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## INDUSTRIALISATION STRATEGY IN SRI LANKA — RECENT CHANGES IN POLICY AND PROMOTIONAL MEASURES

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### Introduction

Sri Lanka's economy is basically a primary one dominated by agriculture. Not only more than 50 percent of the population is engaged in this sector, but also the agriculture and mining sector is responsible for 31 percent of the value of Gross National Product (GNP) and the bulk of export values (43 percent in 1988). Manufacturing sector employs 12 percent of the workforce and generates 16.4 percent of the GNP. However, in Sri Lanka, as in many other developing countries, industrialisation is regarded as one of the key factors in the process of economic development and, since 1948, when political independence was won, considerable emphasis has been placed on the need to transform the country's economic structure. Industrialisation with its linkages to other activities and a potential to offer relief from unemployment and low wage levels and to overcome balance of payment difficulties, was seen as the 'primum mobile' of development, the engine of growth. The role of the industrial sector therefore, has been stressed as an integral part of Sri Lanka's development programmes over the last four decades.

During the British period (1840—1931) the metropolitan government had an interest in developing the plantation sector in the island to provide raw materials for its own economy. Government was also mainly concerned with the establishment and maintenance of the infrastructure and the basic services necessary to administer "law and order" and to facilitate the production and export of a few agricultural commodities. Over this period government was not inclined to engage itself directly in the promotion of industrial development in Sri Lanka. At the beginning of this century there were only factories processing tea, rubber and coconut, and also a few allied industries catering to the requirements of the major agricultural activities, a brewery, a textile mill, and some small scale industries to produce paper, soap, plywood, tea chests, and bricks and tiles. Only ad-hoc measures were taken in this period to diversify the economy through industrialisation, and these have given way to the planned development projects later on. Historically this development can be divided into four convenient phases to highlight the main characteristics of industrial policy, parti-

cularly in terms of initiatives, ownership, location and promotional measures.

These four periods are as follows:

- (i) Early industrial development; 1920 – 1948.
- (ii) Post-independence period; 1948 – 1959.
- (iii) Import-substitution industrialisation; 1959 – 1965.
- (iv) Export-oriented industrialisation; 1965 – 1989.

### **Early industrial Development 1920 – 1948.**

Since the first world war steps were taken by the government towards industrialisation. A commission was appointed by the colonial government to enquire into the industrial potential in Sri Lanka in 1922. The commission published its final report, which dealt with possibilities of developing existing industries and establishing new ones. It argued that industrial development must be delayed until some source of cheap power, namely hydroelectricity was provided. The study identified cement, spinning and weaving, manufacture of packing chests, bricks and tiles etc., as suitable manufacturing activities to be developed in factory – based units while also recommending the development of “Home Industries” or handicrafts such as carpentry, basket weaving, cloth making, chalk making, lace making etc.. The commission also stressed the need for the government to carry out pioneer work regarding new industries and recommended the establishment of a “Central Bureau of Industry and Research” (Report of the Industries’ Commission, 1922) to undertake research. Immediately after this report, government allocated necessary funds for a hydro-electricity scheme, which commenced in 1924. This scheme, the obvious foundation for future industrial progress, did not proceed far due to bad planning and mismanagement (The Ceylon Banking Commission, 1934, pp. 3 – 5).

After a lapse of nearly a decade the need for orderly development of domestic resources was recognized by the government which came into power after the Donoughmore reforms in 1931. Industrial development was made a separate area of administration by the new government and in 1932, a Bureau of Industry and Commerce was established. The government also appointed another commission which made recommendations including the establishment of a State-

aided Bank and a separate Department of Industries to undertake pioneering and administrative work; to render technical advice to industries and to guide the industrial policy of the government. During this period the coincidence of the world-wide economic depression with the reforms retarded progress and weakened further the general economy of the island. However, cottage crafts were liberally assisted by the government.

Efforts were also made in 1935 to develop the economy on the basis of long-term plans, which included the organisation of the agricultural sector for the local production of food, the planning of simpler industries to meet local demand for manufactured goods, and organising the fuller use of other local resources. The emphasis was nonetheless more on development of small and cottage industries. A separate Department of Industries and Commerce was set up in 1938 in preparation for the planned development of industrial activities. The immediate task of this department was to consolidate work already done on the establishment of cottage industries. During this period additional interest was also shown by the government in the establishment of pilot and small factories with a certain amount of mechanisation.

Preliminary investigations were undertaken to test the suitability of local grass for paper manufacture before negotiating with a private firm for local manufacture of paper. This plan did not materialise when the private firm was declared an enemy enterprise (Department of Industries and Commerce, 1939). The state council also approved a plan by a British firm to produce rubber goods locally but failed with protests from local manufacturers. Preliminary work on a leather manufacturing plant was also over by then and the factory was ready for execution. The plywood factory contemplated at this time was meant to serve the needs of the agricultural export industries. Thus these projects were all planned on the needs of the local market and were designed not as monopolies but rather to show the way (Oliver, 1957, p. 58).

The policy was therefore largely to aid private enterprise for which the state council hoped to obtain funds from the State-aided Bank. By 1939, the only definite results of this policy had been the setting up of a model coir factory (1937) and the earmarking of funds for the proposed plywood factory. The outbreak of the second world war, however, disrupted the working of the entire plan and once again drew attention to the inherent defects of the island's economy. Therefore state-sponsored manufacturing industries were not established in the island. The disruption of international trade and communication

during the second world war (1939—1945) led the government to take steps to establish pilot industrial ventures, especially those producing some essential manufactured goods using indigeneous raw materials. Apart from already existing private ventures such as the manufacture of soap, safety matches, textile weaving etc., private capitalists were somewhat apprehensive of investing in unknown areas. Plywood, steel rolling and glass factories were therefore set up by the government in 1941 and the acetic acid and paper factories were set up in the following year. Other war-time ventures included a ceramic factory in Negombo, a drug factory in Colombo and a tannery and shoe factory at Mattakkuliya.

All the industrial ventures of this period were essentially located within a radius of 30 kilometres from Colombo, the only exception being the plywood factory. The selection and the location of these industries were primarily determined by the war-time scarcities and the availability of unused buildings. Since the end of the second world war the government was faced with the need to formulate a clear policy on its role in relation to industrialisation in Sri Lanka. The report on industrial development policy of 1946 was of great importance, its main conclusion being that industrial development should be largely state-controlled. The industrial policy of the government changed considerably between 1939 and 1946.

Industries in general were divided into basic and non-basic, with the former categorised as state monopolies while the latter were left for private capitalists under a licencing system. The basic industries were power, heavy industries including iron and steel, cement, chemicals, drugs and cotton and spinning. Already established non-basic state industries were to be offered to the public for purchase by private enterprise. By 1948, Sri Lanka's major manufacturing concerns comprised a number of government sponsored war-time factories and a few privately-owned plants.

