BUILDING INDUSTRIAL CAPABILITY IN SRI LANKA

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Introduction

This is an attempt to formulate a public policy perspective on promoting industrial development in Sri Lanka. It is different from the approach to this problem advocated by the IMF and World Bank, which is often referred to as the "Washington consensus" (W-con for short). W-con is the orthodox view. The ideas formulated here are based on heterodox approaches to growth and technological change, such as those developed by Richard Nelson of Columbia University and Sanjaya Lall of Oxford.[1] There are, of course, certain elements of the W-con view that are now accepted widely across the spectrum as necessary for healthy economic growth, such as stable macro conditions, realistic exchange rate regimes, conservative fiscal and monetary policies and investments in human capital. The emphasis in this summary is on the perspectives and policy prescriptions that differ from the orthodox view, not on the obvious points of agreement. It is useful to begin this review by stating the conditions that promote healthy industrial growth.

Conditions which Promote Healthy Industrial Growth

1. A stable macroeconomic regime with conservative fiscal and monetary policies, low inflation and a realistic exchange rate.

2. A trade regime that does not discriminate against exports and is relatively stable, simple and transparent. An open trading regime is necessary for industrial growth, since few industries can thrive on the basis of the domestic market alone. Exports promote the acquisition of new technology and productivity growth because international competition forces private companies to develop their capabilities to the utmost.

3. Adequate investment in human capital, ranging from primary and secondary education to the full range of tertiary educational areas, inclusive of technical and managerial training. It should be emphasized that formal education is only an enabling condition for economically significant human capital, since much of it is acquired through the actual experience of economic activity, the so-called "learning-by-doing." (See also point 6.)

4. Investment in physical infrastructure sufficient to support industrialization.

5.Social and economic institutions that support and promote market-oriented development. These include formal and informal institutions, which can be collectively referred to as the "social infrastructure." The importance of the social infrastructure is not often appreciated by orthodox economists.

6.Business entrepreneurship, or socially productive entrepreneurship. The latter exists in all societies, but in developing countries, it is often directed towards socially dysfunctional activities such as rent seeking and crime.

The Role of Public Policy: Orthodox and Heterodox Perspectives

Investments in physical capital and infrastructure are relatively easy to make. Human capital is more difficult and the most difficult task of all is to build up the social infrastructure, or 'social capital' as it is often called. The social infrastructure, which cannot be imported even by an oil-rich country, is crucial since it determines the operation and effectiveness of "market forces," in particular the shift of entrepreneurial energy to socially productive activity. Hence it is quite important to examine how it can be built up. Public policy intervention is crucial here, but the W-con view is that governments should simply "get out to the way" to promote business development. The rationale behind this idea needs to be examined carefully.

The main difference arises out of how growth-promoting market forces are seen to work. Drawing on the failure of various dirigiste strategies of the past the W-con view emphasizes "government failure" rather than market failure, as the source of inferior performance. It argues that governments should focus on fixing the fundamentals (1-4 above) and leave the production of goods and services to the private sector. Dirigiste strategies failed because the private sector was pre-empted from playing its positive role by government intervention in areas that rightfully belong to the private sector. The solution is for the government to retreat from interventionism as much as possible through privatization and the liberalization of markets.

The W-con view sees the power of market forces (the private sector) as a constant, fully charged potential, ever ready to spring into action as soon as the constraints of government interference are removed. They ignore the fact that in many countries, the government moved into crucially important industries because the private sector was not able to build these up. Of course that is only one part of a bigger picture: governments got carried away; following on the example of the Soviet Union, they imagined that they could substitute for the private sector. State enterprises also provided politically expedient patronage opportunities.

While agreeing that the state should not engage in activities that are better handled by the private sector (i.e. in the production of non-rival and non-excludable goods and services), the heterodox position is that market forces operate very imperfectly in developing countries. There exist serious market failures resulting from imperfect information and the low level of development of social institutions. A useful but inadequate metaphor is that market forces operate along social institutions like water flows in channels. Institutions have to be built up over time through actual business activity and the skilled intervention of the government to remedy market failure, even by sometimes distorting temporarily the operation of free markets. The heterodox view is that market forces need to be built up over time by public and private investments and by the provision of adequate incentives for the private sector.

At this point, W-con advocates would respond with two counter-arguments. First, they would say that they are all for the building of business-friendly institutions. But here they usually mean only formal institutions like banks, stock markets and regulatory bodies, whereas the heterodox view is much broader, embracing informal institutions and government capability to understand and promote technology as well. Second, they decry interventionism by invoking the failure of most statist strategies. Here they ignore the point that what is being advocated is emphatically not old-style ISI interventionism, but intervention to build overall technological capability by addressing specific market failures. The third counter-argument heard sometimes is that governments of developing countries do not have the capability to engage in sophisticated intervention of the sort practised by South Korea and Singapore. In response, we would argue that this capability must then be built up through interventions by international organizations such as the World Bank and consulting companies. That would be the best response rather than falling back to misplaced market fundamentalism which is nothing more than a quasi-religious belief that everything would somehow fall into place once the government gives the private sector its head.

