13. Policy Challenges for Industrial Development in Post-conflict Sri Lanka

13.1 Introduction

Emerging out of a protracted conflict, and moving in to a new era of economic progress, Sri Lanka is now ready to place a stronger focus on developing its industrial capacity in contributing to its broader development objectives. Without the stifling effects of political instability and with the dawning of a peaceful environment, Sri Lanka can seize on this opportune moment to re-energize its manufacturing potential.

As a result of the unfavourable environment that prevailed for nearly thirty years, industrial development in Sri Lanka did not reach the heights that many of its regional competitors did. Although the country did grow its manufacturing base to some extent during this time, particularly in textiles and garments, rapid industrialization was not possible. The volume of foreign direct investment (FDI) that the country attracted into the industrial sector was largely of the ‘footloose’ type, and not the high-value type, such as electronics and automobiles industries. Multinational corporations (MNCs), which often lead these types of investments, were unwilling to set up in Sri Lanka, mainly due to the instability related to the conflict. As a result of not being able to attract this ‘right’ type of FDI that was desired, the manufacturing sector did not have the impetus to move further and further up the value chain.

However, in the current post-conflict environment, Sri Lanka has a renewed opportunity to build its higher-value industrial potential, attract better foreign investments, and boost its production of higher income-earning exports. Yet, while the uncertain security and political environment did have a stymieing effect on industrial progress, various other issues also did, and continue to contribute to the lacklustre performance of the manufacturing sector. These include inadequate infrastructure, regulatory impediments including rigid labour laws, lack of clarity in industrial policies, high cost of finance (in part due to crowding out by state borrowing), unavailability of skilled workers, deficiencies in technological capability, and institutional inefficiencies.

This policy brief will examine these historic and existing issues, and provide an outline of policy challenges for the future.

13.2 Industrial Sector Performance

13.2.1 Contribution to the National Economy

The share of industry in GDP has grown modestly in the last several decades, from 26 per cent in 1990, to 29.7 per cent by 2009.1 In recent times, the structure of GDP has changed only marginally in favour of the manufacturing sector, but it continues to employ around 25 per cent of the labour force. The industry sector had not progressed as quickly as the services sector has, which has grown from contributing 47.7 per cent to GDP in 1990 to 57.7 per cent in 2009.

As for its contribution to growth, in 2009 the industrial sector contributed towards 40

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1 Latest estimate following the 2002 base year revision by the Department of Census and Statistics.
per cent of GDP growth. Its contribution to overall exports has also grown steadily, from 33.8 per cent in 1980 to 54.2 per cent in 1990 and to 75 per cent by 2009. By 2009, the sub-category of ‘factory industry’ contributed around 15.8 per cent to GDP.

Figure 13.2
Value Added in Manufacturing by Activity in 2009 (2002 constant prices)

Although more recently other industries have emerged, much of the industrial sector has been, and continues to be, led by the apparel industry which benefited from a quota regime and preferential market access, as well as comparatively low labour costs. As some of these advantages gradually diminish, it is now imperative that the industrial base is expanded and moves towards industrialization in other categories.

It is widely recognized that the manufacturing industry sector can make a more significant contribution to Sri Lanka’s economic development process, as it has a more pronounced employment-generation potential vis-à-vis other sectors such as services, and in meeting the changing aspirations of the youth. Faster growth in the sector can also lead to more export income for the country. Fast-tracking industrial development, therefore, becomes an important component in propelling the country towards lowering unemployment and rapid economic progress in the post-conflict phase.

13.2.2 Lacklustre Industrial Growth during the Conflict Era

The volatile political and security climate that characterized a large part of the last thirty years was largely responsible for the lack of rapid growth in significant private sector undertakings across the country. While private enterprises – particularly those based in the Western Province and largely unaffected by the direct fighting – continued to operate and grow modestly, the private sector was hesitant in moving to other regions due to the various other business climate impediments that prevailed then, and continue to prevail today. A cursory look at the provincial growth figures over the last three decades reveals the heavy bias of production towards the Western Province, with all other regions lagging behind. While this is changing gradually, industrial development has the potential to fast-track the ‘catch-up’ of the lagging regions to the level of the Western Province.

