

**‘AN ACT OF FAITH’?**  
**TEN YEARS OF THE INDIA-SRI**  
**LANKA FREE TRADE AGREEMENT**  
**(ISLFTA)**

**LAW & SOCIETY TRUST**

**SRI LANKA**

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## **ABBREVIATIONS AND ACRONYMS**

AOA	Agreement on Agriculture of the World Trade Organisation
BOI	Board of Investment
CEPA	Comprehensive Economic Partnership Agreement (CEPA)
DOC	Department of Commerce
DVA	Domestic Value Addition
FAO	Food and Agriculture Organisation
FOB	Free on Board
GLOPES	Global Political and Economic Structures
HS	Harmonised Commodity Description and Coding System
ISLFTA	India-Sri Lanka Free Trade Agreement
LST	Law & Society Trust
LTTE	Liberation Tigers of Tamil Eelam
NAMA	Non-Agricultural Market Access Agreement of the World Trade Organisation
OUSL	Open University of Sri Lanka
ROO	Rules of Origin
SAARC	South Asia Association for Regional Cooperation
SAPTA	South Asia Preferential Trade Arrangement
WTO	World Trade Organisation

# **‘AN ACT OF FAITH’? TEN YEARS OF THE INDIA-SRI LANKA FREE TRADE AGREEMENT (ISLFTA)**

**LAW & SOCIETY TRUST<sup>1</sup>**

*“The signing of Free Trade Agreement between us was an act of faith in our joint economic potential”  
(Pranab Mukherjee, Indian Finance Minister, Colombo, 2009).*

## **INTRODUCTION**

The India-Sri Lanka Free Trade Agreement (ISLFTA) was signed in 1998 and became effective in March 2000. After almost ten years of operation, the Law & Society Trust (LST) undertook an evaluation of the ISLFTA over the course of 2009; made more urgent and relevant in view of the strong lobby on both sides of the Palk Straits for its expansion and deepening into a Comprehensive Economic Partnership Agreement (CEPA).

## **METHODOLOGY**

As detailed in the findings, difficulties in accessing reliable data and lack of awareness about ISLFTA among the general public make it extremely difficult to evaluate its consequences through field research among producers and consumers at community-level as initially envisaged in this study. The general lack of information on the ISLFTA was evident when consultations in the early stage of research with a wide range of stakeholders – to gather hard evidence on its beneficial or detrimental impacts – yielded few results. This experience highlights important and interesting aspects of the non-transparency of policy-making processes in Sri Lanka. Therefore this research paper is based on the limited literature available on the ISLFTA and a series of face-to-face and over-the-telephone interviews as well as periodic round-table consultations with stakeholder representatives. The initial

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<sup>1</sup> The lead-researcher and writer was Mr. Dileepa Witharana, Senior Lecturer in the Faculty of Engineering Technology at the Open University of Sri Lanka (OUSL) in Nawala; Ms. Anushaya Collure was the primary investigator and the report was edited by Mr. B. Skanthakumar (both of the Economic, Social and Cultural Rights programme at the Law & Society Trust in Colombo). Ms. Harini Amarasuriya’s contribution in the conceptualisation of this study is also recorded with appreciation. The Law & Society Trust (LST) gratefully acknowledges the grant in support of research received from Diakonia (Sweden) under its global political and economic structures (GLOPES) theme, and the interest and encouragement of Ms. Ankin Ljungman and Mr. Frank Stephen in particular. The opinions expressed here do not necessarily reflect those of Diakonia, nor of any individual or institution interviewed in this study.

findings were circulated to several stakeholder representatives in November 2009, and the comments received were helpful in the revision and finalisation of this report.

## **INDIA-SRI LANKA FREE TRADE AGREEMENT**

The World Trade Organisation (WTO) that was established in 1995 introduced rules for international trade and all local measures affecting such trade. These rules are valid for multilateral trade as well as bilateral and regional trade conducted among the member countries. The WTO, in fact, does not endorse regional or bilateral trade agreements among countries unless they allow “substantial” levels of trade liberalisation over “reasonable” periods of times that go well beyond the commitments of trade liberalisation made by countries at the WTO. The ‘free trade’ approach requires countries to give up various measures they use to safeguard interests of the local farmers and industrialists, convert all such measures to an imposable duty and then reduce that imposable duty to zero over a period of time. Therefore the WTO allows bilateral and regional trade agreements only if these agreements result in accelerating the process of duty elimination.

The ISLFTA<sup>2</sup> which follows the trade liberalisation rules set by the WTO is considered to be a relatively strong agreement in the Asia-Pacific region with substantial product coverage (about 80 percent of tariff lines coming under the HS<sup>3</sup> product classification code at 6 digit level), significant tariff cuts and relatively simple Rules of Origin<sup>4</sup> (Abeyasinghe 2007). Consequent to the economic sanctions imposed following nuclear tests in 1998, it was India that was keen to sign this agreement to counter its short-lived international isolation. From Sri Lanka’s perspective, political and economic objectives such as: reducing prevailing political tensions between the two countries; India’s support on the North-East conflict; attracting foreign direct investment from third countries through gaining an effective position in the Indian market; strengthening trade relations with South Asia’s leading economic power; promoting the transformation of local exports from low value added to high value added goods; and supplying low-income groups with cheap consumer goods from India, appear to have been significant considerations (Kelegama and Mukherji 2007: 2).

