DEVELOPMENT STRATEGY AND INDUSTRIAL POLICY - ISSUES FOR SRI LANKA

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EXECUTIVE SUMMARY

In Sri Lanka, the period since the late-1970s has seen considerable changes in development strategy and industrial policy. In recent years, many papers have been written on industrial policy in Sri Lanka. In this paper, I review these papers and in doing so, attempt to provide a brief overview of industrial policies in Sri Lanka.[1]

1. The Sri Lankan vision is the doubling of per capita income between 1990 and the end of the century. This implies an average annual rate of growth in national income of about 8 per cent. This rate of growth is unlikely to be achieved (section 1.1). Even to achieve a sufficiently high growth rate in national income (of 5 per cent per annum) to prevent unemployment from rising above the present level of 14 per cent will require not only a continued inflow of foreign capital (in aid, loans and direct investment) equivalent to more than 10 per cent of GNP but also a fall in the incremental capital-output ratio.

2. The prospects of Sri Lanka's development being led by agriculture (whether through rice, plantation exports or 'other agriculture') are weak (section 1.2). Diversification away from plantation exports should have a high priority in Sri Lanka. To achieve an annual growth rate in national income of 5 per cent, the manufacturing sector will need to grow at 7 per cent per annum with agriculture and services growing at about 4 and 5 per cent per annum respectively (see also section 1.2). Although the manufacturing sector will spearhead the growth in national income, the bulk of the 2 per cent per annum increase in the labour force will have to be absorbed in the form of continued 'under-employment' in the agricultural and service (especially government) sectors.

3. The manufacturing sector in Sri Lanka is small for a country of Sri Lanka's population and per capita income (section 1.3). Since the liberalisation in 1977, the dynamic part of the sector has been what the Central Bank refers to as 'factory industry' which in 1990 accounted for almost four-fifths of the total. What the Central Bank refers to as

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1. This paper was written in November and December 1992. I was assisted in writing it by a large number of people in and outside Colombo but particular thanks go to staff at the Institute of Policy Studies in Colombo and especially to Chandi Chanmugam, David Dunham, Saman Kelegama, Howard White and to Vasantha for computer assistance. The usual disclaimers apply.

'export processing' (tea, rubber and coconut processing) and 'small industries' were static during the 1980s. The 'factory sector' seems to be dualistic, split between a domestically-oriented sector (DOI) and an export-oriented sector (EOI) but with both sectors being highly import-intensive.

4. The liberalisation of 1977 was characterised by a sharp devaluation and liberalisation of imports and an emphasis on exports. However the period since 1977 can be split into two phases (section 1.4). The first phase up to the mid-1980s was characterised by high government expenditure but the period since the mid-1980s has been characterised by a reduction in the role of the public sector and by a privatisation programme. Nevertheless in 1990 government expenditure in Sri Lanka remained high relative to other South Asian countries -- and in Sri Lanka, the government's budget deficit averaged 11.9 per cent of GDP over the five years covering 1987 to 1991 inclusive -- and even if capital expenditure is excluded, there was a budget deficit which averaged 1 per cent of GDP.

5. There are good theoretical reasons why the state should intervene to promote industrialisation and those newly- industrialising countries (NICs) such as South Korea and Taiwan that have industrialised with spectacular speed and success have done so with the support and discipline of considerable state intervention (section 2.1). By contrast, state intervention in Sub-Saharan Africa (SSA) has been seemingly less successful, but a number of economists suggest that SSA's poor economic performance is due as much to structural features as to poor state intervention.

6. The intervention of the South Korean state was effective because of the 'autonomy' of the bureaucracy (section 2.2). As a result of the changes in the class structure in South Korea, the bureaucracy found itself with a lot of 'political space' in which to work. The situation in Sri Lanka is quite different, with Sri Lankan capitalism being characterised by a mercantile orientation and being dominated by 'rentier capitalists' who make profits by finding politically-inspired monopolies in the market.

7. One of the major issues in Sri Lankan industrialisation concerns the exchange rate. In spite of the sharp devaluation of 1977, the Sri Lankan rupee needs a considerable further devaluation if the large current account deficit is to be eliminated (section 3.1). However, to do this would require a massive cut in living standards. Thus for the foreseeable future Sri Lanka is likely to remain heavily dependent on foreign capital inflows in the form of aid, loans and direct investment. Between 1978 and 1991 the rupee has not been devalued in real terms relative to the US dollar -- if anything there has been a slight revaluation in real terms. However Sri Lanka's trading pattern changed

quite considerably in the 1980s and, relative to its trading partners as a whole, there has been a real devaluation since 1985. On this measure then Sri Lanka has become more competitive.

8. Nevertheless the current account deficit continues at a high level (at more than 7 per cent of GDP if official aid receipts are taken out of the current account). The dependence on foreign capital inflows will continue and the structure of Sri Lanka's trade is such that it will have to depend on selective intervention in trade to expand the dollar value of exports and to reduce the dollar value of imports.

9. The theoretical arguments are strong both for and against trade protectionism and subsidies to promote industrialisation (section 4.1). The strongest argument for subsidies is that they are more transparent and more likely to be subjected to review. However the arguments against subsidies are that they increase government expenditure and risk retaliation from other countries.

10. One solution to this problem might be for the government to give support through protection in the domestic market but only on condition that the recipient of the subsidy exports a certain proportion of the production. This 'cross-subsidization was the policy followed by the South Korean government in the 1960s and 1970s and under such conditions the risk of 'picking winners' for the world market is reduced (section 4.2). Such a policy of cross-subsidisation stands in stark contrast with that of Sri Lanka where protection has not been linked to export targets. As a result little has been done to break down the dualism of the manufacturing sector in Sri Lanka.

11. The linking of production for the domestic market with production for the export market is a major lesson that comes from the experience of South Korea and which the Sri Lankan government could follow. However the implementation of such a 'support-and-discipline' policy requires that the Presidential Tariff Commission, the Export Development Board and the GCEC (now the Board of Investment) work closely together in doing detailed cost-benefit analyses of industries (sections 4.3 and 4.4). In any case, such studies are desirable to analyse the effects of the selective policies (protectionism, tax holidays, export subsidies, export quota allocations, subsidised loans, etc) currently adopted.

12. A major policy issue in Sri Lanka is whether there is a trade bias in favour of or against exports. For firms operating within GCEC agreements there is a bias in favour of exporting. For those not subject to GCEC-type agreements, there is probably a bias against exports. The overall or average effect is probably a bias against exports (section 4.4). In any case, the major policy issue is not whether to promote exports or production for the domestic market but how to

encourage the integration of the two, and in section 4.4, I suggest various policy proposals for promoting such integration.

13. The debates about the financing of industrial investment are discussed in section 5. It seems that Allan Roe's arguments put forward in 1982 are still relevant and that there is a place for the state-sponsored provision of cheap loans for approved long-term investment in Sri Lanka. Such a policy was followed with considerable success in South Korea in the 1960s and 1970s. Thus the South Korea evidence casts doubt on the McKinnon-Shaw arguments for the liberalisation of interest rates. Unfortunately Sri Lanka's long-term funds tend to be channelled into the short-term financing of the very large budget deficit and the structural problems identified by Roe are still present.

14. At Sri Lanka's stage of development (I argue in section 6.1), the adaptation of existing technology is more important than innovation. Reverse engineering is more important than research and development and comparisons of Sri Lankan with current South Korean expenditure on R and D are misleading. At Sri Lanka's stage of development, South Korea's expenditure on R and D was tiny.

15. Reverse engineering requires a much bigger pool of skilled labour than Sri Lanka has available at present. Sri Lanka has a multitude of training schemes but few of them are much good. The essential problem is that the training system is supply-driven and as a result it is not meeting the needs of the users. Section 6.2 puts the argument for a levy-grant system so that the users are supported-and-disciplined to do the training of vocational labour. There are encouraging signs that the Sri Lankan government is moving in this direction.

16. Section 7 of this paper restates the argument for an interventionist industrial policy, but recognises that in the Sri Lankan political context, interventionism may take the form of patronage. It is argued that nationalisation in Sri Lanka has been associated with patronage and has deterred the formation of medium-scale enterprises in the private manufacturing sector. This is particularly unfortunate since in the research of Little, Mazumdar and Page, medium (not small) is beautiful. Privatising the nationalised industries may provide some solution to the problem, provided that it does not give rise to political patronage. However, the paper ends by expressing doubts about whether the 'shareholder capitalist' model of the US and UK is a good one for Sri Lanka. Much of the weaknesses of the American and British economies are said to lie in their 'short-termist, shareholder capitalist' structures. There is little likelihood that such a model would be successful in transforming Sri Lanka's mercantile economy into a dynamic, industrial NIC on South Korean or Taiwanese lines.

DEVELOPMENT STRATEGY AND INDUSTRIAL POLICY - ISSUES FOR SRI LANKA

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1. DEVELOPMENT STRATEGY - STRUCTURAL ISSUES AND HISTORICAL CONTEXT

1.1 Growth in Sri Lanka - Patterns, Problems and Perspectives

The growth of real national income in Sri Lanka in the 45 years since political independence in 1947 has been slightly over 4.5 per cent per annum. Growth in the 1980s - at about 4 per cent per annum - was slightly below this average, but in the past two years - 1990 and 1991 - the annual growth rate has been higher at about 5.5 per cent.[1]

The Sri Lankan government has a target of doubling average income per capita between 1990 and the year 2000. Assuming an annual growth rate of the population of around one per cent, this 100 per cent target increase in per capita income is equivalent to an increase in real national income of about 120 per cent over the same 10-year period - or an average annual rate of about 8 per cent.

What are the chances of achieving this target? What does the target imply for investment and employment? What does it imply for the growth of the manufacturing sector?

The implications for investment depend on the efficiency with which investment is used, that is on the incremental capital-output ratio (ICOR) - on how much extra investment is needed to produce an extra unit of net output. In the 1980s, the ICOR in Sri Lanka seems to have been about 7, but in the second half of the 1980s it came down to about 6.6. However, in the second half of the 1980s, the ratio of investment to real income also fell. Between 1986 and 1990 investment in Sri Lanka averaged about 23 per cent of real income, so that, given an ICOR of 6.6, the average annual increase in real income was about 3.5 per cent.

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1. In this paper, I refer many times to growth rates in national income, but it is important not to make a fetish of aggregate income statistics. It is important to note that national income may be raised by employing people who produce little of social value. Thus the American economist, Milton Friedman, has argued that the growth rates in the national incomes of centrally-planned economies (such as the USSR and China) have overstated the real welfare increase in those countries because many of the goods and services produced were not subjected to the test of the market. Conversely the GNP of a capitalist economy in which income distribution is highly unequal (for example Brazil) or in which ethnic conflicts are acute (for example Sri Lanka) may be inflated by large expenditures on state and/or private security services.

If this performance of the second half of the 1980s is repeated into and through the 1990s, what are the implications for employment? As in most countries, there are good political grounds for considering unemployment in Sri Lanka to be a serious problem. It seems likely that even if unemployment was not the sole cause of the JVP insurgencies of the early 1970s and late 1980s, it was a major catalyst. This social and political importance of employment was emphasised by the Ministry of Industries' Strategy for Industrialisation in 1989 when it pointed out that;

> "About 4 million young people have to be found gainful employment by the end of the century. If not, the cohesion of the social fabric and the future of the country would be in jeopardy" (Ministry of Industries, 1989, 1)

Unfortunately the 'cohesion of the social fabric' has been in jeopardy for at least the past two decades with unemployment in Sri Lanka running at above 10 per cent of the labour force over the whole of that period. Table 1 summarises the available figures.

Table 1
Employment and Unemployment in Sri Lanka - 1971-1990

	Employment (mns.)	Labour Force (LF) (mns.)	Unemployment	
			(mns.)	% of LF
1971	3.55	4.30	0.75	17
1930/81	4.74	5.58	0.84	15
1982	4.84	5.89	1.05	18
1984	5.50	6.40	0.90	14
1985/86	5.18	6.02	0.84	14
1989	5.47	6.67	1.20	18
1990	5.95	6.95	1.00	14

Sources: Edwards 1988 201; Kelegama and Wignaraja, 1992a, 121; Kelly 1992, 1,27; White 1992 Appendix

What are the prospects for the future? As is implied by Table 1, the figures on employment and the labour force vary considerably between one source and another, but it seems that the labour force is growing at about 2 per cent a year, so that the supply of jobs needs to grow at that rate to keep unemployment at its present level. However the **net** supply of jobs depends on the growth of labour productivity and on this there are few reliable figures. The Asian Development Bank gives an estimate of about 3 per cent per annum for the recent past (see reference in White 1992, 11) but the rate at which labour has been absorbed seems to suggest a lower annual rate of productivity growth - of about 1.5 per cent through the 1980s. Assuming this lower rate of productivity growth suggests that the real economy (real net output) needs to grow by at least 3.5 per cent per annum - the rate of increase of the second half of the 1980s - to prevent unemployment from rising. However if the faster rate of productivity growth (of about 3 per cent per annum) is achieved, then the annual growth rate in the economy would have to be about 5 per cent per annum - the rate of increase of the last two years.

However even with this rate of growth, there seems to be little hope of significantly REDUCING unemployment below the 'present' (1990) level of 14 per cent of the labour force.

An increase in real income of 5 per cent per annum requires either;

- an investment-to-income percentage of 33, assuming the ICOR of the recent past, namely 6.6; or,
- an ICOR of 4.6, assuming the investment-to-income percentage of the recent past, namely 23

What are the prospects of either of these? First let us look at the investment-to-income percentage. The prospects of a significant increase here are not very good. Over the five-year period from 1986 to 1990, the investment-to-income ratio of 23% was financed from the following sources;

- national savings 15.6% (12.7% from domestic savings and 2.9% from private transfers less factor payments on direct foreign investment (DFI) and loans);
- foreign sources 7.6% (2.7% from official transfers, 4.4% from loans - including concessional loans - and 0.5% from net inflows of DFI[2]).

What are the prospects of raising any or all of these? The prospect of increasing the national savings ratio is not good. Domestic savings are unlikely to rise significantly with income since DISSAVING by the public sector is unlikely to change rapidly even with a quick settlement of the war in the North and East of Sri Lanka. Between 1988 and 1990 negative saving by the public sector (the excess of current expenditure over current revenue) in Sri Lanka was equivalent to about 1.5 per cent of GDP compared to positive saving by the public sector in Thailand, South Korea and Malaysia of at least 3 per cent of GDP (see World Bank 1992a, 45). The private transfers-less-factor-payments item is unlikely to rise significantly and so it is unlikely if the national savings-to-income ratio can be increased to much above 17% within the 1990s.

What about foreign savings? Again here the prospects are not good. Sri Lanka has been extremely fortunate in mobilising very high levels of grants and concessional loans. But these are unlikely to rise from the present level of 6.5% of GDP given competing demands for aid from Eastern Europe and given the stated desire of the Sri Lankan government not to increase its aid exposure. Private loans are not likely to be increased significantly given the cost of servicing them, so that we are left with direct foreign investment (DFI).

In the 1980s flows of DFI into Sri Lanka were small compared to the DFI flows into many other Less Developed Countries. Thus in 1990, DFI into Sri Lanka was only 0.4% of its GDP which compares with 0.9% into Indonesia, 1.1% into Pakistan and 6.8% into Malaysia. However in 1991, approved DFI into Sri Lanka had risen to about 2.6% of GDP (see Tilakaratne, 1992, 7). There is a good possibility that DFI inflows can

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2. This is the net **capital** inflow on the DFI account. Note that dividends and profits remitted to foreign direct investors is included already in the factor payments (as a negative national saving) section of the current account.

be maintained at around 2 to 3 per cent of income so that a reasonably optimistic outlook would be of total foreign savings being maintained at an average of 11% of real national income. Table 2 summarises the actual savings for 1986-90 and a reasonably optimistic scenario up to the year 2000.

Thus the conclusion must be that national savings in Sri Lanka are unlikely to rise much above 18 per cent in the years up to 2000. As a result, Sri Lanka will be unable to invest even the present 20-25% of real income unless it continues to resort to foreign savings whether in the form of grants, loans or DFI. If we further assume that the likely sustainable inflow through grants, loans and DFI is about 11% of GDP, then the maximum investment would seem to be about 29% of real income.

At the present ICOR of 6.6, such an investment level gives a growth rate in annual real income of about 4.4 per cent, probably enough to prevent unemployment from rising but no more. To achieve the target 8 per cent annual growth rate, the ICOR would have to be reduced to 3.6 assuming an investment-to-income ratio of 29%. And if we assume that the deterioration in the external terms of trade continues at the same rate as between 1986 and 1990, then the growth rate in net output would have to be at least 10% per annum to give an increase in purchasing power of 8% per annum.[3] For an investment ratio of 29%, the ICOR would have to be close to 3 to achieve a growth rate in net output of 10% per annum.

Clearly if we assume that the investment/GNP ratio cannot be increased to much above 29%, then the growth of productivity has to be raised to increase the growth rate of income. There are two ways in which the ICOR can be reduced;

(i) by substituting labour for capital so as to economise on capital; or
(ii) by producing more net output from the same input of labour and capital.

Thus whereas increasing the ratio of investment to income increases the growth of income AND employment, the same does not apply to increasing the ICOR. Employment (but not income) can be increased by substituting labour for capital to produce a given level of output while income (but not employment) can be increased for a given level of investment by raising the efficiency of capital and labour.

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3. The increase in Sri Lanka's net output is likely to have to be greater than 8 per cent per annum if it is assumed that the loss from a decline in the external (barter) terms of trade continues at the 1986-90 level. In 1990, Sri Lanka's GNP would have been something like 10 per cent higher if the external terms of trade had remained at the 1986 level, since 10 per cent was the terms of trade adjustment for the 1986-90 period relative to actual real GNP (see table 4, CBAR 1991). Thus the annual loss was equivalent to about 2 per cent per annum. Not only is this loss very large by international standards but it would seem to be understated by the method adopted by the Central Bank. For it seems that the Central Bank calculates the loss on the basis of exports, but with Sri Lanka running a large Balance of Trade deficit over these five years, this understates the loss. If the loss were calculated on the basis of imports (which were 37% higher than exports on average), the annual loss would be closer to 3 per cent for these five years as opposed to the 2 per cent shown in table 4 of the Central Bank report.

Table 2
Savings in Sri Lanka - 1986-90 Actual Figures and the Outlook for the 1990s

	Percentage of GDP	
	1986-90 actuals	1990s outlook
Domestic savings	12.7	15
Private transfers less factor payments	2.9	3
National savings	15.6	18
Foreign savings		
- official transfers	2.7	3
- plus concessional loans	3.8	4
Equals aid	6.5	7
- plus other loans, and	0.5	1
- DFI	0.5	3
Equals total foreign savings	7.5 (i)	11
Total savings	23.1	29

Note (i): This is not the same as the current account deficit because the deficit is defined in the National Accounts to include official transfers. Thus for 1986-90, the current account deficit as defined was an average of 4.8% of GDP, matched by loans and DFI.

