

Industrial Reforms for Accelerating Growth

The need for industrialising the country has been stressed by almost all governments that came to power since independence. We have had many seminars, workshops and discussions on industrial development in Sri Lanka during the last four decades. Compared to many developing countries, policies and strategies on developing Sri Lanka's industrial sector have been well documented. I myself as a researcher was associated with these discussions on industrial policies over the last two decades.

We were much ahead of many other countries in the region in regard to realising the need for industrialisation and formulating policy strategies and conceptualising about industrial development. Some economists therefore argue that if the thinking and discussions that we have had were translated into practice, we may have even surpassed the Newly Industrialised Countries (NICs) in Asia such as Taiwan, South Korea and Singapore. It is relevant and pertinent even now to address the issue as to why we have not been able to accelerate the industrialisation process as expected.

Sri Lanka has followed to distinctly different development strategies during the post-independent period to accelerate its growth. The import substitution strategy which ended with the opening up of the economy in 1977 created a large number of state enterprises engaged in manufacturing basic industrial products through protectionist policies and trade restrictions which in turn enabled to generate an average growth of 3.5 per cent prior to 1977. Such industrial strategy could not resolve the problems of unemployment and poverty. Per capita income in 1977 was only about US \$ 300, whereas East Asian economies which were behind Sri Lanka had recorded fivefold of Sri Lanka's per capita income. Since 1977, the country followed liberal market-oriented strategy with increased emphasis on export promotion and produced a growth rate on average around 4.5 per cent which is marginally above the overall performance in the pre-1977 period. Although the magnitude of unemployment and the balance of payment difficulties were lesser than the pre-1977 period, Sri Lanka lagged behind the neighbouring countries which had started similar growth strategies to promote their own economies. Per capita income in 2000, 50 years after independence is still around US \$ 850.

Newly industrialised economies have achieved over 10 per cent growth in their GDP together with the growing importance of the manufac-

turing sector, which has become larger than the agricultural sector with manufactured exports accounting for the bulk of total exports.

By this comparison, I do not suggest that we should follow a model adopted by other countries. Each country has its own model of development and we must develop our own model to accelerate the growth by drawing the relevant lessons from the experience gained by other countries that have achieved high growth momentum.

In accelerating the economic development process, the industrial sector could make a more significant contribution, given its greater prospects for growth, employment generation and meeting the aspirations of the educated youth, compared to the agricultural sector which has inherent limitations. An acceleration of the industrialisation process therefore becomes essential if Sri Lanka is to be transformed into a rapidly growing economy.

The pattern of industrialisation during the last two decades indicates that the manufacturing sector has responded to liberalisation policies in a positive manner, although the rate of industrial expansion has been below expectation. The local value added has expanded at a higher rate, but there has been only a small change in the structure of the GDP.

The disaggregation of value added by sector indicates that the services sector recorded an increase in its share from 46 per cent of GDP in 1975 to 53 per cent of the GDP in 2001. This sector had the highest growth rate recorded compared to other sectors during this period. The agriculture sector experienced a continuous decline in its share from 28 per cent of GDP in 1975 to 20 per cent of the GDP in 2001. Agriculture had the lowest growth rates recorded by any sector during this period despite the fact that this sector accounts for more than 1/5 of the total GDP.

The sectoral structure of GDP indicates only a marginal change in favour of the manufacturing sector. The share of value added in manufacturing sector remained at 16 per cent by 2001 which is low compared to 20 per cent in India and about 30 per cent in the NICs, reflecting the fact that the manufacturing sector has not grown at its potential capacity in Sri Lanka.

Sri Lanka's industrial sector faces a severe challenge with regard to sustaining the competitiveness of its products. This is because of the fact that Sri Lanka's industrialisation process has now entered into an environment characterised by a more liberalised trade regime promoted

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under WTO, SAPTA and Indo-Sri Lanka Free Trade Agreement. Expiration of the MFA will also exert global pressures on the export of garments, the leading industrial activity in the country. The challenge therefore is to strengthen the policy framework to promote a business environment which is conducive to entrepreneurship, investment, production and marketing.

