# SRI LANKA'S ECONOMIC LIBERALISATION POLICY REFORMS

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## INTRODUCTORY

In most of the less developed countries "political independence" led immediately to a concern with industrialization as a means of restructuring their economies with a view to end "economic dependence". The policy orientation in Sri Lanka during roughly the first decade of independence constituted a clear departure from this general pattern. During this period the Sri Lankan government was commited largely to laissez faire policies which ensured the continuity of the basic structural features of the classical export economy. It was only since the latter part of the 1950s that a conscious effort has been made towards industrialization.

In line with the then prevalent ideological bias in development thinking and policy orientation in almost all LDS(Hughes, 1980: 15-16); the development strategy chosen by Sri Lanka was "forced" import subsitution through stringent import controls, direct government involvement in production activities in critical areas, and other direct government controls on trade and finance. Some ad hoc reform efforts notwithstanding, this "autarkic" policy stance continued in the ensuing period until the policy reforms of 1977.

Import substitution industrialization (ISI strategy) in fact brought about significant structural changes in the classical export economy inherited from the colonial past. At the time of independence there was little manufacturing activity in the economy other than the processing activities associated with primary export products.

By 1970, the share of manufacturing increased upto about 10 per cent. With the passage of time diversification took place with a wide range of goods, including some investment and intermediate goods, being produced locally.

Despite these changes, in a overall assessment the net outcome of ISI strategy appeared to be negative. The industrial structure evolved during this period was characterised by a plethora of problems which hampered sustained industrial expansion.

Industries were highly capital intensive and hence did little to releive the unemployment problem. While the share of manufacturing increased from about 6 per cent in 1963 to 10 per cent in 1972, the share of employment in that sector increased only from 9.2 to 9.6 between these two years. Being heavily dependent on imported inputs, industry remained more or less an "enclave sector" with little "linkage" effects on the rest of the economy. Many of the early import substitution industries were established by large trading houses to ensure the markets for hitherto imported consumables. One basic drawback which emanated from t this tendency was that much of the industrial capacity established was intended to cater to the requirements of upper-income domestic consumers. As incentives to reduce costs were blunted by high effective protection, there was evidence of substantial inefficiencies and financial losses which invariably implied erosion in consumer welfare. Apart from these, there were additional structural limitations hindering the operation of state industires owing to haphazard planning and various deficiencies in day-to-day management. Given the predominance of state enterprises in producer-good industries, their operational limitations not only caused severe damages to resource allocation and consumer welfare, but also generated pressure on public savings generating budgetary pressure.

Above all these limitations, the major factor which constrained the long-term viability of ISI was the dismal record of the industrial sector in accomplishing envisaged balance of payments relief. In practice, ISI did not diminish the economy,'s external dependence, but merely changed its nature.

While the importance of consumer goods was reduced substantially, this was achieved at the expense of increased reliance on imported capital goods and raw materials, resulting (contrary to expectation) in an even more rigid dependence on imports. Added to this, a large share of industrial production took place at costs that are not competitive in terms of world market prices, and it was not uncommon to find some firms that actually used more foreign exchange than they saved.

On the other hand, despite some policy attempts since the mid - 1960s the industrial sector failed to penetrate export markets, and even by the mid-1970s total earnings from manufactured exports (3% of total exports) covered only 6 per cent of total annual import requirements of the industrial sector.

Unanticipated import curtailments brought about by adverse market conditions of traditional exports, coupled with adverse movements in the terms of trade, continued to be the major constraint on industrial expansion notably in the first half of the 1970s. By this time, it had become quite clear that unless there was a significant break-through in export orientation of industry, import constraints might continue to cause industrial stagnation.

It was against this background that in 1977 a new policy package which constituted a drastic departure from the autarkic policy stance of the preceding two decade was introduced.

