Free Trade Agreements and.Rules of Origin:

- A Case Study of the Indo-Sri Lanka Free Trade Agreement

Free Trade Agreements and Rules of Origin

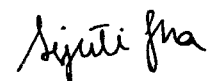## - A Case Study of the Indo-Sri Lanka Free Trade Agreement

Dissertation submitted in partial fulfillment of the requirements for the

Degree of Master of Philosophy in Applied Economics

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Sejuti Jha

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I hereby affirm that the work for the dissertation, **Free Trade Agreements and Rules of Origin: A Case Study of Indo-Sri Lanka Free Trade Agreement,** being submitted as part of the requirements of the M.Phil Programme in Applied Economics of the Jawaharlal Nehru University, was carried out entirely by myself and has not formed part of any other Programme and not submitted to any other Institution/University for the award of any Degree or Programme of Study.

June 30, 2005

Sejuti Jha

Certified that this study is the bona fide work of Sejuti Jha, carried out under my supervision at the Centre for Development Studies.

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for Baba & Ma...

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ABSTRACT OF THE DISSERTATION
Free Trade Agreements and Rules of Origin
- A Case Study of Indo-Sri Lanka Free Trade Agreement
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Centre for Development Studies.

The context of this study is the recent Indo-Sri Lanka Free Trade Agreement (ISLFTA) and its effects on bilateral trade, with special emphasis on Rules of Origin (RoO) of the Agreement. The present study looks into three issues: whether ISLFTA has led to trade diversion or not; whether its RoO are restrictive or not; and whether these rules are enforced properly or not.

Due to methodological difficulties and lack of data needed to evaluate trade diversion effects of a Free Trade Agreement (FTA), we take an alternate route. We examine changes in the regional orientation of bilateral exports (captured by export intensity index), and show how this information can be compared with the Revealed Comparative Advantage (RCA) index of such exports to identify apparent inefficiencies in trade patterns. Although this method does not measure trade diversion directly, it provides closely related information by allowing one to infer whether the additional trade generated by ISLFTA establishment was primarily in products in which both the countries had low enough costs to be competitive in third markets. If not, it implies presence of trade distortion and suggests that the additional trade could have been replaced by more efficient outside suppliers.

Since effects of RoO within a FTA depend on their restrictiveness scale, we evaluate the restrictiveness of ISLFTA RoO by using an index measure and referring to the provisions regarding RoO, given in the text of the ISLFTA. Whether RoO will restrict trade or not depends not only on the provisions of the FTA but also on the way they are implemented. Using secondary sources we look into the issue of RoO implementation, as this has not been given enough attention in the literature, despite the fact that policy implementation is as important as policy design.

Our trade data analysis brings out the evidence of trade distortion in India's exports to Sri Lanka and *vice-versa*. Most of the product groups in bilateral exports, which have increased their export intensity after the operation of ISLFTA, have no RCA in their respective exporting country. Regarding RoO, the study shows that the regime of RoO chosen under ISLFTA is quite restrictive when compared with similar trade agreements across the globe. The restrictiveness is mainly due to absence of supplementary measures to RoO, which actually relax the stringency of such rules. On the topic of proper enforcement of these rules, this study brings to the fore stark examples of circumvention of such rules by simple under-invoicing of imported inputs in case of copper exports from Sri Lanka. In this case the study finds a link between circumvention of these rules and trade distortion.

The study points to the importance of RoO and suggests policy focus should be on proper enforcement of these rules.

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AFTA	ASEAN Free Trade Area
ASEAN	Association of South East Asian Nations
CECA	Comprehensive Economic Partnership Agreement
DGCI&S	Directorate General of Commercial Intelligence and Statistics
EC	European Community
EFTA	European Free Trade Area
EU	European Union
FTA(s)	Free Trade Agreement(s)
GATT	General Agreement on Tariffs and Trade
HS	Harmonised Commodity Description and Coding System
ISLFTA	Indo-Sri Lanka Free Trade Agreement
JSG	Joint Study Group
MERCOSUR	Common Market of the South
MFN	Most Favoured Nation
NAFTA	North American Free Trade Agreement
PTA(s)	Preferential Trade Agreement(s)
RCA	Revealed Comparative Advantage
RoO	Rules of Origin
RTA(s)	Regional Trade Agreement(s)
SAARC	South Asian Association for Regional Cooperation
WCO	World Customs Organization
WTO	World Trade Organization
WTR	World Trade Report

Chapter 1

Introduction

1.1: Introduction

One of the most striking developments in recent history of the world trading system has been the surge in Regional Trade Agreements (henceforth RTAs). Though "RTAs" is the collective term used by the WTO[1] to refer to both Free Trade Agreements (henceforth FTAs) and other regional preferential trading arrangements, FTAs have been central to this recent surge in regionalism. Such proliferation of FTAs has brought two issues to the front. Firstly, there has been a debate amongst economists on the welfare effects of such agreements. Secondly, such proliferation has also brought to the fore the role played by Rules of Origin (henceforth RoO) in such arrangements. In this context we place our study. The specific subject matter of this study is the bilateral trade scenario between India and Sri Lanka in the context of the Free Trade Agreement (FTA) between the two countries, with special emphasis on the Rules of Origin present in the Agreement.

The countries had commercial links since time immemorial due to geographical proximity, common cultural heritage, and shared historical roots. Sri Lanka has always been dependent on its large neighbour for much of its import requirements. India in the past, however, did not import much from Sri Lanka. This led to a huge trade gap in favour of India. One major reason for forming the FTA was to reduce this skew in bilateral trade. This was expected to happen, as establishment of a FTA would grant the small island economy free access to the large Indian market of 1.2 billion people. The FTA was also expected to attract trade driven foreign investments to Sri Lanka. India was expected to gain from the FTA on the ground that it could import cheaper raw materials from Sri Lanka and get an export market for its goods in Sri Lanka.

However the most important impetus for the FTA was emergence of similar trade arrangements around the major world economic powers. The world has seen proliferation in FTAs in recent years.

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[1] WTO: World Trade Organization was established on January 1st, 1995 to replace GATT (General Agreement on Tariffs and Trade) as the legal and institutional foundation of the multilateral trading system of member countries.

Setting up of FTAs has several economic implications. In this study we will first try to identify such effects in case of Indo-Sri Lanka Free Trade Agreement (ISLFTA)[2]. Then we will look into the RoO hereby of the Agreement and its effects.

Such a study is important on account of many reasons. Firstly, Sri Lanka depends on India for most of its imports. For India too, Sri Lanka is becoming an important export destination in recent years. This growing importance of each country on the other, as far as trade is concerned, makes it worthwhile to look into how far policy changes like FTA formation are affecting the dynamics of such trade. Secondly, RoO in Free Trade Agreements (FTAs) worldwide have been the subject matter of intense debate and research in recent years because of their protectionist nature. This study tries to analyse the RoO regime chosen under the ISLFTA and looks into policy implications. Last, but not the least, ISLFTA is the forerunner of similar arrangements both countries are contemplating to undertake in the near future. In this context it is important to have an in-depth study of the pioneering agreement to assist in future policy decisions.

This chapter is organised in the following way. We will first try to trace the context of the sudden spurt in setting up of FTAs across the globe. This we do so in the next section. Section 1.3 lists India's initiatives in FTAs. The economic implications of FTAs and the effects of RoO in it are detailed in section 1.4. Given this background the next section jots down the relevant issues to our study and section 1.6 spells out clearly the specific objectives. Section 1.7 mentions the data source and time period of analysis. The last section presents the chapter scheme.

1.2: March of Regionalism in the World Trading System

At a theoretical level, economists are divided over the desirability of RTAs in a multilateral trade regime. Even after fifty years of debate, no consensus has been reached about this issue. However, regionalism, with its advantages and drawbacks, is a reality of the current global trade regime. According to the World Trade Report (2003) currently 43 per cent of world trade occurs under the umbrella of such RTAs. There are 176 RTAs in force and 70 more are under negotiations. The report states that if these negotiations are successful then within the next two or three years more than 50 per cent of world trade will take place under such agreements. It also points out that 145 out of 146 WTO member countries (as of January 2005) are already a part of or are actively negotiating RTAs.

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[2] Henceforth we will refer to Indo-Sri Lanka Free Trade Agreement as ISLFTA or simply the Agreement.

The surprising factor in this whole thing is the recentness of such agreements as is evident from Figure 1.1. What we see is a spurt in the last decade i.e. the 1990s.

Figure 1.1: Number of RTAs notified to the WTO and in force as of December 2002
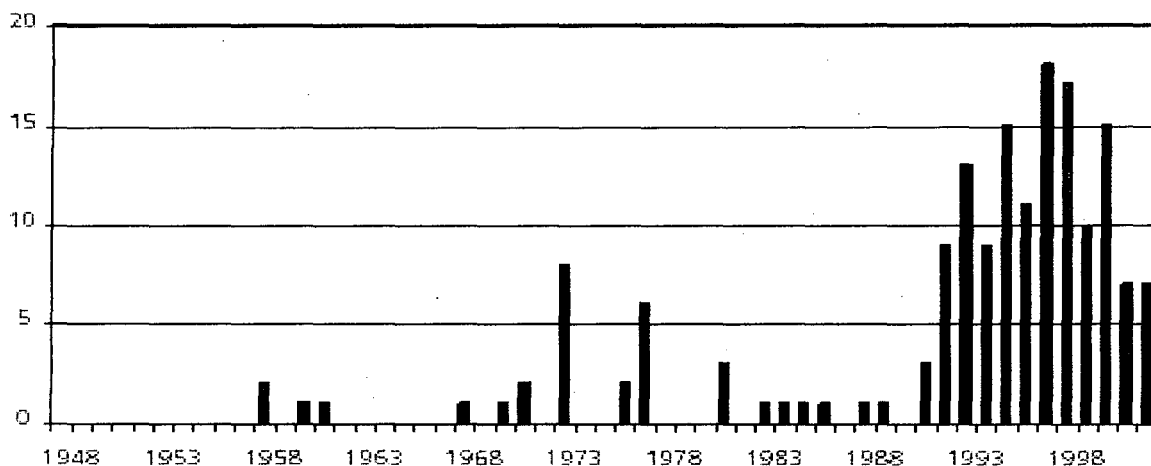
Source: World Trade Report (2003)

The precursor to the first wave of regionalism was the European Economic Community (EEC), which was formed in 1957. It saw the formation of regional agreements in the developing countries of Africa and Latin America. However, this first wave of regionalism did not flourish outside Europe. This was mainly because of America's loyalty to multilateralism (Das 2001). Having witnessed the pernicious effects of discriminatory trade and payments regimes during the Great Depression America had emerged as the champion of a non-discriminatory global trade regime, grounded firmly in the MFN[3] (Most-Favoured-Nation) principle.

All this changed, however, when unable to persuade the EC (European Community) to join the multilateral agenda United States (U.S.) felt obliged to abandon it's long-standing opposition to regional arrangements. It went on to conclude a FTA with Israel in 1985 and Canada in 1989. The North American Free Trade Association (NAFTA) between America, Canada and Mexico was created in 1994. Side by side, the EC continued its expansion, adding more members under its aegis. The deeper integration in the EC and the establishment of NAFTA led to a "domino effect" of renewed interest in RTAs (Panagariya 1999).

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[3] Article III of WTO (previously GATT) declares as a fundamental principle that market access should be extended to all members on a most-favoured-nation (MFN) or non-discriminatory basis.

This regionalism of the 1990s is referred to as the second wave of regional initiatives, or the "new regionalism". And FTAs are central to this new regionalism. With regional agreements becoming so ubiquitous, the default question asked seems increasingly to be why a regional agreement does not exist with a trading partner, rather than why such an agreement should exist. Still let us try to ascertain the reasons for proliferation of such processes in recent years.

There are in general four motivating factors for forging regional alliances. These are to promote economic cooperation among the members of the group by increasing economic efficiency and exploiting economies of scale; to achieve international competitiveness during globalisation; to build a sense of security and to facilitate political harmony within a region; and to forge a collective bargaining position in global negotiations (Mahbub ul Haq Human Development Centre 2002). Another reason why countries wish to participate in such a process is their desire to strengthen their political and economic influence in the international arena. One motivation behind regional integration in Europe after World War II was to strengthen the European countries economic influence over the US and to reinforce their political and military power against the Communist bloc of the Soviet Union and Eastern Europe (Urata 2002). These general reasons give politico-economic rationale for establishing RTAs; still they cannot explain the recentness of such agreements. According to De Melo and Panagariya (1993) one key reason for proliferation of FTAs in recent years is the slow progress of GATT (or WTO).

Krugman (1993) states that the number of players participating in the GATT (or WTO) process has grown large which make negotiations difficult and free rider problem hard to handle. Also the character of protection has changed. Presence of voluntary export restraints, anti dumping mechanisms etc. make the negotiating space in GATT (or WTO) vastly more complicated than it was in the past.

The growing strength of anti-global protestors who perceive trade liberalization under the WTO as a detrimental effect of globalization is another problem to multilateralism. Under these circumstances, with multilateral trade negotiations under the WTO proving so difficult, nations keen to liberalize trade are turning to FTAs as an alternative way to achieve this goal. Also since it involves fewer participants it is much easier under a FTA to establish rules for new issues that are not yet under discussion in the WTO (Urata 2002).

Different types of RTAs are categorised by their degree of integration. Classified this way there are five tiers or stages of regional trading arrangements as shown in figure 1.2.

Figure 1.2: Various Forms of RTAs

Three
Shallow Integration
Stages

Two
Deep Integration
Stages

**Preferential Trade
Agreements**
Partial preference to
trading partners

Free Trade Area
Elimination of all
tariffs, QRs and
NTBs

Customs Union
Common level of
trade barriers
vis-a-vis
non-members

Common Market
Free movements of
factors of production

Economic Union
Integrating national
economic policies
and a common
currency

Source: Das (2001)

Preferential trading areas (PTAs) are the first tier arrangement, where trading partners grant partial tariff reductions to each other. The second tier is the free trade area (FTA)[4], in which members eliminate all tariffs and non-tariff barriers among themselves, but each member can set its own tariff rates on imports from non-members. A Customs Union (CU) goes beyond a FTA and it's members set a common level of trade barriers vis-à-vis non-members. These three stages of regionalisation together are known as "shallow integration" (Lawrence 1996).

The fourth tier is a common market, which attempts to harmonize some institutional arrangements, commercial and financial laws and entails free movement of goods, services and factors of production. The last tier is the economic union and goes a step ahead of the free movement of goods, services, and factors. It involves integrating national economic policies, including taxes and common currency (Das 2001).

In the global network of RTAs shallow integration is far more common than deep. A large majority of existing RTAs is FTAs. As on 4th January 2005, there were 7 CUs, 18 PTAs and 98 FTAs notified to the WTO[5].

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[4] The terms Free Trade Agreement and Free Trade Area, both of which are abbreviated by FTA, are used interchangeably in general practice.
[5] www.wto.org/english/tratop_e/region_e/region_e.htm

India is not an exception to this general trend of regionalism in which FTAs predominate. Recent trade policies in the country have focussed on signing of FTAs with neighbouring countries. India's initiatives in FTAs are given in brief in the next section.

1.3: Free Trade Agreements: India's Initiatives

The first FTA to be signed by India was the Indo-Sri Lanka Free Trade Agreement. It was signed on 28th December 1998 and is in operation from March 2000. This is still the only one FTA in operation for India. However India is focussing on many more FTAs with particular thrust on South East Asia. A summary of this future FTAs are given below. The source is the website of the Department of Commerce in India[6].

A framework agreement on Comprehensive Economic Cooperation (CECA)[7] between ASEAN (Association of South East Asian Nations) and India was signed on 8th October, 2003. The agreement includes FTA in goods, services and investment and an Early Harvest Programme (EHP). EHP covers areas of economic cooperation and a common list of items for exchange of tariff concessions as a confidence building measure. On the very next day a framework agreement (along the same lines as above) for establishing a FTA between India and Thailand was signed by the commerce ministers of the two sides. Tariff concessions on 82 items of the EHP list has begun from September 2004.

Agreement for SAFTA (South Asian Free Trade Area) covering free trade only in goods among SAARC[8] (South Asian Association for Regional Cooperation) member countries was signed in January 2004. The agreement is expected to enter into force from 1st January 2006.

India has also signed a PTA with MERCOSUR[9], which grants reciprocal tariff concessions for now and aims at creating a FTA in the future. A similar kind of arrangement is envisaged with South Africa Customs Union[10] (SACU).

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[6] http://commerce.nic.in/india_rta_main.htm

[7] In a major policy shift the Government of India has reportedly decided to convert all PTAs / FTAs into Comprehensive Economic Cooperation Agreement (CECA). While PTAs / FTAs usually involve structured reduction in tariffs between two countries CECAs would cover preferential relaxation of FDI rules vis-à-vis the partner country, tax holidays on investment and income, easing of visa restrictions. Trade in services too would come under the purview of CECA.

[8] Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka established SAARC on December 8, 1985 for facilitating regional cooperation.

[9] MERCOSUR is the short form of "Mercado Comun del Sur" meaning Common Market of the South. It is a common market among the South American countries of Argentina, Brazil, Paraguay, Uruguay, Chile and Bolivia.

[10] SACU came into existence in 1969 with the signature of the Customs Union Agreement between South Africa, Botswana, Lesotho, Namibia and Swaziland.

On 8th February 2004 Bhutan, India, Myanmar, Sri Lanka and Thailand signed a FTA (BIMST-Economic Cooperation[11] FTA), which was later joined by Bangladesh. It conceives of a FTA in goods, services and investment. India has also signed a framework agreement with GCC (Gulf Cooperation Council comprising of nations of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates) on 25th August 2004, which explores the possibility of entering into a FTA. Negotiations on CECA with Singapore, which includes FTA in goods, services and investment, are in progress. Mauritius, too, is very keen on a FTA with India and a Joint Study Group (JSG) is looking into the modalities of such agreement. Such a JSG also exists in reference to India - Republic of Korea FTA.

Thus we see India has kept up with the pace of regionalism. There is one operational FTA with Sri Lanka and ten more in the pipeline. This surge in FTAs makes it worthwhile to look into the effects of such arrangements.

1.4: Economics of Free Trade Agreements and Rules of Origin therein

For the sake of convenience we have divided this section into two sub-sections. In the first we will deal with the economic effects of FTAs. The effects of RoO under FTAs are detailed in the next sub-section.

1.4.1: Effects of Formation of FTAs

We know that FTAs explicitly deviate from the principle of non-discrimination, which is the cornerstone of GATT (or WTO). However they're consistent with GATT rules. When the GATT was formed in 1947, it's founding members carved out an exception for FTAs (and CUs). Article XXIV of the GATT allows CUs and FTAs between members provided they do not result in higher trade barriers for other non-members. However work done in this area finds that FTAs do not necessarily result in welfare gains for all the members or the world as a whole.

The traditional theory of gains from free trade suggests that removal of trade barriers allow consumers and producers to purchase from the cheapest and most competitive source of supply. This enhances efficiency and increases welfare. Following this logic, it was traditionally believed that regional trade blocks should generate gains from trade as member countries eliminate trade barriers among themselves (Pal 2004). Viner first challenged this

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[11] BIMST-EC was set up in June 1997 to foster socio-economic cooperation among Bangladesh, India, Sri Lanka and Thailand. Myanmar, Bhutan and Nepal were admitted later.

view in his 1950 book titled *"The Customs Union Issue"*. He introduced the concepts of 'trade creation' and 'trade diversion' and showed that the net effect of trade liberalisation on a regional basis is not unambiguously positive. Viner pointed out that RTAs can lead to trade creation if, due to the formation of the regional agreement, RTA members switch from inefficient domestic producers and import more from efficient producers from other members of the RTA. In this case, efficiency gains arise from both production efficiency and consumption efficiency. On the other hand, trade diversion takes place if, because of the RTA, members switch imports from low-cost production in the rest of the world and import more from higher-cost producers in the partner countries. Trade diversion lowers welfare of not only the partner countries but also of the rest of the world.

Is a particular FTA trade creating or trade diverting? The answer, reasoned Viner, depends on who the pre-FTA supplier was. De Melo and Panagariya (1993) give a good example of shoe production in the context of US-Mexico FTA. If the US produced it's shoes before formation of FTA and afterwards shifts to Mexico, then the Mexican shoe producers must be lower cost producers and hence this FTA is trade creating; the welfare of the union and the rest of the world rises. If on the other hand US imported shoes in the initial equilibrium from another country, that country must be a lower cost producer of shoes than Mexico. There is thus trade diversion from a lower to higher cost source. Thus welfare of the union and the world declines.

World Bank (2000) illustrates the trade diversion effect with an example. Suppose an imported good from a partner country costs $105 per unit, $100 from the rest of the world (ROW), and that in both cases duty is $10, making the prices paid by consumers $115 and $110 respectively. In this situation, consumers obviously purchase from the ROW at $110. If the country joins a PTA with the partner, imports are duty-free, so the price consumers pay for imports from the partner country falls to $105, while imports from the ROW still cost $110. Consumer choices are obvious: they switch to the partner country, buying the $105 good and saving $5. But the government now loses $10 per unit (the revenue it was getting on each unit of imports from the ROW), so the net effect for the country is a loss of $5. Thus the PTA has reduced real income. This is the deleterious welfare effect of trade diversion.

Since, Viner did not unequivocally establish the net welfare effect of RTAs it has led to a big debate among the trade theorists about the relative dominance of these two effects. Some studies show that the balance between trade diversion and trade creation is more likely to

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favour trade creation, when MFN tariffs before the formation of the RTAs are low (Meade 1955), member countries of the RTA are already large trading partners (Lipsey 1957) and transportation costs are low (Summers 1991) [quoted in WTR (2003)]. Grossman and Helpman (1995), however, claim that the formation of trade diverting RTAs is the most likely case [quoted in WTR (2003)]. Also according to Bhagwati and Panagariya (1996) if members of the regional trade agreement are small in relation to the outside world, very little trade creation will take place. As a result, under these conditions, trade diversion is likely to be the more dominant effect.

Empirical studies undertaken do not entail any definite conclusion on the net welfare effect (Pomfret 1988). The World Trade Report (2003) states that the evidence drawn from econometric analysis generally produces different results for different RTAs in this regard and a general conclusion cannot be drawn.

However while ascertaining welfare effects in FTAs we have to keep in mind that the concepts of trade creation and diversion are static concepts. Entering into a FTA can have dynamic effects too. Dynamic effects include market expansion effect i.e. the achievement of economies of scale and the ability to choose the best locations for production and distribution as trade barriers are removed and markets expand. The competition enhancement effect is another type of dynamic effect. It refers to the facilitation of efficient production because companies with oligopolies in the region are made more competitive by market integration (Urata 2002). Other dynamic effects include accommodating specialization and division of labour, promoting technical efficiency and terms of trade effects[12] etc. Ideally a study on a FTA should take into consideration both static and dynamic effects of trade due to formation of such a FTA. However this study limits itself in assessing the static trade effects of the ISLFTA, because the short time period available after ISLFTA is not enough to capture the dynamic effects.

1.4.2: Rules of Origin in FTAs

The trade literature on FTAs is vast and growing. A branch of such literature, which is more recent in nature, tries to point to the role RoO play in such FTAs. We now turn our attention to this.

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[12] The terms of trade of members are improved due to their increased influence over non-members as a result of the greater volume of trade between member nations party to a FTA.

RoO are the criteria used to define where (i.e. in which country) a product was made. They are an essential part of trade rules. RoO are applied in both preferential and non-preferential trading regimes. Non-preferential RoO are used for implementing measures and instruments of commercial policy; for compiling trade statistics; for labelling and marking requirements; and for government procurement. Each of these trade regulations involves distinguishing domestic from foreign goods, or distinguishing among foreign goods (Harilal and Beena 2003).

Preferential RoO, which is our concern here, are used to determine whether an imported product will pay MFN tariffs or preferential tariffs in any preferential trading arrangement. A good is eligible for zero tariffs in a FTA only if it originates there. Origin rules in preferential agreements have often been criticised for being more restrictive than general origin rules (Kingston 1994).

RoO weren't that much talked about until recently. In the late 1980s developments in three important areas served to focus more attention on the problems posed by RoO. Firstly, the growth of international trade in goods that are not manufactured in a single country has brought into prominence the rules for determining the "origin" of traded products. Secondly, proliferation of frequently overlapping preferential trading arrangements led to an increase in origin disputes and thus focussed more attention to RoO. Lastly as traditional barriers to trade like tariffs were being brought down under the GATT (and then the WTO) countries turned to the use of RoO as a measure of protection (Harilal and Beena 2003). The discretionary powers in the hands of national authorities implementing the rules give them the protectionist edge (Vermulst 1994).

As a result of such developments, the complexity of the RoO increased, which led them to act as trade barriers *per se*. The ability of RoO to target the input composition of imports has rendered it the protectionist edge. To understand this better let us see the way in which RoO are formulated.

Resolving the issue of origination for primary goods (such as raw minerals, unprocessed vegetable products, live animals and fresh fish) is fairly straightforward. If such goods are "wholly obtained" in the territory of the exporting country, including its territorial waters, or are legally obtained by vessels registered under the country's flag, it is clear that they originate in that country. By extension, goods processed in one country, which are made entirely from primary inputs originating in that country, can themselves be considered

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originating goods, and thus be traded between the members of a FTA under the preferential trade regime. While the criteria to resolve the issue of origination may be relatively simple for primary goods and their immediate derivatives, for most industrial or manufactured products this is not the case. Nowadays, as a result of the globalization of the production processes of many commodities, most industrial goods incorporate inputs produced in a wide range of countries (Ghoneim 2003). In such cases originating status is accorded to that country where the product underwent "substantial transformation".

