Institute of
Social Studies

ANTI-EXPORT BIAS IN THE EXPORT-ORIENTED ECONOMY OF SRI LANKA

A Thesis presented by

Sirimal Abeyratne

(Sri Lanka)

in Fulfilment of the Requirements for obtaining the Degree of

Master of Philosophy in Development Studies

Members of the Examining Committee

Dr G. Irvin
Mr J.V. Alarcón
Dr J. Kol

The Hague, November 1992

INTRODUCTION

The Issue and the Research

Sri Lanka, which in 1960 had almost the same per capita GNP and the same production structure as some East Asian Newly Industrialized Countries (NICs), today lags behind them. Why have the economies of East Asian NICs grown so rapidly, while those of Sri Lanka and many other developing countries grew slowly over the last three decades? Why does Sri Lanka's manufacturing value added to GDP ratio remain at the level it was two decades ago? Trade strategy has become the main development instrument of governments during the post-war period, so that these questions clearly have something to do with, among other things, the choice of trade strategy. Many well documented case studies have shown how differences in trade strategy have led to substantial variations in growth and economic structure (Chenery *et al*, 1986:87).

In principle, the choice of trade strategy as between 'inward' and 'outward' orientation involves the use of trade incentives to create either a 'bias' for the domestic market against exports or a 'neutral bias' as between domestic and export markets. Attempts have been made on various grounds to explain the degree of trade bias of economies resulting from their discriminative use of the instruments of trade strategy (Agarwala, 1983; Balassa and associates, 1971, 1982; Bhagwati, 1978, 1990; Donges, 1976; Greenaway and Nam, 1988; Krueger, 1978; World Bank, *WDR*, 1987). Given the differences in conceptualization and in methodologies adopted in such studies, divergent interpretations continue to exist. Nevertheless, in general, economies which have performed well, particularly, the so-called East Asian NICs, have been identified as *more* export-oriented, or less inwardly oriented, than others. Hence, as Greenaway and Reed (1990:76) conclude, it is difficult to reject the hypothesis that outward orientation is associated more than inward orientation with superior economic performance and that export performance is positively correlated with growth.

From about 1960 until 1977, Sri Lanka was a 'paradigm case' of an inward-oriented trade regime. Since 1977, with the introduction of a new policy regime, the country has come to be regarded as a 'test case' of an 'open economy' model. Economic performance under the new policy regime, although in some respects it appears to have improved since 1977, has been considered as lagging far behind expectations. Although the open economy model has been described as an outward-oriented trade regime, it is arguable whether commercial policy has yet been rationalized and whether anti-export bias has actually been eliminated. This issue has been a source of controversy among academics and policy makers for many years, but no in-depth study of the issue has so far been carried out.

A number of attempts have been made to rationalize effective protection by providing a reasonably low and fairly uniform level of protection to the manufacturing sector. A distinguishing feature of the 1977 commercial policy reforms to rationalize effective protection is that the concern of industrial policy circles was with revisions in protection for the import substitution sector in general, and tariff protection in particular. Although some direct cash subsidies were provided for exports of manufactures, the incentives for export promotion were largely 'indirect'. Surprisingly, effective protection for the export-oriented sector, relative to that of the import substitution sector, was not considered either in policy circles or in the reports on effective protection that guided them. Precisely, this points to the fact that the need for 'reasonable' effective protection for manufacturing exports in order to eliminate anti-export bias appears to have been largely disregarded at the policy level in the so-called export-oriented trade regime in Sri Lanka.

The reports of the Presidential Tariff Commission (PTC) on effective protection to manufacturing industries (Cuthbertson and Khan, 1981; Walton, 1988) were concerned with effective protection for 'manufacturing' in general, and for import substitution in particular. For this reason, the reports, particularly that of Walton (*ibid*), do not provide adequate analyses of protection to export-oriented industries. Nevertheless, some evidence of the reports in respect of effective protection to export-oriented activities suggest that, in general, the system of trade incentives in the post-1977 trade regime may have favoured import substitution at the expense of export promotion. Although these studies paid some attention to the question of protection to export promotion relative to import substitution, the evidence for effective protection can be questioned on various grounds. However, the evidence of the PTC reports, and some other studies of effective protection (cf. Ratnayake, 1988), suggest that the post-1977 trade regime may have suffered from anti-export bias. This is consistent with frequent claims by advocates of trade liberalization, including the World Bank, that trade strategy during the post-reform period has not kept up with the original plan for a 'neutral' trade regime (Athukorala, 1986; Rajapathirana, 1988; World Bank, 1981, 1982, 1987). A trade regime is said to be *neutral* when the net incentive effects of trade strategy on both import substitution and export promotion are the same; this is a basic characteristic of an outward-oriented trade regime. The World Bank (*WDR*, 1987) and Greenaway and Nam (1988) have classified Sri Lanka as 'moderately' inward-oriented during the period 1973-85. Of course, this classification covers part of the pre-1977 inward-oriented trade regime as well and, hence, it is questionable whether this is the case even after 1977. Yet, contrary to the above arguments, Athukorala (1986), Kelegama and Wignaraja (1991) and Wignaraja (1991a), depending on effective exchange rate analyses, claim that the system of trade incentives in the post-1977 trade regime has been 'pro-export biased'.

Given the confusing interpretations of trade regime data in various reports, the present study endeavours to analyse the nature of the trade bias of the Sri Lankan economy that has resulted from the current incentive structure of commercial policy affecting production for import substitution and export. The purpose of the study is fourfold: to quantify and evaluate the present level and the structure of trade bias in the manufacturing sector; to analyse the relative significance of underlying factors that determine trade bias; to assess the effectiveness of the reforms using different measures of commercial policy in terms of the response of trade bias to such changes; and to identify the policy issues arising from the study as means of achieving 'zero' anti-export bias in the manufacturing sector.