

1.2 trillion dollar GDP, 1.1 billion people: How best can we grow with India?

Rohan Samarajiva & Priyanwada Herath*



India is one of the world's most dynamic economies and attractive markets. Sri Lanka has had strong relations with India by reason of proximity and history. Managing relations with India, preferably in a way that can allow Sri Lanka to share its dynamism, is one of the most important challenges facing Sri Lanka. Since 2000, when the India Sri Lanka Free Trade Agreement came into effect, India has featured large in Sri Lanka's economic relationships, in trade in goods as well in services, and in terms of investment. The significance of these relations is documented. The question that has been raised by the stalled Comprehensive Economic Partnership Agreement between the two countries is how best this most important relationship can be managed, with a disciplinary framework (a set of enforceable rules) or not. Drawing from theory and international experience, it is argued that a disciplinary framework that governs goods, services and investment is essential, especially where asymmetry of power exists. The conditions for fair treatment by India are discussed as well as the different interest-groups who will and will not be open to evidence-based discussion.

* Thanks to Payal Malik and Nalini Wijewardena, as well as the Sri Lanka Department of Commerce for data collection assistance. Charitha Ratwatte and Luxman Siriwardene provided helpful comments. Responsibility for conclusions and analysis remains with the authors.

Table of Contents

Importance of the relationship	4
Trade.....	4
<i>Table 1: Destinations of Sri Lanka's Exports: Top 5 Countries in 2007</i>	<i>4</i>
<i>Table 2: Origin of Sri Lanka's Imports: Top 5 Countries in 2007.....</i>	<i>5</i>
<i>Figure 1: Trade between India and Sri Lanka 2001-2007.....</i>	<i>6</i>
<i>Figure 2: Sri Lanka's Total Trade and Trade Balance with India 2001-2007.....</i>	<i>7</i>
<i>Figure 3: Export and Import Growth: Annual Percentage Change.....</i>	<i>8</i>
<i>Table 3: Trade between India and Sri Lanka 2001-2002 (USD millions)</i>	<i>8</i>
Investment.....	10
<i>Figure 4: FDI Top Five Countries Investing in Sri Lanka.....</i>	<i>10</i>
<i>Table 4: FDI Flows to Sri Lanka</i>	<i>11</i>
<i>Table 5: Status of Realized Indian FDI in Sri Lanka by end of 2007</i>	<i>12</i>
<i>Figure 5: Cumulative Increase in FDI from India to Sri Lanka 1993-2007 (excluding local share of investment)</i>	<i>13</i>
<i>Figure 6: Sectoral Distribution of FDI from India to Sri Lanka.....</i>	<i>14</i>
<i>Table 6: Employment in Indian FDI in Commercial Operation by end of 2007</i>	<i>15</i>
Tourism.....	15
<i>Table 7: Top Five Tourist Arrival Countries to Sri Lanka</i>	<i>15</i>
<i>Figure 7: Tourist Arrivals to Sri Lanka by Purpose of Visit 2007.....</i>	<i>16</i>
<i>Table 8: India's Top Five Tourist Source Markets</i>	<i>17</i>
Port and airport services	17
Health and education services.....	18
Discussion	18
Value of a disciplining framework	19
Special problems of non-tariff barriers and services.....	21
Fair treatment by India	25
References	28
Annexes	30

“Living next to you is in some ways like sleeping with an elephant. No matter how friendly and even-tempered is the beast, if I can call it that, one is affected by every twitch and grunt.” Late Prime Minister of Canada Pierre Elliot Trudeau addressing the Press Club in Washington, D.C., USA (25 March 1969)

Both space imagery and legend testify to the antiquity of bilateral relations between Sri Lanka and India, though not without contradiction. Legend is that the crescent-like underwater protuberances are the remains of the bridge built by Lord Hanuman, the monkey god, as part of the war described in the epic, *The Ramayana*. Buddhism, the religion that defines the culture of the Sinhalese, came from India. Tamil is spoken on both sides of the Palk Strait. Sri Lanka gained independence in 1948 as a collateral effect of the successful Indian independence movement. Sri Lanka’s Tamil militants were trained and protected by the Indian government at the outset, for which they suffered among other things the suicide assassination of former Prime Minister Rajiv Gandhi. Indeed, the relationship between the two countries is as deep and complex as any could be.

Except for a bad patch in the 1980s and early 1990s, relations between the two countries have been very friendly; indeed it could be said that they are the best among South Asian countries. But the two countries are very different in size, power and endowments (see Annex 1).

Asymmetry is hard to manage. But in the same way that Canada has no alternative but to manage its relationship with its giant neighbor, Sri Lanka has no alternative but manage its relationship with its large neighbor that has become one of the most dynamic economies in the world and a nascent world power. This paper seeks to contribute to a realistic and informed discussion on how best this relationship can be managed, with emphasis on trade and investment. The stalled India-Sri Lanka Comprehensive Economic Partnership Agreement (CEPA) (Samarajiva, 2008) is not

the sole focus, though it cannot but be a key element in the discussion, and therefore, of this paper.

Importance of the relationship

Trade

Sri Lanka's trade profile has shown remarkable changes during the past few years with an increase in the share of trade with India, particularly after 2000. Initially Sri Lanka's main trading partners were the developed industrialized countries, particularly the USA, Japan and Western European countries. Even after the increase in exports of manufactured products following policy reforms in 1977, Sri Lanka continued to cater to Western markets. In the years after 2000, India emerged as a major player.

Sri Lanka's exports to India which were worth USD 55 million in 2000 reached USD 515.3 million in 2007 (Table 1). This was an increase of 838 percent over seven years, compared with a total export growth of 47.5 percent. India was the third largest destination for Sri Lanka's exports by 2007, behind the USA and UK. As recently as in the 1990s, India was the 22nd largest destination for Sri Lankan exports (Central Bank of Sri Lanka 1997). By 2002, India was the fifth largest destination (Joint Study Group on Indo-Sri Lanka CEPA 2003).

Table 1: Destinations of Sri Lanka's Exports: Top 5 Countries in 2007

Country	2000	2007	% Change
	USD mn ^(a)	USD mn	
USA	2075	1,970	-5.1
UK	697	1,018	46.0
India	55	515.3	838.0
Germany	218	437.9	101.0
Belgium	147	400.1	171.3
Total Exports	5,248	7,740	47.5

Source: Central Bank of Sri Lanka

Note: Not necessarily the top 5 in 2000. Data from 2000 given for comparison only.

In 1997 India became the largest source of imports. Prior to that, India was second to Japan (Central Bank of Sri Lanka 1997, 2007). Sri Lanka's imports from India were valued at USD 568 million in 2000. They recorded rapid growth reaching USD 2,610 million by 2007 (Table 2). Imports from India increased by 359.5 percent during 2000-2007, compared with overall growth of 63.2 percent.

Table 2: Origin of Sri Lanka's Imports: Top 5 Countries in 2007

Country	2000 USD		
	mn ^(a)	2007 USD mn	% Change
India	568	2610	359.5
Singapore	469	1119	138.2
China	370	924	150.0
Iran	192	844	338.8
Hong Kong	488	725	48.4
Total imports	6,923	11,301	63.2

