

## IV. TRADE POLICIES BY SECTOR

### (1) INTRODUCTION

1. Agriculture remains an important sector in Sri Lanka with a third of the population engaged in agricultural or related activities; it contributed some 20% to GDP in 2002. The sector is also a major source of raw materials and earner of foreign exchange. During the period under review, the provision of different subsidies (e.g. consumer, producer and export subsidies) and other forms of assistance have failed to improve the sector's growth and productivity, which have remained low. This poor performance may be attributed, *inter alia*, to low levels of investment, lack of quality inputs, heavy dependence on regular rainfall, traditional cultivation practices, lack of credit, inadequate infrastructure (notably transportation), weaknesses in the marketing system, state control of land, and inconsistent trade policies. Government intervention in agriculture, as in other sectors, remains substantial. Less protection on agricultural goods and other forms of assistance together with the adoption of a more predictable trade policy regime would lead to a better allocation of resources, thus raising productivity and increasing living standards. In addition, the establishment of a transparent land tenure system would make farmers more willing to invest and to adopt modern farming technologies.

2. Industrial policy throughout the years has aimed at diversifying the industrial base; regional industrialization has also been promoted. To this end, attempts have been made by the Government to create an environment conducive to investment, with incentives to encourage both domestic and foreign investment. Nevertheless, manufacturing, which contributed some 16% to GDP and accounted for 17% of employment in 2002, remains heavily concentrated in textiles and apparel, the leading net foreign exchange earner. However, Sri Lankan textile and apparel exports have lost competitiveness; the costs of production have risen as energy, telephone, and other utility prices increased, and labour productivity has declined. The apparel industry faces additional challenges, notably the expected end to the quota system in 2005, and increasing competition from low-cost manufacturers in other countries and from exports under preferential trading arrangements.

3. State intervention in the oil sector is declining. The Ceylon Petroleum Corporation (CPC), a state-owned enterprise, which until recently was the exclusive importing and marketing agency for petroleum and petroleum products, is being reformed. The liberalization of oil product prices also seems to be under way.

4. The electricity sector went through a severe crisis in 2001 and part of 2002, when there were prolonged power cuts, which had an adverse impact on the country's production and productivity. In addition, high electricity tariffs have potentially weakened Sri Lanka's external competitiveness. Investment in the electricity sector has been marginal in recent years; as a result, there have been delays in repairing existing plants and in establishing new power generation capacity. Sri Lanka is therefore likely to continue to face severe power shortages in the future. The Ceylon Electricity Board (CEB), a state-owned monopoly, and its subsidiary Lanka Electricity Company (Pvt.) Ltd. (LECO), are still in charge of the generation, transmission, and distribution of electricity in Sri Lanka. However, the Electricity Reforms Act passed in 2002 stipulates the re-structuring of the electricity sector; it calls for the separation of the generation, transmission, and distribution operation of the CEB, while paving the way for greater private sector participation.

5. The contribution of services to real GDP increased from 59.4% in 1996 to 62% in 2002. Tourism, one of Sri Lanka's largest foreign exchange earners, was severely affected by the domestic armed conflict; however, it rebounded following the peace initiative and offers considerable potential. Nonetheless, the inefficient delivery of key services, such as telecommunications, financial

services and transport, has burdened the economy as whole. The modernization of the services sector is essential to improving the economy's productivity and thus its international competitiveness. The Government has taken some steps to reduce direct state involvement in the sector and raise private, including foreign, participation. For instance, in financial services, foreign investment limits have been relaxed; full foreign ownership in insurance and banks is now allowed. Since the last Review, privatization has been concentrated in the telecommunications and insurance sectors. The state monopoly on basic telecommunications has ended. Moreover, the state-owned insurance company has been fully privatized. However, state involvement in banking and transport remains important. The banking system in Sri Lanka is weak, despite efforts to upgrade prudential supervision. Banks have a high level of non-performing loans, and the two dominant banks, which are state-owned, are particularly weak and in need of major restructuring. State intervention in transportation remains substantial. The provision of air services is still dominated by the majority state-owned national carrier, Sri Lankan Airlines (SLA). Another state-owned company has the monopoly on airport services. Some private-sector involvement was allowed in the provision of port services in 1998, but there have been few reforms since then.

## (2) AGRICULTURE

### (i) Overview

6. Agriculture's contribution to GDP decreased during the period under review, from 22.4% in 1996 to 20.1% in 2002; a trend that started in the late 1970s.<sup>1</sup> Nevertheless, agriculture still plays an important role in the Sri Lankan economy, as a high percentage of the population depends on this sector for its livelihood; it accounted directly for some 22.6% of export earnings in 2002, while directly employing 33.1% of the labour force. Agriculture is also an important source of raw materials for manufacturing. Growth in the sector has remained low despite the various assistance schemes provided by successive governments. Productivity has also remained low, resulting in a high average cost of production compared with some other developing countries.<sup>2</sup>

7. Agriculture's moderate performance can be attributed, *inter alia*, to low levels of investment, lack of quality inputs, heavy dependence on rainfall, traditional cultivation practices, lack of credit, lack of good infrastructure, weaknesses in the transportation and marketing system, and inconsistent policies. These problems are reflected in post-harvest losses, low labour productivity, producer unrest, migration, and price volatility. Government intervention to support the sector has been extensive; it includes measures such as protection through high tariffs and import licensing, price support, subsidies, concessionary credit, etc. These measures have proved unsuccessful. Inadequate irrigation systems increase the vulnerability of the sector to droughts. Small and fragmented lots do not yield economies of scale, thus discouraging mechanization and capital investment. This in turn raises costs of production and lowers international competitiveness. Further, the subsidy-stimulated use of fertilizer may have enhanced productivity but could have caused deterioration of aquifers and soil. A viable response to the falling productivity in the agriculture sector is an intense research and extension service aimed at enhancing productivity. However, it is often alleged that private-sector research is discouraged due to inadequate intellectual property rights in Sri Lanka.<sup>3</sup>

8. Agricultural policy in Sri Lanka has aimed, *inter alia*, at attaining food security (by increasing production while maintaining low consumer prices) and raising incomes in the rural area (through price supports)<sup>4</sup>; these objectives are not obviously compatible and efforts to balance them have

<sup>1</sup> Agriculture's share in GDP was 30.5% in 1978 and 26.3% in 1988.

<sup>2</sup> Central Bank of Sri Lanka (2001).

<sup>3</sup> Central Bank of Sri Lanka (2002a).

<sup>4</sup> WTO document G/AG/NG/W/159, 12 April 2001.

resulted in an inconsistent agricultural policy with constant ad hoc changes especially with regard to trade policy measures.

9. Government intervention in the agriculture markets is common, resulting in price distortions and thus in a misallocation of resources. Policy makers are often caught between the interests of the farmers and the consumers. The frequent and unpredictable market interventions have heightened market volatility, causing welfare losses to society as a whole. These ad hoc policy changes lead to uncertainty, so that potential investors may be deterred from entering the sector. Investment in agriculture could be stimulated by well-specified, consistent policies, and by reliable infrastructure.<sup>5</sup>

10. In 2002, the Ministry of Agriculture and Livestock prepared a draft policy paper, the 'National Agriculture Policy and Strategy' (NAPS). The NAPS identified several problems and challenges in the agriculture sector. It asserts that although food security is an important aspect, it cannot be pursued at the cost of increasing domestic food prices. The NAPS identified the need for market reform, for enhancing the role of private entrepreneurs in agriculture, for the closer integration of the agriculture sector with the food processing industry, and for the conservation and sustainable use of resources.<sup>6</sup> Despite these attempts, contradictions remain in Sri Lanka's agricultural policy regime. As a reasonable income for farmers remains important, "direct involvement in the commodity markets will be reduced gradually, and only by 2005 agricultural trade policy will become more stable and transparent for the main food commodities".<sup>7</sup> In addition, the authorities have stated that the elimination of non-tariff barriers and the reduction of tariffs in the agriculture sector have led to an increase in food imports, which have had an adverse effect on food production and consequently on food security.<sup>8</sup>

11. Due to the above factors, which have been compounded by political instability and in some years by severe drought, the sector's performance since 1996 has been mixed. The major agricultural products in Sri Lanka are rice (paddy), tea, and rubber. Sri Lanka's traditional export products include tea, rubber, and coconut; non-traditional exports include spices, shrimp, fresh fruit, and vegetables, floricultural products, and organic crops. The production of some non-traditional export crops has increased since 1996, with export earnings from non-traditional crops now exceeding combined earnings from rubber and coconuts (Table IV.1). Sri Lanka is the world's largest exporter of tea<sup>9</sup>, which accounted for more than 14.8% of Sri Lanka's export earnings in 2001.<sup>10</sup> Bulk tea amounts to some 60% of Sri Lanka's total tea exports.

**Table IV.1**  
**Agriculture, livestock, and fishing in Sri Lanka, 1995-02**

	1995	1996	1997	1998	1999	2000	2001	2002
Contribution to GDP <sup>a</sup> (Rs million)	..	156,108	175,774	192,665	205,599	223,926	249,790	281,911
Share in GDP (%) <sup>a</sup>	..	22.4	21.9	21.1	20.7	19.9	20.1	20.1
Employment (%)	36.7	37.4	37.1	40.6	36.2	36.0	32.4	33.1
<b>Major crops (volume)</b>								
Tea (million kg.)	246	258	277	280	284	306	295	310

Table IV.1 (cont'd)

<sup>5</sup> Central Bank of Sri Lanka (2002a).

<sup>6</sup> Central Bank of Sri Lanka (2002a).

<sup>7</sup> Statement by the Sri Lankan representative at IFAD's 25th Session of the Governing Council [Online]. Available at: <http://www.ifad.org/events/gc/25/speech/srilanka.htm> [16 June 2003].

<sup>8</sup> Weerasinghe (2003).

<sup>9</sup> In 2001, Sri Lanka retained its position as the world's largest tea exporter for the fifth successive year.

<sup>10</sup> UNSD, Comtrade database.

	1995	1996	1997	1998	1999	2000	2001	2002
Rubber (million kg.)	106	112	106	96	97	88	86	90.5
Coconut (million nuts)	2,755	2,561	2,631	2,552	2,828	3,096	2,796	2,392
Paddy ('000 tonnes)	2,810	2,061	2,239	2,692	2,857	2,860	2,694	2,859
<b>Agricultural exports (US\$ million)</b>	829	961	1060	1,088	947	1,005	932	938
Share of total exports (%)	21.78	23.47	22.85	22.68	20.54	18.20	19.35	19.96
Major exports (US\$ million)	695	829	916	918	783	850	796	771
- Tea	481	615	719	780	621	700	690	660
- Rubber	111	104	79	44	33	29	24	27
- Coconut	103	110	118	94	129	121	82	84
Minor export crops <sup>b</sup>	134	132	145	170	165	155	136	168
Fertilizer subsidy (Rs million)	1,345	1,500	1,895	2,152	1,390	1,733	3,650	2,448 <sup>c</sup>

.. Not available.

a Based on GDP at current factor cost prices.

b These include cocoa, cinnamon, cardamom, cloves, pepper, and coffee.

c Provisional.

*Source:* Central Bank (2002), *Sri Lanka Socio-Economic Data 2002*, Vol. XXV, June 2002; Central Bank of Sri Lanka (2002), *Economic and Social Statistics of Sri Lanka*, Colombo; and Epaarachchi, R. et al. (2002), *Policies and their Implication for the Domestic Agricultural Sector of Sri Lanka: 1995-2000*, Research Studies: Agricultural Policy Series No. 5, August 2002, Institute of Policy Studies, Colombo, Sri Lanka.

#### (b) Tea

12. Tea production increased during 1996-00 when it reached a record high of 306 million kg.; production decreased in 2001, as a result of drought, before recuperating in 2002 (Table IV.1) The upward trend in tea production has been attributed to the privatization of the management of the state plantations in 1992, which led to improved agricultural and management practices. However, despite productivity improvements, the yield levels in the privatized estates are lower than in the smallholder group.<sup>11</sup> As a result, the smallholders still dominate the tea industry, accounting for some 60% of total output in 2002.

13. Sri Lanka's value-added tea exports have increased recently, to some 40% of total tea exports in 2002. As there is potential to increase tea export earnings by moving to more value-added tea, the authorities are interested in further increasing exports of processed tea. In this context, expansion of the tea-blending industry could make a major contribution. The liberalization of tea imports and the modernization of the Colombo tea auction would encourage further development of the blending industry in Sri Lanka.<sup>12</sup>

<sup>11</sup> Smallholders have replanted old plantations with high yield tea plants. Hence, the average yield of smallholders industry (2,212 kg. per ha.) is higher than that in the large plantations (1,365 kg. per ha.) (Central Bank of Sri Lanka, 2001).

<sup>12</sup> Central Bank of Sri Lanka (2001). The Colombo tea auction is the world largest with the participation of almost 200 companies. Almost 95% of the country's tea production is marketed this way. Auctions are held weekly and conducted by the Colombo Tea Traders Association under the aegis of the Chamber of Commerce (see online information. Available at: <http://www.pureceylontea.com/auctions.htm> [7 July 2003]).

14. The Sri Lanka Tea Board (SLTB), established under the purview of the Ministry of Plantation Industries in 1976, is the main government body responsible for the promotion and development of the tea industry in Sri Lanka.<sup>13</sup>

15. Procedures for importing and exporting tea seem cumbersome. Imports of tea are not fully liberalized as they are subject to quality control (i.e. quality standard).<sup>14</sup> Certain types of tea (i.e. orthodox tea) may be imported under a permit, to be blended with domestic tea for re-export. According to the authorities, speciality tea (e.g. green tea, Assam, Oolong, Darjeeling) for which there is no domestic substitute can be imported without being subject to quality control. Imported tea may only be used after it has undergone inspection by the SLTB. Moreover, importers are allowed to blend the imported tea with locally produced tea only if the latter has been purchased through approved channels with export rights. Exporters importing tea for blending and re-export are required to use the Temporary Importation for Export Processing (TIEP) Scheme (Chapter III(3)(iv)(b)). The Export Section of the SLTB samples export consignments when necessary.<sup>15</sup> Samples are taken to ensure that the product is not unfit for export and therefore likely to damage the reputation of "Ceylon Tea" in foreign markets. If tea is deemed unfit (i.e. does not meet the quality standard or is contaminated) its exportation is prohibited.<sup>16</sup> Exporters and packers of tea need to register with the Tea Board. Prior to approving the registration, the Tea Board will ensure that the premises comply with sanitary conditions. Exporters are not allowed to sell 100% of their production directly, at least 75% of the product must be sold through the Colombo Tea Auction. Exports of tea are also subject to export cess of Rs 2,500 per tonne, and a medical cess (to fund tea workers health care) of Rs 3.5 per tonne. According to the authorities, cess revenue is used for R&D and to support small growers.

16. A Regulatory Review Task Force (RRTF), appointed in 2002 to review all the regulations applied in the tea sector, recommended, *inter alia*: the liberalization of the sale of tea; liberalization of importation of tea; and promotion and protection of Ceylon Tea. With the exception of the latter, it is not clear whether these recommendations have been implemented.

17. The SLTB has the statutory authority to regulate the price at which factories buy green leaf from small growers. Since 1960, the Tea Board has applied a "reasonable price formula" for green leaf. The objective of the scheme is to provide a reasonable price both for small-scale tea growers and tea factory owners who buy green leaf tea for processing.<sup>17</sup> Tea factories that do not purchase green leaf from small growers are not subject to this pricing mechanism. The price of green leaf is calculated using the reasonable price formula, which is based on the amount of green leaf that is required to make a kilogram of tea, and the actual price received by the factory at the Colombo Tea Auction. The formula also sets a fixed return for growers and manufacturers. The return received by growers and manufacturers is a percentage of the net sale average monthly price realized by the factory for a kilogram of processed tea. At present, these percentages are fixed at 32% return for the factory and 68% to the grower (Box IV.1).<sup>18</sup> This pricing mechanism discourages quality

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<sup>13</sup> For further online information on the Sri Lanka Tea Board (SLTB), see: <http://www.pureceylontea.com/> [7 July 2003].

