Sri Lanka
State of the Economy Report 2012

Chapter 10
Supporting Growth through Enhanced Foreign Direct Investment

by
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10. Supporting Growth through Enhanced Foreign Direct Investment

10.1 Introduction

With the return of peace, Sri Lanka is at a threshold of economic growth and development. Whilst the country has already made a rapid recovery in GDP growth, sustaining this growth momentum into the long term will require a substantive increase in investment. Sri Lanka is currently bridging its savings-investment gap by resorting to higher volumes of foreign borrowing. A more satisfactory means, however, is to tap into other sources of external finance such as FDI. Indeed, FDI brings cumulative benefits in the form of skills, knowledge, and technology-transfer that are critical to sustaining productivity growth for an economy aiming to sustain an accelerated growth momentum in the long term. Since embarking on a liberal economic policy platform from the late 1970s, Sri Lanka's efforts to attract high volumes of FDI have been hampered by political instability as a consequence of the country's separatist conflict. With the ushering in of peace, the country is in an ideal position to harness the gains from FDI towards its national development effort. The aim of this discussion is to explore and shed light on the opportunities and constraints that Sri Lanka faces in aiming to attract more FDI in the current global environment.

> ***'Sri Lanka has potential to sustain and enhance its growth by attracting export-oriented FDI, in light of current changes in the international organization of production and its comparative advantage in labor-intensive manufacture'***

10.2 The Changing Role of FDI in Developing Countries

FDI can be defined broadly as 'the category of international investment that reflects the objective of a resident entity in one economy to obtain a lasting interest in an enterprise resident in another country.'[1] FDI could be categorized broadly into import-substituting FDI and export-oriented FDI. The former (also referred to as 'market-seeking FDI') is undertaken by multinational enterprise (MNE) affiliates with the objective of serving the domestic market in the host

[1] IMF (1993), *Balance of Payments Manual (5th Edition)*, International Monetary Fund, Washington D.C.

country. Export-oriented FDI (or efficiency-seeking FDI) on the other hand, refers to cross-border investments undertaken in MNE affiliates engaged in production to service the wider global market.

Historically, FDI flows to developing countries have been dominated by import-substituting FDI. In the face of increased trade protection, MNEs, in their bid to uphold former export markets, resorted to undertake tariff-jumping FDI. Over the last two decades, in light of the role of export-oriented FDI in the 'Asian Tiger' economies, the discussion on FDI in developing economies revolved extensively around export-oriented FDI. Export-oriented MNEs disperse production activities geographically across national boundaries, with the fundamental premise of exploiting differences in the availability and relative cost of traditional factor endowments in different geographic regions in the pursuit of maximizing profits.

Export-oriented FDI is, however, not a homogenous phenomenon. Rather, it is a complicated and finely differentiated means of globalization of production.[2] Opportunities available for a particular host-country to attract export-oriented FDI are largely dependent upon the appropriate typological characteristics, the investment climate and the changing patterns of international production in the global context. Three important distinctions could be drawn in relation to the different categories of export-oriented production activities, namely; (i) resource-based manufacturing, (ii) labour-intensive final consumer goods, and (iii) assembly processes within vertically integrated global production systems; each having its unique determinants in terms of site-selection. MNE involvement in a host country is primarily reliant upon the existence of the relevant natural resources. For the second and third product categories, the abundance of low cost labour is more the pertinent factor. It is generally considered that the natural starting point for a typical developing country in the process of export-oriented industrialization (EOI), is the production of labour-intensive consumables such as clothing, footwear and sports goods.

Since the late 1960s, the phenomena of international production fragmentation (also referred to as global production sharing) has become a noticeable and important feature of the international division of labour. International production fragmentation refers to the cross-border dispersion of component production/assembly, within vertically integrated production processes. This has witnessed labour-intensive component production and assembly within vertically integrated international industries increasingly being located in developing economies. This practice is now seen in a number of industries where technology permits industries to separate labour-intensive production from other production activities. Component assembly within the electronics industry is still by far the most dynamic. Other industries include electrical appliances, automobile parts, electrical machinery, watches and cameras. Concerns have been raised that as a consequence of rapid advancements in the automation of production processes in industrial economies, the process of international specialization may be reversed. Notably however, in a number of high-tech industries, the pace of cyclical change and obsolesces as a consequence of rapid innovation and continuous technical change, the automation of production processes has proven to be a formidable challenge. In this light, the indications are that global production sharing is set to intensify and continue well into the future.

[2] Athukorala, P., (2006), "Product Fragmentation and Trade Patterns in East Asia," *Asian Economic Papers*, Vol. 4, No.3.

