Sri Lankan Tea Industry: Prospects and Challenges

S.C. Thushara,
Faculty of Commerce and Management Studies,
University of Kelaniya, Sri Lanka.
E-mail: scthushara@kln.ac.lk; scthushara@gmail.com

Abstract

The tea industry plays a significant role in the Sri Lankan economy in terms of foreign exchange earnings and providing employment opportunities. For more than a century, the tea industry was the main employment provider, the main source of foreign exchange and the main source of government revenue. Nevertheless, recent statistics suggest that the contribution of the tea industry towards the Sri Lankan economy is gradually declining. This study assesses Sri Lanka’s competitiveness in the global tea industry. It examines the nature of competition in the global tea industry and identifies the possible strategies and policies that Sri Lanka should adopt in order to improve the competitiveness of the Sri Lankan tea industry. The Sri Lankan tea industry faces several problems. The area under tea cultivation is stagnant or shrinking, productivity is low, replanting rate is low, production costs are high and there is a shortage of labor willing to work in the industry. Sri Lanka’s share of world exports of tea and production have decline significantly as a result. In this study, the Five Forces Model and the Diamond of National Competitive Advantage Model are adopted to assess the nature of competition and Sri Lanka’s competitiveness respectively. This integrated approach is essential to identify the possible strategies for the Sri Lankan tea industry to improve the competitiveness. The industry analysis reveals that the intensity of competition in the global tea industry is very high. Moreover, Sri Lanka has many unfavorable conditions together with some favorable conditions. Finally some strategies are recommended to improve the Sri Lanka’s competitiveness in the global tea industry.

Key words: Tea Industry, Sri Lankan Economy, Five Forces Model, National Diamond of Competitive Advantage

JEL Classification: F 12, F 20, F 29, N50
1. Introduction

The tea industry plays a vital role in the Sri Lankan economy. In 2014, the tea industry’s contribution towards GDP was 0.9% (CBSL 2014). Tea also accounts for 14.6% of the total export in 2014 (CBSL 2014). It also provides employment to more than one million people in Sri Lanka. For more than a century, the tea industry has been the biggest provider of employment, export earnings and government revenue (Jayasuriya 1998b). However, a closer look at recent statistics shows that the contribution of tea industry towards Sri Lankan economy is gradually decreasing. Tea is an important source of foreign exchange earnings of Sri Lanka. The net foreign exchange earnings of tea exceeds 80 percent of the total value, in contrast to other export industries like garments, which contribute to less than 20 percent of net export earnings (Ganewatta 2002). In 2008, for the first time in the history of Sri Lanka, export earnings from tea exceeded the one billion US$ benchmark, Sri Lanka is the first producing country to achieve this feat. Sri Lankan tea industry took more than 17 years to double its earnings. The main contributory factor for this achievement was the high tea prices. Despite the fact that the Sri Lankan tea industry was once pre-eminent in the world, it has been going through intermittent crises for a long time due to problems related to low productivity and the high cost of production (Jayasuriya, 1998a). Recent studies on the Sri Lankan tea industry have identified several problems that Sri Lanka is currently facing such as stagnant area under tea, low productivity, lower replanting rate, higher cost of production and shortage in labor supply (Jayasuriya, 1998a). Jayasuriya (1998a) claims that the major challenges that the tea industry faces are, raising productivity and remaining competitive.

Sri Lanka’s main competitors - India, Kenya, China and Indonesia - were able to increase the area under tea cultivation significantly during 1976-2013. However, the area under tea cultivation in Sri Lanka dropped significantly 1976 to 2013. In contrast, in Kenya there was an impressive 126.2% increase in area under tea cultivation over the same period. It is difficult to increase the area under tea due non-availability of suitable lands for tea. Moreover, the replanting rate in the corporate tea sector in Sri Lanka is very low. During 1993-2002, it was only 0.70 percent. Evidence suggests that to sustain the industry, replanting rate should be at a minimum 2 percent per annum of the total area under tea cultivation (Mohamed 2004). This implies that, to increase the production, raising productivity is of paramount importance. Kenya as a non-traditional competitor was able to double both production and exports of tea during 1990-2000 (Lama 2001). Kenya is gaining its market share at the expense of other countries like Sri Lanka. Sri Lanka’s share of world production of tea and the share of world exports show a downward trend while that of Kenya shows a significant increase. However, Sri Lanka is still the number one exporter of tea in terms of export revenue. Sri Lanka has
been able to maintain this position due to higher prices received for Sri Lankan tea (ITC 2013).

The Sri Lankan tea industry is facing many problems such as stagnant area under tea cultivation, low productivity, lower replanting rate, high cost of production and shortage of labor. In particular, Sri Lanka’s share of world production and her share of world export are gradually decreasing. These may be the signs of losing competitiveness in the global tea market. Thus, this study mainly will focus on assessing Sri Lanka’s competitiveness in the global tea market. The purpose of this study is to analyze Sri Lanka’s competitiveness in the global tea market while understanding the nature of the global tea industry. The specific objectives of this study are:

(a) To assess the intensity of competition in the global tea industry.
(b) To assess Sri Lanka’s competitiveness in the global tea market.
(c) To identify possible strategies and policies that Sri Lanka should adopt in order to improve competitiveness in the global tea market.

Several studies (Basnayake and Gunaratne 2002; Fonseka 1997; Ganewatta 2002; Jayakody and Shyamali 2002; Mendis 1992) carried out on the Sri Lankan tea industry have identified many problems and implications of those on tea industry. This study will add value to existing literature by attempting to assess the level of competitiveness that Sri Lanka is having in the global tea market as it has important policy implications. Moreover, the study will assess the intensity of competition in the global tea market, as it is important to shape strategies in order to remain competitive. The findings of this study will be of importance to tea producers, sellers and the Government. The study will enable individual firms to shape their current strategies in order to succeed in the increasingly competitive global tea market. Moreover, the findings will also enable policy makers to identify the areas where the Government should intervene and allocate resources with the intention of enabling domestic tea producers and tea sellers to succeed in the global tea market.