<sup>14</sup> The same quality standard applies to exports of tea from Sri Lanka.

<sup>15</sup> Information provided by the authorities based on Sri Lanka Tea Board (Import and Exports) Regulations – 1981.

<sup>16</sup> Weeserasesekera and Kananathalingam (2002).

<sup>17</sup> Small growers are farmers who own less than 50 hectares. Most small grower own farms of less than 5 ha.

<sup>18</sup> According to the authorities, the ratio of 68:32 is decided taking into account the cost of production (COP) of a kilogram of made tea. The costs of the green leaf, of manufacturing, of packaging, and of transportation are taken into account to determine the COP, which is revised from time to time. The ratio of

improvements in both green leaf and tea manufacturing. Factories investing in improving tea quality to get a higher net sales average at the auction get only 32% of the benefit. Similarly, there is little incentive for smallholders to improve the quality of green leaf beyond what is required to have their leaf accepted. According to the authorities, to encourage the production of better quality leaf, a mark-up is given according to the altitude. This pricing mechanism seems complex and arbitrary. In 2002, the RRTF recommended, *inter alia*, an amendment of the formula so that it would take into account quality and variations in production costs of both factories and smallholders so as to provide an incentive for growers and manufacturers to become more efficient and improve quality.

#### **Box IV.1: Reasonable price formula for green leaf**

It is estimated that approximately 4.65 kg. of green leaf is required to manufacture one kg. of tea. The ratio of input to output is 0.215 (i.e. 1/4.65). At present 68% of the returns, go to the green leaf supplier and 32% to the manufacturer.

The following is an example of the application of the reasonable price formula for green tea leaf based on a factory price of Rs 50.00 per kg. of processed tea. This is an assumed price to explain how the pricing mechanism works, as actual prices vary from month to month depending on demand and supply at the Colombo Tea Auction.

- (a) Manufacturer's return  $\text{Rs } 50 \times (32/100) = \text{Rs } 16.00$
- (b) Green leaf supplier's return  $\text{Rs } 50 \times (68/100) = \text{Rs } 34.00$
- (c) Price payable for a kg. of green leaf tea  $\text{Rs } 34 \times 0.215 = \text{Rs } 7.31$

Sri Lanka produces tea at three elevations: low, mid and high. The "elevation factor" may also be included in the formula when the monthly net sale average price of a factory is above the monthly net sale average price for that elevation. The "incremental revenue" (e.g. difference between the two prices) is shared between the factory and grower on a 50:50 ratio. The sharing of incremental revenue is done after applying the formula on a 32:68 basis for the net sale average of the factory for the month.

Example of the application of the reasonable price formula for green tea leaf based on a factory price of Rs 50.00 per kg. of processed tea including the "elevation factor" or "incremental revenue":

Net sale average of average monthly price elevation = Rs 60.00

Net sale average of the factory = Rs 50.00

Difference = Rs 10.00

- (a) Manufacturer's return is:  $\text{Rs } 16.00 \text{ (a)} + 10.00/2 = \text{Rs } 21.00 \text{ per kg.}$
- (b) Green leaf supplier's return is:  $34.00 \text{ (b)} + 10.00/2 = \text{Rs } 39.00$
- (c) Price payable for a kg. of green leaf tea =  $\text{Rs } 39.00 \times 0.215\% = \text{Rs } 8.38 \text{ per kg.}$

Source: Government of Sri Lanka.

18. The Tea Small Holdings Development Authority (TSHDA) continues to play a vital role in supporting smallholders by providing extension services. The TSHDA also implements various subsidy schemes to encourage replanting, infilling, and new planting. The replanting and infilling subsidy rates were revised upwards in 2003 so that smallholders could cope with the increasing cost of cultivation.<sup>19</sup> Total payments to smallholders for 1996-02 amounted to Rs 603.2 million; assistance for replanting accounted for 75%, followed by new planting (18%), and infilling (7%). The

68:32 has been decided considering the cost incurred by growers and COP of made tea (cost incurred by manufacturers).

<sup>19</sup> Assistance to smallholders for new planting increased from Rs 36,000 to Rs 50,000. It is not clear to the Secretariat whether assistance is on a yearly basis or whether all smallholders are eligible to receive it. Assistance for replanting in mid-up country increased from Rs 110,000 to 160,000; and in low country from Rs 100,000 to Rs 150,000. It is not clear to the Secretariat whether outlays are on a yearly basis or whether all smallholders are eligible.

authorities consider that this assistance is essential to smallholders, who produce 61% of the tea in Sri Lanka and account for 72% of total tea exports. In 2000, a subsidy scheme for planting tea together with coconut was put in place. In 2002, only Rs 28,379 were disbursed under this programme.

19. Under the Indo-Sri Lanka Free Trade Agreement, exports of tea to India are subject to a tariff quota. India's tariff quota for tea was set at a maximum of 15 million kg./year at a preferential rate of 50%. The quota for 2000 was set at 11.25 million kg.<sup>20</sup> Exports of tea to India under this quota system have been low; the quota utilization was 4.1% in 2000; 3.1% in 2001, and 3% in 2002. The Sri Lanka Tea Board is in charge of allocating these quotas. There is no quota allocation system per se, quotas are allocated on a first-come first-served basis.

(c) Rice

20. As rice is the staple food in Sri Lankans' diet, policy in this regard has been aimed at self-sufficiency. However, Sri Lanka's level of rice self-sufficiency has been very costly to achieve, not only because of the high levels of protection granted to the sector but also because of the financially unsustainable large-scale irrigation developments that have been required.<sup>21</sup> In addition, the cost of production of paddy has increased significantly in recent years, adversely affecting the profitability of production and incomes to farmers.<sup>22</sup> R&D in rice has been a priority; nevertheless, yields tend to have stagnated.

21. The rice sector has been protected by tariff and non-tariff barriers that are often changed in order to "attain food security". For instance, in 2001, domestic prices of rice increased because of a decline in domestic production and in the quantity of imports because of licensing requirements. In order to lower the domestic price, the Cooperative Wholesale Establishment (CWE), Sri Lanka's former state trading agency, and the private sector were allowed to import rice duty free. In January 2002, the 35% import duty on rice was changed to a specific duty of Rs 7.00 per kg. However, before the harvest, to contain the increase in prices, the CWE was allowed to import 30,000 tonnes of rice at a reduced duty of Rs 4.00 per kg. In March 2002, the import licence imposed on rice in July 2000 was removed, and the specific duty was reduced to Rs 5.00 per kg. (effective as of November 2002). The licence was deemed unnecessary because of the tariff protection. The Central Bank notes that an efficient rice market will not develop in Sri Lanka if the authorities continue to take ad hoc measures, as these will only discourage producers and millers.<sup>23</sup> The authorities recognize that it is necessary to develop a consistent agricultural and trade policy, but also one that ensures the protection of the local rice producer.<sup>24</sup>

22. Rice production has also been adversely affected by the wheat/bread subsidy, as consumers substitute bread for rice.<sup>25</sup>

(ii) Import policy

23. The tariff is one of the Government's preferred agricultural policy instruments as it is easy to administer. Hence, the tariff is modified to attain different goals (for instance to reduce the domestic

<sup>20</sup> See online information. Available at: <http://commerce.nic.in/ilannexure2.htm> [7 July 2003].

<sup>21</sup> The World Bank (1996).

<sup>22</sup> Ranaweera (2002).

<sup>23</sup> Central Bank of Sri Lanka (2001).

<sup>24</sup> The Sri Lankan authorities.

<sup>25</sup> Imports of wheat and meslin flour are duty free (Customs Notification, Revenue Protection Order No. 07/2002, The Gazette of the Democratic Socialist Republic of Sri Lanka No. 1261/12, 6 November 2002), and Ranaweera (2002).

price of staple goods or to protect domestic farmers), or to contain the undesired outcome of other policies. Moreover, the authorities seem to have a high degree of discretion to modify tariffs. As a result, tariffs on basic agricultural goods are often changed. For instance, during 1996-02, the tariff levied on rice was modified at least ten times, the tariffs levied on potatoes was changed eight times, and on big onions and chillies, seven times.<sup>26</sup>

24. The average applied MFN tariff in the agriculture sector has been well above the overall average; in 1998 it was 27.6% (WTO agriculture) compared with an overall average of 11.8% (Table III.2). The average tariff protection to the sector has since decreased, to 21.3% in 2003 but remains well above the overall average of 9.8%. Tariffs in agriculture range from 0% to 250%; the highest protection is granted to the tobacco sub-sector, with an average tariff of 148.6% in 1998 and 152.9% in 2003. This is the only sub-sector in which tariffs have increased since 1998. Protection in all other sub-sectors has declined; the highest declines have been in grains, and fruit and vegetables. According to the authorities, agriculture remains protected because it is still in a developmental phase; tariffs may be reduced gradually once productivity increases have been achieved. However, it remains to be seen whether these high tariffs provide the necessary stimulus to improve productivity.

25. In 2003, specific rates are applied to 1.2% of all tariff lines; all are agricultural products (WTO definition) (Table AIV.1). In 2002, to protect the farming community, the *ad valorem* tariffs levied on certain food items were replaced by specific duties.<sup>27</sup> According to the authorities, "the conversion from *ad valorem* to specific duties would provide domestic farmers with adequate protection, minimizing price risk due to seasonal fluctuation of commodity prices".<sup>28</sup> However, even though their use may tend to stabilize producer prices, specific duties hinder predictability and are equivalent to an increase in *ad valorem* duties when prices fall. Moreover, by using specific duties Sri Lanka could breach its bindings; in the case of tobacco products, for example, it appears that Sri Lanka's applied tariffs are significantly higher than the bound rates, which according to its schedule, should have been implemented in 1995 (Table IV.2). Sri Lanka bound most agricultural products (WTO definition) at 50%. In all instances except for tobacco products (HS 24), the applied rates remain well below the bound rates.

**Table IV.2**  
Lines where the MFN rate is higher than the bound rate

HS Code	Description	Final bound duty rate <sup>a</sup>	MFN 2003 duty rate
24011001	Beedi tobacco	50%	75%
24011002 <sup>b</sup>	Flue cured, of the Virginia type	Rs 1,100 per kg.	75%
24011009	Other	50%	75%
24012000	Tobacco, partly or wholly stemmed/stripped	50%	75%
24013000	Tobacco refuse	50%	75%
24021000 <sup>c</sup>	Cigars, cheroots and cigarillos, containing tobacco	50%	Rs 1,370 per kg. net
24022002	Cigarettes, each not exceeding 60 mm in length	50%	100%
24022003	Cigarettes, each exceeding 60 mm but not exceeding 67 mm in length	50%	100%

Table IV.2 (cont'd)

<sup>26</sup> Epaarachchi et al. (2002).

<sup>27</sup> The import duty of 35% on paddy and rice was changed to a specific duty of Rs 7 per kg. with effect from 21 January 2002 and further reduced to Rs 5 per kg. with effect from 6 November 2002. A specific import duty of Rs 30 per kg. on chillies, Rs 6 per kg. on big onions, and Rs 5 per kg. on red onions was imposed with effect from 23 March 2002. The duty on green gram and cowpea was also changed to a specific duty of Rs 5 per kg. with effect from 6 November 2002.

<sup>28</sup> Central Bank of Sri Lanka (2002a).



HS Code	Description	Final bound duty rate <sup>a</sup>	MFN 2003 duty rate
24022004	Cigarettes, each exceeding 67 mm but not exceeding 72 mm in length	50%	100%
24022005	Cigarettes, each exceeding 72 mm but not exceeding 84 mm in length	50%	100%
24022009	Cigarettes, each exceeding 84 mm in length	50%	100%
24029000	Other	50%	250% or Rs 1,370 per kg. gross wt.
24031001	Pipe tobacco	50%	250% or Rs 1,370 per kg. gross wt.
24031002	Beedi tobacco	50%	75%
24031009	Other	50%	250% or Rs 1,370 per kg. gross wt.
24039101	Pipe tobacco	50%	250% or Rs 1,370 per kg. gross wt.
24039109	Other	50%	250% or Rs 1,370 per kg. gross wt.
24039901	Pipe tobacco	50%	250% or Rs 1,370 per kg. gross wt.
24039909	Other	50%	250% or Rs 1,370 per kg. gross wt.

a Final implementation date: 1995.

b Currently subject to renegotiation. It is not possible to establish whether the applied rate is above the final bound rate as the final bound rate is a specific rate.

c It is not possible to establish whether the applied rate is above the final bound rate as the MFN rate is a specific rate.

Source: Data provided by the Sri Lankan authorities.

26. Import of several agriculture products (85 tariff lines at the HS eight-digit level) are also subject to licensing (Table AIV.2). It seems that import licences are put in place and eliminated according to the Government's assessment of the imports required during a specific period of time to keep prices stable.

### (iii) Subsidies and other assistance

27. The agriculture sector benefits from a range of subsidies in Sri Lanka; these include subsidized inputs, consumer subsidies, support prices, and export subsidies. The major subsidy programme, which has guaranteed funding, is the fertilizer subsidy. Assistance through other programmes seems to be smaller and somewhat ad hoc due to a lack of funds. Since 1997, Sri Lanka has not made any notifications to the WTO regarding support measures. Sri Lanka notified the WTO that during 1995-97, it did not provide export subsidies to agricultural products, and in 1997 it notified a programme aimed at subsidizing the cost of international transport/freight for agricultural products.<sup>29</sup> According to the authorities, implementation of this programme has ceased due to lack of funds.

28. The Fertilizer Subsidy Scheme (FSS), has, since 1997, been confined to urea.<sup>30</sup> Until 2001, the subsidy payment on urea was calculated on its import price (i.e. the higher the import price the higher the subsidy); this resulted in urea being imported when the international price was at its highest with subsidy expenditures amounting to Rs 3,650 million, the highest level since the inception of the programme in 1997.<sup>31</sup> The 2002 Budget proposed a revision of the FSS with a view to providing a direct subsidy to small farmers under the Farm Input Support Scheme.<sup>32</sup> This scheme has

<sup>29</sup> WTO document G/AG/N/LKA/1, 20 May 1999.

<sup>30</sup> This subsidy scheme previously covered urea, potash muriate, ammonia sulphate and triple super phosphate (Central Bank of Sri Lanka, 2000).

<sup>31</sup> Central Bank of Sri Lanka (2001).

<sup>32</sup> Under this scheme coupons were to be issued for a specified amount per acre to small farmers who could use the coupons to purchase agri-chemicals, fertilizer, planting material or farm implements at subsidized rates based on the value of the coupon.

not yet been implemented; instead, a revised fertilizer subsidy scheme was implemented as of October 2002, under which the subsidy is fixed at Rs 6,000 per tonne of urea, irrespective of the international market price. The new scheme is expected to encourage imports when international prices are low.<sup>33</sup> As at end 2002, the total subsidy payments on urea amounted to Rs 2.4 billion (Table IV.1).

29. Irrigation water is free in Sri Lanka. This is an important subsidy, especially for rice producers. Since 1996, the Agricultural Development Authority (ADA) of the Ministry of Agriculture, Livestock and Samurdhi has introduced two new irrigation programmes: the agri wells programme to irrigate small farms (0.5–1 acre) and the Micro Irrigation Subsidy Programme to help farmers purchase pipelines for agri wells.

