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India-Sri Lanka Bilateral Free Trade Agreement: Six Years Performance and Beyond*

Saman Kelegama and Indra Nath Mukherji*****

Abstract: India-Sri Lanka Bilateral Free Trade Agreement signed in1998 was a pioneering attempt in the direction of trade liberalization in South Asian region. This paper examines the performance of the Agreement in the first six years of its coming into being and draws lessons from its success that could be relevant in the context of SAFTA and other such initiatives. Section 1 of the paper gives an overview of the history of Indo-Lanka trade links and the birth of the Indo-SriLanka Bilateral Trade Agreement. It also talks about the conceptualization of the ILBFTA. Section 2 highlights the positive outcomes of the ILBFTA. Section 3 highlights the negative outcomes and problematic areas that have caught the attention of the trade negotiators. Section 4 describes the steps taken and progress made in moving the FTA towards a Comprehensive Economic Partnership Agreement (CEPA). Section 5 discusses about lessons from six years of success.

1. Overview

1.1 History of Indo-Lanka Trade Links

Trade relations between Sri Lanka and India date back to pre-colonial times. Under British rule, trade between the two countries was geared to fulfil the needs of the colonial power in the occupying territory, and was dominated by imports and exports in food-related items. After independence in 1947 and 1948 for India and Sri Lanka respectively, both national governments adopted inward-looking policies centred on the concepts of "self-reliance" and import substitution industrialization. Consequentially, a very modest level of trading took place between what became two virtually closed economies. In 1977, Sri Lanka became the first South Asian country to liberalize its economy, opening it up to the rest of the world. However, substandard products from India – the result of excessive inward-looking policies – were not competitive against the goods from East Asia that flooded the Sri Lankan market.

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With partial liberalization of the Indian economy during the 1980s and further liberalization in 1991, trade began to pick up, particularly in favour of India. Between 1993 and 1996, there was a doubling of two-way trade, and between 1990 and 1996 imports of Indian goods to Sri Lanka grew by 556 per cent. In 1995, India replaced Japan as the largest source of imports to Sri Lanka, accounting for 8-9 per cent of total imports. For Sri Lanka, it became evident that trade with the SAARC[1] region ultimately amounted to trade with India owing to the sheer size of the latter's rapidly emerging economy and expanding middle-class population. Hence, the perceived mutual benefits of free trade between the two countries became increasingly clear.[2] Sri Lanka's private sector – frustrated by the slow progress of the SAPTA[3] to boost regional trade – pressurized the government to enter into a free trade agreement (FTA) with the Indian government that would increase market access for Sri Lankan exporters.

1.2 Birth of the ILBFTA[4]

Politics was ultimately the major player in the move towards free trade. Sri Lanka entertained the hope of clearing away the political tensions of the 1980s and engaging India's assistance once more in solving the North/East conflict of the country. India was propelled by an immediate need to acquire South Asian markets following economic sanctions imposed on the country for the nuclear tests conducted in May 1998. Among other factors, these political forces led to the signing of the Indo-Sri Lanka Bilateral Free Trade Agreement (ILBFTA) on December 28, 1998.

Sri Lanka's economic objectives were to increase trade ties with South Asia's dominant economic power, to induce the transformation of Sri Lanka's exports from low-value added goods to high value-added goods aimed at niche markets, and to provide low-income groups with cheap consumer imports from India (Kelegama, 1999). Moreover, Sri Lanka hoped to attract more export-oriented foreign direct investment (FDI) from third countries by promoting itself as an effective entry point into the Indian market. With the Board of Investment (BOI) being made a "one stop shop" in the early 1990s, Sri Lanka has long been a relatively appealing location for foreign investors compared to its more bureaucratized South Asian neighbours.

1.3 Conceptualization

The conceptualization phase of the ILBFTA occurred between December 1998 and March 2000, and was based on several previous studies and recommendations.[5] The agreement was intended to supersede the existing economic partnership under the SAARC, viz., SAPTA. Bilateral free trade agreements are traditionally formulated using the "positive list" approach, whereby each participating country catalogues the individual commodities for which it would grant preferences to the other. Nonetheless, owing to the time-consuming nature of such a method, the ILBFTA was formulated on the "negative list" approach; each country extending concessions/ preferences to all commodities except those indicated in its "negative" list, namely items of a sensitive nature with regard to protecting national interests. The two countries agreed for preferential treatment on 5112 tariff lines (by 6-digit HS Code). An 8-year time table was devised for phasing out tariffs. Non-tariff barriers, such as Indian State taxes and customs-level procedures (e.g., landing tax), were to be gradually removed as well.

Taking into account the asymmetry between the two countries, Sri Lanka was accorded special and differential treatment; the immediate duty-free list (319 items) and 50 per cent preferential duty list (889 items) were considerably smaller than those offered by India (1,351 items and 2,799 items, respectively), while the Sri Lankan negative list (1,180 items) was considerably larger than India's (196 items). Among others, the agricultural sector of Sri Lanka was not subject to liberalization and was included in the negative list. The majority of Indian exports were initially granted only a 35 per cent duty concession with an 8-year tariff reduction period, while Sri Lankan exports were granted a 50 per cent concession with a 3-year tariff reduction period. Moreover, Sri Lanka was granted the freedom to reduce its negative list at her comfort level, instead of a pre-determined formula.

Rules of origin (ROO) criteria were also relaxed in Sri Lanka's favour. Preferential treatment requires a minimum of 35 per cent domestic value addition, or 25 per cent when Indian inputs comprise 10 per cent. In addition, although the agreement does not feature revenue compensation, Sri Lanka maintained that tariff concessions would not be granted for high-duty

Table 1.1: Duty Concessions under the ILBFTA

Duty Concessions for Sri Lankan Exports to India			
Tariff Reduction	Tariff Lines 1998	Tariff Lines 2005	Remarks
100%	1,351	4,150	
50%	2,799	0	
50% - Tea	5	5	50% fixed tariff concession for imports of tea from Sri Lanka(Annual maximum quota of 15 million kilograms)
50% - Garments	233	233	Garments covering Chapters 61&62 while remaining in the negative list, will be given 50% tariff concessions on a fixed basis, subject to an annual restriction of eight million pieces, of which six million shall be extended the concession only if made of Indian fabric. On utilization of the unrestricted quota, an additional quota of 2 million pieces out of 8 million pieces is permitted. The quota level per category is increased from 1.5 million to 2 million pieces per category per year.
25% - Textiles	528	528	Concessions on Textile items restricted to 25% on Chapters 51-56, 58-60, & 63. Four Chapters under the Textile sector retained in the negative list (Chapters 50,57,61 and 62)
0%	196	196	Negative list
Duty Concessions for Indian Exports to Sri Lanka			
Tariff Reduction	**Tariff Lines 1998**	**Tariff Lines 2005**	**Remarks**
100%	319	1,208	
50%	889	0	
35%	2,724	2,724	Subject to 70% tariff reduction in 2006, and 100% in 2008
0%	1,180	1,180	Negative list

imports such as automobiles; import duties are an important source of government revenue and comprise 2 per cent of Sri Lankan GDP.

Some aspects of the agreement were deferred for subsequent negotiation; these include the number of entry ports, Indian state-level taxes, customs procedures, and the specifics of phasing out non-tariff barriers.[6] The agreement included mechanisms for review and consultation, as well as settlement of disputes above and beyond the protection afforded to both countries under the safeguards clause. Table 1.1 records the progress made till end-2005 in reducing tariffs.

The rest of the paper is organized as follows. Section 2 highlights the positive outcomes of the ILBFTA. Section 3 highlights the negative outcomes

and problematic areas that have caught the attention of the trade negotiators. Section 4 describes the steps taken and progress made in moving the FTA towards a Comprehensive Economic Partnership Agreement (CEPA). Section 5 provides some concluding remarks. The analysis of the paper is confined to the 1999-2005 period.

2. Positive Outcomes

2.1 Trade Flows: View from Sri Lankan Sources

The period 1999-2005 saw a surge in two-way trade; Sri Lanka's exports to India rose from 1 per cent to 9 per cent of total exports, while imports from India increased from 8.5 per cent to 20.7 per cent of total imports (see Table 2.1). The corresponding boom in *preferential* exports to India under the ILBFTA reaffirms the success of bilateral trade liberalization (see Table 2.3). By 2005 about 90 per cent of Sri Lankan exports to India and 45 per cent of Indian exports to Sri Lanka came under the ILBFTA. Sri Lanka's imports-to-exports ratio fell from 10.3:1 to 3.3:1, a relatively fast decline compared to the five-year period prior to 2000 (see Table 2.2).

The number of Sri Lankan export items to India increased from 505 to 1,062, and a visible shift from agricultural products to manufacturing goods was noted (Tables 3.1 and 3.2). In 2005, the main Sri Lankan exports to India were: copper and copper products (28 per cent), vegetable fats/oil (26 per cent), Aluminium (8 per cent), spices (6 per cent), and electrical machinery and equipment (5 per cent) (Table 3.2). India has been the 3rd largest export destination since 2003, whereas it was 16th largest in 2000. It is now Sri Lanka's 3rd largest trading partner after the United States and the European Union. A number of Sri Lankan firms producing both industrial and consumer goods have successfully entered the Indian market with the support of the FTA (see Table 2.4); products include value-added tea, sausages, biscuits, chocolates, ceramics, furniture, metal products, footwear, wooden toys, memory chips, machinery and mechanical appliances, and herbal products. Trade creation and a number of new products entering the Indian market from Sri Lanka were visible after the ILBFTA (Mukherji *et al.*, 2002).

