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Labour Standards and International Trade: The Case of EU GSP Concessions to Sri Lanka



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List of Acronyms

AGOA	African Growth and Opportunity Act
ASEAN	Association of South East Asian Nations
ATC	Agreement on Textile and Clothing
CACM	Central American Common Market
CBSL	Central Bank of Sri Lanka
CBTPA	Caribbean Trade Partnership Act
CN	Combined Nomenclature
DDA	Doha Development Agenda
EBA	Everything But Arms
EC	European Commission
EU	European Union
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GSP	Generalized System of Preferences
HS	Harmonized System
ILO	International Labour Organization
LDCs	Least Developed Countries
M&S	Marks and Spencer
MFN	Most Favoured Nation
NAFTA	North American Free Trade Agreement
NEF	New Economic Foundation
NGO	Non-Governmental Organizations
OECD	Organization for Economic Cooperation and Development
QR	Quantitative Restrictions
ROO	Rules of Origin
SAARC	South Asian Association for Regional Cooperation
ASEAN	Association of South East Asian Nations
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

Executive Summary

The linkage between labour standards and international trade traces a long history since the establishment of the International Labour Organization (ILO) in 1919 and became prominent over the years with the establishment of the General Agreement on Tariffs and Trade (GATT) and subsequently the World Trade Organization (WTO). Tariff concessions extended under the Labour Arrangement of the European Union's (EU) Generalized System of Preferences (GSP) since 2004, is an important juncture in the labour-trade linkage in Sri Lanka. However, such a linkage between labour and trade has many implications and issues that require profound focus. In this light, key concerns of this paper are to underscore the implications of the labour-trade linkage through the EU's labour GSP concessions to Sri Lanka and emphasize the issues of the GSP scheme.

International Labour Standards as defined by the ILO are conventions and recommendations setting minimum standards of basic labour rights. Empirical evidence on the use of trade measures by developed countries to promote labour standards in developing countries reflect heterogeneous experiences, with instances where negative, positive and neutral implications were experienced. The paper identifies three groups in society affected by labour standards, namely workers, producers and consumers. In the context of workers, a favourable working environment instigated by compliance with labour standards lead to a motivated and a productive workforce, which paves the path for greater profitability for producers. Among consumers, ethical consumers would increase their utility by consuming ethically produced goods.

The analysis of the Sri Lankan experience of the EU Labour GSP concessions is with reference to the Textile and Apparel (T&A) industry due to its labour intensive nature of production and its significance in Sri Lanka's export structure in general and to the EU. Sri Lanka's T&A industry; which is lagging behind its competitors in terms of wages, productivity and development of backward linkage industries, is benefited by a 40 per cent duty reduction off the MFN rate for exports to EU. Deeper tariff concessions, on the one hand, improve market access of Sri Lankan products to EU. On the other, the image of Sri Lanka concerning the high labour standards maintained in production, enable producers to charge a higher price for the 'better quality' Sri Lankan products; detach Sri Lankan products from the price war; compensate for falling prices of competitors' products; and promote greater trade of high value added apparel exports. Further, the greater demand for ethical products of Sri Lanka would lead to increased production and subsequent investment and improvement of the human capital in Sri Lanka.

Amidst such positive implications, a main issue concerning the labour GSP is the relatively low utilization of concession due to difficulty in fulfilling Rules of Origin (ROO) requirements. For instance, utilization rate of Sri Lanka's apparel exports in 2002 did not exceed 32 per cent, primarily due to the high import dependency of the industry. The possible improvement of utilization rates through Regional Cumulation among SAARC countries or the proposed Super Regional Cumulation between SAARC and ASEAN regions are considered 'not viable' due to the quality requirements of inputs and buyers' specification of suppliers. The above findings based on the low utilization level under the general arrangement can be considered an appropriate approximation of the performance of concessions under the labour GSP, due to the similarity in rules of origin. Emerging issues in trade preferences for Sri Lanka include the concern among competitors regarding labour standards in their production bases, which will deteriorate Sri Lanka's advantageous position and preference erosion caused by GSP concessions extended to other countries, reduction in MFN custom duties, international agreements to abolish duties on selected products and the free trade agreements at bilateral and regional levels.

Recommendations made in the paper to address the above issues are; development of backward linkages of the top export sectors, improve domestic value addition to improve the eligibility of GSP concessions; possible renegotiation of ROO for favourable 'specific process criterion', value addition criteria and

'change of 4 digit HS heading criterion' to 6 digit level; strive for a successful Super Regional Cumulation of the SAARC and ASEAN regions and explore the possibility of considering Hong Kong, South Korea and Taiwan along with ASEAN for Super Regional Cumulation.

Thus, the EU Labour GSP Scheme in terms of tariff concessions will be of limited value to Sri Lanka in the short run. However, in the long run the positive implication would enable Sri Lanka to acquire a significant contribution to its identity as an ethical producer of apparel, much earlier than the competitors do. The benefits of this enhanced image will be most valuable in future, where price war and tariff cuts would be eliminated from the list of factors deciding competitiveness of an exporting country and be replaced by ethical trading practices.

1. Introduction

'Labour standards' has become a key term in the modern international trade vocabulary. It is widely believed that, in the absence of cooperative international action, increasing economic competition in the era of globalization will lead to downward pressures on labour standards (Bhagwati and Hudec, 1996 as cited by Lee, 1997). In this context, labour standards has emerged a prominent issue in an effort to ensure good labour standards for workers. Among many governmental and non-governmental efforts to guarantee decent labour standards for workers world over, the Generalized System of Preferences (GSP) scheme of the European Union (EU), extends tariff concessions for developing country exports manufactured under compliant labour standards, through its Labour GSP Scheme. Sri Lanka is a beneficiary of tariff concessions under this scheme, since February 2004.

In this setting, the broad objectives of this paper are to highlight the implications of the labour-trade linkage through the labour GSP concessions received by Sri Lanka and highlight the issues of the GSP scheme in a descriptive analysis. The structure of this paper comprises of two parts. Sections 2 and 3 constitute Part I, which deals with the labour-trade linkage at a global level, while Part II consisting of sections 4 to 8, addresses the linkage in the context of Sri Lanka. Section 2, Overview of Labour Standards at a Global Level discusses labour standards in the context of the International Labour Organization (ILO) and the World Trade Organization (WTO). The discussion on the GSP system introduces preferences under the EU GSP scheme to set the stage for later discussions, followed by a review of empirical evidence concerning the labour – trade link. Section 3 titled The Case For and Against Labour Standards, identifies three groups in society who are affected by labour standards, namely: workers, producers and consumers. Section 4 deals with the Sri Lankan experience in the labour standards in the backdrop of the EU GSP scheme. Sub-section 4.1 probes into the strengths and weaknesses of T&A industry in Sri Lanka. The benefits of the EU Labour GSP are discussed in sub-section 4.2 under the broad themes of market access and image/branding. A predominant issue of low utilization rates resulting from rules of origin criteria of the EU GSP concessions and emerging issues in trade preferences such as emphasis of labour conditions and concessions for other countries, preference erosion and issues of the graduation mechanism are discussed in sub-sections 4.3 and 4.4, before arriving at the conclusion and suggestions. The paper consists of 14 Tables, 9 Figures and 6 Boxes.

Part I : Labour Standards and International Trade

2. Overview of Labour Standards in the Global Trading Environment

The first institutionalized effort to ensure good labour standards for workers was initiated in 1919 with the establishment of the ILO, which 'called on governments to endeavour to secure humane conditions for labour at home and in all countries to which their commercial and industrial relations extended'(cited in Karunanayake, 2003). In the same year the 'Article 23 of the Covenant of the League of Nations provided that: "Subject to and in accordance with the provisions of International Conventions existing or hereafter to be agreed upon, the members of the league – (a) will endeavour to secure and maintain fair and humane conditions of labour for men, women and children, both in their countries and in all countries in which their commercial and industrial relations extended..." (CEC, 1995 as cited in Rao, 1999). Subsequently, the preamble of the original General Agreement on Tariffs and Trade (GATT) in 1947 indicated the significance of labour standards in international trade by stating that ' Relations among countries in the field of trade and economic endeavour should be conducted with the view of raising standards of living and ensuring full employment' (cited in Chan *et al*, 2003). In the context of the WTO, the Singapore Ministerial Text was the first instance of acknowledging labour issues within the WTO paradigm. The 1996 Ministerial Text states that 'We renew our commitment to the observance of internationally recognized core labour standards. The International Labour Organization (ILO) is the

competent body to set and deal with these standards, and we affirm our support for its work in promoting them. We believe that economic growth and development fostered by increased trade and further trade liberalization contribute to the promotion of these standards. We reject the use of labour standards for protectionist purposes, and agree that the comparative advantage of countries, particularly low-wage developing countries, must in no way be put into question. In this regard, we note that the WTO and ILO Secretariats will continue their existing collaboration'.¹ Despite the fact that the Singapore Ministerial Text, assigns the responsibility of labour concerns to the ILO, WTO members gave different interpretations to the text.² Overlooking the division of opinion on labour concerns among the WTO members, a clear nexus between labour standards and international trade was evident in different stages of the international trade environment. International Labour Standards as defined by the ILO are conventions and recommendations setting minimum standards of basic labour rights: freedom of association, the right to organize, collective bargaining, abolition of forced labour, equality of opportunity and treatment, and other standards regulating conditions across the entire spectrum of work related issues.

International trade agreements include a legal provision intended to eliminate the most extreme forms of labour exploitation in exporting countries by facilitating importing countries to practise trade measures. Such a legal provision is referred to as the 'Social Clause'. The growing trend of including labour standards provisions in bilateral agreements is evident in the US Trade and Development Act 2000, which embraces the African Growth and Opportunity Act (AGOA) and the US- Caribbean Trade Partnership Act (CBTPA). Conditions under the AGOA for US trade preferences include respect of core labour standards and the implementing of ILO Convention No. 182, which bans worst forms of child labour. CBTPA stipulates the necessity of compliance with core labour standards - right to organize and collectively bargain, and the establishment of minimum wages, maximum hour standards and use of child labour. Further, agreements such as US -Jordan and US-Cambodia Free Trade Agreements (FTA) have provisions on labour standards (CUTS, 2004). At the regional level, the North American Agreement on Labour Co-operation- more commonly known as the labour side-accord attached to NAFTA – includes labour concerns within an economic context. (Globalization and Liberalization and CUTS, 2004).

2.1 GSP Scheme

Part IV of the GATT, dealing with "Trade and Development" sets the scene for the granting of trade preferences to developing countries by developed countries on a non-reciprocal basis through mechanisms outside the GATT (Trebilock and Howse, 2000 as cited in CUTS, 2004). The main window for developed countries to extend such non-reciprocal preferences is the Generalized System of Preferences (GSP) initiated by the United Nations Conference on Trade and Development (UNCTAD) in 1968. The objective of the GSP was to enable developing country exports, particularly of manufactures, to enter developed country markets under autonomous preferences. However, the GSP scheme contradicted with GATT on two principles: a) reciprocity; and b) non-discrimination. In addressing these inconsistencies, a special waivers for GSP was temporarily approved in 1971, and permanently in 1979 through the "Enabling Clause" of the Tokyo Round agreements. The Enabling Clause highlighted that developed countries 'may accord differential and more favourable treatment to developing countries' and 'The developed countries do not expect reciprocity for commitments made by them'.

