

# **Recommendations for Trade Adjustment Assistance in Sri Lanka**

*Draft Paper for Discussion*

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## Executive Summary

Sri Lanka has an excessively complex tariff structure that distorts the structure of the economy in important ways. It is a priority for the Government of Sri Lanka (GoSL) to rationalize the system in order to facilitate a transition to greater economic diversification, stronger export growth, and the emergence of new, higher paying jobs. Sri Lanka's *New Trade Policy* makes this tariff rationalization a priority. It also recognizes that tariff rationalization should go hand in hand with new trade adjustment assistance measures to support the adjustment of firms and of people. The *New Trade Policy* outlines the basic contours of tariff rationalization and trade adjustment assistance measures but does not provide a detailed roadmap.

This discussion paper was prepared at the invitation of the Ministry of Development Strategies and International Trade (MoDSIT) as part of the Center for International Development's research project on sustainable and inclusive economic growth in Sri Lanka. The aim of the paper is to study policy tools that the GoSL could use to structure trade adjustment assistance in the context of tariff rationalization. In order to accomplish this aim, we begin by outlining the type of tariff rationalization that needs to take place in order to address key constraints to growth in a way that is sensitive to both government revenue needs and political economy considerations. We stress that tariff rationalization must be approached in a holistic way that treats the various tariffs and para-tariffs as interrelated, rather than an approach that attempts to address one part of the system at a time. A holistic approach would provide many degrees of freedom to solve the underlying problems in the system while increasing revenues and potentially generating strong public support. Critically, a holistic approach would allow for a single tariff rationalization plan to be phased in over a period of years in a predictable way, whereas attempts to rationalize the system one part at a time would lead to extreme uncertainty.

With the principles of smart tariff rationalization in place, we draw upon international lessons and Sri Lanka's own institutional capabilities to recommend a two-tiered approach to helping industries and workers adjust. In each case, the first tier represents low-cost measures that can begin in the short term to help industries and workers, regardless of whether they will be negatively impacted by tariff rationalization, while the second tier of assistance applies only to trade-affected industries and workers and can be developed in the medium term. For industries, Tier 1 support involves the use of an innovative process of public-private problem solving of industry-specific constraints, and Tier 2 support involves the use of special safeguard measures to provide an objective and transparent process for determining which industries require longer phase out periods for tariff reductions versus the tariff rationalization plan. For workers, Tier 1 support involves improved access labor market information and training opportunities through the development of regional (or local) job centers. Tier 2 support provides government funding for training and job placement services. We conclude that this package of trade adjustment assistance measures could be used to complement a holistic tariff rationalization plan. But we caution that attempts to rush the implementation of these measures without careful design and communication could deeply undermine the potential for the reforms to work in solving underlying economic problems.

## 1. Need for Holistic Tariff Rationalization and Adjustment Measures

Sri Lanka's *New Trade Policy* makes rationalization of the tariff schedule, including both import duties and para-tariffs, a priority. Recognizing that this, together with entering new free trade agreements, will expose some Sri Lankan industries to greater competition, the *New Trade Policy* also outlines the need for policies that will help firms and people to adjust.

### ***What Problem Does Tariff Rationalization Need to Solve?***

Our own growth diagnostic analysis also identifies the need for tariff rationalization. We have found that the Sri Lankan economy's ability to grow is constrained by the weak growth of exports.<sup>1</sup> The economy has consistently expanded faster than exports have grown, leading to cyclical balance of payments crises. In recent years, exports have failed to grow at anywhere near the pace of other countries in the region, and that is because export diversification has fundamentally stalled. Sri Lanka has seen virtually no significant diversification of exports over the last 25 years, and especially little diversification into manufactured goods linked through global value chains, which have spurred growth elsewhere in Asia. Meanwhile, the nontradable economy continues to grow, leading workers to demand higher wages that Sri Lanka's biggest export industries cannot provide. Sri Lanka has, in effect, outgrown its economic structure, but it has lacked the inflows of FDI needed to establish new export industries. There are several important causes behind this lack of FDI and export diversification. The current tariff structure, which is non-transparent, complex and unpredictable, is one such cause.<sup>2</sup>

The structure of *import* duties is a problem for *exports* in at least four critical ways. First, the extremely high effective rates of protection for some products creates a bias against investments in the production of other products. For industries that already have a presence in Sri Lanka and are able to lobby for protection, duties are generally low, para-tariffs are usually exempt, and rates are not subject to change. Much lower (or even negative) effective rates of protection for other products limit the space for investment in new economic activities. Second, the complexity and uncertainty faced by foreign investors interested in manufacturing a new product in Sri Lanka is extraordinary. Insiders can navigate the system but outsiders will see a complicated mix of para-tariffs and tariffs that appear to change on, at times, a weekly basis. Third, the exemptions on import duties that are available to exporters do not fully address the problem. Exporters must still pay para-tariffs on their imported inputs, which in many cases are much higher than the customs duties themselves. Fourth, the system of exempting exporters from some fees creates an artificial barrier between exporters and non-exporters. This creates a

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<sup>1</sup> Hausmann, Ricardo. "Increasing your chances of success while leaving your comfort zone: Adapting Sri Lanka's growth model." 9 January 2017, Bandaranaike Memorial International Conference Hall, Colombo. [http://growthlab.cid.harvard.edu/files/growthlab/files/hausmann\\_january2017\\_2.pdf](http://growthlab.cid.harvard.edu/files/growthlab/files/hausmann_january2017_2.pdf)

<sup>2</sup> There are several other causes behind this lack of FDI and export diversification as well. Some of the most important causes are Sri Lanka's idiosyncratic manner of governing land use, underdeveloped water and electricity infrastructure, gaps in transportation infrastructure, and extreme levels of policy uncertainty faced by investors.

strong bias against the development of local supply chains, since exporters are incentivized to import the inputs they need versus buying from domestic producers.

Meanwhile, the inertia of the system further encourages rent-seeking by industries and locks Ministry of Finance resources into responding to requests for tariff changes on a case-by-case basis. While the Ministry of Finance recognizes this vicious cycle, it has so far only taken small, incremental steps toward fundamental reform to the system. One reason behind this is the revenue implications. With such a complex system where many tariffs serve both the purpose of protection and revenue generation, it has been difficult to imagine a path out. The difficulties are amplified by the overlapping responsibilities of various ministries and agencies when it comes to interactions with industry.

