
FOREIGN DIRECT INVESTMENT IN SRI LANKA : Directions for Policy*

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ABSTRACT

The importance of foreign direct investment (FDI) in contributing to the process of economic development of a country such as Sri Lanka cannot be over-emphasised. This paper attempts to assess the benefits secured by Sri Lanka from FDI inflows in areas such as employment creation, technology and skills transfer, linkages with the local economy and access to international markets. This evaluation is followed by a suggested FDI policy for Sri Lanka drawing upon the experiences of the high performing East Asian economies. The policy framework suggested for Sri Lanka is developed along the lines of sectoral targeting, developing competitive advantages and facilitating project implementation by simplifying the rules and regulations governing FDI. An aggressive marketing effort aimed at countering regional competition for FDI is also advocated, while a regulatory framework able to monitor the macroeconomic impacts of FDI is considered necessary in order to further refine the policy formulation process.

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* This paper is based on a Research Paper submitted by the writer in partial fulfilment of the requirements of the MBA degree for the Postgraduate Institute of Management, University of Sri Jayewardenepura.

Introduction

a) The importance of foreign direct investment

In a developing economy such as Sri Lanka, foreign direct investment (FDI) plays a major role in contributing to the local resource base available for investment. In order to secure adequate rates of economic growth which will enhance the standards of living of its people, a developing country will often need to supplement its own domestic investment with foreign investment. The creation of new business enterprises and the resulting increase in economic activity will help to ease the unemployment problems generally prevalent in less developed economies. By adding to foreign exchange reserves, FDI also helps in bridging balance of payments deficits.

The importance of FDI is more significant in terms of the “package of benefits” which it incorporates. This “package of benefits” comprises not only foreign capital but also new technology, managerial, marketing and technical expertise, access to wider international markets, employment generation and benefits resulting from the linkages established with the local economy. This type of investment, therefore, enables a host country to use FDI as an effective tool in its own economic development strategy.

b) Definition

Foreign direct investment (FDI) may be defined as “equity investments of multinational corporations in host countries, made with the intention of carrying on a business activity in that country as part of the MNC’s overall global business strategy”. Portfolio investments, on the other hand, are investments made by foreign nationals in host country financial markets with the intention of realising capital gains. Generally, a host country would prefer FDI to portfolio investment because the former is effectively trade in entrepreneurial services and ideas while portfolio investment is only asset trade (Sunday Times Business Section, 11 December, 1994).

c) Objective of the study and its significance

If FDI is to be used as an effective tool in economic development, a country needs to have an integrated policy framework governing FDI at national level, which will address all the issues influencing the attraction and retention of appropriate FDI. In this paper, the experiences of the East Asian NICs and the emerging NICs of South

East Asia, are utilized to make policy recommendations. Information and examples for the study were drawn from three sources:

- i. regional level - examples from East Asian countries
- ii. national level - Sri Lankan macro economic data
- iii. firm level - three case studies of Sri Lankan FDI based projects, which were found to have secured some of the more important benefits of FDI.

The three companies studied are Overseas Realty (Ceylon) Ltd., owning company of the World Trade Centre, Ravi Industries Ltd., of the Hayleys Group and Dankotuwa Porcelain Ltd.

Since FDI has already been identified as an important component of Sri Lankan economic activity, evaluating the possible benefits it could bestow on the country is important. The outcome of this study will help policy makers identify critical economic indicators and linkages which could be influenced by encouraging "appropriate FDI" into the country. When supplemented by more detailed studies, therefore, this paper could serve as a useful preliminary study on policy formulation on FDI.

Components of Policy

a) The framework within which FDI operates

If a developing economy is to attract the appropriate type of FDI and secure the best possible advantages of such investment, the policy framework which governs foreign investment should encompass the main parties involved in, and expected to benefit from, the investment process. The three main parties involved are:

- i. the foreign investor,
- ii. the local FDI based project, and
- iii. the local economy.

Two important aspects need to be addressed in a policy framework, namely:

- i. attraction of appropriate FDI, and
- ii. securing the maximum benefits of such investment.

b) Attracting appropriate FDI

The first problem a developing country such as Sri Lanka would be faced with is to attract FDI of the right quality to the local economy. With the opening up of the once dormant economies of India and China, and many other emerging economies in South and East Asia (like Vietnam), the competition to attract FDI has intensified in recent times. This is particularly true of the Asian region, which has become the focus of world economic activity following the successes of its “miracle economies” - Japan, the NICs and the emerging NICs such as Malaysia and Indonesia. With such contenders competing for a share of global investment, a small country such as Sri Lanka which is relatively less known, needs a well thought out plan of action for attracting FDI.

The experiences of some South East Asian nations have now proved that fiscal incentives alone, though necessary, cannot attract FDI. The creation of a stable macro economic environment and an attractive general investment climate appear to be more important for foreign investors as demonstrated by the policies of the East Asian countries. ASEAN in particular was successful in attracting massive international capital flows because those countries were able to offer investors some “basic advantages” essential for the successful conduct of business. These competitive advantages include a skilled workforce, well developed infrastructure, a local industrial base able to support the requirements of MNCs and a stable macro economic policy environment.

At the same time, with so many developing nations clamouring for a limited quantity of FDI, an aggressive programme of marketing aimed at informing and educating foreign investors about the benefits that a country has to offer, will complement the efforts made to develop its competitive advantages. Positive publicity through an effective marketing programme is, therefore, crucial for building foreign investor confidence.