The Kyoto Convention[13] of 1973 laid down the general principle that the origin of such goods should be determined by the last or final country where the good was "substantially transformed". Following Kyoto Convention, origin is typically assessed by the use of one or more of three general tests, described as follows.

One test is the change in tariff classification (CTC), which confers origin if the activity in the exporting country results in a product that is classified under a different heading of the customs tariff classification (nowadays H.S.[14] classification) than it's intermediate inputs. Or it maybe a regional value content (RVC) criterion that requires that in the exporting country a minimum percentage of value added has taken place. There can also be technical requirement (TECH) test, which sets out certain production activities that may (positive test) or may not (negative test) confer originating status (Vermulst 1994).

These tests can be used singly or in combination. For example, ASEAN Free Trade Area (AFTA) applies the RVC criterion only, across all products. However NAFTA applies all the three rules, leading to a complex set of RoO. Let us now see what economic effects these rules lead to.

Though there is a large literature on RoO in the legal domain very little work has been done at the analytical and empirical level in terms of assessing the economic effects of RoO systems, despite the fact that such an assessment would form the very basis of evolving the origin system. This is partly because economic theory has not so far provided a 'standard' against which the efficacy, benefits and costs of RoO could be determined (Falvey and Reed 1998). Methodological difficulties as well as the lack of relevant statistical information have also

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[13] To ensure simplification and harmonisation of customs procedures and facilitate its practical application, the Kyoto Convention was organised in 1973 by the Customs Co-operation Council (CCC).
[14] H.S.: Harmonised Commodity Description and Coding System. A coded classification of traded products, managed by the World Customs Organisation. See Appendix 1.

constrained the economic analysis (Hoekman 1993). The major works in this area points out to the following effects of RoO in FTAs.

Preferential RoO are of crucial importance in the functioning of any FTA in administrating a number of trade issues and in avoiding trade deflection. Now what is trade deflection? In a FTA members maintain their own external tariffs. Hence, tariffs may differ between member countries. In this setting, in the absence of RoO any particular commodity can enter through the country with the lowest duty on the item in question and get re-exported to other countries in the FTA (Krishna and Krueger 1995). This is trade deflection. RoO prevent such simple transshipment of goods by requiring products to originate in exporting member countries. Thus we see RoO become very important in FTAs for their ability to prevent trade deflection.

RoO requirements also check the import content of value addition, thus have the potential to generate backward and forward linkages in a country adhering to these rules. These requirements act as a deterrent to the assembly kind of production. RoO thus have important implications for the development of the manufacturing sector as a whole, which in turn contributes towards enhancing the export supply capabilities of member countries (Panchamukhi and Das (2001). However Brenton (2004) states that with globalisation and splitting up of production chain countries do not have the luxury of setting up integrated production facilities anew to develop its manufacturing sector. He also points out that strict RoO for the past 20 years have not shown any instance of generating backward and forward linkages.

RoO also provide an incentive for regional producers to buy intermediate goods from regional sources, even if their prices are higher than those of identical import from outside the FTA, in order to make their product "originate" in the FTA and qualify for preferential treatment (Krishna 2005). This effect of RoO will be magnified where there are significant differences in the external tariff regimes of the FTA member countries. The larger the differences between their MFN rates, the greater the incentive to buy higher-cost inputs from a FTA member country to satisfy the RoO and thereby obtain the duty concession on their final goods sold within the PTA. Thus trade is diverted from low-cost non-member countries to high-cost member countries. Krueger (1993) was the first one to point out this effect of RoO. She concluded that unless consumption gains from the FTAs are high enough (because of lower prices) trade diversion leads to welfare loss to the importing country.

Krishna (2005) summarises the effects of RoO in three laws. Firstly, they can insulate an industry from the consequences of a FTA and they can provide hidden protection for intermediate inputs used by it. Secondly the precise form of RoO matters i.e. effects of RoO will depend more on the way they're structured. And also the time period matters i.e. in the short run RoO affect trade flows whereas in the long run they influence investment flows. Preferential RoO, when restrictive, can lead to investment diversion. They may motivate, or even force, firms to locate their plants producing intermediate goods within certain members of any RTA to satisfy these rules, albeit the fact that those members may not be the best location from an economic point of view. One well-published case was the US company Intel, which complained that changes introduced by the EC in 1989 to the definition of RoO for integrated circuits "forced" the company to invest in Ireland (Ghoneim 2003). A paper by Duttagupta and Panagariya (2003) argues that these rules can improve the political viability of FTAs.

What are the welfare effects of such rules? From an analytical point of view the basic effect of RoO is to raise production costs of the product, which meets the binding RoO. If these constraints are binding then the choice of inputs used in production differs, from the unconstrained ones and hence costs are higher if RoO are met (Krishna and Krueger 1995). Thus they are welfare reducing. Falvey and Reed (2002), however, demonstrate certain circumstances under which RoO could lead to an improvement in the importing country's terms of trade and thus be welfare augmenting. Panagariya and Krishna (2002) discuss the RoO necessary to support welfare-enhancing FTAs.

RoO are also quite expensive to document. Consequently even if a product satisfies them, an importer may prefer to pay the tariff rather than bother with the documentation needed. Herin (1986) calculated that MFN tariffs were paid on 21.5 per cent of EFTA (European Free Trade Area) imports from the EC and 27.6 per cent of EC imports from EFTA because of the burdensome documentation required to prove origin for availing preferences. More recently Estevadeordal (2000) estimates that the administrative cost of certifying origin is as high as 3-5 per cent of the value of export transactions in the EFTA. Cadot et. al. (2002) found that the negative effects of RoO and other administrative compliance costs largely offset the positive effects of tariff preferences in NAFTA. Exporting sectors in Mexico in 2000 had an average rate of utilisation of preferences (under NAFTA) of 64 per cent. Brenton and Manchin (2002) found that, under the EU's 'Everything but Arms' agreement, only one-third of EU (European

Union)[15] imports from the Balkans that were 'eligible' for preferences actually entered the EU at preferential rates. The low utilisation rate suggests that the RoO are restrictive to the point where many importers forgo the preference and pay the full MFN tariff rate.

A study by Augier, Gasiorek and Lai-Tong (2003) which focus on impact of such rules within the Pan-European system[16] suggests that cumulation[17] of RoO will increase trade in the order of 50 per cent and that such an impact is greater for intermediate inputs than final goods trade. Estevadeordal (2000) noted that the degree of preferential tariff liberalization between the NAFTA partners is highly and significantly correlated with the degree of restrictiveness of RoO. Sectors with stricter RoO were also the ones with longer phase-out periods for tariff liberalisation.

Thus we see in general RoO are used as supporting tools for commercial policies. They determine whether the policy will or will not be applied on the product. However they can become commercial policy tools per se, as they can target the input composition of imports, which was rightly pointed out by Falvey and Reed (1998).

1.5: Issues Relevant to the Present Study

From our above discussions we find that in recent years there has been resurgence in regional trade initiatives which have led to the formation of mainly bilateral or plurilateral FTAs. FTAs result in more trade amidst members sometimes at the cost of non-members. They have the capability of diverting trade away from non-members. This has been a serious concern amongst free trade theorists. Another concern that such proliferation has brought to the fore is the role played by RoO in such arrangements. These rules have a protectionist edge to them and thus can negate the tariff reduction initiatives under FTAs.

Methodological difficulties have constrained empirical analysis in this area. Since different FTAs apply different sets of rules for determining origin mostly case-study approaches have been resorted to while finding effects of such rules. In the main, they focus on origin rules in

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[15] The EEC developed into a common market and has subsequently come close to being an economic union in its current incarnation as the European Union (EU), with the introduction of the common currency, the Euro, in 1999.

[16] To overcome the complexity of preferential RoO and their related problems, the EU together with the EFTA, Baltic countries and Central and Eastern European Countries (CEECs) introduced a unified system for determining RoO in 1997, namely the Pan-European Rules of Origin.

[17] Cumulation provisions allow producers of a country to count materials purchased from outside the country as originating in their country for the purpose of determining origin of their traded goods.

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NAFTA (Simpson 1994, Cadot et. al. 2002, 2003) and those in EU (Brenton and Manchin 2002, Augier, Gasiorek and Lai-Tong 2003).

We are choosing here the ISLFTA (the only operational FTA for India). The signing of the Agreement led to a variety of studies trying to estimate the potential and probable impact of the ISLFTA. Some of these tried to look into the potential for trade expansion (Mukherji 2000, Jayatissa and Thenuwara 1999) or the impact of ISLFTA on a regional perspective (Harilal and Joseph 1999). After the Agreement came into operation some authors tried to estimate the value of tariff concessions exchanged with respect to both product coverage (Weerakoon 2001) and value coverage (Mukherji, Jayawardhana and Kelegama 2003). Kelegama (2003) documented the increase in bilateral trade after the ISLFTA came into operation. The study by Mukherji, Jayawardhana and Kelegama (2003) also estimates the extent of trade creation or diversion under the different categories of concessions.

This FTA is in operation for the last four years. So we have only four years post ISLFTA data. Notwithstanding such data limitations we will try to ascertain effects of ISLFTA and RoO therein on bilateral trade. Most empirical models trying to find effects of formation of a FTA on trade rely on the gravity model. The gravity equation despite many modifications by different authors is likely to remain misspecified and, thus, open to criticism (Panagariya 1999). Mukherji, Jayawardhana and Kelegama (2003) used a formula to ascertain trade creation or diversion in their study of ISLFTA within the first year of the Agreement coming into force. Such a measure needs unit cost data of imports across various product groups for both countries. This information is not available from secondary sources (the above study did a primary survey). So we take an alternate route and try to see whether changing trade orientation of India and Sri Lanka amidst themselves after ISLFTA formation was consistent with their comparative advantage i.e. whether ISLFTA has distorted trade from patterns expected on the basis of efficiency conditions. Although this method does not measure trade diversion directly, it provides closely related information by allowing one to infer whether increase in trade after ISLFTA was primarily in products in which both the countries had low enough costs to be competitive in third markets. If not, then it is the case of trade distortion and it suggests that the additional trade within ISLFTA could have been replaced by more efficient outside suppliers.

Effects of RoO within a FTA depend on their restrictiveness scale. So we will try to evaluate the restrictiveness of the RoO regime chosen under ISLFTA before trying to evaluate their effects. Also, whether RoO will restrict trade or not depends not only on the provisions of the FTA but also on the way they are implemented. The issue of implementation of RoO has not been given enough attention in the literature. This despite the fact that policy implementation is as important as policy design. In case of developing countries like India (and Sri Lanka) policy implementation rather than design is the most difficult governance problem. The relative lack of attention paid to the details of implementation of RoO has resulted in the neglect of a number of interesting real world phenomena. When these are studied, conventional wisdom on a number of issues is challenged and needs to be rethought.

1.6: Objectives of the Study

In the light of the discussions above the specific objectives of this study are enlisted below:
1. To examine whether trade distortion has taken place or not after the ISLFTA.
2. To evaluate the policy design of RoO chosen for the ISLFTA.
3. To ascertain any effects of such rules on trade.
4. To look into the implementation of RoO under the ISLFTA.

1.7: Data Source and Period of Analysis

Our analysis, particularly the part pertaining to our first objective, is largely data intensive. Export and import data are required for bilateral and multilateral trade for both countries at sufficient levels of disaggregation. The two most important national publications providing data on India's trade flows are Directorate General of Commercial Intelligence and Statistics (DGCI&S) and Reserve Bank of India (RBI). Unlike DGCI&S, RBI data does not give desired levels of disaggregation. Hence we use data from the former source. This data will be used to analyse the structure of bilateral trade. For structural analysis we take time period from 1987 to present as from April 1987 Harmonised System of Commodity Classification (H.S.) was resorted to by DGCI&S. Possible mismatch with previous classification hinders us from taking data prior to 1987. The DGCI&S annual trade data from 1996-97 to 2003-04 can be obtained from the Department of Commerce (under Ministry of Commerce and Industry, India) website[18]. We have taken the data for analysing recent trends in bilateral trade from the above-mentioned website. Data prior to 1996-97 has been taken from DGCI&S published "Statistics of Foreign Trade in India by Countries" annual volumes (March volumes).

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[18] http://commerce.nic.in/

To compute the specific indices to analyse presence of trade distortion we have to depend on the COMTRADE database[19] of the UN (United Nations), as Sri Lanka's trade flows with rest of the world cannot be got from DGCI&S data. For comparability India's trade data for computing these indices is also taken from COMTRADE database. Making use of two indices jointly (export intensity index and revealed comparative advantage index), which are calculated from COMTRADE database, we'll try to see the extent of trade distortion, if any.

To evaluate the restrictiveness of the RoO regime chosen under ISLFTA we analyse the text of the ISLFTA[20] to ascertain the provisions of ISLFTA RoO and use an index measure available in the literature to assess the restrictiveness of such provisions. For examining effects to RoO we depend on bilateral trade data and on secondary sources. Analysing documents available largely from secondary sources, we try to examine the issues in implementation of ISLFTA RoO.

1.8: Chapter Scheme

The present study is arranged into four chapters including this introduction. The introductory chapter (the present one) traces the emergence and importance of FTAs and RoO in the present world trading order. It gives a relevant literature review on the economic effects of FTAs and RoO. The issues relevant to our study, the specific objectives, data sources and time period of the study are also presented here. The focus of the second chapter is the bilateral trade scenario in the context of the ISLFTA. It discusses the provisions of the Agreement and tries to find out whether trade distortion has taken place or not after the Agreement has come into operation. A detailed analysis of the restrictiveness index of ISLFTA RoO and rationale for the calculation of the index is the subject matter of Chapter 3. This chapter also looks into the effects and enforcement issue of the RoO under the Agreement. Chapter 4 lists the major findings, states the policy implications, poses issues for further research and concludes the study.

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[19] http://unstats.un.org/unsd/comtrade
[20] Text of ISLFTA is accessed from http://commerce.nic.in/ilfta.htm and is given in Appendix 2.

Chapter 2

Indo-Sri Lanka Free Trade Agreement and Recent Trends in Bilateral Trade

2.1: Introduction

The subject matter of this chapter is the bilateral trade scenario between India and Sri Lanka in the context of the Free Trade Agreement (FTA) between the two countries. The Indo-Sri Lanka Free Trade Agreement (ISLFTA) was signed in December 1998 with the objectives of promoting economic relations by expansion of trade, providing fair means of competition for bilateral trade and contributing to expansion of world trade by removing barriers to bilateral trade. The Agreement provides for duty free as well as duty preference access for goods traded between the two countries subject to fulfillment of Rules of Origin (RoO) criterion. It came into operation in March 2000.

We are here interested to see the impact of this Agreement on bilateral trade. From the concerned literature we have found out that there are two main effects of any regional trade agreement. These are trade creation and trade diversion effects, which have opposite welfare implications and the net effect will depend upon which of these two effects will be dominant. Free trade economists argue amongst themselves about whether trade creation or trade diversion usually predominates under FTAs. Empirical studies undertaken do not entail any definite conclusion on the net welfare effect. Methodological difficulties and lack of data also hamper evaluation of trade diversion. So we take an alternate route and try to see whether changing trade orientation of India and Sri Lanka amidst themselves after ISLFTA formation is consistent with their comparative advantage i.e. whether ISLFTA has distorted trade from patterns expected on the basis of efficiency conditions. For estimating this we have to first identify product groups in bilateral trade whose trade intensity has increased significantly after the ISLFTA came into operation. Since formation of any RTA cannot cause a disincentive to trade our analysis concerns only products whose trade intensity has increased. Then we'll probe whether this increase is compatible with efficiency considerations.

The chapter is organised in the following lines. In section 2.2 we give the details of the ISLFTA: its objectives, provisions, and progress. In this section we also give a brief review of existing studies on the ISLFTA and explain how our study is different. In section 2.3, as a prelude to our discussion on trade distortion analysis, we give a general overview of bilateral trade in the historical context.

Section 2.4 focuses on whether this agreement led to trade distortion or not. Using two indices jointly (export intensity index and revealed comparative advantage index) we'll try to see the extent of trade distortion, if any. The study closes with an overall assessment of the findings.

2.2: Indo-Sri Lanka Free Trade Agreement

Establishing a Free Trade Agreement was in the agenda of India and Sri Lanka since 1992. However coming to a consensus on the modalities of the agreement delayed the process. Ultimately on Sri Lankan president's visit to India, on December 28th 1998, the two countries signed the agreement. It was the first FTA for both countries to enter into. It was envisaged to expand bilateral trade, strengthen the economic reform process and to enlarge markets. The Agreement provided for zero tariffs on some products upon entry into force, while some others were subject to phased removal of tariffs. The rest of the products were kept in negative lists, implying no tariff concessions would be given. This was done to protect some sensitive domestic sectors. Details of the Agreement are given in the following sub-sections. First we define the objectives of the Agreement. In the next three sub-sections we detail the tariff concessions offered by individual countries and mention about the Rules of Origin under the Agreement. Then we give a brief review of work done on the ISLFTA. Finally we specify what we propose to do in our study.

2.2.1: Objectives of the ISLFTA

The objectives with which the agreement was established are as follows:

(i)   To promote through the expansion of trade the harmonious development of the economic relations between India and Sri Lanka;

(ii)   To provide fair conditions of competition for trade between India and Sri Lanka;

(iii)   In the implementation of this Agreement the Contracting Parties shall pay due regard to the principle of reciprocity;

(iv)   To contribute in this way, by the removal of barriers to trade, to the harmonious development and expansion of world trade.

2.2.2: India's Tariff Concessions under ISLFTA

India, on its part, pledged to remove tariffs on all items (except those on negative list) within 3 years from entry into force of the Agreement. In addition to these the Indian provisions included 50 per cent fixed tariff concessions on tea and garments (subject to annual quotas i.e.

these items come under tariff rate quota-TRQ[21]) and 25 per cent fixed tariff concessions on most textile items. The details of the provisions for tariff reduction by India are given below in Table 2.1.

Table 2.1: Tariff concessions offered to Sri Lankan Exports under ISLFTA

Degree of tariff cut	Number of items (H.S. 6-digit level) receiving tariff cut
No tariff removal	429
25% fixed tariff removal	528 (for textile items in Chapters 51-56, 58-60, and 63)
50% fixed tariff removal (TRQ)	228 (annually upto 15 million Kgs of tea and 8 million pieces of garments provided 6 million of them contain Indian fabrics)
50% tariff removal followed by phased out removal of tariff	2799 (margin will be increased upto 100% in two stages within 3 years)
100% tariff removal	Remaining 1351 items

Source: The text of the Indo-Sri Lanka Free Trade Agreement[22], Department of Commerce (India) website.

India's negative list consists of 429 items, majority of which are rubber, plastics and their articles. Sri Lankan exports of some textile items and alcohol also will not get any tariff concessions under ISLFTA.

In March 2003 India has fulfilled its promise of phased removal of tariffs on 2799 items. So now 4150 items (i.e. 92 per cent of tariff lines by H.S. 6 digit) can get duty free access to Indian markets when exported from Sri Lanka. The Indian government has also relaxed market access restrictions on garments and tea consequent to the Joint Ministerial Meeting in New Delhi in June 2002.

2.2.3 Sri Lanka's Tariff Concessions under ISLFTA

Details of Sri Lanka's tariff concessions under the Agreement are given in the following table.

Table 2.2: Tariff concessions offered to Indian exports under ISLFTA

Degree of tariff cut	Number of items (H.S. 6-digit level) receiving tariff cut
No tariff removal	1180
50% tariff removal followed by phased out removal of tariff	889 (the margin will be deepened to 100% in 3 years from entry into force of the agreement)
100% tariff removal	319
Phased out removal of tariff	For remaining 2724 items tariff will be reduced by not less than 35% before expiry of 3 years, 70% before expiry of the sixth year, and 100% by the end of the eighth year

Source: Same as in Table 2.1.

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[21] TRQ: The application of a reduced tariff rate for a specified quantity of imported goods. Imports above this specified quantity face a higher tariff rate.
[22] The text of the ISLFTA is given in Appendix 2.

Negative list of Sri Lanka is quite extensive. It consists of 1180 items. Such a big list was kept to protect the small economy's domestic industries. Main items in the negative list are animal products (especially marine products), fruits and nuts (including coconut), coffee, tea and spices, some edible oils, certain prepared foodstuff (like sugar and sugar confectioneries) and rubber and plastics (and articles thereof).

Sri Lanka, too, has deepened tariff cut from 50 per cent to 100 per cent on 889 items by March 2003 as was committed. Sri Lanka was given a longer time scale of 8 years to phase out its tariffs on rest 2724 items, keeping in view the skew in bilateral trade relations (India consistently have huge trade surplus with Sri Lanka).

2.2.4: Rules of Origin in the ISLFTA

These tariff concessions will be applicable provided Rules of Origin (RoO) criterion is met with. The RoO for ISLFTA is 35 per cent value addition to the traded product in the exporting country with a change in tariff heading of the product. If raw materials are sourced from the other country, the value addition norm reduces to 25 per cent. Details of RoO are discussed in the next chapter.

2.2.5: Studies done on Potential and Impact of ISLFTA

From the Tables 2.1 and 2.2 it is clear that liberal concessions are exchanged between the two countries. However Weerakoon (2001) points out that only a few items out of these concessions were actually traded bilaterally (prior to ISLFTA). For example, out of the 1351 items that were given immediate 100 per cent tariff concessions by India, only 68 were exported by Sri Lanka to India. These items constitute 17.9 per cent of Sri Lanka's total exports to India. Also there will be no tariff removal on 13.1 per cent of Sri Lanka's exports (India's negative list). Within 3 years upon entry into force of the Agreement approximately 75 per cent of Sri Lanka's current exports (prior to ISLFTA) will get tariff concessions in India. Compared to this only 27 per cent of India's exports will get exempted from Sri Lankan tariffs after the first three years. This is because roughly one-fifth of the Indian exports are subjected to no tariff removal (Sri Lanka's negative list). More shockingly, only 3 items (0.1 per cent of India's total exports to Sri Lanka) that were being exported (before the ISLFTA) by India got 100 per cent tariff removal! Details of his findings based on Sri Lanka's customs database are given in Tables 2.3 and 2.4.
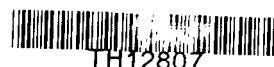
Table 2.3: India's concessions (product coverage)

Degree of tariff cut	Number of items (H.S. 6-digit level)	Items actually exported by Sri Lanka
No tariff removal	429	50 (13.1%)
25% fixed tariff removal	228	44 (11.6%)
50% tariff removal	2799	218 (57.4%)
100% tariff removal	1351	68 (17.9%)

Note: Figure in parentheses indicates percent of total exports.
Source: Weerakoon (2001).

Table 2.4: Sri Lanka's concessions (product coverage)

Degree of tariff cut	Number of items (H.S. 6-digit level)	Items actually exported by India
No tariff removal	1180	623 (21.4%)
50% tariff removal	889	598 (20.6%)
100% tariff removal	319	3 (0.1%)
Residual list[23]	2724	1683 (57.9%)

Note: Figure in parentheses indicates percent of total exports.
Source: Same as Table 2.3.

Even though the above tables do not show a very liberal framework, we have to keep this in mind that value of trade coverage rather than product coverage is more significant in estimating the value of concessions exchanged. This was done by Mukherji, Jayawardhana and Kelegama (2003). The results are given in Table 2.5 and 2.6.

Table 2.5: Percentage Share in India's Imports of Products under Different Categories Offered Concessions

Categories	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02
Negative List	16.00	15.66	8.15	10.08	9.03	5.93
Zero Duty	6.98	3.51	9.69	10.78	24.19	19.13
Residual	71.81	65.72	75.58	71.79	59.79	68.35
Tea (TRQ)	0.12	1.98	1.81	4.56	3.89	3.63
Textiles	1.52	0.81	3.77	2.25	2.71	2.18
Garments (TRQ)	0.00	0.01	0.51	0.83	0.30	0.10

Note: 'Residual' here implies the list of items for which a 50 per cent tariff reduction is applicable upon entry into force (and then phased removal in three years).
Source: Mukherji, Jayawardhana and Kelegama (2003).

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[23] Residual list refers to those items, which will see tariff reduction in Sri Lanka over a period of 8 years.

Table 2.5 reveals that the residual list was the largest category of items liberalized by India accounting for two-thirds to three-fourths of India's imports from Sri Lanka. Next in importance was the negative list accounting between 6-16 per cent of India's total imports. Looking at the trend over the six-year period under study, we notice that India's import share for zero duty products has been increasing steadily. The share increased steadily from nearly 7 per cent in 1996-97 to 24 per cent in 2000-01. It is also to be noted that India's import share of tea and textiles, even though modest, have been increasing its share steadily. The import share of garments has however declined from 1999-00.