Source: CBAR 1991

The substitution of labour for capital can take place within an industry but it can also take place by changes in the composition of output. One would expect that labour intensities vary between sectors and therefore would be likely to affect the trajectories of employment and income. If so, then the composition of output would be an important determinant of the mix of income and employment growth in the future. This is the theme of a paper by Irma Adelman published in 1990 (see Adelman in Kerkoven 1990). Some implications of her arguments are discussed in the next sub-section.

1.2 The Problems of Industrialisation - and the Problems of Agriculture ?

In her paper, Adelman argues that the sectoral mix of output has important implications for the substitution of labour for capital. She argues that the employment elasticity of the industrial sector is typically very much lower than the employment elasticity of the agriculture and the service sectors. Given this, if Sri Lanka's development strategy is based on industrialisation and income growth is derived largely from the growth of the manufacturing sector, then, she argues, the growth in a given average income is likely to be alongside an increasing inequality of income.

Adelman's argument is that as (export-led) industrialisation proceeds, the demand for unskilled labour is likely to be weak and the bargaining power and real wages of the unskilled will fall behind, so increasing inequality. In addition to arguing that the elasticity of total employment with respect to output is significantly different in

each sector, she adds another argument, namely that the elasticity of types of employment (skilled and unskilled labour) with respect to output is significantly different in each sector.

Thus Adelman's argument is not only that the employment elasticity of the industrial sector is lower than that of the agricultural and service sectors. It is also that total factor productivity growth (TPFG) in industry is biassed towards skilled labour and displaces unskilled labour whereas in agriculture, TFPG is consistent with the GROWTH of demand for unskilled labour. And so, Adelman argues, if income is increased through industrialisation, then inequality is bound to grow.

Adelman argues for what she refers to as an agriculture- development-led-industrialisation strategy. Adelman argues that these are not pie-in-the-sky suggestions. She claims that simulations of such a strategy for South Korea and other NICs show its superiority. However this is where her argument begins to be somewhat confused and confusing, for she then argues that growth in South Korea and Taiwan was based not only on high-productivity agriculture but also on export-led growth in industry (Kerkoven (ed) 1990, 20). She then further moves away from the agricultural emphasis by arguing that even during the high point of growth in the major export industries (textiles and clothing) in South Korea and Taiwan only about 36% was exported and 64% was consumed domestically (Kerkoven (ed) 1990, 20), so that the industrialisation was not exclusively export-led.

Thus it seems that in her short paper, Adelman is recommending a balanced growth path with the 'industrialisation' of BOTH the agricultural and industrial sectors. This, she argues, is what happened in both South Korea and Taiwan. However a slightly different emphasis is given in the paper by Guimaraes (1991, 12). He agrees with Adelman that agriculture was developed rapidly in Taiwan through to the 1960s, but he also argues firstly that the agricultural sector was already well- developed in South Korea and Taiwan at the end of Japanese colonialism and secondly that a surplus was sucked out of agriculture in the 1960s (see Guimaraes 1991, 12). In South Korea, a surplus was sucked out of agriculture during the 1960s through a decline in the internal terms of trade for agriculture brought about by the government's procurement of grain and monopoly control over fertiliser supply and facilitated by the provision of cheap food under US aid programmes (see Edwards 1992, 120). A similar process took place in Taiwan.

At the same time in both South Korea and Taiwan, this extraction of surplus was not accompanied by the increasing immiserisation of the peasantry. The extensive land redistributions in both countries at the end of Japanese colonialism effectively permitted the rents previously extracted by landowners to be transformed into low prices of the staple wage good (rice) for industry (see Amsden 1979 and Edwards 1992).

Thus the relationship between the development of agriculture and industry is a complex one. The agricultural sector contains a reserve army of the underemployed and in the early stages of development it generally provides the major input (staple food) into industrial labour. Furthermore in Sri Lanka plantation agriculture plays a direct role in eaming foreign exchange. However, as Guimaraes emphasises, agriculture is unlikely to be able to play a **leading** role in development. As he points out, no agriculture-based economy has ever achieved a per capita income of above US$500 for any significant period of time (Guimaraes 1991, 1).

Although a detailed discussion of the prospects for growth from the agricultural sector in Sri Lanka is beyond the scope of this paper, even a cursory examination suggests that the prospects for success of an agriculture-led development strategy in Sri Lanka are not good. This is the case whether we look at the rice, plantation or 'other agriculture' sectors.

Table 3 shows that the growth in RICE yields per hectare were good from the beginning of the 1970s to the mid-1980s, but Sri Lanka is still not a low-cost producer for the world market. The table shows that the ex-farm gate price in 1990 was about 11 per cent above the world price, so that the prospects of large rice exports from Sri Lanka are not good since the scope for cutting production costs is small - the rice-producing areas already contain the majority of Sri Lanka's poor (see Edirisinghe 1990).

Table 3
Rice in Sri Lanka - Output, Yields and Prices

	Averaage for the periods		
	1970-1976	1977-1985	1990
Paddy output (mn tonnes)	1.38	2.17	2.54
Paddy yield (000 kg./ha)	2.52	3.02	3.45
Yield growth (% p.a.)	1.1	5.4	-
A. Rice equivalent farm-gate price (US$/tonne)	271	205	272
B. Rice import price (cif) (US$/tonne)	184	226	245
A as a percentage of B	167	96	111
% of farm-gate price to black market import price	79	80	n.a.
Employment in paddy production (000)	795	832	1075

Source: World Bank 1992a, 27

When we look at the PLANTATION sector, the prospects are no brighter. On the 'small country'[4] assumption, the producer in the plantation sector has been heavily taxed in Sri Lanka and this has undoubtedly held back the development and restructuring of the sector. Between 1982 and 1986, the profitability indices for tea, rubber and coconut all fell (see Edwards 1988, 196). As a result of the historical neglect of the plantation sector in Sri Lanka, physical yields are relatively low in Sri Lanka for

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4. This is a common assumption but one which may easily lead to mistakes in policy. In particular it may lead to what Michael Lipton has referred to as the 'fallacy of composition'. By this he means a situation in which the production of crops are encouraged for which (in the world markets) there is both a low income elasticity of demand and a low price elasticity of demand. This means that the world market for such crops is growing only slowly with rising income, so that as crop productivity and supply in the world market increase, the price (relative to other goods) falls. Unfortunately because of the low price elasticity of demand, the quantity demanded does not increase significantly with the fall in price. A classic example of such a crop is tea. Thus unless all major exporting countries agree to impose an optimum export tax (or agree through say quotas) to cut back their production, they will all suffer. In other words although the expansion of tea production may be good for each producer looked at in isolation, when all are considered the effect is harmful. This is what Lipton means by the 'fallacy of composition' (see Lipton 1987) - the whole is greater than the sum of the individual parts.

tea and rubber and the prospects for a sharp increase in export volume are far from bright. There is some scope for the upgrading of plantation exports (again see Edwards 1988, 206), but there are no realistic prospects of the plantation sector playing a leading role in the further development of Sri Lanka's economy. This is particularly the case if the 'small country' assumption is relaxed (see again footnote 4). By encouraging the exports of the plantation sector (through, say, a sharp devaluation of the rupee), countries like Sri Lanka producing primary commodities (for which the market grows slowly) could invite a competitive devaluation from the other tea-producing and natural rubber producing countries. Sri Lanka's short term gain would be everyone's long term loss. (In section 4 of this paper I discuss the implications of devaluation in more detail).

Finally the immediate prospects of a dramatic rise in the exports from 'OTHER AGRICULTURE' are not good. Given present technologies and yields, the net returns per labour-day for most 'other agricultural' crops are not significantly higher than those from paddy (see table 4 below).

Table 4
Financial Returns - 'Other Field' Crops Compared with Rice

	Net return (Rs. per work-day) with present technology
Maha season (rainfed)	
- chillies	63
- green gram	50
- black gram	48
- rice (rainfed	49
Yala season (irrigated)	
- red onions	102
- black gram	80
- rice (irrigated)	88

Note: That ONLY those crops with net returns close to or above rice are shown in the table. In the maha season, cowpea, groundnut, maize, soyabean and sesame all give a financial return significantly below that of rainfed rice, and in the yala season, chillies, groundnuts, green gram, soyabean and cowpeas all give returns lower than rice. All returns are based on costs excluding labour costs and all are based on 1987 prices. Source; World Bank 1992a, page 30

Thus for most 'other agricultural' crops, the returns are small. With these low returns and in addition the poor transportation infrastructure, the prospects for a significant increase in the exports of 'other agriculture' crops are weak (for more on 'other agriculture' see Dunham 1992).

Thus from this admittedly brief look, it seems doubtful whether agriculture can lead development in Sri Lanka. Nevertheless it is likely to provide some useful back-up to the manufacturing sector, as it has in the past - see table 5 below.

Table 5
Growth Rates in the Sri Lankan Economy - 1970-1991

	% per annum increase in net output			
	1970-77	1978-82	1983-86	1987-91
GDP	3.1	6.2	4.9	4.0
Manufacturing	1.7	4.6	6.7	6.3
Agriculture	2.3	4.0	4.0	3.0
Services	3.6	7.4	5.1	3.6

Source: World Bank 1992a, 3 and CBAR 1991

The table suggests shows that the value added of the agriculture sector has grown at a rate of a little under 4% per annum over the past decade or more. This is very much slower than that of the manufacturing sector. This is not surprising. The manufacturing sector has tended to be the most dynamic force in the development process in country after country. The statistical studies of the growth process have shown that for countries with small populations we would expect the value added in the manufacturing sector to grow at about 1.4 times the pace of the net output of the economy as a whole. Sri Lanka more or less matches this expectation for the period since 1982. Thus if we want national net output to grow at something like 5 per cent per annum, then we would expect the manufacturing sector's value added to have to grow by 7 per cent per annum.

But what happens to employment if growth is led by the manufacturing sector? Unfortunately the employment statistics in Sri Lanka are not sufficiently reliable to answer this question with much confidence. Table 6 on the next page gives figures for employment and net output by sector and from these I have calculated the value added per employee for each of the three years, 1971, 1982 and 1990.

The table shows some seemingly odd results with value added per employee in the manufacturing sector falling from Rs 37,000 in 1971 to Rs 23,000 in 1982 and then rising again to Rs 34,000 in 1990. I find it difficult to explain these figures. The most likely explanation is that the employment figures (derived from Kelegama and Wigneraja 1992a, 121 and table 1 of this paper) are inaccurate, especially for 1981/82. It seems unlikely that the labour-intensity of the manufacturing sector rose between 1971 and 1982 (as is implied by the value added per employee figures). Indeed the opposite is generally accepted to be the case, at least for the period between 1977 and the early 1980s. Thus it has been argued that between 1977 and 1983 the number employed in the garments manufacturing sector rose sharply by some 35,000 but alongside this there was a drop of some 40,000 in the number of jobs in the handloom sector as a result of the liberalisation programme of the late 1970s (see Kelegama and Wigneraja 1992a, 133, Kelegama 1992a,19 and Osmani 1987, 195).

However if we rely on the 1971 and 1990 figures it is clear that if the growth of the Sri Lankan economy is led by the manufacturing sector, then the prospects for aggregate employment are not good unless either the growth rate of the manufacturing sector is particularly rapid or unless particularly labour-intensive industries develop rapidly. If the figures in table 6 for 1982 and 1990 are to be believed what has been happening over those eight years is that labour productivity in the manufacturing sector has risen by an average of about 5% per annum while labour productivity in the agricultural and service sectors has been more or less stationary. Labour productivity in

the economy as a whole seems to have risen at an average of between 1% and 2% over the 1982-90 period with under-employment in the agricultural and service sectors increasing. Under such circumstances 'employment' becomes a slippery concept.

Table 6
Net Output and Employment by Sector - Sri Lanka- 1971-90

	Agriculture	Manufacturing	Mining and services	Total
1971				
Net output (Rs. bn. in 1982 prices)	20.6	12.2	40.0	72.8
Employment (mn)	1.78	0.33	1.44	3.55
Value added per employee (Rs.000)	12	37	28	21
1981/82				
Net output (Rs. bn. in 1982 prices)	25.0	13.6	56.1	94.7
Employment (mn)	2.48	0.60	1.76	4.84
Value added per employee (Rs.000)	10	23	32	20
1990				
Net output (Rs. bn. in 1982 prices)	30.9	24.0	80.5	135.4
Employment (mn)	2.72	0.71	2.51	5.95
Value added per employee (Rs.000)	11	34	32	23

Sources: CBAR 1991, table 3; IFS Yearbook 1991; Kelegama and Wignaraja, 1992a, 121; White 1992, 32; Table 1 of this paper.

Given this, it is difficult to assess the effects of future economic growth on employment. Clearly if net output in the manufacturing sector grows at 7 per cent a year but with labour productivity growing at 5 per cent a year, then employment in the manufacturing sector will grow at only 2 per cent a year, which is about the annual growth rate in manufacturing employment over the 1982-90 period (again if the figures are to be believed). Clearly under such circumstances the agricultural sector and especially the service sector are going to have to soak up much of the increase in the labour force. They will have to provide the 'reserve army of the underemployed'. This is why a reduction in public sector employment has to be gradual while alternative sources of employment arise.

The somewhat bleak employment prospects in Sri Lanka might be thought to make a case for slowing down productivity increases in the manufacturing sector. This would be a mistake. The manufacturing sector needs to continue to increase its productivity if it is to remain the driving force of development in Sri Lanka. This is because for manufacturing growth to be rapid, it has to be export-led and to be export-led it has to be internationally competitive. The alternative of relying on the domestic market is unlikely to be viable. The Sri Lankan market is simply too small to provide the basis for an efficient, dynamic manufacturing sector.

However it needs to be emphasised that an export-led growth is not the same as a free market-led growth. This is one lesson that comes from the spectacular growth record of South Korea and Taiwan, as we shall see in section 2. However before looking at the policies necessary to achieve export-led industrialisation, it is useful to

set the scene by looking at the structure of the manufacturing sector in Sri Lanka and then at the nature and effects of the liberalisation programme adopted in 1977.

1.3 The Manufacturing Sector in Sri Lanka: Structure and Growth

Unfortunately the statistical base for painting a good picture of the manufacturing sector (ISIC 31) in Sri Lanka is weak. The Department of Census and Statistics (DCS) is the main agency responsible for collecting statistics although other government agencies also collect statistics on the manufacturing sector. The DCS carries out the Annual Survey of Industries based on a sample of 5,000 enterprises taken from a Register of Establishments. Unfortunately as the World Bank points out (1992a, 100, fn.);

> "the latest Survey reports only the estimated sector-wide employment based on the survey responses".

Thus the Survey did not blow up the figures to provide national estimates (DCS, 1991, 6), and as a result, the Survey is of limited use for statistical analysis.

If we switch to the Central Bank Annual Report, the net output of the manufacturing sector between 1970 and 1991 - in Rs.bn. and as a percentage of national net output or GDP - is shown below in table 7.

Table 7
Net Output in Manufacturing: Sri Lanka - 1970-91

(1982 prices)	1970	1976	1982	1991	
Net output (value added)	rs. bn	rs. bn	rs. bn	rs. bn	%
Tea, rubber and coconut processing	3.1	3.0	2.8	3.3	14
Small and 'other' industry	1.0	1.3	2.0	2.0	8
Factory industry	5.7	6.3	8.8	18.7	78
Total manufacturing	9.8	10.6	13.6	24.0	100
GDP	57.4	67.1	94.7	129.2	
Manufacturing as a percentage of GDP	17	16	14	19	

Sources: Guimaraes 1991 29; CBAR 1991.

Three points can be made about these manufacturing sector figures. **Firstly,** over the whole of the period, the manufacturing sector has not been the dynamic sector that might be expected for a country at Sri Lanka's stage of development. In the 1970s, the growth in the sector was slower than the average for the economy as a whole, although from 1982 the growth rate has been faster than that of the economy as a whole, with its value added rising from a share of 14 per cent in 1982 to 19 per cent in 1991. The **second** point which is related to this is that Sri Lanka's manufacturing sector is 'underdeveloped' relative to its per capita income and population especially if the manufacturing sector is defined to exclude the export processing sub-sector. Then the manufacturing sector accounts for only 16 per cent of total GDP in 1991 well below the 'norm' of about 19 per cent for a country of Sri Lanka's population size and per capita income (estimated from UNIDO 1988/89). The **third** point that can be made is that, within the manufacturing sector, the share of export processing together with small and other industries has declined from 42 per cent in 1970 to only 22 per cent in 1991. The dynamic sub-sector has been factory industry especially in the 1980s with its share

growing from 65 per cent in 1982 to 78 per cent in 1991. It can be seen from the table that the value added of the small and other industries sub-sector was the same in 1991 in real terms (that is at 1982 prices) as it was in 1982.

Since the share of 'factory industry' in the total manufacturing sector is now so large (78 per cent in 1991), it is convenient to focus attention for more analysis on this sub-sector. Here I switch to the 1990 figures because the latest available Annual Survey of Industries is for 1990.

There is a sharp distinction within the 'factory industry' sub-sector between those industries which are heavily export-oriented and those which are heavily oriented towards sales in the domestic market. The gross outputs together with estimated exports for each sub-sector are shown in table 8 below

Table 8
Gross Outputs and Exports: Manufacturing: 1990

ISIC (International Standard Industrial Classification)		Gross output (rs. bn)	Exports (rs. bn.)	% of exports to gross output
Domestically-oriented industries (DOI)				
31	Food, beverages and tobacco	22.0	1.3 (i)	6
33/34	Wood and paper products	2.6	0.5 (ii)	19
35	Chemicals, petroleum, rubber and plastic products	21.2	6.3	30
36	Non-metallic mineral products	7.6	1.0	13
Export-oriented industries				
32	Textiles, clothing and leather	27.9	26.2	94
37/38	Basic metals, metal products and machinery	5.2	2.4	46
Totals/average (iii)		86.5	37.7	44

(i) mostly (Rs 0.9 bn.) shellfish and fish
(ii) mostly (Rs. 4.0 bn.) petroleum products.

Sources: Tables 17 and 42 of CBAR, 1991

(iii) In this table, the total output of the manufacturing sector excludes ISIC 39 (Rs. 0.3 bn.) while exports exclude jewellery and diamonds (Rs 3.8 bn.) even though these are included by Table 42 of CBAR 1991 under the heading of 'manufacturing exports'.