Furthermore, by the mid-1980s, successful indigenous enterprises of the newly industrialized economies (NIEs) had become key overseas investors in their own right. In their quest to maintain competitiveness in the face of rising cost pressure at home, these so called Third World MNEs have turned to investing in latecomers. The intermediary role played by these 'Third World MNEs' in linking latecomers to the global economy is anticipated to intensify in the future. Unlike MNEs from industrial economies, they are more accustomed and readily adaptable to operating in difficult business environments exhibited in developing countries. It is also argued that these MNEs, having developed specialized knowledge of small-scale labour-intensive production processes in the manufacture of standardized products, possess a competitive advantage over indigenous firms and MNEs from industrial countries operating in latecomer environments.

In essence, globalization has brought about profound changes to the manner in which international production is organized. Considering these developments, Sri Lanka, given its comparative advantage in international production (i.e., labour-intensive manufacture), has ample opportunities to link its economy to the global economy by engaging in labour-intensive component manufacture/assembly within vertically integrated and/or tightly controlled production processes. Export-oriented FDI has surged in importance as the principal channel through which latecomers can exploit these opportunities. Improving the investment climate and revamping the policy-induced incentive structure in order to exploit the opportunities presented is seen as paramount priority for latecomers to support growth through EOI.

10.2.1 Determinants of Export-oriented FDI

Having a comparative advantage in international production may not necessarily guarantee the involvement of MNEs in the export expansion of a host country. Rather, a host of other factors also influence the MNE site selection process. More specifically, it could be argued that 'the relative attractiveness of a given country for export-oriented FDI depends on both its comparative advantage in international production and the investment climate.'[3] The term 'investment climate' entails both the general business environment and the foreign investment policy regime.

The natural starting point for all latecomers is getting the 'fundamentals' right. More explicitly, 'fundamentals' refers to the general business environment. Political stability is deemed fundamental to attract all forms of FDI. Export-oriented MNEs engaged in hi-tech industries compared to 'footloose' export-oriented MNEs, who are engaged in light consumer goods industries, and are particularly sensitive in this regard. Investment undertaken by MNEs in globally integrated hi-tech industries such as electronics and electrical goods involves far greater sunk costs. Furthermore, given that these MNEs most often employ and/or service other MNEs which employ modern production management techniques such as, just-in-time and total quality management which maintain zero inventory systems, disruptions along the value chain would prove detrimental in ensuring timely delivery of the end product to the market. Thus, unlike MNEs involved in the light consumer goods industries (e.g., clothing, footwear and sport goods), MNEs in hi-tech industries place a far greater emphasis on political stability and policy continuity. Thus, MNEs in the hi-tech industry

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[3] Athukorala, P., (1995), "Foreign Direct Investment and Manufacturing for Export in a New Exporting Country: The Case of Sri Lanka,' *The World Economy*, Vol. 18, No. 4.

seek far more stable political climates within which to operate.

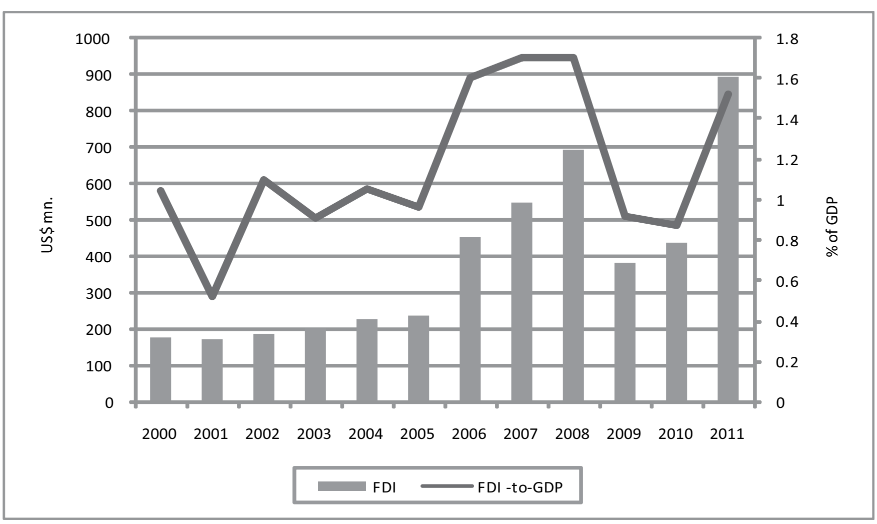
Other factors, which constitute the investment climate, range from macroeconomic stability, the orientation of the trade policy regime, foreign investment policy regime, labour market policies, the strength and quality of judicial and regulatory institutions, and the availability and access to infrastructure.