The uncertain climate was a disincentive to private investment in general and capital-intensive industrial investment in particular. It is widely acknowledged that the perceptions of uncertainty do govern the spirits of the private sector to a large extent. This was evident by the surge in stock market activity, IPO listings, and new expansion undertakings in the months following the end of the conflict. Security issues affect the long-term decision making of firms, impact on present and future profitability, and thus lead to hesitation to undertake any significant new or expansionary investments.

The political environment is a crucial determinant of industrial development, and the importance of promoting a business climate generally conducive to entrepreneurship, investment, production, and innovation cannot be stressed upon enough. Economic policy plays an important signalling role in attracting investments to the industrial sector. The speed and nature of industrial progress in a country is often influenced by the effectiveness of policy measures which impact industrial activity in the country - from the regulatory framework to tax policy and investment incentives.

In summary, the growth of the industrial sector during the years of the conflict were hampered primarily by the unstable security environment, government attention being placed elsewhere (i.e., on tackling the armed conflict), and thus, the state machinery having limited policy space to promote industrial development in a sustained and strong manner.

13.3 Sri Lanka’s Industrial Development Journey

The quest for greater industrialization in the Sri Lankan economy has been an area of fo-
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by nearly all governments since the country attained independence. Various policy prescriptions were attempted towards fulfilling this, each with differing degrees of success. Industrialization in the period between independence and 1977 was characterized by import-substitution industries producing basic industrial products, mainly by state-run manufacturing companies. This was coupled with high import tariffs and other protectionist measures. These policies, however, failed to deliver. By 1977, most import substitution industries had become largely import-dependent, not saving any foreign exchange and functioning at below capacity level.²

Following the 1977 liberalization of the economy, there was a sustained focus on export-oriented industrialization, accompanied by various incentives. The open trade regime was allowed to dictate industrial development, and so trade policy became the main instrument of industrial promotion in the country until the late 1980s.³ FDI played a major role in export-led industrialization and firms with FDI contributed substantively to the export expansion.⁴ There was a notable rise in industrial output in general, and manufactured exports in particular. Yet, in the decade following liberalization, industrialization was very much urban-biased, with nearly 80 per cent of industrial output concentrated in the Western Province. It also remained relatively undiversified with 60 per cent of industrial output originating from the textile and garment sector alone.⁵

To address some of these issues, in 1989 Sri Lanka released its first industrialization policy statement. To implement this, an Industrial Promotion Act was enacted in 1990 which created an 'Industrialization Commission' tasked with devising suitable policies and addressing identified impediments. These efforts were bolstered by a second wave of liberalization in the early 1990s which included liberalizing FDI flows, supported by a reconstituted Board of Investment (BOI). Incentivized schemes such as the '200 Garment Factory' programme were initiated to take industries to rural areas. On the whole, however, geographically-spread industrial development was slow to take off due to the unsuitable business environment that existed, mainly characterized by a lack of suitable infrastructure.

Sri Lanka’s experience with export-oriented industrialization was often referred to as a 'late comer’s story' compared to most East Asian countries,⁶ as Sri Lanka transitioned to this strategy around a decade 'late'. However, unlike the Newly Industrialized Economies (NIEs) of East Asia, with their skills and technology upgrading and industrial diversification, Sri Lanka’s manufactured exports consisted mainly of low value-added products that utilized low-skill/low cost labour.

