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SRI LANKA

Background Papers

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Approved by the Central Asia Department

May 10, 1995

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I. Introduction

This supplement to the statistical tables (SM/95/94) provides background information on the recent economic developments described in the staff report (SM/95/95) and on some of the important issues noted there. Recent developments in the domestic and external sectors are discussed in Chapter II. The deficiencies of the official consumer price index that resulted in a substantial understatement of inflation performance in 1994 and alternative estimates of underlying inflation are described in Chapter III. The structural rigidities in the labor market that perpetuate high unemployment and limit job growth are described in Chapter IV. Fiscal sustainability, which emerged as the key medium-term policy objective, is discussed in Chapter V. The pricing and marketing policies of the Cooperative Wholesale Establishment, which came under greater scrutiny in 1994 as a result of the emergence of widespread subsidies on basic consumption items, are presented in Chapter VI. Sri Lanka's trade regime, which has been liberalized significantly since the early 1990s, is described in detail in Chapter VII.

II. Recent Economic Developments

1. Real sector

a. Growth, saving, and investment

Despite a good harvest, real GDP growth slowed late in 1994 and averaged about 5 1/2 percent, almost 1 1/2 percentage points below the previous year's strong performance. Of the output growth, agriculture contributed about 1 percentage point, manufacturing 2 percentage points, and most of the remainder came from a further expansion of the services sector.

The ratio of overall investment to GDP increased by about 1 1/2 percentage points to 27 percent in 1994. This increase was fully accounted for by the purchase of two airplanes by Air Lanka. Private investment stagnated as the political uncertainties led to delays in capital spending, while public investment also slowed in response to significant project delays.

The ratio of national saving to GDP, which recorded significant increases in 1992-93, decreased by a little over one percentage point to about 19 percent in 1994. This decline reflected a large increase in public sector dissaving in relation to GDP that was only partly offset by an increase in private sector saving. The former resulted from a weak revenue effort and lack of expenditure control, while the latter reflected, in part, the household sector's response to efforts by the banking sector to mobilize increased savings.

Against these developments, the economy's saving/investment gap widened from about 5 1/2 percent of GDP in 1993 to about 8 percent of GDP in 1994. This widening mirrored a significant increase in the trade deficit, which resulted from strong import volume growth and a significant deterioration in the terms of trade.

b. Sectoral developments

i. Agriculture

Favorable weather and improved performance of some of the privately managed plantations led to production gains for all major crops--tea, rubber, coconut, paddy, and sugarcane--in 1994. Coconut output was particularly strong as the subsector continued its recovery from the 1992 drought. The increase in paddy output stemmed exclusively from an increase in cultivated area as average yields decreased slightly. Despite the production gains in the major crops, sectoral growth was limited to only 3 1/3 percent by low tea and rice prices and by the poor performance of other agriculture. ^{1/} The latter result was disappointing in view of the Government's agricultural development strategy, adopted in the late 1980s, to diversify production away from the major crops. Poor performance of minor food crops during the year was attributed to pest and disease problems, a lack of high-quality seed material and, in the case of potatoes, excessive rain. Agriculture accounted for about 20 percent of GDP in 1994.

An encouraging development in 1994 was the significant improvement in the financial performance of the private plantation management companies. It is estimated that 10 of the 23 private companies were profitable in 1994. By contrast, only 4 companies made a profit in 1993 and none were profitable in 1992. The improved performance is attributed to retrenchment of redundant workers--mainly through attrition and buyouts--and improved management resulting from implementation of an incentive-based system whereby managers receive a share of the profits. Higher rubber prices also contributed to the increased profitability of some companies.

ii. Manufacturing

The manufacturing sector, which accounts for about 20 percent of GDP, continued to be the main engine of growth, expanding by 9 percent in 1994. Growth was largely concentrated in private sector production of chemicals, rubber, plastic products, textiles and apparel, metal products, and food and beverages. By contrast, public sector industrial output is provisionally estimated to have declined slightly during the year, reflecting large declines in output of wood and non-metallic mineral products. These declines offset increased output of petroleum and petroleum byproducts

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^{1/} Sri Lanka produces a range of minor food crops, including potatoes, onions, chilies, cowpeas, groundnuts, green gram, sesame seeds, and other crops, mainly spices.

(e.g., plastics and petrochemicals) by the Ceylon Petroleum Corporation (CPC) and strong expansion of the public sector food and beverage processing industry.

The Government has used a multifaceted approach to promote industrial development in Sri Lanka, including divestiture and restructuring of public enterprises, rationalization of investment incentives, and deregulation. Further progress on these fronts was minimal in 1994. Public enterprise restructuring and divestiture ground to a halt as the new Government re-evaluated its approach to selling off state-owned companies. The Board of Investment continued to grant tax concessions on a case-by-case basis, although the approval process for foreign investment was streamlined somewhat. On the positive side, a fledgling market for commercial paper arose during the year that could prove to be an effective conduit for long-term finance in the future.

iii. Services

The services sector, which accounts for about 50 percent of GDP, is principally composed of wholesale and retail trade, transport, finance, public administration and defence, tourism, and energy (electricity/gas/water). The consolidated services sector grew by 5.2 percent in 1994. The main sources of growth were wholesale and retail trade, financial services, and electricity. On the other hand, tourism is estimated to have grown by only about 2 1/2 percent, possibly reflecting increased political uncertainty during the election period and bombings of tourist hotels earlier in the year. Nonetheless, investment in tourism, including hotels, appears to have been strong.

Growth in the energy subsector, at 10 percent, was particularly strong during the year. Power generation increased by almost 9 percent through November in response to strong demand, despite considerable increases in electricity tariffs. The Ceylon Electricity Board (CEB) was able to meet the bulk of the demand for electricity through hydroelectric power generation. However, in the middle of the year, as reservoir levels dropped during the dry season, thermal power generation also had to be relied upon, and registered a large increase during the year. Domestic consumption of major petroleum products also rose significantly in response to price decreases. However, the financial impact of the price declines on the CPC was moderated by low international petroleum prices.

iv. Other

The construction and mining sectors, which together account for about 10 percent of GDP, were both estimated to have increased by 6 percent in 1994. Construction remained buoyant, benefiting from strong demand for commercial outlets and private housing. The increase in mining output was driven by demand for quarrying products from the construction industry.

c. Prices, wages, and employment

i. Prices

The annual average inflation rate, as measured by the Colombo consumer price index (CCPI), declined by some 3 percentage points to about 8 1/2 percent in 1994. However, the drop resulted from duty waivers on key mass consumption items and the impact of cuts in government administered prices of wheat flour, bread, and kerosene. Excluding the effect of the cuts in administered prices, consumer prices are estimated to have increased by 11 1/2 percent. Underlying inflation in 1994 is therefore estimated to have been much higher than the recorded inflation, in a range of 12-14 percent. Issues relating to the official index and estimates of underlying inflation are discussed in more detail in Chapter III.

While most commodity subsidies had been eliminated by early 1994, populist measures enacted in the context of the Parliamentary election in August and the Presidential election in November resulted in the re-emergence of large subsidies on bread/flour, diesel, kerosene, electricity, and fertilizer. The fertilizer and bread/flour subsidies have been brought directly into the 1995 government budget, while the subsidies on diesel and kerosene are being absorbed by the CPC and those on electricity by the CEB. An unintended side effect of the flour subsidy was a decline in rice prices as demand shifted to bread.

ii. Wages

Private sector wages in Sri Lanka are generally market determined, although minimum wages for 31 trades are set by the Wages Boards, which consist of government, employee, and employer representatives. The minimum wages for all workers covered by the wage boards on average increased by only 4 percent in 1994. However, the minimum wages typically are not binding and most workers receive wages well above the minimum. Accordingly, actual wage increases were much higher. For example, nominal wages for workers in the service industry increased about 18 percent, while those for workers in the textile industry increased in a range of 17-19 percent. Several larger companies that are members of the Employers' Federation of Ceylon negotiate collective wage agreements, which typically cover a 2-3 year period and include a cost-of-living allowance based on changes in the CCPI. The average wage increase granted in collective bargaining agreements in 1994 generally exceeded the increase in the CCPI.

Civil service wages rose by about 12 1/2 percent in 1994. The overall wage rate index for government employees increased by about 9 percent as a revised civil service salary structure was put fully in place. The pay scales for clerical and allied grades, in particular, were revised sharply upward in order to rectify anomalies in the salary structure. Grade drift contributed a further 4 percent rise for civil service wages--most scales have 10-12 levels and staff move automatically upwards.

iii. Labor and employment

Overall employment is estimated to have increased by 2 percent in 1994, with manufacturing and services registering the largest gains. Although official employment statistics are not available, government employment is also believed to have increased as casual employees were made permanent and large numbers of unemployed graduates were hired as teachers. Women's labor force participation, which increased sharply in 1993, declined slightly in 1994, moderating the overall increase in the labor force. The number of Sri Lankans working abroad is estimated to have increased modestly during the year.

There was an upsurge of labor unrest following the November presidential election directed primarily at foreign-owned enterprises. The new Government, which had been expected to be sympathetic to the strikers' demands, adopted a hard line in response to the unrest and the strike activity dissipated quickly.

iv. Unemployment

According to Labor Force Survey data, the unemployment rate fell slightly to 13 percent in 1994. The relatively sluggish response of labor markets to the rapid expansion in economic activity can be attributed to structural rigidities stemming, at least in part, from government regulations and hiring practices. ^{1/} Unemployment is concentrated in rural areas. Many young people continued to spend long periods unemployed, waiting for coveted government jobs. The mass hirings of teachers in 1994 reinforced this behavior. Accordingly, a large proportion of the unemployed are young and relatively well educated; two thirds are 24 years of age or younger and over half have passed General Certificate of Education (GCE) Ordinary level examinations.

2. Public finance

a. Structure of the public sector

The public sector in Sri Lanka consists of three interrelated branches: the Government, public enterprises, and a broad range of public institutions. The central government includes the presidency, the parliament, the judiciary, 28 ministries, and several other departments and agencies which are covered by the central government budget. The local government sub-sector also includes district, municipal, urban, and village councils, which provide financial, technical, and other services, and oversee the implementation of social development projects.

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^{1/} Structural rigidities in the labor market and the impact on unemployment are discussed in more detail in Chapter IV.

Sri Lanka's approximately 200 public enterprises encompass a variety of organizational forms, including commercial enterprises, boards, bureaus, authorities, corporations, agencies, and institutes. In 1994, the central government made budgetary transfers to over 90 public corporations and institutions, including the following sectors: agricultural and fisheries, manufacturing and mining, energy and water supply, trade and commerce, transport and communications, and development. The largest recipients were the Mahaweli Authority, the CEB, the Central Transport Board, the National Water Supply and Drainage Board, and the Road Development Authority, which were generally engaged in large-scale infrastructure projects. The total transfers to public enterprises declined only slightly, from 3.4 percent of GDP in 1990 to 3.1 percent of GDP in 1994, mainly because savings from privatization under the public enterprise reform program were offset by the cost of subsidizing operations affected by the 1994 relief measures.

b. Fiscal developments

After two years of fiscal consolidation, the budget position deteriorated significantly in 1994. The overall fiscal deficit (excluding grants) increased to 10 percent of GDP, compared with 8 percent in 1993, largely reflecting a reduction in the tax base and expenditure overruns associated with relief measures introduced before and after the parliamentary elections in August 1994 and lax control over other expenditures. ^{1/} The deficit on current operations, which declined to less than 1 percent of GDP in 1992 and 1993, jumped to 3 percent of GDP in 1994. Pressures on current expenditures from the security situation continued throughout the period, with defense expenditures expanding from 3 percent of GDP in 1990 to 4 3/4 percent of GDP in 1994. Capital expenditures recovered somewhat in 1991, with an increase in foreign resources. The revenue-to-GDP ratio fell from about 20 percent in 1993 to 19 percent in 1994, owing to the tax relief. A greater portion of the deficit was financed by domestic borrowing though the Government made little recourse to bank financing.

i. Revenue

The decline in central government revenues relative to GDP in 1994 principally reflected the negative impact of the tax relief measures taken during the election year despite a buoyant economy, rapidly growing external trade, and improved tax collection procedures by Inland Revenue and Customs. Sri Lanka has traditionally relied on trade and other indirect taxes for the bulk of its revenue. Growth in revenue from turnover taxes, which constitute the largest share of tax revenues, slowed during 1994, despite sharp growth of revenue from nonmanufacturing sources--banks, electricity supply, telecommunications, and hotels--as the relief measures reduced the tax yields from imports. Provisional data suggest that the loss of revenue

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^{1/} Appendix I presents a detailed description of the fiscal relief measures adopted by the previous Government in its May Day package and those introduced by the new Government.

resulting from waivers and exemptions for turnover tax and import duties totalled SL Rs 17 billion in 1994, half the actual receipts collected. These factors were somewhat offset by increased excise taxes (higher rates were imposed on tobacco) and high collection rates for the defense levy--a 3 1/2 percent levy on most domestic and international payments. Personal and corporate income taxes continued to comprise a relatively small share of total revenue in Sri Lanka, and receipts were further affected by raising of the threshold for personal income tax to SL Rs 12,000 per month and the lowering of the rate of corporate income tax from 40 percent to 35 percent from April 1994. Nontax revenue remained largely unchanged as a percent of GDP, although its composition changed, with a greater share derived from interest payments by the CEB.

ii. Expenditure

Total central government expenditures and net lending were projected in the 1994 budget to be slightly lower as a share of GDP than in 1992 and 1993 as further fiscal consolidation reduced current expenditure while capital spending would rise. In the event, current expenditure, which represented 77 percent of total expenditure, grew faster than nominal GDP and capital expenditure was adversely affected by project delays. The fastest growing components were spending on goods and services, pensions, and interest payments. Total current expenditures on other goods and services rose by 34 percent in 1994, reflecting a 53 percent increase in defense-related purchases, which required SL Rs 3 billion of supplementary budget allocation at the end of the year. In contrast, whereas defense salary costs rose less than inflation, the civilian wage bill increased by 15 1/2 percent, and average salaries of nonteachers by 12 1/2 percent. Of this 12 1/2 increase, 8 1/2 percent reflected the upward adjustment in the salary scales to eliminate anomalies and the remainder wage drift. Teachers were awarded substantial pay increases, 40-50 percent, in November 1994 though the impact was not felt on the 1994 outturn. The number of civilian staff rose during the year, particularly when 8,000 trainee teachers were hired in May.

The cost of pensions and gratuities increased by 30 percent in 1994, following a small increase in recipients and the decision to pay, over the period 1994-98, back-dated arrears on cost-of-living-adjustments previously omitted. Spending on poverty alleviation programs was similar to 1993 despite improved targeting and greater efficiency, reflecting the decision to go ahead with the fifth round of Jana Saviya in June 1994 and the expansion of the midday meal program. ^{1/} The increasing size of the public debt, both domestic and foreign, and the impact of the widening of the fiscal deficit on interest rates during the year, led to a sharp increase in debt service costs to 6 1/2 percent of GDP.

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^{1/} A full description of the reform of the poverty alleviation programs is given in Appendix II.

Total capital spending, which had increased to 7.5 percent of GDP in 1993, fell to 6.6 percent of GDP in 1994, well below the levels projected in the budget, as some projects were delayed. After completion of a number of large public investment projects during the 1980s (including the Mahaweli Dam project), public sector capital spending has been directed toward maintenance and operation of the existing capital stock and smaller infrastructure projects to support private sector development.

Lending minus repayments remained below 1 percent of GDP during 1994. The Government provided substantial on-lending to the CEB for hydroelectric projects as well as loans to the Port Authority and Telecom. Included in this category of expenditure are the costs of servicing the long-term bonds provided as recapitalization to the two state-owned commercial banks. The Government also received proceeds from the divestiture of a number of public corporations and loan repayments during the year.

iii. Financing and debt

The reliance on foreign grants and borrowing to finance the Government's deficit declined to 31 percent of total requirements in 1994. Delayed program aid accounted for the decrease in foreign loans. As a result, there was a sharp increase in domestic borrowing, which reached 6.6 percent of GDP in 1994. The bulk of domestic borrowing was mobilized by traditional captive sources such as the Employees Provident Fund (EPF), the Employees Trust Fund (ETF), and the National Savings Bank (NSB) in the form of treasury bills and longer-term rupee loans. The average yield on treasury securities during the year was 15 percent.

At the end of 1994, total central government debt, domestic and foreign, was SL Rs 548 billion, 95 percent of GDP compared with 97 percent of GDP in 1993. Sri Lanka continued to benefit from large amounts of concessional foreign aid which made up 53 percent of the total debt. The low interest rates on such financing has permitted the authorities to limit the cost of servicing such a high level of debt, but the overall fiscal position is not fully sustainable. ^{1/}

iv. 1995 budget

The 1995 budget incorporates a surplus on current operations of 0.6 percent of GDP and a decline in the overall deficit to 7.5 percent of GDP. The ratio of revenues to GDP is targeted to increase by almost 2 percentage points through elimination of tax waivers and exemptions and through higher excise duties and fees. The fiscal objectives are to be achieved through substantial reductions in current expenditures, equivalent to about 2 percent of GDP, while capital expenditure is projected to increase to 8 percent of GDP.

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^{1/} The issue of fiscal sustainability is discussed in Chapter V.

The main new revenue measures introduced in the 1995 budget, including tax increases announced in January 1995, are as follows:

- increases in excise taxes on cigarettes, liquor, gasoline, diesel, and consumer durables: + SL Rs 4.2 billion
- increase in low turnover tax rate to 6 percent: + SL Rs 1 billion
- net change on import duties, less exemptions: + SL Rs 800 million
- tax on luxury vehicles and diesel engines: + SL Rs 1.9 billion
- tax on domestic sales of export companies: + SL Rs 2.3 billion
- increase in fees, and tax on textile quotas: + SL Rs 900 million
- levies on Telecom and CPC: + SL Rs 1.3 billion

On the expenditure side, the main cost saving efforts will be in the area of military outlays, through improved expenditure control to reduce costs by 1 percent of GDP. Savings in the welfare program and other transfers will be offset by the explicit budget provision of SL Rs 5 billion to cover the cost of subsidizing wheat flour and bread. The 1995 fiscal deficit is expected to be financed through continued foreign aid and purchases of government securities by the domestic nonbank savings institutions.

c. Tax reform

Sri Lanka's tax system has a relatively sophisticated structure for its stage of economic development, with a higher tax-to-GDP ratio than most Asian countries. A number of specific measures to improve the system were introduced in the context of the 1995 budget. The lower band of turnover tax was increased from 5 percent to 6 percent in preparation for the adoption of a value-added tax system in October 1995. The new tax, the Goods and Services Tax (GST), will be revenue neutral with two rates. Items included at the lower rate will be mass consumption goods such as milk, sugar, kerosene, diesel, and soap. The GST will eliminate the current markup of 25 percent applied to the computation of turnover tax on imports. The system of trade taxes has also been simplified, with the introduction of a three-band import tariff system with a lower maximum rate and a reduction in several export tax rates (see Chapter VII).

Substantial progress by the Inland Revenue Department has been made in improving tax administration, increasing compliance, and enhancing enforcement of penalties. A parallel computerized system to improve tariff collections and increase the efficiency of administration in the Customs Department is being implemented. In addition, Customs collection should be improved in the future with the introduction of preshipment inspection of both imports and exports. This inspection will aid correct valuation and classification of external trade.

3. Financial developments

a. Overview of the financial system

The financial system in Sri Lanka is relatively diverse and sophisticated. The banking system includes the Central Bank of Sri Lanka, 23 commercial banks, a national savings bank (NSB), three merchant banks, two development finance institutions, and a state mortgage investment bank, among other institutions. Long-term financial resources are mobilized mainly by the two large pension funds, the EPF and the ETF, and five insurance companies. In the capital market, activity in the Colombo Stock Exchange has picked up sharply in recent years after the adoption of a scripless trading system and increased participation by foreign investors.

While considerable progress has been made in recent years in laying the foundation for a modern financial system, many structural impediments remain, constraining Sri Lanka's growth potential. In the banking sector, competition has been hampered by the continued dominance of the two largest banks, which are state owned. The market share of these banks has been broadly unchanged since 1990 at about 60 percent of total assets of the commercial banking system despite the establishment of new banks and branches of foreign banks. In addition, their close relationship with the Government has made it difficult to enforce the supervisory regulations, for example, the provisioning for bad loans, and as a result a recapitalization was necessary in April 1993. The lack of effective competition has resulted in large interest rate spreads that keeps up the cost of finance for the private sector.

The market for deposits has been distorted by the operations of the state-owned NSB. The NSB mobilizes deposits from small savers nationwide through a decentralized network of branches and post offices. However, there are no limits on the size of deposits and even corporate depositors are allowed to deposit funds. The deposits carry a government guarantee and the NSB is not subject to reserve or liquidity requirements. The interest rates offered by the NSB, which must be approved by the Minister of Finance, have tended to put a floor on all deposit rates. This lack of flexibility has at times resulted in average term deposit rates higher than the NSB can earn from investing in treasury bills.