A recent UNCTAD publication claimed that over US\$ 70 billion per annum of developing country exports receive preferential treatment in developed country markets due to the GSP. The tariff concessions could vary from a reduction in Most Favoured Nation (MFN) tariff rate to a complete duty free entry of eligible products. The eligibility of products would be determined differently by different GSP schemes.

¹ Para 4 of Singapore Ministerial Declaration 1996.

² For instance, together with France 'USA was not the only country that interpreted the Singapore Ministerial Declaration as mandating future work on labour standards within the WTO'(CUTS, 2004). A somewhat reconciliation of the two views were proposed by the European Union EU in 1999. At the Seattle Round the EU proposed the 'setting up of a joint WTO – ILO forum with a remit to establish dialogue among all interested parties on the issue of relationship between trade and labour standards (CUTS, 2004).

At present, the GSP scheme is practised by 29 developed countries including the 15 EU countries. Both US and EU have incorporated labour standards as conditions for eligibility for preferences. US specifies that if a country has not taken or not taking steps to 'afford internationally recognized workers' rights to workers in the country' (CUTS, 2004) the country may not benefit from the preferences. The EU's Labour GSP Arrangement specifies that developing countries which do not observe the minimum international standards³ identified by the EU may be deprived of preferential access to the EU market.

In 1994, the EU established a direct link between trade and labour standards in the context of developing countries through its GSP scheme. This was specifically through the Labour arrangement which provides tariff concessions for compliance with labour standards. These preferences are granted subsequent to providing proof of compliance with identified labour standards in the beneficiary country. The other four arrangements are: a) General arrangement, which is available to all beneficiary countries of the scheme; b) The special arrangements for least developed countries (LDCs), also known as the "Everything But Arms" (EBA) initiative. EBA grants duty-free access to imports of all products from least developed countries without any quantitative restrictions, except for arms and munitions; c) The special arrangements to combat drug production and trafficking, intended to assist beneficiary countries in their fight against drugs; and d) The special incentive arrangements to protect the environment. These concerns are available subsequent to request by countries implementing certain standards for the sustainable management of tropical forests.⁴ Based on these arrangements and depending on the sensitivity of the product, it may enter the EU market duty-free or benefit from a tariff reduction.

The product coverage and the availability and extent of tariff preferences depend on the arrangement enjoyed by the beneficiary country in which the products originate. Further, rules of origin (ROO)⁵ and graduation mechanism⁶ ensure that preferences are targeted to those countries that need them most. Along with origin criterion, transport criterion and documentary evidence criterion are required to be met for ROO. Graduation refers to preferences being phased out for countries which have become competitive in certain sectors, based on objective criteria: the development index and the specialization index and also based on the lion's share clause.

2.2 Empirical Evidence on Labour-Trade Linkage

A review of empirical evidence concerning the labour – trade linkage and its implications of the social clause on developing countries reflects heterogeneous experiences. Studies that reflect the possible threats of the labour clause include, a UNDP study on Globalization and Liberalization that shows a world-wide ban on child labour enforced through the WTO could lead to increased incidence of poverty in developing countries, given that these children work as an unavoidable consequence of poverty. A recent World Bank survey examining the theoretical basis for resorting to trade restrictions towards improving labour standards overseas identifies that 'the impacts of trade restrictions taken by foreign countries depend on the circumstances and could backfire if the aim is to improve the situation of workers with limited rights' (Muskus, 1997). Further, Bates (2000) states that 'in practice there is little evidence of trade sanctions being used to effectively promote improved labour standards overseas' and Sing and Zammit (2000), show that South Korea and Taiwan recorded high growth rates in the absence of freedom of association and collective bargaining.

In reflecting the possible opportunities of the labour clause, Polaski (2003) states that in the case of Cambodia, the bilateral textile agreement with USA has resulted in providing basic level of access to the US market for Cambodian apparel, with additional market access awarded on an annual basis if progress is made in respecting worker rights. This arrangement has created 200,000 well paid employment opportunities with improved working conditions and worker rights in Cambodia. Moreover, an OECD survey had revealed that observance of worker rights 'may work as an incentive to raise productivity

³ EU-GSP system's minimum international labour standards will be discussed later.

⁴ Till July 2005, after which, the new GSP Scheme with three arrangements will come into effect (see Box: 6).

⁵ See section 4.3 for a detailed discussion on Rules of Origin.

⁶ Graduation is applicable only to preference granted under the general arrangement and the drug clause.

through investment in human and physical capital'(FES, 2002). Neutral implications are reflected by the analysis of countries petitioned under the GSP scheme where 'the 30 cases ended up being evenly divided

Box 1: Labour Standards and Ethical Trading

In the present context of globalization, where production of a single good is scattered in many factories within one or most often many countries, the conditions under which the production took place is frequently vague. This uncertainty about labour and environment conditions in production has resulted in it being a priority concern of the modern buyer, who is more than price conscious. A common term that encompasses the concern on labour and environment issues is called 'ethical trading'. In the absence of a clear cut definition for ethical trading, one could identify ethical trading in a broad sense as an 'umbrella term' for all types of business practices that promote more socially and / or environmentally responsible trade. In a narrow sense, it could be defined as the assumption of responsibility by a company for the labour and human rights practices within a supply chain. In terms of the narrow definition, implementation of ethical trading often takes place by a sourcing company setting out a code of conduct, consisting of minimum labour standards that they expect their suppliers to maintain. However, the code varies from company to company, but most codes encompass the key ILO conventions on labour rights.

During the 1990s the issue on ethical trading became prominent in international trade mainly due to the growing pressure by trade unions and NGOs in both producing and buying countries. This trend continues to grow and presently, many sourcing companies have policies in terms of ethical trading. For instance, Marks and Spencer (M&S) has a stringent trading policy as their customers have a right to expect that M&S 'products will provide them with truly aspirational levels of quality and value without exploiting the people who work for the suppliers that manufacture it'.

A recent study on Green and Ethical⁷ Consumer Markets has identified a few demographic and economic factors that contribute to the growing demand for green and ethically sourced products (Key Note, 2000). The findings of the study reflect that those over 35 are far more responsive to ethical and green issues and they are expected to become more influential in the market. 'Those in the empty nester 45-54 age groups are most likely to have refused to purchase an item of clothing on ethical grounds'. Compared to men, women have shown a more positive attitude to green and ethical issues. The survey has further found that older respondents attach a greater priority to ethical issues. Exhibiting the regional variations in attitude towards ethical issues, East Anglian respondents of the survey, admitted to not having bought clothing whenever they felt that workers were being exploited.

The Ethical Purchasing Index of the UK published by Co-operative Bank and the New Economics Foundation (NEF) in 2001 shows that spending on green and ethical products rose by 18.1 per cent during 2000, in contrast to the 3 per cent growth of the mainstream economy. The growth on spending on ethical products was six times more than that of non-ethical products. The findings of the Green and Ethical Consumer Market Assessment study in 2002, further states that only one in five consumers would buy any product with no reference to ethical or green issues and one in four men would buy any product regardless of ethical or green concerns.

In the present context, there are various efforts taken by both developed and developing countries to facilitate ethical trading. However, the opinion on ethical trading or more specifically, on labour standards remains divided. On the one hand, labour standards are widely viewed as a protectionist effort by the developed countries to safeguard their domestic industries from low cost products of developing countries (Rao, 1999). On the other hand, it is viewed as a genuine effort to promote good labour and environment standards especially in developing countries.

⁷ Green and ethical consumer markets refer to markets in which the consumers are concerned about environment concerns and ethical concerns.

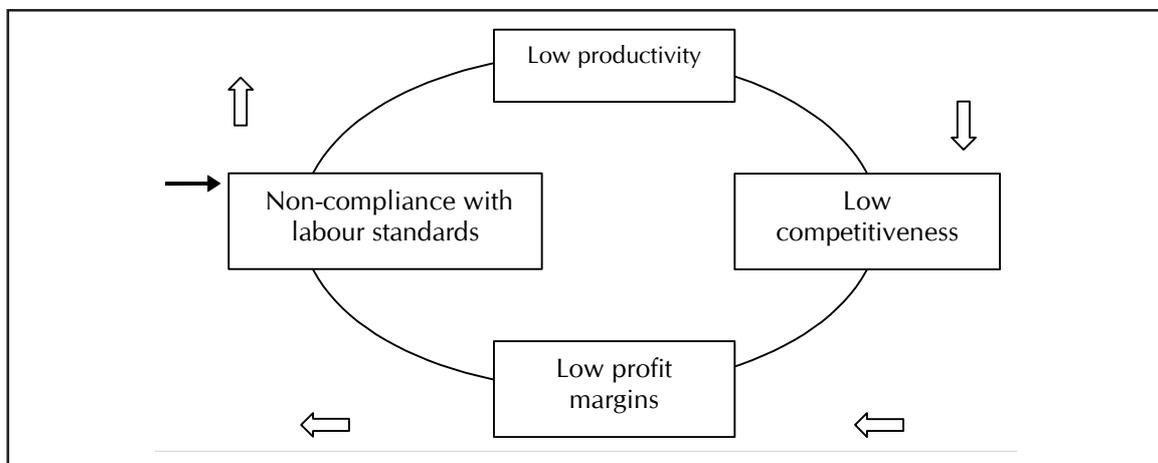
between success and failure’ (Elliot as cited in Bates, 2000). Further, ‘Rodrik (1996) econometrically rated basic measure of labour standards across countries, such as ratification of ILO conventions covering core labour standards and an indicator of enforcement problems in child labour standards, to international trade flows. He was unable to determine any relationship in the data’ (Muskus, 1997).

3. The Case For and Against Labour Standards

The non-compliance with good labour standards have potential to affect three main groups in society. Firstly and most importantly, the absence of compliance with labour standards would affect workers. The prevalence of low wages, exploitation of workers, discrimination in the work place, inability to organize to redress their grievances and being forced in to work in an unfavourable environment have a negative impact on workers. Working under conditions similar to sweatshops, they are often prone to illnesses due to the lack of fresh-air, pressure of loud noise of machinery and dust of material etc. At times, workers may be forced to work overtime to meet deadlines against their will and not be duly compensated for the services rendered. Thus, the absence of labour standards, is detrimental to the worker. An OECD study in 2000 (as cited in Sengenberger, 2002) reveals that ‘countries which strengthen their core labour standards can increase economic efficiency by raising skill levels in the workforce and by creating an environment that encourages higher productivity and innovation’. Further, as identified by the afore-stated OECD study, the gains arising from respect for core labour standards through a motivated and productive workforce are likely to be significantly greater than the saving from suppressing labour standards.