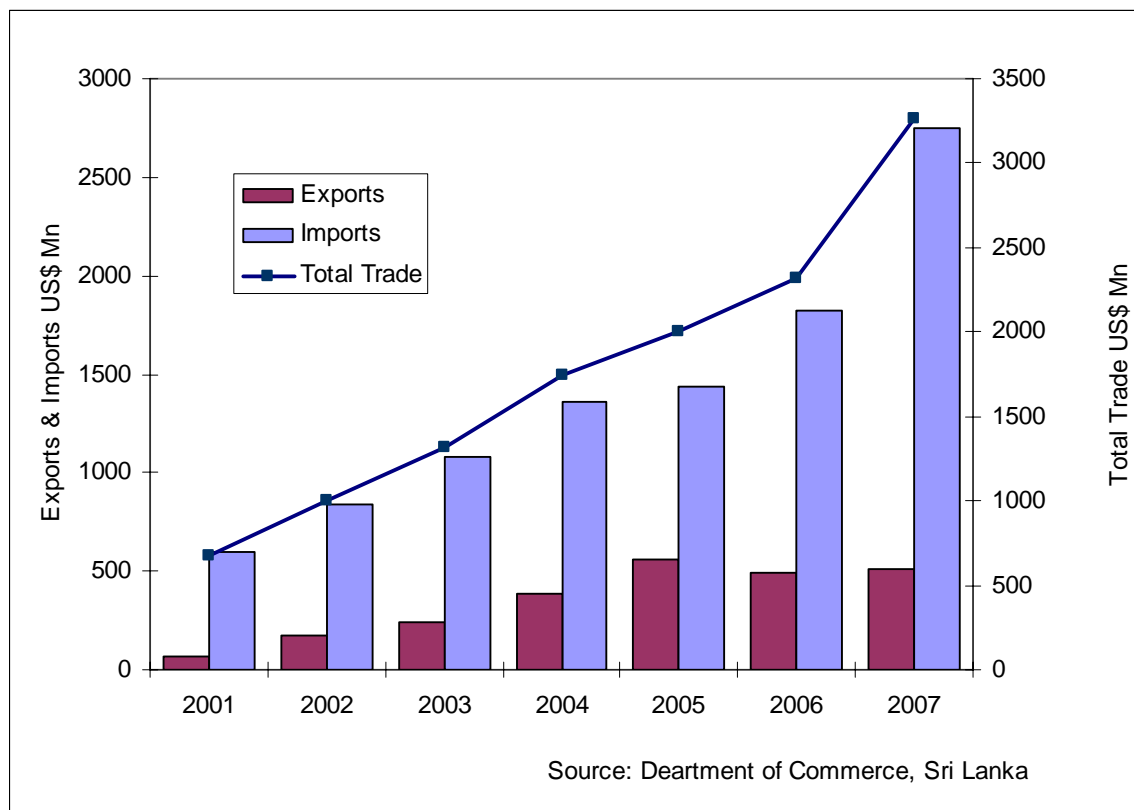
Source: Central Bank of Sri Lanka

Note: Not necessarily the top 5 in 2000. 2000 data given for comparison only.

Trade expansion requires liberalization by both trading partners. This condition was satisfied in the 1990s with the initiation of policy reforms in India. However, impetus for trade expansion also came from bilateral and multilateral trade agreements. The Indo-Lanka Free Trade Agreement (FTA) was negotiated by 1998 and implemented in 2000. The South Asian Preferential Agreement (SAPTA), which was effective since 1997, provided limited scope for trade expansion under preferential tariffs among the South Asian countries. The FTA, however, increased the salience of the subject even prior to coming into operation, and introduced significant reductions in tariffs. Tariff reductions across a wide range of commodities resulted in a rise in Sri Lanka's exports to India (Mukherji et al. 2003).

The items covered by the agreement were eligible for preferential treatment, provided they met the stated rules of origin¹ criteria. India's progress in removing non-tariff barriers (NTBs) was slow, while Sri Lanka did not have any significant NTBs at the time. After the FTA review meeting in 2002, quota restrictions and rules-of-origin criteria were relaxed and additional Indian ports opened for Sri Lankan exports. These restrictions had been identified as NTBs affecting exports to India.

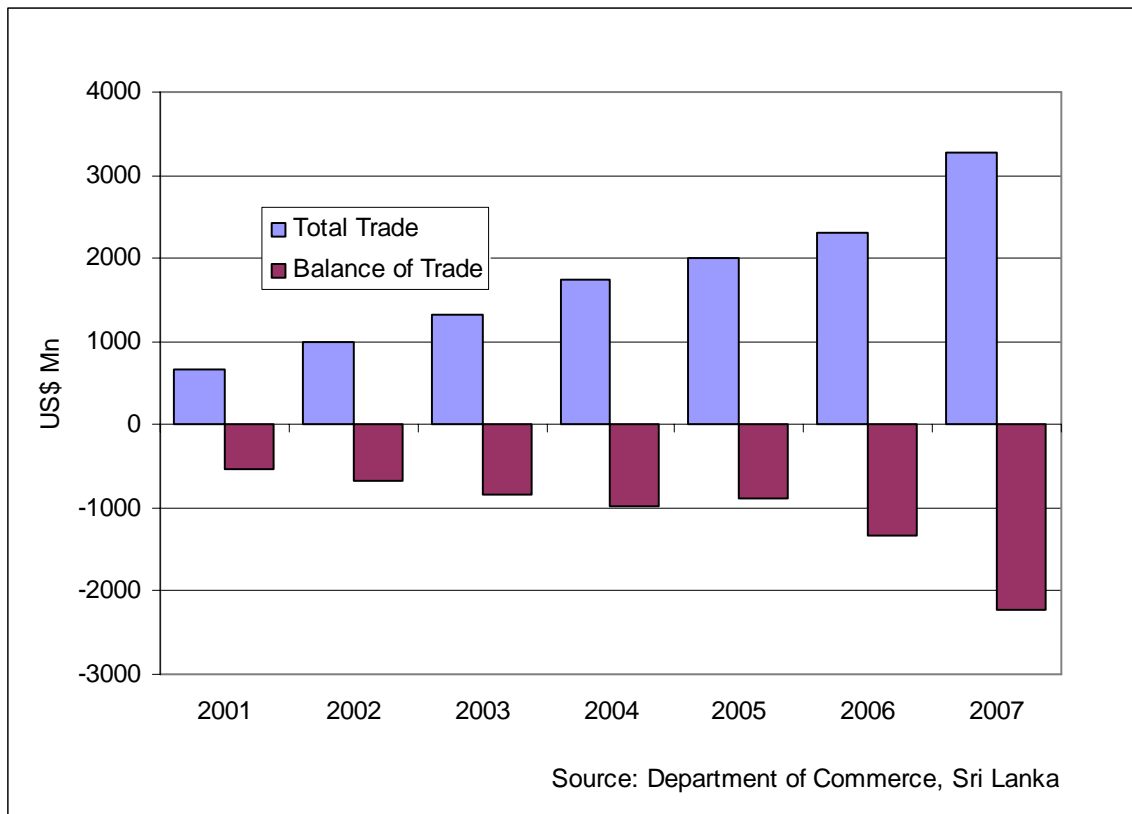
Figure 1: Trade between India and Sri Lanka 2001-2007



Total Sri Lanka-India trade (exports plus imports) increased from USD 671.6 million in 2001 to USD 3,265.2 in 2007 (Figure 1). However, the increase in export volume was lower than the increase in import volume. From 2001 to 2007, exports to India grew from USD 70 million to USD 516 million, while imports grew from USD 602 million to USD 2,750 million. Therefore, the bilateral trade balance increased in favor of India from USD 531 in 2001 to USD 2,234 million in 2007 (Figure 2).

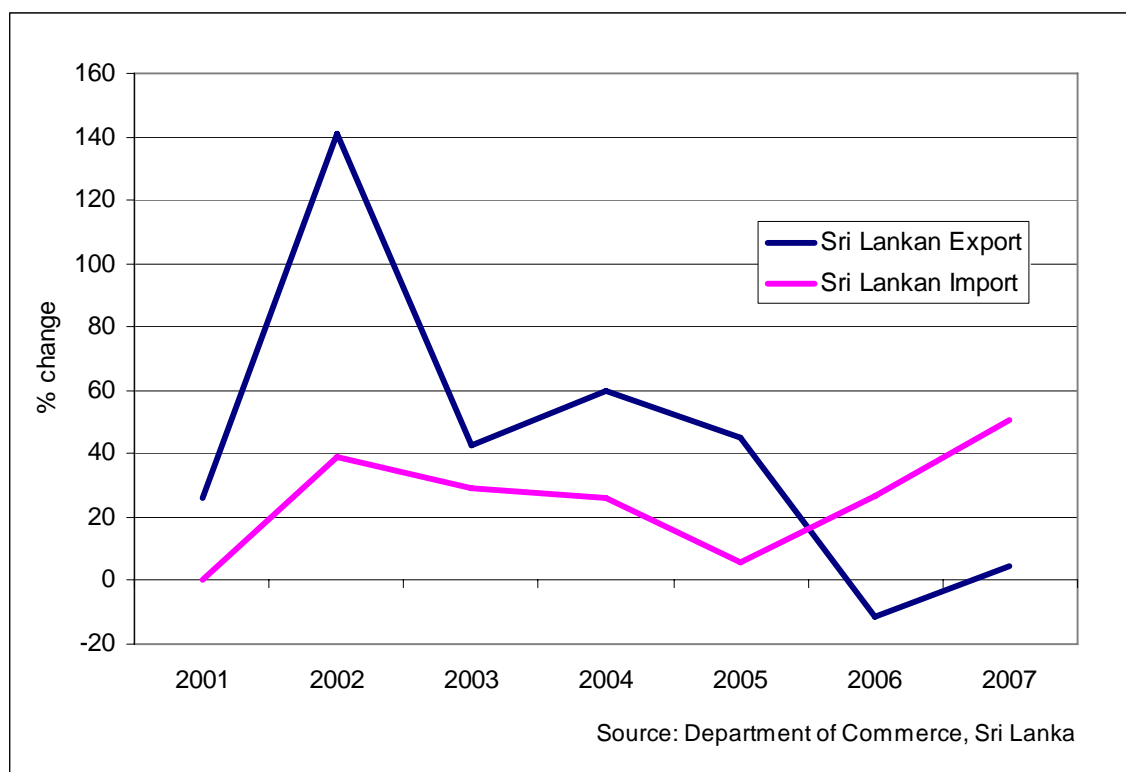
¹ Local value addition has to be more than 35 percent of the output value to be eligible for export under the FTA.