Finally, not only does the current tariff schedule constrain growth and well-being of Sri Lankans through its effect on exports, but it is Sri Lankan consumers that ultimately pay the price for the system through higher prices on the things they buy. Therefore, an important benefit of tariff rationalization is that it should reduce the cost of living for Sri Lankans. Given the very high levels of tariff protection for food products, the reduction in the cost of living for the average Sri Lankan as a result of tariff rationalization could be very large.

### ***Principles for Smart Tariff Rationalization***

Sri Lanka does not need just any tariff rationalization; it needs a smart tariff rationalization plan that addresses the ways in which the system constrains export diversification and encourages rent-seeking behavior by industries. This means that a smart rationalization plan must remove the bias the system creates against new industries by lowering overall nominal rates of protection (especially on potential inputs to production) and reducing the variance of effective rates of protection. A smart plan should provide a predictable and transparent path over time to much simpler system. It should do this in a way that reduces the incentives for industries to lobby for exceptions, including by providing industries time to adjust. The rationalization process must also be sensitive to the immense importance of revenues from tariffs to the overall government budget. Ideally, it should be revenue-neutral or revenue-positive. Finally, the rationalization process must lower overall prices for consumers.

Designing a plan that meets all of these needs is far from easy. There are many more ways to do the rationalization poorly than there are to do it well. However, based on our review of revenue data provided by the Ministry of Finance, it is clear that there are ways to achieve all of these goals if the rationalization of the system is treated holistically rather than part by part. This means treating import duties, external para-tariffs (CESS and PAL) and other duties (in particular VAT and NBT) as an integrated system, rather than one piece at a time. It also means developing one plan that is phased in gradually, rather than many different plans announced each year, which would only serve to increase uncertainty for firms.

It is especially important to treat the import duty and the external para-tariffs as connected because they effectively serve the same purpose. Removing only the external para-tariffs

without touching the import duty would not fully address the bias in the system against new products. Moreover, removing the external para-tariffs without also considering the import duty would lead to radical reversals in which industries are most protected, leading to inevitable conflict with industry groups. Alternatively, if the import duty and external para-tariffs were to be rolled into one single external tariff and simplified into a number of tariff bands, it would be a fairly straightforward exercise to reduce the spread of nominal protection while maintaining the ranking of what industries get the most protection. An approach like this would lead to a dramatically simpler tariff schedule and be perceived as more fair and acceptable by the private sector. (See Appendix 1 for a visual contrast of this approach versus removing para-tariffs in isolation.) On top of this simple system, certain products could still be given extra tariff protection (i.e. a tariff that is higher than the highest band), but because the system would now be more transparent, the GoSL would have the ability to make such protection time-bound and the expectations for industry performance could be made explicit.

Firms would much prefer a single, predictable plan that could be phased in over time versus the extreme unpredictability of addressing different parts of the system year by year. Addressing very high external para-tariffs first may be a feasible first step in holistic tariff reform, but without being embedded within a larger plan, this would increase uncertainty for the private sector in very problematic ways. The GoSL should also prefer a gradual phase in of a single plan for its revenue implications. Instead of making a series of changes with high levels of uncertainty in how revenues would respond, the GoSL could structure a gradual transition that would allow for revenue expectations to be updated year by year and small adjustments to be made if necessary. Treating the tariff system holistically in this way would also give the GoSL many more degrees of freedom to manage the revenue implications from the start. The GoSL would be free to determine how many tariff bands to use and at what levels. It could also use the opportunity to remove some of the unnecessary VAT and NBT exemptions that exist on many imports. Currently, widespread exemptions of these two taxes lack coherence but have major revenue implications. Some of these exemptions may not solve a justifiable purpose.

### ***Need for Trade Adjustment Assistance for Firms, Industries and People***

Regardless of the exact form that tariff rationalization takes, the GoSL must simultaneously develop measures to help firms, industries and workers adjust. Tariff rationalization of any kind will change the type of competition faced by industries and, in turn, change the labor market conditions faced by workers. The remainder of this paper develops a number of recommendations for the GoSL based upon tools used internationally for trade adjustment assistance and based on the existing and emerging institutional capabilities of the GoSL to implement such measures. Although the *New Trade Policy* calls for measures to help firms adjust, these measures more accurately apply at the level of industries. This is because trade adjustment assistance should not support one domestic firm over another. Rather, actions must support the domestic industry as a whole. Also, while the *New Trade Policy* calls for measures to help people adjust, we focus our attention on workers in particular. As noted above, tariff changes have important implications for consumers as well, but the measures to be discussed are exclusively about helping workers to adjust.

## 2. Helping Firms and Industries to Adjust

We propose a two-tier system for helping firms (organized in industries) to adjust to a new tariff system with lower levels of tariff protection. Tier 1 involves an institutional innovation to structure a new type of public-private dialogue and problem solving of industry-specific constraints. This option would be available to all industries, including those that would not be directly harmed by tariff rationalization. Tier 2 involves extending use of safeguard measures for certain industries that face a direct threat of injury from tariff rationalization. These industries would be provided extended phase out periods of protective tariffs in order to have a chance to increase competitiveness. These industries would also be able to participate in the Tier 1 mechanism. These two tiers for the adjustment of industries are discussed in detail in this section.

It is also important to note that tariff rationalization should itself support the adjustment of many firms and industries by lowering input costs. This will be the case for firms that use highly protected products as inputs in their production processes. Some industries that see their nominal tariff protection reduced over time will simultaneously see the prices of many of their inputs fall. This will offset some of the lost nominal protection for many industries, and this offsetting effect could be very large for some firms. In some cases the net effect may actually be an *increase* in a firm's effective rate of protection. Although protection tends to be the most extreme for food items, there are widespread materials of rubber, plastic, metal, and fabric, among others that are common inputs to manufacturing processes, that are made expensive by the current tariff system.

### ***Tier 1: Public-Private Problem Solving of Industry-Specific Constraints***

The phasing in of tariff protections will provide an opportunity for the GoSL to institutionalize an innovative process where the public sector and the private sector co-develop solutions to industry-specific problems. This is sometimes referred to as high-bandwidth problem solving (or high-bandwidth policymaking) because it is process that recognizes the high bandwidth of information that is needed to make wise public sector decisions in support of a complex economy.<sup>3</sup> Use of this process need not be restricted to trade adjustment assistance, but the GoSL may want to prioritize its use for industries facing new competitive pressures as a result of tariff rationalization.<sup>4</sup>

The rationale behind this is that any industries lean on tariff protection as a second-best solution to deeper constraints to productivity growth and competitiveness. Versus tariff protection, which is an extremely blunt instrument, there are almost always more targeted actions that government can take in collaboration with self-organized industries in order to resolve biggest issues that industries face to doing business. These constraints may have to do with missing

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<sup>3</sup> Hausmann, Ricardo, The Other Hand: High Bandwidth Development Policy (September 2008). CID Working Paper No. 179.