The growth performance of the economy and the industrial sector in particular, shows an increased trend towards export of manufactured goods. However, this expansion is confined largely to growth of the apparel industry. The growth of the apparel industry was influenced by the market access through textile quota available to the country. The availability of reasonably adequate infrastructure particularly through export processing zones and free trade facilities extended to this industry, helped to sustain this growth. This sector was also fortunate to absorb a surplus labour force which was educated but unemployed to a large extent in 1977. The unemployment rate in 1977 was around 20 per cent. The gradual decline in unemployment and labour migration to overseas employment has dramatically reduced the availability of low cost labour.

Although few other industries have also emerged through export-oriented strategies during the post-1977 period, the country's overall industrial structure is still dominated by the apparel industry posing a considerable vulnerability for the Sri Lankan economy in the future. Moreover, increased competition in the international markets has forced Sri Lankan manufacturers to restructure their industries to become more competitive in the domestic as well as global markets.

The unsatisfactory growth performance and the under-utilised potential of the industrial sector suggest the urgent need for rapid industrialisation in the country. This requires a series of reforms to create a conducive environment. Labour reforms, deregulation, improving corporate governance and educational reforms are required to remove the impediments to acceleration of industrial growth.

It was evident that technological capabilities, skills and the quality of products have been improved in selected areas due to export orientation in industrial strategy. This was reflected in the creation of new capacities, in-

roduction of new products and increased output in the industrial sector. However, this process has still not gained a momentum to improve the standard of living similar to those standards achieved by NICs in Asia.

The industrial strategy seems to have produced less satisfactory performance due to a variety of reasons. The post-1977 development strategy suffered a setback due to the escalation of the Northeast conflict. However, the static performance in the economy, and particularly, the industrial sector cannot be fully explained by the war and the conflict.

The unstable macro economic environment due to continued large fiscal deficits, inadequate infrastructure facilities, institutional rigidities and inefficiencies, rigid labour laws, inconsistencies in development policies and high financial costs are the main causes for the current performance in industries.

In this background, the acceleration of economic growth requires considerable reforms in each of these areas. The National Budget will require to reduce its large deficits in order to provide resources required for the private sector for its expansion. The reduction in the budget deficit will also enable to reduce the cost of funds to the private sector. It is worth recognising the fact that except in a few selected years, average cost of funds in Sri Lanka has been 20 per cent and budget deficit has been around 11 per cent during the post-1977 period. This has imposed a severe financial burden on industries in raising funds at competitive rates. The viable import substitution industries as well as small and medium industries which cannot raise funds from foreign sources, suffered heavily.

While the Sri Lankan private sector is faced with problems of high cost of funds and inadequate long-term resources due to heavy government borrowings, the labour market adds a further constraint to industrial growth due to rigid labour laws and regulations, putting industries in a disadvantaged position over their competitors. In a liberalised market-oriented environment, industries are required to adjust to market conditions and reposition themselves for which factor market should be flexible. However, while product market is being liberalised and allowed for high competition through inflow of imports to the country, the local industry has not been able to face with this competition as they have not been free to restructure their industries due to rigid employment conditions and high capital cost. In this background, it is necessary to recognise that the Sri Lankan economy is now competing with countries which have virtually eliminated their budget deficits and implemented relatively competi-

tive and modern labour laws. A small economy like Sri Lanka will have to compete with large economies such as Indonesia and China, whose cost of labour and capital are relatively low. These economies also have the advantage of exploring the economies of scale because of their large domestic markets.

The experience in newly industrialised Asian countries demonstrates that their economies have also benefited from having modern infrastructure that has improved the comparative advantage for industrial exports. These infrastructure facilities have increased their access to global markets with least cost. Therefore, the industrial reforms for accelerating growth would require much more concerted efforts in providing the required infrastructure together with flexible labour and capital market conditions. Emphasis will have to be placed on reforms focusing on the role of the government, the speed of reducing the fiscal deficits, role of the state banks, cost of funds, skills and human resource development, as well as labour market reforms.

A rapid industrial growth in the country will also require institutional reforms that are necessary to respond to the emerging market conditions. While trade liberalisation has made considerable progress, further simplification and rationalisation of the tariff structure, integration with global markets through liberal trade arrangements are necessary to increase export orientation in industrial strategy. The support institutional structures such as Customs, Ports and regulatory agencies should become business-friendly in providing their services. The time taken for processing of transactions at Customs, Ports and other regulatory agencies has imposed higher cost for imports and exports compared to that of Sri Lanka's competitors. It is time now for Sri Lanka to move into electronic data network to process trade transactions to reduce transaction cost and sustain competitiveness of the industries.

