LIBERALIZATION AND INDUSTRIALIZATION: THE SRI LANKAN EXPERIENCE OF THE 1980s

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by

Saman Kelegama

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1. INTRODUCTION

Industrialization is seen today as the main instrument for restructuring an economy. During the 1950s and 1960s import-substitution was seen as the principal means of promoting industrialization. With the passage of time, import-substitution industrialization (ISI) proved to be a failure in many countries. Thus in the early 1970s there was a notable shift of emphasis away from ISI to export-led industrialization (see, for instance, Little *et al*, 1970). Unlike import-substitution regimes, which were administered by quantitative controls characterised by widespread dispersion of unpredictability, export-promoting regimes relied on price incentives that were more predictable. Export-promoting industries were seen as stimulating greater productivity because of increased foreign competition, access to new technology and methods of production, and benefits of economies of scale (see, for instance, Krueger, 1978). Import-substitution industries producing for a narrow domestic market could not match these advantages. Thus it was argued that superior economic performance could be achieved by following an export-oriented industrialization (EOI) strategy. (For more details of the ISI versus EOI debate, see Griffin, 1988).

The main area of attention in regard to EOI is economic liberalization and, in particular, trade liberalization. Trade liberalization is seen to be the essential requirement for EOI. Literature on industrialization has pointed out that trade liberalization leads to increased growth and diversification in the industrial sector. The argument goes that, firstly, a liberalized trade regime has no disincentives against exports and the exchange rate is generally uniform for different categories of foreign trade transactions. It follows that with uniformity of incentives there will be less wasteful allocation of resources and more

planning would move contrary to its liberalization policy. The policy reforms can be described in the context of this study as follows:

1.1 Trade Policy Reform

Reduced direct intervention in foreign trade and exchange or, in other words, trade liberalization (removed most import quotas and replaced them with a tariff system, devalued currency, partially liberalized exchange controls, etc.)

1.2 Trade Policy Reform Supporting Policies

1.2.1 Other economic liberalization measures: partial liberalization of financial markets (raising interest rates, establishing Foreign Currency Banking Units etc.), partial liberalization of the commodity markets (elimination of consumption subsidies and other price controls, reduction of the state monopoly on commodity purchases by import liberalization, etc.) and partial liberalization of the labour market (reduction of trade union powers in wage bargaining, implementing new labour laws for the Export Promotion Zone (EPZ), etc.).

1.2.2 Fiscal incentives to encourage private sector (tax reduction, subsidies to offset increase in cost of production).

1.2.3 State intervention to encourage private-sector development (infrastructure development under a massive Public Investment Programme, e.g., hydro-electric power from the Mahaweli scheme, establishment of the EPZ, etc., and other infrastructure development activities, such as development of the Colombo Sea Port).

1.2.4 Establishment of state institutions to support trade policies: In order to promote exports, the Export Development Board (EDB) was established in 1979. A pre-shipment refinancing scheme for non-traditional exports and an Export Credit Insurance Corporation (SLECIC) were also established, among others.

1.3 Ad hoc Industrial Policies

1.3.1 With a view to promoting Foreign Direct Investment (FDI) in order to meet Sri Lanka's needs of imported technology, and for export development purposes, the Greater Colombo Economic Commission (GCEC) and the Foreign Investment Advisory Committee (FIAC) were established in 1978.

1.3.2 In order to strengthen the national innovation system for local industry, a National Science and Technology Planning Coordination Committee (NSTPCC) was appointed in 1984. It was empowered to develop an integrated science and technology plan for several productive sectors, including industries. To enhance innovation at the micro level, a few Product Development and Service Centres for R & D were established, such as the Clothing Industrial Training Institution (CITI) -- 1984, Textile Training and Service Centre (TTSC) -- 1984, and the Rubber Products Development and Services Centre (RPDSC) -- 1982.

1.3.3 The National Development Bank was established in 1979 to make available long-term concessional loans for industries. In 1984, the Sri Lanka Business Development Centre (SLBDC) was established to promote entrepreneurial development.

1.3.4 Measures were taken to rationalize the functioning of public sector industries (see, for instance, Athukorala, 1986).

In this paper, the intention is to take a broad look at the developments in the industrial sector during the 1978-89 period, and offer an explanation for the prevailing weaknesses of the manufacturing sector. The paper also explores how effective liberalization has been in enhancing the industrial growth process. Certainly, there are various other means as well that one can adopt to analyse industrial growth. The liberalization framework is used here because it appears to be the core around which the Sri Lankan policy debate revolves. There are those who say that Sri Lanka's liberalization was inadequate to achieve rapid and sustainable industrialization (see, for instance, Lal and Rajapatirana, 1989). On the other hand, there are others who claim

that Sri Lanka has liberalized far too much and this has worked against industrial progress (see, Herring, 1987, Osmani, 1987, and others). The paper takes a broad look at this debate and highlights some issues that are of relevance to policy-making. The period of study is from 1978 to 1989 and the paper is divided into four sections. Section 2 analyses industrial progress during the 1978-89 period. Section 3 analyses the incentive regime. Section 4 sets out the concluding remarks with some suggestions for policy formulation.

2. AN ANALYSIS OF THE INDUSTRIAL PRODUCTION STRUCTURE

At the most aggregate level, the 1977 policy regime has had an impressive effect on the performance of the manufacturing sector. As Table 1 shows, value added in the manufacturing sector grew at an impressive rate of 6.1 per cent per annum (p.a.) during the 1986-89 period, and at 5.1 per cent p.a. during the 1978-85 period, compared with a 3.0 per cent p.a. during the 1970-77 period. Despite this increase, however, major weaknesses appeared in the growth pattern of the manufacturing sector. Three general types of weakness can be identified: erratic growth momentum, lop-sided growth, and inadequate export orientation.

In 1978, the year immediately following liberalization, value added in manufacturing recorded a growth rate of 7.8 per cent, but the performance since then has been erratic, and considerably poorer on average (see Table 1). In fact, the figures for capacity utilization and new industrial investment also confirm the tapering-off of the initial upsurge. Table 2 indicates that the capacity utilization of manufacturing increased from 60 per cent in 1977 to 70 per cent in 1978, but remained only slightly above that level in the ensuing years. Also, Table 3 shows that the high number of approvals by the LIAC (Local Investment Advisory Committee) in 1978 and 1979 fell drastically after 1979. Moreover, a large number of investment proposals failed to materialize; only 43 per cent of the cases approved since 1977 were actually in production or about to commence production by 1982.[1]

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[1] See MISA (1983).

Table 1
Manufacturing Real Growth and Shares

	70-77	78	79	80	81	82	83	84	85	86	87	88	89	78-89
Manufac. (Mfg)	3.0	7.8	4.6	0.8	5.2	4.8	0.8	12.3	5.2	8.4	6.8	4.7	4.4	5.6
GDP	2.8	8.2	6.3	5.8	5.8	5.1	5	5.1	5	4.3	1.5	2.7	2.3	4.1
Mfg./GDP	1.04	0.95	0.73	0.14	0.90	0.94	0.16	2.4	1.04	1.95	4.53	1.74	1.91	-
Mfg. Share of GDP	15.5	15.4	15.2	14.8	14.4	14.4	13.8	14.7	14.8	15.4	16.2	16.5	16.6	15.2

Source: Central Bank of Ceylon, Review of the Economy, various issues

Table 2
Capacity Utilization in Manufacturing (percentage)

1970-77*	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
53	60	70	72	73	74	76	74	75	74	78	79	78	79

Source: Central Bank of Ceylon, Review of the Economy, various issues
Note: * = Average for the period

Table 3
Approval from the Local Investment Advisory Committee (LIAC), 1978-85

	1978	1979	1980	1981	1982	1983	1984	1985
No. of Units	2385	1803	699	460	297	349	474	344
Total Investment (Rs.mn.)	1061	875	337	262	231	422	567	321

Source: Central Bank of Ceylon, Review of the Economy, various issues.

As Table 1 shows, the average ratio of manufacturing growth to GDP growth for the 1978-85 period was very close to 1, reflecting the fact that the manufacturing sector did not show a 'distinct' growth pattern relative to the growth of GDP. Excluding 1983 (the year of ethnic disturbances), in only two years out of the seven-year period had this ratio remained significantly above unity. During the period 1986-89 too the ratio remained above unity, but this was owing to low GDP growth rather than high manufacturing sector growth. The share of manufacturing in GDP, remaining around 14-16 per cent throughout the 1978-89 period (the same as during the 1970-77 period),

indicates that no major structural transformation in the economy was effected by the manufacturing sector (see Table 1). The third-world country average of the share of manufacturing in GDP in 1981 was 19 per cent.[2] In comparison, Sri Lanka's figure of 15.2 per cent p.a. during 1978-89 seems grossly inadequate for the manufacturing sector, considered a major component of the economy. It is also vital to note that during the 1978-89 period, the tree-crop processing industry's share in GDP was nearly 4.1 per cent p.a.[3] Thus the percentage share in GDP of the manufacturing sector proper, i.e. factory industries, was only 9.7 per cent p.a. during 1978-89.[4] It is clear therefore that the manufacturing sector has not lifted the economy and directed it towards a higher level of sustainable growth.

In a scenario of slackening growth momentum, sustained growth was achieved in only a few sectors. Table 4 shows the real growth rates for the standard (ISIC) narrowly defined manufacturing industries, i.e. the registered manufacturing enterprises in the formal sector. As shown in the table, the most impressive growth rates were achieved in the Textiles and Wearing Apparel and the Petro-Chemical sectors. In fact, these were the only two sectors which registered high growth rates during 1978-82 in comparison with 1970-77.[5] One other sector which recorded reasonable progress in the early years after 1977, was that which included the industries allied to the construction sectors, namely the group comprising clay, sand and cement (most of these industries are categorized under Non-Metallic industry). Growth picked up in most industries after 1983 (see Table 4, Compound Growth Rates). However, this growth has not been substantial to diversify the manufacturing sector. The lop-sided nature of growth in the manufacturing sector is reflected in the output shares of various industries as a percentage of total manufacturing sector output (see Table 5).