10.3 Trends and Patterns of FDI in Sri Lanka

Consistent with Sri Lanka's comparative advantage in international production, standard labour-intensive manufacture was the most attractive sector for FDI. Thus, Sri Lanka's initial spurt of FDI was into manufacturing, with a heavy concentration of export-oriented foreign enterprises involvement in the textile and garment industry. Indeed, the uncertainties related to the long separatist conflict tended to reinforce the trend towards more of this 'footloose' type of FDI that did not require significant capital investment nor production process networks. Other notable industries that drew in FDI included footwear, travel goods, plastics, diamond cutting, and jewellery manufacture. From the 1990s, the sectoral distribution of FDI in Sri Lanka started to move away from manufacturing and into services activities with the initiation of moves to de-regulate and privatize SOEs in areas such as utilities. As such, nearly 60 per cent of FDI inflows have been concentrated in the services sector over the last decade. It is also noteworthy that only a handful of major MNE engaged in export-oriented manufacture has setup operations in Sri Lanka over the last decade, and that export-oriented FDIs have remained heavily concentrated in the labour-intensive light consumer goods sector.

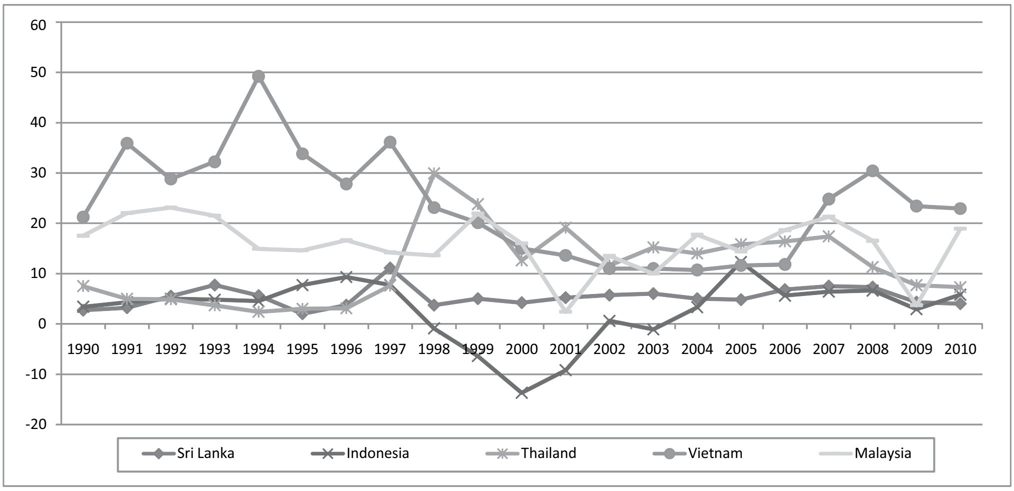
As clear from Figure 10.1, FDI inflows have risen steadily in recent years despite the unfavourable security climate during this time. The major drivers for FDI during 2006-08 were in areas such as energy and telecommunications. In the aftermath of the global financial crisis, FDI flows deteriorated sharply, but picked up in the post-conflict era, with a noteworthy jump in FDI in 2011 mainly as a result of renewed interest in the leisure sector following the revival of tourism prospects in the country.

Figure 10.1
Trends in FDI Inflows to Sri Lanka (1990-2011)



Source: CBSL, *Annual Report*, various years.

Figure 10.2
FDI Flows as a Percentage of Gross Domestic Capital Formation (GDCF)



Source: Based on data compiled from UNCTAD, *World Investment Report 2010: Investing in a Low Carbon Economy*, United Nations, Geneva.

Sri Lanka's performance has been relatively lacklustre when assessed against peer competitors (Figure 10.2). Noticeably, Vietnam, another latecomer to the process of EOI, which reoriented its industrial policy a good three years further down the road than Sri Lanka in 1980, has been far more successful in attracting FDI. When benchmarked against the performance of newly industrialized economies such as Thailand, Malaysia and South Korea, Sri Lanka's track record is even weaker.

10.4 Opportunities for a Latecomer:[4] Sri Lanka

The ensuing section will assess the consistency of Sri Lanka's policy regime for exploiting the opportunities present to attract greater volumes of FDI. The Sri Lankan experience will be compared to countries such as Thailand, Malaysia, Philippines, Bangladesh and Vietnam. India has been left out of the comparative analysis as its attractiveness in terms of FDI has been heavily geared towards investments in services.

