

Generalised System of Preferences (GSP+) and Its Impacts on the Sri Lankan Economy

What is GSP+?

The European Union's (EU) Generalised System of Preferences (GSP) is a trade arrangement through which the EU provides preferential access to its market to developing countries, in the form of reduced tariffs when goods of developing nations enter the EU market. This trade arrangement is non-reciprocal in nature¹.

Under the EU GSP scheme, there are three separate preference regimes (European Commission web site):

- The standard GSP arrangement, which provides preferences to 176 developing countries and territories on over 6300 tariff lines.
- The special incentive arrangement for sustainable development and good governance, known as GSP+, which offers additional tariff reductions to a selected number of countries.
- The Everything But Arms (EBA) arrangement, which provides duty-free and quota-free access for all products (except for arms and ammunition) for the 50 Least Developed Countries (LDCs).

As a developing country, Sri Lanka gets preferential access to the EU market, based on the standard GSP system. Over and above the GSP accorded to all developing countries, special incentives are provided under the GSP+ regime for countries that ratify and implement 27 international conventions in the areas of human rights, core labour standards, sustainable development and good governance. GSP+ provides duty free access to over 7200 products in the European market. Sri Lanka, together with 14 other countries, qualified for GSP+ for a period of three years, from December 31st, 2005 to December 31st, 2008. All beneficiaries are evaluated by the EU Commission, every three years, before an extension of the trade

arrangement. In December 2008, the European Commission listed Sri Lanka among 16 developing countries to which GSP+ was awarded from January 2009 till December 2011². Nevertheless, Sri Lanka's status as a GSP+ beneficiary is currently subject to the outcome of an eligibility review³.

The overall value of imports to the EU under each of the three GSP regimes mentioned above, and an approximate value of the preferences provided to countries, in terms of nominal duty loss for the year 2007 are given in Table 1⁴. Understandably, more imports come into the EU under the standard GSP scheme, as this has been awarded to 176 developing countries. The beneficiaries of GSP+ have competitive advantage over most developing nations other than the LDCs, given the fact that, this is enjoyed by only 16 countries.

Sri Lanka's Trade with the EU

Given Sri Lanka's high dependence on trade (with a trade: GDP ratio of 54 per cent) and the size of its domestic market (small economy of 20 million people) export markets like the EU have been vital for Sri Lanka's economic sustainability. The EU is Sri Lanka's largest trading partner, and having duty free access to the world's largest market through the GSP+ scheme, gave impetus to the Sri Lankan exporters to increase trade with the EU. Sri Lanka currently exports goods and services worth over US\$ 3 billion (37 per cent of Sri Lanka's total exports) to the EU. It is also Sri Lanka's second major source of imports, accounting for 12 per cent of the country's total imports. The importance of GSP+ to Sri Lanka has also been highlighted in the wake

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of the economic crisis. The impact of the GSP+ on Sri Lanka's exports to the EU has been substantial, and the industries, especially, the garment industry has been vociferous about the need of securing GSP+ concessions. Sri Lanka's exports to the EU increased significantly in the recent years. The main factor that can be attributed to this development is the concessions extended through the GSP+ scheme, since it came into operation in 2005. Under this non-reciprocal preferential trade arrangement, Sri Lanka is eligible to export more than 7,200 products duty free to the EU.

The scheme has helped boost exports to the EU, by enabling local manufacturers to remain competitive despite an increasingly competitive global environment. As a result, the value of exports to the EU increased from US\$1.8 billion in 2004 to US\$2.9 billion in 2009. In 2006, when Sri Lanka had zero duty access to the EU market, exports increased substantially, with a growth of 24.7 per cent compared to a growth of 2.7 per cent in 2005 – this higher growth trend since 2005 is clearly shown in Figure 1.