Building Technological Capability: The Path Not Taken in Sri Lanka

The details of building up technological capability have been written up in many articles by Sanjaya Lall (1990, 1999). See in particular Lall's (1990) OECD monograph on the subject of building technological capability. Joseph Stiglitz, who is a front rank economic theorist on anyone's short list for a Nobel Prize, has developed the theoretical arguments supporting this approach in some detail. See Stiglitz (1996) and Stiglitz and Uy (1996). Stiglitz shows that intervention to correct market imperfections is not inconsistent with more sophisticated theoretical developments, which take account of information imperfections and other departures from the idealized neoclassical model. The W-con view is based on the simple neoclassical model. While he was the chief economist at the World Bank, Stiglitz has also developed detailed criticisms of the W-con worldview.

The problem of building technological capability can be explained very simply by comparing the industrial experience of Sri Lanka with that of the East Asian economies of South Korea, Taiwan and Singapore. The East Asian economies maintained very high rates of productivity growth by continuously upgrading the technological basis of industry. This happened for the following two reasons. They were compelled to compete in export markets, which meant that technology and quality had to be continually upgraded to international levels. This upgrading was supported by the state through public investments in building supporting capabilities and by export incentives to manufacturing industry. The building up of technological capability takes place mostly through manufacturing industry, rather than agricultural or agro-industrial exports.

Even in South Korea and Taiwan, such technological upgrading does not take place automatically. Companies confronted with increasing competition in export markets, typically relocate their production to low wage countries such as Indonesia and China to restore falling profitability through lower wages. The availability of such 'extensive expansion' options always acts as a brake on the advance of technological upgrading, which is the socially more useful response to falling profitability. This is why the USA shot ahead of Britain and France in technological strength and productivity after 1900. In Britain and France, industries concentrated mostly on extensive expansion through their colonies. Not having colonies, the USA was forced to develop technology in order to raise labour productivity.

Therefore, contrary to the common view that imperialism was favorable to capitalism, I would argue that it actually held back British and French industry vis-à-vis US industry. The other misconception is about the importance of natural resources for economic development. Abundant natural resources are often a detrimental condition for healthy industrial growth, as evidenced by Nigeria and Indonesia. The East Asian tigers and Japan have no natural resources to speak of; hence they were compelled to develop their human resources, which is the real source of economic development. The emphasis on natural resources as a major source of growth, is in any case a feature of early stages of capitalism.

Industrial development in Sri Lanka has been mostly confined to the form of extensive growth described above. Thus industrial companies nurtured in the culture of export agriculture have expanded into other low-technology products and services, such as the building of tourist facilities. There are a number of reasons for this failure of "market forces."Moving into new and unfamiliar technologies is fraught with uncertainty, even in advanced countries. It requires much higher levels of investment and business entrepreneurship. It did not happen automatically even in countries such as Taiwan and South Korea. Furthermore, the political climate for investments in innovative technologies has not existed in Sri Lanka at any time. The fact that most senior managers are trained as accountants before assuming general management responsibilities, make them excessively risk-averse by international standards. Finally, our business culture has yet to make a decisive shift from its commercialist orientation to an aggressive industrialism.

Extensive growth through unrelated low-technology activities has meant that Sri Lanka has been locked into a low-productivity mode of expansion. East Asian-style high growth rates are possible only with the movement of industry along a technology-intensive trajectory. Contrary to the expectations of the W-con view, Sanjaya Lall and others have argued strongly that such an outcome does not take place automatically through liberalized market forces. Unaided market forces in developing countries typically concentrate on exploiting natural resource endowments, low-cost unskilled labour and low-productivity service activities. Business-people in such countries do not typically have the capability of developing advanced technologies without special public policy support or the assistance of multi-national companies (MNCs).

While Singapore developed largely through MNCs, such an option is not open to Sri Lanka, even if political conditions are more conducive. Hence, if we want rapid industrial growth, public policy intervention to build up technological capability is absolutely crucial. That however, is a medium-term to long-term strategy. There are no quick fixes that will magically change the situation. One of the major problems is the enormous ideological resistance to the ideas set out here, at key policy making levels in government. The policies advocated here are also not inconsistent with the promotion of agro-industries in the short-to-medium term. (See Tabor, Abeyratne and Epaarachchi (2000) for details of an agro-industrial strategy for Sri Lanka.)

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End Notes

1. A detailed statement of these views is given in *Technology, growth and crises in East Asia* by G. Chris Rodrigo (forthcoming 2001, Edward Elgar). Sanjaya Lall's (1996) "Building Sri Lankan competitiveness: a strategy for manufactured export growth" (National Development Council) develops specific strategies for Sri Lanka. ■

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HONOURING DR. S.A. WICKREMASINGHE

April 13th 2001 is the 100th centenary of the birth of Dr. S.A. Wickremasinghe, former leader of the Communist Party, member of parliament and medical practioner.

An assesment of his life and work will appear in the next issue of *Pravada*.