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2 See Griffin (1989), p.102.

3 Estimated from CBC-AR, various issues.

4 Manufacturing sector is composed of tree-crop processing industries, factory industries (large-scale industrial units of the formal sector) and small industries (in the formal and informal sectors).

5 In 1983 most industries showed low growth rates owing to the ethnic disturbances. In order to avoid the influence of these low growth rates, the 1977-82 period was selected . The discussion at present is confined only to the registered manufacturing industries in the formal sector.

Table 4
Growth of Gross Output in Manufacturing by Industry (at constant prices, 1974)

	Regression			Compound	
	1970-77	1977-82		1979-82	1983-88
Food, Beverages and Tobacco	7.43	3.95		9.83	34.28
Textile, Wearing Apparel, etc.	-2.36	29.33		172.29	212.03
Wood and Wood Products	24.09	3.33		31.73	-11.16
Paper and Paper Products	12.54	3.75		29.54	46.09
Petro-chemical Products	8.71	13.68		21.54	0.18
Petroleum Products	25.00	14.33			
Chemical, and Rubber Products	12.25	23.49			
Non-Metallic Products	5.37	5.22		22.48	21.35
Basic Metal Products	15.55	2.57		-50.53	10.67
Fabricated Metal Products etc.	3.28	0.45		-3.77	58.97
Other Manufacturing Products	2.36	-1.01		-10.35	43.30

Source: Estimated from Central Bank of Ceylon, Annual Reports, various issues.

Note: Regression growth rates given in the first two columns and the compound growth rates given in the second two columns are not comparable. Compound growth rates were estimated using the real value of output for 1979, 1982, 1983, and 1988. The relevant deflators were obtained from the Central Bank monthly bulletins. 1989 was not considered to estimate growth rates because of the political disturbances during the year.

Among all sectors, the Textile and Wearing Apparel industry shows the most impressive growth performance. Its contribution to total manufacturing output increment between 1978 and 1985 was 29 per cent while the same ratio for 1978 and 1989 was nearly 40 per cent.[6] However, this was the most adversely affected industry after import liberalization. Despite attempts to increase efficiency through foreign management partners, the output of government-owned Textile Mills tended to stagnate throughout the period 1978-89 (see Table 6)[7]. In these circumstances, the expansion of this industry was mostly due to the rapid expansion of the Garment subsector (which is categorized under Wearing Apparel).

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6 Estimated from CBC-AR, various issues.

7 The increase in output after 1984 can be attributed to the introduction of private management to some of the textile corporations, e.g. Pugoda Mills managed by Lakshmi, India.

Table 5
Output Share of the Industry Sample
(as a percentage of total output of the manufacturing sector)

	Year	Output share
Food, Beverages, etc.	1977	32.8
	1985	27.1
	1989	29.9
Textile & Wearing Apparel	1977	10.0
	1985	24.6
	1989	35.7
Petrol-Chemicals etc.	1977	35.2
	1981	52.2
	1985	33.9
	1989	20.6
Wood & Wood Prodcucts	1977	1.8
	1985	1.8
	1989	1.1
Paper & Paper Products	1977	3.9
	1985	3.0
	1989	2.4
Non-Metallic	1977	5.9
	1985	4.8
Fabricated Metal, Machinery & Transport equipment	1977	8.1
	1985	4.1
	1989	5.2
Manufacturing (nes)	1977	0.5
	1985	0.3
	1989	0.4

Source: Central Bank of Ceylon Annual Reports, various issues.

Table 6
Output of Government-owned Textile Mills, 1978-88 (in constant 1970 prices)

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Output (Rs.mn.)	25.9	13.1	7.3	10.1	11.8	9.9	9.25	11.2	12.4	13.5	16.5	15.2

Source: Central Bank of Ceylon, Review of the Economy, various issues

The growth of the Garment industry largely reflects the growth in the number of such units in the Greater Colombo Economic Commission (GCEC) and the Foreign Investment Advisory Committee (FIAC). Table 7 shows the number of firms with foreign-capital participation before the policy reforms in 1977, and for the years 1985 and 1988. During the 1978-88 period, the GCEC and the FIAC approved 267 and 298 foreign projects, respectively, in the manufacturing sector; 276 of these projects (113 in GCEC and 163 in FIAC) had started production by 1985. From Table 7 it is clear that the Garment sector was the major area of attraction for foreign capital. More than 40 per cent (46 out of 113) of GCEC projects were in this sector in 1985. In the FIAC, approximately 32 per cent of firms (52 out of 163) were in this sector. The Garment sector prospered in the GCEC and FIAC, favoured by Sri Lanka's hitherto unfulfilled quotas in the western markets, while the quotas for the East Asian NICs were rapidly being exhausted.

Table 7
Sectoral Distribution of Manufacturing Firms with Foreign Capital Participation

		Operational		Approvals	
	No. of firms by 1977	GCEC (end-1985)	FIAC (end-1985)	GCEC [end-1988]	FIAC [end-1988]
Food, beverages & tobacco	7	2	14	9	22
Textiles, wearing apparel & leather products	19	46	52	87	82
Wood & paper products	2	6	7	6	14
Chemicals, petroleum etc.	16	15	35	29	58
Non-metallic mineral products	5	13	14	32	31
Basic and fabricated metal products	20	5	26	21	55
Other manufactured products	1	26	15	79	34
Total in operation	70	113	163	--	--
Total approvals	-	203	220	267	298

Sources: Ministry of Finance and Planning (1984) and Ministry of Finance and Planning (1986 and 1989).
Note: 1988 operational figures were not available at the time of writing.

While the incentive package introduced by the liberalization programme might have been an added attraction, it could be said that the redirection of international capital towards Sri Lanka would have occurred in any case, owing to quota exhaustion in the East Asian countries, and to the availability of a cheap but educated labour force in the country together with its convenient geographical location in the international transport network.

Turning now to the Petro-Chemical industry, one finds that the key to its success was the impressive performance of the Chemical and Rubber Products sub-sector (see Table 4). The production of the Petroleum sub-sector, which accounted for 77 percent of output growth of the Petro-Chemical industry in 1977, declined considerably because the main refinery reached its capacity level in 1981.[8] During the 1981-85 period, Textiles and Wearing Apparel and the Food industry grew mainly at the expense of the Petro-Chemicals sector, whose share of output declined from 52.2 per cent to 33.9 per cent (see Table 5). The drop in the Petro-Chemicals sector can also be attributed to the decline in the price of Petroleum products due to the reduction in protection and a fall in the international price of oil. It has also been caused by terrorist activities adversely affecting the output of the Paranthan Chemicals Corporation (MOFP, 1987a, p.66).

There were two factors that contributed to the success of the Chemical and Rubber Products sub-sector during the 1978-82 period. First, a few multinational companies produced almost all of the Chemical sub-sector's output (paints, toilet products, pesticides, drugs and medicine[9]) and were well poised to withstand import competition, and also to internalize market failures. In fact, they not only benefited from the free availability of imported inputs but also, to a significant degree, from the protection provided by the new tariff structure.[10] Secondly, in order to protect the industries using domestic rubber, the government decided to raise a high tariff wall against imported rubber products -- a policy measure which went quite contrary to the liberalization programme. As a result, the domestic rubber industry thrived under a secure protective umbrella.[11]

The growth of industries allied to the construction sector resulted from the construction boom that was generated by the three lead sectors: Mahaweli, Housing, and the EPZ. However, with the decline in construction activities during the post-1980 period, investment in allied industries also declined. This is reflected in the mediocre performance of the Non-Metallic industry (see Table 4).

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8 See CBC-ROE (1981), p.45.

9 For example, even during the mid-seventies nearly 75 per cent of local drug production was under multinational control. See Lall (1980), pp.223-224.

10 See People's Bank (1987), p.14.

11 See Cuthbertson and Khan (1981).

With regard to the remaining sectors, the following observations may be made: The Fabricated Metal Products, Machinery and Equipment and 'Other Manufacturing' Products sectors appear to be the most adversely affected by import competition. These two sectors mostly included locally-owned firms which expanded in response to the high priority given to them under the pre-1977 import-substitution strategy. A survey by the Ministry of Industries found that 'export dumping' practices were widespread in these product categories. As a result, domestic industries were adversely affected.[12]

In the four sectors - (1) Wood, (2) Paper, (3) Non-Metallic, and (4) Metallic Products -- the public-sector undertakings accounted for an overwhelming share of the output during the late-1970s and early-1980s (see Table 8). Owing to haphazard planning and inefficient management in public corporations, they failed to face import competition effectively (see Section 3.1.1). For example, sales of the Leather Products Corporation, Ceramics Corporation, Steel Corporation, Hardware Corporation, etc., fell to record low levels during the 1978-83 period.[13] The above observations clearly show that post-1977 efforts to rationalize management practices in the public sector did not produce the desired results.

Varied encouragement given to the private sector failed to yield the anticipated result of promoting higher growth in these sectors during the 1978-85 period. Analysing this situation, Athukorala (1986) notes:

> "one can reasonably argue that, notwithstanding relatively less satisfactory performance of state industries, had it not been for their continued operation, manufacturing output would, in fact, have indicated negative growth" (p.83).

During the period 1986-89, however, private sector industries showed an impressive performance vis-a-vis public industries owing to the improvement of the incentive structure. A rough picture of this phenomenon can be obtained from Table 17.

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12 See MISA (1980).

13 In fact, sales declined despite high tariff protection offered to some of these public corporations, See Kelegama, J.B. (1986), pp. 23-24, and Cuthbertson and Khan (1981), p.90.

Table 8
Percentage Contribution of Public Sector Manufacturing Enterprises to Value Added in Manufacturing

	1974	1981	1989
1. Food, Beverages and Tbc.	44	13.2	35.2
2. Textile and Leather Products	31	53.1	11.8
3. Wood and Wood Products	100	88.3	74.3
4. Paper and Paper Products	99	73.4	31.8
5. Chemical, Petroleum, Coal and Plastic Products	79	52.8	53.9
6. Non-metallic Mineral Prod.	100	84.6	54.6
7. Basic Metal Products	100	70.2	45.5
8. Fabricated Metal Products	12	22.6	35.5
Factory Industry Total	56	43.0	32.2

Source: Estimates for 1974 are from Lakshman (1979), Table 4.7. Estimates for 1981 are from Department of Census and Statistics (1981), pp. 72-73. Data for 1990 were estimated from the data given in Department of Census and Statistics (1990).

