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Research Paper

INCULCATING AN INNOVATIVE CULTURE IN SMEs OF SRI LANKA: A PATH TOWARDS ENTERPRISE COMPETITIVENESS

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ABSTRACT

This paper discusses the possibilities of inculcating an innovative culture in small and medium size enterprises (SMEs) in the informal sector of Sri Lanka economy within the framework of competitiveness. The number of SMEs and employment therein of Sri Lanka has been growing and currently two-third of workforce are employed in this SMEs sector. The Government of Sri Lanka finds this issue as challenging because it has the obligation of providing social security, work security and employment security for all those who are employed in these SMEs of the country. Achieving inclusive growth remains another challenge for the Government as income distribution has been getting widened over the years. The paper discusses the ways and means of improving competitiveness among SMEs of the informal sector through new product innovations which is crucial for inclusive economic growth of Sri Lanka. The suggestions of innovation points and strategies that are discussed and included in the paper may be useful for policy makers of responsible agencies, administrators of key agencies, the private sector enterprises and chambers, the academia for teaching purposes and for the researchers for further research in this sector.

KEY WORDS: SMEs, Informal Economy, Competitiveness, Industry Sectors, Innovations

1.0 INTRODUCTION

This paper diagnoses possibilities of inculcating an innovative culture for improvement of competitiveness in small and medium size enterprises (SMEs) in the informal economy of Sri Lanka. The paper will look at the growing phenomenon of SMEs of Sri Lanka and its consequences and challenges in practical and theoretical manner. The paper will suggest innovations that could possible to be implemented among SMEs for the betterment of the sector itself and more importantly which help the sector to be competitive. The innovation points that are discussed and included in the paper may be useful for policy makers of responsible agencies, the academia for teaching

purposes and for the researchers for further research in this sector. The donors¹ and investors will have a good use of the recommendations of the paper who have been putting resources in order to uplift the competitiveness and sustainability of the SME sector of Sri Lanka.

2.0 OBJECTIVES

The following are the objectives of the paper:

- to define and explain the growing phenomenon of SMEs in Sri Lanka
- to explain the underlying reasons for gradual enlargement of the sector
- to diagnose and make suggestions for inculcating an innovative culture among SMEs



- to suggest strategies for making the sector competitive and sustainable

The paper will reach above objects with a significant coverage of existing knowledge by review of literature related to the topic under discussion.

2.1 Background of the phenomenon – some definitions

SMEs of Sri Lanka have been growing and currently 63% of work force is employed in this sector (Central Bank of Sri Lanka, 2015). The SMEs are in the informal sector or informal economy which is a broader term that refers to an economy that is not taxed, monitored by any form of government, or included in any national accounts (like GDP), unlike the formal economy (Cooray, 2012). Cooray (2012) defines the sector based on employment parameters i.e “job security” as the measure of formality, defining participants in these SMEs as those “who do not have employment security, work security and social security”. The meaning of “employment security” is whether or not the work is arranged and governed as per formal written agreement. Work security is referred to as whether the occupational health and safety measures are adopted during the work. Social security is defined as whether the worker has contributory fund or pension scheme or kind of a “super” where both the employer and employee contribute to the fund as per agreed rates and thereby end of the work period the worker receives an accumulated amount of money (Cooray, 2012). (Census and Statistics Department of Sri Lanka, 2011)² identifies SMEs in the informal sector based on 4 key aspects i.e registration of the organization, accounts keeping practices of the organization, total number of

regular employees of the organization, whether employees get social security benefits. If the SMEs in the informal sector do not maintain a valid registration, do not maintain accounts (audited financial statements), number of employees remain less than 3 and not paid any social security benefits then such players fall in informal economy. Whereas formal economy is referred to as all recognized production of goods and services by legally accepted firms and individuals. The output of formal economy is well included in the national accounts. This includes production and services of both public and private sector organizations (Cooray, 2012). As per (Arunatilake & Jayawardena, 2010) employment in the formal sector comprises employment in the government sector, including all levels of the government: central, provincial, and local—the corporate sector, and employment in large establishments in the private sector, including foreign owned enterprises and employment in the estate sector.