2. Literature Review

With the process of globalization, competitiveness has become an important issue for both developed and developing countries. Today all countries in the world depend more or less depends on international trade. As such, the export revenue is vital for a country’s economic health. To be successful in this respect a country needs to maintain and enhance its competitiveness against its rivals. The failure to do so may result in eroding the market share of that country in the relevant industry and hence decline in export revenue.

Competitiveness has been defined by many scholars in different ways, though those share some common features. However, there is no commonly accepted definition for competitiveness or national competitiveness (Krugman 1996). Competitiveness can be
assessed in three levels: country level, industry level and firm level. OECD (1996) defines competitiveness at country level (or national competitiveness) as, “the degree to which a country can, under free and fair market conditions, produce goods and services which meet the test of international markets, while simultaneously maintaining and expanding the real income of its people over the long term.” The definition for national competitiveness from the Institute for Management Development (IMD 2003) is, “how nations create and maintain an environment which sustains the competitiveness of its enterprises.” The World Economic Forum (WEF 2003) refers to national competitiveness as, “the set of institutions and economic policies supportive of high rates of economic growth in the medium term.” Scott and Lodge (1985) define national competitiveness as, “a country’s ability to create, produce, distribute, and/or service products in international trade while earning rising returns on its resources.” Fagerberg and Srholes (2007) maintain that competitiveness of countries is a relative term and hence how well a country performs relative to others is imperative. Furthermore, they contend that the concept, competitiveness has double meaning, relates to both the economic well-being of its citizens and the trade performance of the country.

Many view competitiveness and productivity as synonymous; nevertheless, these two related terms are different (Zanakis and Becerra-Fernandez 2005). “Productivity refers to the internal capability while competitiveness refers to the relative position against its competitors” (Cho and Moon 1998). However, productivity is the key to competitiveness. Shurchuluu (2002) argues that the recent success of many countries, such as Japan, Hong Kong, Taiwan, and Singapore cannot be explained using the theory of factor-comparative advantage which sees competitiveness as being dependent on the possession of abundant natural resources and labor, though it was successful in explaining the growth of Western countries. He highlights the link between the possession of natural assets and competitiveness. Moreover, he stresses the need to transform those natural assets into competitive assets in order to gain greater competitiveness (Figure 2.7). While the above definitions are different and defined in different points of view, they emphasize the significance of certain aspects in competitiveness. Firstly, those definitions draw attention to the importance of creating an environment conducive to be successful in the international market place. In other words, the Government role is fundamental to enhance competitiveness of a country. Secondly, what is most important is not the absolute performance of a country, but the relative performance.
Fagerberg & Srholec (2007) have identified the following four different aspects of competitiveness.

1. Technology competitiveness: Fagerberg & Srholec (2007) define technology competitiveness as “the ability to compete successfully in markets for new goods and services.” Moreover, he highlights that this type of competitiveness is associated with the innovations of a country.

2. Capacity competitiveness: Fagerberg & Srholec (2007) refer to capacity competitiveness as “the capabilities that are important for the capacity to exploit technological opportunities.” For this purpose, three general factors have been identified by Abramovitz (Fagerberg & Srholec, 2007) as relevant to enhance capacity competitiveness: (1) technical/organizational competence (level of education), (2) availability/quality of financial institutions/markets, and (3) quality/efficiency of governance.

3. Price competitiveness: the traditional view on competitiveness focused mainly on the price and/or cost comparisons when engaging with competitiveness.

4. Demand competitiveness: Demand competitiveness is believed to be an important aspect of competitiveness. Under this, the relationship between a country’s production (or trade)
structure and the composition of world demand is taken into consideration (7). Fagerburg (2007) argues that products based on important innovations are likely to experience high growth and this may affect countries differently depending on their specialization patterns.

Competitiveness is central to the capability of firms to survive and succeed in the global market. The recent drive towards globalization makes this issue even more serious. Thus, measuring competitiveness is an important step for policy makers. Onsel et al. (2008) argue that although many scholars have attempted to provide objectivity in the development of measures of national competitiveness; many subjective judgments are involved in the process. Many scholars and leading institutes have attempted to measure national competitiveness using different approaches.

The World Economic Forum (WEF) and Institute for Management Development (IMD) annually publish ranking of countries in accordance with the degree of national competitiveness those countries have. However, these frameworks rank countries, but not specific industries. Measuring competitiveness based on the specific industries is imperative since different industries encounter different issues in the global market and hence different strategies are needed. IMD when preparing the World Competitiveness Yearbook (WCY) does not evaluate all countries in the world. It evaluates OECD countries and some newly industrialized countries (Onsel et al. 2008). IMD considers four factors which comprise of more than 300 criteria: economic performance (77 criteria), government efficiency (72 criteria), business efficiency (68 criteria), and infrastructure (95 criteria). To highlight the various aspects of competitiveness, each of these factors have been broken down into five sub-factors, resulting 20 sub-factors. Countries are given scores on each factor based on the data collected and a weighted average is considered when producing the overall competitiveness index. Moreover, when computing this index, hard data are given a weight of two thirds in the overall ranking while the survey data is the remaining one-third (Onsel et al 2008). In 2006, IMD assessed 61 countries and regional economies (Onsel et al. 2008). WCY is assumed to be the leading publication that ranks countries based on national competitiveness (Onsel et al 2008). However, some scholars criticize that the methodology used in this report is hard to understand and thus suggest the need for alternative statistical or mathematical programming approaches to measure competitiveness. Boltho (1996) argues that the real exchange rate is a short-term measurement of competitiveness and trend productivity growth a long-term measure (Kao et al. 2008). Nevertheless, this approach to measure competitiveness seems to be very narrow definition. The short-term measurement of competitiveness in this approach overlooks all other important factors while the latter consider only the internal productivity which is not adequate to compete in the highly competitive global market.
WEF annually publishes ranking of countries based on the national competitiveness through its Global Competitiveness Report (GCR). CGR prepares its Global Competitiveness Index (GCI) based on three principles: (1) the determinants of competitiveness are complex, and consist of twelve pillars (Institutions, Physical infrastructure, Macro-stability, Security, Basic human capital and Advanced human capital, Goods market efficiency, labor market efficiency, Financial market efficiency, Technological readiness, Openness and market size, Business sophistication, and Innovation); (2) economic development is a dynamic process of successive improvement; and (3) as economies develop, they move from one stage to the next in a smooth fashion (Onsel et al 2008). WEF organizes 33 indicators that reflect economic performance and environment for the competitive development of nations into 3 categories: the technology index, the public institutions index, and the macro-economic environment index. This report evaluates 104 economies. Therefore, GCR considers more countries than the WCY. Onsel et al (2008) assert that the weights given to the various criteria are different for countries at different stages of development and the weights are subjective. Moreover, he argues that the threshold-values used to separate stages are subjective and the classification of countries according to different clusters at different stages of development is illogical or based on their level of per capita income alone. In addition, (Lall 2001) argues that the GCI is too wide-ranging; its approach is unfair; and the methodology is unsound. Both GCR and WCY utilize hard data and survey data (soft data). Though the methodology used in these approaches is heavily criticized by many scholars, these two reports still remain important to policy makers (Wang et al 2007). Almost all the countries in the world today believe and adopt an open economy or market economy. As a result, the role of the Government in the economy is gradually shrinking. However, the role of the Government in enhancing national competitiveness cannot be underestimated. Shurchuluu (2002) argues that despite the fact that Governments have a reducing influence in today’s world, the Government has two important roles in enhancing competitiveness: providing infrastructure and maintaining a good education system. He further contends that the most important source of competitive advantage is the knowledge and skills of the workforce. Porter (1998a) also believes the same. He maintains that the role of Government in influencing national competitiveness is vital. Moreover, he cites the recent success of firms in Korea and Japan is associated with the Government policies which created an environment where firms can compete successfully in the global market. In addition, he highlights that the Government influence on the national competitiveness can be positive or negative.