It is evident from the foregoing, that the few industries which prospered after 1977 were mostly helped by factors other than those related to the liberalization programme. This is not to suggest that liberalization did not have any salutary effect. It did in fact contribute, by facilitating access to raw material and by improving the quality of products as a result of competition from imported products. But the most disconcerting aspect of liberalization was its failure to invigorate certain crucial sectors such as light engineering industries, electronic industries, etc., which are usually considered essential to the development of a solid base for domestic industry. The other area where liberalization failed was in achieving a major breakthrough in manufactured exports growth. This is briefly analysed below.

Manufactured exports increased from SDR 33.18 million in 1978 to SDR 121.65 million in 1989.[14] Table 9 shows that the total manufactured exports as a percentage of GDP increased from about 14 per cent in 1977 to 51 per cent in 1989. This rising share, however, was not based on a broad diversified spectrum of manufactured goods but rather on the outstanding role of Textile and Wearing Apparel exports. Table 10 shows that Textile and Wearing Apparel exports as a percentage of total manufactured exports increased from 15.6 per cent in 1977 to 63 per cent in 1989. Thus, in 1989, nearly 73 per cent of the total manufactured exports came from the Textile and Wearing Apparel and Petro-Chemical exports. Most of the Textile and Wearing Apparel export expansion could be attributed to the increase in Garment exports from the GCEC and the FIAC.

Table 9
Industrial Exports (as a percentage of total exports, f.o.b.)

	1977	1979	1981	1983	1985	1987	1988	1989
1. Manufacturing	13.8	23.6	35.6	35.2	40.0	46.7	48.0	51.0
1.1 Garments	2.1	7.2	14.4	17.4	21.5	30.2	30.0	31.0
1.2 Petroleum products	9.0	12.8	16.5	10.7	10.9	6.3	5.3	4.7
1.1 + 1.2	11.1	19.8	30.9	28.1	32.4	36.5	35.3	36.7
1.3 Others	2.7	3.8	4.7	7.1	7.6	12.2	13.0	15.0
2. Mining and Quarrying	4.9	4.1	3.8	4.6	2.4	4.3	5.6	4.8
Total Industrial Exports (1+2)	18.7	27.7	39.4	39.8	42.4	53.0	53.6	55.8

Source: CBC-ROE, various issues

Studying the geographical distribution of Sri Lanka's manufactured exports, UNIDO (1986) observes:

> "Developed market economies have been of overwhelming importance as export markets, absorbing 85 per cent of the narrowly defined manufactures. What may give rise to concern is the fact that these non-traditional exports are lacking in geographical diversification: more than two-fifths (43 per cent) in 1982 was accounted for by the U.S. market alone which was a larger share than all other developed market economies taken together" (p.34).

[14] See EDB (1991), p. 16.

In 1989, nine Western countries accounted for more than 85 per cent of manufactured exports (Australia -- 4.5 per cent, Canada -- 5 per cent, France -- 4.5 per cent, Germany -- 5.5 per cent, Italy -- 8.25 per cent, Japan -- 11.25 per cent, Holland -- 6.25 per cent, U.K. -- 12.2 per cent, and USA -- 28.5 per cent[15]). Clearly, there has been no major change in the geographical distribution of Sri Lanka's manufactured exports during the 1982-89 period.

Table 10
Performance of Manufactured Exports, 1977-89

	Percentage of Total Exports													
	1970	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Food and Beverages (& Tobacco)	19.7	11.5	14.3	10.0	5.5	6.0	7.6	6.1	5.2	3.9	4.5	3.9	4.5	3.5
Textiles & Wearing Apparels	8.5	15.6	26.6	30.2	32.3	41.4	42.3	53.7	59.8	58.1	60.7	64.5	62.9	61.9
Chemical Products	11.7	2.3	2.7	1.5	1.2	0.9	2.7	1.3	1.5	2.5	2.9	2.2	3.0	3.4
Petroleum Products	47.0	65.9	51.6	52.1	55.2	46.2	39.7	30.4	26.1	28.5	14.8	13.0	9.9	7.9
Leather, Rubber, Paper, Wood & Ceramics	10.3	4.0	3.9	4.9	4.4	3.9	5.5	5.8	5.6	5.3	7.4	8.3	9.7	8.9
Machinery, Mechanical & Electrical Appliances	2.8	0.6	0.9	1.1	1.2	1.4	1.9	2.2	1.4	1.6	2.8	2.0	2.2	2.5
Total	100	100	100	100	100	100	100	100	100	100	100	100	100	100

Source: Central Bank of Ceylon, Review of the Economy, various issues

The slow and lop-sided growth of most manufactured exports is reflected in the continued inability of the sector to finance its import needs through its exports. For example, the ratio of manufactured exports to total imported inputs used in manufacturing -- a rough indicator of the ability of this sector to meet its own import requirements -- increased only marginally from 38 per cent to 43 per cent between

15 Estimated by the author using the EDB data base.

1978 and 1980.[16] As mentioned earlier, one of the main devices used, after 1977, to increase manufactured exports, was the encouragement of Foreign Direct Investment (FDI). Its impact on manufactured exports is examined below.

2.1 An Analysis of FDI in Increasing Manufactured Exports

Table 11 gives the percentage contribution of FDI firms to export increments during the 1977-89 period. It can be seen that nearly 62 per cent of the increase in total manufactured exports between 1983 and 1989 was brought about by firms with FDI as compared with 36 per cent between 1977 and 1979. Clearly, FDI has made a significant contribution to manufactured exports after liberalization in 1977.

Table 11
Role of FDI in Manufactured Export Expansion: Contribution (percentage) to Export Increment (based on Rs. values)

	1977-79	1979-82	1983-89
Firms with FDI	35.5	47.2	61.5
Fully locally-owned firms	64.5	52.8	38.5

Source: 1977-79, Athukorala (1986), p.96, post-1979 data were obtained from the GCEC and the Central Bank of Sri Lanka.

The contribution of firms with FDI in GCEC and FIAC for the entire 1979-89 period is shown in Table 12. As Table 12 shows, the relative position of GCEC firms in total manufactured exports increased from 6.4 per cent in 1979 to 41.5 per cent in 1985 and to 41.6 per cent in 1989, while FIAC firms increased from 2.9 per cent to 14.9 per cent and to 15.0 per cent, respectively. Thus the total FDI-related exports from the GCEC and FIAC, as a share of total manufacturing exports, increased from 9.3 per cent in 1979 to 56.4 per cent in 1985 and to 56.6 per cent in 1989. Although the performance of the post-1977 FDI-related firms appears to be impressive there are, however, some disconcerting features that are noteworthy.

16 See CBC-ROE (1983), pp.52-53.

Table 12
Percentage Contribution of Firms with FDI (In the GCEC and FIAC) to Total Manufactured Exports, 1979-85

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
GCEC firms	6.4	15.0	23.1	29.4	45.9	40.4	41.5	34.0	37.6	42.1	41.6
FIAC firms	2.9	6.3	8.0	9.4	18.5	13.0	14.9	19.9	16.0	16.3	15.0

Note: FIAC was abolished in 1989. The 1989 figure is an unofficial figure for the former FIAC firms.
Sources: External Resource Department, Colombo; Ministry of Finance and Planning (1988).

In the EPZ for example, where all the GCEC firms are located, first, garments constituted an overwhelming proportion of EPZ exports.[17] Secondly, the long-term benefits the EPZ can generate depend on the nature and extent of linkages between the EPZ industries and the rest of the economy. With regard to forward linkages, EPZ's contribution was negligible, since the zone was designed to produce for exports only. Backward linkages of the EPZ, which are simply measured by the local content, were insignificant since the utilization of local inputs was low. Purchase of local raw materials by the GCEC firms amounted to less than 10 per cent of their total raw material purchases during 1981-84.[18] Another important factor is that, although GCEC firms did contribute to the expansion of manufactured exports, the net foreign exchange gains from them were generally much lower than gross earnings on account of the high import content (import of machinery and raw materials), remittance of profits, royalties and salaries of expatriate management personnel.

To examine next the firms that were established under FIAC, it is important to note that the greater part of investment in FIAC projects was in services. Out of the total investment in the 1977-85 period, about 45 per cent was in tourist hotels and 12 per cent in other services, while the share of investment in agriculture was 15 per cent and that in industries it was 28 per cent.[19] About 40 per cent of the FIAC firms' output was exported during the period 1979-85, but nearly 40 per cent of these exports consisted of Textiles and Garments.[20]

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17 See UNIDO (1986), Table A-14, p.95.

18 Information obtained from the Department of External Resources, Colombo. Also see Karunatilake (1987), pp. 430-431 and World Bank (1987SL), p.65.

19 See Ministry of Finance and Planning (1988), p.33, Table III.

20 Ibid, p.31, Table IV.

In overall terms, in 1979, 61 per cent of total exports from all firms with FDI participation consisted of Garments and this share increased to 70 per cent by 1989.[21] In 1988, foreign firms accounted for 54.9 per cent of Garments exports and 42.9 per cent of Gems and Jewellery exports (EDB, 1988, p.26). Thus it is clear that although FDI played a major role in the expansion of manufactured exports, the original expectation that they would contribute towards a diversified export structure did not materialize. Moreover, linkage effects and net foreign exchange contribution from GCEC industries were poor, while the contribution to manufactured exports from FIAC firms was not impressive.

The overall picture therefore is one of unfulfilled expectations. While the liberalization programme did provide an initial spurt to all-round industrial growth, subsequent developments were disappointing. The plight of the small and rural-sector industries, which is analyzed next, has to be understood in this context.