It is not possible to say from published statistics whether these two EOI and DOI sectors are 'enclaves' in the sense that they import a large proportion of their material inputs. However it seems that in the mid-1980s almost all sub-sectors imported at least half of their raw material inputs - the major exception being the food, beverages and tobacco industry (see Kelegama and Wigneraja 1992a, 132). However more recent figures are not available.[5] The Annual Survey only gives material inputs without differentiating between imports and inputs from domestic sources. Kelegama and Wigneraja have stated that;. "..the Sri Lankan manufacturing sector depends substantially on imported inputs" (1992a, 125); and from interviews with government officials and managers in the private sector, it would seem that almost all industries ARE enclaves in this sense. The problems stemming from this enclave characteristic are discussed in more detail in section 4.

5. Although the data on individual manufacturing firms collected by Cuthbertson et al 1992 (Appendix A) suggested that import-dependence was high.

As already stated, the statistics on employment in the manufacturing sector are very imprecise. The employment for 1990 given for the manufacturing sector by the Annual Survey (page 9) was 244,000. The World Bank in 1992 has pointed out that this is less than half of the manufacturing employment[6] given in the labour force survey (World Bank 1992a, 100). The Asian Development Bank gives a figure for manufacturing employment in 1990 of over 700,000 (see White 1992, 32), and so, it seems, the picture on manufacturing employment is very confused. Certainly the Annual Survey figures do not provide a detailed picture of employment in the manufacturing sector.

1.4 Development Strategy in Sri Lanka - The Period Since 1977

The period since 1977 has been characterised as a period of liberalisation, but the liberalisation programme has not been a uniform one. In 1977 a number of steps were taken to change the regulation of the economy. Interest rates were raised, import controls (through tariffs and quotas) were reduced, the exchange rate was unified,[7] exchange controls were relaxed and price controls abolished (Osmani 1987, 177 and Tilakaratna 1992, 8). As far as the manufacturing sector was concerned there was a marked switch in emphasis towards exports; the Export Development Board was established and the Greater Colombo Economic Commission was set up in 1978 to promote the establishment of Free Trade Zones.

Nevertheless following 'liberalisation' a huge share of investment continued to be undertaken by the public sector through the Mahaweli scheme and the Housing programme. Furthermore whereas in the period from 1970 to 1976, ten per cent of annual current public expenditure was spent on transfers to public enterprises, in the period from 1977 to 1985 almost 25 per cent was spent in this way (Athukorala and Rajapatirana, 1991, 11). It is only since 1988 with an emphasis on privatisation that the share of the private sector in total investment has risen sharply (see table 9 below):

Table 9
Investment (Gross Domestic Capital Formation) in Sri Lanka - 1978-91
(at current market prices)

	1982 %	1988 %	1989 %	1991 %
Private sector	48	48	51	63
Public corporations	36	26	23	18
Government and public enterprises	16	26	26	19
Total GDCF				
- %	100	100	100	100
- Rs. bn.	30.5	50.5	54.7	86.4
GNP (Rs. bn.)	100.3	221.4	250.1	373.7
% of GDCF to GNP	30	23	22	23

Sources: Tables 1 and 7 of CBAR 1991.

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6. This is in spite of the fact that the gross output given by the Annual Survey was, at Rs. 71.4 bn., over 80% of the gross output for factory industry given by the CBAR 1991.

7. Prior to 1977, a multiple exchange rate system was in force. A Foreign Exchange Entitlement Certificate Rate (FEEC) had been introduced in May 1968. The official exchange rate applied to essential imports and traditional exports while the higher FEEC rate applied to non-essential imports and non-traditional exports. The premium was initially 45 per cent but then rose later to 65 per cent (see Tilakaratna 1992, 4,6). The devaluation of the unified currency was equal to about 30 per cent on a transaction-weighted basis (see Osmani 1987, 177)

However in spite of some reduction in recent years in the role of the public sector in Sri Lanka, the share of public expenditure in Sri Lanka's GNP remains well above that of other countries in South Asia. (see Table 10)

Table 10
Central Government Expenditure (CGE) - 1990 - South Asia

	Sri Lanka	Bangladesh	Pakistan	India
CGE as % of GNP	28	15	24	18
Per capita GNP ($)	470	210	380	350
CGE per capita ($)	132	32	91	61

Sources: World Bank 1992b, 218,238

In the same way as there has been a shift towards the private sector over the post-1977 period, so there has been a shift in the official manufacturing strategy. In 1987, the Ministry of Finance and Planning issued an Industrial Policy Statement which stated that "there was a clear and unambiguous need for industrialisation" (MFI 1987, para 2.1). The Industrial Policy Statement favoured - low protection (para 3.4); - an exchange rate which is not overvalued (para 3.9); - compensatory support for exporters to provide a broadly neutral incentive structure (para 5.1); - the introduction of a Transferable Tax Credit (TTC) (para 5.4); - the commercialisation of public enterprises (para 8.4); - the raising of interest rates except to exporters (para 9.1); and- the attraction of DFI (para 10.1)

According to UNIDO, this Industrial Policy Statement did not provide adequate guidelines for industrial development in Sri Lanka (see UNIDO 1988). However about a year later the Ministry of Industries issued a slightly more detailed Strategy of Industrialisation in Sri Lanka. In this, by comparison with the 1987 Industrial Policy Statement there was a greater emphasis on exports (para 1.6), on the development of human resources (section 7), on lower interest rates to industry (para 3.1), on tax holidays on reducing tariff differentiation (section 5), and on developing the infrastructure (section 10). The 1989 Strategy stated the government's intention of setting up an Industrialization Commission (page 20).

In sections 3 to 6 of this paper, I look at these industrial policies in Sri Lanka to see how they operate and what their effects are. But before doing that I look briefly at the general arguments for and against government intervention to promote industrialisation and at the lessons from industrialization and industrial policy in East Asia and Sub-Saharan Africa.

2. INDUSTRIALISATION AND INDUSTRIAL POLICY - STATE INTERVENTION OR THE FREE MARKET ? WHAT CAN WE LEARN FROM THEORY AND PRACTICE?

2.1 State Intervention or the Free Market ? - Theory and Practice

In the previous section, I argued that the main motor for future growth in the Sri Lankan economy would have to be industrialisation. But if this is to be the case, will it develop most efficiently and rapidly through the free market or through state

intervention? If the state is to intervene, in which markets should it intervene? These are questions that I look at in some detail in sections 3 to 6. However before doing so, it is useful to look at the general case for and against state intervention to promote industrialisation.

This is an issue on which there has been and continues to be considerable debate. The debate has been especially lively since the early 1980s when it has focused on the Newly- Industrialising Countries (NICs) and on the spectacular growth of South Korea and Taiwan in particular.

In 1983, the World Bank's World Development Report (WDR) presented an analysis which suggested that there was an inverse relationship between 'distortions from the free market' and economic growth. The implications of the presentation were that if a country adopted 'free markets', then growth would be fast.[8]

The methodology that the World Bank used in that study has been subjected to fierce criticism (see Evans and Alizadeh 1984 and Wade 1990, 19) and the equation of growth in certain economies with free market operations has been subjected to attack. For example South Korea was one of the countries picked out by the World Bank as combining few distortions and rapid growth. Yet most of the detailed research that has been done on the South Korean economy covering the period between the 1960s and the 1980s paints quite a different picture. The research suggests that there was considerable intervention by the South Korean government. In fact one writer has gone as far as to say 'No state outside the Socialist bloc ever came anywhere near this measure of control over the country's investible resources' (Datta-Chaudhuri in Lee (ed) 1981, 56). A similar emphasis is given by Alice Amsden in her book **'Asia's Next Giant; South Korea and Late Industrialisation'.** She emphasises that the South Korean government used a mixture of discipline and support to create dynamic comparative advantage and she argues that the South Korean state was able to pick winners (see Amsden 1989, 139).

It is now fairly widely accepted that in not just South Korea but also other NICs that have industrialised rapidly, there has been considerable intervention by the state. Detailed research (see Rodan 1989, Van Liemt 1988, Wade 1990 and White 1988) has shown considerable state intervention to be evident not only in South Korea but also in Singapore and Taiwan. These states intervened in a number of areas or 'markets', so that to say that their economies 'suffered few distortions from the free market' is highly misleading.

However talk of distortions is itself somewhat misleading since it implies that a 'perfect market' exists as a standard by which to judge the operations of the economy. Even Hayek, the Austrian economist who is usually associated with advocacy of the free market, stated that;

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8 The early 1980s was a period in which the neo-classical counter-revolution was at a high point. This was a period in which state intervention was being particularly heavily criticised. Jokes were being made that 'Latin America only develops at night when the government sleeps' and UNCTAD which was advocating state intervention was said to stand for 'Under No Circumstances Take Any Decision'.

> "Probably nothing has done so much harm to the liberal cause as the wooden insistence of some liberals on certain rough rules of thumb, above all the principle of laissez-faire" (Hayek, 1986, 13)

The model of a perfect free market is wrong not only because of the well-known problems posed for the market by the existence of public goods, externalities and natural monopolies but also because of the less well-publicised problems posed by market transactions and coordination costs. The recent development (or rather resurrection) of games theory and 'Institutional Economics' (see Aoki et al (eds) 1990, Chang 1991, and Williamson 1985) has highlighted these difficulties. A major problem with the uncontrolled free market is that it tends to make a 'bonfire of the certainties' and for the 'free market' to cope at all adequately with uncertainty requires such a multiplicity of contracts that the transactions costs rapidly escalate.

Thus it is increasingly recognised that to compare government failure with market perfection is wrong. **Instead it is argued that what economists should be doing is to compare market failure with government failure.** This has been recognised to a considerable extent in a recent World Bank publication on industrial development in Korea, India and Indonesia where it is argued that;

> "The case for interventions to remedy market failures depends on three things; the nature of the market failures in question; the availability of market-based solutions; and the ability of the government to design and implement correct solutions...." (see World Bank 1992c, 1)

Once the inevitability of 'free market' failure is acknowledged, then the desirability of government intervention grows. The test for state intervention then becomes a less stringent one and the case for the government pursuing an active industrial policy and disciplining as well as supporting industry becomes much stronger.

However does state intervention always succeed? Some would point to the experience of Sub-Saharan Africa (SSA) and say 'no'. The argument is that in SSA there has been a relative lack of success alongside considerable state intervention. SSA economic performance has been weak. Certainly between 1965 and 1990, GNP per capita in SSA grew in real terms at 0.2 per cent per annum (compared with an average for Sri Lanka of 2.9 per cent per annum - World Bank 1992b, 218) and between 1980 and 1990 the manufacturing sector in SSA grew at an annual average of only 3.1 per cent compared with Sri Lanka's 6.3 per cent (World Bank 1992b, 220). Thus in spite of its weakness relative to South Korea, Sri Lanka's industrial performance has been outstanding relative to that of SSA. Why? What, if any, are the lessons from SSA?

The first point that needs to be made is that there are no easy generalisations that can be made about SSA's relatively weak economic performance over the past 25 years. There are 45 or so national economies within SSA and they vary considerably in history and political and economic structure. They also vary considerably in economic performance, with some having very good long-term growth records. Thus Lesotho and Botswana have both experienced faster growth rates in real GNP per capita between 1965 and 1990 than Sri Lanka and the annual (real GNP per capita) growth rates in Burundi, Cameroon, and Mauritius have all been 3 per cent or more. Because of this diversity, a 1989 World Bank report is correct in saying;

".....there are no quick fixes and no simple blueprints" (World Bank 1989, 185).

However a common thread running through World Bank reports on SSA has been that poor state policy has provided the major explanation for the poor growth record of SSA and in a useful article entitled "Explaining Africa's Post-Independence Development Experiences", Tony Killick cites the following weaknesses of government policy in SSA (1992, 22-30);

(i) inappropriate exchange rates, particularly in the 1970s;
(ii) high taxes and (state) marketing margins on exports;
(iii) heavy protection on production for small domestic markets;
(iv) excessive state consumption and weak state enterprises.

However, having cited these weaknesses, Killick argues persuasively that it is too simplistic to say that poor state policies fully explain the poor growth record of SSA. He argues that the World Bank has placed too little emphasis on the structural 'economic' and historical weaknesses in the SSA economies. One of the most important of these is the smallness of the SSA economies and the low density of income. Thus in 1990 the 'density of income' in SSA was only $7,000 per square kilometre compared with densities many times as great in Sri Lanka ($110,000 per sq. km.) and South Korea (over $2 mn. per sq.km.).

This low density of income in SSA is likely to have been and continues to be a barrier to the growth of the manufacturing sector insofar as industrialisation is characterised by economies of scale. The importance of scale economies in the manufacturing sector is implied in the work of Kuznets, Chenery and others who have shown that not only does the manufacturing sector acquire increasing importance as GNP per capita increases, but its importance is greater (for a given GNP per capita) the larger a country's population.

Thus it seems plausible to argue that small domestic markets and low 'densities of income' in the countries of SSA prevent producers from achieving the necessary economies of scale to be competitive in the world market. It seems that industry is necessary to development, but that industry thrives on economies of scale which may not be easily achievable in the small national markets of SSA.

Other 'economic' weaknesses of SSA are, to an extent, historically derived. One is the low level of education; a second is the concentration of the economy on primary products for which the trend in the external terms of trade has been weak. In the first respect SSA differs from Sri Lanka; in the second, SSA and Sri Lanka are similar and both have suffered.

Thus the education level in SSA was extremely low at the time of Independence in the 1960s (see Fransman 1982, 33 and Killick 1992, 43), whereas at Independence Sri Lanka had a highly literate and educated population.[9] Even now the education and literacy levels in SSA are still very low compared to those of Sri Lanka. For example the

9. However the substantial difference in the average per capita incomes of SSA and Sri Lanka should be noted. Even as long ago as 1965 (but in 1990 prices), the GNP per capita in Sri Lanka was above that of present-day SSA. GNP per capita in Sri Lanka in 1965 was about US$220 (in 1990 prices) compared with US$200 in SSA in 1990 (estimated from World Bank 1992b, 219).

percentage of the relevant age group enroled in secondary schools in SSA in 1989 was only 18 compared to 74 in Sri Lanka (World Bank 1992b, 274,275).

On the second, terms of trade, aspect, SSA has suffered (like Sri Lanka) a sharp decline in the external (net barter) terms of trade. However SSA has suffered less than Sri Lanka. Between 1966 and 1986 SSA's annual loss averaged about a third of a percentage point of national income (see ODI 1992, 4) compared to an annual loss for Sri Lanka over the same period of over half a percent of national income.

It could of course be said that it is a failure of government policy in both SSA and Sri Lanka that they have not diversified sufficiently out of weak primary commodities to avoid these deteriorations in the terms of trade.[10]

However to diversify an economy needs some strength in the economy in the first place. This is the argument of Paul Mosley on the effects of Structural Adjustment when he says;

> "In countries such as Guyana and Ghana in the early 1980s, caught in a process of systemic decline, 'structural adjustment' in the liberalising sense can be described only as a historical irrelevance..." (Mosley in Balasubramanyam and Lall, 1991, 242).

Thus, Mosley argues, once it is acknowledged that there are severe structural obstacles to development, intervention will be required to help the economy over these obstacles.

But in which markets should the state intervene? As the recent World Bank study on industrialisation points out, there are a number of markets which are likely candidates. The study states that FACTOR market failures are likely in areas such as; physical infrastructure, labour markets, human capital, science and technology, capital and financial markets; technology imports and various industry-related institutions. The same World Bank study also pointed out that there are also PRODUCT market failures which may arise for three reasons; anti-competitive behaviour by large firms in oligopolistic markets; lack of information and high transactions costs in marketing; and the effects of international competition on new entrants who have to bear significant 'learning' costs (World Bank 1992c, 2). The study goes on to point out that the South Korean government intervened in almost all these areas.

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10. Alternatively it can be argued that a continuing concentration on primary products has provided a better income growth path than the realistic alternatives, although this is doubtful. It is doubtful if we bear in mind the low price elasticity of demand (PED) for primary products. Thus taking tea as an example, it has been estimated that the PED for tea in the world market is -0.33 (see Godfrey 1985). Since Sri Lanka's share of the world tea market has in recent years averaged about 17 per cent, this implies that the PED for Sri Lankan tea is -0.33/0.17 = -1.9 or approximately -2. The relationship between the marginal revenue from exports and the PED can be shown to be;
MR = p (1 + 1/PED), so that when the PED = -2, we have;
MR = p (1 + 1/-2) = 0.5p
This means that the additional revenue from an extra unit of tea exports is only half the export (fob) price. This is because the additional output drags the price down in the weak world market and affects the revenue from the **existing** output. Thus it is likely that with a marginal revenue per pound of tea equal to only about half the price, tea production in Sri Lanka is not a viable vehicle for development.

In this paper I discuss these forms of intervention under the headings of exchange rate policy in section 3; selective trade policy (covering marketing, linkages, and infant industries) in section 4; capital markets in section 5; and human capital and technology in section 6. Physical infrastructure and the pattern of ownership are briefly discussed in the last, concluding, section.

Thus in sections 3 to 6 of the paper I move away from generalisations about the desirability of state intervention in general to more detailed arguments about specific forms of intervention. However these interventions need to be considered within the framework of a particular political structure since the political structure may itself constitute an obstacle to 'effective' intervention. It is important to recognise that the state is not merely a 'black box' but is part of the problem as well as the solution.

2.2 Is The Political Framework Conducive to Efficient Intervention ?

Once we begin to recognise the importance of the political context for intervention, an interesting question that immediately arises is: why did the South Korean bureaucracy manage to discipline as well as support business? For, in spite of some 'corruption' in South Korea, the bureaucracy was able to promote rapid industrial growth through flexible and highly selective action. It was able to do this because, as has been emphasised by a number of writers (especially by Amsden 1989, Hamilton, 1986 and Johnson in Deyo (ed) 1987), the South Korean state was not 'captured' by particular interest groups or classes.

Amsden, Hamilton and Johnson all emphasise that:

- the landlord class was weakened by the land reform programme undertaken soon after the end of Japanese colonialism;
- the domestic, merchant capitalist class which was in any case quite small in the 1950s since much of the Japanese capital had been taken over by the state, was weakened further by the campaign against illicit wealth and by the nationalisation of much of financial capital at the beginning of the 1960s; and,
- the growth of a labour aristocracy was impossible because of the repression of organised labour and a substantial labour surplus through the 1960s and 1970s.

As a result, the South Korean bureaucracy, which had been strong under Japanese colonialism, and which had been further strengthened by the large aid programmes of the 1950s, found itself, especially from the second half of the 1960s, with a large 'political space' in which to work. Industrial policy which was increasingly centralised through the Economic Planning Board after the Park coup in 1961, could be, and was highly selective and effective. With the subordination of financial to industrial capital as represented by the state, the stage was set for a period of rapid industrial accumulation facilitated by wages which were low, due to anti-trade union pressure, low food prices and a labour surplus.