Economic development of a country should aim at increasing welfare of its citizens. Though the contribution of a country’s competitiveness toward the economic growth is imperative, Monk (2008) argues that the competitiveness literature and theories appear to be
ambivalent, and at times pessimistic about the impact of social welfare institutions. He criticizes Porter for maintaining the idea that the social institutions and conditions are secondary considerations for a healthy economy. Concisely, these theories suggest that social welfare institutions do not enhance or create competitiveness. However, Monk (2008) provides a rather different view on this. He concludes that no matter the size and scope of the competitive benefit, social institutions must be considered when evaluating regional competitiveness which has been ignored by the mainstream competitiveness theorists.

The exchange rate fluctuations can have a make-or-break effect on a specific industry of a country. If that industry is an export-oriented industry, like the Sri Lankan tea industry, the effect can be significant on the export competitiveness. If a country’s currency is depreciating against other currencies, the cost of production tends to be lower and products of that country may be more competitive in the global market. Daigneault et al (2008) argue that, though the future trends in exchange rates are uncertain, it is important to consider the effects of future trends in exchange rates.

Technology is critical in enhancing competitiveness of a country in our age of information. The world is getting increasingly interdependent and connected as a result of the rapid globalization process. A firm can start a global business with a minimum investment with the help of e-commerce technology. Nevertheless, only the innovative firms can survive in the global market. Wang et al (2007) contend that the recent drive towards globalization and e-commerce has enhanced the utilization of technology and has greatly influenced the competitiveness of countries. Moreover, they maintain that technology is a key to sustained competitiveness of countries. Fagerburg (2007) identifies technology competitiveness as one of the major sources of competitiveness. Furthermore, he maintains that technology competitiveness is related to the innovativeness of a country and well-developed ICT infrastructure is necessary for innovation. He has identified that the deteriorating technology competitiveness as a main factor hampering many developing countries in exploiting the potential to catch-up in technology and income. Castellacci (2008) argues that the focus of economic research has shifted from the analysis of price-and-cost related factors of competitiveness to the important role played by technological change. He further maintains that this greater attention to technology and the non-price factors have been inspired by the seminal contribution by Schumpeter. Moreover, he argues that the sectoral innovative activity and international diffusion of new technologies are closely related and both of them are vital to sustain the competitiveness of national industries in the international arena.

A recent study by Matthysens & Vandenbempt (2008) highlights the importance of moving from basic product offerings to the value-added products to regain competitiveness. This fact is enormously pertinent to the global tea industry. Value-added tea products
command high prices in the global tea market while bulk tea fetches low prices. Thus increasing the share of value-added tea in total tea export is central to remain competitive in the global tea market and to increase the contribution of Sri Lankan tea industry towards the national economy. In addition, Matthysens & Vandenbempt (2008) argue that companies must break existing rules of the game and reshape the boundaries of the industry in order to regain competitiveness. Technology and innovation play a central role in this regard.

Porter’s contribution to the literature on competitiveness is highly admired by many researchers. Porter emphasizes the need to analyze why firms are based in a particular nation able to create and sustain competitive advantage against the world’s best competitors in a particular field and why one nation is frequently the home for so many of an industry’s world leaders (Porter 1998a). Furthermore, Porter (1998a) argues that the home nation’s influence on competitive advantage is critical to the level and rate of productivity growth achievable.

Based on a four-year study of ten important countries (Denmark, Germany, Italy, Japan, Korea, Singapore, Sweden, Switzerland, United Kingdom, and United States), Porter presented a new methodology called the ‘National Diamond of Competitive Advantage’ to assess the national competitiveness. Basically, this model is used to analyze the economy of a country, industry by industry. The model, National Diamond of Competitive Advantage, analyzes economies based on six factors, which can be classified into two parts: endogenous variables and exogenous variable. Factor conditions, Firm Strategy, Structure, and Rivalry, Related and Supporting industries, and Demand conditions are known as endogenous variables while Government and Chances are recognized as exogenous variables (Cho et al 2008; Porter 1998a). This model has been widely used in studying the competitiveness of nations (Bellak and Weiss 1993; Hodgetts 1993). Nevertheless Porter’s National Diamond of Competitive Advantage is not free from criticisms. Dunning (1993) argues that Porter’s Diamond Model undervalues the impact of globalization and markets for the competitive advantage of nations. Porter’s framework focuses on a set of home country determinants, which affect national competitiveness. Thus, Allan and Verbeke (1993) contend that this puts forwards analytical difficulties when applying to international business since Dunning’s eclectic theory of the multinational enterprise reveals that it is the interaction between national and international determinants that leads to the competitive success of global industries. Furthermore, they suggest extending the Porter’s Diamond by incorporating the modern theory of the multinational corporation. In addition, Bellak and Weiss (1993) indicate that this model has weaknesses in analyzing small, open economies. Cho et al (2008) argue that Porter has narrowly focuses on the home base. Moreover, Cho et al (2008) point out that, to overcome the shortcomings of the model Porter’s single Diamond model has been extended in two directions: 1) incorporation of multinational activities through the introduction of the
double diamond model; (2) nine-factor model (nine factor models takes into account four additional human variables, workers, politicians and bureaucrats, entrepreneurs, and professionals). In addition, they conclude that the Government should not be treated as an exogenous variable and need to be treated as an endogenous variable since the Government is the main factor for a nation’s competitiveness.