Monetary management in Sri Lanka is hampered by a lack of depth and competition in money and securities markets. For example, there is no active market for government securities with maturities over one year. Although a substantial part of the Government's financing requirement has been covered by issuing long-term rupee securities, these have been placed with captive sources, primarily the EPF and the NSB, at fixed interest rates determined by the authorities. Further, while short-term interest rates are market oriented, the primary treasury bill market is not fully operated according to market principles and the secondary market is still very limited.

b. Monetary policy

The Central Bank has used a combination of direct and indirect policy instruments to influence the growth of monetary aggregates in recent years. These have included, among other instruments, statutory reserve requirements, refinance facilities, selective credit controls, and moral suasion. Since 1992, however, greater emphasis has been placed on indirect instruments of monetary control, including open market operations in treasury bills and central bank securities, within the context of reserve money programming. Accordingly, the basic monetary approach followed by the Central Bank has been to target the annual growth of reserve money in the context of a Fund program. The annual targets are converted to intra-year paths taking into account seasonal and other variables, such as the government cash flow pattern, and are monitored by the Central Bank on a weekly basis.

The conduct of monetary policy in 1993 and early 1994 was significantly complicated by large unanticipated inflows of interest-sensitive capital, which rendered the system of reserve money management more difficult. The main policy response of the authorities to these inflows was aggressive sterilization by open market operations through the Central Bank's secondary window. However, with a rapidly declining inventory of treasury bills to carry out open market operations, the Central Bank considerably eased the degree of sterilization in late 1993. Since then, the authorities have experienced difficulties in containing domestic liquidity expansion, and have, as a result, adopted a passive policy stance that continues at the present time. Few policy actions were taken in 1994 to curtail liquidity creation: the Central Bank belatedly began issuing its own securities again--which it had ceased in April--in September in a vain attempt to drain liquidity; and its short-term refinance facility was phased out and no new medium- and long-term refinance was extended during the year.

In late March 1995, the Central Bank began to issue additional amounts of its own securities to restrain credit growth. However, after successfully rolling over SL RS 3/4 billion plus an additional SL Rs 1/4 billion in late March, subsequent issues have been limited because low demand resulted in high expected yields. The Central Bank has been reluctant to take any further action because of the impact on interest rates that have begun to rise.

c. Developments in money, credit, and interest rates

Developments in major monetary and credit aggregates in 1994 should be viewed against the backdrop of the passive policy stance adopted by the authorities. Monetary policy accommodated both the fiscal slippage and the private sector's strong demand for credit, resulting in a large increase in net domestic assets (NDA) of the banking system during the year. Reinforced by a surplus in the balance of payments, broad money grew by 20 percent in 1994, a level similar to the average expansion during the early 1990s, perpetuating the high underlying inflation. Unlike in 1993, when growth of

monetary aggregates largely reflected the accumulation of net foreign assets (NFA) of the banking system, NDA and NFA contributed about equally to liquidity expansion during 1994. Monetary aggregates have continued to expand rapidly thus far in 1995, particularly credit to the private sector, in the absence of decisive measures to tighten monetary policy.

Net credit to the public sector declined by 4 percent during 1994. Improved profitability of the CPC stemming from lower world petroleum prices enabled public corporations to reduce their bank financing by 34 percent during the year. However, net credit to central government increased by 4 percent, in contrast with significant declines in 1992-93. The Government was forced to seek recourse to SL Rs 6 billion in additional bank financing during the last quarter of the year to finance the widening fiscal deficit as the nonbank captive sources were fully tapped.

The modest decline in net credit to the public sector failed to offset the 21 percent expansion in credit to the private sector. Notwithstanding the relatively high real lending rates (on the order of 4-6 percent), bank credit to the private sector increased unabated, reflecting continued strong demand for trade finance and a sharp increase in consumer credit and housing loans. Unlike in the recent past, the Central Bank did not attempt to stem credit growth through increases in the required reserve ratio or through moral suasion on the commercial banks. Government-directed credit schemes did not contribute significantly to private credit expansion during the year.

Although foreign inflows fell considerably from 1993 levels, the increase in the Central Bank's NFA still accounted for 10 percentage points of broad money growth and all of the increase in reserve money in 1994. The Central Bank's lack of instruments with which to carry out open market operations constrained its ability to sterilize the impact of the inflows. Owing to the lack of instruments as well as the passive policy stance adopted by the monetary authorities, reserve money continued to expand at over 20 percent.

The passive stance of monetary policy also led to wide swings in short-term interest rates on treasury bills. Treasury bill rates, which peaked at about 21 percent in September 1993, began to soften as the Central Bank eased sterilization operations, reaching about 13 percent in March 1994. Short-term rates stabilized in the middle part of the year as inflows of foreign capital abated. However, rates began to fall again in July in the face of high domestic liquidity, reaching 11 1/2 percent at end-October, before rising sharply to 19 percent by end-year in response to the Government's need to finance the widening budget deficit. Short-term rates subsequently fell quickly to 13 1/4 by early February in response to a surge in liquidity related, in part, to renewed capital inflows. Rates have firmed somewhat in recent weeks to over 15 percent in response to the modest tightening by the Central Bank.

Because of institutional factors that inhibit market adjustments in the banking system, the large movements in short-term rates were generally not reflected in lending and deposit rates, which remained broadly positive in real terms. In the latter half of 1994, however, lending and deposit rates declined by 1-2 percentage points in response to pressure exerted by the Government on commercial banks to lower interest rates. Nonetheless, the spread between deposit and lending rates remained large, at 8-10 percent, throughout the year and continued to keep up the cost of finance for the private sector.

4. Public enterprise reform

After the Parliamentary elections in August 1994, the new Government halted the existing divestiture program. As a result, there were only seven small enterprises sold during the year, though the budget benefitted from delayed proceeds from the sale of Puttalam Cement Co. at the end of 1993. For 1995, there has been a reappraisal of the approach to be taken on public enterprise divestiture and restructuring and a new body, the Public Enterprise Reforms Commission, was established in March 1995 to oversee this work.

The Commission has decided that five entities would be handled first, the National Development Bank, the Capital Development and Investment Company, Orient Lanka (which owns duty free shops at the airport), Air Lanka, and the plantations. At the same time, some of those bodies previously listed for divestiture and which are ready to be sold would proceed. The divestiture of many of the enterprises listed in the budget speech only required formal Cabinet approval. The general method of divesting would include assistance of a private company to arrange the sale, attempts to restructure firms prior to sale with voluntary redundancy schemes if necessary, and a proper safety net to reassure the public. The Commission would also be examining some of the past privatization and through audits of the accounts attempting to assess whether some further action should be taken--reversing the sales was not intended.

The Government's 15 percent holding in the National Development Bank, already a listed company, will be sold on the Stock Exchange. Estimated receipts could be SL Rs 1 billion--2.625 million shares with current price of SL Rs 360. There is also a possibility of realizing a sizeable stock option. Foreign interest is expected. The World Bank is currently studying the case of Air Lanka. It is intended to capitalize extended leases for the plantations and distribute 20 percent of shares to the general public through vouchers, selling 51 percent on the stock market. The Government will retain the balance of the equity, and is expected to divest one plantation company at a time. The World Bank is involved in setting the modalities and terms of reference for the operation.

5. Balance of payments and external debt

a. Overall developments

External sector performance had remained strong in recent years. The current account deficit declined from 7.5 percent of GDP in 1991 to 6.1 percent in 1992 and further to 5.3 percent in 1993. Capital inflows were strong and rising since 1992, in large measure due to the strength of foreign direct investment. In 1993, a sharp decline in the current account deficit together with the strength of capital inflows produced a particularly large overall surplus and a sizable increase in gross official reserves to 5.1 months of imports. However, in the face of loose financial policies, the current account deficit widened to an estimated 7.9 percent of GDP in 1994. The overall surplus in 1994 was, nevertheless, sufficient to maintain gross official reserves at about five months of imports.

b. Current account transactions

The terms of trade, which improved slightly in 1992 and 1993 (1.7 percent over the two years), worsened significantly in 1994 (3.4 percent), owing mainly to a decline in export prices for key goods including garments and tea. Export volume growth in 1993-94 averaged about 16 percent per year owing to the strength of nontraditional exports, which averaged about 20 percent real growth per year. Garments and textiles comprised about 75 percent of nontraditional exports with the remainder including mainly machinery and electrical appliances, leather, rubber, paper, wood and ceramic products. The growth in traditional export volumes--tea, rubber, and coconuts--averaged about 10 percent real growth after a 12 percent decline in 1992.

Owing in large part to tariff cuts and a reduction in the scope of import licensing restrictions, import volume growth in 1993 and 1994 was robust--over 18 percent in each year. This reflected mainly strong textile imports--linked to clothing exports--but also revealed the growth in imported investment goods, including the purchase of commercial aircraft by Air Lanka. In 1993, somewhat less than one-half of the volume growth in investment goods was attributable to purchases by Air Lanka--SDR 62 million. In 1994, when two Airbus Industries aircraft were purchased (valued at SDR 142 million) more than one-half of the volume growth in investment goods was attributable to this lumpy purchase. Overall, when these purchases are eliminated, import volume growth remains robust at 14 percent in 1994, compared with about 17 percent in 1993.

In 1994, net private transfers remained strong, showing about 9 percent growth over the high level of 1993. Nevertheless, consistent with the view that the 1993 surge reflected interest-rate sensitivity, this was a sharp reduction in the growth of private transfers relative to 1993, which was about 23 percent over 1992. Profit and dividend outflows in 1994 were also substantially higher than in 1993, presumably reflecting a temporary delay in repatriations in 1993. Thus, the deepening of the current account

deficit in 1994, apart from the strength of imports due to loose financial policies, also reflected events in the services trade and private transfers.

The direction of foreign trade has remained broadly stable since 1992. The United States absorbed about 35 percent of Sri Lanka's total exports in 1993-94. Exports to the European Union were about 31 percent and just over 5 percent went to Japan in 1993-94. Apart from Japan, Asia countries consumed less than 10 percent of exports from Sri Lanka during this period. Since 1988 there has been a appreciable shift in the direction of exports away from Asia and toward the European Union and the United States. Whereas the United States and the European Union received about 50 percent of total exports from Sri Lanka in 1988, in 1993-94 over 65 percent of exports flowed to these two groups. This mainly reflects Sri Lanka's increased production of textiles and clothing and the relatively liberal access offered to Sri Lanka for these products under the Multifibre Arrangement by the European Union and United States. Sri Lanka's imports have been more concentrated in Asia. Some 60 percent of imports were from Asia (including Japan) in 1993-94, whereas less than a quarter originated in the European Union and the United States combined.

c. Nonmonetary capital flows

Net capital flows increased sharply in 1993-94 owing to the strength of foreign direct investment, to continued high levels of concessional aid to the central government, and to large trade credits linked to Air Lanka's purchases of commercial aircraft. Private investment flows--both direct and portfolio investment in the Colombo Stock Exchange--were particularly strong in 1993, with net portfolio inflows reaching twice the levels of 1991-92. With both presidential and parliamentary elections during 1994 and a change of government, uncertainty contributed to the overall drop in portfolio inflows during the year. The increase in private short-term inflows during 1993-94 reflects both an increase in credits from foreign suppliers to export-oriented firms (Board of Investment--BOI--firms) for the importation of raw materials and an increase in lending by foreign-currency banking units to these BOI firms.

d. External debt

Sri Lanka's external debt-service burden continued to ease during the past two years, with the total debt-service ratio falling from about 20 percent of exports of goods and nonfactor services in 1992 to under 12 percent in 1994. The ratio of debt-to-GDP rose somewhat to about 76 percent in 1993, but preliminary information points to a slight decline in 1994, due in part to a shortfall in project lending. As has been the case throughout the 1990s, most of Sri Lanka's increased debt was on concessional terms with the International Development Association and the Asian Development Bank, the primary multilateral lenders. Japan was by far the largest bilateral lender on concessional terms during this period.

6. Exchange and trade system

Detailed descriptions of developments in the exchange and trade system are provided respectively in the Fund's Annual Report on Exchange Arrangements and Exchange Restrictions, 1994 and in Chapter VII. Only the main developments are highlighted briefly.

a. The foreign exchange market and exchange rate developments

Sri Lanka's foreign exchange regime can be characterized as a very closely managed float. Under current procedures, the Central Bank announces intervention points each morning at which it stands ready to buy or sell U.S. dollars, the intervention currency. A number of factors enter the Central Bank's daily rate-setting decision, including developments in rupee bilateral rates, the rupee/SDR rate, and the rupee real effective exchange rate (REER).

From March 1992 through March 1995, a one percent difference separated the Central Bank's intervention points and an interbank foreign exchange market operated within this narrow range. If the rupee/dollar rate moves to the top (bottom) of the band and there remains excess demand for (supply of) dollars in the interbank market, the Central Bank sells (buys) as many dollars as are demanded (supplied) at that rate. Because of the narrowness of the spread, the interbank rate frequently moved to the top or bottom of the band, thereby limiting interbank transactions.

On March 20, 1995 the Central Bank increased the spread between intervention points from one percent to two percent in order to increase the scope for transactions in the interbank market. The Central Bank intends to monitor developments in the interbank market and the functioning of the exchange rate system before determining whether to widen the spread further.

The REER was little changed from beginning-1993 to end-1994, but it fluctuated substantially during this period. The authorities have tended to depreciate the rupee against the U.S. dollar gradually by the amount of the effective inflation differential, regardless of exogenous movements in the nominal effective exchange rate. As a result, broad-based swings in the dollar have been transmitted directly to the rupee REER. The depreciation of the dollar against the yen and the D-mark through mid-April 1995 stimulated essentially no change in the rupee/dollar rate. In 1995, the rupee is estimated to have depreciated by about 6 1/2 percent in real effective terms through mid-April.

b. Forward exchange market developments

A forward market for foreign exchange is provided by commercial banks and forward rates are market determined. Through March 1993, however, commercial banks were prohibited from writing forward contracts with maturities of more than six months. The forward market was then liberalized to allow contracts with maturities of as much as one year. Most forward

transactions continue to involve contracts with maturities of three months or less. While the Central Bank quotes forward rates for the U.S. dollar at the request of commercial banks, it was not an active participant in the forward market in 1993-94.

c. Exchange restrictions

Sri Lanka accepted the obligations of Article VIII, Sections 2, 3, and 4 in March 1994 and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions.

d. Trade policy

Sri Lanka has maintained essentially a four-band tariff system since November 1991, when it adopted standard rates of 10, 20, 35 and 50 percent. In November 1993, the maximum standard tariff was reduced from 50 percent to 45 percent. Further unilateral liberalization occurred in February 1995, when the maximum rate was again reduced to 35 percent, achieving a three-band system with rates of 10, 20, and 35 percent.

Several zero-rated items (principally pharmaceuticals and fertilizer) remain. Moreover, some items, for example automobiles, alcoholic beverages and tobacco products, face tariffs in excess of the maximum standard rate. Duty waivers are in place for a number of items and occasionally new waivers are introduced. BOI firms have duty free import privileges and are empowered to clear customs on their own authority.

During 1993-94 the Government removed export licensing restrictions on all but four items, most justified for reasons of environmental protection. A large number of import licensing restrictions were also removed, with most of the remaining restrictions justified for reasons of national security, public health, public morals, or environmental protection.

III. Issues Pertaining to the Official Price Index
and Estimates of Underlying Inflation

1. Overview of the issues

The deficiencies of the Colombo consumer price index (CCPI) as an indicator for measuring inflation have been a long-standing issue. In particular, the CCPI has long been viewed as understating the true extent of price increases. The use of the CCPI in the computation of several components of the GDP deflator may also be overstating real growth. Thus, the deficient index hampers the authorities' ability to analyze economic developments and to formulate appropriate policies. Despite the obvious shortcomings, the authorities have been reluctant to adopt a better index owing to the tradition of using the CCPI to determine cost of living adjustments for civil servants and workers covered by the Wages Boards. The Central Bank had for a time compiled a separate, island-wide index for

policy formulation purposes based on a more representative consumption basket that consistently showed higher inflation, but stopped doing so in the early 1990s because of pressure from labor unions.

The deficiencies of the official price index became accentuated in 1994 in the face of widespread duty waivers on essential consumer imports and significant downward adjustments in administered prices of several mass consumption items beginning in May that resulted in the CCPI substantially understating the underlying rate of inflation. The recorded rate of inflation, as measured by the CCPI, declined significantly in 1994 to 8.4 percent (annual average) and 4.2 percent (December-to-December), from 11.7 percent and 10.3 percent, respectively, in 1993. However, the underlying inflation in 1994 is estimated to be significantly higher than the recorded inflation as a result of the duty waivers and administered price reductions. Against this background, this chapter describes the deficiencies of the CCPI in more detail, presents alternative approaches to estimating underlying inflation, and assesses inflation performance in 1994.

2. Deficiencies of the official price index

The CCPI covers a basket of 219 items consumed by an average working class family in the greater Colombo area as revealed in a 1949-50 survey of 455 households. The consumption basket was subsequently revalued at prices in 1952, which has been the base year for constructing the CCPI. The CCPI consumption basket thus reflects the consumption patterns of the lowest four deciles of the income distribution over 40 years ago. The base year weights for broad expenditure categories and selected consumption items are summarized in Table 1.

The main deficiencies of the CCPI stem from its outdated consumption basket and weighting system and its heavy bias toward the lower end of the income distribution. These deficiencies result in a heavy weight of staple food items in the index, which in turn, make the CCPI unduly vulnerable to seasonal factors. Moreover, given that prices of many mass consumption food, as well as nonfood, items that figure prominently in the consumption basket are administered, the index is also unduly influenced by Government action.

The outdated consumption basket also excludes several important present day consumption items, such as gasoline. Similarly, other regularly consumed items in the present day, including various household goods, liquor, and tobacco, have a very small weight in the index. In addition, rent, one of the major household expenditure items in urban areas, is not properly reflected in the index. The rent component of the CCPI is based on a government-controlled price for low-income housing that has not changed in over a decade. Yet another limitation relates to the limited geographic coverage of the index. The CCPI only covers the Colombo metropolitan area and thus is not fully representative of price changes in the entire country.

Table 1. Sri Lanka: Colombo Consumer Price Index Weights

Category/Item	Weight (percent)
Food	61.9
Rice	(6.4)
Bread/wheat flour	(9.4)
Clothing	9.4
Fuel and light	4.3
Kerosene	(4.0)
Rent <u>1</u> /	5.7
Miscellaneous	18.7

Source: Information provided by the Sri Lanka authorities.

1/ Refers government-provided low-income housing, which is under rent control.

3. Alternative indicators of inflation performance

a. General considerations

Consumer price indices are only proxy measures of inflation, as true inflation also reflects changes in prices of capital goods and services as well as those for consumers. The above considerations suggest that the CCPI is neither a good indicator of underlying inflation nor a particularly accurate reflection of price movements of consumer goods and services. There is little doubt that price increases affecting the average family in Colombo were much higher than those indicated by the CCPI in 1994. Rent, for example, increased sharply in a range of 15-20 percent in the Colombo area during the year but was not even captured by the index. Hence, alternative indicators must be looked at to assess underlying inflation and price developments in Sri Lanka during 1994.

Most definitions of underlying inflation employed in the literature revolve around some notion of a long-run, persistent component of changes in the measured price index that is typically, but not always, linked in some manner to monetary expansion. Thus, most measures of underlying inflation attempt to remove transitory or random effects on the price level, such as food and oil price shocks, and non-competitive forces such as administrative price controls. The United States Department of Labor, for example, has devised a measure of underlying inflation by removing food, energy, and shelter-related prices from the consumer price index and rescaling the remaining components.

b. Alternative approaches to estimating underlying inflation

Perhaps the most straightforward approach to estimating underlying inflation in 1994 is to simply remove the impact of duty waivers and administered price reductions from the index. The impacts of duty waivers were broad-based and spread over many categories of goods over a period of several months, and thus are difficult to estimate with any degree of precision. However, the administered price reductions were implemented at discrete points in time on particular goods that are easily identified. The impact of cuts in administered prices of wheat flour, bread, and kerosene is simulated by adding back to the official price index the index point reductions that are estimated to have resulted from the price changes. This method yields an annual average inflation of 11.7 percent and a December-to-December price increase of 11.9 percent in 1994 (Table 2 and Chart 1). As these estimates exclude the impact of duty waivers, they could be viewed as a lower bound for underlying inflation in 1994.