<https://growthlab.cid.harvard.edu/publications/other-hand-high-bandwidth-development-policy>

<sup>4</sup> This could also be a tool to utilize as part of the National Export Strategy.

public goods or public services, regulatory issues, policy gaps, bureaucratic red tape, or even private sector coordination failures and labor market failures. Public-private problem solving requires open channels for high levels of information exchange between government and firms in order to develop and prioritize government actions that unlock private sector productivity. Since the problems faced industries tend to differ greatly, effective problem solving requires dedicated channels for different industries. The *New Trade Policy* recognizes that many industries in Sri Lanka face severe trade facilitation problems. This type of problem solving can be a tool for addressing industry-specific trade facilitation issues, but its use is not limited to such issues.

As opposed to tariff protection, which is a one-time decision that compensates industries for low competitiveness, the aim of public-private information problem solving is to achieve active and responsive policymaking that supports the evolving needs of industries through continuous information flows and feedback loops. As such, public-private problem solving requires more than just open information channels; it requires coordination on both the side of the public sector and on the side of industry. The industry must be organized enough to reach agreement and present evidence of issues that constrain productivity, while the government must have an organized system through which actions can be taken. This is difficult for governments because responsibilities tend to be spread across ministries and decision-making authority exists within rigid hierarchies, but the experience of other countries shows that public sector teams can learn to navigate these difficulties over time through iterative action within the public-private problem solving process.

### *Lessons from Peru*

Peru has built a functional approach for achieving public-private problem solving through its *Mesas Ejecutivas*, which were developed by Peru's Ministry of Production.<sup>5</sup> A helpful guide written by the Ministry of Production defines what the *Mesa Ejecutivas* (MEs) are and what they do as follows:

MEs are temporary, public-private working groups that are formed to enhance productivity for a specifically targeted vertical sector (such as forestry, textiles or aquaculture) or horizontal factor of production (such as logistics or capital markets).

MEs are temporary in that they are not meant to replace existing government ministries and agencies, nor private trade groups and associations, and instead to draw in participants from across these public and private entities. However, as part of its work a ME may reform or create these agencies.

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<sup>5</sup> Peru's Ministry of Production has published a comprehensive explanation of this program that serves as a guide for countries that want to build a similar process:  
[www2.law.columbia.edu/sabel/papers/LIBRO%20MESAS%20EJECUTIVAS%20English%20version.pdf](http://www2.law.columbia.edu/sabel/papers/LIBRO%20MESAS%20EJECUTIVAS%20English%20version.pdf)



They are working groups to the extent that are focused on rapid action and implementation of potential solutions, meeting weekly and showing continuous progress. This is not a space for high-level dialogue and understanding. This is a place for action.

The MEs are focused on one single vertical sector or horizontal factor of production, rather than more abstract discussions of general economy-wide competitiveness. This is for an important reason: the majority of the unresolved problems that are hindering structural transformation in Peru are unique to particular sectors and activities, and can only be identified and resolved at that level. (Ministry of Production, 2016)

Peru developed this approach based on an urgent need to spur productive diversification - much like the need faced by Sri Lanka - and through trial and error learned several important principles, which are presented in detail in their guide.

### *Capabilities in Sri Lanka*

The example from Peru provides a successful model of public-private problem solving. The pressing question is if and how the model can be applied to the context of Sri Lanka, where authorities and responsibilities of line ministries and other government bodies are uniquely fragmented. Our work in training teams from MoDSIT between 2016 and 2017 suggests that there are capabilities on which to build a process similar to that used by Peru. For example, one team of individuals from the Board of Investment (BOI) was able to work closely with a solar panel manufacturing company to co-develop a training program to teach a specific skill set need by the industry. This is one promising example of public-private coordination to identify and work to resolve an industry-specific constraint. Meanwhile, the Export Development Board (EDB) has a long-established capability for convening firms and developing an understanding of industry-specific constraints. MoDSIT could therefore play a central role in public-private problem solving like that of the Ministry of Production in Peru.

However, the MoDSIT teams we have worked with have consistently run into roadblocks when response actions to industry-specific constraints require the decision-making authority across numerous ministries. Requests and recommendations made through multiple cabinet levels have often become stuck. To date, the GoSL lacks a clear channel of coordination through which prioritized actions to ease industry-constraints can be quickly authorized and enacted by disconnected government organizations. For example, the EDB is well aware that multiple inspections at the point of export at the airport, which does not have cold storage facilities, lead to the loss of competitiveness of many agricultural exports. But there is no effective channel of authority and decision-making through which this problem can be at least partially addressed. Action would require some combination of action by the Department of Customs (under the Ministry of Finance), the Ministry of Transport and Civil Aviation, and the Ministry of Defence. These types of public sector coordination problems are ubiquitous in Sri Lanka, but they were also ubiquitous in Peru. Over time, Peru's efforts through its MEs allowed it to develop the necessary mechanisms for prioritized actions to be communicated and enacted across ministries.

As the example from Peru clearly shows, public-private problem solving also requires coordination within the private sector. Firms and industry groups need to coordinate to attend and actively contribute to the problem-solving process. One of the most important lessons from Peru is that little progress is possible if the private sector does not put in the work to prepare for meetings and put forth feasible proposals to address their problems. The participation of many firms in an industry is also needed to avoid the risk of elite capture as discussions must be about the welfare of the industry rather than one or two large firms. Sri Lanka can rely on the same principle of self-organization that Peru does in order to prioritize problem solving with industries that are willing to put in their share of the work. Another important lesson is that focusing discussions around increasing productivity, rather than profitability, is a powerful tool for re-orienting demands from the private sector. Industries that can participate in problem solving around productivity will see real improvements in their business environment, while those that can only argue for profitability-increasing measures will see their MEs discontinued. If applied in Sri Lanka, these principles would inevitably lead to some industries taking advantage of this tier of support before others. Ideally, industries that initially lack the ability to self-organize and focus on productivity questions would rise to the opportunity over time when the potential gains of doing so become clear.