Table 2.1: India's Emergence as a Trading Partner (Share of Sri Lankan Trade)

Year	% of Total Exports	% of Total Imports
1986	1.0	4.3
1990	1.0	4.4
1994	0.7	8.5
1998	0.8	9.2
1999	1.0	8.5
2000	1.0	8.2
2001	1.5	10.1
2002	3.6	14.0
2003	4.8	16.1
2004	6.8	18.0
2005	8.9	20.7

Source: Sri Lanka Customs.

Table 2.2: Sri Lanka's Trade with India (US $million)

Year	Exports US $ mn	Imports US $ mn	Ex+Im US $ mn	Exports/ Total Trade	Imports/ Total Trade	Trade Balance US $ mn	Imports/ Exports
1995	30.23	444.89	475.12	0.06	0.94	- 414.65	14.72
1996	41.80	547.68	589.47	0.07	0.93	- 505.88	13.10
1997	42.13	538.84	580.97	0.07	0.93	- 496.71	12.79
1998	35.91	513.97	549.88	0.07	0.93	- 478.06	14.31
1999	47.47	499.38	546.85	0.09	0.91	- 451.92	10.52
2000	54.93	568.04	622.97	0.09	0.91	- 513.10	10.34
2001	69.05	576.97	646.03	0.11	0.89	- 507.92	8.36
2002	168.64	843.47	1,012.12	0.17	0.83	- 674.83	5.00
2003	244.77	1,070.81	1,315.58	0.19	0.81	- 826.03	4.37
2004	391.51	1,439.51	1,770.86	0.21	0.79	- 1,048.00	3.68
2005	556.41	1,835.43	1,611.60	0.23	0.77	- 1,279.02	3.30

Sources: 1. Sri Lanka Customs. 2. Central Bank of Sri Lanka, *Annual Report*, various issues.

Table 2.3: Preferential Exports to India under the ILBFTA

Year	Exports (Rs. million)	% of preferential exports to India
2000	655	15.5
2001	1,423	22.1
2002	10,930	67.0
2003	15,820	68.0
2004	30,616	79.0
2005	31,089	74.0

Source: Department of Commerce, Sri Lanka, Country of Origin certificates.

Table 2.4: Sri Lankan Firms whose Products Entered the Indian Market under the ILBFTA

Company	Product
Ceylon Chocolates (Pvt) Ltd.	Chocolate (Kanbar)
Edna Chocolates	Chocolates
Maliban	Biscuits
Prima Ceylon Ltd.	Processed food
Keells	Processed food
Mlesna	Branded tea
DSI	Rubber slippers / rubber products
Gloves Lanka (Pvt) Ltd.	Knitted gloves
Lanka Walltiles	Ceramic wall tiles
Damro	Furniture
Eclar Toys	Wooden toys
Tandon Associated Lanka (Pvt) Ltd.	Dual inline memory modules
Skyspan Asia (Pvt) Ltd.	Substitute to conventional roofing systems
Tantri Trailers	Trailers / long vehicles
Link Natural	Ayurvedic medicines

Source: Board of Investment (BOI) of Sri Lanka.

2.2 Trade Flows: View from the Indian Sources

The data on trade flows from Indian source shows similar trends. As may be seen in Table 2.5. India's trade with Sri Lanka has increased briskly since ILBFTA was signed between the two countries. Both exports and import shares in relation to world exports and imports increased. Further, since India's imports from Sri Lanka increased faster than its exports to that country, the export to import ratio declined from as high as 14.22 in 2000-01 to less than 3.72 per cent in 2004-05 (Table 2.5). The main Indian exports to Sri Lanka were: automobiles/ transport items (19 per cent), mineral fuels/oils (17 per cent), cotton (6 per cent), iron and steel (5 per cent), machinery and mechanical appliances (5 per cent), and pharmaceuticals (4 per cent).

Table 2.5: India-Sri Lanka and South Asian Trade: Value in US $ Million

	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004	2004-2005
India's Exports to Sri Lanka						
Export to the World :	36822	44560	43827	52719	63843	48389.85
Exports to Sri Lanka	499.27	640.14	630.89	920.98	1319.2	1355.23
(% Share of World)	1.36	1.44	1.44	1.75	2.07	2.80
India's Imports from Sri Lanka						
Imports from the World	49671	50536	51413	61412	78150	61937.79`
Import from Sri Lanka	44.23	45.01	67.38	90.83	194.74	364.39
(% Share of World)	0.09	0.09	0.13	0.15	0.25	0.59
Export/Import Ratio	11.29	14.22	9.36	10.14	6.77	3.72

Source: Customs data of India.

Table 2.6 gives the value as well as value share of products offered concessions by India to Sri Lanka in respect of different categories. It will be seen that in 1999 India imported US$ 4.4 million of such products under the proposed duty free list from Sri Lanka.

After the offer of **duty free concessions,** India's imports increased to US$ 12.2 million in 2003. As a share of world imports, it increased from 0.29 per cent in 1999 to 0.50 per cent in 2003 as can be seen in Figure 2.1. Even though the share trend is not very marked, there remains considerable opportunity for India to further increase its imports share from Sri Lanka in respect of such products.

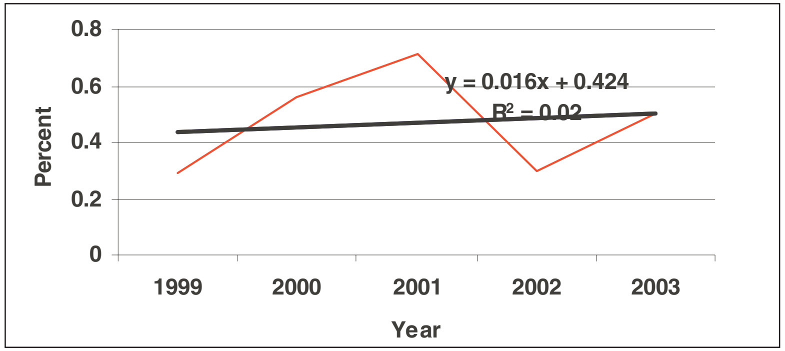
Table 2.6: India's Imports from Sri Lanka and World under Different Categories

(Value in '000 USD)

Concessions	No. of Products	Partner/ Share	1999	2000	2001	2002	2003	1999-2003
Negative List(NL)	14	World	56508	65095	90495	100207	158381	470686
		Sri Lanka	548	217	236	258	4525	5784
		Share (%)	0.97	0.33	0.26	0.26	2.86	1.23
Zero Duty(ZD)	55	World	1535995	1933475	1785472	2064873	2463872	9783687
		Sri Lanka	4477	10748	12617	6218	12264	46324
		Share (%)	0.29	0.56	0.71	0.3	0.5	0.47
Tea	5	World	5908	9774	14198	25771	13891	69542
		Sri Lanka	2014	1779	2469	981	682	7925
		Share (%)	34.09	18.2	17.39	3.81	4.91	11.4
Textile(TEX)	35	World	350340	332591	525954	389562	550895	2149342
		Sri Lanka	826	940	1229	1243	2816	7054
		Share (%)	0.24	0.28	0.23	0.32	0.51	0.33
Garment(GAR)	5	World	1934	2283	2221	9674	1522	17634
		Sri Lanka	299	0	61	36	172	568
		Share (%)	15.46	0	2.75	0.37	11.3	3.22
Residual(RES)	205	World	5360426	5636152	6369449	7572914	10626296	35565237
		Sri Lanka	31045	26332	45431	73796	160466	337070
		Share (%)	0.58	0.47	0.71	0.97	1.51	0.95
Total (NL+ZD+ Tea+TEX+ GAR+RES)	319	World	7311111	7979370	8787789	10163001	13814857	48056128
		Sri Lanka	39209	40016	62043	82532	180925	404725
		Share (%)	0.54	0.50	0.71	0.81	1.31	0.84
Total (ZD+Tea+ TEX+GAR+RES)	305	World	7254603	7914275	8697294	10062794	13656476	47585442
		Sri Lanka	38661	39799	61807	82274	176400	398941
		Share (%)	0.53	0.50	0.71	0.82	1.29	0.84
Total Imports (All Categories)	332	World	49710774	51374343	51905070	61113981	77196379	291300547
		Sri Lanka	42835	43696	66127	88053	187485	428196
		Share (%)	0.09	0.09	0.13	0.14	0.24	0.15

Source: Customs data of India.

Figure 2.1: India's Imports from Sri Lanka under Zero Duty (%)

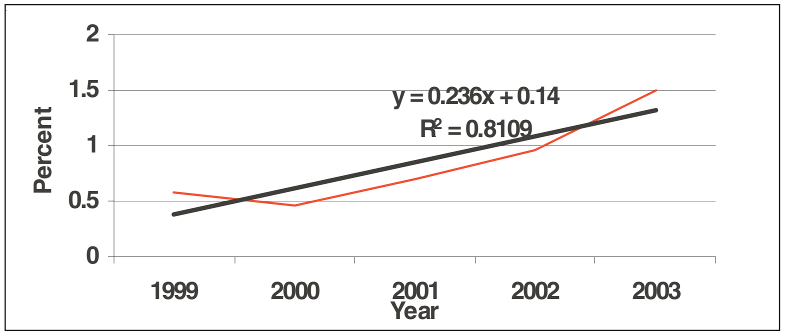


Source: Estimated using Customs data of India.

India's imports of **residual products** as a group increased from US $ 31 million in 1999 to US $ 160 million in 2003. Its share in world imports has also been increasing steadily from 0.58 per cent in 1999 to 1.5 per cent in 2003. This increasing trend is shown in Figure 2.2.