Another approach to estimating underlying inflation is to look at the price changes of goods that are not affected by the duty waivers and administered price cuts. In the Sri Lanka context, the miscellaneous component--comprising, among other items, various household goods, alcohol, tobacco products, newspapers, medicine, entertainment, transport, and school

Table 2. Sri Lanka: Alternative Colombo Consumer Price Indices, 1993-94

	Official Index	Alternative A <u>1/</u>	Alternative B <u>2/</u>
	<u>(1952 = 100)</u>		
1993: Dec.	1,498.7	1,498.7	1,498.7
1994: Jan	1,536.8	1,536.8	1,536.8
Feb	1,554.4	1,554.4	1,554.4
Mar	1,561.9	1,561.9	1,561.9
Apr	1,574.1	1,574.1	1,574.1
May	1,543.2	1,543.2	1,582.3
Jun	1,546.6	1,546.6	1,586.4
Jul	1,502.1	1,552.1	1,632.4
Aug	1,520.7	1,570.7	1,645.5
Sept	1,467.3	1,572.3	1,646.6
Oct	1,456.6	1,571.3	1,657.2
Nov	1,502.2	1,617.2	1,672.7
Dec	1,561.8	1,676.8	1,683.9
	<u>(Percentage change)</u>		
Annual average	8.4	11.7	14.4
Dec-to-Dec	4.2	11.9	12.4

Sources: Data provided by the Sri Lanka authorities; and staff estimates.

1/ Excludes the impact of cuts in administered prices of wheat flour, bread, and kerosene.

2/ Reflects the monthly increase in the miscellaneous component of the official index from May onward.

fees--of the CCPI was probably least affected by administered price changes and duty waivers, but has a weight of only 18.7 percent in the overall index. The miscellaneous component and the overall CCPI moved quite closely together through 1993. Over the period 1980-93, for example, the CCPI indicated an annual average inflation rate of 13.2 percent against an average of 13.6 percent for the miscellaneous component. After May 1994, however, the miscellaneous component continued to increase while the overall index declined.

In light of this, one method of estimating underlying inflation in 1994 would be to revise the overall index to reflect the increase in the miscellaneous component from May onward when the duty waivers and administered price reductions began to take effect. Applying the monthly increase in the miscellaneous component to the overall index beginning in May indicates an annual average inflation of 14.4 percent and a December-to-December price increase of 12.4 percent in 1994 (Table 2 and Chart 1). This approach is subject to upward bias as the reduction in the cost of purchasing necessities enabled a greater proportion of consumers' income to be spent on other goods, such as those in the miscellaneous category. This, in turn, could have put pressure on miscellaneous items, resulting in greater price increases of these goods than would have been the case otherwise. However, this bias is considered to be modest owing to the time lags involved.

Another approach seeks to relate underlying inflation to monetary expansion. Broad money growth of about 20 percent during 1994, together with real GDP growth that averaged 5.6 percent and an estimated slight decline in velocity, suggests an increase in the GDP deflator of 11-13 percent in comparison with an official estimate of 9.7 percent. Given the methodology employed in Sri Lanka for calculating the GDP deflator, which utilizes the CCPI to estimate certain components, a deflator of 11-13 percent would be consistent with a December-to-December increase in consumer prices of 12-14 percent and consumer price inflation of 14-16 percent. The downward bias in the deflator may also have resulted in an overestimation of real GDP growth, which would imply even higher consumer price inflation.

A final consideration on underlying inflation is to look at the rate of increase of factor costs, such as the rental price of capital and unit labor costs. In this connection, it is interesting to note that interest rates on loans ranged from 17 to 20 percent during the year while civil service wages rose 12 1/2 percent and private sector wages outstripped the increase in the CCPI by a wide margin. For example, the minimum wage of workers in the service industry increased by about 18 percent, while workers in the textile industry received wage increases in a range of 17-19 percent. These developments provide further evidence that underlying inflation was well above the recorded inflation in 1994.

CHART 1
SRI LANKA
ALTERNATIVE COLOMBO CONSUMER PRICE INDICES, 1993-94
(1952=100)

Sources: Data provided by the Sri Lanka authorities; and staff estimates.

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4. An assessment of inflation performance in 1994
and implications for policy

Although the above analysis is hardly exhaustive, it strongly suggests that the recorded decline in the CCPI during 1994 is not an accurate depiction of inflation performance in Sri Lanka. On the contrary, the analysis indicates that inflation performance during the year was little changed from the double-digit inflation rates that have prevailed throughout the SAF/ESAF period. This conclusion has important policy implications. In particular, the lack of improvement in underlying inflation indicates the need to significantly tighten monetary policy from last year's 20 percent liquidity expansion. In addition, double-digit inflation implies that the real effective exchange rate appreciated, rather than depreciated as suggested by the change in the official price index.

IV. Unemployment and Structural Rigidities
in the Sri Lanka Labor Market

1. Overview of the unemployment problem

Sri Lanka has an excellent record of social development, as evidenced by social indicators that compare favorably with much higher per capita income countries. At the same time, the country has failed to create sufficient employment opportunities for its people. Since independence in 1948, measured unemployment has never been below 11 percent and has been as high as 21 percent. These are high levels of unemployment for a developing country, particularly one in which the agricultural sector has been dominant. In virtually all developing countries, unemployment has been primarily an urban problem that tended to increase with urbanization. However, in Sri Lanka, 40 percent of the labor force is still employed in agriculture, and three fourths of the population still live in rural areas, as do four fifths of the unemployed. The persistently high unemployment rate--currently at 13 percent--and the lengthy duration of unemployment spells have thus been longstanding social concerns in Sri Lanka.

Although the sudden surge in population growth in the 1950s owing to malaria eradication may have contributed initially to unemployment, population growth has not been a major contributor to the problem. Population growth fell steadily from about 3 percent in the 1960s to 1 1/2 percent by the mid-1980s and to 1 1/4 percent by the early 1990s, one of the lowest growth rates in the developing world. High rates of unemployment have not resulted from exacting definitions of employment either; the labor force surveys from which unemployment is estimated are very generous in their definitions of employment. Measured unemployment, in fact, probably understates the true extent to which the labor force is under-utilized.

The unemployment problem has also not resulted from lack of attention or concern by policymakers and planners. Reducing unemployment has been an

important component of government development plans since the early 1950s. However, much of the problem appears to result from structural rigidities in the labor market relating to Sri Lanka's restrictive labor regulations and public sector hiring practices. The high value of government-mandated wages and benefits and of job security in the regulated segment of the labor market, and possibly the social status of government employment, appear to motivate a long-lasting search for employment by the young and relatively well educated. A government tendency to hire from the ranks of the unemployed may also encourage youth to remain unemployed. The best example of this phenomenon is the occasional mass hiring of teachers from among the ranks of unemployed school leavers. This tendency may be reinforced by social transfer programs that reduce the incentive to accept low-wage employment. Moreover, the restrictive labor laws greatly reduce firms' flexibility in utilizing labor and distort relative factor prices, slowing employment growth. Despite the chronic unemployment, labor market reforms that would have reduced the structural rigidities and thus have broadened employment opportunities have not been enacted.

2. Segmentation of the labor market

The most significant result of the policy-induced structural rigidities is the segmentation of the labor market into three distinct sectors: plantations; activities for which labor market regulations are enforced (the "regulated" sector); and activities for which regulations are not enforced (the "non-regulated" sector). Government policies offer very different rewards to workers and job seekers in the various segments, on the one hand, but create barriers or incentives that sharply restrict mobility between sectors, on the other.

a. The plantation sector

Although the plantations formally belong to the regulated sector in the sense that they are subject to a high degree of labor market regulation, it is best to consider them separately because of their unique features. The tea plantations currently provide employment to about 450,000 mainly Tamil workers, which is about 8 percent of total employment. Tamils were originally brought from India by the British during the colonial period, and only recently became citizens of Sri Lanka. Fears of ethnic clashes between the Sinhalese majority and the Tamil minority, and other barriers, have limited the geographical mobility of the Tamil plantation workers outside the plantations (Rama 1994). Wages are very low on the plantations: the average plantation wage was about SL Rs 80 per day in 1993, in comparison with SL Rs 95 per day for a casual laborer in paddy, itself a relatively poorly paid occupation.

Lack of mobility is a major problem because there is substantial excess employment in the plantations. Since their nationalization in 1970, the plantations have been over-staffed owing to generous hiring of workers' children by the Government and declining levels of replanting investment. As a result, the plantations' financial position deteriorated steadily, and

Sri Lanka's share of the world tea market fell from nearly 40 percent at independence to about 10 percent at present. The performance of the sector began to improve somewhat in 1992 with the privatization of the management of the estates, although the improvement has been modest owing to constraints placed by the Government on the private managers. For example, the new managers have been prevented from retrenching staff for economic reasons, although disciplinary dismissals are allowed. Further, the duration of the management contracts is not long enough for replanting to be profitable. Hence, little new investment has been made, and it appears that the overstaffing problem will persist.

b. The regulated sector

The regulated sector covers roughly one fourth of employed workers--about 1 1/3 million persons--comprising civil servants in central and local government agencies, the military, state enterprises, and about one fifth of those employed in the private sector. Workers in the regulated sector benefit from the enforcement of a profuse array of government regulations that provide distinct advantages such as job security, high wages, and generous pensions. These advantages, in turn, provide a strong incentive to work in the regulated sector.

The Government either sets or regulates wage and non-wage benefits in the regulated sector. Government wages, at least in the lower skill grades, are well above comparable wages paid in the private sector. In the private sector, the Government sets minimum wages for most skilled trades through the Wages Boards. Although actual wages are usually higher than the minimum wages, the activities of the Wages Boards serve to keep regulated sector wages well above those in the other segments.

Perhaps the most important non-wage benefit is the pensions. Government employees benefit from a pension (or lump sum settlement) upon retirement, and their heirs benefit from a Widows and Orphans Protection Fund. Employees of public enterprises and private companies that fall under the regulated sector are covered by the Employees' Provident Fund (EPF) and the Employees' Trust Fund (ETF). The EPF is financed by employer contributions of 12 percent of the wage bill and employee contributions of 8 percent. Employers also contribute 3 percent of the wage bill to the ETF. In addition, employers must hold another 4 1/2 percent of wages in reservation under the Gratuity Act of 1983.

Job security is another important element of the regulated sector. Retrenchment restrictions are legislated by the Industrial Disputes Act and

the Termination of Employment of Workmen Act (TEWA). ^{1/} The TEWA prevents companies with more than 15 employees from laying off workers for non-disciplinary reasons without either obtaining their agreement or the prior written approval of the Commissioner of Labor. The TEWA covers lay-offs motivated by retrenchment or business closure, even termination for incompetence. Moreover, it is usually not possible to obtain permission to terminate workers from the Commissioner of Labor, so that downsizing or closure typically necessitates generous severance packages to induce voluntary retirement.

Workers in the protected segment also benefit from 26 public holidays per year, and typically from the two-day weekend common in industrial countries. Overtime and work on public holidays are remunerated at 1 1/2 times the basic wage rate, adding further to the burden of regulated sector employers.

c. The nonregulated sector

The majority of Sri Lanka's workers--about 3 1/2 million persons--are employed in the non-regulated sector. Although much of the nonregulated sector comprises agricultural activities, it also includes numerous private manufacturing and service enterprises in urban areas. Many urban enterprises have avoided labor regulations by being below the size threshold--the TEWA does not apply to firms with less than 15 employees. Other firms are able to avoid labor market legislation with impunity owing to bureaucratic inefficiency. In addition, some firms have received compliance waivers from the Commissioner of Labor. For example, most foreign companies setting up operations in the Export Processing Zones (EPZs) have been able to negotiate very lax application of labor regulations. ^{2/} Because their employers largely avoid the intricate array of labor market legislation, workers in the non-regulated sector receive correspondingly lower wages and fewer nonwage benefits.

3. Structural explanations of unemployment

In an efficient labor market, wages adjust to provide full employment. In the Sri Lanka context, structural impediments introduced by the Government prevent this from happening, creating high levels of unemployment. The main structural explanations of unemployment relate to

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^{1/} In addition to these two pieces of legislation, the Gratuity Act mandates that, in the event of termination of employment, workers with five years of service or more are entitled to receive half a month of salary for each year of service, irrespective of the cause of termination--i.e., whether they were fired or voluntarily resigned.

^{2/} Furthermore, firms in the EPZs, through strict security controls at the entrances of the industrial estates, have been able to prevent union activists from infiltrating their operations, and thus have avoided unionization as well.

queuing by young school leavers for coveted jobs in the regulated sector, primarily in the civil service, and distortions in relative factor costs resulting from the rigidities that constrain job growth.

a. Queuing

The available evidence indicates that young graduates conduct an extended search for coveted jobs in the regulated sector, especially in government and the state enterprises. This search is motivated by the superior benefits and job security described above. There is thus a voluntary aspect to this unemployment. The advantage of public sector employment are sufficiently high that they appear to justify queuing even when the probability of obtaining such employment is relatively low. Reflecting this, two thirds of the unemployed are 24 years old or younger, and half have attained their General Certificate of Education (Ordinary or O-level).

A necessary condition of voluntary unemployment is that the unemployed must be wealthy enough to afford it. Evidence from household surveys indicates that the median duration of unemployment is 15 months and that more than one in ten of the unemployed have been so for more than four years. Moreover, survey data indicate that virtually all unemployed school leavers receive assistance from their families. These findings, together with the fact that well over half of the unemployed have never had a job, suggest that the majority of the jobless are the children of relatively wealthy families.

Many observers have attributed the high voluntary unemployment to government hiring practices that favor the unemployed. As described above, government jobs provide generous benefits and a high degree of job security in comparison with private sector jobs in the non-regulated sector. In addition, there is a great deal of prestige attached to government jobs. Those queuing do not take other employment because of a perceived or real government preference for hiring the unemployed. Although this contention is controversial, recent action by the Government to hire large numbers of unemployed graduates as teachers reinforces this perception. Irrespective of the actual behavior of the Government, the widespread perception that it favors the unemployed in its hiring practices contributes to the unemployment problem in that young school leavers do not accept jobs in the nonregulated sector because they believe it reduces their chances of obtaining more desirable employment in the public sector.

Survey evidence indicates that many of the unemployed young engage in a variety of activities while waiting for government jobs, such as studying to retake the O- and A-level examinations, to become eligible for such jobs while receiving financial support from their families. The high rate of

second and further sittings for O- and A-level exams confirms this. ^{1/} Young people in Sri Lanka may also prefer unemployment to accepting a low-wage job in the non-regulated sector because they can count on parental support, and choose not to work if not required to do so by their parents. The evidence also suggests that low-wage employment in the nonregulated sector is not taken because of the stigma attached to it by the relatively well-educated segments of the population.

b. Relative price

Government policies increasing the cost of labor relative to capital induce investment in labor-saving and capital-intensive manufacturing technology, and thus slow the growth of employment. The main policies that increase labor costs are the TEWA and the 23 percent social security tax rate on wages. The TEWA, in particular, has been viewed as being a major constraint to efficient utilization of factors of production, resulting not only in a more capital-intensive production structure than relative factor endowments would dictate, but also in a lack of vertical integration of industrial operations as firms have sought to stay under the 15 worker threshold over which the TEWA becomes operative. ^{2/} The TEWA prevents any retrenchment on non-disciplinary grounds without the written consent of the workers concerned in production units with fifteen or more personnel. Historically, firms that have attempted to discontinue all or part of their operations without the workers' consent have paid dearly for doing so. In virtually every case, the Commissioner of Labor--the legislated arbiter of labor disputes--has sided in favor of labor, often imposing compensation amounts equivalent to several years wages per worker. Since consentment requires generous severance pay, the TEWA has been viewed by private firms as a major constraint to expanding or diversifying their operations, and provides them a powerful incentive to minimize the size of their work force.

Duty waivers and reductions on the import of capital goods used in export industries, a common practice in Sri Lanka for firms located in the EPZs, could also lead to lower employment growth because they raise the price of labor relative to capital. Policy measures that lower the price of capital, such as interest subsidies, which are a common feature of various government industrial development programs, might also be resulting in greater utilization of capital than relative factor costs would dictate.

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^{1/} Failure rates for those taking the O-level examination for the first or second time is over 80 percent.

^{2/} The TEWA has also complicated the privatization process, making it difficult for the new private owners to retrench staff in bloated public enterprises.

V. Fiscal Sustainability in Sri Lanka

1. Introduction and background

Sri Lanka has endured persistent high fiscal deficits ^{1/} over the past two decades. These deficits have led to rising public debt which has grown from 50 percent of GDP in 1974 to nearly 100 percent twenty years later. By simple comparison with other countries, therefore, the Government of Sri Lanka is highly indebted (Table 3). This chapter attempts to explain how the debt position evolved, whether it is a problem for the authorities, and what kind of fiscal strategies could be adopted to improve the situation.

2. History

Since independence in 1948, Sri Lanka has striven to establish a fully functioning economy. During the 1960s, the Government concentrated on its social agenda, aimed at reducing poverty and unemployment through socialist measures. Sri Lanka has also prided itself on the relatively high levels of education and medical services, compared with many other Asian countries. During the past two decades, Sri Lanka has experienced fluctuating, and at times, very substantial primary deficits, that is deficits excluding interest payments (Chart 2). The rising interest burden exacerbated the fiscal position; interest payments doubled as a share of GDP from 1974 to 1994. The availability of concessional foreign financing enabled high levels of both capital and current spending to take place. The country has maintained a large and inefficient public sector including an unwieldy civil service and state control over much of the plantations, manufacturing, and service sector. Though the investment program has been partially successful--the country has averaged real growth of 4-6 percent for most of that period--the result has been a growing debt burden. The macroeconomic consequences of this fiscal expansion became evident in the 1980s. Inflation has averaged 10-15 percent in the period since 1978 as monetization of the deficit exceeded what could be absorbed through increased money demand and high reserve requirements.

3. Sustainability

Is this level of government debt a serious problem? The conventional literature defines sustainability as when the government can meet future debt obligations should it continue with its present fiscal policy. As such, this is a solvency test which all governments can meet ex post through higher taxes, lowering expenditure of all forms, and if necessary, debt repudiation. However, for the condition to be economically meaningful, the

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^{1/} Although the unadjusted fiscal balance is an unreliable indicator of the stance of fiscal policy, it does lead directly to the debt position.

Table 3. Sri Lanka: Selected International Comparison of External and Domestic Central Government Debt, 1989-93

	External Debt	Domestic Debt	Total
<u>(As percent of GDP)</u>			
Sri Lanka	55.8	41.3	97.1
<u>Industrial countries</u>			
Belgium <u>1/</u>	16.5	97.5	114.0
Germany	10.6	16.0	26.6
Italy	5.0	75.5	80.5
Japan <u>2/</u>	0.3	57.2	57.5
United Kingdom	5.3	29.2	34.5
United States	8.3	38.9	47.1
<u>Other Asia</u>			
India	5.9	47.2	53.1
Korea	2.3	4.8	7.1
Malaysia	15.2	51.5	66.6
Pakistan	33.0	42.6	75.5
Philippines	22.5	34.0	56.5
Singapore	--	85.2	85.2
<u>Heavily indebted</u>			
Argentina <u>3/</u>	12.5	2.3	14.8
Bolivia <u>4/</u>	22.1	4.8	26.9
Mexico <u>5/</u>	...	...	53.0

Source: IMF Government Finance Statistics Yearbook, 1994.

1/ 1989-92.

2/ 1989-90.

3/ 1988.

4/ 1993.

5/ 1989.

SRI LANKA
GOVERNMENT DEBT, 1974-95
(In percent of GDP)

Sources: IMF, International Financial Statistics; and IMF, Government Finance Statistics; and staff estimates.

1/ Budget.

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current fiscal stance should be such that the test can be met ex ante, with no recourse to debt write-offs. Recent debt crises have shown that there are clear perceived limits on the government's ability to repay debt by borrowing from future generations to finance present consumption. 1/ The important implication of unsustainable deficits is that costly and disruptive economic adjustment may be imposed on the country by capital markets, reluctant to acquire the government's debt, should policy makers fail to undertake fiscal adjustment. These questions of fiscal sustainability are evaluated by investigating the path of the debt-to-GDP ratio.

There are two components to the increase in government debt in each fiscal year. First, reflecting tax and spending choices, debt will increase on account of borrowing to finance the present year's deficit. This financing is equal to the primary deficit that is not financed by money creation. 2/ Second, future debt will increase by the interest burden incurred on the outstanding debt. To put these levels in context, it is useful to examine them in real terms and in relation to GDP, thus the change in the debt/GDP ratio is,

$$\Delta (\text{Debt/GDP}) = \text{Primary deficit/GDP} + (\text{Real interest rate} - \text{growth rate}) * \text{outstanding Debt/GDP}$$

Typically, in countries in which interest rates are market determined, interest rates exceed the rate of growth so that there needs to be a primary surplus to avoid the debt ratio rising inexorably. 3/ Fiscal adjustment must be more substantial when the stock of debt is greater and countries with high debt levels have less scope to adjust over time. Equally important, the sustainability condition whereby the debt/GDP ratio is stabilized may imply that there is little scope to provide fundamental noninterest public services or taxes are unrealistically high.