In this context, a working definition for informal economy could be derived as consisting of wide range of individuals and small production units producing goods and services mainly by the use of their own resources and often employing very little capital. They use very few formal procedures and hardly use any accounts or book keeping. Even they employ others on informal engagements subject to terminate at will. Most informal enterprises are household based even they employ few persons who are mostly close relatives. As per the Quarterly Labour Force Survey report³ of 2011 Sri Lanka’s informal sector is the biggest part when it compared with employment. The table below depicts the employment by industry and sector as in 2011.

Table 1: Employment by sector

Sectors	Economic sectors				Total	%
	Agricultural	%	Non-agricultural	%		
Formal sector	364,015	13.4	2,693,729	49.1	3,057,744	37.3
Informal sector (SMEs)	2,344,005	86.6	2,795,178	50.9	5,139,183	62.7
Total	2,708,020	100.0	5,488,907	100.0	8,196,927	100.0

Source: Quarterly Labour Force Survey – Annual Report-2011

As per Table 1, agriculture sector remains the single key sector in providing highest number of employment. Formal agriculture includes the plantations which are well organized and remains as an important foreign income earner where employment share is 13.4% in 2011. Informal agriculture is the sector where a majority of informal employment is recorded (86.6%) which includes mainly small holders of paddy, rubber, coconut, tea and other minor export agriculture. These

small holders collectively make a considerable contribution in terms of providing employment and bringing foreign income to the country. Non-agricultural sector includes the industry and services sectors. In these two sectors employment are in almost equal percentage. In the Non-agricultural sector, manufacturing, construction, transport, retail trade enterprises employ considerable number of persons. Except manufacturing sector, all these industry sectors are key sectors that provide informal employment.

2.2 Possibilities for Innovations

Innovations are possible in all sectors irrespective of size, type of product/service, location etc., as long as these sub economic sectors are organized may be under the Chambers of Commerce⁴ or any other trade association. For instance, in the rubber sector, producing rubber brushes for automobiles is an area where the SMEs can give attention to. Likewise, almost all SMEs in informal sectors can do innovations that help increase the competitiveness.

3.0 LITERATURE REVIEW

Keith Hart (1971, 1973), a social anthropologist, was the first scholar who brought the term 'informal sector' (in a developing country context) into the academic literature. He used the term informal sector to imply a part of the urban labor force, which operates outside of the formal labor market. Hart considered the 'informal sector' as almost synonymous for the categories of those self-employed in small and micro size enterprises. Even though Hart's original notion of the 'informal sector' is limited to the 'self-employed' in small enterprises, the introduction of the concept helped incorporate activities that were previously ignored in theoretical models of development and in national economic accounts (Swaminathan, 1991). Renooy (1990) as cited in (Gerxhani, 2011) models the informal sector as a simple cyclical phenomenon in which operators or players undertake activities (work), which may or may not lead to transactions, from which payments may or may not result which produce income.

Importance of making innovations for enterprise competitiveness is a topic many scholars and researchers engaged in discourse all parts of the world. According to Martins and Terblanche (2003) organizational success depends on creativity, innovation, discovery and inventiveness. Foregoing researchers identify innovations as a demand of the firm and reaction to demand not only makes the firm competitive but also makes changes in employee behavior which is crucial. Innovations ensure continuous existence of firm in the business (Read, 1996). Organizational culture plays a crucial role in innovations irrespective of the nature and size of the firm (Martins & Terblanche, 2003). When a culture of knowledge sharing, idea generation and encouragement of creativity enhances in the organization, innovations and changes take place rapidly (Martins & Terblanche, 2003). Organizations need a culture that constantly guides its members to strive for innovations and a climate that promotes innovations (Ahmed, 1998). Organizations

need to allocate sufficient funds for research and development programs which pave the way for innovations in organizations (Ahmed, 1998). Organizational culture appears to have an influence on the degree to which creativity and innovation are stimulated in organizations. Buckler (1997) has argued that innovation is an environment, a culture, almost a spiritual force that exists in a company which drives value creation forward. When it comes to "climate of the organization", it is inferred as organizational practices, procedures and rewards system deployed to do routine activities (Ahmed, 1998). Scheider *et al* (1996) as cited in (Ahmed, 1998) define four dimensions of climate; Nature of interpersonal relationships, Nature of hierarchy, Nature of work, Focus of support and rewards. Ahmed (1998) further conclude that organizational climate closely ally with culture and therefore a reflection of climate, but operates at a deeper level.