A convenient “investor friendly” initial project approval procedure, with priority given for those projects satisfying minimum eligibility criteria, would also help to attract more foreign direct investment of the right quality. Minimising bureaucracy, ‘red tape’ and corruption at the approval stage will, in addition, help to create a positive impression about the host country in the minds of investors. Flexibility in the regulatory mechanism would also be a factor supportive of greater FDI inflows. The regulatory mechanism would encompass labour laws applicable to FDI-based projects, exchange control regulations, granting of work permits to expatriate personnel, foreign exchange repatriation rules, etc.

c) *Securing the maximum benefits of FDI*

If a developing economy is to secure the maximum advantages from FDI, the policy framework governing it should, ideally, integrate with national economic policy. In this research study, eight benefits of FDI are identified, of which, four are considered as being of national importance in the long term. These benefits are:

Priority benefits from FDI

- Employment creation
- Technology transfer and skill development
- Linkages with the local economy
- Access to wider international markets

Other benefits

- Increased investment - creation of new enterprise
- Contribution to balance of payments
- Increased exports
- Regional and socio economic development within the host country

In the Sri Lankan context, the first four aspects are considered to be more important for long term economic development for the following reasons:

- *Employment creation* - to solve the problem of high unemployment, particularly among the youth and rural population
- *Technology transfer and skill development* - in order to keep pace with global developments and ensure that exports are internationally competitive
- *Linkages with the local economy* - to strengthen the local agricultural and industrial bases and reinforce the objective of employment generation
- *Gaining access to diverse international markets* - especially in view of Sri Lanka's high level of dependence on Western markets (which are becoming increasingly protectionist for her exports)

Since these four benefits are of national importance, specific policies need to be consciously formulated to secure these benefits to the maximum possible extent. What are classified as "other benefits" will automatically accrue if an effective FDI policy framework is in place and carefully implemented.

Benefits Derived by Sri Lanka from FDI

a) *Employment creation*

Employment in foreign investment based projects increased from 35,786 in 1985 to 241,970 as at mid-1995. The annual average growth rate is, therefore, around 21% per annum. Correspondingly, employment growth at the national level has averaged only 3%-5% over the period 1990-1994 (Central Bank, Sri Lanka Socio-Economic Data, 1994). FDI based ventures have accounted for 1.2%-1.8% of national employment over these four years. Table 1 which follows examines the labour intensity in FDI projects in various sectors of the economy. Labour intensity is measured in terms of "jobs created per billion rupees invested".

Apart from the garments sector, the volume of FDI is found to be fairly small in all other labour intensive sectors highlighted in the table. This means that although Sri Lanka may desire to generate more jobs through FDI, it may not be happening as effectively as envisaged, because foreign investors appear to prefer less labour intensive sectors. If Sri Lanka attaches high priority to employment generation through FDI, then appropriate market interventionist policies, as practised by the East Asian economies, to direct FDI to the more labour intensive sectors of the economy would have to be adopted by policy makers.

Most foreign investors are concerned about labour management problems in developing countries, and Sri Lanka is no exception. As pointed out in the case studies on Sri Lankan FDI based ventures, most foreign investors acknowledge the skills and intelligence of the local labour force. But at the same time, they are more concerned about its lack of discipline, a factor which had an impact on work schedules at the World Trade Centre project. Trade union action too was a matter for concern, but once again the East Asian model serves as a useful lesson on how trade unions can be made to contribute positively to investment by involving them more effectively in the employment policy making process both at the sectoral/industrial level and national level.

Table 1: LABOUR INTENSITY IN FDI PROJECTS

Sector	Employment generated per Billion Rupees Invested (Number)	Percentage of Foreign Funds Allocated to the Sector %
Food, beverages and tobacco	4,133	2.6
Textiles, apparel and leather products	11,985	22.0
Wood and paper based products	3,307	1.3
Chemicals, rubber and plastics	3,377	9.8
Non metallic mineral products	3,905	1.5
Fabricated metal products	1,280	1.2
Other manufactures	5,841	5.8
Services	353	55.8
TOTAL	3,231	100.0

Source: Central Bank, Socio-Economic Data, 1994-95

b) Technology and skills transfer

NICs such as Singapore and Hong Kong were highly dependent on the foreign inputs of MNCs in developing their economies. They were basically “capitalist havens” which used the resources of the MNCs to upgrade their economic base virtually from scratch. On the other hand, for South Korea and Taiwan, and the emerging NICs like Malaysia and Indonesia, which already possess sound agricultural economies, FDI became a stepping stone for becoming internationally competitive by acquiring modern technologies, managerial and marketing skills necessary for building an advanced industrial base.

Some countries, such as South Korea, were not very open to foreign investment initially because it wanted to preserve national ownership of business enterprises and technological independence. Therefore, means other than majority foreign ownership were often used to acquire new expertise, mainly through technical transfer agree-

ments, licensing, franchising, and outright purchase of turnkey operations. Though somewhat expensive, these methods are effective alternatives to majority foreign ownership, which pose problems of their own such as excessive foreign exchange repatriation.

Numerous studies have cited the low level of technology transfer and skill development in Sri Lankan FDI-based projects, especially those related to garment manufacturing. A study done by Schokman and De Alwis, states that the level of skills of the labour force is relatively low “with nearly 40% of the workforce being in the semi-skilled category, and taken together, more than 75% being in the trainees, unskilled and semi-skilled categories” (People’s Bank Economic Review, July 1994 :31).