## BASIC ELEMENTS OF THE POLICY PACKAGE

The industrialization strategy embodied in the new policy package is based on the now-popular neoclassical diagnosis of the widespread failure of ISI in less developed countries. It ascribes this failure basically to excessive protection and government intervention in the economy which resulted in distortions in factor and product markets causing inefficient allocation of resources. The policy prescription which follows from this dignosis is to take "decontrol" steps in the direction of greater reliance on market forces, rather than on direct controls to guide the allocation of resources so that the country's production structure is brought in line with its comparative advantage. The major elements of Sri Lanka's policy package formulated in line with this thinking are summarised below. It should be noted at the outset that in the process of implementation, certain policy tools have indicated noteworthy deviations from the originally proposed form. A clear understanding of these deviations is an essential pre-requisite for our ensuing analysis of the impact of the policy reform.

### Liberalization of import trade and exchange payments, accompanied by an exchange rate reform and tariff reform

Retaining only a limited list of items still under specific licencing, the bulk of import trade was placed under open general licencing. With regard to the latter category, in place of the hitherto existing direct controls, a tariff structure or six rate bands with provisions to give "reasonable" effective protection to local industry, was introduced. The tariff reform was immediately followed by the setting up of the Tariff Reform Commission, transformed in 1980 in to Presidential Tariff Commission(PTC). The assigned task of this instituion was to revise the overall tariff structure to attain the twin objectives of. achieving neutrality in protection across various industries and reducing the overall level of protection.

The exchange rate reform which was introduced as an essential element of the trade liberalization attempts, comprised the unification of the dual exchange rate (which existed under the Foreign Exchange Entitlement Certificate System since May 1968) at a depreciated (46.2 per cent against the US$ in terms of the non-FEEC rate) level and allowing the new unified rate to float in response to basic developments in the foreign exchange market.

The trade and tariff reforms were aimed, among other things, at improving capacity utilization of local industries, eliminating excessive administrative regulations which had given rise to corruption, uncertainity and delays, discouraging private initiative, removing the bias against export production generated by high quota premiums on import-substitution production, and encouraging a correct pattern of domestic industries based on international comparative advantage. Reducing the bias of the incentive system towards high capital and import intensity in domestic manufacturing, and increasing relative profitability of production of exports and other tradables (import substitutes) against non-tradable activities, were among the objectives of the exchange rate reform.

In recent years there has been much concern by the proponents of the policy reform, including the World Bank, that tariff revisions and exchange rate policy during the post-reform period have not kept up with the original plan of liberalization (World Bank, 1981

Table 1

**STRUCTURE OF PROTECTION FOR MANUFACTURING INDUSTRY : ASSISTANCE TO INDUSTRIES IN TERMS OF EFFECTIVE PROTECTION ON DOMESTIC SALES-1979 AND 1981**

| | 1979 | EPC* 1981 |
|---|---|---|
| (1) Food beverages and tobacco | | |
| Meat, fish and dairy products | 0.95 | 0.54 |
| Fruit and vegetable products | 1.26 | 1.85 |
| Confectionary, bakery & cereal products | 1.70 | 0.88 |
| Spirit, alcohol and areated water | 0.25 | 1.10 |
| Other food products and tobacco | -.36 | 1.34 |
| (2) Textile, wearing apparel | | |
| Textiles | 0.95 | 1.37 |
| Wearing apparel | 3.47 | 2.38 |
| (3) Chemical, petroleum, rubber & plastic products | | |
| Petroleum & petroleum products | 0.45 | 1.24 |
| Salt and salt based chemicals | 0.93 | 1.56 |
| Pharmaceuticals | 0.12 | 1.30 |
| Other chemicals | 0.90 | 1.07 |
| Oils and fats | 1.88 | 10.07 |
| Rubber products | 2.14 | 2.35 |
| (4) Wood, paper and pulp | 1.88 | 1.53 |
| (5) Non-metalic mineral products (Clay, soil and cement products) | 1.47 | 0.91 |
| (6) Basic metal industries and Machinery (excluding transport equipment) | 0.70 | 1.29 |
| (7) Ferrous and nonferrous metal products (other than machinery) | 3.85 | 2.07 |
| (8) Transport equipment | 1.52 | 0.87 |
| (9) Electrical goods | 2.05 | 2.42 |
| (10) Optical and Photographic goods | 0.50 | 1.96 |

Note: *The Effective Protection Coefficient (EPC) is the ratio between value added per unit of gross output in the absence of tariff (i.e. at "world" prices) and value added per unit of gross output made possible by the tariff structure.