3. Methodology

In the analysis both Five Forces Model and Diamond of National Competitive Advantage Model are adopted. The Five Forces Model is a valuable tool to assess the intensity of competition in the global tea market while the Diamond model assists in assessing the competitiveness that a country has. The findings of both models are essential to suggest the possible strategies that Sri Lanka should adopt in order to improve competitiveness. Industry analysis helps to understand the key factors for competitive success and the important industry opportunities and threats (Porter 1998b: xxviii). Moreover, potential attractiveness and profitability of an industry can also be identified through a comprehensive industry analysis (Oster 1999:29). The Five Forces model developed by Michael E Porter has been widely used to analyze industries. According to Porter’s Five Forces Model, the state of competition in an industry is determined by five basic competitive forces: rivalry among existing firms, the threat of new entrants, the bargaining power of suppliers, the bargaining power of buyers and the threat of substitute products and services. This model is used in this Chapter to analyze the global tea industry. It is also important to understand why some countries do well and others fail in international competition. Porter maintains that focus on why firms are based in a particular nation are able to create and sustain competitive advantage against the world’s best competitors in a particular industry, and why one nation is often the home for so many of an industry’s world leaders are important. Thus, assessing the level of competitiveness that a country has in relation to a particular industry has important policy implications. To assess Sri Lanka’s competitiveness in the global tea industry, the Diamond of National Competitive Advantage Model developed by Porter is used in this Chapter. Despite the fact that it has some limitations, it provides a valuable tool to assess the competitiveness. This model recognizes that the competitiveness of a nation stems from six factors: factor conditions, firm strategy, structure and rivalry, related and supporting industries, demand conditions, government and chances. These factors will be applied to the Sri Lankan tea industry in order to assess the level of competitiveness that Sri Lanka has in the global tea industry.

4. Analysis and Discussion

4.1 The Global Tea Industry: An Industry Analysis
Five forces model developed by M.E. Porter recognizes that the state of competition in an industry depends on five basic forces: rivalry among exiting players, the threat of new entrants, bargaining power of suppliers, bargaining power of buyers and threat of substitute products and services (Figure 3.1). The collective strength of these five forces determines the ultimate profit potential in the industry (Porter 1998b). These forces are closely examined in relation to the global tea industry in order to assess the competition and the profitability in the global tea industry.

**Figure 2: Forces Driving Industry Competition**

![Diagram of Five Forces Model]

Source: Porter (1998b), pp.4

### 4.1.1 Intensity of Rivalry among Existing Competitors

This force is also known as internal rivalry. Internal rivalry refers to jockeying for share by existing players within an industry (Besanko et al 2007). Intense rivalry among existing players in an industry tends to reduce average profitability (Oster 1999). Ali et al (1997) argue that this force is very dominant and can affect the industry, both positively and negatively to a great extent. This force can provide competitive pressures to rationalize costs and bring about product and process improvement. This is the positive side of this force. In contrast, it can drive down prices and thereby hurt the entire industry (Ali et al 1997). Excess capacity, high fixed costs, lack of differentiation, absence of switching costs, slow industry growth, high strategic stakes, high exit barriers, and numerous or equally balanced competitors are some factors that create intense competition among existing players in an
industry (Ali et al 1997; Oster 1998; Porter 1998b; Besanko et al 2007). With new entrants, particularly African countries to the global tea industry, there has been an excess capacity in the industry. During the last decade global tea production is much higher than the global tea consumption. In other words, there is an excess capacity in the tea industry. In 2013 the excess capacity as a percentage of supply was 4.38 percent. This has a downward pressure on tea prices. Moreover, this enhances the rivalry among existing players. At present, there are more than 35 tea producing nations. The top five of them are Sri Lanka, India, China, Kenya, and Indonesia, and they account for over 75 percent of both global tea production and consumption. The lack of differentiation is evident in the global tea industry. In 2012, Sri Lanka exported 57.4 percent of tea exports as value added tea and only the balance was exported as bulk tea. Sri Lanka is considered to be the number 01 exporter of value added or differentiated tea.

In the tea industry high fixed costs are evident. Factory machinery which is used to process tea leaves has no value if a firm quits. Thus, the firms try to cut prices to secure orders which are necessary to utilize their full capacity (Fonseka 1997). This high fixed costs act as an exit barrier. As a result, firms try to be in the industry even at a loss. Moreover, Sri Lanka has emotional attachment to the tea industry as it is a century old industry (Fonseka, 1997). Thus, the Government offers various subsidies and support for the tea industry. This also acts as an exit barrier for Sri Lanka.

4.1.2 Threat of Substitute Products

The presence of substitute products can have a considerable impact on the profitability of a given industry. Oster (1998) maintains that the presence of substitute products in an industry controls the capability of a firm to increase its price or alter the attributes of its products. Moreover, he argues that if the industry under consideration has few competitors in the narrow market or it is hard to raise industry supply quickly, the presence of substitutes limits excess profits accrued to firms in the industry.

Substitute products are the products that can perform the same function as the product of the industry (Porter 1998; Oster 1998). If one wants to find a chain of substitute products, one should ask the question, “What set of products constrains the ability of firms in this industry to substantially raise their prices?” (Oster 1998). According to Besanko et al (2007), there are three main factors to consider when assessing the substitutes: the availability of close substitutes, the price-value characteristics of substitutes and the price elasticity of industry demand. Soft drinks, fruit juices, coffee and alcohol can be regarded as the major substitute products for tea (Ali et al 1997; Kenneth Abeywickrama Associates, 1990). Modern marketing of these beverages has eroded the value of the tea market, especially in the developed countries which has the bulk of consumer spending power (Kenneth
Abeywickrama Associates (1990), the annual per capita consumption of tea in developed countries has fallen dramatically (Table 1).