#### **Post-Independence Period 1948 — 1959.**

With the attainment of political independence in 1948, government initiated active steps to develop the industrial sector. This period in the history of industrialisation in Sri Lanka was noteworthy in two respects. Firstly, six-year development plans were formulated by internal and external bodies indicating the growing awareness of the need for planning. Secondly, the period witnessed a shift in emphasis in the industrial policy sphere from initial establishment of large state-

owned industries, to a subsequent stress on the development of large and small scale industries by private enterprise corporations. The first six-year plan (1947/48 — 1952/53) contained a more definitive restatement of the pre-independence proposals on industrial development (Snodgrass, 1966). The major objective of this plan was to diversify the economy and to reduce the dependence of the country on imports. In consequence a series of major manufacturing industries was selected for investigation and development. Of the many state factories planned, only the cement project came to fruition during this plan period, while several other projects including the manufacture of paper, textiles, caustic soda, iron and steel, fertiliser and vegetable oil remained at a preliminary stage of planning and development. Delayed action during this period was attributed to several factors which included delays in deliveries of plant and machinery from foreign suppliers, the need to revise constantly the scope and costs of some schemes in the light of further reports made by overseas experts and consultants, and other factors such as delayed construction of the hydro-electricity scheme (Report of the Commission on Government Industrial Undertakings, 1954). In the meantime the manufacturing activities established in the war period began to incur heavy losses when faced with competition from cheaper and often high quality foreign imports. As a remedy for this, government introduced a legislation "The Industrial Products Act" No. 18, 1949. However, most of these war-time factories were faced with difficulties under conditions of normal competition, and this led to the closure of most of these plants. Within a short span of 4 — 5 years after the attainment of independence a slow but definite shift in government industrial policy had occurred after the submission of recommendations of International Aid Agencies. During the latter part of 1951 a team of experts from the International Bank for Reconstruction and Development arrived in the island to report and recommend on the performance of various sectors of Sri Lanka's economy. The critical evaluation and recommendations by this world bank team in fact resulted in a temporary suspension of the schedules. The team recommended the closure of most of the inefficient war-time ventures at the earliest possible date and the repeal of the Industrial Products Act (IBRD, 1952). In particular, proposals for developing iron and steel, fertiliser and textile plants were considered to be premature, while some project plans were also condemned as too superficial and relatively unsound technically. The team recommended a review of the locations already selected for projects such as the caustic soda, D.D.T., paper and vegetable oil plants. The mission also advocated the carrying out of basic research and the acquisition of technical skills aimed at intensified industrialisation at a future date

together with the immediate implementation of smaller projects more suited to the raw materials, labour, technical knowledge, experience and enterprise available in the island. Criticising the complete state ownership and management they have stated, "our conclusion is that for the present Ceylon's main industrial growth should be centered on the development of numerous small and medium-sized industries rather than large ones. These should be widely scattered and diversified to take advantage of labour and raw materials in various parts of the island. Government assistance should include technical advice, tax incentives, marketing and similar measures to encourage the private sector to do its share" (IBRD, 1952, p. 267). Immediately following the IBRD Report, government appointed another commission (Gunasena de Zoysa Commission, 1953) to examine the economic viability of those commercial undertakings begun during the war and post-war periods which were run with government capital.

The commission recommended the closure of the war-time factories still in operation: rice hulling, steel rolling, carpentry and the manufacture of ceramic ware. One of the main recommendations was the conversion of government-sponsored manufacturing projects into corporations, joint-stock companies or into co-operative organisations. Following these recommendations a shift in government industrial policy was observed in early 1950's. By 1954, the government pronouncements were placing less emphasis on state-run industrial enterprises. The new policy stressed the importance of private enterprise, giving initial aid from the state. Under this new approach, the government and private industry were seen as partners in industrialisation, the former being expected to undertake the initial risks of development before handing over new industrial projects to the latter. Based on the recommendations of this Commission and of IBRD, the Ceylon Institute of Scientific and Industrial Research (1955) and the Development Finance Corporation (1955) were set up to foster private enterprise. However, these reformulations were hastened by the foreign exchange crisis following the Korean boom which led to a 'drastic slash in food subsidies and even greater emphasis in finance' (Oliver, 1957, p. 52).

The government policy indicated a shift of emphasis from the large-scale to small-scale industries and the role of the state to that of a promoter rather than of sole entrepreneur (Planning Secretariat, 1955). A new six year programme of investment was formulated by the government (1954/55 - 1959/60). It advocated the establishment of large and small-scale industries which would initially be largely dependent on local raw materials, As a first measure towards implementing this policy the government sponsored Corporation Act 19 of 1955

was presented to the parliament in 1955. According to this Act government enterprises were to be transferred to the private sector in three stages. Initially the enterprise was to be transferred to a corporation with government capital and the government shares in the project would be sold to the public. When the government finally held less than 20 percent of the capital the corporation was to be constituted as a public company under the Company Law Act. Under this new policy private investments by foreign companies were encouraged. However, the government industrial policy initiated in the six-year programme was not implemented, due to the change of government in 1956.

The new government made an industrial policy declaration to the effect that it would place high priority on industrial development with state-ownership and control of basic industries. In 1957, it enacted the State Industrial Corporation Act which provided for the takeover of an existing industry or the setting up of a new industry under public ownership. The existing Public Industrial Corporations set up under the 1955 Act were dissolved and reconstituted under the new Act, and the government went on further to expand the public sector. While basic and essential industries were to be reserved for development by the state, a group of industries in the consumer class was left open for development through the private sector.

### **Import-Substitution Industrialisation 1959 - 1965.**

During the first few years of the new government it engaged itself in preparing a comprehensive plan of development for the island's economy covering both public and private sectors. A long term perspective plan covering a ten-year period (1959 - 1968) was formulated and the import substitution strategy was included in the plan. Government realised that, as in many other developing countries, the only viable strategy of economic development was "import substitution" - the production of anything needed for growth at home. The development of industries in a protected market to meet domestic demand was the prime objective of the plan. The plan had some long-term possibilities for the expansion of manufactured exports, but this was an objective to be achieved as an outgrowth of import - substitution industrialisation, not as an integral part of the overall industrialisation strategy.

The ten-year plan provided for an overall investment, during the ten years, of Rs. 13,600 million of which Rs. 2,217 million or about 20 percent was the share allocated to industry. The programme for industry consisted of two parts: The first part comprised the planned sector to correspond broadly with industrial projects to be undertaken by the

government, and the second part the unplanned or private sector to correspond mainly with the small-scale and cottage industries. The plan also proposed the investment of Rs. 400 million in the development of small-scale and cottage industry during the plan period. Certain basic industries were to be owned by the government and some industries like textile and sugar were to be opened by the government with private sector participation. The private sector was allowed to participate only in light consumer industries.

