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Utilization of Trade Agreements in Sri Lanka: Perceptions of Exporters vs. Statistical Measurements

by

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1. Background

Sri Lanka's economy which followed an inward-looking policy regime in the 1960s and the 1970's witnessed a marked shift towards the liberalization of the economy since 1977. This was followed by structural transformations, with the economy changing its course from being primarily an agricultural economy to one driven by the services and industrial sectors. Furthermore, with the liberalization of the economy, Sri Lanka became increasingly dependent on trade, with the trade to GDP ratio being 41 per cent as of 2008.

In the early stages of trade reform the country's strategy to improve outward orientation was through unilateral tariff reforms, and Sri Lanka was slow in pursuing reciprocal preferential trade initiatives¹. Nevertheless, from the mid-1990s preferential trade policy initiatives were pursued, especially to strengthen bilateral trade and investment linkages with the selected partners in the region. As a result, Sri Lanka is now party to two bilateral agreements, Indo-Lanka Free Trade Agreement (ISFTA) and the Pakistan-Sri Lanka Free Trade Agreement (PSFTA) and two regional agreements, Asia Pacific Trade Agreement (APTA) and South Asia Free Trade Agreement (SAFTA).²

These trade agreements have been driven by both political and economic imperatives. Many traders see the proliferation of FTAs as unavoidable. But some see such deals as harmful, raising costs and diverting trade rather than increasing it, primarily owing to the low level of tariff preferences and lack of information pertaining to many such agreements like SAPTA. Yet, in the absence of a multilateral deal through Doha, FTAs are a second-best tool of trade liberalization. The effective utilization of trade agreements becomes a pressing issue in such a background.

A common concern of trade agreement proliferation is the possibility of overlapping rules and preferences amongst different agreements – what Bhagwati referred to as the Spaghetti Bowl effect, and became known as a Noodle bowl in Asian context. For example, Sri Lanka can export to India through ILFTA, APTA or SAFTA and soon under Bay of Bengal Initiative for Multi - Sectoral Technical and Economic Cooperation (BIMSTEC) – each agreement with its own preferential tariffs, negative lists and technical requirements such as value additions. This causes the exporter to incur a search cost in identifying the most suitable agreement and/or often has to **alter source of supply of inputs in order to qualify for preferences**. This process is made all the more challenging given the complexity of many of these rules. Such changes in production methods are both economically inefficient and may raise trade - related business costs of industries. The Rules of Origin (RoO) are the most complicated components in regional and bilateral trade agreements. The RoO are included to stipulate prevention of trade deflection and to ensure that the product receiving preferences originated in the exporting country that is party to the agreement, and not simply a re-export of a third party free riding on the said agreement.

Whilst RoO might be problematic for traders, they are necessary for ensuring the viability of a bilateral or regional trading agreement due to the free rider problem. **Adopting the less restrictive RoO could result in significant trade deflection and redundancy of a trade agreement**, while adopting the most restrictive RoO may result in no increased trade under the agreement.³ So far there has not been any standard framework that could be used as a reference-point by policymakers in devising rules of origin criteria for a regional grouping.

¹ Ibid

² It also receives preferential access to the EU market through the GSP+ which is a non-reciprocal agreement.

³ Ratna, R. S., (2008), "Rules of Origin: Diverse Treatment And Future Development In The Asia And Pacific Region", Chapter 3 in "Towards Coherent Policy Frameworks: Understanding Trade and Investment Linkages", UN-ESCAP.

There has been very limited analytical or empirical research carried out on assessing the economic effects of RoO systems in Sri Lanka, despite the fact that such an assessment should form the very basis of the RoO system.

In this background, this study will explore several areas, (i) the extent and the degree to which the Sri Lankan exporters use the preferences negotiated in various trade agreements, (ii) the benefits and costs of using trade agreements (iii) impact of multiple RoO on industries, and (iv) measures that can be taken to increase utilization of trade agreements will be observed. The study will focus on market access issues of FTAs to assess the noodle bowl effect on goods related to Sri Lanka. Section 2 of the paper reviews the existing literature while Section 3 provides an overview of the preferences and RoO requirements under each agreement. Section 4 analyses the usage of trade agreements in Sri Lanka and Section 4.1 focuses on the methodology. Section 4.2 examines the utilization of trade agreements followed by Section 4.3 that presents the analyses of the perception survey results. Conclusion and the way forward is presented in the final section that stem from the findings of the study.

2. Literature Review

Theoretical research on effectiveness of RoO has made progress over the years with early studies dealing with RoO dating back to the 1950s.⁴ Sound empirical work on the other hand is rare as RoO has been difficult to measure and model explicitly⁵. This section of the paper however, reviews fairly recent literature on RoO and the noodle bowl effect.