### ***Tier 2: Special Safeguard Measures to Support Adjustment of Industries***

Tier 2 of this system would provide a process for industries that face a measurable threat of injury from tariff rationalization to retain temporary tariff protection. GoSL can do this through an extension of the trade remedies mechanisms that are currently being developed. Using the same legal and institutional architecture as is being prepared for safeguard measures, GoSL could build an objective process for providing temporary tariff protection in the context of tariff rationalization.

In general, the safeguard measures for temporary tariff protection to be imposed for industries that can show that they are injured or are soon to be injured by exposure to an increased imports. The process requires not only that industries provide evidence of injury (or threat of injury) but also that they develop an adjustment plan in order to become competitive once the temporary tariff protection expires. In the context of tariff rationalization, a similar process could be applied but with a slightly different type of protection. Instead of imposing a temporary tariff increase, a special safeguard measures in the context of tariff rationalization would simply provide a longer period over which the tariff is reduced. For example, say that the tariff rationalization plan included a reduction of the duty (possibly inclusive of para-tariffs) on a particular product from 80% to 20% over a period of three years. If the domestic industry producing that product were to provide evidence that this change would expose it to competition from imports that would threaten the industry, it could then be given an extended phase out period of five years, or perhaps longer, depending on the intensity of the competitive pressure.

Thus, this trade adjustment process would provide a direct response to trade exposure from tariff rationalization in some industries. It would have the benefits of being simple in its design

and implementation so long as the process for general safeguard measures is in place. It also would be an objective process that distinguishes between industries that are under an actual threat from tariff rationalization and industries that will merely lose some profitability. Critically, the tariff protection delivered would be self-liquidating, which would provide industries with clarity on the protection they would receive over time and give them adequate time to adjust. Finally, the process would be transparent and go a long way to protect the GoSL from the level of rent seeking that it faces today.

### *Building on the Existing Legislative Package for Trade Remedies*

This tier of trade adjustment for firms would exist alongside Sri Lanka's envisioned processes for safeguard measures, anti-dumping, and countervailing duties (recently published in the Gazette of 6 October). Including the use of special safeguard measures for tariff rationalization, as described above, would require several design considerations and resulting legal steps, but would build directly onto the same legal foundation. Some key design questions are as follows:

- How should vulnerable industries be identified for review for special safeguards? Under the current design for safeguard measures, investigations can be requested either by firms that represent a large share of domestic producers in that industry or by the Director General of the Department of Commerce. For tariff rationalization, it may be appropriate to define a slightly different process, likely involving staff from the Ministry of Finance and perhaps allow a smaller share of firms in the industry to make the request.
- Should the responsibility for conducting investigations fall under the Department of Commerce (as is the case for general safeguards and anti-dumping)? Using this process in the context of tariff rationalization would likely require a large number of investigations and would require a complete understanding of the tariff rationalization plan. Thus, it may be wise to create a coordinating body between the Department of Commerce and the Ministry of Finance with shared responsibility to evaluate the evidence of injury.
- Should the level of injury required for special safeguard measures be lowered? A lower standard may be appropriate than for general safeguard measures, which require "serious injury" or the threat of such. The anti-dumping standard based on "material injury" may be more appropriate.
- Should the domestic industry be required to carry the burden of proof of the threat of injury? The investigating body will need to have information on prices and quantities of domestic goods and foreign competition in order to make objective judgments. But it might not need as extensive data and other evidence as it does for general safeguards measures.
- Should the domestic industry be required to submit and follow an adjustment plan or specify the duration required for adjustment? These steps could be encouraged but not required for special safeguard measures in the context of tariff rationalization.

- When should this process take place? The process for determining whether or not an industry needs special safeguard measures could be treated as a one-time only system in response to a specific tariff rationalization plan or it could be left open indefinitely for any future tariff reforms. It would make sense for the process to be open before a tariff rationalization plan goes into effect, but there is a design question of how long the process should remain open.

### *Other Trade Adjustment Mechanisms Beyond Safeguard Measures*

Since tariff protection is not the only means by which to support trade-affected firms, countries often have programs that provide some type of subsidies to help firms adjust. These programs tend to be very complex to administer because of the need to prevent rent-seeking and inefficient use of government resources. For example, the Trade Adjustment Assistance (TAA) Program in the United States, which provides support to both firms and to workers, supports eligible import-impacted U.S. firms through cost-sharing technical assistance. Firms can receive technical assistance to create and implement targeted business recovery plans. This assistance is provided through matching funds to reduce the costs that firms pay for third-party consultants to help expand markets, strengthen operations and increase competitiveness. Funds are not provided directly to firms. The program works through a strict administrative process to determine firm eligibility, certify adjustment proposals, and enforce cost sharing rules, which lasts a number of years.

While it is generally the case that production subsidies are more economically efficient measures of protection than tariffs (because they incentivize production without disincentivizing domestic consumption), the administrative burden of such an approach appears to be a poor fit for the Sri Lankan context. In contrast, the implementation considerations discussed in detail above for special safeguard measures are much more manageable. Although countries often utilize both approaches, we recommend that Sri Lanka focus on special safeguard measures to address industries that may be harmed by the tariff rationalization plan.

## **3. Helping People to Adjust**

In reality, the motivation for the urgency of tariff reforms is not about firms or industries, but rather about people. Rationalization of the tariff system is needed because the current system is a constraint to the emergence of new exports and the emergence of new, high paying jobs that go along with that. The goal of tariff rationalization, in fact, is to catalyze the movement of a large share of Sri Lankan workers from lower paying jobs in traditional sectors to higher paying work in new industries, especially in exporting industries. At the same time, the growth of exports is essential for sustaining the expansion of the overall growth. This means that the expansion of jobs in exports is also critical for maintaining long-term job growth and wage growth throughout the nontradable sector.

However, this desired transformation of the labor market will not benefit all workers equally. While some workers will see new opportunities emerge and willingly move between jobs, others may lose their job unwillingly, face unemployment, and possibly move to a lower paying or less desirable job. In the long-term, most of these workers may find themselves better off, but in the short-term many will be worse off. The *New Trade Policy* recognizes this problem and outlines the need for policies and tools that help workers to adjust to the changing labor market.