Table 2.6: Per Cent Share in India's Exports of Products under Different Categories offered Concessions by Sri Lanka

Categories	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02
Negative List	43.36	37.30	32.46	36.60	36.66	38.28
Zero Duty	0.84	0.88	1.55	0.97	0.78	0.83
Residual	39.17	44.07	52.82	51.76	49.19	43.84
Phased	12.66	12.46	12.47	10.23	12.68	11.50

Note: 'Residual' here implies the list of items for which a 50 % tariff reduction is applicable upon entry into force (and then phased removal in eight years).
Source: Same as Table 2.5.

The figures for 2001-02 in Table 2.6 reveal that products under residual list accounted for nearly 44 per cent of India's exports to Sri Lanka. Next in importance came products under the negative list, accounting for nearly 37 per cent. The products under phased category accounted for nearly 12 per cent. The products covered under zero duty concessions accounted for a little less than one per cent.

Again there were some studies done on potential of trade expansion just after the Agreement was signed. Mukherji (2000) using relative cost analysis had shown that Sri Lanka's exports to India would increase by US$ 180 Million (total will be US$ 215 Mn) as a result of the ISLFTA. Sri Lanka's imports from India will increase by US$ 111 Mn (total will be US$ 664 Mn). Using market opening factors, Jayatissa and Thenuwara (1999) had estimated the short-run improvement on exports at US$ 276 Mn. Sri Lanka's imports will increase up to US$ 729 Mn. But these are all projections. Now let us see how much bilateral trade has actually increased after ISLFTA came into force. Kelegama (2003) using data from Department of Commerce, Sri Lanka, estimated this. He found that Sri Lankan exports to India has increased by 158 per cent (in Sri Lankan Rupee value terms) in the first two years after the Agreement came into force, whereas its imports from India has increased by only 49 per cent.

His analysis also shows that trade gap between India and Sri Lanka has improved from 16:1 to 5:1 in the last few years. His study indicates that 23 per cent of total exports to India by Sri Lanka was under preferential exports in 2001 and the figure has gone up to 68 per cent in 2002. He also found the top 10 commodities exported to India after ISLFTA. His findings are given in Tables 2.7 and 2.8.

Table 2.7: Bilateral Trade (1998-2002)

Year	Imports (Rs.Mn) into SL	Exports (Rs.Mn) of SL	Import: Export Ratio
1998	35837.7	2279.4	16:1
1999	36012.9	3320.3	11:1
2000	45477.1	4217.3	11:1
2001	53750.0	6265.7	8.6:1
2002	79847.1	16152.9	5:1

Source: Kelegama (2003).

Table 2.8: Top 10 export items from Sri Lanka under Preferential Tariffs (2002)

Commodity	Percentage Share
Copper Related Products	63.5
Waste Paper	5.3
Dual Inline Memory Modules	4.0
Black Pepper	3.4
Pine Resin	2.5
Lead Ingots	2.2
Naphthalene	2.5
Iron Scrap	1.7
Furniture	1.3
Tyres	1.3

Note: In 2001 preferential copper related imports amounted only to 10 %.
Source: Same as Table 2.7.

The context of a study done by Harilal and Joseph (1999) was the impact of the ISLFTA on the different regions within India focussing on Southern India with special reference to Kerala. They argue that even a successful preferential trade arrangement, which augments the welfare of individual partners and the community as a whole, could have highly varying impacts on different regions within each partner country. Using trade data they show that South Indian states would have to bear a disproportionately larger share of the adverse consequences of this free trade treaty because it accounts for a lion's share in the production

of those crop (viz., tea, natural rubber, coconut, and spices), in which Sri Lanka has comparative advantage. Especially Kerala depends a lot on the above products. In 1996-97, coconut, rubber and tea accounted for about 66 per cent of the net-cropped area in Kerala. With the limited industrial base, these crops are also major sources of income and employment in the state. Therefore they conclude that with free imports of the same products from Sri Lanka (which are actually cheaper than those produced here) will have far-reaching effects on Kerala's economy.

These are the major works done in trade data analysis with respect to ISLFTA. However our concern here is trade distortion, if any. Any Free Trade Agreement (or as a matter of fact any regional trade agreement) has the ability to distort trade from patterns expected on the basis of efficiency conditions and comparative advantage. So in our study we will try to see whether trade distortion has taken place or not and which are the product groups in which trade has been distorted the most. But before going into such a detailed analysis, let us give a brief overview of bilateral trade.

2.3: Bilateral Trade Overview

Our main purpose in this section is to analyse bilateral trade in recent years. Since having a historical perspective will help in understanding bilateral trade relations, we present a historical overview in the following sub-section.

2.3.1: Bilateral Trade in the Historical Perspective

Historically India and Sri Lanka had good commercial links mainly because of the strategic position of the island nation in the Indian Ocean. It served as a transshipment centre for foreign trade in the region. Geographical contiguity and cultural affinity have played no small part in shaping Indo-Ceylon[24] trade through the centuries. The presence of a large Indian population within the island, which was strengthened by immigration from time to time, has kept the bond of kinship intact through years and thus promoted trade.

Another point to be noted here is that historically India was more important to Sri Lanka as its import sources than was Sri Lanka to India, given the huge size difference between the countries. During the British rule India was Sri Lanka's most important import source. This is evidenced from the fact that in 1938, 42.5 per cent of Sri Lanka's import bill was on imports

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[24] The name Ceylon was changed to Sri Lanka on May 22, 1972.

from India (Jayasuriya and Weerakoon 2001). On the other hand, historically, Sri Lankan exports to India has been dismal barring the time of the Second World War when India absorbed about half of Sri Lanka's total exports (Sarvananthan 1994). India's intake of Ceylon's exports in no year between 1930-47 exceeded 9 per cent (Menon 1947). The large adverse balance of trade was due to the fact that India herself produced most of the commodities, which were significant in Ceylon's export trade. Tea, rubber and coconut products accounted for 95 per cent of Ceylon's exports in 1947. With the single exception of China, India was the largest tea producer in those times. Also those days India was a large-scale producer of both rubber and coconut. An examination of composition of Ceylon's import trade in 1947 showed that 72 per cent of Sri Lanka's exports to India was accounted for by two items viz. copra and coconut oil. Out of total imports from India 54 per cent was in food, drink and tobacco items; 37.5 per cent in manufactured items; 7.5 per cent raw materials; and 1 per cent in animals not for food (Menon 1947). After independence from British rule both countries followed import substituting industrialisation policies resulting in decline in bilateral trade. Sri Lanka's imports from India fell to 15 per cent by the end of the 1940s and continued to decline. India's recorded imports from Sri Lanka declined from US$ 12 million in 1961-65 to less than a million dollars by mid 1970s (Maheshwari 1987). With the liberalisation of the Sri Lankan economy in 1977, India again regained its position. India was the second largest source for Sri Lankan imports during many years between 1977-1992 (Sarvananthan 1994). The composition of bilateral trade showed changes over the years. During the 1960s textiles (cotton yarn and fabrics) and agricultural products (spices, fish products) were major Indian exports to the island. However from the decade of the 70s engineering products (particularly transport equipment) became increasingly important over-riding the traditional exports. However Sri Lanka's exports to India was less diversified. Coconut products and natural rubber constituted the bulk of exports. In the 1960s copra alone accounted for more than 75 per cent of total exports to India (Jayasuriya and Weerakoon 2001).

2.3.2: Recent Trends in Bilateral Trade

Ethnic issues in Sri Lanka and ensuing civil war in the 1980s generated political tensions between the two countries and was a major cause of worsening of the commercial links. This however improved with Indian policy liberalisation process in 1991, which coincided with the second wave of policy reforms in Sri Lanka. The South Asian regional integration initiatives in the 1990s and ISLFTA at the end of the decade and the peace process in Sri Lanka had

positive effects on bilateral trade. One might argue the recent increase in bilateral trade to the re-routing of illegal trade through legal channels. The total two-way informal trade is still quite significant estimated at $207 million and is 30 per cent of formal trade (Taneja 2002)[25]. Sarvananthan (1994) first proposed that free trade would reduce informal trade between the countries. As discussed in Taneja and Pohit (2000) the traditional argument is that informal trade takes place due to trade and domestic policy distortions. As and when such distortions are corrected informal trade would shift to the formal channel. Taneja's study finds that the incidence of informal trade between India and Sri Lanka has gone down after liberalization and further reduction of tariffs might reduce the incidence of informal trade. Because of the nuances of informal trade we cannot hope to get an exact picture of bilateral trade. With the peace process ensuing in Sri Lanka much of this informal trade is getting routed through legal channels so that the growth in bilateral trade in recent years cannot be completely attributed to ISLFTA formation. Thus official trade data usage has some limitations. Another limitation to our study, which we can state at the outset, is the fact that we have only four years trade data to analyse after the formation of the Agreement (it came into operation in March 2000). We can find some change in bilateral trade after ISLFTA operation, but keeping in mind that there exists significant year to year fluctuations in bilateral trade and that we have only four years trade data in hand we cannot say whether these changes are sustainable or not. However any such study undertaken suffers from these drawbacks. Our conclusion therefore will have to be interpreted with caution. Let us now look into the recent trends. Trade between the two nations has increased substantially in the 1990s as is evident from Table 2.9.

Table 2.9: Bilateral trade over the years: commodities, value and percentage share

Years	Exports to SL			Imports from SL		
	No. of commodities at H.S. 4-digit level	Value (Rs. Lakh)	% of total exports	No. of commodities at H.S. 4-digit level	Value (Rs. Lakh)	% of total imports
1987-88*	525	10328.80	0.66	60	1134.74	0.05
1997-98	850	181820.11	1.39	200	11226.15	0.07
2003-04	1000	606191.31	2.08	450	89484.88	0.25

Note: Rs. implies Indian rupee and number of commodities is approximate.
* From April 1987 the DGCI&S resorted to H.S. classification of traded goods, which makes it difficult to compare trade data before 1987-88 due to possible mismatch.
Source: Compiled from Statistics of Foreign Trade of India by Countries, DGCI&S, 1987-88 annual volume & Department of Commerce website for 1997-98 and 2003-04.

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[25] According to her study the most important factor influencing informal trade flows from India to Sri Lanka is the ability of the informal channel to deliver goods much faster than the formal channel. Other important factors were absence of procedural delays and paper work in the informal channel; ethnic ties between trading partners etc.

From the table we see that bilateral trade has intensified in recent years. It is important to note that Sri Lanka has substantially diversified its export basket to India. It used to export to India mere 60 items (by H.S. 4-digit level) in 1987-88. Recent trade data shows this to have gone up more than 7 times. Also bilateral trade has registered significant growth in recent years. In terms of US$ value[26] Indian exports to Sri Lanka have grown at approximately 170 per cent from 1997-98 to 2003-04 when total Indian exports grew by 84 per cent only. The same figure for imports from Sri Lanka is 545 per cent and 88 per cent respectively for the same time period.

We calculated the export intensity index[27] of India with respect to Sri Lanka and found that it has increased from 13.4 (in 1999) to 17.4 (in 2002). The same index for Sri Lanka with respect to India increased from 1.1 (in 1999) to 3.6 (in 2002). So we see that trade has expanded significantly between India and Sri Lanka, especially in recent years. This is mirrored in the relative trade rankings of the two nations. In recent years Sri Lanka has improved its trade rankings with India. In 1997-98 it ranked 17th in India's export destinations. Latest available data shows the rank to be 12th. Similarly the rank for Sri Lanka as India's import source was 68 in 1997-98, which improved significantly to 39 as per latest data available. More significantly in the last one year this rank had a sudden jump of 10 points from 49 to 39 (Table 2.10).

Table 2.10: Sri Lanka's rank in trade with India

Years	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Exports from India	17	17	19	19	20	15	12
Imports into India	68	60	59	55	52	49	39

Source: Found from the Department of Commerce (India) website.

From Sri Lanka's point of view, India for the last many years has been in the top slot in its import sources (see the table below).

Table 2.11: India's rank in trade with Sri Lanka

Years	1994	1995	1996	1997	1998
Exports from SL	22	21	16	18	21
Imports into SL	2	2	1	1	2

Source: Jayatissa and Thenuwara (1999).

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[26] We use US$ value to take care of exchange rate fluctuations.
[27] The export intensity index and its calculation is explained in section 2.4.

Before ISLFTA approximately 10 per cent of Sri Lanka's imports came from India alone which has increased to 14 per cent now. On the other hand Sri Lanka does not export much to India. Trade balance with Sri Lanka was always in favour of India. However in recent years trade gap is improving in favour of Sri Lanka.

In 1997-98 export (to Sri Lanka)-import (from Sri Lanka) ratio was 16:1 which improved (in Sri Lanka's favour) to 6:1 in 2003-04 (calculated from data provided in the Department of Commerce website). In the past one year Sri Lanka has exported 3.6 per cent of its exports to India compared to less than 1 per cent in 1998 (calculated from COMTRADE database). Thus we see that there has been an increase in bilateral trade. Now let us see the changes in the structure of trade.

2.3.3: Changes in Structure of Trade in Recent Years

Till now we mainly talked about the growth of trade in recent years. Now let us look into how the structure of trade is changing in recent years. Table 2.12 gives the top 10 products exported to Sri Lanka in three time periods. From the table we can see that in 1987-88 India mainly exported textiles, transport equipment, medicaments, spices, marine products, and vegetable products, to Sri Lanka. The top 10 products accounted for a disproportionate large share of total exports (approximately 50 per cent). In 1997-98 project goods and special transactions not elsewhere specified (n.e.s.) became important export items besides traditional exports. However, spices lost their importance. In 2002-03 more new items like sugar, wheat, cement, paper products came up in India's exports to the island nation. Top10 products accounted for only 35 per cent of total exports in 2002-03.

In Table 2.13 we present the top 10 import products from Sri Lanka into India for three years (viz. 1987-88, 1997-98 and 2002-03). In 1987-88 only three major import products from Sri Lanka viz. glycerol, leguminous vegetables and pepper accounted for 60 per cent of total imports. The top 10 exported commodities explained 85 per cent of imports. This high concentration in the imports somewhat reduced in the later two time periods. In 1987-88 imports were more focussed on the traditional items of Sri Lanka like spices, coconut, rubber and plastics, vegetable products etc. In the later two years though spices import did not reduce in importance, approximately 30 per cent of total imports were base metal products (especially copper products and ferrous waste and scrap).

Table 2.12: Top 10 commodities exported to Sri Lanka over the years

1987-88		1997-98		2002-03	
H.S. code and commodity description	% in total export to Sri Lanka	H.S. code and commodity description	% in total export to Sri Lanka	H.S. code and commodity description	% in total export to Sri Lanka
5208: Woven cotton fabrics wt< 200 g/m²	14.01%	0713: Leguminous vegetables	5.35%	1701: Cane/ beet sugar & chemically pure sucrose	9.59%
8706: Chasis fitted with engine for motor vehicles	6.67%	5205: Cotton yarn	5.07%	8711: Motor cycles	5.54%
8708: Parts & accessories of motor vehicles	5.27%	8711: Motor cycles	3.69%	3004: Medicaments for retail sale	4.56%
3004: Medicaments for retail sale	5.12%	3004: Medicaments for retail sale	3.5%	2523: Portland cement, aluminous cement etc.	3.07%
8714: Parts & accessories for cycles	4.64%	5209: Woven cotton fabrics wt >200 g/m²	3.22%	5208: Woven cotton fabrics wt< 200 g/m²	2.96%
0904: Pepper	4.59%	5208: Woven cotton fabrics wt< 200 g/m²	2.75%	5209: Woven cotton fabrics wt >200 g/m²	2.49%
0305: Dried, salted fish and fish meal	3.84%	2304: Oilcake & other solid residues	2.72%	5407: Woven fabric of synthetic filament yarn	2.23%
3003: Medicaments not for retail sale	3.00%	9801: Project goods	2.57%	1001: Wheat & meslin	2.23%
1404: Vegetable products not elsewhere specified (n.e.s.)	2.92%	9993: Special transactions n.e.s.	2.55%	4802: Uncoated paper for writing	2.13%
5201: Cotton not carded or combed	2.85%	8706: Chasis fitted with engine for motor vehicles	1.96%	5205: Cotton yarn	1.88%

Note: See Annex 1 for the method of calculation of percentages.
Source: Calculated from Statistics of Foreign Trade of India by Countries, DGCI&S, 1987-88 annual volume & Department of Commerce website for 1997-98 and 2003-04.

Table 2.13: Top 10 commodities imported from Sri Lanka over the years

1987-88		1997-98		2002-03	
H.S. code and commodity description	% in total import to Sri Lanka	H.S. code and commodity description	% in total import to Sri Lanka	H.S. code and commodity description	% in total import to Sri Lanka
0904: Pepper	25.72%	7204: Ferrous waste & scrap	22.28%	0907:Cloves	15.21%
1520: Glycerol	18.69%	4707: Waste & scrap of paper	9.4%	0904: Pepper	12.98%
0713:Leguminous vegetables, dried/shelled	16.13%	1520: Glycerol	8.11%	7408: Copper wire	9.51%
0907: Cloves	7.50%	4001: Natural rubber	7.76%	7403: Refined copper & alloys,	7.63%
7311: Containers for compressed gas	6.88%	0904: Pepper	7.49%	3926: Other articles of plastics	4.89%
9993: Special transactions n.e.s.	5.43%	5402: Synthetic filament yarn	5.02%	7404: Copper waste and scrap	4.06%
4403: Stripped wood	2.58%	7404: Copper waste and scrap	3.65%	7204: Ferrous waste & scrap	3.87%
1513: Coconut, palm kernel	2.13%	7902: Zinc waste and scrap	2.37%	7402: Unrefined copper, copper anodes	3.46%
3920: Plates or sheets of plastics	1.76%	0907:Cloves	2.28%	0908:Nutmeg, mace and cardamoms	3.11%
4106: Goat or kidskin leather	1.43%	3926: Other articles of plastics	2.15%	8473: Parts for typewriters & computer accessories	2.18%

Note: Refer to Table 2.12.
Source: Same as in Table 2.12.

Since we find that recent years are showing more changes in structure we analyse the data more intensively for the last few years. Tables A, B C and D in Annex 1 record the bilateral trade in commodities at H.S. chapter (2-digit) and heading (4-digit) level in terms of their percentage shares in total trade, from 1996-97 to 2002-03. We consider only those products whose percentage shares has been at least 0.25 per cent in any of the years. We are using this cut-off mark as traded products that have consistently (for seven years under consideration) contributed less than 0.25 per cent share in the value of total trade can be safely considered to be of not much importance to trade.

From Table A, we find that the most important product group in India's export basket over the last few years has been the traditional textile items. It has however seen some decline in more recent years, mainly due to decline in cotton textile exports (H.S. Chapter 52). Some other textiles like man-made filaments and staple-fibres (H.S. Chapter 54 and 55) have increased their percentage share. Vegetable products (though still an important export section) have seen a decrease in recent years, due to decrease in share of edible vegetables, fruits and nuts (H.S. Chapter 7 and 8). Importance of prepared foodstuff (mainly sugar and sugar manufactures, H.S. Chapter 17) and mineral products (H.S. Section 5) have increased. Important product groups like rubber and plastic (H.S. Section 7), cellulose products (H.S. Section 10) and machinery and mechanical appliances (H.S. Section 16) have displayed a stable performance over the years. Interestingly wood products (H.S. Section 44) have completely vanished from India's export basket after 1998-99. Other items like chemical products (H.S. Section 6) and transport equipment (H.S. Section 17) have shown a cyclical trend over the years. Animal products (only fish products, H.S. Chapter 3, are exported to Sri Lanka) have lost whatever little significance they had.

Table B shows India's imports from Sri Lanka at the H.S. 2-digit level. Studying it we observe that vegetable products (especially those under H.S. Chapter 9 i.e. coffee, tea, mate and spices) is the most important in terms of imports from Sri Lanka, followed by base metals and articles thereof (H.S. Section 15). However, within base metal imports, certain changes are apparent. Iron and steel (H.S. Chapter 72) is losing its importance to copper and articles thereof (H.S. Chapter 74) within the base metal group. Other important groups like cellulose and textile products (H.S. Sections 10 and 11) have shown considerable fluctuations over the years. Another traditional export item of Sri Lanka plastics and rubber (H.S. Section 7) has seen a consistent decline in India's imports due to decline in rubber articles (H.S. Chapter 40). Some new chapters like furniture (H.S. Chapter 94), articles of stones and ceramics (H.S.

Chapter 68 and 69) have gained prominence in recent years. Animal product imports (particularly H.S. Chapter 5 comprising of various products of animal origin) have declined in significance in recent years.

From the tables we can see that after the ISLFTA came into force (March 2000) there have been some changes in composition of bilateral trade. There has been product diversification of export basket (especially that of Sri Lanka). To study this in detail we move to bilateral trade data at more disaggregate level (H.S. 4-digit). Tables C and D gives our calculated percentage share of commodities at the above level of disaggregation.

From these tables we see that some commodities have increased their share in total exports (/imports) in the last three years (i.e. after ISLFTA formation) whereas some others have decreased. ISLFTA has made possible tariff elimination/concessions so that it might help in improving share of existing export products or result in export of newer products. There is no apparent reason for exporters to cut back exports on account of ISLFTA. Inability to prove *origin* should not lead to decline in export shares as exporters still may pay MFN tariffs and continue to export. Since the formation of ISLFTA cannot cause a disincentive to exports but on the contrary promote exports of existing or newer products, we, in our analysis, have taken only "new" and "increasing" products. "New products" imply those, which had negligible share (< 0.25 per cent) in all years before ISLFTA operation (i.e. till 1999-00) and then suddenly surfaced after the policy change (i.e. from 2000-01). "Increasing products" cover all products that have increased their percentage share after ISLFTA (i.e. from 2000-01 to 2002-03) compared to before it (i.e. from 1996-97 to 1999-00). These are the products, which have increased their share consistently in all years after ISLFTA came into operation. Thus here we are taking formation of ISLFTA as the break point. In March 2000 ISLFTA was put into operation. We are comparing the percentage share of the products 4 years before it (i.e. from 1996-97 to 1999-00) and 3 years after it (2000-01 to 2002-03) and jotting down products under 2 headings: new and increasing. Tables 2.14 and 2.15 give a brief overview of such products.

Table 2.14: Changes in Indian exports to Sri Lanka after ISLFTA: New and Increasing products

H.S. Code	Product description
New products	
1001	Wheat & meslin
1101	Wheat or meslin flour
1208	Flour & meal of oilseeds & olea fruit
4001	Natural rubber
4801	Newsprint in rolls or sheets
4810	Paper & paperboard, coated with kaolin
6105	Men's/ boy's shirt, knitted or chrocheted
6201	Men's/ boy's overcoat, cloaks, not knit
7217	Wire of iron & non-alloy steel
7407	Copper bars, rods & profiles
8406	Steam turbines
8413	Pumps for liquids, liquid elevators
8528	Television receivers (monitors & project receivers)
8602	Rail locomotives
8901	Vessels for transport of persons or goods
Increasing products	
1701	Cane/ beet sugar & chemically pure sucrose, solid form
2523	Portland cement, aluminous cement, slag cement etc.
5407	Woven fabric of synthetic filament yarn
6908	Glazed ceramic flags & paving hearth tiles

Source: From Table C in Annex 1.

Table 2.15: Changes in India's imports from Sri Lanka after ISLFTA: New and Increasing products

H.S. Code	Product description
New products	
4411	Fibreboard of wood or other non-ligneous materials
6802	Worked monument of stone & art etc.
6911	Ceramic tableware of porcelain/china
6913	Statuettes & other ornamental ceramic articles
7402	Unrefined copper, copper anodes for electrolytic refining
7403	Refined copper & alloys, unwrought
7407	Copper bars, rods &profile
7408	Copper wire
8517	Electrical apparatus for line telephony, telephone sets etc.
8525	Transmission apparatus for radio telephony, tv, cameras, cordless phones
8539	Electrical filament, discharge lamp
8542	Electronic integrated circuits & micro assemblings
8803	Parts of balloons, aircraft, spacecraft etc.
8908	Vessels & floating structures for scrapping
9023	Instruments, models for demonstrational use
9033	Parts n.e.s. for machines/appliances of chapter 90
9403	Furniture not elsewhere specified & part thereof
9406	Prefabricated buildings
Increasing products	
0907	Cloves (whole fruit, cloves and stems)
7404	Copper waste and scrap

Source: From Table D in Annex 1.

In case of changes in the structure of bilateral trade in recent years, the most important thing apparent from the above two tables is that a whole lot of new products have come up after the Agreement. Especially copper products (refined copper and alloys, copper wire and copper bars, rods and profiles) have come up in a big way in India's imports from Sri Lanka. Electrical, medicinal and transport equipment are also being imported in a substantial manner (in conjunction with Table 2.15 refer to Table D in Annex 1). India's exports of machinery and transport equipment, garments (especially men's or boy's dressing) have seen a massive increase after ISLFTA operation (in conjunction with Table 2.14 refer to Table C in Annex 1). With establishment of FTAs more trade is likely to be created mainly because of tariff elimination. However more trade can also be on account of trade diversion i.e. trade being diverted from non-members to members due to tariff preferences. Measuring trade diversion directly is outside the scope of this study. Here we try to take an alternate route to analyse the changing orientation of the two countries' trade towards each other in terms of efficiency considerations i.e. whether these changes in the structure after ISLFTA operation were a result of trade distortion. We move to this question in the next section.

2.4: Has there been Trade Distortion after ISLFTA?