Table 1: Trade Volumes under GSP and value of preferences

2007	GSP Preferential Imports (€ millions)	Nominal Duty Loss (€ millions)
Standard GSP	49.390	1.542
GSP+	4.927	0.501
EBA	4.321	0.505
Total	58.637	2.548

Note: These figures would vaguely under-estimate the value of GSP for developing countries, since they do not factor in all reductions in tariff preferences applied to specific duty rates.

Source: European Commission web site.

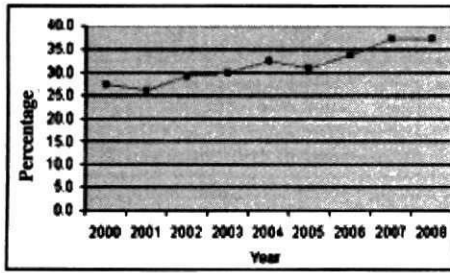


Figure 1: Exports to the EU as a percentage of total exports

Source: Central Bank of Sri Lanka, Annual Report (various issues)

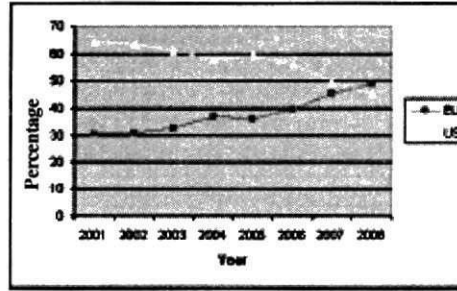


Figure 2: Garment exports to the EU and USA as a percentage of total garment exports

Source: Central Bank of Sri Lanka, Annual Report (various issues)

Like in all preferential deals that offer tariff concession, in GSP and GSP+, there are certain conditions, such as the Rules of Origin (ROO) criteria, that have to be met. Rules of Origin require a certain percentage of domestic value addition to take place for a product to be eligible for concessions. Challenging rules of origin criteria, requiring high levels of domestic value addition, have been a constraint for better utilisation of the GSP scheme. There have been proposals to relax ROO, so that the beneficiary countries can make better use of tariff preferences. As a result of high ROO, the utilisation of preferences has been an issue, especially for sectors, such as the garment industry. Nevertheless, Sri Lanka has been able to improve its utilization rate gradually over time (see Table 2).

The majority of Sri Lanka's exports to the EU are garments; garments account for over half (51 per cent) of Sri Lanka's total exports to the EU (Central Bank of Sri Lanka, 2008), and the local ready-made garment industry has been the largest beneficiary of the GSP+ scheme so far. In this context, GSP+ is of particular importance to the garment industry. The 24.7 per cent growth in exports to the EU in 2006 was led by garment exports which grew by 21.2 per cent (IPS, 2008). It is possible to identify some key changes in the trends in several sectors of the economy as a result of GSP+. Sri Lanka's garments exports to the EU have been increasing rapidly after it was awarded GSP+, while Sri Lanka has been losing its market share in the USA. As illustrated

in Figure 2, in 2008, the EU for the first time surpassed the USA, to be the largest market for Sri Lanka's garment exports, with the EU absorbing 49 per cent and the USA, 45 per cent of total garment exports. The importance of GSP+ to Sri Lanka has emerged strongly during the times of the economic crisis.

Although there was an initial decline in garment exports in December 2008, the garment sector appeared to be fairly resilient recording positive growth rates in 2009 till March this year: textile and garment exports to the EU grew by 18.4 per cent in March while exports to the USA declined. Interviews with some key players in the industry revealed that the growth of the garment sector was sustained in Europe in the first few months of the year, owing mainly to the concessions of GSP+. These concessions helped Sri Lankan garment exporters to offer competitive prices in the EU⁶ compared to its competitors, and this had led to an increase in demand for Sri Lankan garments in the first 3 months⁷.