When we look at SSA, it can be argued that the situation has been quite different. In general, Killick argues, in Africa the state has been less autonomous (and

'weaker') than in the South Korea of the 1960s and 1970s. However it needs to be noted that a 'weak' state may be just as incapable of enforcing free markets as of intervening effectively. As Amsden has argued, to impose free markets requires just as 'strong a state' as does extensive and effective intervention (Amsden 1989, 18).

Thus whether free markets or controlled markets are being advocated it is important to take account of the particular configuration of political forces in the country. It has been argued that the World Bank has failed to do this in the context of SSA and many economists and political scientists have criticised the World Bank for not paying sufficient attention to political characteristics and constraints in making its recommendations for market reforms. In other words the criticism is that these political constraints need to be explicitly taken into account in formulating policy.

This lack of attention exists even though, in 1989, the World Bank admitted that "Underlying the litany of Africa's development problems is a crisis of governance...." (World Bank 1989, 60). How is this crisis to be explained? Although I do not have the space to go into a more detailed discussion here (see Killick 1992, pages 34-40 for more on this), there are a few points which it is useful to note. For example, Hyden has argued that low population densities and 'indirect' colonial rule in SSA have enabled 'traditional' social structures to survive, these structures being characterised by vertical (ethnic) rather than horizontal (class) political groupings. Such vertical structures, it is argued, are hostile to 'formal bureaucratic principles' (see Hyden 1986). Connected with this is the idea that capitalism has not sufficiently 'broken open' African society. Geoffrey Kay has argued that merchant capital, which makes its profit not by revolutionizing production but by controlling markets, tends to block the development of productive facilities. Kay argues that in many parts of the South (and especially in Africa) merchant capital has remained powerful, and as a result, "we have to face the unpalatable fact that capitalism has created underdevelopment not simply because it has exploited the underdeveloped countries but because it has not exploited them enough" (Kay 1975, 55).

Kay's reference to merchant capital is very relevant to the situation in Sri Lanka, since a number of economists and political scientists have argued that Sri Lankan capitalism is essentially a merchant form of capitalism. The most recent argument along these lines is that put forward by Mick Moore (see Moore, 1992). Moore argues that Sri Lankan business or capitalism is characterised by;

- a mercantile orientation;
- a lack of specialisation; and,
- manifestations of what he calls 'closedness' in business relations.

These characteristics are engendered, he claims, by the high foreign trade orientation of the economy, the political and economic risks and 'interference' in the economy, the legal framework, the nature of management engendered by the plantation economy and the privileging of loan over equity capital. All this, Moore says, means that there are limited pressures on businesses to obtain a high rate of return on assets.

While I agree with much of what Moore says, I have two problems with his analysis. Firstly he does not define one essential characteristic of merchant capitalism, namely that it makes its profits by buying cheap and selling dear - that is by having a monopoly position in the market. The problem stems not from the lack of pressure to

obtain a high rate of return on assets but rather from the **way** in which the rate of retum is obtained. The 'social' problem of merchant capitalism is that resources are spent in searching out politically-inspired and/or spatial monopolies. This contrasts with the pressure on industrial capitalism to make higher profits (or to just survive) by improving the productivity of inputs and/or the design/quality of the output. If this argument is accepted, then we can move on to the second criticism of Moore's analysis. Why is the privileging of loan capital a problem? It may be a problem in the **particular** conditions in which it has operated in Sri Lanka but in general the privileging of loan capital is not necessarily harmful. Indeed it has been argued that the dominance of long-term loan (or bank) capital in Germany and Japan has given industries in those countries a great advantage over the UK and USA in which a 'short-termist' culture has been encouraged by the dominance of equity capital (see Ball 1991, Dore 1985, Eltis 1992, and Walker 1985). Having said this, it should be pointed out that Moore recognises that shareholder capitalism might not be a solution to the problems of Sri Lanka's mercantile capitalism (see Moore 1992, 46 et seq.) and that the 'governed market' model of France, South Korea or Taiwan might be better.

Thus the major problem with the sort of capitalism that exists in Sri Lanka is that not that it aims to make a profit but that it makes its profit in a way which is not socially beneficial. What is needed in Sri Lanka is a 'controlled market' system in which businessmen are forced to look and to plan beyond the next day or the next month or the next year. What is needed is a system of controlled markets in which businessmen are forced continually to search for higher productivity ways of making profits. This is the issue which needs to be borne in mind when considering the various markets and the nature of market failure.

However if useful guidance is to be given on industrial policy, we need to raise not only the question;

(i) In which markets should the state intervene to exert control and to make the markets work more efficiently?
..but also...
(ii) What is the political framework within which intervention will take place? Does the political framework mean that the intervention can achieve the desired effect? What, in other words, is the shortest path for transforming merchant capitalism into industrial capitalism?

I tackle the first question by looking at a number of markets about which there has been considerable debate and discussion both in Sri Lanka and elsewhere. I discuss the second question in the final section of the paper.

3. EXCHANGE RATES AND INDUSTRIALISATION

One of the most commonly discussed industrial policy weapons is the exchange rate. Changing the exchange rate is also one of the weapons for changing a balance of payments deficit, the others being monetarist and expenditure-reducing policies. Monetarist policies act by reducing domestic credit expansion whereas expenditure-reducing policies act more directly by reducing the level of aggregate 'real' demand and therefore by reducing the volume of imports. In this paper I do not discuss the relative

merits of these other balance of payments weapons, but instead merely focus on expenditure-switching, namely devaluation.

In preparing this paper, I held many interviews with businessmen and government officials and in discussing the role of the exchange rate in industrialization, there were strong feelings both in favour and against devaluation.

Exchange rate policy is intimately connected with selective trade policies such as protective tariffs, quotas and export subsidies, since a revaluation of the rupee, making Sri Lankan goods less internationally competitive, will reduce the protection afforded to domestic industry by tariff and non-tariff barriers.[11] Similarly if a devaluation of the rupee is a real one,[12] then exports are also assisted since a real effective devaluation reduces the ratio of the price of non-traded goods (and most notably labour) to traded goods. Thus the effect of a real devaluation on the pattern of industrialisation depends on the importance of non-traded goods in the production process. The major non-traded 'good' is labour and in so far as a devaluation is successful (is 'real'), the incentive given by devaluation will be greater for labour-intensive exports.[13]

In looking at the exchange rate, three questions need to be considered;

(i) is the Sri Lankan rupee overvalued? if the answer to this question is 'yes', then;
(ii) can the Sri Lankan government bring about a medium-term real devaluation or is a change in the nominal exchange rate likely to be cancelled out by rising prices in the Sri Lankan economy? and,
(iii) even if a real devaluation can be brought about, is it likely to be effective in correcting the overvaluation?

3.1 Is The Rupee Overvalued ?

There are some economists whose answer to this is 'no'. They argue that the rupee has not been significantly overvalued since the large real devaluation in 1977. For example in his 1985 study of effective protection in Sri Lanka, Geoffrey Walton estimated that the shadow price of foreign exchange for that year was 30 rupees to the dollar compared to an average actual exchange rate of about 27 rupees to the dollar. Thus, he argued, the rupee was only slightly overvalued.

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11 Thus in writing on industrial development in Thailand, Jansen notes that between 1981 and 1987 a rise in the effective rate of protection was swamped by a real depreciation of the baht (Jansen, 1991).

12. Note that in this paper I use the term 'real effective exchange rate' to refer to a trade-weighted exchange rate adjusted for inflation differentials between Sri Lanka and its trading partners. 'Effective' refers to the trade-weighted and 'real' refers to the adjustment for inflation differentials.

13. This not only assumes that the devaluation is a real one, but also that the devaluation does not itself cause a change in the relative prices of traded goods. The latter assumption - usually called the 'small country' assumption - is almost certainly not a realistic one for Sri Lanka. Many of the prices of the goods in which Sri Lanka trades in the world market are **not** independent of the volume of Sri Lanka's own exports and imports, an obvious example being tea. (See footnote 10 for more on this).

More recently, Cuthbertson et al (1992) have argued that;

"With the overall balance of payments in surplus in 1990, with exchange controls substantially liberalised and with no large, unusual and obviously temporary inflows in the balance of payments accounts, we can only conclude that any continuing overvaluation of the rupee remains to be proven" (Cuthbertson et al 1992, 55).

This seems a surprising statement given the huge inflow into Sri Lanka of grants and concessional loans since 1978. These are surely 'large and unusual' although they are not 'obviously temporary' with aid inflows having continued at between 6 and 8 per cent of GNP for more than a decade. Nevertheless the Sri Lankan government's aim is to reduce its reliance on aid so that in its eyes at least, these are temporary inflows. As pointed out in section 1.1, the current account deficit between 1986 and 1990 averaged a little under 5 per cent of Sri Lanka's GDP even after official transfers (amounting to 2.7 per cent of GDP) had been credited. Thus foreign savings amounted to something like 7.5 per cent of GDP. With a gap between national savings and investment of this magnitude, it is surely nonsensical to say that the rupee is not overvalued.[14]

However even if it is agreed that the rupee **is** overvalued, can a real devaluation be brought about? This takes us on to the second question.

3.2 Is a Real Devaluation Possible ?

If we look at Sri Lanka relative to its largest trading partner, the USA, the record since 1977 is mixed. As figure 1 shows, in 1978 there seems to have been a large devaluation in both nominal and real terms but, since then, the nominal devaluation of the rupee against the US dollar has been more than cancelled out by prices rising faster in Sri Lanka than in the USA. The net result has been that the real exchange rate of the rupee relative to the dollar fell by about 11 per cent between 1978 and 1991.

Thus the evidence is mixed. A sharp real devaluation was brought about in 1978 but the nominal devaluations since then seem to have been cancelled out by price rises.[15] A number of economists have argued that Sri Lanka's inflation has been caused not by excessive demand in the domestic economy but by cost-push factors (see Liyanage 1992). For example Deepak Lal has argued that;

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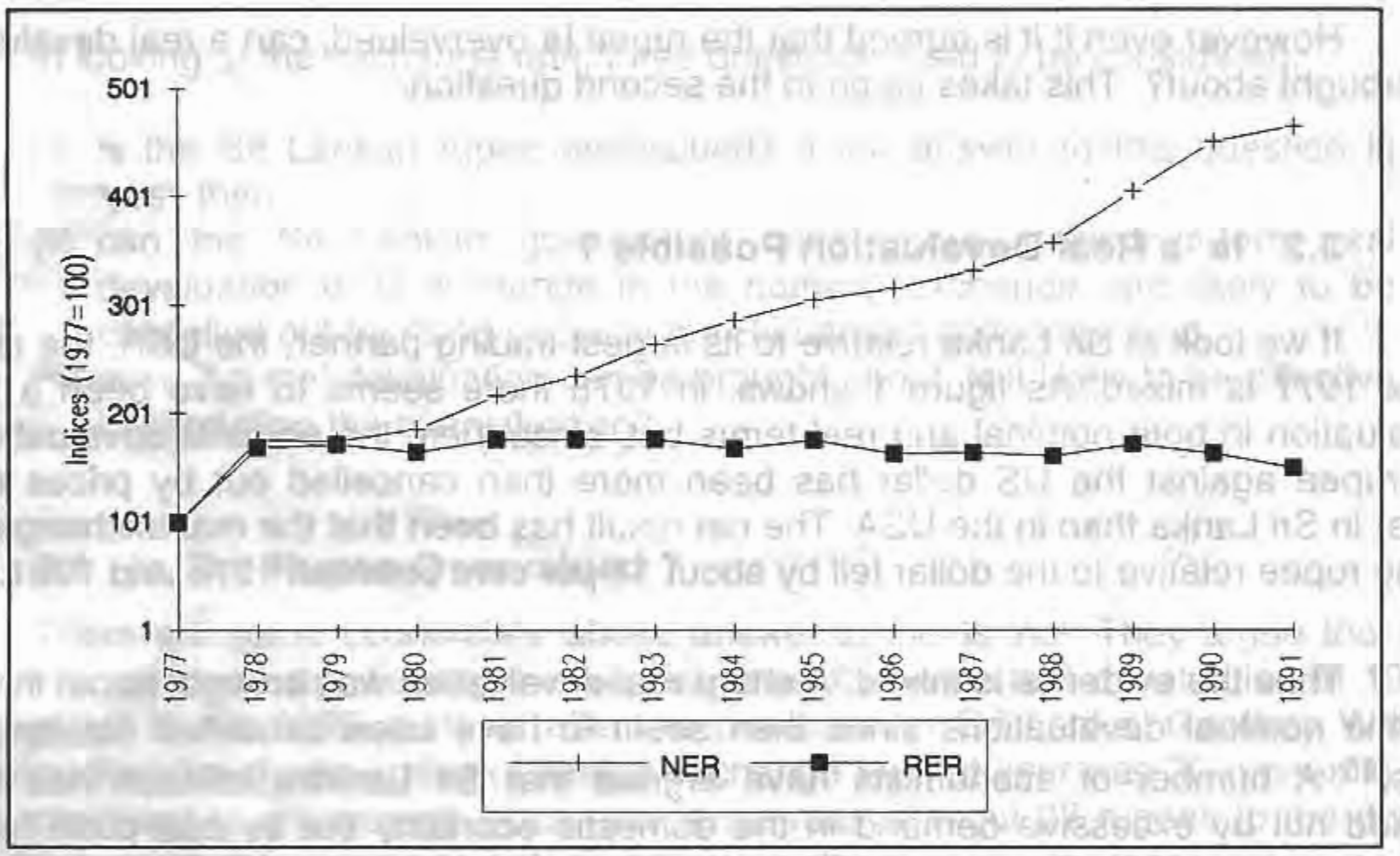
14. The issue of overvaluation is linked with the lively debate about exchange controls in Sri Lanka. On the one hand, Cuthbertson et al implied that exchange controls are not very restrictive in Sri Lanka (1992,3), although they admitted that the extent to which exchange controls "still bind is a matter for more detailed investigation" (1992, 54). On the other hand, in a paper published in September 1991, Lakshman and Nicholas estimated that the complete dismantling of exchange controls would cause a deterioration in the current account of the balance of payments of at least 3%-4% of GDP (1991, 25) so that in their view exchange controls still have a considerable rationing effect. Accordingly they argued that Sri Lanka was not in a position to justify a policy thrust towards the total elimination of exchange controls (1991, 26).

15. The real exchange rate in figure 1 was calculated by multiplying the index of the nominal exchange rate by the ratio of the wholesale price index in the USA to the consumer price index in Sri Lanka. This real exchange rate is probably the most reliable way of indicating changes in the competitiveness of Sri Lanka relative to the USA.

> "Most of the inflation that Sri Lanka has experienced since 1977 can be accounted for by these two factors (a rise in foreign currency prices and the devaluation of the nominal exchange rate)" (Lal, 1985)

Nicholas and Yatawara 1991 also emphasise that "credit expansion would appear to have played no more than an accommodating role" (in sucking in imports and causing inflation) (1991, 3 - see also White and Wignaraja 1991, 19,20). They argue that purely exogenous rises in the prices of imports are a major factor in raising imports and increasing inflationary pressures in the Sri Lankan economy and that a significant factor in pushing up imports has been foreign aid. A slightly different role for foreign aid is emphasised by White and Wigneraja who have argued that aid inflows have played a significant role in pushing up the prices of non-traded goods and have thereby prevented nominal devaluations from being reflected in real devaluations (White and Wignaraja 1992).

Figure 1 : Exchange Rates
(Sri Lankan rupee against the US$)



Thus, although there is some consensus that inflation in Sri Lanka is caused by cost-push factors, it is not clear to what extent these cost-push factors are aggravated by a nominal devaluation. The nominal devaluation of 1977/1978 was successfully reflected in a real devaluation and yet later devaluations seem to have been cancelled out by rising prices. Why? It could be that the sharp improvement in Sri Lanka's terms of trade in 1976 and 1977 helped to keep prices from rising and from cancelling out the sharp devaluation of November 1977. (The important effect of the external terms of trade on Sri Lanka's balance of Payments is highlighted in a paper on external shocks by White and Kelegama 1992).

However looking at the rupee/dollar exchange rate can be misleading, since Sri Lanka's trade with the USA has declined relative to its total over the period since 1977. And if we move away from looking just at the rupee/dollar exchange rate,

we get a somewhat different picture. If we look at Sri Lanka's real exchange rate weighted by the actual trade pattern between 1981 and 1990, then there does seem to have been a significant real devaluation between 1986 and 1990 as shown in figure 2. From figure 2 we can see that Sri Lanka's trade-weighted real exchange rate

Figure 2 : Real Exchange Rates
(Against all currencies and US$)

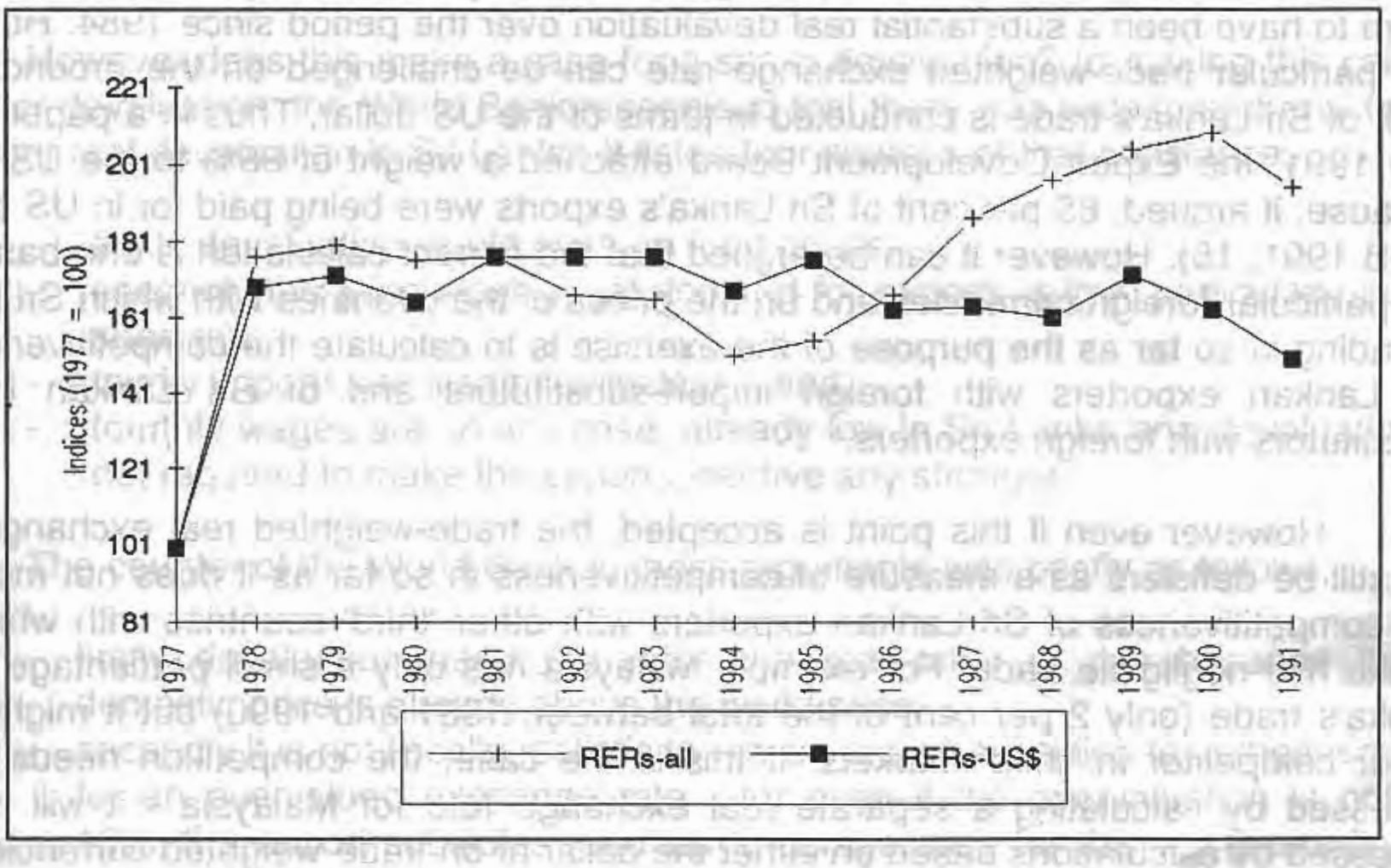


Table 11
Trade Weights (1981-90) and Real Exchange Rates (1991) - Sri Lanka

	Share of 1981-90 trade (%)	Real exchange rates (1977 = 100)	
USA	20.4	163	150
Japan	16.2	188	186
United Kingdom	8.9	226	216
Germany	7.7	183	169
Iran	7.1	786	730
Saudi Arabia	6.2	86	81
Singapore	6.0	149	135
India	4.6	124	100
Korea South	3.4	158	148
Pakistan	3.4	112	100
Belgium-Luxembourg	2.9	128	114
Netherlands	2.9	172	158
South Africa	2.9	162	156
France	2.8	206	189
Thailand	2.4	138	136
Australia	2.3	167	149
Totals/averages	100.0	209	195

Notes: Real exchange rates were calculated by multiplying the nominal exchange rate index by the foreign country's wholesale price index and then dividing by Sri Lanka's consumer price index. In two cases (Saudi Arabia and France) the foreign country's consumer price index was used. Some countries with significant trade shares (Hong Kong, 3.1%; China(Taiwan),2.7%; China(People's Republic), 2.7%; and Malaysia, 2.0%) were excluded because complete data were not readily available. The countries shown above accounted for about two-thirds of total trade with Sri Lanka between 1981 and 1990.

rose sharply from 1984 to 1990. The real devaluation over these 6 years was almost 40 per cent whereas over the same period the real exchange rate appreciated against the US dollar by about 3 per cent.