Source: *Presidential Tariff Commission (The estimates are based on the Cordon method").*

and 1982, Lal and Rajapathirana, 1985). Data presented in Tables 1 and 2 in fact support this criticism. A comparison of sectoral effective protection coefficients for 1979 and 1981 shows that the variance of the degree of protection afforded to individual sectors has increased over this period against the original objective of attaining a "neutral trade regime" (i.e. removal of policy-induced distortions in the allocation of resources among sectors). Moreover, for the majority of the sectors, the magnitude of the effective protection coefficient was significantly higher in 1981 compared with 1979. It seems that in the process of subsequent fine turning of tariff rates, policy makers have given prominance to the politically sensitive objective of giving protection to local industries on a selective basis at the expense of the original objective of achieving neutrality in protection. However, it is important to keep in mind that, whatever the magnitudes of new tariff rates and their variablity, the drastic shift from quantitative restriction to tariffs per se would undoubtedly, have reduced the overall level of effective protection through eliminating the scaricity premia attached to such restrictions.

Real effective exchange rate (REER) for both exports and imports have tended to decline over the past three years or so following the relatively higher levels recorded in the immediate policy reform years (Table 2). This pattern suggests that over the time the degree of direct depreciation achieved through the floating exchange rate system plus indirect depreciation implied in various incentive schemes lagged behind the rate of domestic inflation (measured by the GDP deflators). However, throughout the period, the REER for manufactured exports remained at a higher level compared with that for total exports reflecting the favourable treatment accorded to the former under the existing selective export incentive schemes. The REER for manufactured exports also has remained at a higher level compared with that for imports suggesting a bias in favour of producing manufactured goods for the export market than for the domestic market. However, this bias has tended to reduce in recent years reflecting the impact of upward adjustments in import duties. The REER for imports in recent vears is suggestive of the fact that despite upward adjustments in import duties, on the average, imports have become relatively cheaper than their local substitutes.

**Removal of Price Controls**

Except for a few "essential" consumer goods, price controls which existed with regard to a wide range of products were removed. The purpose of these decontrol measures was to make profits more responsive to efficiency and market orientation rather than to administrative decisions by the However, "administered prices" still remain for the products of most of the public corporations.

**Adoption of measures to attract direct foreign investment (DFI)**

The new policy envisages DFI to play an important role in the process of industrialization, as a supplement to scarce domestic capital, technology and managerial skills. In particular, it is expected that foreign investors, thanks to their technological expertise and marketing skills and their greater ability to resist protectionist pressures within their home economies, can be instrumental in penetrating international markets for manufactured exports.

**Steps to limit expansion of public sector investment in industry (and other areas) and to rationalise the operation of existing public sector ventures**

The new policy envisages that "the public sector will concentrate on essential areas that are not attractive to the private enterpreneur either because the investment involved is too large or because the financial rate of return is not attractive" (Budget Speech, 1978 : 30). With a view to making public enterprise more efficient and commercially viable and to eliminating the distortionary impact on the rest of the economy emanating from their operation, a four-element rationalization programme was announced in 1978: (a) setting up of minimum standards of financial viability, (b) requirement that they compete on equal and non-discriminatory terms with the private sector, (c) "professionalization" of the top management, and (d) privatization or closing down of uneconomical and inefficient projects (CB ROE, 1978 : 57) 4. The previous practice (which existed since 1957) of reserving certain industrial sectors for public investment only has been terminated.

The experience over the past seven years shows that the ratationalization programme lost much of its rigour in the process of implementation. Despite widespread inefficiencies across various public enterprises, privatization has gone in a big way only in the textile industry. In 1983 the government authorised private sector participation in projects of several corporations (including Ceramics, Leather, State Mining and Mineral Development, Petroleum, Hardware and Mineral Sand), but to date this initiative has not generated tangible