From the preceding section it is clear that bilateral trade has increased substantially after ISLFTA. We have also seen that some changes in the structure of trade have taken place. Were these changes a result of trade distortion? In this section we want to determine whether the changing trade orientation of India and Sri Lanka amidst themselves after ISLFTA formation was consistent with their comparative advantage. The study proceeds as follows. First, we calculate trade orientation index of specific goods to analyse recent shifts in the direction of trade. This index is then compared with a measure of Revealed Comparative Advantage (RCA)[28] to show how the two can be employed jointly for analysing potential inefficiencies in trade patterns. Yeats (1997) used a similar method[29] to analyse if formation of MERCOSUR led to trade distortion or not. Following Yeats, Chong-Sup Kim (2002) used the same methodology to find recent trends in trade between Korea and Latin American countries.

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[28] Revealed comparative advantage is not the first best measure to study comparative advantage, as it is only a revealed measure, still it is easier to ascertain.
[29] Yeats developed a new index called regional orientation index, however we here go by the traditional trade intensity index as a measure of trade orientation.

Let us first describe the two indices we plan to use to measure trade distortion and explain why we choose them. Let us take the trade orientation ratio first. Trade orientation ratios give a picture of the adequacy of the representation of a country in another's market, relative to the latter's importance in the world market. In this way we depict the intensity of bilateral trade, which seems to be explained rather by the bilateral factors than the general ones influencing trade flows e.g. the increase in India's exports due to factors like competitiveness of India in international market may not orient India's exports specifically towards Sri Lanka, which therefore needs a purely bilateral explanation. Using this ratio we will be able to determine whether India and Sri Lanka were also able to successfully export the fastest growing products in intra-regional trade to third countries. In other words, does the exchange in these goods meet the "test of the marketplace"?

The most commonly used tools to analyse the trade orientation between any two countries are trade intensity indices popularised by Kojima (Wadhva and Asher 1985). It appears that Brown (1947) was the first to use this index five decades ago. The measure has been used since the 1940s in numerous analyses of the direction and level of international trade.

The intensity of trade index (I_{ij}) is defined for country i's exports to country j as the share of i's exports going to j $\dfrac{X_{ij}}{X_i}$ relative to the share of j's imports (M_j) in world imports (M_w). The specific formula is:

$$I_{ij} = \frac{\dfrac{X_{ij}}{X_i}}{\dfrac{M_j}{M_w}} \qquad (2.1)$$

If the trade intensity index takes a value above (or below) unity the countries have greater (or smaller) bilateral trade than would be expected based on the partner's share in world trade. Trade intensity indices can provide additional insights into the nature and importance of secular changes in bilateral trade flows such as those occurring for ISLFTA. Specifically, these indices can highlight the relative importance of (seemingly minor) changes in trade between countries that have relatively small global trade shares. Since India and Sri Lanka have very small global trade shares (less than one percent) it is appropriate to use this trade intensity index. In the short to medium-term, changes in comparative advantage, transport costs, or relative tastes should be minimal so index value changes are likely to be more heavily influenced by factors such as differential changes in trade barriers (such as those

which accompanied the formation of ISLFTA). When computed for a given single point of time the measure is of obvious limited utility. However, analysis of changes in these indices over time can show whether two countries are experiencing an increased, or decreased, tendency to trade with each other.

Here we use export intensity index, as export intensity index of a country with its partner is the mirror image of import intensity index of its partner with it. As we noted earlier in section 2.3.2 export intensity index of Sri Lanka with India was 1.1 in 1999, which increased to 3.6 in 2002. Same index for India with regard to Sri Lanka was 13.4 in 1999 and increased to 17.4 in 2002. But we are more interested in calculating the index at a more disaggregate level. The formula for export intensity index of a commodity (I_{ij}^c) is:

$$I_{ij}^c = \frac{\dfrac{X_{ij}^c}{X_i^c}}{\dfrac{M_j^c}{M_w^c - M_i^c}} \qquad (2.2)$$

where,

X_{ij}^c = export value of commodity c in country i's exports to country j

X_i^c = total export of commodity c from country i

M_j^c = total import of commodity c into jth country

M_w^c = total world imports of commodity c

M_i^c = total import of commodity c into ith country

Now let us move on to our next index i.e. the Revealed Comparative Advantage (RCA) index. A RCA index identifies the extent to which a country has comparative advantage (or disadvantage) in a product. In empirical trade literature RCA measures are used to analyse specialisation patterns of countries. Generally countries will specialise in and be net exporters of commodities in which they have comparative advantage. The concept of RCA is rooted in conventional trade theory. The first and still widely used RCA measure is the Balassa's (1965) RCA index. . If we use c to denote a commodity, i a specific country, w for world and X for exports the formula for Balassa's Index (BI) is:

$$BI = \frac{\dfrac{X_i^c}{X_i}}{\dfrac{X_w^c}{X_w}} \qquad (2.3)$$

To eliminate country and commodity double counting present in the above formula, we use the modified formula given below.

$$c_i = \frac{\dfrac{X_i^c}{X_i}}{\dfrac{X_w^c - X_i^c}{X_w - X_i}}$$

(2.4)

where,

c_i = revealed comparative advantage index of commodity c exported by country i

X_i^c = total export of commodity c from country i

X_i = total export of country i

X_w^c = total world exports of commodity c

X_w = total world exports

RCA index can take value from zero to infinity. If RCA index is more than unity it implies the country has comparative advantage in the production of the commodity concerned.

Now we have to analyse whether bilateral trade has been distorted after the ISLFTA. Direct comparisons of the above two indices provide an indication of the extent to which ISLFTA distorted exports from patterns consistent with comparative advantage. The RCA index asks whether the trade changes were consistent with member countries' current comparative advantage i.e. whether the increased intra-regional trade was in sectors where both the countries had evidenced an ability to compete in markets where they were not shielded by preferential trade arrangements. Thus if there is increase in export intensity of a product whose RCA index is less than unity, then we can conclude that trade distortion is present in that particular product. Although this method does not measure import diversion (which FTAs are supposed to foster) directly, it provides closely related information by allowing one to infer whether the additional trade generated by any FTA was primarily in products in which member countries had low enough costs to be competitive in other markets. If not, they suggest that the additional trade within the region could have been replaced by more efficient outside suppliers. The issue is essentially whether FTAs foster "high cost" imports at the expense of "low cost" ones. The traditional calculations of trade diversion based on import data infer this from the displacement of imports from non-partners by those from partners, implicitly comparing partner and non-partner costs by their relative competitiveness in the pre-FTA regional market. The supplementary view used in this method makes inferences about "high" and "low" costs by implicitly comparing the relative competitiveness of partner

and non-partner goods in world markets (Yeats 1997). Direct cost comparisons are also not the better method due to possible estimation problems. We use the product groups that have increased their export shares substantially and the products, which have suddenly come up in bilateral trade after ISLFTA came into force. For this we refer to Tables 2.14 and 2.15. We take the products from these tables and then calculate their respective export intensity and RCA indices. In the following two tables we report those commodities, which have increased their export intensity from 1999 (before ISLFTA) to 2002 (after ISLFTA). We note their increase and then compare with their RCA index.

In Table 2.16 we have reported those commodities of Table 2.14 which have registered an increase in export intensity from 1999 to 2002[30]. We have stated the amount of this increase in export intensity and then compared that with the concerned product's RCA index in 1999. The same thing has been done to Sri Lanka's exports (commodities of Table 2.15) and reported in the Table 2.17. Note that RCA 1999, instead of 2002, is chosen as RCA 2002 might be under the influence of the ISLFTA. Also we cannot take wheat and sugar exports from India (and also spices exports from Sri Lanka) in this calculation even though their export intensity has increased substantially after ISLFTA. This is because trade in agricultural products is distorted by export incentives and trade barriers, which are likely to obscure whether a country has a real comparative advantage, or disadvantage, in these products. Thus RCA indices are generally computed for processed goods or manufactures.

Table 2.16: Export intensity and RCA indices of Indian exports to Sri Lanka

H.S. code	Commodity description	Export intensity index 1999	Export intensity index 2002	Increase in export intensity from 1999 to 2002	RCA 1999
8901	Vessels for transport of persons or goods	10.06	32365.24	32355.17	0.25
6201	Men's/ boy's overcoat, cloaks, not knit	0	2581.28	2581.28	1.42
8406	Steam turbines	0	244.98	244.98	0
4801	Newsprint in rolls or sheets	66.97	269.57	202.6	0.03
8413	Pumps for liquids, liquid elevators	0	46.81	46.81	0
6105	Men's/ boy's shirt, knitted or chrocheted	20.47	40.7	20.23	27.75
7217	Wire of iron & non-alloy steel	9.88	28.44	18.56	0.36
2523	Portland cement, aluminous cement, slag cement etc.	2.07	14.14	12.06	1.68
8528	Television receivers (monitors & project receivers)	14.58	18.89	4.31	0.2
5407	Woven fabric of synthetic filament yarn	7.82	9.09	1.27	2.72

Source: Calculated from COMTRADE database.

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[30] COMTRADE gives data for Sri Lanka's trade for only two years 1999(-2000) and 2002 (-2003).

Table 2.17: Export intensity and RCA indices of Sri Lankan exports to India

H.S. code	Commodity description	Export intensity index 1999	Export intensity index 2002	RCA 1999
7403	Refined copper & alloys, unwrought	0	437.36	0.00
9403	Furniture not elsewhere specified & part thereof	0	348.69	0.00
6802	Worked monument of stone & art etc.	0	334.80	0.00
9023	Instruments, models for demonstrational use	0	182.72	0.00
7407	Copper bars, rods &profile	0	147.58	0.00
7408	Copper wire	0	146.43	0.00
4411	Fibreboard of wood or other non-ligneous materials	0	138.96	0.00
9018	Medical instruments, non electrical & parts thereof	0	12.34	0.00
9406	Prefabricated buildings	0	10.37	0.00
9033	Parts n.e.s. for machines/appliances of chapter 90	0	2.91	0.00

Note: Export intensity index 1999 (and thereby RCA 1999) is zero for all the products as all of them are new entrants to India after ISLFTA.
Source: Calculated from COMTRADE database

Results reflected in Table 2.16 and Table 2.17 are discomforting. For most commodities (6 out of 10 products) in the export basket of India (for whom there has been a substantial increase in export intensity indices from pre ISLFTA-1999 to post ISLFTA-2002) RCA indices lie below unity, implying that India does not have comparative advantage in producing these commodities. So there is trade distortion in most of these commodities. The case of Sri Lanka is quite shocking. The products whose export intensity has increased after ISLFTA did not have any revealed comparative advantage before the Agreement. Even if we compare them with RCA 2002 we find that only the copper products are showing revealed comparative advantage, which can be due to very high exports to India that explains the total of it's world exports.

However, since our calculations include only those products, which have increased their export intensity after ISLFTA formation, we cannot generalise our results. In the case of India's exports to Sri Lanka the commodities in which we found trade distortion actually account for only 2 per cent (approximately) of total exports to Sri Lanka (comparing Table C in Annex 1 and Table 2.16 here) in 2002-03. But in case of Sri Lanka's exports to India it is a serious issue. The Sri Lankan export items, in which we found trade distortion, accounts for more than one-fifth of India's imports from the island nation (comparing Table D in Annex 1 and Table 2.17 above) in 2002-03. Especially copper items (7403,7407 and 7408) alone account for 20 per cent of total imports in the same year and from our analysis we find that they did not have any revealed comparative advantage in Sri Lanka before ISLFTA came into operation. Sri Lanka also does not have any copper mines within its territory. So the question is that how is it able to export these items in such huge proportions? Is it due to trade deflection? But we have Rules of Origin (RoO) provisions in place to inhibit such simple

transshipment. So it can be due to the fact that these provisions are not enough or may be due to failure of proper implementation of these rules. We will try to find this out in our next chapter.

2.5: Summary

The present chapter has been an attempt to give a general overview of India-Sri Lanka trade, particularly in the context of Indo-Sri Lanka Free Trade Agreement. We first looked into the features of ISLFTA in detail. We have also done a brief review of work done on the ISLFTA. Then we embarked on trade data analysis. We found that bilateral trade has increased substantially after the Agreement came into force. We also found that Sri Lanka has diversified its export basket to India considerably. India's exports to the island nation have also increased. We have seen that aggregate trade intensity indices of both countries with respect to each other have gone up after the ISLFTA became operational. Our work here has focussed on trade distortionary effects of ISLFTA. Making use of two indices (export intensity index and revealed comparative advantage) jointly we have inferred that trade distortion is very much present in the increased bilateral trade. However we cannot generalise the case of trade distortion for the overall two-way trade since our analysis covered only those commodities (at H.S. 4-digit level) that have shown increase in export intensity after the Agreement. Still it is a serious concern that most products, which are traded more intensively now, have no revealed comparative advantage in their respective exporting countries. We have thus identified certain product groups where trade distortion is present. Given this now we turn our attention to how RoO could have played a role in this trade distortion. This we do in the next chapter, which deals with the design, effects and enforcement issues of RoO.

Annex 1

The tables below give the percentage share of various commodities in the bilateral trade between India and Sri Lanka at H.S. 2-digit and 4-digit level. Here percentage share indicates how much percent of total trade value (export or import value) in a particular year is explained by the commodity concerned e.g. animal products in 1996-97 (see Table A) accounted for 1.37 per cent of total Indian exports to Sri Lanka. As petroleum trade is generally unstable, to get a true representation of various items in bilateral trade we have calculated their percentage shares in total trade after deducting trade in petroleum. Since anticipation of a FTA can provide incentives to exporters to hold back exports, we start our analysis two years prior to the signing of the agreement. Our analysis is from 1996-97 to 2002-03. We give only those products whose percentage shares has been at least 0.25 per cent in any of the years. Any product whose share has been persistently below this cut-off mark is ignored as negligible. We are using this cut-off mark as traded products that have consistently (for seven years under consideration) contributed less than 0.25 per cent share in the value of total trade can be safely considered to be of not much importance to trade.

Table A: Commodity exports as a percentage of total export value: From India to Sri Lanka at H.S. Section and Chapter (2-digit) levels

H.S. code	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
Section 1: Animal products*	**1.37**	**1.15**	**0.96**	**0.81**	**0.55**	**0.69**	**0.48**
Chapter 3							
Section 2: Vegetable products	**21.4**	**17.66**	**10.36**	**15.06**	**10.63**	**10.67**	**9.92**
Chapter 7	5.91	8.05	6.91	8.86	7.34	4.42	2.67
Chapter 8	0.30	0.35					
Chapter 9	2.20	1.34	1.71	2.58	2.37	2.64	2.51
Chapter 10	11.83	7.07	1.01	2.43		2.11	3.36
Chapter 11		0.44				0.29	0.30
Chapter 12	0.42	0.40	0.42	0.71	0.42	0.72	0.56
Chapter 14	0.54		0.31	0.47	0.50	0.49	0.50
Section 4: Prepared foodstuff	**8.63**	**4.42**	**2.9**	**2.9**	**3.48**	**12.54**	**11.86**
Chapter 17	5.44	0.67			1.22	10.12	9.67
Chapter 19	0.44	0.69	0.62	0.49	0.38	0.37	0.28
Chapter 21					0.27		
Chapter 23	2.34	3.05	2.27	1.91	1.61	2.05	1.91
Chapter 24	0.40			0.49		·	
Section 5: Mineral products*	**1.20**	**1.16**	**0.51**	**0.48**	**4.82**	**4.83**	**3.26**
Chapter 25							
Section 6: Chemical products	**8.14**	**9.49**	**13.93**	**10.17**	**10.18**	**9.56**	**10.32**
Chapter 28	1.50	1.61	3.02	1.51	1.67	1.28	1.73
Chapter 29	0.82	0.88	1.53	0.83	0.77	0.81	0.97
Chapter 30	4.35	4.88	6.51	5.59	5.26	4.52	5.18
Chapter 32	0.35	0.50	0.63	0.46	0.47	0.53	0.57
Chapter 33	0.28	0.37	0.72	0.56	0.75	1.09	0.62
Chapter 34	0.29	0.51	0.54	0.28	0.33	0.40	0.34

Chapter 38	0.56	0.74	0.97	0.93	0.92	0.93	0.90
Section 7: Rubber & Plastics	**3.73**	**4.88**	**4.03**	**3.28**	**4.16**	**3.73**	**3.56**
Chapter 39	2.32	3.10	2.63	2.36	3.19	2.90	2.52
Chapter 40	1.41	1.78	1.40	0.92	0.97	0.82	1.04
Section 9: Wood products*	**0.32**	**0.30**	**0.28**				
Chapter 44							
Section 10: Cellulose products	**3.38**	**3.33**	**3.12**	**4.21**	**4.76**	**4.47**	**4.35**
Chapter 48	3.02	2.90	2.37	3.52	3.98	3.85	3.80
Chapter 49	0.36	0.42	0.75	0.70	0.78	0.62	0.54
Section 11: Textiles & textile articles	**14.98**	**16.96**	**20.88**	**23.4**	**20.14**	**17.57**	**17.1**
Chapter 52	11.76	12.60	14.12	13.02	10.72	9.61	9.49
Chapter 54	0.92	1.10	1.91	2.61	2.71	2.51	2.64
Chapter 55	0.44	0.63	1.33	1.66	1.34	1.15	1.49
Chapter 56	0.48	0.28	0.30	0.43			0.29
Chapter 58		0.59	0.84	1.13	1.16	0.84	0.33
Chapter 59			0.30				
Chapter 60	0.48						
Chapter 61			0.26	0.50	0.63	0.69	0.67
Chapter 62	0.58	1.10	1.25	3.49	3.12	2.02	2.18
Chapter 63	0.32	0.65	0.56	0.57	0.45	0.75	
Section 13: Articles of stone & ceramic	**1.04**	**0.79**	**1.44**	**1.42**	**1.53**	**1.19**	**1.46**
Chapter 68			0.55	0.45	0.30		
Chapter 69	0.43	0.46	0.56	0.60	0.70	0.76	0.83
Chapter 70	0.61	0.33	0.33	0.36	0.53	0.43	0.63
Section 14: Precious & semi-precious stones**	**0.29**		**0.32**	**0.63**	**0.36**		
Chapter 71							
Section 15: Base metals & articles thereof	**9.29**	**10.97**	**10.86**	**10.27**	**12.97**	**8.83**	**10.81**
Chapter 72	5.63	6.34	4.50	5.13	7.23	5.09	5.59
Chapter 73	2.70	3.12	4.31	3.34	4.28	2.66	3.05
Chapter 74	0.28	0.31	0.47	0.43	0.39	0.48	1.34
Chapter 76	0.68	0.84	0.95	0.88	0.80	0.61	0.55
Chapter 82		0.36	0.34	0.49	0.28		0.25
Chapter 83			0.28				
Section 16: Machinery & mechanical appliances	**7.81**	**8.38**	**9.14**	**9.35**	**8.45**	**7.64**	**8.13**
Chapter 84	5.73	5.48	6.14	5.41	4.97	5.26	5.21
Chapter 85	2.08	2.90	3.00	3.94	3.48	2.38	2.92
Section 17: Transport equipment	**11.28**	**11.46**	**16.53**	**12.84**	**12.38**	**7.91**	**13.36**
Chapter 86			0.26			0.68	
Chapter 87	11.28	11.46	16.27	12.84	12.38	7.23	12.81
Chapter 89							0.55
Section 18: Precision instruments*	**0.36**	**0.37**	**0.71**	**1.01**	**1.02**	**0.58**	**0.61**
Chapter 90							
Section 20: Furniture, toys etc.	**0.27**		**0.42**	**0.76**	**0.37**	**0.35**	**0.31**
Chapter 94				0.34			
Chapter 96	0.27		0.42	0.42	0.37	0.35	0.31
Others	**3.93**	**5.28**	**0.6**	**0.42**	**0.61**	**5.50**	**1.02**
Chapter 98	3.11	2.57					
Chapter 99	0.83	2.71	0.60	0.42	0.61	5.50	1.02

Note: The spaces left blank imply absence or less than 0.25 % share of the particular commodity in total export.
* Only one Chapter under the H.S. Section is important for India's exports to Sri Lanka.
** The H.S. Section comprises of only one Chapter.
Source: Calculated from Department of Commerce (India) website.

Table B: Commodity imports as a percentage of total import value: From Sri Lanka to India at H.S. Section and Chapter (2-digit) levels

H.S. code	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
Section 1: Animal products*	**1.09**	**1.82**	**2.48**	**1.58**	**1.01**	**0.40**	**0.41**
Chapter 5							
Section 2: Vegetable products	**20.5**	**17.7**	**43.5**	**42.42**	**32.95**	**47.17**	**35.6**
Chapter 7			1.31	0.62			
Chapter 8	4.32	1.56	11.53	4.77	0.86	0.26	0.28
Chapter 9	9.69	13.15	30.66	31.44	29.14	45.46	32.80
Chapter 12	1.69	1.16		0.78	1.39	0.51	1.50
Chapter 13	4.80	1.83		4.81	1.56	0.94	1.02
Section 3: Edible oils*	**5.10**	**8.11**	**4.94**	**6.19**	**5.51**	**1.96**	**1.64**
Chapter 15							
Section 4: Prepared foodstuff			**0.77**		**2.99**	**0.46**	
Chapter 17			0.25				
Chapter 18			0.25				
Chapter 19			0.27				
Chapter 21					0.51		
Chapter 23					2.48	0.46	
Section 5: Mineral products	**0.68**					**0.7**	**0.25**
Chapter 25						0.30	
Chapter 26	0.68					0.40	0.25
Section 6: Chemical products	**0.84**	**2.44**	**2.7**	**0.7**	**0.61**	**4.63**	**1.5**
Chapter 28					0.35	0.30	
Chapter 29	0.84		0.48	0.29		3.67	0.65
Chapter 32					0.26	0.37	0.53
Chapter 33		0.98	1.64	0.41		0.28	
Chapter 34							0.32
Chapter 35		0.98	0.25				
Chapter 38		0.47	0.33				
Section 7: Plastics & rubber	**15.78**	**11.17**	**6.96**	**8.46**	**6.81**	**5.77**	**6.96**
Chapter 39	0.79	2.75	3.64	5.30	4.91	4.19	5.41
Chapter 40	14.98	8.43	3.32	3.16	1.90	1.58	1.55
Section 8: Hides & skins	**0.46**	**1.43**	**0.78**			**0.89**	**0.69**
Chapter 41	0.46	0.79	0.78			0.89	0.69
Chapter 43		0.64					
Section 9: Wood products*	**0.55**	**0.97**	**0.93**	**0.54**	**0.55**	**0.61**	**1.13**
Chapter 44							
Section 10: Cellulose products	**3.11**	**10.7**	**7.69**	**9.48**	**10.72**	**7.16**	**4.53**
Chapter 47	2.73	9.50	6.69	7.55	5.98	4.82	2.03
Chapter 48	0.38	1.20	1.00	1.93	4.41	2.33	2.50
Chapter 49					0.33		
Section 11: Textiles & textile articles	**1.98**	**5.21**	**5.73**	**3.91**	**5.48**	**2.18**	**1.51**
Chapter 50			0.33				
Chapter 52			1.74	0.76	0.26		0.69
Chapter 54	1.98	5.21	1.43	1.18	3.41	0.82	
Chapter 55			0.32				
Chapter 56			0.37	0.27	0.69	0.65	0.37
Chapter 58			0.28		0.70	0.70	0.45
Chapter 59			0.29				
Chapter 60			0.56	0.86	0.42		
Chapter 62			0.41	0.83			

Section 13: Articles of stone & ceramic			**0.66**	**0.38**	**0.85**	**2.59**	**1.32**
Chapter 68					0.30	1.74	0.71
Chapter 69			0.28	0.38	0.55	0.85	0.34
Chapter 70			0.38				0.27
Section 14: Precious & semi-precious stones **		**1.22**	**0.68**	**1.00**		**0.51**	
Chapter 71		1.22	0.68	1.00		0.51	
Section 15: Base metals & articles thereof	**40.44**	**30.15**	**16.25**	**20.04**	**19.95**	**16.4**	**32.39**
Chapter 72	17.32	22.30	13.33	18.32	14.60	5.30	4.10
Chapter 73	17.58	0.84	0.86	0.53	0.95	0.51	0.42
Chapter 74	3.59	3.65	1.68	0.72	3.46	8.92	25.62
Chapter 76					0.62		1.24
Chapter 78					0.32	1.39	1.01
Chapter 79	1.95	3.09	0.38				
Chapter 80						0.28	
Chapter 81		0.26		0.46			
Section 16: Machinery & mechanical appliances	**4.37**	**4.13**	**2.69**	**2.26**	**7.16**	**3.25**	**7.08**
Chapter 84	3.05	3.68	2.23	1.26	6.47	2.89	3.06
Chapter 85	1.31	0.45	0.46	1.01	0.69	0.36	4.02
Section 17: Transport equipment		**0.29**				**0.4**	**0.42**
Chapter 87		0.29					
Chapter 88							0.42
Chapter 89						0.40	
Section 18: Precision instruments*					**0.99**	**0.55**	**0.67**
Chapter 90							
Section 20: Furniture, toys etc.*					**0.65**	**0.97**	**1.21**
Chapter 94							
Others	**3.54**	**1.83**	**0.96**	**0.55**	**0.38**	**0.72**	
Chapter 98						0.72	
Chapter 99	3.54	1.83	0.96	0.55	0.38		

Note: The spaces left blank imply absence or less than 0.25 % share of the particular commodity in total import.