Figure 2: Sri Lanka's Total Trade and Trade Balance with India 2001-2007



Nevertheless, Sri Lanka's exports to India grew at faster pace than imports during the initial period of 2001-2005 (Figure 3). During 2006-2007, the trade deficit increased because of increased petroleum imports and decreased exports.

Figure 3: Export and Import Growth: Annual Percentage Change



The import/export ratio decreased from 8.6:1 in 2001 to 2.6:1 in 2005, but started to increase after 2006 as a result of growing petroleum imports and decreases in major export items from Sri Lanka such as vanaspati and copper (Table 3), but was still lower than at the start of the FTA.

Table 3: Trade between India and Sri Lanka 2001-2002 (USD millions)

Year	Exports	Imports	Total Trade	Balance of Trade	Import / Export Ratio
2001	70.1	601.5	671.6	-531.4	8.6:1
2002	168.9	834.7	1,003.6	-665.8	4.9:1
2003	241.1	1,076.2	1,317.3	-835.0	4.5:1
2004	385.5	1,358.0	1,743.5	-972.5	3.5:1
2005	559.3	1,440.4	1,999.7	-881.1	2.6:1
2006	494.1	1,822.1	2,316.2	-1,328	3.7:1

2007	515.6	2,749.6	3,265.2	-2,234	5.3:1
------	-------	---------	---------	--------	-------

Source: Department of Commerce, Sri Lanka

The Compound Annual Growth Rate (CAGR)² of exports to India was 25.1 percent; the CAGR of imports was 27.3 percent during 2002-2007 (Annexes 2 and 3).

In 2002, the main exports to India were pepper, cloves and refined copper products. By 2007, exports were more diverse. Major export items (value more than USD 10 million) included insulated wires and cables (HS 8544), vegetable fats, oils, palm oils, margarines (HS 151620, 151110, 151790), articles of stone, plaster, cement (HS 68), rubber and articles thereof (HS 40), other including unsorted waste (HS 470790), pepper (HS 090411) and refined copper products (HS 7403). CAGR was more than 200 percent for insulated wires and cables (HS 8544) and other margarine (HS 151790). Vegetable fats and oils also grew by over 144 percent. Palm oils and fats (HS 151110), articles of stone, plaster, and cement (HS 68) and, rubber and articles thereof (HS 40) showed CAGRs ranging from 50 to 99 percent. There were also a few export products such as refined copper products (HS 7403), cloves (HS 090700), articles of apparel & clothing (HS 392620), unwrought aluminum (HS 7601 and, aluminum wire (HS 7605) which declined after 2005 (Annex 2).

Among Sri Lanka's major imports from India, light oils and preparations (HS 271011), other kerosene, diesel, gas and oil (HS 271019), motor vehicles (HS 8704) and, copper and articles thereof (HS 74) grew at high CAGRs of 55-88 percent. Motor cycles (HS 8704), carbon (HS 280300), plastics and articles thereof (HS 39), motor cars (HS 8703) and, aluminum and articles thereof (HS 76) showed CAGRs of 20-40 percent. Imports of electrical machinery (HS 85) and lentils (HS 071340) declined during 2002-2007 (Annex 3).

$$^2 CAGR(t_0, t_n) = \left\{ \left[\frac{V(t_n)}{V(t_0)} \right]^{\frac{1}{(t_n - t_0)}} - 1 \right\} 100$$

V(t₀) : Start value

V(t_n) : End value

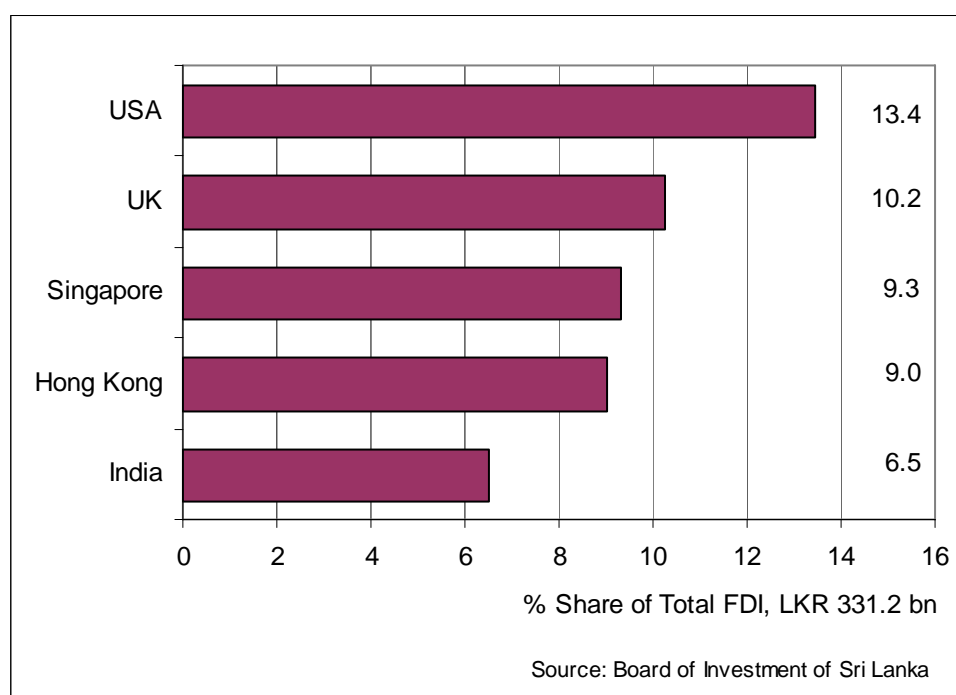
t_n - t₀ : number of years

Imports of major items such as motor vehicles, petroleum products, agricultural products and paper products, being in the negative list of the FTA, grew as part of normal trade. According to the Department of Commerce, Sri Lanka's imports under the FTA which amounted to LKR 42,627 million in 2007 was only about 14 percent of the country's total imports from India. This suggests that imports from India would have increased rapidly even without the FTA.

Investment

Sri Lanka has become an attractive destination for Indian Foreign Direct Investment (FDI), particularly since 2000. India was one of the top-five countries investing in Sri Lanka by the end of 2007, accounting for 6.5 percent of the total FDI stock of LKR 331.2 billion (Figure 4). The Board of Investment of Sri Lanka (BOI) states that over half of Indian investments in the SAARC region are located in Sri Lanka (www.boi.lk).

Figure 4: FDI Top Five Countries Investing in Sri Lanka



According to the *World Investment Report 2006* (UN, 2006: 315), Sri Lanka's FDI stock in 2005 was 10.4 percent of its GDP, higher than the average of 6.2 percent for South Asia and much lower than the 43.2 percent average in South East Asia. Annual

FDI flows to Sri Lanka averaged USD 339 million during the period 2001-2007 (Table 4). Significant increases in 2006-2007 were driven primarily by the expanding telecom industry. Contributing on average USD 33 million per annum, India accounted for over 16 percent of total FDI flows during 2001-2007.