Market liberalisation has certainly led to a greater 'internationalization' of Sri Lankan industries, with many manufactured exports enjoying valuable positions in foreign markets. In many manufactures like apparels, rubber products, fabricated metals and ceramics, Sri Lankan industries have improved their technological capability, skills, and product quality to match international standards. However, this is limited to a small

⁴ Ibid.
Box 13.1
An Overview of Recent Policy Thrusts for Industrial Development

The 1995 Policy Statement of the People's Alliance (PA) had a considerable industrial development component that was spearheaded by the Ministry for Industrial Development. Plans were instituted to establish 20,000 small and medium industries, employing over 250,000. There were also several divestitures of state-owned industries during this regime. There was a focus on expanding the labour-intensive manufacturing sector, while pursuing technology-intensive manufacturing. It was in this era that the National Productivity Decade was launched, the National Productivity Secretariat was set up, and several initiatives to improve productivity in the country's industry sector were championed. Alongside this, the need for skills upgrading to cater to the industrial sector was identified, and the Skills Development Fund was launched, to provide incentivized grants to private firms undertaking skills training programmes for the workforce.

Under the 'Regaining Sri Lanka' vision of the United National Front (UNF) elected in December 2001, the policy focus shifted to promoting private investment in general (including FDI), improving Sri Lanka's competitiveness and productivity in all spheres. However, there was no specific focus for industrial development, and especially none to promote industries in the regions outside the Western Province. However, a clear recognition of the contribution that productivity improvement can make in enhancing Sri Lanka's manufacturing competitiveness was made. Productivity improvement was recognized as not only an issue of labour productivity, but one that permeated the power sector (high energy costs), lands (restrictive land use policy) and business regulatory frameworks (complex and archaic tax laws and other regulatory constraints). To action this, a Productivity Programme was initiated, and the National Competitiveness Council was mobilized as the thrust forum to push for required reforms, be it in industry or in other sectors. However, within the industry sector much of the focus, at least in terms of the stated plans, was towards the apparel industry.

The 'Rata Perata' vision of the United People's Freedom Alliance (UPFA) government in 2004 also had an industrial development focus, and continued on the work that began in 1995, but more importantly it saw the setting up of the National Council for Economic Development that consisted of industry clusters to improve competitiveness of several thrust industries (garments, ceramics, gem and jewellery, etc.).

Under the 'Mahinda Chinthana' vision set out by the UPFA in 2005, a plan to set up 12 new industrial investment zones in 12 small townships was envisaged. Additionally, 300 new industries in each Divisional Secretariat, with five year tax holidays for such investments exceeding Rs. 50 million was proposed. Policies to promote greater industrialization in the minerals sector, and expansion of the apparel industry were to be pursued. A particular focus of the policy framework was the emphasis placed on promoting the domestic production base, and giving priority to domestic industrialists, including those in the small and medium sector. Domestic export-oriented industries which source 75 per cent of their raw materials locally were to be granted a 5 year tax holiday.
number of firms, and the key is to propagate this more broadly.

While there has been an expansion of the import-substitution industry sector, with a focus on quality - particularly in the categories of instant food products, biscuits, confectionery, beverages, milk food, clothing, plastic items, paints and ceramics - the limited size of the domestic market remains a constraint to rapid growth of this sub-sector. Nevertheless, there are a large number of imported consumer items that still have the potential to be produced by import-substituting industries in Sri Lanka.

In the near term, however, the growth in the industrial sector is likely to come largely from the growth of industrial exports. Despite the end of the quota regime in 2005, apparel exporters have successfully managed to exploit domestic design and product development capabilities to carve lucrative niches abroad. It will be increasingly important to replicate this success in other export-oriented industries, as the country’s manufacturers attempt to move from low value-added to high-value-added export products.

13.3.1 Current Industrial Development Policy Framework and Ongoing Strategies

The current industrial development policy framework has been broadly set out under the government’s latest vision statement ‘Mahinda Chintana: Idiri Dekma’, and moves along similar strategies set out in 2005 as highlighted in Box 13.1.

