14

1. Introduction
2. Key trade and related policy issues
3. Additional cross-cutting trade issues

14

Sri Lanka – Agricultural trade policy issues

Kamal Karunagoda, Parakrama Samaratunga, Ramesh Sharma and Jeevika Weerahewa

1. Introduction

As many other developing countries, Sri Lanka has also experimented since independence with alternative development strategy and policy regimes - from open, free-market policies up to 1959 to import-substituting industrialization during 1960-1977, and then to export-oriented liberalization since 1977. While trade policies are fairly liberal in the non-agricultural sector, the range and depth of policy interventions are wider and deeper when it comes to agriculture, especially the food sub-sector.

Sri Lanka's economic growth performance, especially since the reforms of late 1970s, is considered to be relatively satisfactory in comparison to many similar developing countries. But this has not been the case for the agricultural sector, especially the food sub-sector. There is a widespread feeling among economists that economic reforms did not work well for the import-competing food sub-sector. Sri Lanka has two distinct agricultural sub-sectors: traditional export crops dominated by tea but also including rubber, coconut, spices, and more recently some non-traditional products like fruits and vegetables; and an import-competing food sector dominated by rice and including many other crops, livestock and diary products, and sugar. Trade and price policy regimes have been historically very different for the two sub-sectors, which continue.

The Sri Lanka case study in the World Bank agricultural distortions project (Bandara and Jayasuriya 2009) shows that the production of traditional exports (tea, coconuts and rubber) was taxed to the tune of over 40 percent in the 1960s and 1970s but fell gradually to about 20 percent in the 1980s up to 1990s and to a position of no net taxation since the mid 1990s. In contrast, importables generally enjoyed positive protection, ranging at modest levels for rice to high levels for products like chillies, onions and potatoes, but also for some other food products in recent years.

As the next section illustrates, the Government of Sri Lanka (GoSL) continues to intervene actively on a range of food products in particular with a variety of trade and pricing policies. These policies often have multiple goals such as containing retail prices, protecting farmers and encouraging value adding industry. As a result, various stakeholders in the agricultural chain are affected in different ways, and this has generated lively debate in policy circles and the media.

It is against this background that this paper seeks to contribute to the process of articulating appropriate trade policy. This process involves understanding the goals, identifying policy options, assessing the impacts and choosing appropriate responses through analysis and stakeholders consultations. The paper is prepared by a team of analysts on the basis of the review of literature, data analysis and stakeholder consultations. The process was led by the Sri Lanka Institute of Policy Studies (IPS). About 10 national experts consisting of independent analysts and government officers were involved in the background work. Many meetings were held with government officers and non-state stakeholders, including the CSOs. This provided a rich perspective on different views and responses. This paper utilizes the inputs from the following four background studies prepared for the FAO project (Karunagoda 2010a and 2010b, Samaratunga 2009 and Weerahewa 2010).

The rest of the paper is organized as follows. Section 2 discusses trade and related policy issues for selected commodities and product groups as well as some cross-cutting topics. Section 3 discusses some additional cross-cutting issues.

2. Key trade and related policy issues

In common with many other developing countries, trade and pricing policy interventions in the Sri Lankan agriculture are increasingly focused on fewer and fewer products. These are typically 8-10 import-competing food products, plus some close substitutes. As these products play important, politically sensitive, role in the economy in one form or other, policies invariably attract keen interest and debates are often divisive.

The following groups of products are covered: i) traditional and non-traditional agricultural exports; ii) cereals and other field crops (rice, wheat, wheat flour, chillies, onions and potatoes); iii) other basic food products (milk powder, poultry and sugar); and iv) exporting coconut industry. Also discussed are two cross-cutting topics: i) Indo-Sri Lanka Free Trade Agreement; and ii) domestic support measures.

2.1 Traditional and non-traditional agricultural exports

Sri Lanka's prominent *traditional agricultural exports* are tea, rubber, coconuts and spices, with the former three together making up 85 percent of the total export. Since 1977 the volume and value of the total agricultural export have shown an increasing trend. A number of factors are considered to have contributed to this: i) significant trade liberalization freeing up many controls on trade; ii) elimination of distortionary taxes; iii) privatization of government plantations; and iv) strengthening of the world market prices. As a result, plantations have been restructured and revitalized, leading to increased productivity and production.

Export duties on all minor agricultural exports were abolished in 1988 and on major exports in 1992. Other restrictive policies like quotas or controls by STEs were also abolished and have not been re-imposed in the post-reform period. These exports do not receive any direct export subsidy nor the WTO-compatible subsidy for reducing transport and marketing cost. To maintain the quality of Sri Lankan exports, some restrictions are imposed on the import of tea and spices to prevent re-export.

A reading of the literature and media reports indicates that there are relatively few divisive issues facing this sub-sector on policies like export tax and incentives. The cess on exports attracts some debate but more from the side of the revenue utilization than on the policy itself. Cess is low, e.g. Rs 2.50/kg on tea for some time and raised to Rs 4/kg in 2006. Tea and spices have hit headlines from time to time but in the context of the India-Sri Lanka FTA (see below). One other prominent topic in the literature is the question of the extent to which farmers, especially small farmers, have benefited from the growth in exports of this sub-sector (discussed below).