Importance of GSP+ Concessions to Sri Lanka

In the event Sri Lanka loses the GSP+ concessions, Sri Lanka would still continue to enjoy general preferences under the GSP arrangement (i.e., 20 per cent margin of preference on garment exports) but it would be less competitive without duty free access vis-à-vis countries like Bangladesh and China. LDCs, like Bangladesh, currently receive duty free access under the EBA initiative. Countries like China and Vietnam, who are recipients of the normal GSP concessions with a

20 per cent margin of preference on Most Favoured Nation (MFN) rates, are more price competitive compared to Sri Lanka due to their lower production costs. Therefore, loss of the GSP+ scheme would directly affect the price competitiveness of Sri Lanka's garments. Simple average tariff (MFN) for garments in the EU is 7.4 per cent. The highest band is 12 per cent.

Under the standard GSP arrangement, Sri Lanka will continue to get a 20 per cent marginal preference on garment exports to the EU, and would therefore, pay an average tariff of 5.9 per cent and at the highest band a tariff of 9.6 per cent on garment exports - a major shift from the current zero duty currently enjoyed under GSP+ (IPS, 2008).

This would put Sri Lanka in a vulnerable position with stiff competition from China, especially after the China safeguards on exports to the EU were lifted from December 31st 2008 as a result of the expiration of the EU agreement with China. During the period of safeguards, the annual growth of Chinese textile and apparel imports in 10 categories were limited to growth between 8 and 12.5 per cent.

However, it has to be noted that between the expiry of the MFA in January 2005 and the agreement to enter into quotas in June 2005 the annual growth rates were massive in categories, like sweaters (534 per cent growth on the previous year), men's trousers (413 per cent) and blouses (186 per cent) (IPS, 2008). It is clear that the

Table 2: Total utilisation rate of GSP by Sri Lanka⁸

Year	Total Utilisation Rate (%)
2004	42.1
2005	51.3
2006	64.5
2007	67.1

Source: From data collected by the Department of Commerce (DOC)

China safeguards suppressed Chinese export potential. In addition to the expiration of these safeguards and the current slow down of the world economy, if the GSP+ concession is withdrawn by the EU, this will expose Sri Lanka to a major external shock. Given Sri Lanka's high trade dependence, this will have substantial impacts across the entire economy.

It is important to note that, although, the benefits of GSP+ on the garment sector have been substantial, it has also had a considerable impact on other industries as well (Table 3).

GSP+ covers almost all the goods Sri Lanka exports to the EU, and industries, such as prepared food, leather products, gems and jewellery and fisheries, are also reaping benefits from the scheme. According to the Department of Commerce of Sri Lanka, one of the strongest beneficiaries of GSP+ has been the fisheries sector, while new industries, such as the bicycle exports, have also benefited from the GSP+ concessions. During 2005-2006, the plastics and rubber industry exports grew by 13 per cent. Processed food exports also grew by 13 per cent in the same period, while machinery and mechanical appliances exports grew by 29 per cent and transport equipment exports grew by 26 per cent. As a result, most non-garment product exporters of Sri Lanka have been able to find new markets and expand their existing market shares through GSP+. It is clear that GSP+ has supported and encouraged the diversification of Sri Lanka's overall export basket - a key requirement for the sustainable development of Sri Lanka's economy. The GSP+ scheme encourages increased value addition within Sri Lanka, and thereby promotes backward integration, resulting in the setting up of new industries, and creating new employment opportunities in the country. It is difficult to estimate the exact

number of people who have jobs related to GSP+. Nevertheless, the garment sector provides direct employment to 280,000 people. Apart from that, it is estimated that about a million indirect employment opportunities have been generated by the industry.

The local agriculture sector has also started to export under GSP+ with vegetables, like gherkins, and fish like tuna, being sent to the EU. The concessions under GSP+ are likely to have assisted the financially less privileged farmers who are engaged in agriculture and fisheries industry in Sri Lanka. It is also noteworthy that Sri Lanka maintains high labour standards. Compliance with labour laws has helped Lanka by developing their livelihoods and raising income levels, ensuring better working conditions, especially, in the Sri Lankan garment factories when compared to those of many other developing countries. The use of child labour is non-existent in Sri Lankan garment factories. Special projects have been initiated by associations, such as the Joint Apparel Association Forum (JAAF), in order to uplift the social status and image of garment workers.