The ten-year plan gave fairly high priority to industrial development but failed to achieve its targets and hence was abandoned, after the first few years of its formulation. Nevertheless, the development thinking embodied in it provided the major guideline for policy makers throughout the period up to about the late sixties. Starting with the 1957/58 budget, a tendency towards using the tariff policy as a tool for promoting import substitution, by imposing protective tariffs on selected industrial products and lowering tariff on capital equipment and industrial raw materials, could be observed (Snodgrass, 1966, p. 216). The acceleration of reserve depletion had reached a critical level by 1960, and at the end of that year available reserves were sufficient to cover only "three months imports". The ten-year long-term plan was translated into a three-year development action programme. The 1962 short-term implementation programme, in theory ran from 1961/62 to 1963/64. The overall objectives and targets remained much the same as in the previous plan, but greater emphasis was laid on the increasing population and the unfavourable balance of payment position. The plan recommended a shift in favour of less capital-intensive and more labour-intensive investments. Also quantitative import restrictions were imposed to curtail imports to a level consistent with the available import capacity. In January 1961, for the first time, a system of import control with individual licencing and allocation of quotas to importers was introduced for several semi-essential consumer items. In 1963, the foreign exchange budget committee was set up to function as the supreme authority for allocating scarce foreign exchange among alternative uses on the basis of national priorities (Kappagoda, 1967). By the end of 1964, the Open General Licence System (OGLS) of foreign exchange allocation had completely ceased to exist, and for all practical purposes Sri Lanka had turned into what can be called a "closed economy".

The existence of a highly protected domestic market implied relatively low profitability of production for the export market. The maintenance of an over-valued exchange rate through import controls

further aggravated this situation by eroding rupee earnings of exports and lowering import cost of import-substituting activities (Rasaputram, 1972, pp. 14-15; Dahanayake, 1977, pp. 1-65). A noticeable feature in the development of government-sponsored large-scale industry during this period has been the establishment of branch plants of existing industries to meet increased demand within Sri Lanka. The small and medium-scale consumer goods industries were considerably benefitted from the concessions given by the government. Between 1960 and 1963 over 1000 new small and medium-scale industries were granted approval within the private sector compared to approximately 500 industrial establishments during the preceding 15 years. A notable promotional move undertaken in this sphere during this period was the establishment of the Industrial Estates Corporation, which was entrusted with the task of building, medium-scale industries on industrial estates where basic facilities such as power, water and transport would be readily available.

During the years roughly between 1959 and 1963—the initial or “Early Phase” of import substitution—the country witnessed the growth of a large number of consumer goods industries largely based on imported inputs, catering to local demand. In the early stages not only was the quality of products poor, but in many cases production involved only a minimum conversion of imported inputs. Government approval for setting up of new industrial ventures was granted freely without due consideration of the foreign exchange costs involved, particularly in the initial period. During the first phase many of the import-substituting industries in the private sector began to concentrate on those very items which were earlier restricted or banned on the grounds of being non-essential and luxuries (I.L.O., 1971). Evidently, the early phase of import substitution in industries, particularly with regard to the private sector, “lacked careful planning and clearly defined priorities” (Development Policies in Ceylon, 1972). In the later years, a more strict and rationalised approach came to be adopted both in the approval of new private sector industries and in the foreign exchange allocation for raw material imports as the country’s foreign exchange situation became increasingly difficult.

However, by the mid 1960’s the import — substitution development strategy had reached a crisis point. Although the main objective of the import substitution strategy was to lessen the dependence of the growth momentum of the domestic economy on the structurally weak traditional export sector, the newly established industries made the economy more dependent on the traditional export sector. These

industries showed an overwhelming reliance on imported machinery and raw materials. Also the earnings from traditional exports continued to stagnate and the quantum of foreign aid inflow was not large enough to fill the gap in import capacity. Due to these difficulties there was a growing recognition by the policy-makers that increased emphasis should be placed on export promotion. This recognition led to a number of policy revisions within the existing import-substitution framework to promote exports.

### **Export-Oriented Industrialisation 1965 – 1989**

The policy measures taken for the promotion of exports included setting up of an Import Duty Rebate Scheme for manufactured goods exports in December 1964, introduction of an import Entitlement Scheme (Bonus Voucher Scheme) for selected minor exports, in 1966, devaluation of the rupee in 1967, and the introduction of a Dual Exchange Rate System (Foreign Exchange Entitlement Certificate Scheme, FEECS) with a premium exchange rate for non-traditional exports in 1968. The white paper on foreign investments, issued in 1966, aimed at attracting foreign investment geared to production for export. However, between 1965 and 1969 the government in power placed greater emphasis upon agricultural than upon industrial development. Expansion of public sector industry therefore was confined to developments which were already underway. Increased development in the private sector was nevertheless facilitated by adequate import allocation of raw materials and machinery. Government encouraged agro-based processing industries, based on domestic raw materials, export prospects and indigenous technology. In the year 1966, The Industrial Development Board was set up to provide facilities for small and medium-scale entrepreneurs. The objectives of IDB as defined in the Industrial Development Act. No. 36 of 1969 were, (a) to assist in the encouragement, promotion and development of industries, (b) to assist in the proper co-ordination and in the growth of all industrial undertakings in the public and private sectors of the economy of the country, (c) to foster industrial research with the objective of utilising the natural resources of Sri Lanka, improving the technical processes and methods used in industries, developing appropriate technologies and equipment for local industries and discovering processes and methods for the better utilisation of waste products, (d) to foster the export of local industrial products, (e) to provide for services and facilities of every description required by or in connection with any industrial establishment in Sri Lanka, and (f) to advise on matters relating to the promotion and development of industries (IDB, 1970).

The policy emphasis on export promotion continued well into the 1970's with the new government that came into power in May, 1970. In fact the onset of the oil crisis in 1973 with its attendant balance of payment pressure, and the increasing debt—servicing burden due to continuous reliance on foreign financing since the late 1960's, had made export promotion even more urgent in the 1970's than in the 1960's (Hewavitharana, 1975).

The industrial policy of the new government emphasised maximum support for export—oriented industries. The creation and development of a “new export sector based on industrial production”, was a key element in the five year plan, 1972—1977. This represented an attempt to move away from the import—substitution industrialisation of the past. To encourage export—oriented industrialisation, a number of steps was taken by the government. The FEECS scheme continued to be in operation with periodic upward adjustments in the premium rate. In 1971, the Import Duty Rebate Scheme which upto then had been virtually inactive due to rigid operational rules, was subjected to a major revision. In the same year, a new Import Entitlement Scheme—the Convertible Rupee Account Scheme for exporters of non—traditional products—was introduced. Apart from these there was a number of newly introduced fiscal incentives including an eight year tax holiday on export profits of approved exporting ventures. The Export Promotion Secretariat was established in 1972 to function as an institute for directing and co—ordinating export development efforts of the country. Among the other institutional steps taken was the establishment of the State Gem Corporation in 1971. The five Year Plan (1972—1977) also stressed the importance of developing the basic (large) industries and allocated Rs. 1,250 million for the public—sector industrial projects. The new industries established during this period were the iron and steel plant at Oruwala, a tyre and tube factory at Kelaniya, a hardware project at Yakkla, a cast iron foundry at Enderamulla, a silicate brick factory at Ekala and three textile plants. With all these measures, however, the manufacturing value—added which had grown at a respectable rate of 6 percent per annum in the early import—substitution era of 1960's, dropped to 1.8 percent in the period 1970—1977. Several factors were believed to be responsible for this. Firstly, it was felt that the limits to import—substituting industrialisation had long been reached, given the small size of the domestic market of Sri Lanka. Secondly, rapid growth of the export sector led to a severe foreign exchange crisis which restricted the availability of imported raw materials and capital goods. By the mid—seventies, total earnings from manufactured exports covered only 6 percent of the total import

requirement of the industrial sector. As a result, industrial growth had become increasingly dependent on the foreign exchange earnings of traditional exports which were themselves suffering from both instability and stagnation.