Non-traditional agricultural exports generally refer to products like vegetables, fruits and some other speciality products. In particular, vegetables are considered to have significant export potential in view of the large Sri Lankan diaspora in the Gulf and Europe. The government promotes these products through the Export Development Board (EDB). Among the incentives provided are subsidies of 3 percent of the fob value during the first year of operations, custom duty waiver on imported intermediate inputs, and income tax exemption on export earnings. Additional subsidies are available for value added agricultural exports. In addition, production subsidies are also provided for encouraging production for export.

Unlike for import-competing foods, trade and pricing policies for these products have not been divisive, presumably because of the small amount of the assistance provided for exports (less than 1 percent of the total export value) and for domestic production support (around 1-2 percent of the value of production). The other reason could be that these interventions do not distort domestic prices much, unlike for example in the case of sugar and poultry.

2.2 Cereals and other field crops[1]

Rice/paddy

Being the main staple, the GoSL's desire for decades has been to attain full rice self-sufficiency. Import protection was a major policy applied throughout this period, along with development measures like irrigation, research etc. The data show that Sri Lanka has raised the level of rice self-sufficiency and imports have been declining over the years. Rice trade was tightly controlled through stringent import licensing system and STE monopoly on trade. Following the implementation of the WTO agricultural agreement in 1995, a major policy change took place in 1996 when quantitative import restrictions for several products were replaced with *ad valorem* tariffs together with licensing requirement. Until 2000, this tariff was 35 percent plus a national security levy of 4-5 percent (Table 1). From 2002 onwards, when world prices were depressed, this was replaced with specific tariff that ranged from Rs 5/kg to 9/kg except for Rs 20/kg in 2008 (plus 5-6 percent security tax).

The GoSL waives these statutory tariffs periodically for short periods when domestic prices are high. This has happened for about half of the time during the past 10 years or so. Analysts have questioned this policy on the ground of its effectiveness as traders have often taken advantage of the waivers to stockpile rice and release it to market later, undermining the desire to maintain farm prices.

Some studies have documented that local market prices of rice in Sri Lanka are largely determined by domestic supply and demand conditions, with the correlation coefficient between domestic and world prices of about 0.5-0.6 (Karunagoda 2010a). In an analysis for the late 1990s, Sharma (2002) had also found little transmission of changes in the world market to domestic markets for rice as well as wheat. The main reason was trade policy, namely the frequent and consistent variations in tariffs that prevented the transmission. Another indicator of market functionality is stability of marketing margins. The data show that these margins have been stable throughout the year and thus paddy market can be considered to be efficient even in the absence of major government interventions or supporting structures (Karunagoda 2010a). Analysts also hold that price differences among markets in the country were not the result of deliberate manipulations as can happen under a monopolistic or monopsonistic market structure but due to imperfections inherent in the system which make effective arbitrage in response to spatial price differences difficult (Karunagoda 2010a). Inter-market price spreads exist due to erratic supply changes linked to seasonal imports which often destabilize inter-market arbitrage and dissemination of price information.

[1] Some issues on maize are covered under poultry.

TABLE 1:
Rice tariffs, 1995-2010

Year	Period	Statutory duty	Duty waiver	Effective import duty %	NSL
1995	Jan 1 1995-Feb 7 1995	35 or Rs 7/kg	0	55	4.5
1996	Feb 8 1995-April 14 1996	35	0	35	4.5
1997	Apr 15 1996-Jan 30 1997	35	35	0	4.5
	Jan 31 1997-Nov 20 1997	35	0	35	4.5
1998	Nov 21 1997-Jan 31 1998	35	35	0	4.5
	Feb 01 1998-Nov 05 1998	35	0	35	4.5
1999	Nov 06 1998-Oct 23 1999	35	0	35	4.5
	Oct 24 1999-Dec 31 1999	35	25	10	5.5
2000	Jan 01 2000-May 10 2000	35	0	35	5.5
	May 11 2000-Jul 16 2000	35	0	35	5.5
2001	July 17 2000-22 Nov 2001	35* (L)	0	35	6.5
	22 Nov-10 Dec 2001	35** (IQ)	35	0	6.5
	10 Dec-31 Dec 2001	35	50%	17.5	6.5
2002	21 Jan 2002-6 Nov 2002	7 Rs/kg (32%)	0	34	6.5
2003	6 Nov 2002-5 March 2003	5 Rs/kg (24%)	0	24	6.5
	6 March 2002-19 Aug 003	7 Rs/kg (33%)	0	33	6.5
	20 Aug 2003-31 Dec 2003	9 Rs/kg (34%)	0	43	6.5
2004	1 Jan 2004-04 Oct 2004	9 Rs/kg (34%	0	34	6.5
2004	05 Oct 2004-15 Jan 2005	9 Rs/kg (29%)	9 Rs/kg	0	6.5
2005	1 Jan 2005-15 Jan 2005	9 Rs/kg (29%)	9 Rs/kg	0	6.5
2006	16 Jan 2006-31 Dec 2006	9 Rs/kg (27%)	0	27	6.5
2007	1 Jan 2007-31 Dec 2007	9 Rs/kg (52%)	0	52	6.5
2008	1 Jan 2008-31 Jan 2008	20 Rs/kg (26%)	20 Rs/kg	0	6.5
	1 Feb 2008-31 Dec 2008	20 Rs/kg (26%)	0	26	6.5
2009	1 Jan 2009-30 Nov 2009	20 Rs/kg (30%)	0	30	6.5
2009	1 Dec 2009-31 Jan 2010	20 Rs/kg (30%)	20 Rs/kg	0	6.5