**Table 2**

**REAL EFFECTIVE RATE (REER) ESTIMATES FOR EXPORT & IMPORTS , 1975-83 (RUPEES PER US$, BASE YEAR 1980)**

| | 1975 | 1976 | 1977 | 1978 | 1980 | 1981 | 1982 | 1979 | 1983 |
|---|---|---|---|---|---|---|---|---|---|
| (1) Total Commodity Exports | 6.95 | 8.24 | 9.72 | 11.56 | 11.34 | 12.83 | 12.66 | 11.39 | 11.56 |
| (2) Manufactured Exports | 17.07 | 16.60 | 23.01 | 25.19 | 18.91 | 21.56 | 21.85 | 21.85 | 16.61 |
| (3) Total Commodity Imports | N.A. | N.A. | N.A. | 14.47 | 16.57 | 17.98 | 18.15 | 18.75 | 18.70 |
| (4) Trade-Bias Index | .... | .... | ... | ..... | ...... | ..... | .... | .... | ...... |
| Total Exports | N.A. | N.A. | N.A. | 0.56 | 0.59 | 0.71 | 0.79 | 0.85 | 0.83 |
| Manufactured Exports | N.A. | N.A. | N.A. | 1.08 | 1.11 | 1.20 | 1.22 | 1.19 | 1.16 |

Notes: a. The REER for exports, measured at one point in time, is the real return to exporters, in local currency, from exporting goods worth one unit of foreign exchange (one dollar in this case) and is estimated as,

REER = (OER (1-TX+SB) px / pd

OER = Official exchange rate (Rs. per US$)

TX = Export tax rate

SB = The rate of total effective subsidies

P x = Index of export prices

P d = Index of domestic prices (the GDP deflator has been used in these calculations)

In the same vein, the REER for imports measures the real cost to the importer of importing one dollar worth of goods and is estimated as, REER = (OER ( 1+TX) Pm/ Pd

b. Ratio of nominal effective exchange rate for exports to nominal effective exchange rate for total imports.

Source: *Complied by the author for the forthcoming World Bank study, The Timing and Sequencing of a Trade Liberalisation Policy: The Case of Sri Lanka.*"

results. Contrary to the originally declared policy, a number of corporations have been accorded preferential treatment including higher tariff protection (Cutbbertson and Khan, 1981 : 90). In addition, the continual practice of licensing of certain imports has provided indirect protection to certain state industries. (CBC, ROE 1978: 71). Even after the elapse of about six years since the introduction of the policy reform, in his 1985 Budget Speech the Finance Minister had to observe that, "unfortunately some public corporations are becoming an intolarable burden on the Budget and on the people of the country....Unless we do something immediately to improve their efficiency the implications for the future are likely to be serious" ( p. 12).

### (e) Emphasis on Export Development

To establish a sound institutional background for the export development drive, the Export Development Act No 40 was enacted in 1979. Under the Act, the Export Development Board (EDB) was established in 1980 with the assigned tasks of formulating export development programs and monitoring their implementation, and co-ordination of the activities of various government bodies responsible for various aspects of the export development drive. Under the auspices of the EDB, a specific export development policy package including direct cash subsidies, import duty rebates, manufacture- in-bond, and various measures aimed at product and market development have been introduced. The EDB, in collaboration with the Central Bank and genous commercial banks,provides both equity and working capital to firms on scrutiny of their export potential. Since 1977 the government has taken steps to streamline and improve fiscal incentives for export production at successive stages finally limiting tax holiday concessions only to export ventures (by the 1983 budget).

In addition to these explicit measurer, the government has also taken steps to remove rigidities in the labour market and to "tidying up" its functioning through informal repression of militant trade unions. In particular, the erosion of trade union power through the dismissal of a large number of workers following the strike in 1980 helped to contain real wage growth (Lall and Rajapatirana, 1985).

To sum up, in the process of actual implementation, many elements of the policy package have left much to be desired when viewed from the original objective of achieving neutrality in the overall industrial incentive structure. There are still policy elements inherited from the past without undergoing modifications to fall in line with the new strategy. Despite this "unfinished" nature of the agenda, the overall policy reform undoubtedly marks a substantial break with the industrialization policy of the previous restrictive regime. Let us now pass on to examine the implications of this new policy orientation for trends, patterns and development consequences of industrialization.