Being a qualitative performance indicator, the extent of technology and skill transfer was difficult to measure. The best indication would be given by the value of imported technology in local FDI based projects and the costs of foreign training of local personnel, but such information was not readily obtainable. This too reveals the lack of attention paid so far to this important component of FDI by Sri Lankan policy makers. Evidence of technology and skill transfer were seen in the case studies on Dankotuwa Porcelain and Ravi Industries where factory personnel had been trained abroad in the latest production and quality control techniques; and villagers had been trained through a subcontracting arrangement to supply components to a FDI based project.

It is necessary that technology and skill transfer becomes an integral part of Sri Lanka’s FDI policy because it will help the country’s exports to become internationally competitive. In view of the relatively small domestic market which is still not very affluent, exports will necessarily have to play an important role in Sri Lanka’s economic development. The securing of this vital benefit through FDI should, ideally, commence at the investment approval stage itself.

c) Linkages with the local economy

Linkages can be established in two ways:

- i. use of local natural resources as inputs in the main production process
- ii. local manufacture of intermediate goods and components to be used in the main production process.

The research study revealed that the import content in the exports of FDI based projects ranged from 61% to 73% over a period of ten years. The ten year time series analysis also revealed that whenever the share of garments in total exports becomes high, the net foreign exchange earnings (NFEEs) of FDI based companies becomes low. NFEEs refer to the quantum of foreign exchange retained within Sri Lanka for purchase of local inputs or reinvestment. It is represented by the formula:

Export revenue – Imported inputs - Share of earnings repatriated

A study by Schokman and Chandradasa (People's Bank Economic Review, July 1994) states that the content of imported inputs is generally high in the following sectors:

- i. textiles, apparel and leather products
- ii. electronic and electrical goods
- iii. chemicals, and
- iv. transport equipment, e.g., buses.

Import content was found to be low in the following sectors:

- i. activated carbon and coir products
- ii. rubber based products
- iii. food, beverages, tobacco and horticulture, and
- iv. non-metallic minerals

It has also been found that linkages for most industrial sectors were created on the basis of supply of raw materials and not by links created with local manufacturing industries, e.g., those which supply components. Some of the other findings of the study by Schokman and Chandradasa are quoted below:

- a) the import content in the garment sector is very high since almost all inputs are purchased abroad. Though some items such as buttons, tags and hangers can be made locally, importing is found to be cheaper due to the economies of scale enjoyed by foreign suppliers.
- b) packaging materials such as corrugated cartons and polythene are locally procured but the failure of local suppliers to meet delivery schedules have compelled exporters to obtain even these basic materials from abroad.

- c) linkages are also created through the supply of labour, purchase of infrastructural facilities e.g., electricity, and income derived by the service sector.

Generally, government policy must attempt to maximise the linkage effects of FDI so that the domestic economy would also be activated thereby. Most of the East Asian NICs are resource rich and their FDI policies have targeted industries linked to these resources as priority sectors for development. Malaysia has identified its natural resources like rubber, timber, tin, palm oil and clay as linkage industries to promote the manufacture of high value added products for the export market. Industrial linkages too have been consciously developed, e.g., the automotive parts business through the Proton Saga project. In Sri Lanka too, the potential for establishing linkage industries is high, especially in agro-based industries. The agricultural sector and provision of inputs to the industrial sector e.g., packing material supplies, offer opportunities for creation of linkages. The few natural resources available e.g., gemstones, graphite and some agricultural products could be developed as raw material suppliers for high value added manufacturing industries.

d) Access to diverse international markets

Table 2 shows the classification of Sri Lankan exports over the last three years, into their different destinations of despatch:

Table 2: SRI LANKA'S EXPORTS - CLASSIFIED ACCORDING TO DESTINATION

	1993 %	1994 %	1995 %
Western Europe, Australia and North America	71.2	70.7	72.0
Eastern Europe	1.6	1.0	2.5
Asia	16.0	17.3	15.0
Middle East	9.0	8.5	7.5
Africa and South America	2.2	2.5	3.0
	100.0	100.0	100.0

Source : Annual Reports, Central Bank of Sri Lanka.

Over this period Sri Lanka has become more dependent on USA and Western Europe as trading partners. With the decline in tea exports to the Middle East, particularly Egypt and Iraq, the importance of Asia as an export destination has declined. Thus, most industrial exports of which FDI project based exports are a part, are being directed in increasing volumes to Western Markets which have become protectionist oriented in recent times. The top ten countries of origin of FDI for Sri Lanka are given in Table 3.

Table 3: TOP TEN COUNTRIES OF ORIGIN OF FDI FOR SRI LANKA

Country of Origin	\$ Million
Hong Kong	137
South Korea	97
Singapore	70
Australia	67
Japan	65
Germany	34
US	9
Britain	8
India	6
Belgium	5

Source: Far Eastern Economic Review, Oct. 12, 1995

There appears to be a mismatch between the countries of origin and export destinations. However, it is felt that achieving a greater diversification in the countries of origin may help to achieve greater diversification in export markets as well. Attraction of more Western MNCs, for instance which want to trade in Asian markets may help Sri Lanka to achieve a better spread in export markets.

Since the late 1980s intra-regional direct investment has been growing rapidly in East Asia, signifying an increasing economic integration and cooperation within the region (ADB, Asian Development Review, 1993). Japan, one of the global economic superpowers has become an important regional investor. The East Asian NICs also invest substantially in neighbouring Asian developing countries. The formation of economic cooperation zones such as the SIJORI Growth Triangle involving Singa-

pore, the Southern Malaysian State of Johor and the Western Indonesian province of the Riau Islands, has promoted investment further. The East Asian nations have realised the importance of regional interdependence in international trade to counter the growing threat of protectionism in Western markets.