Both countries were in agreement that the ISLFTA should offer more than that offered in the SAARC Preferential Trading Arrangement (SAPTA) signed in 1995. Though bilateral trade agreements in general are formulated using the ‘positive list’ approach, ISLFTA was formulated on the ‘negative list’ approach to expedite the negotiations. A timetable to streamline the free trade process was also adopted (Kelegama and Mukherji 2007: 3). Application of a ‘negative list’ is convenient when the product coverage of a trade agreement is substantial. While the ‘positive list’

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<sup>2</sup> Department of Commerce, Sri Lanka, [http://www.doc.gov.lk/web/indusrilanka\\_agreement.php](http://www.doc.gov.lk/web/indusrilanka_agreement.php) and Department of Commerce, India, <http://commerce.nic.in/ilfta.htm>.

<sup>3</sup> The Harmonised Commodity Description and Coding System is an international commodity classification system developed by the World Customs Organisation in Brussels.

<sup>4</sup> Criterion by which the product’s origins are determined as goods may be processed, assembled, packaged or finished in more than one country or shipped via a third country.

identifies the list of products offered to be freely traded by removing tariff barriers, the 'negative list' identifies the products that are to be protected. By placing sensitive products on a no-concessions list, it allowed tariff protection for identified products subject to review at a later date.

Concerning the asymmetry between the economies of the two countries, Sri Lanka was to have special and differential treatment with regard to the conditions of the Agreement. Accordingly, Sri Lanka had a larger negative list, which identifies local products that are to be protected and on which the concessions are not given. It enumerated 1 180 items (or tariff lines) which are mainly agriculture or livestock items, rubber products, paper products, iron and steel, machinery and electrical items. India's negative list contained 429 tariff lines that include garments, plastic and rubber products among other items. Sri Lanka was given a longer period – eight years – for the phasing out of tariffs and also was accorded the liberty to reduce its negative list at her comfort level. Therefore, on the Sri Lankan side 3 932 tariff lines were made zero duty for Indian exporters over eight years. On the other hand, India's 4 150 tariff lines were made zero duty over a period of three years. Under the ISLFTA, India and Sri Lanka by 2009 offer duty free access to 4 233 and 4 024 tariff lines respectively (Department of Commerce website 2009).<sup>5</sup>

In addition, flexible criteria for Rules of Origin (ROO) were accepted for Sri Lanka, as the exclusion of a product from the negative list is not the only criterion on which it receives duty concessions. In order to receive ISLFTA duty-free benefits, a product needs to comply with ROO criteria that specify a minimum local content. Wholly obtained products (produced solely from the material of either Sri Lanka or India) such as tea, fish, spices etc., will be allowed duty-free benefits provided that those products are not on the negative lists of the respective countries. Products which are not wholly obtained or produced have to comply with the Domestic Value Addition (DVA) rule of having not less than 35 percent of the Free on Board (FOB)<sup>6</sup> value of the finished product. Further, if the raw materials needed for a product are obtained from each other, then an exporter has to show a DVA of 25 percent of the finished product. However, when quotas are offered for products that are not covered by the negative list things get further complicated. Products that are traded above the quota limits may still not come under the ISLFTA even if the products do qualify under the Rules of Origin stipulated by the ISLFTA. At the same time Sri Lanka retained import duties imposed on high duty imports such as automobiles.

By 2008, the ISLFTA entered into full force. Both governments are pleased with the results achieved through the Free Trade Agreement and proclaim that it has facilitated the expansion of two-way trade between India and Sri Lanka. India, which was once the second largest exporter to Sri Lanka pre-ISLFTA, has now become the island's largest source of imports. Meanwhile India has become the third largest export destination for Sri Lankan products (after the United States of

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<sup>5</sup> Department of Commerce (<http://www.doc.gov.lk/web/index.php>). Last accessed on 13 September 2009.

<sup>6</sup> Goods are shipped on either Free on Board (FOB) terms or Cost, Insurance, Freight (CIF) terms. FOB means that the cost of freight and insurance has not been added by the exporter. The CIF value is the landing value of a good, with insurance and freight already added on to the cost.

America and the European Union). The argument is that, given the asymmetrical proportions of the economies of the two countries, if not for the ISLFTA, Sri Lankan exports would not have been able to achieve their current level of market penetration. The bilateral import-export ratio that had been 10.3:1 in 2000 had improved in Sri Lanka's favour to 5.3:1 by 2007. According to the then Indian High Commissioner to Colombo, the ratio may have been as skewed as 40:1 (in India's advantage, of course) had the ISLFTA not been in operation (Prasad 2009).