30. The consumption subsidy in the form of a reduction in the price of wheat flour seems to have been eliminated in 2001.<sup>34</sup> Wheat flour prices were administered by the Cooperative Wholesale Establishment (CWE) until 2001; in 2000, the CWE incurred a loss of Rs 6 per kg. of flour. However, for political reasons, the Government was reluctant to make any considerable increase in wheat flour prices. At that point, the CWE was the sole wheat importer. The Government paid a premium of around US\$10-12 for the imported wheat; as the sole miller for the Sri Lankan Government, Prima (Ceylon) Ltd, was only willing to process wheat of a specific quality. In June 2001, Prima (Ceylon) Ltd. was privatized and imports of wheat were liberalized. The contract to sell Prima (Ceylon), which seems to have the force of a law, stipulates a formula to fix the price of general purpose standard wheat flour for five years (i.e. June 2006). This formula is based on the f.o.b price at the Kansas City Board of Trade, and the costs of transportation and packing. However, the authorities noted that Sri Lanka imports cheaper kinds of wheat from India and Argentina, so that Prima (Ceylon) is by law allowed for at least five years to charge a high price and make a considerable profit. The contract also stipulates that "the tariff difference of wheat grain and wheat flour will be maintained at a rate of 25% for a period of seven years" commencing in 2001 (i.e. until June 2008). This high tariff protection would give Prima (Ceylon) a de facto monopoly in the milling of flour.<sup>35</sup> It seems that the authorities are not enforcing this part of the contract since tariffs on wheat flour are not at that level (as at March 2003).<sup>36</sup> Nevertheless, these two policies (i.e. the pricing mechanism for wheat flour and the high tariff protection) seem to be in contradiction with the Government's former policy of subsidizing wheat flour consumption; most probably, domestic prices of wheat flour and related products currently are higher than world market prices.

31. The Department of Export Agriculture (DEA) continues to assist exporters of spices through the implementation of subsidy schemes and the provision of necessary inputs, technical information, and extension services for the cultivation and processing of spices.<sup>37</sup> In order to promote poultry exports, the 2002 Budget introduced an export rebate scheme for exports of poultry meat. As of October 2002, a rebate of Rs 20 per kg. is granted for chicken exported to any country. The exporter receives Rs 17 per kg. while the exporter's designated farmer receives Rs 3 per kg. Rebates are available for exports of a maximum of 6 million kg.

<sup>33</sup> Central Bank of Sri Lanka (2002a).

<sup>34</sup> However, according to other sources the subsidy seemed to still be in place in 2002 (Ministry of Finance, 2002).

<sup>35</sup> An Agreement made on 26 April 2001 between the Government of the Democratic Socialist Republic of Sri Lanka and Prima Ceylon Limited (which means and includes the said Prima Ceylon Limited, its successors and permitted assigns) (Agreement provided by the Sri Lankan authorities).

<sup>36</sup> In March 2003 the tariff on durum wheat was zero per cent and that on wheat flour was 10%.

<sup>37</sup> The subsidies disbursed under the Export Agriculture Assistance Scheme (EAAS) declined from Rs 72 million to Rs 25 million during 2002 due to lack of funds; more than 50% of the subsidy payment was for pepper (Central Bank of Sri Lanka, 2002a).

32. Concessionary credit is also available to farmers through the state banks and local commercial banks. No information was provided to the Secretariat as to the percentage of credit provided to the agriculture sector at subsidized or preferential rates. Under the New Comprehensive Rural Credit Scheme (NCRCS), in place since 1999, loans are provided to farmers at an interest rate of 12%.<sup>38</sup> The Government gives an interest subsidy of ten percentage points to the banks. The total amount of credit granted during the 1998/99 cultivation year amounted to Rs 463 million.<sup>39</sup> It is not clear to the Secretariat whether this programme is still in place. At the end of 2002, the Agriculture and Livestock Ministry launched a loan scheme to boost multi-seasonal crops. Under the scheme, loans ranging from Rs 50,000 to Rs 13 million will be granted at 12.08% interest rate with a grace period of one to four years; loans have to be repaid in ten years. In addition to providing subsidized lending, in the past the Government has written off farmers' loans.

**(iv) Marketing**

33. The Government has also intervened in marketing activities to stabilize prices of several goods at both upper and lower levels through the Cooperative Wholesale Establishment (CWE). The main objective of the CWE was to stabilize prices and assure food security. When the Government attempted to stabilize farm-gate prices through the CWE, the latter had to intervene in the market when the "market price" went below the minimum producer price. The CWE was the only state trading agency involved in buying and selling major agricultural commodities.<sup>40</sup> At present, it seems that it is not operating. Since 1996, the CWE has imported, *inter alia*, chillies, lentils, onions, potatoes, rice, sugar, and wheat. The CWE had the monopoly on imports of wheat grain until 2001.<sup>41</sup> CWE's operations often failed and the institution incurred substantial losses.<sup>42</sup> According to the Central Bank, the Government should not get involved in commercial activities. Instead, it could implement consistent policies and provide good infrastructure, and other essential public goods and services, which the private sector fails to supply.<sup>43</sup>

34. In order to improve marketing infrastructure, dedicated economic centres (DECs) were established in the main fruit and vegetable growing areas. These centres provide a trading floor for farmers to sell directly their products to retail and wholesale dealers.<sup>44</sup> In 1999, the Central Bank introduced a forward sales contract system, which at present covers, *inter alia*, big onion, chillies, gingelly, maize, paddy, and medicinal plants. Under this mechanism, farmers are encouraged to enter into forward contracts with buyers at pre-determined prices. This scheme is expected to reduce the volatility of farmer incomes and to promote agri-business and agri-processing enterprises.<sup>45</sup>

**(v) Privatization**

35. As in other sectors of the Sri Lankan economy, public ownership in the agriculture sector has historically been substantial, especially since the majority of land is under public control. Major

<sup>38</sup> In 1999, the average prime lending rate at commercial banks was 15.16%, but interest rates ranged from 12% to 24% (Central Bank of Sri Lanka, 2002a).

<sup>39</sup> Central Bank of Sri Lanka (1999).

<sup>40</sup> The Paddy Marketing Board (PMB) was closed in 1996. The State Trading Corporation (STC), which had the monopoly on imports of over 90 agriculture-related items, today has the monopoly to import only three chemical compounds, for security reasons.

<sup>41</sup> Epaarachchi et al. (2002).

<sup>42</sup> For instance, in 2001/02, to avoid plummeting farmgate paddy prices, the Government told CWE to purchase paddy at a specific price during the peak harvesting season. However, the CWE was not able to intervene, *inter alia*, because it was unable to store the grain.

<sup>43</sup> Central Bank of Sri Lanka (2002a).

<sup>44</sup> Central Bank of Sri Lanka (2002a).

<sup>45</sup> Weliwita and Epaarachchi (2003).

reform of the plantation sector (tea, rubber, and coconut) began in 1992, when management (but not the land or assets) was privatized. During the period 1995-02 the Government progressively privatized the management of paddy, sugar, and seed farms, and sold some dairies and 20 plantations.<sup>46</sup> More recently the Government sold the majority of the shares it held in two sugar plantations.<sup>47</sup>

36. The crop insurance market was liberalized in 1999 when private insurers were allowed to enter this market. In 1999, the former Agricultural Insurance Board (AIB), which held the monopoly on crop insurance, was reconstituted with wider scope and re-named the Agricultural and Agrarian Insurance Board (AAIB).<sup>48</sup>

#### (vi) Land policy

37. Sri Lanka has not made much progress in reforming the land market, and the lack of a well developed land market has constrained performance of the agriculture sector.<sup>49</sup> The land market in Sri Lanka is characterized by heavy state presence. The Government owns 55% of non-plantation crop land, mainly in large-scale irrigation projects. State-owned land is for lease only; inter-generational transfers are allowed, but no sales or subleases. Private-sector land is mainly in older, village-based minor irrigation schemes. Private-sector land sales, the only ones allowed by law, are few, as disputed titles make these very difficult. Government policy, aimed at equitable distribution of land, has fostered smallholder agriculture. Population pressure and inheritance practices have contributed to the substantial fragmentation of both private and public land, leaving average farm-size well below the public-sector irrigation-scheme norm of 1 ha; overall, 72% of farms are below 1 ha.<sup>50</sup>

### (3) MANUFACTURING

38. The "export-oriented industrialization strategy" adopted by Sri Lanka in 1977, which aimed at diversifying the industrial sector, is still in place. In order to encourage both domestic and foreign investment in manufacturing and strengthen regional industrialization, the Government offered a series of incentives, while attempting to create an environment conducive to investment. However, despite the incentives and other assistance, at present, the manufacturing sector remains highly concentrated on a few products, particularly apparel, and dependant on a few external markets, hence its vulnerability to changes in the external environment.<sup>51</sup> The authorities consider that the diversification of both manufactured products and export markets is critical for improving the future growth prospects of the sector. Other policy goals include moving into higher-value-added industries and increasing access to the Indian market and others through the existing free-trade agreement and the negotiation of new ones.<sup>52</sup> However, according to the authorities, to achieve sustained growth in the sector, several issues need to be addressed, including the distortions in the tariff and in the labour

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<sup>46</sup> Information provided by the authorities.

<sup>47</sup> The Government sold 90% of the shares held in Sevanagala Sugar Industries to a private entrepreneur for Rs 550 million. The remaining 10% of the shares was given to the employees. Meanwhile, 53% of the shares in Pelwatta Sugar Industries Ltd were also sold.

<sup>48</sup> Central Bank of Sri Lanka (1999).

<sup>49</sup> Jogaratnam (2001).

<sup>50</sup> World Bank (1996).

<sup>51</sup> In 2002, textiles and clothing accounted for 40% of the Sri Lankan manufacturing production and 66.8% of total manufactured exports. Moreover, in 2001 the United States accounted for 64% of Sri Lanka's garment exports, and the European Union (EU) accounted for another 30% (the United Kingdom alone accounted for 19%)

<sup>52</sup> Central Bank of Sri Lanka (2001).

market, the quality of infrastructure, the removal of inefficiencies in the legal system and the excessive controls/regulations, and the unfavourable terms and conditions in international trade.<sup>53</sup>

39. The manufacturing sector contributed 15.9% to GDP in 2002 (Table I.1). The textiles and clothing sector, the leading net foreign exchange earner, is the largest industrial sector, accounting for 40% of industrial output (Chart IV.1). Food, beverages and tobacco is the second most important industry, followed by the chemicals, petroleum, and rubber. Production in the latter industries is dominated by state-owned enterprises.<sup>54</sup> Growth in manufacturing was 2.8% in 2002, reflecting a partial reversal of the 3.9% decline in 2001 (Chart IV.2).<sup>55</sup> The three largest sub-sectors (i.e. textiles and clothing, food and beverages, and chemicals) accounted for 92% of the manufacturing growth in 2002. In 2001, the performance in the manufacturing sector was adversely affected by weak demand, power cuts, and increased costs of production. The subsequent recovery may be attributed to an increment in export orders received in the second half of 2002, supported by a gradual improvement in global markets, an increase in domestic demand reflecting improved consumer confidence, and the end of the power cuts in mid 2002.<sup>56</sup>

40. Labour productivity in manufacturing grew only marginally in 2002. Growth in labour productivity has been constrained by stringent labour laws, poor working conditions, the lack of a proper transport network, insufficient investment in modern technology, and strained employer-employee relations. In addition, the lack of skilled labour has become a constraint on the development of certain industries. In response, the Skills Development Fund was set up in 1999 to encourage employers to train, retrain, and upgrade the skills of their employees. The 2003 Budget proposed replacing this Fund with the Human Resources Endowment Fund, which would be used to provide tertiary education and vocational training to students to upgrade their skills.<sup>57</sup>

41. Historically, foreign direct investment (FDI) has played an important role in the expansion of manufacturing exports; almost 85% of the total increment in manufactured exports between 1985 and 1995 originated in foreign firms.<sup>58</sup> FDI, which had showed a declining trend in 2000-01, rose in 2002, with the peace initiative. In 2002, the Board of Investment (BOI) approved 504 projects, amounting to total investment commitments of Rs 70,604 million.<sup>59</sup> The foreign investment component of the projects was 52%, and 60% of the projects were in the manufacturing sector. Within the manufacturing sector, 72 projects were approved in the textiles, clothing and leather products category.

<sup>53</sup> Central Bank of Sri Lanka (2002a).

<sup>54</sup> The output of state-owned enterprises operating in the manufacturing sector increased by 7.5% in 2002, recovering partially from the drop of 11.3% in 2001. The production of the Ceylon Petroleum Corporation (CPC), which accounted for over 90% of public-sector manufactured output, increased by 8.5% in 2002. This increase in output was the result of the CPC's uninterrupted production throughout 2002. In 2001, the petroleum refinery was closed for about two months for routine maintenance. However, the share of manufactured output produced by state-owned enterprises, excluding petroleum products, decreased by 21.8% in 2002.

<sup>55</sup> Growth in the manufacturing sector was estimated by the Central Bank of Sri Lanka based on information collected from the Industrial Production Survey 2002 of the Central Bank of Sri Lanka, production data of public sector industries, and export data relating to BOI enterprises. These estimates cover only factory industries; the other two sub-sectors of manufacturing, i.e. agriculture processing and small-scale industries, are estimated separately.

<sup>56</sup> Central Bank of Sri Lanka (2002a).

<sup>57</sup> It is not clear whether the fund was established.

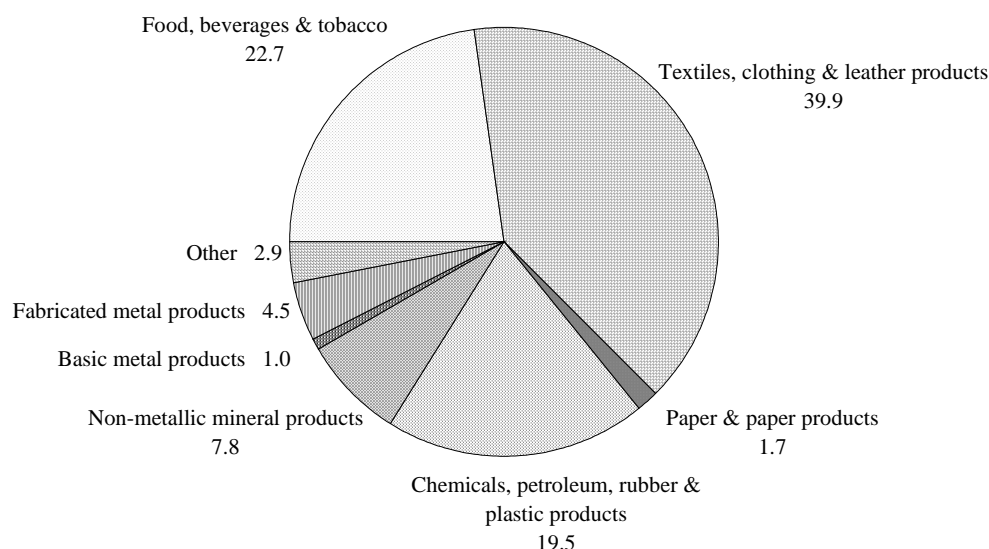
<sup>58</sup> Athukorala and Rajapatirana (2001).

<sup>59</sup> This includes 300 projects approved under Section 17, and 204 projects under Section 16 of the BOI Act.

## Chart IV.1

Structure of production in manufacturing, 2002<sup>a</sup>

Per cent

<sup>a</sup> Provisional.Source: Central Bank of Sri Lanka, *Annual Report 2002*.

42. In 2003, the average applied MFN tariff was 8% for the manufacturing sector as a whole (WTO non-agricultural products)<sup>60</sup>, with tariffs ranging from 0% to 25%. Average protection to the sector has decreased since 1998, when it was 9.3%. The industries that benefit from higher-than-average protection include leather, rubber, footwear, and travel goods, with average rates of around 14.9%. Sri Lankan manufacturing continues to be highly dependent on imported intermediate goods; thus average protection for fully processed goods and primary goods is high, at 12.1% and 12.4% respectively, while protection for intermediate goods is 4.4% (Table AIV.3).<sup>61</sup>

43. In the Uruguay Round, Sri Lanka bound less than 10% of the tariff lines covering manufactured products.<sup>62</sup> Thereafter, it bound all tariffs affecting textiles (HS Section 11).<sup>63</sup> Nevertheless, Sri Lanka's percentage of bound lines covering manufactured products (WTO definition of non-agricultural products) remains low, at 26%. There are sectors, such as plastics and rubber (HS Section 7), and arms and ammunitions (HS Section 19), in which no tariff lines have been bound.