While Sri Lanka's lucrative Western export markets must be maintained and if possible, even promoted, it is also important for us to explore markets closer to home viz., Japan, the NICs and the emerging NICs. These markets are affluent as well as highly populated. They are liberalising trade at a time when the West is adopting protectionism, and World Bank forecasts predict that South and East Asia will grow at the rate of 5.3% and 7.6% within the next five years, while Western economies will grow at only 2.5% (Institute of Policy Studies, State of the Economy 1994). Sri Lanka could, therefore, focus on diversifying its export markets by having closer ties with its Asian neighbours. Ventures which will enable the country to gain access to the affluent Asian markets should be given priority in the approval process.

Suggested FDI Policy for Sri Lanka

The central focus of the suggested policy is to attract quality FDI-based projects to Sri Lanka, and to secure the maximum possible benefits to the country from those projects. The seven point policy framework is set out below under headings A - G.

a) Defining the role of FDI in national economic development

As stated before, the following have been selected as priority benefits which Sri Lanka can derive from FDI, considering the present state of development of the country.

- i. Employment generation.
- ii. Technology transfer and skill development.
- iii. Linkages with local industry to enhance value addition.
- iv. Access to diverse international markets.

b) Targeting sectors for development through FDI

As identified earlier, industry targeting as successfully practised by the East Asian countries is needed in all major areas of the economy. The following industries have been selected for targeting of FDI after considering the priority benefits identified above. Appropriate tax incentives, preferential credit allocation and other incentives, could be offered to make these sectors more attractive to potential investors.

i) Agricultural and fisheries sector

1. High value added crops for export

Sri Lanka possesses the capability to cultivate a variety of crops due to its diverse climatic and soil conditions and an abundant rural agricultural labour force. While local farmers have gained adequate mastery of cultivation techniques for the more common types of crops, their skills need to be further developed to undertake the cultivation of newer varieties, and it is in this area that FDI is expected to make a useful contribution. Additionally, once the harvesting is done, Sri Lankan producers need to acquire the skills necessary to process, package and add value to these crops. For instance, although Sri Lanka has been cultivating tea for over a hundred years, we still do not have adequate knowledge of packaging operations and international tea marketing activities for which we are still dependent on Western MNCs. The establishment of proper collection centres, warehousing, processing centres and where necessary cold room chains, is also vital for the growth of the agricultural sector. Use of outgrower/sub-contracting methods such as those employed by CPC International in Sri Lanka is effective in establishing linkages with the local economy. Sri Lanka should in future, therefore, use FDI to learn the more technology-based and knowledge-based value addition processes related to its local crops, while passing on the benefits so acquired to the local farmers.

2. Agro-research

Sri Lanka has already established an agricultural research base, comprising the research institutes for rice, tea, rubber and coconut. Through foreign involvement, the technical capabilities of these institutes can be further upgraded. If certain parts of the cultivation sector are going to be opened up for FDI, as suggested above, then the support services offered by these institutes for carrying out research and development assignments for such

mass scale agricultural projects, will be essential. The investors could operate these research institutes as profit-making ventures, able to provide fee-based services to clients.

The activities of research institutes should cover both the traditional and non-traditional crops. Foreign expertise could be obtained from other Asian countries such as India and Thailand since they possess agricultural techniques and crop varieties which are more relevant to the climatic and soil conditions of this country. The investors could benefit by charging a fee from organisations which use the services of the research institute.

Moreover, if these FDI-based research institutes are developed in conjunction with the local universities and agricultural schools, then they can be used as a means of promoting greater industry-university collaboration.

3. Aquatic resources and dairy/livestock industry

Though Sri Lankan entrepreneurs have the basic grounding required for undertaking small business ventures in these sectors, they do not yet have the expertise to develop those ventures into large industrial undertakings. Therefore, mass scale deep sea fishing, development of inland fisheries harbours, etc., are areas where technical inputs can be secured through FDI.

The dairy industry should be developed more as an import substitution industry targeted to serve the domestic market. Production of fresh milk, powdered milk, butter and cheese are specific sub-sectors which could be promoted. At this point, it must be emphasised that since these projects are not deemed to be technologically highly advanced ones, the necessary foreign inputs should be secured as far as possible through means other than majority foreign ownership, e.g., licensing or franchising.

ii) Industrial sector

During the period 1970-77 as well as the post 1977 economic liberalisation, Sri Lanka's industrial sector has been receiving a fair amount of prominence among policy-makers. It has been identified as the stepping stone to "developed country" status. While this need not necessarily be the case, *and a balanced growth of all three major sectors may be more beneficial, the development of the industrial sector still remains an important component of the country's economic policy.* Presently the distribution of FDI in the industrial sector is concentrated in the garments industry which is a relatively low NFEE generator. Future FDI policy should, therefore, *attempt to achieve greater diversification in the local industrial base.* Industries which could be targeted for development are identified as follows:

1. High “value-added” industries

The earlier analysis revealed that three industries viz., garments, non-metallic minerals and miscellaneous manufactures recorded above average labour intensity. Wood and paper-based industries could also be classified as fairly labour intensive.