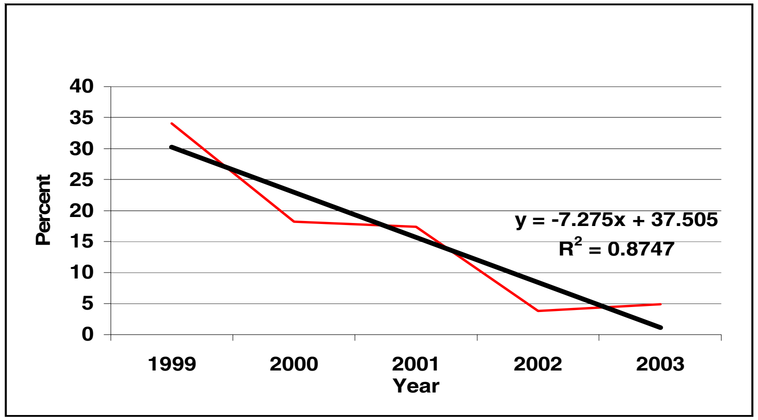
Unlike the increasing trends shown earlier, the value of India's **tea imports** (after increasing in 2001) has been declining. India imported US $ 2.0 million in 1999 but this declined to US $ 0.7 million in 2003. The share of Sri Lanka in India's world tea imports declined from 34 per cent in 1999 to 4.9 per cent in 2003. Figure 2.3 shows the trend.

Figure 2.2: India's Imports from Sri Lanka under Residual (%)



Source: Estimated using Customs data of India.

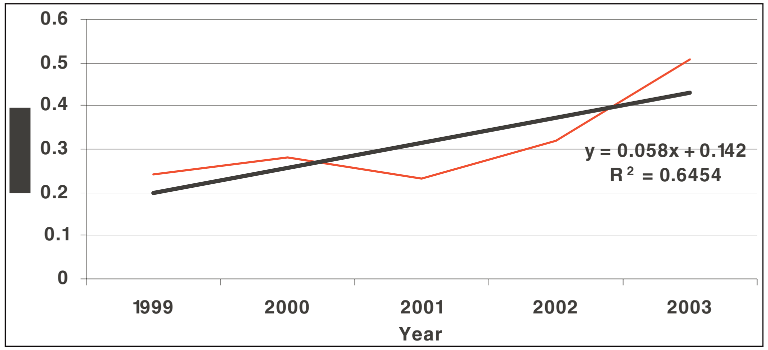
Figure 2.3: India's Imports from Sri Lanka : Tea (%)



Source: Estimated using Customs data of India.

India's import of **textiles** from Sri Lanka increased from US $ 0.82 million in 1999 to US $ 2.8 million in 2003. During this period its share in world imports increased from 0.24 per cent to 0.51 per cent. This trend is presented in Figure 2.4.

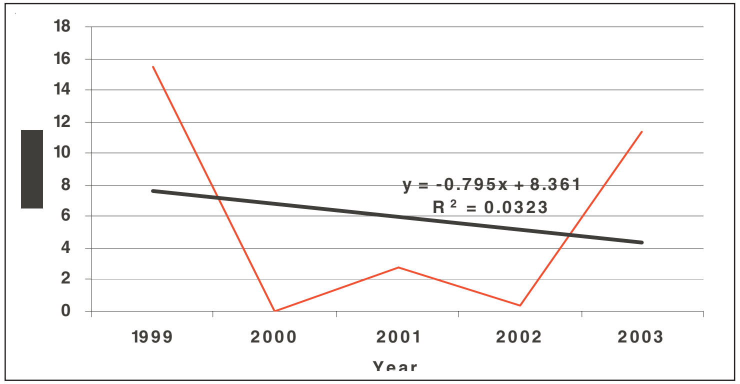
Figure 2.4: India's Imports from Sri Lanka : Textile (%)



Source: Estimated using Customs data of India.

India did not show any positive inducement to buy **garments** from Sri Lanka. In fact, its garment imports declined from US $ 0.30 million in 1999 to US $ 0.17 million in 2003. The declining share of India's garment imports from Sri Lanka is shown in Figure 2.5.

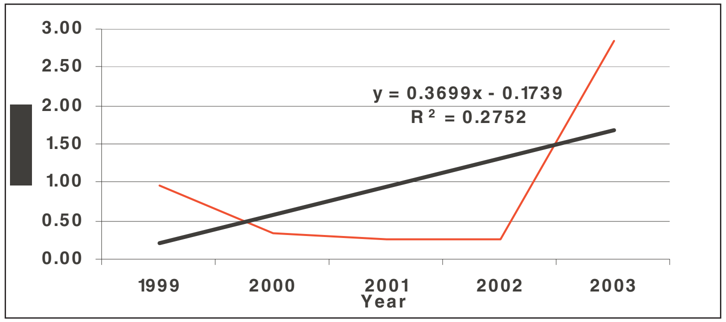
Figure 2.5: India's Imports from Sri Lanka : Garment (%)



Source: Estimated using Customs data of India.

The products under **Negative List** have not been offered tariff preferences and hence were not expected any positive impact on Indian imports from Sri Lanka. However the data reveals that that India's imports under this list declined steadily from 1999 to 2002 but shot up from 2002 to 2003. Hence over the period the import value increased from US $ 0.54 million in 1999 to US $ 4.5 million in 2003 as shown in Figure 2.6.

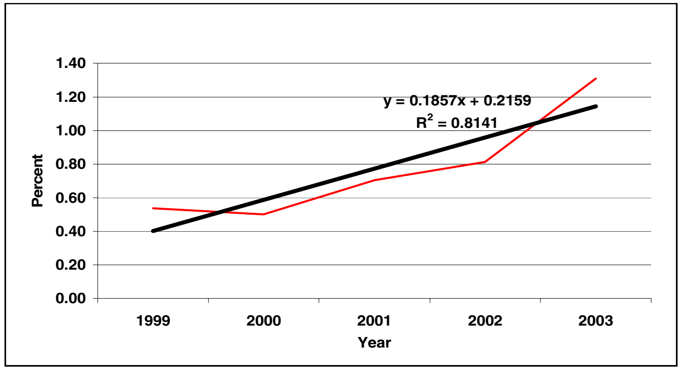
Figure 2.6: India's Imports from Sri Lanka under Negative List (%)



Source: Estimated using Customs data of India.

The value of products imported under all categories increased from US $ 39 million in 1999 to US $ 181 million in 2003. The increasing share in world imports is shown in Figure 2.7. This share increased in spite of falling shares in case of tea and garments.

Figure 2.7: India's Imports from Sri Lanka : All Categories (%)



Source: Estimated using Customs data of India.

Now we turn to examine whether Sri Lanka has been able to increase its share of Indian imports in relation to world imports for products offered concessions by it. In this case we have data for 1999, 2001 and 2002. The trend for all categories is shown in Table 2.7.

With respect to **duty free products** we notice that Sri Lanka's imports from India increased from US $ 3.49 million in 1999 to US $ 3.83 million in 2002. This reflected an increasing share from 36.88 per cent in 1999 to 43.70 per cent in 2003. Figure 2.8 illustrates this trend.

Sri Lanka's imports of **phased products** increased from US $ 59.20 million in 1999 to US $ 115.71 million in 2002. This reflected an increasing share from 16.93 per cent in 1999 to 24.47 per cent in 2003 as may be seen in Figure 2.9.

It is interesting to note that even in the case of products under **Negative List** Sri Lanka's imports from India increased significantly from US $ 213 million in 1999 to US $ 396 million in 2002. This reflected an increasing share in relation to world imports from 14.61 per cent in 1999 to 23.15 per cent in 2002. Figure 2.10 illustrates this trend.

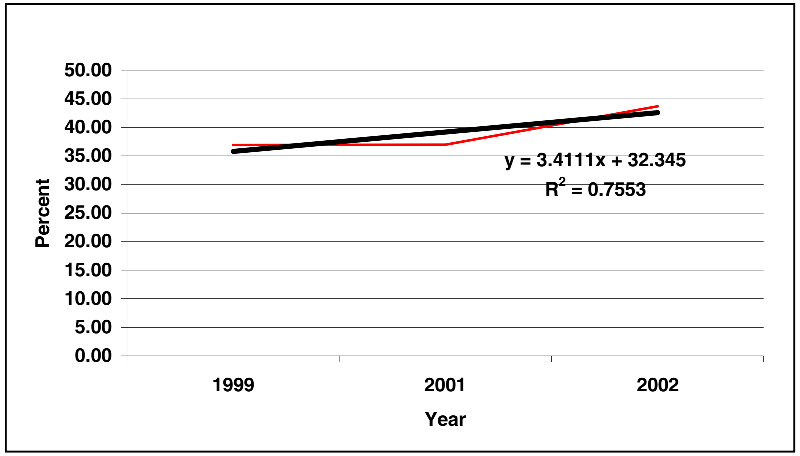
Table 2.7: Sri Lanka's Imports from India and World under Different Categories

(Value in '000 USD)

Lists	No. of Products	Partner/ Share	1999	2001	2002	1999-2003
Negative List(NL)	**277**	World	1458417	1219098	1712199	4389714
		India	213004	258771	396244	868019
		Share (%)	14.61	21.23	23.14	19.77
Zero Duty(ZD)	**26**	World	9483	8371	8760	26614
		India	3497	3091	3828	10416
		Share (%)	36.88	36.93	43.70	39.14
Phased(Pha)	**257**	World	349712	346975	472895	1169582
		India	59205	64524	115710	239439
		Share (%)	16.93	18.60	24.47	20.47
Total (NL+ZD+Pha)	**560**	World	1817612	1574444	2193854	5585910
		India	275706	326386	515782	1117874
		Share (%)	15.17	20.73	23.51	20.01
Total(ZD+Pha)	**283**	World	359195	355346	481655	1196196
		India	62702	67615	119538	249855
		Share (%)	17.46	19.03	24.82	20.89
Total Imports(All Cateories)	**1231**	World*	5322981	5393186	6024760	16740927
		India	494961	588143	817775	1900879
		Share (%)	9.30	10.91	13.57	11.35

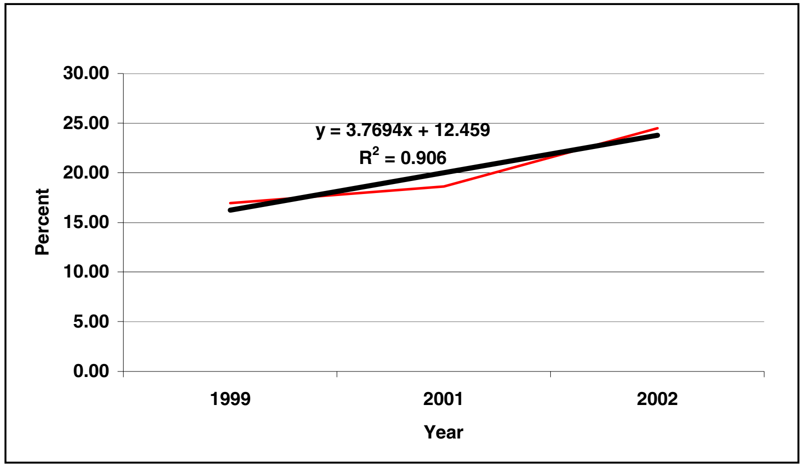
Source: Customs data of India.