Notes: *(L) = Import licensing, ** (IQ) = Import quota of 60 000 duty free, NLS = national security levy. Figures within the parentheses are equivalent ad valorem tariffs.
Source: Sri Lanka Customs

Thus, overall, the trade policy regime for rice has been guided principally by considerations of domestic market price, waiving duties during shortages and raising tariffs and providing farm support/subsidy when prices are depressed. Sri Lanka is considered to be a relatively high-cost rice producer in Asia and so the sector would come under considerable pressure if trade were fully freed. Price stability – especially avoiding the extremes of low and high prices – will remain the primary goal and this means that trade policy will continue to be used as in the recent years.

Wheat and wheat flour

Wheat flour is considered an *essential* commodity in Sri Lanka and is second important staple after rice. All requirements are fully met by imports and imports have been increasing over time. The primary reason for policy interventions in wheat is considered to be the GoSL's 1978 agreement with a private mill (Prima Ceylon Limited) to process grain into flour. The agreement was to expire in 1999 but was extended to 2004. The company guaranteed providing the government with 74 percent of the milled flour for every 100 units of wheat grain supplied, the remaining flour retained by Prima as payment for milling cost. It is said that using this excess flour, Prima supplies the local market with animal feed, over which it has now a virtual monopoly.

Indeed, the agreement with Prima has defined the character of the policy interventions on wheat as well as on animal feeds. First, the contract served to delay the liberalization of the wheat/wheat flour and animal feeds markets, until June 2001 when Prima was privatized and wheat imports liberalized. The contract to sell Prima (Ceylon), which seems to have the force of a law, stipulated a formula to fix the price of general purpose standard wheat flour for five years (until June 2006) on the basis of the f.o.b price at the Kansas City Board of Trade. Second, the contract also stipulated that "the tariff difference of wheat grain and wheat flour will be maintained at a rate of 25 percent for a period of seven years" commencing in 2001. This high tariff protection should have given Prima (Ceylon) a *de facto* monopoly in the milling of flour. However, tariffs on wheat flour have often been set below the stipulated levels (Table 2). Further, a second flour mill commenced operations in August 2008. Import duty on wheat was raised to 15 percent in 2009 and a cess of 5 percent imposed on flour imports. As a result of the above pricing and tariff policies, domestic prices of wheat flour and related products have been higher than the world market prices – thus penalizing consumers and undermining the GoSL's designation of wheat as an essential food item.

TABLE 2:
Import tariffs on wheat and wheat flour, 1995-2009

	1995	1996	1997	1998	1999	2000	2004	2006	2008	2009
Wheat	35%	20%	Full duty waiver	Full duty waiver	20%	5%	Full duty waiver	6%	10%	15%or 10 Rs/kg
Wheat flour	35%	35%	Full duty waiver		Full duty waiver	25%	Full duty waiver	15% or 4.50 Rs/kg	15%or 4.50 Rs/kg	15% or 10 Rs/kg +5% cess

Trade and pricing policies on wheat have implications of their own for wheat consumption but also, and importantly, on rice (see Dayaratna-Banda *et al.* 2008). Notably, the reductions in wheat tariffs have been found to have suppressing effects on the farm gate prices of rice. It is largely for this impact on rice that wheat policy comes to prominence from time to time. This close cross-price effect was also observed in 2000 when the government introduced consumption subsidy in the form of reduced price of wheat flour. Because of the effect, the subsidy was quickly withdrawn in 2001.

The GoSL's long term goal seems to be to reduce the consumption of wheat to be replaced by domestic rice. According to an IPS media report, some unofficial figures show that consumption of bread and wheat-based products has fallen by as much as 40 percent. Indeed, wheat imports have fallen significantly, from around 120 000 tonnes a month about five years ago to around 80 000 tonnes per month in recent months. National food security experts have welcomed this. Even the President of the country is said to have welcomed this trend.[2]

Chillies, onions and potatoes

Among the "other field crops" (OFCs), trade policies for chillies, onions and potatoes have been relatively contentious in the past. Although small crops in volume and concentrated in some regions only, these have been highly sensitive crops politically. The promotion of the OFCs was initiated in the mid 1960's with the introduction of the government's *Food Production Drive* programmes. Trade policy was very protective and when imports were banned in 1971 there were unprecedented price

[2] "I am exceedingly glad at the fall in consumption of wheat-flour based products. Despite the fact that we possess very fertile lands, the consumption of (imported) wheat was forced upon us, initially by the provision of wheat free of charge, and later on credit, until we were addicted to it," according to the President, as reported by IPS in a news story on 15 April 2008 (http://ipsnews.net/news.asp?idnews=41993).