Companies in the ceramic and walltile industry such as Dankotuwa Porcelain, Lanka Tiles and Lanka Walltiles have been widely acclaimed as successful export-oriented ventures having won many Presidential Export Awards and Certificates of Merit. Similar ventures could be set up with foreign collaboration, where foreign technology and skills and market contacts need to be secured.

Companies such as Ravi Industries and Richard Pieris Exports which use indigenous raw materials, viz., coconut fibre and latex, have also proved to be successful exporters. Therefore, it would be beneficial for the country to promote more high value added ventures such as these, where access to new technology and markets could be secured through FDI. Granting of appropriate incentives, a planned marketing effort and flexible approval procedures, will facilitate the securing of these benefits. Apart from labour intensity, all these industries have the added advantage of having a fairly high degree of linkages with the local economy.

Similarly, resource-based industries, e.g., graphite, wood and paper based ones, which are also labour intensive, could be identified as suitable industries for development through FDI. Value addition could take the form of producing finished products for the export market eg. knockdown furniture using rubber wood, printing and publishing ventures, stationery manufacture, etc.

The Sri Lankan gem and jewellery industry is a fast developing one as highlighted in various studies detailing the successes of costume jewellery manufacturers such as Stone ‘N’ String and Crest Jewels. A natural extension of this would be to undertake the manufacture of exclusive jewellery using local gemstones for which Sri Lanka is known worldwide. Scientific gem mining techniques, unavailable in Sri Lanka, could be obtained through foreign involvement. However, when promoting an industry such as this, one must bear in mind, the potential negative side effects such as environmental degradation.

2. High-tech industries

Most NICs developed their industrial bases through the promotion of high-tech industries. Initially, this took the form of assembly operations, which were gradually extended to complete manufacture. Therefore, assembly of electronic/electrical items, semiconductors, computer circuitry, etc., are possible areas where Sri Lanka could invite foreign participation. But it is essential that the country should, over a period of time, acquire the skills necessary to manufacture these items locally rather than engaging in assembly only. Since most Asian NICs as well as India have substantial expertise in this sector, FDI could be sourced from these countries as well as from the West. Software production too is an area which could be considered, particularly to be carried out in conjunction with Indian ventures.

3. Apparel industry

With the gradual phasing out of the quota system for garments as a result of the discontinuation of the GATT Multi Fibre Agreement, the local garment industry will have to gear itself to compete with other manufacturers in the world market after the year 2005. Two strategies which could be used to make the apparel industry more competitive are, to develop more design capabilities through foreign expertise and/or become subcontractors for internationally reputed clothes manufacturers such as Benetton, Levi's, etc. While FDI itself is not essential for this type of collaboration, a licensing or technical transfer agreement may be a more suitable form of alliance, as this will ensure a more complete transfer of technology and skills.

iii) Services sector

Overall, the service sector of the country is found to be fast growing and dynamic, with growth rates averaging around 6% as per Central Bank statistics. The specific areas targeted for development through FDI have been identified as tourism and leisure industries, financial services and shipping. The high levels of initial capital outlay required for these projects (which local investors may not be willing to bear) and the potentially high levels of foreign exchange earnings which could be generated through them, are the reasons for their selection as target areas for development through FDI.

1. Tourism and leisure business

The volume of tourist traffic which Sri Lanka attracts has proved to be fairly small when compared with regional competitors such as Thailand, the Philippines, etc. The diversity of attractions the country possesses viz., coastal resorts, ancient cities, wildlife and the hill country, within a very small area, offers much potential for developing it as a major tourist resort. It is important that the tourism product which Sri Lanka has to offer is more sophisticated than what it is at present. For instance, the water sports facilities available in Sri Lanka are not up to international standards; nor do we have adequate leisure/sports complexes or shopping facilities to cater to the more up-market and affluent tourist; at the same time general infrastructure, viz. transportation, communications, etc., must match up to international standards. The industry too must attempt to keep pace with global trends, e.g., by offering new concepts such as health resorts to the more discerning tourist. While it is up to institutions such as the Ceylon Tourist Board working together with the private sector to promote Sri Lanka as a destination, FDI inputs could be used to develop the overall status of the leisure industry.

2. Financial services and transshipment

These areas have been identified for development so that Sri Lanka could follow the direction previously set by Hong Kong and Singapore in becoming the financial and commercial centres of East Asia. Sri Lanka's banking system has shown rapid improvement over the last few years. Apart from banking, other financial services too have been growing rapidly as shown by the increased interest in new financial instruments, merchant banking and fund management services. The participation of major foreign merchant banks and "financial service providers" of international repute in the Sri Lankan financial market will further strengthen the confidence of regional clientele and help to improve the quality of local service. FDI could, therefore, be used to acquire more knowledge and enhance the sophistication of the financial services business. This may require positive actions from the government in respect of further exchange liberalisation and capital market development.

By serving as a regional financial services centre to its neighbours India, Bangladesh and Pakistan, Sri Lanka may be able to attract at least 1% or 2% of the capital flows directed to South Asia. This itself would give a major boost to Sri Lanka's relatively small economy. As pointed out in the President's Policy Statement of January 1995, encouraging regional fund

managers to base their operations in Sri Lanka would be a vital first step. Since India has been identified as one of the 10 Big Emerging Markets by the US Department of Commerce, the spillover effects of US investment in India alone would be enough to activate our economy substantially.

Further upgrading of port facilities in Colombo and the development of existing harbours such as Galle and Trincomalee could also be undertaken through FDI-based ventures. Appropriate contractual arrangements (such as Build Own Operate/Build Own Transfer - BOO/BOT) could be made with foreign investors for infrastructural development projects such as these.