The new government which came to power in 1977 decided that the way out of the economic stagnation was first to adopt an outward-looking strategy of export-led growth so as to overcome the limitations of both small domestic market and foreign exchange constraint. Prior to 1977, the strategy was essentially an interventionist one, consisting of heavy protection through tariff and quota, reserving certain activities exclusively for the small sector and preferential access to public resources. After 1977, the interventionist regime gave way to a liberalised economic environment whose aim was to promote export orientation, along with 'efficient' import substitution, through the interplay of market forces. The new government introduced a set of wide-ranging reforms which has come to be known as the programme of economic liberalisation. Major elements of the new policy package of November 1977, with a direct bearing on the performance of industry were the following.

- (i) Liberalisation of import trade and exchange payments, accompanied by exchange rate and tariff reform with only a limited list of items on specific licencing.
- (ii) Promotion of private enterprise including direct foreign investment.
- (iii) Limits on expansion of the public sector in industry (and other areas) and steps to rationalise operations of existing state ventures.
- (iv) Emphasis on promotion mainly to establish a sound institutional background for the development of export orientation.

Several important measures were taken by the government to promote the export oriented industrialisation over the last decade. Therefore, policies and promotional measures to encourage foreign investment, to improve financial and fiscal incentives, to decentralize manufacturing activities are discussed in detail under separate sub-headings.

### **Direct Foreign Investment in Industrialisation Strategy**

With the shift of policy from import substitution to export orientation, greater attention was given to private foreign capital as a catalyst in a vigorous process of export-oriented industrialisation. As Lakshman (1980) pointed out, foreign capital participation has come to be viewed as indispensable to break the barrier of otherwise inaccessible foreign markets. Further, the post-1977 policy reforms placed great emphasis on the role of direct foreign investment in industrialisation. The overall policy and the recognition and the strong approval given by the international financial community to the government's growth strategy produced the necessary confidence within the international business circles to make Sri Lanka highly attractive for their investments.

A number of steps has been taken in an attempt to provide an environment conducive to foreign investment. The most important element in this policy package is the setting up of the Greater Colombo Economic Commission (GCEC) in 1978, with the main task of establishing and operating Investment Promotion Zones (IPZ). The first such zone, namely, the Katunayake Investment Promotion Zone, comprising 165 hectares was set up in 1978, and the second zone at Biyagama covering initially an area of 85 hectares, providing 20 industrial plots was commenced in 1983 (Figure 1). As shown in table 1, a noteworthy feature during the period from 1948 to 1988 was the marked decline in direct foreign investment in the period 1970-1977. Unfavourable atmosphere for private investments generated by the nationalisation attempts and related legal enactments (mainly the Business Undertakings Acquisitions Act of 1971) and stringent criteria adopted in approving investments were the main reasons for this decline.

With the policy reforms in 1977 and the setting up of the GCEC in 1978 the foreign investments had rapidly increased during the period from 1978 to 1988. By the end of 1988 the GCEC had issued approvals for 276 industrial projects with an envisaged total investment of Rs. 6,149 million and an employment potential of 105,272 persons (Table 1). Of these commercial production had commenced in 69 projects within the Katunayake Investment Promotion Zone and 21 in various other parts of the country.

A significant feature of the pattern of GCEC investments is their concentration on the 'footloose' industries, which have short gestation periods, such as textile wearing apparel, followed by a progressive shift to more skill-intensive industries such as chemical and non-

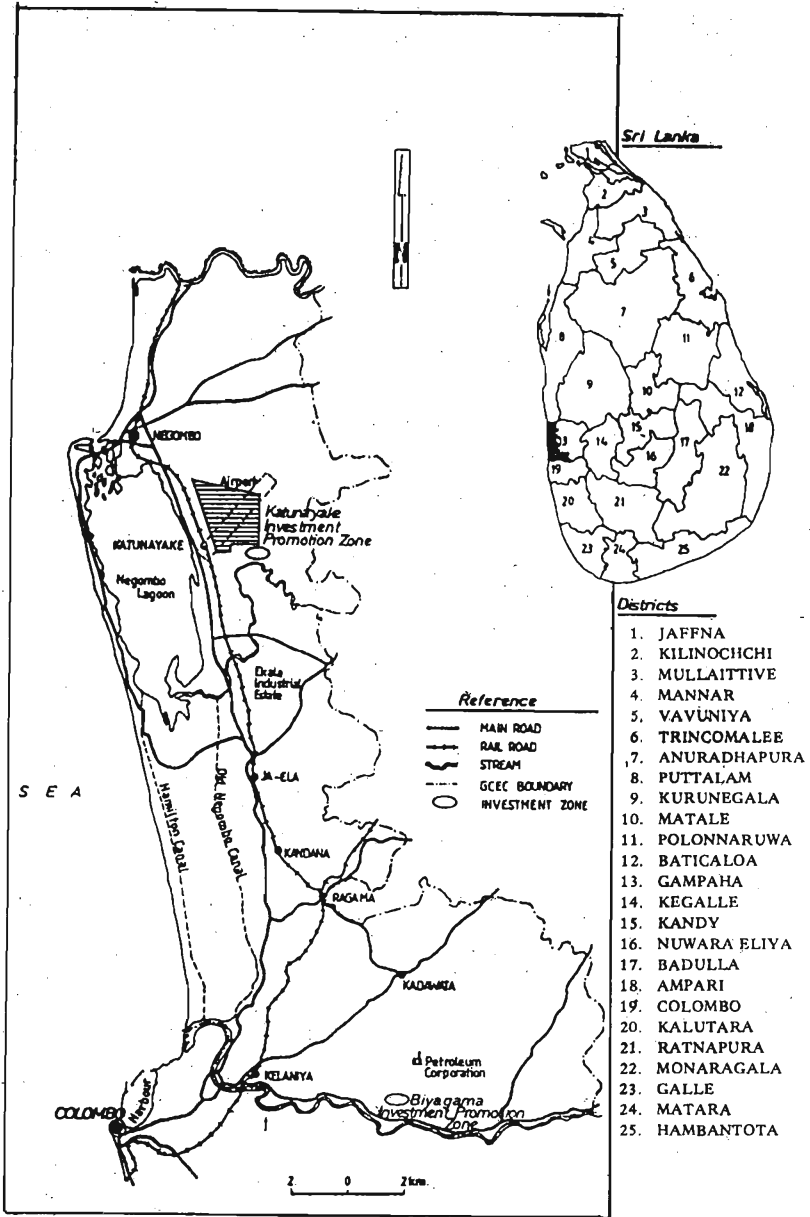


Figure 1 : GCEC : Area of Authority

metallic mineral-based industries and manufactured products. The projects approved by the GCEC in 1988, included the production of leather and surgical gloves, towels, bathrobes, ladies' wear, rubber-based products, porcelain figurines, marble and granite, steel moulds and dyes, marine sports-ware, ice-skating boots, horticulture, electronic and electrical goods, vegetables and gherkins, foliage plants, manufacture of machinery, commercial and residential diffusers and computer software development. (Central Bank of Sri Lanka, 1988).