Table 4: FDI Flows to Sri Lanka

	Total FDI	Indian FDI	
	USD	USD	% of
	million	million	Total
2001	82	42	51.2
2002	220	20	9.1
2003	212	50	23.6
2004	234	28	12.0
2005	287	18	6.3
2006	604	27	4.5
2007	734	43	5.9

Source: Board of Investment of Sri Lanka

The conditions for increased Indian FDI since 2000 were created by developments in the trade and investment climate in the region. Policy reforms, since 1978 in Sri Lanka and since 1991 in India had made conditions more conducive to bilateral trade and investment flows.

The increase in Indian FDI can be partially attributed to the FTA. It increased the scope for the expansion of trade in goods between the two countries, and thereby broadened the scope for investment expansion to exploit the advantages of bilateral trade between India and Sri Lanka. Besides, Sri Lanka had already entered into a bilateral Investment Promotion and Protection Agreement (IPPA) with India to promote foreign investment in 1997.

By 2003, the two countries were making preparations for the proposed CEPA, which was on a fast track at that time. Under that the process of bilateral economic integration was to be expanded to include trade in services and investment. However, even without an agreement as such, the higher trade profile of Sri Lanka resulting from the bilateral agreements and negotiations appear to have caused Indian FDI to Sri Lanka to increase.

The BOI also improved its facilitation of FDI flows from India. Under the BOI Act of 2002, it established Regional Economic Development Commissions within the country and set up its first overseas office in Bangalore in 2005 as part of a greater focus on India.

By the end of 2007, realized FDI from India to Sri Lanka was LKR 28.6 billion in 90 projects (Table 5). This included 20 projects with investments totaling LKR 5.8 billion awaiting commercial operation. Realized Indian FDI included joint ventures, which meant that the Indian share of investment was 71.5 percent of the total.

Table 5: Status of Realized Indian FDI in Sri Lanka by end of 2007

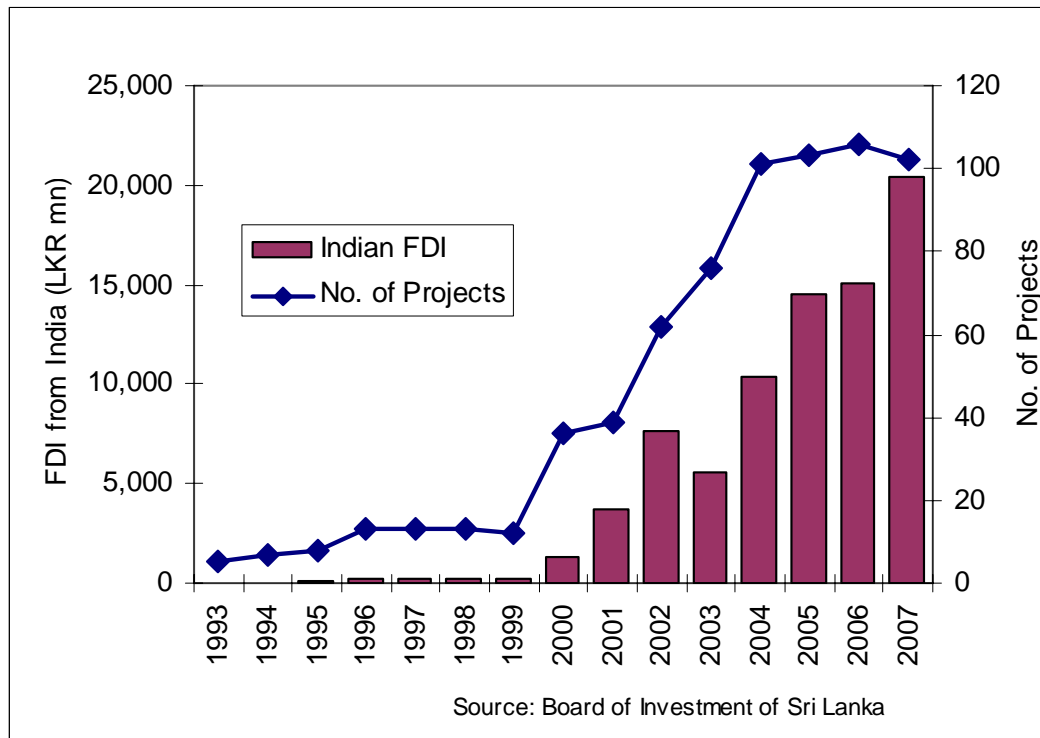
Status	No. of Projects	Investment	
		Total in LKR bn	Local share (%)
Realized Investment	90	28.6	28.5
In Commercial Operation	70	22.7	33.3
Awaiting Operation	20	5.8	9.8

Source: Board of Investment of Sri Lanka

Until the end of 1990s, there was little FDI from India to Sri Lanka. There were only 12 Indian FDI projects, with a total value of LKR 177 million. It was after 2000 that the FDI flows from India increased rapidly (Figure 5). Indian FDI (the foreign country

shares only, excluding the local contribution) increased to over LKR 20 billion under 90 projects by the end of 2007.

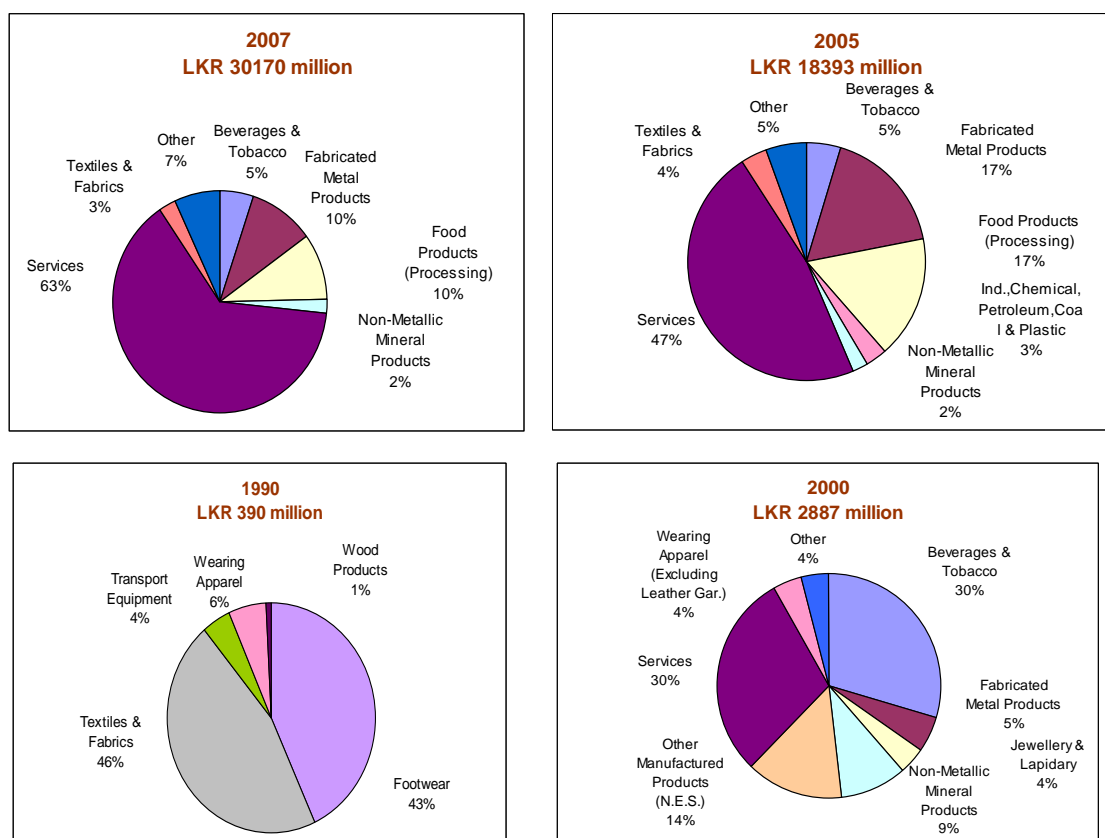
Figure 5: Cumulative Increase in FDI from India to Sri Lanka 1993-2007 (excluding local share of investment)



In the post-2000 expansion the sectoral distribution of Indian FDI flows changed remarkably (Figure 6). Indian FDI is now mostly in the service sector, amounting to 63 percent of total; in 2000, the service-sector share was only 30 percent. There was no service-sector investment from India in 1990. This change was due to the fast growth of Indian investment in services such as health, education, fuel distribution, hotel industry, tourism, IT training, computer software and professional services.

