Manufacturing in South Asia- The Way Forward: The Case of Sri Lanka-

In the 1880s and early 1990s Sri Lanka was defined as a classical type dual economy characterized by export oriented plantation agriculture and domestic agriculture. Since the mid-1880s, both sectors co-existed for more than 100 years in virtual isolation. The presence of excess labour, low productivity in the subsistence agriculture sector, segmented labour market, and wage differentials between plantation and subsistence agriculture workers represent a Lewisian type dual economy.

Sri Lanka has come a long way in the 65 years since it gained independence in 1948.It has transformed from a plantation economy with over 90% of its exports consisting of plantation crops (about 60% tea alone) to an economy whose exports are predominantly manufactures (about 40% in garments alone). Its exports in 2012 comprise of agriculture (24%),manufacturing (70 %) and ICT (3%). The agricultural sector's share declined from 35% in 1953 to 11% in 2012. The share of the industrial sector increased from 23% in 1955to 31% in 2012 while the share of manufacturing in GDP increased from 15% to 20% between 1953 and 1994. It's share reduced to 18% in 2012. The services sector has become the main contributor to GDP accounting for 42 % in 2012 up from 32% in 1952. The composition of employment also revealed similar changes with a reduction of employment share in agriculture form 57% to 32% between 1953 and 2012. The employment share of industry sector increased from 13% in 1953 to 26% in 2012. The rate of unemployment reduced from around 24% in 1973 to 14 percent in 1993, 8% in 2003, and 3.9% in 2012.

On relative terms however, the achievements of the economy appear to be far behind its growth and development potential. For example, Korea and Taiwan, two countries that were slightly poorer than Sri Lanka in the early 1950s, that were level pegging in 1960s, achieved much higher level of development by the mid – 1990s.Their manufacturing sector and industrial exports are highly diversified and continues to take an upward trend while Sri Lankan, manufacturing continues to be less diversified and the ratio of manufacturing exports to GDP has marked a declining trend since 2011.This could be attributed to loss of competitiveness in major export product groups which accounts for about 78% of exports. It could also be viewed as a reflection of inadequate institutional and policy support to enhance productive efficiency and global competitiveness of Sri Lankan exports. There has been a number of developments in the Sri

Lankan policy scene over the past 5 years, which marked a notable departure from the market-oriented policy stance maintained for over three decades from the late 1970s. Over the past five years, the main drivers of growth have been the non-tradable sectors (construction, transport, utilities, trade and other services), reflecting largely the role of the major public sector construction and infrastructure development projects. These sectors accounted for over 70% of the total increment in real GDP in 2012.

The evidence onemployment elasticity for the national economy indicates an upward trend from 1953 to 2005 and a significant drop between 2005 and 2012. Same pattern was noted for both secondary and tertiary sectors and employment elasticity in agriculture sector reached the highest level during the last five years (2005-2012). The labour productivity in agriculture was 1.5 times lower than manufacturing in the 1950s and the gap increased up to 2.5 times and 5 times in 1982 and 2012 respectively.

Similar to several other Asian countries the weights of labour intensive industries in manufacturing declined. Forexample, the share of top 5 labour intensive sectors declined between 1962 and 2012. The share of top 5 capital intensive sectors also decreased from 24% in 1983 to 10% in 2005 and then marked a significant increase up to 40% in 2012.The growth in some labour intensive sectors has also been negative and a good proportion of relatively more capital intensive industries have achieved faster growth. This is counter to the predictions of international trade theory and plausible explanations may be found in institutional and policy support systems.The evidence on employment elasticity effect in terms of ‘sector composition effect’ and ‘technology effect’ reveals presence of a low value added, low technology oriented narrow industrial base in Sri Lanka in spite of its pro-liberalized policy regime for more than three decades.