Figure 2.8: Sri Lanka's Imports from India under Zero Duty



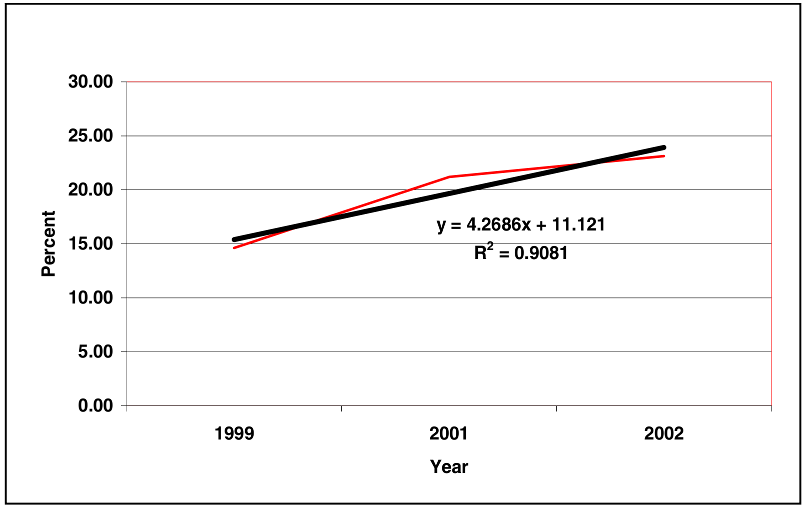
Source: Estimated using Customs data of India.

Figure 2.9: Sri Lanka's Imports from India under Phased Products



Source: Estimated using Customs data of India.

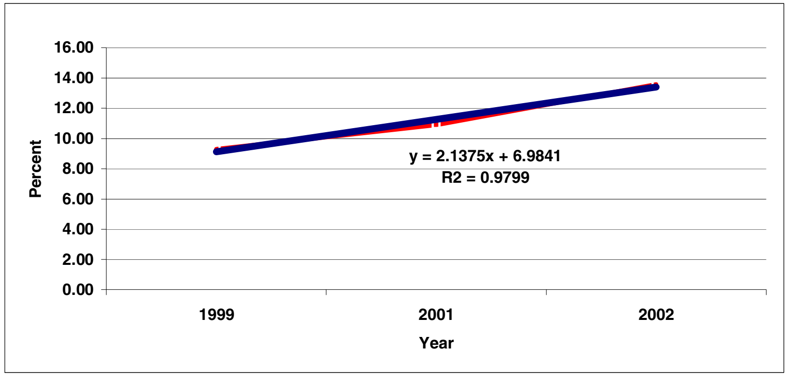
Figure 2.10: Sri Lanka's Imports from India under Negative List



Source: Estimated using Customs data of India.

Sri Lanka's imports of all categories (excluding residual products) from India increased from US $ 275 million in 1999 to US $ 516 million reflecting an increasing share from 15.17 per cent to 23.51 per cent during the same period. This is illustrated in Figure 2.11.

Figure 2.11: Sri Lanka's Imports from India



Source: Estimated using Customs data of India.

The Indian imports that recorded maximum growth in recent years, namely automobiles/transport items and mineral fuels/oils are in the Sri Lankan negative list. As stated, these are not subjected to tariff preferences due to revenue considerations.[7] However, the rapid increase in imports to Sri Lanka of the items in the negative list calls for serious examination of maintaining its status quo. A gradual phasing out of the negative list so as to keep it to a bare minimum may be considered.

2.3 Investment

While the exchange of tariff preference no doubt induced the accelerated flow of bilateral trade between the two countries, the more rapid increase in Sri Lankan exports to India had also much to do with the emergence of Sri Lanka as a production and profit centre for Indian companies seeking access to regional and global markets. Over 50 per cent of Indian joint ventures and wholly owned subsidiaries in the South Asian region are located in Sri Lanka. The inflow of direct investment from Indian companies began in the wake of Sri Lanka's economic liberalization programme during the 1980s. By the end of June 2000 the number of Indian projects stood at 120 with an

estimated investment of Rs. (SL) 12.5 billion. The principal sectors are steel, cement, rubber products, tourism, computer software, IT training, textiles and garments, food products, automobile components, plaits products, construction, chemicals, electrical equipment, printing, shipping, financial and non-financial services.

During past six years, leading Indian companies such as Gujrat Ambuja, Indian Oil, Apollo Hospitals, Asian Paints, Larsen and Toubro, CEAT, Taj Hotels, Mudra Communications, National Diary Development Board, Ashok Leyland, Exide Industries, Tata Tea, Cadila Pharmaceuticals, Ansal Housing, Arvind Mills, etc., have committed substantial investments. The signing of ILBFTA gave further impetus for Indian companies to set up their ventures in Sri Lanka with a view to buy back for the duty free Indian market, particularly in southern India. Such investment flows contributed in no small measure in promoting entry of products made in Sri Lanka to the Indian market. Prominent among them were copper, vanaspathi, bakery shortening/ margarine and marble industries.

Table 2.8 Top Ten Countries Ranked by Cumulative FDI in Sri Lanka, 2000-2003

(US $ million)

2000		2001		2002		2003	
Country	**$ Mn.**	**Country**	**$ Mn.**	**Country**	**$ Mn.**	**Country**	**$ Mn.**
Singapore	273	UK	290	UK	329	UK	354
UK	260	Singapore	253	Singapore	237	Singapore	283
Japan	244	Japan	209	Japan	204	Japan	205
Korea	190	Korea	165	Hong Kong	137	Hong Kong	193
Hong Kong	150	Hong Kong	126	Korea	161	Australia	185
Sweden	99	Australia	107	Australia	140	Korea	155
Australia	96	Sweden	83	USA	113	USA	135
Br. Virgin Is.	55	USA	63	India	89	India	115
Netherlands	52	India	53	Sweden	48	Netherlands	68
Finland	52	Finland	45	Netherlands	43	Sweden	53

Source: Board of Investment (BOI) of Sri Lanka (reproduced from Thenuwara, 2005).

India is now amongst the top 5 foreign investors in Sri Lanka after being in 9th place in 2001 (see Tables 2.8, 2.9 and 2.10). 40 Indian manufacturing projects are currently operating in the country as a result of investment driven by the FTA (Table 2.11). Sri Lanka's access to the Indian market, together with its conduciveness to investment, has attracted more third-country investors also (Thenuwara 2005). However, Indian investment in Sri Lanka is still less than 1 per cent of India's total investment overseas (which stood at US $ 9.6 billion in 2005). In contrast to Indian investment in Sri Lanka, Sri Lankan investment in India is small. Food processing, furniture, textiles, freight and forwarding are among them. Some prominent Sri Lankan investments in India are Ceylon Biscuits, Damro and Brandix. It is reported that Brandix is investing US $ 650 million in setting up a textile/garment city in Vizag.

Table 2.9: Top Ten Countries Ranked by Foreign Investment*, 2004-2005 (Projects approved under Section 17 of the BOI Law)[8]

	2004			2005*		
Rank	Country**	No. of Projects	Investment (Rs. Million)	Country**	No. of Projects	Investment (Rs. million)
1	UK	108	21,673	Malaysia	21	24,418
2	Singapore	44	20,752	USA	67	23,688
3	USA	62	19,032	UK	126	22,879
4	India	101	14,846	Singapore	50	20,966
5	Malaysia	17	13,844	India	102	19,471
6	Hong Kong	56	12,928	Hong Kong	55	12,655
7	UAE	17	12,744	Korea	92	12,361
8	Korea	94	8,049	UAE	20	11,553
9	Switzerland	19	7,686	Switzerland	20	8,075
10	Japan	63	6,244	Japan	66	6,096

Source: Board of Investment (BOI) of Sri Lanka.

Note: 2004-2005 based on current investment country.
* Realized (cumulative) foreign investment as at year end.
** Investment where country specified is involved (100% owned foreign & joint venture projects).

Table 2.10: Foreign Direct Investment of BOI Enterprises during 2005 – by Country (Projects approved under Section 17 of the BOI Law)

No.	Country	No. of Projects	US $ million
1	Malaysia	8	99.556
2	Singapore	12	30.626
3	UK	33	26.338
4	India	19	17.855
5	Luxemburg	4	17.312
6	Hong Kong	12	15.468
7	U.S.A	16	12.662
8	Italy	5	10.563
9	Sweden	6	10.130
10	Belgium	2	8.382
11	Others (less than 8 million)	18	38.312
	Total	**199**	**287.204**

Source: Board of Investment (BOI) of Sri Lanka.

