, TRIMs, and TRIPS.

7. Sri Lanka's trade measures on imports focus on tariffs, import licences, and additional charges and taxes; it does not have non-preferential rules of origin nor does it have legislation for trade remedies, i.e. anti-dumping, countervailing duties, and safeguards. Sri Lanka has followed the rules for valuation under the WTO Customs Valuation Agreement since 2003 but retains the right to use minimum values under certain conditions, which it applied to certain categories of motor vehicles during the review period.

8. The tariff regime remained relatively unchanged during the period, with applied rates declining slightly from an average of 11.5% in 2010 to 10.3% in 2016. MFN tariffs are quite varied; over 50% of tariff lines are duty-free, about 20% of tariff lines have a 15% duty, and 23% have a duty of 30%. About 4% of tariff lines have non-*ad valorem* rates, these include alternate and specific duties; specific duties mainly concern agricultural products. On average, there is significantly higher tariff protection in the agricultural sector (24%) compared to the industrial sector (7.5%). Sri Lanka maintains considerable flexibility with respect to tariffs as only 37.5% of tariff lines are bound and the average rate for bound tariffs is 34%, thus reducing somewhat the predictability of the tariff regime. Sri Lanka has amended its tariffs during the review period to reduce the number of tariff bands from four to three, which has also had an impact on the number of applied tariffs exceeding the bound rates. This has deteriorated since the last review with the MFN rate exceeding the bound rate on 132 lines in 2016, up from 103 lines in 2010; this situation mainly affects tobacco products, alcoholic beverages, textiles, carpets and switches.

9. Sri Lanka has in place a large number of additional levies and charges that are applied in addition to the tariff on a wide variety of products; these include the Export Development Board Levy (Cess), Excise Duty, Value Added Tax (VAT), Ports and Airports Development Levy, Nation Building Tax, port handling charges and the Special Commodity Levy. The Excise Duty, VAT, and Nation Building Tax apply to both imported and domestic goods while the others are charged on imported goods. The charges can be high and significantly increase the cost of importing, in some cases exceeding 100% of the c.i.f. value. Furthermore, many have been modified several times during the review period, thus adding unpredictability for importers.

10. The main developments in terms of customs procedures during the period were Sri Lanka's implementation of a single window system in January 2016 and its acceptance of the WTO Trade Facilitation Agreement in May 2016. Sri Lanka's single window application allows all entities involved in importing and exporting to submit required regulatory information to a single electronic gateway and to use electronic funds transfer or online payments. Pursuant to its notification of Category A commitments under the Trade Facilitation Agreement, Sri Lanka identified 11 provisions for implementation upon its entry into force.

11. Sri Lanka's regime and legislation for TBT and SPS measures have remained unchanged over the review period. The main legislation governing standards continues to be the Sri Lanka Standards Institution Act No. 6 of 1984; 123 trade-related technical regulations are in place. Food imports are regulated by the Food Act No. 26 of 1980, including its regulations and related amendments; animal, veterinary, and related products by the Animal Diseases Act No. 59 of 1992; while plant imports are governed by the Plant Protection Act No. 35 of 1999. Since January 2010, Sri Lanka has made 19 notifications to the Committee on Sanitary and Phytosanitary Measures regarding its SPS measures and 2 notifications to the Committee on Technical Barriers to Trade on technical regulations.

12. In terms of export measures, Sri Lanka applies duties, an export cess, prohibitions, and licensing requirements for selected exports. These are applied on a variety of products pursuant to the laws and requirements of different government entities. Export prohibitions are maintained for reasons of public health, protection of endangered species and the environment, and concern items such as explosives and drugs. The export cess is often levied on Sri Lanka's major export items, such as tea, rubber, coconuts, and cinnamon. There have been no major changes to Sri Lanka's export procedures except for the establishment of the single window system. Export incentives include tax and various fiscal incentives, a duty drawback scheme, a Temporary Importation for Export Processing (TIEP) Scheme, and a manufacture in bond scheme. A number of export finance instruments have been introduced during the review period to mitigate the impact of the financial crisis and to provide financial assistance; these include an Export Development Reward Scheme (EDRS), a Simplified Value Added Tax Scheme (SVAT), and the establishment of an Exim bank.

13. SOEs represent a substantial share of Sri Lanka's economic activity and the Government has acknowledged there is a need for their reform. There are 245 SOEs in Sri Lanka that collectively represent a risk to public finances as their outstanding obligations are the equivalent of 12% of GDP. As such, initiatives have commenced to strengthen the legal framework and oversight of SOEs, introduce market-based pricing mechanisms, and improve the efficiency of SOEs.