In 1990, Indian FDI was concentrated in two sectors: 46 percent being in textiles and 43 percent in footwear. However, expansion of Indian FDI in other sectors has reduced this share to 3 percent by 2007. Similarly, Indian FDI in beverage & tobacco which was 30 percent in 2000 declined to just 5 percent by 2007.

Figure 6: Sectoral Distribution of FDI from India to Sri Lanka



Source: Board of Investment of Sri Lanka

By 2007, in addition to the service sector, Indian investment was present in the fabricated metal and food industries. The FTA provided opportunities for Indian investors to produce in Sri Lanka for export to India. For instance, vanaspatti and copper exports grew rapidly for this reason, competing with Indian domestic producers. Approval for exports of copper products to India under the FTA was granted in 2000 and for vanaspatti in 2003. According to the BOI, Indian investment in copper projects amounted to LKR 2 billion, with exports to India amounting to LKR 6.6 billion by 2006. Indian investment in vanaspatti projects amounted to LKR 5.6 billion and resulted in exports to India of LKR 8.6 billion by 2006.

Indian FDI has provided 6,747 employment opportunities in 70 projects by the end of 2007 (Table 6). There were 40 projects with employment less than 49 (for a total of 711); and 18 projects with employment between 25 and 99 (total 1,215). Twelve

large projects with more than 100 employees provided employment to 4,811 persons.

Table 6: Employment in Indian FDI in Commercial Operation by end of 2007

Employment	No. of projects	No. of employed	Investment (LKR mn)
1 < 9	12	60	2,716
10 < 24	16	247	780
25 < 49	12	404	3,099
50 < 99	18	1,215	3,145
100 < 499	10	2,097	12,389
Over 500	2	2,724	587
Total	70	6,747	22,715

Source: Board of Investment of Sri Lanka

Tourism

India is Sri Lanka's biggest source market ahead of the UK, Germany, Maldives and Australia (Table 7). During 2002-2007 tourist arrivals from India grew rapidly at 20.9 percent per annum (CAGR). Tourist arrivals from Western countries grew slowly, if at all, due to security perceptions. Improved bilateral relations between India and Sri Lanka, including visa liberalization by Sri Lanka, contributed to the rapid growth of Indian tourist arrivals.

Table 7: Top Five Tourist Arrival Countries to Sri Lanka

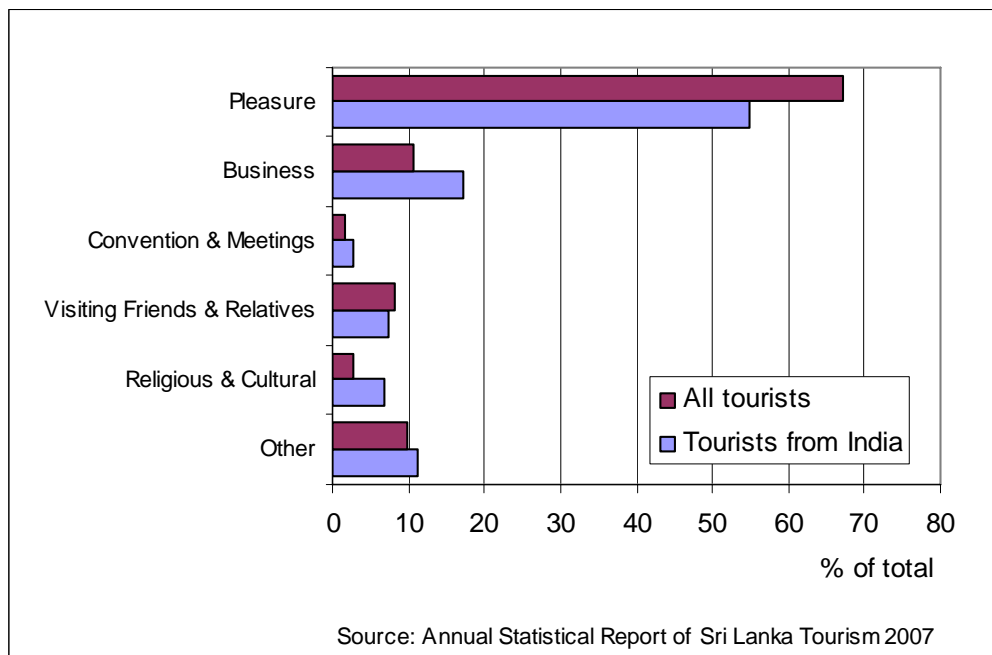
	2007		2002-2007
	No. of tourists	Share of total (%)	CAGR
India	106,067	21.5	20.9
U.K	94,060	19.0	5.6
Germany	35,042	7.1	-8.7

Maldives	29,539	6.0	21.9
Australia	20,241	4.1	9.9
Total	494,008	100	6.6

Source: Annual Statistical Report of Sri Lanka Tourism 2007

Seventeen percent of Indians visit for business purposes, compared to 10.5 percent of all visitors (Figure 7). Abeyratne and Paswan (2003) state that even if average earnings from tourists from India are lower than those from Western tourists, they come throughout the year and therefore offer a welcome cushion for the relevant industries.

Figure 7: Tourist Arrivals to Sri Lanka by Purpose of Visit 2007



Sri Lanka is India's fifth largest source market (Table 8). Sri Lankans visiting India account for a relatively small share (3.5 percent) of the 4.5 million tourists coming to India every year, but in absolute numbers, Sri Lankans visiting India still outnumber Indians visiting Sri Lanka. Sri Lankan tourist arrivals in India have been growing at only at 3.6 percent per annum during 2001-2006. Information about purpose of visit is not available, though pilgrimage appears to be the major reason.

Table 8: India's Top Five Tourist Source Markets

	2006	2001-2006	
	No. of tourists	Share of total (%)	CAGR
UK	734,240	16.5	9.2
USA	696,739	15.7	12.3
Canada	176,567	4.0	13.2
France	175,345	3.9	9.1
Sri Lanka	154,813	3.5	3.1
Total	4,447,167	100	12.9

Source: Ministry of Tourism, India

Port and airport services

The Port of Colombo is the main transshipment hub in the Southern Asian region. According to *The Island Online*, about 70 percent of total transshipment cargo from India is handled by Colombo Port (Venkat Narayan, 2008). The bulk of Indo-Lanka trade and transshipment cargo occurs between Tuticorin or Cochin and Colombo. Relative efficiency of the port, has made transshipment via Colombo port cost- and time-effective. However, expansion of the Colombo Port is behind schedule and may fail to keep up with the demands of fast growing Indian exporters. In addition, the development of South Indian Ports will also challenge the primacy of the Colombo Port (Venkat Narayan, 2008). Sri Lanka makes little or no use of Indian ports for transshipment.

Despite recent cutbacks and problems, SriLankan Airlines continues to be the largest foreign carrier into India. A majority of the transit passengers it carries through the Colombo Airport are from India. Transit passengers increased to 46 percent in 2008 from 28 percent in 2003-04 when the market was liberalized as part of the negotiations for the CEPA (TradeArabia, 2008).

Health and education services

Trade in health and education services between Sri Lanka and India has developed as a one-way transaction, with Sri Lankans traveling to India for health and education services, and Indians not reciprocating. Sarvananthan (2003) reported that prior to the opening of the Apollo Hospital in Colombo in 2002 an average of 70 patients from Sri Lanka used to travel to Chennai for medical treatment every month. He also reported that about 4000 Sri Lankan students were studying in India in 2003 according to the Indian High Commission in Colombo.

The factors underlying the export of health and education services from India to Sri Lanka are supply constraints, low costs and proximity. For the many middle income Sri Lankans, India is the preferred destination for higher education as well as for medical treatment, because of inadequate supply and quality resulting from government control of the education and health industries. The wealthiest Sri Lankans can obtain these services from Singapore, Europe and the US, but India is the only option for middle-income groups,.