Table 2.11: Manufacturing Projects in Sri Lanka related to ILBFTA (2005)

Products	Country	No. in operation
Copper and copper-based products	India/UAE	10
Vanaspati (vegetable oil)	India/UAE Singapore/Malaysia/ Sri Lanka	09
Electric and electronic products	India/USA	07
Lead and lead-based products	India	02
Zinc oxide	India	01
Other chemicals and chemical-based products	India/USA/Sri Lanka	03
Marble products	India	03
Pine resins	India	02
Rubber-based sports goods	India	01
Ghee from milk cream	India	01
Diamond cutting tips	India	01
Total		**40**

Source: Board of Investment (BOI) of Sri Lanka.
Note: UAE – United Arab Emirates.

2.4 Services

The natural linkages between goods and services opened up a number of service sectors to bilateral trade in the aftermath of increased goods flows. Unilateral liberalization of FDI in various services have opened the door for various Indian services to invest in Sri Lanka such as the ones listed in Table 2.12. Retailing and distribution – although a "sensitive" area that neither India nor Sri Lanka liberalized under the GATS during the Uruguay Round of WTO talks – now makes up a significant component of services trade between the two countries, mainly through franchise arrangements. Such franchise led retail services are Titan, Usha, Godrej, Bajaj, etc. from India and Damro (pre-fabricated furniture), Noritake porcelain and Dankotuwa porcelain, etc., from Sri Lanka. Although FDI in retailing in not permitted in India, initiatives by the Export Development Board of Sri Lanka (EDB) with Reserve Bank of India (RBI) made way for Sri Lankan firms to engage in exhibition-cum-retail sale for a brief period during 2004-2005.

In early 2002, the tourism sector was given a boost when Sri Lanka took the unilateral measure of granting visas upon arrival to Indian tourists. Since then, the largest number of tourist arrivals to the country has been from India (sometimes coming a close second to UK or Germany). In a reciprocal gesture, India granted 4 additional destinations to Sri Lankan Airlines. Now with a total of 10 destinations, tourist flows from Sri Lanka to India have also risen significantly.[9] With 94 weekly flights to India, Sri Lankan Airline is today the largest foreign airline operating into India and 42 per cent of the Airline's revenue comes from Indian operations.

Table 2.12: Indian Service Suppliers in Sri Lanka

Sector	Service suppliers
Health	Apollo Hospital
	Escorts Heart Centre at Durdans Hospital
Hotels and restaurants	Taj Hotels
	Barista (fast food/coffee outlets)
	Amaravathi (restaurant)
Air travel	Jet Airways
	Air Sahara
Retailing/distribution	Indian Oil Company
	Titan (watches)
	Usha (electrical appliances)
	Godrej (consumer durables)
	Bajaj (three wheelers/scooters)

3. Negative Outcomes: Perceptions in India and Sri Lanka

3.1 Lopsided Trade

The perception that trade growth under the FTA has been far from uniform amongst industries is shared both in Sri Lanka and in India. Nearly 50 per cent exports from Sri Lanka to India is restricted to copper and vanaspati (a hydrogenated vegetable oil similar to ghee). 2005 showed a greater asymmetry in the distribution of exports compared to 1999 (see Tables 3.1 and 3.2). This is reflected in the uneven distribution of preferential exports under the FTA (Table 3.3). Of the 1,351 items that were initially granted 100 per cent duty concessions by India, only 68 have been of export interest to Sri Lanka.[10] If copper, vanaspati, bakery shortenings and marble were removed from the export items, Sri Lanka's trade deficit with India may ratio-wise have shown an increase rather than a decrease.

Table 3.1: Sri Lanka's Main Exports to India in 1999

Products	Value Rs. million	Percentage
Pepper	695	20.30
Areca nut	382	11.15
Waste and scrap of alloy steel	272	7.94
Dried fruit	214	6.25
Cloves	199	5.81
Waste paper & paper board	191	5.57
Glycerol	181	5.28
Apparel & clothing accessories – plastic	149	4.35
Black tea in bulk	146	4.26
Nutmeg	81	2.36

Source: Department of Commerce, Sri Lanka.

One reason for lopsided trade in Sri Lankan perception is that many export items are subjected to para-tariffs such as port charges, and non-tariff barriers (NTBs) such as discriminatory sales taxes, which more or less erode the preferential margins granted by the FTA.[11] For instance, Sri Lankan exporters complain of difficulties rising from entry tax and sales taxes in the southern state of Tamil Nadu; whereas local manufacturers pay only 10.5 per cent in sales tax, Sri Lankan products are charged at the

Table 3.2: Sri Lanka's Main Exports to India in 2005

Product	Value Rs. million	Percentage
Copper and Copper products	15,590	27.74
Vegetable fats and oil – Vanaspati	12,321	21.92
Aluminium Products	4,534	8.07
Electrical Machinery and Parts	2,304	4.10
Antibiotics	2,279	4.06
Cloves	1,659	2.95
Iron & Steel Products	1,511	2.69
Pepper	1,088	1.94
Pulp	1,077	1.92
Fibre board of wood etc.	1,034	1.84

Source: Department of Commerce, Sri Lanka.

higher rate of 21 per cent. The Indian government maintains that goods from other parts of India are too subjected to Tamil Nadu's higher tax rate, a corollary of India's federal structure that grants autonomous powers to state governments.

Table 3.3: Top Ten Export Items under Preferential Tariffs (2003)

Product	Value Rs. million	Percentage
Copper-related products	11,820	51.71
Waste paper	968	4.23
Black pepper	818	3.58
Dual Inline memory Modules	808	3.53
Cloves	387	1.70
Iron scrap	332	1.45
Tyres	290	1.27
Furniture	141	0.62
Rice bran	131	0.57
Marbles	122	0.53

Source: Department of Commerce, Sri Lanka.

However, not all market access barriers are erected by India. Sri Lankan exporters have been held back by their own lack of aggression in pursuing the many opportunities offered to them by the agreement. The Sri Lankan mindset is somewhat constrained by the traditional export bias towards

developed nations in the West, resulting in the unfortunate failure to perceive the immense market potential in India's growing middle class of 350 million – larger than the entire population of the United States.

3.2 Rules of Origin

A major Indian perception is that non-compliance with rules of origin (ROO) by exporters from Sri Lanka has somewhat undermined the spirit of free trade. Customs officials are not always able to detect the national origin of a product; this is especially true of spices, such as cloves and pepper. Goods from third countries have illegally entered duty-free into India via Sri Lanka, prompting demands from Indian entrepreneurs to clamp down on free trade and revert to protectionist policies. Pepper growers in India, for instance, allege that the surge in pepper imports from Sri Lanka has led to falling prices, to the detriment of domestic producers.[12] Growers have demanded quotas on imports in addition to restricting entry to a single port, preferably Kochi, to facilitate the enforcement of ROO.

Sri Lanka, on the other hand, maintains that the existing rules of origin are too stringent and obstruct free trade, especially when coupled with para-tariffs and non-tariff barriers (NTBs). Under the 35 per cent rule, 74 per cent of non-garment exports and 46 per cent of garment exports qualified for the Indian market (Department of Commerce as cited in Kelegama, 1999). Ready-made garments (RMGs), although granted duty concessions, are subjected to the condition that Sri Lanka restricts exports to 8 million pieces with at least 6 million manufactured from Indian fabric inputs. The remaining 2 million, although favoured under relaxed ROO, are nevertheless subjected to various NTBs. Consequently, Sri Lankan garments are more expensive than those produced in India and exporters have failed to gain a foothold in the Indian market; at present, less than 1 per cent of the quota is being utilized. Similarly, a quota of 15 million kilograms is imposed with strict ROO on tea exports with entry ports limited to Kochin and Kolkata. Section 3.3 elaborates the ROO issue in regard to tea. Less than 1 per cent of total Sri Lankan tea exports make their way to India, amounting to a meagre 2.7 per cent of the quota.

Table 3.4: Sri Lankan Exports of Garments to India, 2003-2005

Year	HS 61 Quantity	HS 61 Value Rs. million	HS 62 Quantity	HS 62 Value Rs. million	Total Value Rs. million	% Share of Total Garment Exports
2003	2,953 kg 39,067 pieces	11.16	2,819 kg 42,441 pieces	33.06	44.22	0.02
2004	1,851 kg 66,742 pieces	16.75	1,222 kg 26,386 pieces	30.32	47.07	0.02
2005	37,970 kg 16,533 pieces	22.95	544 kg 47,183 pieces	28.37	51.32	0.02

Source: Sri Lanka Customs.
Note: HS 61– apparel, knitted or crocheted; HS 62 – apparel, not knitted or crocheted. Annual apparel quota for Sri Lanka – 8 million pieces.

Table 3.5: Sri Lankan Exports of Tea to India, 2005

Product	Quantity (metric tonnes)	Value (Rs. Million)
Green Tea	7.26	2.10
Black tea (packs not exceeding 3 kg)	101.18	43.65
Black Tea – bulk	290.46	64.39
Instant tea	4.70	0.25
Total	**403.60**	**110.39**

Source: Sri Lanka Customs.
Note: Quota allocation for Sri Lanka – 15 million kg of tea per annum Quota utilization – only 2.69% (based on total exports).