The country-by-country trade weights (for 1981-1990) and real exchange rates for 1990 and 1991 (for 1977 = 100) are shown in table 11.

Thus if we look at the trade-weighted exchange rate in figure 2, there would seem to have been a substantial real devaluation over the period since 1984. However this particular trade-weighted exchange rate can be challenged on the grounds that most of Sri Lanka's trade is conducted in terms of the US dollar. Thus in a paper dated July 1991, the Export Development Board attached a weight of 85% to the US dollar because, it argued, 85 per cent of Sri Lanka's exports were being paid for in US dollars (EDB 1991, 15). However it can be argued that the correct calculation is one based on the particular foreign currencies and on the prices of the countries with which Sri Lanka is trading in so far as the purpose of the exercise is to calculate the competitiveness of Sri Lankan exporters with foreign import-substitutors and of Sri Lankan import-substitutors with foreign exporters.

However even if this point is accepted, the trade-weighted real exchange rate will still be deficient as a measure of competitiveness in so far as it does not measure the competitiveness of Sri Lankan exporters with other 'third' countries with which Sri Lanka has negligible trade. For example Malaysia has only a small percentage of Sri Lanka's trade (only 2 per cent of the total between 1981 and 1990) but it might be a major competitor in 'third' markets. If this is the case, the competition needs to be assessed by calculating a separate real exchange rate for Malaysia - it will not be assessed by calculations based on either the dollar or on trade-weighted currencies.

3.3 Would Devaluation Eliminate the Balance of Payments Deficit ?

In 1987 the World Bank argued that;

"to maintain even a substantially reduced growth rate, while containing the current account deficit at manageable levels, would require a change in the exchange rate policy" (World Bank 1987a, 31).

But what change? What is a realistic exchange rate policy? In 1986, the trade-weighted real exchange rate was close to its 1978 level, but the World Bank posed the question "as to whether bringing the exchange rate to its 1978 level is sufficient" (World Bank 1987a, 31). There were four reasons why the Bank doubted whether it was sufficient;

- firstly Sri Lanka s barter terms of trade had deteriorated sharply since 1978;
- secondly Sri Lanka's debt service had grown considerably since 1978;
- thirdly even with the devaluation that had taken place, the profit margins of the traditional exporting sectors were very low; and,
- fourthly Sri Lanka`s competitors had devalued their currencies at a faster pace than Sri Lanka.

All of these were undoubtedly true in 1987 and continued to be true in 1992. Sri Lanka's terms of trade has continued to worsen since 1987; the ratio of external debt to GNP was slightly higher in 1990 than in 1987; the profit margins of the traditional exporting sector remained low; and if Sri Lanka's main competitors are thought to be India, South Korea, Pakistan, Singapore and Thailand (see EDB 1991, 24), three of these (India, Pakistan and Singapore) had significantly more competitive (relative to Sri Lanka) real exchange rates in 1991 than in 1987 while those of South Korea and Thailand were more or less the same.

However does this make a case for a sharp devaluation? In making this call for a further devaluation, the World Bank recognised that there was widespread resistance to further real devaluation in Sri Lanka. It listed four sources of that resistance;

- firstly devaluation would push up food prices;
- secondly the price elasticity of demand for exports is low, particularly in the short run;
- thirdly imports are also price inelastic; and,
- fourthly wages are, in any case, already low in Sri Lanka and devaluation is not required to make the export incentive any stronger.

The counter of the World Bank to these arguments was briefly as follows;

- firstly devaluation need not raise the real price of rice because the domestic price is already above the world price;
- secondly it is not fiscally realistic to rely on export subsidies to compensate for an overvalued exchange rate - for even if the overvaluation is only 10%, the export subsidies required to compensate for this will (according to the World Bank) be 0.5% of GDP even without including garments, petroleum and traditional exports;
- thirdly the import rigidity can only be overcome by an aggressive exchange rate policy; and,
- fourthly what is needed is an expansion of employment and devaluation will help to expand employment.

Some economists would not be convinced by such arguments (especially the third and fourth). To correct the Balance of Payments deficit through a real devaluation requires highly elastic supply and demand curves for exports and imports. But (as the World Bank seems to realise) such an assumption is not realistic for many of Sri Lanka's exports and imports. For example traditional exports probably have a low price elasticity of demand in world markets and a low price elasticity of supply (at least in the short run). Non-traditional exports may also face a low price elasticity of demand in foreign markets because of the quota system on garments. Thus devaluation would give higher profits (in rupee terms) to the garment producers but this may be remitted overseas. Admittedly the level of profits might make Sri Lanka more attractive to foreign investors but with Sri Lanka producing at or near its quota limit, the scope for further DFI in garments would be constrained. A real devaluation may also not have the effect of reducing imports particularly of machinery, since the price elasticity of demand for imported machinery is probably quite low in Sri Lanka.

Thus there must be large doubts about whether a real devaluation would succeed in correcting the deficit on the current account of the Balance of Payments. It seems that exports from Sri Lanka have not been particularly price-responsive and that

non-price factors and changes in world markets seem to be at least as important as devaluation in increasing exports (see Nicholas et al 1990, 20-23, White and Kelegama, 1992, 27 and Kelegama 1992a, 31).[16]

Given these doubts about the efficacy of devaluation, it seems likely that Sri Lanka will continue for some time to come to run a substantial deficit on the current account of the balance of payments. There must be doubts as to whether what the World Bank calls "a more realistic exchange rate policy" (see World Bank 1987a, 32) would be effective in reducing let alone containing the external deficit. The developmental question is what the balance should be between, on the one hand, selective encouragement to exports through cheap finance, tax holidays etc and to import-substitutes through tariffs, quotas, etc and, on the other, general encouragement through devaluation. The liberalisation programme of 1977 eliminated the formal multiple exchange rates (MERs) that Sri Lanka was then operating. Now Sri Lanka still has what amounts to MERs - a mixture of import protection and export subsidies - though admittedly not on the scale of the MERs of the 1970s.

The argument for general encouragement through real devaluation is that Sri Lanka is well-placed to expand its exports; it has low wage rates, a plentiful supply of well-educated labour and, at present, a small percentage of world trade so that retaliation is unlikely. But there are also strong arguments against; restriction is likely if the exports are concentrated in certain sectors (as for garments and the MFA quotas); the volume of traditional exports cannot be expanded without risking a further sharp deterioration in the external terms of trade; machinery imports cannot be easily substituted by domestic production; and to expand exports across a wide front is likely to take time given the risks and economies of scale in exporting.

The argument then is that to create a sufficiently large incentive for a widespread expansion in manufactured exports and a balancing of the current account requires a massive squeezing of living standards (see Kaldor 1984, 1094). Even if this is considered theoretically necessary, it is likely to be politically impossible. In other words, the government may simply be unable to effect a major devaluation in **real** terms for more than a short period. As Kaldor emphasises, devaluation is an instrument which works by compressing the real income of the organised sector of the economy by more than that of the traditional sector but this is a type of income re-distribution which runs directly counter to the balance of political forces (Kaldor 1984, 1093). This is almost certainly applicable to Sri Lanka.

The argument of Kaldor is that comparative advantage is not natural but created. In other words specific supply-side assistance is required for targeted industries. This is the line taken by Sri Lanka's Export Development Board (the EDB) in July 1991. The EDB argued that the real exchange rate of the rupee had declined by about 11 per cent against the dollar between 1989 and the middle of 1991. That is Sri Lanka had become less competitive (again relative to the dollar) by about 11% in that two year period. However the EDB argued that;

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16. Non-price factors also seem to have been important in SSA. As a result of the weak infrastructure and of what Riddell (1990,36) calls a weak 'climate' of exporting in SSA, export expansion from SSA has been slow in spite of declining real effective exchange rates, especially since the early 1980s (Killick 1992, 23-25).

> "devaluation is always accompanied by an escalation of the general price level in the domestic market. Opponents of devaluation also claim that certain product areas with a long gestation period or with low demand elasticities may not respond at all" (EDB 1991, 15)

Therefore the EDB considered the alternative of selective encouragement by granting compensation for those exporters with value added-to-output ratios greater than 40%. However it was thought that the Treasury would not approve the cost involved - the latter being about Rs 500 mn. or about 0.15% of GDP.[17] Thus the EDB's final suggestion was a compromise - namely that the rupee should be devalued slowly over a period of time in spite of the probability that inflation would be generated.

It can be seen from this discussion that the Sri Lankan government is in a very difficult situation as far as exchange rate policy is concerned. The deficit on the current account of the balance of payments is very large - over the 1986-90 period equivalent to about 7.5% of GDP (if official transfers are taken out of the current account). To eliminate such a deficit would require a huge devaluation which would entail a massive cut of 10% or more in living standards over a long period of time. The inflationary impact of the necessary nominal devaluation would be considerable and yet it is hard to see what realistic alternatives there are. For if Sri Lanka does not devalue then it will need to give export subsidies to promote exports. The problem then is that these export subsidies violate GATT (General Agreement on Tariffs and Trade) regulations and are likely to lead to retaliatory action by other countries. They are also heavily constrained (as pointed out already) by restrictions on public expenditure.

Thus to eliminate the current account deficit by a devaluation seems to be impossible in the medium term of, say, the next 5 to 10 years. However the alternative of restructuring Sri Lanka's trade pattern through selective encouragement (eg through export subsidies) is heavily constrained by restrictions on government expenditure. This is the challenging framework within which I look (in the next section) at trade policy and selective intervention by the government.

4. INDUSTRIAL POLICY AND TRADE POLICY; OPTIMUM TARIFF, INFANT INDUSTRY AND SUBSIDY ISSUES

4.1 The Theoretical Arguments

Is there a case for state intervention to promote industrialisation through subsidies whether given directly or indirectly through protective tariffs and quotas? This question can be broken down into two parts; firstly should the manufacturing sector be promoted as a whole? and secondly should the government try to 'pick winners' within the manufacturing sector by promoting particular sub-sectors or industries and if so how?

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17. The value of non-traditional exports with a value added to output ratio greater than 40% was estimated to be about Rs 10 bn in 1991 so that an overvaluation of 10% was estimated to require a subsidy of Rs 1 bn. A subsidy of Rs 500 mn was already committed so that the **additional** sum required was Rs 500 mn.

Over the period since the 1950s there has been a lively debate among economists about the role of trade policy and industrialisation, and there is some but not much agreement about the answers to these questions and what constitutes a 'best' trade policy.

If we go back to the theoretical debates of the 1950s, we can find a case being made for the promotion of the manufacturing sector as a whole. This argument derived from the argument for the diversification out of primary products arising from the Prebisch-Singer argument that there was a tendency for the barter terms of trade of primary product exporters to deteriorate. Their prediction seems to have been correct inasmuch as the barter terms of trade for non-fuel primary products have deteriorated over this century (see World Bank 1991, 106) and this in spite of some considerable diversification by Less Developed Countries into manufactures. As many LDCs became politically independent, the 1950s and 1960s were decades in which there was a push for diversification through the deliberate promotion of import-substituting industrialisation (ISI) behind protectionist barriers.

However, by the end of the 1960s, there were beginning to be considerable doubts about the benefits of ISI. There were doubts as to whether there was any saving in net imports from so-called ISI once account was taken of the inputs imported to produce the import-substituting output. Thus there was a concern that the primary commodity enclaves of the 1950s had been replaced by import enclaves. As a result, in the 1970s, the thinking began to swing in favour of industrial development through export promotion and the free market. The example for both was supposed to be provided by the spectacular growth of the 'gang of four' - namely Hong Kong, Singapore, South Korea and Taiwan.

- the case against 'infant industry' protection through import duties -

The case against industrial promotion (and particularly against promotion through protectionism) seemed to be overwhelming. The only argument for specific trade intervention which the neo-classicists would admit was one based on the 'optimum tariff'. Neo-classical economists conceded that there might be a case for countries discouraging the production of primary products (and thereby perhaps indirectly encouraging a move into manufactures) if they were faced (like Sri Lanka) with a long-term decline in the terms of trade for their primary exports. However this was not an argument for selective (case-by-case) protection of manufactures. Even if an industry was needed on the grounds of national security then it should be promoted directly through subsidies (including government procurement) rather than through the more indirect way of imposing protective import duties or quotas. Protectionism through import duties was said to be a 'second best' method of support.

Similarly market failures were not thought by neo-classicists to make the case for protectionism. If market failures (for example due to a lack of information or incomplete capital markets) existed, they should be corrected at source or, failing that, compensated by **subsidies.** In this view, the infant industry argument for protectionism was a weak one. If domestic producers were to be supported because they were reluctant to invest in industries - either because of uncertainties about learning economies or because they faced very high set-up costs - then the economy would be less distorted by subsidies than by protection. And if, as the so-called 'new trade theorists' argued (see Helpman and Krugman 1989, and Brander and Spencer 1985), there was thought to be a case for the support of a domestic producer to give it a head

start in global markets which are inherently monopolistic, then again it was a case for subsidies rather than protection.

The neo-classicists argued that the same general principle applied where the case for protectionism was based on the external economies that may be generated by particular industries. The externalities might arise not just in the form of trained labour but also through "technological innovation and the cumulative interaction of learning economies, scale economies, innovation and market growth" (Stewart and Ghani 1991, 569). It is on these grounds, that Howard Pack has argued that there is a particularly strong case for the promotion of a capital goods (engineering) sector in Less Developed Countries. Pack has argued that such a development will generate externalities to other industries again not just in the form of skilled labour but also because of the greater likelihood of the supply of capital goods which are more appropriate - that is, which match the domestic resource price ratios (Pack 1981). **These externalities, it is argued, are unlikely to be generated uniformly by every industry and thus there is a case for selective protectionism.** The argument for a uniform rate of protection as advocated for example by Corden (1974) and Balassa (1975) is weakened. What Pack and Westphal (1986) call the 'strategic' approach, involving selective support for particular industries, becomes more attractive.

However, again the neo-classicists argue that if these external economies exist, then it is a case for subsidies or grants aimed directly at the source of the externality and not for protectionism. For example, we will see in section 6 that the neo-classicists concede that there may be case for a levy-grant system to optimise skill development.

In general, then, the neo-classicists argue that subsidies are superior to tariff and non-tariff barriers because they are more transparent, less distorting and more likely than protectionist measures to be reviewed. For these reasons subsidies are best.

In general, the free marketeers' argument goes, promotion through protectionism will lead to a loss of welfare. The losses will be in the form of greater domestic resources being used to produce the domestic product than other products of equal worth in the international market and a loss of 'consumer surplus' through consumers being forced to buy less of the product at the higher protected prices. In addition to these 'static' losses, protectionism is likely to give rise to 'dynamic' losses - that is, losses over time. Dynamic losses will occur if there is a rise (over time) in the costs of domestic production as a result of protection from international competition. The protection may result in domestic producers becoming slack and less efficient, or spending resources on 'public relations' to persuade ministers and other policy-makers of their case for protection. The latter costs have been labelled as **rent-seeking costs** (see Krueger, 1974).

Of course these higher static costs and the rent-seeking waste could arise even if subsidies are used to promote industrialisation. But it is argued that subsidies, being relatively transparent to the public, are more likely to be subject to review than protectionist measures and are less likely to generate rent-seeking.

Thus the case against selective promotion through protectionism is that it is likely to;

(a) give rise to high domestic costs through both static and dynamic effects;

(b) deter the growth of exports through its effect on the costs of supplies into the potential export industries;
(c) deter the growth of backward linkages because protection given to intermediate goods will deter the production of the final goods. To overcome this, if protection is given to the intermediate producer, the producer of the final good may be compensated by being given further protection. And so protection breeds further protection;
(d) be permanent. To correct for market failures, the protection should be temporary to enable the 'infant industry' to grow up but, once given, may be politically difficult to remove.

Thus the neo-classicists' argument is that if, for whatever reason, industrialisation is to be encouraged, it is better that direct cash subsidies, rather than tariff protection, be given to the industries to be promoted. With tariff (and especially non-tariff) protection, considerable domestic resources may be used to generate small foreign exchange savings, and yet this domestic resource cost (DRC) may not be at all obvious.