<table>
<thead>
<tr>
<th>Year</th>
<th>UK</th>
<th>Canada</th>
<th>South Africa</th>
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<tr>
<td>1979-81</td>
<td>3.22</td>
<td>0.81</td>
<td>0.69</td>
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<tr>
<td>2000-2002</td>
<td>2.26</td>
<td>0.59</td>
<td>0.47</td>
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<tr>
<td>2005-2007</td>
<td>2.17</td>
<td>0.54</td>
<td>0.39</td>
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<tr>
<td>2009-2011</td>
<td>1.97</td>
<td>0.48</td>
<td>0.39</td>
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<tr>
<td>2011-2013</td>
<td>1.92</td>
<td>0.48</td>
<td>0.35</td>
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4.1.3 Bargaining Power of Buyers

If the buyers are powerful in a particular industry, they tend to force down prices, bargain for higher quality or more services, and play competitors against each other. All these affect profitability of the industry adversely (Porter 1998:24). There are several factors that lead to higher bargaining power by buyers. The most important factor in determining the bargaining power of buyers is the number of buyers and the distribution of their purchases. The larger the number of buyers and the smaller their individual purchases, the less power each one will have (Oster 1999:41). In the global tea industry, buyers are highly concentrated and this leads to higher bargaining power over the tea producing countries that supply tea as an agricultural commodity (Fonseka 1997). The market share of multinational companies is very high in most producing countries (Ganewatta 2002). Four major multinational companies account for approximately 80 percent of international tea trade (Ganewatta 2002). Thus multinational companies are dominating the global tea trade. Moreover, they are in the process of backward integration which enhances the bargaining power of buyers. For instance, Unilever has resorted to backward integration through the ownership of 17,533 hectares of tea in five different countries (Fonseka 1997). The high concentration of buyers has intensified the competition amongst them to supply tea at low prices to supermarket chain (Fonseka 1997).

“Competitive price cutting of retail packs by the large distributors, without lowering the quality of the packs or reducing their profits, has been made possible by keeping purchase price low at the auctions. Plantations have traditionally relied on the auctions to dispose of their tea. This means in effect that the packers will always tend to keep the producer prices low.”

Presidential Commission on the Tea Industry and Trade, 1995:21

(Fonseka 1997:163)

The other factor that contributes to higher buyer power is that the nature of the product sold. In the global tea industry, considerable portion of tea sold as bulk tea which is standardized. Due to lack of differentiation, buyers can easily switch from one supplier to the
other virtually at no cost. This enhances the power of buyers. However, Sri Lanka exports a considerable portion of tea as value added tea commanding higher prices (ITC, 2014). Therefore, Sri Lankan tea producers can minimize the adverse effect of bargaining power of buyers to some degree. Thus, further increase of the value added tea exports is necessary. Overall, it is evident that the bargaining power of buyers is high in the global tea industry.

4.1.4 Bargaining Power of Suppliers

Like dominant buyers in an industry can squeeze profits by putting downward pressure on prices, suppliers can squeeze profits by increasing input costs (Oster, 1998). The ability to do so depends on several factors. The number of suppliers available, the product standardization, the threat of forward integration, the transaction form, the nature of demand, the switching costs and the ability of suppliers to discriminate prices can be regarded as the major factors that determine the bargaining power of suppliers (Oster 1998; Besanko et al 2007; Porter 1998 and Ali et al 1997).

The tea industry is reliant on suppliers of fertilizer, chemicals, packing materials, tea chests, paper sacks, labor etc. As there are many suppliers for those products in Sri Lanka and they are heavily dependent on the Sri Lankan tea industry, firms can exert a significant downward pressure on prices except for labor in Sri Lanka (Outschoorn 2000). The cost of labor accounts for more than 50 percent of total cost of production in Sri Lanka. Labor is highly unionized and thus they exert high pressure on increasing wage rates (Fonseka 1997).

4.1.5 Threat of New Entrants

New entrants to an industry add additional capacity to it and come with desire to gain market share. As a result, prices can be bid down and costs may go up. This leads to reduced profitability in the industry. The potential threat of new entrants to an industry depends on entry barriers. Porter (1998) has identified six major sources of barriers to entry: economies of scale, product differentiation, capital requirements, switching costs, access to distribution channels, and government policy.

In the 1970s, African countries entered into the tea industry in a large-scale. During 1970s, the Sri Lankan Government nationalized many of its plantations. As a result, the British investors who ran many of the Sri Lankan plantations went to Kenya to invest in the tea plantation sector. The Kenyan Government provided them with the necessary support. The tea produced by the Kenyan estate sector is marketed by the multinational companies (Ali et al 1997). Thus, Kenya has relatively strong international marketing mechanism. This enabled Kenya to be a major player in the global tea market. Kenya is now enjoying significant portion of the global tea production and the global tea exports. Ali et al (1997) maintain that the entrance of these countries brought overcapacity which is still a problem in the industry. Moreover, these entrants, particularly Kenya, gained market share at the expense of the major players such as Sri Lanka and India. This was possible due to several reasons. Firstly, the
Kenyan tea industry is backed by the leading multinational companies. This led to the establishment of an efficient estate sector under the British tea companies. These companies introduced new practices to the factory management. Secondly, the Kenyan Government took a major step to integrate small scale growers into the mainstream of tea growing. Thirdly, the Kenyan tea industry is using high yielding varieties. These factors led to higher productivity and lower cost of production. (Gesimba et al 2005). Until Kenya entered the UK tea market, Sri Lanka and India were the major players. However, Kenya was able to amplify its market share in the UK tea market aggressively and Sri Lanka and India lost its market share significantly as a result (ITC 2014).