Job losses and the need to help workers to adjust to a changing labor market is actually not something that is particular to tariff rationalization or other trade reforms. Competition in general, whether domestic or international, leads to job losses that benefit the overall health of the economy but are costly for individual workers. This is the concept of “creative destruction”. International trade, especially when brought on by trade reforms or trade agreements, tends to accelerate these kinds of labor market transformations as well as provide a clear source of blame for individual job losses. With this in mind, it is not surprising that developed countries often provide a two (or more) tier approach to supporting the adjustment of workers. Countries tend to provide basic support mechanisms to help workers who have lost their job for any reason and additional (often highly visible) support mechanisms to help workers who have lost their job because of international trade. So, in parallel to the two tiers of adjustment assistance for firms, the GoSL can likewise take a two-tier approach to adjustment assistance for workers.

### ***Tier 1: Social Safety Net, Job Training and Other Adjustment Support***

Tier 1 support to workers is about providing a social safety net and job training opportunities for all individuals who lack good employment. We recommend that Sri Lanka focus improving its Tier 1 support to workers through better organizing public facing information on its job training programs and opening public job centers where labor market information can be organized and services are made available. This step could be budgeted and started in the short-term.

#### ***Social Safety Net***

The first tool that a country has to respond to job losses is its social safety net. This covers various services for the poor, often including temporary benefits for individuals who lose their source of income. Of course, Sri Lanka has a large and developed social safety net in the Samurdhi Program. It is beyond the scope of this paper to delve into detail on this program but it is important to note that the Samurdhi Program provides many welfare services but little in the form of specific assistance for people who lose their jobs. Unlike most more developed countries, Sri Lanka does not have an unemployment insurance program. This should not be taken as an essential gap to fill at this time - unemployment insurance is an expensive and administratively complex policy to implement - but it does underscore the importance of having other tools in place to support workers who become displaced, due to trade or automation or any other reason.

## *Active Labor Market Adjustment Assistance*

Beyond different forms of unemployment insurance, countries also use more active labor market adjustment measures to train and match displaced workers to emerging job opportunities. European countries tend to have more developed publicly supported training and apprenticeship programs than the United States. Some argue that this is because Europe faced long-term unemployment for many years before the United States started to encounter the same problem. It has been estimated that Denmark spends an amazing 2.3% of GDP on training and assistance, Germany spends 0.8% of GDP on its highly effective apprenticeship program, and the U.S. spends just 0.1% of GDP on similar measures.<sup>6</sup> However, even the U.S. at this low level of spending has achieved measurable improvements in the employability of workers through the implementation of its Workforce Innovation and Opportunity Act, and its precursor, the Workforce Investment Act. This system structures “one-stop-shops” at the state and more local levels with physical and online offices where out-of-work individuals can access an array of job training and job placement services.<sup>7</sup> The reason for relying on state and more local implementation is that job markets and skill demands vary dramatically between regions. Local job centers differ in the scope of their services, but at minimum they provide a centralized place where job openings are listed and career advice is made available. An independent study of the Workforce Investment Act found strong positive results of the program across all its core services (providing outreach, job search and placement assistance, and labor market information), intensive services (comprehensive individual assessments, individual employment plans, counseling, and career planning), and training services (occupational and basic skills training).<sup>8</sup> In 2014, the program was updated and expanded with rare, bipartisan support.

## *Building on Sri Lanka’s Strengths*

In terms of this kind of active labor market adjustment, Sri Lanka is in a strong position in that it already has a large vocational training system that includes both public and private institutions. Our own analysis of these vocational training programs (See Appendix 2) has found that they are associated with large and statistically significant wage premiums (ranging from 10% to 25% per year of training) for participants across almost all programs, both public and privately run. TVET graduates are also more likely to be employed. While our analysis does not show strict causation (due to the fact that more capable individuals may be drawn to the programs to begin with), it does provide very strong evidence that vocational training institutions in Sri Lanka are delivering skills that employers demand and that are not provided by the formal education system. However, in work together with the Prime Minister’s Policy Development Office, we have also found that access to these vocational training programs is negatively impacted by a very fragmented institutional structure and a lack of easy-to-navigate public information for potential participants.

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<sup>6</sup> "Getting Americans Back to Work: A Long Way Still to Go." *Council on Foreign Relations*. Web. 25 Oct. 2017.

<sup>7</sup> See website: <https://www.careeronestop.org/>

<sup>8</sup> Heinrich, Carolyn J., et al. "Workforce Investment Act non-experimental net impact evaluation." *Report to US Department of Labor*. Columbia, MD: IMPAQ International (2008).

These current strengths and weaknesses suggest that Sri Lanka could benefit greatly from a system like that of the U.S. that channels resources to regional or local job centers, where any jobseeker can find information on relevant job opportunities, training resources (vocational training as well as any other job training programs) and potentially individual support in career planning and placement. Such an initiative would be fairly simple and inexpensive to begin in the short-term and would deliver important services to many workers in the country, regardless of whether they are impacted by trade or tariff rationalization.

## ***Tier 2: Government Funding for Trade-Affected Workers***

Because trade-related job displacement is usually a very salient form of job loss, countries often treat these cases differently. We recommend that Sri Lanka take the same approach by providing specialized job placement services and financial support for trade-affected workers to access Tier 1 training and other career services. But the administrative challenges and financial costs of such programs should not be overlooked, meaning that this tier of support should be developed carefully and phased in only after Tier 1 improvements have been instituted.

## ***The U.S. Model for Trade Adjustment Assistance to Workers***

The United States delivers special benefits to workers displaced by trade through its Trade Adjustment Assistance program for workers. The TAA program builds upon the structure of the nationwide workforce development programs described under Tier 1 to provide trade-affected workers with opportunities to obtain the skills, resources, and support they need to become reemployed. In addition to job training and job search resources, individuals in the TAA program receive special case management services and financial support through relocation allowances, weekly income support payments, and assistance with healthcare premium costs. For workers over the age of 50, TAA also offers a form of wage loss insurance where the government will cover part of the difference in wages when a worker moves to a lower paying job for up to two years. This program is capped at a certain level of income and capped on the total possible payment over the two years. In order to receive TAA benefits, a petition must be filed with the U.S. Department of Labor (DOL) by or on behalf of a group of workers who have lost or may lose their jobs, or who have experienced a reduction in wages as a result of foreign trade. After the DOL investigates the facts behind the petition, it determines whether foreign trade was an important cause of the job loss (or the threat of job loss) or wage reduction. Evaluations of TAA program for workers have found mixed results, as exemplified by an independent evaluation of the program in 2012.<sup>9</sup> This evaluation found that the financial support alone was not associated with any better employment outcomes than standard unemployment insurance, but when combined with job retraining, participants standing in the labor market improved. The evaluation also found that training worked better for younger workers than older workers. Older, more experienced workers are harder to equip with a new skill set, which is why the TAA program uses wage loss insurance for older individuals. E.U. countries use similar tools as the U.S. for

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<sup>9</sup> D'Amico, Ronald, and Peter Z. Schochet. *The evaluation of the trade adjustment assistance program: A synthesis of major findings*. Mathematica Policy Research, 2012.

training, job matching and providing financial support to trade-affected workers. The European Globalization Adjustment Fund helps national governments to develop and implement these programs by subsidizing their costs, effectively sharing the costs of trade adjustment programs for workers across E.U. countries.