14. Government procurement in Sri Lanka represents about 6.3% of GDP and it is characterized as being fragmented, as it is done by decentralized agencies. Procurement continues to be an important instrument of economic policy, to promote domestic suppliers by granting price preferences for locally manufactured goods. There are 13 different procurement methods depending on the threshold and type of good/service or work to be procured. Works, services, and supplies are generally procured through the open competitive procedure but exceptions may occur under specific circumstances, e.g. emergency purchase or below thresholds. Sri Lanka has participated in the WTO Plurilateral Agreement on Government Procurement (GPA) as an observer since 2003.

15. Intellectual property rules in Sri Lanka cover copyright and related rights, industrial designs, patents, marks and trade names, layout designs of integrated circuits, unfair competition and undisclosed information, and geographical indications. They continue to be covered under the Intellectual Property Act No. 36 of 2003 and the Intellectual Property Regulations No. 1 of 2006. No new developments have occurred in the IP sector during the review period. Legislation on plant varieties has been developed but has not yet been adopted.

16. Sri Lanka's agricultural sector remains an important contributor to the economy and trade, accounting for nearly 9% of GDP and about one fourth of total exports. The sector can be divided into the main plantation crops, e.g. tea, rice, rubber, and coconut; and minor export crops, i.e. spices such as cinnamon, ginger, and pepper. Agricultural exports are dominated by a few commodities, i.e. tea, coconuts, cinnamon, and pepper, while imports are to meet domestic consumption needs, e.g. wheat, sugar, and milk products. A number of policy instruments are used in the sector, such as a special commodity levy; export cess; subsidies, notably the fertilizer subsidy; and tariffs. A number of state enterprises or marketing boards operate in the sector mainly for distribution and marketing, e.g. Paddy Marketing Board, Sri Lanka Cashew Corporation, and Sri Lanka Tea Board.

17. Manufacturing continues to be a significant area of economic activity accounting for about 20% of GDP. Sri Lanka continues to encourage development of its manufacturing sector by promoting value-added goods, capitalizing on its relatively low labour costs, benefiting from its connectivity, and improving linkages through value chains. The sector is dominated by the food products and beverages, and textiles and clothing subsectors. The textiles and clothing subsector is particularly important to trade and the economy as it accounted for over 45% of 2015 total exports, ranked second in terms of foreign exchange earnings, and accounted for approximately 50% of manufacturing employment.

18. Sri Lanka has a number of mineral resources that contribute to its economy and exports, in particular high purity graphite, mineral sands, and gemstones. The mining sector has not undergone any significant changes in its legal framework but recent developments included the prohibition of foreign firms from mining gems, a temporary ban on the export of scrap metal, and restrictions on soil mining. In the energy sector, Sri Lanka has diversified its energy sources during

the period by starting to use coal and promoting alternative sources such as wind and solar; achieved 100% countrywide electrification; and is expected to resume its first oil exploration activities in more than 25 years. Both the mining and energy sectors continue to have significant participation of state-owned enterprises either in production or distribution activities.

19. Sri Lanka's tourism sector has exhibited strong growth in recent years, achieving a 14.2% compound average growth rate, as it has benefited from policy initiatives and investment incentives. Tourism has been a focus of the Government post-conflict as a sector to expand the economy and invest in infrastructure. The sector has a significant impact on the economy as it is the third-largest foreign exchange earner, contributing over 12% to the foreign exchange earned in 2015. Developments during the period include the launching of a new policy and strategy for the sector, aligning regulations with international standards, and establishing a "One Stop Unit" for investment in tourism.

20. Other services sectors examined include financial, telecommunications, and transportation services as they are considered important to the continued development of the country by providing the necessary infrastructure for economic progress. While there has not been any major liberalization in the telecommunications sector during the last six years, the sector nonetheless experienced significant expansion during the review period mainly due to growth in the mobile sector. The introduction of the Telecommunications Levy in 2011 was to simplify the various taxes by having one composite tax applied to telecommunications services. Sri Lanka's financial sector, i.e. banking, insurance, and other specialized financial institutions, continued to show improved performance, reflecting prudential regulatory measures undertaken in recent years. The insurance subsector has undergone substantial liberalization and deregulation over the last decade, promoting its continued expansion, reaching a growth of 16.12% in total premiums in 2015. As for capital markets, as of June 2016, a number of legal amendments were being consolidated into a draft law to further strengthen regulatory oversight, e.g. align SEC governance with international standards and introduce civil and administrative penalties. During the review period, the transportation sector benefited from continued investment in both ports and roads to improve infrastructure for trade in goods and movement of persons. The air transport subsector experienced overall growth of over 50% between 2010 and 2015, in part due to the increases in tourism and trade. There was continued reliance on foreign grants to maintain the rail sector.