What has been spelt out in above are the potential sectors, industries and businesses, which could be targeted especially for development through FDI. This does not mean that other sectors will be closed to foreign investment; but investors in those sectors may not be granted as many special concessions and incentives as firms in the sectors specifically targeted for development. From an institutional setting, the BOI could help towards this effort by preparing pre-feasibility studies on potential ventures for these sectors.

c) Marketing Sri Lanka to foreign investors

In view of the growing regional competition for FDI, it is important that Sri Lanka should market itself aggressively, in order to attract appropriate investors to this country. Coordination of the marketing effort should be made the responsibility of the BOI, and specialist marketing consultancy and advertising services should be secured to undertake the task of developing a marketing plan. Just as companies have planned marketing/advertising campaigns targeting different consumer groups and using different media and channels, the country should also develop a planned marketing campaign for attracting foreign investment.

The paper identified some of the key sectors which Sri Lanka could target for development using FDI. The marketing effort should be specifically directed at these sectoral investors and large companies operating in those sectors. Moreover, the marketing plan should also focus on exports to the newly emerging, more affluent Asian markets, since this would eventually help to diversify Sri Lanka's export markets away from the West. As regards the communication channels to be used, the various alternatives available are:

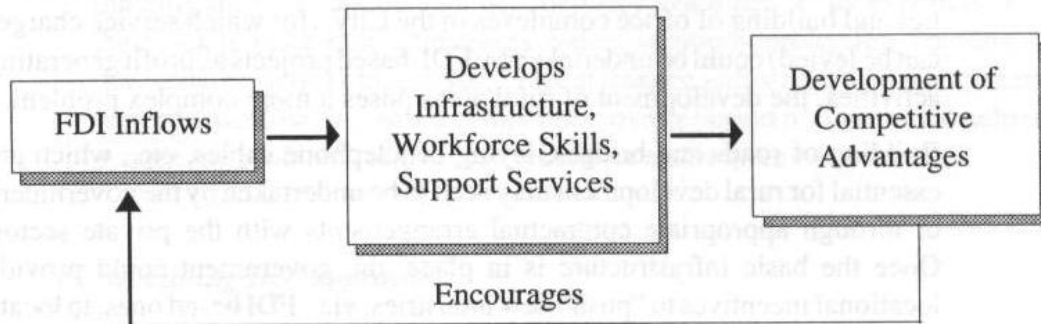
- *advertising* - in business magazines, trade journals related to specific business groups, business newspapers such as the Asian Wall Street Journal or Financial Times and export directories. Although generalized advertising could be used, specific advertisements promoting some particular aspect of Sri Lanka or a sectoral advantage are preferred.
- *personal marketing* - this is a more expensive alternative than advertising, but it could prove to be more effective. Trade delegations can be sponsored either by the government or a trade association such as the Chamber of Commerce. Delegations must comprise fewer government officials and more private sector businessmen who wish to establish links with foreign investors. As long as the government facilitates the setting up of an itinerary and the required meetings with foreign businessmen, the private sector could undertake to fund the cost of such trade delegation visits.
- *participation in international trade fairs/conferences* - Active participation in various international conferences and seminars related to trade will give the country adequate exposure, which over a period of time can build investor confidence in the Sri Lankan economy. The recent foreign investor's conferences organised jointly by the BOI and other institutions, for instance, were reported to have been well attended by local as well as foreign business communities.

d) developing Sri Lanka's competitive advantages

The NICs became popular host destinations for FDI due to the inherent advantages which they possessed, e.g., a well trained labour force, adequate infrastructure, a clear and stable macroeconomic environment and policy framework conducive to investment. They were also well equipped with ancillary industries and services able to support the needs of MNCs.

While honest political commitment is the key to having a stable macroeconomic and political environment, the other advantages spelt out can be built up while the country is undergoing economic change and growth. While FDI itself can give the initial impetus to developing infrastructure, improving work force skills and broadening the base of linkage industries; achievement of these competences can in turn encourage the inward flow of FDI. Therefore it is a cyclical process where each factor facilitates and reinforces the achievement of the other. (Figure 1)

Figure 1: REINFORCING EFFECTS OF COMPETITIVE ADVANTAGES



Competitive advantages in these areas can be developed using some of the following strategies:

1. Workforce skills

It has already been recognised that Sri Lanka possesses an intelligent and trainable work force. High unemployment among graduates has arisen due to their unsuitability for employment given the present skills they possess. Therefore the need to retrain these graduates to make them able to take up employment in the non-governmental sector is strongly felt. While the correction of this problem in the long term, is part of the educational policy of the country; it would be useful if certain skills are imparted to at least some selected youth, which will make them better suited for employment in the industries/sectors earmarked for development through FDI.

The allocation of government funds to develop more vocational training institutes and professional development institutes would help in this effort. Harnessing the support of the private sector and foreign investors towards this effort is also important. A Skills Development Fund, which is in the course of being set up in Sri Lanka, would be a means of ensuring that the local private sector as well as foreign investors, contribute to developing work force skills.

Over the long term, the development of more university - industry linkages, e.g., in carrying out primary research would help to enhance the job-related skills of graduates.

2. Infrastructure development

While infrastructure enhancements, e.g., improved telecommunication facilities and building of office complexes in the City, (for which service charges can be levied) could be undertaken by FDI-based projects as profit generating activities, the development of rural areas poses a more complex problem.