To lead this vision, there are several government agencies involved in industrial promotion in varying capacities, but is principally spearheaded by the Ministry of Industries. The main focus of the development strategy at present is broad-basing growth by stimulating growth in lagging regions. For decades, the Western Province has dominated the country’s economic geography, contributing to half of the country’s GDP. However, there has been a marginal shift with some of the other regional economies making inroads in more recent years (Figure 13.3).

Figure 13.3
Provincial GDP Shares - 2004 vs. 2008 (percentage)

![Provincial GDP Shares - 2004 vs. 2008 (percentage)](image)

In the industrial sector particularly, there is an ongoing thrust to take industries to other regions, under the present development vision. A joint scheme recently launched by the Ministry of Industries and the BOI - 'Gamata Karmantha' (or 300 Enterprise Programme) - is aimed to develop industrial potential in rural areas, by mapping the unique resource and skill advantages inherent in each area and then leveraging on them to develop relevant industries.

Finance has been a perennial stumbling block for domestic industrialists in their growth efforts, either due to its cost, or in the case of regional businesses a lack of access to large loans. The state-run Lankaputhra Development Bank has been mandated to provide this finance on sub-market rates to domestic industrialists. Moreover, state banks, private development banks and also donor re-financed concessionary loan schemes have been mobilized to provide finance for industries in lagging regions. There also exist some special loan schemes for the revival of, and establishment of new industries in the Northern and Eastern Provinces.

The small and medium enterprise (SME) sector has often been touted as the backbone of the private sector in the country, and is being given priority under the current policy framework. The National Enterprise Development Authority (NEDA) was set up to assist this sector, and ease the constraints that are holding it back. Together with the Industrial Development Board (IDB), NEDA is involved in encouraging small scale industrialists to adopt a product-based cluster approach to build scale economies and improve technical capacities, and then help these industries 'internationalize' - i.e., link up with regional and global supply chains. Moreover, recently a committee for Small and Medium Industry (SMI) development was appointed and was tasked with looking into the problems of, and prospects for expanding this sector and increasing its contribution to overall industrial sector growth. Having rightly identified 'access to finance' as a key impediment to SMI growth, this committee includes representatives from the banking sector as well.

### 13.4 Opportunities and Constraints in Post-conflict Industrial Development

Infrastructure remains a constraint to industrial development country-wide, and as a result, much of the large industrial production facilities are concentrated in the Western Province. As a second-best solution to expanding industries to other regions, several Export Processing Zones and Industrial Estates have been established, which offer improved infrastructure within the zone and good road connectivity to the country’s international port and airport. The Achchuveli Industrial Zone in the Jaffna district, which is being developed under a partnership between the United Nations Office for Project Services (UNOPS) and the Ministry of Industries, and the Kappalthurai Industrial Zone in the Trincomalee district, offer much encouragement in the prospects for industrial development in these previously conflict-torn regions. Already some industries have begun setting up in both these zones. As physical infrastructure in these areas requires much improvement, the rapid development of infrastructure-ready zones like these will undoubtedly be an important first step in reviving the industrial potential and in creating employment opportunities. However, relevant skills development must go hand in hand, so that the labour force is able to take advantage of the opportunities arising from these developments.

Additionally, there is vast untapped capacity in the agriculture and fisheries sectors in the Northern and Eastern regions. Following the dawning of peace, restrictions both in fishing (fishing areas, durations, permitting radio tracking, multi-day fishing, high-speed
out-board motors, etc.) and agriculture (lands becoming unlocked after de-mining) in these areas have been dismantled. With production capacities increasing, there are opportunities for related industries in agro-processing (spice products, fruit and vegetable canning, jams, cordials, food products, etc.) and fish-processing and related activities (fish canning, ice production, etc.) to take off.

While recent investments in commercial water supply and wide-scale electrification programmes have relieved many operational constraints, energy costs still remain high compared to Sri Lanka’s regional competitors. Countries like China benefit from nuclear power, which is inexpensive to the end-user, and Thailand, Bangladesh and others in the region benefit from vast natural gas deposits.