* Only one Chapter under the H.S. Section is important for India's imports from Sri Lanka.

** The H.S. Section comprises of only one Chapter.

Source: Same as Table A.

Table C: India's exports to Sri Lanka at H.S. 4-digit level

H.S. code	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
0303		0.42					
0305	0.58	0.49	0.64	0.66	0.41	0.43	0.28
0306	0.51		0.25				
0701	0.59	0.34		0.62	0.33		
0703	3.03	1.59	1.48	1.7	2.12	1.72	1.82
0709		0.7	0.30	0.34	0.45	0.38	
0713	2.04	5.35	4.83	5.97	4.15	2.14	0.49
0902	0.69	0.62	0.48	0.35	0.31	0.40	0.35
0904	1.08	0.41	0.86	1.82	1.65	1.95	1.86
1001						**0.85**	**2.23**
1005	0.36						
1006	11.39	7	0.97	2.38		1.20	1.07
1101							0.29
1103		0.28					
1202				0.37		0.26	

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1208						0.25	
1404	0.45		0.27	0.37	0.42	0.41	0.41
1701	**5.28**	**0.59**			**1.14**	**9.95**	**9.59**
1901		0.49	0.47	0.35	0.26		
2106					0.25		
2304	2.08	2.72	2.01	1.88	1.57	1.98	1.68
2309		0.26	0.26				
2401	0.39			0.43			
2523	**1.05**	**1.03**	**0.30**	**0.33**	**4.69**	**4.63**	**3.07**
2803	0.39	0.55	0.73	0.7	0.98	0.77	0.78
2815	0.42	0.37	0.37	0.26			
2818			1.20				
2941	0.34	0.28	0.71				0.29
2942		0.18		0.27			0.26
3003	0.61	1.15	1.51	1.15	0.86	0.57	0.33
3004	**3.57**	**3.5**	**4.70**	**4.17**	**4.01**	**3.69**	**4.56**
3204	0.25	0.26	0.36				
3304						0.69	
3402		0.25	0.38				
3405						0.26	
3808		0.3	0.31	0.42	0.48	0.46	0.41
3902				0.4	0.55	0.59	0.48
3904	1.07	1.02	0.42				
3920		0.28	0.33	0.28	0.38	0.48	0.54
3923		0.7	0.50	0.56	0.52	0.39	0.32
3926			0.32	0.28	0.8	0.82	0.38
4001							0.31
4011	0.86	1.2	0.79		0.47	0.27	0.26
4013		0.25	0.27				
4801							0.25
4802	**2.36**	**1.91**	**1.86**	**2.2**	**1.92**	**2.06**	**2.13**
4804					0.37		
4810					0.49	0.80	0.74
4811				0.41	0.31		
4819		0.28					
4901	0.29	0.33	0.62	0.42	0.47	0.41	0.34
5201	0.47	0.51					
5205	**4.09**	**5.07**	**3.06**	**3.3**	**3.24**	**2.55**	**1.88**
5207	0.27	0.51	1.60	1.94	1.51	1.89	1.48
5208	**2.26**	**2.75**	**4.01**	**3.98**	**2.46**	**2.29**	**2.96**
5209	**3.02**	**3.22**	**4.38**	**2.74**	**2.4**	**2.07**	**2.49**
5210	0.66		0.57	0.69	0.32	0.43	0.37
5211	0.94				0.25		
5212					0.25		
5402	0.30	0.46		0.29	0.37		0.31
5407	**0.29**	**0.44**	**1.47**	**2.12**	**2.23**	**2.14**	**2.23**
5509			0.29	0.27			0.32
5512				0.29			
5513				0.32			0.25
5515			0.52	0.63	0.54	0.45	0.59
5607	0.35			0.3			
5801		0.26	0.58	0.52	0.86	0.56	
5810				0.34			

Code							
6002	0.41						
6105						0.26	
6201					0.33		0.66
6203				0.28			
6204			0.35	1.15	0.87	0.45	0.33
6205		0.35	0.29	0.51	0.90	0.42	0.41
6206				0.53	0.35		
6304			0.36	0.29	0.26	0.59	
6307		0.29		0.26			
6908			0.29	0.34	0.41	0.51	0.52
7005	0.35						0.28
7102	0.27		0.25	0.51			
7206					1.36		
7207		0.27			0.45	1.01	1.09
7208		0.45	0.84	0.43	0.74	0.36	0.64
7209	0.75	0.69		0.32	0.54	0.29	0.74
7210	0.35	0.43	0.70	1.23	1.48	1	0.73
7212		0.52					
7213			0.87	0.36		0.78	0.69
7214	0.33	0.74	0.12	0.24			
7215			0.28	0.28			
7217					0.29		0.29
7218	0.56	0.27			0.39	0.27	0.28
7221				0.31			
7222					0.33		
7223		0.32					
7224	1.39	0.25					
7225			0.33	0.28			
7226		0.31					
7228	0.65	0.94	0.47	0.28			
7305	0.45	0.78		0.32	0.26		
7306	0.66	0.46	0.70	0.35	0.62	0.64	1.02
7308		0.39	0.84	0.52	0.52		0.41
7312			0.37	0.38			
7318			0.43		0.91		
7323	0.37	0.34	0.52	0.71	0.72	0.49	0.39
7326			0.37	0.27			
7407							0.53
7606	0.41	0.52	0.53	0.31	0.46	0.32	0.26
8406							0.81
8407			0.31	0.29			
8409		0.27	0.28				0.3
8413							0.27
8414	0.26	0.33	0.36	0.39	0.41	0.32	0.32
8418			0.41	0.3	0.31		0.28
8419	0.82	0.31					
8422				0.25			
8426	0.39						
8438		0.55					
8443			0.25				
8473	0.43						0.26
8477			0.32	0.33	0.25		
8479	0.33	0.48	0.78	0.44	0.6	1.53	0.31

H.S. code	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
8502	0.37						0.6
8504		0.31					
8509				0.27			
8517				0.26			
8524				0.42			
8528					0.37	0.25	
8535		0.42					
8539		0.32	0.44	0.39	0.37		
8544		0.31					
8546		0.38	0.29	0.7	0.34		
8602						0.49	
8701			0.43				
8702	1.12	1.93	4.27	3.01	3.96	1.18	3
8703	0.49	0.43	0.50	0.76		0.26	1.07
8704	0.60	0.58	0.97	0.37	0.94		
8705		0.3					
8706	2.88	1.96	2.33	2.62	1.79	0.97	1.18
8708	1.08	1.19	1.85	1.52	1.23	1.06	0.81
8711	**3.72**	**3.69**	**4.49**	**2.96**	**2.52**	**2.89**	**5.54**
8714	0.66	0.75	1.03	1.12	1.18	0.68	0.79
8901							0.54
9018				0.25	0.38	0.33	0.3
9030				0.332			
9403				0.26			
9801	3.11	2.57					
9993	0.78	2.55	0.45	0.28	0.37	5.27	0.87

Note: The spaces left blank imply absence or less than 0.25 % share of the particular commodity in total export. The top ten export items (by percent shares) of 2002-03 are put in bold font.

Source: Same as Table A.

Table D: India's imports from Sri Lanka at H.S. 4-digit level

H.S. code	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
506		0.33	0.25				
508	0.80	1.38	2.19	1.36	0.84	0.36	0.41
713			0.97	0.42			
801		0.71	1.48				
802	4.28	0.85	10.05	4.77	0.83		0.27
902		1.98	1.81	4.56	3.91	3.88	0.98
904	**7.41**	**7.49**	**22.63**	**16.06**	**15.39**	**5.43**	**12.98**
907	**0.79**	**2.28**	**3.67**	**5.38**	**6.32**	**34.26**	**15.21**
908	**0.78**	**1.28**	**2.55**	**3.25**	**3.47**	**1.73**	**3.11**
910	0.58			2.15			
1211	1.69	1.16		0.78	1.38	0.51	1.48
1301	1.22	1.83		0.34	0.75	0.94	0.59
1302	3.58		·	4.47	0.81		0.41
1502			0.26				
1511							0.36
1520	4.97	8.11	4.68	6.19	5.51	1.95	1.21
1704			0.25				
1806			0.25				
1905			0.27				
2101			0.49				
2306			2.48				0.42

Code							
2614	0.65						
2620						0.40	
2849			0.32				
2902						3.46	
2903	0.68						
2905			0.32				
2941							0.52
3208						0.29	
3301		0.98	1.64	0.41			
3401							0.32
3503		0.98	0.25				
3901							0.27
3908			0.45	0.29			
3911					0.28		
3923		0.29					
3926	0.66	2.15	2.90	4.43	4.17	3.82	4.89
4001	14.26	7.76	2.62	2.44	0.76	0.75	0.41
4008				0.28			
4011							0.61
4014					0.35		
4015	0.59	0.57	0.53	0.34	0.4	0.37	0.29
4104	0.29	0.5	0.43			0.61	0.42
4304		0.62					
4403	0.55	0.95	0.92	0.47	0.53	0.61	
4411							1.01
4707	2.73	9.4	6.69	7.55	5.98	4.82	2
4802					0.47		
4810		0.27					
4817					0.31		
4819		0.41	0.57	1.22	1.87	1.27	1.43
4821		0.35		0.59	1.1	0.83	0.68
4823					0.5		
5002			0.33				
5201			0.48	0.48			
5202			0.67				
5208				0.29			0.55
5209			0.33				
5402	1.62	5.02	1.28	1.01	2.73	0.50	
5407					0.64		
5408	0.30						
5515			0.30				
5601					0.26	0.46	
5603					0.41		
5806					0.31		
5807						0.45	0.33
5811					0.26		
6001			0.53	0.34			
6002				0.52	0.42		
6212				0.65			
6802						1.74	0.69
6911					0.31	0.34	
6913						0.41	
7016			0.28				

7102				0.55			
7103		0.72	0.68	0.45			
7108		0.51					
7110						0.29	
7204	**17.10**	**22.28**	**13.12**	**18.21**	**14.49**	**4.94**	**3.87**
7210						0.32	
7304	17.06						
7308			0.35				
7311	0.41	0.38	0.43	0.42	0.59	0.34	
7326		0.43					
7402							**3.46**
7403						**5.16**	**7.63**
7404	**3.58**	**3.65**	**1.68**	**0.72**	**3.35**	**2.40**	**4.06**
7407						1.02	
7408							**9.51**
7409							
7602					0.56		
7801						1.38	0.95
7901		0.69					
7902	1.92	2.37	0.38				
8104				0.46			
8408		0.69					
8418					1.15	0.49	
8422	1.51						
8438			0.50		0.54		
8441		0.41					
8443		0.47			0.47		
8445	0.39				0.78		
8451						0.32	
8471			0.41	0.57			
8473		**1.35**	**0.48**		**1.73**	**1.18**	**2.18**
8477					0.51		
8479			0.30	0.44	0.51		
8504		0.36					
8517							0.45
8525							1.5
8536	0.4						
8539							0.45
8541					0.26		
8542							1.21
8548	0.72						
8803							0.41
8908						0.4	
9018							0.28
9023					0.32		
9033					0.44	0.33	0.3
9403					0.52	0.51	1.12
9406						0.42	
9801						0.72	
9993	3.54	1.83	0.96	0.55			
9999					0.25		

Note: The spaces left blank imply absence or less than 0.25 % share of the particular commodity in total import. The top ten import items (by percent shares) of 2002-03 are put in bold font.

Source: Same as Table A.

Chapter 3
Rules of Origin in Indo-Sri Lanka Free Trade Agreement

3.1: Introduction

This chapter gives an overview of Rules of Origin (RoO) present in Indo-Sri Lanka Free Trade Agreement (ISLFTA) and tries to analyse its effects. From the existing literature on RoO we have found that in the set-up of any FTA (Free Trade Agreement or Area) their absence will induce trade deflection. Trade deflection takes place when goods from non-member countries enter the FTA through the lowest tariff member country. When RoO are there in place, which in effect warrant genuine value addition in the exporting country, such simple transshipment can not take place. In the same set-up RoO might also lead to trade diversion. Any FTA in itself has the potential to divert trade from non-member countries to members because of tariff reduction/elimination. RoO, in this set-up, facilitate trade diversion in intermediates as member producers will try to buy more intermediates from the domestic sources to make their products "originate" in the FTA and qualify for preferential treatment. Because of this RoO can also result in high cost and inefficient production. Thus we find that RoO are almost like "necessary evil" in the context of FTAs.

Assessing the economic effects of RoO in reality, however, is a major problem because of methodological difficulties and lack of data. Empirical work on them has been very little due to the absence of a "standard" against which the efficacy, benefits and costs of RoO can be determined. Moreover since different FTAs apply different set of rules, majority of the work done in this area are case studies like assessing the effect of RoO in NAFTA or the EFTA. We are also undertaking a case study of this type i.e. we are trying to see the effects of RoO in FTAs with respect to the ISLFTA.

Responses to RoO are time dependent. In the short run RoO affect trade flows, while in the long run they affect investment decisions. Only four years have passed since the ISLFTA has come into force and the RoO have become operative. Given this short period and keeping in mind the year-to-year fluctuations in bilateral trade flows, we cannot hope to get a very clear picture of the effects of RoO. Trade diversion effects are difficult to measure as for that we need unit cost data of imports for both the countries (trade is considered to be diverted only if unit cost of imports from inside the FTA is higher than that of outside imports), which we could not find in secondary literature.

Effect of RoO on domestic production costs is also outside the scope of this study. We can, however, find the restrictiveness scale of ISLFTA RoO. The restrictiveness scale of RoO determines the actual effects these rules will have. From the provisions of the Agreement we can find out, by the way in which the rules are designed, whether they can have restrictive effect on trade flows or not. For ascertaining this we resort to an index measure. We compare this index measure with similar Preferential Trade Arrangements (PTAs) across the globe, to find out the restrictiveness of ISLFTA RoO on a comparative scale. We will also try to ascertain effects of these rules and look into the question of enforcement i.e. whether these rules on paper are able to ascertain genuine value addition in production activities. From our analysis we will try to identify important policy issues in this regard.

The chapter is outlined as follows. First we detail the features of RoO as is present in ISLFTA in section 3.2. In the next section we explain the restrictiveness index of RoO and give the comparative analysis of ISLFTA RoO with similar PTAs around the world. In section 3.4 we try to find out whatever effects of RoO we can discern, in the short period in hand, and also look into the enforceability issue. The last section summarises our findings and looks into the policy issues related to them.

3.2: Features of RoO in Indo-Sri Lanka Free Trade Agreement

The objective of the RoO in ISLFTA is to determine the origin of goods under the Free Trade Agreement so that products, which have achieved the status "originating in Sri Lanka (/ India)", will be eligible for preferential tariff treatment upon imports into India (/ Sri Lanka). The RoO in ISLFTA are simple enough compared to those in other similar agreements. Almost 200 pages of the draft of NAFTA (North American Free Trade Area) agreement itself had to do with defining these RoO. In the proposed Singapore-U.S. FTA there are over 240 pages of product specific rules of origin [Brenton (2003)]. Also the main text of a typical Association Agreement between the EU (European Union) and a Barcelona process country[31] is between 20-30 pages long, while the annex covering the rules of origin at the 6-digit H.S. level of disaggregation is close to 100 pages [Augier-Gasiorek-Lai Tong (2003)]. In contrast the ISLFTA text covering 15 pages has an annex on RoO of only 5 pages. The specific criteria of determining origin (as given in the text of the agreement) are detailed below.

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[31] The Euro-Mediterranean Partnership or Barcelona Process is a wide framework of political, economic and social relations between the EU and countries of the Southern Mediterranean. It was initiated in 1995 through a conference held on Barcelona.

Origin will be granted to a product if it is "wholly obtained"[32] in the exporting country. If products are manufactured in the exporting country using such "wholly obtained" materials they will also get preferential treatment. If in addition to these materials some other country materials are used in the manufacture of a product then RoO requires that value of imported materials does not exceed 65 per cent of the f.o.b. (free on board)[33] value of the concerned product. This implies 35 per cent value addition should take place in the exporting country (domestic value addition). Moreover, imported materials used should also be "sufficiently worked or processed" in the making of the export product. "Sufficient working" under the ISLFTA implies that the export product should be classified under a different heading (at H.S. 4-digit level) than that in which imported materials (used in its manufacture) are classified.[34]

If, however, the imported raw materials come from the partner, then the domestic value addition norm is reduced to 25 per cent, provided total value addition in both countries is not less than 35 per cent. For example if Sri Lanka produces a commodity using Indian raw material (in addition to its own or imported materials) then 25 per cent value addition to this commodity in its own territory satisfies the RoO, provided value of the Indian raw materials is at least 10 per cent of the f.o.b. value of the commodity, so that total bilateral value addition is not less than 35 per cent. Thus bilateral cumulation is incorporated into the agreement. There are two other additional clauses. Firstly, the final manufacturing process (in case of not "wholly obtained" products) must be done in the territory of the exporting country. Also products should be directly consigned from the exporting country to the importing country.

Direct consignment means that the exported products are transported to the importing country without passing through the territory of any other third country. If these rules are satisfied, then any importer can avail of preferential treatment under the ISLFTA[35].

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[32] For example mineral products extracted from the soil of the exporting country, vegetable products harvested there, animals born and raised there etc. For details see Appendix 2.

[33] The value of exports is the free on board (f.o.b.) transaction value of the goods expressed in national currency. The f.o.b. value includes the value of packaging (other than containerisation) and excludes freight and insurance costs for the overseas route.

[34] There are certain operations which have been identified by both the countries to be insufficient working or processing even if change of heading takes place e.g. simple operations like labelling/packaging, assembly of parts etc. For a full list see the agreement text given in Appendix 2.

[35] Any importer at the time of importation, if he or she wants to get preferential treatment under the ISLFTA, should produce a certificate of origin for his/her imports. Certificates of origin are issued by the Export Inspection Council (EIC) in India and by the Director General of Commerce in Sri Lanka.

Interesting to note is that there are no tolerance (or de minimis), absorption rule, or DMRM (determined manufactured raw materials) provisions in ISLFTA. These kinds of supplementary rules add to the flexibility of any RoO regime. For example, tolerance rule allows a certain percentage of non-originating materials to be used without affecting the origin of the final product. It applies to the change in tariff classification criterion. On the other hand absorption principle is of particular relevance to the value-added test. It provides that parts or materials, which have acquired originating status by satisfying the relevant rules of origin, can be treated as being of domestic origin in any further processing and transformation. In other words any non-originating materials are no longer taken into account when assessing the nature of further operations. DMRM provisions allow for certain materials of third country origin that are not manufactured in either partner economy to be defined as 'manufactured raw materials' and treated as qualifying expenditures for the determination of origin. Absence of these rules, which make room for using third country materials, makes ISLFTA RoO less flexible.

3.3: Restrictiveness Index of RoO in ISLFTA

An index approach is a particular way of assessing the restrictiveness of policy instruments whose impact on price and quantity are not readily available. Since RoO can act as non-tariff barriers to trade, their impact is not easily measured or evaluated. So we resort to this index approach to ascertain the restrictiveness of RoO in ISLFTA. Such an index will quantify prevailing restrictions into a summary measure to facilitate comparisons on a common basis across PTAs. Index methodologies have been applied to analyse origin rules in NAFTA and European Union-related agreements [Estevadeordal (2000), Brenton and Manchin (2002), Augier, Gasiorek and Lai-Tong (2003), Estevadeordal and Suominen (2003)]. Indices developed in these studies have focused on particular provisions of RoO. A more comprehensive index measure was developed by the Australian Government's Productivity Commission[36] (2004) while trying to assess economic problems with operation and design of RoO under the Australia-New Zealand Closer Economic Relations Trade Agreement (ANZCERTA). Since this is the most comprehensive RoO restrictiveness measure available in literature we use it to assess the restrictiveness of RoO under ISLFTA. The index methodology is given in the next subsection. We then give a detailed calculation of the index value. In the last sub-section the calculated index measure for ISLFTA is compared with those

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[36] The Productivity Commission, an independent agency, is the Australian Government's principal review and advisory body on microeconomic policy and regulation.

of other Preferential Trade Agreements (PTAs), to get an idea of the degree of restrictiveness of RoO present in the ISLFTA.

3.3.1: Index methodology

The index methodology, used here, involves specifying a regimen of provisions or criteria used to determine origin in a PTA, a weight for each criterion reflecting its relative importance in the index and a score reflecting the restrictiveness of the variant implemented in the RoO regime. The index value lies between zero and unity. A higher index value (closer to unity) indicates a more restrictive trading environment on account of RoO. In this methodology, RoO are grouped into three broad headings: primary criteria reflecting the main methods of origin determination; supplementary criteria for other provisions related to preferential RoO; and other effects of RoO[37]. The basic structure of the index is reported in Table 3.1.

Table 3.1: Restriction categories for preferential RoO

Number	Restriction category	Weight
Primary criteria		**0.60**
1	Change in tariff classification	0.20
2	Regional value content or percentage criterion	0.20
3	Specified manufacturing process test and/or sector-specific rules	0.20
Supplementary criteria		**0.25**
4	Type of cumulation	0.05
5	Provisions that go beyond cumulation	0.05
6	Duty drawback	0.05
7	Territoriality or outward processing	0.05
8	Geographic location of manufacturing process	0.05
Other effects of RoO		**0.15**
9	Degree of certainty	0.05
10	Compliance and administration costs	0.05
11	Rigidity	0.05
Total weight		**1.00**

Source: "Rules of Origin under the Australia–New Zealand Closer Economic Relations Trade", Productivity Commission (2004).

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[37] The categorisation adopted here reflects the methods, or tests, of origin determination canvassed by the World Customs Organization (WCO), and regulations that have evolved to support the application of those tests.

The primary criteria consist of three sub-categories. The weight assigned to the primary criteria, as a group, is 0.6 out of a total weight of one. This relatively high weight was assigned to this group because of the likely predominance of the tests in origin determination. Group weights are further disaggregated into subgroups on the basis of frequency of use and their likely importance in RoO regimes. Details of the disaggregation are provided later in the chapter. There are some supplementary features of RoO, which can influence whether or not origin is conferred on a product and hence determine the impact of the RoO regime on trade flows. These are cumulation rules, tolerance or de minimis thresholds, duty exception and drawback provisions, the extent of permissible outward processing and the last stage of manufacturing process requirement. These features are included as supplementary criteria and allocated one-fourth of the total index weight, with uniform weights being allocated between five sub-categories. The restrictiveness of RoO can also be influenced by other factors such as certainty in proving origin, level of compliance and administrative costs, and degrees of flexibility in accommodating technical change. This group's weight is 0.15 with weight of each sub-category fixed at 0.05.

There are some limitations of using this index methodology as was clearly pointed out by the Productivity Commission. Firstly, the provisions in the PTAs are assessed in the index according to the actual provision in agreements, rather than the extent to which the provision may have been implemented. Index value of a particular regime reflects ex-ante the restrictiveness of the origin rules faced by firms. However, the index alone does not provide a measure of the ex-post effects of an implementation of RoO. Also, because the information base for compiling restrictiveness indices is limited, the results should be seen as indicative of orders of magnitude, rather than as a precise measure of restrictiveness.
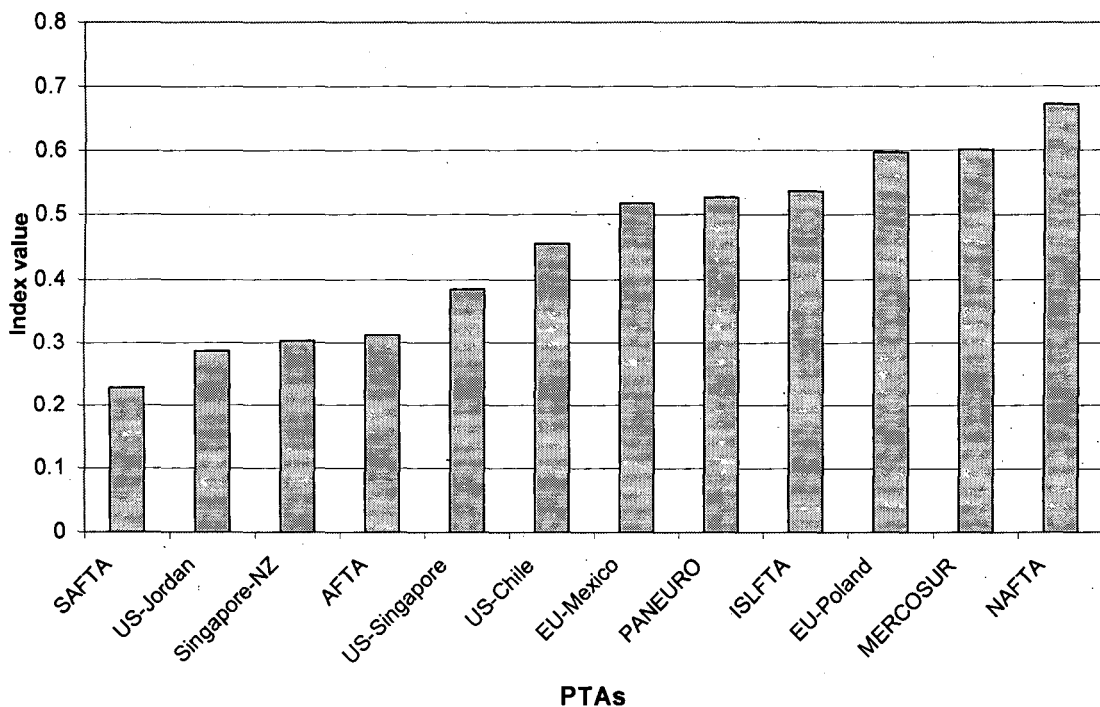
3.3.2: Calculating the Index

Now we elaborate the structure of the restrictiveness index outlined in section 3.3.1. The scores assigned to different criteria of RoO range from 0 for the least restrictive variant to 1 for the most restrictive variant identified. According to this structure, the greater the likely restrictiveness of a provision, the higher the score it has received. The score of zero is also applied when a provision is not identified as part of a RoO regime. To complete the index, the score assigned to each item was aggregated according to the weights shown in Table 3.1. Rationale for scoring within each criterion and the index in detail is given in Table E in Annex 2. The concerned scores for ISLFTA RoO are calculated by analysing the text of

ISLFTA (given in Appendix 2) using this index. The aggregate restrictiveness score for ISLFTA RoO, thus calculated, is 0.536. The ISLFTA scores are given in bold font in Table E of Annex 2.