The industrial sector growth also requires effective checks and balances, particularly, assuring quality standards of imports in order to ensure that local industries which are competitive but unable to cope up with dumping of sub-standard product of other countries. Therefore, the legislation of anti-dumping and countervailing duties which are being formulated, should be rapidly implemented to achieve the desired results.

Given the weak entrepreneurial base, the kick-start of small industries has been problematic. The problem has become aggravated due to strong competitive pressures. Thus an initiative have been made to promote mechanisms such as "Industrial Incubators" just like South Korea did at one time during their industrial take off. Industrial Incubators will systematically coach

and guide the start-up, growth, management and technological upgrading of small and medium industries.

Under liberalisation strategies, the taxation regime also needs to be given serious consideration for industrial development. The traditional strategy in the past has been to grant tax holidays to investors to promote industries. However, one of the common problems faced by industries is the upfront cost that has to be paid on raw material and other project related inputs due to high indirect taxes and lack of efficient input tax refund system. In a country where the cost of funds is high due to large fiscal deficits and high interest rate, upfront costs through taxation create heavy cash flow problems in industries. The adoption of a more efficient value added tax system in place of the multiple tax system will therefore be conducive to promote industrial activities. Value added tax system should address input tax refund mechanism that will eliminate upfront tax burden in production.

In addressing the labour market reforms, the focus should be on creating efficient labour dispute settlement mechanism, developing skills in work places to improve the mobility of labour and productivity. The reorientation of labour skills could be undertaken in work places, so that redeployment of labour and restructuring of industry can be initiated without large-scale layoffs that would create unemployment in the short-run.

Labour problems are complex and if there is a need in Sri Lanka to create a conducive environment for workers and maintain a harmonious relations between employers and employees. For this purpose, it is necessary to initiate an awareness programme on "Industrial Culture". An initiative to create new industrial culture will contribute to the entire labour reform exercise in the industrial sector.

In the industrial development strategy, it is also necessary to address the role of the bureaucracy, regulatory involvement and the legal framework to safeguard private property rights. In Sri Lanka, one of the problems relating to these regulatory arrangements is the existence of multiplicity of government agencies to perform these responsibilities. The duplication of work undertaken by various institutions necessitates the creation of a rational institutional structure to perform the regulatory responsibilities and provide support services required for the industrial sector growth in a co-ordinated manner.

Lack of coherent strategies to address multiple problems confronted by the industrial

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sector has imposed a heavy burden on the exchange rate which eventually has compensated for the difference in competitiveness between Sri Lanka and its trading partners. The Sri Lankan economy, with its large import and export base for its economic activity, should achieve exchange rate stability in order to reduce the cost of inputs particularly raw material and capital goods. The use of exchange rate to promote export and viable import substitution industries without solving fundamental structural constraints, as discussed, will be self-defeating. Therefore, the undue adjustment burden imposed on exchange rate has to be shifted to other areas by addressing these root causes. The high cost of power and energy, inadequate telecommunication facilities and high cost of transport and storage, have raised the cost of production of many domestic industries. The competitiveness of such products internally can be maintained by adopting least cost energy sources, liberalisation of import of petroleum products, improving access to global technological facilities and reducing domestic transaction costs as well as high cost of funds.

In sum, industrial reform strategy should be for-

mulated giving consideration to the following important factors.

Firstly, the fiscal imbalances together with macro economic fundamentals aiming at creating an environment conducive for investment in a predictable environment, should be addressed. Such a policy framework will bring down the cost of funds and increase the availability of resources for industrial development. Stabilising macro economic conditions will also provide the required stability for the exchange rate as well as the interest rate. Secondly, labour market as well as capital market reforms aiming at required flexibility in utilising factor inputs and technology should be recognised. Thirdly, the industrial reforms focusing on the required tax and trade regime, institutional arrangements for various agencies should be adopted. Lastly, the infrastructure including electricity, water, telecommunication, roads, port and other infrastructure should be developed to attract investment into industries. In addressing these issues, it is necessary to have a coherent policy framework with both public and private sector participation to accelerate industrial growth.