In this backdrop, the second group in society that is affected by labour standards are producers. Producers could perceive that curtailing production costs through non-compliance of labour standards is favourable for price competitiveness of their products. Such employers fail to realize that ‘labour standard-related costs are only one component, and often not a major component, of cost structures. Improving adherence to labour standards will not necessarily translate into a significant increase in total costs’ (Commonwealth of Australia, 1996). Further, the suppression of production cost at the expense of labour standards could inevitably lead to low productivity of such labour compared to the productivity of the same work force under better labour standards. The study by Alexander Egorov (Egorov, 2003) shows that high productivity cannot be achieved and maintained in the long term under poor labour standards. As such, low productivity leads to low competitiveness, and subsequently gives a minor profit margin. Inadequate profit margins compel producers to continue to employ labour under low labour standards and as a result the cycle continues. The Figure below depicts the vicious cycle of low labour standards.

Figure 1
Vicious Cycle of Low Labour Standards



Ratification of labour conventions and compliance with the social clause enable producers to break away from this vicious cycle of low productivity. In considering the cost versus the benefit of maintaining

better labour standards, in the long run the benefit would outweigh the cost involved. 'Even where the adoption of higher labour standards significantly increases total costs that may not necessarily be reflected in increased export prices or poorer export competitiveness. Exporters may be prepared to absorb the cost increases and, if consumers are willing to pay more for what they perceive as "better quality" goods, exporters may be able to charge higher prices without losing sales. Where this is the case, increases in adherence to labour standards may lead to improvements in the terms of trade for those countries as importers in industrial countries pay more for each imported good' (Commonwealth of Australia, 1996).

Consumers would be the third group to face implications in a scenario of non-compliance with labour standards. A consumer who is concerned about the price he pays for a good may perceive that non-compliance with labour standards would decrease the price of the goods he purchases. But an ethical consumer would not consider the decline in prices of goods by reducing cost of production through suppressing labour standards, as a saving. Instead, such an ethical consumer would be more conscious about the decrease in his utility due to the decline in price and prefer paying an 'ethical premium' for maintaining high labour standards. Presently, many western consumers are increasingly becoming conscious about the labour standards under which the goods they purchase have been produced. For instance, revelations such as use of child labour in Bangladesh for apparel produced for Wal-Mart in 1993, in China use of child labour and violation of health and safety codes in manufacturing toys and clothes in 1997 and use of child labour by Nike-contract companies in Cambodia in 2000, resulted in boycotting of products by consumers. Subsequently, reacting to the signal given by consumers, 'some international multinational corporations commissioned international accountancy firms such as Ernst & Young and Peat Marwick to assess and adjudicate their labour practices in developing countries, while others resorted to recruiting local NGOs in developing countries and assigning specific 'in-house' personnel to monitor labour practices (Wilkins, 2003). These instances reflect the preference of consumers towards goods produced in an ethical manner and also the importance buyers place to such concerns of the consumers.

Some benefits of adhering to labour standards in the long run could lead to the balance of power between the employer and the employee to be equally shared, which would contribute to reduced inequality in income and a subsequent creation of a mass market for development of the economy. Also labour standards promote the development of human capital as appropriate wages enable workers to maintain and develop their and their children's qualifications and adopt performance oriented behaviour.

As such, the implementation of the social clause in producing countries has a capability to benefit workers, producers and consumers across both buyer and producing countries and the society in general.

Part II: EU Labour GSP and Sri Lanka

4. Sri Lanka's Experience with the EU Labour Incentive

For many years Sri Lanka has been improving labour standards through changes to the labour legislation etc. As a culmination of these improvements Sri Lanka submitted a written application to the EU in 2002, specifying that the core labour standards mentioned in Table 1 are complied with.

The EU conducted an independent evaluation and granted the incentives under the labour clause effect from February 1, 2004, as 'Sri Lanka was making good progress towards full compliance'. In addition to Sri Lanka, Moldova is the only other beneficiary of the labour GSP.

Prior to granting the preferences under the Labour GSP, Sri Lanka was entitled for duty reduction of 3.5 percentage points from the Most Favoured Nation (MFN) rate for sensitive products, except for garments which were eligible for 20 per cent of MFN rate. Out of the total product coverage of the GSP scheme, 50 per cent are classified under non-sensitive products which enjoyed duty free access to the EU market.

Table 1
Core Labour Conventions

ILO Convention No	Convention
29	Forced Labour Convention (1930)
87	Freedom of Association and Protection of the Right to Organize Convention (1948)
98	Right to Organize and Collectively Bargain (1949)
100	Equal Remuneration Convention (1951)
105	Abolition of Forced Labour Convention (1957)
111	Discrimination (Employment and Occupation) Convention (1958)
138	Minimum Age Convention (1973)
182	Worst Forms of Child Labour Convention (1999)

Box 2: Moldova

In 2000, Moldova was the first country to benefit from deeper tariff concessions under the EU's special protection scheme for the promotion of labour rights. Subsequent to the increase in tariff preferences, Moldova's exports to EU increased from US\$ 83.6 million in 2000 to US\$ 116.3 million in 2002, with a dominance of clothing and footwear exports.

Since February 2004, sensitive products which entered the EU market under a 3.5 percentage points duty reduction of the MFN rates receive an additional 5 percentage points duty reduction which totals to 8.5 percentage points duty reduction of the MFN rate as seen in Table 2 below. The textile and garment exports previously eligible for 20 per cent reduction off the MFN rate are now eligible for another 20 per cent reduction which gives a total duty reduction of 40 per cent. Certain products which were receiving a 30 per cent tariff reduction under the GSP scheme are eligible for another 30 per cent, which totals to 60 per cent tariff reduction. Items under the Combined Nomenclature (CN) 2207, which were on a specific duty with a tariff reduction of 15 per cent under the GSP general arrangement, are presently eligible for an additional 15 per cent and a total tariff reduction of 30 per cent off the MFN rate (EU Press Release, 2004).

Table 2
EU GSP Concessions for Sensitive Products

Products	GSP General Arrangement Concession	GSP Social Clauses Concession	Total GSP Concession	Final Applicable Tariff Rate
Sensitive products	3.5 p.p.*	5 p.p.	8.5 p.p.	CCT rate ** - 8.5 p.p.
Textiles and Garments	20%	20%	40%	CCT rate - 40%
Specific duties, except CN*** code 2207	30%	30%	60%	CCT rate - 60%
Specific duties for CN code 2207	15%	15%	30%	CCT rate - 30%

* p.p refers to percentage points.

** CCT Rate: Combined Custom Tariff Rate

*** CN code 2207 refers to Undenatured ethyl alcohol of an alcoholic strength by volume of 80% vol. or higher; ethyl alcohol and other spirits, denatured, of any strength as identified by the HS code 2207.

Source: GSP Manual, 2002.

Benefits offered by the EU under the GSP scheme for maintenance of good labour standards is applicable to all exports once the country is recognized by the EU as a nation that is compliant with the core labour standards. However, the analysis on implications of the social clause on Sri Lanka is limited to Sri Lanka's apparel exports to the EU due to three main reasons:

- 1) The apparel industry is one of the leading labour intensive industries and has a high applicability for labour standards.

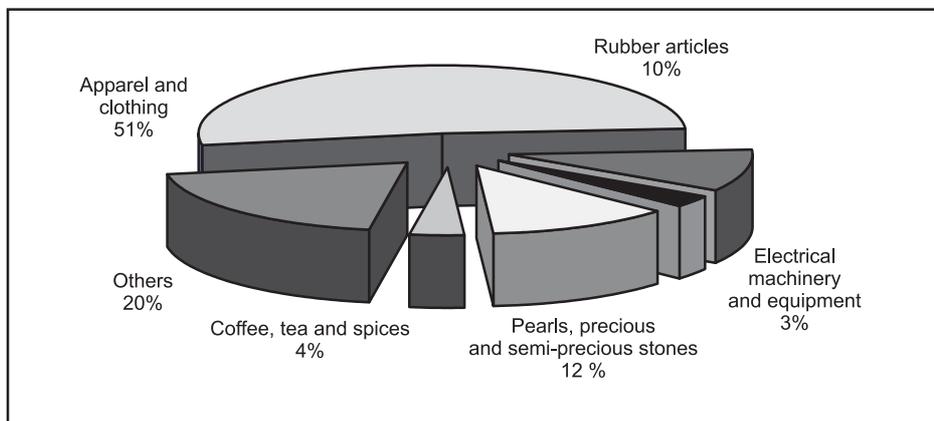
Present state of play in the international apparel trade is a quota free environment governed by open competition except for a few restrictions such as safeguard mechanisms and countervailing duties⁸ etc., since the end of the Agreement on Textile and Clothing (ATC) on December 31, 2004. The ATC integrated textile and apparel trading into multilateral rules over a period of 10 years. However, in the EU market, Sri Lanka's exports were not subject to any quantitative restrictions since 2001, while certain other countries were under QR.⁹ The open competition in the textile and apparel trade is often regarded as a case for a race to the bottom, where competition for a larger market share leads to a downward spiral of labour standards (Rao, 1999; and Chan, 2003).

- 2) The textile and apparel sector is the leading export sector in Sri Lanka.

- 3) Apparel sector in Sri Lanka is the leading export sector to EU in recent years.

Apparel exports constitute 51 per cent of total exports from Sri Lanka to EU.

Figure 2
Composition of Sri Lanka's Exports to EU, 2003



Source: Compiled using European Trade Commission statistics.

⁸ Countervailing Duty is a duty imposed to offset subsidies by foreign governments.

⁹ In 2000, Sri Lanka negotiated an agreement with the European Union to bind its tariff on a range of products, and in return the European Union withdrew the application of the quantitative restrictions in respect of textile and clothing products exported from Sri Lanka effective January 2001 (Fernando, 2002).

4.1 Sri Lanka's T&A Trade with the EU

In the Sri Lankan economy textile and apparel sector plays a lead role by accounting for 43 per cent of the value of industrial production, 64 per cent of industrial exports and 50 per cent of total export earning (in 2003). This sector accounts for approximately 350,000 direct employees and a significant number of indirect employees. In 1986, textile and apparel sector overtook the plantation exports and remained the main contributor in the growth of exports. During the past five years T&A accounted for over half of total export earnings and 5.3 percent of the GDP.

