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# Utilization of Preferential Trade Arrangements: Sri Lanka's Experience with the EU and US GSP Schemes

By

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# *Executive Summary*

The GSP scheme was initiated by UNCTAD in 1968 with the objective of enabling developing country exports to enter developed country markets under preferential rates. Sri Lanka has been a beneficiary under the GSP scheme over the last three decades. However, meeting the scheme's objective of export expansion seems to have fallen short and Sri Lanka has not been able to export effectively under the EU and US GSP schemes, which are the most important non-reciprocal preference arrangements providing access to Sri Lanka's main export markets. The paper using three indicators (coverage, utilization and utility rates) assesses the usefulness of the EU and US GSP schemes for Sri Lanka and discusses Sri Lanka's performance under both schemes while suggesting possible measures that can be taken to improve the schemes.

In the case of the EU GSP scheme, a substantial proportion of exports are covered: as much as 98 per cent of exports from Sri Lanka to the EU are eligible for preferential treatment. Though the product coverage is high under the EU scheme, Sri Lanka records low utilization and utility rates of about 40 per cent, highlighting that the scheme has been of limited use. The study finds that some sectors such as textile and textile articles, which is the main export sector from Sri Lanka to the EU, are unable to fulfill the Rules of Origin (RoO) requirements, highlighting the need to simplify the existing RoO criteria in the EU to improve the usage of the scheme. The facility allowing for the use of inputs from South Asia to meet the RoO requirements i.e., the regional cumulation rule, has proved useful only for a limited number of sectors and the extension of the idea beyond South Asia under the proposed super-regional cumulation together with simplification of the RoO criteria could substantially improve Sri Lanka's utilization of the EU scheme.

While the coverage rate is low in the case of the US GSP scheme (about 8 per cent), Sri Lanka records high utilization rate of 89 per cent but a low utility rate of 7 per cent. The US scheme has been of limited use to Sri Lanka due the exclusion of textile and textile articles from preferential treatment. One way to increase the real benefits of the US scheme is to improve the product coverage of the scheme.

Interviews of exporters and other stakeholders reveal several reasons for the limited use of trade preferences under the EU and US GSP Schemes. These include low product coverage (in the case of the US scheme), strict rules of origin criteria (in the case of EU scheme), and weak supply capacity of the country. Lack of awareness of the schemes and understanding the conditions attached to the scheme on the part of exporters do not seem to have been a significant factor in explaining limited usage. Neither have exporters encountered any significant problems in obtaining certificates of origin.

# 1. Introduction

Over the years Sri Lanka has entered into a number of bilateral and regional trade agreements and has negotiated and exchanged tariff concessions to obtain better market access for its produce abroad whilst participating in multilateral negotiations. Sri Lanka is a party to the Asia Pacific Trade Agreement (1975),[1] Global System of Trade Preferences (1988), South Asia Preferential Trade Agreement (1995), Indo-Lanka Free Trade Agreement (2001), and Pakistan-Sri Lanka Free Trade Agreement (2005). Following the success of the Indo-Lanka Free Trade Agreement (ILFTA), Sri Lanka and India are in the process of converting the FTA into a comprehensive economic partnership agreement (CEPA) covering trade in services and investment, whilst South Asia Free Trade Agreement (SAFTA) in 2006 replaced SAPTA, which has been in place since 1995 and BIMSTEC[2] is slated to form a free trade area. Sri Lanka has also engaged in the recent past of negotiating an FTA with the US, Singapore and Egypt to name a few, each at different stages of consideration and negotiation. The India Ocean Rim Association for Regional Cooperation (IOR-ARC), which Sri Lanka is a participating member, is also studying the feasibility of a preferential trade agreement amongst the member countries. While the above agreements have been reciprocal in nature, Sri Lanka has also been a beneficiary of non-reciprocal trade arrangements such as the Generalized System of Preferences (GSP), which has been providing preferences to exports from developing countries for over three decades.[3]