Building of roads and bridges, laying of telephone cables, etc., which are essential for rural development may need to be undertaken by the government or through appropriate contractual arrangements with the private sector. Once the basic infrastructure is in place, the government could provide locational incentives to "push" new industries, viz., FDI based ones, to locate in those areas. Locational incentives could include concessionary levies for use of utilities such as electricity and water, accelerated depreciation allowances and other tax incentives. The geographical areas targeted for government development should be those with high unemployment.

Alternatively, the government could involve foreign investors in infrastructure development, by encouraging one investor or a consortium of investors to undertake the construction of industrial parks equipped with facilities matching up to international standards. The investors could be permitted to charge a levy from firms which wish to locate their facilities in those industrial parks. Locational incentives could then be extended to such industrial park users as well.

Much has been said, especially in the President's Policy Statement and successive Budget Speeches about the private sector (mainly foreign investors), taking on the burden of infrastructural development projects through BOO/BOT arrangements. It is mainly the inadequacy of local capital and skills, which necessitates the use of FDI for infrastructure related projects. Rural electrification, water supply, sanitation, roads and irrigation schemes could also be secured using BOO/BOT arrangements.

3. Development of linkage industries

Presently, tax incentives are offered to certain industries which are able to form linkages to existing export-oriented firms, e.g., integrated textile mills which produce inputs for the garment industry and cold room chains which form linkages to the agricultural sector. Monitoring the performance of these ventures is important to determine whether the priority benefits actually accrue to the economy and the main industry, through these linkages.

Target industries/sectors for development through FDI have been identified in an earlier section of this study. Industries forming linkages to these could

also be identified as potential target industries, to be developed through FDI. This study revealed that one reason for the low level of linkages was the inability of local suppliers to meet delivery deadlines set by exporters, and their lack of price-competitiveness. Selective import protection, granting of duty rebates, and tax incentives for local linkage industries, would help them to keep costs low. Increased competition over a period of time would help to correct the problems of delivery schedules and non-competitiveness.

e) Obtaining BOI approval

Further simplification of the procedure for obtaining approval is recommended. The priority objectives identified for Sri Lanka were employment generation, technology and skill transfer, linkages with local industries, and access to diverse world markets. Hence, FDI-based projects which are able to secure these advantages to at least a minimum specified extent should be given a priority for approval. For example, a project could be identified as a priority project and speedily evaluated and approved if it meets the following criteria:

- i. provides employment to over 250 people or is in a “labour intensive” industry (employment intensity is over 5,000 people per billion rupees invested), and
- ii. has an imported technology content (i.e., Machinery and processes) amounting to over 75% of the capital cost of the project, and
- iii. provides systematic training in new techniques to over 50% of the work force, and
- iv. purchases over 35% of its raw material requirements locally, and
- v. exports its goods to more than 3 major regional groupings, and
- vi. has majority local ownership,

Some of the figures and percentages indicated above are tentative based on the findings of the analysis done in this study. A more detailed study will facilitate the setting of suitable limits for approval. In addition, the social and environmental implications of a project should be considered, prior to granting approval.

Other projects not satisfying these criteria may be approved on a case by case basis. Nevertheless, there must be a clear set of guidelines on the basis for approval to ensure that projects which do not bring in any lasting benefits are not actively

encouraged. In addition, priority should be given for foreign investors coming in for the purpose of creating a new venture, rather than acquiring an existing venture. But more importantly, project appraisers must be better trained to spot the beneficial aspects of a project so that they can enter into negotiations with the foreign investors to further enhance such desirable qualities. The incentives structure and approval procedure should also be further simplified, made easier to understand, and presented in a more readable form to potential investors.

Moreover, promoting the concept of a “one-stop-shop” the BOI must contribute to greater facilitation of approvals from the Central Environmental Authority and other local authorities.

f) Simplifying the regulatory framework applicable to BOI companies

The entire gamut of regulatory mechanisms are not covered in this study, but some important issues which have been widely discussed are highlighted below:

1. Labour laws and trade unions

The unionisation of workers in FDI-based companies has been a topic of controversy ever since a spate of strikes troubled the economy after the election of a new government to office in 1994. While one option available to the government would be to ban trade unionism altogether in BOI companies, it is felt that this measure is not practicable under the present circumstances. A better measure would be to establish a forum for the resolution of employer-employee disputes. All trade unions in BOI companies would have to be registered with this body which will comprise, representatives from the BOI, Labour Department, and a Foreign Investors Group. Any trade union activity which has not been first put up for resolution to this “deliberation council” may be declared as illegal. Deterrents such as these will help in curbing unnecessary politically motivated union action in FDI-based ventures.

These deliberation council members or trade union members could also act as a regulatory body to monitor the activities of employers, to ensure that there is no unfair treatment of workers. Moreover, trade unions can be made to contribute positively to the productive process, by giving them more opportunities to comment on, and add value to, policy issues related to employment.

By encouraging trade unions to be institution-based rather than profession or industry-based, policy makers can ensure that labour disputes in one organisation do not spread across the entire industry.

Alternatively, as practised in some of the East Asian countries, the entire labour force within an industrial zone can be controlled by a government-based centralised body. This will mean that foreign investors would effectively have no responsibility for employment-related problems.

2. Work permits for expatriates in FDI-based projects

While this is not a major issue relevant to the regulatory framework, it was decided to include it here in order to draw a useful lesson from the ASEAN countries in this regard. The relevant excerpt from a study of FDI in ASEAN reads:

Work permits are generally granted for essential staff especially those in high management levels, or for which there are no equivalent local personnel. In most cases, however, work permits are granted on condition that local personnel are trained to assume technical and managerial jobs to ensure that there is real transfer of technology from foreign ventures.