TABLE 3:
Nominal protection coefficients (NPCs) of chillies, onions and potatoes

	1985-89	1990-94	1995-99	2000-04	2005-08
Chillies	1.20	1.52	1.59	1.49	1.28
Onions	1.41	1.00	1.32	1.08	1.17
Potatoes	0.84	2.41	2.78	3.53	2.59

Note: Higher protection level for potatoes after 1996 also reflects higher domestic prices of the domestic variety.

increases which led farmers to respond strongly and production doubled. Even in the post-1977 reform period, potatoes, chillies and onions were heavily protected right up until 1996. Since 2000, specific tariffs were used for protection. These high tariffs also show up in computed Nominal Protection Coefficients (NPCs), with high levels for potatoes in particular throughout the past 20 years or so (Table 3), although in part this was also due to the higher quality of domestic potatoes.

Despite the highly protective regime, both the area planted and production of these crops show declining trends since the early 1990's. One reason given is lack of appropriate technology (variety). The other is labour shortage and the generally rising wage rates in Sri Lanka (these crops are relatively labour intensive). A third reason is said to be the much bigger focus of policies and support measures on rice self-sufficiency and the neglect of the OFCs generally. A message from the experience of chillies, onions and potatoes, and the OFCs in general, is that restrictive trade policies, no matter how intense, alone will not help when other factors are not favourable.

2.3 Other basic food products

Milk powder

Sri Lanka produces only 20 percent of the country's national milk/dairy needs. Annual imports of milk powder have reached around 60 000 tonnes. Aside from the large and rising import bills, policy problem in the country intensifies whenever the price of milk powder rises in the world market.

Milk powder is designated as an *essential* food item and so the GoSL can regulate (fix, contain) its maximum retail price.[3] Milk powder price is a hot political issue, and

[3] Under the Consumer Affairs Authority Act of 2003, the Authority may enter into agreements with any manufacturers or traders of goods on the maximum retail price. In addition, the Act also states that no manufacturer or trader shall increase the retail or wholesale price of any good in the essential basket except with the prior written approval of the Authority.

promises of price cuts have even featured in some election manifestos. Accordingly, policy is primarily geared towards this goal and interventions are made from time to time to set maximum retail prices. In response, milk powder dealers do also petition the government for raising the price. A typical government response has been to hold on to the maximum retail price but to provide some relief in other ways, such as reduced tariff and tax exemption. Thus in February 2010, the Cabinet Sub Committee for Cost of Living decided not to permit an increase in milk powder price after, as reported in the media, long deliberations in the committee on the prevailing domestic and world prices. The issue then was a request from powder traders for a price rise of Rs 135 on a one kilo packet and Rs 35 on a 400 gm packet. The government responded by adjusting import tariff on milk powder.

Given this recurring policy problem, raising domestic production and competitiveness obviously became a high priority. In 2004, a national programme was announced to establish 1 000 *Dairy Farmer Villages* countrywide, promising large outlays with the goal of raising self-sufficiency level to 50 percent in 4-5 years from 20 percent then, and to full self-sufficiency by around 2015. Besides the prospect of saving on huge import bills, the policy was also justified on the ground of assisting the dairy sector dominated by small producers.

The consensus view in the country seems to be that raising milk production is feasible and the one reason why production lagged so much so far was inadequate support to the sector (Ranaweera 2005). Also, depressed world prices of milk powder lessened the pressure for putting more efforts. That era of low price is considered to be over now and so there is a stepping up of investment by both the government and private sector.

On trade policy, there is a consensus that for an enabling environment for private investment, policy needs to be much less *ad hoc* than it is now. For many, this amounts to some variant of a variable levy scheme, such as that in Chile in the past, so that stakeholders have a better sense of tariff protection and domestic prices when world prices fluctuate.

Poultry and feeds

The poultry sub-sector policy is complicated in large part because there are two administered prices along the value chain - a maximum retail price for chicken meat (as poultry is designated an *essential* food item), and a guaranteed farm price for maize, the main feed. Influencing this value chain is import duty and a cess for the maize development fund. For all these reasons, poultry policy has become contentious and complex.

The industry has been complaining that its margins have been squeezed narrowly because of the maximum retail price for processed chicken on the one hand and the guaranteed maize price on the other. The Chairman of the All Island Poultry Association (AIPA) was quoted in 2008 as saying that the industry was in a serious crisis "due to these imprudent policies".[4] He said the industry has been on the decline since 2005 and 25 percent of small farmers have closed their business.

The industry claimed, based on its own calculations, that the maximum retail prices set at various periods have been below the cost of production. At the same time, poultry feed prices are said to have soared by close to 50 percent in recent years. While the maize price spiked in the world market, the industry blamed the government for high tariff and a 20 percent cess, as well as the guaranteed farm price of maize. It was further claimed that as farmers sell the entire maize immediately after harvest, it is the intermediaries who benefit from the tariffs and guaranteed prices as they buy cheap from farmers while benefiting from the guaranteed higher prices.

The AIPA Chairman further said that fixing the maximum retail price for a perishable product like meat also does not make sense if the government's concern is with hoarding and speculative price fixing because farmers cannot hold meat stocks for more than a few days. He also disagreed that chicken is an essential consumer food item (saying, instead, it is a luxury food), and further went on to say that at one time the AIPA even intended to initiate legal action against the Ministry of Consumer Affairs for setting a fixed maximum retail price.