Nevertheless, the number of industries so far approved, contracted and in operation in the IPZ proves that textile and clothing has been the major industry of attraction (Table 1 and 2). In 1988, of 101 projects in operation 43 firms were in the production and export of ready-made garments and related items. This was mainly due to two reasons:

- (i) The imposition of stringent quota restriction by major consuming countries on garment imports from "traditional developing country producers" generates a potential market for 'new comers',
- (ii) The comparative advantage Sri Lanka enjoys in the production of garments in the face of increase in cost of labour in other major garment-producing countries in Asia. Apart from garments, the other areas of production in the Investment Promotion Zones in terms of the number of firms were those dealing with labour-intensive low-technology products such as non-metallic mineral products, rubber products, foot-wear and toys. Contrary to expectation of policy makers and to the experience of other Asian countries such as Malaysia, Thailand and the Philippines, foreign investment in high-technology and more promising product sectors, such as electrical and electronics goods was insignificant. (Athukorala, 1987).

The most striking feature over the last decade is the sharp increase in the position of investors from less developed countries in terms of both the number of firms and aggregate equity investment. Of the total number of firms in the GCEC area, approximately 50 percent of firms have capital participation from less developed countries. Among these investors Hongkong and Singapore occupied the predominant positions. Another noteworthy feature of these investors is the conspicuous absence of large world-class multinationals. Even those from the developed countries appear to be relatively small multina-

TABLE 1

**Industrial Investments Approved and Contracted  
by Greater Colombo Economic Commission  
1978 - 1988**

Category	No. of Units		Foreign Investment (Rs. Million)		Total Investment (Rs. Million)		Employment Potential (Nos)	
	Approvals	Contracted	Approvals	Contracted	Approvals	Contracted	Approvals	Contracted
1. Food, beverages and Tobacco	9	4	74	26	124	50	2,868	735
2. Textile, Wearing apparel and Leather Products	86	59	1,901	1,312	2,808	1,925	54,872	39,531
3. Wood and Wood Products	6	5	27	3	48	6	873	379
4. Paper and Paper Products	4	1	34	25	42	29	385	56
5. Chemicals, Petroleum, Coal, Rubber and Plastics	29	18	1,185	961	1,753	1,140	6,098	4,880
6. Non-Metallic Mineral Products	32	20	837	626	1,058	787	8,380	5,932
7. Fabricated Metal Products	21	7	776	253	982	329	5,705	2,193
8. Manufactured Products not elsewhere specified	80	39	1,940	1,281	3,054	1,883	26,877	16,078
<b>Total</b>	<b>267</b>	<b>153</b>	<b>6,744</b>	<b>4,487</b>	<b>9,869</b>	<b>6,149</b>	<b>1,05,272</b>	<b>69,784</b>

Source: Greater Colombo Economic Commission, 1989.

**TABLE 2**  
**Sectorwise Distribution of Manufacturing Firms**  
**Established with Direct Foreign Capital Participation**  
**1948 - 1969, 1970 - 1977 & 1978 - 1986**

	1948-1969	1970-1977	1978-1986		Total
	*1	*2	*3 GCEC	*4 Non-GCEC	
1. Food, Beverages and Tobacco	5	2	1	14	15
2. Textile, Wearing apparel and Leather Products	7	12	42	52	94
3. Wood and Wood Products	—	—	4	7	11
4. Paper and Paper Products	2	—	—	—	—
5. Chemicals, Petroleum, Coal, Rubber and Plastics	16	—	12	35	47
6. Non-Metallic Mineral Products	1	4	13	14	27
7. Basic Metal Products	3	2	—	—	—
8. Fabricated Metal Products	15	—	2	26	28
9. Manufactured Products not elsewhere specified	1	—	17	15	32
<b>Total</b>	<b>50</b>	<b>20</b>	<b>91</b>	<b>163</b>	<b>254</b>

Sources: \*1 & 2 Ministry of Industries and Scientific Affairs, Official Files, 1983.

\*3 Greater Colombo Economic Commission, 1987.

\*4 Ministry of Finance & Planning, 1987.

tionals. IPZ's are generally known to be areas of investment for small "multinationals". However as Lakshman (1980) pointed out there are two types of risks involved in these types of foreign investments. Firstly, these small multinationals are unlikely to be interested to continue business at one place. The migratory, footloose nature of these investors brings with them a high degree of instability into the host economies. The large number of garment firms are clearly this migratory type. These projects originally located in Hong Kong, Singapore and other Asian countries appear to be shifting their base with the gradual increase in wages in these countries. The small size of investments in such new locations makes it easy for them to shift into different locations when socio-political-economic conditions start changing to their disadvantage. Secondly, the migratory character of these investments makes it imperative for the foreign investors to try to make as large profits as possible to enable them to recoup their capital as early as possible. However, foreign investments attracted into the IPZ's in Sri Lanka were impressive over the last decade of its existence, when compared with the industries in the IPZ's of the other countries. Nevertheless, it should be noted here, that the amount of foreign capital invested, cannot be considered as a measure of the effectiveness of the IPZ's.

One of the basic objectives of the promotion of foreign investment in the country in general, is to increase the industrial exports and to improve the country's balance of payments situation. The export earnings from IPZ's have recorded a noteworthy increase over the last decade. The relative share of IPZ firms in total export earnings was 1.14 percent in 1978 and it increased to 20 percent in 1988. Among these manufactured exports, garments has indicated the most impressive steady growth record. In 1988, 80 percent of export earnings came from textiles and ready-made garments (Central Bank of Sri Lanka, 1988).

Nevertheless, there are some criticisms on the foreign capital participation in the manufacturing industries. Foreign capital is quite obviously and naturally interested in exploiting cheap labour and cheap natural resources that are available in the country for the purpose of private profit. The lasting benefits this type of industrialisation is likely to generate within the socio-economic system, in terms of the development of human skills and technological capabilities, are likely to be minimal unless conscious and deliberate policies are adopted to optimise such benefits (Lakshman, 1980). There is a fair number of industries with foreign participation, in which the use of local material

is high, but there are industries processing, imported raw materials for re-export using cheap domestic labour. The majority of industries established in the IPZ's and the rest of the country are consumer goods industries and their requirements of capital goods have to be obtained from abroad. The involvement of private foreign capital therefore has increased the economy's dependence on foreign sources for investment and intermediate goods.