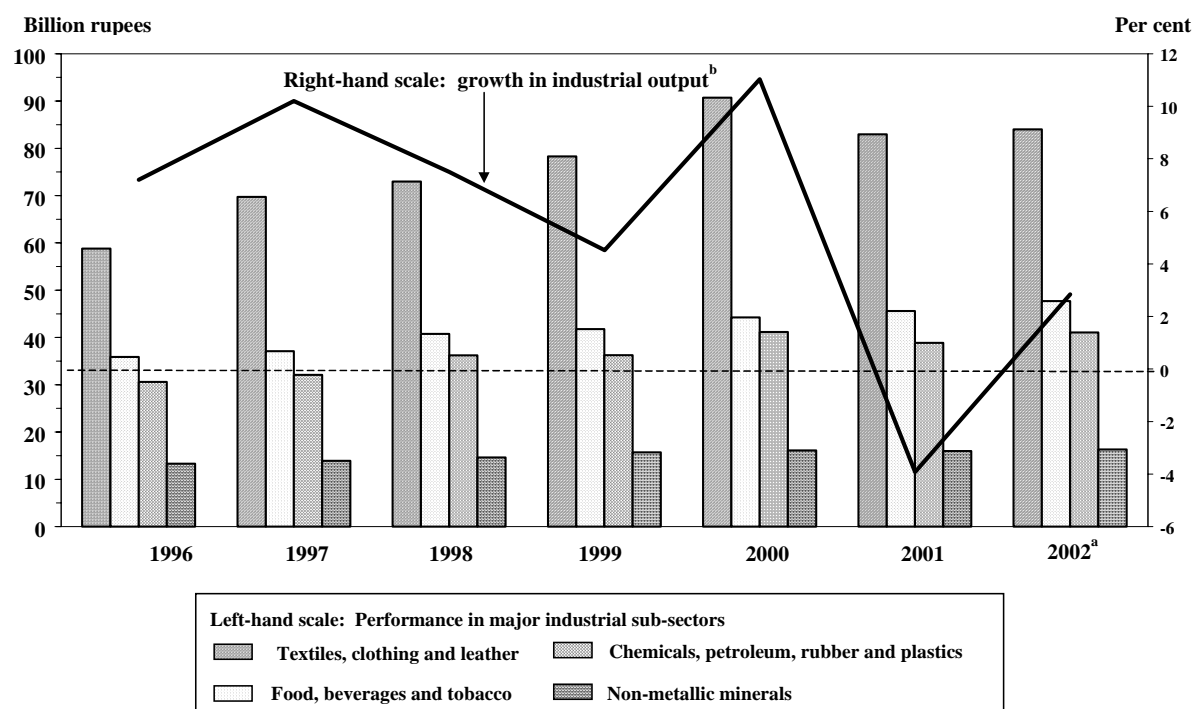
<sup>60</sup> For industrial products (HS 25-97) the average protection was 7.9%.

<sup>61</sup> The textile industry, which is highly dependant on imported inputs, is an example of this pattern of protection: protection for semi-processed goods is 0.1%, while for fully processed and primary goods average protection is 8.7% and 4.3%, respectively.

<sup>62</sup> WTO (1996).

<sup>63</sup> Textiles and clothing using the WTO definition is not fully bound. This classification includes unbound tariff lines from HS Chapter 39, 65, 66, 77.

**Chart IV.2**  
**Manufacturing indicators, 1996-2002**



**a** Provisional.

**b** Measured as the output of "factory industries" only.

**Note:** Data are based on 1990 constant prices.

**Source:** Central Bank of Sri Lanka, *Annual Report 2002*; and the Sri Lankan authorities.

44. Whereas the tariff is the Government's preferred policy instrument to assist domestic agriculture, incentives are the preferred instrument to assist manufacturing. Through the years, Sri Lanka has offered a wide range of incentives (e.g. tax holidays and tariff concessions) to manufacturing, to promote diversification and the acquisition of modern technology in the sector.<sup>64</sup> The incentive regime is complex and has been changed several times since 1996 in an effort to attain specific goals and to target mainly export-oriented enterprises.<sup>65</sup> However, as already stated, the provision of various incentives has not proved effective in diversifying the industrial base. Regional industrialization has also been encouraged through the provision of tax incentives and infrastructure facilities in the remoter districts. However, most of the industries in Sri Lanka are still located in the Western Province due to the proximity to the harbour and airport, and close access to product and labour markets. In a new attempt to promote regional development the 2003 Budget announced a special tax incentive package for enterprises approved under the new BOI Act passed in 2002 and located in specific regions.<sup>66</sup>

<sup>64</sup> These incentives include tax concessions (especially tax holidays) and tariff concessions (duty-free entrance of machinery, equipment, and raw materials)

<sup>65</sup> Central Bank of Sri Lanka (2000).

<sup>66</sup> The new BOI Act was passed by Parliament but has not been implemented yet; hence, it is not clear to the Secretariat whether these new incentive programmes have been implemented.

45. Commercial banks provide short and medium-term credit to the manufacturing sector at market rates, while the development banks (i.e. the National Development Bank (NDB) and the DFCC Bank) provide long and medium-term assistance under special credit schemes in the form of subsidized direct loans and equity participation. The NDB has continued to grant credit under the second stage of the Small and Micro Industries Leader and Promotion Project (SMILE 2) implemented in 2001. In 2002, credit amounting to Rs 506 million was granted under SMILE 2. The NDB also provided Rs 2,531 million in direct financial assistance to the manufacturing sector.<sup>67</sup> Interest rates on these loans ranged from 10%-20%. Credit granted to the manufacturing sector by Development Finance Corporation of Ceylon (DFCC) Bank increased from Rs 2,432 million in 2001 to Rs 4,190 million in 2002.<sup>68</sup>

**(i) Textiles and clothing**

46. In 2002, exports of textiles and clothing accounted for 53% of Sri Lanka's total export earnings and amounted to 5.3% of GDP (about 40% of manufacturing output). There are approximately 830 factories operating in Sri Lanka, providing employment to 330,000 people. Production and employment in the clothing industry in Sri Lanka are highly concentrated in a few large-scale manufacturers. The 50 largest factories accounted for over 50% of total output of the industry and the top 12 exporters account for about 72% of exports.<sup>69</sup> Sri Lanka's apparel exports are also heavily concentrated in a few markets. In 2002, some 94% of clothing and textile products were exported to U.S. and EU markets.

47. The textiles and clothing sector recovered in 2002, growing by 1.2% after undergoing a sharp decline (of 8.5%) in 2001. The global demand for textiles and clothing, which had been declining since the first quarter of 2001, showed signs of recovery during the second half of 2002. However, the full recovery of the sector will depend on international demand, as more than 90% of apparel products are manufactured for export. The price of Sri Lankan textiles and clothing exports declined by 6% in 2002, and the cost of production increased sharply because of increases in energy, telephone, and other utility prices, and a decline in labour productivity. In order to face this unfavorable environment, a few apparel manufacturers reduced their scale of operations and restructured their factories, while others have been able to rationalize costs of production, improve product quality, reduce turnaround time, and find new markets. In addition, greater attention has been paid to the selection of fabrics, design, and quality.<sup>70</sup>

48. The Sri Lankan garment industry relies heavily on imports of fabric and other accessories (e.g. buttons, zippers, labels, and packing material). Imports of textiles and related products accounted for 39% of intermediate-goods imports in 2000. It is estimated that imports account for nearly 85-90% of the fabrics used by exporters. This results in long turn-around times to meet export orders and keeps the net foreign exchange earnings of the garment industry low. The local textile industry appears to be unable to supply the type of fabrics demanded by the export garment industry due to technical handicaps. The authorities consider that the high dependence on imported raw materials is an impediment to the sector's future growth.

<sup>67</sup> Of the total credit approved by NDB in 2002, 19% was granted to the food, beverages and tobacco industry, 21% to the chemicals, petroleum, rubber, and plastics sub-sector, and 9.7% to the textiles, clothing and leather industry.

<sup>68</sup> In 2002, the DFCC Bank approved Rs 1,765 million to the food, beverages and tobacco industry; Rs 734 million to the chemical, petroleum, rubber, and plastics industry; Rs 459 million to non-metallic mineral products; and Rs 452 million to textiles, clothing, and leather products.

<sup>69</sup> Central Bank of Sri Lanka (2002a).

<sup>70</sup> Central Bank of Sri Lanka (2002a).



49. The average tariff protection on textiles and clothing has declined since 1998, to reach 5.8% in 2003, with tariffs ranging from 0-25% (Table AIV.4). Most intermediate inputs enjoy low levels of protection and some bear none at all. Duties on textiles and other related raw material were abolished in the 1998 Budget to overcome the customs-related problems faced by exporters who rely heavily on imported raw materials.<sup>71</sup> Imported textiles and textile articles (i.e. goods classified under Chapters 50 to 63 both inclusive) are exempt from the import surcharge.<sup>72</sup>

50. Textiles are subject to a reduced VAT rate of 10%. However, to assist this sector the 2002 Budget proposed that fabrics should be exempt from VAT. This exemption was expected to simplify procedures and eliminate delays, allowing apparel exporters to respond to buyers promptly. It is not clear to the Secretariat how this measure would “simplify procedures and eliminate delays”. The 2002 Budget also announced that the VAT on garments would be replaced with a flat fee of Rs 25 per garment sold in the local market by Board of Investment (BOI) enterprises.<sup>73</sup> It is unclear to the Secretariat whether this measure was implemented.

51. Sri Lanka's exports of textiles and clothing have been subject to quotas, to varying extents, in Canada, the European Union, and the United States. Sri Lanka has signed administrative arrangements with Canada<sup>74</sup>, the United States<sup>75</sup>, and the EU<sup>76</sup> to implement the textiles and clothing restraints under the ATC. In December 2000, the Government of Sri Lanka signed an agreement with the EU to lift by March 2001 all quantitative restrictions on exports of Sri Lankan garments to the EU. As a quid pro quo, the agreement also provides for tariff reductions by Sri Lanka and binding of all its tariffs for the textiles and clothing sector: Sri Lanka bound its rates for the entire sector at 0% for raw materials, 5% for fibres and yarns, 10% for fabrics, and 17.6% for clothing products. As a result, the EU suspended the application of four restraints on imports of textiles and clothing from Sri Lanka.<sup>77</sup>

52. In 2002, the number of items subject to quotas in the U.S. and Canadian markets declined. In 2002, Sri Lanka exported 30 different clothing and textiles items to the U.S. market and 11 items to the Canadian market. According to the authorities, the quota utilization in the U.S. market declined by 8.9% in 2001 (due to the slowdown in the U.S. market); as a whole Sri Lanka used 72.2% of the available U.S. quotas.<sup>78</sup> The quota utilization rate in the Canadian market also declined, from 42.3% in 2001 to 33.3% in 2002.<sup>79</sup> According to the authorities, quota utilization is decreasing because manufacturers have concentrated in production of higher-value-added non-quota items to export to the EU market. However, the decline in quota utilization in these markets might also be the consequence of a fall in the competitiveness of Sri Lanka's producers and/or trade diversion owing to the NAFTA.

<sup>71</sup> Central Bank of Sri Lanka (1998).

<sup>72</sup> Sri Lanka Customs (undated e).

<sup>73</sup> Central Bank of Sri Lanka (2002a).

<sup>74</sup> WTO document G/TMB/N/170, 16 July 1996.

<sup>75</sup> WTO document G/TMB/N/286, 22 July 1997.

<sup>76</sup> WTO document G/TMB/N/261, 18 July 1997.

<sup>77</sup> These quotas covered trousers (category 6), cotton blouses (category 7), cotton shirt (category 8), and anoraks (category 21) (Kelegama and Epaarachchi, undated).

<sup>78</sup> The quota utilization rate in the United States declined during 2001-02 from 80.1% to 75.2% for apparel and from 13.9% to 4.8% for fabrics. In 2002, Sri Lanka used 90% of the U.S. quota for dresses, knit shirts and blouses, skirts, nightwear, trousers, and underwear; and less than 25% of the quota for playsuits, fabric poplins and spun-cell, suit-type coats, dressing gowns, non-suit coats, playsuits, coveralls, and overalls.

<sup>79</sup> The most popular quota items in the Canadian market were winter outerwear, trousers, overalls and shorts, shirts, underwear, and blouses. In the Canadian market, the quota utilization rate was below 5% in respect of swimwear, baby garments, and bed-sheets.

53. Textile quotas are allocated by the Textile Quota Board (TQB), a statutory body with private-sector participation<sup>80</sup>, under the Ministry of Enterprise Development, Industrial Policy and Investment Promotion. In general, quotas have been distributed to manufacturers depending on their past performance. However, a certain percentage (some 3%) is left for small-scale manufacturing units and residual/unutilized quotas are allocated according to the number of employees involved or at the TQB's discretion.<sup>81</sup> (Box IV.2). The complexity and consequent lack of transparency of the quota allocation system renders it susceptible to administrative discretion; hence, there have been allegations of corruption in the distribution of quotas.<sup>82</sup> The private-sector representatives of the TQB have deplored the interference of various interested individuals in the allocation of quotas.<sup>83</sup> As a result, in 2002, the Sri Lanka Apparel Exporters Association (SLAEA) launched a special unit to monitor the allocation of quotas and their use. The SLAEA considered that there were many irregularities in the process of allocation, and that transparency was key to keeping track of the quota movement.<sup>84</sup> The authorities claim that these allegations are false, and that the quota allocation process is transparent.

#### **Box IV.2: Quota-allocation System**

##### **Main criteria of allocation**

- (i) 90% of the quotas are allocated on the basis of past export performance. Allocations on this basis are referred to as "Performance Quota" or "Main Quota".
- (ii) Approximately 3% of the quota available in a year will be reserved for small-scale manufacturing units; this will be allocated on the basis of the number of employees.
- (iii) 50% of any remaining quotas (after allocations on the basis of (i) and (ii)) are reserved for resuscitation of sick factories or any other purpose determined by the Textile Quota Board from time to time.
- (iv) Any quota balances remaining after allocation of (i), (ii), and (iii) will be put to a "common pool" and allocated under the common pool scheme.

These quotas may be transferred.

##### **Common pool quota schemes**

Pool quotas are not transferable.

The pool quota scheme is divided in two schemes

- (a) Cold Category (i.e. less the 80% quota utilization in previous year) pool quota scheme: allocation is in two phases

Phase I: The basis of allocation and the quantities to be allocated will be decided by the TQB.

Phase II: Any quantity remaining after operation of Phase I will be made available via an application.

- (b) Main pool quotas scheme: allocation is primarily on the basis of the number of employees.

*Source:* Government of Sri Lanka.

54. The Two-Hundred-Garment Factory Programme and the Fifty-Garment Factory Programme, which were implemented in 1992 and 1994, respectively, to promote the production of textiles and

<sup>80</sup> The private sector is represented through five associations: the Sri Lanka Apparel Exporters Association, the Free Trade Manufacturers Association, the Sri Lanka Garment Buying Offices Association, the National Apparel Exporters Association, and the Sri Lanka Chamber of Garment Exporters.

<sup>81</sup> A small-scale manufacturing unit is a unit that employs a minimum of 50 and a maximum of 200 employees and whose quota holding in all fast moving categories is 4,000 dozens or less.

<sup>82</sup> *Sunday Times* [Online]. Available at: <http://www.sundaytimes.lk/020602/bus/bus2.html>.