2.2 Small and Rural Industries

As in many LDCs, the informal sector occupies an important position in Sri Lanka's total manufacturing. As a whole, the combined factory-based small-scale sector and the rural-cum-informal sector is of major importance to the economy, both in terms of its contribution to manufacturing value added (25 per cent in 1980) and its employment-generation capacity, in comparison with the large-scale manufacturing sector.[22] All small and rural industries are owned by the private sector. Two significant aspects are the high employment share in total manufacturing sector employment (30 per cent) and the low capital/labour ratio compared with overall manufacturing. The promotion of small industries was seen to be not only consistent with, but also conducive to the post-1977 outward-looking strategy. For instance, MOFP (1985) stated:

> "The small-and medium industries sector provides a reservoir of vast potential for accelerating export-led industrial development. These (small-and medium industries) can be linked vertically as a supply base for large industries" (p. 98).

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21 Information obtained from the Department of External Resources, Colombo.

22 See IDB (1980).

However, most small industries failed to take advantage of the opportunities opened up by liberalization and, in fact, have been harmed by its direct and indirect consequences (Osmani, 1987). Most small industries producing matches, soap, salt, coil wire, soft drinks, etc., were virtually wiped out by import liberalization, dumping, high interest rates, and the like. In addition, rural industries producing handlooms, treacle, jaggery, coconut toddy, copra, sugar cane, etc., which were popular cottage industries at one time, gradually declined in production and some of them were wiped out of the market. In the rural sector, the handloom industry is perhaps the most important industry, and it was also the one most severely affected by liberalization polices. In the pre-1977 period, the handloom industry was fostered by means of deliberate policies of intervention and protection. This was not to be so under the liberalized regime. There were about 111,000 looms in the country in 1977. By 1980, the number was reduced to 81,000 looms and by 1986 was further reduced to 15,000 looms.[23]

The rationale of economic liberalization is doubtless the expectation that inefficient small industries will give way to more efficient ones through the interplay of market forces. But the IDB (1980) shows that many of the difficulties faced by small industries stemmed mainly from the fact that they were small. Being small, they were either unable to take advantage of liberalization or were actually harmed by it, as the bigger industries gained a competitive edge over them by virtue of their sheer size. In addition, the Ministry of Finance and Planning (1986) found many of these industries "....to be severely under-protected" (p. 103).

The incentives provided for export promotion hardly had any impact on small industries. It was expected that the small firms would realize their potential comparative advantage of export-oriented production by making use of an export-biased incentive programme created by the liberalization programme. But, as noted earlier, the overall shift towards export-orientation of domestic industry did not occur to any appreciable degree. Even where it did occur to some extent, the small firms were by and large left out of the process. This happened, firstly, because the leading export products, like Garments and Petroleum re-exports, had very little backward linkage effect and, secondly,

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23 The government is now seriously considering the revival of the handloom industry so that by the year 1995 there will be 60,000 looms in the country (The Island, 16/5/91). Specific non-liberalization policies are currently being considered for this purpose and a Ministry of Handloom Industries was also established for this purpose.

because the benefits did not percolate down to any great extent even where the potentiality of linkage effect did exist.

Although it was expected that the benefits of export incentives would be passed down to the subcontractors, certain market imperfections prevented the small industries from exploiting such benefits.[24] The subcontracting exchange that was established was not very effective in executing its functions. The large buyers were not keen to operate through the subcontracting exchange, and preferred to deal directly with known and trusted suppliers. The information supplied by buyers to the subcontracting exchange fell short of the full specifications required by potential suppliers. Furthermore, the easy availability of imported materials provided a strong disincentive to the large buyers to seek their suppliers from the technically less well-equipped subcontractors. UNIDO (1986) observed that:

> "..integration between large-scale and small-scale enterprises is largely absent in industry which may have contributed to the high degree of import dependence" (p.75).

However, in the late 1980s, some subcontracting did take place for Garment industries. This happened owing to the 60 per cent duty that was imposed on the importation of Garment ancillaries.

The adverse effects of liberalization on the overall manufacturing sector contributed towards exacerbation of regional disparities in economic development. The geographical distribution of manufacturing production after 1977 is shown in Table 13. It is also noted here that manufacturing activities were geographically extremely concentrated; two-thirds of all manufacturing enterprises, generating more than 80 per cent of manufacturing output in 1981, were located in just two of the country's 22 districts, i.e. Colombo and Gampaha or, in other words, the Western province. There was only a marginal change in the pattern of regional distribution of manufacturing activities over the 1980s. The policy to promote 200 Garment factories in areas outside Colombo came into existence in late 1991 as a consequence of the abovementioned regional disparity in industrial growth.

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24 See Ministry of Finance and Planning (1983), p.109.

Table 13
Regional Distribution of Economic Activity
in Manufacturing Sector by Provinces, 1981 and 1989

Province	Output (%)		Employment (%)	
	1981	1989	1981	1989
Western	88.8	70.9	74.8	70.0
Central	1.3	5.7	5.0	8.2
South	2.7	3.8	3.9	5.5
North	1.4	0.6	2.8	0.7
East	2.0	8.5	4.1	1.2
North West	1.2	3.0	3.4	6.6
North Central	0.4	0.5	1.0	0.9
Uva	0.0	3.6	0.1	3.0
Sabaragamuwa	2.2	3.4	5.0	6.0
	100.0	100.0	100.0	100.0

Source: Estimated from Department of Census and Statistics, 1981 and 1990.
Note: Strictly, these statistics cannot be compared owing to difference in surveying techniques.

The analysis in this section has given a macro-picture of industrial performance. The incentive regime that was operational for industrial development in Sri Lanka during the 1978-89 period, is examined next.

3. INCENTIVE FRAMEWORK AND INDUSTRIAL PRODUCTION CONSTRAINTS

The overall thrust of the policies declared in 1977 was to tilt the structure of incentives first in favour of tradables as opposed to non-tradables, and secondly, in favour of non-traditional exports within the tradable sector. Trade-liberalization measures were used for the former, while specific promotional measures, devised by the EDB [e.g., Export Development Investment Support Scheme (EDISS)], were used for the latter. The EDB's specific export development package consisted of direct cash subsidies, import duty rebates, "manufacturing-in-bond" scheme, etc. (see EDB, 1988). Moreover, the EDB, in collaboration with the Central Bank and indigenous commercial banks, provided both equity and working capital to enterprises with an export potential. However, as stated earlier, an industrial strategy was not formulated because planning was dismissed in favour of market forces [the state confined planning, in the form of a "rolling plan", to the Public Investment Programme (PIP)]. In fact, the state relied

heavily on trade policies for rapid industrialization (for more details see Kelegama, 1989).

Although most liberalization measures were implemented with the aim of achieving an incentive regime conducive for export of non-traditional goods, this could not be achieved by liberalization policies and the limited export subsidies initially offered by the EDB and other institutions. In fact, to maintain the proper incentives, more export subsidies and tax reductions were required than had been originally envisaged. This was because, in the aftermath of liberalization, the country faced two major shocks that led to macroeconomic instability and which, in turn, led to currency appreciation. This currency appreciation led to the intensification of commercial policies (external trade taxes and subsidies). Let us briefly look at this sequence of events. When Sri Lanka was in the bottom edge of the so-called "J" curve, it faced two major shocks. First, in 1979, there was the oil-price hike, and in the early-1980s there was recession in the world economy. These massive shocks from the external trading environment, continued to affect the Sri Lankan economy adversely during the 1979-83 period. Secondly, during the post-1978 period, the country faced massive internal macroeconomic shocks. There were two dimensions to these shocks. One was the massive demand shock during the 1978-85 period induced by the PIP. The other was a shock on the supply side induced by two factors: (i) the long-gestation period of the PIP, and (ii) civil war in the country, particularly during the 1983-89 period. The consequence of these shocks was a major imbalance in the macroeconomy.

Thus, although the economy was liberalized it was not stabilized, and as a result inflation averaged nearly 16 per cent during the 1978-89 period. Consequently, as shown in Tables 14 and 15, realistic exchange rates could not be achieved by devaluations alone. (In fact, the real exchange rate appreciated till 1985, and it was only after 1985 that the exchange rate became somewhat realistic). Thus commercial policies (tax/subsidy) were required on a large scale during the 1977-89 period to maintain the competitiveness of non-traditional exports and, in particular, of manufactured exports. The government relied heavily on commercial policies because

it wanted to avoid the immediate inflationary effects of further devaluations adding to the prevailing high levels of inflation. The prevailing literature in academic circles (e.g. Cuthbertson and Athukorala, 1991) as well as research commissioned by the EDB, demonstrate that the commercial policies that were adopted did succeed in maintaining a clear export bias towards manufactured exports (see Table 15).[25] Therefore, it is evident that although Sri Lanka faced a difficult period, she still managed to generate the "correct" price incentives for the manufacturing sector.

Table 14
Indices of Real Exchange Rate for Trading Partners and Competitors of Sri Lanka: 1978-89 (1978=100)

Country	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
USA	100	101	100	108	113	109	95	120	130	125	120	131
UK	100	113	123	108	99	85	61	90	110	119	123	127
W. Germany	100	101	81	72	72	60	45	61	87	98	91	92
Japan	100	74	87	87	80	80	60	80	107	107	113	111
France	100	102	89	78	74	61	48	68	94	105	98	99
S.Korea	100	100	75	100	100	75	75	75	75	75	75	100
Singapore	100	104	112	118	106	95	78	92	81	87	81	89
Thailand	100	102	106	100	100	96	66	80	88	88	89	96
Malaysia	100	95	87	92	93	89	75	90	93	89	80	83
Philippines	100	108	109	111	109	78	77	109	124	131	119	134
India	100	104	108	100	96	92	71	92	100	96	88	85
Pakistan	100	95	87	96	75	71	58	71	75	71	71	70

Source: Estimated from CBC-ROE various issues.

Despite the export bias that prevailed, why was the manufacturing sector's growth narrowly based, and why did not the manufacturing sector take the lead in restructuring the economy ? The answers to these two questions could be found in five factors; viz:

(i) inefficiencies in public enterprises,
(ii) problems of making the export bias effective,
(iii) legal impediments,
(iv) problems of competition, and
(v) lack of supply-side factors required for successful industrialization.