The evidence on total factor productivity (TFP) reveal capital deepening (increase in capital per worker) as a dominant source of labour productivity during the early phase of liberalization (1974-1981) and subsequently (1998-1991), labour productivity growth emerging as the main source of productivity growth. However, TFP evidence for twenty years from 1990 indicate an increase in the relative contribution of capital deepening and negative contribution of TFP to labour productivity. The broad picture that emerges from the analysis on wages levels appears to be stagnation of real earnings since the 1980s in respect of a number of trades in industry, corresponding to the slowing down in the rate of growth of statutory minimum wages. It also reveals a declining trend of income share of labourin manufacturing andincreasing returns to capital.

Moreover, the low value added share of labour intensive industries during the post-liberalization period particularly after three decades of liberalised policy practice points to some interesting policy implications. First, it confirms the view that liberalization alone does not enable a country to attain labour intensive industrialization. It requires wide range of institutional and policy support systems. In Sri Lankan context, this includes trade policy, investment policy, research and development, macro-economic policy and labour market reforms. Second, policy induced distortions such as tax concessions for machinery and equipment provides an incentive for a capital intensive industry in a labour abundant economy. Third, it appears that government interventions in the labour market, (e.g. labour laws, minimum wages etc.) and delays in labour market reforms have increased wage-rental ratio and shift towards a capital intensive system of production.

The findings reveal that trade liberalization as the key policy instrument that promoted labour intensive growth in manufacturing. However, it appears that Sri Lanka has not been able to get the full benefits of trade liberalization and reach the next stage of structural transformation. Sri Lanka is yet to reach the Lewis turning point in its industrial transformation process. Sri Lankan manufacturing industries still operate on a low-skilled, low technology oriented narrow industrial base. Its factor productivity is mainly driven by capital deepening. The income share of labour is around 19% of value added. Investments in research and development are very low (i.e. 0.15% of GDP) and Sri Lanka's high-tech exports in total manufactured exports have come down from 2.2% to 1% between 2001 and 2010. According to the Global Competitiveness Report (WEF, 2013/2014), out of 148 countries Sri Lanka was ranked 65th, down from 52^{ed} in 2011/12. Sri Lanka's overall competitiveness performance particularly with respect to technology related factors is very poor. In terms of technology index ranking, Sri Lanka is placed at 72^{ed} position out of a total of 148 countries.A growing R&D base promotes better and faster technology diffusion within the economy and facilitates efficient use of local resources.

The evidence on labour market transformation lends further evidence in support of slow progress in Lewis type structural transformation. The decline in unemployment is partly due to increase in public sector employment and continuous increase in international migration which is estimated to be around 24% of the labour force. The relative share of informal sector is still around 63% of the total employed.

The way forward

Recent developments in the Sri Lankan policy scene point to a notable departure from the market-oriented policy stance maintained for over three decades from the late 1970s.Recent initiatives of promoting inward oriented, state-led import substitution industrialization could hurt the country's economic development. The policy makers need to continue with outward-oriented policy regime and export oriented growth strategies to promote employment intensive growth. This requires choice of a policy mix targeted at enhancing productivity, skills development, productivity based wage policies,and investment promotion. The policy reforms relating to both product and factor markets are long overdue.More specifically, this involves institutional and policy reforms covering six main areas: a) trade policy, b) investment policy including foreign direct investment, c) labour market reforms, d) human capital development, e) research and development, and f) macro-economic policy.

Ad hoc trade measures to raise and lower tariffs and para-tariffs, over- valuation of exchange rate and policy emphasis on import substitution should be avoided. Sri Lanka needs to rethink its export strategy and the need to treat export policies within the broader context of domestic economic policies. Similarly, Sri Lanka requires investment of 35% of GDP to achieve 8% growth. Given the investment savings gap of 10% of GDP to maintain 8 % growth and promote export oriented FDI, right investment climate need to be created. Sri Lanka is no more competitive as a low cost production center and hence creation of flexible labor markets and investments in skilled workforce and fostering innovations through R&D are pre-conditions for Sri Lanka to move towards Lewisian turning point. Finally, policy adjustment to promote export led growth through reduced fiscal deficit, government debt, money supply, credit policies, and reserve levels are needed at macro level.

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