<sup>83</sup> *Daily News*, 5 June 2002 [Online]. Available at: <http://origin.dailynews.lk/2002/06/05/bus03.html>.

<sup>84</sup> *Daily News*, 31 July 2002 [Online]. Available at: <http://origin.dailynews.lk/2002/07/31/bus05.html>.

clothing in backward areas, are still in place. Under these schemes, tax exemptions are granted and quota allocations are guaranteed. The size of the quotas allocated to these factories is contingent on location and number of employees. The more backward the area and the more labour employed the bigger quota. This acts as a disincentive for factories to use more capital-intensive technologies. According to the authorities, these programmes have been very successful. At present, there are 160 factories operating under the Two-Hundred-Garment Factory Programme, and 69 factories under the Fifty-Garment Factory Programme.

55. The Sri Lankan clothing industry is now facing several challenges including the expected end to the quota system in 2005, increasing competition from low-cost manufacturers and exports under preferential trading arrangements, and the slow progress in domestic infrastructure development, which impairs external competitiveness. In order to remain competitive, the industry needs to, *inter alia*, upgrade its technology, rationalize costs of production, improve product quality and speed of delivery, maintain high labour standards, and develop a domestic inputs base.<sup>85</sup>

56. At present, most of Sri Lanka's exports are subject to quotas; however, it seems that dependence on quotas has declined somewhat over the years. Quota-based exports have declined from 63% in 1996 to 53% in 2002. Many large-scale manufacturers have already established strong marketing links with foreign buyers to decrease their dependence upon quota availability. Therefore, the loss of exports following the abolition of the quota system may not be as high as many fear. Large-scale manufacturers have started to upgrade technology and skills, but not smaller producers. Some manufacturers had already upgraded their production in 1998 when tariffs on textiles were reduced. The Textile Restructuring Programme was introduced in 1998 to assist the sector in this process.<sup>86</sup>

57. The authorities consider that the growing trade of textiles and clothing under preferential arrangements is becoming a severe threat to small, middle-income countries like Sri Lanka. To face this challenge, Sri Lanka is also lobbying for preferential trade concessions in major markets (e.g. the United States and the EU), forming regional trading blocks, and entering into bilateral trade agreements. In this regard, Sri Lanka has signed an agreement with the EU and has initiated discussions to obtain preferential treatment in the U.S. market.

## **(ii) Petroleum**

58. The two main developments in the petroleum sector since 1996 have been the introduction of competition in the sector and of a formula to determine the local price of petroleum products. Until February 2003, the Ceylon Petroleum Corporation (CPC) had the monopoly to import, export, refine, distribute and market petroleum and petroleum products in Sri Lanka. It was prohibited for any other person or entity to engage in any of these activities without a written approval from CPC. Most imports of petroleum products (HS 27.10) are duty free.<sup>87</sup>

59. The restructuring of the petroleum sector in Sri Lanka started in the early 1990s. As a result, the loss-making Ceylon Petroleum Corporation (CPC) was separated into subsidiaries, which undertook different activities. Of these subsidiaries, Lanka Lubricant (import, blending, distribution, and marketing of lubricant oil), Colombo Gas (import and distribution of liquefied petroleum gas (LPG)), and Lanka Marine Services (bunkering oil) have already been privatized and their related activities liberalized.

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<sup>85</sup> Central Bank of Sri Lanka (2002a).

<sup>86</sup> No information was provided to the Secretariat on this programme.

<sup>87</sup> Department of Imports and Exports Control (2002).

60. CPC previously had monopoly rights, among other things, to import crude oil and refined petroleum, to refine crude oil, and to distribute petroleum products through approximately 300 filling stations. CPC has been restructured and the importation and distribution of refined petroleum liberalized in February 2003.

61. The restructuring of CPC has four features. First, the market for refined products was divided among three players: the CPC, the Lanka Indian Oil Company (LIOC), and a third party licensee to be selected through a competitive bidding process.<sup>88</sup> Second, a separate company will be established to manage CPC's common user facilities, such as oil terminals, storage facilities, and pipelines. Third, the aviation fuel operations of CPC (the Aviation Fuel Company) will be restructured through a competitive bidding process. Fourth, CPC will be converted into a fully state-owned public limited company in charge of operating the refinery and the remaining facilities (used to supply and distribute petroleum products).

62. Once the sector is fully restructured, the Government will play only a regulatory role. However, this is somewhat confusing, as it seems that CPC will continue to be a fully state-owned company competing with the other suppliers. It would control a third of the market through its distribution/service network and operate the refinery on commercial terms.<sup>89</sup> CPC's infrastructure (e.g. storage tanks, pipelines, loading facilities, and distribution network) will become a "common user facility (CUF)", which will be available to all users. A regulatory mechanism will be set up to ensure competition, adequate supply, service standards, and consumer safety. The oil and gas sector will eventually operate under the regulatory framework stipulated in the envisaged Public Utilities Commission of Sri Lanka Act No. 35 of 2002, which is to encompass the Ceylon Petroleum Corporation Act No. 28 of 1961 and the Energy Supply (Temporary Provisions) Act No. 2 of 2002. Until the regulatory arrangements are put in place, non-commercial and regulatory functions will remain under the purview of the CPC and will be governed by the CPC Act.

63. Lanka Lubricants Limited, originally the lubricating oil blending plant of the CPC, was incorporated as a government-owned company in December 1992. The company was in charge of blending, importing, distributing, and marketing lubricating oils and greases. The company blended 95% of its production locally, using imported base oils; it supplied 98% of the domestic demand. Lanka Lubricants Limited was privatized in 1994 with the sale of 51% of its shares to Caltex Trading and Transport Corporation.<sup>90</sup> The monopoly on the importation and distribution of finished lubricants expired on 31 March 1997. Import licences have been issued to six companies to import and market finished lubricants. However, the monopoly on local manufacturing and distribution through CPC's owned and managed service stations will continue until 2004.<sup>91</sup>

64. Shell Gas Lanka Limited (SGLL), formerly known as Colombo Gas Company, provides liquefied petroleum gas (LPG) to over one million domestic and industrial customers in Sri Lanka. A

<sup>88</sup> In February 2003, a subsidiary of the Indian Oil Company called Lanka Indian Oil Company (LIOC) signed an agreement with the Government of Sri Lanka to enter the market by taking over 100 of CPC's 300 filling/service and importing refined petroleum products. In addition, the Trincomalee Tank farm comprising 99 tanks was handed over by CPC to LIOC under a lease agreement. The targeted completion of the privatization of the 100 filling stations earmarked for Lanka Indian Oil Company (LIOC) is November 2003. CPC's common user facilities will be transferred to one company and valued. The target date for completion of the valuation exercise is June 2003. The transfer to LIOC of one third of the common user facilities is expected to take place soon after. Identification of the third player/investor will begin in July 2003 and is expected to be completed in April 2004 (Public Enterprises Reform Commission of Sri Lanka (undated e)).

<sup>89</sup> Because of the small size of the market, during the first five years only three companies will be allowed to engage in the marketing of oil.

<sup>90</sup> Public Enterprises Reform Commission of Sri Lanka (undated c) and (undated d).

<sup>91</sup> Public Enterprises Reform Commission of Sri Lanka (undated c), (undated d), and (undated f).

51% stake of SGLL is held by Shell Overseas Investments; the remaining 49% of the shares, which are still owned by the Government of Sri Lanka, are in the process of being sold.<sup>92</sup> A new local company entered the LPG market in 2001 and it is claimed that consumers have already benefited from the competition through lower prices and improved services.<sup>93</sup> However, the press has reported that the price of LPG has been on the increase in 2002.<sup>94</sup>

65. Lanka Marine Services Ltd. (LMSL), a fully owned subsidiary of CPC, was the monopoly provider of bunker-oil in Sri Lanka. LMSL operated within the harbour by providing bunker-oil to ships calling at the Colombo Port. LMSL was privatized in 2002. However, according to the authorities, the buyer of LMSL has been granted exclusive rights to provide bunkering within the Port of Colombo for 18 years. The Government is planning to allow all parties who own, or have access to, vessels certified by the Marine Pollution Prevention Authority (MPPA) as being suitable for bunkering, to import and sell marine fuel. There will be no price regulation and licensees are expected to practice self-regulation with regard to price and quality. Licences are to be issued by the Minister of Power and Energy at no cost to locally incorporated companies.<sup>95</sup>

66. In January 2002, an automatic price adjustment mechanism to determine local prices of petroleum products was introduced. The new pricing methodology has prevented CPC from accumulating further losses.<sup>96</sup> Under the new pricing policy, local prices of major petroleum products (i.e. petrol, diesel, kerosene, and furnace oil) are regulated through a formula. The formula is expected to be revised monthly, based on changes in the cost of production. With this pricing system, any gain or loss due to the fluctuation of international oil prices, any other input or the exchange rate will be passed on to consumers according to the formula.<sup>97</sup> The price of LPG is not regulated by the formula; the two market players set it. Prices were previously revised on recommendations made by the CPC to the treasury. According to the authorities, price adjustments were highly political. Prior to 2002, the price of petroleum products was subsidized. However, in 2000, the Government, no longer able to subsidize fuel in view of the rising oil prices and the cost of war, announced a series of price increases on diesel, kerosene, fuel oil, and transport.

#### **(4) ELECTRICITY**

67. In 2002, Sri Lanka's state-owned installed electrical capacity of 1,704 MW consisted of 1,137MW of hydropower, 564MW of thermal power and 3MW of wind power; the private sector owned an additional capacity of 228MW.<sup>98</sup> Sri Lanka is heavily reliant on hydropower for its electricity, making it vulnerable to fluctuations in rainfall. Although thermal power capacity has doubled since 1996, it has not been enough to meet demand during periods of low rainfall. Most of the thermal plants use diesel. Investment in the electricity sector has been marginal in recent years, resulting in serious power shortages during drought periods. Sri Lanka is likely to continue facing severe power shortages in the future owing to delays in establishing new power generation capacity and in repairing existing plants.

68. The electricity sector underwent a severe crisis in 2001, which extended until mid-2002. There was a significant drop in the generation of hydropower due to poor rainfall, delays in power

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<sup>92</sup> Public Enterprises Reform Commission of Sri Lanka (undated f).

<sup>93</sup> Central Bank of Sri Lanka (2001).

<sup>94</sup> *The Island*, 29 October 2002 [Online]. Available at: <http://origin.island.lk/2002/10/29/news04.html> [24 June 2003].

<sup>95</sup> Public Enterprises Reform Commission of Sri Lanka (2001).

<sup>96</sup> Central Bank of Sri Lanka (2002a).

<sup>97</sup> Central Bank of Sri Lanka (2001).

<sup>98</sup> Central Bank of Sri Lanka (2002a).

plant repairs and the discontinuation of hiring power plants. This led to prolonged power cuts in the second half of the year, which disrupted economic activity, and thus had an adverse impact on the country's production and productivity. At present, power tariffs in Sri Lanka are the highest in the region, potentially weakening Sri Lanka's external competitiveness. Power generation capacity increased by 7% in 2001 with the commissioning of a combined cycle power plant (110MW), reducing hydro dependence to 61%. However, effective generating capacity remained below its potential due to low water levels in reservoirs. The demand for electricity has increased at a faster rate than the expansion in power generation capacity, aggravating the power shortage.<sup>99</sup> Thus, electricity generation needs to be expanded not only to eliminate the existing excess demand, but also to meet increasing new demand.

69. The Ceylon Electricity Board (CEB), a state-owned monopoly, and its subsidiary Lanka Electricity Company (Pvt.) Ltd. (LECO), are still in charge of the transmission and distribution of electricity in Sri Lanka.<sup>100</sup> There is some private participation in the generation of electricity. The Ceylon Electricity Board (CEB) has run a deficit for several years as electricity tariffs are not adjusted to cover costs. In 2001, the average tariff (Rs 5.53 per unit) was kept below the average cost (Rs 7.20 per unit) resulting in losses of about Rs 12 billion for the CEB.<sup>101</sup> In addition, many large industrial and commercial organizations have standby generators, which are used under a CEB subsidy programme<sup>102</sup>, and the Government uses high-cost generators hired on a short-term basis to meet the power shortages, at CEB's expense. The introduction of an automatic tariff adjustment system and the elimination of subsidies could reduce CEB's losses.

70. The 2001 crisis was a repetition of the 1996 crisis and demonstrated the power sector's continued weakness. To avoid future crises, the industry needs to be restructured, the repairs to the CEB's power plants need to be completed, and a transparent automatic power tariff adjustment system needs to be introduced. Dependence on hydropower has to be further reduced by diversifying power generation to other sources to minimize the vulnerability of the electricity supply to rainfall variation.<sup>103</sup>

71. The Electricity Reforms Act passed in 2002 stipulates the re-structuring of the electricity sector. The Act calls for the separation of the generation, transmission, and distribution operation of the CEB paving the way for greater private-sector participation.<sup>104</sup> Private participation is envisaged, although it is not clearly stated in the law. The Act proposes the creation of several state-owned companies: one generation company to take over the functions of Ceylon Electricity Board; one company to take over the transmission functions of CEB, three or more distribution companies; and one or more companies to take over the other functions of CEB and LECO.<sup>105</sup> According to the authorities, creation of eight new state-owned companies to take over the functions of CEB and LECO has been approved.<sup>106</sup> CEB will eventually disappear in accordance with Section 66 of the Act, which refers to the repeal of the CEB Act and the Electricity Act. Despite the efforts to

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<sup>99</sup> Central Bank of Sri Lanka (2001).

<sup>100</sup> Bureau of Infrastructure Investment (undated).

<sup>101</sup> Central Bank of Sri Lanka (2001).

<sup>102</sup> In 1997, under this programme, large industrial and commercial consumers were granted a subsidy of Rs 3,000 per kVA subject to the following conditions: for a specific period of five months from 1997-00 beneficiaries could consume only 25% of their average monthly consumption from the national grid.

<sup>103</sup> Central Bank of Sri Lanka (2001).

<sup>104</sup> Central Bank of Sri Lanka (2002a).

<sup>105</sup> Section 45 of the Electricity Reform Act, No. 28 of 2002, 11 December 2002.

<sup>106</sup> There will be one generation company, one transmission company, five distribution companies, and one company to deal with the other functions.

reorganize the sector, Sri Lanka is moving from one monopoly situation to another, competition will be allowed only in distribution. Moreover, private involvement is at present not allowed.

72. A shortcoming of the Electricity Reform Act is that it only deals with the generation of thermal and hydro power. It makes no provision for the development either of alternative energy sources or for privately owned supplies.

73. Under the Electricity Reform Act, licensees should submit their tariff proposals according to "cost reflective methodology" to the Public Utilities Commission (PUC); the PUC reviews the proposal prior to approving the tariff. If the Government decides that a tariff needs to be subsidized, it undertakes to compensate the licensee for the lost revenue.

## **(5) SERVICES**

### **(i) Overview**

74. Services (including construction, and electricity, gas, water, and sewerage) contributed some 62.2% to Sri Lanka's GDP in 2002, up from 59.4% in 1996 (Chapter I). Real growth of 6% in 2002 (negative in 2001) reflected further expansion in telecommunications and financial services, and restored growth in wholesale and retail trade, tourism, and port services. Services employed some 31% of the labour force in 2002. The largest services subsectors in 2002 were wholesale and retail trade (21% of GDP), transport and communication (12.4%), and banking, insurance, and real estate (9.2%). Key services, such as tourism, buoyed also by rekindled foreign investment, have expanded recently following the domestic peace initiatives. Services, mainly transportation and travel (tourism), accounted for about one fifth of exports in 2002 (one sixth in 1999); Sri Lanka is a net services exporter (Chapter I). More efficient services delivery is a government priority; several state utility monopolies exist, often incurring large losses.