Over the ten years in which the ISLFTA has been in operation, Indian foreign direct investment in Sri Lanka has also expanded exponentially, most recently in telecommunications (Bharti Airtel) and glass-manufacturing (Piramal Glass), and biscuits and sweets (Britannia). In 2009, India was the island's third largest foreign investor (after China and the United Kingdom) with inflows of US\$78 million and largely attracted to the telecommunications, energy and power sectors (Central Bank of Sri Lanka 2010: 114). The Institute of Policy Studies (2008: 47-48) has estimated that Indian foreign direct investment has expanded from a cumulative total of LKR165 million in 1998 (1.3 percent of total FDI) to LKR19.5 billion in 2005 (8.3 percent of total FDI). However, the causal connection between the commencement of the ISLFTA and the spiral in inward foreign direct investment from India is asserted rather than demonstrated, and may have more to do with aggressive Indian investment strategies since that country's economic boom, than the existence of the Free Trade Agreement.

## **COMPREHENSIVE ECONOMIC PARTNERSHIP AGREEMENT**

No sooner was the ISLFTA operational, than both governments began drawing plans to convert the Free Trade Agreement into a Comprehensive Economic Partnership Agreement (CEPA). India has pronounced through its Finance Minister that "CEPA can only be a win-win situation for both India and Sri Lanka"; and that common economic prosperity will "fortify peace, security and development in the region" (Mukherjee 2009). Therefore, with the aim of attaining the objectives such as deepening of existing trade integration through reductions in the 'negative list', and the expansion of trade integration with the inclusion of the liberalisation of trade in services as well as the liberalisation of investment, a Joint Study Group was created in 2003 to pursue the conversion of ISLFTA to the Comprehensive Economic Partnership Agreement (CEPA). Their report was released in October 2003. Newly elected governments in both India and Sri Lanka affirmed their support for CEPA in 2004. In 2005 there were five rounds of negotiations on services, financial markets, trade facilitation, economic cooperation and investment (Kelegama 2006: 299). However, trade-related disputes arising from ISLFTA adversely affected the negotiation process of CEPA (Lanka Business Online 2006).

Indian business interests protested that the ISLFTA was being abused. Kelegama (2006: 297) observes that, "about half of the increase in Sri Lankan exports to India—from one per cent to seven per cent of overall exports—was the result of trade diversion, not trade creation". Palm oil was imported duty-free into Sri Lanka by Indian-owned enterprises, processed into *vanaspati* (a vegetable oil substitute for ghee) and exported duty-free into India as a Sri Lankan product, thereby

avoiding an 80 percent duty on direct imports. Likewise, copper products were also imported into Sri Lanka, smelted into copper ore by Indian-owned enterprises, and exported to India taking advantage of the ISLFTA. Another anomaly was the enormous growth in the volume of pepper exports to India which was unsupported by any comparable level of growth in domestic pepper production. Indian businesses charged that pepper and cloves were being imported from South-East-Asia into Sri Lanka, mixed with locally grown pepper and cloves and exported as wholly Sri Lankan product into India, again exploiting duty-free concessions.

Following the *vanaspathi* controversy in 2006, negotiations only resumed again after 2007. Both governments appearing to be optimistic that the trade disputes that arose through abuse of the ISLFTA could be ironed out in the negotiations for an expanded agreement on trade in services. Sri Lanka identified 75 items to be removed from the negative list. India agreed to consider 118 items. At Sri Lanka's request India also has agreed to ease rules of origin criteria for 346 items such as apparel items, jewellery, furniture, machinery and electrical and other appliances; to inclusion of Mode 4 (movement of natural persons) in liberalisation of services; at the same time elimination of non-tariff barriers were to be explored. India also has agreed to strengthen economic cooperation in the areas preferred and chosen by Sri Lanka such as energy, manufacturing, services, transport and infrastructure, science and technology, human resource development, and small and medium enterprises.

In July 2008 both governments declared the Comprehensive Economic Partnership Agreement to be "fully negotiated and ready for signature" (Prasad 2009). The South Asian Association for Regional Cooperation (SAARC) summit in Colombo that month, hosted by Sri Lanka in its capacity as Chair of the regional grouping, was to provide the occasion and venue. However, vigorous opposition from a section of the Sri Lankan business community with close ties to government, as well as several political parties of Sinhala nationalist ideology within or supportive of the government, scuttled these plans.