Foreign Investment Advisory Committee (FIAC) is an authority which approves and monitors foreign investment outside the GCEC areas. It is empowered to approve import-substitution projects too, on the basis of criteria such as employment generation, net import savings and contribution to domestic technology. However, the potential contribution towards export development is usually taken as a major criterion.

During the period 1977 - 1988, 664 manufacturing industrial projects were approved by the FIAC. The total capital investment in these approved units stood at Rs. 5,752 million of which Rs. 2,208 million was foreign capital. Firms set up under the FIAC showed a higher degree of dispersion across production sectors. Apart from textile and clothing the other major areas of attraction have been chemicals, chemical products, basic metal and rubber goods (Table 3). The major reason for this pattern seems to be the relatively more liberal and broader criterion adopted by the FIAC in approving new projects. In June 1986, total export earnings of the FIAC projects were Rs. 3,161 million, of which Rs. 2,954 million or 93 percent came from the manufactured exports. A sector-wise classification of manufactured exports shows that non-metallic mineral products (43 percent) has been the largest foreign exchange earner, while textiles and garments (40 percent) has been the second largest foreign exchange earner in 1986. The shares of non-metallic mineral products and textile garments in total FIAC export earnings were 40 percent and 37 percent respectively.

However, it is noteworthy that the FIAC firms recorded a relatively unsatisfactory growth trend over this period. One obvious reason seems to be the closing down (due to internal management problems) in 1981 of two leading foreign garment producing firms which upto then accounted for about 15 percent of garment exports from Sri Lanka. The indifferent attitude of "import substitution type" foreign firms towards exporting under the liberalised import regime appears to be another reason.

**TABLE 3**  
**Foreign Investment Advisory Committee Investment**  
**and Employment in Manufacturing Industries**  
**Classified by Sector**  
**1977 - 1986**

**Projects Approved and in Operation**

	No. of Projects		Actual Total Investment (Rs. million)		Employment (Nos)	
	Approved	In Operation	Approved	In Operation	Approved	In Operation
1. Food & Beverage	24	14	1,588	820	1,223	1,120
2. Textile and Readymade Garments	82	52	1,438	934	22,101	19,260
3. Wood and Paper Products, Printing and Publishing	13	7	57	38	604	175
4. Chemical, Plastic and Rubber based industries	44	35	654	545	3,242	2,598
5. Non-Metallic Mineral Products	25	14	674	668	2,412	2,329
6. Basic Metal and Engineering Industries	45	26	244	101	1,217	741
7. Other Industries	28	15	191	122	2,384	2,062
Total	261	163	4,146	3,228	33,854	28,285

Source : Ministry of Finance and Planning, 1987.

### **Industrial Location and the Policy of Decentralisation.**

Over the last two decades, several steps were taken by the government to decentralise manufacturing activities from Colombo to the peripheral regions, but the broad geographical distribution hardly changed (Table 4). Manufacturing industries are concentrated in the primate city and adjacent areas. District-wise distribution of manufacturing in Figure 2 shows the concentrated pattern of registered<sup>1</sup> establishments in Colombo and Gampaha districts (56 percent). In Colombo these establishments are located within the city centre and urban and sub-urban areas such as Ratmalana, Dehiwala, Moratuwa, Maharagama and Homagama. However, unregistered establishments are dispersed throughout the island.

Several measures were taken by the government to encourage entrepreneurs to locate industries away from Colombo. Small and medium scale industries which commenced on or after 15th November 1977 and located outside municipalities are entitled to exemption of profits up to a limit of Rs. 200,000 per annum. The Urban Development Authority (UDA) which came into existence in 1978, has also taken steps to decentralise manufacturing industries. The UDA identified industries which could be allowed in the city of Colombo, preventing major and appropriate industries being located in the city. Mainly small scale labour intensive industries which have least impact on the available infrastructure facilities are permitted in the Colombo city. Restrictions have been imposed to disperse industries which have no specific locational advantage in operating in the city to other suitable locations. Under the development plan (UDA, 1982) UDA launched a programme to identify the areas outside the city which are suitable for the location of new industries and also for the relocation of some industries currently located in the city.

Under this programme three areas have been identified as suitable locations outside the city.

- (i) in the Peliyagoda area, the provision of industry and warehousing is being developed along with housing and other community facilities under the Peliyagoda Integrated Development Project,
- (ii) at Ratmalana a site of 21 acres is being developed for industries where preference will be given in allocating sites within the industrial area to industries which are being shifted out of the city,

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1. Registered establishments are those approved by the Ministry of Industries and Scientific Affairs and the Ministry of Textile Industries in the year 1983.

Figure 2 : Distribution of Registered and Unregistered Establishments (based on the data obtained from the Census of Manufacturing Industries 1983 and the Ministry of Industries and Scientific Affairs, 1983)