Discussion

The India-Sri Lanka relationship has been transformed in the past decade. India, already the biggest source of imports, also became a major destination for exports. Indian FDI became a major contributor to Sri Lanka's economic development and employment creation. It has not been possible to gather systematic data on Sri Lankan investments in India, but there has been increasing activity on this front as well, with Brandix establishing a large fabric park in Tamilnadu, Damro well established in furniture manufacturing and Aitken Spence managing hotels (with minority equity participation), for example.

Reliable data on service trade are hard to come by. However, the export of port services, one among the few service sectors for which some data are available, is illustrative of Sri Lanka's significant service exports to India. Indians export business services to Sri Lanka, though of course, this is very difficult to document. Health and

education services are also exported by India under Modes 2 and 3. Sri Lanka has long been a consumer of tourism services in India, but has begun to supply tourism services to India since 2002, as shown above.

There are those who seek to draw conclusions, generally negative, about increasing trade deficits (seen as a loss to the country), increasing incoming FDI (seen as increasing foreign control) and increasing foreign investments by local form (seen as capital flight). There is nothing particularly good or bad about a trade surplus or deficit with a specific country, contrary to these populist mercantilist concerns. If Sri Lankan firms are buying more low-cost inputs from countries like India to make our higher-value-added exports more competitive or if the Indian imports are replacing higher-cost imports from other countries, they are good; if not, they are bad. In general appears that increased trade with India, even with increasing deficits (but lower import-export ratios) is a good thing.

The critical event during the decade of change was the FTA which contributed to the growth of exports to India as well as Indian investment in Sri Lanka. The fact that it was India's first FTA, would have raised Sri Lanka's profile within the Indian business community, contributing to these outcomes. If not for the fast growth of exports, in some cases from Indian-owned firms, Sri Lanka may have an even greater trade deficit than what exists today.

Value of a disciplining framework

Some wonder why protestors target meetings of the WTO and the World Bank/IMF and not those of the UN and its specialized agencies, such as UNESCO or the ITU. Protestors target the institutions of the Brettonwood triad because that is where the discipline, the power, resides. When a country breaks the rules of the WTO or of the IMF or the World Bank, it gets disciplined; not by being thrown into Brettonwood jail, but by having countervailing duties being imposed on its exports or the support being withdrawn for its currency. Trade agreements are disciplines; there are

consequences to transgression. Entering into one constitutes a voluntary diminution of national sovereignty.

Negotiations for the Canada-US FTA were driven by the Mulroney administration in Canada and those for NAFTA were driven by the Salinas administration in Mexico. The initiative for the India-Sri Lanka FTA and the CEPA also came from the smaller, weaker country. This simple fact contradicts the conventional wisdom of the opponents of liberalization that trade agreements are imposed on weak and unwilling partners by powerful trading nations. Trade agreements reduce the sovereignty of both the powerful and the weak, but why would the weak take the initiative?

Jackson (1978) answers this question by positing a continuum between power-oriented regimes and rule-oriented regimes. A state of anarchy that comes with a power-oriented regime is advantageous to a powerful country in general and disadvantageous to a weaker one. Therefore it generally makes sense for weaker partners to seek rule-oriented regimes, like trade agreements.

The Jackson continuum is best explained using an analogy, that of a schoolyard bully who forcibly appropriates the lunch of, say, five children on a random basis. The victims have a number of options, the most interesting being the creation of a regime, in the sense that the term is used in international relations. That is, they could negotiate with the bully to create a system of rules to govern the appropriation of the lunch, a fundamentally unfair act. Instead of being randomly attacked and left hungry, they now take turns to bring extra helpings or whatever to look after their hunger and happiness. The bully gets his lunch regularly without exerting any effort and without the risk of a bullied child fighting back.

Though patently unfair, it is an improvement on the *status quo ante* for all parties. The conclusion is that many rule-based regimes are superior to anarchy, even when there is substantial asymmetry of power among the parties and even if the rules are not perfect. Of course, a rule-based regime that is entered into on the basis of

principles of fairness and mutual respect, by parties that are equally endowed with knowledge and power, using means of negotiation that are equitable and non-violent, would be best. Therefore, in general: no-rules, power-oriented regime < rule-based regime agreed to by unequal parties < rule-based regime agreed to by equal parties.

Jackson also posits that multilateral regimes tend to be closer to the ideal than bilateral or plurilateral regimes, because the power asymmetries are neutralized when the number of parties increases. This is a separate and distinct rationale for multilateral agreements, beyond the normal one regarding reduction of transaction costs. For Sri Lanka, the first-best method of managing its all-important economic relationship with India is through a multilateral agreement under the World Trade Organization. Second-best would be a plurilateral agreement, such as SAFTA. But it is well known that not much is happening on these two fronts. A bilateral agreement, the third-best solution, is the sole remaining option. It is superior to a power-oriented regime, which is what currently exists for economic relations not governed by the FTA.

Special problems of non-tariff barriers and services

The Canada-US agreement was the first to impose international trade disciplines on service trade (Samarajiva, 1993). Until the Canada-US FTA, trade agreements only covered goods. The objectives were to reduce tariffs and lower NTBs so that the overall efficiency of the economy would be improved by each party specializing in the activities it had comparative advantage in. Goods would move through customs points at ports and other designated locations, where the FTA provisions would be implemented in the form of lower duties and less onerous clearance procedures. There was no intrusion into the domestic affairs of a country, and no obvious diminution of national sovereignty.

After multiple rounds of liberalization brought down the tariffs on a large range of goods, attention was then focused on NTBs and subsidies. At this stage the intrusions into national sovereignty began to appear: Americans complaining that

the Canadian lumber industry was not more efficient than the American industry, but simply the beneficiary of unfair subsidies in the form of different fee structures; Europeans complaining the US aerospace industry was the beneficiary of elaborate subsidies through the military procurement system, and so on. The short-term effects of trade liberalization, or simply competition, necessarily resulted in some form of blaming of the other, which was easier to do if the other was foreign (e.g., Wickremesinghe, 2008): It could not be that they were more efficient than I; they had been given some unfair advantage by their government; someone had to level the playing field for me. The frictions appeared with regard to NTBs affecting goods first and then services.

As more people began to work in service industries, the thinking was that services would increasingly be traded across borders. Of course the Americans thought at that time that they had some kind of natural comparative advantage in services; but that misconception has been corrected thanks to Bangalore and accent neutralization. There were debates about how one could trade hair-cutting services, for example, across borders. But over time the conceptual issues were settled in a pragmatic way through the definition of the four modes:

- Mode 1, where services are traded across borders, just like goods, with the seller in Country A and buyer in Country B;
- Mode 2, where the buyer from Country B would travel to Country A, to consume the service produced by the seller in her location;
- Mode 3, where the seller would establish a commercial presence in Country B to produce and sell services to the buyer; and
- Mode 4, where natural persons (i.e., those other than the unnatural corporate persons establishing commercial presence) would travel from Country A to Country B to provide services to buyers from Country B.

So hair-cutting services could be traded in the following ways:

- Mode 2, where the person wishing to buy haircutting services would cross the border to Country A for a haircut;

- Pure Mode 3, where the supplier of hair-cutting services, from Country A, would establish subsidiaries or franchises in Country B, but employ only persons from Country B to cut hair;
- Modes 3 and 4 combined, where the above subsidiaries or franchises would be staffed by hair cutters or trainers from Country A; and
- Pure Mode 4, where itinerant hair cutters would cross the border to cut hair in Country B.

Mode 1 service trade is very much like good trade, with the seller remaining in Country A and the buyer staying in Country B. The service would be supplied through telecommunication for the most part. Under current technology, hair-cutting services cannot be traded under Mode 1.

Services have been traded across borders for centuries. What was new was the qualitative increase in services trade, enabled by improved communication, including both transportation and telecommunication. The key to Mode 1 service trade is telecommunication. Mode 2 and Mode 4 primarily rely on transportation. Mode 3 is more or less like foreign investment, with the usual issues of transnational control (exerted by what media?) and repatriation of profits. Like trade in goods, all modes of services trade require extensive use of transportation and communication systems. Some services trade can occur purely through communication systems.

Services trade differs from goods trade because services cross borders in multiple ways, not through government-controlled customs points as goods do (smugglers aside). From the perspective of a government seeking to control and regulate trade, this poses a serious problem. How can one control things that do not go through chokepoints? Even more importantly, how can one extract duties from such things?