25 For a definition of the Export Bias Index, see Krueger, 1978, pp.99-105. A study on Effective Protection Coefficents by Cuthbertson and Khan (1981) showed that there was an import substitution bias in the incentive regime during the 1978-81 period. However, it must be pointed out that this conclusion was based on an industrial sample that consisted mostly of import substitution industries. Thus their conclusion is biased and does not reflect the true picture. Subsequent studies by the EDB (e.g. Athukorala and Jayathilake, 1984 and Hulugalla, 1987) have shown that even at the disaggregate level, most export industries enjoyed an export bias during the 1978-86 period. Further, it is worth noting that the "export bias" estimated using effective exchange rates is more accurate than the same estimated using effective protection coefficients.

Table 15
Indicators of the Incentives

	Behaviour of trade-and Competitor-Weighted Exchange Rate Indices											
	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
TPWRER	100	99.7	98.3	98.8	99.4	93.4	77.3	100.9	117.2	117.6	114.3	120.9
CPWRER	100	101	97.8	102.6	97	85.1	71.4	86.9	90.9	90.8	86.1	93.8
	Export Bias Index for the Manufacturing Sector											
	1978	1979	1980	1981	1982	1982	1984	1985	1986	1987	1988	1989
	1.08	1.11	1.20	1.22	1.19	1.16	1.20	1.14	1.29	1.28	1.19	1.15
	Effective Protection Coefficient for Total Sales (Domestic & External), Selected Years											
	1976	1979	1981	1983	1985	1987	1989					
	>2.0	1.50	1.61	1.56	1.30	-	-					

Note:

1. (a) TPWRER = Trading Partner Weighted Real Exchange Rate with 1978 as the base year. The weights of trading partner currencies are as follows: USA-0.57, UK, 0.13, Germany, 0.15, Japan, 0.11, and France, 0.02.

   (b) CCWRER= Competitor Country Weighted Real Exchange Rate with 1978 as the base year. Each competitor country (India, S.Korea, Pakistan, Singapore, Philippines, and Thailand) is given the same weight.

   If W_i is the weight of the respective currency and R_i is the real exchange rate (with 1978 = 100) of the respective country, then the two indexes are estimated as :

$$\frac{\sum_{i=1}^{n} R_i W_i}{\sum_{i=1}^{n} W_i}$$

   where n is the number of trading partners in the case of TPWRER and the number of competitor countries in the case of CCWRER.

2. EBI = Nominal Effective Exchange Rate for Manufacturing Exports/Nominal Effective Exchange Rate for Total Imports. (For more details on this index, see Krueger, 1978).
3. It is noted that for 1985, Walton (1988) estimated EPC to be around 1.95 by neglecting excise duties for certain products. Walton's estimates have been challenged by Edwards, (1988) and Edwards found that the excise duties incorporated EPCs to be around 1.30.

Source:

1. TPWRER & CCWRER: Estimated using IMF (1987) and CBC-ROE (various issues).
2. EBI: 1978-83, Athukorala (1986), p.75, 1977, 1984-87 values were estimated by the author using data from the CBC-ROE (various issues) and official records of the Sri Lanka Export Development Board.
3. EPC: 1976 -- Sirisena (1988), p.50; 1985 -- Edwards (1988), p. 191; 1979, 1981, and 1983 were obtained from the Presidential Tariff Commission.

3.1 Inefficiencies in Public Enterprises

The manufacturing sector was characterized by highly significant public-sector industrial enterprises which contributed 54 per cent to total manufacturing value-added in 1983 (see Table 16). Their share remained quite large even after 1977 because the government was confronted with a multitude of problems in its attempt to privatize them (Kelegama, 1992). Moreover, for political reasons, the state failed to make these enterprises more efficient by improving management (see Kelegama, 1989, pp. 77-78; some aspects of these problems are dealt with briefly later on in the text). Furthermore, most of these public enterprises found it extremely difficult to survive because of the across-the-board import liberalization policy introduced in 1977 (Athukorala, 1986).

Table 16
Some Indicators of the Public Sector Industries:
Public Sector Output Share in Total Manufacturing Output (percentage)

1970	1977	1981	1983	1985	1987	1989
29.6	65.5	63	54	41	35	26

Source: 1970 and 1977 figures from CBC-ROE (various years); 1981 to 1989 statistics from MISA (1990), p.21.

In 1988, twenty public enterprises which manufactured industrial goods accounted for 33 per cent of total industrial production or about 3 per cent of GDP. They contributed less than 5 per cent of industrial exports and 2 per cent of total exports. The poor performance of Public Manufacturing Enterprises (PMEs) can be seen very clearly in Table 17 (also see, Kelegama, 1992).

3.2 Problems of Making the Export Bias Effective

As pointed out earlier, the export bias was, in fact, produced by commercial policies. But there were two major shortcomings in the operation of commercial policies.

Table 17
Public Manufacturing Enterprises Performance
(All figures for the year 1988)

			1977-1988	
	PME OutputShare as a % of Total Output	PME Export US $ Million	Overall Subsector Growth	PMEs Growth
Food, beverages, and tobacco	9.1	-	10.3	-10.1
Textiles, wearing apparel, and leather products of which [Textile Corporation]	9.7 [9.1]	2.1 [2.2]	25.3	6.0 [9.0]
Wood and wood products (including furniture)	29.7	-	7.9	-3.0
Paper and paper products	43.3	-	8.8	4.0
Chemicals, petroleum, coal, rubber, and plastic products of which [Petroleum Corporation]	74.8 [71.2]	14.7 [12.8]	8.9	1.6 [1.7]
Non-metallic mineral products (except petroleum and coal) of which [Cement Corporation]	80.5 [56.2]	17.0	8.8	3.3 [5.2]
Basic metal products	100.0	-	4.9	-1.4
Fabricated metal products, machinery, and transport	2.1	-	6.5	-3.8
Manufactured products n.e.s.	0.0	-	-	-
Total	30.6	33.9	12.2	1.2

Source: Estimated using data from the Central Bank of Sri Lanka.

First, as is well known, tax incentives and subsidies (which are direct incentives) involve cumbersome bureaucratic procedures, and therefore take time in producing their intended results.[26] The Sri Lankan experience has shown that small exporters benefit less from subsidy schemes than large exporters because of the inability and/or reluctance of the former to comply with administrative procedures which qualify them for these subsidies. Further, the ad hoc process of providing incentives to satisfy the needs of various pressure groups, did not give the proper investment signals and may have also created problems of credibility. The ad hoc nature of commercial policies is clearly reflected in the tariff structure that evolved during the post-1977 period (see the erratic behaviour of the Effective Protection Coefficients during the period -- Table 15).

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[26] This was compounded by the instability of the real exchange rate during the 1977-85 period (see Table 14). Although the World Bank (1987) has highlighted exchange rate stability as an important factor in promoting exports (*op.cit.*, p.101) this fact has not been fully established in the current literature (Helliner, 1990,p. 884).

The tariff structure did not have any rationale either in terms of comparative advantage or the encouragement of infant industries, till about late 1984 (for details, see Kelegama, 1989). Secondly, the targets set out by the state for export development were at the macro-level, and the EDB hardly played a role in planning targets at the micro-level, as was done in South Korea, (i.e. at the product level or at the firm level). In other words, indirect exporters were virtually neglected. Thus, most direct incentives were of little assistance to small producers who made up the base for certain Sri Lankan exports, such as agro-based products.

3.3 Legal Impediments

It is claimed by many industrialists that there are far too many labour laws in the country that work against the profit motive and innovation. According to them, the most serious obstacle to the rationalisation of business activities is the Termination of Employment of Workmen Act of 1977 (for details see Act). For example, according to the Employers' Federation of Ceylon:

> "... employers have been driven to the brink of liquidation because of the inability to take speedy action to reorganize and rationalize their business in situations of acute redundancy and/or losses. The effect of the Act is to preclude the immediate pruning down of business in such circumstances; and redundant employees must continue to be paid until the conclusion of inquiries".

The adverse impact of labour laws on competition is described along the following lines in the same report :

> "The overprotection afforded to them (by law) enables them to be non-productive with impunity. The regular absentee sees that it would take a considerable amount of time for an employer to terminate his services and to justify it before a court and also in the case of malingerer. The system does not reward the efficient and productive but inadvertently protects the inefficient and non-productive employee. In consequence, productivity suffers, as also business profit and profit margins."

Some of these legal impediments could have been overcome by further liberalization of the labour market. However, this was not an easy task given the strongly rooted trade

union system of Sri Lanka. Moreover, since employment opportunities in other sectors of the economy was limited, further liberalization of the labour market could have incurred further adjustment costs.

Although Sri Lanka has liberalized its economy to a significant extent, there are certain areas where the legacy of the past legal system remains. The cumbersome procedures and bureaucratic delays involved with export subsidies were earlier highlighted. Such procedures are not confined to subsidies alone. For example, manufacturers complain bitterly of the multiplicity of procedures and documentation required for various investments, importations, and exportations (Yapa, 1990). Most of these procedures emanate from laws such as the Customs Ordinance, Import-Export Control Act, the Inland Revenue Act, etc. Although the state appointed a committee (the S.K. Wickremasinghe Committee) to look into this matter, the problems remained till the late 1980s.[27] The legal framework also worked against technological innovation. For instance, Piyadasa (1990) notes:

> "...in Sri Lanka, the legal framework provides disincentives for technology development, access and application. The delay in legal proceedings and the rigidity in the processing of legally binding regulatory measures, appear to make technology development and innovation unattractive" (p. 108).[28]

3.4 Problems of Competition

Domestic competitive environment is very important for effective industrial competition and growth. Creating a competitive environment was not in the agenda of the policy-makers during the 1977-86 period. The attitude can be traced to the belief that, in a liberalized economy, the world market provides ample competitive pressure to domestic industry. Frischtak, *et al.* (1989), have shown that a non-competitive market structure can have opposing effects on efficiency in individual markets. On the one hand, non-competitive market structures enable economies of scale in production, and, on the

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27 In order to adjust the legal framework to suit the post-1989 industrialization strategy, the post-1988 government took steps to restructure the entire economy by appointing a Taxation Commission, Finance and Banking Commission, and by passing new legislation on debt recovery.