3.3.3: Comparative Analysis

We calculated the restrictiveness index for ISLFTA RoO and it is 0.536. In itself it does not indicate much. But when it is compared with various PTAs across the world, we find that ISLFTA RoO are restrictive enough. This is evidenced from the figure below. For comparison those PTAs are chosen, from the Productivity Commission study, which are part of the "new regionalism" (i.e. those formed in the decade of the 90s and later). The reason for choosing recent PTAs is that RoO was not much of an issue with earlier PTAs. We get the RoO restrictiveness index for such PTAs from the Productivity Commission study.

Figure 3.1: Restrictiveness index of RoO

Note: Our study here has calculated the index value for ISLFTA by using the index provided in the Productivity Commission study and referring to the provisions of ISLFTA, as given in text of the Agreement.
Source: "Rules of Origin under the Australia–New Zealand Closer Economic Relations Trade", Productivity Commission (2004).

From the figure, it is evident that EU-POLAND, MERCOSUR and NAFTA are the only PTAs having more restrictive RoO than those present in ISLFTA. ISLFTA RoO is 4th in rank from the high end. Compared with levels of restrictiveness identified in other PTAs, ISLFTA RoO appear to be relatively high.

From section 3.2 we found that ISLFTA RoO are very simple compared to their counterparts in other PTAs. So why still it is more restrictive than the more complex ones? When we look into the different categories of restrictiveness index, we find that as far as the "PRIMARY CRITERIA" are concerned ISLFTA RoO are not much restrictive in the comparative scale (see Table F in Annex 2). For "OTHER EFFECTS OF RoO" restrictiveness is almost uniform across all the PTAs. However it is the "SUPPLEMENTARY CRITERIA" where RoO for ISLFTA have scored the highest, which has pushed up the overall measure. This is because most PTAs considered allow for supplementary rules to the main methods of origin determination e.g. provisions that go beyond cumulation, duty drawback etc. These PTAs also do not specify geographic location of the last manufacturing process to be the exporting country. Thus on these counts ISLFTA has become more restrictive as far as its RoO are concerned. But we have to keep in mind that since such additional rules are absent for ISLFTA it has more procedural simplicity. Criteria for originating products are very complicated issues in any trade agreement. If we add more clauses stating exceptions to the general rules agreed upon, it increases the complexity of the RoO regime chosen. In ascertaining country of origin under ISLFTA there is no such complexity involved. So even if ISLFTA RoO has high restrictiveness value we feel that there is not much need for concern as ISLFTA RoO has more simplicity procedurally.

From our literature review on RoO (in Chapter 1) we have found that effects of RoO depend on their restrictiveness scale. We have found from our analysis here that ISLFTA RoO are restrictive enough. Let us now see what can be their effects. We also address the enforcement of RoO issue in the next section.

3.4: Effects of Rules of Origin

ISLFTA was set up with the view of liberalising trade. However the restrictive RoO it incorporated can negate the effect of trade preferences. And it will affect Sri Lanka more than India. Why, we explain below.

Sri Lanka is a small island economy, which is highly dependent on other countries for most of its raw materials, intermediate inputs and capital goods. In fact Sri Lanka's Import-GDP ratio is as high as 38 per cent (in 1999). A corollary of such high import dependence is low domestic value addition in Sri Lanka. The manufacturing sector as a whole has very low value addition in Sri Lanka. The value added to output for the manufacturing sector as a whole was

only 34.5 per cent in 1985 and increased marginally to 36.5 per cent in 1998 (Weerakoon and Wijayasiri 1999).

Sri Lanka also has very poor industrial base. In contrast to this India is a much larger economy with well-diversified industrial structure. This is evident from the fact that India has been able to establish a relatively diversified industrial base with knowledge intensive modern industries like engineering industries contributing over a quarter of its manufacturing value added. On the other hand 74 per cent of Sri Lanka's manufacturing value added is accounted by traditional and resource based industries like food-products and textile and garment. Also specialisation index[38], which accounts for the extent of specialisation of the manufacturing industry in a country, is the lowest for India in the SAARC region, implying it has the most diversified manufacturing industry in the region (SADC 1999).

Now between the large subcontinent, with well-diversified industrial base, and the small island economy, with very high import dependence and low industrial base, a Free Trade Agreement (FTA) is established which has fairly restrictive Rules of Origin (RoO). So meeting stringent value-addition norms will be more difficult for Sri Lanka than India. The Joint Study Group of ISLFTA (JSG 2003) stated that rigidities of the present Rules of Origin criteria were seen as inhibiting potential exports from Sri Lanka. It being a small island nation with poor industrial base depends a lot on imported inputs and finds difficulty in fulfilling the ISLFTA RoO. In fact in recent discussions between the two countries there was a Sri Lankan proposal that given their import dependence in various sectors[39], there should be downward revision of RoO norms. However no downward revision has been done yet. Given this situation what effects can we expect?

We can hypothesise the possible effects and then try to see whether such effects are discernible yet. Firstly, the Agreement provides for bilateral cumulation facility. This implies that Sri Lankan producers can import their raw materials and intermediates from their Indian counterparts, so that value addition norm for the final product will be 25 per cent instead of the usual 35 per cent. Such cumulation facilities may translate into trade diversion in intermediates if Indian intermediates are not lower cost ones for Sri Lanka. In case of ISLFTA it'll be more pronounced due to the fact that 35 per cent domestic value addition is difficult

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[38] Specialization index of a country is equal to 100 if that country specialises completely in one industry. Higher index value implies lower extent of diversification of the industrial structure.
[39] Sri Lanka has very high import dependence in most of its important export sectors e.g. the textile & garments sector (that accounts for half of its export earnings) had 90% of its intermediate inputs imported in 1988. By the end of the 90s this came down to 60% but that is still very high (Weerakoon and Wijayasiri 1999).

for Sri Lankan producers[40]. This hypothesis is widely discussed in trade literature. However no study has tried to connect cumulation facilities with trade diversion in intermediates. This shift in trade flow hasn't become very apparent in this short period and will require more time to be proved beyond a doubt. Still among the export products of India whose export intensity to Sri Lanka has increased after ISLFTA, there are some intermediate products. These are wire of iron and non-alloy steel (H.S. Heading 7217), television receivers (H.S. Heading 8528) and woven fabric of synthetic filament yarn (H.S. Heading 5407). None of these products have Revealed Comparative Advantage (RCA) in India implying trade distortion. The way trade distortion is arrived at here can also imply trade diversion. Trade diversion is difficult to measure directly[41].

The other effect of restrictive RoO in this can be more FDI (Foreign Direct Investment) inflows into the Sri Lankan export sector targeting the huge Indian market. If strict origin rules are absent, third countries can simply take the transshipment route to push their products to the Indian market. But since considerable value-addition norms are in place, these third countries will be forced to relocate some of their production bases in Sri Lanka (given its liberal environment for investment) and then export their final products. The Board of Investment (BOI), Sri Lanka states that within a year of implementation of the FTA, Sri Lanka had received investment in as many as 41 projects in regard to the FTA, whose total value is US $1 million (SADC 2004). Further work needs to be done in this area to accept these hypotheses.

Now let us move to the question of RoO circumvention. Limitation of time has confined us to secondary literature. So we try to see if any case is reported about RoO violation under ISLFTA and what has been the dynamics of such a case. And we find that RoO violation in case of copper exports from Sri Lanka is documented in some places. So we look more into the matter.

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[40] Exporters, on account of very restrictive RoO, may also forego the tariff preferences and export paying MFN tariffs. This can be found out by ascertaining how much of bilateral exports (under different preferential categories) are paying MFN tariff rates. Such data needs to be collected at the customs level and we couldn't do it in the short time period of our study.

[41] The study by Mukherji, Jayawardhana and Kelegama (2003) calculated trade diversion of the items under different preferential categories. The basis of their calculation of trade creation/diversion was the symbolic formula: $(M99-00-M01-02)*(UC_{row} - UC_p)$ where the first term denotes the increase in quantity imported from 1999-00 to 2001-02 and UC_{row} & UC_p are unit cost of imports from the rest of the world & from partner country respectively. They did not however try to find presence of trade creation/diversion in terms of final or intermediate product groups. In our study lack of unit cost data did not permit us to look further into it.

The JSG (2003) reported that the surge in Sri Lankan copper exports created a 'critical circumstances'[42] situation, which was resolved through discussion under the consultative mechanisms in place under the ISLFTA. The Indian copper industry has alleged that RoO norms are flouted in case of copper products exported by Sri Lanka. Before going into their allegations, let us see what has been the dynamics of such copper trade.

From our trade data analysis we have seen that imports of Copper and articles thereof (H.S. Chapter 74) from Sri Lanka into India has increased tremendously after the ISLFTA came into operation. Before ISLFTA imports of copper was roughly 1 per cent of total imports. However in the next three years it increased to approximately a quarter of total imports. We had also seen in our previous chapter that a study by Kelegama (2003) stated that 63.5 per cent of total preferential exports from Sri Lanka was accounted by copper related products in 2002. This extraordinary trade performance is brought out clearly from the following two graphs. From Figure 3.2 we find that exports of copper articles to India has increased tremendously, so much so that now almost 98 per cent of copper exports from Sri Lanka come to India! Also if we take the top five countries from which India is importing copper in recent years we find an interesting result (Figure 3.3). Except Sri Lanka all other countries (USA, UK, UAE and Korea) are showing a declining trend as far as import of copper is concerned. Sri Lanka on the other hand has shown an increase after 2000. This increase is sharper in the last one year maybe because from March 2003 copper imports have become absolutely duty free under ISLFTA[43].

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[42] "Critical circumstances" means the emergence of an exceptional situation where massive preferential imports are causing or threatening to cause serious injury to domestic producers difficult to repair and which calls for immediate action.

[43] Basic customs duty for copper imports into India is 25 per cent under MFN clause and it is from March 2003 zero duty for ISLFTA.

Figure 3.2: Export of Copper from Sri Lanka to different countries

Export to India ▨ Export to Japan ■ Export to U.S. ▥ Export to china-Hong Kong ▨ Export to Germany
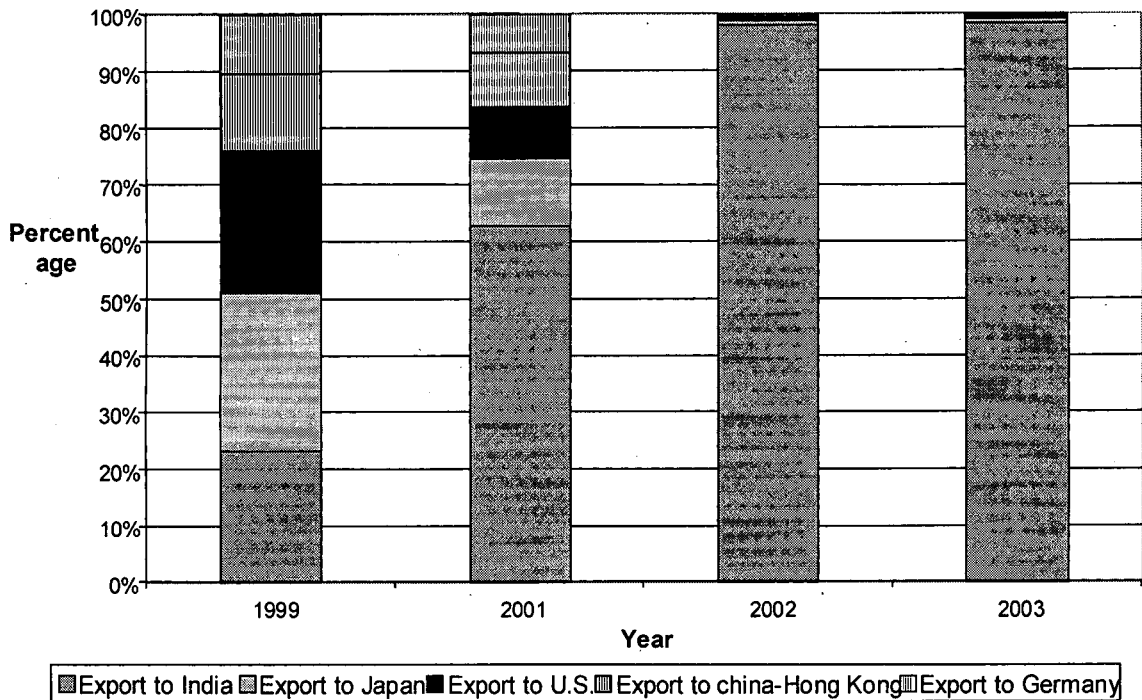
Source: Drawn using data from COMTRADE database. Note: The years refer to 1999-00 to 2003-04.

Figure 3.3: Import of Copper into India: Top 5 countries

◆ im fr sl ■ im fr USA ▲ im fr UK ✕ im fr UAE ⊖ im fr Korea
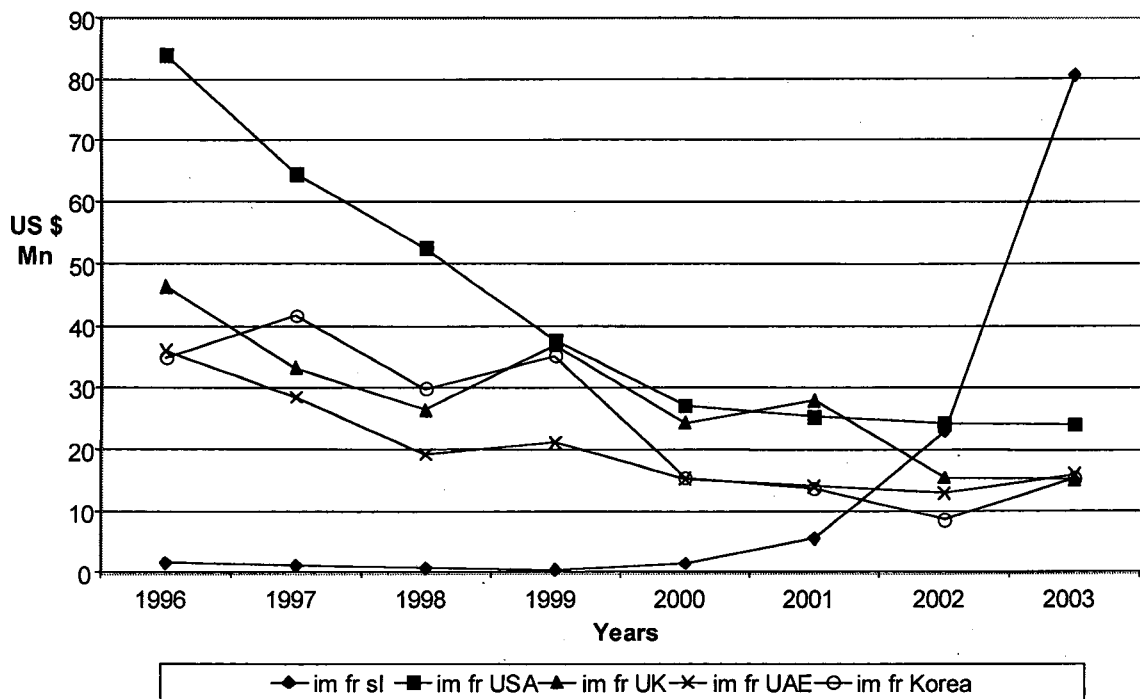
Note: Sri Lanka, USA, UK, UAE and Korea are top 5 countries with respect to copper imports into India in 2003-04. Till 2001Sri Lanka was nowhere amidst the top 5 countries.
Source: Drawn from data available with Department of Commerce website.

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Thus beyond doubt copper has become a major import item for India under the ISLFTA. This surge in copper imports has affected the domestic industry adversely. However, Indian consumers of copper (especially the electrical industries) have benefited out of it. One ton of copper remelted wire bars imported from Sri Lanka costs Rs. 20,000 less than what the domestic production costs. In this context the Indian Electrical and Electronic Manufacturers' Association (IEEMA) has stated that electric equipment manufacturers suffer because of the protection to domestic copper smelters, which also makes import of the downstream products like electric cables, winding wires and conductors from countries like Sri Lanka very attractive (The Economic Times 02/07/04). But then the Indian copper producers allege that required value addition is not done in Sri Lanka to these copper products.

Since Sri Lanka does not have copper mines, third country copper scrap is melted and cast into ingots and exported to India as "Sri Lankan" products. Industry officials claim that maximum value addition possible in the process of conversion of copper scrap to remelted ingots is 7 per cent. These allegations found validity in the findings of an Indian team (comprising of the Director of Ministry of Mines, Deputy Director of Directorate General of Foreign Trade, and Deputy Director of the Revenue Department), which during its visit to Sri Lankan copper units, observed that value addition was shown only by under-invoicing of imported scrap. Local copper producers feel that by fixing a floor price below the legitimate price of imported copper scrap, under-invoicing becomes easy (The Economic Times 12/02/05). This led to the posting of a circular in the Indian Customs departments website dated August 13, 2003, which stated "the Sri Lankan authorities have been informed that the rise in exports of copper is not due to genuine value-addition of 35 per cent, but due to circumvention of the value-addition norms by some unscrupulous traders." The circular further stated, "the Sri Lankan side has been requested to put an end to the export of copper strips and profiles immediately, and other items of copper within a period of six weeks from July 18, '03."(Customs Circular No. 73/2003- www.ieport.com). This circular, however, went unimplemented because of the bilateral discussions under the consultative mechanisms placed under the ISLFTA.

Thus what we find in this case is that even though strict RoO are there in place to ensure genuine value addition in the exporting country, unscrupulous traders can circumvent these rules. And provisions of the treaty are such that they do not provide necessary powers to

Indian authorities to challenge the value-addition norms, once the consignment is cleared by the Sri Lankan authorities[44].

The JSG in its report (2003) noted India's concerns regarding under-valuation of preferential trade and offered the following way out. "In recognition of the critical importance of this issue, the Sri Lankan Government has indicated that it would have no objection to Indian Customs and/or trade officials being based in Colombo to ensure effective implementation of the CEPA[45]. The JSG recommends that a Working Group consisting of appropriate officials of both Governments be set up to examine and approve a verification procedure that would refine the issuance of Certificates of Origin as well as validate their content. Once such a Joint Working Group (JWG) sets up a verification procedure that is acceptable to both sides, the validity of such certificates of origin should not be questioned".

In our previous chapter we have seen that exports from Sri Lanka which has increased their export intensity after the ISLFTA did not have revealed comparative advantage. Amidst them copper related items (Headings 7403,7407,7408) had a major share (17 per cent of total imports into India). In case of all these products we found that Sri Lanka does not have any revealed comparative advantage, still it could increase its exports to India. Thus there was clear evidence of trade distortion. In case of the copper products we found that they could increase their export intensity by flouting the origin rules of the ISLFTA. Can it be true for the other products also? We cannot emphatically say that the same is the case for each of these products, but at the same time we cannot entirely rule out the possibility. It is not because of the failure of the RoO regime opted under ISLFTA that this has happened. RoO, the way they are designed in the ISLFTA, do take care of genuine value addition if they are adhered to. Here the main problem is that there is no way of enforcing these rules from the point of view of the partner country.

It does not necessarily signify that the issuer of the certificate of origin is at fault. Value addition norms require lengthy and costly audits to verify claims of exporters requesting for preferences. This is a problem for developing countries, which lack sophisticated accounting systems necessary under this method.

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[44] Certificates of origin are issued by the Export Inspection Council (EIC) in India and by the Director General of Commerce in Sri Lanka.
[45] India and Sri Lanka are planning to convert ISLFTA to a Comprehensive Economic Partnership Agreement (CEPA), which includes trade in services.

And corrupt trade practices, which are so prevalent in case of developing countries, have made it all the more easy for circumventing these rules. We thus have to be more careful while implementing RoO in FTAs of the future.

3.6: Summary of Findings and Major Policy Implications

In this chapter we first described the features of RoO in ISLFTA. We found that there are two main clauses for not "wholly obtained" products to satisfy ISLFTA RoO. Firstly, 35 per cent value addition should take place in the manufacture of such products in the exporting country. Secondly, the product must be classified under a different H.S. heading than in which imported inputs used in its preparation are classified. Bilateral cumulation facility is also included whereby value addition norms, for products using inputs from partner country, come down to 25 per cent. The final manufacturing is specified to be carried out in the exporting country and direct consignment of exports is required. We found that these rules are clear and simple, as no lengthy product specific rules are included. However, using an index analysis we found that the provisions present in the text of the Agreement are quite restrictive. The specific restrictiveness index value of ISLFTA RoO is 0.536. On a comparative scale this index value turned out to be on the upper end amongst index values of similar PTAs (implying very restrictive RoO). Absence of some supplementary rules, which allow for third country materials use, duty drawback and territoriality provisions made this simple set of ISLFTA RoO more restrictive in the comparative scale. Thus the first finding of our analysis is that the provisions of the ISLFTA RoO are capable of restricting trade in the ex-ante sense. Given this we tried to see what can be the effects of this restrictive RoO. We explained that restrictive RoO are going to affect Sri Lankan exporters more than Indian ones owing to high import dependence of Sri Lanka. If these rules are a hindrance to these exporters we hypothesised that three things can happen. First, restrictive RoO may lead to trade diversion in intermediate products. Second, it may also lead to investment diversion. Also there might be circumvention of these rules, as we know that restrictiveness depends on the way rules are enforced. In the context of the ISLFTA we found some effects regarding the first two hypotheses though due to paucity of data we could not examine them in sufficient detail. We need more years of experience as well as data to test such hypotheses on the effects of RoO in ISLFTA.

Regarding the last hypothesis we come to the question of implementation of RoO. If such rules are circumvented then it is a question of enforcement failure. So we moved to the

enforcement question. We found that RoO are not enforced properly specifically in the context of copper imports from Sri Lanka, which has become the major import item for India under ISLFTA. We saw that simple under-invoicing of imported input prices by Sri Lankan exporters was enough to circumvent 35 per cent value addition norms easily in this case. And there are no enforcement mechanisms to check this. Provisions of the FTA does not have any mechanism to stop a consignment of goods cleared by Sri Lankan customs as originating in their country. There is a dispute settlement mechanism between the two countries. However, despite the allegations of "critical circumstances" emerging in case of copper imports nothing was done. The Indian Customs Department issued a circular to stop copper imports, but it was not put to effect.

The major policy implications coming out of our study is to strengthen the enforcement mechanism for RoO. Some FTAs (like AFTA) go for joint certification mechanism for RoO whereby both partners are involved in verifying claims of exporters that their products have originated within the FTA. This seems to be a better arrangement than the one adopted for ISLFTA. There has been a conscious policy shift in India towards regional cooperation via FTAs (there are 10 more FTAs in the pipeline). Most of these FTAs are on the lines of ISLFTA regarding their structure (including RoO). In that context our study suggests more attention be given to RoO especially on their implementation.

Annex 2

Table E: Restrictiveness index for preferential RoO — index in detail

Weight	Score	Restriction category	Rationale for provision
		PRIMARY CRITERIA	
0.2		Change in tariff classification	The CTC method can be applied at different levels in the HS. A change in tariff classification at the broad (2-digit) chapter level provides the highest hurdle for conferring origin and is therefore given the highest restrictiveness score of one. Progressively lower scores are assigned to the heading (4-digit), sub-heading (6-digit) and tariff item (8-digit) levels.
	0	Tariff item (HS 8-digit)	
	0.2	Sub-heading (HS 6-digit)	
	0.5	Heading (HS 4-digit)	
	1	Chapter (HS 2-digit)	
			ISLFTA score = 0.2 * 0.5 = 0.1
0.1		Regional value content or percentage criterion	The pivotal sub-criterion for the application of RVC method is the threshold percentage adopted, expressed as either a minimum percentage of value that must have been added in the PTA region or a maximum percentage of value of imports from non-member economies allowed. This sub-category takes the highest weight of 0.1. The remaining five sub-criteria is given an equal weight of 0.02 each. The rule used in assessing restrictiveness in the percentage criterion is unambiguous. The higher the percentage of originating material required, the higher the restrictiveness score.
		Percentage of originating material[46]	
	0	Less than 25%	
	0.2	26-35%	
	0.4	36-45%	
	0.6	46-55%	
	0.8	56-65%	
	1	More than 65%	
			ISLFTA score = 0.1 * 0.4 = 0.04
Weight	**Score**	**Restriction category**	**Rationale for provision**
0.02		*Formulation of regional value content*	The percentage of originating and non-originating materials can be formulated in three different ways: value of parts, domestic content and import content. Wherever the value of parts test is used, it is assessed as the most restrictive of the alternatives because it focuses on a very small set of either local or non-local material inputs. Formulation of the percentage criterion based on domestic content is considered to be more restrictive than a specification based on the imported content because it is considered to facilitate manipulation and to add to compliance and administration costs.
	0	Any method	
	0.3	Import content	
	0.6	Domestic content	
	1	Value of parts	
			ISLFTA score = 0.02 * 0.3 = 0.006
0.02		*Elements of production costs for domestic content*	Typically, the narrower the range of qualifying expenditures relative to total costs, the harder it would be for a firm to reach the origin threshold and the more restrictive would be an origin rule. Accordingly, RoO which include fewer expenditure items as qualifying expenditures are
	0	All costs included	
	0.1	Taxes and duties paid on materials excluded	

Table E continued....