Traditionally, governments have not levied customs duties from services traded across borders. Regulation has been by means other than tariffs. Examples are the questions professionals get asked when they cross borders about whether or not they receive payments for services (barriers to Mode 4 services trade); restrictions on the hiring of foreigners (barriers to Mode 4 trade); and investment approvals

(barriers to Mode 3). Bringing down tariffs a few percentage points at a time and ensuring that customs inspectors did not unduly delay shipments would not liberalize services trade; it had to be done by removing barriers throughout the economy. It meant reaching into the very capillaries of government and changing procedures. Sri Lanka's WTO commitments led to my walking around with the governing statute, the country's telecom commitments to the WTO and the incumbent's license all bound together as one text, and telling people what could and could not be done under those disciplines during my tenure as Director General of Telecommunications of Sri Lanka.

Therefore, liberalization of services trade under international trade disciplines posed difficulties so significant that eminent authorities such as John H. Jackson argued against bringing services within the scope of the international trade disciplines. Nevertheless, starting with the US-Canada FTA, services were brought under international trade disciplines.

The approach used in the negotiations for the General Agreement on Trade in Services (GATS) and then adopted in regional and bilateral agreements covering services, was far more permissive than that used for goods. In goods, the general principles apply uniformly, with very limited use being made of negative lists. If something is not explicitly taken out, it is presumed to be in. In services, the approach is based on positive lists: if something is not explicitly included, it is presumed to be out.

As has been seen in the short experience with the India-Sri Lanka FTA, NTBs are crucial. The Sri Lankan entrepreneurs, who faced difficulties in India, experienced them in the form of NTBs. With service exports, the only things that matter are NTBs, there being no tariffs to lower. Without a framework, it is not possible to police NTBs in a systematic manner.

The misguided opponents of broadening the scope of the India-Sri Lanka FTA through the CEPA are therefore harming Sri Lankan service industries (exporting as

well as non-exporting). Absent a disciplinary framework, everything has to be negotiated case-by-case. Sri Lankan service exporters have no readymade remedies if they face problems in India; Sri Lankan service providers within the country do not have a clear path on what to complain about and to whom, in the face of possibly unfair practices by Indian service providers operating in Sri Lanka under whichever mode.

In many cases these opponents are not doing this knowingly, but are simply reacting to normal problems of a transition to a rule-governed regime in goods. The unintended consequence of their action is that the service sector which could benefit the most from a proper disciplinary framework has to do without one.

Fair treatment by India

There are those who believe that the power asymmetry between India and Sri Lanka is so vast that fairness is impossible: if an agreement is signed, it will be prejudicial to Sri Lanka; even if the agreement is fair on its face, India will distort its implementation. A subset among this group is not amenable to reason; they are irrationally Indophobic. They as well another subset who are doing the bidding of countries that fear India's emergence as a world power cannot be convinced however powerful the evidence is and however strong the arguments are. Another group is fearful of all external engagements, wanting to live quietly in a small market, even if the result is underdevelopment. There is little reasoning possible with them too.

A related group wants to trade, but to trade with similarly positioned countries, not powerhouses like India. They may be amenable to some arguments. Their main concern would be the power asymmetry with India. The best argument that can be presented to them is in relation to the alternatives. If a disciplinary framework for goods and services trade as well as for investment exists, there is some recourse when Indian firms misbehave. Without that, all that could be done is to seek recourse from Indian government officials and politicians on a case-by-case basis. It

might work some times, but it can be clearly seen that the absence of a disciplinary framework would enhance, not reduce the likelihood of unfair treatment by India.

Those who wish to ride the Indian wave, either by broadening the scope of the markets they serve to enable exploitation of economies of scale or those wish to exploit the synergies of production and distribution, especially in service industries, still worry about how they will fare with the large and powerful Indian bureaucracy, including, in particular, the less enlightened members at the levels of the states such as Tamilnadu and Kerala. For them the need for a framework is not the issue; it is whether it will be fairly implemented. The only way this group will be fully convinced is through experience. But how can experience be gained without a framework first existing?

Even two countries like Canada and the US, which share the world's longest undefended border and many common values, found it necessary to enter into a bilateral free trade agreement covering goods as well as services. However friendly relations are, a framework clarifies the relationship and reduces friction. In the same way that good fences make good neighbors, a good disciplinary framework, including effective dispute-resolution mechanisms, will make good neighbors the best neighbors.

But does the relationship become frictionless? No. Every agreement has ambiguities. Reality is more complex than what drafters can envisage. Therefore, there are always possibilities of situations emerging that are not covered by the text and of language requiring to be interpreted. Both countries will have within them various interest groups and lobbies that will not allow the right thing to be done. The old license-raj mentality of the Indian bureaucracy may reemerge at various times. For example, even during a very harmonious phase of inter-governmental relations (2001-2004), the Indian bureaucracy pressed hard for the third petroleum distribution license to be given to an Indian state-owned firm, despite that fact that the government of Sri Lanka had received a much higher bid through a transparently conducted process.

These kinds of situations are to be expected. Indeed, even after a decade and a half, disputes keep coming up under NAFTA (Kinneer, Bjorklund, and Hannaford, 2006), between Canada and the US. The difference when you have a disciplinary framework is that the disputes do not snowball into major conflicts; they get channeled into the proper dispute-resolution mechanism and get resolved for the most part quietly. Case law gets built up and the areas that give rise to friction shift elsewhere.

India, which is signing a series of bilateral trade agreements with much larger economies such as Japan and the EU, gave Sri Lanka the opportunity to be at the head of the line, just behind Singapore. Due to a lack of understanding and will (and possibly shortsighted responsiveness to signals from India's regional rivals) on the part of its decision-makers, Sri Lanka has now lost its place in the line.

But the fact remains that Sri Lanka is still the best neighbor India has among the countries it shares borders with. The Gujral Doctrine, which has successfully weathered several changes of government since first articulated in the 1990s, allows for non-symmetrical negotiations with India's immediate neighbors and thus creates conditions conducive to workable frameworks (Gujral, 1997). A robust and productive relationship with Sri Lanka would be of great value to India and serve as a model for managing its relationships with its other neighbors. So, the train has not yet left the station. There is still time to make it.

References

- Abeyratne, S. and Paswan, N.K. (2003) "Economic Impact Assessment of the Proposed Indo-Lanka Land Bridge: Tourism Sector", Seminar Paper, New Delhi Central Bank of Sri Lanka, *Annual Report*, (various issues)
- Gujral, I.K. (1997, January 20). "Aspects of India's Foreign Policy," speech at the Bandaranaike Center for International Studies in Colombo, Sri Lanka, <http://www.stimson.org/southasia/?sn=sa20020116302>
- Jackson, J. H. (1978). The crumbling institutions of the liberal trade order. *Journal of World Trade Law*, 12: 93-110
- Joint Study Group (2003), *Report on India – Sri Lanka Comprehensive Economic Partnership Agreement*
- Kinnear, M., A. Bjorklund, J. F. G. Hannaford (2006). *Investment disputes under NAFTA. An annotated guide to NAFTA Chapter 11*. Kluwer Law International.
- Mukherji, I.N. (2002), 'Charting a Free Trade Area in South Asia-Instruments and Modalities', in T.N. Srinivasan, (ed.), *Trade, Finance and Investment in South Asia*, New Delhi: Social Science Press.
- Samarajiva, R. (2008, July 28). Manjokka choices: India Sri Lanka economic links derailed by protectionism. *Lanka Business Online*. <http://www.lbo.lk/fullstory.php?nid=1680904995>
- Samarajiva, R. (1993). Down dependency road? The Canada-US free trade agreement and Canada's copyright amendments of 1988, in J. Wasko and V. Mosco eds., *Illuminating the blindspots: Essays honoring Dallas W. Smythe*. Norwood NJ: Ablex, pp. 152-180.
- Sarvananthan, M. (2003) "Rapid Assessment of the Impact of the Proposed Land Bridge between India and Sri Lanka on Trade and Services", Seminar Paper, New Delhi
- Sri Lanka Tourist Board (2007) *Annual Statistical Report of Sri Lanka Tourism 2007*, Colombo

TradeArabia (2008 April 4), SriLankan makes Colombo a transit hub,

http://www.tradearabia.com/news/TTN_139644.html

United Nations (2006), *World Investment Report 2006*, Geneva

Venkat Narayan, S. (2008) "South Indian ports spending \$2.5bn to compete with

Colombo", *The Island Online* at <http://www.island.lk/2008/08/09/business1.html>

Wickremesinghe, M. (2008, December). Some thoughts on CEPA, *Montage*, 2(11):

82.