Sri Lankan SMEs in informal economy is characterized by wide range of individuals and small production units producing goods and services mainly by the use of their own resources and often employing very little capital (Arunatilake & Jayawardena, 2010). They follow very few formal procedures and hardly use any accounts or book keeping. Even they employ others for work that is on informal engagements subject to terminate at will (Cooray, 2012). Most informal enterprises in Sri Lanka are household based even they employ few persons. Scholars who do research in innovation management stream are unanimous on the fact that innovation plays a key role in maintaining competitive advantage (Alistair, Anderson, & Cruickshank, 2013). This is especially true for small firms in the SME sector in any country. Innovation requires new combinations and collaborations between small firms especially new combinations of knowledge to develop new products (McAdam, 2005). For most small firms this means they have to work together to acquire and share information on new product innovations (McAdam, 2005). Forming collaborations through networking is essential to be successful in this regard (Jack, Dodd, & Anderson, 2010). Trust plays a key role in doing business and sustaining it in the long run (McAdam, 2005). Batt and Purchase (2004) as cited in (McAdam, 2005) says trust is the critical determinant of a good relationship. As most of small business owners are sole proprietorships the notion of trust is everything that run the businesses. Collaboration is an integral

component for innovation, especially the sharing of tacit knowledge of producing items and new designs (McAdam, 2005). In Light of all these literature, it can conclude that mutual trust plays a key role in innovations in SMEs in the informal sector of Sri Lanka. Nearly two third of Sri Lanka’s labour force is employed in the informal sector which comprises various economic activities in agriculture, fishing, livestock rearing, a range of micro and small-scale enterprises, petty trade, and other small commercial activities. People choose to participate in the informal sector despite it is characterized by low social security and changing incomes (Arunatilake & Jayawardena, 2010). The government has given its attention to the informal sector as the players in the sector do not receive the employment benefits that the formal sector players receive throughout the employment period and the end of the employment (Arunatilake & Jayawardena, 2010). As the number of people engaged in informal economic activities are increasing, improving the income-earning potential of workers while minimizing the variability of incomes is a common interest of entire economy. The government is keen in ensuring a sustainable income of players as there is a danger they fall into poverty in case they fail in economic activities (Canagarajah & Sethuraman, 2001).

The Government has a role to play in the best interest of the SMEs to address the existing issues. Sources of insecurities and vulnerabilities of the SMEs have been well documented in the literature (Arunatilake & Jayawardena, 2010). The nature and magnitude of these insecurities vary across socio-economic groups and across geographical regions due to obvious reasons (Arunatilake & Jayawardena, 2010). Canagarajah and Sethuraman (2001), based on World Bank study report summarize the issues that needs to be addressed by the government in order to ensure that SMES have the

potential to earn adequate incomes in consistent manner. As per (Canagarajah & Sethuraman, 2001) the interventions from the government shall be focused on expanding opportunities, ensuring empowerment, and providing security for SMEs. The government has to provide economic and social infrastructure i.e access to credit, access to roads and markets, access to electricity, water and sanitation, and to education and healthcare. These facilities will ensure returns of economic activities for SMEs (Canagarajah & Sethuraman, 2001).