Connective infrastructure in many parts, particularly in the N&E remain a constraint, with road transport from Batticaloa in the East taking as much as 8-9 hours. Highways and high-speed rail connectivity will certainly ease this constraint. The latter is particularly useful, and it is encouraging that Sri Lanka Railways has expressed willingness to grow its rail cargo services.

Although currently any export-oriented industries setting up in the N&E would have to make this long and expensive journey to transfer its goods to the only container port in Colombo, the proposed redevelopment of the Trincomalee and KKS ports as industrial ports will certainly improve the prospects for industrial development in these areas. It will also enhance the cost-competitiveness for industries in the border regions like the North Central Province.

Owing to both the connectivity constraint and also a skills constraint, industrial sector undertakings in the N&E, in the short to medium term, are likely to cater mainly to the domestic market, i.e., as import-substitution industries. As mentioned earlier, with agriculture and fisheries sectors demonstrating a fast recovery, there is strong potential for agro and fisheries-based industries to thrive. Capacity for export-oriented industries may take more time to develop and mature.

Constraints in the enabling environment in areas besides infrastructure also require attention. As highlighted previously, a conducive business environment effected by appropriate policy fixes are vital to spur industrial development. Key business climate constraints like labour laws, tax regulations and time and costs associated with licensing and permits, etc., prevail. Sri Lanka is at a disadvantageous position in many of these indicators relative to its competitors. Selected issues are shown in the comparative figures as set out in Table 13.1.

13.5 Policy Priorities: Key Areas Requiring Attention

13.5.1 Infrastructure

A key priority for the government is providing the requisite infrastructure base to spur industrial development in all regions. This process has already begun, with several roads, highways, port and airport projects ongoing island-wide. Connective infrastructure, alongside improvements in commercial water and electricity, are vital. However, while building and improving the quality of existing regular roads is useful, it is important to fast-track investments in high-speed rail and motor highways to better connect industries across regions, as well as with external markets via the new and existing ports and airports.

Port access is an important pre-requisite to creating strong industrial capacity in a region, and currently only the Western Province enjoys that advantage. However, with the construction of the Hambantota port, and
the proposed industrial zone linking with it, Sri Lanka will be able to create its second industrial hub. Moreover, with a natural deep-water harbour and airport, Trincomalee appears ideally poised to become another new industrial trading hub of the country, providing the linkage to international markets for industries in the Northern, Eastern and North-Central Provinces. The Trincomalee harbour has a natural depth sufficient to cater to the newest range of deep-hull industrial goods vessels. While many prominent ports around the world are having to gradually undertake dredging and other upgrades for this purpose, the Trincomalee port enjoys a natural advantage in this aspect.

13.5.2 Labour Regulations

Existing rigid labour market regulations place Sri Lankan industries, especially those employing large numbers, at a disadvantage relative to competitor countries. Thus, there is a need to reform these labour laws in line with global changes in this area, while maintaining adequate protection for workers. Currently in Sri Lanka, the average cost of severance payments for a worker, as mandated by law, is 178 weeks of wages. This is the 4th highest level in the world.7

Within a liberalized and dynamic global environment, it is important to allow for industries to adjust its factor positions to cope with market changes; this is particularly applicable to the factor labour. Sri Lankan industries need to compete with larger economies like China, Indonesia, Thailand and Malaysia who enjoy scale economies and countries like Vietnam and Bangladesh which enjoy lower costs of labour. Export-oriented industries often report of difficulties in attracting potential foreign investors to expand their production due to preconditions of having to streamline the workforce, and this bearing a restrictively high cost of severance.