3.3 Problems and Issues on Trade Flows and the Investment Regime

The surge in certain import items from Sri Lanka has caused considerable distress amongst Indian domestic manufacturers unable to compete with cheaper foreign goods. A number of issues have been raised at recent meetings between the two parties and have been the subject of intense dispute. Tariff rate quotas (TRQs), initially applied only to tea and garment exports, have found their way back to the negotiating table with India requesting export

caps on several products. We highlight below some TRQ issues and other issues that have disturbed the smooth progress of the ILBFTA.

a) Vanaspati

The FTA gave licence to substantial trade deflection in the vanaspati oil industry, to the benefit of Sri Lanka and detriment of India. Vanaspati oil is refined from palm oil inputs which are imported from East Asia under duty free conditions to Sri Lanka (by industries coming under the BOI) but under a hefty 80 per cent duty rate to India. Consequently, several Indian manufacturers relocated their refineries to Sri Lanka and profited from exporting the finished product to India under the duty free privileges of the FTA. This led to a surge in exports of vanaspati from Sri Lanka to India (adding to India's woes are duty-free imports from Bangladesh, Bhutan and Nepal as well). As a result, vanaspati and bakery shortening/margarine (a close substitute to vanaspati, but with its own customs code: 1516) imports to India rose from 10,000 metric tonnes in 2004 to 170,000 metric tonnes in 2005 from 14 factories operating in Sri Lanka and earning Rs. (SL) 13.6 billion in 2005.[13] Indian manufacturers claim that 120 of the 260 vanaspati manufacturing units in the country have shut down.[14]

Sri Lanka acquiesced with India's request to restrict vanaspati manufacturing to 10 factories and cap exports at 250,000 metric tonnes annually. However, in early 2006 India re-fuelled the dispute by demanding that shipments of both vanaspati *and* bakery shortenings/margarine be restricted even further to 100,000 metric tonnes per year, a move which was resisted by Sri Lanka. Manufacturers in Sri Lanka claim that, with an average output of 3,500-4,500 metric tonnes per month, even the quota of 250,000 per annum can easily be fulfilled within six months.[15] In early 2006, Sri Lanka did attempt to alleviate India's concerns by imposing a special import levy of US $25 per metric tonne of crude palm oil, which is also an input for bakery shortenings. Nevertheless, India has found these measures to be inadequate; in early June 2006, citing mounting social unrest among domestic industrialists; India imposed a quota of 250,000 metric tonnes per annum and canalized vanaspati imports by permitting only the state-run National Agricultural Marketing Federation (NAFED) to import vanaspati from Sri Lanka. In Sri Lanka's view, such rigorous safeguard measures are potentially damaging to the credibility of the BOI and the prospect of attracting future foreign investment to the country.[16] Moreover, it is of the view that such measures are contrary to the spirit of an FTA. A request was made to remove these restrictions. Manufacturers in Sri Lankan claimed that 4,000 jobs in the industry were at stake.[17] Both sides attempted to work towards a mutually advantageous solution during June-December 2006.[18] During this period hardly any vanaspati /bakery shortenings were exported to India.

One main grouse of the Indian vanaspati manufacturers is that the ROO criteria in ILBFTA is that this specifies value addition criterion only and not minimum local raw material content. As such it is very easy to qualify for preferential entry to the Indian market since labour content can easily be inflated. In addition, the local manufacturers under-invoice their exports to easily qualify for the ROO criteria. The Indian vanaspati manufacturers further state that under ILBFTA there should be provision for accounting professionals to visit manufacturing sites to ascertain the conformity to the ROO criteria.[19]

In January 2007 the matter was solved with the NAFED removed and India adhering to a quota of 250,000 metric tonnes per annum. Vanaspati/ bakery shortening exports to India resumed in early 2007.

b) Pepper

The other major source of conflict is the pepper industry. Sri Lanka ships approximately 6000 metric tonnes of black pepper, nearly half of which is exported under advanced licensing scheme. However, pepper growers in India fear that pepper from other origins have contributed to the recent surge in pepper imports from Sri Lanka. They are concerned that without any mechanism to oversee imports and harvesting in Sri Lanka, the Indian market would be flooded with imported pepper, bringing down prices even further.[20] India is demanding a maximum export volume of 2,000 metric tonnes per annum, while Sri Lanka is requesting at least 3,000 metric tonnes (which Sri Lanka says amounts to only 4 per cent of India's pepper production). Moreover, India wanted to restrict shipments of the mature berry pepper from the ports of Tuticorin and Cochin and restrict exports during the months of January to March.

c) Garments

Owing to the serious under-utilization of the quota of 8 million pieces, Sri Lanka has requested: (a) that India provides market access for at least 2 million pieces regardless of the fabric's national source (i.e., in addition to the 2 million already granted under the FTA); and (b) that India increases tariff concessions on textiles from 25 per cent to 50 per cent. At present, Sri Lanka's Department of Commerce is in consultation with the Joint Apparel Associations Forum (JAAF) to identify a limited number of product lines with potential for export to India.

d) Tea

The two main Ports of entry — Kolkata and Kochin have not been supportive of tea exports entering the Indian market. This is because these two ports are located in tea growing areas and the anti-tea import lobbies are strong and thus resist any foreign tea coming into the domestic market. Second, the rules of origin (35 per cent minimum local value addition for blended tea and 25 per cent minimum local value addition for blended tea with Indian tea) stipulates that customs HS heading (0902) corresponding to tea should shift at four digit HS heading level which is practically impossible (it is possible only at six and eight digit HS codes). As a result, even Ceylon tea blended with Indian teas cannot enter the Indian market. It has virtually ruled out any blended tea from Sri Lanka entering the Indian market under the ILBFTA. Moreover, cumbersome procedures as applied by the Indian customs for registration has put off many tea exporters from Sri Lanka. The under-utilization of Sri Lanka's tea export quota as a result of these non-tariff barriers has prompted the Tea Boards of both countries to engage in several discussions in search of a solution.

e) Cement

Bulk and bagged cement from India is imported at 35 per cent and 47 per cent margins of preference (MoP), respectively, over and above the 15 per cent MFN (most favoured nation) concession. Currently, Indian cement constitutes 40 per cent of Sri Lanka's total cement imports. In the tariff phase-out process, Sri Lanka is obliged to increase the MoP to 100 per cent by March 2008. However, local manufacturers are requesting a 10 per cent duty on imports in addition to extending the existing 10 per cent surcharge on bagged cement to bulk cement as well. There is concern that imposing such restrictions could hamper reconstruction in tsunami-affected areas. Further study is required on the potential socio-economic impacts of capping cement imports.

f) Desiccated coconut

India has requested a quota of 500 metric tonnes for desiccated coconut (DC) under the previous Bangkok Agreement (BA) duty rate of 30 per cent. Sri Lanka, however, has asked for at least 6,000 metric tonnes under the same rate. Current exports of DC stand at less than 1,000 metric tonnes per year.

g) Copper

The ISLBFTA paved the way for a large number of copper industries to mushroom in Sri Lanka to cater to the growing Indian demand. At least, 30 projects in copper were operating during 2002/2003 period in the country mostly controlled by Indian entrepreneurs. The industry is multifaceted where scrap copper is imported from Indonesia, Russia, and other suppliers, and then melted to produce ingots, rods, etc. The technology used for the melting operations has created environmental problems. However, if pure copper were used with the latest technology such environmental problems would not have arisen. Although the value addition of the raw copper conversion for exports has been low, the BOI has made it clear that the industry should venture into high value added products.

Concerned about the high exports of copper ingots under the FTA, India has accused Sri Lankan exporters of deliberately under-valuing the goods in order to show the required domestic value addition (DVA) of 35 per cent as stipulated in the FTA. In response, Sri Lanka imposed a floor price scheme based on European market prices and revised on a monthly basis. Dissatisfied, India maintained its initial assertion. Taking into account the copper industry's negative environmental impact and marginal contribution to the economy, the government of Sri Lanka took a decision in 2004 to stop approving scrap iron melting projects.

Business executives of Sterlite Industries are of the view that the producers of Sri Lanka are merely melting scraps and selling ingots to India at reduced price. Such refining processes do not qualify for the ROO

certification. The Indian company has filed applications with the concerned government authorities for invoking safeguard measures under FTA but no action was taken. The ROO are weakly defined and misapplications are rampant.[21]

Another Indian copper industry - the Hindalco Industries Ltd. also pointed to the adverse price effects of imported copper from Sri Lanka. They are of the view that copper items under Chapters 74 and 85.44 should be put in the Negative List of India under ILBFTA. They feel that ROO is weakly defined and Change in Tariff Heading (CTH) should be also part of the ROO.[22]

h) Sri Lanka Trade Centre in Chennai

Although India does not permit foreign entities to own 100 per cent equity in retail sales, with the approval from the Reserve Bank of India (RBI), Sri Lanka's Export Development Board (EDB) established a trade centre in Chennai's Spencer Plaza in early 2004 where 17 Sri Lankan exporters exhibited and sold their products. However, in March 2005, the RBI announced that all commercial and trading activities in the centre would be prohibited. With only products samples allowed to be sold, several exhibitors have been forced to withdraw their stalls, reducing their number to 12. Considering that the EDB's presence in Chennai allowed a number of retailers to successfully enter the Indian market on a franchise basis, Sri Lanka is currently working towards a mutually beneficial compromise and in order to increase the number of exhibitors at the centre.

i) Investment-related issues

The delay in payment of the subsidy enshrined in the agreement between the Indian Oil Corporation – largest Indian investor in Sri Lanka – and the government of Sri Lanka did dampen investor confidence in India. Gujarat Ambuja cement that wanted to set up a plant of cement manufacturing abandoned its plans due to the government of Sri Lanka taking over the earmarked land for a highway project and not allocating an alternative piece of land. Now the company is involved in importing cement from India and then putting them to sacks for retail trading. Many such investor related problems have cropped up from time to time. From the Sri Lankan side complaints are similar, for example, Ceylon Biscuits has encountered a plethora of problems in India after taking over the third largest biscuits manufacturer in India (Bakemans) and obtaining market access to another product –Tic Tac (Wickremasinghe, 2006). Both sides seem to have taken note of these difficulties and steps have been taken to address them.