(Business and Investment Environment in ASEAN - South Pacific, Asian and Pacific Development Centre, 1987).

While at present, there is no real “problem” to be addressed by Sri Lankan policy makers, clauses such as these could be included in foreign investment contracts to serve the country’s long term interests.

3. Permission to sell a specific volume of export quality goods in the local market

This provision has already been introduced whereby exporters are now permitted to sell 10% of their output in the local market provided they pay the necessary input taxes on these items.

Local consumers would benefit by having access to a wider choice of better quality goods. The country would also benefit since this would enable the curtailment of imports of some of these items, e.g., clothes and shoes; and add to fiscal revenues through the levy of input taxes. Therefore, it has both an import substitution and revenue enhancing effect. It will also encourage greater competition in the local market.

g) Monitoring the performance of FDI-based ventures

One factor which was highlighted while carrying out the data analysis for this study was the lack of information on certain critical aspects related to the performance of BOI ventures, e.g., distribution of exports by country or region, indicators of technology transfer and skills development, etc.

If the country has a planned programme of action for encouraging FDI through an appropriate policy framework, then the collection of relevant information on these projects is necessary. Statistics collected should serve the purpose of measuring the direct and indirect benefits of FDI. Subsequent data analysis and evaluations should enable policy makers to identify the weaknesses of the present policy framework; and formulate new policies to overcome those weaknesses, in keeping with overall national objectives.

Moreover, a distinction needs to be made when evaluating the performance of foreign investments which “created” new enterprises and those which “acquired” existing businesses. If the latter situation has not proved to be advantageous to the country in the long run in terms of generating substantial additional benefits, then the policy framework needs to be reformulated to discourage FDI meant for acquisition of existing enterprises.

In the Sri Lankan context, the first four aspects were considered to be more important for long term economic development for the following reasons:

- *Employment creation* - to solve the problem of high unemployment particularly among the youth and rural population
- *Technology transfer and skill development* - in order to keep pace with the global developments and ensure that exports are internationally competitive
- *Linkages with the local economy* - to strengthen the local agricultural and industrial bases and reinforce the objective of employment generation
- *Gaining access to diverse international markets* - especially in view of Sri Lanka's high level of dependence on Western markets (which are becoming increasingly protectionist oriented for its exports)

Since these four benefits are of national importance, specific policies need to be consciously formulated to secure these benefits to the maximum possible extent. What are classified as “other benefits” will automatically accrue if an effective FDI policy framework is in place and carefully implemented.

Conclusion

This paper attempted to assess the benefits of foreign direct investment on a developing economy, with particular reference to Sri Lanka. The assessment was carried out at three levels a) the regional level by drawing upon the experiences of the East Asian economies, b) the national level to assess the current Sri Lankan situation and to make recommendations and c) the firm level to assess the benefits to individual business units. The main focus was on the national level analysis and recommendations for the future.

The priority benefits to Sri Lanka from FDI were identified to be employment creation, technology transfer and skill development, linkages with the local economy and the access to international markets. The fulfillment of these priority objectives through FDI was found to be limited.

The recommendations for a new policy framework focused more on ensuring that these priority objectives are fulfilled in the best possible way, for instance providing privilege status to industries fulfilling the necessary criteria and targeting such industries for incentives and credit allocation. At a national level, promoting the country and the priority sectors more actively to foreign investors and developing the infrastructural facilities, workforce skills and linkage industries were also recommended as necessary preconditions for attracting FDI.

The Policy Matrix at a Glance

The suggested FDI policy for Sri Lanka is summarised below according to the four priority benefits:

Priority Benefit	Policy Area	Strategy to be Adopted
1) Employment Generation	a) Sectoral targeting	Identify and promote labour intensive projects/ sectors, e.g., agriculture, through tax incentives
	b) Developing competitive advantages	Upgrade workforce skills through joint effort with private sector
	c) BOI approval	Priority to be given to labour intensive projects
	d) Marketing	Intensify marketing effort directed at labour intensive industrial groupings
	e) Regulatory framework	Mediation bodies for settling employer/ employee disputes
2) Technology Transfer and Skill Development	a) Sectoral targeting	Promote 'High-tech' industries/projects, e.g., agricultural research, electronics, financial services, through tax incentives
	b) Developing competitive advantages	Infrastructure development through BOO/BOT arrangements
	c) BOI approval	Priority to be given to projects involving substantial imported technology or foreign training for local employees BOI appraisers to be trained to critically evaluate means of further enhancing technology transfer and skills development aspects of a project.
	d) Regulatory framework	Work permits for expatriates to be granted only on condition that locals are trained to take over their jobs

Priority Benefit	Policy Area	Strategy to be Adopted
3) Enhancing NFEs/Value Addition through Linkages	a) Sectoral targeting b) Developing competitive advantages c) BOI approval d) Regulatory framework	Incentives and selective protection to be given to industries providing local inputs Promotion of import substitution industries, e.g., dairy industry Developing resource-based projects, eg. gems, and services based on locational advantages, e.g., tourism, transshipment Protecting/incentivising linkage industries and resource-based industries which provide inputs Priority to be given to projects procuring major part of inputs locally Permit the sale of export quality goods in local market
4) Diversification of Export Markets	a) Marketing	Select target markets in Asian region to promote investments Priority to be given to projects having diversified export markets

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