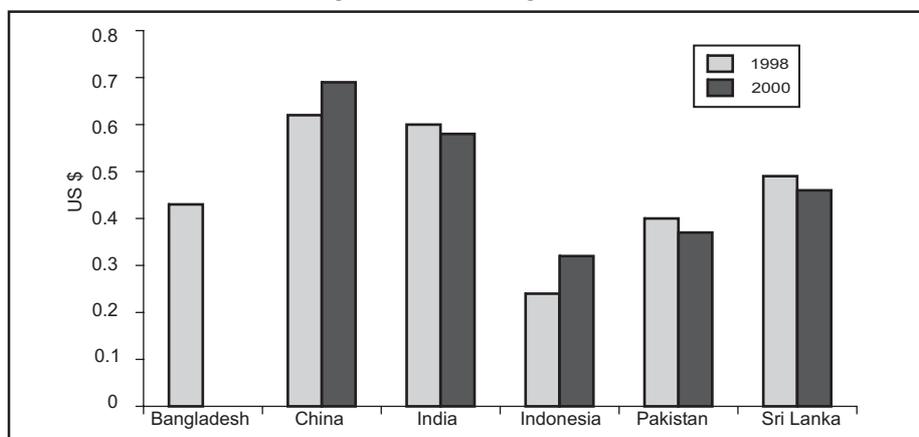
Despite being a dominant sector in the economy, the T&A sector consist of both strengths and weaknesses. The strengths identified by the Five Year Strategy of the T&A industry include reputation for being a quality apparel manufacturer for the mass market; compliance with International Labour regulations; relatively disciplines and skilled labour and a trainable labour force; reputed international customer base; while the weaknesses identified include the geographical location of the country and lack of geographic diversity in markets; increasing cost of labour (in relations to other South Asian producers); low productivity of labour; limited access to technology ; non existence of product design and new product development; inadequate focus on developing backward integration linkages to support the industry and relatively high cost of utilities, etc. The following section, discusses three areas of concern for Sri Lanka's T&A trade performance.

Wage cost

In the globalized apparel production system, the location of apparel industries has undergone three successive phases. In the initial phase Hong Kong, Singapore, Republic of Korea and Taiwan were the main production sources while Philippines, Indonesia, Thailand and Malaysia later became dominant producers in the second phase. In the last phase another group of countries including Turkey, China, Bangladesh, Pakistan, Sri Lanka, Laos, and Vietnam became the significant apparel producing countries. As the garment industry is relatively low skilled and labour intensive, the shift of production has been based on the comparative advantage of low wage costs. The present position is that over the years Sri Lanka has gradually lost its comparative advantage in low labour cost (Kelegama, 2004; and Dheerasinghe, 2003).

As depicted in Figure 3 below, the wage rates in Bangladesh were lower than Sri Lanka in 1998 and Pakistan and Indonesia were lower than that of Sri Lanka in 1998 and 2000. This reveals Sri Lanka's relatively less competitiveness in the region, in terms of wage cost.

Figure 3
Average Hourly Labour Cost in Selected Countries, 1998 & 2000
(wages & social charges in US\$)



Note : Statistics for Bangladesh for 2000 was not available.

Source : World of Work 1999, Werner International 2000.

Extracted from Dheerasinghe, R. 2003.

Productivity

Studies have identified that productivity and the labour efficiency of the apparel industry in Sri Lanka is significantly low when compared with competitors such as Bangladesh, Vietnam and China (Kelegama & Eparachchi, 2004; Dheerasinghe, 2003; Strategy, 2002). The Table below shows that Sri Lanka’s annual wage per employee was US \$ 700, while in India this was US \$ 600. In terms of value addition, India was around five times the wage while in Sri Lanka this was less than three times the wage. The US\$ 100 difference in wage translates to a 109 per cent higher value addition to wage ratio in India. As per this Table the wages per employee in India was lower than in Sri Lanka for the period considered, however, the corresponding labour cost as a percentage of output was almost three-fold of Sri Lanka’s share.

Table 3
Selected Characteristics of the Wearing Apparel Sector in Selected South Asian Countries (Annual Data), 1993/94

Country	Value added per Employee (1000 dollars)	Wages per Employee (1000 dollars)	Percentage in Output		
			Cost of Inputs materials etc.	Cost of Labour	Operating Surplus
India	3.4	0.6	68.8	5.3	25.9
Nepal	1.6	0.5	59.7	11.4	28.9
Sri Lanka	1.9	0.7	55.4	15.5	29.1

Source: UNIDO, 1998.
 Extracted from Kelegama, 2004, pp82.

Box 3: Good Labour Standards vs Poor Labour Productivity

A contradiction in theory and empirical evidence worth additional consideration is the issue of good labour standards and the poor labour productivity in Sri Lanka. As stated earlier, high wage rates and good labour standards are prevalent in Sri Lanka. On the other hand, in competitor countries wage rates are lower, while the labour standards maintained are also said to be lower. However, in terms of labour productivity the lower waged workers in other countries working under worse labour standards account for a higher labour productivity, while the higher paid Sri Lankan workers who also work under better labour standards account for a lower productivity.

Backward linkages

The availability of inputs for the apparel industry within the country is another important factor in determination of trade performance. The abundance of raw material required for the industry facilitates the speedy production of goods and lesser turn-around time or lead times for the finished good to reach the final destination (Dheerasinghe, 2003). A comparison of the availability of raw material for the apparel industry is approximated by considering the significance of textile imports in relation to apparel exports.

As evident in Table 4 below, Sri Lanka imports of textiles as a share of apparel exports is the highest among the countries considered. ‘The high dependence on imported raw materials in Sri Lankan apparel industry is becoming a severe impediment for future growth’ (CBSL, 2002) which has negative implications on Sri Lanka’s apparel export performance. The geographic location of Sri Lanka, significantly away from the major apparel markets coupled with the high dependency on imported inputs results in a double disadvantage in turn round times. Firstly, the disadvantage in the shipping time taken to import the inputs to Sri Lanka and secondly, due to the time taken to ship the finished good to the final destination.

Table 4
Apparel Exports and Textile Imports in Selected Countries, 2003
 (in US\$ billion and percentages)

Country	Apparel Exports (US\$ Bn) (1)	Textiles Imports (US\$ Bn) (2)	Share of Imports (2) / (1) * 100
Bangladesh	4.4	1.3	29
India (2002)	6.5	0.9	14
China	52.1	13.0	25
Pakistan	2.7	0.3	9
Sri Lanka (2002)	2.3	1.3	57

Source: www.wto.org

In 1998, all tariff rates applicable for cotton fibre, cotton yarn and fabric imports to Sri Lanka were abolished (see Table 5). This tariff elimination on imported apparel inputs is viewed to have contributed to low development of backward linkage industries – mainly textile inputs, as many domestic producers gradually ceased the production of textile, with the inflow of imported textiles. However, the tariff policy change in 1997 (to remove tariff on cotton fibre, cotton yarn and fabric imports) cannot be regarded as a main reason for the low development in the backward linkage industries. Parallel to tariff policies, high investment costs, lack of any cotton or synthetic raw material, high cost of electricity and the relatively small domestic market are some of the other reasons that have contributed to the low level of development of backward linkage industries of the apparel industry (Fernando, 2002).

Table 5
Textile Import Duty Rates (%)

Year	Cotton Fibre	Cotton Yarn	Fabric	Garments
1984 (Nov)	0	5	45	45
1987 (Dec)	5	25 (or Rs. 25/kg)	60 (or Rs. 15/sq.m)	60 (or Rs. 15/sq.m)
1989 (Mar)	10	25 (or Rs. 25/kg)	60 (or Rs. 15/sq.m)	60 (or Rs. 15/sq.m)
1991 (Nov)	0	20	35	35
1993 (Apr)	10	25	100	100
1993 (Nov)	3	25	50 (or Rs. 10/sq.m)	50 (or Rs. 10/sq.m)
1995 (Feb)	0	10	35	35
1998 *-2002	Free	Free	Free	10

* Import duty on textile was eliminated in 1998.

Source: SOE, 2003.

The disadvantageous position due to importation of inputs, is counter-argued on the basis that the availability of a wider choice of higher quality imported inputs to complement Sri Lanka's apparel exports. However, the validity of this counter argument is questionable due to two reasons. Firstly, the relatively high wage cost and low productivity together with higher price paid for imported inputs lead to higher cost of production of apparel produced in Sri Lanka. Secondly, though imported inputs complemented Sri Lanka's apparel exports during the quota era, in the present quota free era, the ability to be total solution providers has become an important criterion to remain a significant supplier in the top apparel markets. 'The future customers of the global apparel industry would look for the fulfilment of the entire process – commencing from market information, product concept, product design and development, high quality manufacturer, shorter delivery schedules and superior after sales service' (Strategy, 2002). In this setting, the stagnation of backward linkage industry development would hold disadvantageous for Sri Lanka.

Box 4: Contradicting Experience of Backward Linkage Industries

A contradicting experience of backward linkage industries was depicted in terms of Indonesia¹⁰ for the period 1985-1995. This study found out that emphasis on linkages can be both ineffective and counterproductive. 'In the context of the ongoing process of internationalization of production, industries characterised by high import intensity and hence low domestic input linkages have the potential to make a greater contribution to employment expansion and growth of net export earnings' (Athukorala, 1998). However, the study highlights that 'the study by no means imply that the linkages are bad..... What we simply argue here is that there is little room for creating linkages through policy intervention, and such policy intervention may in fact act as a brake on development' (Athukorala, 1998). The study further notes that 'the greater the linkages between the export sectors and the rest of the economy the greater would be the benefit to the economy from export expansion, provided such linkages are the natural outcome of industrial deepening'(Athukorala, 1998).

Kelegama and Foley (in Kelegama, 2004) showed the Sri Lankan scenario of the above issue. Their study depicted that production of inputs for the T&A industry within Sri Lanka would be not be competitive in terms of price as well as quality, as the country 'still does not have the conditions for capital-intensive industrial production. As such, Kelegama and Foley conclude that ' Supply will respond to demand as Hirschman (1958) visualized once the proper environment exists. It will be a natural outcome of industrial deepening. Thus, formation of backward linkage is time dependent in an open economy'.

Amidst these concerns of the T&A industry in Sri Lanka, T&A exports play an important role in the export structure. The majority of Sri Lanka's T&A exports are directed to EU and USA, which together accounted for over 90 per cent of Sri Lanka's T&A exports in recent years. In 2004, EU accounted for 37 per cent of Sri Lanka's apparel exports, while USA accounted for the largest share of 57 per cent. However, the large proportion of Sri Lanka's T&A exports to EU translates into an almost insignificant 0.8 per cent of the EU T&A market. In 2003, the EU imported apparel worth of US\$ 101,294 million (see Table 6). China was the largest exporting country in 2003 by accounting for 12.2 per cent of total imports of the EU. Bangladesh was the fifth largest supplier to by accounting for 3.4 per cent, while India secured the seventh place with a share of 3 per cent. Indonesia (1.5 per cent), Pakistan (1.1 per cent) and Sri Lanka (0.8 per cent) occupied 11th, 12th and 17th place respectively. Over the five year period from 1999 to 2003, Sri Lanka's market share in the EU has been hovering around 1 per cent, while China has gradually increased its market share as the leader. A point worth taking into consideration here is that the said countries were ahead of Sri Lanka while experiencing QRs for their exports, and their export performance in the EU market would improve significantly in the present context, where no QRs apply.

As depicted in the Table, Sri Lanka's neighbours, India, Bangladesh and Pakistan, are all ahead of Sri Lanka in terms of their share in the EU market in 2003. This reveals that at an aggregate level, Sri Lanka is not a significant player in EU market compared to the neighbouring countries.