The opposition stems from the lack of transparency in the negotiation and the drafting process of CEPA, and doubts and anxieties of a section of the local business community with regard to the costs of the proposed Agreement given the asymmetrical economies of the two countries, as well as their belief that it would open the floodgates to the entry of Indian professionals and service-sector firms into Sri Lanka. The advocates of CEPA counter that these fears are unfounded (De Mel 2009). CEPA will accord special and differential treatment to Sri Lanka in recognition of its economic weakness relative to India. Sri Lanka will be able to determine which services sectors it chooses to liberalise. Finally, Indian labour will only be able to enter Sri Lanka on a temporary or contract basis and subject to the work-permit regime. The difficulty is that the text of CEPA has never been disclosed to the public. Individuals involved in its negotiation have discussed purported provisions in the draft agreement, which are also published on the website of the Indian High Commission in

Colombo<sup>7</sup>, but regrettably not on that of any Sri Lankan state agency. However, in the absence of a public official document there is no way of objectively assessing the claims and counter-claims.

One of the key findings of this report is that lessons from the operation of the India-Sri Lanka Free Trade Agreement have yet to be drawn, in the haste towards its expansion and transformation into a wide-ranging Comprehensive Economic Partnership Agreement that will have consequences in sectors and among communities thus far unaffected by the current Free Trade Agreement. Therefore the section below isolates certain issues that illustrate the shaky empirical foundations on which positive claims are made for the ISLFTA. These issues are framed to generate discussion and for further investigation.

## **POVERTY OF TRADE STATISTICS**

Although now into its tenth year of operation, the assessment of impacts of the ISLFTA is not an easy or a straightforward task. The first hurdle is the non-availability of data of critical importance to the general public, and the unreliability of trade statistics that are publicly available. There are at least four sets of problems here: (1) the unreliability of trade statistics; (2) the partial or selective provision of information on trade; (3) the non-analysis of trade statistics; and (4) the unavailability of credible data on employment generated and lost as a direct and indirect result of the ISLFTA.

### *1. The Unreliability of Trade Statistics*

It is important to observe from the outset, that in the course of consultations on the ISLFTA, we were repeatedly warned by some trade experts of the possibility of arriving at wrong conclusions if currently available data is used for analysis. This warning was made on the basis of the common approach of many, especially enthusiasts for the ISLFTA, which is to conflate the volume of trade between Indian and Sri Lanka in general with the trade that is attributable solely to the operation of the Free Trade Agreement. As described above, the negative lists, conditions of Rules of Origin and concessions offered on the basis of quotas, allow only a percentage of overall trade between the two countries to come under the ISLFTA. Therefore, bilateral trade between India and Sri Lanka cannot be reduced to the ISLFTA.

The Department of Commerce itself (DoC), the institution officially responsible for the ISLFTA, seems to reinforce this methodological mistake when it does not provide disaggregated and reliable trade statistics for ISLFTA on its web-portal.<sup>8</sup> For example some of the items – subcategories of

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<sup>7</sup> “Facts about Comprehensive Economic Partnership Agreement (CEPA) between India and Sri Lanka”, [http://www.hcicolombo.org/ecserv\\_economic\\_partnership.cfm](http://www.hcicolombo.org/ecserv_economic_partnership.cfm). Last accessed on 31 March 2010.

<sup>8</sup> Department of Commerce, Sri Lanka “Indo-Sri Lanka Free Trade Agreement (ISFTA): Introduction”, [http://www.doc.gov.lk/web/indusrilanka\\_freetrade\\_introduction.php](http://www.doc.gov.lk/web/indusrilanka_freetrade_introduction.php). The initial findings of this report were shared with the Department of Commerce (DoC) among other institutions and individuals on 06 November 2009, and comments invited although none were received from the DoC.

which come under the Indian negative list and hence not traded under the ISLFTA – are displayed under “major items, which recorded export growth”. Thus, “rubber and articles thereof” (HS Code 40), “articles of paper pulp, paper and paper board” (HS Code 48) and “articles of apparel” (HS Code 61-62), all of which belong to the category above, still occupy 3<sup>rd</sup>, 13<sup>th</sup> and 19<sup>th</sup> place in the list of “major items, which recorded export growth” in 2007. The website also does not provide reasons for the appearance of “articles of apparel and clothing accessories” (HS Code 392620) in the list of “export items, which recorded export decrease” which also appears as an item in the Indian negative list (Department of Commerce website 2009).<sup>9</sup>

The Rules of Origin (ROO), however, is the most serious challenge to the accuracy of data provided on the ISLFTA. As described above any item traded has to fulfil the ROO for the item to receive duty concessions and hence to fall under the ISLFTA. Surprisingly trade statistics (e. g. export volume and export earnings) of items presented by the DoC in reference to the ISLFTA is similar to the overall trade statistics of the same items presented under the general trade between India and Sri Lanka. This leads us to arrive at two conclusions: either all items exported have satisfied the criteria of ROO or the figures provided under the ISLFTA are not accurate and do not incorporate ROO. However, considering the controversies involved with value addition, which led India to introduce quotas for some Sri Lankan exports, it is not logical to arrive at the first conclusion and to assume that all Sri Lankan products now satisfy the condition of ROO.