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[46] Agreements applying regional content thresholds to confer origin can use different valuation methods. To improve comparability of thresholds in alternate agreements, the thresholds have been normalised to a factory cost basis. In case of ISLFTA transaction value method, defined as the value of locally sourced materials expressed as a percentage of the value of the final product, is used. Thus a conversion factor of 1.20 is used which makes the 35% domestic value addition norms to 42 %.

	0.2	Indirect labour also excluded	considered to be more restrictive and are given a higher score. **It does not apply to ISLFTA as it goes by import content method.**
	0.3	Other capital costs also excluded	
	0.4	Inner containers also excluded	
	0.5	Other packaging expenses also excluded	
	0.7	Selling, general and administrative expenses also excluded	
	1	Profits also excluded	
0.02		*Treatment of determined manufactured raw materials*	Determined manufactured raw materials (DMRM) provisions allow for certain materials of third country origin that are not manufactured in either partner economy to be defined as 'manufactured raw materials' and treated as qualifying expenditures for the determination of origin. The inclusion of DMRM provisions in a trade agreement tends to have a liberalising effect. Thus, origin rules without such provisions are treated as more restrictive than rules that allow the inclusion of certain materials from third countries.
	0	Imports from all zero tariff line items to member economies are treated as eligible expenditures	
	0.5	Imports from selected zero tariff line items to member economies are treated as eligible expenditures	
	1	No provision for allowing DMRM in calculating domestic content	
			ISLFTA score = 0.02 * 1 = 0.02
0.02		*Methods of qualifying production costs*	Of the RVC methods applied, the factory cost method is typically considered to have the narrowest cost base (since it focuses on the manufacturing aspect of the production and distribution chain), affording the least flexibility to businesses in making their input choices. It is also administratively more complicated. This method is treated as most restrictive. On the other hand, the transaction value method is typically considered to have the widest cost base (since it focuses on transaction values, typically including transport and distribution costs) that affords the most flexibility to firms in making their input choices.
	0	Any method	
	0.25	Transaction value method	
	0.5	Net cost method	
	1	Factory cost method	
			ISLFTA score = 0.02 * 0.25 = 0.005
0.02		*Valuation of non-originating materials*	An 'ex-factory' cost basis is considered to be the narrowest valuation basis and origin rules incorporating this provision are treated as the most restrictive on this account. Less restrictive valuation bases, in order of restrictiveness, include free on board at port of embarkation (fob), cost insurance and freight at port of unloading (cif) and free into store (fis).
	0	Not relevant or unspecified	
	0.25	Free into store (fis)	
	0.5	Cost, insurance and freight (cif)	
	0.75	Free on board (fob)	
	1	Ex-factory cost	
			ISLFTA score = 0.02 * 0.5 = 0.01
0.1		Type of specified manufacturing process test applied	The inclusion of specific process tests adds to the restrictiveness of origin rules. Such tests typically are specified in terms of particular industrial processes and ways of working, limiting the prospect for technological or organisational change and productivity improvement. Variants of the method prescribe at the outset certain production or sourcing requirements that must be met — termed the *positive test* — or must not be evident — the *negative test* — to confer origin. The negative test is treated as being the more restrictive, as it may indiscriminately and unintentionally exclude products on the basis of a particular product characteristic rather than the characteristics of the full production process. **In ISLFTA no specific manufacturing tests are present.**
	0	No test	
	0.5	Positive test for specific process	
	1	Negative test for specific process	
0.1		Sector-specific rules	The presence of sector-specific rules for more than one sector is treated as the most restrictive

	0	All sectors treated uniformly	variant. RoO including sector-specific rules for only one manufacturing sector (the less common
	0.5	Single manufacturing sector only	case) are treated as moderately restrictive. **In ISLFTA no sector specific rules are present.**
	1	Multiple sectors	

<div align="center">SUPPLEMENTARY CRITERIA</div>

0.05		Type of cumulation	Origin rules that involve no cumulation in the valuation of regional content are treated as being the
	0	All	most restrictive, and rules allowing bilateral cumulation as being more restrictive than methods
	0.2	Diagonal	involving full or diagonal cumulation. Diagonal cumulation is treated as least restrictive on the
	0.4	Full	grounds that it allows specified materials from non-member countries to be counted as qualifying
	0.6	Bilateral	materials.
	1	No cumulation	
			ISLFTA score = 0.05 * 0.6 = 0.03
0.05		Provisions that go beyond cumulation	Some provisions in PTAs go beyond cumulation in allowing origin of non-members' materials.
	0	Cumulation allowed	For any cumulation method, detailed testing of the source of inputs can influence the
	0.1	Tolerance or de minimis allowed	restrictiveness of the origin rules. Of the alternatives, tracing tests are treated as the least
	0.25	Absorption principle	liberalising because they restrict valuations to include only originating materials. By contrast, under the absorption principle, the full value of the material input is given originating status if an
	0.5	Tracing test	initial test is satisfied. Tolerance tests are treated as the most liberal of the options because they are
	1	Absorption principle, tracing and tolerance tests not used	regarded as providing the greatest scope for raising the level of 'originating' content.
			ISLFTA score = 0.05 * 1 = 0.05
0.05		Duty drawback	Duty drawback schemes allow tariffs due on imported materials used in the production of export
	0	Drawback allowed	items to be waived or refunded. Such schemes selectively lower the cost of inputs used to produce
	1	Drawback not allowed	goods for export. In origin rules, access to drawback provisions generally available to exporters can be restricted, or denied entirely, raising the cost of exporting to member economies and encouraging firms to purchase inputs from potentially higher-cost local sources. Origin rules that disallow or derogate drawback arrangements for exporters are treated as more restrictive than rules that do not.
			ISLFTA score = 0.05 * 1 = 0.05
0.05		Territoriality or outward processing	Territoriality provisions go beyond the cumulation provisions in PTAs in allowing the use of
	0	Territoriality or outward processing included	materials from non-member countries. However, this is treated as a separate item in the index
	1	Territoriality or outward processing excluded	because of its importance in modern industrial manufacturing and organisation (e.g. through contracting-out and commission work). Origin rules that limit or disallow origin being conferred on goods produced using outsourcing and outward processing arrangements are treated as more restrictive than rules that do not.
			ISLFTA score = 0.05 * 1 = 0.05
0.05		Geographic location of manufacturing process	RoO specifying the location of the last place of manufacture receive a higher restrictiveness score
	0	Anywhere or not specified	than RoO that do not. Rules allowing the last stage of manufacture to occur in any partner country
	0.5	Any partner country	(e.g. when the last process is contracted out) receive a lower restrictiveness score than rules requiring that the last place of manufacture be in the 'exporting' partner country only.

	1	Exporting partner country only	
			ISLFTA score = 0.05 * 1 = 0.05

OTHER EFFECTS OF RoO			
0.05		Degree of certainty	Regulatory risk associated with uncertainty of origin determination (e.g. arising out of exchange rate fluctuations) would be expected to influence the way businesses act, thereby adding to the restrictiveness of an origin regime. It is therefore possible for origin regimes to be highly restrictive (e.g. CTC method applied at the 2-digit chapter level) but it is relatively certain. On the other hand, other methods that may be less restrictive, including those based on an RVC requirement with a relatively low and uniform threshold, could be less certain because of exogenous factors (e.g. exchange rate fluctuations). RoO based purely on RVC methods are considered less certain and hence more restrictive according to this criterion. RoO based on a combination of RVC and CTC methods are relatively less certain and given the highest restrictiveness score.
	0	Higher certainty (e.g. CTC alone or technical test)	
	1	Lower certainty (e.g. RVC or combination of CTC and RVC or technical test)	
			ISLFTA score = 0.05 * 1 = 0.05
0.05		Compliance and administration costs	Membership of multiple agreements involves additional coordination effort (the 'spaghetti bowl' effect). In such cases, the existence of multiple agreements would add to the trade restrictiveness of individual agreements. The restrictiveness of an agreement is considered to be at its highest when most member countries are also members of more than one agreement and those agreements invoke more than one method for determining origin, while membership of only a single agreement is considered the least restrictive according to this criterion.
	0	Most PTA members are only a member of one PTA	
	0.5	Most PTA members are involved in more than one PTA with similar RoO	
	1	Most PTA members are involved in more than one PTA with multiple RoO	
			ISLFTA score = 0.05 * 0.5 = 0.025
0.05		Rigidity	RoO that do not allow waivers for origin determination based on product-specific requirements are treated as more restrictive than origin rules that allow waivers
	0	No rigidity: waiver provision applied to all tariff items	
	0.25	Partial rigidity: waivers allowed for a minority of tariff items	
	0.5	More than partial rigidity: waivers allowed for a majority of tariff items	
	1	Global rigidity: no waiver, RoO applies to all tariff items	
			ISLFTA score = 0.05 * 1 = 0.05
1		GRAND TOTAL	Index value 0.536 for ISLFTA RoO

Note: Index value of ISLFTA is calculated in our study by analysing the provisions of the ISLFTA as given in the text of the Agreement and using the index provided in the Productivity Commission study

Source: "Rules of Origin under the Australia–New Zealand Closer Economic Relations Trade", Productivity Commission (2004).

Table F: Restrictiveness index for preferential RoO: detailed results by PTAs

RESTRICTION CATEGORY	MERCO SUR	AFTA	NAFTA	EU-POLAND	CHILE-MERCO SUR	PANEUR O	SINGAP ORE -NZ	EU-MEXICO	ISLFTA	US-SINGAP ORE	US-JORDAN	SAFTA	US-CHILE
PRIMARY CRITERIA													
Change in tariff classification	0.100	0.000	0.200	0.100	0.000	0.100	0.000	0.100	0.1	0.050	0.000	0.000	0.100
Regional value content or percentage criterion													
Percentage of originating material	0.060	0.040	0.060	0.100	0.080	0.080	0.040	0.060	0.04	0.040	0.040	0.040	0.060
Formulation of regional value content	0.006	0.006	0.012	0.006	0.006	0.006	0.012	0.006	0.006	0.012	0.012	0.012	0.006
Elements of production costs for domestic content	0.010	0.001	0.010	0.006	0.002	0.000	0.006	0.006	0.00	0.000	0.020	0.006	0.010
Treatment of DMRM	0.020	0.010	0.010	0.010	0.020	0.000	0.000	0.020	0.02	0.010	0.010	0.000	0.010
Methods of qualifying production costs	0.005	0.005	0.005	0.005	0.010	0.005	0.020	0.005	0.005	0.005	0.010	0.020	0.005
Valuation of non-originating material	0.015	0.015	0.015	0.005	0.015	0.005	0.015	0.015	0.01	0.015	0.005	0.015	0.015
Specified manufacturing process test	0.100	0.000	0.050	0.050	0.000	0.050	0.000	0.050	0.00	0.050	0.000	0.000	0.000
Sector-specific rules	0.050	0.000	0.100	0.050	0.050	0.050	0.000	0.050	0.00	0.050	0.000	0.000	0.050
Subtotal	**0.366**	**0.077**	**0.462**	**0.332**	**0.183**	**0.296**	**0.093**	**0.312**	**0.181**	**0.232**	**0.097**	**0.093**	**0.256**
SUPPLEMENTARY CRITERIA													
Type of cumulation	0.030	0.030	0.030	0.010	0.030	0.010	0.030	0.030	0.03	0.010	0.010	0.030	0.020
Provisions that go beyond cumulation	0.005	0.005	0.005	0.005	0.005	0.005	0.005	0.005	0.05	0.005	0.005	0.005	0.005
Duty drawback	0.050	0.000	0.000	0.025	0.025	0.050	0.000	0.000	0.05	0.000	0.025	0.000	0.025
Territoriality or outward processing	0.000	0.050	0.025	0.050	0.025	0.000	0.050	0.050	0.05	0.000	0.025	0.000	0.000
Geographic location of manufacturing process	0.025	0.025	0.025	0.025	0.025	0.025	0.025	0.025	0.05	0.025	0.000	0.000	0.025
Subtotal	**0.110**	**0.110**	**0.085**	**0.115**	**0.110**	**0.080**	**0.110**	**0.080**	**0.23**	**0.040**	**0.065**	**0.035**	**0.075**
OTHER EFFECTS OF RoO													
Degree of certainty	0.050	0.050	0.050	0.050	0.050	0.050	0.050	0.050	0.05	0.050	0.050	0.050	0.050
Compliance and administration costs	0.025	0.025	0.025	0.050	0.025	0.050	0.025	0.025	0.025	0.050	0.025	0.025	0.050
Rigidity	0.050	0.050	0.050	0.050	0.050	0.050	0.025	0.050	0.05	0.013	0.050	0.025	0.025
Subtotal	**0.125**	**0.125**	**0.125**	**0.150**	**0.125**	**0.150**	**0.100**	**0.125**	**0.125**	**0.113**	**0.125**	**0.100**	**0.125**
GRAND TOTAL	**0.601**	**0.312**	**0.672**	**0.597**	**0.418**	**0.526**	**0.303**	**0.517**	**0.536**	**0.385**	**0.287**	**0.228**	**0.456**

Note: Figures for ISLFTA calculated from the index provided in the Productivity Commission study and referring to the text of the ISLFTA.

Source: RoO under Australia-New Zealand Closer Economic Relations Trade Agreement, Australian Government Productivity Commission (2004).

Chapter 4

Summary and Conclusions

This chapter tries to put together the salient findings of our study on India-Sri Lanka trade relations set out on the background of the Free Trade Agreement (FTA) between the two nations. There is a growing debate amongst economists on the welfare effects of Free Trade Agreements (FTAs) and also on the emergence of Rules of Origin (RoO) as policy tools in such arrangements. This was the specific context of our study. The main objectives of the study were to find out if trade is being distorted as a result of ISLFTA; to evaluate the design of RoO under ISLFTA; to ascertain the effects of these rules; and also to look into the enforcement of ISLFTA RoO.

In the first chapter we gave a historical trajectory of regionalism as it has evolved in the world trading system. Then we focussed our attention to a specific and most important variant of regionalism- the FTAs. We gave a brief literature review on FTAs with special emphasis on RoO. The two majors static effects of FTAs are trade creation (the effect whereby trade is created between the members of a group by lifting the trade barriers between them) and trade diversion (after the establishment of a FTA imports are diverted away from more efficient non-members towards members that may be less efficient). RoO in FTAs assume great significance as necessary tools to prevent trade deflection (transshipment). RoO prevent such simple transshipment of goods by requiring products to originate in exporting member countries. However RoO in a FTA set-up can also induce domestic producers to buy intermediate goods from domestic sources notwithstanding the fact that imported inputs might cost less or are of better quality. This they do, so that their final product will satisfy RoO conditions (if it asks for a minimum value to be added domestically) and they can export them duty free to other FTA members. Thus trade diversion in intermediates is a very plausible effect that RoO has in the set-up of a FTA. If strict RoO are designed in a FTA the importers may even forgo tariff preferences and pay full MFN tariffs as compliance cost of such RoO will be very high.

Given this background we discussed the specific issues relevant to our study and narrowed down to the four objectives mentioned above. The first chapter also details the data source, period of analysis and gives the chapter scheme.

The first objective regarding trade distortion was dealt with in Chapter 2. This chapter first gave the details of Indo-Sri Lanka Free Trade Agreement (ISLFTA) and also a review of studies done on ISLFTA. The works done in this area are too scarce given the short time that has passed ever since the Agreement came to force. Some of the works have focussed on finding the product coverage or value coverage of bilateral trade under various preferences given while others have concentrated on the potential of the ISLFTA in trade creation and yet some others have actually analysed trade flows to find out the changes taking place. Though product coverage of concessions gives not so optimistic a picture, value coverage over the last few years under various concessions have increased. The literature reviewed gives a positive feedback on this trade liberalization initiative as bilateral trade has seen new heights. These studies have shown that there has been an orientation of trade between the two countries. Our study has focussed whether this changing trade orientation is compatible with efficiency considerations i.e. we tried to find out whether ISLFTA has distorted trade. In this method if there is increase in export intensity of a product whose RCA index is less than unity, then we concluded that trade distortion is present in that particular product. Although this method does not measure import diversion (which FTAs are supposed to foster) directly, it provides closely related information by allowing one to infer whether the additional trade generated by any FTA was primarily in products in which member countries had low enough costs to be competitive in other markets. If not, they suggest that the additional trade within the region could have been replaced by more efficient outside suppliers.

Before going into the trade distortion analysis we have given an overview of bilateral trade. We have first given a historical sketch of Indo-Ceylon trade. We found that geographical proximity and cultural affinity have ensured trade between the two nations from time immemorial. Because of size differences historically India was more important to Sri Lanka than the opposite as far as trade is concerned. India was mostly amongst the top few import supplying countries to the island nation whereas Sri Lankan exports to the subcontinent has been traditionally negligible. Similar export structure in both the countries limited bilateral trade to only a few items. This was evidenced from the fact that in 1947 approximately three-fourth of Sri Lankan exports to India were accounted by just two export items viz. copra and coconut oil. At the same time food, drink and tobacco items explained more than half of imports from India to Sri Lanka. During the 1960s textile items became more important in exports to the island nation, which was replaced by engineering products (especially transport

equipment) from the decade of the seventies. However coconut products continued to rule Sri Lanka's exports till the whole of sixties.

The structure as well as the value of trade has seen remarkable changes in recent years. We did a detailed examination of the trends in bilateral trade in recent years starting from 1987-88. We found that there have been considerable changes in structure of trade apart from increase in trade values over the years. India used to export 525 commodities (by H.S. 4-digit level) in 1987-88 to Sri Lanka, majority of them being cotton textiles, transport equipment, spices and marine products. By 2003-04 near to 1000 commodities were being exported in which sugar, wheat, cement and man-made filaments figured in a large way apart from cotton textiles and transport equipment. On the other hand India imported a mere 60 items from Sri Lanka in 1987-88 which was highly concentrated in only 4 products viz. pepper, cloves, glycerol and leguminous vegetables. Though spices have not lost their importance still, however approximately one third of imports is now explained by base metal groups (especially copper items).

For analysing trade distortion we tried to pinpoint those commodities that have increased their trade share or have suddenly come up in bilateral trade after ISLFTA came into operation. Since formation of ISLFTA cannot cause a disincentive to exports but on the contrary promote exports of existing or newer products, we have only taken "new" and "increasing" products of the changing structure of trade in our analysis. We identified these items at H.S. 4-digit level for both India's exports to and imports from Sri Lanka. Then we tried to see whether this change in structure is compatible with efficiency conditions. For finding this we have employed two trade indices, the export intensity index and the Revealed Comparative Advantage (RCA) index. We have taken the "new" and "increasing" product groups and calculated their export intensity ratios for two time periods: pre-ISLFTA (1999) and post-ISLFTA (2002). We have also calculated their RCA index in 1999 and compared the two indices to find if trade distortion has taken place after ISLFTA or not. If export intensity has increased and RCA 1999 is below unity it implies trade distortion as commodities in which countries do not have any apparent comparative advantage are being exported intensively after ISLFTA. This exercise reveals that most of the products that have been traded intensively after ISLFTA do not have any RCA in their respective exporting countries, implying presence of trade distortion. This is a serious concern especially for Sri Lanka's exports to India, as the products, which showed trade distortion, account for one-fifth of India's imports from the island nation in the latest year. Notably copper imports from Sri

Lanka have shown a huge surge after ISLFTA, though the country does not have any RCA in copper products.

Chapter 3 dealt with the issue of RoO in ISLFTA. First we described the RoO clauses under ISLFTA. We found them to be quite simple. There are two main clauses. The products (if not "wholly obtained" in the exporting countries) wanting preferential treatment should have 35 per cent value addition in their exporting countries and they should belong to a different H.S. heading than any of their intermediate inputs. From our literature review in Chapter 1 we found that effects to RoO depends on their restrictiveness scale. So we tried to measure the restrictiveness of the provisions of ISLFTA RoO. For ascertaining this we resorted to an index measure. Analysing the provisions regarding RoO given in the text of the ISLFTA and using an index measure available in the literature, restrictiveness level of ISLFTA RoO was calculated and found to be equal to 0.536. On a comparative scale we found that the ISLFTA RoO are quite restrictive relative to similar trade agreements around the world. The restrictiveness is mainly due to the absence of supplementary measures to RoO, which actually relax the stringency of such rules. However, we have to keep in mind that in negotiating any FTA agreeing on the criteria for originating products is the most difficult task. If we add more clauses stating exceptions to the general rules agreed upon, it increases the complexity of the RoO regime chosen. So even if ISLFTA RoO has high restrictiveness value it has more simplicity procedurally. We next focussed our attention on the effects of these restrictive RoO.

We hypothesised three effects, which can take place on account of very restrictive RoO under ISLFTA. First, as Sri Lanka is a small island economy with low industrial base and very high import dependence it does not seem far-fetched that it will source raw-materials from India to satisfy restrictive RoO (due to cumulation of rules if Sri Lankan exporters use Indian raw materials value addition norms under ISLFTA drops to 25 per cent from the normal 35 per cent). Thus our first hypothesis was trade diversion in intermediates under ISLFTA. This effect is widely discussed in trade literature. However no study has tried to connect cumulation facilities with this type of trade diversion. Some intermediate products (e.g. some textile items and parts of electronic equipment) have increased their export intensity after ISLFTA from India to Sri Lanka without having any revealed comparative advantage in India implying trade distortion in these products. The way trade distortion is calculated here is an alternate way to find trade diversion. Still we cannot establish this hypothesis beyond doubt.

The second hypothesis relates to more foreign investment in Sri Lanka to get access to the vast Indian market via ISLFTA. In the absence of RoO other countries could simply transship their products to India via Sri Lanka. But due to RoO they'll be forced to invest in Sri Lanka, do the required value addition in the country and then export to India duty-free. The Board of Investment (Sri Lanka) states that many new export projects have got foreign investment keeping in mind specifically the ISLFTA. More in-depth research is needed in this area, which will be possible only with more time and data.

Restrictive RoO may also lead to lesser utilisation of preferences under ISLFTA. This can be found out by analysing how much import from Sri Lanka are paying MFN tariff rates instead of ISLFTA fixed rates. This needs data from the customs level, which needs primary survey and was not possible to conduct in the course of this study due to time limitation. So these can be very good areas of further research.

In the context of these two developing countries, where corrupt trade practices are rampant, we hypothesised that exporters may find a way out to circumvent the restrictive RoO. Here comes the specific issue of implementation of RoO. Also whether RoO will restrict trade or not depends not only on the provisions but also on the way they are implemented. The issue of implementation of RoO has not been given enough attention in the literature. This despite the fact that policy implementation is as important as policy design. For probing into the implementation issue we had to depend on secondary sources. We found reports of RoO flouting regarding copper exports from Sri Lanka. We delved deeper into the matter and found an interesting phenomenon. Import of copper and its articles have increased tremendously after ISLFTA came into force. In 2003-04, 98 per cent of copper exports from Sri Lanka came to India compared to approximately 20 per cent in 1999. Another interesting thing was that amongst the top five countries, from which India imports copper products, four of them are showing declining trend from 1996-97 to 2003-04. Only Sri Lanka (which has emerged as the top most import partner country in copper products in 2003-04) has shown a reverse trend after 2000 (the year of ISLFTA operation). Sri Lanka does not have any copper mines or smeltering facilities. Thus naturally it did not have any RCA in copper products before ISLFTA operation. The instant explanation for increase in copper products from such a background is that there has been transshipment of copper from Sri Lanka to India.

But since we have already found that very restrictive RoO are present in the Agreement it will inhibit such trade deflection. Then the only other possibility is that the RoO provisions are being circumvented implying enforcement failure.

From the secondary literature we found that required value addition in copper products (to fulfill ISLFTA RoO) is shown by under-invoicing of imported copper scrap prices i.e. Sri Lankan exporters import copper scrap from third countries and under-invoice this import price so that import content of final copper product exports is not much and permissible under ISLFTA RoO. Some Indian copper industry officials are of the opinion that maximum value addition in the process of converting copper scrap to their export products is hardly 7 per cent. Such allegations have found validity in an official inquiry. However, there are no enforcement mechanisms to check this. Provisions of ISLFTA are such that they do not provide necessary powers to Indian authorities to challenge the value-addition norms once the Sri Lankan authorities clear the consignment. However this does not mean that the issuer of the certificate of origin is at fault. Value addition norms require lengthy and costly audits to verify claims of exporters requesting for preferences. This is a problem for developing countries, which lack sophisticated accounting systems necessary under this method. Corrupt trade practices have made it easier for circumventing these rules. So we have to ensure proper implementation procedures to ensure that such cases do not happen in the future.