### Sectoral Distribution of New Firms

Throughout the recent period, the textile and garment sector has been the major area of attraction for both foreign and local capital. However, for the former this degree of concentration is much higher than that of the latter. More than 50 per cent ( 33 out of 65) of the GCEC projects are in this sector. This supports the view that ,"getting round the quota" motive (the desire to utilize Sri Lanka's export quotas in foreign markets as a way out of stringent quota restrictions which the investors face in their home countries) was a major factor behind the recent upsurge in direct investment flows to Sri Lanka. Out of the FIAC projects, more than 62 per cent (71 out of 114) are in sectors other than in textile and wearing apparel. And most of these projects are of "import-substitution" type. According to a recent field survey, out of the total output of FIAC approved projects only 44 percent is exported, and out of the total number of firms in operation only 36 percent exported even a small portion of their output (Ministry of Finance and Planning, 1984).

In an overall comparison, capital goods industries, and light manufacturing industries indicate a relatively lower number of new projects compared with the other sectors. An analysis of changes in the import structure over this period shows that these are the sectors which were severely affected by trade liberalization. Next to textiles, the other sectors which have been areas of attraction are food products, chemical and rubber based products (mainly PVC products, roofing material, paints and other inputs used in construction industry) and non-metalic mineral products (clay, sand and cement products, bricks etc). In the case of various food products, protective tariffs coupled with relatively low purchasing power of local consumers, have continued to ensure a profitable market for local produce compared with high-priced imports. Various products in the other two categories, because of their "cuasitradable" nature, are naturally protected from import competition. On the other hand, some of them , especially those in the chemical and rubber based product groups are highly import dependent, and therefore have benefitted from import liberalization.

**Business Failures and Other Impact on Existing Firms**

Table 3 which is based on the MISA Survey (1980) compares for each three-digit ISIC sector the number of manufacturing units which were supposed to be in production by July 1980 and the number found inoperative during the course of the survey. The average business failure rate for the total number of companies (3018) is about 20 per cent. In an inter-sectoral comparison various food producing sectors (1 through 4), ferrous and nonferrous metal sectors and chemical products indicate relatively low failure rates compared with the average rate. On the other hand, machinery and equipment, electrical goods and other light-manufacturing sectors indicate relatively higher rates. In general, this overall pattern closely corraborates with the pattern of setting up of new production units and therefore the same reasoning seems valid here. The MISA Survey did not cover the textile and wearing apparal sector. However, information given in successive issues of the Review of Economy of the Central Bank suggests that this sector (especially the spinning and weaving subsector) was among the most affected. For instance in 1978 out of 1300 firms in this sector, which were on the mailing list of the Central Bank annual industrial survey, 200 firms informed of the closing down of their business.

Production units in the "unorganised" sector (unapproved units, mostly cottage industries) bulk large in the industries which a priori seem to be highly vulnerable to competition from imports (e.g. textile, jaggery, pottery, blacksmithy products, sugar-cane syrup). However, no data is available on business failures in this sector.

Table 3

SECTORAL DISTRIBUTION OF DISPLACEMENT OF MANUFACTURING UNITS, 1977 - 80

| | Units in operation as per Ministry Records, Sept. 1980 | Inoperative units servey results | Business failure rate (%) (2) / (1) |
|---|---|---|---|
| | (1) | (2) | (3) |
| **(1) Food, beverages and tobacco** | 291 | 58 | 19.93 |
| **Meat, fish and milk products** | 19 | 05 | 26.31 |
| **Fruit and Vegetable products** | 19 | 07 | 36.84 |
| **Confectionery, bakery and cereal products** | 141 | 23 | 16.31 |
| **Spirits, alcholic beverages & areated water** | 15 | 03 | 20.00 |
| **Other food products and tobacco** | 97 | 20 | 20.61 |
| **(2) Chemical, petroleum, rubber & plastic products** | 995 | 78 | 7.83 |
| **Petroleum products and petro-chemicals** | 223 | 32 | 14.35 |
| **Salt and salt based chemicals** | 13 | 02 | 15.38 |
| **Other chemicals** | 79 | 25 | 31.64 |
| **Pharmaceuticals, medical supplies & cosmetics** | 69 | 0 | 0 |
| **Soap, oils and fats** | 208 | 17 | 1.95 |
| **Leather and rubber products** | 403 | 02 | 0.49 |
| **(3) Wood, paper and pulp** | 278 | 84 | 30.21 |
| **(4) Non-metalic mineral products (clay, soil and cement products)** | 312 | 55 | 17.62 |
| **(5) Basic metal and machinery** | 162 | 43 | 26.54 |
| **(6) Ferrous and non-ferrous metal products (other than machinery)** | 379 | 78 | 20.54 |
| **(7) Transport equipment** | 240 | 68 | 28.33 |
| **(8) Electrical goods** | 267 | 84 | 31.46 |
| **(9) Optical and photographic goods etc.** | 92 | 31 | 33.70 |