4.2 Sri Lanka’s Competitiveness in the Global Tea Industry

Firms in some nations always achieve international success in some industries. Thus, Porter (1998) emphasizes the role of the home nation in creating an environment in which firms in that nation can create and sustain competitive advantage in the global market place. Porter (1998) introduced the Diamond of National Competitive Advantage which can be used as a framework to analyze the competitiveness of nations in providing a better environment for firms in that nation to succeed in the global market. This model is used to analyze Sri Lanka’s competitiveness in the global tea market.

Porter (1998a) in his model, ‘Diamond of National Competitive Advantage’ presents four broad elements of a country that shapes the environment in which local firms compete that support or hamper the creation of competitive advantage: factor conditions, demand conditions, related and supporting industries, firm strategy, structure and rivalry. In addition to these four factors, the role of chance and the role of government are also taken into account in assessing the national competitive advantage that a nation has in a particular industry (Figure 2).

**Figure 2: The Determinants of National Competitive Advantage**

![Diagram of the Diamond of National Competitive Advantage](source: Porter (1998a), pp.127)
4.2.1 Factor Conditions

Classical trade theories suggest that the initial endowment of factors of production is critical in the determination of competitive advantage. Porter, by factor condition, means the suitability of the nation’s factors of production to compete successfully in a particular industry (Czinkota et al 2002). Moreover, he argues that the ability of a nation to continually create, upgrade, and deploy its factors are most important than the initial endowment (Czinkota et al 2002). Porter (1998b) categorizes factors into five groups: human resources, physical resources, knowledge resources, capital resources and infrastructure. Porter (1998b) emphasizes that a nation’s firms achieve competitive advantage if they enjoy low-cost or uniquely high quality factors of the particular types that are imperative to competition in a specific industry. Furthermore, he highlights the importance of distinguishing between the basic factors which include natural resources, climate, location, unskilled and semi-skilled labor, and debt capital and the advanced factors which include modern digital data communications infrastructure, highly educated personnel, and university research institutes in sophisticated disciplines. The basic factors are important particularly in the agricultural industries. However, advanced factors are the most significant factors for competitive advantage and they are vital to produce differentiated products (Porter 1998b). Advanced factors are vital to gain competitiveness in the global tea industry since these factors are necessary produce differentiated or value added tea that fetches higher prices.

Tea production is highly a labor intensive operation. Recent study carried out by Tea Research Institute of Sri Lanka shows that labor cost accounts for more than 65 percent of the cost of tea planting/replanting (Jayakody and Shyamali 2002). Moreover, about 56 percent of cost of production is from labor (Pitigala 2000). Kenya’s cost of production is much lower compared to Sri Lanka (Pitigala 2000). This implies that increasing labor productivity is vital if a country is trying to compete in the global tea market using cost leadership strategy. In Sri Lanka, workers in the plantation sector are highly unionized. This makes any cost reduction programs in relation to labor almost impossible. Union actions such as strikes demanding higher wage rates are common in the plantation sector. These union actions exercise a significant pressure on cost of production. Despite these facts, Sri Lanka has been able to fetch higher prices for its tea owing to high quality standards (Pitigala 2000). The high quality standards were possible due to the quality control; the great care that the firms exercise to ensure that quality standards are met with regard to customer requirements in all processes including timely delivery (Fonseka 2001).

Tea productivity can be used as one of the measures to assess the level of competitive advantage that the countries have in relation to factor conditions. Sri Lanka’s productivity is much lower compared to Kenya and India. Kenya has the highest productivity. There are
several factors attributed to this difference. Lack of high yielding varieties is one identified reason (Mohamed, 2004). Sri Lanka had a very favorable factor conditions during the colonial period such as virgin lands, ideal agro-climatic conditions, an abundant supply of cheap labor without trade union etc. However, these favorable conditions are not available any more (Manikam 1995). Kenya has abundant of virgin lands and its tea plantations are relatively new and uses high yielding varieties. This leads to higher productivity (Ganewatta 2002). However, productivity in small holding sector is much higher than the corporate sector. Sri Lanka expects to increase productivity 2000-2100 kg/ha within next ten years (MPI 2006).

According to a recent report by the Bartleet Produce Marketing (World Tea Market Monthly Sep 2008), fertilizer use in the Sri Lankan tea industry has fallen by almost a third in the past four years. The cost of urea has risen tenfold from Rs. 10,000 per tone in 1995 to Rs. 105,000 in 2008 (World Tea Market Monthly, Sep 2008). Further decrease in fertilizer application is likely due to the decrease in tea prices owing to the slowdown in the global economy.

The Lack of adequate labor force, the lack of trained work force especially in the small holding sector and the lower labor productivity are also considered as major challenges that the Sri Lankan tea industry is facing (MPI 2003). Due to both low land productivity and lower labor productivity, Sri Lanka is unable to bring down its cost of production. Thus, Sri Lanka cannot afford to compete in the global tea market using cost leadership strategy.

Mendis (1992) states that, in Sri Lanka, the tea growing areas are confined to the “wet-zone”, comprising the southern quadrant of the Island. Being tea an agricultural product, weather patterns have a significant direct impact on the production volume. However, almost all the tea producing countries have weather patterns which are conducive to tea production (ITC 2003). Nonetheless, occasional natural disasters such as floods, droughts are evident in tea producing countries. Nevertheless, there is no sufficient evidence to suggest that one country is enjoying a better weather patterns relative to other producing countries.

4.2.2 Demand Conditions

Porter (1998) argues that the local firms which compete in the global market benefit by home demand conditions in two ways by improving competitive advantage. The first is the mix or the composition of home demand and the other is character of the home buyer needs. Porter describes character as demanding buyers (Czinkota et al 2002). Concisely, Porter maintains that firms, which are successful in highly competitive and demanding home market are likely to survive and succeed in the global market.

Both Sri Lanka and Kenya basically produce tea for exports. The home demand in these countries is less than 10 percent and 5 percent respectively (ITC, 2014). As a result, both countries are likely to experience difficulties when international demand decreases. As global demand for tea is adversely affected by the slow down in the global economy, these countries
are severely affected. Moreover, due to the small home market, producers and marketers in these countries have fewer opportunities in identifying changing patterns of tea drinkers. Conversely, India and China have a huge home market. Moreover, the home demand for these countries shows an increasing trend. Thus, India and China can absorb the adverse effect of the fall in the global tea demand relatively well compared to Sri Lanka and Kenya. However, Sri Lanka has the highest per capita consumption of tea followed by India, China, Kenya and Indonesia. India has given good examples of having a strong home market. India was able to innovatively produce many new tea varieties and later was able to find niche markets in other countries for those products. Moreover, it was possible for India to make substantial investment in R&D as a result of having a huge home market, and develop better clones for tea (Ali et al 1997).