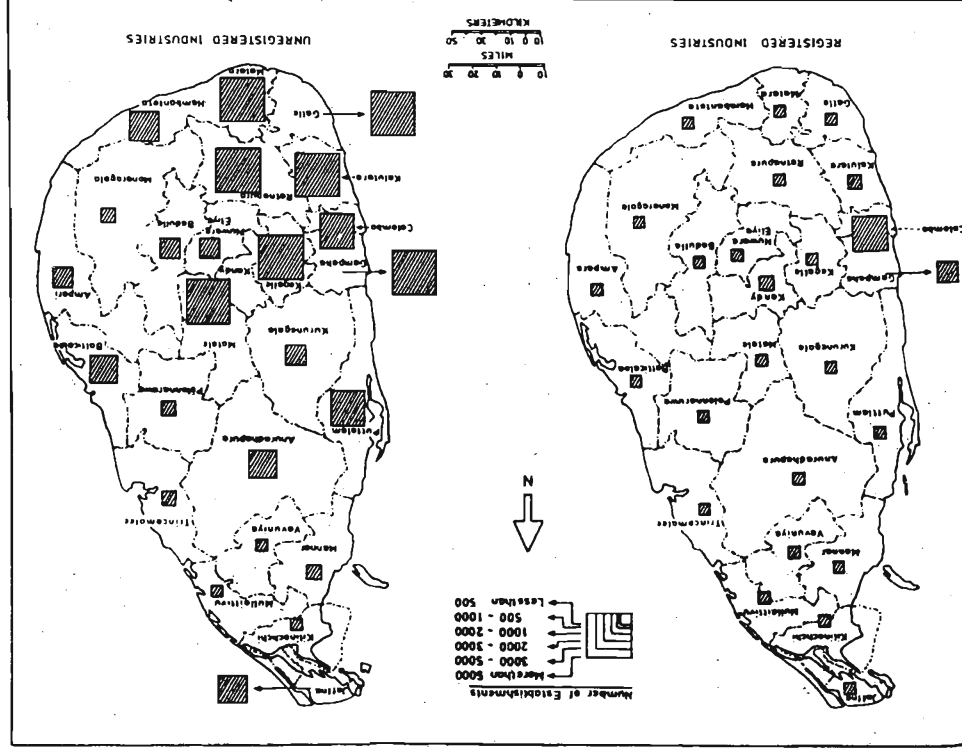


TABLE 4

**Percentage Share of Registered and Unregistered  
Manufacturing Establishments in 1977 and 1983 by Districts**

	Registered		Unregistered	
	1977 <sup>1</sup>	1983 <sup>2</sup>	1977 <sup>1</sup>	1983 <sup>2</sup>
1. Colombo	47.38	35.82	10.05	4.23
2. Gampaha	16.28	19.96	21.12	8.52
3. Kalutara	5.33	7.22	4.28	6.43
4. Kandy	5.39	6.29	3.83	6.41
5. Matale	.80	.01	1.83	2.12
6. Nuwara Eliya	.50	1.06	.50	2.11
7. Galle	3.13	3.56	5.99	11.00
8. Matara	3.46	4.39	5.74	8.93
9. Hambantota	0.70	0.01	1.39	3.17
10. Jaffna	3.91	2.90	1.38	3.06
11. Mannar	0.10	.00	0.08	.01
12. Vauniya	0.20	.00	—	.00
13. Mulativu	—	.00	0.06	.00
14. Batticaloa	0.60	.01	0.60	2.88
15. Amparai	0.70	2.33	5.42	1.96
16. Trincomalee	0.50	.00	0.91	.01
17. Kurunegala	3.07	3.77	9.46	11.58
18. Puttalam	1.69	2.99	5.26	3.95
19. Anuradhapura	0.70	1.09	2.81	2.19
20. Polonnaruwa	0.20	.00	0.50	1.05
21. Badulla	1.51	1.77	3.41	2.04
22. Moneragala	0.30	.01	1.68	.01
23. Ratnapura	0.70	1.24	0.90	6.00
24. Kegalle	1.51	2.20	12.59	9.85
Total	100	100	100	100

Sources : 1. Data compiled from the Directories of Registered and unregistered manufacturing establishments (IDB, 1980)

2. Figures are calculated using the lists of approved manufacturing establishments (Ministry of Industries & Scientific Affairs, (1983) and the Census of Manufacturing Industry (Dept. of Census and Statistics, 1983).

- (iii) the Athurigiriya area has been reserved for the development of major industries (Figure 3).

Although considerable effort has been made to decentralise industries from Colombo, it is apparent that entrepreneurs prefer to locate industries within it. The high market potential together with transportation and other infrastructural amenities constituted a big gravitational pull for the establishment of industries in and around Colombo.

### **Promotional Measures for the Development of Manufacturing Industries.**

Over the last decade steps have been taken to promote industrialisation through export incentive schemes, financial assistance schemes, fiscal and tariff concessions and import liberalisation policy. Among the export incentive schemes in operation presently in Sri Lanka the Duty Rebate Scheme (DRS) is one of the most important in terms of both the export coverage and the amount of annual cash outlay involved. Import Duty Rebate implies the reimbursement of import duties paid on imported material after the final product is exported. Although this was introduced in 1964 there was no clear trend in annual payment till 1983 when the scheme was revised. A higher degree of export profitability was recorded with the operation of the duty rebate facility (Athukorala and Jayatileke, 1984).

Export Expansion Grant Scheme (EEGS) was introduced by the Export Development Board in 1981. Under the scheme, a tax exempt grant is payable as a percentage of the amount of which the grant year export earnings exceeded the average export earnings in the preceeding three years. Apart from these several other grants and subsidies are available for export producers. It has been apparent from a field survey that few entrepreneurs have benefitted by these schemes (Dias, 1988). Most entrepreneurs are not aware of these schemes. The documentary requirements and related administrative formalities also seem to dissuade some entrepreneurs.

The Export Development Village Programme is a measure for extending the export development drive to the village level with a view to attaining the objectives of export development and the upliftment of the rural economy. The first Export Production Village (EPV) was set up in Dambadeniya in 1981 to produce reed packs for tea. By the end of 1988 32 EPV's had been registered (Figure 4) but only 18 were

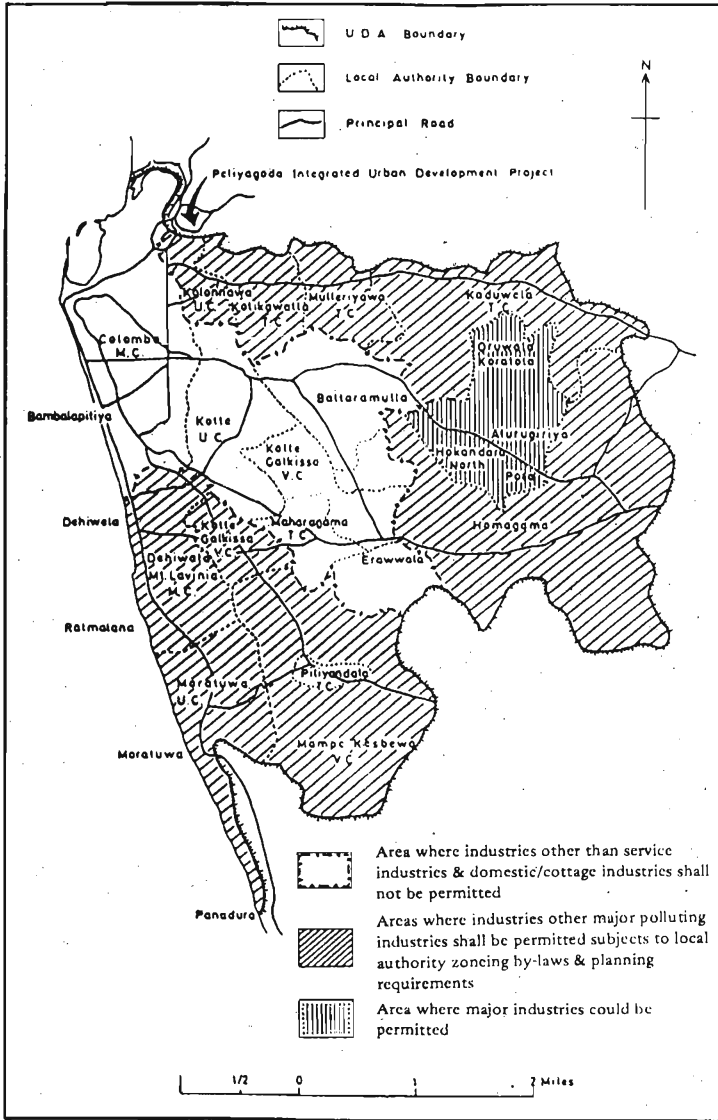


Figure 3 : Urban Development Area : guidelines for industrial location.



reported to be operational and even some of these were affected adversely by the current unstable condition in the country. Each EPV is managed by a people's company incorporated under the Companies Act (1982) with share-holding by the village producers.