1/ The limitations of the conventional deficit concept are not addressed in this presentation. Such limitations and the value of balance-sheet presentations for the measurement of public net worth are discussed in Chapter 13 of Blejer and Cheasty, editors, How to Measure the Fiscal Deficit, IMF, 1993. However, in Sri Lanka social security is outside the fiscal accounts, eliminating a major distortion to net worth.

2/ In some countries, the budget is financed in part by asset sales. Though these proceeds can be substantial, they are generally temporary and may not sustain a high deficit in the long term. The government balance-sheet approach as an indicator of solvency allows for the full implications of asset sales to be evaluated. In Sri Lanka, privatization proceeds have in the past been classified as negative capital spending, reducing the recorded deficit, although in many cases majority state-ownership has been retained. In the 1995 budget, SL Rs 4.5 billion of such sales are included "above the line" while other possible receipts are expected to lower the level of debt, from the financing side.

3/ The interest rate on external debt must be adjusted for the local currency impact of revaluing debt denominated in foreign currency.

On the simple basis of stabilizing the debt/GDP ratio, Sri Lanka's fiscal stance in recent years could be seen as sustainable. In fact, the level of the debt ratio has declined since its peak of 109 percent of GDP in 1989. Even after an overall fiscal deficit, excluding grants, of nearly 10 percent of GDP in 1994, the ratio actually fell slightly. The reasons for this development are the relatively high rates of growth enjoyed by the country--5.6 percent in 1994--and the extremely low rate of interest paid by the Government on its debts. These low rates result from the high levels of foreign concessional aid provided to the country and an element of nonmarket domestic interest rates as much of such financing comes from state-controlled savings institutions. ^{1/}

What then is the case for fiscal consolidation? The compelling argument for fiscal adjustment centers on the impact of the current policies.

The budget deficit implies a transfer of real resources to the government from the domestic private sector and from external sources. On the domestic front, this means crowding-out of private investment while the external resources result in a substantial current account deficit in the balance of payments. In the case of Sri Lanka, the high cost of financing has been identified by private companies as the main impediment to investment, with the savings institutions diverting most of their deposits back to the Government. For Sri Lanka there is little evidence that the deficit financed public investment provides a rate of return that would exceed the cost of borrowing if no concessional aid was involved.

The size of the interest payments dictates that the authorities must tailor their expenditure plans and monetary policy accordingly. In 1994 over 37 percent of tax revenues were consumed by interest payments. As a result, worthwhile current expenditures have been overlooked while ad hoc cuts in capital spending have been used as a short-term source of savings in recent years. A fear of raising interest rates because of the debt servicing implications is also impeding monetary policy objectives for inflation and the overdue financial sector reform.

Thus overall, fiscal policy is having a negative impact on macro-economic stability in the short run and impeding growth-oriented structural and macroeconomic policies in the longer term.

4. Sustainable fiscal strategies

In the 1995 Budget Speech, the Government outlined several broad objectives of medium-term economic reform. Fiscal adjustment is intended to raise public savings to enable the country to phase out gradually domestic borrowing and absorb concessional foreign aid for public investment and

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^{1/} Appendix III describes the composition of debt and the related interest payments.

rehabilitation. The principal goal is to accelerate growth to 7-8 percent by 1997, in a context of low inflation (5-6 percent) and a reduction in the external current account deficit to about 5 percent. The Government aims to maintain its revenue effort by broadening the tax base, limiting ad hoc concessions and changes in tax rates. On the expenditure side, adjustment will come from reduction in waste, moderated defense and refugee expenditure, and increased participation of the private sector in public enterprises. The fiscal deficit, after grants, is targeted to be reduced to 4 percent of GDP by 1997. Privatization proceeds are expected to provide a means to reduce the public debt during this period.

What would be the effect of such a medium-term fiscal strategy on debt and the burden of interest payments? To illustrate the impact of this policy adjustment, projections up to 1998 have been made utilizing the framework adopted for the staff report (SM/95/95) on the following basis:

Scenario A: A no adjustment path of fiscal deficits, excluding grants at the level of 1994, that is 10 percent of GDP. Foreign financing, including grants, to remain concessional but at declining amounts, with the residual financed by domestic sources. Inflation is kept reasonably in check by tight monetary policies, raising interest rates.

Scenario B: A reduction in fiscal deficit, after grants, to 2.5 percent of GDP by 1998. Financing to continue as currently, with 3 percent of GDP foreign financing, at concessional terms, some privatization proceeds, and the remainder from the domestic sources.

Scenario C: As in scenario A but all financing moves to market rates.

Under scenario A, the debt ratio increases only marginally to 98 percent of GDP by the end of 1998 (Table 4). Nevertheless, the burden of interest payments would continue to increase, as interest rates rise, and there would be some clear inflationary pressures. Interest payments would rise to 7 percent of GDP by the end of the period. The implied primary deficit would remain above 2 percent of GDP. It is projected that the restrictions on private sector investment implied by the policy mix would constrain real growth somewhat. However, if monetary policy cannot be used to restrain inflation, because of the excessive crowding out of the private sector that would result, the consequences will be continued higher inflation.

Scenario B shows the impact of sharp fiscal correction on the government's debt and debt-service burden. If the government's overall fiscal deficit were reduced to 2 1/2 percent over the medium term (corresponding to a surplus on primary operations of 1 1/4 percent of GDP), interest payments might decline significantly. Assuming GDP growth of 6 percent and a small decline in real interest rates, debt would fall to 80 percent of GDP by 1998, and to less than 70 percent soon after. The decline in the budget financing would allow for a significant increase in

Table 4. Sri Lanka: Illustrative Fiscal Scenarios for
Debt Stabilization and Debt Reduction

(In percent of GDP; unless otherwise indicated)

	Debt Stabilization	Debt Reduction	Debt Stabilization Market Interest Rate
	Scenario A	Scenario B	Scenario C
Real GDP growth (percent per annum)	5.0	6.0	5.0
Inflation (percent per annum)	10.0	4.0	10.0
Real domestic interest rate <u>1/</u>	3.0	1.0	4.5
Total debt			
In 1994	94.8	94.8	94.8
In 1998	99.3	80.6	99.3
Interest payments	7.3	3.8	10.3
Interest payments/total tax revenue	44.0	15.2	61.8
Overall deficit	9.5	2.5	9.5
Primary balance <u>2/</u>	-2.2	1.3	0.8

Source: Staff simulations.

1/ Assumed weighted average interest rate on government paper.

2/ Overall deficit minus gross interest payments on government debt.

credit to the private sector. Combined with lower interest rates, and other structural reforms, the authorities could then lay the foundation for a higher level of sustained growth.

Scenario C was chosen to illustrate a major problem with the existing fiscal stance. It is not prudent to assume that the sources of budgetary financing will continue to supply the necessary funds in the context of continued failure to establish financial stability. Foreign donors may be unwilling to extend concessionary aid to the same degree while the domestic banking and savings institutions may require higher levels of real interest rates. Under such circumstances, the continuance of current levels of fiscal deficit, financed at market interest rates, would suggest an unrealistic increase in debt service to 10 percent of GDP by 1998, equivalent to over 60 percent of tax revenues. The primary balance would need to reach a small surplus.

5. Conclusions

The main conclusion to be drawn from the examination of the factors underlying the Government's current debt position is that though the debt ratio is stable, this position is not sufficient to provide macroeconomic stability. The size of the debt burden currently limits the authorities in their expenditure choices, and impedes structural reform. Moreover, the factors helping Sri Lanka to maintain the debt/GDP ratio--concessional aid and high growth--cannot be taken for granted in the future.

VI. Pricing and Marketing Policies of the Cooperative Wholesale Establishment

The Cooperative Wholesale Establishment (CWE) was established in 1949 as the main government organization entrusted with the task of procurement and distribution of a wide range of consumer goods in the post-Independence period. Its broader mandate includes: meeting the supply requirements of the cooperative societies; undertaking trade and commercial activities in the agricultural, industrial, and services sectors; and investing and acquiring financial stakes in public corporations with similar objectives.

The role and the scope of activities of the CWE have changed over the years in line with the evolving government policies. In its early years, the CWE maintained a virtual monopoly on importation, local procurement, and distribution of many consumer goods as most aspects of internal and external trade were rigidly controlled by the Government. Beginning in the late 1970s, consistent with government policies to deregulate the economy and liberalize commerce, the CWE's main activities increasingly focused on the procurement and distribution of essential food items. At the same time, in parallel with the increased private sector participation in external and internal trade, the CWE's market share began to diminish gradually at the import, wholesale, and retail levels. Nevertheless, the CWE still continues

to play a major role in the procurement and distribution of some essential foodstuffs, notably wheat grain and flour.

This chapter outlines the pricing and marketing policies of the CWE in the context of the Government's efforts to ensure the availability of essential foodstuffs at low prices. Section 1 provides background information by describing the role and relative importance of the CWE in the importation, procurement, and distribution of major food items. The pricing policy of the CWE for major food items is discussed in Section 2. Section 3 highlights the CWE's role as the major importer of wheat grain and distributor of wheat flour, as well as the evolution of flour and bread prices over the past few years leading to the emergence of large-scale subsidies in late 1994. Section 4 presents conclusions.

1. CWE's market share at import and retail levels

Wheat grain, onions, red lentils, sugar, rice, and dried chilies are the main mass consumption food items that are imported or procured locally, and sold at the wholesale and retail levels by the CWE. There is no significant domestic production of wheat or red lentils, but local production currently accounts for virtually the entire domestic consumption of rice, 80 percent of chilies, 70 percent of onions, and about 10 percent of sugar.

The gradual liberalization of external trade since the late 1970s culminated in the elimination of the CWE's monopoly on imports of: sugar in 1990; rice in 1991; lentils, onions, and chilies in 1992; and wheat grain in 1994. Nevertheless, until recently, the Government continued to exercise control on private imports of a number of agricultural products through licensing in order to protect domestic producers during the harvest season. In late 1994, as a part of the ongoing reform of the trade regime, such import licensing was confined to chilies, onions, and potatoes during the harvest.

In 1994, the CWE maintained the major share of wheat grain imports (72 percent of total imports), but private traders accounted for about two thirds of imports of lentils and onions and for virtually all imports of sugar, rice, and chilies (Table 5). The CWE's purchases of onions, rice, and chilies from local sources are negligible, but it procures about 35 percent of the domestic production of sugar. Excluding wheat grain and flour, the procurement and distribution policy of the CWE has been generally geared toward meeting temporary market shortages and dampening seasonal price fluctuations, particularly price increases in advance of holiday seasons. The CWE also exports some nontraditional items such as beetle leaves and coir.

The CWE carried out wholesale and retail sales of foodstuffs, as well as some other basic consumer items through its 38 wholesale outlets and 130 retail stores throughout the country. The CWE currently accounts for about 50 percent of the retail trade in lentils, but its retail market share of other main foodstuffs is about 10 percent or less. Wheat flour is the only

Table 5. Sri Lanka: Imports of Essential Foodstuffs, 1990-94

	1990	1991	1992	1993	1994
<u>(In metric tons)</u>					
Wheat grain	652,964	667,000	706,140	826,300	877,060
CWE	652,964	667,898	706,140	826,398	634,124
Private	--	--	--	--	243,736
Wheat flour	111,003	--	--	34,355	--
CWE	111,003	--	--	34,355	--
Private	--	--	--	--	--
Onions	31,447	48,689	35,507	39,457	47,400
CWE	31,447	48,689	35,507	24,846	12,849
Private	--	--	--	14,611	34,551
Lentils	33,665	38,412	43,371	49,267	79,431
CWE	33,665	38,412	41,058	30,671	27,757
Private	--	--	2,313	18,596	51,674
Sugar	282,264	352,174	358,597	394,753	491,750
CWE	12,000	3,000	6,000	8,500	3,000
Private	270,264	349,174	352,597	386,263	488,750
Rice	131,926	132,047	217,508	183,100	60,735
CWE	131,926	--	--	--	2,301
Private	--	132,947	217,508	183,188	58,434
Chilies	3,488	8,350	6,985	1,000	9,037
CWE	3,488	8,350	6,985	1,000	--
Private	--	--	--	--	9,037
<u>(CWE imports as percent of total imports)</u>					
Memorandum items:					
Wheat grain	100	100	100	100	72
Wheat flour	100	--	--	100	--
Onions	100	100	100	63	27
Lentils	100	100	95	62	36
Sugar	4	1	2	2	1
Rice	100	--	--	--	4
Chilies	100	100	100	100	--

Sources: CWE; Sri Lanka Customs; Import and Export Department; and the Central Bank of Sri Lanka.

essential commodity of which the CWE and the Food Commissioner's Department have a monopoly at the wholesale level.

In late 1994, the CWE began franchising outlets, for a nominal fee, in order to improve the accessibility of basic foodstuffs in remote areas. In the first phase, some 1,000 franchises are to be established, ultimately expanding to 5,000 franchised outlets selling CWE products at uniform prices. Transactions between the CWE and its franchises would be on a cash basis although some initial financial support by the CWE is envisaged for inventory financing.

There are currently no official guidelines with regard to strategic buffer stocks for the major food commodities. In earlier periods, when the CWE had a monopoly on the importation and distribution of foodstuffs, it maintained buffer stocks equivalent to about two months of domestic consumption. In recent years, the CWE stock levels have declined reflecting high storage costs and the dominant role played by the private sector in the procurement and distribution of some essential foodstuffs.

2. Pricing policy of the CWE

In principle, the CWE's pricing policy has been aimed at full cost recovery plus a profit margin of 10 percent. As such, the changes in import prices are typically transmitted to final consumer prices with a lag. The CWE also takes into consideration prevailing market conditions in setting prices at its retail outlets, particularly for those commodities in which it has a relatively small share of the retail trade.

Most essential food commodities in Sri Lanka are subject to various duties, taxes, and levies at the import level (Table 6). Some import duties are ad valorem, some specific, and others are combinations of ad valorem and specific rates. In recent years, these duties and taxes have been changed frequently to meet the often conflicting objectives of providing protection to domestic producers, on the one hand, and effecting price reductions at the wholesale and retail levels, on the other. In 1994, as containing increases in the cost of living became a top government priority, the substantial reduction in retail prices of food items from midyear reflected the granting of duty waivers and the lowering of tax rates on imports, as well as reductions in the CWE's profit margins on trade. Specifically, full duty waivers were granted for imports of wheat grain, flour, and lentils, while the duties on sugar and rice were reduced. Moreover, the turnover tax on imports of wheat grain, flour, and lentils was waived and the tax rate for onions was reduced. With the exception of wheat grain, all essential food items are subject to a defense levy of 3.5 percent. Imports of onions are also subject to a cess of 10 percent.

As reductions in final consumer prices are typically realized through adjustments in import taxes and profit margins, the retail prices of the main imported foodstuffs (with the exception of wheat flour) are, in most cases, at least equal to border prices plus handling and distribution

Table 6. Sri Lanka: Structure of Taxes on Imports of Foodstuffs, 1990-94

	1990	1991	1992	1993	1994
Wheat grain					
Import duty	25%	25%	20%	20%	--
Turnover tax	5%	5%	5%	5%	--
Defense levy	--	--	--	--	--
Wheat flour					
Import duty	35%	35%	35%	35% or Rs 6.5/kg	--
Turnover tax	6%	5%	5%	5%	--
Defense levy	--	--	1%	3%	3.5%
Onions					
Import duty	5%	5%	10%	35% or Rs 9.0/kg	35% or Rs 9.0/kg
Turnover tax	10%	10%	10%	20%	5%
				5% (from Nov.)	
Defense levy	--	--	1%	3%	3.5%
Lentils					
Import duty	60% or Rs 20.0/kg 50% or Rs 10.0/kg (from Nov.)	50% or Rs 10.0/kg	10%	45% or Rs 12.0/kg	35% or Rs 12.0/kg
Turnover tax	10%	10%	10%	10%	5%
				5% (from Nov.)	-- (from Nov.)
Defense levy	--	--	1%	3%	3.5%
Sugar					
Import duty	Rs 4.5/kg	Rs 4.5/kg	Rs 5.0/kg	35%	25% or Rs 6.60/kg Rs 3.0/kg (from May)
Turnover tax	13.5%	12.5%	12.5%	10%	10%
			10% (from Nov.)	5% (from Sept.)	5% (from May)
Defense levy	--	--	1%	3%	3.5%
Rice					
Import duty	25%	25%	20%	35% or Rs 7.0/kg	35% or Rs 7.0/kg
					20% (from Dec.)
Turnover tax	--	--	--	--	--
Defense levy	--	--	1%	3%	3.5%
Chilies					
Import duty	5%	5%	10%	50%	35% or Rs 20.0/kg
				35% or Rs 20.0/kg (from Nov.)	
Turnover tax	10%	10%	10%	10%	
				5% (from Sept.)	5%
Defense levy	--	--	1%	3%	3.5%

Sources: Data provided by CWE; and the Central Bank of Sri Lanka.

charges. As such, there are no explicit or implicit subsidies involved. Moreover, since private sector importers also benefit from the same changes in taxes and duties affecting CWE imports, any price differential between the CWE outlets and the private market should reflect, in principle, the differences in c.i.f. prices and in distribution and handling charges, as well as variations in quality.

However, since the CWE maintains a small share of the retail market for most foodstuffs, price differences between the CWE outlets and the private market are not significant on a prolonged basis for commodities of similar quality. Moreover, the CWE sells bulk to private traders only at the wholesale level and such sales are at times restricted to prevent price arbitrage opportunities from emerging. Nevertheless, the possibility of temporary price differentials between the CWE prices and market prices exists even for similar products because market prices tend to adjust more quickly to changing conditions, whereas the CWE would require official authorization for price changes in the case of more essential foodstuffs.

In addition to its own direct imports, the CWE periodically purchases foodstuffs, both imported and domestically produced, from local traders at prevailing wholesale market prices to augment its supplies and meet local shortages. Although the situation varies in line with market conditions from year to year and among commodities, for the most part, the procurement prices from domestic output have been below prices of comparable imports, reflecting import taxes as well as the higher quality of most imported foodstuffs (Table 7). Also, the CWE typically covers its handling and distribution costs in marketing commodities purchased from local sources.

Given this cost-pricing policy for both imports and domestically procured food, CWE operations have been generally profitable, with the notable exception of wheat flour. In 1994, the commodity-wise weighted average profit margins on CWE operations, involving both imports and domestic procurement, are estimated to have ranged from 3 percent for sugar to 11 percent for onions, with the markup for the other main commodities being of the order of 8-10 percent. Profits from these operations partially cross-subsidized the losses on wheat flour in 1994.

3. Wheat grain, flour, and bread

Sri Lanka meets its entire domestic requirement of wheat grain through imports, mainly from the United States. In recent years, effective import prices have been below international market prices, reflecting the availability of subsidized wheat through the U.S. commodity assistance program. As mentioned earlier, the CWE's monopoly on imports of wheat grain was eased in 1994, when private importers were allowed to import up to 250,000 metric tons per year through open tenders. Of this amount, 244,000 metric tons were imported by the private sector in two shipments, one on fully commercial terms and the other under the U.S. commodity aid program.

Table 7. Sri Lanka: CWE Prices of Essential Foodstuffs, 1990-94

(In Sri Lanka rupees per metric ton)

	1990	1991	1992	1993	1994
Wheat grain					
Procurement prices					
Imports	6,663	5,071	6,498	6,852	7,030
Local purchases	--	--	--	--	--
Wholesale price	--	--	--	--	--
Retail price	--	--	--	--	--
Wheat flour					
Procurement prices					
Imports	9,218	--	--	9,260	--
Local purchases	--	--	--	--	--
Wholesale price	12,700	11,800	11,300	12,650	7,000
Retail price	13,160	12,250	11,750	13,100	7,450
Onions					
Procurement prices					
Imports	12,950	17,595	14,400	16,950	24,233
Local purchases	14,143	22,000	10,304	19,599	20,470
Wholesale price					
Imported	25,500	27,000	23,660	24,000	28,350
Locally produced	23,000	28,500	18,600	18,400	21,700
Retail price					
Imported	27,000	20,100	25,670	37,600	31,900
Locally produced	25,000	29,000	22,000	22,400	23,000
Lentils					
Procurement prices					
Imports	37,200	49,000	48,866	44,720	25,114
Local purchases	--	--	--	--	--
Wholesale price	42,500	49,250	52,270	48,000	27,500
Retail price	44,400	51,000	53,715	51,000	31,850
Sugar					
Procurement prices					
Imports	24,370	22,850	23,485	25,242	28,080
Local purchases	17,075	21,700	22,131	22,423	26,535
Wholesale price					
Imported	26,100	24,000	24,200	25,250	27,250
Locally produced	25,000	23,500	24,000	26,500	27,500
Retail price					
Imported	26,200	24,000	24,600	25,000	28,500
Locally produced	27,100	24,100	24,250	27,130	28,250
Rice					
Procurement prices					
Imports	10,209	--	--	--	15,298
Local purchases	13,133	14,528	16,140	16,512	15,401
Wholesale price	14,800	15,350	17,530	17,900	16,600
Retail price	15,360	16,050	16,080	16,700	17,750
Chilies					
Procurement prices					
Imports	44,009	59,448	93,243	54,550	--
Local purchases	61,000	85,000	82,585	89,546	85,052
Wholesale price					
Imported	48,200	91,700	101,100	80,000	45,000
Locally produced	...	110,000	110,000	70,000	93,230
Retail price					
Imported	66,700	96,700	108,750	91,000	53,000
Locally produced	--	115,000	115,000	75,000	100,000

Sources: Data provided by CWE; and the Central Bank of Sri Lanka.