All in all, these were some of the stumbling blocs that have featured during the five rounds of negotiations in 2005 and two rounds of negotiation in 2006 between the trade negotiating teams of both countries.

4. Looking beyond the FTA

4.1 Comprehensive Economic Partnership Agreement (CEPA)

The problems and conflicts of bilateral free trade have not discouraged either party from pursuing bilateral economic integration at a far more inclusive level than the trade of goods. Deep and across-the-board economic ties with India's 350 million strong middle class population, fast-growing economy could prove to be an important engine of economic growth in Sri Lanka. In 2004, India accounted for 20 per cent of Asian economic growth and 10 per cent of world economic growth; it is expected to be amongst the top five industrialized nations and the services hub of the world by 2015 (Thenuwara, 2005). India's push for economic cooperation is incited by a desire to promote to the world its potential for economic prosperity and friendly political relationships.

The decision to work towards a Comprehensive Economic Partnership Agreement (CEPA) was taken in June 2002. A Joint Study Group (JSG) was appointed in April 2003 to investigate the possibility of achieving greater economic integration while renewing the synergy of the bilateral FTA. The report of the JSG was released in October 2003, containing a series of recommendations.[23] Both sides have committed to an agreement consistent with the rules of the WTO. While the numerous shortcomings of the existing FTA must be remedied, its evident achievements can be built upon with relative ease to formulate the new agreement. The required institutional support is already in place with the Federation of Indian Chambers of Commerce and Industry (FICCI) and the Ceylon Chamber

Commerce, which function as the focal points for economic cooperation, as well as the Indo-Lanka Joint Commission and the FTA's Working Group on Customs.

The first round of technical-level negotiations (TLNs) on the CEPA commenced in February 2005, somewhat delayed after changes in government in both countries.[24] Seven rounds of negotiations have been completed by 2006. The CEPA is to cover trade in goods and services, investment liberalization, and economic cooperation. The negotiations on goods focus primarily on reducing the ILBFTA's negative lists, relaxing ROO criteria, signing mutual recognition agreements (MRAs) on product standards and certification procedures, and concluding the Memorandum of Understanding (MOU) on consumer protection and legal metrology. Particular attention will be given to developing the supply side of the Sri Lankan economy. The CEPA will be notified under the GATT's Article XXIV,[25] which covers substantial trade instead of under the "Enabling Clause" which provides more flexibility to determine the trade coverage between developing countries.

In a nutshell, the main objectives of the CEPA are to:

1. Deepen existing preferential trade between the two countries
2. Reduce the negative lists of the ILBFTA
3. Relax ROO criteria
4. Liberalize the services sector beyond the coverage of the General Agreement on Trade in Services (GATS)
5. Liberalize investment
6. Facilitate economic cooperation as an impetus for liberalization of t he services and investment sectors, with the Indian Line of Credit to play a crucial role.[26]

4.2 Services Liberalization

Services comprise two-thirds of global output, one-third of global employment, 40 per cent of global FDI, and 20 per cent of global trade. It is the fastest-growing component of world trade and investment. Services liberalization is already underway at the multinational level under the WTO's General Agreement on Trade in Services (GATS). Both India and Sri Lanka reflect the importance of services to economic prosperity. Sri Lanka's services sector contributed to 55.8 per cent of GDP in 2005 with a growth rate of 6.4 per cent and accounting for 44.8 per cent of total employment (CBSL, 2005). The Indian services sector has maintained a growth rate of about 8 per cent since the mid-1990s, contributing towards 57.6 per cent of GDP in 2004-2005, although accounting for only one quarter of total employment.[27] In both countries, the services sector has markedly outdone both industry and agriculture as an engine of growth, and is the fastest-growing sector in the economy.

Despite the surge of bilateral services flows triggered by the ILBFTA, services are not extensively liberalized at present. One reason is that the greater extent of domestic value addition and employment is associated with services than with goods, thus prompting the desire to safeguard national interests. Another reason is that services flows are difficult to monitor due to their predominantly intangible nature. Hence, in order to maintain standards, streamline payments, and protect domestic workers, a complex tangle of regulations – such as accreditation processes, foreign exchange restrictions, licensing and registration requirements – prevail in each country. In fact, domestic regulations are more prominent in services trade than in goods trade.

Table 4.1: Role of Services Sector in GDP Growth in Sri Lanka

Year	Sector	Rate of Growth (%)	Contribution to Change in GDP (%)	Share of Real GDP (%)
2004	Services	7.6	75.8	55.6
	Industry	5.2	25.4	26.4
	Agriculture	-0.3	-1.2	17.9
2005	Services	6.4	59.3	55.8
	Industry	8.3	36.3	27.0
	Agriculture	1.5	4.4	17.2

Source: CBSL, 2005.

However, many unilateral liberalization measures have been undertaken by both parties in recent years (as mentioned in Section 2.3). Sri Lanka and India have made commitments to the WTO under the GATS as well.[28] The

rationale behind the CEPA is to exceed these WTO commitments. Furthermore, unlike in the ILBFTA, a "positive-list approach" will be used for the CEPA as in the GATS (Article V) given the level of sensitivity that surrounds services liberalization (for details, see Chapter 9, IPS, 2006). It is argued that this approach provides more flexibility to member countries – especially developing economies – with gradual, progressive liberalization in keeping with national developmental strategies.

Table 4.2: Role of Services Sector in GDP Growth in India

Year	Sector	Rate of Growth (%)	Contribution to Change in GDP (%)	Share of Real GDP (%)
2003-04	Services	8.9	58.9	56.7
	Industry	6.5	16.9	21.6
	Agriculture	9.6	24.3	21.7
2004-05	Services	8.6	70.5	57.6
	Industry	8.3	25.9	21.9
	Agriculture	1.1	3.6	20.5

Source: RBI, 2005.

India and Sri Lanka have already submitted their request lists to each other and are in the process of exchanging schedules which outline market access, national treatment, and other regulatory matters. Sri Lanka's request list for India consists of liberalization in tourism, retail trade, finance, insurance, and maritime services. India's request list is much longer; it contains liberalization in audio visual services, information and communication technology (ICT), transport, tourism, professional services (accounting, architecture, medicine, dentistry, nursing, midwifery, engineering, etc.), maritime services, energy, education, and construction. The possible gains from liberalization of some of these sectors and impediments to further liberalization have been highlighted by Taneja *et al.* (2004).

In regard to financial services, Sri Lanka's liberalization under CEPA will be mostly in relation to Mode 3, with deeper concessions granted through national treatment. Any measure under Mode 1 will pose significant difficulties and will be considered only along with national policies on capital account liberalization. Both Mode 2 and 4 are also largely restricted (Thenuwara, 2005).

Sri Lanka has specifically requested liberalization in the aviation sector. Aviation is one of several sectors *not* covered by the GATS because it lies outside the usual mandate of a trade minister (ITC/CS, 2002). Given the GATS-plus nature of the CEPA, and given the fact that aviation is covered in the India-Singapore Comprehensive Economic Cooperation Agreement (CECA), Sri Lanka has taken the position that aviation should be covered under CEPA. Sri Lanka is of the view that for any significant economic partnership and integration, a vibrant air sector is essential as a support mechanism. More importantly, the aviation sector is one of the few sectors that Sri Lanka can effectively compete with India. India, however, has maintained the position that that air services are dealt bilaterally between the respective civil aviation authorities and should remain outside the CEPA. This issue is far from settled but the aviation authorities of both countries are due to discuss the possibility of more commercial air travel with twice-daily flights to major destinations, 5th freedom for airlines to travel beyond the SAARC region, and increased code-sharing.

4.3 Unresolved Issues in Services Negotiations

At present, negotiations are underway with regard to denial of benefits (rules of origin in services), professional services liberalization, the employment of spouses and dependents, etc. Some of the key issues are highlighted below.

a) Denial of Benefits/Rules of Origin

Unlike with goods trade, whereby the nationalities of inputs are pre-determined by the geographic location of production, the nationality of a service-providing firm depends on the nationality/nationalities of its ownership (i.e., investment capital or shareholders). The firm's labour (human capital) could also be multinational. The ownership/nationality of a service provider – which determines ROO criteria in services trade – frequently changes with share transfers, mergers, acquisitions, and labour turnover. Hence, in negotiating the CEPA, the two parties have to decide on a sufficient percentage of inputs from the source country while also

ensuring that the concessions granted to each other are not undermined by overly stringent ROO. Determining ROO criteria could thus prove to be a very complex and lengthy process. In Sri Lanka's case, a number of important service-providers with large-scale business operations – for example in the telecommunications sector – are controlled by foreign-owned companies.

b) Professional Services

Several professional services sectors in Sri Lanka have serious shortages. For instance, certain highly-focused areas of medicine (neurosurgery, glaucoma) and law (intellectual property rights, information technology law) have very few specialists, rendering their services inaccessible to a majority of the population. With the current lack of skills in Sri Lanka, India has much potential to fulfil these deficiencies under a liberalized environment. However, the movement of professionals in a certain sector can only be facilitated via Mutual Recognition Agreements (MRAs) signed by corresponding professional bodies in both countries. Liberalization of professional services would be imprudent without adequate legislation to cover standards, professional qualifications, and registration of practising professionals. Unfortunately, very few service sectors in Sri Lanka are formally organized under an overseeing authority sanctioned by the government, and these tend to be restricted to the traditionally "prestigious" professions such as medicine, law, engineering, accountancy, etc. The legal framework for professional services is seriously lacking (unlike in India), and some of the existing Acts of Parliament governing professional bodies are in need of amendment before signing of any MRA.