13.5.3 Investment Incentives Structure

Investment incentives via various income tax breaks and import duty concessions have been a feature of Sri Lanka’s industrial promotion strategy implemented through the BOI. Although generous incentives have been continuously offered under the BOI regime, rapid industrial development has been slow to materialize. This can be largely attributed to the security climate which was a disincentive for private investment in industries, particularly those that require significant capital commitments. Foreign collaborations in the industry sector were also slow to materialize during this time. During the period of

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### Table 13.1

<table>
<thead>
<tr>
<th>Country</th>
<th>Paying Taxes No. of Payments</th>
<th>Paying Taxes Time (hours)</th>
<th>Construction Permits No. of Procedures</th>
<th>Construction Permits Duration (days)</th>
<th>Electricity Tariffs (US$/KWh)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sri Lanka</td>
<td>62</td>
<td>256</td>
<td>21</td>
<td>214</td>
<td>0.18</td>
</tr>
<tr>
<td>Singapore</td>
<td>5</td>
<td>84</td>
<td>11</td>
<td>38</td>
<td>0.09</td>
</tr>
<tr>
<td>Thailand</td>
<td>23</td>
<td>264</td>
<td>11</td>
<td>156</td>
<td>0.08</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>21</td>
<td>302</td>
<td>14</td>
<td>231</td>
<td>0.05</td>
</tr>
<tr>
<td>Indonesia</td>
<td>51</td>
<td>266</td>
<td>18</td>
<td>176</td>
<td>0.06</td>
</tr>
<tr>
<td>Vietnam</td>
<td>32</td>
<td>1050</td>
<td>13</td>
<td>194</td>
<td>0.09</td>
</tr>
</tbody>
</table>

Source: BOI, Statistics and Policy Advocacy Unit.
uncertainty, some industrial development did take place despite this, but was confined mainly to labour-intensive industries.

Now it is important to re-visit the current incentive structure, and revise and rationalize it in line with a broader industrial development policy. Industries face high capital costs, and the initial expenditure on facilities, machinery and equipment poses significant cash flow challenges. To tackle this, there is a need to reform the existing investment incentive structure which focuses only on tax breaks that come into effect years after set-up, and instead introduce alternative incentive tools like accelerated depreciation, up-front capital write-offs, and investment credits that reduce initial capital costs. These tools are also more attractive to those industries with FDI that have to still pay taxes in their home country despite enjoying tax breaks in the host country. Instead of tax breaks which erode future tax revenue, the government could also consider granting government land at concessionary prices. The BOI should also actively promote foreign ‘anchor investments’ for large, ready-to-use industrial zones. Under a Build-Own-Operate (BOO) model, the concessionaire is granted tax holidays to develop the zone, and is then responsible for drawing in industries to operate in it. Similar models have been successfully followed in other industrialized countries in the region, and there are indications that such an arrangement is proposed for the Muttur region in Trincomalee.

13.5.4 Skilled Labour

Building a skilled talent pool to feed into industries remains a constraint. Although Sri Lanka boasts near universal primary education, achievements at higher levels of learning like O/Ls and A/Ls, particularly in science and mathematics streams remain weak. Additionally, the graduates passing out from local universities remain unattractive to industrial enterprises, as they lack the management and technical capabilities as well as soft skills which private enterprises place heavy emphasis on. Overall, there needs to be greater investment in vocational training, skills-for-work for school leavers, and measures to grow the science and engineering talent pool. Enrolments for science and engineering subjects in Sri Lankan universities are low, compared to other subjects in the Arts and Commerce streams. While this is indicative of the general lack of science, engineering and technology teaching in the universities, it is also a consequence of the fact that the number of schools across the country that offer science and maths streams at A/Ls is very limited.

Sri Lanka has been unable to preserve its science and engineering talent due to the conflict-related instability, and also due to the unappealing potential for advancement in the innovation industry in the country. Sri Lanka is second only to the Philippines on the extent of brain drain in this sector.8 The Indian diaspora has been touted as being a key reason for India’s IT and R&D boom. The Indian diaspora actively sought contracts for science, engineering and IT firms back home. They were also linked with the academia and research organizations in India. Sri Lanka too enjoys a similar position. There are many Sri Lankan scientists and engineers, graduating from local institutes and now well qualified, but are domiciled abroad. Sri Lankan experts in the diaspora range from NASA scientists to globally-recognized ISO certificators. This potential must be tapped by introducing innovative mechanisms to create diaspora-local linkages, with knowledge exchanges between them and local research and

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training institutes, as well as leading local firms.