Table 1: Summary of the Literature Review with Key Finding

Author/s Name	Year	Title of Paper	Methodology	Main Findings
Kala Krishna and Anne Krugner	1995	Implementing Free Trade Areas: Rules of Origin and Hidden Protection		<ul style="list-style-type: none"> When RoO is taken as Regional Value Content constraint (RVC) on a price and cost basis under perfect and imperfect competition, the results are different. The cost and price definitions are not always equivalent and the effects of RoO are not necessarily monotonic.
Miriam Manchin and Annette O. Pelkmans-Balaoing	2007	Rules of Origin and the Web of East Asian Free Trade Agreements		<ul style="list-style-type: none"> Proliferating preferential trade agreements in East Asia containing different RoO have important implications for economic integration in the region. Expansion of separate FTAs would result in high administrative costs and if there are considerable differences in RoO for each trade agreement, even the production costs would increase. The effects of the increased costs are mostly experienced by small producers than large producers and the costs would be so high that producers would be restricted to utilize just one single preferential channel.

⁴ Viner, J., (1950), "The Customs Union Issue", New York, Carnegie Endowment for International Peace

⁵ Tapp, S. (2007), "Understanding Rules of Origin: A Critical Review of the Literature", Working Paper, available at www.econ.queensu.ca/students/tapps/papers/tapp_ROO.pdf

Brian Rankin Staples and Jeremy Harris	2009	Origin and Beyond: Trade Facilitation Disaster or Trade Facilitation Opportunity	<ul style="list-style-type: none"> • Origin compliance can be costly and complex which can lead to disincentive for the development of sophisticated and efficient international trade but the traceability of goods and materials is essential not just for preferential origin but for environmental protection, consumer safety and security purposes. • The following three areas are recognized for improvement. <ol style="list-style-type: none"> 1. Reforms of Origin Value: allow coequal RoO and extend cumulation so that it would give firms the option to choose among two or more substantively equivalent criteria for showing origin. 2. Reform of Origin Administration: which would give firms much needed predictability and transparency in administrative aspects of origin compliance and documentation for both preferential and non-preferential trade and this would enable to assign any liability for duties even penalties if the administrative process identify non-compliance. 3. Embrace E-origin Traceability: develop and promote integrated information system.
Janaka Wijayasiri	2007	Utilization of Preferential Trade Agreements: Sri Lanka's Experience with the EU and US GSP Scheme	<ul style="list-style-type: none"> • In the EU GSP scheme, the coverage of products under the scheme has been high and the utilization and utility rates have been low, limiting the usefulness of the scheme. This is mainly due to the restrictive nature of the EU's current RoO. There is an obvious need to simplify its current RoO criteria and reduce the domestic value addition requirement to reflect the industrial capacity of the country for Sri Lanka to better utilize the scheme. • But the utilization rates are quite high under the US scheme, while the coverage and utility record low rates but the usefulness of the scheme is limited due to exclusion of sensitive products such as textiles and textile articles, which are the main exports from Sri Lanka to the US. Therefore one way to increase the real benefits of the US scheme is to improve the product coverage of the scheme.

Masahiro Kawai and Ganeshan Wignaraja	2009	The Asian “Noodle Bowl” : Is it Serious for Business?	Secondary data and a survey which was the first survey of firms in East Asia.	<ul style="list-style-type: none"> • Use of East Asian FTAs is higher than expected from previous studies. Around 22% of the East Asian firms surveyed use FTA preferences. • East Asian firms report more benefits than costs from major FTAs in effect including AFTA. • At the present level of concluded FTAs in the region, the evidence suggests that multiple RoOs impose a limited burden on firms in East Asia. • The four East Asian countries have institutional support systems of varying degrees of comprehensiveness and quality. • The above findings indicate the need for a comprehensive set of policies to mitigate the negative effects of Asian noodle bowl (caused by 37 FTAs) in the future.
Rajan Sudesh Ratna	2008	Rules of Origin: Diverse Treatments and Future Development in the Asia and Pacific Region		<ul style="list-style-type: none"> • RoO differ from agreement to agreement and country to country. Therefore it creates a complex web of RoO. Adopting less restrictive RoO would result in significant trade deflection and redundancy of a trade agreement while adopting the most restrictive RoO may result in no increased trade under the agreement. • Following elements can be considered for harmonization. <ol style="list-style-type: none"> 1.General definitions 2.List of wholly obtained or produced goods. 3.Insufficient or minimal operations or processes that do not confer origin 4.Neutral elements 5.Consignment criteria 6.Certificate of origin 7.Denial of preferential tariff

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