Whilst the purpose of such agreements was to provide greater access abroad for Sri Lankan exports, most of them seem to have fallen short of their expectations. International experience from trade agreements show that granting preferential market access does not necessarily translate into full utilization of the agreements nor does it result in increased exports for all countries. Several reasons could be attributed to the low levels of the utilization of preferences in the agreements. These include low product coverage, low preference margins, weak supply capacities, strict rules of origin criteria, non-tariff barriers, non related trade conditions linked to labour standards, environment, and governance, etc. Rules of Origin have been largely demonstrated to be one of the main obstacles to a better utilization rate of the available trade preferences in most agreements. Other reasons are weak institutional capacity to effectively administer these agreements and lack of knowledge about preferences on the part of exporters. To take advantage of preferential agreements, recipients also need to understand the complicated tariff structures, and conditions attached. Moreover, trade preferences have eroded over time with unilateral, regional and multilateral trade liberalization.

The purpose of this study is twofold. First, the study would *empirically* assess Sri Lanka's experience in utilizing trade preferences. As mentioned above Sri Lanka is a beneficiary to a number of trade agreements but its use of these agreements has been less

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1 Prior to November 2005 the agreement was known as Bangkok Agreement.

2 Now called the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation.

3 While being 'non-reciprocal' in terms of granting of tariff preferences, these arrangements are tied up with non-trade related issues such as labour standards, environment, and governance and thus not strictly speaking non-reciprocal in nature.

than satisfactory – that is, preferences have remained largely underutilized by exporters. Whilst there have been a number of studies and work carried on these individual arrangements, no single study has *empirically* estimated the utilization rates of these agreements and explained for the variation of rates across sectors and between the agreements. A possible reason for this might have been the lack of readily available data for calculating the utilization rate.[4] The present study would be confined to examining the performance of two non-reciprocal trade agreements which Sri Lanka is currently a beneficiary – that is, the EU and US Generalized System of Preferences (GSP).

There are several GSP schemes in the world but those of the US and EU are the most important ones for developing countries including Sri Lanka. The EU GSP is the most widely used of all developed country GSP schemes. The volume of imports to the EU from developing countries under the GSP is greater than the combined volume of imports under the US, Canadian and Japanese GSP systems. The US GSP scheme is the world's second most widely used. Moreover, the EU and US are Sri Lanka's main export markets and better access to them under the GSP scheme is considered important. Sri Lanka has been a beneficiary of both the EU and US schemes since their inception in the late 1970s but they have not been properly examined, especially the US GSP scheme with respect to Sri Lanka due to lack of readily available data. The present study overcomes this problem by drawing on secondary data from the UNCTAD database, which keeps a record of utilization rates of beneficiary countries under various GSP schemes. The quantitative analysis is supplemented with qualitative analysis of the utilization rates across sectors and across schemes (EU and US) based on discussions with stakeholders (government officials of various departments/institutions, chambers/associations and top exporters) to obtain their points of view on the performance of Sri Lanka under both schemes.

Second, the study will suggest possible measures that can be taken to improve the schemes given that they are up for revision in the near future (in the case of the US as early as December 2006 and in the case of the EU towards the end of 2008). Thus, a closer examination of these two agreements and their effectiveness in providing market access to Sri Lankan exports is both pertinent and timely.

The remainder of the paper is organized as follows. First, the paper provides a literature survey of studies on non-reciprocal trade agreements and their respective results. Second, the paper discusses the US and the EU GSP schemes and highlights the main features of both schemes. Third, the paper assesses the performance of Sri Lanka under both schemes using a number of variables. Fourth, a brief comparison of the utilization rates of Sri Lanka under the EU and US GSP schemes is also presented. Fifth, the paper discusses some of the problems which have constrained the use of the schemes and in conclusion, suggests possible measures to address them.

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4 The Department of Commerce of Sri Lanka, which is the competent authority to conduct international trade relations, trade negotiations and act as trade policy advisory and implementation arm of the Ministry of Trade, Commerce & Consumer Affairs, has just begun to electronically document the utilization of preferential agreements by Sri Lanka by recording the number of certificates of origin issued. The database was unavailable at the time of writing of this paper.