4.0 THEORETICAL SIGNIFICANCE

Researching on issues of SMES is important as many are employed in this sector especially in developing countries. Breman (1980), as cited in (Gerxhani, 2011) argues that low rate of industrialization and productivity, and the presence of surplus labor as a result of insufficient job creation are listed as principal reasons why an increasing number of SMEs arose in the developing countries. The SMEs provide sort of a “cushion” for those who are unable to secure a formal employment in the formal economy. The SMEs in informal sector gives a relief to the formal economy where inadequate/insufficient employment opportunities exist in developing countries (Gerxhani, 2011). Therefore, analyzing issues and recommending innovative points for development in this sector is important.

4.1 Conceptual Model

Currently, there exists Chambers of Commerce for about 56 industry sectors in Sri Lanka that are registered with the Federation of Chambers of Commerce of Sri Lanka (FCCISL)⁵. Also, there exists provincial Chambers of Commerce which supports industries in provinces. However, as SMEs in informal sector are operating without notice of the Local Government⁶ or the central Government, they are not part or members of such Chambers of Commerce. The model illustrated below explains the issue with connections to strategies for innovations.

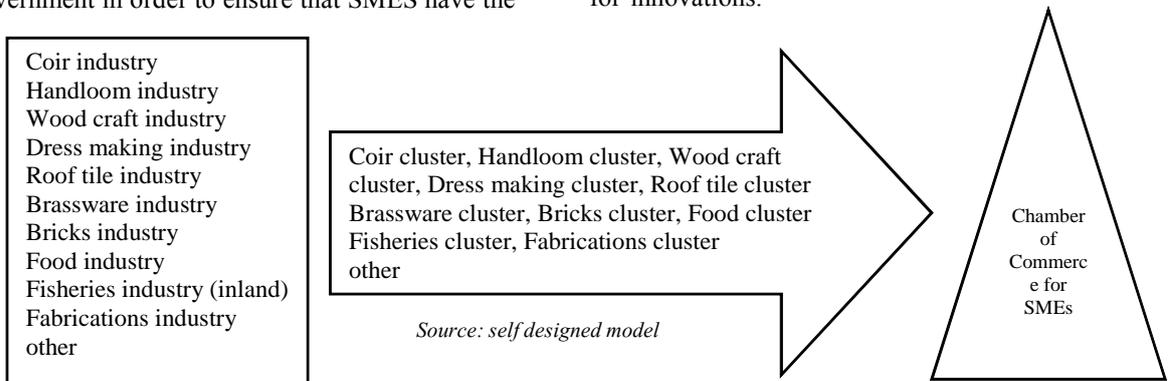
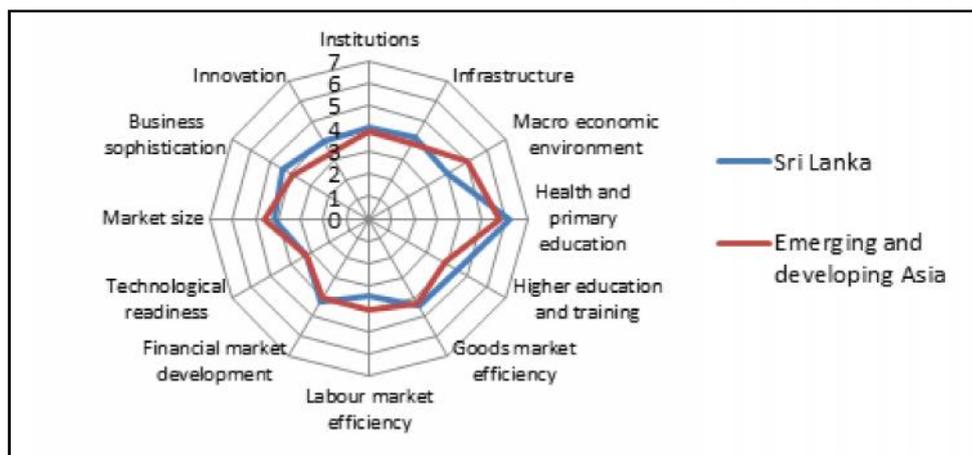


Figure 1: Conceptual model – reorganize firms as clusters

As shown in model, SMEs operate stand alone and currently there is no organization to look after the interests of SMEs. Clustering the identical industries together and creating dedicated organization to look after the interests of SMEs is the concept explained in the model.