Confusion also arises on items that are subject to quantitative restrictions that impose duties on amounts traded above the quota. A classic example of this is pepper, one of Sri Lanka’s main agricultural exports to India. The Department of Commerce declares the value of pepper traded under the ISLFTA for 2006 and 2007 to be US\$13.2 million and US\$18.3 million respectively. When compared to the overall statistics on Indo-Lanka trade also presented by the same source, we learn that these export earnings correspond to 6 544 and 4 948 MTs of pepper respectively (Department of Commerce website 2009). However, since the duty-free concession for pepper is limited to 2 500 MT under the quota system established in the ISLFTA, it is not at all correct to state that the gross export earnings are identical to the export earnings that are attributable to the operation of the ISLFTA.

## *2. The Partial or Selective Provision of Information on Trade*

One measure of the ISLFTA is to investigate the degree of impact of Indian exports on the sectors of agriculture and small and medium scale industries in Sri Lanka. However, when looking for statistical evidence in these sectors, the partial nature of the data and analysis available on imports covered by the ISLFTA is all the more apparent. For instance, the website of the DOC provides the income earned by 35 exported items for the years 2006 and 2007. Curiously, no such data on foreign exchange outflow is made available for any of the imported items entering under the ISLFTA. Again the website indicates that 37 from the top 100 imports from India received duty free concessions in

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<sup>9</sup> Last accessed on 29 November 2009.

2007. However, it is surprising that trade statistics with respect to these imports are not explicitly presented.

This omission of data for imports may be explained as follows: Firstly, it is shown that most of the Indian imports do not receive duty free concessions and hence do not fall under the ISLFTA. Secondly, almost all the sensitive agricultural products are said to be in the Sri Lankan negative list and hence protected from adverse impacts of the ISLFTA. For example, all of the agricultural imports for 2007 in the list of imported items from India and displayed under general imports, “onions and shallots” (HS code 070310), “other maize (corn)” (HS code 100590) and “lentils” (HS code 071340), are in the Sri Lankan negative list and hence are not imported under the ISLFTA.

The purpose of the negative list should be to achieve the dual objective of protecting the existing local agriculture and industries as well as to leave the space open for future development avenues suggested by the sectoral policies of the state. For example, an industry that does not exist presently could still be in the negative list by incorporating the future targets of sectoral policies at national and provincial levels. It is worth noting that there has been a trend where the products under Sri Lanka’s negative list such as automobile/transport items and mineral fuels/oils have recorded maximum growth in the initial years of ISLFTA’s implementation. Therefore, it is imperative to investigate impact of imports under the ISLFTA from a broader perspective.

The distinct significance given to exports raises legitimate concerns among the public regarding whose interests the agencies and actors associated with the ISLFTA represent: Are they the interests of the few big players with the capacity to produce for the export market or the interests of the many small players who produce for the local market and for their own consumption? Consultations in the course of field research with representatives of the local business community and industrialists in general consistently highlighted these concerns, and underpin their criticism of the ISLFTA and opposition to the CEPA.

### *3. The Non-Analysis of Trade Statistics*

State agencies such as Ministries of Finance and Planning, Export Development and International Trade, Enterprise Development, Investment Promotion, Labour Relations, the Department of Commerce, the Export Development Board, Customs Department are or ought to be involved in the implementation process of the ISLFTA. However, we found that no attempt has been made by any of these institutions having a stake in the ISLFTA to investigate the wide ranging impacts either of imports and exports coming under the Free Trade Agreement or even of the overall imports from and exports to India. As a result, what is normally available for the public is a rather understated description of increase or decrease in trade between the two countries (and sometimes trade deficit), over time. A causal link is then drawn between those trends and the duty concessions offered by the ISLFTA and statistics are provided for a selected number of items that top export or import lists based only on the generated revenue.

#### *4. The Absence of Data on Employment*

At the same time, data and analysis of the impact of the ISLFTA on employment creation or displacement – surely an important dimension of the ISLFTA from a national perspective as well as from the perspective of affected sectors – is absent. The number of overall jobs created or lost; whether new jobs created were a result of jobs lost at another location; who occupied those jobs i.e. Sri Lankans or Indians; and the types and quality of employment are important parameters in assessment of the ISLFTA. However, for ten years, no such information has been gathered or presented.

Instead, what is available at times is a selective presentation of jobs created or lost in a few selected companies or sectors, which may or may not be an outcome of the ISLFTA in particular, but rather of trends in the international economy and trade liberalisation in general. These snapshots often present contradictory pictures. Thus De Mel (2009: 24) cites another study that estimates as of the end of 2007, some 6 747 individuals received employment as a result of Indian investment in 70 projects. However, most of these projects appear to be in the services sector that is excluded by the ISLFTA, and therefore cannot be assumed to be jobs created as a result of the Free Trade Agreement, and in any case the number of jobs is meagre in comparison to the quantum of investment. An earlier study on impacts of trade liberalisation on food security and farmers livelihoods quotes the United Nations Food and Agriculture Organisation (FAO) to estimate that some 300 000 jobs in the agricultural sector were lost following the drop in the production of onions and potatoes alone as a result of past trade liberalisation measures (Indikadahena 2008: 65).