28 These problems have been addressed by the Technology Initiative for the Private Sector (TIPS) programme that is currently (1991) being put into operation by the Ministry of Industries (MPPI, 1991, p. 47).

other, they can be a disincentive to domestic innovation efforts directed at reducing costs and enhancing the productivity of inputs. The latter negative effect seems to dominate over the former positive effect because evidence from case studies in developing countries suggest that:

> "competition is the prime motive for managers to cut waste, improve technical parameters of production and allocate resources efficiently" (*ibid*, p.1).

Table 18 is formulated to gauge the competitive environment, in accordance with Frischtak, *et al.* (1989). It shows the overall concentration in manufacturing for small, medium, and large firms (classified according to numbers employed). Clearly, between 1980 and 1988 the share of large firms in manufacturing output fell from 89.6 per cent to 82.1 per cent, i.e., during this period overall concentration in manufacturing sector declined. However, as large firms controlled the bulk of the manufacturing output, the level of overall concentration was high during the 1977-88 period. Statistics on changes over time in seller concentration at individual industry level in Sri Lankan manufacturing, are difficult to estimate. From the available data, seller concentration can be obtained as a share of output controlled by the largest three firms for 1978, 1981, 1988 and 1989. However, it is not possible to obtain comparable data for the four years. Comparison can be made only between 1978 and 1981 data and between 1988 and 1989 data. Table 19 shows the seller concentration for 1979 and 1981 while Table 20 shows seller concentration under a different industrial classification (ISIC two digit level) for 1988 and 1989. Clearly, the seller concentration has been remarkably high in 1978 and 1981. Even during 1988 and 1989, except for a few industries, seller concentration has been quite high. Higher seller concentration, especially if strengthened by high overall concentration, implies the existence of a non-competitive market structure in the local industries (Frischtak, *et al*, 1989).

Given the anti-competitive market structure of the Sri Lankan industrial sector, there would have been a natural incentive bias towards a larger firms vis-a-vis the smaller ones. This may be one reason why small industries and rural industries performed poorly under the liberalized economy. Competition policy in Sri Lanka was governed, for a decade after liberalization, by the National Prices Commission Law No. 42 of 1975.

Table 18
Overall Concentration of Manufacturing for 1980 and 1988

Size in terms of Employment	1980		1988	
	Number of industries (%)	Share of Output (%)	Number of industries (%)	Share of Output (%)
0-49 (small)	78.0	5.0	79.0	10.1
50-99 (medm.)	8.1	5.4	10.3	7.8
> 100 (large)	13.9	89.6	10.7	82.1

Source: Estimated using Department of Census and Statistics (1980 & 1988) data.

Table 19
Industrial Concentration, 1979 and 1981

Industry	1979	1981
Meat, fish and dairy products	81.0	92.2
Fruit and vegetable products	63.5	99.3
Confectionery, bakery, and cereal products	74.5	88.9
Spirits and alcoholic beverages	84.6	85.1
Other food products and tobacco	99.6	99.0
Textiles	41.7	54.4
Made-up garments	54.5	43.1
Petroleum and petroleum products	43.1	64.3
Salt and salt-based chemicals	98.1	99.4
Other chemicals	58.8	72.5
Pharmaceuticals and cosmetics	69.3	62.5
Soap, vegetable and animal oils and fats	99.5	86.7
Leather and rubber products	64.2	61.6
Wood, paper and pulp products	51.7	43.6
Clay, sand, and cement products	80.6	88.3
Basic metal industries and machinery	58.7	59.1
Ferrous and nonferrous metal products	41.7	41.2
Transport equipment and spares	66.5	88.8
Eiectrical goods	47.5	80.1
Optical and photographic goods	77.8	79.2

Note: The share of the three major firms in total gross output of each sector.
Source: Cuthbertson and Athukorala (1991), p. 308.

Under this law price-surveillance was performed by an ineffective body with limited functions. Thus the industrial concentration was not effectively curbed and, consequently, the Fair Trading Commission Act No. 1 was enacted in 1987. Under this act, the Fair Trading Commission has the authority to control monopolies, mergers, and restrictive business practices, as well as continue price surveillance. A recent study,

however, shows that the Fair Trading Commission has not proved effective in ensuring a competitive environment in the Sri Lankan economy (Gray, 1991).

Table 20
Industrial Concentration, 1988 and 1989

ISIC no.	Industry	1988	1989
31	Food, Beverages, and Tobacco	51.1	52.9
32	Textile, Wearing Apparel, and Leather	21.4	19.0
33	Wood and Wood Products	41.5	41.6
34	Paper and Paper Products	61.7	52.3
35	Petro-Chemicals, etc.	83.5	78.8
36	Non-Metallic	61.9	44.5
37	Basic Metals	99.9	96.2
38	Fabricated Metal Products, etc.	46.9	39.3
39	Other Manufacturing	79.0	82.6

Note: The share of the three major firms in total gross output of each sector.
Source: Estimated by the author using unpublished data of the Department of Census and Statistics.

3.5 Lack of Supply-side Factors

There were important factors from the supply side that acted as serious impediments to export-oriented industrialization. These impediments were highlighted in EDB (1989). Prominent among them were: (1) inadequate research effort; (2) poor understanding of marketing; (3) inadequate attention paid to quality, design, and packaging; (4) poor negotiating skills with potential buyers; (5) lack of cooperation with one another in production; (6) poor record of reliability and promptness in supply; (7) underdeveloped capital markets; (8) high freight charges and lack of cargo space; (9) the lack of a dynamic industrial class which could dedicate itself to industrialization.

Poor market information and a lack of continued and regular contact with markets were perhaps two of the most severe drawbacks to export development. There was no private sector organization or a conglomerate in a major market for any kind of

promotion and feedback to producers. Government officials performed trade promotion activities through foreign embassies with very few links with private sector producers and exporters.[29] Moreover, limited attention was paid to developing 'trading houses' along Korean or Japanese lines. It was only very recently (i.e.1991) that the EDB started pushing ahead this concept.

Pre-shipment credit was popular with Sri Lankan exporters because the alternative was an overdraft from the commercial banks at an interest rate which was at least 5 per cent higher. But the pre-shipment credit itself was granted at a high interest rate and this became a constraint on export expansion, because competing countries enjoyed very low interest rates on pre-shipment credit. Furthermore, cargo space was not readily available to exporters owing to administrative problems such as lack of computerization and delays in processing export orders. As a result, sea-food and horticultural items -- which need to be sold within a short time span -- could not be exported, and had either to be sold in the domestic market or thrown away in many instances. It was only in early-1990 that the government seriously addressed itself to these problems and took the initiative to liberalize shipping.

Underdeveloped capital markets also acted as a serious impediment. Working capital financing has never been automatic in Sri Lanka and banks do not consider financing purely on the basis of confirmed orders. The banking system is security-conscious and provides quick loans only for known customers. Although the Sri Lanka Export Credit Insurance Corporation (SLECIC) was established to provide guarantees to banks (to overcome the problem of collateral) it did not prove to be effective. Most commercial banks insisted on security and collateral over and above SLECIC guarantees and this discouraged new and small exporters who were not considered creditworthy. The reasons for this lay partly in inadequate entrepreneurial development (discussed later) and partly in debt recovery laws which were heavily in favour of the borrower than the lender. It has been reported frequently that the formulation of project proposals by potential industrialists was poor, and the banks found it difficult to evaluate them. In

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29 During the last two years a number of Sri Lankan missions abroad have set up business councils to promote trade relations with those countries. These councils were set up under the recently established Bilateral Cooperation Unit (BCU) of the Ministry of Foreign Affairs.

fact, most Sri Lankan banks were not geared to project evaluation and, above all, they were reluctant to spend time on this issue.

A view expressed often is that banks systematically give preference to credit applicants from elite backgrounds who speak fluent English, and exclude even educated Sri Lankans who are neither well connected nor fluent in English. Recent field surveys provide evidence to substantiate these claims. It is possible that the World Bank-funded SMI loan scheme has not proved very effective owing to the abovementioned factors. In addition to these problems, the absence of an active capital market limited the potential for raising equity finance for large industries. It was only in the November 1990 Budget that the government took serious measures to develop the domestic capital market (Kelegama, 1992).

The nature of local entrepreneurs also acted as a serious constraint. Frequent reference has been made in Sri Lankan literature to the inadequate development of domestic entrepreneurs stemming from an inadequate accumulation of productive capital by the Sri Lankan business class, over the years. Capital accumulation in plantation and mining during the colonial era and during the 1948-60 period was not sufficient to finance large-scale industrialization. Further, during the 1960-77 period, although some industrial capital was accumulated, a substantial portion was concentrated in public enterprises. Thus the capital base was inadequate to allow a rapid industrialization in 1977. This was compounded by certain social attitudes because those who engaged in business and industry were considered to be school drop-outs or those who had no university education; in other words they were the 'uneducated'. Thus the businessmen and industrialists wanted to see their children professionally qualified as doctors or engineers rather than following in their own foot-steps.

The poor entrepreneurial development was reflected in the private sector response during the post-1977 period. Private sector participation in industries was not very impressive considering the wealth of incentives that the government offered over the post-1977 period. Most private investment took place, even during the 1986-89 period, in low-risk and quick-return activities. This happened despite the formation of the SLBDC in 1984. Productive investment in the tradable sector was limited. In actual

fact, the government found it very difficult to dismantle loss-making and inefficient public enterprises during the 1977-86 period because of the inadequate response of private sector industries. The government felt that such dismantling would lead to a steady erosion of the productive base of the country in an environment where there was no other productive base to replace it. It must also be mentioned that strong private sector lobbies as in Japan and South Korea did not emerge in Sri Lanka during the 1978-89 period.