Annexes

Annex 1: Economic profiles of India and Sri Lanka, compared			
	India	Sri Lanka	Year
Population (million)	1095	20	2005
Population (average annual growth rate %)	1.5	0.5	2000-05
Population under age 15 (%)	33	24.2	2005
Population above age 65 (%)	5.0	6.5	2005
Population density (per sq km)	368	303	2005
Net migration (thousands)	-1400	-160	2000-05
Net migration as % of population	-0.13	-0.80	2000-05
Urban population (% of total)	28.7	15.1	2005
Fertility rate (births per woman)	3.1	2.0	2000-05
Inflation rate based on CPI (%)	4.2	11.6	2004-05
Gross National Income (USD billions)	793	22.8	2005
Per capita income (USD)	720	1160	2005
PPP Adjusted Gross National Income (USD billions)	3787	89	2005
PPP adjusted per capita income (USD)	3460	4520	2005
National income share of Poorest Quintile (%)	8.9	8.3	2000
GDP (USD billion)	785.5	23.5	2005
Average annual growth of GDP (%)	6.9	4.2	2000-05
Gross Capital Formation (% of GDP)	30	28	2005
Exports (USD billions)	89.8	6.3	2005
Imports (USD billions)	131.6	9.0	2005
FDI inflow (USD million)	5335	233	2004
Human Development Index (1:highest)	0.619	0.743	2005
Economic Freedom Index (10:highest)	6.59	6.11	2006
Ease of Doing Business (rank out of 178 countries)	120	101	2008
Sources:			
World Development Report 2007, World Bank			
Doing Business Report 2008, World Bank			
Human Development Report 2008, UNDP			
Economic Freedom of the World Annual Report 2008, Economic Freedom Network			

Annex 2: Major Exports from Sri Lanka to India 2002-2007

HS No	DESCRIPTION	USD million						CAGR ^a
		2002	2003	2004	2005	2006	2007	(%)
8544	Insulated (including enamels) wire, cable	0.1	7.9	41.5	19.6	33.1	38.1	264.4
151790	Other margarine	0.0	0.0	0.8	12.9	23.2	25.0	209.2 ^b
441199	Other (fiberboard of wood)	0.0	0.1	7.6	10.3	9.3	4.7	179.6 ^c
151620	Vegetable fats & oils & their fractions	0.0	0.0	9.7	122.6	79.7	145.3	144.4 ^b
151110	Palm oils & its fractions (crude oil)	0.3	1.8	3.6	5.2	5.5	10.1	98.6
61/62	Articles of apparel & clothing	0.2	0.5	0.5	0.5	2.4	4.2	93.1
282490	Other (lead)	0.1	3.3	4.3	4.4	4.7	3.2	86.6
68	Articles of stone, plaster, cement,	0.8	4.0	11.1	6.8	22.7	15.8	81.4
40	Rubber & articles thereof	2.3	4.1	9.7	9.0	19.0	35.4	72.7
7413	Stranded wire, cables, plaited band	0.0	0.2	8.3	21.1	38.8	1.6	63.5 ^c
470790	Other, including unsorted waste	1.8	3.0	4.1	8.0	11.2	13.3	49.9
94	Furniture, lamps & fittings,	1.7	2.0	4.1	5.5	6.4	8.4	38.0
48	Articles of paper pulp, paper	2.3	2.3	3.8	6.1	5.3	5.7	20.2
84	Boilers & machinery & parts	4.5	10.1	8.2	8.6	9.0	9.4	15.9
0902	Tea, whether or not flavored.	1.0	0.9	1.2	1.1	1.4	2.1	15.7
090411	Pepper (neither crushed nor ground)	12.4	9.6	7.8	10.3	13.2	18.3	8.1
72/73	Iron or steel & its articles	4.8	9.0	21.9	15.0	6.9	5.0	0.8
7403	Refined copper and copper alloys	34.6	70.6	109.1	123.7	49.1	21.2	-9.3
090700	Cloves (whole fruit, cloves & stems)	26.2	5.0	13.3	16.5	11.8	8.4	-20.4
392620	Articles of apparel & clothing	4.5	4.2	5.5	5.8	3.8	1.1	-24.9
7601	Unwrought aluminum	0.8	1.7	8.0	14.2	3.2	0.2	-26.3
7605	Aluminum wire	0.0	0.0	7.6	30.6	25.0	0.0	-92.7 ^b
294190	Other (antibiotics)	0.0	0.0	10.0	22.7	7.3	0.0	-95.4 ^b
Other		70.5	100.8	83.8	78.7	101.9	139.9	14.7
Total Exports		168.9	241.1	385.5	559.2	494.1	516.4	25.1

Notes: a: Compound Annual Growth Rate (CAGR)

b: CAGR for 2004-2007 due to zero values prior to 2004

c: CAGR for 2003-2007 due to zero values prior to 2003

Source: Department of Commerce, Sri Lanka

Annex 3: Major Imports from India to Sri Lanka 2002-2007

HS No	DESCRIPTION	USD million						CAGR ^a
		2002	2003	2004	2005	2006	2007	(%)
100590	Other maize (corn)	0.3	2.2	22.8	24.8	15.0	17.9	120.4
271011	Light oils & preparations	11.3	23.4	32.4	39.2	68.4	267.4	88.5
271019	Other kerosene, diesel, gas oil,	44.1	172.3	229.8	159.1	296.7	896.0	82.7
8704	Motor vehicles for the transport	5.0	10.6	26.2	53.5	60.1	66.3	67.8
74	Copper & articles thereof	5.3	11.6	27.6	38.4	62.8	48.0	55.1
8711	Motorcycles (including mopeds) & cycles with motor	17.8	35.1	50.9	81.6	91.3	90.0	38.3
280300	Carbon (carbon black & other forms of carbon)	7.6	10.2	15.0	18.5	19.1	26.5	28.3
39	Plastics & articles thereof	19.3	23.6	36.2	40.9	49.7	60.4	25.6
8703	Motor cars & other motor vehicles	25.7	51.8	56.9	67.9	91.5	66.0	20.7
76	Aluminum & articles thereof	4.6	4.8	12.8	31.5	24.6	11.7	20.4
270900	Petroleum oils & oils obtained from	0.0	0.0	22.6	40.8	36.9	38.9	19.6 ^b
55	Man made staple fibers	10.6	15.6	12.8	16.3	18.9	25.3	18.9
070310	Onions & shallots	19.5	21.1	21.8	19.7	22.3	43.9	17.6
230400	Oil-cake & other solid residues	16.9	14.6	26.2	27.4	26.7	38.0	17.6
84	Boilers & machinery & parts	38.3	48.1	61.7	68.4	76.8	78.8	15.5
8702	Motor vehicles for the transport of ten or more persons	19.6	20.9	40.5	33.7	53.2	40.0	15.3
72/ 73	Iron or steel & its articles	62.8	76.9	85.1	101.1	114.2	125.8	14.9

300490	Other medicaments	35.8	39.8	43.9	53.2	65.5	69.9	14.3
4802	Uncoated paper & paperboard	18.3	20.0	21.5	26.9	32.1	33.6	13.0
52	Cotton	66.1	65.6	77.0	86.3	96.5	112.0	11.1
252329	Other (cement)	24.2	31.1	20.1	26.0	33.8	33.6	6.7
85	Electrical machinery, sound recorder	56.5	24.8	35.9	38.6	37.1	40.4	-6.5
071340	Lentils	3.9	0.9	7.4	22.5	11.5	1.5	-17.3
Other		321.0	351.0	370.9	323.8	417.1	553.1	11.5
Total Imports		834.7	1076.2	1357.9	1440.3	1822.1	2785.0	27.3

Notes: a: Compound Annual Growth Rate (CAGR)
b: CAGR for 2004-2007 due to zero values prior to 2004

Source: Department of Commerce, Sri Lanka