All imports of wheat grain are processed at the country's only mill, Prima Ceylon Limited, which is under foreign ownership and management. According to a 20-year contract expiring at the end of this decade, Prima mills the imported wheat grain for the CWE in return for wheat bran, calculated according to an extraction rate of 74 percent for flour; there are no other milling fees or charges. The private imports of wheat grain in 1994 were also sold to the CWE and milled at the Prima facility according to the same arrangement. The CWE surrenders the wheat flour to the Food Commissioner's Department for distribution to cooperatives; the Department, which owns and operates storage facilities as well as transport, is the sole wholesale distributor of flour in the country. After deducting a fixed handling and distribution fee (currently, SL Rs 0.93 per kg), the Food Commissioner's Department surrenders the proceeds from sales of flour to the CWE. The cooperatives, in turn, provide the flour to bakeries at wholesale prices and to the general public at retail prices.

There have been no direct imports of wheat flour by the private sector and, given the present cost structure, private imports of wheat flour are not economical. The CWE's rather limited direct imports of flour in the past were for meeting temporary market shortages.

Bread is predominately baked and sold by private bakeries, which are expected to provide adequate supplies of the basic coarse bread (weighing 450 grams per loaf) in return for wholesale purchases of wheat flour from the cooperatives. The Food Commissioner's Department also operates a bakery and supplies coarse bread to meet the demand in urban areas. While rice is the traditional staple in Sri Lanka, bread is consumed more heavily in the urban areas and on the plantations.

Although the domestic price of wheat flour has been, in principle, linked to the landed cost of wheat grain, social considerations have been important in setting the price, particularly in 1994. The flour prices are set at three stages of distribution: direct sales to cooperatives by the Food Commissioner's Department; wholesale purchases by bakers from cooperatives; and retail sales to the general public (Table 8). This price differential has varied over the years. Currently, the cooperatives are allowed a profit margin of SL Rs 0.35/kg on their sales to bakeries, and retail prices are SL Rs 0.45/kg higher than the wholesale prices for bakers. The retail price of the basic coarse bread is set countrywide according to a formula linking the price of bread to the wholesale price of flour, including a profit margin for bakers. The prices of higher-quality bread, cakes, and pastries are set according to market conditions.

From 1990 until mid-1994, the price structure of wheat flour was such that there were no explicit subsidies; in fact, the CWE enjoyed small annual operating profits on its operations in wheat flour even though such profits declined over the years (Table 9).

Table 8. Sri Lanka: Wheat Flour and Bread Prices, 1990-94

	Wheat Flour			Bread
	Cooperative	Bakeries (SL Rs/kg)	Retail	(SL Rs/450/grams)
End-1989	11.45	11.80	12.25	4.30
1990				
February 9	12.35	12.70	13.15	4.60
May 29	13.45	13.80	14.25	5.20
December 6	12.45	12.80	13.25	4.90
1991				
January 10	11.45	11.80	12.25	4.50
1992				
October 1	10.95	11.30	11.75	5.00
1993				
June 6	13.30	13.65	13.10	5.50
October 12	12.40	12.75	13.20	5.50
November 1	12.50	12.85	13.30	5.50
1994				
July 1	11.00	11.35	11.80	5.00
August 29	6.65	7.00	7.45	3.50

Source: Data provided by the Central Bank of Sri Lanka.

Table 9. Sri Lanka: Estimated Profit/Loss of the CWE
on Wheat Flour, 1990-94

(In Sri Lanka rupees per kg)

	1990	1991	1992	1993	1994
Landed cost of wheat grain (including import taxes)	6.66	5.07	6.50	6.85	7.03
Cost of flour ex-mill <u>1/</u>	8.00	6.85	8.78	8.26	9.50
Defense levy on flour	--	--	0.09	0.29	0.33
Other charges	1.78	2.01	1.87	1.89	2.00
Administrative expenses	0.15	0.22	0.21	0.21	0.23
Bank charges	0.38	0.39	0.27	0.32	0.35
Gunny bags	0.48	0.47	0.46	0.43	0.49
Distribution charges	0.77	0.93	0.93	0.93	0.93
Total cost of flour	10.78	8.80	10.74	11.43	11.89
Average wholesale price <u>2/</u>	12.92	11.45	10.95	12.34	10.30
Profit/loss	2.14	2.59	0.21	0.91	-1.53

Sources: Staff calculations based on data provided by CWE; and the Central Bank of Sri Lanka.

1/ Calculated on the basis of an extraction rate of 74 percent for flour.

2/ The wholesale price for cooperatives; weighted by months, rather than by CWE sales.

In July 1994, as a part of a comprehensive relief package, the Government reduced the price of flour and bread by 12 percent and 9 percent, respectively. The new Government, which came to power in August 1994 on a populist platform, further reduced the flour and bread prices, respectively, by 40 percent and 30 percent. As such, the flour and bread prices at end-1994 were 47 percent and 36 percent lower than their levels at end-1993, contributing to the loss for 1994 as a whole. The financial implications for the CWE arising from this substantial reduction in flour prices were limited in 1994 because of timing. For 1995, however, once the full annual impact of reduced prices is felt, the CWE is expected to incur a substantial loss on its operations in wheat flour, compounded by the rising trend in international wheat prices, the expectations of lower commodity assistance, and the rapid rise in the consumption of flour. ^{1/}

In addition to the large subsidy arising from the pricing of wheat flour, the changes in administered prices have also induced a shift in consumption in favor of flour and bread at the expense of rice. The combination of lower demand for rice and a bumper paddy crop (reflecting, in part, the provision of fertilizers at subsidized prices) contributed to the 15 percent reduction in the average domestic market price of rice in 1994. This, together with the upward adjustment of the guaranteed price for paddy in early 1995, is expected to substantially increase paddy purchases by the Paddy Marketing Board during the year.

4. Conclusions

Since mid-1994, the Government's efforts to protect the general population from price pressures and to provide relief to the poor have included cuts in the prices of most essential foodstuffs, mainly by lowering various taxes, duties, and levies at the import stage (Appendix I). Because the CWE's pricing policy is essentially based on cost recovery, there are no subsidies. The collective profits from these operations are, however, insignificant compared with the large losses stemming from the pricing of wheat flour, which has been based on social considerations.

Despite its limited market share in the case of most foodstuffs, the CWE's procurement and marketing involvement has, to some extent, distorted market signals, led to market segmentation, and created temporary price arbitrage opportunities because of delays in effecting administered price changes. In these circumstances, the interests of consumers, as well as procurers, could be perhaps better served by reducing, and eventually eliminating, the role of the CWE in the marketing of foodstuffs, beginning with those commodities in which it has a small market share. Moreover, the likelihood of hoarding and creating artificial shortages during peak demand

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^{1/} The domestic consumption of wheat flour has been increasing at an annual rate of 20 percent following the reduction in bread prices during July-August 1994.

periods would be reduced by encouraging broader private sector participation, which would also reduce the possibility of collusion.

The recent introduction of a universal wheat flour subsidy has worsened the financial position of the CWE, created a heavy burden on the budget, distorted production incentives, and encouraged waste, while providing only limited tangible benefit to the most needy.

VII. Recent Trade Policy and Reform

1. Introduction

The year 1977 marked the beginning of a new approach to international trade in Sri Lanka. Trade liberalization was viewed by the new United National Party (UNP) Government as an essential part of its program of economic development through market-based reforms. The 1977 reforms brought a sharp reduction in quantitative restrictions (QRs), although a significant number of QRs remained. While many of the remaining QRs were intended to protect public health and national security, some were retained explicitly to protect domestic industry. The tariff system adopted in 1977, a marked improvement on the previous system, consisted of 8 bands, ranging from duty-free status for certain essential consumer goods to 500 percent on items identified as luxury goods. Basic raw materials, machinery, and spare parts faced duties of 5 percent and certain intermediate goods ranged from 12.5 percent to 25 percent.

With tariff rates varying from duty free to 500 percent and certain quantitative restrictions remaining in place, effective rates of protection varied widely and appeals for "rationality" in the tariff system resulted in the formation of the First Presidential Tariff Commission (PTC) in October 1980. The Commission's mandate called for it to recommend modifications of the tariff structure, with a view to promoting the Government's social and economic priorities, which included an ongoing belief in the appropriateness of protecting local industry. ^{1/} In response to the PTC's ongoing reviews and with sensitivity to the appeals of industry groups and other special interests, frequent changes in the tariff structure and the overall trade regime have taken place since 1980. While it is certainly true that significant net liberalization of trade has taken place since 1977, this process has been marked by delays, setbacks, and policy reversals.

The purpose of this note is to take stock of recent developments in Sri Lanka's trading system, describe the current trade regime, and identify a number of additional trade reforms suitable for the medium term. Section 2 reviews recent developments in the trading system--both setbacks to, and progress toward, liberalization, focusing on 1993 through end-1994. Section 3 takes stock of current trade policies. Section 4 identifies areas

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^{1/} Report of the Presidential Tariff Commission, November 1991, p.3.

for further trade reform over the medium term. Section 5 presents conclusions.

2. Recent developments in the trading system

When the harmonized system (HS) was introduced in mid-1989, there were 19 tariff bands. The 1991 budget (November 1990) reduced these 19 bands to 13 bands, and the thirteen-band system was replaced by a four-band tariff system (10, 20, 35, and 50 percent) on November 12, 1991. The four-band system satisfied a performance criterion under the first annual ESAF arrangement and conformed to recommendations of the Second Presidential Tariff Commission.

Despite this progress, anomalies to the consolidated tariff system have persisted. These include the continued application of a number of specific tariffs, the maintenance of several items at nonstandard rates, certain duty exemptions, full and partial duty waivers, and the addition of certain charges and markups. In recent years, trade measures were under constant reappraisal, rendering a significant portion of the de facto trade regime in a state of flux. During 1993 and 1994, a number of measures were introduced altering the overall trade regime. Several of these were trade liberalizing, but others were unambiguous setbacks to Sri Lanka's reform agenda.

a. Trade-liberalizing measures: 1993-94

Under the ESAF II, the Government aimed at reducing the maximum tariff under the four-band system from 50 percent to 45 percent by April 1993. In the event, this reduction was implemented with the 1994 budget (November 1993). At the same time, the Government's commitment to further trade liberalization was strengthened when it announced that the maximum rate would again be reduced to 35 percent in the 1995 budget. ^{1/} In the event, the 1995 budget submitted to Parliament by the People's Alliance further consolidated the tariff system by reducing the maximum standard tariff rate from 45 percent to 35 percent.

Consistent with the Government's intention to consolidate the tariff system and to eliminate anomalies, all specific tariffs on textiles were converted to an ad valorem rate of 100 percent in April 1993. The official ad valorem rate on textiles was then reduced in November 1993 from 100 percent to 50 percent. Also in the 1994 budget, the specific tariffs on various garments were removed, leaving these items with a 50 percent ad valorem customs duty. A significant number of other items that had

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^{1/} Budget Speech, 10 November 1993 by Herald Herat, M.P., Minister of Justice and Minister of State for Finance.

previously combined specific and ad valorem rates--applying the higher of the two--were brought into the four-band system in the 1994 budget. 1/

Another significant development in 1993 involved the duty treatment of various automobiles. Progress was made toward integrating automobiles into the standard tariff bands when the Government announced a downward adjustment in duties, with cuts differentiated by engine size. The 1993 revision specified auto tariffs of from 50 percent to 100 percent (Table 10). 2/

The Government made additional progress in 1993 toward eliminating all import and export licensing restrictions not justified for reasons of national security, public health, public morals, or environmental protection. Of the eleven items remaining under export licensing control in 1993, 3/ the Government removed all but four from the list.

Regarding import licensing restrictions, the Government eliminated all but a few restrictions not justified under the above criteria in 1993. Items removed from import licensing control included, for example, various agricultural products, 4/ articles of jewelry and parts thereof, automobiles not exceeding three years in use, other motor vehicles not exceeding

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1/ These items were exercise books (from 35 percent or 70 cents per 40 pages to 35 percent); certain footwear (from 50 percent or SL Rs 45 per pair to 45 percent); other footwear (from 50 percent or SL Rs 90 per pair to 45 percent); umbrellas (from 50 percent or SL Rs 45 per article to 45 percent); refrigerators and freezers (from 50 percent or SL Rs 3150 per unit to 45 percent); and water pumps (from 35 percent or SL Rs 750 to 45 percent).

2/ Under the end-1993 revision, automobiles of up to 1500 cc face a tariff of 50 percent; from 1500 cc to 2000 cc the tariff is 75 percent; and over 2000 cc the tariff is 100 percent. Previously, autos up to 1500 cc faced a duty of 50 percent on the first SL Rs 150,000 (about \$3,000), 75 percent on the next SL Rs 100,000 (about \$2,000), 100 percent on the next SL Rs 100,000, and 200 percent on any amount in excess of SL Rs 350,000. Autos of 1500 cc and above faced a duty of 100 percent on the first SL Rs 80,000 (about \$1600), 150 percent on the next SL Rs 40,000, and 200 percent on any amount above SL Rs 120,000. Thus, for example, a vehicle with engine size 1850 cc, valued at SL Rs 350,000 (about \$7,000), would have faced a duty of SL Rs 600,000, or 171 percent under the old schedule.

3/ The 11 items were: betel leaves; animal feeds; metal scrap; bone and bone products; fertilizer; mineral and mineral products; metal ores; timber; coral shanks and shells; ivory and ivory products; and old vehicles (1945 vintage or older).

4/ These included potatoes (other), red onions, B'onions, black gram (but not green gram), red lentils (masoor dahl), chilies, and various rice products. As reported below, a number of agricultural products remain under import license, and some of those removed from license in 1993 were again under license in 1995 (e.g., potatoes and B'onions).

Table 10. Sri Lanka: Nonstandard Customs Duties, 1994-95

Product	Nonstandard Customs Duties <u>1/</u>	
	1994	1995 Budget
Pharmaceuticals	zero-rated	no change
Fertilizers	zero-rated	no change
Various Printed Materials <u>2/</u>	zero-rated	no change
Gold and Silver Coins <u>3/</u>	zero-rated	no change
Selected Items for Physically Impaired	zero-rated	no change
Certain Cotton & Synthetic Fibers not Carded or Combed or otherwise processed for spinning <u>4/</u>	3 percent	zero-rated
Cement Clinker <u>5/</u>	5 percent	no change
Certain Portland Cement in Bulk <u>6/</u>	7.5 percent	no change
Various Yarns not for Retail Sale	25 percent	20 percent
Textiles and Clothing	50 percent	35 percent
Various Agricultural Products	Typically include a standard ad valorem rate and a specific tariff, with the higher of the two applied.	Specific duties eliminated, ad valorem rate now at 35 percent.
Various Tobacco Products	From 50 percent to not less than 250 percent; specific tariffs remain in some cases and the higher of the specific and the ad valorem apply.	no change
Various Alcoholic Beverages	Specific tariffs as high as Rs 570 per liter.	no change
Certain Petroleum Products <u>7/</u>	35 percent or Rs 2500 per metric ton.	Specific tariff eliminated, except one item, for which the specific tariff was increased. <u>8/</u>
Certain Articles of Porcelain or China <u>9/</u>	45 percent or Rs 90	20 percent
Certain Tiles, Cubes and Similar Articles	45 percent or Rs 3	no change
Bicycle Frames <u>10/</u>	35 percent or Rs 2503	20 percent
Carpets and Other Textile Floor Coverings <u>11/</u>	50 percent	A subset of items changed to 35 percent. <u>12/</u>

1/ Nonstandard rates include all ad valorem rates outside the four-band system in 1994 (outside the three-band system in 1995), and all specific tariffs.

2/ Most items in the range HS 49.01-49.07 are duty free.

3/ Items in HS 71.18 are duty free.

4/ Items HS 52.01.00, and HS 5503.10, 5503.20, 5503.30, 5503.40, 5503.90.

5/ HS 2523.10.

6/ HS 2523.29.03.

7/ Includes HS 2709.00, 2710.00.02, 2710.00.07.

8/ Item HS 2709.00 went from 35 percent or Rs 2500 per MT in 1994 to 35 percent or Rs 3000 per MT in 1995.

9/ Items HS 6914.10, 6914.90.

10/ Item HS 8714.91.01.

11/ Includes items in HS 57.01, 57.02, 57.03, 57.04, and 57.05.

12/ All items in HS 57.01 and 57.02 were changed to 35 percent in the 1995 budget. However, the remaining items are not identified as having been lowered to 35 percent.

Table 10 (concluded). Sri Lanka: Nonstandard Customs Duty, 1994-95

Product	Nonstandard Customs Duties	
	1994	1995 Budget
Certain Paper and Paper Board, Corrugated, Creped, Crinkled, Embossed or Perforated in Rolls or Sheets <u>1/</u>	50 percent	no change
Vehicles Specially Designed for Travelling on Snow, Golf Cars and Similar Vehicles <u>2/</u>	50 percent	no change
Automobiles up to 1500 cc	50 percent	no change
Automobiles from 1500 to 2000 cc	75 percent	no change
Automobiles Greater than 2000 cc	100 percent	no change

Source: Staff's compilation from Sri Lankan Customs Schedule of 1994 and changes announced in the official directive to customs officers (Ref. No. PL/RPO\95\02 dated February 9, 1995, from the Director General of Customs).

1/ Item HS 4808.90.09.

2/ Items HS 8703.10 and 8703.21.09

ten years in use, various photocopying equipment, newsprint in roles or sheets, and photographic or cinematographic film.

b. Setbacks to trade liberalization: 1993-94

A setback to the Government's overall policy of trade liberalization became effective December 22, 1993, when it imposed a number of import surcharges intended to provide temporary protection to local manufacturing sectors. 1/ The order implementing these surcharges called for their automatic expiration at end-1994. 2/ Surcharges were imposed on exercise books, woven cotton fabrics, sarongs, steel bars and rods, razors and razor blades, certain batteries, and bicycles. In the case of cotton fabrics, the surcharges partially restored the level of protection that had been lost when the ad valorem rate on textiles was cut from 100 percent to 50 percent in November 1993. Regarding the other products, the authorities maintained that these surcharges were necessary to offset foreign "dumping." 3/ It is also evident, however, that in some cases the intent of these surcharges was to restore a measure of the protection that had been lost when specific tariffs were eliminated in the 1994 budget. 4/

Notwithstanding its commitment under the ESAF arrangement to eliminate all quantitative restrictions not justified for reasons of national security, public health, public morals or environmental protection, the UNP Government introduced in 1992 and 1993 a number of new import licensing restrictions not meeting the agreed profile. Import licensing restrictions were introduced in June 1992 on several additional agricultural products in

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1/ These surcharges were all specified in terms of specific rates. The Government's estimates of the ad valorem equivalent of customs duty plus surcharge are as follows: exercise books, 55 percent; woven cotton fabrics, from 55 percent to 60 percent; sarongs, 90 percent; steel bars and rods, 45 percent; razors, 102 percent; batteries, 85 percent; and bicycles, from 27.5 percent to 32.5 percent.

2/ In discussions with the Fund and the World Bank, the Government agreed to remove these surcharges, with the exception of those applying to cotton fabrics and sarongs, substituting an increase in the customs tariff to the nearest ad valorem rate within the four-band system by end June-1994. In the event, these surcharges were not removed until they expired at end-1994.

3/ Sri Lanka currently has no formal antidumping regime. The Report of the Second Presidential Tariff Commission (November 1991) recommended that Sri Lanka not adopt specific antidumping legislation at that time. Instead, the Commission pointed out that allegations of dumping could be handled under Sri Lanka's Customs Laws. The Commission specifically identified the possibility of the "imposition of a surcharge under Section 10 A of the Customs Law (p.101)."