- the case for trade protection and against direct subsidies.

However, this argument for direct (and against indirect) subsidies can be challenged. Subsidies may not be the first best solution that they are dressed up to be. **Firstly**, subsidies may violate the trading 'regulations' of the GATT and be subject to retaliation; and **secondly**, government expenditure is usually heavily constrained, so that the financial or opportunity cost of subsidies may be high. Protectionism rather than subsidies may be desirable if public expenditure is not easily substitutable for private expenditure. If public revenue is constrained, giving cash subsidies or grants to 'deserving industries' is not as straightforward as it appears. As the World Bank admits;

> "In practice, protection has been a more popular tool because it is more practical administratively and financially" (World Bank 1991, 102).

Both these arguments against direct subsidies have some force in Sri Lanka. In 1985 the US Department of Commerce imposed countervailing duties on Sri Lankan textiles and garments in retaliation against the export subsidies granted by the Sri Lankan government (see Edwards 1988, 193). And as pointed out in the previous section, in 1991 the EDB argued against compensatory subsidies for currency overvaluation on the grounds that the Treasury would not approve the expenditure.

Thus it is clear that there are theoretical arguments for and against the promotion of the manufacturing sector and, within the manufacturing sector, for selective promotion. The jury is still out on these questions. However it is fair to say that the case for the general promotion of the manufacturing sector - for uniform subsidies - is reasonably widely accepted in theory. The case for selective promotion is much less widely accepted, although again the arguments for it are being increasingly widely accepted. This is partly because of the success of the South Korean government in 'picking winners'. The following paragraphs look at this and the other 'evidence' on trade policy.

4.2 The Evidence and Experience of "Picking Winners"

The evidence on 'picking winners' is by no means conclusive.[18] Recent discussions of the connection between trade policy and efficiency are contained in an article by Havrylyshyn (1990), in the World Bank's World Development Report for 1991 and in the UNCTAD Trade and Development Report for 1992.

One conclusion of Havrylyshyn's useful survey is that;

> "both protection and liberalisation may have some similar effects.... protection at moderate levels and for moderate periods may increase productivity, but too much protection reverses this effect and leads to a sharp deterioration in productivity" (1990, 21).

Havrylyshyn emphasises the importance of scale economies. If trade policy encourages high capacity utilisation, then it will be successful. The evidence in the World Bank's 1991 WDR is less conclusive. As the World Bank points out, one difficulty of measuring the effect of trade policies on growth is that trade policy itself may be a function of other variables, including growth (1991,99). UNCTAD's 1992 Trade and Development Report also finds it difficult to draw general lessons, but it does draw attention to the importance of the way in which particular trade policies are managed. One country in which trade policies were well managed seems to have been South Korea.

A popular criticism of selective policies is that it is difficult (some say impossible) to "pick winners". The empirical counter-argument is the seeming success of South Korea in doing precisely that (Pack and Westphal 1986, Enos and Park 1988), and a major weapon in this selection has been selective trade policy. South Korea provides an interesting example because of the **way** in which the government intervened. In the 1960s and 1970s, the South Korean government attempted to integrate industrial production for exports with industrial production for the domestic market. This had not been the case in the 1950s when an ISI was followed. But in the 1960s an EOI phase was followed. It had to be as aid from the US was reduced. It is widely acknowledged that the earlier ISI phase helped domestic capital to build its competitive strength for the later entry into the world market, but it is also worth noting that the later entry into the world market during the EOI phase was assisted by continuing protection on domestic sales. Manufacturers were commonly given protection on their sales in the domestic market on condition that they achieved export targets (Westphal 1990, 47), so that the high profits in the domestic market offset the low profits or even losses in the export market.

Thus the South Korean government practised what may be called 'EPconEP' - 'effective protection conditional on export performance'. The logic for such conditionality is that the recipient of the protection in the domestic market is forced to exploit scale economies which it might otherwise not find profitable to exploit. Without the conditions, the company's profit-maximising output may be less than that level of output which gives a lower rate of profit to the company but one which is nevertheless socially preferable. Thus it may be socially beneficial for the 'stick' of export targets to be

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18 The export Development Board has a 'priority product' list for export development and promotion. The problems of choosing and ranking such a list are discussed in Kelegama and Wignaraja 1992b.

imposed in return for the 'carrot' of protection in the domestic market (see Krugman in Keirzkowski (eds) 1984, 181). This is what the South Korean government did.

By contrast, the trade policy followed in Sri Lanka has not encouraged the integration of production for the domestic market with production for exports. Thus trade policy in Sri Lanka seems to have done little to break down its 'dual' industrial structure. In this respect Sri Lanka is similar to Malaysia for, superimposed upon a resource-based industrial sector, there is an export-oriented industrial (EOI) sector which is quite separate from a domestically-oriented industrial (DOI) sector. The two are quite separate in Sri Lanka as they are in Malaysia (see Young et al, 1980, 189) and therefore the categorisation by the World Bank in 1987 of the Malaysian economy as a moderately outward-oriented one is misleading (see World Bank 1987b) - as misleading as saying that a person standing with one foot in boiling hot water and the other foot in ice-cold water is moderately comfortable.

This dual industrial economy has emerged in Malaysia as a result of different phases of industrial policy. In the 1960s, there was a DOI phase, then in the 1970s an EOI phase based on Free Trade Zones. Then in the early 1980s, there was a second phase of DOI with public sector investment in heavy industries financed from loans from overseas. This was associated with a rising REER index which, combined with a recession in the world market, caused an economic crisis in the mid-1980s. Then in the second half of the 1980s and into the present decade there has been a new export-led drive following a sharp real effective devaluation in 1986. There has been some evidence towards the end of the 1980s of some integration of the EOI and DOI sectors but progress has been slow.

In Sri Lanka as in Malaysia[19] the 'dual' structure has emerged as a result of phases of industrial policy. In the 1950's through to the 1970s, there was a DOI phase (mostly through the public sector) and then in the late 1970s and through the 1980s, there was a dramatic switch to EOI. Since 1977 export-led industrialisation has been encouraged through the establishment of FTZs at Katunayake, Biyagama and Kogalle, the sharp real effective devaluation of the rupee (not against the US but on a trade-weighted basis -- see the earlier figure 2) in the second half of the 1980s,and the spreading of tax holidays beyond the FTZs.

What are the disadvantages of this dualism and what can (and should) be done to break it down? As we shall see, the answers to these questions have important implications for government policy but before looking at these, I first look at the the general principles of protectionism that come from the theoretical studies and from the South Korean experience.

4.3 The Lessons for Trade Protection From Theory and from the South Korean Experience

I argued above that there are few clear, general lessons that can be drawn from empirical studies on trade protection. However the studies suggest the following six principles;

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19. Interestingly Thailand, which was also categorised by the World Bank as 'moderately outward-oriented', has a manufacturing sector which is also said to be "highly dualistic and (lacking) a better structural integration" (UNIDO 1990, 27; see also Jansen 1991).

- **firstly,** the level of protection should be low. This means that an industry's effective rate of protection should be no more than about 15 to 20 per cent;[20]
- **secondly,** the protection should be temporary and be subject to frequent and automatic review (every 4 or 5 years);
- **thirdly,** the protection should be transparent. Specific tariffs, quantitative restrictions and quotas should be replaced by ad valorem tariffs. Tariffs should be a sufficient protection against dumping and 'under-invoicing' to evade ad valorem tariffs should be prevented not by specific tariffs but by 'policing' by the customs authorities;
- **fourthly,** any protection given should be based on a study of the costs and benefits of that protection and not on what is claimed necessary by the industry to make a profit;
- **fifthly,** protection should be limited to those industries where there are significant market imperfections (for example where external economies or economies of scale are widespread and where a future comparative advantage is likely);
- **sixthly,** and linked to the fifth principle, the protection should be conditional on export targets being met so as to force a producer to combine the security of the domestic market with the stimulus of international competition. Such export conditionality will be particularly beneficial if there are believed to be significant economies of scale in the industry. In this context, it should be noted that there may be economies of scale in marketing as well as in research and production.

This last principle is especially useful in combining the security of a domestic market with the discipline of the competitive international economy. And if such a principle made sense for South Korea, it is likely to make even more sense for the smaller economy of Sri Lanka, since Sri Lanka's total GDP is only about 3% to 4% of that of South Korea.

There may, of course, be other instruments of trade policy which can be used to tackle the economies of scale problem. One of these is the encouragement of regional integration either on an economy-wide basis or on the basis of industrial complementation agreements. Unfortunately there are only a few successful examples of regional integration schemes and progress on regional integration under SAARC has been slow (Kelegama 1991).

If regional agreements cannot be agreed to facilitate the establishment of industries subject to economies of scale and such industries continue to be established in Sri Lanka on a national basis through protection, then that protection should be conditionally linked with export targets. In this way, export diversification would be encouraged, a healthy development given the fears about the links between concentrated growth in LDC exports and protectionism in the EEC and North America.

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20 In a recent article in which he expressed some doubts about the benefits of trade liberalisation if all LDCs expanded their exports, William Cline argued that any protection given should be moderate - "in the range of 15 to 25 per cent" (Cline 1985, 547). Cline seems to have been referring to the effective rate of protection. Sri Lanka's Industrial Policy Statement of 1987 argued for "modest levels of protection" without specifying what was meant by "modest" (MFI 1987, para 3.4)

Above then are six principles of protection which receive some broad agreement from economists. There are also some arguments for protectionism which have **less theoretical** support. The most blatant of these is **dumping**. Within the Sri Lankan government, as elsewhere, **dumping** is often given as a reason for protectionism (see MFI 1987, 7 and Ministry of Industries 1989, 12). But the anti-dumping argument is only valid where dumping is shown to be predatory - that is when it can be shown to be clearly discriminatory. Otherwise if it simply means that Sri Lanka has the prospect of being able to buy, over some years, a product very much more cheaply than producing it, then clearly it should do so.

How does the trade policy of Sri Lanka match up to these six 'good principles'? This is what I look at next.

4.4 Industrial Promotion Through Selective Trade Measures - Practice and Policy in Sri Lanka

As stated earlier, Sri Lanka seems to have a dual industrial structure. Super-imposed on a resource-based sector are two sectors - an EOI sector producing almost entirely for the export market and a DOI sector producing almost entirely for the domestic market. Not only are these sectors separate in terms of their outputs but they also seem to be quite separate in terms of their inputs. Both sectors seem to be highly import-intensive. The following paragraphs look at the subsidies provided to each of these two sectors (DOI and EOI) and then at the policy issues which arise.

(i) The DOI sector and subsidies through protectionism.

It is well known that the real incentives given to manufacturers through a tariff and quota system can best be measured through what is known as the effective protection coefficient (EPC). This is the ratio of value added at domestic prices to the value added at world prices. This takes account of the structure of tariffs (and quotas) on the tradable inputs as well as on the outputs.

A number of EPC studies have been carried out in Sri Lanka in recent years, most of them under the supervision of the Presidential Tariff Commission which was set up in 1980 and which replaced the Tariff Review Committee. The EPC studies suggest that the DOI manufacturing sector has been highly protected, but there seem to be alarmingly large variations in the EPCs revealed by these studies, much larger than might be expected to have occurred from year to year. Even at the level of the whole manufacturing sector, the year-to-year variations are considerable, as shown in table 12.

Some differences would not be surprising given the potential differences in method of calculation (Balassa/Corden, direct price comparisons/listed tariffs), coverage (import substitutes only/all manufacturing including exports) and different years. However not only are the differences surprisingly large for closely-adjacent years but even for the same years there are some major discrepancies. Unfortunately it is not easy to assess the sources of the errors since in general the reports do not contain the detailed calculations from which the effective protection coefficients (EPCs) are derived.

However this is not true of the study which looked at protection in 1985 and 1987 and I was able to do a crude assessment of that study (Edwards 1989, 10). It was clear that the average EPC was overstated for that year because excise duties were not taken into account. I estimated that the revised average EPC was closer to about 1.35 and the later PDP study confirmed this estimate (see table 12).

Table 12
Average EPCs for the Manufacturing Sector in Sri Lanka

Year	EPC	Source
1979	1.50	PTC quoted in Wignaraja, 1992 (table 3)
1981	1.61	PTC quoted in Wignaraja, 1992 (table 3)
1983	1.56	PTC quoted in Wignaraja, 1992 (table 3)
1985	1.35	Edwards 1989, 10
1985	1.97	Walton, 1987, 47-49 quoted in Edwards 1989, 3
1987	2.07	Walton, 1987, 47-49 quoted in Edwards 1989, 3
1987	1.40	PDP Cosultants, April 1990, 4 (based on 1985 input-output coefficients - see PDP, page 3 n.2)
1988	1.77	PTC 1991, 57

The studies on protection shown in table 12 have been carried out using the listed tariffs and few direct price comparisons have been carried out. As a result in so far as the tariff is not fully used and there is 'tariff redundancy' then the protection will be overstated, and in so far as the tariff is 'swamped' and the domestic price exceeds the world-price-plus-the-tariff due to quota restrictions then the protection will be understated. Overall it seems in the Sri Lankan context that the level of protection is likely to have been **overstated**.

The latest study for 1988 estimated that the effective protection coefficient (EPC) was 1.77 (see PTC 1991, 57). The net subsidy equivalent (NSE) (defined as the difference between the value added at domestic prices and value added at world prices) was estimated to be Rs 5.6 bn. (see PTC 1991, 59) with the private sector receiving about 85 per cent of this, although it only accounted for about 70 per cent of the total gross output (see Kelegama 1992b, 26). This subsidy (NSE) was equivalent to about 2.7% of national income.

How does this total compare with the direct subsidies given to the export-oriented industrialisation (EOI) sector?

(ii) Subsidies to the EOI sector

In Sri Lanka there has been considerable concern that trade (tariff and non-tariff) protection for the import-competing sector in Sri Lanka has greatly disadvantaged exporters and non-traded goods producers (see Cuthbertson et al 1992, 117).[21] Generally it has been argued that there has been a bias against exports. This concern in part explains the measures to subsidise and encourage exports, especially non-traditional exports. This encouragement has taken the form of tax exemptions, duty

21. The Strategy for Industrialization (Ministry of Industries, 1989, para 1.6(f)) stated that "there should be complete neutrality between import substitution and export- orientation among industries".

rebates, accelerated depreciation allowances, capital grants, subsidised loans, refinancing schemes etc. However export subsidies given in Sri Lanka seem to have been substantially reduced in recent years, although it is difficult to get precise estimates.

As a result, it is extremely difficult to get an assessment of the bias against or in favour of exports given by the tariffs and subsidies in the manufacturing sector. Firstly there is a sharp division between the subsidies available to firms subject to agreements with the GCEC (now the Board of Investment) and the non-GCEC firms. Secondly there is a large number of different types of subsidies (for details see Cuthbertson et al 1992, chapter 4) and they are administered with considerable discretion (Cuthbertson et al 1992, 131). As one would expect, traditional exports are disadvantaged by the tariff/subsidy structure (Cuthbertson et al 1992, 133) and as far as the non-GCEC manufacturing sector there would seem to be a bias against exports (Cuthbertson et al 1992, 133) but it is not clear from the Cuthbertson report what the overall bias is if the GCEC firms are included.

Abeyratne (1992, Chapter 4) agrees with the Cuthbertson report and argues that there was anti-export bias in 1988. In addition Abeyratne argues that; "Apart from some exceptional cases, good sectoral export performance appears to have been associated with high effective protection for exports, and poor performance with that for import substitution" although he adds that; "High or low performance in exports does not seem to be related only to the level of effective anti-export bias, but to a number of other factors as well" (Abeyratne, 1992, 109).

However other studies disagree with the Cuthbertson report and suggest that there has tended to be pro-export bias in the manufacturing sector. Cuthbertson and Athukorala suggest that there was a pro-export bias in the manufacturing sector in 1983 (Cuthbertson and Athukorala 1991, 379) and Kelegama and Wigneraja suggest that this is the case for all years between 1977 and 1987 (1991, 40 - see also Kelegama 1992a 23,24).

Thus in the assessment of the subsidy/tariff effects, there are considerable differences of opinion. These differences are perhaps not surprising given the unreliability of the data and the 'dual' structure of the manufacturing sector. As far as the data are concerned, I have already referred to the variations in estimates of effective protection. In addition however the total value of export subsidies is difficult to estimate. The major forms of subsidy seem to be;

- the Export Development Investment Support Scheme (EDISS)
- Duty Rebates, and
- the tax holidays in so far as these are tied to exports.

New EDISS commitments were withdrawn in 1991 but continuing commitments are estimated to be costing about Rs 500 mn. for 1992.There is some debate as to whether duty rebates should be included as a subsidy (see Cuthbertson and Athukorala 1991, Appendix B), but where rebates are given in excess of the actual duty (as they seem to be) then the excess should certainly be included as a subsidy. This excess is estimated as about Rs 100 mn. for recent years. Tax holidays probably are the largest 'potential' subsidy tied to exporting but again these are difficult to quantify, this time because it can be argued that without these, the companies would not be operating in Sri Lanka. However if we assume that the firms would be operating even in

the absence of the tax holidays, then the subsidy could be as much as Rs 400 mn. per annum (This assumes a 40% tax on net profits to KEPZ companies; that the net profits of KEPZ companies are about Rs 400 mn. a year in recent years and tax on that would therefore be Rs 160 mn.; and that KEPZ firms are equivalent to about 40% of all GCEC activities).

The value of other export subsidies, it seems, are small compared to the above. For example although refinancing of exports involves a current commitment of about Rs 2 bn., the 4% subsidy on the interest rate for 3 months is equivalent to 'only' about Rs 20 million per annum.

Thus the export subsidies total between Rs 1 bn. and Rs 1.5 bn. This compares with total industrial exports in 1990 of about Rs 40 bn. (CBAR 1991, table 34). Therefore the subsidy to industrial exports would seem to be about 2.5 per cent of the gross value.

Thus the subsidy on the EOI sector of about Rs 1 bn is small compared with the subsidy on the DOI sector of over Rs 5 bn. As a percentage of the value added at world prices, I estimate that the subsidy for the DOI sector is probably about double (at 25%) that for the EOI sector (at 12%).

These are very crude estimates but the net effect is that there is almost certainly an anti-export bias overall. However, as stated above, the manufacturing sector in Sri Lanka is dualistic with an EOI sector quite separate from the DOI sector. This separation would not only seem to render any assessment of export bias somewhat problematic but much more importantly has significant implications for industrial policy as is discussed next.

(iii) Trade policy issues

There are a number of policy issues which arise from a consideration of the EOI and DOI sectors. Here I first look at the problem of integrating the EOI and DOI sectors;

(a) can and should the DOI and EOI sectors be integrated?