Developing industry-oriented skills improve worker's employability, productivity and labour mobility. Thus, there is a need to expand industry-specific vocational training programmes, once future growth industries are identified under an industrial development policy. Moreover, there needs to be better re-training and re-skilling programmes to enable re-deployment of labour, to help mitigate the impact of large-scale layoffs, and dampen the impact of changes in sectoral structure over time. This would also make the country's workforce more dynamic and able to move with global changes.

It is encouraging that a high proportion of production-sector workers (compared to managers and professionals) in Sri Lanka receive training, and is far ahead of countries like Bangladesh, India and Pakistan. This augurs well for the availability of workers for the industrial sector. However, a problem experienced by the majority of SMIs looking to grow is that they are constrained by the availability of technical as well as managerial talent, with the right soft-skills.

Considering the previous conflict-affected regions particularly, the potential for industrial development will be fairly contingent on the labour force there acquiring the requisite skills suited for manufacturing sector jobs.

13.5.5 Productivity, R&D and Technology

There needs to be a stronger productivity-improvement programme to support industrial sector growth. Governments have had several initiatives to improve awareness on productivity improvement in the last decade. The most wide-ranging was the National Productivity Decade 1996-2006, which provided Sri Lankan industries practical information and supported firm-level productivity improvements. Such a scheme needs to be re-introduced, especially as the government’s priorities now focus on economic growth following the end of the conflict. A Presidential Task Force on Productivity has also been established, but there has been little movement with this so far and its needs to be revived. It is indeed encouraging that ‘productivity’ features in a Cabinet ministerial portfolio for the first time in 2010 - the Ministry of Labour and Productivity Improvement. However, associating productivity improvement with the labour sphere alone is insufficient. Productivity is a much more holistic concept that requires a focus in every sphere of activity, from the firm-level to mezo and macro level state institutions.

Sri Lanka has made little advances in the area of research and development (R&D) recently, and a focussed effort is required to arrest this trend. According to various indicators that measure this, such as the number of researchers in R&D per million people, scientific and technical journal articles per million people, patents granted to Sri Lanka by the United States Patent and Trademark Office (USPTO), etc., Sri Lanka has made little progress in the last decade. Sri Lanka lags behind regional competitors in many of these indicators.

At the 1979 Vienna Conference on Science and Technology for Development it was advocated that countries looking to achieve faster growth rates should spend at least 1 per cent of GDP on R&D activities. Possibly owing to the heavy burden of the war, Sri Lanka has spent only a small percentage of its GDP on R&D work, amounting to

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9 World Bank, Investment Climate Survey, various issues.
around 0.14 per cent of GDP annually. This has remained largely stagnant; the corresponding figure for 2001 was 0.19 per cent, with a similar figure for 1996. In contrast, India spends around 0.85 per cent annually, and China, a clear outlier, allocates 1.44 per cent. It is commendable that the current policy framework has set a target of raising spending on R&D up to 1.5 per cent of GDP by 2016.

Sri Lanka is home to several impressive research institutes, like the Industrial Technology Institute (formerly the CISIR), and the National Engineering Research and Development Centre. They continue to play an important role in developing national and firm-level technology capabilities. Their potential needs to be further harnessed, and their scope needs to be expanded to be more relevant to the needs of the industrial community.

Forging industry-research linkages and public-private partnerships for R&D are important in advancing this field, and a model initiative that has engendered this idea is the Sri Lanka Institute of Nanotechnology (SLINTEC). Nanotechnology is increasingly gaining prominence, not only in the R&D field per se, but more importantly in the industrial sector where nanotechnology can benefit in new product developments and efficiency improvements. The SLINTEC has brought together key innovators from the private sector and scientific community to find new ways of feeding nanotechnology into broader industrial development.