75. Sri Lanka's specific commitments in the Uruguay Round covered only tourism.<sup>107</sup> Sri Lanka subsequently participated in the extended negotiations on basic telecommunications and financial services and accepted the GATS Fourth Protocol (basic telecommunications) and Fifth Protocol (financial services) on 27 November 1997 and 20 January 1999, respectively.<sup>108</sup> The monopoly on basic fixed wire telephony services (international) of the majority state-owned Sri Lanka Telecom was scheduled to last until at least 2000, when issuance of another licence would be conditional on satisfactory progress in tariff re-balancing. Sri Lanka also reserved the right to issue no new licences for mobile services until at least 2000 and to retain the duopoly on basic telephony services supplied by wireless local loop (WLL) for five years (i.e. 2002). Foreign equity caps were scheduled, at 35% for Sri Lanka Telecom and 40% for other operators unless the Board of Investment (BOI) approved on a case-by-case basis higher levels (up to 100%). Sri Lanka adopted the Reference Paper on Regulatory Principles as an additional GATS commitment.

76. Sri Lanka's commitments in financial services allow for an economic needs test to govern approval, registration and licensing of banks and other financial institutions, foreign branches, and maximum foreign equity of 49%. Moreover, the entry for direct insurance provides for new establishments to be subject to government licensing; the relevant criteria are not further specified in the schedule. Foreign equity participation throughout the financial service sector is limited to 49%, except for reinsurance and retrocession where Sri Lanka has not accepted any bindings on commercial presence.

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<sup>107</sup> WTO document GATS/SC/79, 15 April 1994.

<sup>108</sup> WTO document S/DCS/W/LKA, 24 January 2003.

77. The only MFN exemption listed by Sri Lanka relates to telecom accounting rates on international calls.

78. Sri Lanka grants most-favoured-nation (MFN) treatment in services to all WTO Members. The only MFN exemption listed is to reserve the right indefinitely to apply different accounting rates on international services under bilateral International Telecommunications Agreements between Sri Lanka Telecom and foreign operators, including from SAARC partners.

79. Notwithstanding the limitations inscribed in Sri Lanka's schedule the authorities view services liberalization as important in attracting foreign investment and developing infrastructure, and this is reflected in recent decisions to allow full foreign ownership in certain key services, especially banking and insurance. They are examining the possibility of further commitments in a number of non-infrastructure services, such as tertiary education, retail trade and professional services. Sri Lanka believes that GATS Article IV must more effectively raise developing-country participation in services trade. It has suggested that developed countries be required to provide meaningful access in services of export interest to developing members, and to limit their liberalization requests to developing countries.<sup>109</sup>

## **(ii) Financial services**

80. The main laws regulating financial services are the Banking Act, the Monetary Law Act (amended in 2002), the Finance Companies Act, the Insurance Industry Act, the Insurance Board of Sri Lanka Act, the Securities and Exchange Commission Act, and the Finance Leasing Act. The Monetary Law Act and the Banking Act are to be fully overhauled within the next two years.<sup>110</sup> Anti-money-laundering legislation is also being drafted, covering most institutions, such as banks, insurance firms, stock brokers, finance companies, and leasing firms.<sup>111</sup>

81. The Central Bank, the Securities and Exchange Commission, and the Insurance Board regulate the financial sector.<sup>112</sup> The Government has considered forming a single regulator, the Financial Services Authority (FSA).<sup>113</sup> However, the Ministry of Finance recently deferred its creation.<sup>114</sup> The FSA would regulate non-bank financial institutions, such as securities firms, insurance companies, employer-sponsored private pensions funds, anti-money-laundering, and oversee accounting and auditing standards. However, the subsequent transfer of bank supervision from the Central Bank to the FSA appears no longer to be planned.

### **(a) Banking**

82. The Central Bank regulates four types of banking institutions: commercial banks, specialized banks, leasing companies, and finance companies.<sup>115</sup> Commercial and specialized banks require a

<sup>109</sup> WTO document S/CSS/W/131, 6 December 2001.

<sup>110</sup> Central Bank of Sri Lanka (2002a).

<sup>111</sup> Preliminary draft laws have been prepared on combating financing of terrorism (Ministry of Foreign Affairs), prevention of money laundering (Ministry of Justice), and financial transaction reporting (Central Bank).

<sup>112</sup> Central Bank of Sri Lanka (2001).

<sup>113</sup> The FSA's creation was recommended by the Government's Financial Sector Reform Committee, which was set up in March 2002 to evaluate financial sector reforms (Asian Development Bank, 2003, p. 10).

<sup>114</sup> The Ministry of Finance (Department of Fiscal Policy and Economic Affairs) and the Central Bank advise on financial sector reforms, including legislative changes; the Cabinet Sub-Committee on Economic Policy must approve all reforms.

<sup>115</sup> Licensed banks are supervised by the Bank Supervision Department of the Central Bank while the Department of Supervision of Non-Bank Financial Institutions supervises leasing and finance companies.



license (Banking Act), and leasing and finance companies must be registered under the Leasing Act and Finance Companies Act, respectively. Bank licence applications are considered case-by-case and licence numbers are not limited. Factors used in deciding whether to issue a licence are the applicant's economic viability, the bank's potential, and the "economic need" for its services and operations. "Due diligence" checks are performed on directors and owners/shareholders. The Central Bank issues prudential regulations for licensed banks, for example on minimum capital, capital adequacy, and liquid assets. Banks listed on the stock exchange are also subject to the disclosure requirements of the Securities and Exchange Commission. While the Ministry of Finance does not directly regulate banking institutions, the Minister's consent is needed in certain situations, such as an investor acquiring a material interest (above 10% of issued share capital) in a commercial bank.

83. Services provided by commercial banks include accepting deposits repayable on demand, and dealing in foreign currency (subject to Minister of Finance approval). Specialized banks provide specific services such as mortgages and housing loans, and financing for rural and development projects. They provide interest-bearing savings products and can accept time deposits, but not demand deposits. Registered finance companies can accept time deposits from 6 to 60 months, and lend, mainly for hire purchase, leasing, and real estate. Licensed banks and registered finance companies cover about two thirds of Sri Lanka's banking business. Other financial institutions are not supervised.

84. In 2002, there were 23 commercial banks; 12 were foreign banks (Table IV.3). Foreign equity limits were raised from 49% to 60% in 2000, and eliminated in May 2002. According to the authorities, there are no restrictions on foreign competition in banking, including from overseas (unincorporated) branches, and foreign suppliers receive national treatment.

**Table IV.3**  
Sri Lanka's banking system, 2002  
(Per cent and Rs million)

Type of banking institution	Number of banking institutions <sup>a</sup>		Total assets		Total deposits		Percentage of NPLs
	Number	Per cent of total	Amount	Per cent of total	Amount	Per cent of total	
<b>Commercial banks</b>	23 (26)	63.9 (100.0)	953,601	79.6	640,575	81.0	15.3
Domestic banks	11 (8)	30.6 (30.8)	828,810	69.2	565,024	71.4	16.3
Bank of Ceylon	1 (1)	3.8 (3.8)	258,013	21.5	170,603	21.6	15.6
People's Bank	1 (1)	3.8 (3.8)	206,909	17.3	141,205	17.9	20.4
Foreign banks	12 (18)	33.3 (69.2)	124,790	10.4	75,550	9.6	7.7
<b>Specialized banks</b>	13 (0)	36.1 (0)	244,370	20.4	150,492	19.0	13.7
<b>Total</b>	36 (26)	100.0 (100.0)	1,197,971	100.0	791,067	100.0	100.0

a Figures in brackets are for 1999.

Source: Sri Lankan authorities.

85. The banking sector suffers from high levels of NPLs and low provisioning, inefficient state banks, insufficient bank capitalization, and inadequate prudential supervision and regulation.<sup>116</sup> Capital injections have strengthened many banks; average capital ratios are around 10%. NPLs of commercial banks improved in the last half of 2002 from 16.5% to 15.3%.<sup>117</sup> They were higher for

<sup>116</sup> IMF (2002d), p. 17.

<sup>117</sup> World Bank (2002a), p. 1, and Central Bank of Sri Lanka (2002a), p. 243.

the state banks (rising from 17.0% to 18.7%).<sup>118</sup> In general, the Government does not provide blanket deposit guarantees, but it has guaranteed deposits of one specialized savings bank.

86. The two state banks, Bank of Ceylon and the People's Bank, continue to account for over half of deposits and credit. Their operations have not always reflected commercial criteria; past government intervention, including in management, dividend, credit, and investment policies had directed credit into high-risk state and private enterprises. Both state banks need to be restructured.<sup>119</sup> They were re-capitalized in 1993 and 1996, but needed large capital injections again by 1998. While the Bank of Ceylon's performance has improved, the People's Bank remains technically insolvent (negative net worth).<sup>120</sup> However, restructuring plans to improve long-term viability were announced in 2002 and the government guarantee on certain problem loans was withdrawn in July 2002. The Government intends to sell the People's Bank as a single entity and has formed a Restructuring Committee to examine options.<sup>121</sup>

87. The Monetary Law was amended to strengthen the Central Bank's regulatory role by clarifying its powers to examine company records and to obtain additional information to ascertain compliance with prudential requirements. Bank insolvency provisions were also extended to licensed specialized banks, and "winding up" procedures to liquidate insolvent banks enhanced.<sup>122</sup> Takeovers and mergers are unrestricted but must be approved by the Monetary Board and the Minister of Finance to safeguard prudential requirements.

88. The Central Bank has tightened prudential regulations and introduced stricter compliance based on BIS standards, but they do not yet fully reflect the Basel pre-conditions for effective supervision.<sup>123</sup> These regulations are applied uniformly to local and foreign commercial banks. Prudential requirements for commercial banks were extended to offshore banking units in December 2002. In 2003 the (risk weighted) capital adequacy ratio of commercial and specialized banks was increased from 9% to 10%. The Bank's Supervision Department has issued new directives and regulations in key areas, such as loan classification, provisioning, and single borrowers. It has reviewed bank loan portfolios and insisted on additional provisioning where required. State-directed lending has been phased out; outstanding loans of the two state banks fell from Rs 139.6 billion at end 2001 to Rs 81.1 billion at end June 2003. Financial reporting and disclosure requirements have also been upgraded, along with additional off-site and at least bi-annual on-site inspections. The Central Bank released in June 2002 a voluntary, but strongly recommended, Code of Corporate Governance for banks and other financial institutions, comprising 12 principles to protect the financial system's integrity.<sup>124</sup> Banks are encouraged to obtain credit ratings from Fitch Ratings Lanka Ltd (joint venture of Fitch Inc (USA), the Central Bank, and several other institutions).

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<sup>118</sup> The Government is to establish an Asset Management Company to expedite bank restructuring, loan recoveries, and NPL liquidation; legislation is at the draft stage.

<sup>119</sup> Central Bank of Sri Lanka (2001).

<sup>120</sup> Fitch rated the Bank of Ceylon in 2002 as AA (very high credit quality) for long-term debt.

<sup>121</sup> IMF (2002d), p. 9.

<sup>122</sup> Central Bank of Sri Lanka (2002a), p. 40.

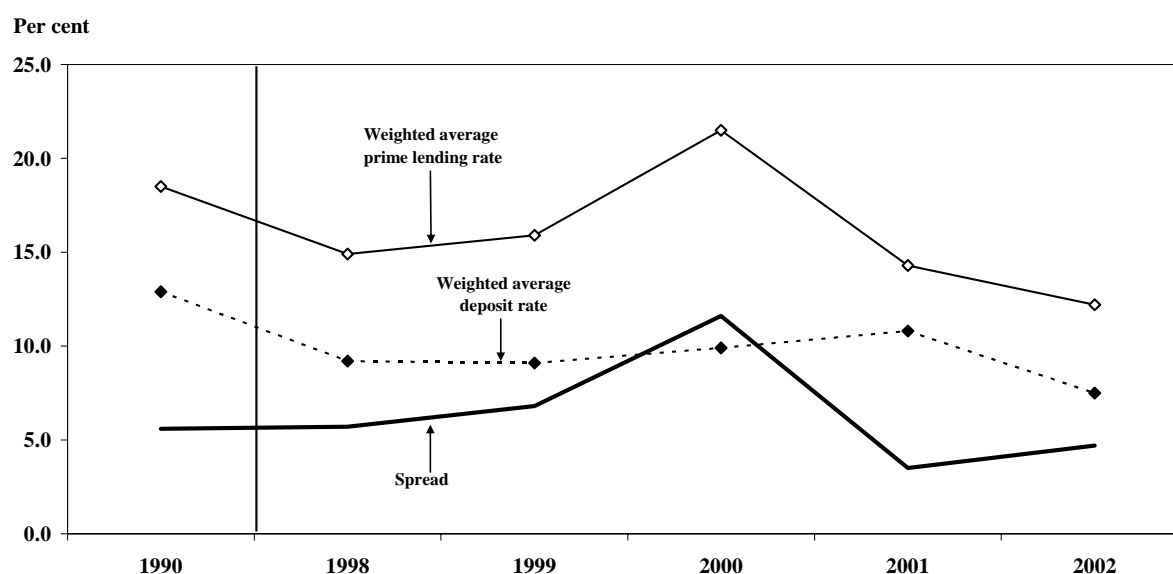
<sup>123</sup> IMF (2002d), p. 17. According to the authorities, the main areas of non-compliance are the principles of consolidation supervision, information sharing, globally consolidated supervision, host country supervision, and supervision over foreign banks' establishments. The Banking Act is to be amended to allow comprehensive risk-based consolidated supervision. The authorities do not currently give priority to compliance with cross-border supervision principles because the presence of foreign banks in Sri Lanka is not very large.

<sup>124</sup> The guidelines cover the board's conduct, including qualification and appointment of directors and senior managers; transparency, such as external audits and financial disclosure; risk management systems, such as monitoring all material business risk; and prudential regulation and supervision.

89. The wide spread between commercial bank lending and deposit interest rates, of some four to eight percentage points, reflects many factors, including high exposure to NPLs, risk premiums on loans with inadequate collateral, high corporate risk, and domestic security concerns.<sup>125</sup> It also indicates banking sector inefficiencies. Spreads have narrowed substantially since peaking in 2000 (Chart IV.3). However, while deposit and lending rates both fell in 2002, the spread widened as lending rates declined more slowly.

**Chart IV.3**

**Interest rate spreads of commercial banks, 1990 and 1998-2002**



Source : Central Bank of Sri Lanka, *Annual Report - 2002, Key Economic Indicators*.

(b) Insurance

90. The insurance sector has been substantially reformed since 1996. The main developments have been: the establishment of a new regulator; the privatization in 2003 of the Sri Lanka Insurance Company (SLIC); and the removal of foreign investment limits in April 2002 (Gazette Notification No. 1232/14 of the Controller of Exchange, Central Bank). The Insurance Board of Sri Lanka (IBSL), staffed by the Secretariat of the Securities and Exchange Commission, has regulated the insurance sector since 1 March 2001 (Regulation of Insurance Industry Act No. 43 of 2000).<sup>126</sup> It must register all insurers, but has limited capacity in insurance regulation, especially reinsurance and on-site inspection.

91. The state no longer has any commercial role in insurance. Its SLIC interests were sold in 2003.<sup>127</sup> The Government's remaining 39% equity in National Insurance Company (NIC) was also sold in 2002. State agencies were no longer required to insure with SLIC after privatization.

<sup>125</sup> Central Bank of Sri Lanka (2002a), p. 239.

<sup>126</sup> IBSL replaced the Controller of Insurance of the Ministry of Finance (Control of Insurance Act of 1962)

<sup>127</sup> Ninety per cent was divested to a domestic consortium (with a Dutch technical partner) for Rs 6.05 billion and the rest given to SLIC employees. The owners must continue to employ all staff, estimated at 3,000, on no worse terms and conditions.