## 2. Literature Survey

The purpose of this section is to review available evidence regarding utilization of preferences of non-reciprocal trade agreements. The evaluation of preference utilization across markets is difficult not only because there is a lack of widely available data on preference utilization by scheme but also due to important difference between various schemes in terms of rules of origin, country eligibility and depth of preferences given to eligible countries. In addition to data issues, there are two methods available to estimate preference utilization (see Box 1) and comparing results across studies should be treated with caution. Nevertheless, it is possible to highlight four characteristics regarding the utilization of non-reciprocal schemes from the available literature (WTO, 2004):

### a) Utilization of non-reciprocal preferences is less than 100 per cent

A number of studies suggest that the utilization rates of non-reciprocal agreements are consistently below 100 per cent and usually low. According UNCTAD (2003), the aggregates utilization of GSP schemes of the QUAD countries (Canada, EU, Japan and US) by LDCs varied from a low of 26 per cent in the EU in 1998 to a high of 96 per cent in the US in 2001. Low utilization rates appear to be a cross cutting problem affecting all schemes and this issue is particularly important for markets such as the EU and to a lesser extent Japan. Although both Canada and US record relatively higher utilization rates, the figures may be misleading as a large amount of LDC exports are excluded by these schemes – important export items such as textiles and clothing.

Utilization rates of other non-reciprocal preferences schemes such as Cotonou Agreement, and AGOA also confirm that utilization rates are less than 100 per cent (UNCTAD, 2003). However, one needs to bear in mind that measuring utilization rates of preferential schemes in isolation to one another may be misleading because exporting countries may have access to the same markets through a number of preferential schemes. This is especially true in the case of Sub-Saharan African countries, which have access to the EU either through the Everything But Arms (EBA) initiative or the Cotonou agreement, which predates the EBA. Candau and Jean (2005) find that when all EU preference schemes are examined together, rather than in isolation to one another, utilization rates are considerably better (but still low).

### b) Utilization of preferences varies by product within a scheme

Many reasons exist as to why utilization rates vary across products for a given scheme but the most studies identify rules of origin as one of the main reasons for the variation in the utilization rates under a scheme. For GSP schemes offered by the QAUD, UNCTAD (2003) estimates show that the utilization rate is above 90 per cent in certain products but as low as 56 per cent in others for some LDC beneficiaries across HS product sections (1-21).

### c) Utilization of preferences varies across beneficiaries within a scheme and across schemes

Breton and Ikezuki (2005) find for example, that Madagascar and Ivory Coast utilized 86 and 58 per cent, respectively of preferences extended under the US GSP scheme while exporters from Mali received preferential treatment for 66.8, 87.5 and 49.8 per cent of exports in the EU, US and Japanese markets respectively.

**d) Utilization of preferences varies within a market for given LDCs**

LDCs face different market access conditions in a given market under different preference schemes. Two such schemes are EU's Everything But Arms (EBA) initiative and the US's African Growth and Opportunity Act (AGOA). AGOA is a regionally based non-reciprocal preferential agreement and its beneficiaries are located in Sub-Saharan Africa while non-African LCDs are not eligible to benefit from improved market access offered by the US under the scheme – though they are eligible for LDC specific preferences under the US GSP scheme.

**Box 1**
**Measuring the Utilization of Preferences**

There are two methods for measuring the utilization rates, each with different data requirements. The most commonly used method in calculating the utilization rate, which is used in this study, is based on customs data while the other one is based on the total customs revenue collected.

The method for calculating the first indicator is straightforward and is given by the value of imports receiving preferential treatment divided by the total value of imports eligible for preferences. Despite the simplicity of the method, it is not easy to estimate it in practice. Official data on the duty paid on a specific import originating from a specific exporter is not readily available. Even if available, it is based on information of requests submitted by exporters for preferential duties. Whether or not a duty is applied depends on the evaluation by customs officials and as such information based on request data may be biased. This method also assumes that the exporter is aware about the preference scheme and applicable preferential duties, which may not be the case. It is quite possible that customs officials might apply the preferential duty on an import even though when it is not requested by the exporter. Despite the difficulties associated with this method, such request data is available for major preference granting countries. This study relies on