4.2.3 Related and Supporting Industries

Porter introduces presence of related and supporting industries that are internationally successful as the third determinant of national competitive advantage. This determinant can create competitive advantage in several ways: providing efficient, early and sometimes preferential access to the most cost effective inputs, providing ongoing coordination, close working relationships between world class suppliers which leads to innovation, and proximity of managerial and technical personnel along with cultural similarities which tends to facilitate a free and open information flow (Porter 1998).

The emergence of companies to export tea in value added form has enhanced the competitiveness of Sri Lanka. Tea marketing has been a very complex business and multinationals are dominating the market. This keeps the producer countries at a disadvantage because the multinational companies buy tea in bulk at lower prices from auctions and market them after blending at very high prices. Nevertheless, Sri Lankan tea packaging industry has developed to an extent that they can compete with the multinationals (Maxwell Fernando, 2000). For instance, the Ceylon Tea Services (Dilmah) and Euro Scan Exports (Mlesna) are competing in the global tea market successfully. Dilmah is the preferred supplier to McDonalds in 18 countries including Australia, and Singapore Airlines, Emirates Airlines and Egypt Air (Fonseka 2001). The success of these packaging companies is likely to enhance Sri Lanka’s competitiveness due to the fact that most of the tea can be exported in value added form fetching better prices. Moreover, this reduces the dependence on multinational companies who buy tea in bulk form and market them in the value added form. According to a recent report issued by Asian Development Bank (2008), the Sri Lankan tea industry needs to capture a greater share of the global tea value chain through branding and marketing of tea.

4.2.4. Firm Strategy, Structure and Rivalry

By this fourth determinant of national competitive advantage in an industry, Porter means the context in which firms are created, organized, managed and the domestic rivalry (Porter
These factors broadly differ among nations. Thus, Porter asserts that a superior match between these options and the sources of competitive advantage in a specific industry leads to a national competitive advantage. However, Porter does not advocate any universally acceptable managerial, ownership, or operational strategy. He emphasizes that it depends on the fit and flexibility of what works for that industry in that country at that time (Czinkota et al 2002).

A firm needs to implement a unique and inimitable strategy in order to succeed in the global tea market that is increasingly becoming more and more competitive. A salient feature in the global tea market is value added tea fetches better prices compared with bulk tea. Thus, the exporting of more of value added tea enhances the competitiveness. The value added tea denotes the all type of tea except tea marketed in bulk form. Thus, value added teas take the form of tea packets, tea bags, instant tea and green tea (Ganewatta 2002). Sri Lanka’s performance in this regard is impressive. The value added tea exports have increased from 0.8 percent of the total exports in 1962 to 57.4 percent in 2012 (SLTB Annual Report, 2013). However, it does not show an increasing trend during the recent years. Sri Lanka is considered as the leading value added tea exporter in the world. This has enabled Sri Lanka to remain as the leading tea exporter in the world in terms of export revenue. The strategy of exporting more value added to tea contributes to enhance Sri Lanka’s competitiveness in the global tea market. Some Sri Lankan companies have developed their own brands. Dilmah, Mlesna, Impra, HVA are some examples. Dilmah has been able to compete successfully with multinationals. Dilmah’s strategy is to export differentiated tea products to the global market (Fonseka 2001). Given the intensive competition that Sri Lanka faces, the exports of value added tea need to increase significantly.

The dominance of the small holding sector in Sri Lanka impedes the exporting of more tea in value-added form due to the lack of expertise, and the inability to easily access the capital market (Pitigala 2000). The small holders’ contribution to tea industry is high in many producing countries such as Sri Lanka, India and Kenya. Moreover, most of the tea estates which were under state control were privatized in 1995 (CBSL 1998). The privatization of state plantations has contributed to enhance Sri Lanka’s competitiveness by way of improving management practices and providing adequate finance. Pitigala (2003) maintains that privatization of state plantation has contributed to a rapid improvement in productivity. Furthermore, the privatization of state plantation enabled the firms to adopt better management practices and effective marketing strategies in the international market (Ali et al 1997). Moreover, the most of the plantations are now listed on the Colombo Stock Exchange and thus they have easy access to capital compared with pre-privatization period. These
factors are likely to encourage more value added tea production and exports, and thereby enhancing Sri Lanka’s competitiveness.

4.2.5 The Role of Chance

Chance events are not a determinant of national competitive advantage. These events take place outside the control of the firm, industry or the government (Ali et al 1997). However, Porter (1998b) argues that the chance events can have a significant impact on the competitive advantage. Furthermore, he maintains that chance events can alter the conditions in the diamond and have asymmetric impacts on different nations.

Mainly two chance factors which affect the competitiveness can be identified: the exchange rate movements and the slow down in the global economy. The Sri Lankan government does not control directly the exchange rate; it is determined by the demand and supply in the foreign exchange market.

The Sri Lankan Rupee (LKR) has been depreciated significantly compared to other major competitors in the global tea industry. This chance event enhances Sri Lanka’s competitiveness as the Sri Lankan tea becomes cheaper in international markets. Moreover, it encourages Sri Lankan tea producers and exporters due to the increased local currency they receive for their tea. The other chance event is the slow down in the global economy. This event has an adverse affect on the competitiveness of tea producing countries. The oil prices have come down significantly as a result. Sri Lanka’s major export destinations are oil producing countries. Owing to reduced per capita income in these countries, it is expected that the tea demand for tea from these countries will fall.

4.2.6 The Role of the Government

Porter (1998) argues that the role of the Government is in influencing the four determinants in national competitive advantage. The Government can influence each of the four determinants positively or negatively. Thus, he argues that the role of the Government is not a determinant in national competitive advantage, but an influencer.