Source: Ministry of Industries and Scientific Affairs 1980 *Survey of Industries to Ascertain the Impact of Import Liberalisation (Unpublished official document).*

Only for hand-loom textile production, there are some tentative estimates prepared by the Ministry of Textile Industries which suggests that out of about 111,000 handlooms that existed in the country about 30,000 had ceased to function by 1980 (People's Bank, Economic Review 6 (1) : 29). The IDB survey (1980) provides some useful evidence on the relative impact of liberalization on approved and unapproved units at the aggregate level. This evidence is summarised in Table 4.

Table 4

**THE IMPACT OF TRADE LIBERALIZATION ON MANUFACTURING : A COMPARISON OF APPROVED AND UNAPPROVED UNITS (1977-1979)**

| | Approved Industries | Unapproved Industries | All Industries |
|---|---|---|---|
| (A) Percentage distribution of number of firms according to the "nature" of impact: | | | |
| i. Closed down | 8.6 | 3.1 | 4.3 |
| ii. Adversely affected | 15.8 | 26.9 | 24.6 |
| iii. Benefited | 37.6 | 18.5 | 22.5 |
| iv. Unaffected | 38.0 | 22.5 | 48.7 |
| | 100 | 100 | 100 |
| (B) Percentage changes in selected performance indicators between 1977 & 1979* | | | |
| i. Investment | +69.7 | -20.9 | 54.4 |
| ii. Production | +20.5 | -6.0 | 12.8 |
| iii.Sales | +14.1 | -28.0 | -1.6 |
| iv.Profit | + 7.1 | -16.1 | -6.0 |
| v. Employment | +39.0 | -28.7 | +6.5 |
| vi. Raw material usage - Local | -15.0 | -16.1 | -15.4 |
| Foreign | +30.2 | -27.6 | +14.2 |

* For the purpose of these calculations, value figures for 1979 have been converted into 1977

Source: *Compiled using data from, IDB (1980), A Study of the Effects of Liberalization of Imports on Local Industries unpublished working paper)*

## Export Expansion, Import Dependence and Balance of Payment Implications

Total industrial exports have indicated considerable growth dynamism in recent years. Current SDR value of these exports (excluding petroleum products) increased from the level of SDR 30 million in 1977 to SDR 354 million in 1984. Their share in total exporters in these two years was 6 per cent and 26 per cent respectively.

In a disaggregated analysis, the expansion of manufactured exports appeared to be rather lopsided. The growth has predominantly emanated from a single item, wearing apparel (garments).. This was in fact, the only item in this category which indicated a significantly higher real growth (58%) for the period 1978-82 compared with that for 1970-77 (33%). Among the other items (at 3-digit BTN level) only sea-foods, rubber goods and ceramic-ware indicated average positive real growth during 1978-82. Even in these cases the growth was rather spasmodic and, for most of the items, average growth rates were lower than those recorded in 1970-77.

From a policy point of view, an aspect of manufactured export expansion which is perhaps even more important than changes in absolute export levels (as discussed above) is the degree of export orientation of manufacturing output. The overall export orientation of manufacturing appears to have some-what improved over time. In 1976, the "export coefficient" (the ratio of exports to total gross manufacturing output) was 12 per cent. This increased to 18 per cent in 1978 and then to 24 in 1980. Yet sectoral estimates indicate that only a few product categories (at 3-digt I SIC level) namely wearing apparel, leather goods, rubber and plastic goods, ceramic-ware, and non-ferrous metal, have contributed to this favourable trend. The Export Coefficient of each of the remaining product categories has declined in 1980 compared with 1978, reflecting an increase in "domestic market orientation"..