In addition to aggregate market share, category level experience of Sri Lanka's apparel exports too reflect lack of market power in the EU market. During the month of January 2004, Sri Lanka's top apparel export category to EU in terms of value was Category 6¹¹: Breeches, Shorts etc., for which exports were valued at US\$ 11.8 million (see Figure 4). However, in considering the market share of Category 6, Sri Lanka accounted for a mere 0.42 per cent while Bangladesh accounted for almost 3 per cent. Further, except for

¹⁰ Athukorala, Prema-Chandra, 1998, *Trade Policy Issues in Asian Development*, Routledge, pp. 90-110.

¹¹ Men's or boys' woven breeches, shorts other than swimwear and trousers (incl. slacks); women's or girls' woven trousers and slacks, of wool, of cotton or of man made fibres; lower parts of track suits with lining, others than category 16 or 29, of cotton or of man-made fibres.

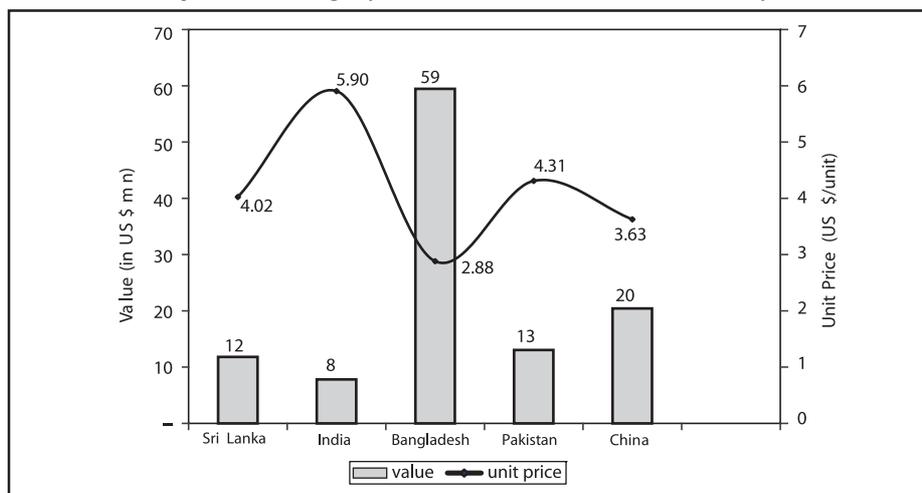
India, Sri Lanka's market share was the lowest among the countries considered in the Figure. This further highlights Sri Lanka's mediocre performance in the EU market even in terms of a top export category.¹²

Table 6
Clothing Imports of EU by Supplier, 2003
(values in million dollars and percentages)

Supplier	Value 2003	Share 2003	2002	2001	2000	1999
World	101294	100	100	100	100	100
European Union (15)	40903	40.4	39.9	39.5	38.9	41.3
China	12364	12.2	11.5	10.6	9.4	8.6
Turkey	8325	8.2	7.8	6.8	6.4	6.3
Romania	4160	4.1	4.1	3.7	2.9	2.7
Bangladesh	3453	3.4	3.0	3.1	2.8	2.3
Tunisia	3084	3.0	3.2	3.2	3.1	3.2
India	3012	3.0	3.0	3.0	2.9	2.7
Morocco	2815	2.8	2.9	3.0	2.8	2.7
Hong Kong, China	2341	2.3	2.6	2.9	5.5	5.2
Poland	1683	1.7	1.9	2.2	2.2	2.4
Indonesia	1520	1.5	1.7	2.0	2.2	1.9
Pakistan	1130	1.1	1.1	1.1	1.0	0.9
Bulgaria	1093	1.1	1.0	1.1	0.8	0.7
Thailand	1061	1.0	1.1	1.1	1.3	1.3
Hungary	992	1.0	1.1	1.3	1.1	1.2
Czech Republic	891	0.9	0.8	0.7	0.6	0.6
Sri Lanka	831	0.8	0.9	0.9	1.0	0.9
Korea, Republic of	709	0.7	0.8	0.9	1.1	1.0
Switzerland	655	0.6	0.6	0.6	0.3	0.5

Source: WTO, http://www.wto.org/english/res_e/statis_e/its2003_e/section4_e/iv68b.xls visited on 31/08/ 2004 and 23/03/2005.

Figure 4
EU Imports of Category 6 of Selected Countries in January 2004



Compiled using Sigl data. <http://sigl.cec.eu.int/>

¹² Different performance may be seen in other countries, during different periods.

4.2 Benefits to Sri Lanka’s T&A Sector from EU GSP

As evident from the foregone discussion, Sri Lanka’s trade performance in the EU apparel market is relatively weak. However, the tariff concessions extended under the EU GSP scheme improves Sri Lanka’s position in the EU market in two broad areas, namely- market access and image/branding.

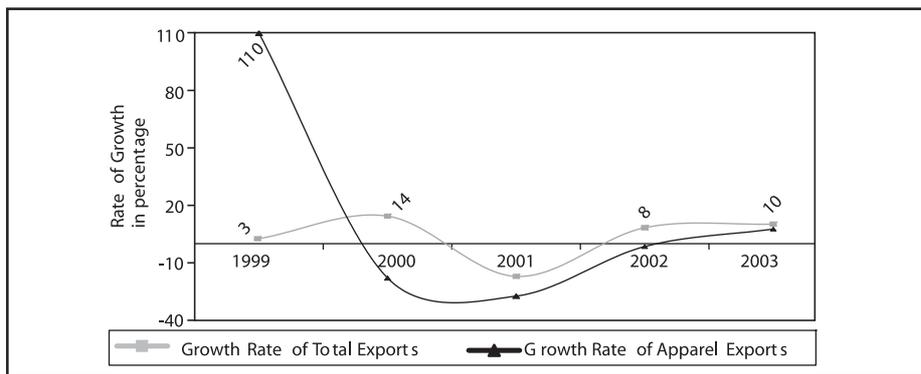
An important barrier for exports to reach a foreign market is the barrier imposed by tariff rates. ‘For approximately four decades, developing countries have asked for and received considerable preferential access to developed country markets. EU has clearly contributed its share towards such market access’ (Panagariya, 2002). The provision of deeper tariff concession to Sri Lanka under the labour incentive of the EU GSP mechanism gives Sri Lanka an advantage over the other exporting countries. This could be capitalized by Sri Lanka’s exporters to improve Sri Lanka’s trade performance in the EU market. Due to the difficulty in obtaining actual prices and tariff rates, a hypothetical example of a three country framework with single traded good is depicted in Table 7 below. The EU imports the good and Sri Lanka is the beneficiary, while Country X is the non-beneficiary of preferential tariff rates for Labour Standards. Both Countries benefit from tariff preferences under the general arrangement. The example assumes that the benefit accruing to Sri Lanka depends only on the preferential margin of the labour GSP and the price of the good is equal in both exporting countries. In the background, the example shows that Sri Lanka’s apparel exports get a greater concession under the labour incentive and the general arrangement, while the other country would be enjoying a lower concession. The non-beneficiary country exports (of labour concessions) are crowded out by Sri Lankan exports benefiting from labour GSP preferences.

Table 7
Example of Greater Market Access with Deeper Tariff Cuts

Country	Price of Apparel Article in US\$	EU Tariff Rate (10%) US\$	GSP Concession	Final Price (US\$)
Country X	100	10	10 - 2 = 8 (a)	108
Sri Lanka	100	10	10 - 4 = 6 (b)	106

(a) Concession for General Arrangement 20% off MFN Rate.
 (b) Concession for General Arrangement + Labour Incentive 40% off MFN Rate.

Figure 5
Growth Performance of Sri Lanka’s Exports to the EU, 1999-2003



Source: Compiled using CBSL statistics.

In terms of a trade flow analysis from 1999 to 2003, it is evident that except for 1999, in all other years growth rate of apparel exports to EU has been lower than that of total exports to EU. From 2000 to 2002 apparel exports have recorded negative growth rates. This reflects a degree of difficulty apparel exports have experienced in exporting to EU under open competition. However, in considering the significance of the apparel industry in Sri Lanka, and its significance in the export composition to EU, a deeper tariff concession of 40 per cent off the MFN rate for apparel would provide greater market access.

In addition to tariff rates, another constraint to market access is the price of the product. Considering the cost structure in Sri Lanka, in relation to regional competitors, apparel products manufactured in Sri Lanka are relatively more expensive than a similar product made in Bangladesh. As stated earlier, the price war in the apparel trade has started a race to the bottom, where the producers are striving to cut production costs, often at the expense of the facilities provided to the employees. The following Tables depict the movement of price in the EU and US markets for selected apparel products of various producing countries.

Table 8
Unit Price of Cotton Knitted Baby Garments Produced in Selected Countries
for the EU Market (unit value in Euro per Kilo)

Country	2001	2002	2003
Bangladesh	11.15	10.83	9.11
China	26.71	16.16	11.32
India	15.44	14.18	12.47
Indonesia	17.74	15.75	13.89
Pakistan	10.89	11.3	10.41
Philippines	17.23	14.06	12.06
Sri Lanka	17.48	14.58	12.15

Source: SIGL.

Extracted from EmergingTextile.com, 3 May 2004.

Table 9
Unit Price of Knitted Cotton Shirts Produced in Selected Countries
for the US Market (unit value in US\$ per dozen)

Country	2001	2002	2003
Bangladesh	49.75	44.59	42.95
Burma	29.94	27.09	28.40
China	80.33	72.16	76.04
Honduras	23.13	21.45	19.83
India	71.2	60.51	65.88
Pakistan	52.1	45.65	42.83
Sri Lanka	70.82	66.53	64.84
Vietnam	25.33	38.76	38.44

Source: OTEXA.

Extracted from www.emergingtextiles.com, March 8 2004.

As indicated in Tables 8 and 9, it is clear that many producing countries try to reduce the unit price of their exports to increase their market share and the unit price offered by most countries are lower than those of Sri Lanka.

In considering the performance of EU's Top apparel imports from Sri Lanka for the month of January 2004, in the top two categories namely, Category 6 and Category 4 Bangladesh recorded the lowest unit price of 2.88 US\$ per unit and 0.99 US\$ per unit, respectively (see Table 10). The Table further depicts that Sri Lanka's unit price of all the five categories analyzed were not the lowest. For instance, for Category 17, India's unit price was lower than 50 per cent of Sri Lanka's price, while for Category 7 Pakistan's unit price was almost one fourth of Sri Lanka.