Based on media accounts, the GoSL seems to be sympathetic to the industry concerns but finds the poultry-feed complex difficult to resolve. It has been reported that the Minister for Consumer Affairs had said that the government wished to keep the price of maize around Rs.28/kg to encourage maize production but that maize prices had gone up to Rs.45/kg or more as market tightened (plus the effect of the tariff). He also conceded that many poultry farms had to even cease operations and that the government needs to allow more maize imports to contain the price. The poultry issue indicates the difficulties in balancing multiple interests and where cross-commodity linkages are strong. These issues obviously require a good analysis based on a sound conceptual framework and disaggregated statistics covering the entire value chain. No such study was found during the background work.

Sugar

Managing trade and pricing policies for sugar is a difficult challenge for most countries and the Sri Lankan story is not very different. Over the years, sugar production lagged demand and import dependency soared, to around 90 percent

[4] "Imprudent policies will hit poultry industry" by Gamini Warushamana, Sunday Observer, 20 April 2008 (http://www.sundayobserver.lk/2008/04/20/fin04.asp)

currently. There is a pressure "to do something" to contain the high import bills. In the mean time, sugar is also designated as an *essential* food item which means that the GoSL also intervenes from time to time on behalf of consumers. When world market prices crash, as they do frequently, interventions are called upon again to maintain farm price.

From time to time, one response from the government has been to consider higher self-sufficiency target for sugar and production programmes. At one time, a target of 35 percent was set for the year 2000. In July 2009, there was a media report that the Ministry of Plantation Industry had a six-year plan to expand cane farming to additional 96 000 acres with a target of reaching 50 percent self-sufficiency.

In the 1950s, the government had established one sugar factory, later in partnership with the private sector. Plans were announced from time to time to add other factories. On 15 March 2010, the *Daily News* reported that the government was in the process of reviewing four sugar plants (at Pelawatta, Hingurana, Kantale and Sevanagala) in order to raise production. There are some serious challenges to expanding cane farming. One is agronomy, sugarcane yield is fairly low to start with. The other is lack of land for expansion, on which there are some serious environmental concerns. Sugar farming is also labour intensive whereas Sri Lanka has been experiencing labour shortages and rising wages.

On top of these difficulties, further policy challenge emanates from the government's desire to guarantee a farm price for cane and at the same time a maximum retail price for sugar, being an essential food. High price volatility in the world market complicates the matter. Addressing the interests of all the three groups involved (farmers, industry and consumers) with a single policy (tariff) is very difficult. The typical response is for the government to vary tariffs responding to changes in the world market price. In 2009, relief was provided to the only sugar factory in the country by waiving the VAT on its products, at the same time raising import tariff. There was also a media story that the industry used a state-supported credit scheme to encourage farmers to continue growing cane rather than switch over to other more attractive crops. One study has even raised a question on the underlying motive for these interventions. It said that the high protection of the sugar industry was not so much for revenue but to honour an agreement signed by the government in the early 1980s with a foreign private enterprise, a case strikingly similar to the Prima wheat agreement (Bandara and Jayasuriya 2009).

2.4 Exporting coconut industry

The main issue facing this industry is that the price of imported edible oils determines the price of locally processed coconut oil, the main input for the export products. Thus, a high import tariff on edible oils raises the domestic price of coconut oil, hurting the export industry. The challenge for the government is to strike a workable balance for *four* stakeholders: coconut growers; industry exporting coconut products; coconut oil industry for domestic use; and consumers of edible oils (Karunagoda 2010b). The key instrument is import policy, notably tariff. To strike a balance for four stakeholders with one policy instrument is never easy.

About 75 percent of Sri Lanka's annual coconut production is used for domestic consumption and the balance is used for various kernel-based industries such as desiccated coconut, coconut oil and coconut milk powder. Notable export products are desiccated coconut, coconut milk, coconut cream and coconut milk powder. The price of coconut oil is linked to the price of imported edible oil. The domestic edible oil consumption in Sri Lanka is around 165 000 tonnes per annum and more than 50 percent of this is met through imported edible oils (mainly edible grade palm oil and palm kernel oil).

Import tariffs on edible oils are typically varied with changes in the world market prices. Thus, the duty was as low as 5 percent towards the end of 2008 when world market price crashed. It was raised from 28 percent in January 2009 to the specific rate of Rs 40/kg and further to Rs 60/kg in early April, and maintained at high level despite the easing of the global edible oil prices. At its peak, total tariff was estimated to be 125 percent *ad valorem* including customs and other duties (VAT, ports and aviation levy, social responsibility levy, surcharge, nation building tax and cess). As a result, the price of coconut oil in the domestic market also rose, to Rs 200/kg from Rs 135/kg in March 2009, compared to around Rs 110/kg in the world market. As a result, export industries claimed that it became very difficult to compete with the domestic coconut oil industry and still be competitive in the export market. Restrictions are placed on the import of fresh coconuts, primarily for phytosanitary reason but also to protect coconut farmers. Fresh coconut is much cheaper in Indonesia and some other countries, and so in theory can be imported for use by Sri Lanka's export industry.