### *Considerations for Adapting the U.S. Model to Sri Lanka*

The U.S. TAA model could be adapted to be applied in Sri Lanka if carefully designed under both administrative and financial constraints. As Sri Lanka improves Tier 1 support to all workers through increasing access to labor market information and training, Tier 2 support to trade-affected workers could include covering the costs (through either waived fees or direct payments) for vocational training programs, other training programs, and individual job placement services. So the main difference between Tier 1 and Tier 2 support to workers would be that trade-affected workers receive government funding in order to take advantage of all Tier 1 services. In theory, GoSL could also consider building a wage loss insurance program for trade-affected workers, but the administrative challenges of wage loss insurance would likely make it impractical.

The development of Tier 2 support for workers would require answering important administrative design and financial sustainability questions. First, GoSL would need to develop a means through which to certify that a worker is displaced or negatively impacted through trade, including in the current case of tariff rationalization. This process could be linked to the envisioned investigation process for safeguard measures (including the special safeguard measures described previously). Workers could become immediately eligible for Tier 2 support if they work in an industry that has been determined to be trade-affected and can present documentation that they have lost their job or suffered a reduction in their wages. This determination could be facilitated through local representatives at job centers in communication with the Department of Commerce and potentially the Inland Revenue Department. To begin, it might be necessary to restrict Tier 2 assistance to only workers who have lost their job. Since we do not know how what share of workers would be traceable through Inland Revenue Department records, we do not know if it would be feasible to screen for workers who have seen their wages fall. There may also be some workers who are trade-affected even though a determination was never made through the safeguards process. For example, this could occur if an employer was to shut down due to trade pressures but never make an application for temporary protection because its industry was especially small or fragile. For any workers in such a situation, there would need to be a separate process whereby a panel of experts could make a special determination if such worker qualifies for Tier 2 support. This could be conducted by the experts that investigate safeguard measures, but using a streamlined process requiring a lower burden of proof. These detailed administrative questions should not be overlooked, and any consideration to develop a wage loss insurance program should recognize that additional administrative steps would be needed to keep track of new wages and to facilitate payments to the worker.



In terms of financial sustainability, money would have to be provided through the budget for this Tier 2 assistance to workers. The preferred means through which to raise funds for such a trade adjustment program would be through the tariff reform itself, although GoSL may choose to transfer resources to this program from elsewhere in the budget. If the adjustment package for workers were to be paid for through increased customs collections, this would mean that the tariff rationalization would not only need to break even in revenue terms but would actually need to be revenue positive. Careful analysis is therefore needed on both the expenditure and revenue sides in order to properly adapt the U.S. model of TAA to Sri Lanka. The time and resources devoted to proper design of this would be well worth the cost in order to develop a sustainable program that improves worker mobility. However, if not properly planned, rushed delivery and broken promises of a system like this could be disastrous for the public support of trade reforms and undermine the ability of the GoSL to rationalize tariff structure.

### *Brief Discussion on the Adjustment of Communities*

In recent years, there has been emerging evidence that some trade shocks (for example, imports from China to the U.S. after China entered the WTO<sup>10</sup>) lead to very intense local labor market disruptions as the closure of a large local employer can lead to the hollowing out of an entire local economy. This can happen through reduced demand for nontradable services in the area and a chain reaction of job losses and wage reductions across the local economy. Since the shock occurs at the community level rather than the individual level in these cases, there is a strong argument for the use of tax-base insurance.<sup>11</sup> The idea of this instrument is for local governments to insure against a sudden loss of their tax base such that public investment does not also become part of the downward spiral. This risk is mitigated in Sri Lanka because of the centralized nature of tax collection in the country, but the GoSL should ensure that budget allocations are not reduced for regions that face high levels of trade-related job losses. If anything, budget allocations and public investment should be increased to any areas that are hit by a large trade shock.

## **4. Conclusions and Recommendations**

This paper has laid out a set of approaches that Sri Lanka could prioritize to facilitate the adjustment of firms, industries and workers to much needed tariff rationalization in the country. These approaches would be most effective if the tariff rationalization plan itself is holistic in nature and phased in slowly after clear communication with the private sector. Both careful design and communication of the tariff rationalization plan are critical for its effectiveness and for gaining public support from industries, workers and consumers.

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<sup>10</sup> Autor, David H., David Dorn, and Gordon H. Hanson. "The china shock: Learning from labor-market adjustment to large changes in trade." *Annual Review of Economics* 8 (2016): 205-240.

<sup>11</sup> Deep, Akash, and Robert Z. Lawrence. *Stabilizing State and Local Budgets: A Proposal for Tax-base Insurance*. Brookings Institution, 2008.

The trade adjustment plan should go hand in hand with the tariff rationalization plan. As described by the *New Trade Policy*, the assistance measures must help to facilitate the adjustment of firms to new competition and the adjustment of workers to labor market changes that result from tariff rationalization. We recommend a two-tier approach for both the adjustment of industries and the adjustment of workers as summarized in Table 1.