Given the heavy emphasis of the policy on foreign investors in the process of export-oriented industrialization, it is pertinent here to examine the role they have played in recent export expansion. Table 5 summarises the findings of a recent study related to this aspect. According to the table, exports by foreign firms increased by 244 per cent between 1979 and 1982 compared with 163 per cent between 1977 and 1979. In both periods, these growth rates were higher than growth rates of total manufactured exports from fully locally owned Sri Lankan firms. Nearly 57 per cent of total export increment between 1979 and 1982 was brought about by foreign firms compared with their 36 per cent contribution between 1977 and 1979. As a consequence the foreign firms share in total manufactured exports increased from 24 per cent in 1977 to 31 per cent in 1979 and then to 46 per cent in 1982. The table also shows that this growth dynamism was due mostly to the expansion of activities in the KIPZ. According to disaggregated estimates (not reported in this Table) about 61 per cent of total exports by foreign firms in 1979 comprised of wearing apparel, and this share increased to 77 per cent in 1982. In summary, this evidence supports the view that foreign investors have played an important role in recent expansion in manufactured exports. However, the original expectation that they would contribute towards the establishment of a highly diversified export structure has not materialized.

Table 5

**ROLE OF FOREIGN DIRECT INVESTMENT IN MANUFACTURED EXPORT[a] EXPANSION : BASIC DATA (BASED ON SDR VALUES)**

| | 1977-79 | | 1979-82 |
|---|---|---|---|
| 1. Growth[b] (%) | | | |
| Exports by firms with FDI | 162.6 | | 243.7 |
| Exports by fully locally-owned firms | 151.7 | | 132.6 |
| 2. Contribution (%) to export increment | | | |
| Firms with FDI | 35.5 | | 56.7 |
| Exports by fully locally-owned firms | 64.5 | | 43.3 |
| | 1977 | 1979 | 1982 |
| 3. Percentage contribution of firms with FDI to manufactured exports | 23.6 | 30.8 | 45.5 |
| IPZ firms | - | 3.6 | 31.3 |
| Non-KIPZ firms | 23.6 | 27.2 | 14.2 |

Notes: a. Excluding petroleum products
b. These estimates relate increase in exports between the two end years of each subperiod.

Source: *Athukorala, 1984, chapter 5 (Estiamtes have been made using firm-level Customs export data).*

## Redistributional Aspects

The industrial structure of Sri Lanka, as it evolved in the 1960s, led to a high degree of concentration of asset-ownership contributing to income inequality in the economy (Karunatilake, 1976: 187: Hewavitharana, 1979-26). At the initial stage of private sector expansion in manufacturing in the early 1960s, the industries were set up by a handful of enterpreneurs who until then had been involved in import and wholesale trade. Generous and indiscriminate tax concessions awarded, heavy protection; and favourable treatment in exchange allocation helped these entrepreneurs to expand rapidly forming themselves into a new rich class. The wealth this class was able to amass over a short period of time in many instances, exceeded the inherited wealth of people who had been connected with the plantation economy over a hundred years. A survey conducted by the Treasury in the early 1970s found that out of a total investment of Rs. 275 million in industrial undertakings each with a capitalization of over Rs. 1 million, Rs. 205 million (or 75%) was held by eleven family groups (Budget Speech 1973: 35). Moreover, out of the total number of companies which were formed during this period more than 84 per cent were private companies reflecting the increased concentration of wealth (Ibid). In 1966, the top 6.2% of the firms accounted for 63.3% of total industrial output. In 1974 the top 7.5 per cent of the firms accounted for 89% of output.

We do not have sufficient evidence for a detailed analysis of the changing pattern of wealth and income distribution related with industrial changes since 1977. Nonetheless, there is evidence which suggests that the degree of concentration has in fact increased since then. Firstly, during the period 1978-82, 927 manufacturing companies were formed in the private sector of which only 67 (7%) were public companies. Moreover, most of these private companies (about 75 per cent) were subsidiaries or affiliates of existing companies. Even in the case of public companies a close look at their share ownership structure suggests that most of these companies are not "broad-based" in a strict sense. Secondly, an analysis of the ownership pattern of joint-ventures approved by the GCEC and FIAC shows that almost all of the local collaborators belong to the top bourgeosie of the country. Thus, the recent increase in foreign capital inflow has given this class further opportunity for expansion providing access to foreign technology, marketing know how, and cheap and easy foreign financing (Bastian, 1984: 44-45). Thirdly, we have already noted that with trade liberalization, a significant number of small and medium scale firms went out of production in the face of severe import, competition, while llarge scale firms, mostly those with foreign capital links could face the new market situation successfully.