The Governments of all the top players in the global tea industry affect in altering competitive landscape adopting various strategies and policies. The role of the Sri Lankan Government has been a key influencer since the independence. The strategies and policies which were adopted had both positive and negative impacts on the Sri Lankan tea industry (Bandara and Jayasuriya, 2007).

Sri Lanka provides subsidies for replanting, new planting, infilling in order to improve the productivity and the production. The Sri Lankan Government also recently introduced a fertilizer subsidy scheme. This would encourage small-holders to apply adequate fertilizer to their plants and thereby increase both productivity and production.

Sri Lanka also has established various institutes such Sri Lanka Tea Board, Tea Research Institute of Sri Lanka, Tea Small Holdings Development Authority and National Institute of
Plantation Management to facilitate Sri Lankan tea industry. Sri Lanka Tea Board plays a key role in influencing the competitiveness favorably by way of uni-national promotion campaign, trade fair participation, generic promotion and local tea promotion. Thus, it is evident that the Government role in affecting competitive landscape in the global tea industry is imperative.

5. Conclusions and Recommendations

The tea industry plays a significant role in the Sri Lankan economy in terms of foreign exchange earnings, providing employments. For more than a century the tea industry was the main employment provider, the main source of foreign exchange and the main source of government revenue. Nevertheless, recent statistics reveal that the contribution of the tea industry towards the Sri Lankan economy is gradually decreasing. However, the tea industry still plays an important role in terms of net foreign exchange earnings.

The Sri Lankan tea industry has now come under siege. The tea industry is encountering many problems and issues due to low productivity and higher cost of production. Raising productivity and remaining competitive have been identified as the main challenges that the Sri Lankan tea industry is now facing.

India, Kenya and Indonesia as the main competitors were able to amplify their tea extent significantly where as that of Sri Lanka show a considerable drop. Kenya’s progress is impressive. Conversely, Sri Lanka’s share of the world production and exports show a downward trend. These facts suggest that Sri Lanka’s competitiveness in tea is under pressure. Thus, identifying the strategies to remain competitive is of greater importance. The industry analysis reveals that the intensity of competition in the global tea industry is very high. Except for the threat of new entrants, all the other forces are found to be very powerful. The excess capacity, equally balanced competitors, the lack of differentiation, high switching costs, and slow industry growth enhance the rivalry among existing competitors. The threat of substitutes is found to be high due to the modern marketing of soft drinks, fruit juices, coffee and alcohol. This fact is evidenced by the declining annual per capita consumption of tea, particularly in developed countries. The multinational companies dominate the international tea trade. Four major companies account for more than 80 percent of the global tea trade. Also, they are in the process of backward integration. In addition, the buyers can easily switch due to the absence of switching costs. These factors contribute to higher bargaining power by buyers. The bargaining power of suppliers is found to be high particularly due to high bargaining power of labor. Kenya’s entrance to the global tea industry triggered new challenges to the existing competitors. However, there is no sufficient evidence to suggest that further entrants are likely to emerge. Thus, the threat of new entrants is moderate. Consequently, the attractiveness and the profitability of the tea industry are low, given the
high intensity of competition. Nonetheless, Sri Lanka has a very favorable opportunity as the leading exporter of value added tea. This enables Sri Lanka to be the leading exporter of tea in terms of value even though Sri Lanka comes second in terms of export volume. The exports of value added tea need to be increased in order to remain competitive.

The analysis of Sri Lanka’s competitiveness reveals that the there are many unfavorable conditions together with some favorable conditions. Sri Lanka is not blessed with good factor conditions. The low labor productivity and the low land productivity are mainly due to unfavorable factor conditions such as higher labor costs, inflexible labor, lower replanting rate, the lack of high yielding varieties, inadequate fertilizer application, and the lack of trained work force particularly in the small holding sector. These unfavorable factor conditions prevent Sri Lanka from adopting cost leadership strategy. However, Sri Lanka has a good reputation in the global tea industry as a high quality tea producer. Unfavorable demand conditions such as the lower home market and the declining trend in annual per capita consumption of tea are likely to affect the Sri Lankan tea industry when the global demand reduces. The emergence of companies to export tea in value added form has contributed to enhanced competitiveness. Sri Lanka still needs to capture a greater share of the tea value chain through branding and marketing. The tendency of Sri Lankan companies to export tea in value added form can be regarded as a favorable factor. The Privatization of state plantations has contributed to improved competitiveness. The small holding sector is a dominant force in the Sri Lankan tea industry and has higher productivity compared with the corporate sector. The recent downturn of the global economy has brought new challenges to the tea industry. The depreciation of the Sri Lankan rupee against US$ contributes to improved competitiveness. The Sri Lankan Government attempted to increase competitiveness through different strategies and policies such as the fertilizer subsidy scheme, replanting, new planting and infilling subsidy. It has also established many institutes to support the tea industry.

In order to enhance Sri Lanka’s competitiveness in the global tea industry the following recommendations are made.

- Sri Lanka is considered the leading exporter in terms of export earnings. This was possible owing to the fact that Sri Lanka exports a significant share of the total exports in value added form. Given the higher prices fetched by value added tea compared to bulk tea, increasing the exports of value added tea is important. Thus, policy makers should pay due attention to adopt policies that will encourage local firms to export more tea in the value added form. The expensive machineries are essential to blend value added tea. Therefore, the government should provide bank loans at concessionary rates.
- Improvement in productivity is important to remain competitive. Since both the land productivity and labor productivity are lower compared with the other major competitors in the global tea industry, immediate steps are needed to address this issue. The Government should intervene to encourage local producers to increase the replanting rate, the application of fertilizer, and planting high yielding varieties. As a result of the present downturn in the global economy, the tea prices have declined significantly. Thus, the Government assistance by way of increased subsidies is needed. The failure to do so may lead to a further decline in productivity. The management of plantation companies needs to work closely with the laborers. The laborers and the management staff need to be given adequate training where necessary.

- Given the cost structure of the Sri Lankan tea, it is impossible to adopt cost leadership strategy, which requires the companies to produce at the least cost and sell them at lower costs. Nonetheless, being the leading exporter of value added tea, Sri Lanka has to position herself in the global tea industry offering differentiated tea products. These differentiated products are likely to fetch premium prices, which can compensate for the highest cost structure in Sri Lanka.

References