4/ In the case of exercise books, for example, the applicable duty prior to the 1994 budget had been 35 percent or 70 cents per 40 pages, whichever was higher. The 1994 budget dropped the specific component. The end-1993 surcharge added 40 cents per 40 pages to the 35 percent ad valorem rate.

order to secure more effective protection for domestic producers. 1/ In January 1993, the Government introduced new licensing restrictions on the importation of certain diesel engines. 2/ The latter measure was taken in order to stanch the recently observed tendency to substitute diesel engines for petrol engines, which had arisen largely in response to the Government's policy to subsidize diesel fuel. The Government expressed its intention to remove these restrictions by end-June 1994. In the event, these were not removed.

3. The structure of tariff and nontariff barriers to trade

This section presents Sri Lanka's trading system at end-1994 as well as modifications contained in the 1995 budget (February 1995). The central elements of the trading regime at end-1994 and those of the present regime are presented in Table 11.

a. The tariff structure at end-1994

The tariff structure through end-1994 was dominated by the four-band tariff system with rates of 10, 20, 35, and 45 percent. Generally, the 45 percent rate applied to finished goods and certain food products, but a large number of items fell outside these categories. 3/ The 35 percent rate was less amenable to categorization, but was applied to a number of intermediate goods some of which are manufactured locally, a number of consumer goods, various flours and cereal grains, and miscellaneous other items. The 35 percent band appears to have served more as an exceptional rate to the 45 percent band than as the primary rate for a well-defined set of items. This was also true of the 20 percent rate, although it was slightly more dominated by components and parts than was the 35 percent band. 4/ The 10 percent band applied principally to capital goods and raw materials, including various chemical products.

1/ Agricultural items brought under license in 1992 include certain potatoes, rice in the husk (paddy or rough), husked (brown) rice, semi-milled or wholly milled rice whether or not polished or glazed, and broken rice.

2/ Gazette Extraordinary No. 743/13 of January 7, 1993.

3/ Exceptions included, for example, various crude vegetable oils (e.g., crude soybean, nut, and palm oil), brewing sugar, various paints, printing ink, various tubes, pipes and hoses of plastic, articles for the conveyance or packing of goods of plastics, certain tanned or dressed furskins, various items of builders' joinery and carpentry of wood, including cellular wood panels and shakes and shingles, waste and scrap of paper or paper board, continuous computer stationary, ceramic pipes, conduits, guttering and pipe fittings.

4/ A small number of consumer goods appear in the 20 percent band, including various padlocks and locks, lawn mowers, various cameras, pianos, and certain other musical instruments.

Table 11. Sri Lanka: Trade Regime in January 1994 and early-1995

Trade Measures	January 1994	1995 Budget
Import Taxes	Standard ad valorem rates of 10, 20, 35, and 45 percent. A number of items are zero rated and a number of other items are at rates in excess of 45 percent. A number of specific tariffs remain.	Standard ad valorem rates of 10, 20, and 35 percent. A significant number of items are zero rated. Autos, tobacco products, and alcoholic beverages face tariffs exceeding 35 percent. Virtually all specific tariffs were eliminated.
Tariff Bindings	125 tariff lines [8 digit HS] bound at rates ranging from 75 percent to 100 percent. This was about 4 percent of tariff lines for industrial products.	Total of 2,128 tariff lines [8 digit HS] are now bound and all bindings are set at 50 percent. In the case of industrial products, Sri Lanka's UR bindings represent about 8 percent of total tariff lines.
Exemptions and Duty Waivers	Numerous full- and partial duty waivers and exemptions.	Numerous full- and partial duty waivers and exemptions remain. Government's policy on granting these tightened somewhat and made more transparent. Pre-shipment inspection (PSI) system expected to be introduced in September 1995.
Import Quotas and Licensing	Most remaining import licensing restrictions are warranted for reasons of national security, public health, public morals, or environmental protection. Exceptions include a number of agricultural products, certain used transport vehicles, and certain diesel engines. Pharmaceuticals and chemical products now to be subject to automatic licensing.	no change
Export Taxes	Export duties were abolished on December 22, 1992. Nevertheless, a number of "royalties and cesses" remain.	no change
Export Quotas and Licensing	Four product categories remain under export license. Timber, coral shanks and shells, ivory and ivory products, and old vehicles (prior to 1945).	no change
Foreign Exchange Restrictions	All restrictions on current account transactions eliminated in March 1994. Obligations of Fund's Article VIII accepted.	no change

Source: Information provided by the Sri Lanka authorities.

At end-1994, a significant number of items continued to face customs duties outside the four-band system (Table 10). Virtually all pharmaceuticals and fertilizers were zero-rated. A number of printed materials were also zero-rated. 1/ Various silver and gold coins and certain devices for the physically impaired also were zero-rated in the customs schedule. It is noteworthy that the set of zero-rated items applying to devices for the physically impaired is a subset of all such items. 2/ Among the most significant items facing customs duties in excess of 45 percent at end-1994 were automobiles (described above), as well as most textiles and garments (50 percent). Various tobacco products carried customs duties of 50 percent or more, with some greater than 250 percent. 3/, 4/ As indicated in Table 10, a small number of items other than textiles and garments also faced customs duties of 50 percent. Other miscellaneous rates outside the four-band system also continued to apply in 1994. Revisions that occurred in the 1995 budget are reported in Table 10.

Because of a number of special charges and markups in place through 1994 and into 1995, the full discriminatory tax treatment of imports is not captured by the customs duty alone. In the case of goods with duties at 45 percent or above, a special surcharge, the Export Development Board (EDB) cess, is imposed. 5/ The EDB cess is assessed at 10 percent of the import duty. Thus, with the highest standard duty at end-1994 set at 45 percent, the EDB cess added 4.5 percent to the customs duty.

In addition to the EDB cess, a discriminatory element exists in the calculation of two domestic taxes. While turnover taxes and the defense levy apply to both imports and domestically sourced products, these taxes are not simply applied to the CIF value of imports, nor to the CIF value plus customs duties (customs duty plus EDB cess). Instead, these "nondiscriminatory" taxes are applied to imports in a discriminatory manner.

1/ The latter category includes: (1) printed books, brochures, leaflets, and similar printed matter in single sheets, including dictionaries and encyclopedias; (2) newspapers, journals, and periodicals; (3) children's picture drawing or coloring books; (4) music printed or in manuscript; (5) printed globes and maps; (6) plans and drawings for architectural, engineering, industrial, commercial, topographical or similar purposes; and (7) certain other printed matter including printed pictures and photographs.

2/ The complete list of zero-rated items in this category is as follows: invalid carriages; hearing aids; pacemakers (excluding parts); becotide rotahaler (an artificial respiration device); and colostomy and urinary bags. Various artificial limbs and joints, dentures, and crutches face a 10 percent customs duty.

3/ Beedi tobacco carries a 50 percent ad valorem duty.

4/ Most tobacco products carry a joint ad valorem and specific rate, with the higher of the two applicable.

5/ A cess is a tax whose revenues are earmarked for a specific expenditure or subsidy.

The turnover tax, for example, when applied to a product whose customs tariff is 45 percent, is calculated on the basis of the CIF price plus duties, plus a 25 percent markup. ^{1/} The defense levy also is calculated based on a 25 percent markup. The markup, which has been changed from time to time, implies a de facto increase in the discriminatory tax treatment of imports. In the case of a 20 percent turnover tax and a 3.5 percent defense levy, the 25 percent markup adds over 8 percent in additional discriminatory taxes on imports (i.e., a discriminatory element in excess of the customs duty and the EDB cess). Because an item in the 45 percent tariff band (applicable through end-1994) pays 49.5 percent before the application of domestic taxes--due to the EDB cess--and because the calculation of domestic taxes includes about a 9 percent discriminatory element, the full discriminatory tax treatment of a good in the 45 percent tariff band may exceed 58 percent. ^{2/}

A number of specific tariffs also remained as anomalies in the four-band system at end-1994 (Table 10). Among the agricultural products, specific tariffs applied to potatoes, onions, green and black gram, lentils, chilies, rice, beedi leaves, sugar, and tobacco (other than beedi tobacco). Specific tariffs also applied to certain petroleum products, alcoholic beverages and spirits, certain ceramic tiles, and bicycle frames.

b. The tariff structure established in the 1995 Budget

The 1995 budget reduced the maximum standard tariff rate from 45 percent to 35 percent. This folded the old four-band system into a new three-band system with standard rates of 10, 20, and 35 percent. Virtually all items that had been in the 45 percent band (described above) were moved to the 35 percent band. Items that had been at 10, 20 and 35 percent remained virtually unchanged. In addition, the budget incorporated all textiles and clothing (previously facing a 50 percent tariff) into the 35 percent band. As indicated in Table 10, several other nonstandard tariffs were eliminated in 1995, but some remain.

The EDB cess and the use of markups before the application of turnover tax remained in place under the new three-band system. With the implementation of the goods and services tax (GST), expected for October 1995, the markups, but not the cess, would be removed. The cess is currently slated for elimination at end-1995.

c. Duty waivers and exemptions

An important problem in the trading system that was clearly evident through mid-1994 was the practice of granting duty waivers and exemptions. The practice was nontransparent and was not constrained by a narrowly defined set of rules or procedures. The Minister of Finance (de facto this

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^{1/} This markup was changed from 10 percent to 25 percent in 1992.

^{2/} Appendix IV provides an illustrative calculation.

implied either the Secretary or the Deputy Secretary to the Treasury) was empowered to waive all or part of any customs duty. The recommendation of line ministries and/or the Cabinet were taken into account in granting such waivers. While such actions were typically gazetted (i.e, formally opened to public notice), frequently these notices were issued well after the fact. The Fund and the World Bank have expressed great concern about the practice of granting duty waivers and exemptions and the new Government has expressed similar concerns. ^{1/}

The distinction between duty exemptions and duty waivers is blurred. Both can apply to either a specific product or to a specific class of importer. One distinction that can be made is that, while all exemptions imply full relief from the customs duty, duty waivers may be either full or partial. It is noteworthy that duty waivers in Sri Lanka have been granted both on a standing basis and on the basis of individual import consignments. Standing duty waivers remain in place until further notice, or until expiration. Waivers granted for individual consignments have been far less transparent and evidence of their frequent use is anecdotal and unofficial.

At end-1993, the official list of full duty waivers contained 25 items including, for example, nurses' uniforms, certain cellular telephones, items donated to schools and educational institutions, and all products imported for use in new and existing tourist hotels. The list of partial duty waivers at end-1993 included a number of agricultural products, certain milk powder, and some strike-related items temporarily in short supply, 13 items in all. ^{2/} With the revisions in the tariff code contained in the 1995 budget, the Government narrowed the list of duty waivers--19 categories with full waivers and 4 with partial waivers remained as of February 8, 1995. A number of the items removed from the list were simply placed into the zero rate in the tariff code.

A list of 34 categories of duty exemptions was also in place at end-1993. While importers claiming a duty exemption must typically receive certification from the Director General of Customs, some require the specific authorization of the Secretary or Deputy Secretary to the Treasury. Representative of the list of duty exemptions in force at end-1993 are: (i) containers and accessories for use for the safe carriage of goods as defined by and subject to the conditions laid down by the Director General of Customs; (ii) drugs proved to the satisfaction of the Director General of Customs as being homeopathic drugs; (iii) materials proved to the satisfaction of the Director General of Customs as having been imported for the manufacture of pharmaceuticals; (iv) goods imported for display or use at

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^{1/} See, for example, the statement of Minister G.L. Peiris appearing in The Island newspaper on December 28, 1994 in which he refers to the recent practice in granting duty waivers as "naked plunder of the Treasury".

^{2/} A number of the partial duty waivers applied to strike-related items and were removed as the strikes were settled in 1994.

exhibitions, fairs, meetings, or similar events, approved by the Secretary/Deputy Secretary to the Treasury, subject to the conditions laid down.

The list of duty exemptions was narrowed somewhat in the 1995 budget to 22 categories. Among the categories removed from the previous list of exemptions are, for example, certain work trucks, certain shrimp feed and chemicals, and certain rough diamonds and semi-precious stones. About 40 percent of the categories remaining on the list are health-care items, items used in pharmaceutical production, or certain homeopathic drugs.

In the past, there have been significant delays between the time various duty waivers and exemptions were issued and the time when they were formally gazetted. In the interest of minimizing discretionary elements in the trade regime and maximizing transparency, the UNP Government agreed with the Fund and the World Bank in February 1994 to revise its policy toward waivers and exemptions. 1/ Under the new policy, the Government would issue in a timely fashion a press release indicating the product(s) involved, the recipient(s), and the time frame, if any, for all new duty waivers and exemptions. This was not intended to substitute for the formal gazetting of waivers and exemptions, but to act as a vehicle for increasing the transparency of such actions. The Government also stated its intention in January 1994 to refrain from issuing new duty waivers, except under exceptional circumstances. Notwithstanding this commitment, the Ministry of Finance announced a significant number of new waivers during the first half of 1994. 2/

The new Government has expressed its concern over past practices and now reports that the procedures for granting all new duty waivers or exemptions have been significantly tightened. Under the new system, any request for a new waiver or exemption would be sent for Cabinet deliberation. The Cabinet would then determine whether a waiver or exemption would be in the "public interest". If so, the Cabinet would approve the new waiver or exemption, the Minister of Finance would sign the order, and a press release would be issued immediately on that decision. Whether the new practice will produce greater restraint will ultimately depend on how broadly ministers choose to define the "public interest." At end-March 1995, the Government had already announced the first new duty waiver under the new system. 3/

1/ See the Government's statement in EBS/94/47 Appendix I, p.50.

2/ Imports of certain stationary generating sets were granted full duty waivers in February 1994. Also in February 1994, the authorities granted a full duty waiver for tractors, and partial duty waivers for lorries exceeding three tons, certain yarns and fibers, and certain construction equipment. Between March and June 1994, full or partial duty waivers were granted for edible oils, sugar, dried fish, fabrics, canned fish, and dhal.

3/ A duty waiver was granted on imports of cotton yarns for a period of six months.

d. Special status of Board of Investment (BOI) firms

Another problematic aspect of Sri Lanka's trade regime into 1995 involved the preferential status assigned to BOI firms. ^{1/} These firms are export-oriented firms approved by the Board of Investment. Among other tax concessions, BOI firms are granted duty-free import privileges and are empowered to clear customs on their own authority. Nominally, this policy is intended to create an incentive for setting up nontraditional export-oriented manufacturing operations by reducing the cost of foreign-sourced intermediate and capital goods. However, there is strong anecdotal evidence that the special status of BOI firms has been an important source of leakages at the border. Customs officials currently have no authority to check BOI imports for unauthorized goods. In early 1994, the UNP Government indicated that it was in the process of establishing a special "import-monitoring unit" within the Treasury with the authority to monitor the import consignments of BOI firms. This initiative was taken in lieu of establishing a preshipment inspection (PSI) scheme, which had been rejected by the authorities in early 1994. The authorities also indicated that they intended to extend the duty-free status of BOI firms to certain other export-oriented firms.

With the change in government, the special status of BOI firms was reconsidered. By early 1995, the new authorities were actively pursuing the implementation of a PSI scheme, which is expected to be in place by as early as September 1995. Imports of BOI firms will be subject to PSI review and this is expected to stanch some of the leakages at the border.

e. Export taxes

A benchmark under the second annual ESAF arrangement (ESAF II), the Government eliminated all on-budget export duties in December 1992. ^{2/} While export duties were formally abolished, a number of export cesses and "royalties" remain. Royalty payments are required upon the export of live elephants, natural graphite, coral and similar materials (including conch shell), quartz (silica), and iron and non-alloy steel. Export cesses apply to various coconut products, including fibers, coir mats/rugs, and pads/mattresses for bedding. Cesses also apply to tea packets and bags, rubber, cashew nuts in shells, and raw hides and skins. Both cesses and royalties are off budget.

f. Export and import licensing

By 1994, just four items remained under export licensing restrictions. These were timber, coral shanks and shells, ivory and ivory products, and old vehicles (1945 vintage or older).

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^{1/} The BOI was formerly the Greater Colombo Economic Commission (GCEC).

^{2/} On this date, the Government eliminated export duties on coconuts and coconut products, Brazil nuts, cashew nuts, tea, and rubber.

While most of the items currently under import license are justified for reasons of national security, public health, public morals, or environmental protection, a few exceptions remain. These exceptions include a number of agricultural products, certain used transport vehicles, 1/ and certain diesel engines. 2/ Under the terms of the third annual arrangement under ESAF, the government stated its intention to eliminate the licensing restriction on diesel engines by end-June 1994. Presently, the new Government intends to eliminate the diesel-engine licensing restriction by end-1995. The authorities expressed the intention in February 1994 to subject pharmaceuticals and chemical products to GATT-conforming automatic licensing procedures. 3/

g. Regional trade agreements

Sri Lanka is a member of the Bangkok Agreement, which is intended to promote regional economic development through trade expansion among members of the Economic and Social Commission for Asia and the Pacific (ESCAP). Under the Bangkok Agreement, Sri Lanka offers concessional tariff rates to Bangladesh, India, Lao P.D.R., the Republic of Korea, and Papua New Guinea. 4/ The product coverage is about 300 items.

Sri Lanka is also a member of the South Asian Association for Regional Co-Operation (SAARC), established in 1985. SAARC countries are committed to step-by-step liberalization of trade in a such a manner that all countries in the region share the benefits of trade expansion equitably. In July 1992, a decision was reached to draft an agreement for a SAARC Preferential Trading Arrangement (SAPTA). The draft Agreement was submitted to the SAARC Standing Committee in December 1992 with the recommendation that all formalities for operationalizing the SAPTA, including the finalization of schedules of concessions, be completed before 1995. 5/ The end-1994 deadline was not met. By January 1995, Sri Lanka had forwarded its "request list"--which will form the basis for negotiations on national schedules of

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1/ Automobiles over three years old, various other vehicles (including, e.g., auto trishaws, prison vans, and hearses) over three years old, and certain other vehicles (e.g., tractors, trucks, and the like) over ten years old remain under license.

2/ The Government has agreed to remove these diesel engines from import license by end-June 1994. The Government will also review the status of the remaining agricultural products and used vehicles with Fund staff with a view to their elimination by end-1995.

3/ See EBS/94/47 Appendix I, p. 51. This commitment now implies adherence to the provisions of Article 2 of the Uruguay Round Agreement on Import Licensing Procedures.

4/ Papua New Guinea recently acceded to the Bangkok Agreement. Sri Lanka and the other countries were founding members in 1976.

5/ The contracting states include Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.

concessions--to all contracting states except Pakistan and had received a formal request list in return only from Bangladesh.

h. Overview of Uruguay Round market access commitments

The import coverage of Sri Lanka's tariff bindings 1/ committed under the Round is among the least ambitious undertaken by developing countries (Table 12). Among all developing countries, the percentage of bound tariff lines for industrial products rose from 21 to 73 percent. Sri Lanka's tariff line coverage for industrial products went from 4 percent to 8 percent under the Round. Prior to January 1, 1995, Sri Lanka had 125 tariff lines bound at the 8-digit HS level, at rates ranging from 75 percent to 100 percent, all well in excess of applied rates. With the implementation of the Round, 2,128 tariff lines at the 8-digit HS level are now bound and bindings are set at 50 percent. 2/ Tariff bindings after the Uruguay Round cover about 11 percent of the value of imports of industrial products, as against about 7 percent prior to the Round.

In 1995, Sri Lanka continued to use variable duty waivers and licensing restrictions on certain agricultural products in order to maintain greater stability in domestic food prices. Import licensing restrictions were being applied to wheat, potatoes, and onions at the time of the 1995 consultation discussions held in March. The Uruguay Round prohibition on the use of quantitative restrictions in agriculture apparently is not applicable, as cover for these comes from Sri Lanka's continuing use of Article XVIII:B of the GATT/WTO and/or from the exceptions for agricultural imports that are primary staples in developing countries. 3/

4. Future trade reform

As stated at the outset, Sri Lanka's unilateral efforts toward liberalizing its trade regime since 1977 have been substantial. Recent steps to further rationalize import and export licensing restrictions, to eliminate almost all specific tariffs, and to adopt a three-band system with a maximum standard rate of 35 percent are noteworthy. Given this progress and the current state of the trade regime, Sri Lanka can reasonably aspire to a highly liberal trade regime over the medium term. In this connection, the Government has expressed the view that it should implement a unified tariff of 15 percent by end-1998. While this alone would be a highly

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1/ A tariff binding is an obligation in the GATT/WTO not to raise tariff rates on specific products above a specified level without compensating reductions in other tariffs. Such bindings help to enhance the sustainability of tariff liberalization.

2/ At end-March 1995, bindings on various agricultural products were under renegotiation under GATT/WTO Article XXVIII.

3/ GATT Article XVIII:B authorizes temporary restrictions (including quantitative restrictions) in support of a country's external financial position.