As a result, workers in Sri Lankan garment factories have been provided with good working conditions. However, as a result of strong labour regulations in the country, the current wage rate in Sri Lanka is high compared to those of Sri Lanka's competitors, like Bangladesh, Vietnam and Laos. Therefore, the prices of Sri Lankan garments are relatively high, and in this context, Sri Lanka is already at a competitive disadvantage. Inter alia, with GSP+ concessions, Sri Lanka has been able to offer competitive prices while engaging in ethical garment manufacturing. This has helped keep buyers from shifting to producers in competing countries that offer cheaper but has more lax labour standards.

If GSP+ is withdrawn at any stage, it is likely that it would lead to numerous job losses, with the possibility of foreign investments being pulled out and factories being closed down. Although, the large and more established garment sector firms will be in a better position to meet greater price competition given their established buyer relations, differentiated products and marketing capabilities, the small players would

Table 3: Sri Lankan exports under the GSP scheme 2004-2006

Product	2004		2005		2006	
	€'000	Utilisation (%)	€'000	Utilisation (%)	€'000	Utilisation (%)
Textiles and garments	822,289 (70.4)	30.4	819,005 (68.3)	40.5	992,988 (66.4)	57.1
Plastics and rubber	142,843 (12.2)	77.7	166,540 (13.9)	83.7	189,135 (12.6)	83.4
Live animals and animal products	4,310 (0.4)	92.9	4,900 (0.4)	96.3	74,644 (5.0)	98.6
Machinery and mechanical appliances	33,296 (2.9)	47.4	38,409 (3.2)	54.7	48,657 (3.3)	64.3
Prepared foodstuff	38,529 (3.3)	25.5	38,795 (3.2)	31.3	43,571 (2.9)	41.0
Transport Equipment	15,827 (1.4)	80.0	26,592 (2.2)	82.4	33,388 (2.2)	69.9
Total	1,167,979	42.1	1,199,317	51.3	1,495,357	64.5

Source: IPS (2008)

Note: Figures in parentheses are percentages of total value.

be forced to close down their factories⁸. This could result in increased unemployment and possibly increased poverty. It should be noted that the garment factories have been one of the major sources of employment for young women in the rural areas where employment opportunities are limited. Ninety per cent of workers directly employed in the garment sector are women (<http://jaaf.eureka.lk/newsView.cfm?nId=40>). Majority of these workers come from already impoverished households.

Given that the unemployment level among Sri Lankan women (8 per cent in 2008) is high (Central Bank of Sri Lanka, 2008), more than double that of men, withdrawal of GSP+ would further aggravate this problem. Livelihoods will be lost and job opportunities reduced for young women, especially those in the rural areas who are fighting poverty. Large-scale unemployment may well lead to social unrest, as seen in countries like China, in the recent past, as a result of the global economic downturn. Another concern is the ability of the government to support industry and workers in the event of a downturn. The outstanding public sector debt in the country already amounts to 81 per cent of GDP (Central Bank of Sri Lanka, 2008). Given the constrained fiscal position of the Sri Lankan government, in the event of large-scale disruptions to production due to a loss of GSP+, the government may not be in a position to provide meaningful support to affected firms and workers through financial bail outs and unemployment benefits.