Although declining, SLIC still dominated life and general insurance in 2002 with 32% and 42% of the respective markets. Crop insurance was also liberalized to allow provision by private insurers. In addition, foreign investment restrictions were removed and limits on overseas re-insurance were eased.<sup>128</sup> Entry of insurance companies is unrestricted. Foreign branches must be locally incorporated firms under the Companies Act of 1982.

(c) Capital market

92. The performance of the Colombo Stock Exchange rebounded in 2002 after hostilities ceased. Market capitalization rose to Rs 163 billion in 2002 (Rs 124 billion in 2001), assisted by the return of net inward portfolio foreign investment of Rs 2,443 million (US\$25 million), improved corporate profitability, and the listing of several new companies, including Sri Lanka Telecom. The Securities and Exchange Commission (SEC), which regulates the stock exchange and the securities industry, is formulating a code of best practice for market intermediaries.

93. In November 2000, new stock exchange listing rules replaced merit-based with disclosure-based requirements.<sup>129</sup> These are intended to facilitate company listings and to promote greater disclosure to protect investors. The bond market has expanded and debt instruments diversified, including with longer maturity dates. Dealers of government securities are regulated by the Central Bank; licensed commercial banks have been eligible since February 2002. A secondary securities market exists. Foreign investment requirements were relaxed in the 2000 Budget, and full foreign ownership of licensed stockbroking firms was allowed in March 2000. Unit trusts that invest no more than 20% of their total investment in government securities may also be foreign owned.

94. Regulation of superannuation funds is to be enhanced; the Ministry of Finance has submitted a draft of the Superannuation Benefit Fund Regulatory Bill to the SEC for comments. The Government also intends to establish a Pensions Reform Office to develop the pensions industry, which is dominated by government schemes. A government task force representing all stakeholders has been established to examine possible reforms.

(iii) Telecommunication services

95. Sri Lanka's telecommunications market, especially for mobile services, has expanded (Table IV.4). The number of fixed lines rose from 254,500 in 1996 to 768,620 in 2002, raising the telephone density (number of telephones per 100 persons) from 1.4% to 4.7%. However, the waiting list for a fixed telephone line increased, from 224,411 in 1998 to 306,268 in 2002.<sup>130</sup> Mobile services have grown much faster, from 71,028 subscribers in 1996 to 907,422 in 2002. The number of internet users has also risen greatly (from 4,110 in 1996 to 70,082 in 2002) and there are currently 29 internet service providers. Telecommunications growth has been hampered by regulatory constraints restricting competition, especially the state monopoly on fixed wire services, and resulting high charges and inadequate services that penalize consumers, including businesses.

<sup>128</sup> World Bank (2002b).

<sup>129</sup> Central Bank of Sri Lanka (2002a).

<sup>130</sup> Actual waiting lists are likely to be much higher. These figures are based on registered applications with SLT, and do not therefore include the high number of potential customers who do not bother to apply.

Table IV.4  
Telecommunication services, 1996-02

Service	1996	1997	1998	1999	2000	2001	2002 <sup>a</sup>
<b>Fixed access services (number)</b>							
SLT telephone lines	254,500	315,241	455,598	580,199	653,144	708,200	768,620
New telephone connections	50,170	72,457	143,075	133,709	90,647	77,535	69,258
Applicants on waiting list	270,800	284,876	224,411	236,225	248,486	257,707	306,268
WLL subscribers	527	26,381	67,931	86,914	114,267	121,082	114,488
Telephone density (per 100 persons)	1.39	1.93	2.93	3.70	4.17	4.44	4.65
<b>Other services (number)</b>							
Cellular phones	71,028	114,888	174,202	256,655	430,202	667,662	907,422
Public pay phones	3,002	3,682	4,761	5,799	8,222	7,281	6,681
Radio paging services	10,721	10,829	10,511	10,300	7,009	6,535	5,516
Internet and e-mail	4,110	10,195	18,984	25,535	40,497	61,532	70,082

a Provisional.

Source: Central Bank of Sri Lanka (2002d), *Sri Lanka Socio-Economic Data 2002*; and Central Bank of Sri Lanka (1997) and (2002a), *Annual Report*.

96. The Government took steps to end the monopoly of Sri Lanka Telecom (SLT), until recently majority state owned, over international voice services and wire line operations in August 2002. As part of this liberalization programme, Sri Lanka adopted a new National Communications Policy in 2003, including new interconnection rules (effective 7 March 2003) to provide for mandatory interconnection on an "efficient, non-discriminatory and cost oriented basis". The policy's cornerstone was to provide "effective and fair competition based on non-discriminatory allocation and administration of scarce resources, open licensing, interconnection, equal access, dispute resolution and access to information".<sup>131</sup> The regulatory regime was to be strengthened by granting more independence to the national regulator, the Telecommunications Regulatory Commission (TRC), which was formed in 1996 (Box IV.3). A liberal licensing regime was to be implemented to allow unrestricted competition from new, including foreign, entrants. Pre-determined limits on the number of licences or the types of services offered were to be removed when exclusivity clauses in existing licences expired. Other licence restrictions, such as the limit of four mobile licences and on the number of data communication operators, were also to be lifted. However, very few of these measures had been implemented when the Government indefinitely suspended the policy in August 2003. The current status of the policy is unclear.

97. SLT continues to operate the wire network and is the sole provider of fixed phone services.<sup>132</sup> Despite initial intentions, no new licences have been granted to supply domestic services. SLT's fixed-line competition remains limited to restricted wireless local loop (WLL) services provided by a licensed duopoly.<sup>133</sup> Four licensed operators provide competing mobile services. However, SLT no longer has a monopoly on international call services. There is now no restriction on issuing External Gateway Operator licences; some 30 licences have been issued since August 2002. Licences for fixed and mobile phone services are usually for 20 years, and 10 years for internet providers. The

<sup>131</sup> Ministry of Mass Communication (2002).

<sup>132</sup> Central Bank of Sri Lanka (2002a), p. 126.

<sup>133</sup> The duopoly on wireless local loop (WLL) services (held by Suntel and Lanka Bell) is intended to be discontinued in 2005 when their exclusivity licences, extended for five years in 2000, expire. They were initially licensed in 1996 to provide basic telephony and other services in competition with SLT.

Minister of Mass Communication, based on TRC's recommendations, must license all telecommunication operators.<sup>134</sup>

**Box IV.3: National Communications Policy 2003**

The centrepiece of the new policy was to establish "a liberal licensing regime designed to promote an open market, which would allow the private sector maximum flexibility to develop the sector in response to consumer demand and public needs". Licensing was to be "open, non-discriminatory, transparent and light handed". The number of licences would have been unrestricted, except where scarce resources were involved, such as radio frequencies. According to the policy, traditional licensing and other barriers to market entry were to be "reduced or eliminated to allow market forces and technology to determine the most efficient means of providing services". Public fixed-wire network services were to be encouraged, and new mobile and wireless local loop (WLL) licences issued using available spectrum frequencies. Entry barriers for establishing transmission networks to service wholesale and retail customers were to be removed, and "regulatory burdens" minimized. Licences were to be issued in a competitively neutral manner across licensees in each market segment and "not at unreasonably high fees that may deter market entry or limit operators' ability to invest".

The TRC was to develop and enforce universal service obligations to ensure that all rural consumers had "reasonable and affordable" access to the full range of telecommunication services, including voice telephony, internet, e-mail, and text messaging. A Telecommunications Development Fund (TDF) was to be established to finance universal services. Licensed operators were required to contribute an agreed percentage of the licence fees to the TDF. The TDF was intended to support mainly non-commercial (non-profitable) services, such as extending services in isolated areas. Multi-purpose community telecentres (MCTs) in rural areas were to be used to help meet universal access; the TRC was to ensure that MCTs received access to essential networks at reasonable and affordable charges. Under the suspended policy, all operators were to participate in establishing a National Disaster and Emergency Service telephone system.

TRC's independence and authority was to be enhanced under the new policy, with more transparent operations and procedures, to ensure full autonomy from operators, the Ministry and Government. The Ministry of Mass Communications is currently its Chairman. The TRC was also to be re-named the Communications Regulatory Commission (CRC).

*Source: Ministry of Mass Communication, Proposed National Communications Policy, September 2002.*

98. The suspended policy would require operators to negotiate access conditions subject to TRC approval to ensure that the agreed terms were in the interests of fair market competition. Under these provisions, the TRC is to set interconnection terms, either by mediation or specific rulings, if parties do not agree. Interconnection charges are to be cost oriented. Additional interconnection rules apply to dominant operators declared by the TRC (such as SLT)). They must publish an approved reference interconnection offer within three months of being declared, stating all charges, and technical and other conditions for allowing interconnection.<sup>135</sup>

99. The TRC must approve all tariffs, except for WLL and external gateway services, to protect consumers. Tariffs are generally approved on a cost-plus basis. Tariff re-balancing is aimed at reducing cross-subsidies, such as lowering the relatively high cost to large users and international

<sup>134</sup> The Minister may reject the TRC's recommendation and grant a licence on his own discretion (section 17(2) of the Telecommunications Act).

<sup>135</sup> Any operator may re-negotiate the reference interconnection offer by SLT provided it is TRC approved. Any new offer must conform to the Interconnection Rules and the dominant operators' connection offer; be non-discriminatory against other connectable operators; and not curtail competition (Interconnection Rules of 2003, paragraph 15). A reference interconnection offer must conform to the WTO's Fourth Protocol on Basic Telecommunications, including the Reference Paper (paragraph 14(3)). SLT's offer was submitted to the TRC for approval before the policy was suspended.

callers.<sup>136</sup> The TRC has subsidized the construction and operation of new public payphones in rural areas since February 2002, to help supply universal services; the per unit subsidy was raised recently from Rs 50,000 to Rs 75,000.<sup>137</sup>

100. The Government partially divested ownership in SLT in 1996 by selling 35.2% equity to Japan's Nippon Telephone and Telegraph Corporation (NTT). In November 2002, SLT was listed on the Colombo Stock Exchange and a further 15.3% of the Government's stake divested; this reduced state equity to 49.5%.<sup>138</sup> The initial target was to divest more locally and to sell remaining equity to foreign interests, but these plans were revised due to the relatively low level of domestic and international interest.<sup>139</sup> The Government is currently considering the divestment of a further 8% equity in SLT.

#### (iv) Transport

101. There is a long-standing need for major reforms in public transport.<sup>140</sup> The Ministry of Transport, Highways and Aviation, and the Ministry of Port Development and Shipping are responsible for transport policy and the development of a national integrated transport system. Investment in transport infrastructure has been inadequate. The Government's Bureau of Infrastructure Investment has tried to promote foreign infrastructure investment through build-own-operate (BOO) or build-own-transfer (BOT) arrangements, but with limited success. Tax incentives have also been used to promote foreign investment (Chapter III(3)).

##### (a) Air services

102. The major change in air transport services since the previous Review of Sri Lanka in 1995 has been the Civil Aviation Authority Act No. 34 of 2002, which established the Civil Aviation Authority of Sri Lanka (CAASL) to replace the Department of Civil Aviation as the principal regulatory agency. It commenced operations in December 2002. The CAASL is responsible for preparing a national aviation policy, developing an aviation plan, issuing licences, monitoring commercial air services, and ensuring safety.

103. Sri Lanka has one international airport, Bandaranaike International Airport (BIA), which is being expanded. Airport and Aviation Services (Sri Lanka) Limited (AASL), a fully state-owned monopoly, continues to provide airport and navigation services.<sup>141</sup> It also allocates cargo space, carries out refuelling, and sublets restaurants and shops. There are plans to allow new entrants to provide these services and to privatize AASL. Sri Lanka Airlines (SLA) continues to operate all ground handling services.<sup>142</sup>

104. Approximately 32 airlines (three domestic carriers) were operating in 2002 (27 carriers provided international services in 2001). Following the terrorist attack at BIA in July 2001, several

<sup>136</sup> Central Bank of Sri Lanka (2002a), p. 127. Domestic call charges, for example, increased on average by 15% in May 2002, while international rates were reduced by 8%.

<sup>137</sup> The subsidy is capped at Rs 125 million or 2,500 new payphones (100 payphones per district). The maximum number of subsidized payphones for any single operator is 25 per district.

<sup>138</sup> The Government's share allocation gave preference to domestic retail investors, domestic non-state institutional investors, and foreign investors; state-controlled investment funds and institutions received lowest priority. The allocation of the 12% shareholding was: domestic retail 34%, domestic non-state institutions 23%, state institutions 27%, and foreign investors 16%.

<sup>139</sup> Central Bank of Sri Lanka (2002a), p. 193.

<sup>140</sup> Central Bank of Sri Lanka (2002a), p. 193.

<sup>141</sup> See online information. Available at: <http://www.airport.lk/services.htm> [24 July 2003].

<sup>142</sup> WTO (1996).

major foreign carriers downgraded services and moved their bases from Colombo; some resumed operation in 2002 after the peace initiative.<sup>143</sup> Air passengers at BIA rose by 6% to 2.9 million in 2002 and cargo by 6%. The majority state-owned national carrier, SLA, retained a substantial market share in 2002 (60% of passengers and 44% of cargo).<sup>144</sup> SLA is the only designated Sri Lankan international carrier. SLA's divestment agreement made it the sole Sri Lankan international carrier until March 2008.<sup>145</sup>

105. International carriers operate from Sri Lanka under bilateral air service agreements. New agreements have been signed since 1996 with Cyprus, the Czech Republic, Greece, Iran, Israel, the United States, Yemen and Macau, China; several existing agreements were also renegotiated. Cabotage rights are not allowed, but are not an issue since Sri Lanka has only one international airport. The Sri Lanka/United States Open Skies Air Transport Agreement has, since November 2002, provided for unrestricted capacity and frequencies by respective airlines, including liberalized code sharing and charter arrangements, both for passenger and cargo services.<sup>146</sup>

106. The CAASL has recently removed restrictions preventing domestic operators from providing international charter flights between neighbouring countries.<sup>147</sup> All three domestic operators (Serendib, LionAir and ExpoAviation) have reportedly expressed interest in operating these services. According to the authorities, the only restriction on foreign registered operators providing domestic air services is that 60% of their directors must be Sri Lankan.

(b) Maritime services

107. Port services recovered strongly in 2002, buoyed by the removal of the war risk surcharge in March. This surcharge, imposed by insurance companies in July 2001, along with security fears, led to several major shipping lines diverting operations to neighbouring ports.<sup>148</sup> Ships arriving at Colombo Port rose by 6% in 2002 to 3,787, and container handling increased by 2% (Table IV.5). Total cargo at the three main ports (Colombo, Galle, and Trincomalee) rose by 5% to some 28 million tonnes in 2002. Most cargo passes through the Port of Colombo, which also conducts trans-shipment business. The state entity, Sri Lanka Ports Authority (SLPA), manages these ports (and the port at Kankasanthurai) and is responsible for all cargo handling and harbour development (SLPA Act of 1979). It handles all port services (apart from the Queen Elizabeth Quay at Colombo) and also has a monopoly on providing certain services, such as navigation and pilotage. SLPA is under the Ministry of Port Development and Shipping, which is responsible for maritime policies and regulation. There are no plans to privatize SLPA. The Government plans to establish an independent Port Regulatory Authority by 2005 to safeguard competition and prevent anti-competitive practices, including cross-subsidization and price fixing.

<sup>143</sup> Three private domestic flight services, suspended in 1998 due to security fears, resumed operations in 2002, and several new licences were issued (Central Bank of Sri Lanka, 2002a).

<sup>144</sup> Central Bank of Sri Lanka (2002a).

<sup>145</sup> SLA was partially divested in 1999 and 2001, and is currently 51.05% state-owned. According to the authorities, Emirates Airline owns 43.63% and SLA employees 5.32%. This information is inconsistent with data in Table AIII.5, which is based on the PERC website.

<sup>146</sup> See online information. Available at: <http://www.slaito.com/aboutus.htm> [24 July 2003].

<sup>147</sup> *Daily News*, "Local airlines allowed charter flights", 15 October 2003, p.1.