Concerns over the quality of jobs created, and the reliance on Indian management and skilled labour, came up in the course of field interviews. For example, the harsh working conditions in factories producing copper products were frequently mentioned. It was also noted that the quality of specific professional expertise that was brought under ISLFTA through Indian investment was not particularly monitored by the relevant government authority. Therefore, a detailed assessment of working conditions of jobs generated as a result of trade under ISLFTA is awaited, as is credible data on the number of net new jobs.

#### **TRADE EXPANSION AS AN END IN ITSELF**

The problem with the literature on the India-Sri Lanka Free Trade Agreement is that it often reads as if the expansion of trade is both means and end. Even within the narrow boundaries of mainstream economics, the disciplinary background of most commentators and analysts on the Free Trade Agreement, issues that ought to be at the forefront of developing countries are marginal or invisible.

What consequences has the ISLFTA on domestic agricultural production and food security or the environment for future industrial development or government revenue for essential services are among the many crucial questions unaddressed in the literature. How far the ISLFTA has

contributed in bridging the gap between the rich and poor – one of the most important indicators of balanced development – is not discussed at all as attention to income and wealth inequality is now unfashionable and in some quarters unpalatable.

Issues such as the lack of capacity of Sri Lankan exporters to export large scale to exploit duty free concessions to the maximum; the outright exclusion by the Indian negative list of many of the major sectors where Sri Lanka has comparative advantage; the lack of export diversification and erosion of marginal preferences as a result of trade liberalisation in India (Bandara and Yu 2009: 14) appear as ‘additional notes’ after concluding ISLFTA to be beneficial rather than appearing as a part of the main text influencing the conclusion. The issues appear in the main text, if they appear at all, only as justification of further liberalisation of trade. This suggests that inconvenient data that controverts the pro-liberalisation argument is secreted away as ‘additional notes’, when it has a direct and critical bearing on the main argument and conclusions.

Another crucial facet in any appraisal of the ISLFTA is the impact that it has on the policy space at national and provincial levels. Particularly in a post-war context where strengthening of the 13<sup>th</sup> Amendment on the sharing of power among ethnic communities and between the centre and provinces has been in debate, it is vital to know how far the commitments on liberalisation of trade decided exclusively by trade experts at the national-level, impact on powers vested with provincial governments and their development plans to strengthen their own agricultural and industrial sectors and to provide livelihood opportunities for people living within provincial boundaries.

There is a serious lack of analysis of the overall performance of the ISLFTA as well as all other measures of trade liberalisation such as the unilateral liberalisation of trade post-1977 and other bilateral agreements. Even the limited literature available analyses the Free Trade Agreement within the narrow focus of trade as discussed above. Whether this is a result of the non-availability of data or whether data is not available as a result of disinterest in the broader analytical questions is a matter for conjecture. In any event, the analysis of the ISLFTA from a human development and social justice perspective by non-trade specialists is hard to find.

#### *Lack of Stakeholder Participation*

A broader issue is that consultations are within and decisions are made by a small network of trade policy specialists who share the same disciplinary tools and the same ideological convictions, and often the same disdain for the opinions of the citizenry. For instance, even representatives of the Central, Southern and Western provincial governments when contacted in the course of field research were reluctant to offer their opinions on the ISLFTA through lack of information on it. They also confirmed that no attempt had been made by central government to consult with them in the design and operation of the ISLFTA. A section of the local business and industrial community also complained of their exclusion from the ISLFTA (and now CEPA) negotiation process and in its monitoring. It transpired in the course of investigation that only a handful of central government

officials from the Finance Ministry and Department of Commerce had been engaged in the finalisation of the bilateral agreement.

With the increasing awareness on the range of impacts of the strong regimes of trade liberalisation the list of stakeholders who should be consulted in the process of drafting trade and services agreements has lengthened. Any exercise to liberalise trade affects a range of stakeholders from large traders and state officials to representatives of the interests of thousands of small and medium scale traders and producers, representatives of the private sector, peoples' representatives at all governance levels, civil society groups, organisations representing various professional groups and trade unions. Sector-wise the ministries of policy-planning, environment, social services, small and medium scale industries, consumer affairs, constitutional affairs and justice are also vital stakeholders of free trade agreements (Witharana, Amarasuriya and Uvais 2007: 21-23). Currently, the consultations on CEPA are conducted behind closed doors and within a closed circle of institutions and individuals who promote the ideology of trade liberalisation.