There are a number of steps which can be taken to promote the integration of the EOI and DOI sectors. This integration is desirable because it will not only promote the exploitation of economies of scale in the manufacturing sector but also reduce the risk of investment in production for export. The first would raise the ICOR while the second might increase the level of investment for a given rate of profit. There are a number of ways in which this integration can be promoted. Briefly they are;

(i) by promoting sales from the EOI into the domestic market. At present companies get tax holidays if they export more than 90% of their output (or 70% for agricultural products). Many companies argue that this makes too sharp a distinction between exports and domestic sales and that it discourages the exploitation of economies of scale;

(ii) by promoting the incorporation of inputs from the DOI into the EOI. Such backward linkages might be promoted by providing rebates for the import duties paid indirectly on inputs, but this is difficult to administer. A more promising route to encouraging backward linkages would be for the government to actively promote these bringing together potential suppliers and users to discuss quality, delivery and pricing problems. Such a coordinating role has been played to good effect by the Penang State Development Corporation in Malaysia. Another suggestion made by the Ceylon National Chamber of Industries to encourage backward sourcing is to allocate garment export quotas at least partially on the basis of the previous year's value added. The higher a company's local sourcing, the higher would be its export quota allocation;

(iii) by promoting exports from the DOI sector. This is a stated objective of the 1989 Strategy for Industrialisation (see para 1.5). It was pointed out above that within the DOI sector there is almost certainly a bias against exports because of the higher-than-world prices paid on inputs either because of import duties paid indirectly or because the supplier of the input is protected. One possible way of compensating for these higher prices is for direct export subsidies to be given but as already pointed out, export subsidies have two disadvantages - they risk retaliation and they increase government expenditure. However there is an indirect and very effective way of giving a subsidy and that is, for the Presidential Tariff Commission, to make protection in the domestic market conditional on the attainment of export targets. This policy was followed by the South Korean governnment and is very effective in forcing companies to cross-subsidise exports from the relatively high profits in the domestic market. Such a policy induces companies to take advantage of economies of scale. In the absence of the coercion, they might otherwise not export because of the low rate of profit on export sales.

Thus there are a number of ways in which the governmment can break down the apparent dual structure of the manufacturing sector in Sri Lanka. To implement these policies effectively requires further information on the nature of the dualism; on whether the DOI sector is growing up; on whether the DOI sector is simply making easy profits behind tariffs; on why the DOI sector is not exporting; and on what is going on behind the effective protection.

Thus if the Presidential Tariff Commission (PTC) is to continue to provide protection on a selective basis to so-called 'infant industries', more information will be needed on what is going on behind the tariffs so that the protectionist policies can be used as a more effective lever for increasing the efficiency of the protected companies. As I have argued in a separate paper, the PTC should be carrying out cost-benefit analyses of protection to guide it in its protectionist policy.

However the PTC is not the only government department which should be carrying out cost-benefit analysis. The GCEC (Board of Investment) should also be carrying out more detailed analyses to see whether it can implement policies which increase the value added retained in Sri Lanka from the EOI sector. It seems from a cost-benefit study of the Katunayake Export Processing Zone (KEPZ) which I carried

out in 1992 that the KEPZ has generated net benefits to the Sri Lankan economy.[22] However in that study I emphasised that it is important to go beyond the cost-benefit analysis to see whether there are steps which the government can take to increase the retained value added. It seems important that the government assesses the profits of the companies at the EPZs to see, for example, whether it is necessary to extend the tax holidays to keep the companies in Sri Lanka.[23] It would seem reasonable to assume that if the companies are making a very high rate of profit on capital (of say 40% or more), then the extension of a tax holiday might be less necessary than if the companies are making a very much lower rate of profit. Similarly another way in which the government might take action to raise the value added retained in the KEPZ is the enforcement of a minimum wage rate. Clearly it is important to analyse the profits of the different companies to assess how footloose they are likely to be and which industries can best be attracted to Sri Lanka. At present this sort of analyis seems to be lacking.

The conclusion of this section is that selective trade policy is necessary in the Sri Lankan context to promote industrialization but that such a policy must have one aim in mind - **to integrate whereever possible production for the export market with production for the domestic market so that economies of scale in production can be achieved.**

5. THE FINANCING OF INDUSTRIAL INVESTMENT

Selective trade policy is not the only way in which the state can promote industrialisation. Governments can also promote industrial investment by subsidising the financing of industrial investment. There are theoretical arguments for and against this, with (as we shall see) the arguments extending beyond the micro-impact of the subsidies. The debates around this issue have been particularly sharp in Sri Lanka.

The theoretical argument for subsidising loans to the manufacturing sector is that such investment is particularly risky and uncertain given the long gestation period of many types of industrial investment. It is argued that without such subsidies companies may 'socially' under-invest in long-term production facilities if the rate of profit required by companies is significantly higher than that required by the state or 'society'. As a result long-term investment may be less than the social optimum unless the state underwrites it. The theoretical argument is reinforced by the allegation that bank-based economies such as Japan and Germany have been more successful than the equity-based economies of the UK and USA. The argument may be particularly applicable to the economy of Sri Lanka with its high levels of inflation and insecurity and its associated 'mercantile culture'.

However there are **two theoretical arguments against** subsidising industrial loans. Firstly, it is argued, low real interest rates will depress savings and will mean a correspondingly lower level of investment. Secondly, it is argued, the quality of investment will be lowered as profitable investors are starved of funds rationed not by

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22. My cost-benefit study covered the KEPZ from its inception in 1978 to 1990 and followed the methodology adopted by Peter Warr, an Australian economist. Warr carried out cost- benefit studies of EPZs in Indonesia, South Korea, Malaysia and the Philippines and found that, with the exception of the Philippines, they had generated net benefits and a good return on investment (Warr, 1989).

23. In their study, Cuthbertson et al recommended the abolition of all tax holidays (1992, 8, 10 and 95).

price but by administrative selection. Doubt is expressed as to whether this administrative selection will be efficient and free of corruption, but even if it is, it is argued that some investors will be **`financially-repressed'.**

The arguments against subsidising loans are associated with two economists called **McKinnon and Shaw** who developed their arguments in the context of South Korea. There, in the early 1960s, after the coup which overthrew President Syngman Rhee, some private assets were confiscated, special development banks were created and the state took control of a large part of the commercial banking sector. Following this, in the mid- 1960's, major reforms were made to the financial system. Real interest rates were raised and it was on the basis of this experience that McKinnon and Shaw based their `financial deepening' theory. The theory is that the higher real interest rates led not only to an increase in the quantity of investment but also to an improvement in its quality.

The McKinnon-Shaw arguments can be, and have been challenged, both in terms of their theory and in terms of their description of what happened in South Korea. The McKinnon-Shaw **theory** has been accurately referred to by Thirlwall (1976) as the prior-savings approach (as opposed to a Keynesian investment-led approach). The criticism of the theory is particularly directed at the notion that it will give rise to an increase in the volume of investment. It is argued that such an increase is highly unlikely since investment is likely to be discouraged by the rise in the rate of interest. If this is the case, the fall in investment will give rise to a multiplied drop in national income and the fall in national income is likely to give rise to a fall in savings. Thus instead of rising, savings will fall in line with the drop in investment.

The empirical evidence is far from conclusive but it seems to suggest that the responsiveness (or elasticity) of savings with respect to interest rates is low. For example, Cho and Khatkhate (1989) conclude from their recent analysis of the financial liberalisation experience of five Asian countries (the Republic of Korea, Malaysia, Sri Lanka, the Philippines and Indonesia);

> "Finally, financial reform, whether comprehensive and sweeping or measured and gradual, does not seem to have made any significant difference to the saving and investment activities in the liberalised economies. It was believed until recently that removal of the repressive policies would boost saving. The survey in this paper of the consequences of reforms does not reveal any systematic trend or pattern in regard to savings (and also investment), through it clearly demonstrates that reform has greatly contributed to the financialisation of savings" (Cho and Khatkhate 1989; see also, for similar conclusions about the low elasticity of savings to interest rates, Fry 1988, 131 ff).

Thus although the rise in interest rates may channel savings into the official banking system from the informal money markets, this is not the same as saying that the aggregate level of savings will rise.

What then about the quality of investment? Will highly profitable investments be squeezed out by the rationing? This is a much more difficult issue, but if the level of investment is lowered rather than raised as a result of the higher interest rates, then profitable investments are just as likely to be squeezed out as accommodated by the higher interest rates.

Thus there are many economists who have questioned the theoretical soundness of the McKinnon-Shaw theory. In addition, doubt has been cast on the extent to which the South Korean experience lends support to the McKinnon-Shaw arguments. This doubt has been expressed most strongly by Dornbusch and Park, 1987 and by Lawrence Harris, 1988. Firstly it is argued that although interest rates were raised to depositors in the late 1960s, in general from 1960 to 1980 real interest rates in South Korea were negative (see Dornbusch and Park 1987, table 14). Secondly Harris has argued that even when interest rates were raised for depositors, the increase in funds being channelled through the formal banking system served to increase the power of the government to direct investment since most of the formal banking system was under state control. Thus, Harris concluded;

> "The reform contributed to growth but that contrary to the McKinnon-Shaw thesis, it did so because it increased the role of the state rather than rolling it back to liberate private market forces" (Harris 1988, 369).

Thirdly Harris pointed out that the government continued to use its power to selectively direct investment through the use of differential interest rates (see also Hamilton 1986 47 and Van Liemt 1988 48).

The arguments of Harris, Dornbusch and Park and other researchers were so successful in demolishing the arguments of McKinnon and Shaw that in its 1989 World Development report, the World Bank was forced to concede that;

> "Korea's heavily-regulated financial system was a key instrument in the government's industrial policy of the 1960's and 1970's. Interest rates were controlled and were kept low during most of this period" (WDR 1989a, 126).

The Economist also agreed with Harris's interpretation in arguing that

> "Financial regulation was one of the main instruments of its (South Korea's) industrial policy in the 1960's and 1970's... and this form of intervention is one reason that South Korea now has an industrial structure that is dominated by a relatively small number of big firms" (Economist 1989, 36,39)

Thus the McKinnon-Shaw theory has been challenged both on theoretical and empirical grounds - that it never applied to South Korea in the way that was claimed.

Has it applied, or does it apply to Sri Lanka?

Interestingly, in an article published in World Development in 1982, Alan Roe, who worked as an adviser to the Ministry of Finance and Planning in Sri Lanka, looked at the McKinnon-Shaw arguments in relation to the Sri Lankan economy (Roe, 1982). Broadly he concluded that the arguments did not apply but that liberalisation had been both too drastic and yet not drastic enough. He argued that it had been too drastic in the sense that, whereas before 1977 real interest rates were **too low,** after 1977 they were **too high**. But the reforms had not been sufficiently radical in the sense that no attempt had been made to break up the compartmentalisation of the capital market. The market was compartmentalised with;

(a) the public corporations having access to cheap funds from the public sector (eg subsidised funds from the National Savings Bank);
(b) foreign investors having access to relatively cheap funds from overseas with the result that;
(c) domestic private capital was being squeezed out.

Thus,he argued, given this institutional structure, the allocation (or investment quality) argument of McKinnon-Shaw did not apply. Roe argued that higher real interest rates were a **necessary but not sufficient** condition for an efficient capital market. What was also needed was a change in the institutional structure. Roe saw the establishment of the National Development Bank (NDB) as central to this process. He argued that the NDB should have access to the funds of the non-bank, mostly public sector, financial institutions (the EPF, insurance corporation, NSB and private provident funds). The NDB would then act as the intermediary to put the public sector corporations on to a commercial basis as well as to offer cheaper long-term funds to the private sector. But alongside this there would have to continue to be controls on direct foreign investment. The controls were necessary because he argued that the economy was not on a sound enough footing to liberalise the foreign exchange market. Foreign direct investors would have an advantage over local investors in having access to cheaper capital unless there were some controls, such as the insistence on local participation. In 1987, Osmani reinforced Roe's arguments by pointing out that;

> "While financial liberalisation ..did very little to help the small firms through its effect on resource mobilisation, it actually did them harm through its effect on the cost of finance" (Osmani 1987, 185)

However, more recently, Athukorala and Rajapatirana (1991) have argued against Roe in pointing out that the rise in real interest rates since 1977 (see table 13) did result in a rise in the level of savings.

Table 13
Interest Rates in Sri Lanka - National Savings Bank (NSB) Deposit and National Development Bank (NDB) Lending Rates - 1971-1991 (% p.a.)

	Nominal rates		GDP deflator	Real rates	
	NSB deposit rate	NDB lending rate		NSB deposit rate	NDB lending rate
1971-76	7.2	n.a.	15.6	-8.4	n.a.
1977-83	14.9	13.0	13.6	1.3	-0.6
1984-87	14.2	10.5	9.0	5.2	1.5
1988-91	15.0	13.8	13.1	1.9	0.7

Notes: The figures for 1971-87 for the NSB and the GDP deflator are taken from Athukorala and Rajapatirana 1991, 39. The figures for the NSB for 1988-91 and for the NDB for all periods are taken from CBAR 1991, table 88. The GDP deflator for 1988-91 is derived from International Financial Statistics Yearbook 1992, 153.

Athukorala and Rajapatirana argue that with the rise in real interest rates after 1977 there was an impressive increase in savings deposits compared with the period prior to 1977 (1991, 25). They argue that this increase was not simply a transfer from the informal to the formal sector but represented an increase in the ratio of private savings to private income (see 1991, 13). They argued that this evidence refuted the

neo-structuralist claim (as put forward by Roe 1982 and repeated by Jayawardena et al 1987), that the rise in formal savings would simply represent a switch from the informal to the formal markets. They explained that the lack of a switch was due to the high degree of segmentation between the formal and informal financial markets in Sri Lanka (Athukorala and Rajapatirana, 1991, 23).

They also argue that the rise in interest rates was unlikely to have deterred investment. Roe had argued that this deterrent effect was likely because the rate of return on capital was low -about 5 to 10 per cent per annum. However Athukorala and Rajapatirana criticised Roe for basing his argument on the estimated rates of return of the relatively unprofitable public sector corporations. These rates were exceptionally low compared to the rate of return of the private manufacturing sector in the 1978 to 1983 period which Athukorala and Rajapatirana estimated to be over 25 per cent per annum.

Thus, they argued, whereas a rise in real interest rates of a few per cent per annum (see table 13) had made a significant difference to savings, it was likely to have little impact on investment. However they did agree that the compartmentalisation of the financial markets was a continuing problem (1991, 19). There was a high diversity of interest rates but there was little evidence, they claimed, of a significant increase in lending for long-term industrial investment geared to exports, even from the Development Finance Institutions (1991, 21). They argued that the failure of the directed credit policy in Sri Lanka needs further study (1991, 21).

Again, then, it seems that Sri Lanka and South Korea might be quite different cases. The directed credit policy in South Korea seems to have been successful in promoting long-term investment in export-oriented industries and yet in Sri Lanka this does not seem to have been the case. In Sri Lanka there is a clear need for such long-term investment but the Development Finance Institutions (DFIs) do not seem to be promoting long-term, outward-oriented manufacturing investment on a sufficient scale. Various reasons have been given for this; the first is that the concessional (aid) funds being channelled through the DFIs are insufficient relative to the demand; the second is that the DFIs are being required to operate 'too commercially' and obliged to earn profits at the expense of their developmental role.

The major problem remains a structural one. As the 1991 study by the World Bank on Financial Institutions in Sri Lanka pointed out, the large public sector budget deficit (for which see section 2.1 of this paper) means that the long-term sources of funds in Sri Lanka (the pension funds) are being used to finance the budget deficit through the purchase of short-term securities. The public sector can be said to be 'crowding out' private long- term investment - unless it is argued that the private sector would fail to provide the same demand stimulus as the public sector following a reduction in the public sector deficit.

The alternatives remain unpleasant.[24] On the one hand, continued liberalisation and higher lending rates to the manufacturing sector will mean that foreign investors will have an advantage over Sri Lankan industrial capital while at the same time the 'short-termist' outlook of domestic capitalists will continue to be encouraged. At the same time such liberalisation will do little to break down the alleged inefficiencies of the two major

24. For an interesting discussion of interest rates and the associated policy problems in Sri Lanka, see Kelegama 1992b.

state banks (these inefficiencies were the main focus of the World Bank's 1991 study - see World Bank 1991a). What is needed is a state-directed credit policy which will channel cheap funds to approved (long-term, export-oriented) industrial investments. Whether this is feasible given the institutional structure in Sri Lanka is a moot point, but the alternative of a 'free market' is not particularly attractive given the 'privileged' access of foreign investors to relatively cheap funds.

6. TECHNOLOGY, SKILL DEVELOPMENT AND INDUSTRIALISATION IN SRI LANKA

Technology and skill development are both areas where market failure is likely because in the case of technology there is considerable uncertainty and high transactions costs and because in the case of skill development, there are considerable externalities. In these markets as in others, the form of state intervention is crucial in determining whether the market failure is corrected. In Sri Lanka, in the area of skill development, it is alleged that the market does not operate very efficiently not because the state intervenes but because its intervention takes the wrong form.

In this section, I discuss the issue of skill development but it is useful to put this in the broader context of technology and development in Sri Lanka.

6.1 Techonology and Development

First what is technology? There is little agreement among economists on a precise definition, but technology is usually described as 'know-how' which leads to increased productivity. It may be embodied in capital or labour or disembodied. In the disembodied case, technology will lead to an increase in total factor productivity (a growth in the volume of output greater than the combined input of labour and capital - the difference being called residual growth). There has been a considerable debate over the source or sources of this 'residual' growth with it being variously ascribed to education, technology or even Confucianism.

The consideration of technology and development raises the following questions;

Which technology is best? What technology will cause the fastest growth? What is the relationship between technology and growth? Where should Sri Lanka acquire technology?

There is considerable evidence from Germany (in the late C19th), Japan (in the late 19th and early 20th centuries) and from South Korea and Taiwan (in the post-war period), that;

(i) middle-level engineering is more important than high- technology research and development;
(ii) the adaptation of technology is more important than development of new technology; and that,

(iii) 'reverse engineering' (taking components apart and copying/adapting them) is also important.

These imply that at Sri Lanka's stage of development, adaptation is more important than advanced technology. A study carried out for the Natural Resources Energy and Science Authority in 1991 estimated that Sri Lanka's expenditure on research and development in 1985 totalled about Rs 257 mn., or about 0.2 per cent of GDP (NRESA of Sri Lanka, 1991, 32). There have been many complaints about this low level of research and development expenditure and comparisons have been made with South Korea where expenditure on research and development is now equal to at least 2% of national income. **But such a comparison is misleading** because in 1970, when South Korea's stage of development was closer to that of present-day Sri Lanka (although even then South Korea's per capita income was about double of that of Sri Lanka today), research and development expenditure in South Korea was only about 0.4% of GNP (Amsden 1989, 328).[25]

Therefore it is questionable whether research and development expenditure needs to be raised very sharply in Sri Lanka. What is more important is for the state institutions to work closely with the private sector since more than 90 per cent of research and development is carried out by the state sector in Sri Lanka. Given this, it is essential that the state institutes (such as the National Engineering Research and Development Centre) interact closely with industrial producers. It was precisely this lack of contact between industrial research institutes in Sri Lanka and industry that has been widely criticised (see Weiss 1988 and Piyadasa in Kerkoven (ed) 1990).