The industry has claimed that for export industries to come back to normalcy, import duty on edible oils should be around 28 percent (as was in December 2008). With that level of tariff, total duty will be about 65 percent and will bring about a workable balance for the export industry, consumers, local coconut oil industry and growers. Another demand of the industry is for predictability of the import regime. The industry complains that in 2008 the duty was revised as many as five times and 2-3 times in 2009 also. The point made is that such *ad hoc* changes make it very difficult to continue to be competitive in the export market with exporters from other countries enjoying lower and stable prices for raw materials.

Coconut growers of course have the opposite set of complaints, and need to be taken into account in articulating a sound policy.[5] In November 2008, for example, the growers' association complained that as the world price of palm oil crashed towards the end of 2008, import tax was reduced to one of the lowest levels, 5 percent, hurting coconut growers for months because traders imported and stockpiled palm oil for use over the next several months. The association has made a number of suggestions for the government. These include: i) formulating an import tax schedule linked to world palm oil prices with tariff levels adequate for safeguarding coconut growers; ii) preventing exploitation of tariff adjustments by palm oil importers by regulating import volumes (to prevent stockpiles); iii) monitoring palm oil inventory held by traders in the country with a view to regulate quantities held in stock; iv) equitably disbursing of the Cess fund collected for the development of the coconut industry; v) instituting measures which will reduce the high margins retained by middlemen on retail sales in times of scarcity; and vi) directly channelling nut production from state-owned estates to city centre in time of scarcity.

2.5 Indo-Sri Lanka Free Trade Agreement (ILFTA)

The ILFTA is considered to be an important agreement for Sri Lanka in particular. Trade statistics show that trade did surge in both directions since 1999, confirming that the tariff and other concessions exchanged were effective. The agreement provides much more concessions to non-agricultural products, but some agricultural products have been prominent in the export basket of Sri Lanka, notably *vanaspat*i oil (processed vegetable oil), spices, sausages, biscuits and chocolates. Tea is also prominent but faces a binding quota. Based on the experience so far, some issues have become prominent and need to be addressed. These issues also provide lessons for improving similar trade agreements with other countries. The points below on the issues are based on Kelegama and Mukherji (2007).

First, there is a strong perception in Sri Lanka that its exports are unfairly subjected to India's para-tariffs such as port charges and NTBs like discriminatory sales tax which more or less erode the preferential margins granted by the ILFTA. Other NTBs includes periodic directives from India to channel imports from 1-2 designated ports only.

Second, there are complaints with the rules of origin (RoO) requirements. This surfaced prominently for spices (pepper and cloves). Indian producers have complained that spices of non-Sri Lankan origins have surged into India via Sri Lanka, hurting them. They demanded import quotas and entry restrictions through a single port to enforce the RoO.

[5] Palm oil futures news, 25 Nov 2008. http://www.palmoilprices.net/news/sri-lanka-coconut-growers-worried-about-growing-palm-oil-imports/

Third, the case of *vanaspati* oil has brought to the fore the issue of safeguard. As happened in the India-Nepal trade agreement, manufacturers took advantage of the large differential on palm oil tariff between India and Sri Lanka and exported processed products to India duty free under the agreement. This led to a surge in exports of *vanaspati* and bakery shortening and margarine (from 10 000 tonnes in 2004 to 170 000 tonnes in 2005), inviting complaints of injury from the Indian industry. Eventually, India enforced "rigorous" safeguard measures like an import quota of 250 000 tonnes per year and canalizing imports through an Indian parastatal.

Fourth, there is a perception in Sri Lanka that India has restricted the import of some products in which the former has a comparative advantage, tea being seen as the main victim. The agreement has a quota of only 15 million kilograms of tea. Tea also faces difficult issues on RoO and imports can take place only from the Kochin and Kolkata ports. In effect, only a meagre 3-4 percent of the quota is exported, which amounts to less than 1 percent of Sri Lanka's total tea export.

2.6 Domestic support measures

Under the WTO Agreement on Agriculture, Sri Lanka does not report trade-distorting domestic subsidies (the Amber Box), claiming implicitly that such subsidies are within the *de minimis* limit. Some outlays are reported under Article 6.2 (subsidies for small and resource poor farmers), mostly for fertilizer subsidies. On export subsidy, Sri Lanka reported some outlays for reducing the cost of marketing (under Article 9.4), mostly for fresh fruits, vegetables and flowers. Overall, the notified outlays are very small relative to the value of agricultural production. Outside of these notifications, there are many government programmes for agriculture, most of them being the Green Box type.

Investment on agriculture is a major determinant of competitiveness and therefore the issue of appropriate trade policy is also linked to the allocation of the limited resources. One policy issue is the allocation between investment and subsidy. The other is allocation across various products. This is the subject of trade support measures or Aid for Trade and discussed in a subsequent chapter. The following points illustrate the links between investment (and subsidies) and the choice of policies, both general and product-specific as were covered above.

- Whether or not to impose some export tax or cess for raising fund for commodity development, and if yes, how best to allocate/utilize the resource?
- To what extent should export products be assisted through WTO-compatible subsidies to reduce marketing costs (Article 9.4), and to grant various incentives like tax exemptions to export-oriented industries?
- Should the government provide subsidies and other forms of assistance (e.g. interest subsidy) when import prices fall and farmers/industry suffer, and to what extent?