#### *Poor Design, Coordination and Monitoring of the ISLFTA*

Though there is a powerful lobby to ideologically promote trade liberalisation, the ISLFTA is poorly coordinated, monitored and implemented. Consequently, there is no central institution that provides data, statistics and analysis of the ISLFTA at the moment. Even though the Department of Commerce (DoC) is mandated to play the above role, different functions are seen to be exercised by different institutions. In the absence of an information hub where all relevant information may be gathered, trade statistics have to be collected from a range of locations such as the DoC, the Export Development Board, the Customs Department, the Department of Census and Statistics, the Central Bank, the Board of Investment among others. The Department of Commerce, the Ceylon Chamber of Commerce, and the Institute of Policy Studies, it is observed, conduct analysis from a trade perspective on the bilateral India-Sri Lanka Agreement. However, analysis of the ISLFTA and CEPA from a human development and social justice perspective are few and far between. The absence of a central authority with the capacity to sufficiently engage with these diverse approaches and to convert such analysis into policy prescriptions can also be noted in this respect.

Several other gaps in the process of designing, coordinating and monitoring were highlighted in the course of investigations for this report. For example the actual benefit of some of the items that occupy the top positions of the list of exports to India in 2007 (e.g. insulated wire and cable – HS Code 8544) among *vanaspati* and copper were questioned by some of those interviewed. Others interviewed identified the lack of investigation on trade regulation and taxes (especially at state-level within India) as a lacuna. The unavailability of basic statistics of trade under the ISLFTA is further proof of this lack of coordination and monitoring. The uneven communication between State agencies and business groups was also noted in the course of the research. Some Ministries linked to agricultural and small and medium industrial sectors and Provincial Council administrations seem to be ignorant of the existence of the ISLFTA, and unaware of its consequences for their own sectoral policies and economic targets. The absence or at least inadequacy of monitoring mechanisms on the

implementation of the ISLFTA, and the dissemination of information on the operation of the ISLFTA, is patently clear.

## **MISSING EVIDENCE**

What stands out from this research study is the weak relationship between the findings of the literature and the policy conclusions derived. The literature on the ISLFTA is overwhelmingly supportive of the Free Trade Agreement and approving of its expansion but the predilection for trade liberalisation and integration with the Indian economy is skimpily supported by the evidence. Apart from the growth of trade between the two countries there is either hardly any detailed substantiation to make the case for the ISLFTA; and in fact the available evidence appears to contradict their conclusions. Nowhere is there a major Sri Lankan ‘success story’ of the significant benefits realised by local communities or in terms of national development as a consequence of the Free Trade Agreement. The case of *vanaspati* and copper that were the major new exports to India were actually examples of the manipulation of duty concessions offered under the ISLFTA, as discussed above, and provided minimal gains to Sri Lanka.

Between 2005 and 2007 *vanaspati* was the main single agricultural product responsible for the increase in Sri Lankan exports to India and often cited in accounts of the ‘success’ of the ISLFTA. However, *vanaspati* was neither a genuine Sri Lankan product with backward or forward linkages to the domestic agricultural sector, and nor did it provide large-scale skilled employment to Sri Lankan nationals. The *vanaspati* industry was an investment of a few Indian manufacturers to exploit the duty-free access of palm oil (one of its main ingredients) to Sri Lanka, and the duty-free access from Sri Lanka into the Indian market. Almost all the initial workforce was Indian. Most of the income generated by *vanaspati* therefore would have been repatriated to India. As a result of protests by manufacturers in India – alleging inadequate value addition and unfair competition – *vanaspati* exports were discontinued in 2008.

Until 2005 Sri Lankan industrial exports to India were dominated by copper and copper products. Even by 2007 copper, copper alloys, and insulated wire and cables, all of which are copper products were the main industrial export to India. The story of copper is very similar to that of *vanaspati*. The copper ingots were manufactured mainly by Indian companies established in Sri Lanka and operated entirely by Indian labour. It was said that Sri Lankans were not willing to work under the conditions of extreme heat in the factories. The Indian copper industry challenged these exports from Sri Lanka for not meeting the required level of value addition that should be maintained under the ISLFTA. The initial practice of some in the industry, as disclosed to the Law & Society Trust, was to import copper pieces from India, reduce the size in Sri Lanka, and re-export to India. The Sri Lankan Board of Investment finally introduced tougher regulations on value addition and refused to grant approval for new Indian investment in this industry. Out of the 14 companies that were in operation, 10 are now out of business.

The hope for a better future seems to dominate the current analysis on ISLFTA. It is common practice by many of the proponents of ISLFTA to propose CEPA which is not yet implemented as the solution for the shortcomings of ISLFTA. However, CEPA is not testable and justifying CEPA requires far more detailed analysis of the ISLFTA which is simply not available. Simulation tools<sup>10</sup> are used sometimes to predict impacts of different trade scenarios. The results, however, are confined to a few indicators of trade and how these tools can be used to facilitate decision making from a development perspective is rather questionable. Likewise the critics of the ISLFTA reproduce the same methodological error as their opponents. Their arguments are based on a critique of the overall trade and economic relationship between India and Sri Lanka, as well as ideological hostility to trade liberalisation, with little detailed analysis of the Free Trade Agreement.