Where should the technology be obtained and how? Here it should be noted that it is not necessary to acquire technology from overseas along with direct foreign investment (FDI). The technology can be 'depackaged'. The government can play a useful role in helping industry to do this - as in South Korea in the 1960s and 1970s (see Enos and Park 1988). Thus the government can play a valuable role in helping to ensure that technology is acquired at the lowest price. There may be economies of scale in getting information about technology and there may also be a 'free rider' problem - with the latter occurring if a company believes that even if the price of technology is high it will be given protection or other 'subsidies' to cover the cost. The government may be able to exploit the economies of scale in getting hold of information about technology (see Fransman and King 1984, 4 and for the South Korean experience see Enos and Park 1988, Pack and Westphal 1986 and Pack 1989, 370).

The emphasis in the 1960s was on this issue - the acquisition of technology - but in the 1970s attention switched to the adaptation of technology (see Fransman and King 1984, 5) and for adapting technology, skill development at the vocational level is vital. Unfortunately in Sri Lanka, the supply of vocational labour is poor and improving skill development must have the highest priority if Sri Lanka is to move from a mercantile economy to an industrial economy.

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25. I think that Saman Kelegama (1992a, 36) is mistaken in comparing the research and development expenditure in South Korea and Taiwan in the mid-1980s with that of Sri Lanka since the GNP per capita levels are so different.

6.2 Skill Development

The Sri Lankan government has long recognised that skill development cannot be left to the free market. Leaving training to the free market gives rise to two problems;

(a) general 'transferable' skills will not be developed because of the uncertainties involved;
(b) skills for existing industries may not be developed because of the problem of externalities.

It has long been recognised that the public sector should provide the 'transferable' skills and general education of the population. In terms of formal schooling, Sri Lanka has an excellent record. As table 14 shows, in 1989 the percentage of the relevant age group enrolled at the secondary level was high compared to both other low income countries and middle income countries.

Table 14
Enrolment in Education - A Comparison of Sri Lanka and Other Less Developed Countries - 1989

	Percentages of age group enrolled in education		Per capita GNP (in 1990 $)
	Secondary	Tertiary	
Sri Lanka	74	4	470
Low-income economies	38	4	350
Middle-income economies	55	17	2220

Sources: World Bank 1992, 218,274

However although Sri Lanka is strong in knowledge skills, it is weak in work skills (see Kelly 1992), with the training of labour for the work-place being high in quantity but low in quality.

Why is this? And what can be done about it? To answer these questions requires us to look at the basic economics of vocational training.[26] It is commonly argued that the corporate sector will not develop the training of skills currently required unless the skills are unique to particular companies (which is unlikely). In the general case where skills are not firm-specific, companies are likely to fear that if they train the labour, then it will be 'poached' by another company. In such a situation, a company bears the costs of training but one of its competitors gets the benefits. This is a classic example of what economists call 'externalities' and it is likely that these 'externalities' will be greater, the greater is job mobility.

Thus if there is a tradition or 'culture' of labour being tied to a particular company (as in Japan - see Eltis 1992,8), the company is likely to find it worthwhile to train the labour itself. However if such a tradition does not exist, then how can companies internalise the externalities? One obvious way is for the companies to set up an

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26. In this paper, I do not discuss the shortages of managerial skills in Sri Lanka which, some company directors allege, have arisen as a result of the emigration of managers during the 1988/89 JVP crisis.

apprenticeship scheme where either the trainee gets a very low wage in return for being trained and/or, after becoming qualified, the trainee is 'tied' to the company to repay any implicit 'training loan'. However in such a system the trainee has to have the confidence that the apprenticeship training will benefit him or her. Germany is a country in which such a system works particularly well. Because vocational skills are so widely recognised throughout Germany, the individual trainee has a positive incentive to train in order to gain access to a better job.

It may be appropriate for the government to step in to overcome the uncertainty problem by combining with the private sector to provide a certification structure (as in the German 'dual' system). Unfortunately it takes time to build a widely-accepted system of certification in which an apprenticeship system can operate effectively. In Sri Lanka some apprenticeship training takes place particularly through placements from the National Apprentice and Industrial Training Authority (NAITA).

An alternative approach to skill development at the vocational level is for the government to do the training itself. This is the dominant system in Sri Lanka where there is a proliferation of training schemes. There are reported to be over 3,000 publicly-supported training programmes being operated by 20 different Ministries (Kelly 1992). There is widespread criticism that the training system is not providing the skills required by the corporate sector and the few tracer studies that have been done confirm this. It is significant that in some specialist fields (eg textiles and garments) where there are close links with industry and fees are charged for certain levels of training, the training is reported to be effective (World Bank 1992d, 2,3) but the broad criticism is that the vocational training system is supply-driven and that the training is not designed and implemented by those organisations using the skills. In brief the training is generally ineffective.

In 1990, a reform was implemented whereby the major responsibility for skills development in Sri Lanka was centralised under the Tertiary Vocational Education Commission (TVEC) which reports to the Ministry of Youth Affairs and Sports. However the danger of such a development is that the defects of the training system will be attributed to poor planning instead of to the divorce of training from the user. The problem of public sector training is that while it appears to surmount the externalities problem, it creates new problems namely that the training may not only be inappropriate but also an additional burden on public expenditure.

Both these problems may be overcome through a **levy-grant** system under which the public sector becomes the coordinator but not necessarily the trainer. Levy-grant systems operate in a number of countries, a notable example being the Skill Development Fund which was set up in Singapore in 1979. [27] The advocates of such a levy-grant system argue that this provides both the stick and carrot for the corporate sector to do the vocational training. It is not (and this needs emphasising in the Sri Lankan context) another tax burden on the private sector because those companies who do the training get reimbursed for the cost and thereby recover the levy which they pay into the fund. Thus not only does a levy-grant system provide the inducement for

27. A similar scheme also operated (quite successfully in the UK) between 1968 and 1981. Indeed many economists have argued that the vocational training system in the UK has deteriorated considerably since the abolition of the Industrial Training Boards by the Thatcher government.

training, but it is also a system which is likely to ensure that suitable training is provided. This is because those who use the skills are directly involved in developing them.

Sri Lanka is moving towards such a system.[28] An announcement was made in February 1992 that a Skill Development Fund would be established (see Daily News, February 1st 1992, 1,14) and in the middle of the year, proposals were made to set up such a Fund with the support of World Bank finance. Initially the plan is to set up a Fund which has the grant but no levy element, but it is anticipated that when the Fund has demonstrated its effectiveness as a machinery for financing training which meets industry's needs and contributes to increasing productivity, part of the costs could be transferred to industry.

Thus government policy on vocational training in Sri Lanka is moving in the right direction.

7. DEVELOPMENT STRATEGY AND INDUSTRIAL POLICY ISSUES - THE WAY FORWARD IN SRI LANKA?

The main messages of the early part of this paper are that industrialization has to be the driving force for development in Sri Lanka and and that this industrialization has to be outward-oriented. The crucial question raised then was; how is this industrialization to be most efficiently promoted?

I have argued that there is a good theoretical case for state intervention in industrial development. This case is based on the widespread existence of market failures. Thus the comparison should not be between market perfection and interventionist failure but between the imperfections of the market and of interventionism. The issue is essentially one of making markets work most effectively by regulating and directing them. Thus this is not a plea for all-embracing central planning, but for mixing the best of the market with the best of state intervention.

However, efficient state intervention is no more inevitable than are efficient markets. Efficient and effective state intervention requires not only an informed, competent bureaucracy but also a strong and well-coordinated one, since such an interventionist policy needs to **discipline** as well as **support** industry. Alice Amsden has claimed that this combination of discipline and support was provided in the 1970s by the South Korean government. The South Korean bureaucracy had both the expertise and the political strength to implement such a policy but the reference to political strength resurrects the question raised earlier - namely what is the political context of industrialization? - and this immediately raises the question - **can** Sri Lanka copy South Korea?

As soon as the industrial policy problem is set within a socio-political and historical context, contrasts between South Korea and Sri Lanka become evident -

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28. Within the past two years, the Malaysian government has also taken steps to introduce a levy-grant system following a period in which considerable dissatisfaction has been expressed about the vocational training system. The complaints in Malaysia have a similar flavour to those in Sri Lanka, namely that the system is supply-driven and not sufficiently responsive to the needs of the users in the private or public corporate sectors.

contrasts in the colonial experiences; in the geo-political situation; and in ethnic structures.

These contrasts have meant not only that the initial conditions between the two countries differed at political independence but that the political conditions for further development differed. Thus the manufacturing sector in Korea was more highly developed in 1945 at the end of Japanese colonialism than it was in newly-independent Sri Lanka in 1947. Furthermore, through the 1950s, import-substituting industrialization went faster in South Korea than in Sri Lanka. As a result in 1960, even though the per capita incomes of the two countries were about the same - about US$150 - the manufacturing sector was relatively more advanced in South Korea than in Sri Lanka. Thus South Korea's experience of manufacturing has been longer than that of Sri Lanka.

Furthermore when aid flows to South Korea declined in the 1960s, it was forced to export. Unlike Sri Lanka, it could not rely on primary products to finance its imports. But, also unlike Sri Lanka, after the first 'easy' phase of import-substituting industrialisation in the 1950's, South Korea did not rely on Export Processing Zones for its manufactured exports. Instead, exports from South Korea were built up from a base of producing for a protected domestic market. Export targeting was the name of the game in South Korea, whereas a dualism seems to have developed within the Sri Lanka manufacturing sector with a DOI sector quite separate from the EOI sector based in the EPZs. In South Korea, the state was able to play an active role in the promotion of exports through targeting because of the peculiar strength of the bureaucracy vis-a-vis other groups. By contrast with the situation in South Korea, the Sri Lankan bureaucracy has not had the same 'autonomy'.

As a result, the bureaucracy in Sri Lanka finds it difficult to implement an efficient industrial policy. It is a difficult task to trace the links between the industrial policies and the political structure in Sri Lanka. What seems clear is that the bureaucracy in Sri Lanka is too weak relative to strong rentier classes based in the major political parties to bring about the emergence of an efficient, 'deepening', industrial policy. The political structure in Sri Lanka has prevented and continues to prevent the emergence of an efficient industrial policy administered on South Korean lines - and yet what is needed is an industrial policy which will break down the dualism and short-termism which characterises the Sri Lankan manufacturing industry.

Thus the political structure in Sri Lanka has not been conducive to the development of an efficient manufacturing sector. The private sector was not encouraged to develop in the manufacturing sector from the 1950s through to the end of the 1970s (see Kelegama and Wignaraja, 1991, 30,31), but although it has been encouraged in the 1980s, it has not been disciplined. On the other hand, the public sector **was** encouraged during the 1950s through to the end of the 1970s but was not disciplined. Thus, as Uyangoda has pointed out, the state in Sri Lanka has not constituted itself as an 'intermediate regime' substituting for private capital in the development of a productive, dynamic manufacturing sector.

Yet it needs to be emphasised that there is nothing inherently inefficient about a state-owned manufacturing sector. This has been highlighted in an excellent, recent UNCTAD paper by Chang and Singh (1992). It is often said that the private sector is bound to be more efficient because of its allegedly more direct accountability and incentive structure. However this is not necessarily the case. As Chang and Singh point

out, "shareholder collective action" may not exist and shareholder control may be ineffective in as much as there is little incentive for small, individual shareholders to collect sufficient information to hold the management accountable. As they also state;

> "...privatisation can also actually worsen public enterprise performance by substituting more effective ministerial monitoring with less effective monitoring through 'shareholder collective action' "(Chang and Singh 1992, 13)

Thus accountability is a complex issue.[29]

Chang and Singh also make the point that;

> "Amazing as it may seem, despite the current accusation of public enterprise inefficiency and the consequent vogue of privatisation, there are relatively few systematic studies comparing the performance of public enterprises and privately-owned firms" (Chang and Singh 1992, 30).

They also emphasise that, of the detailed studies that have been done, most have been carried out in countries where bad public enterprise performance has been of great concern. Studies in countries like South Korea, Singapore and Taiwan where public enterprises are largely regarded as good performers have been rare (1992, 35). In Sri Lanka, no detailed study of the efficiency of public enterprises in the manufacturing sector seems to have been carried out,[30] but it is widely alleged that the state-owned enterprises have been inefficient.[31] Assuming that this is the case, why is it? What are the structural reasons for the inefficiency?

The main explanation seems to be that public enterprises have been used as a 'political football' in Sri Lanka. Thus Uyangoda states that the nationalization programmes of the 1950s and 1960s had essentially sectarian and factionalist origins. He argues that;

> "When it was first formulated in the mid-fifties it was directed not against foreign-owned plantations or enterprises, but against economic ventures owned by local capitalist groups that happened to be politically aligned with the rival UNP" (Uyangoda 1992,188).

However, even when the foreign-owned plantations were nationalised in 1975, Herring states that "the major thrust was to place the core of the national economy under state control, significantly increasing resources for the ordinary politics of patronage and partisan manipulation" (Herring 1987, 327). Kelegama has stated more

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29. Bhaskar also makes the same points in a paper on privatization in Bangladesh (Bhaskar 1992)

30. Details of the financial performance of public enterprises in Sri Lanka are easily available, but financial profitability is rarely likely to be a good indicator of efficiency (see Chang and Singh 1992, 19ff.)

31. Saman Kelegama has pointed out that operational efficiency in the narrow sense was not high on the list of objectives of public enterprises in Sri Lanka between 1957 and 1977. Other, 'social', objectives had a higher ranking and were important in generating initial popularity for the nationalization programmes (Kelegama 1991a, 5). It has also been alleged that the government intentionally let the public manufacturing enterprises deteriorate in order to justify privatization (see Karunatilake 1987, 165-166).

generally that; "It is no secret that those in power always treated the public sector as a convenient means of employment creation and patronage" (Kelegama 1987, 8).

Two problems have stemmed from this interweaving of the nationalization programme and political patronage. Firstly the private sector was held back or denied entry into many manufacturing sub-sectors. Secondly the problem arose about how to reform the situation. It is worth looking at these two problems in more detail.

(i) Even though public sector enterprises seem to have been inefficient, they have been sufficiently dominant to deter the growth of medium-size manufacturing firms in the private sector (see Uyangoda 1992, 189). Under such conditions, two forms of dualism developed alongside one another. I have already referred to the dualism between the EOI and DOI sectors, but in addition there was a dualism between very large and very small enterprises. Thus in 1987, about 88 per cent of material inputs into public sector industries were imported (see Kelegama and Wignaraja, 1991, 51) and there is a low level of sub-contracting between large and small enterprises (see Dias 1991 and Kelegama 1992a,20) in spite of many programmes for the promotion of sub-contracting and small and medium-scale enterprises (see Dias 1991 and Lakshman 1991 26ff).

As a result, there seems to be a large gap between small and large enterprises with medium-scale enterprises accounting for a small share of total output (Kelegama 1992a, 30). This is particularly unfortunate since, in recent research by Little, Mazumdar and Page;

> "....the figures suggest that small firms rather often have both low capital and low labour productivity. Capital productivity and total factor productivity peak in the medium size range of 50-500 workers in most industries" (Little 1987, 215)

In general, Little et al found, small firms export little or nothing (Lakshman et al also found the same in Sri Lanka - see 1991, 92) and Little argued that;

> "if our research can be held to suggest anything about size and economic or social desirability, it is that beauty is to be found mostly in the middle of the size distribution" (Little 1987, 215).

In the light of this, the absence of medium-sized enterprises in Sri Lanka is to be regretted. Nevertheless there are two reasons why the government needs to press on with programmes which promote sub-contracting. Firstly linkages will be developed faster with than without institutional support (see Dias 1991, 32) but secondly, even with institutional support, the linkages will take a long time to develop.

(ii) The second problem is; what is to be done about the inefficient public-sector enterprises? The policy implemented to deal with this problem in Sri Lanka has been to privatise the public sector enterprises. This policy has been adopted since 1987, but privatization has itself been subjected to accusations of patronage and crony capitalism with the lack of transparency in the implementation of the programme leading to rumours of corruption and favouritism (see Kelegama 1991a, 29 and Tilakaratna, 1992 July, 11).

The privatization programme has been emphasised alongside the development of the stock market and 'shareholder capitalism'. In his paper, Mick Moore suggested that the development of 'shareholder capitalism' might help to develop and open up merchant capitalism in Sri Lanka, but then he also expressed some doubts about whether 'shareholder capitalism' would encourage long-term development in Sri Lanka (Moore 1992, 45). I share Moore's doubts. The development of 'shareholder capitalism' on the US/UK model is likely to do little to encourage the development of industrial capitalism in Sri Lanka. Many economists suggest that the dominance of 'shareholder capitalism' has been detrimental, and continues to be detrimental to the economies of the US and UK (see Dore 1985, 21,25; Eltis et al 1992,14,22; and Singh 1992,31), and as Singh argues;

> "The Japanese and also the German financial systems which are bank rather than stock-market-dominated, are.... regarded as being much more conducive to the development of the real economy and to international competitiveness" (Singh 1992, 32)

Singh concludes that;

> "to the extent that developing countries have a choice, they should attempt to foster bank-based financial systems more along the lines of the 'follower' countries (Japan, Germany and France) rather than to establish and encourage stock-markets" (Singh 1992, 43).

This is a similar conclusion to that reached by Moore. However Singh recognises that such bank-based systems may generate crony capitalism (Singh 1992, 44) so that the proper regulation of such systems is essential. If this is impossible, or if stock markets are to be encouraged in spite of their speculative nature, then, he argues, it is important that share turnover should be discouraged, that take-overs should be regulated and that product market competition should be fostered (Singh 1992, 45).

Thus the problems facing the merchant-capitalist economy of Sri Lanka are considerable and their solutions need political as well as technical analysis. As Alice Amsden has argued, it is not just effective state intervention that requires a 'strong state' - to introduce free markets also requires a 'strong state' (see Amsden 1989). Thus while it may be difficult for a 'weak state' to pick 'industrial winners', it may be equally problematic for a 'weak state' to introduce free markets across the economy. Furthermore if some markets are liberalised, while others are kept restricted, we may end up in a 'third-best situation' inferior to the previously more restricted situation.

Free markets may work well when it comes to arranging short-term trading - but this is not what Sri Lanka needs. What it needs is long-term investment in a manufacturing sector which will be competitive internationally. This means consistency, long-term planning and guidance for the market so that it can work more effectively. Unfortunately the obstacles to this effective working of the market are just as much political as technical.

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