Table 10
Unit Price of EU Imports in January 2004 (in US\$/unit)

Category	Bangladesh	China	India	Pakistan	Sri Lanka
6	2.88	3.63	5.90	4.31	4.02
4	0.99	2.10	2.51	1.46	1.91
5	3.25	5.40	3.54	2.92	4.01
13	0.94	0.60	0.38	0.40	0.81
7	1.77	4.11	3.12	0.97	3.26

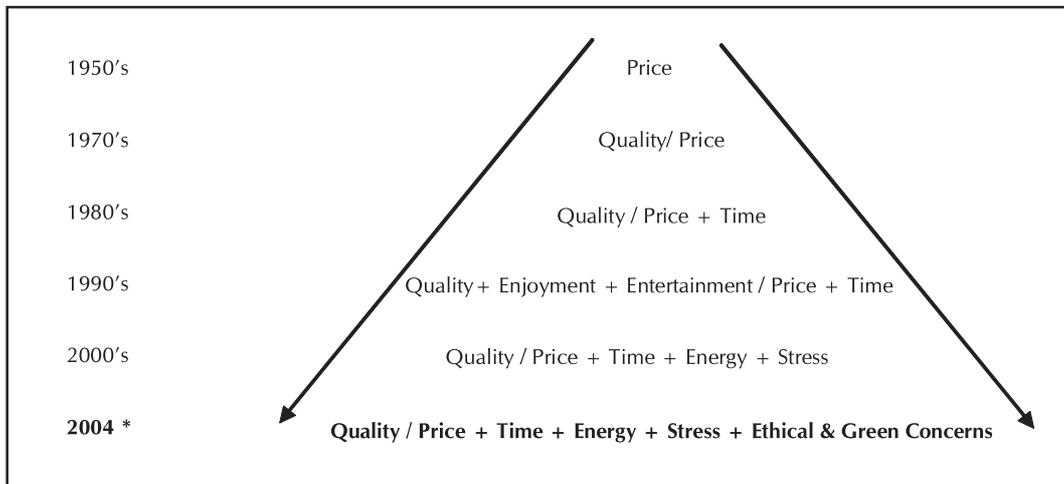
Source: Compiled using Sigl data (Euro converted to US\$ using average exchange rate in January 2004).

Many studies have indicated that at the end of the quota system prices are expected to go down further (Mlachila and Yang, 2004). For instance, ‘China’s prices declined an average of 48 per cent after the quotas were removed, falling from an average of 6.23 dollars per square metre in 2001 to 3.12 dollars per square metre as of year to date March 2004’ (NCTO, 2004).

In the traditional international trade arena Sri Lanka holds a relatively weak position due to high cost of production, which includes wages and other factor costs, infrastructure availability and productivity. However, in the context where, consumers are increasingly becoming conscious about the social clause in production they prefer products manufactured under ethical conditions. They tend to seek brand names recognized for practicing ethical and green trading. Thus, the greater degree of acceptance by consumers results in promoting Sri Lanka’s image in two ways.

Firstly, the consumer preference for Sri Lankan apparel produced under ethical conditions has an impact on the demand for the product. The value equation of the apparel consumers has evolved significantly over the previous decades. Instead of the sole importance of price in 1950s, by 2000s other new determinants such as quality, time, energy and stress have entered the value equation. The necessity to include another determinant, namely ethical and green priorities is severely felt at present. The following figure includes the current trend.

Figure 6
Changing Consumer Equation



* 2004 included based on current trends.

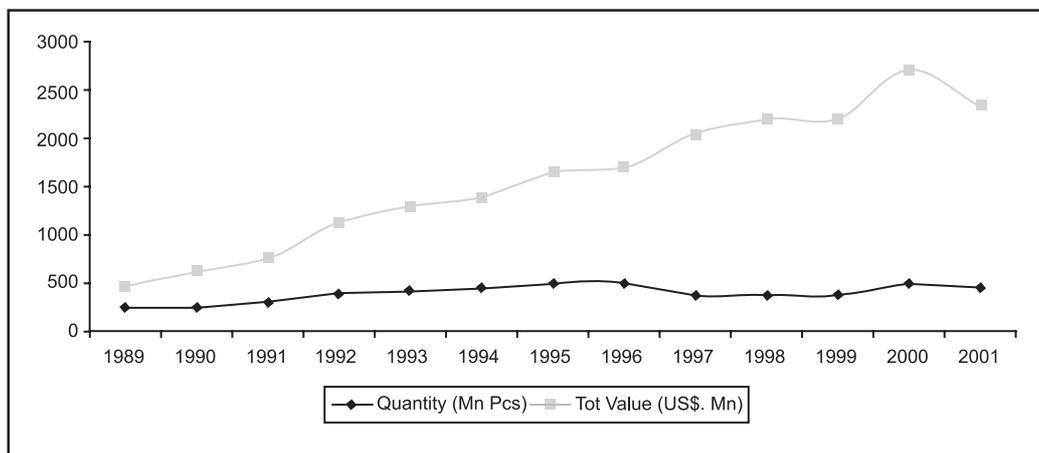
Source: JICA, 2000.

The modern consumer who is concerned about the conditions under which the goods they purchase were manufactured attaches a high value for the recognition Sri Lanka has acquired in terms of compliance with labour standards. This may enable producers to charge a higher price for the 'better quality' products produced under ethical conditions (Commonwealth of Australia, 1996). Sri Lanka's eligibility for the labour GSP concession of the EU is a significant endorsement of the high labour standards maintained by the production bases in Sri Lanka. This tends to increase the preference an ethical buyer would have over a similar product produced in India or Bangladesh, which is not reputed to be following stringent labour standards.

In this context, Sri Lanka's disadvantage due to the inability to competitively decrease prices is compensated to a degree by the acceptance received by the buyers in terms of compliance with the labour clause. Furthermore, as mentioned, an ethical consumer's decision to purchase would not be driven by the price of the article. Thus, the price war in the EU market would be less applicable for Sri Lanka's products. On the other hand, the entry of Sri Lanka's products to EU at a concessionary tariff rate would compensate Sri Lanka's prices against the falling prices of competitors' products. Therefore, Sri Lanka's image in the EU, as a recipient of the tariff concession under the Labour GSP, to some extent minimizes the negative implications on Sri Lanka's products caused by the price war.

Another aspect of image/branding and related demand instigated by the Labour GSP, is the movement of Sri Lanka's apparel exports towards high value added items instead of low value added items that benefit from volume of exports. The movement towards high valued exports is evident in Figure 7 below. The volume of exports during the last decade has been relatively flat, while the value of exports have increased significantly (Fernando, 2002). The recognition by EU would further facilitate to continue to export high value added exports in future.

Figure 7
Sri Lanka's Apparel Exports 1998-2001
(volume in million pieces and value in US\$ million)



Source: Extracted from Fernando, 2002.

Further, the consumer preference for Sri Lankan apparel produced under ethical conditions would contribute positively towards Sri Lanka as a production base for T&A. To begin with, the higher demand for Sri Lanka's products in the EU market would lead to increased production in Sri Lanka. The rise in production would be funded by both domestic and foreign capital as investors would be encouraged (mainly foreign) to set up production bases within Sri Lanka where investors would be better able to meet deadlines, amidst a positive rapport between the employers and the employees and higher labour productivity. Thus, on the one hand, the Foreign Direct Investment (FDI) inflows would improve. Such FDI is accompanied by foreign technology, expertise and know-how. This would contribute to the improvement of the human capital in Sri Lanka.

Improved identity of Sri Lanka in the apparel circle as an ethical producer of apparel has also resulted in many world class factories being located within the country, despite the disadvantages the apparel sector in Sri Lanka faces in the region, as discussed above. Further, Sri Lanka has many reputed large buyer sourcing apparel from Sri Lanka. For instance, representative offices of buyer such as Liz Claiborne, Federated, May Department Stores, Gap, London Fog and Tommy Hilfiger are established in Sri Lanka.

In this light, the EU labour GSP creates many opportunities for Sri Lanka's apparel industry. However, parallel to opportunities are the issues concerning the labour GSP. The following sections bring out various issues concerning trade preferences.

4.3 Rules of Origin & Utilization of EU GSP Preferences

Eligibility of exports for tariff concessions under the EU GSP scheme is based on the origin of the product. The EU GSP scheme requires three main conditions in terms of Article 81¹³, to be met for exports to be applicable to receive concessions under the GSP. They are:

- Origin Criterion: The good must originate in the beneficiary country as defined in the EC GSP rules of origin
- Transport Criterion: The good must be transported directly to the EC from the beneficiary country
- Documentary Evidence Criterion: The goods must be accompanied by proof of their originating status, which is the certificate of origin. This document has to be issued by the beneficiary country's identified competent authority to issue certificates of origin.

For exports to be qualified as originating as per the EU rules of origin the products should be either wholly obtained in the beneficiary country, or the non-originating materials contained in the final product must have been 'sufficiently' worked or processed in that country. The determination of a product has been subjected to 'sufficient' working or processing is based on one of the three criteria mentioned below:

- The change of 4 digit Harmonized System (HS) of Coding heading criterion
- The value criterion
- The specific process criterion

Under the first criterion on change of heading, a product is considered sufficiently worked or processed when the 4 digit HS Nomenclature is different from that of all of the non-originating inputs used in the production process. Under the second criterion the value addition in the originating country should be greater than a specified percentage, for the product to be considered to have originated within the beneficiary country. The third criterion refers to a situation where specific operations or stages in the production process of the final product have to be carried out in the beneficiary country. This criterion is mostly applicable in exports of textiles and apparel articles. Table 11 below summarizes the value criterion and specific process criterion for apparel articles.

In addition to the basic rules of origin criteria, the beneficiary countries are given two allowable exceptions:

- Bi-lateral cumulation (donor country content):

Inputs originating in EU, Norway or Switzerland are considered to be originating in that particular country if such inputs are further worked or processed in a beneficiary country claiming the GSP concessions.

¹³ Article 81 is the article on Certificate of Origin Form A.

Table 11
Conditions for Selected Exports to be considered 'Sufficiently Worked or Processed'

Chapter	Description	Specific Process	Value Criterion
Chapter 61	Articles of apparel and clothing accessories, knitted or crocheted:		
	- obtained by sewing together or otherwise assembling, two or more pieces of knitted or crocheted fabric which have been either cut to form or obtained directly to form	Manufactured from yarn	-
	- other	Manufactured from - natural fibres, man-made staple fibres, not carded or combed or otherwise processed for spinning, or - chemical materials or textile pulp	
Chapter 62	Articles of apparel and clothing accessories, not knitted or crocheted	Manufactured from yarn	In most cases manufactured from fabric which does not exceed 40 per cent of the ex-works* price of the product.

* ex-works price means the price paid for the product ex-works to the manufacturer in whose undertaking the last working or processing is carried out, provided that the price includes the value of all the materials used, minus any internal taxes which are, or may be, repaid when the product obtained is exported.

Source : Compiled using Annex 15 of the A Guide for Traders on GSP Rules of Origin.
http://europa.eu.int/comm/taxation_customs/resources/documents/guide-annex_3-en.pdf

- Regional cumulation:

The EU recognizes four regional groups for regional cumulation namely: South Asian Association for Regional Cooperation (SAARC), Association of South East Asian Nations (ASEAN), Andean Community and Central American Common Market (CACM). Under this provision inputs originating from one member of a regional grouping are considered as further worked or processed and originating in the particular beneficiary country.