<sup>148</sup> The rate was 0.75% of one quarter of the value of the ship and cargo.



Table IV.5  
Shipping services, 1997-02

Service	1997	1998	1999	2000	2001	2002 <sup>a</sup>
Vessels arrived (number)	4,087	4,233	4,339	4,232	4,014	4,062
Colombo	3,627	3,879	3,968	3,832	3,570	3,787
SLPA	-	-	-	3,090	2,824	2,942
SAGT <sup>b</sup>	-	-	-	742	746	845
Galle	56	104	97	97	117	76
Trincomalee	404	250	274	303	327	199
Total cargo ('000 tonnes)	26,832	26,847	26,995	27,535	27,062	28,313
Colombo	25,117	24,793	24,825	25,222	24,741	26,273
SLPA	-	-	-	21,986	21,207	20,298
SAGT <sup>b</sup>	-	-	-	3,236	3,534	5,975
Galle	182	402	439	597	662	526
Trincomalee	1,533	1,652	1,731	1,718	1,659	1,514
Container traffic ('000 TEUs)	1,687	1,714	1,704	1,733	1,727	1,765
SLPA	-	-	1,636	1,432	1,397	1,207
SAGT <sup>b</sup>	-	-	68	301	330	558
Trans-shipment containers ('000 TEUs)						
SLPA	-	-	1,108	959	959	848
SAGT <sup>b</sup>	-	-	45	222	236	370
Employment (SLPA)(number)	19,033	18,777	18,930	19,344	18,561	17,910
Colombo	17,101	16,964	17,075	17,411	16,744	16,157
Galle	831	769	777	758	737	752
Trincomalee	1,101	1,044	1,078	1,175	1,080	1,001

a Provisional.

b South Asia Gateway Terminal Ltd (SAGT) commenced cargo handling on 5 September 1999.

Note: TEUs = twenty-foot equivalent container units.

Source: Central Bank of Sri Lanka (2002a), *Annual Report 2002*, Table 35.

108. Productivity at the Port of Colombo increased substantially in 2002; net gantry moves per hour rose by 44%. This largely reflected improved performance by SAGT (Private) Ltd, a private company, which was granted a 30-year BOT concession in 1998 to operate Queen Elizabeth Quay and the South Asian Gateway Terminal (SAGT).<sup>149</sup> In 2002, container throughput rose by 69% and trans-shipments by 57%. SAGT's share of cargo also increased in 2002 from 14% to 23%. Reorganization of the terminals managed by SLPA has also added to productivity. The Jaye Container Terminal (JCT) was corporatized in 2002 and many shipping lines have signed Terminal Service Agreements to use it. However, SLPA's gross profitability declined and operating expenses rose by 6% in 2002.<sup>150</sup>

109. Government policy, as outlined in the 1997 National Policy Statement on Ports and Shipping, is being revised and will be re-issued shortly. There have been no major policy or legislative changes in shipping since 1996. Long-standing government policy is to liberalize port operations and encourage private participation by implementing a landlord port concept to complement BOO/BOT operations. SLPA would provide the port structure (fairways, sites, roads, and quays) while super-

<sup>149</sup> SAGT equity is 41.25% Sri Lankan owned, including 15% owned by SLPA.

<sup>150</sup> A productivity-based Target Bonus System replaced the "speed money" system and a new voluntary retirement scheme allowed shedding of almost 3,000 redundant staff in 2002. However, SLPA's staff of 18,000 at end 2002 was still double the optimal levels (Central Bank of Sri Lanka, 2002a, p. 136). The target is to further lower current staff levels from 14,000 to 8,000 within two years.

structures (cranes, warehouses, etc.) and stevedoring services would be owned and operated by private contractors. However, few reforms have occurred since SAGT was contracted.<sup>151</sup> The Government abolished plans to privatize the JCT in early 2001, due mainly to labour union resistance.

110. The priority is to expand Colombo port to become a regional hub. Existing capacity is expected to be insufficient by 2005 and Hambantota is being considered as a possible long-term replacement. Galle is to be developed as a multi-purpose port to help meet regional, including coastal, shipping requirements. Trincomalee is thought to have potential as a port for commercial shipping and cargo handling, ship repair/building, and cruise and marina activities.

111. Sri Lanka has a national fleet of two vessels operated by the state-owned national carrier, Ceylon Shipping Corporation (CSC). CSC must carry all government import cargo provided it is the cheapest alternative. This requirement is to be removed at the end of 2003. Government policy is to strengthen its operations, including involvement in foreign joint ventures. Several private companies own and operate small fleets under the Sri Lankan flag, including Mercantile Shipping (a joint-venture company with German participation). Coastal shipping is reserved for Sri Lankan flagged vessels; offshore companies and BOI firms can register their vessels as Sri Lankan flagged vessels. International shipping lines handle virtually all of Sri Lanka's overseas shipping. According to authorities, no "exceptional" requirements are imposed on ships using Sri Lankan ports.

112. The Government is liberalizing the provision of bunker oil to international ships. The state-owned Lanka Marine Services was privatized in 2001 (Section (3)(ii) above). The Government is also developing private investment in ship chandelling and offshore supplies, which are open to the private sector. The Colombo Dockyard Limited (CDL), 51% foreign owned, conducts ship repair and ship building activities. There are no government subsidies to ship building or repair. According to authorities, the only foreign investment restriction in shipping is the foreign equity limit of 60% for shipping agencies.

(c) Land services

113. Road and rail transport are important modes of transport both for cargo and passengers. The state monopolist Sri Lanka Railways (SLR) operates about 1,500 kilometres of track; it serviced some 4 billion passenger kilometres (106 million passengers) and 131 million freight tonne kilometres in 2002. Rail accounts for about 6% of passenger and 4% of freight transportation in Sri Lanka. Freight operations expanded in 2002.

*Road*

114. The Road Development Authority develops and maintains national highways. Road development continues to be hampered by financial constraints and land acquisition problems. A Road Fund was established in 2002 to finance road maintenance, funded by a special vehicle levy. The Government wishes to increase private-sector funding in road construction.<sup>152</sup>

<sup>151</sup> The Government completed feasibility studies in 2002 on two major development projects; the US\$1 billion Colombo South Harbour Expansion Project, designed to accommodate post-Panamax vessels involved in trans-shipment traffic, and the Hambantota Port Development Project. The private sector is to fund the South Harbour expansion, as a public-private partnership involving BOT concessions similar to SAGT.

<sup>152</sup> It is concurrently considering a private proposal to finance the Rs 11 billion construction of the Colombo-Katunayake Expressway that started in 2000. It has also invited expressions of interest from the private sector to construct the Colombo-Kandy alternative highway on a BOO/BOT basis.

115. Passenger bus services are provided by private operators and state-owned regional transport companies (RTCs, also called cluster bus companies) under the Central Transport Board. RTC services account for about one third of the commuter bus market. RTCs are poorly managed and over-staffed (over 40,000 staff for 5,000 operating buses). Their operating losses rose by 55% in 2001, but fell by 9% in 2002, to Rs 2.2 billion. Government subsidies to RTCs totalled Rs 1.2 billion in 2002.<sup>153</sup> Private bus operators are disadvantaged by small operations and low government-set fares. A new bus-fare policy for private and public operators, adopted in 2002, replaced the ad hoc fare revisions with annual reviews using an improved cost-based pricing formula.<sup>154</sup> However, the Government directed RTCs not to adopt the 15% fare increase recommended by the National Transport Commission (NTC), the national transport regulator, from July 2002. The regulatory regime for bus transport remains fragmented with overlapping responsibilities vested in provincial Councils and the NTC (National Transport Commission Act No. 37 of 1991).

116. The Government is establishing private-public partnership arrangements (PPPA) in RTCs to improve efficiency. In 2002, the Public Enterprises Reform Commission (PERC) invited investors to acquire 39% equity in and to manage RTCs. They are expected to inject extra funds through government-guaranteed debt financing, maintain existing employees on no worse terms and conditions, and provide public services under government supervision, all in return for state subsidies.<sup>155</sup> As a result of low interest in RTCs, divestment was postponed. Six RTCs were to have been divested to a private consortium in 2003. However, following court action, Cabinet withdrew this award and the PERC is calling for new tenders for all 13 RTCs.

117. Independent truckers dominate road transport. According to the authorities, there are no restrictions on road transportation, and freight rates are set by market forces.

### *Rail*

118. Terrorist activities badly affected rail operations, and restoring these services is a high priority. Major sections of track are being reconstructed, such as the Northern and Eastern railway lines, at an estimated cost of Rs 8 billion.

119. Passenger rail services have deteriorated due mainly to financial constraints, aggravated by overstaffing, low charges, and operational as well as managerial deficiencies in Sri Lanka Railways (SLR).<sup>156</sup> Its losses totalled Rs 2.8 billion in 2002 (one quarter of all state transfers to public entities). Passenger fares have not changed since 1996; freight rates were raised by 50-250% from September 2001. The Government wishes to improve SLR's management and operational efficiency through private sector participation, but is yet to announce clear policies. A broad-based restructuring programme is needed involving private-sector partnership and a self-financing mechanism to avoid excessive budgetary pressures.<sup>157</sup>

<sup>153</sup> Rs 225 million was also paid to subsidize bus travel by school children and Rs 300 million to fund bus services on uneconomic rural routes.

<sup>154</sup> Cost components of the formula are fuel (27%), crew (22%), repairs (12%), service, lubricants, tyres, and tubes (11%), depreciation (10%), finance costs and risk (10%) and overheads (8%). Interim fare increases are possible when diesel prices rise rapidly.

<sup>155</sup> Government guarantees are limited to 30% of the investor's purchased equity.

<sup>156</sup> Central Bank of Sri Lanka (2002a), p. 133.

<sup>157</sup> Central Bank of Sri Lanka (2002a), p. 135.

**(v) Tourism**

120. Tourism was Sri Lanka's third largest foreign exchange earner in 2002, and directly accounted for some 3% of GDP (9% including indirect contribution).<sup>158</sup> Following the peace initiatives, the sector is recovering. After declining sharply by 15.9% in 2001, tourist arrivals rose by 16.7% in 2002 to 393,171, with substantial growth (over 100%) since mid-year (Table IV.6). Gross earnings expanded by 24.6% in 2002 to Rs 23.7 billion (US\$248 million). Room occupancy rates remained low, at 43.1%, but had increased from 2001. Total tourism employment rose by 8.3% to 87,600. Tourism has strong linkages with the economy, generating significant indirect employment (51,100 in 2002) and growth, especially outside Colombo.

**Table IV.6**  
**Tourism statistics, 1996-02**

Indicator	1996	1997	1998	1999	2000	2001 <sup>a</sup>	2002 <sup>b</sup>	Percentage change	
								2001	2002
Tourist arrival	302,265	366,165	381,063	436,440	400,414	336,794	393,171	-15.9	16.7
Tourist guest nights ('000)	2,947	3,680	3,944	4,479	4,056	3,342	3,989	-17.6	19.4
Room occupancy rate (%)	40.3	49.1	52.8	57.6	52.3	42.1	43.1	-19.5	2.4
Gross tourist receipts (Rs million)	9,195	12,316	14,873	19,288	19,095	19,034	23,724	-0.3	24.6
Per capita tourist receipts (Rs)	30,420	33,635	39,030	44,194	47,688	56,515	60,340	18.5	6.8
Total employment	76,711	81,614	83,427	87,744	91,063	80,904	87,600	-11.2	8.3
Direct <sup>c</sup>	31,963	34,006	34,780	36,560	37,943	33,710	36,500	-11.2	8.3
Indirect <sup>d</sup>	44,748	47,608	48,692	51,184	53,120	47,194	51,100	-11.2	8.3

a Revised.

b Provisional.

c Direct employment is employment in hotels and restaurants, travel agencies, tour operators, airlines, agencies providing recreational facilities, and tourist shops.

d Indirect employment are domestic producers and suppliers of inputs, and manufacturers and suppliers of handicraft.

Source: Central Bank of Sri Lanka, Annual Report, various issues.

121. The composition of tourists has changed. While about half still originate in Western Europe, especially France, Germany, and the UK, Asian arrivals have increased. In 2002, most tourists came from India. Tourism diversification covering markets like China, Japan, and Singapore through joint public/private promotion is a key government objective. The Chinese Government recently accepted Sri Lanka as an official tourist destination. Sri Lanka also promotes tourism through bilateral and regional cooperation. "Visa on arrival" was introduced for tourists from South Asian Association for Regional Cooperation (SAARC) partners in January 2003.

122. Factors constraining the sector's development include: insufficient international air services; lack of adequate internal transport, especially roads, and other basic infrastructure, including telecommunications, water and electricity; a shortage of skilled human resources; and concentration of tourism in a few specific areas with associated environmental degradation, such as beach erosion and seawater pollution.<sup>159</sup> Availability of international air services to Sri Lanka is a major

<sup>158</sup> Direct contribution covers hotels and restaurants, travel agencies, tour operators, airlines, agencies providing recreational facilities and tourist shops. Indirect contribution is that of domestic producers and suppliers of inputs.

<sup>159</sup> The Department of Wildlife Conservation provides permits for the development of tourism projects to ensure environmental protection.

constraint.<sup>160</sup> The terrorist attacks limited the country's air access by reducing the total capacity of Sri Lankan Airlines. Insurance premiums for landing at the BIA increased by over 100%, and made airline operation difficult. The number of charter companies operating in 2002 fell from nine to four (Aeroflot, Edelweiss Air, CSA Czech Airlines, and Transavia Airlines). However, seven new bilateral air service agreements in 2002 have improved flight access to Sri Lanka, and new scheduled airlines began services (section iv(a)). The availability of qualified tourism labour is a high government priority; it established the Sirimavo Bandaranaike Institute of Tourism and Hotel Management in August 2000 to train tourism personnel.

123. Tourism was declared a government priority, or "thrust" industry for rapid development in 1999; this seems to have been the main policy change in the sector since 1995. The Ministry of Tourism sets tourism policy, as enunciated in the Tourism Master Plan 2002-04. The policy is for the private sector to develop tourism with the Government playing a facilitating role. The state-owned Sri Lanka (Ceylon) Tourist Board (CTB) works with the Ministry to regulate the industry, implement policy and promote tourism.<sup>161</sup> CTB also helps the private sector to promote tourism.<sup>162</sup> In 2003, a tourism embarkation levy of US\$5 per arriving air passenger was introduced and a 1% turnover levy applied to all CTB approved establishments, to fund overseas marketing and promotion.<sup>163</sup> CTB approves hotel projects and tourist guides; guides must pass accredited courses. Foreigners may become guides subject to the same testing and course requirements. All hotel projects must undergo an environmental impact assessment study by the Central Environmental Authority.<sup>164</sup>

124. The Ceylon Hotels Corporation (CHC), established in 1966 to provide tourist accommodation, is 28.57% state owned and is being restructured.

125. The BOI supports tourism with tax incentives (Chapter III(3)). Tourism on the east coast, which was closed in 1987 for security reasons, re-opened in 2002. The Government has established a concessional loan facility of up to Rs 50 million to help hotels in the Trincomalee district to refurbish.

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<sup>160</sup> A serious bottleneck in available airline seats developed in 2002, especially from major European markets (Central Bank of Sri Lanka, 2002a, pp. 22 and 223).

<sup>161</sup> Ceylon Tourist Board Act No. 10 of 1966.

<sup>162</sup> The CTB launched a major tourism promotion and marketing campaign in 2000 aimed at raising tourist numbers to one million by 2010, based on developing niche markets such as eco-tourism, culture tourism, incentive travel, adventure tourism, conventions, and exhibitions.

<sup>163</sup> Tourism promotion is to be transferred from CTB to the Tourist Promotional Bureau, to be established in 2004. The CTB would be restructured, and a Tourist Development Council formed for tourism planning and regulation.

<sup>164</sup> UNESCAP (2001).

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