Furthermore, in the year 2008, Sri Lanka's trade deficit expanded by 60.6 per cent (Central Bank of Sri Lanka, 2008). Therefore, if there is any further pressure on foreign exchange earnings due to the withdrawal of GSP+, there is a possibility of Sri Lanka being faced with a Balance of Payments (BOP) crisis. In this context, continuity of GSP+ is vital for the Sri Lankan economy. Given that the garment sector is the largest contributor to the local economy (contributing 8 per cent to GDP, 40 per cent to total industrial production and 40 per cent to total export earnings⁹), the withdrawal of the GSP+ scheme would have ripple effects on the economy. The local garment industry has been greatly affected by global economic downturn and credit crunch, with its largest export markets, the USA and the EU, being severely hit. As a result, export orders from

these major markets have fallen and are expected to fall even further with time. Factory closures and job losses have already been recorded in the garment sector, as a result of falling orders due to the global economic crisis. Losing GSP+ concessions at this juncture would not only have crippling effects on the garment sector, but also on other export sectors and the economy as a whole. A decrease of the number of orders from the EU, following the withdrawal of the GSP+ scheme will force some garment factories to close while others would move out of the country, seeking lower cost destinations.

In 2008 when there was doubt on the extension of GSP+ to the country, the government offered to provide a bail out package to exporters so as to cushion the impact of losing GSP+ concessions. Although such bail out packages would provide temporary relief to the industries, it would not be a long-term solution. Given the sheer size, especially of the garment industry, and its contribution to the economy, the loss of GSP+ will have a substantial impact on the entire economy.

Sri Lanka continues to receive preferential access during the course of the investigations. If it is decided to withdraw the GSP+ concessions, the country will be given a six-month notice period prior to the withdrawal. Therefore, according to government and industry sources, GSP+ will be available for Sri Lanka at least till October this year.

Conclusion

With the GSP+ concessions in place, Sri Lanka has been able to beat price competition and expand its market share in the EU in the recent past. Although Sri Lanka is listed as a GSP+ beneficiary for the period 2009-2011, and continues to enjoy the concessions, its status as a beneficiary depends on the outcome of the current investigations on the implementation of the relevant international conventions. The garment industry has been the largest beneficiary of the GSP+ scheme, and if the scheme is withdrawn, its impact on the industry as well as the entire economy will be substantial. The importance of GSP+ has been highlighted in the wake of the economic crisis as well, with the garment exporters fairing better in the EU market rather than in the USA. Nevertheless, the current situation underlines the need for Sri Lanka to

diversify its export products and markets and seek alternative markets so as to reduce its over-dependency on the EU and the US and on the garment industry. Moreover, it highlights the need for the country not to rely on such schemes which are non-reciprocal in kind and the urgent need to find other means of remaining competitive.

References:

Institute of Policy Studies (2008), Sri Lanka State of the Economy 2008.

Central Bank of Sri Lanka, Annual Report (various issues).

Footnotes:

¹ Non-reciprocity means, that the countries that get the benefits (in this case the developing countries) are not required to offer similar preferential access to their markets in return for the access concessions they are granted to the EU market.

² The other 15 countries that have qualified for GSP+ are Armenia, Azerbaijan, Bolivia, Colombia, Costa Rica, Ecuador, El Salvador, Georgia, Guatemala, Honduras, Mongolia, Nicaragua, Paraguay, Peru, and Venezuela.

³ According to the EU, the Commission's investigation will try to establish whether the national legislation of Sri Lanka incorporating the International Covenant on Civil and Political Rights, the Convention against Torture and other Cruel, Inhuman or Degrading Treatment or Punishment and the Convention on the Rights of the Child is effectively implemented.

⁴ This is the duty that could have been earned by EU if the products were imported and if the duties were paid under the EU's standard MFN conditions of access.

⁵ The utilisation levels of GSP+ are not calculated separately and are included in this calculation of the total utilisation rate of GSP.

⁶ From stakeholder interviews.

⁷ Garment exports to both EU and USA declined in April and May. However, the situation may have been worse if GSP+ was not in place. In May, exports to the USA fell at a higher rate than that to the EU.

⁸ Many small-scale factories were hit by the MFA expiration and were forced to close down.

⁹ Calculated using Central Bank of Sri Lanka, Annual Report statistics.