## RECOMMENDATIONS

Following the discussion above, this report makes two modest recommendations:

### *1. Investigate the Impact of the entire Trade Liberalisation process*

When it comes to imports the protection provided by the negative list is minimal mainly as a result of several reasons. Firstly, the maximum imposable duties were drastically reduced as a part of tariff reforms in several stages during the last three decades. By the time the ISLFTA was implemented, some of the agricultural and industrial products were already wiped out in the face of cheap imports (Indikadahena 2008). Those tariff reforms, hence, limit the protection provided by the negative list of the ISLFTA. Secondly, Sri Lanka has committed to further tariff reductions under multilateral trade mechanisms, in particular under the Agreement on Agriculture (AoA) and Non-Agricultural Market Access (NAMA) of the World Trade Organisation. This further restricts the maximum imposable tariff, making the protection offered by ISLFTA extreme marginal. It would be more meaningful therefore – when investigating the impacts on communities of producers and consumers involved with agriculture and industries – to look at the entire trade liberalisation process including the multilateral commitments, rather than to study the ISLFTA in isolation.

### *2. Reorient the Role and Mandate of the Department of Commerce*

The Department of Commerce (DoC) is the focal point within the Government of Sri Lanka for all trade negotiations and is therefore mandated to collect data and information, generate statistics and conduct analysis of all trade mechanisms. Its mission statement is to “to develop and promote Sri Lanka's foreign trade relations at bilateral, regional and multilateral levels by the effective implementation of government trade policy, with a view to raising the standards of living and realising a higher quality of life through the increase of total production, income and employment levels, thereby actively contributing to the overall economic growth of Sri Lanka”. However, in practice the DoC appears to have interpreted its role to be the defender and promoter of trade

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<sup>10</sup> Such as Global Trade Analysis Project (GTAP) model used in Perera (2009).

liberalisation within the Government of Sri Lanka. Unless it is assumed without evidence that any and all free trade measures will automatically enhance the welfare and prosperity of society, the prime responsibility and obligation of the DOC is to evaluate all trade agreements including the ISLFTA against its own objectives in its mission statement, which is to what extent these agreements contribute to raising the standard of living and achieving a higher quality for life for Sri Lankans as measured by increase in total domestic production, rise in income levels, and increase in total employment.

## CONCLUSION

This report concludes that an objective assessment of the overall impact of the India-Sri Lanka Free Trade Agreement on the developmental goals of Sri Lanka is not possible due to serious problems with the existing data. The macro-level trade statistics that are available do not even permit us to systematically analyse the ISLFTA as a result of issues concerning the accuracy of data; the inadequate attention to statistics on imports; and the narrow focus with which data is collected. These issues disallowed field investigation to document the experiences of communities directly affected by the implementation of the ISLFTA, in the absence of clear connections between macro-level trends and micro-level impacts on producers and consumers.

Given the paucity of information and confusion regarding available data, the strength of claims that are made by protagonists of the ISLFTA and now CEPA are questionable and appear to be founded on ideological supposition rather than scientific evidence. Indeed, similar concerns are in fact valid for any other trade liberalisation measure whether it is unilateral, bilateral, regional or multilateral. The findings of this study indicate that the basis on which decisions are made on the relevance and value of these agreements and measures to the developmental needs and goals of Sri Lanka are unclear at best, and unsound at worst. If trade liberalisation is to be promoted as a necessary instrument of economic development, then there is a need for more critical engagement on the basis of this argument. In order to do so, relevant data, information, statistics and analysis need to be gathered at least by the respective state institutions responsible for handling trade agreements, and shared transparently with the people of Sri Lanka.

How is it that these policy initiatives and agreements are being implemented without debate? Why is concrete evidence not being demanded when far-reaching decisions on trade are made? Several reasons can be advanced in this regard. The hegemonic position occupied by free market ideology for several decades at least since the election of Margaret Thatcher in the United Kingdom and Ronald Reagan in the United States of America in 1979 and 1980 respectively. The lack of awareness and understanding in civil society that the implications of the neo-liberal trade regime extend well beyond the traditional issues of trade policy, is another significant reason. Ignoring the adverse impacts of liberalisation of trade in a *quid-pro-quo* for foreign aid and balance of payments support; and securing international support for the war against the Liberation Tigers of Tamil Eelam (LTTE) can also be another reason.

However, the context described above has now changed. The global financial crisis, climate change crisis and the depletion of oil reserves have posed serious challenges to the hegemonic status occupied by free market ideology. The war that absorbed almost the entire attention of Sri Lankan civil society is over. 'Development' is being peddled as the cure-all to the underlying grievances that fuelled the conflict and to issues of poverty and unemployment in general. Therefore it has never been more opportune for civil and political society to critically engage with the instruments of trade liberalisation – such as the India-Sri Lanka Free Trade Agreement and the Comprehensive Economic Partnership Agreement – and its political and economic ideology, in contestations over the pathways of development in Sri Lanka.

### **INTERVIEWEES (IN ALPHABETICAL ORDER)**

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