Fourthly, we have also observed that during this period "wage to value added ratio" in industry recorded a decline reflecting an uneven distribution of value added in favour of non-labour factor owners. This evidence supports the view that "by the current liberalization, the process of concentration of income has gained a coherence and consistency which it lacked before" (de silva, 1982:486).

## CONCLUDING REMARKS

The analysis shows that the spurt in aggregate industrial production recorded in 1978 slowed down in subsequent years indicating a rather erratic pattern in annual growth rates. The growth momentum in industry has been much lower than that of trade and services sectors which are directly linked with the essence of the new policy. At the sectoral level, the pattern of industrial growth seems rather lop-sided, emanating predominantly from the wearing apparel industry, some industries within the chemical and related products sectors and industries enagaged in the production of some inputs for the construction industry.

The available circumscribed firm-level data, supplemented with data on sectoral growth rate differentials, suggest that the nature of the impact on a given producer is not necessarily correlated with the degree of effective protection provided by the existing trade regime. While there is little doubt that the degree of effective protection contributes to the ability of a given producer to face competition from imports, there seems to be other, perhaps even more important, fundamental structural factors such as the nature of ownership (foreign vs. locally owned), the scale of operation, the pattern of local demand, and protection gained through the very nature of the commodity involved, which determine the net impact of trade liberalization on his performance. In particular, the impact has been more adverse (or less favourable) to small-scale producers whatever the type of products they produce. This observed pattern cast doubt on the adequacy of the blanket approach embodied in the present tariff related industrial assistance policies in promoting a "desired" pattern of industrial development.

Despite the government's stated desire to make the private sector the driving force of the economy, the aggregate share of public enterprises in the organised manufacturing sector has not shown any decline in the post-liberalization period. With regard to the private sector operation in the economy, a process of "deindustrialization" resulting from shift in resources to non-tradable sectors, is discernible.

The degree of export market penetration of product sectors with the exception of the garment sector, still remains insignificant and does not show any sign of improvement. The inflow of foreign direct investment has shown an upsurge since 1977, but, as yet, foreign capital participation is limited only to low-technology and unskilled-labour intensive export industries, (mainly garments and import substitution product sectors). Increased import-intensity in domestic production has limited the net balance of payments impact and spread effects of industrialization. The fortune of the industry sector still depends very much on foreign exchange generated by the traditional export industries as in the ISI era. Employment in the organised industry has somewhat expanded, but this expansion has originated mostly in the garments industry while in most of the other sectors the level of employment has either declined or remained stagnant. While we do not have adequate data on the unorganised manufacturing sector, the existing circumscribed data base leads one to surmise that when both organised and unorganised sectors are taken together total level of industrial employment might have even declined. Real wages per industrical worker has tended to decline in the face of an increase in the share of value added accruing to the industrialist. The pattern of industrialization over these years might have further strengthened the tendency towards a higher degree of wealth and income concentration in the economy.

Why has progress not been up to expectations. Economists who maintain a profound faith in the basic neoclassical tenets behind the policy reforms, usually ascribe the blame for this failure to inadequacies in the industrial and trade policy package (World Bank, 1981, 1982, 1983: Lal and Rajapathirana, 1985). In particular, the existing discriminatory tariff structure which has led to distortions in resource allocation, the anti-export bias built into the incentive structure, and continued government involvement in direct production sectors have been highlighted as major limitations. The Industrial Policy Mission of the World Bank which visited Sri Lanka in 1983 has, therefore, suggested further policy measures to ensure "a system of neutrality of incentives between import substituting and exporting activity". These measures include the introduction of new export incentive measures or expanding and refining the existing ones, reducing the existing barriers to import, and reducing the government's claim on domestic resources (World Bank, 1983:53-62).

The view is frequently expressed in Sri Lanka policy circles that the impressive growth and development record of the South-East Asian countries was due firstly to free trade, and secondly to the very low level of