The EDB supports the operation of EPV's by providing seed capital in the form of non-cumulative preference shares, marketing, technical and other assistance (EDB, 1988). It is difficult to evaluate the pattern of linkages that exist between rural producers and exporters without conducting a detailed study. However, the available information shows that the EPV's are doing better in the following areas.

- (i) agricultural products, e.g., vegetables, fruits, yams, spices and flowers,
- (ii) agro-based industries, e.g., white fibre, ekel and cashew and
- (iii) manufactured/assembled goods, e.g. reed tea packs, electronic components and umbrellas.

A large number of rural small producers are being able to join in these programmes and therefore, to a certain extent sub-contracting relationships between exporters and small producers have been developed.

Over the last few decades commercial banks and other financial institutions were engaged in financing the development projects. A significant credit guarantee scheme was introduced by the National Development Bank (NDB) in 1978. The objective of this scheme is to provide medium and long term credit and other forms of financial assistance and to stimulate the growth of a share and security market in Sri Lanka in order to mobilise internal and external capital for investment in industrial, agricultural and commercial fields. The Small and Medium Industry Scheme (SMI) I and II have already been completed and SMI III was operative with effect from April 1988. Nearly 50 per cent of the loans so far granted were for the development of industrial projects either for the expansion of existing industrial plant or for the setting up of new industrial projects. Industries which have been promoted under the first scheme were mostly rice milling, metal crushing, manufacture of ready made garments and bricks and tiles. Under the second and third projects, food processing and other agro industries, wood products and metal products have been given high priority, (Table 5). The available information suggests a concentration of credit

TABLE 5

**Sectoral Classification of Financial Assistance under  
Small and Medium Industries Projects**

	(Rs. 000')					
	SMI - I		SMI - II		SMI - III	
	No.	Loan Amount	No.	Loan Amount	No.	Loan Amount
Food Processing	474	56,625	842	452,438	55	33,262
Other Agro Industries	120	10,087	49	23,023	05	1,015
Rubber Products	29	6,756	72	54,871	08	7,575
Metal Products	215	22,397	239	112,835	31	9,414
Construction Material	272	42,936	161	87,166	21	12,105
Construction Contracting	11	5,018	26	32,200	03	1,650
Wood Products	176	20,391	165	55,225	23	14,150
Garments	89	9,526	129	70,189	19	10,376
Textiles	52	7,738	55	45,775	04	6,380
Repair Workshop	51	4,108	101	40,177	13	7,107
Miscellaneous	252	43,950	677	399,993	81	51,922
<b>Total</b>	<b>1741</b>	<b>229,532</b>	<b>2,510</b>	<b>1,373,892</b>	<b>263</b>	<b>154,956</b>

Source: National Development Bank of Sri Lanka, 1989.

granted in the Colombo metropolitan area. Colombo district accounted for 37 percent and 42 percent of the value of loans granted under the schemes I and II and Gampaha district accounted for 13 percent and 5 percent respectively. It should also be noted here, that some of these funded projects have ceased production, due to reasons such as lack of working capital, market failure and management problems.

Since 1977, several tariff concessions and tax incentives have been introduced. A new tax holiday was introduced in terms of section 22c of the Inland Revenue Act No. 28 of 1979. Industries engaged in the manufacture of finished products or assembly of goods or commodities or processing of local agricultural products are eligible for this tax holiday. Apart from tax exemptions since November 1977, almost all the raw materials and machinery required for industries were freed from licence control. Only a very few consumer items were under licence control (Sri Lanka's Industrial Policy, 1980). Imports of finished products were permitted with an introduction of tariffs. However, from these liberalisation policies certain categories of industries have benefitted to a great extent while adverse effects have been felt by certain others, to such an extent as to cause the closure of their establishments (ILO-ARTEP, 1986). It is apparent that the competition from imported goods coming to the country has affected their development. Although the liberalisation of imports has removed legal constraints on importation of raw materials, small industrialists have to depend on importers as they are not in a position to import their own requirements directly. Especially, the small scale sector failed to take advantage of the opportunities opened up by the liberalisation and has, in fact, been harmed in many cases by its direct and indirect consequences (Osmani, 1987). From time to time several small industries have requested the Presidential Tariff Commission to grant them protection from imported competition. The recommendations made by the commission and implemented through the Budgets for the last few years have provided some relief by way of increased effective protection to a number of industries.

## **Conclusions**

This paper has highlighted the policies and promotional measures taken by the government for the development of manufacturing industries over the last few decades. In spite of short term fluctuations due to the factors arising from external sources, political disturbances in the country and other domestic problems, the significance of the manufacturing sector rose during the period from 1978 to 1988. Value of

industrial production increased from Rs. 8,852 million in 1978 to Rs. 54,063 million in 1988. The rate of growth in both state and private sectors was 8.4 percent, while a more spectacular growth was recorded in the private sector (15 percent) and state owned industries recorded 7.6 percent. Value of industrial exports increased from Rs. 1,891 million in 1971 to Rs. 22,674 million in 1988 resulting in an increase in the share of industrial products from 14 percent of total export earnings in 1978 to 48 percent in 1988.

However, with the introduction of import liberalisation policies, small and medium entrepreneurs have been put through a revolutionary phase in relation to their sustained growth and expansion. It has been found that these entrepreneurs have not come up to the expectations of national level planners and decision makers due to numerous problems. It is therefore necessary to re-examine the entire policy environment within which small and medium industries are operating, and to undertake measures which can counter the disadvantages they are suffering from. Special privileges to small and medium industries should be offered and incentives could be provided in their favour by adopting measures such as preferential pricing and special tariff protection.

Although considerable effort has been made to decentralise industries from Colombo, there are problems faced in the enforcement of a policy which is designed to prevent new industries in Colombo and relocate the existing industries. It has been recognised that many problems cannot be solved by designing policies and strategies to be operative only within Colombo. Further, physical planning efforts also cannot provide effective and appropriate solutions, therefore, problems should be viewed from a much broader perspective calling for a comprehensive policy which has to be determined by the concerted efforts of many agencies at national and provincial level, reflecting both economic and physical considerations. For instance the locational bias towards Colombo shown by industrialists might be lessened by locationally directional fiscal and monetary strategies. The Ministry of Industries and the Ministry of Rural Industries could provide enhanced assistance to industries sited in locations outside Colombo. Tax incentives and concessions could similarly be discriminatory in terms of locations. Provincial councils could respond by improving particularly the infrastructure facilities in locations away from Colombo, thus making such locations attractive to the prospective investors. This in effect will mean the integration of physical and economic planning where national economic strategies are located by appropriate physical strategies.

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