It appears that over the last decade, policy-makers were pre-occupied with devaluation, tariff adjustment, and manipulating other incentives such as export subsidies and taxes, and that, consequently, they neglected the above-mentioned crucial constraints to the development of manufacturing exports. These impediments to manufactured export expansion are nothing but constraints on the supply side -- inadequate skills, inadequate training, inadequate research, lack of institutions, insufficient entrepreneurial development, etc. According to the proponents of trade liberalization, these supply-side factors would be called into being by the mere existence of outward-oriented trade policies (or broadly speaking, by "getting prices right"). In actual practice, however, the right prices usually fail to provide these factors, particularly in LDCs like Sri Lanka, where there are difficult dynamic learning sequences, externalities, and underdeveloped skills and support systems. In short, the abovementioned impediments to export-led growth are simply market failures of the supply-side.

Recent research on industrialization has shown that successful industrialization at national level is the outcome of interplay between incentives and supply-related factors (Pack and Westphal, 1986, and Lall, 1991). This theory recognizes that there can be widespread market failures on the supply-side, i.e. factor, product, and technology markets, so that, in addition to 'correct' price incentives, selective intervention is required to rectify these failures. Accordingly, it is through such a strategy that dynamic comparative advantage can be achieved for successful export-led industrialization. Supply-side factors consist of capabilities and institutions. Capabilities broadly comprise the whole gamut of human skills: technological, entrepreneurial, and managerial, while institutions may be defined as bodies set up to overcome specific market failures in the development of industrial capabilities.

Given the abovementioned supply-side-related market failures in Sri Lanka, available evidence suggests that neither the capabilities nor the institutions required for export-led industrialization have been fully developed during the post-liberalization period. New promotional and financial institutions that were set up by the state under ad hoc industrial policy measures to assist export-led industrialization (e.g. EDB, NDB, SLBDC, etc.) seem to have had a limited impact on the acquisition of industrial capabilities by manufacturing firms. UNIDO (1986), for instance, states:

> "... there is great scope for technical assistance in the field of production support facilities such as quality control, testing, design, packaging. These major non-price determinants of competitiveness are currently insufficiently developed..." (p.75).

Similarly, state-owned R&D institutions [pre-1977 institutions such as the Ceylon Institute of Scientific and Industrial Research (CISIR), the Industrial Development Board (IDB), the National Engineering Research and Development Centre (NERDC), the Sri Lanka Standards Institute (SLSI), and the post-1977 institutions such as RPDSC (see Section I)] had poor links with clients and few technology transfers took place (Weiss, 1988, Piyadasa, 1990). In part, these R&D institutions concentrated on basic research (at the frontiers of technological change) rather than on research applied to solving technical problems encountered by industry. For example, UNCTAD (1989) stated:

> "In the chemical and metal working sectors ... they (industrialists) unanimously fault local R&D institutes for an excessive interest in academically-oriented research and a lack of adequate interest in the problems of local industry" (quoted in People's Bank, 1989, p.32).[30]

Thus, they were unable to meet the needs of industry.

Moreover, Sri Lanka lacked a supply of technical manpower and devoted inadequate resources to research and development. In 1984, for example, there were 124 scientists and engineers in R&D per million inhabitants. The corresponding figures for South Korea and Taiwan were 802.9 and 1285.3, respectively. So although Sri Lanka has high basic needs indicators, it does not by any means imply that the country also

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30 It is only now (1991) that R & D institutions such as CISIR are seriously being geared to support the industrial sector (MPPI, 1991, p. 47).

has a skilled manpower base (see, Kelegama, 1992). As Table 21 shows, Sri Lanka's current training pattern falls far short of the required manpower output for the mid-ninetees. The two NICs also spend a higher proportion of their resources on R&D than Sri Lanka. By the mid-1980s, gross R&D expenditure as a percentage of GNP amounted to 1.1 per cent and 0.9 per cent in South Korea and Taiwan, respectively, while Sri Lanka's figure was 0.18. The interesting fact about the Sri Lankan case is that R&D expenditure fell slightly during the post-1977 period -- in 1975, it was 0.20 per cent of GNP.

Table 21
Industrial Manpower Position and Requirements in Sri Lanka

Required Personnel		Average Annual Output in 1989 (Approximate figure)	Required Average Annual Output for the mid-nineties
Group A: (to be trained by Service Training)			
Managers	General Managers	120	180
	Textile Industry	180	250
	Engineering Industry	75	100
	Farm, Fishing, Mining	80	100
	Petroleum/Leather	90	100
	Human Resource/Personnel	50	120
	Marketing	80	200
Technical	Foreman	300	500
	Supervisors	200	350
	Computer Technicians	150	500
	Plant/Machine Operators	250	350
	Construction	200	350
Group B (to be trained by universities and professional institutions)			
	Engineers	300	350
	Accountants	180	500
	Computer Professionals	35	80
	Consultants (MBA)	40	80
	Scientific Service	20	50
Group C (to be trained by Business Schools/Technical Colleges)			
	Higher National Diplomas	3000	6000
	National Diplomas	1000	2000
	Certificate Technicians	10,000	12,000
	Trade Course Technicians	2000	2500
	General Skills	5000	7000
	Junior Business Administration	200	600
	Accounting Technicians	250	600

Source: Department of Labour and Manpower (also see,Kuhathasan, The Island, 6. April 1992, p.9).

The inadequate development of capabilities and institutions had adverse effects on the government's FDI policy. Evenson (1990) has pointed out that highly skill-intensive FDI tends to regard inadequate domestic industrial capability (technological, managerial, and entrepreneurial) as a major locational disadvantage. It can be argued that owing to the lack of industrial capabilities, Sri Lanka failed to attract skill-intensive FDI that would have supported the local capability development further and thereby generated skill-intensive industrialization.

In the light of the above analysis, the weaknesses in the performance of the Sri Lankan manufacturing sector during the post-1977 period should not come as a surprise. From the very beginning of liberalization, an appropriate link between trade policies and an industrial strategy was not effected. Policy-makers neglected selective intervention according to an industrial strategy that would rectify market failures, and assumed that price incentives generated from trade policies (exchange rate adjustments, tariff adjustments, etc.) and ad hoc industrial measures *per se* would provide the required supply-side factors for an industrial push. Whatever interventions that were used were not based on an industrial strategy, but were ad hoc, and were mostly based on political lobbying by various interested groups (Kelegama, 1989). For example, in the case of public sector industries, such ad hoc intervention has been described in the following manner by Karunatilake (1987):

> "..the policy framework for public sector industry after 1977 has been formulated by many groups of people with different interests and views. This often resulted in adopting of a large number of different selective policies which in aggregate conflicted with one another" (pp. 155-156).

It was only in 1987 that an industrial strategy was formulated (see MOFP, 1987 b). Why was an industrial policy not formulated during the 1977-87 period ? Several reasons could be found for this.

(1) The government was of the view, as suggested by the neo-classical policy advocates, that achievement of a "proper incentive" regime (pro-export bias or neutral) was all that was required to pinpoint Sri Lanka's industrial areas of comparative advantage and thereafter such industries would take-off to reap the international economies of scale.

(2) The government assumed that the incentives provided by institutions such as the EDB, NDB, etc. and the influence of foreign investment in the GCEC and FIAC would be adequate for efficient industries to become exporters.

(3) The high growth achieved after the import-induced boom and the PIP in the early years after liberalization, and the advent of new industries in the EPZ, made the government presume that export-led industrialization has begun.

(4) The two Ministers who were in charge of Industries during 1977-88, hardly had a plan for industrialization. This is because, from the very inception of liberalization, planning was disregarded as a policy tool. As Fernando (1986) put it:

> "Planning, which for a long time has been associated with various notions of socialism and state sector development, faced a degree of difficulty of acceptance initially as a concept. It was in the minds of many, a concept inconsistent with economic liberalization. Moreover, the practice of planning before 1977 had done very little to improve its image and suggest its appropriateness in the new conditions. It appeared, in the circumstances, to be a costly and time-consuming exercise, when the task at hand was to get on with the job of development" (p. 116).

(5) The government was pre-occupied with other activities rather than export-led industrialization during the early-1980s. This fact is lucidly captured in the following statement of the former EDB Chairman, Mr. Victor Santiapillai (1981):

> "The pivotal role of exports in economic development ... is not easily seen by politicians or bureaucrats. Foreign trade, somehow, is generally viewed as something distinct that does not directly touch the day-to-day lives of people as would, for example, a multipurpose river diversion scheme concerned with human resettlement, agricultural expansion, energy development, etc., all of which capture the attention of both government and the people at large. This is the root cause of the problem of mobilizing support for a concerted national effort to develop exports " (p.1).

Although an industrial strategy was formulated in 1987, it had major shortcomings. For example, during the 1977-87 period the ad hoc measures taken towards the industrial

sector and implementation fell within the purview of a number of different ministries and there was little coordination among them.[31] Although an attempt was made to coordinate ministries under the new policy package, it did not result in the implementation of any significant policy during the 1987-1989 period. Lack of coordination among ministries and state departments is in fact one of the major problems encountered in Sri Lanka.

All in all, unlike trade policy, industrial strategy was not emphasized during the 1977-87 period. The prevalence of a non-competitive market structure discouraged cost-reducing and productivity-improving innovation efforts in industry. Besides, the public R & D institutes failed to provide the required support for industrial innovation. Finally, the post-1977 policy towards foreign investment tended to attract low capital and skill-intensive rather than high capital and skill-intensive FDI. The stages of comparative advantage theory suggests, as mentioned in the introduction to this paper, that factor endowments of countries alter over time, so that their comparative advantage will switch from current to new patterns of specialization. In Sri Lanka, this would mean a shift from labour-intensive products to capital-and skill-intensive products. The lack of an industrial strategy prevented Sri Lankan industries from progressing through these stages of comparative advantage.