13.5.6 Access to Credit

Due to the need to finance growing defence expenditure, while also maintaining humanitarian relief efforts, government borrowings continuously rose during the peak war years, and often crowded out private investment. Additionally, consistently high budget deficits brought on to an extent by continuing welfare schemes, and support for loss-making public enterprises led to high borrowing costs for the private sector. While interest rates have fallen since reaching a peak of over 20 per cent in 2008, maintaining a low interest rate regime will be a challenge in view of ongoing heavy public spending in post-war reconstruction and on a wide range of public works programmes throughout the country.

13.6 Way Forward and Future Prospects

In the quest to expand Sri Lanka’s industrial sector, the need now is to diversify the country’s industrial exports by enabling the shift from labour-intensive products to more skilled and technology-driven products. Sri Lanka is gradually losing its low-cost labour advantage, and is already at a disadvantage with regard to energy costs. Thus, the debate that needs to be brought to the fore, and factored into industrial development strategies, is one of low cost versus higher value. In mapping out a strategy for export-oriented industrial development, a key question that needs an answer is whether Sri Lanka is able to continue to compete on the labour cost advantage that it has so far exploited fairly successfully, or whether the country is rapidly losing this to competitors such as China, on labour costs, and to countries like Thailand, Vietnam and Bangladesh on both labour and energy costs.

There is a clear need to re-evaluate Sri Lanka’s market position, and discover where the country’s strengths truly lie. If Sri Lanka intends to move away from the labour-cost fo-
cus, what strategies need to be employed to ensure Sri Lankan industries can move towards higher technology utilization, increased efficiency and productivity, and tap into more value-added and possibly niche product categories? In the services sector this is taking place already, and it holds valuable lessons for the industrial sector. Sri Lanka, unable to compete with India’s cost and scale in standard business process outsourcing (BPO) activities, has successfully shifted to more knowledge process outsourcing (KPO) activities and niche market software development. Sri Lankan IT firms are global market leaders in stock trading software, mobile phone applications and e-commerce applications.

Attracting more and better FDI is also a strong need, as highlighted earlier. Although the debate surrounding the ‘technology spillover from FDI’ continues inconclusively, it is clear that Sri Lankan industrialists can gain from being more exposed to global best practices and technology-enhancement opportunities. Meanwhile, it is vital that the effort towards greater internationalization, higher value-addition and new product development is bolstered by an appropriate mix of government policy, which is transparent, consistent and investor-friendly.

While the literature on industrialization lists several factors that underpin successful industrial development – country size, political and macroeconomic stability, availability of natural resources, human capital and skills, physical infrastructure, previous industrial experience, entrepreneurial appetite, and external sector stability – development economists broadly agree that the prevailing policy regime of the country (relating to trade, industry, investment and macroeconomic management) is probably the single-most important factor. Understandably, much of this took a policy ‘back seat’ during the conflict years. In the post-conflict environment, the government needs to now focus heavily on creating the right policy regime conducive for private enterprise growth. As the industrial sector faces many challenges in an increasingly competitive global trade arena - which has moved towards greater liberalization and preferential arrangements - the key policy priority is to provide industrialists with the right business environment to grow and compete more effectively - i.e., an environment favourable to investment, entrepreneurship, production, and marketing.

This policy brief has attempted to highlight some of the key constraints in developing the industrial sector, and provided an indication of where the way forward may lie for Sri Lankan industries. On one hand, a coherent industrial development strategy, coupled with a liberal trade regime, will encourage entrepreneurs to engage in industries; while on the other, a stable macroeconomic environment, coupled with the right economic incentives, will create a conducive business environment that encourages savings and promotes investment in new industries. It must be continuously borne in mind that for an industrial development policy to be strategic and successful, it requires more than just a focus on industries per se, but rather, a holistic approach that encompasses reforms and improvements in infrastructure, labour, education, governance and state regulations.