**Table 1: Summary of Recommended Trade Adjustment Assistance Measures**

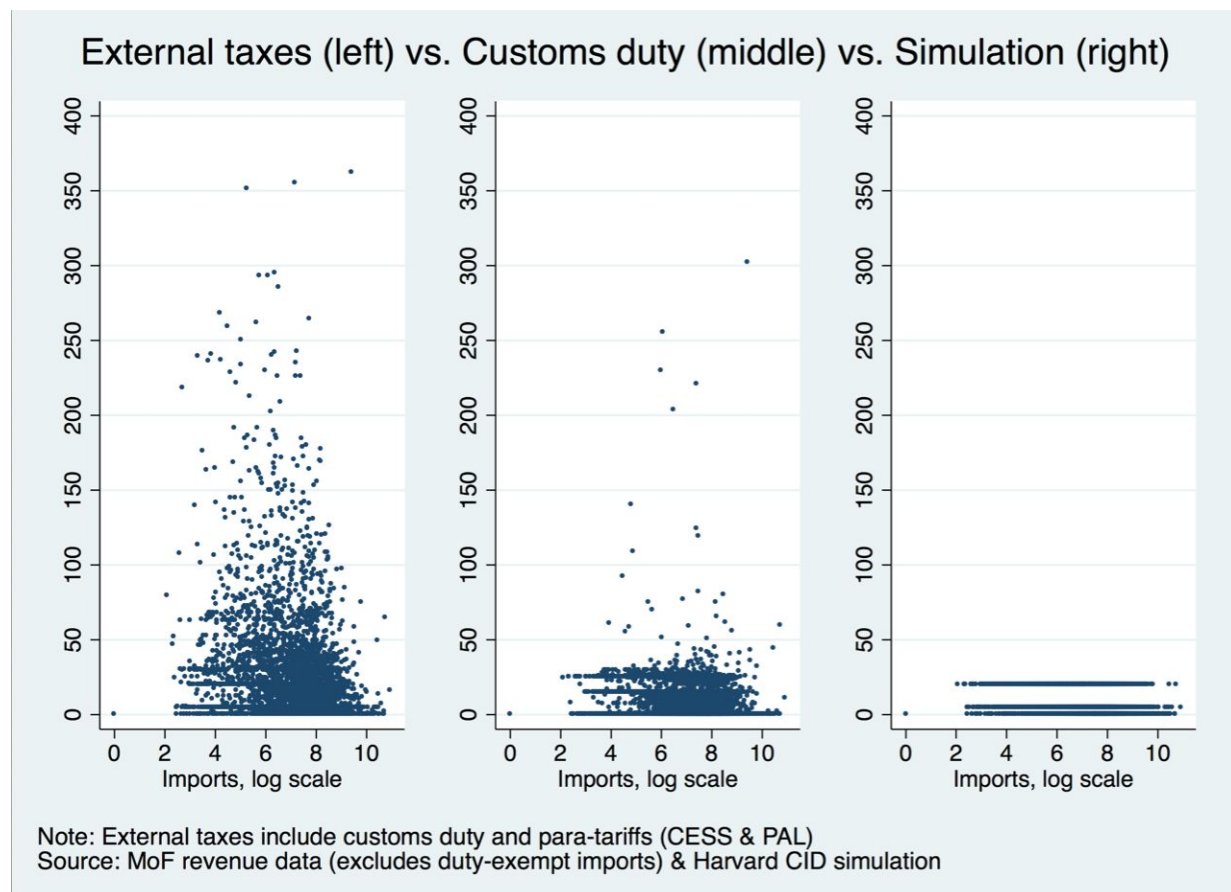
	<b>Adjustment of Industries</b>	<b>Adjustment of Workers</b>
<b>Tier 1 (Available to all)</b>	Public-Private Problem Solving	Job Training & Local Job Centers
<b>Tier 2 (Trade-affected)</b>	Special Safeguard Measures for Tariff Rationalization	Funding for Training / Job Placement Services

The approaches under Tier 1 are low-cost measures that would benefit all industries and all workers, regardless of whether or not they are negatively impacted by tariff rationalization. These measures build directly upon existing capabilities in Sri Lanka and would increase the productivity of firms and the employability of workers. The approaches under Tier 2 apply only to industries and workers that are directly harmed by tariff rationalization according to objective criteria. Industries that qualify would be provided temporary tariff protection in the form of longer phase out periods of tariffs. Workers that qualify would be provided with free access to training and other placement services. Each of these measures will require planning by the GoSL to put the administrative structures in place and budget for operational costs. Tier 1 measures may be possible to begin in the short term, but Tier 2 measures (along with the tariff rationalization plan itself) should not be rushed. Tier 2 measures for workers will require particular attention be paid to what costs will be expected and whether the tariff rationalization plan itself can cover these costs through generating increased revenues.