Given the time-consuming nature of the legislative process, Sri Lanka is taking a cautious stance towards professional services liberalization under the CEPA. Sri Lanka is adamant that liberalization under Mode 4 or "movement of natural persons" (in GATS terminology) only take place with Mode 3 ("commercial presence").[29] Up to now, the presence of Indian professionals in Sri Lanka has been tied to investment; for example, doctors at Apollo Hospital, executives at the Indian Oil Company, and senior staff at Taj Group hotels. The BOI determines at its own discretion the number of foreign professionals allowed to work in Sri Lanka. India, however, demands that Mode 4 be de-linked from Mode 3, which Sri Lanka will consider if it is done explicitly under government-to-government economic cooperation in specific sectors only. At present, Sri Lanka is willing to open up Mode 4 to fulfil the acute shortages of nurses in the war-affected North-East and for English teacher trainers to train Sri Lankan school teachers in English throughout the country.

Bringing Indian professionals on a sector-specific basis with government involvement in this manner will provide a signal to domestic professional bodies that services liberalization is well on its way, thus giving them the opportunity to re-organize themselves before large-scale liberalization takes place. Concerns of "opening the floodgates" to Indian professionals can be addressed within the WTO framework which provides for adequate safeguards (market access, national treatment, etc.) to control services flows. Professional bodies are already being persuaded to sign MRAs with their Indian counterparts, and this in turn has prompted a move towards re-assessing and restructuring the regulatory framework that governs professional services. Opening up competition from India could also prove to be a catalyst for enhanced technical skills training of Sri Lankan professionals.

4.4 Investment Liberalization

Investment relations between the two countries have been fast catching up with trade relations as an important channel of economic cooperation. Several unilateral liberalization measures have already taken place. Currently, in both countries, all sectors of the economy, barring a small negative list and few restricted areas, are entitled to foreign direct investment (FDI) under the automatic route.[30] A notable recent development in FDI flows has been the change from a one-way flow (India to Sri Lanka) to an increasingly two-way relationship. In addition, sectoral composition of direct investment has been diversifying.

Most bilateral investment flows take place from India to Sri Lanka; investments in the opposite direction are very small in comparison. Thus, investment liberalization under the CEPA could be greatly beneficial to Sri Lanka in terms of capital formation, technology transfer, and trade creation. Moreover, Sri Lanka should see the imbalance in the trade account due to its limited export supply capacity getting compensated by investment flows

into the capital account (RIS, 2004). Sri Lanka requires high FDI inflows to fill the projected gap of 4 per cent of GDP – about US $1 billion – between national savings and investment to achieve annual economic growth of 8-10 per cent in the long term (JSG, 2003). The ongoing CEPA negotiations cover a number of issues pertaining to MFN treatment, expropriation and dispute settlement, and have prompted reviews of existing investment treaties – the Bilateral Investment Promotion and Protection Agreement (BIPPA) of 1997 and the Agreement on Double Taxation and Prevention of Fiscal Evasion (DTAA) of 1982. Agreement was reached on the latter during the seventh round of negotiations in June 2006. With regard to national treatment (NT), Sri Lanka at present offers only post-establishment NT to foreign investment. However, as noted by the Joint Study Group, *pre-establishment* national treatment could provide a substantial boost to investment and could be considered for sectors where 100 per cent FDI is anyway permitted under the automatic route.

5. Lessons from Six Years of Success

In determining the future of Indo-Lanka economic ties, six important lessons can be drawn from the ILBFTA. First, both governments have displayed the political will to forge ahead towards economic integration which is reflected in the growing share of both partner countries' bilateral trade in world trade in all categories of concessions exchanged (with the exceptions of Sri Lankan tea and garments). Second, considerable size disparity between two countries does not hinder bilateral free trade when appropriate special and differential treatment is accorded to the smaller country. Third, FTAs can invigorate dormant complementarities, as Sri Lanka discovered when its comparative advantage in producing a number of consumer goods that found entry to the Indian market for the first time following the exchange of preferences. Fourth, a bilateral FTA activates *unilateral* liberalization measures that are unrelated but complementary to the agreement, creating deeper economic integration; this is clearly visible in the tourism and air travel sectors of India and Sri Lanka. Fifth, the ILBFTA's conciseness is a likely reason for its success; it is a 14-page document devoid of excessive rules and regulations. Finally, the economic benefits of free trade can and do override political problems; the ILBFTA has done much to clear the acrimonious political atmosphere that marked Indo-Lanka relations during the 1980s.

However in order to sustain this growing partnership, products having genuine comparative advantage should be encouraged, if not sustaining the trade momentum will be difficult due to the political economy of international trade. It can be observed from the 2006 trade data that Sri Lankan exports to India have declined by 12.11 per cent due to the clamp down on both vanaspathi/bakery shortening and copper exports to India, while India sustained the earlier growth momentum of trade by recording a 25.9 per cent increase in trade. This calls for addressing the lopsided nature of bilateral trade, largely the result of differing external trade policies of the two countries and misutilization of ROO provisions under the Agreement. India needs to ensure that the temporary decline of Sri Lankan exports is offset by more unilateral initiatives in favour of Sri Lanka so that the growth momentum is restored. In the services sector also a number of unresolved issues need to be addressed. It is by resolving these issues that the movement towards CEPA could be put on fast track to make it a reality in 2007. CEPA has the potential to break new ground in South Asia's forward movement towards economic prosperity.

Notes

1 South Asian Association for Regional Cooperation.

2 For background details, see, for instance, Kelegama (1999).

3 The SAARC Preferential Trading Arrangement (SAPTA) was signed in April 1993 and came into operation in December 1995.

4 Available on the Board of Investment of Sri Lanka website, http://www.boi.lk

5 See Jayawardena, L. *et al.* (1993) and Panchamukhi, V.R. *et al.* (1992).

6 India had committed to the WTO that it would remove non-tariff barriers by 2004.

7 Sri Lankan government loses Rs. (SL). 1.5 -1.8 billion yearly due to the tariff concessions under the ILBFTA. This is a substantial revenue loss in the context of the escalating budget deficits in Sri Lanka. The Sri Lankan government has resorted to imposing various import cesses to cover up for these losses (*Sunday Leader*, Business, 8 October 2006).

8 Under Section 17 of the BOI Law, the Board has the power to grant a wide range of incentives and concessions to foreign investors satisfying eligibility criteria in terms of exports and employment.

9 The 10 destinations are: New Delhi, Mumbai, Buddh Gaya, Chennai, Bangalore, Hyderabad, Trichy, Trivandrum, Cochin, and Goa.

10 During the first year of operation of the ILBFTA only 10 per cent of Sri Lanka's exports to India qualified for duty-free status, 68 per cent for 50 per cent duty concession, 8.5 per cent for 25 per cent duty concession while 13.6 per cent of Sri Lanka's exports to India were in the Indian negative list. In fact, out of the 2,799 items offered at 50 per cent duty preference only 218 items were of export interest to Sri Lanka (Weerakoon, 2001).

11 Also, specifying ports of entry for particular products acted as an impediment to specific exports.

12 "Govt. working to check Lankan pepper imports", *Hindu Business Line*, June 9, 2006, *http://www.thehindubusinessline.com/2006/06/09/stories/2006060903050800.htm*

13 *India May Invoke Safeguards in Lanka FTA*, Centad (Centre for Trade and Development), March 2006, http://www.centad.org/tradenews_46.asp

14 ibid.

15 "Chess Game", *Lanka Business Online*, April 24, 2006, *http://www.lankabusinessonline.com/fullstory.php?newsID=1808775410*

16 This led to a number of other issues such as the allocation of the quota among the 14 factories, etc.

17 "Oily Row", *Lanka Business Online*, April 4, 2006, *http://www.lankabusinessonline.com/fullstory.php?newsID=137372311*

18 Discussion were dragged because there was an attempt to link a deal for vanaspathi with more restrictions on pepper and desiccated coconuts from Sri Lanka.

19 Bhanja (2006).

20 "Govt Working to Check Lankan Pepper Imports", *Hindu Business Line*, June 9, 2006, *http://www.thehindubusinessline.com/2006/06/09/stories/2006060903050800.htm*

21 Op cit, n13.

22 Ibid.

23 The report can be downloaded from www.ips.lk

24 When the JSG report on CEPA was exchanged between the two Prime Ministers in October 2003, the intention of both leaders was to have CEPA operational by March 2004. However, due to change of governments in both countries during the first half of 2004, the new governments. needed more time to study the CEPA before committing to it. It took nearly one year to re-start the negotiations.

25 GATT – General Agreement on Tariffs and Trade.

26 The Indian Line of Credit is a credit facility granted by India to other developing countries to purchase goods and services from India, usually with a long re-payment period. Since January 2001, Sri Lanka has borrowed a total of US $281 million for the purchase of food, petroleum, buses, roofing sheets, and consulting services.

27 CIA World Factbook.

28 Sri Lanka's commitments cover tourism, telecommunications and financial services. India's commitments cover professional services, communications, construction, distribution, education, environment, financial services, health and social services, tourism and culture, sports, and transport.

29 This position is mainly influenced by the following factors: (a) as stated, many professional bodies not having an effective regulatory framework in place, and (b) fearful perception that, Indian workers will flood the market. This perception has been triggered by a number of Indian workers engaging in work at Copper and Vanaspathi factories using the 3 months visa at arrival policy of Sri Lanka (now the arrival visa is offered only for one month). The BOI has also been relaxed in monitoring such worker inflows. Once perceptions are rectified and regulatory frameworks are put in place Sri Lanka will consider the Indian request of de-linking Mode 4 from Mode 3.

30 FDI via the "automatic" (non-governmental) route requires prior approval of the Reserve Bank of India (RBI) in the case of India, and the Board of Investment (BOI) in the case of Sri Lanka; both institutions function autonomously.

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