Pathfinder Economic Alert

Reviving Agriculture: The Case for a Fundamental Re-think

Sri Lanka's Low Productivity/Growth Syndrome

The 35 years since liberalization of the economy has seen repeated cycles of the economy overheating once growth exceeds 6%. Growth of 8% or more is necessary over a sustained period to achieve economic transformation similar to that achieved by a number of countries in East and South East Asia. The causality for Sri Lanka's inability to sustain accelerated growth (as seen again after 3Q 2012) is complex. An unstable macroeconomic framework, with an unsustainable budget deficit, is an important explanatory factor. Low productivity is another as it limits the capacity of the economy to achieve non-inflationary growth. In addition, it results in Sri Lanka not being able to produce goods and services the rest of the world needs in sufficient quantities at competitive prices i.e. to earn adequate foreign exchange to support the level of imports necessary to sustain an 8% growth rate without running into balance of payments difficulties. Low productivity also reduces the scope for a non-inflationary rise in incomes.

In this connection, agriculture is a large well of low productivity which absorbs substantial amounts of financial and human resources while yielding extremely low returns. This means that the output per unit of land (eg acre) is low. In addition, the output generated by a unit of labour is also much less than that of a worker in comparator countries or even in other sectors of the economy. Furthermore, the return on the financial outlay (ie expenditure on seeds, fertilizer, pesticides etc) is also very low. Improving agricultural productivity would, therefore, need to be a key element of any growth strategy for the country.

Low Agricultural Productivity: An International Perspective and a Drag on Growth/Incomes

Sri Lanka recorded productivity of 6.3% in 4Q 2012. The corresponding figure for Thailand was 19.4%. It is noteworthy that Thailand also has a large paddy growing sector. In Sri Lanka, the agricultural sector employs 32% of the labour force. Yet it accounts for only 11% of GDP. This means that agricultural productivity is only 1/3 of the national average. In view of Sri Lanka's low overall productivity (see above), this is a matter of serious concern, particularly as large amounts of public funds are allocated to the agricultural sector through, inter alia, irrigation systems providing free water; extensive extension services; the fertilizer subsidy; and guaranteed price schemes.

The low productivity in agriculture acts as a major drag on the prospects for achieving accelerated growth and higher incomes. The low returns on financial and human resources also reduce the space for non-inflationary growth. In addition, it limits the scope for non-inflationary rises in incomes. In Sri Lanka, one is constantly confronted with the assertion that the cost of living is too high. In fact, the real problem is that productivity is too low to support incomes that are high enough to absorb international prices of key imports, including oil and fertilizer. This results in pressure for subsidies that have become unaffordable now that Sri Lanka has to finance its twin budget and balance of payments deficits without recourse to the highly concessional foreign aid that was available when the country was in the low-income category.

The way ahead

There is a strong case for a fundamental re-thinking in relation to the future of agriculture in Sri Lanka. Land titling issues and uncertainty regarding public policy related to the sale and/or leasing of government land are issues that require attention. In the paddy sector, the size distribution of holdings is a major constraint. The problem continues to be exacerbated by fragmentation of land holdings which has led to plot sizes that do not generate the cash flow necessary to undertake investments in high-yielding seed varieties and sound cultivation practices. This is vividly demonstrated by companies, such as CIC, achieving exponentially higher yields per acre compared with the national average.

Yields in the plantation sector are also extremely low. They have been constrained, inter alia, by disincentives to investment created by short-life remaining on land leases. The tea and rubber sectors account for large extents of land and earn $ 1.7 billion in foreign exchange. This raises the question whether an adequate return is being earned on this large extent of land. If not, there is a case for re-thinking land use patterns in these areas.

The way ahead should include a fundamental reassessment of the future structure of the agricultural sector. Land titling; sales/leasing of state owned land; land use policies; the product mix; and the role of commercial agriculture are issues that should be addressed in a pragmatic manner that balances economic, social and political imperatives. In doing so, the driving principle should be the transformation of Sri Lanka from a low productivity; traditional services (construction, transport, retail/wholesale trade); and low technology manufacture economy to one with high productivity agriculture; modern services (ICT/BPO, tourism, maritime and aviation services, and financial and accounting services); and higher technology manufacturing (including penetration of Asian supply chains).

Modernizing agriculture will be politically challenging as it will inevitably lead to a displacement of labour. It would, therefore, have to be part of a package of reforms necessary to revitalize other sectors of the economy to absorb the displaced labour. The current labour shortages in the manufacturing sector already offer part of the solution.

The transformation of the economy requires the transfer of financial and human resources from low to higher productivity economic activities. This requires a strategic approach on the part of government and businesses, rather than ad hoc measures.

The need for flexible and forward-looking policies is reinforced by Sri Lanka's graduation to middle-income-country status and the increasing exposure to international capital markets, particularly the $4 billion foreign holding of Treasury instruments. This places a high premium on sound macroeconomic management and structural reforms which increase the competitiveness of the economy.

Safety net

The scope for strategic, as opposed to populist decision making can be increased by designing a well targeted safety net to meet the transitional costs associated with the wide ranging reforms needed to address the extremely low productivity of Sri Lankan agriculture. It would need to be a time-bound program involving unemployment benefits as well as retraining and skills development. The government's fiscal consolidation should be continued to create the space for such a program. Financing can also be mobilized from international agencies, such as the World Bank to support the structural reforms envisaged.

Conclusions

The current productivity levels in agriculture entail a squandering of the country's scarce resources. Transitioning to modern agriculture involves a fundamental re-thinking of land titling; sales/leasing of government land; land use patterns; the product mix; and the role of commercial agriculture. These reforms are likely to increase the price of agricultural land and incentivize land consolidation. There will also be a displacement of labour. The movement in agricultural wages would depend on whether increased opportunities can be created in other sectors of the economy or through temporary migration.

The wide ranging reforms that are necessary are politically very challenging. The transitional costs necessary to transform the economy by increasing agricultural productivity can be mitigated by a package of reforms to revitalize other sectors as well as a well designed social safety net. Of course, the status quo can be allowed to continue with minor tinkering at the edges. This will, however, result in a significant drag on the prospects of achieving a path of accelerated non-inflationary growth and rising incomes.

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