- How best to balance support/subsidies across crops? It was noted above that a bigger focus on rice self-sufficiency was one reason for the neglect of other food crops.
- How to determine the extent to which the government should support/ subsidize sub-sectors like milk and sugar that have lost import competitiveness considerably, where self-sufficiency rates are very low, and face binding constraints for reversing these trends?

3. Additional cross-cutting trade issues

Section 2 discussed a number of issues and policy interventions, covering both specific products and some cross-cutting issues. In addition to the observations made there, this section summarizes three cross-cutting messages coming from that analysis as further inputs to the process of articulating appropriate trade policy.

Fair and rules-based trade policy for addressing multiple objectives

The review of trade policies on basic foods in Section 2 showed that the main challenges faced by policy makers – and the main complaints of the private sector - are over two issues: i) *ad hoc* changes in trade policy, notably import tariffs; and ii) the level of the tariff itself. Both are related. In large part, the difficulty arises because a single instrument (tariff rate) is used to address the interests of at least three stakeholders along a value chain - farmers, agro-industry and consumers. For some products, two prices are fixed along the value chain, the farm price and maximum retail price. Even if a balance is maintained at a given point in time, this is easily destabilized by exogenous shocks, and there are several of these - high price volatility in the world markets, exchange rate changes, production shocks and change in governments. For some products, there are strong cross-commodity linkages, e.g. poultry and maize, and palm oil and coconut oil. Faced with the shocks, policy makers find themselves in a situation where they frequently change and adjust instruments (type of tariff, quota) as well as the level of the intervention (tariff rate). This creates an environment of uncertainty and confusion for the private sector, and in the process also hurts the export sector.

Despite the complexity of the policy problematic, and intense media attention, it is striking that no serious analyses were found on the issues. This makes it very difficult for a paper like this, based mostly on review of studies and evidences, to discuss the matter further. It must be the same for the policy makers also.

One issue for urgent analysis is the system of fixing maximum retail price for essential food products like poultry, sugar and milk powder. One could start by asking whether these are essential foods? What are the resource costs and other externalities of a policy trying to maintain retail price for these products? There is a large database available from national household budget surveys that need to be utilized for analyses that would provide guidance on these questions, including on alternatives like targeted food subsidy schemes.

If both the farm and retail prices are to be administered, the margins in between need a very close scrutiny. This is about market efficiency and competition, and investment on infrastructures (see below). In Section 2, some complaints from the private sector were noted that the government does not allow adjusting retail prices when farm prices are changed, or when tariffs or other policies destabilize the existing (agreed) margins. Other than making adjustments in an *ad hoc* manner, there is no clear guideline on how the government should respond in such situations, not just with tariffs but also with other instruments (e.g. VAT, subsidy).

The above illustrations point to the need for formulating rules and procedures for policies that are seen by all as being fair as well as rules-based (see Weerahewa and Kodithuwakku 2010 for an assessment of the recent trade and pricing policies during the global food and financial crises. This is not easy but doable as the issues are well known and necessary database and expertise exist.

Some views were found in the policy literature and the media for rules-based policy regimes. One of them is to have some variant of a variable tariff regime where tariffs vary in a predictable manner in response to world market prices so that import prices are stable around some desired level of protection. Such a scheme was followed by Chile for some products (the price band policy) as well as some other countries in that region. The problem is that this was not found to be WTO-compatible. What is compatible is for the government to vary tariffs in an *ad hoc* manner, but then it will fall short of being predictable. Nonetheless, these ideas deserve some serious analysis.

Another scheme that was floated in some media reporting, quoting the poultry association AIPA, resembled like an "absorption agreement" that Colombia and several other countries had implemented (some still do) whereby the domestic industry/trader agrees to purchase from farmers their produce in specified quantities and prices in return for something else from the government (e.g. access to import quota). In Sri Lanka, the AIPA had said once that it would ensure the purchase of all maize harvest at a price fixed by the government (and also support the government's effort to increase maize production) in return for low tariffs for maize for the industry's needs for feeds. This method is also not WTO-compatible, but variants of the scheme that could be made compatible could be explored.

These are the types of alternative schemes that need to be analysed in order to articulate appropriate trade policies and to avoid the continued divisiveness and frequent and *ad hoc* changes in policies for the 7-8 sensitive food products. It seems that adequate efforts on analysis and consultations have not been made.

Recognizing the limits of trade and pricing policies in the face of binding supply-side constraints

A widely held view in Sri Lanka is that the performance of the agricultural sector is constrained by a wide range of supply-side, infrastructural and institutional impediments that are too serious to be overcome or offset by trade protection and pricing policy alone. This may be the case in particular in the sugar and milk sub-sectors. The argument is that where supply response to price incentive is zero or close to zero because of these other constraints, trade and pricing policies are not effective. In practice, it is exceedingly difficult to determine supply response and so to decide where trade and pricing policies cease to be effective in stimulating the sector.