Table 12. Sri Lanka: Tariff Bindings on Industrial Products
for Selected Developing Countries 1/

Country	Pre-Uruguay Round		Post-Uruguay Round	
	Shares of lines	Shares of imports	Shares of lines	Shares of imports
Argentina	5	21	100	100
Brazil	6	23	100	100
Chile	100	100	100	100
Colombia	1	3	100	100
Costa Rica	100	100	100	100
El Salvador	100	100	100	100
Hong Kong	1	1	24	23
India	4	12	62	68
Indonesia	10	30	93	92
Jamaica	0	0	100	100
Korea Rep.	10	24	90	89
Macau	0	0	10	10
Malaysia	0	2	62	79
Mexico	100	100	100	100
Peru	7	20	100	100
Philippines	6	9	59	67
Romania	21	10	100	100
Senegal	29	40	32	41
Singapore	0	0	65	73
Sri Lanka	4	7	8	11
Thailand	2	12	68	70
Tunisia	0	0	46	68
Turkey	34	38	37	39
Uruguay	3	11	100	100
Venezuela	100	100	100	100
Zimbabwe	8	11	9	13

Source: GATT (1994).

1/ Excludes petroleum.

significant achievement, additional reforms can be identified that would help to further liberalize and simplify the trading system, introduce greater stability, enhance transparency, and protect hard-won liberalization measures from future reversals.

In light of the above, what follows summarizes well-known principles that are recommended to many developing countries that are pursuing trade reform. The principles set out in Table 13 assume that Sri Lanka intends to continue to pursue tariff rationalization and trade liberalization, establish a higher degree of stability and transparency in its trade system while also retaining a modest degree of protection (to be phased down over a longer-run time frame), including limited access to contingent protection (possibly antidumping and formal safeguard procedures). Two fundamental economic principles are: (i) protection should be low and tariff-based; and (ii) the procedures for granting special treatment/exceptions should be relatively stable, transparent, and highly nondiscretionary. The former is intended to reduce the Harberger costs of protection (deadweight loss) while the latter elements help to minimize the Tullock costs of protection (i.e., the withdrawal of resources to rent seeking activity). Some elaboration on the rationale for each of the liberalizing measures summarized in Table 13 is presented below.

a. Tariff structure

Recommending trade liberalization per se requires no explanation, as the proposition that free trade maximizes potential national welfare in the small-country case is well-established. The recommendation for a uniform tariff, however, requires some commentary. This prescription cannot be justified on neoclassical economic grounds. There are two significant rationales underlying the prescription for a uniform tariff, both rooted in the political economy of protection. First, adopting a uniform tariff can help to deflect pressures for protection. By establishing a credible uniform-tariff constraint, a government effectively reduces the expected payoff to industry-specific lobbying for a tariff change, while also creating a free-rider problem for would-be protectionists. A credible uniform-tariff constraint thus tends to induce a rational reduction in lobbying activity for protection. ^{1/} The second rationale is that a uniform tariff provides a focal point for future tariff discussions and so can facilitate future tariff cuts, either unilaterally or in the context of multilateral trade negotiations.

With the 1995 budget, Sri Lanka implemented a three-band tariff system with standard rates of 10, 20, and 35 percent. The rationale for achieving greater consolidation of the tariff structure is analogous to that behind the uniform tariff. With the implementation of a GST expected for October 1995--thus establishing the administrative infrastructure for a

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^{1/} See, for example, the discussion and citations in Subramanian, Ibrahim and Torres-Castro (1993).

Table 13. Sri Lanka: Principles for Trade Liberalization

Policy Area	Policy Prescription
Customs Tariffs	A relatively low and uniform ad valorem tariff should be targeted--in the neighborhood of 15 percent, with exceptions for not more than two selected products. Products such as autos, tobacco, and alcoholic beverages should be brought into the three-band system immediately, substituting domestic taxes for the current high nonstandard tariffs. Sri Lanka could expand the scope of tariff bindings in the WTO, and such bindings could be set at, or very close to, existing applied rates.
Markups and Surcharges	All existing markups and surcharges applied to imports should be eliminated, and the practice of introducing such charges on an ad hoc basis should be stopped. The authorities intend to take this step with the implementation of the GST/VAT.
Import and Export Licensing	Quantitative restrictions, except those warranted for reasons of national security, public health, and public morals, or by international agreement (e.g., CITES ^{1/}), should be eliminated.
Duty Waivers and Exemptions	Duty waivers and exemptions should be limited to <u>truly</u> exceptional circumstances. Procedures for granting waivers and exemptions should be made highly transparent, and fixed administrative rules should be adopted that clearly delineate the exceptional criteria under which waivers and exemptions will be granted so as to minimize ministerial and bureaucratic discretion. Existing waivers and exemptions should be eliminated (unless they warrant retention under the "exceptional-circumstances" standard).
Export Taxes	All export cesses and export royalties should be eliminated and replaced with royalties that do not discriminate according to the point of consumption.
Safeguards Policy	Formal rules for granting temporary emergency protection should be adopted that conform to the GATT safeguards clause (Article XIX), and Article XVIII(B) of GATT should be disinvoked.
Dumping, Antidumping, and Countervail	Measures taken to remedy allegations of dumping or subsidization should be treated as temporary exceptions to liberalization, based on administrative procedures that are transparent, and aim to systematically internalize the social costs and benefits of temporary protection.

Source: International Monetary Fund.

^{1/} CITES stands for the Convention on International Trade in Endangered Species. Sri Lanka's export licensing restriction on ivory and ivory products is necessary to enforce compliance with Sri Lanka's CITES obligations.

broad-based, efficient, non-trade tax--Sri Lanka will be well-positioned to move decisively in de-emphasizing import duties as a revenue source, something clearly not in evidence over the last decade (Table 14). An appropriate next step in tariff reform would be to implement a two-band system with rates of 10 and 20 percent in the 1996 budget. In order to prepare the private sector, this should be announced immediately. Revenue losses could be offset, for example, by some combination of adjusting the standard GST rate, moving items taxed at the lower non-standard rate to the standard rate, and/or by eliminating selected GST exemptions.

b. Surcharges, special protection, and tariff bindings

Maintaining simplicity, stability, and full transparency in the tariff system is important, in part, because it helps to minimize administrative costs. But, more fundamentally, it is desirable because it creates an environment that is hostile to rent seeking. A practice of repeatedly setting, modifying, and revoking general markups and surcharges clearly runs counter to these objectives. The practice of granting selective import surcharges is particularly problematic because it introduces a policy window through which interest groups can pursue sector-specific protection, thereby defeating the purpose of tariff consolidation by undermining the credibility of the standard rates. The goal of reform in this area should be to credibly establish the government's virtual insulation from sector-specific pleas for special protection. How might credibility be achieved?

There are a number of policy reforms that would help to achieve credibility. Petitions for special protection would be channeled automatically to administrative agencies whose responsibility is to ascertain whether specific criteria (detailed in legislation) have been met. Meeting such criteria would then be a necessary, but not sufficient, condition for granting special protection. A formal safeguards mechanism and antidumping rules, for example, could establish the specific criteria under which exceptions would be processed (discussed below) and new protective duties granted. Such an automatic rules-based administrative approach would help to insulate legislators and government officials from requests for special protection.

There is another avenue through which any government can constructively choose to surrender a degree of autonomy in setting tariffs. This can be achieved by unilaterally increasing the scope of tariff bindings under the GATT/WTO. Expanding the scope of tariff bindings helps to lock-in gains from liberalization while also increasing the credibility of the government's future liberalization goals. Of course, this prescription begs the question of how a government might summon the political will to undertake such a bold step.

Table 14. Sri Lanka: Trade Taxes, 1985-95 ^{1/}

	1985	1986	1987	1988	1989	1990	1991	1992	1993	<u>1994</u> Est.	<u>1995</u> Proj.
<u>(As a percentage of total revenue)</u>											
Taxes on Imports	22.3	25.3	26.2	25.6	27.6	24.7	24.4	24.3	22.0	20.7	20.8
Taxes on Exports	8.0	4.4	4.6	4.4	2.9	3.8	1.5	0.1	--	--	--
Total Trade Taxes	30.3	29.7	30.8	30.0	30.5	28.5	25.9	24.3	22.0	20.7	20.8
<u>(As a percentage of total imports)</u>											
Import Duties	15.0	17.3	18.3	15.0	18.6	15.6	14.7	13.6	11.7	9.7	10.3
<u>(As a percentage of total exports)</u>											
Export Duties	8.0	4.8	4.7	3.9	2.8	3.2	1.3	0.7	--	--	--

Sources: Central Bank of Sri Lanka Annual Report; staff estimates; and staff projection.

^{1/} Includes EDB cesses on import and export royalties, which are off budget.

c. Safeguards

Prescriptions for reform should include means as well as ends. The final two entries in Table 13 acknowledge that a "safeguards" mechanism (broadly defined) ^{1/} is likely to be a necessary part of any program of progressive trade liberalization. A system of safeguards may be necessary to moderate the strength of opponents to liberalization and to occasionally vent protectionist pressures so that progress toward greater liberalization can be politically feasible. As indicated above, these pressures can be channeled toward administrative agencies (as opposed to legislators and high-level Government officials) and managed, more or less, by establishing a legal framework that delineates the rules under which special protection will be granted. GATT/WTO establishes certain definitions and procedural obligations for member countries regarding the adoption of such rules. Two such areas in which special protection is authorized are "emergency protection" and "antidumping."

Despite longstanding membership in GATT, Sri Lanka has not had to concern itself with the formal procedures for resorting to emergency protection under Article XIX ^{2/} or to antidumping for at least two reasons: (1) Article XVIII:B of GATT has been invoked by Sri Lanka since before 1971, which authorizes temporary restrictions (including quantitative restrictions) in support of Sri Lanka's external financial position; and (2) Sri Lanka was almost entirely unconstrained by the multilateral trading system in its use of tariffs to raise protection for selected industries because the scope of its tariff bindings prior to January 1, 1995 was very narrow and because bindings were well in excess of most applied rates.

Developments in the European Union and the United States should give pause to anyone who would recommend that a developing country adopt laws sanctioning "unfair" trade (i.e., antidumping and countervailing duty laws). Sri Lanka, like many developing countries without formal antidumping/countervail regimes, has engaged de facto in the practice of granting duties (temporary surcharges) in response to allegations of dumping and/or subsidies for some time--the end-1993 package of surcharges was informally justified on these grounds. The Sri Lankan Fair Trade Commission is

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^{1/} Following Finger (1995, p. 2), safeguards broadly defined include the set of rules that "allow for product-specific restrictions in political context that suggests that such restrictions are an exception to the country's liberal import policy."

^{2/} Article XIX of the GATT offers an avenue to escape GATT obligations and to erect protective barriers to trade under the condition that a "product is being imported into the territory of that contracting party in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers in that territory" (Article XIX[1][a]). Under the Uruguay Round agreement, the duration of measures taken under Article XIX is limited to a maximum of ten years for developing countries.

currently investigating the question of whether to implement a formal antidumping (and countervailing duty) regime. However, the objective of these deliberations appears not to be the containment of protectionist pressures with a view to facilitating further trade liberalization. Rather, the authorities have expressed interest in finding alternative means of accommodating protectionist pressures; means used--and abused--by their trading partners. The risk is that, if rules are not carefully tailored to the objective of facilitating liberalization, adopted procedures may be readily captured by import-competing industries for their protection.

With a few critical procedural modifications, policies toward allegations of "unfair" trading practices could be improved, helping to contain the Government's responsiveness to protectionist pressures. The intent here is not to specify the details of a well-conceived antidumping/countervailing regime, but merely to set out in broad terms the parameters of such a regime. First, conditions under which petitions would be investigated should be codified and, conform to GATT/WTO rules. Second, the formal consideration of a petition for special protection should be announced in a timely fashion and the views of opposing interests should be automatically solicited by the Government. Third, an assessment of the costs and benefits of potential new measures to grant special protection should be released to the press early in the process, even if only a back-of-the-envelope assessment is practicable. Fourth, meeting the necessary conditions laid out in the GATT/WTO for imposing antidumping or countervailing duties should not be regarded as sufficient. Rather, based in part on the outcome of the cost-benefit analysis, an independent agency should be charged with making the final decision once it has been established that the necessary conditions for duties have been met. Fifth, protective duties, if granted, should not exceed the amount necessary to offset injury to the domestic industry. Finally, all new measures should be explicitly digressive and time-bound. These recommendations generally exceed the minimum conditions necessary to comply with the Uruguay Round agreement on the Implementation of Article VI. 1/

d. Export and import licensing

Sri Lanka's remaining quantitative restrictions largely meet the criteria that they are warranted for reasons of national security, 2/ public health, and public morals, 3/ or by international agreement. However, Sri Lanka also maintains restrictions on the basis of environmental protection, such as the export licensing restrictions on lumber and coral

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1/ On the outcome of the Uruguay Round for antidumping policy, see, e.g., Finger (1995) and Leidy (1995).

2/ Article XXI (Security Exceptions) of GATT/WTO provides for exceptions to GATT strictures based on national security considerations.

3/ Article XX (General Exceptions) of GATT/WTO explicitly allows for exceptions to GATT strictures based on public morals and "human, animal or plant life or health."

shanks and shells. It is well-known that border measures are rarely first-best environmental policy instruments. 1/ In Sri Lanka's case, the implied environmental objective, preservation of forests and coral reefs, could be achieved at a lower social cost by directly restricting yearly harvests through the issuance of harvesting permits. Ownership of a valid permit would then be sufficient to obtain an automatic export license. 2/ Whether permits are auctioned, allocated by lottery, or given away, the socially desirable level of preservation would be achieved without distorting the domestic price. 3/

e. Duty waivers and exemptions

Eliminating all duty waivers and exemptions and eliminating or grandfathering the special treatment of BOI firms would contribute substantially to the overall objective of purging the regime of unnecessary discretionary elements. As mentioned in the context of surcharges, mixing broad discretionary authority with the authority to revise trade policies is conducive to rent seeking and corruption. To the extent that officials feel that contingencies may arise that would call for duty waivers or exemptions, a second-best alternative to the absolute elimination of waivers and exemptions would be to allow a limited number of time-bound waivers and exemptions under truly exceptional circumstances. These circumstances should be delineated in precise terms in legislation--general allusions to the "public interest" are not sufficient--and the rules should be strictly enforced.

The Government's trade policy toward domestically produced agricultural products through 1994 and into 1995 used a combination of import licensing restrictions and variable-rate levies (typically achieved via partial duty waivers) to bring a high degree of stability to domestic prices while also maintaining protective margins above world prices. In March 1995, the Government stated its intention to refrain from using import licensing restrictions on agricultural products and to use variable rate levies instead. Economic efficiency requires that domestic prices fluctuate broadly in line with developments in the world market. Thus protection, if it is to remain, should be tariff-based and stable. While opportunities to hedge price and crop-yield risk in Sri Lanka are underdeveloped, the Government's trade policies toward agriculture have largely obviated the need for a futures market. Hedging opportunities will likely improve as the demand for hedging is unleashed.

1/ See, for example, Anderson and Blackhurst (1992).

2/ Customs would, of course, retain the right to verify that an exporter was in possession of a valid harvesting permit in order to verify that the proposed export consignment was legally harvested. In this way, illegally harvested product would continue to be stopped at the border.

3/ Auctioning permits, of course, offers the added benefit of capturing the rents for Government.

There is no difference between export duties, cesses, and royalties in terms of the trade-distorting effects they produce. Items funded from export cesses should be funded from general revenue sources. Any royalties due to the state upon the sale of a product should be collected independently of whether that item is exported or used domestically.

5. Conclusions

Liberalization of trade in Sri Lanka has been focused appropriately on tariff cuts and consolidation, the elimination of most export taxes, and the elimination of quantitative restrictions. The process, however, has been marked by occasional setbacks and exceptions. Over the medium term, as discussed in Section 4, the priority should be to formally institutionalize a high degree of transparency in the formulation of trade policy in order to facilitate open public debate, which would in turn help to preclude insiders from dominating the process. Further, priority should be accorded to establishing a rules-based system for granting time-bound special treatment only under truly exceptional circumstances, in place of the current system of ad hoc measures that tend to induce rent seeking, complicate the trading system over time, and encourage creeping protectionism. Such efforts over the medium term would send a strong signal domestically and internationally that the new Government in Sri Lanka intends to proceed decisively toward liberal economic policies, external and internal.

Sri Lanka: Fiscal Policy Measures (Since January 1, 1994)

Item	Description	Old rate (In percent)		New rate (In percent)		Effective Cost (Rs Mn)
		Import duty	Turnover tax	Import duty	Turnover tax	
<u>Revenue measures</u>						
1. Import duty/turnover tax revisions						
Motor cycles	Import duty rates revised with effect from (w.e.f) 12.01.1994	10-45%	0-20%	0-50%	0-20%	49.4
Newsprint	Import duty rates revised w.e.f 07.02.1994	10%	10%	20-35%	10%	-94.7
Chassis fitted with buses with a g.v.m. exceeding 3000 kgs.	Fully exempted from turnover tax w.e.f 02.28.1994	10%	20%	10%	0%	59.8
Iron or steel Drilling, threading or tapping tools	Turnover Tax rates revised w.e.f 01.03.1994	20-35%	10%	20-35%	0-10%	6.7
		10%	20%	10%	0-20%	16.7
Tractors	Full import duty waiver granted on 07.02.1994 Turnover Tax rate on prime movers reduced w.e.f 01.03.1994	10%	0-10%	0%	0-10%	33.4
Stationary Electric Generating Sets	Full import duty waiver granted w.e.f 21.02.1994	10%	10%	0%	0%	2.0
Agricultural Equipments	Full import duty waiver granted on 22.02.1994 Turnover Tax is automatically exempted for such items under Turnover Tax Act Item (20)	10%	5-20%	0%	0-20%	46.0
Construction Equipments (includes transport vehicles such as lorries and trucks)	Partial import duty waiver granted on 23.02.1994 with minimum duty of 10%. Turnover Tax rates revised w.e.f. 01.03.1994	10-20%	20%	10%	0-20%	361.3
Generators	Full import duty waiver granted on 22.02.1994 Turnover Tax is automatically exempted for such items under Turnover Tax Act Item (20)	10%	10%	0%	0%	13.7
Yarns	Partial import duty waiver granted on 23.02.1994 Turnover Tax rates revised w.e.f 31.01.1994 & 01.03.1994	10-35%	0-20%	5-30%	0-10%	530.4
Fibre	Full import duty waiver granted on 23.02.1994 Turnover Tax rates revised w.e.f 31.01.1994 & 01.03.1994	10%	10-20%	0%	0-10%	393.2

Item	Description	Old rate (In percent)		New rate (In percent)		Effective Cost (Rs Mn)
		Import duty	Turnover tax	Import duty	Turnover tax	
Edible oil	Partial import duty waiver granted w.e.f 01.04.1994	45%	20%	35%	20%	14.6
Skimmed milk power	Partial import duty waiver granted to the Nestle Lanka Ltd. for 6 month period w.e.f 01.01.1994 for imports of 1,215 MT of skimmed milk power	20%	0%	10%	0%	10.6
Sugar	Partial import duty waiver granted w.e.f 12.05.1994	Rs 6.50/	10%	Rs 3.00/	5%	850.2
Dried fish Sprats Other	Full import duty waiver granted w.e.f 12.05.94 Turnover Tax is automatically exempted for such items under Turnover Tax Act Item (20)	10% 10%	5% 20%	0% 0%	0% 0%	316.2
Fabrics	Partial import duty waiver granted w.e.f 12.05.1994	50%	10-20%	35%	10-20%	290.6
Canned fish	Partial import duty waiver granted w.e.f 12.05.1994 Turnover Tax is automatically exempted for such items under Turnover Tax Act Item (20). w.e.f 28.04.1994	10%	10%	5%	0%	56.5
Dhal	Full import duty waiver granted w.e.f 12.05.1994 Turnover Tax is automatically exempted for such items under Turnover Tax Act Item (20)	Rs. 12/kg	5%	0	0%	468.7
Full cream milk powder	Partial import duty waiver granted w.e.f 01.06.1994	20%	0%	10%	0%	167.8
Precious or semi- precious stones precious metals and metals clad with precious metal	These items were exempted from Turnover Tax w.e.f 01.05.1994 (earlier turnover tax rate for gold 10% & others 20%)	10%	10-20%	10%	0%	1118.0
Nitrogen	Turnover Tax rates revised w.e.f 01.05.1994	10%	20%	10%	5%	0.3
Rice	Import duty reduced w.e.f 08.12.1994	35%	0%	20%	0%	7.9
Sales of sugar, wheat flour and rice by Co-operatives	Removal of turnover tax on sales of sugar, wheat flour and rice by Co- operative societies on 12.10.1994. Cost per year is around Rs. 123million.					
2.. PAYE Tax						1200.0
	Increase in the PAYE tax exemption for those earning upto Rs. 12,000 per month w.e.f 01.04.1994					

Item	Description	Old rate (In percent)		New rate (In percent)		Effective Cost (Rs Mn)
		Import duty	Turnover tax	Import duty	Turnover tax	
3. Treasury Bill withholding Tax	Withholding Tax on Treasury Bills & Government securities withdrawn from 01.07.1994. However tax liability of interest income from such instruments remains unchanged.					
<u>Expenditure Measures</u> Janasaviva 5th round	Implemented for 120,000 families w.e.f 01.06.1994 Allowance is Rs. 1,458/=per month					1049.8
Mid-day Meal	Mid-day meal stamp worth of Rs.50/=per month is granted for additional 1.7 million school children. (excluding school vacations)					340.0
8000 graduates	Employment of 8000 graduates w.e.f 01.07.1994 Average salary assumed at Rs. 2,500	On-going project				120.0
Permanent status to casual employees	All casual employees with 180 days of undermines public service as at 01.05.1994 to become permanent					300
Housing loans to corporation employees	Advance account					750.0
Distress loan to Government employees	Distress loan increased from 6 months salary to 10 months salary for government					50.0
Fishing boat subsidy	A subsidy of 25%-50% for the purchase of equipment					..
Mahapola Scholarship Scheme	The monthly allowance of Mahapola Scholarship increased by Rs.250 from Rs.1,000 to Rs.1,250 w.e.f 01.07.1994. Cost of allowance shared by Mahapola Trust Fund & U.G.C					
Fertilizer subsidy	Thirty percent price subsidy was granted on the base price w.e.f. 10.10.1994.					1200.0
Salary revision for teachers	Average salary increase ranging from Rs.400 to Rs.700 is proposed for 187,000 government teachers w.e.f 06.10.1994. Estimated cost is at around Rs.2800 million per year.					700.0
Salary revision for Postal Services	On average 25% salary increase is recommended for postal services on 01.08.1994. This revision is effective from 01.05.1994.					
Pension	Government agreed to pay cost of living allowance to pensioners w.e.f 01.01.1994 The estimated cost is Rs.3,655 Mn. However this will be paid in an instalments over several years.					