5.0 CONCLUSION AND DISCUSSION

Competitiveness of a nation is determined by status of its institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency, labour market efficiency, financial market development, technological readiness, market size, business sophistication, innovation, and institutions. (World Economic Forum)⁷. Figure 2 below shows the competitiveness position of Sri Lanka in each of said determinants.



Source: Global Competitiveness Report:2015-2016, WEF

Figure 2: Sri Lanka competitiveness position

As shown in figure 2, in the area of technological readiness and innovations, Sri Lanka is lagging behind due to the reasons of lack of government involvement, lack of focus on SMEs in informal sector etc. In business sophistication, the country is in a moderate position. It can be argued that if innovations can be improved, business sophistication can be enhanced to greater extent. As number of small firms in the informal economy is high, firm level technology absorption may be low that leads to low productivity. Low productivity hinders the competitiveness. Usage of internet and mobile phone subscription is at a higher level compared to other Asian countries which is a positive factor for business sophistication. As suggested in conceptual model (figure 1), SMEs in the informal sector are operating separately without a group or cluster involvement. “State of cluster development” is a competitiveness parameter which this paper suggests to introduce for SMEs in the informal sector of Sri Lanka. The local Government has to play a leadership role in this regard and create “industry clusters” as proposed in the figure 1. Cluster is a “knowledge pool” and such collaborations leads to new products development (McAdam, 2005). In a

cluster, information sharing and networking is possible which are integral aspects for new product development and innovations. SMEs usually have “insights” in relation to their products which they gathered by engaged in production for long time. As discussed in the literature review, the building of “trust” among small firms is critical for good relations that finally lead to new product development. The forming of “clusters” promotes “trust” among the members of the cluster. The Government has a crucial role in relation to formalization of SMEs in informal enterprises for the purpose of expanding business opportunities, economic empowerment and providing social security, employment security and work security for SMEs.

The main recommendation proposed in this paper is creating clusters for SMEs. The benefits of clustering are discussed in previous sections. The Government shall create a separate Chamber of Commerce for SMEs as shown in figure 1 above. The Chamber gives the leadership for innovations in each cluster considering economic directions of the country. The Chamber shall identify project level, people level and strategic level innovations in each sector and provide resources for new product development.

6.0 LIMITATIONS

This paper has had common limitations which any secondary data based research has as a research methodology. In order to eliminate misapplication of available information and increase reliability of conclusions and innovative points, all duly approved and verifiable secondary information have been used in the analysis and discussion. However, all possible measures have been taken to ensure validity and reliability of conclusions and innovations points spelled out in this paper.

Based on availability of funds and other resources, further research can be undertaken on the SMEs of informal economy as there is no comprehensive list or register of SMEs in the country. Accordingly,

- a separate survey can be undertaken on SMEs of each sector
- Impact assessment of SMEs in informal sector may be undertaken for identifying critical sectors for further development

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NOTES

¹ TheWorld Bank, Asian Development Bank and several agencies of the United Nations allocate resources and implement numerous programs in the SME sector which is a major partner of informal economy of Sri Lanka.

² Visit www.statistics.gov.lk for details

³ Quarterly Labour Force Survey is a quarterly report published by the Department of Labour of Sri Lanka which can be accessed through www.statistics.gov.lk

⁴ Chamber of Commerce is an industry specific association that lead, support and guide a particular sector.

⁵ Visit www.fccisl.lk for details.

⁶ In Sri Lanka some subjects like education, health, road, youth affairs, tra

de etc. are devolved to local governments. Sri Lanka has 9 provinces and 25 districts where there are Provincial Councils in each province. Provincial Council is the local government where there are representative members appointed democratically by elections. The Provincial Council governs the matters of devolved subjects of districts clustered in each Provincial Council. For each Provincial Council, there are 2-5 districts clustered.

⁷ Based on WEC Global Competitiveness Report, 2015-16

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