Public sector support to agriculture is acknowledged to be too low, most likely in the range of 3-4 percent of the agricultural GDP. If so, this is obviously one main reason why the sector is suffering on supply-side capacity from multiple weaknesses like underperforming research and development, limited use of improved seeds and plant varieties, high transaction costs, poor market infrastructures, and structural barriers to agricultural performance (including state ownership of land). A subsequent chapter focuses on agricultural support measures.

Trade and poverty alleviation – transmission of benefits through the value chains

The impact of trade on poverty is a hotly debated matter world wide as the channels through which trade and trade policies impact on the poor are not clearly understood. Indeed, many trade-related interventions are made in the name of the poor. Trade-poverty linkage is also a debated issue in Sri Lanka and some studies have been undertaken. Overall, there is a feeling that while trade has benefited the economy considerably, rural poor have not gained through trade, especially those associated with the food production sub-sector.

Furthermore, it is also widely held that the benefits of trade are largely captured by market intermediaries in the value chains, and not by farmers and rural poor. In the case of exports, some studies have found that while trade expanded considerably, the real farm price of the exportables received by farmers has not changed much, and indeed this was found to decline in many instances with some exceptions like that for rubber after 2001. Among producers, small farmers in particular tend to fare worse generally.

Similar view is widespread in the case of importables, where again higher prices resulting from tariff protection are not said to be transmitted down to small farmers but captured by market intermediaries. One reason for this is that farmers make distress sales after harvest and only those who procure and stock benefit from higher prices. These are often product- specific and so can be resolved only through careful empirical studies. Rafeek and Samaratunga (2000) find that for rice, consumers have benefited from Sri Lanka's trade liberalization at the cost of producers. Such analyses are not easily available for other commodities, making it difficult to get a fuller picture of the impact of trade liberalization. The balance of the view in the research community seems to be that the transmission of trade policy objectives of higher prices to small scale producers is not clear. There are very few studies to debate this matter with facts.

The impact on the poor, especially urban consumers, of policies that fix maximum retail prices of essential food products is also not clear for lack of empirical studies. To the extent that these measures contain price rise, all consumers benefit but the rich benefit proportionately more, which may not be the goal in the first place.

In summing up, there is obviously a need for a better understanding of the link between trade policies and poverty. While studies by outside agencies and researchers are helpful, the government needs to lead the process. One response would be to put in place a monitoring system that generates data and indicators. For example, for export agriculture the employment created and wage rates in the estate and plantation sectors, and the share of the export price received by small holders would be those indicators. This is doable. In Ghana, for example, the government had set a target several years back that cocoa farmers should receive 70 percent of the export price. A monitoring system was put in place and interventions fine-tuned, finally reaching that target recently. There is also a need for more value chain analyses because this framework enables quantifying the margins and gains and losses at different points in the chain, thus helping to identify corrective measures.

References

Bandara, J. & Jayasuriya, S. (2009). "Sri Lanka", *in* K. Anderson and W. Martin (eds.) Distortions to Agricultural Incentives in Asia, The World Bank, Washington, D.C.

Dayaratna-Banda, O. G, Jayawickrama, J. M. A. & Ranathilaka, M. B. (2008). Sense and Nonsense of Rice Price Controls in Sri Lanka. Paper prepared for the Pathfinder Foundation, Colombo.

Karunagoda, K. (2010a). Sri Lanka – Articulating Appropriate Agricultural Trade Policies. Background paper prepared for FAO project on articulating and trade mainstreaming trade policies, Colombo, Sri Lanka.

Karunagoda, K. (2010b). Sri Lanka - Value Chain of Rice, Coconut, Fruits and Vegetables and Milk, Background paper prepared for FAO project on articulating and trade mainstreaming trade policies, Colombo, Sri Lanka.

Kelegama, S. & Mukherji, I. N. (2007). "India-Sri Lanka bilateral free trade agreement: Six years performance and beyond". RIS Discussion Paper 119, RIS - Research and Information System for Developing Countries, New Delhi, India.

Rafeek, M. I. M. & Samaratunga, P. (2000). "Trade liberalization and its Impact on rice sector of Sri Lanka", Sri Lankan Journal of Agricultural Economics, Vol.3, No.1.

Ranaweera, N. (2005). Import Surge of Milk and Milk Products: Sri Lanka Case Study, Background paper submitted by the consultant for the FAO Commodities and Trade Division Import Surge Project.

Samaratunga, P. (2009). Adapting Trade Policies to Promote Food Security and Sustainable Agriculture. Paper presented at Asia-Pacific Trade Economists' Conference: Trade-Led Growth in Times of Crisis, Bangkok, 2-3 November 2009, IPS, Sri Lanka.

Sharma, R. (2002). The transmission of world price signals: concepts, issues and some evidence from Asian cereal markets, OECD Global Forum on Agriculture, Paris: OECD. Transmission

Weerahewa, J. (2010). Towards Evidence-based Formulation of Agricultural Trade Policy: Sri Lanka, Background paper prepared for FAO project on articulating and trade mainstreaming trade policies, University of Peradeniya, Sri Lanka.

Weerahewa, J. & Kodithuwakku, S. S. (2010). Effects and Implications of the Global Food and Financial Crises and Policy Responses: A Study on the Agricultural Sector in Sri Lanka. Study prepared for FAO, July 2010, University of Peradeniya, Sri Lanka.