The lack of an industrial strategy and its adverse implications have been described in the following terms by UNIDO (1988):

> "The current administration has pursued a policy of generalized promotion of manufacturing activities aimed at maximizing gross earnings of foreign exchange. This policy has explicitly discarded any notion of industrial planning or even of the selection of target areas for investment. For this reason, government institutions have not sought to acquire branch-specific information and have preferred to leave the details of decision-making and the operation of branches to the companies involved. .....
>
> ....as manufacturing industry enters more into the producer good area, the absence of a targeted industrial policy tends to become, at least in some respects, a disadvantage for entrepreneurs rather than an

31 The ministries were: Industries and Scientific Affairs, Rural Industrial Development, Plantation Industries, and Policy Planning and Implementation.

> advantage. Given that the demand for capital goods is a derived demand, and therefore closely associated with overall performance of the economy, and that many capital goods are supplied either to other branches themselves producing capital goods or to heavy consumer durable industries, the interlinkages of production system and of production with demand are much more complex than for simple consumer items. In these circumstances companies look for a clear orientation from the government as to the likely evolution of markets for their products.
>
> It is unfortunate that in Sri Lanka's economic history, an approach of targeting industrial branches has been associated with rigid bureaucratic controls rather than with promotional endeavours. At present, it appears essential that the administration embrace the idea of a promotional approach to industrial targeting and that, within this perspective, it set out clear guidelines for the expected development ...." (p. 36)

A well formulated industrial strategy would have assisted the state to overcome, in particular, the last three problems that were discussed earlier, i.e. legal impediments, lack of competition, and lack of supply-side factors. To rectify these shortcomings, in late 1989, a serious attempt was made by a committee comprising top state officials and private entrepreneurs, to formulate an overall industrial policy.[32] To what extent this new policy would enhance industrialization remains to be seen.

4. CONCLUDING REMARKS

The experience of South Korea and Taiwan demonstrates that other developing countries, such as Sri Lanka, can reach the status of a newly industrialising country (NIC). The transition from a pre-industrial to a semi-industrial society is, however, a long and difficult process, often spanning several decades. It also requires the prior fulfilment of a number of economic and non-economic conditions.

Other things being equal, appropriate trade policies are an important determinant of successful transition to a semi-industrial society. The policy reforms of 1977 brought Sri Lankan industry further into the global arena. Nevertheless, trade reform and the supporting policies did not lead to sustainable industrialisation. After causing an initial

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[32] A revised version of the 1987 industrial strategy was formulated in December 1989 (see Ministry of Industries, 1989).

surge of production in simple labour-intensive activities (footloose industries such as Textiles and Wearing Apparel) the stimulant of trade liberalization petered out. Our findings suggest that this was the case in Sri Lanka. As stated, there were several shortcomings in the implementation of trade reforms and the movement towards a liberal trade regime was not as rapid as was originally intended, despite the adoption of an "ultra export-promotion strategy" for manufacturing. This was, however, inevitable but it was not something unique to Sri Lanka.

The World Bank (1988), for instance, shows that there has been a low degree of full implementation in the area of trade policies in many developing countries (see World Bank, 1988, Table 1.3). Of the nine areas for policy reform identified in the above-mentioned Table of World Bank (1988), the percentage grade for trade reform is among the three lowest figures, for the period under consideration (both during and after the loan period). This suggests that the implementation of policy reforms in the area or trade may be more difficult than in other areas of the economy. Why is this the case?

A partial answer could be found in the literature relating to timing and sequencing of trade liberalization policy. Few would disagree with Michaely's (1986) argument that, in a world where rigidities are ubiquitous, the trade reform process should be multi-staged with the speed of implementation, depending on the degree of flexibility and adaptability of response. If the impact of trade liberalization on growth is substantial and realised soon, the positive effects of trade reforms may outweigh the adjustment costs, and trade reforms may be pursued to achieve full uniformity in the incentive structure (neutral incentive regime). But in most LDCs, the cost of the adjustment process is higher than the positive gains from trade reforms in the short-run, thus vigorous pursuit of trade reform becomes politically difficult and this happened to be the case in Sri Lanka (Kelegama, 1989). By overlooking these adjustment costs, some have blamed the lack of industrialisation in Sri Lanka on inadequate trade liberalization (Lal and Rajapatirana, 1989; these authors have described this as an "unfinished agenda"). It must be emphasised here that such a hypothetical conclusion cannot be reached without taking into consideration adjustment costs and above all market failures. There is no reason to believe that further liberalization of the economy would offset the adjustment costs or rectify market failures. Although the World Bank (1987) claims that adjustment costs are small, the Sri Lankan experience does not provide

evidence to substantiate this claim (UNICEF 1985, Shan, 1987, and others). In fact, the Sri Lankan post-1977 industrialisation experience is quite similar to the Chilean experience during the late-1970s, where the high adjustment costs slowed down the trade reforms to achieve the originally envisaged export-oriented industrialisation. The important question here is-: "Why is the industrial progress resulting from initial trade reforms inadequate to carry those trade reforms further?" Michaely's (1986) analysis provides few empirical or theoretical guidelines in this regard. Several points in regard to this issue could be highlighted here.

It must first be noted that our understanding of the interrelationship between trade policy changes and industrial performance and growth is at best partial, despite extensive discussion in both the theoretical and empirical literature. A few cases may be cited to emphasise this point. The NBER project directed by Krueger tried to relate total industrial factor productivity growth to different trade policy phase, but failed to give any clear evidence to support the hypothesis that trade liberalization will stimulate productivity growth (Bhagwati, 1978, Chapter 5). Reviewing the evidence accumulated during the seventies, Bhagwati and Srinivasan (1979) concluded that :

> "Contrary to the enthusiasm of many proponents of liberalized regimes, there is no systematic evidence on their side either of dynamic efficiencies... and no general conclusions seem warranted" (p.14).

Even in the subsequent studies carried out in the 1980s, those few authors who found a positive relationship between productivity growth and export expansion have cast serious doubts on this causality because export expansion may have been caused by productivity growth rather than vice versa. Reviewing the evidence accumulated during the eighties Pack (1988) notes :

> "Thus, to date there is no clear confirmation of the hypothesis that countries with an external orientation benefit from greater growth in technical efficiency in the component sectors of manufacturing. When combined with relatively small static costs of protection, this finding leaves those with predilection towards a neutral regime in a quandary." (p. 353).

Considerable knowledge has accumulated since the influential studies of Little, Scitovsky and Scott (1970), Bhagwati (1978), and Krueger (1978) on trade and industrialisation. There has been much research in this area in the 1980s; in particular, mention should be made of the World Development Report of the World Bank (1987). Although this report has come out strongly in favour of outward orientation and liberal trade regimes for successful industrialisation, it has failed to explain why the efficacy of trade policies currently being recommended to, and adopted by, many developing countries continues to be the subject of considerable professional disagreement. Thus it could be said that the literature on industrialisation that uses trade policy as the main explanatory factor of industrial success has failed to provide a satisfactory answer to the question that was posed earlier i.e. Why are trade reforms inadequate for rapid and sustainable industrialisation? In fact, Helleiner (1990) after reviewing the recent research on industrialisation conducted for the World Bank by Chenery *et al.* (1986), has shed some light on this issue:

> "..... trade policy orientation while important, may not be the dominant determinant of growth and may not therefore deserve the attention that the World Bank and others have given" (p. 886).

There are strong theoretical reasons to believe that industrial success needs a number of complementary factors that are not simply summoned forth by trade policies. Recent research done on industrialisation by Pack and Westphal (1986), Lall (1991), and others has shown that the process of getting prices right and of achieving dynamic comparative advantage requires selective interventions in product, factor, and the technology markets. The reason is that there are wide-spread imperfections in these markets. Not all such failures call for government intervention; some are better dealt with by finding non-government institutional solutions. However, recent evidence from the NICs shows that interventions addressed at specific market failures, if practised carefully and selectively, do work well (Pack and Westphal, 1986). It suggests that besides some degree of outward-orientation, and industrial strategy is required for successful industrialisation. This is because incentives by themselves cannot produce the 'supply-side' factors needed for an industrial push. The development of supply-side factors -- that is, rectifying market failures by selective intervention -- is the basic requirement of an industrial strategy.

The key lesson from the success of South Korea and Taiwan is that they did not rely solely on trade policies but combined trade policies with an industrial strategy to attain a high level of industrialisation. The principle of dynamic comparative advantage was consciously incorporated into their industrial policy, and industries of future potential requiring favoured treatment were singled out for incentives in a phased manner until those industries achieved their required maturity. Moreover, these countries did not formulate policies only in terms of creating an outward-oriented trade environment (neutral or pro-export bias), but also paid attention to eliminating the bias in favour of large firms vis-a-vis small firms, in favour of public enterprises vis-a-vis private ones, etc.

Replication of the experience of these countries will not be easy given the initial conditions in Sri Lanka and the current global environment. If, however, Sri Lanka is to succeed as South Korea and Taiwan have done, then the next stage of industrial transformation in Sri Lanka into more skill and technology-intensive production requires a different approach: i.e. key market failures affecting industrialisation should be identified and then selective trade and industrial policies should be used to rectify them. For this purpose, careful and selective interventions that improve the ways in which markets function are essential. Some may argue that Sri Lanka does not possess an efficient administrative structure to handle effective state intervention. This is partly true, and in fact valid for all developing countries. However, in the past, the results from such interventions have proved to be superior to having no intervention at all. Of course, this is not to say that maintaining macro-economic stability, realistic exchange rates, and other measures such as further liberalization of particular areas of the economy, should be overlooked.

The main issue in regard to Sri Lanka's liberalization programme and industrialization should not be whether Sri Lanka liberalized too much or too little, because such a debate depends very much on an individual's value judgement. Moreover, hypothetical scenarios are required for a debate of this kind and they have no relevance for a genuine debate on this question. Thus the issue should be the types of interventions that accompanied the liberalization programme. From the points highlighted in this paper, it is clear that although the state played a major role after liberalization, that role

was not in accordance with an export-led industrial strategy. In other words, the interventions were not in the correct direction. This is the issue that needs utmost attention in any future industrial strategy.

The new industrial strategy (announced in 1989) has given importance to many of the prevailing shortcomings in the manufacturing sector. It is hoped, that with the new policy measures that are now being implemented Sri Lanka will be able to achieve sustainable industrial progress and acquire the status of a mini NIC by the year 2000.

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