We have found flouting of RoO in case of Sri Lankan copper exports. There are several other products that have increased their export intensity in the two-way trade despite having no revealed comparative advantage in the respective exporting countries. It can be due to the enforcement failure of RoO. Under ISLFTA certificates of origin are issued by the individual countries for their exports. However a joint certificate mechanism in which agencies from both countries examine the authenticity of originating products can improve the enforcement of RoO.

Our study has several limitations. We have used RCA index to reflect comparative advantage in export of a product. The major limitations of this index is that it relates to "revealed" rather than "real" comparative advantage. Another disadvantage was that our analysis completely relies on official trade data, which does not capture the huge informal trade present between the two countries. So our analysis might not reflect the actual level of bilateral trade.

Moreover ending of the ethnic conflict in Sri Lanka in recent years have led to the increase in trade through the official channels. So the increase we have witnessed in our analysis maybe

due to this translation of informal to formal trade rather than having much to do with ISLFTA formation. Also our analysis on effects of ISLFTA is confined to the four years trade data we have after its operation. We cannot say whether the changes we have found in bilateral trade in recent years will be sustained or not, because of the year to year fluctuations present in such trade and the short time period in hand. However any study undertaken in this area will be bound to suffer from these problems.

Notwithstanding the limitations our study concludes that we have to focus more attention on implementing RoO properly. Circumvention of RoO may be the cause of the trade distortion as we have found in our study (we proved this in the case of copper product exports from Sri Lanka). For unravelling the mechanism behind the link between RoO and trade distortion under ISLFTA much more analysis is needed. The examination of this link in greater details within conventional trade theories seems to be a further area of research. Since India is in the process of establishing many more FTAs in the near future this issue of RoO enforcement takes a very important dimension as a policy tool.

Appendix 1

1. Introduction: Harmonised Commodity Description and Coding System (H.S. in short) is a commodity coding system in international trade. In the pre H.S. code era countries followed different coding systems for export-import operations. In 1983 for the sake of convenience a standard coding system, the H.S., was evolved under the aegis of the Customs Cooperation Council (now named as World Customs Organisation).

2. H.S. Code: The basic Harmonised System uses a 6-digit number to identify basic commodities. Each country is allowed to add additional digits for statistical purposes.

3. How the HS works:

The Harmonized System is a commodity classification system in which articles are grouped largely according to the nature of the materials of which they are made, as has been traditional in customs nomenclatures. The H.S. contains approximately 5000 headings and subheadings covering all articles in trade. These provisions are organised in 97 chapters (Chapter 77 reserved for future use by WCO) arranged in 21 sections, which, along with the interpretive rules and legal notes to the chapters and sections, form the legal text of the Harmonized System. The basic six-digit code that makes up the HS is made of three parts. The first two digits identify the chapter the goods are classified in. For example:

07	Edible Vegetables and Certain Roots and Tubers

The next two digits identify groupings within that chapter:

07.06	Carrots, Turnips, Salad Beetroot, Salsify, Celeriac, Radishes and Similar Edible Roots, Fresh or Chilled.

The next two digits are even more specific:

07.06.10	Carrots and Turnips

This is the last point at which different countries' classification codes are identical. After this point countries can add more digits to make the HS classification numbers even more specific. India has evolved the Indian Trade Classification based on Harmonised System [ITC (HS)] from 1987. India uses two additional numbers for both imports and exports. In India for exports the next step in the above progression is:

07.06.10.10	Carrots, fresh or chilled

Appendix 2
FREE TRADE AGREEMENT BETWEEN
THE REPUBLIC OF INDIA AND
THE DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA[47]
Preamble

The Government of the Republic of India and the Government of the Democratic Socialist Republic of Sri Lanka (hereinafter referred to as the "Contracting Parties").

CONSIDERING that the expansion of their domestic markets, through economic integration, is a vital prerequisite for accelerating their processes of economic development.

BEARING in mind the desire to promote mutually beneficial bilateral trade.

CONVINCED of the need to establish and promote free trade arrangements for strengthening intra-regional economic cooperation and the development of national economies.

FURTHER RECOGNIZING that progressive reductions and elimination of obstacles to bilateral trade through a bilateral free trade agreement (hereinafter referred to as "The Agreement") would contribute to the expansion of world trade. **HAVE** agreed as follows:

Article I   - Objectives
Article II   - Definitions
Article III   - Elimination of Tariffs
Article IV   - General Exceptions
Article V   - National Treatment
Article VI   - State Trading Enterprises
Article VII   - Rules of Origin
Article VIII   - Safeguard Measures
Article IX   - Domestic Legislation
Article X   - Balance of Payment Measures
Article XI   - Joint Committee
Article XII   - Consultations
Article XIII   - Settlement of Disputes
Article XIV   - Duration and Termination of Agreement
Article XV   - Amendments
Article XVI   - Annexures to be finalized
Article XVII   - Entry into Force
Annexure - 'A' - Concession offered by India
Annexure - 'B' - Concession offered by Sri Lanka
Annexure - 'C' - Rules of Origin

Article I
Objectives

1. The Contracting Parties shall establish a Free Trade Area in accordance with the provisions of this Agreement and in conformity with relevant provisions of the General Agreement on Tariff and Trade, 1994.
2. The objectives of this Agreement are:
    i.   To promote through the expansion of trade the harmonious development of the economic relations between India and Sri Lanka.
    ii. To provide fair conditions of competition for trade between India and Sri Lanka
    iii. In the implementation of this Agreement the Contracting Parties shall pay due regard to the principle of reciprocity

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iv. To contribute in this way, by the removal of barriers to trade, to the harmonious development and expansion of world trade

Article II
Definitions

For the purpose of this agreement:

1. "Tariffs" means basic customs duties included in the national schedules of the Contracting Parties.
2. "Products" means all products including manufactures and commodities in their raw, semi-processed and processed forms.
3. "Preferential Treatment" means any concession or privilege granted under this Agreement by a Contracting Party through the elimination of tariffs on the movement of goods.
4. "The Committee" means the Joint Committee referred to in Article XI.
5. "Serious Injury" means significant damage to domestic producers, of like or similar products resulting from a substantial increase of preferential imports in situations which cause substantial losses in terms of earnings, production or employment unsustainable in the short term. The examination of the impact on the domestic industry concerned shall also include an evaluation of other relevant economic factors and indices having a bearing on the state of the domestic industry of that product.
6. "Threat of serious injury" means a situation in which a substantial increase of preferential imports is of a nature so as to cause "Serious injury" to domestic producers, and that such injury, although not yet existing is clearly imminent. A determination of threat of serious injury shall be based on facts and not on more allegation, conjecture, or remote or hypothetical possibility.
7. "Critical circumstances" means the emergence of an exceptional situation where massive preferential imports are causing or threatening to cause "serious injury" difficult to repair and which calls for immediate action.

Article III
Elimination of Tariffs

The Contracting Parties hereby agree to establish a Free Trade Area for the purpose of free movement of goods between their countries through elimination of tariffs on the movement of goods in accordance with the provisions of Annexures A & B which shall form an integral part of this Agreement.

Article IV
General Exceptions

Nothing in this Agreement shall prevent any Contracting Party from taking action and adopting measures, which it considers necessary for the protection of its national security, the protection of public morals, the protection of human, animal or plant life and health, and the protection of articles of artistic, historic and archaeological value, as is provided for in Articles XX and XXI of the General Agreement on Tariff and Trade, 1994.

Article V
National Treatment

The Contracting Parties affirm their commitment to the principles enshrined in Article III of GATT 1994.

Article VI
State Trading Enterprises

1. Nothing in this Agreement shall be construed to prevent a Contracting Party from maintaining or establishing a state trading enterprise as understood in Article XVII of General Agreement on Tariff and Trade, 1994.

2. Each Contracting Party shall ensure that any state enterprise that it maintains or establishes acts in a manner that is not inconsistent with the obligations of the Contracting Parties, under this Agreement and accords non-discriminatory treatment in the import from and export to the other Contracting Party.

Article VII
Rules of Origin

1. Products covered by the provisions of this Agreement shall be eligible for preferential treatment provided they satisfy the Rules of Origin as set out in Annexure C to this Agreement which shall form an integral part of this Agreement.
2. For the development of specific sectors of the industry of either Contracting Party, lower value addition norms for the products manufactured or produced by those sectors may be considered through mutual negotiations.

Article VIII
Safeguard Measures

1. If any product, which is the subject of preferential treatment under this Agreement, is imported into the territory of a Contracting Party in such a manner or in such quantities as to cause or threaten to cause, serious injury in the importing Contracting Party, the importing Contracting Party may, with prior consultations except in critical circumstances, suspend provisionally without discrimination the preferential treatment accorded under the Agreement.
2. When action has been taken by either Contracting Party in terms of paragraph I of this Article, it shall simultaneously notify the other Contracting Party and the Joint Committee established in terms of Article XI. The Committee shall enter into consultations with the concerned Contracting Party and endeavor to reach mutually acceptable agreement to remedy the situation. Should the consultations in the Committee fail to resolve the issue within sixty days, the party affected by such action shall have the right to withdraw the preferential treatment.

Article IX
Domestic Legislation

The Contracting Parties shall be free to apply their domestic legislation to restrict imports, in cases where prices are influenced by unfair trade practices like subsidies or dumping. Subsidies and dumping shall be understood to have the same meaning as in the General Agreement on Tariff and Trade, 1994 and the relevant WTO Agreements.

Article X
Balance of Payment Measures

1. Notwithstanding the provisions of this Agreement, any Contracting Party facing balance of payments difficulties may suspend provisionally the preferential treatment as to the quantity and value of merchandise permitted to be imported under the Agreement. When such action has taken place, the Contracting Party, which initiates such action shall simultaneously notify the other Contracting Party.
2. Any Contracting Party, which takes action according to paragraph 1 of this Article, shall afford, upon request from the other Contracting Party, adequate opportunities for consultations with a view to preserving the stability of the preferential treatment provided under this Agreement.

Article XI
Joint Committee

1. A Joint Committee shall be established at Ministerial level. The Committee shall meet at least once a year to review the progress made in the implementation of this Agreement and to ensure that benefits of trade expansion emanating from this Agreement accrue to both Contracting

Parties equitably. The Committee may set up Sub-Committees and/or Working Groups as considered necessary.

2. In order to facilitate cooperation in customs matters, the Contracting Parties agree to establish a Working Group on customs related issues including harmonization of tariff headings. The Working Group shall meet as often as required and shall report to the Committee on its deliberations.

3. The Committee shall accord adequate opportunities for consultation on representations made by any Contracting Party with respect to any matter affecting the implementation of the Agreement. The Committee shall adopt appropriate measures for settling any matter arising from such representations within 6 months of the representation being made. Each Contracting Party shall implement such measures immediately.

4. The Committee shall nominate one apex chamber of trade and industry in each country as the nodal chamber to represent the views of the trade and industry on matters relating to this Agreement.

Article XII
Consultations

1. Each Contracting Party shall accord sympathetic consideration to and shall afford adequate opportunity for, consultations regarding such representations as may be made by the other Contracting Party with respect to any matter affecting the operation of this Agreement.

2. The Committee may meet at the request of a Contracting Party to consider any matter for which it has not been possible to find a satisfactory solution through consultations under paragraph 1 above.

Article XIII
Settlement of Disputes

1. Any dispute that may arise between commercial entities of the Contracting Parties shall be referred for amicable settlement to the nodal apex chambers. Such references shall, as far as possible, be settled through mutual consultations by the Chambers. In the event of an amicable solution not being found, the matter shall be referred to an Arbitral Tribunal for a binding decision. The Tribunal shall be constituted the Joint Committee in consultation with the relevant Arbitration Bodies in the two countries.

2. Any dispute between the Contracting Parties regarding the interpretation and application of the provisions of this Agreement or any instrument adopted within its framework shall be amicably settled through negotiations failing which a notification may be made to the Committee by any one of the Contracting Parties.

Article XIV
Duration and Termination of Agreement

This Agreement shall remain in force until either Contracting Party terminates this Agreement by giving six months written notice to the other of its intention to terminate the Agreement.

Article XV
Amendments

The Agreement may be modified or amended through mutual agreement of the Contracting Parties. Proposals for such modifications or amendments shall be submitted to the Joint Committee and upon acceptance by the Joint Committee, shall be approved in accordance with the applicable legal procedures of each Contracting Party. Such modifications or amendments shall become effective when confirmed through an exchange of diplomatic notes and shall constitute an integral part of the Agreement.

Provided however that in emergency situations, proposals for modifications may be considered by the Contracting Parties and if agreed, given effect to through an exchange of diplomatic notes.

Article XVI
Annexures to be finalized

Annexure D (i) and D (ii) (Negative Lists of India and Sri Lanka respectively), E (Items on which India has undertaken to give 100 % tariff concession on coming into force of the Agreement) and F (Items on which Sri Lanka has undertaken to give 100 % tariff concession on the coming into force of the Agreement) shall be finalised within a period of 60 days of the signing of this Agreement. All the Annexures shall form an integral part of the Agreement.

Article XVII
Entry into Force

The Agreement shall enter into force on the thirtieth day after the Contracting Parties hereto have notified each other that their respective constitutional requirements and procedures have been completed.

In witness where of the undersigned, duly authorised thereto by their respective Governments, have signed this Agreement.

Done in duplicate at New Delhi this 28th day of December 1998 in two originals in the English language.

Sd/-   Sd/-
For the Government of the   For the Government of the Democratic
Republic of India   Socialist Republic of Sri Lanka

Annexure – 'A'
Concession offered by India

The Government of India shall grant duty free access to all exports from Sri Lanka in respect of items freely importable into India, except on items listed in Annex D of this Agreement, in accordance with the phase out schedule detailed below:
1. Upon entry into force of the Agreement :-
   a. Zero duty access for the items in Annexure 'E'
   b. 50 % margin of preference on the remaining items except on items listed in Annexure D. Concessions on items in Chapters 51 to 56, 58 to 60 and 63 shall be restricted to 25 %.
2. The margin of preference on the items mentioned in (b) above shall be increased to 100 % in two stages within three years of the coming into force of the Agreement, except for the textiles items referred to in 1(b) above.

Annexure – 'B'
Concession offered by Sri Lanka

Government of Sri Lanka shall provide tariff concessions on exports from India to Sri Lanka in respect of items freely importable into Sri Lanka, as detailed below: -
1. Zero duty for the items in Annex 'F' – I, upon entering into force of the Agreement.
2. 50 % margin of preference for the items in Annex 'F' – II, upon coming into force of the Agreement. The margin of preference in respect of these items shall be deepened to 70 %, 90 % and 100 %, respectively, at the end of the first, second and third year of the entry into force of the Agreement.
3. For the remaining items except those in Annex 'D', the tariffs shall be brought down by not less than 35 % before the expiry of three years and 70 % before the expiry of the sixth year and 100 % before the expiry of eight years, from the date of entry into force of the Agreement.

Annexure – 'C'
RULES OF ORIGIN

1. **Short title/commencement**

   These rules may be called the rules of Determination of Origin of Goods under the Free Trade Agreement between the Democratic Socialistic Republic of Sri Lanka and the Republic of India.

2. **Application**

   These rules shall apply to products consigned from the territory of either of the Contracting Parties.

3. **Determination of Origin**

   No product shall be deemed to be the produce or manufacture of either country unless the conditions specified in these rules are complied with in relation to such products, to the satisfaction of the appropriate Authority.

4. **Claim at the time of importation**

   The importer of the product shall, at the time of importation:

   a. make a claim that the products are the produce or manufacture of the country from which they are imported and such products are eligible for preferential treatment under the Agreement, and

   b. produce the evidence specified in these rules.

5. **Originating products**

   Products covered by the Agreement imported into the territory of a Contracting Party from another Contracting Party which are consigned directly within the meaning of rule 9 hereof, shall be eligible for preferential treatment if they conform to the origin requirement under any one of the following conditions:

   a. Products wholly produced or obtained in the territory of the exporting Contracting Party as defined in rule 6; or

   b. Products not wholly produced or obtained in the territory of the exporting Contracting Party, provided that the said products are eligible under rule 7/ rule 8.

6. **Wholly produced or obtained**

   Within the meaning of rule 5(a), the following shall be considered as wholly produced or obtained in the territory of the exporting Contracting Party:

   a. raw or mineral products extracted from its soil, its water or its seabed;

   b. vegetable products harvested there;

   c. animals born and raised there;

   d. products obtained from animals referred to in clause (c) above;

   e. products obtained by hunting or fishing conducted there;

   f. products of sea fishing and other marine products from the high seas by its vessels[3,4];

   g. products processed and/or made on board its factory ships exclusively from products referred to in clause (f) above[4,5];

   h. used articles collected there, fit only for the recovery of raw materials;

   i. waste and scrap resulting from manufacturing operations conducted there;

   j. products extracted from the seabed or below seabed which is situated outside its territorial waters, provided that it has exclusive exploitation rights;

   k. goods produced there exclusively from the products referred to in clauses (a) to (j) above.

7. **Not wholly produced or obtained**

   a. Within the meaning of rule 5(b), products worked on or processed as a result of which the total value of the materials, parts or produce originating from countries other than the Contracting Parties or of undetermined origin used does not exceed 65% of the f.o.b. value of the products produced or obtained and the final process of manufacture is performed within the territory of the exporting Contracting Party shall be eligible for preferential treatment, subject to the provisions of clauses (b), (c), (d) and (e) of rule 7 and rule 8.

   b. Non-originating materials shall be considered to be sufficiently worked or processed when the product obtained is classified in a heading, at the four digit level, of the

Harmonised Commodity Description and Coding System different from those in which all the non-originating materials used in its manufacture are classified.

c. In order to determine whether a product originates in the territory of a Contracting Party, it shall not be necessary to establish whether the power and fuel, plant and equipment, and machines and tools used to obtain such products originate in third countries or not.

d. The following shall in any event be considered as insufficient working or processing to confer the status of originating products, whether or not there is a change of heading:

1. Operations to ensure the preservation of products in good condition during transport and storage (ventilation, spreading out, drying, chilling, placing in salt, sulphur dioxide or other aqueous solutions, removal of damaged parts, and like operations).

2. Simple operations consisting of removal of dust, sifting or screening, sorting, classifying, matching (including the making-up of sets of articles), washing, painting, cutting up;

3. (i) changes of packing and breaking up and assembly of consignments,
   (ii) simple slicing, cutting and repacking or placing in bottles, flasks, bags, boxes, fixing on cards or boards, etc., and all other simple packing operations.

4. the affixing of marks, labels or other like distinguishing signs on products or their packaging;

5. simple mixing of products, whether or not of different kinds, where one or more components of the mixture do not meet the conditions laid down in these Rules to enable them to be considered as originating products;

6. simple assembly of parts of products to constitute a complete product;

7. a combination of two or more operations specified in (a) to (f);

8. slaughter of animals.

e. The value of the non-originating materials, parts or produce shall be:

i. The c.i.f. value at the time of importation of the materials, parts or produce where this can be proven; or

ii. The earliest ascertainable price paid for the materials, parts or produce of undetermined origin in the territory of the Contracting Parties where the working or processing takes place.

8. Cumulative rules of origin

In respect of a product, which complies with the origin requirements provided in rule 5(b) and is exported by any Contracting Party and which has used material, parts or products originating in the territory of the other Contracting Party, the value addition in the territory of the exporting Contracting Party shall be not less than 25 % of the f.o.b. value of the product under export subject to the condition that the aggregate value addition in the territories of the Contracting Parties is not less than 35 % of the f.o.b. value of the product under export.

9. Direct consignment

The following shall be considered to be directly consigned from the exporting country to the importing country:

a) if the products are transported without passing through the territory of any country other than the countries of the Contracting Parties.

b) The products whose transport involves transit through one or more intermediate countries with or without transshipment or temporary storage in such countries; provided that

i. the transit entry is justified for geographical reason or by considerations related exclusively to transport requirements;

ii. the products have not entered into trade or consumption there; and

iii. the products have not undergone any operation there other than unloading and reloading or any operation required to keep them in good condition.

10. Treatment of packing

When determining the origin of products, packing should be considered as forming a whole with the product it contains. However, packing may be treated separately if the national legislation so requires.

11. **Certificate of origin**

   Products eligible for a Certificate of origin in the form annexed shall support preferential treatment issued by an authority designated by the Government of the exporting country and notified to the other country in accordance with the certification procedures to be devised and approved by both the Contracting Parties.

12. **Prohibitions**

   Either country may prohibit importation of products containing any inputs originating from States with which it does not have economic and commercial relations;

13. **Co-operation between contracting parties**

   a. The Contracting Parties will do their best to co-operate in order to specify origin of inputs in the Certificate of origin.

   b. The Contracting Parties will take measures necessary to address, to investigate and, where appropriate, to take legal and/or administrative action to prevent circumvention of this Agreement through false declaration concerning country of origin or falsification of original documents.

   c. Both the Contracting Parties will co-operate fully, consistent with their domestic laws and procedures, in instances of circumvention or alleged circumvention of the Agreement to address problems arising from circumvention including facilitation of joint plant visits and contacts by representatives of both Contracting Parties upon request and on a case – by – case basis.

   d. If either Party believes that the rules of origin are being circumvented, it may request consultation to address the matter or matters concerned with a view to seeking a mutually satisfactory solution. Each party will hold such consultations promptly.

14. **Review**

   These rules may be reviewed as and when necessary upon request of either Contracting Party and may be open to such modifications as may be agreed upon.

   Notes:

   1. Includes mineral fuels, lubricants and related materials as well as mineral or metal ores

   2. Includes agricultural and forestry products

   3. "Vessels" shall refer to fishing vessels engaged in commercial fishing, registered in the country of the Contracting Party and operated by a citizen or citizens of the Contracting Party or partnership, corporation or association, duly registered in such country, at least 60 % of equity of which is owned by a citizen or citizens and/or Government of such Contracting Party or 75 % by citizens and/or Governments of the Contracting Parties. However, the products taken from vessels, engaged in commercial fishing under Bilateral Agreements which provide for chartering/leasing of such vessels and/or sharing of catch between Contracting Party will also be eligible or preferential treatment.

   4. In respect of vessels or factory ships operated by Government agencies, the requirements of flying the flag of the Contracting Party does not apply.

   5. For the purpose of this Agreement, the term "factory ship" means any vessel, as defined, used for processing and/or making on board products exclusively from those products referred to in clause (f) of Rule 6.

   6. Cumulation as implied by Rule 8 means that only products which have acquired originating status in the territory of one Contracting Party may be taken into account when used as inputs for a finished product eligible for preferential treatment in the territory of the other Contracting Party.

CERTIFICATE OF ORIGIN

1. Goods consigned from (Exporters' Business Name, Address, Country)	Reference No. INDO-SRI LANKA FREE TRADE AGREEMENT (ISFTA) (Combined declaration and certificate) Issued in............................... (Country) (See notes overleaf)				
2. Goods consigned to (Consignee's Name, Address, Country)	4. For Official use				
3. Means of transport and route (as far as known)					
5. Tariff item number	6. Marks and numbers of packages	7. Number and kind of packages: description of goods	8. Origin criterion (see Notes overleaf)	9. Gross weight or other quantity	10. Number and date of invoice
11. Declaration by the Exporter The undersigned hereby declares that the above details and statements are correct; That all the goods were produced in .... (Country) and that they comply with the origin requirements specified for those goods in ISFTA for goods exported to .... (Importing Country) .... Place and date, signature of the authorised signatory	12. Certificate: It is hereby certified, on the basis of control carried out that the declaration by the exporter is correct. .... Place and date, signature and stamp of certifying authority.				

I. To qualify for preference, products must:

1. fall within a description of products eligible for concessions in the country of destination under this agreement.

2. comply with ISFTA Rules of Origin. Each Article in a consignment must qualify separately in its own right; and

3. comply with the consignment conditions specified by the ISFTA Rules of Origin. In general products must be consigned directly within the meaning of Rule 9 hereof from the country of exportation to the country of destination.

II. Entries to be made in Box 8:

Preference products must be wholly produced or obtained in the exporting Contracting Party in accordance with Rule 6 of the ISFTA Rule of Origin, or where not wholly produced or obtained in the exporting Contracting Party must be eligible under Rule 7 or Rule 8.

a. Products wholly produced or obtained enter the letter 'A' in box 8.

b. Products not wholly produced or obtained; the entry in box 8 should be as follows:

1. Enter letter 'B' in box 8 for products, which meet the origin criterion according to Rule 7. Entry of letter would be followed by the sum of the value of materials, parts or produce originating from non-contracting parties or undetermined origin used, expressed as a percentage of the f.o.b. value of the products; (example B( ) percent).

2. Enter letter 'C' in box 8 for products, which meet the origin criteria according to Rule 8. Entry of letter 'C' would be followed by the sum of the aggregate content originating in the territory of the exporting Contracting Party expressed as a percentage of the f.o.b. value of the exported product: (example 'C' ( ) per cent).

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