In recent years, EU has been ranked second in Sri Lanka's direction of trade, and also in terms of apparel exports from Sri Lanka. However, the GSP utilization rate of the total exports as well as apparel exports¹⁴ have been at a relatively low level in 2002 compared to the performance of Rubber and Coffee, Tea etc. (see Table 12).

¹⁴ The annual average GSP utilization rate of apparel exports for the period 1997 to 2003 was only 11.6 per cent.

Table 12
EU's Imports from Sri Lanka: 2002 (values in percentages)

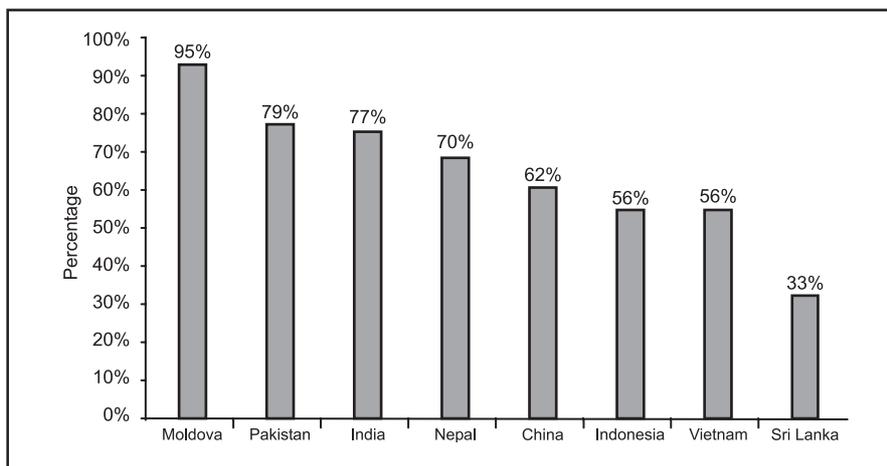
Chapter No.	Description	Eligible Imports as a share of Total Imports	Preferential Imports as a share of Eligible Imports = Utilization Rate
61	Apparel, knitted and crocheted	100%	32%
62	Apparel, not knitted and crocheted	100%	11%
71	Pearls, precious and semi-precious stones	2%	34%
40	Rubber articles	92%	88%
9	Coffee, tea, mate and spices	5%	84%
84	Electrical machinery and equipment	53%	12%
others		73%	71%
Total		76%	38%

Note : Total Imports = All EU imports from Sri Lanka.
 Eligible Imports = EU imports from Sri Lanka that have the potential to benefit from the EU GSP Scheme.
 Preferential Imports = EU imports from Sri Lanka that have actually benefited from the EU GSP Scheme.

Source : European Trade Commission.

In analysing the Table further, it is evident that, unlike other EU imports from Sri Lanka, apparel imports have a high potential (100 per cent) to benefit from the GSP scheme. However, Sri Lanka's utilization rate of the benefits was low. For instance, in 1999¹⁵ Sri Lanka's GSP Utilization was 33 per cent, while that of the competitors' was over 50 per cent (see Figure 8).

Figure 8
EU GSP Utilization Rates of Selected Countries, 1999

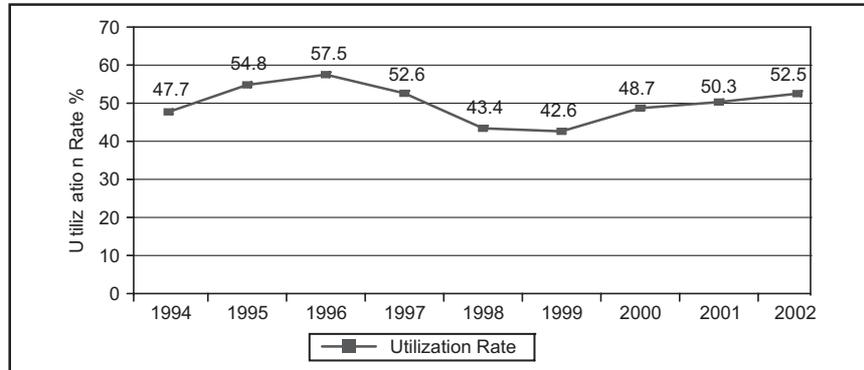


Source: Compiled using data in Comparison of US & EU Preference Programme, 2001.

Consideration of the GSP utilization rate of total imports to EU shows that 2002 recorded a utilization rate of 52.5 per cent (see Figure 9). Compared to the average utilization rate for the period 1994-2002, which was 50 per cent, Sri Lanka's GSP utilization rate is low.

¹⁵ 1999 was chosen due to availability of data.

Figure 9
GSP Utilization Rates of EU Imports in 1994 -2002



Source: Commission of the European Communities.

In a study Lyn Fernando *et al*, 2002 identifies Non-fulfilment of the rules of origin as the main reason for poor GSP utilization rates by Sri Lanka and points out that Sri Lanka has 'little room for improving the utilisation of the EC-GSP by the garment industry within the existing scheme.' 'Sri Lankan garment exporters know about the EC-GSP scheme and have very few complaints about the administrative procedures that they have to comply with'. As explained earlier, eligibility for GSP concessions is based on the fulfilment of stringent ROO criteria outlined by the EU. Given the high import dependency of Sri Lanka's apparel production, meeting the rules of origin requirement is exigent. The above stated study further identifies that 'the import content of the fabric taken up in Sri Lankan manufactured garments is mostly 60 per cent of the ex-works price of the garments, which conflicts with the value (ad valorem) requirement under the rules of origin'. As stated in the CBSL Annual Report in 2002, net foreign exchange earnings of the apparel industry is estimated for about 30 per cent of the export earnings. In this context, the significance of the imported input component in the production acts as a deterrent for benefiting from GSP preferences.

Regional cumulation provision for SAARC countries is often regarded to further facilitate benefiting from the preferences. 'However, this is also ineffective since for technical reasons Sri Lanka's garment producers need to source from other Asian countries outside SAARC' (Dheerasinghe, 2003).

The fundamental reasons for sourcing fabric mainly from South East Asian countries are twofold. Firstly, Sri Lankan apparel produced for niche markets in the EU requires specific fabric qualities mostly originating from Hong Kong, Korea, Indonesia, China, Taiwan etc. rather than those of SAARC origin (Fernando, 2002). Secondly, the specifications from the buyers result in fabric and other inputs being sought from identified supplies in countries outside the SAARC region. Both these reasons restrain the Sri Lankan manufacturers from sourcing inputs from SAARC countries. As shown in Table 13, the share of imports from India and Pakistan were 6 per cent and 2 per cent, respectively, while Hong Kong, South Korea and Taiwan accounted for 58 per cent of Sri Lanka's imported apparel imports.

The proposed Super Regional Cumulation (SRC)¹⁶ between SAARC and ASEAN for EU GSP rules of origin is expected to redress this issue to an extent, if the two regional groupings are considered by the EU for SRC. However, the benefit of a possible SRC is not guaranteed due to two fundamental reasons. On the one hand, the materialization of the SRC still remains vague given the opposition by SAARC members such as Bangladesh and India with a substantial input base within the country. For instance, the Textile Mill Owners Association President in Bangladesh has stated that "It will be detrimental to our national policy of developing the backward linkage industry if the government endorses the new EU proposal" (The Independent, 2004). On the other hand, the SRC's benefit to Sri Lanka is limited as Sri Lanka's top import origins of textile inputs are Hong Kong, South Korea and Taiwan, which are not members of the ASEAN.

¹⁶ Super Regional Cumulation is the consideration of two regional groupings together for ROO requirements.

The above analysis was carried out with respect to the GSP concessions under the General arrangement. Since the rules of origin for the general and the labour incentive arrangement are similar, a comparable trend in utilization levels could be expected for the labour GSP too.

Table 13
Imports of Textile Inputs to Sri Lankan Apparel Industry - 2002
(values in US\$ million)

Country Name	Woven	Knitted	Other	Accessories	Total	As % of Total
Hong Kong	158.53	38.42	34.23	40.95	272.12	29
South Korea	117.35	5.59	8.89	9.75	141.59	15
Taiwan	93.63	21.93	10	6.96	132.51	14
China	54.05	3.18	1.97	1.76	60.96	6
India	48.58	0.49	1.19	2.77	53.02	6
U.S.A	37.76	1.72	7.57	1.63	48.69	5
United Kingdom	14.49	3.93	9.14	8.69	36.25	4
Indonesia	25.62	0.49	0.78	0.38	27.26	3
Thailand	16.51	1.4	5.9	1.14	24.95	3
Japan	20.17	0.96	0.35	1.21	22.7	2
Pakistan	21.64	0.61	0.13	0.1	22.48	2

Source: Sri Lanka Customs Data.

4.4 Emerging Issues in Trade Preferences

One emerging issue in the context of trade preferences under the EU Labour concessions is the trend that the advantageous position of Moldova and Sri Lanka would be soon challenged by other competitors. Producers securing orders from buyers with codes of conduct or labour standards, have already initiated an approach towards compliance with labour standards. In this setting, for instance, China is seriously considering labour standards and the consensus among labour experts is that 'many Chinese manufacturers have got the message that corporate social responsibility is not something they can dodge forever' (The Straits Times, 2004). Some manufacturers in China consider that the labour concerns are legitimate concerns to help prevent workplace abuse, while a considerable majority sees it as a yet another non-tariff barrier to block their products from entering the developed markets.

Though India's dislike for the labour clause was evident as early as 2002 when they 'requested the establishment of a WTO panel to determine whether provisions under the EU's Generalized System of Preferences (GSP) tariff programme relating to labour rights, the protection of the environment and combating the production and trafficking of illicit drugs is compatible with WTO rules' (Bridges Weekly, 2003), a study by Jenkins, R. *et al*, in 2003 show that Indian government and textile and apparel industry supports the compliance of labour standards in India.

Another prominent emerging scenario in trade preferences is the issue of preference erosion. On a macro level, the benefits of the EU GSP scheme are reduced by four main factors.

a. GSP Concessions for other countries

As mentioned earlier the GSP Labour concessions are a privilege extended to Sri Lanka and Moldova only, while none of Sri Lanka's regional competitors are benefited. However, in considering the broader picture of the GSP concessions, Bangladeshi products benefits from EBA clause to enter the EU market duty free while Pakistan benefits from the drug clause by accessing the EU market under zero duty till July 2005 (see Table 14).

Box 5: EU vs India

The WTO Panel ruled in favour of India on 1 December 2003 and stated that under the Enabling Clause and in particular the non-discrimination principle, identical tariff preferences have to be provided to all developing countries without any differentiation with the exception of Least Developed Countries and the so-called "a priori limitations" (graduation mechanisms). A subsequent ruling in 2004 in response to an appeal by EU reversed the decision and rejected India's claim that WTO rules do not allow to differentiate between developing countries. The WTO Appellate Body has nevertheless found that the EU's GSP drug regime is not based on objective and transparent criteria for the selection of the beneficiary countries. Thus, as a result Pakistan lost its claim to special incentive for combating drug. However, this change will come to effect with the new GSP Plus scheme to be implemented from July, 1, 2005.