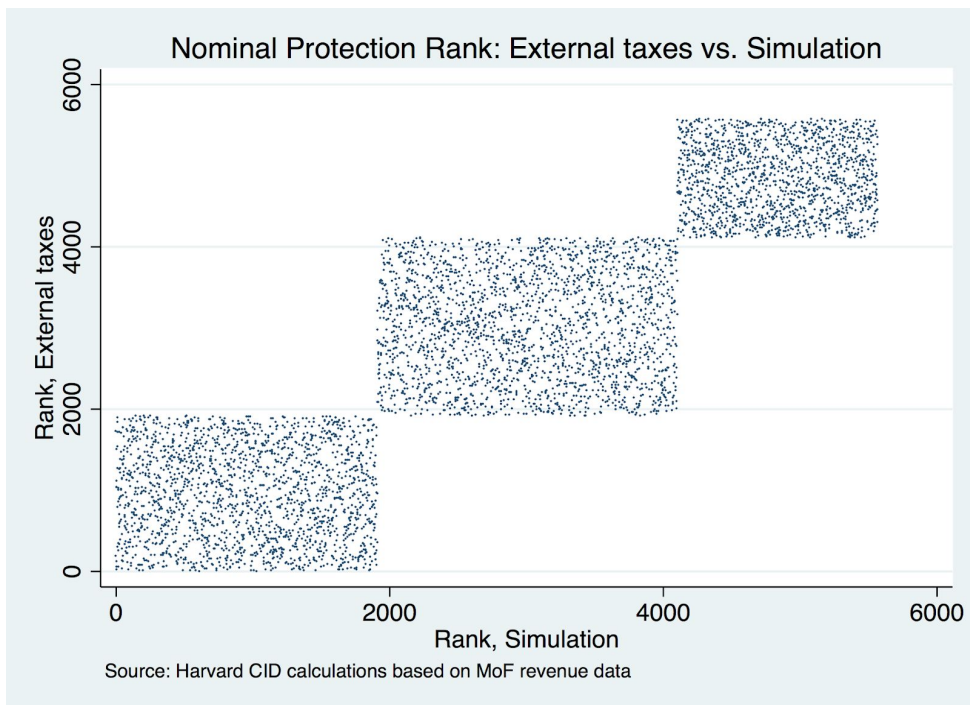
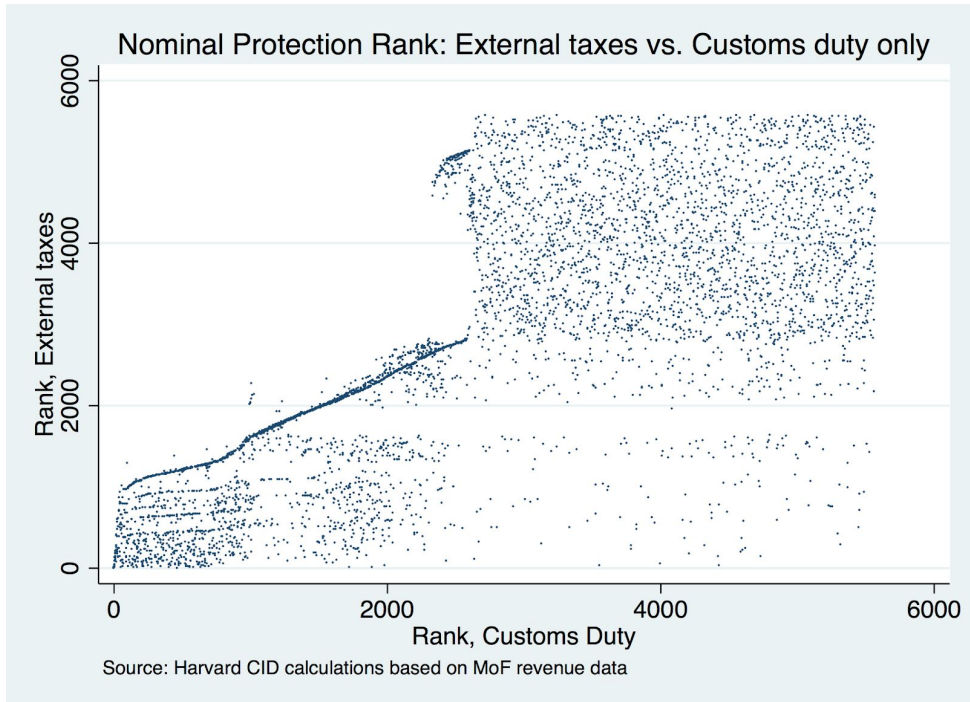
We recommend that sufficient time be taken to properly develop these measures in detail and package them together with a carefully designed, holistic tariff rationalization plan. This will require collaboration between the Ministry of Finance, the Ministry of Development Strategies and International Trade, the Department of Commerce, the Attorney General's Office, and the Ministry of Skills Development and Vocational Training, among others. A complete plan that is developed and communicated to the public over the next year will be much more effective and have much greater public support than a disconnected set of reforms and adjustment actions taken one at a time. Partial plans that are announced in the interest of acting fast - especially those with sudden implementation - will in reality only lead to intense public opposition, a slower and less effective process overall, and a higher likelihood of complete failure of the initiative.

## Appendix 1: Visualizations of Hypothetical Tariff Rationalization

The following graphs plot external tariffs versus the the *current* volume of imports using Ministry of Finance revenue data from 2015. Each dot represents a product according to 8-digit HS code. The leftmost graph shows total external tariffs calculated from this dataset. The middle graph shows the customs duties only as calculated from this dataset (i.e. what the external tariffs would like if all external para-tariffs were removed). The rightmost graph shows a hypothetical tariff structure that could result from holistic tariff reform (as detailed in a memo sent to the Ministry of Finance by Harvard CID on 5 July 2017). Note that the volumes shown on the x-axis are unchanged across the three graphs. In reality, any tariff rationalization will result in changes in import volumes as a result of the elasticity of imports to the external tariff.



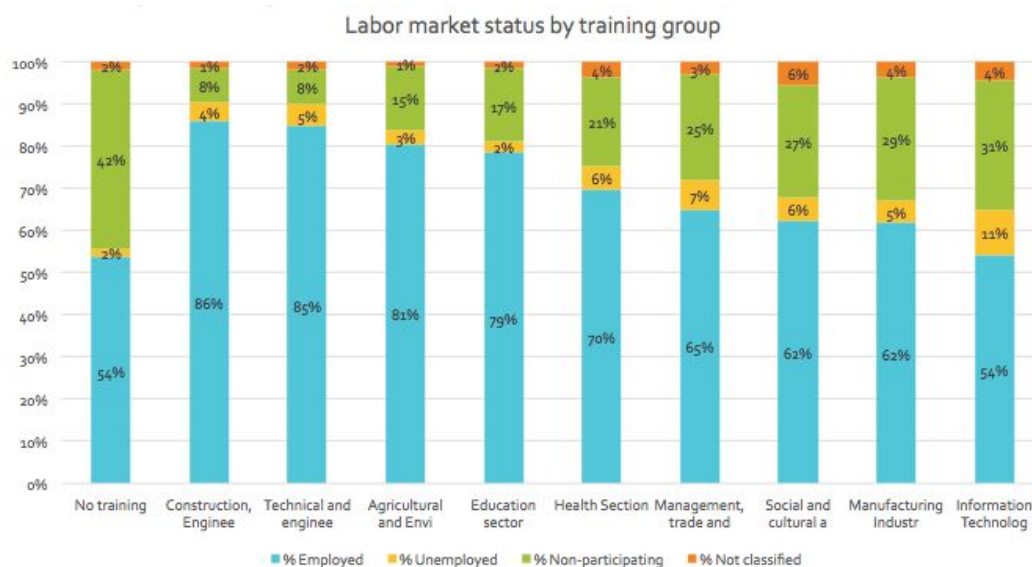
The graph in the middle could in some ways be seen as stop on the path to a system like the one on the right. However, one important difference is the implications for industries. Moving from the system on the left to the system in the middle would radically alter the rank of nominal protection that different products receive. In contrast, moving directly from the system on the left to the system on the right would allow for the ranking of nominal protection to be maintained.



## Appendix 2: Select Findings on Vocational Training in Sri Lanka

We worked with the Prime Minister's Policy Development Office in 2016 to study the TVET system of Sri Lanka within a broader research agenda of understanding constraints to growth and skill mismatches in the economy. Several relevant findings from this research are provided below.

- In 2014, almost 11% of Sri Lankans age 15-65 had completed some kind of formal professional technical training (TVET) on top of formal education.
- TVET graduates numbers are divided about equally between the private and the public sector training institutions.
- About a third of all TVET graduates are computer technicians (figure to right).
- People graduating from the TVET are better employed than those without it (figure below)



Source: LFS 2013 and 2014.

- There are significant returns per year spent in TVET in almost all types of training except for manufacturing/industry training (figure below). This is after controlling for formal education, meaning that TVET provides valuable skills that formal education does not.