Item	Description	Old rate (In percent)		New rate (In percent)		Effective Cost (Rs Mn)
		Import duty	Turnover tax	Import duty	Turnover tax	
Petroleum Price reduction	Prices of selected petroleum products were reduced w.e.f 29.09.1994	Auto diesel	12.40	11.40		357.0
		Super diesel	15.20	14.20		
		Heavy diesel	11.70	10.70		
		Kerosene	11.80	9.50		
Electricity tariff reduction	The electricity tariff reduced for all consumers for units below 100 w.e.f 01.05.1994					500.0
Wheat Flour	Price of wheat flour reduced by Rs.1.50 from Rs.13.30 to Rs.11.80 w.e.f 01.07.1994. (CWE price from Rs.12.50 to 11.00)					576.0
Wheat Flour	Price of wheat flour reduced by Rs.4.35 from Rs.11.80 to Rs.7.45 w.e.f 29.08.1994 (CWE price from Rs.11.00 to 6.65)					1333.1
15,000 Projects		On-going project				1300.0
NITA Training	NITA to train additional 60,000 youths with increased allowance from Rs.450 to Rs.750 month w.e.f 01.07.1994	On-going project				108.0
Computer Training	On the job training in computer technology to estimated 20,000 youths w.e.f 01.08.1994 Allowance of Rs.750 per month.	On-going project				75

Source: Sri Lanka authorities.

Poverty Alleviation Programs

Despite three decades of economic growth, averaging about 4 1/2 percent per annum, Sri Lanka has a continued problem of poverty. Moreover, according to surveys of income distribution, the bottom 20 percent of the population have not increased their share of the country's national income in the past 15 years. Together with cost considerations, this lack of progress has led to a reform of the social welfare programs provided with a new system introduced in mid-1995.

The old system

Food stamps

Introduced in 1979, this scheme has a fixed income criterion for eligibility which, by its very nature, is difficult to enforce in a developing country like Sri Lanka, where income deriving from agriculture is substantial, sporadic, and unlikely to be assessed on a consistent basis. Due to the difficulty of determining eligibility, some poor families get excluded from the scheme or the non-poor are included.

In 1979, this program covered 7 1/4 million persons and the number increased gradually until 1980, when no new additions to the list were allowed. In 1986, an effort at improving the targeting of the food stamps program resulted in 1.84 million households on the program costing about SL Rs 3.6 billion or 1.4 percent of GDP. However, as there was no satisfactory system for monitoring and review of beneficiaries, an additional 20 percent of families should have been included in the scheme as they were entitled to these benefits on the basis of the income criteria. With the introduction of the Janasaviya program (JSP), the number of food stamp recipient households has declined to 1.4 million, as recipients in each division go through a screening program to determine their eligibility to participate in the Janasaviya program.

The value of stamps was determined in September 1979 so as to provide the same basket of goods as the ration holders had previously received. In January 1980, however, the subsidies on essential food commodities were removed and price levels increased. Since the food stamps were not price-indexed, the high rates of inflation eroded the value of the stamps. Consequently the average monthly benefit per household (approximately SL Rs 167 between 1989 and 1992) was only equivalent to around three days' average wage of an unskilled worker by then.

Purchases with food stamps are supposed to be confined to food and can only be made in cooperative stores. However, in certain locations, the food items in demand were not available in adequate quantities, and food stamps

holders purchased items that they may not otherwise have intended to or non-food items.

Public assistance and social welfare schemes

Although well-targeted, the programs for the indigent and socially disadvantaged were underfunded, partly because the nominal value of benefits had not been adjusted in line with inflation. Public assistance payments to individuals/families rose from an average of SL Rs 100 per month to only SL Rs 160 per month, but this represented a decline in real terms of 50 percent over the last decade. Monthly support payments to non-profit homes for orphans, abandoned and handicapped children, and the aged were held constant at SL Rs 100 per person for over a decade; ad hoc grants for capital work have also been extremely restricted. At the same time, the number of children in difficult circumstances, the aged, and disabled was burgeoning.

The Janasaviya program

In 1989, recognizing the ineffectiveness of the "safety-net" programs, the Government launched the Janasaviya Program (JSP) to promote self-employment in rural areas and alleviate poverty. This program provides a grant of SL Rs 2,500 per family per month for a two year period, to families whose monthly incomes are less than SL Rs 700. The allowance is divided into two components i.e. a consumption transfer of SL Rs 1,458 per month of which SL Rs 1,000 is to be spent to purchase essential food items (largely locally produced) from the respective multipurpose co-operative societies, and SL Rs 458 per month to be saved in a bank. The investment component (SL Rs 1,042 per month) is compulsorily saved and accumulated to SL Rs 25,000 at the end of two years; it can then be used as collateral (individually and/or collectively) to obtain a loan for a small business.

The program was designed to cover all divisions in 11 rounds, picking up one division from each district in each round. The divisions were selected on the basis of need i.e. those with the highest percentage of food stamps received being given priority. Round 1 began in October 1989 and included 161,000 households, of which 42,000 that were in the northeast were removed in mid 1990. Round 2 began in December 1990 with 104,000 households. Round 3, with 101,000 household started in February 1992. Round 4, with 100,000 households started in March 1993, and Round 5, with 120,000 families started in June 1994. Increasingly, community participation and detailed, region-specific thresholds for land ownership, consumer durables and other income sources have been used to determine eligibility.

During the five years of its operation, certain weaknesses became apparent in the program. Janasaviya benefits are given on a uniform flat rate to all households which were selected, regardless of the size of family or how far household income is below the cut-off point; this was relatively disadvantageous for large families with very low income. It was found that there were leakages of 10-20 percent, and about 5-10 percent of eligible households have been excluded; that households which now reveal an income of

SL Rs 1,500 per month, had been close to these levels or above them even prior to the Janasaviya Program and that the improvements in income-earning capacity are in fact marginal; that approximately 31 percent of families who completed the two year period were still in need of continuing support; and that another 12 percent have not been able to move out of severe poverty, even with Janasaviya assistance.

Since 1991, the JSP objectives have been supported by the Janasaviya Trust Fund, (JTF) which is financed through government and a concessional World Bank loan of US\$ 60 million. In addition, UNDP funds a technical assistance component of US\$ 2 million. The JTF operates through partner organizations, which can be government and non governmental organizations, to promote employment generation through a rural works program; to support the human resource development of beneficiaries and the institutional development of its partners; and to run a program to enhance nutritional intakes in children, pregnant women and lactating mothers.

The target group of the JTF are those engaged in self-employment with a monthly income below SL Rs 1,500. Youth and women are given priority. The loans do not exceed SL Rs 5,000. About 60 percent of the approved loans have been destined for agricultural activities. No collateral is required when applying for loans, and a compulsory skill training course precedes the granting of the loan. These loans are provided by the partner organizations. They borrow money from the Trust at 7 percent and lend to the beneficiaries at the going commercial rate (about 20 percent).

Since 1992, although 1,549 employment creating projects have been initiated, only 5 to 10 percent of the supported businesses have become self-sustaining. This may be due to the nature of the system. The partner organizations have become dependent on the income derived from interest payments and thus tend to reduce the size of the loan and select quick yielding investments in order to safeguard timely repayment and hence their revenue. As a consequence, the JTF approach has become more a mechanism for income subsidy than a tool for business development.

Midday meal program

The Midday Meal Program was set up to reduce malnutrition in school-age children and currently has about 4.2 million recipients at a total cost of about SL Rs 1.2 billion in 1994. Primary and secondary school students receive daily coupons, worth 50 rupees per month, which can be used for food purchases from the cooperative societies. Currently, all children receive the coupon, regardless of household income level.

The Samurdhi Movement

In order to provide a more effective "safety-net" and income generation program for the poor, the present Government has designed the Samurdhi Movement. It will be launched on June 1, 1995 and will cover one-third of the entire population of the country, consisting of about 1,200,000 families estimated to be at the bottom of the income scale by the Central Bank. The

poorest within this category earn on average about SL Rs 500 per month, consisting of about 100,000 families, scattered in about 20,000 villages. The intention of the program is to raise their income levels to about SL Rs 1,500 per month by a direct income transfer of SL Rs 1,000 per month. The remaining 1,100,000 families, who are estimated to earn an average of around SL Rs 1,000 per month, will get an income supplement of SL Rs 500 a month. Thus, the effect of this program will be to raise incomes of the poor to about SL Rs 1,500 per month, and with the additional income that could arise from the Samurdhi Program's self-employment activities, these incomes will rise to SL Rs 2,000 per month.

The ultimate objective of the Samurdhi program is to promote self-reliance on the basis of nurturing saving habits and the development of income generating self-employment. Hence, all Samurdhi beneficiaries will be encouraged to save a part of the income supplement--SL Rs 200 per month by the poorest and SL Rs 100 per month by the rest--in order to develop savings, which will be utilized to finance new income earning activities among the beneficiaries, along with supplementary finance from outside.

The current food stamp scheme of SL Rs 200 per month will be continued until the Samurdhi program replaces it in June, 1995. The already operational Janasaviya 5th round will be integrated with the Samurdhi program. The school mid-day meal program too will continue until May. The interest payment of SL Rs 250 currently paid on "Ghost (non-existent) Janasaviya deposits" will continue. The current Janasaviya Trust Fund program will complement the financing of self-employment projects. Those Samurdhi beneficiaries who have identified viable and durable income earning opportunities will be given the option to convert two year's Samurdhi payments into a single capital grant for investment ranging from SL Rs 25,000 to SL Rs 50,000. This could be supplemented by loans of an equivalent amount. Thereafter they will graduate from the Samurdhi program.

Beneficiaries exit from the program when their income exceeds SL Rs 2,000 per month for a continuous period of six months or when at least one member of the family finds employment. As Samurdhi beneficiaries exit from the program, new entrants to poverty will be able to join the program. The identification of some of the beneficiaries will be undertaken by the Samurdhi Niyamakas (SN), on the basis of a process of participatory identification.

The Samurdhi program will work as follows. The selected households will be divided into two groups: (a) pure savers and (b) groups of potential entrepreneurs. For the first group, the savings will accumulate in a personal savings bank with interest. The principal sum will become available at the end of five years or whenever a poor household is able to generate an income of SL Rs 2,000 per month (including other transfers) for an uninterrupted period of six months.

The second group, consisting of potential entrepreneurs, will be organized in voluntary groups with their savings accumulating in each group's bank account. They will save an additional amount, compared to poor

savers, as determined by themselves. In a typical Grama Niladari (GN) division of 200 families, where the target group of the poorest, would comprise 45 families, as much as SL Rs 100,000 could be accumulated in a relatively short period of time if all were investors. When the savings pool in each GN division reaches SL Rs 60,000, the voluntary groups within it are expected to combine to form a Samurdhi Society which can extend loans to participating families. The first loans to any individual in the group will be funded exclusively with the voluntary savings of the group, with the creditors therefore being the other group members. Of necessity these loans will be small (at most a couple of hundred rupees), basically to cover emergency needs.

The Samurdhi Societies are expected to join any of the existing grassroots savings and loans institutions catering to the needs of the poor, including NGOs with national coverage such as Sanasa and Sarvodaya. This can also include other smaller institutions which may have more limited area coverage. In areas where there are no NGOs, Societies will join the established banking institutions such as the People's Bank. On transfer of any Society's savings to one such institution, the group can receive loans from these institutions, initially drawing on the group's savings but subsequently drawing also on other sources of funds. The JTF will now become the National Development Trust Fund (NDTF). All participating NGOs will be encouraged to seek partner organization status under this Fund. Lending under the Samurdhi program will follow the established lending practices of these partner organizations.

The improvement of the entrepreneurial abilities of poor families will be the main function of the Samurdhi Movement. This will undertaken by a Samurdhi Committee consisting of 10 Samurdhi Niyamakas to be appointed in each Grama Niladhari Division. Two members of the committee will be selected from among the young unemployed in the area who have passed the GCE Ordinary Level or Advanced Level examination and they will be paid SL Rs 2,000 per month. The remaining 8 members will be from respected social groups at village level such as teachers, clergy and nongovernmental organizations and will serve on a voluntary basis.

The SN will be given a comprehensive training in the relevant field with the assistance of NGOs who have developed the strongest social mobilization capacity at the grass roots level. The SN's activities will be supervised by university graduates (recruited under the recent Graduate Placement Service) and an Advisory Board to be appointed in each GN division under the Samurdhi Movement. After being trained, the SN will conduct a comprehensive survey to identify capabilities of households to pursue self-employment. On the basis of their identified abilities, the SN will develop project proposals for each family for funding.

The administration of the Samurdhi Movement will be undertaken at various levels with the assistance of Samurdhi committees. At village level Samurdhi Centers (SC) will be established to administer and coordinate the program. In each division a Divisional Samurdhi Committee will be set up, comprising the Divisional Secretary, officers of the Samurdhi Authority at

divisional level, and representatives of the SCs. The committee will attend to all activities connected with the program at divisional level and report progress to the District Committee, which should report on a regular basis to the Commissioner General of Samurdhi and/or the Samurdhi Authority on the progress of the projects.

Government Debt and Interest Payments

This Appendix examines the composition of Government debt and interest payments in the Sri Lanka fiscal accounts. ^{1/} The large proportion of foreign debt, with low levels of interest payments and long maturity, accounts for the relatively small cost of debt service.

Domestic debt

It is estimated that during 1994 the average domestic debt stock of the central government was equivalent to 40 percent of GDP while the domestic interest bill was 5.4 percent of GDP. The domestic debt of the central government consists of four main categories: central bank advances, medium-term rupee loans, treasury bills, and recapitalization bonds issued to the two state-owned commercial banks.

Central Bank advances to the budget can equal no more than 10 percent of budget revenues (including debt payments) according to the Monetary Law Act and carry no interest charge. At the end of 1994, the stock of these advances represented 5 percent of the total domestic debt.

Rupee loans are proceeds from the sales of 3-5 year Government securities primarily to the commercial banks and the nonbank savings institutions. Though the rate of interest is not fully market-determined and instead is set by the Ministry of Finance, the authorities do aim to follow trends in the yields on treasury bills. At the end of 1994, the stock of these loans represented 55 percent of the total domestic debt, of which the National Savings Bank (NSB) and the Employees' Provident Fund (EPF) hold over four fifths. The average yield paid on these loans in 1994 is estimated at 14.1 percent.

Treasury bills are generally sold with three-month, six-month, and one-year maturities through weekly auctions. Prior to May 1995, the Central Bank announced the total size of issue and bids were sought at the these maturities. The authorities then accepted some or all of the bids. Captive sources, such as the NSB and the EPF could reserve some amounts of the bills, at the average accepted prices. If necessary, the Central Bank could take on any remaining issues, also at the average yields. From May 1995, the authorities are able to specify the size of issues at each specific maturity to improve control on the debt portfolio. At the end of 1994, the

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^{1/} Local government does not generally borrow, relying on central government transfers and own resources. Little information is known about the total size and cost of public corporations' borrowing other than from central government or the banking system. At the end of 1994, public corporations as defined in the monetary survey owed domestic banks SL Rs 5.1 billion.

stock of outstanding bills accounted for SL Rs 99 billion, or 40 percent of domestic debt, with the majority of three-month maturity. In the Sri Lanka fiscal accounts, interest on treasury bills is recorded on a cash accounting basis, when the bills mature. During 1994, interest rates fluctuated sharply between 11 and 20 percent, with an average yield of 18.1 percent, reflecting high interest rates on bills sold in late 1993.

Recapitalization bonds worth SL Rs 24 billion were provided to the two state-owned banks, the Bank of Ceylon and the People's Bank, in 1993 to improve their capital base. These bonds earn 12 percent interest. However, in their budget presentation, the authorities treat these payments as restructuring costs and classify them to capital expenditure and net lending. The banks were originally expected to pay tax on the interest income, but this stipulation was dropped in 1994.

Foreign debt

Of the SL Rs 300 billion of foreign debt equivalent to 52 percent of GDP, 97 percent is in the form of concessional loans provided by the International Development Agency (IDA), the Asian Development Bank (AsDB), and the Fund and on a bilateral basis. The currency composition of foreign debt equates fairly closely to the SDR basket of currencies. In local currency terms, average interest rates were about 2 percent in 1994. The impact of rupee depreciation has tended to increase the value of the debt by 6-10 percent each year in local currency terms.

Table 1. Sri Lanka: Central Government Debt and Interest Payments, 1993-94

	Stock end- 1993	Stock end- 1994	Interest Payments in 1994
<u>(In billions of Sri Lanka rupees)</u>			
Central Bank advances	10.5	12.4	--
Rupee loans	81.6	113.5	13.8
Treasury bills	97.2	98.9	17.7
Recapitalization bonds	24.1	24.1	2.9
Other	0.3	0.3	--
Total domestic debt	213.7	249.1	34.4
Foreign debt	269.9	299.4	5.4
Total government debt	483.6	548.5	39.8

Source: Data provided by the Sri Lanka authorities.

Discriminatory Effects of Charges and Markups on Imports

The purpose of this appendix is to illustrate, by numerical example, how the EDB cess and markups applied to imports in connection with the calculation of turnover tax and defense levy increase the discriminatory tax on imports over and above that of a given tariff rate (Table 1). For this illustration, consider that the CIF value of an imported item is \$100.00 and that this item is subject to a tariff of 45 percent, or \$45. Such an import is also subjected to the EDB cess at 10 percent of the tariff rate, which translates into 4.5 percent of the import's CIF value, or \$4.50. Thus, the tariff and the EDB cess amount to \$49.50.

In addition to these taxes, this item is also subject to both the basic turnover tax (BTT) of 20 percent and defense levy (DL) of 3.5 percent. A markup is applied to the sum of the CIF value, the tariff, and the EDB cess before the BTT and the DL are applied. Accordingly, the discriminatory element of the basic turnover tax is \$7.48 (the amount attributable to the markup), while that of the defense levy is \$1.31. Thus, the total discriminatory tax applied to the import in this example is \$58.29.

Table 1. Sri Lanka: Discriminatory Tax on Item with CIF Value of \$100

	Tariff only	Tariff and EDB cess	Tariff and EDB cess with markup
Tariff	\$45.00	\$45.00	\$45.00
EDB cess		\$4.50	\$4.50
Discriminatory element of BTT			\$7.48 <u>1/</u>
Discriminatory element of defense levy			\$1.31 <u>2/</u>
Total discriminatory taxes on imports	\$45.00	\$49.50	\$58.29

1/ The 20 percent basic turnover tax applied to 125 percent of the sum of the CIF value and the EDB cess, together with the markup, creates a discriminatory element equivalent to $0.20[0.25(\$149.50)] = \$7.48$.

2/ The 3.5 percent defense levy applied to 125 percent of the sum of the CIF value and the EDB cess, together with the markup, creates a discriminatory element equivalent to $0.035[0.25(\$149.50)] = \$1.31$.

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