Table 14
EU GSP Scheme applicable to Selected Countries

Country	General Arrangements	LDCs/EBA	Labour Clause	Environmental Clause	Drug Clause, (c)
Bangladesh	Yes	Yes	No	No	No
China	Yes, a)	No	No	No	No
India	Yes, b)	No	No	No	No
Pakistan	Yes, b)	No	No	No	Yes
Sri Lanka	Yes	No	Yes	No	No

Notes:

- a) Excluded are certain iron or steel products, while tariff preferences have been removed for certain products of animal origin, grains, seeds, fruits and plants, chemicals, articles of leather and fur skins, clothing, footwear, glass and ceramics and base metals.
- b) Tariff preferences have been removed for leather and articles of leather and fur skins, textiles.
- c) The drug clause will not exist after July 1, 2005 (see footnote 14 for details).

Source: Extracted from Fernando, 2002 and modified.

In this context, Sri Lanka's apparel entering the EU market at a concessionary duty reduction of 40 per cent off the Combined Customs Tariff rate cannot be considered a unique opportunity for Sri Lanka. However, the tariff concession leaves Sri Lanka better off than India and China and abreast with Bangladesh and Pakistan. On the other hand, China and India have potential to benefit more than Sri Lanka due to their developed backward linkage industries, which contribute towards meeting rules of origin requirements and the subsequent high utilization rates of the GSP benefits.

- b. The reduction of MFN custom duties. This tends to automatically reduce the average preference margin, which is the difference between the MFN rate of duty and the GSP preferential rate.
- c. WTO level international agreements aimed at abolishing custom duties on selected products¹⁷ eligible for the GSP.
- d. Rising number of bilateral and regional free trade agreements (COM: 2004).

This reducing impact of the GSP benefits will eventually question the applicability of tariff concessions, be it under the labour clause or the general arrangement.

¹⁷ Such as coffee since 2001 and electronic products and information technology since 1996.

Another emerging issue with regards to the EU GSP concessions is the implications resulting from Graduation. Graduation mechanism leads to phasing away tariff concessions to beneficiary countries which have become competitive in certain sectors. The threshold for graduation under the lion's share is, if exports from a country in a specific sector exceed 25 per cent of all imports in the EU from all beneficiary countries in that sector during three consecutive years. In such an instance, exports from that country in that sector will lose GSP treatment. Such a graduation mechanism, on the contrary to its targeting objective, serves as a disincentive to improve efficiency in certain export sectors, in order to remain within the preference threshold. In this light, many developing countries are concerned regarding the graduation mechanism. 'The practice of product or country graduation had severely damaged industrialization in developing countries, their export trade and investment and cooperation projects' (Raghavan, 1993). Moreover, the graduation mechanism of the EU GSP scheme has an element that runs contradictory to the Doha Development Agenda (DDA). The DDA focuses on the issue of development at the core of the multilateral trading system and identifies that market access negotiations must particularly encompass sectors and products of particular interest to developing countries, to boost their export and growth opportunities. However, the graduation mechanism of EU GSP preferences results in reducing market access for sectors and products that are of particular interest to developing countries.

Box 6: GSP Plus

The EU Trade Commission is intending to introduce a differed version of the existing GSP scheme for the next ten year period. Where appropriate the rules of origin under the new scheme will be relaxed to allow countries to take fuller advantage of the benefits of this scheme. The significant difference of this intended new scheme from the existing one, is the reduction in the number of arrangements to three from five. The revised system designed to be simpler, more transparent and more stable would include the following three arrangements:

1. General arrangement: product coverage increases from about 6900 to about 7200. It will incorporate 300 additional products mostly in the agriculture and fishery sectors, of interest for developing countries.
2. The GSP Plus: would integrate the labour clause and the environment clause of the existing system as the arrangement to encourage sustainable development especially for vulnerable countries with special development needs. It will cover around 7200 products which can enter the EU duty free. The beneficiaries must meet a number of requirements including ratification and effective application of 27 key international conventions on sustainable development and good governance (see below)¹⁸.
3. Special arrangement for LDCs (EBA): will remain unchanged.

Another improvement in the new scheme is the simplification of the graduation mechanism. The current criteria (share of preferential imports, development index and export-specialisation index) have been replaced with a single straightforward criterion: share of the Community market expressed as a share of preferential imports. This share would be 15 per cent, with 12.5 per cent for textiles.

Requirements to be eligible for GSP Plus

- Demonstrate that their economies are poorly diversified, and therefore dependent and vulnerable. Poor diversification and dependence is defined as meaning that the five largest sections of its GSP-covered imports to the Community must represent more than 75 per cent of its total GSP-covered imports.
- GSP-covered imports from that country must also represent less than 1 per cent of total EU imports under GSP.

¹⁸ The Drug Clause will be removed from the scheme as mentioned in footnote 13 above.

- They also have to have ratified and effectively implemented the 16 core conventions on human and labour rights and 7 (out of 11) of the conventions related to good governance and the protection of the environment. At the same time beneficiary countries must commit themselves to ratifying and effectively implementing the international conventions which they have not yet ratified. In any case, the 27 conventions have to be ratified by the beneficiary countries by 31 December 2008.

Core human and labour rights UN/ILO Conventions (all must be ratified and effectively implemented for GSP Plus to apply):

- International Covenant on Civil and Political Rights
- International Covenant on Economic Social and Cultural Rights
- International Convention on the Elimination of All Forms of Racial Discrimination
- Convention on the Elimination of All Forms of Discrimination Against Women
- Convention Against Torture and other Cruel, Inhuman or Degrading Treatment or Punishment
- Convention on the Rights of the Child
- Convention on the Prevention and Punishment of the Crime of Genocide
- Minimum Age for Admission to Employment (N° 138)
- Prohibition and Immediate Action for the Elimination of the Worst Forms of Child Labour (N° 182)
- Abolition of Forced Labour Convention (N° 105)
- Forced Compulsory Labour Convention (N° 29)
- Equal Remuneration of Men and Women Workers for Work of Equal Value Convention (N° 100)
- Discrimination in Respect of Employment and Occupation Convention (N° 111)
- Freedom of Association and Protection of the Right to Organise Convention (N° 87)
- Application of the Principles of the Right to Organise and to Bargain Collectively Convention (N°98).
- International Convention on the Suppression and Punishment of the Crime of Apartheid

Conventions related to environment and governance principles (7 must be ratified and effectively implemented for GSP Plus to apply, all must be ratified and implemented by 2009):

- Montreal Protocol on Substances that deplete the Ozone Layer
- Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and Their Disposal
- Stockholm Convention on persistent Organic Pollutants
- Convention on International Trade in Endangered Species
- Convention on Biological Diversity
- Cartagena Protocol on Bio safety
- Kyoto Protocol to the UN Framework Convention on Climate Change
- UN Single Convention on Narcotic Drugs (1961)
- UN Convention on Psychotropic Substances (1971)
- UN Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (1988)
- Mexico UN Convention Against Corruption.

Possible implications of the New Scheme on Sri Lanka

- Under the GSP Plus, more exports from Sri Lanka will be eligible to enter the EU market under zero duty status. However, despite Sri Lanka's completion of 'all preparatory work leading to the implementation of this proposed duty concession' (Daily News, 2005) the issues concerning rules of origin would impede utilization rates of the concessions offered.
- Requirements for eligibility such as 'demonstrate that their economies are poorly diversified, and therefore dependent and vulnerable' would exclude large players from GSP concessions. For instance, 'China's and India's textile and apparel exporters will lose most of EU's GSP Treatment' (Emerging Textiles, 2004). This would contribute towards Sri Lanka securing an advantage over large players at least in the context of the EU GSP concessions.
- The International Confederation of Free Trade Unions (ICFTU), European Trade Union Confederation (ETUC) and World Confederation of Labour (WCL) have stressed the necessity to include strong clauses to defend worker rights under the new GSP scheme, as they fear that European Commission and certain member states are 'considering a clause to water down the GSP's Labour standards content' (ICFTU, 2005). In this context, 'the international trade union organizations also underline the necessity for the government of Sri Lanka to implement the 'road map' to establish its compliance with labour standards' (ICFTU, 2005).

5. Conclusion

As shown by the above analysis the GSP incentives offered to Sri Lanka by the EU is ideally a good market access opportunity for exporters in Sri Lanka to enter the EU market at a lower tariff rate than the tariff rate applicable to most of the competitors. However, the detailed analysis of the apparel export sector reflected that despite the availability of opportunity for tariff concessions, the actual utilization of GSP concessions was poor. The statistical analysis was for exports to EU in 2002, when only the concessions under the general arrangement were in effect. The focus of this paper is on the labour incentive, for which actual export statistics are still not available as the scheme came to effect as recent as February 2004. Nonetheless, the rules of origin applicable for the labour GSP as well as the general arrangement are the same. Thus, it is clear that exports attempting to qualify for the labour GSP too would face the same issues as faced under the general arrangement.

In this setting, emphasising good labour standards maintained by Sri Lanka alone would not be sufficient in the future, as the benefit derived from the concession is not optimum. New ways and means have to be explored to reap the maximum benefit of the concession scheme and overcome the challenges. The paper identified a few areas as measures to bridge the gap between the exports eligible for the GSP concessions and those actually utilizing the concessions in terms of measures to be taken within Sri Lanka and those need to be taken beyond Sri Lanka. They are to;

- Develop backward linkages of the top export sectors such as apparel industry to improve the eligibility of GSP concessions.
- Improve on domestic value addition component of production, to benefit from the GSP scheme.
- Renegotiate to consider specific processes that are currently carried out in Sri Lanka under the 'specific process criterion'.
- Strive for a successful SRC of the SAARC and ASEAN regions as the success case of the Andean Community and CACM.
- Explore the possibility of considering Hong Kong, South Korea and Taiwan along with ASEAN for Super Regional Cumulation allowable exceptions of the ROO.

- Explore the possibility of a revision on the rules of origin criterion of 'change of 4 digit HS heading criterion' to 6 digit level.
- Explore the possibility of renegotiating the ROO for Sri Lanka with favourable value addition criteria for top export items such as apparel.

Further, the continuation of the Sri Lanka's eligibility of the labour concessions is subject to the review process. Implementation of necessary changes pertaining to labour standards to comply with the review process, would guarantee the continuation of the benefit of the tariff concessions.

In conclusion, the EU Labour GSP Scheme in terms of tariff concessions will be of limited value to Sri Lanka in the short run. However, in the long run the positive implication would enable Sri Lanka to acquire a significant contribution to its identity as an ethical producer of apparel, much earlier than the competitors do. The benefits of this enhanced image will be most valuable in future, where price war and tariff cuts would be eliminated from the list of factors deciding competitiveness of an exporting country and be replaced by ethical trading practices.

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