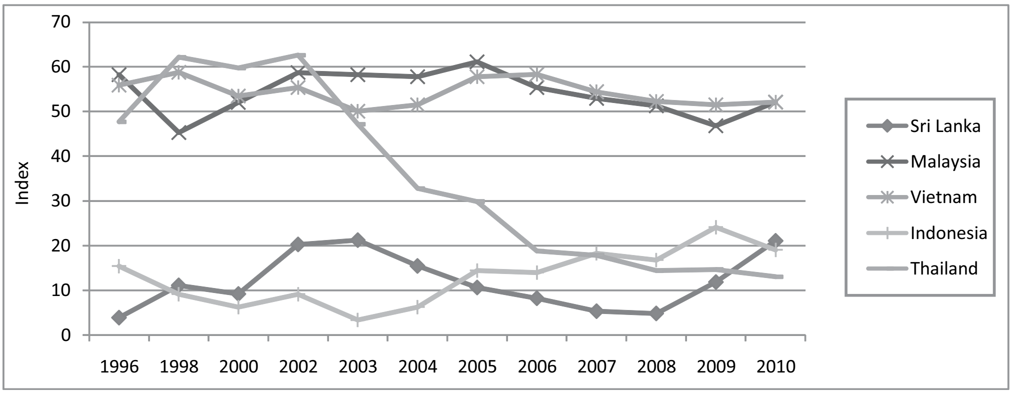
10.4.1 The Political Environment

Political instability was a major impediment to Sri Lanka's prospects for attracting FDI. Prior to the escalation of the separatist conflict in 1983, two MNE giants in the electronics industry, namely Motorola and Harris Corporation, were particularly eager to setup export-oriented ventures within the country, to the extent that both companies had been in the process of establishing the required infrastructure to commence operations. Brewing political instability, as a consequence of the escalation in violence, triggered both companies to abandon their investments, leading to their subsequent withdrawal in search of safer pastures. In the end, Malaysia proved to be the preferred destination.

As can be noted from Figure 10.3, throughout much of the 1990s and up until the end

[4] The term latecomer exporting countries refers to developing countries which are gradually orienting themselves towards specializing in manufactured exports in their attempt to replicate the success of the NIEs of East Asia.

Figure 10.3
Political Stability and Absence of Violence Indicators



Note: a. The index varies between 0 (worst score) and 100 (best score).
Source: Compiled from data obtained from World Bank (2011), World Governance Indicators Database.

of the separatist conflict, the political climate had remained largely unfavourable. With the conclusion of the conflict in May 2009, the political climate has shown signs of stability and improvement. Despite this recent upward trend, the level of confidence in the political environment, compared to other more advanced developing economies such as the NIEs, is moderate and still far from attractive to entice investors in hi-tech industries. With the return of peace, it is envisaged that the renewed confidence in the Sri Lankan political climate will be sustained over the long term to better enhance the country's prospects for attracting export-oriented FDI.

10.4.2 Trade Policy Regime

From around 2001, the relatively liberal trade policies of the preceding decades saw some reversals with the introduction of the unfettered use of para-tariffs. By 2009, in addition to Customs duties – the principal tariff levied on imports – nine other border charges and fees (i.e., para-tariffs) had been introduced. By January 2011, two of these para-tariffs were withdrawn. However, the average level of tariff protection remains significantly higher than before. The level of para-tariffs imposed on industry increased more than four-fold, from 2.5 per cent in November 2002 to 10.6 per cent by January 2011.[5] Whilst export-oriented ventures under the BOI scheme are exempt from Customs duties, they are still liable to incur border charges and fees on importation of both, capital goods and raw materials, which can erode the competitiveness of exports.

In addition to the levying of para-tariff on imports, the Budget of 2011 saw the introduction of para-tariffs in the form of cess on exports of all commodities in raw and semi processed form. Exports of finished goods are, however, exempt from such levies. The stated rationale behind such a policy stance has been to encourage domestic value addition. However, such requirements suffice as local-content requirements which are deemed inconsistent with attracting export-oriented

[5] Purcell, G., and F.M.Z Ahsan (2011), "Sri Lanka's Trade Policies: Back to Protectionism," Working Paper No.2011/03, Australia South Asia Research Centre, Australian National University. Integrated Learning and Implications for Science and Technology Policy", *Technological Forecasting and Social Change*, Vol. 66, No. 1.

FDI, particularly given the present context and intensity of international production fragmentation.

10.4.3 Labour Market Policy

Sri Lanka is argued to have a long history of trade unionization and worker militancy.[6] These trade unions wield significant political influence and are driven by political agendas. Given the high degree of politicization, historically, governments were of the view that worker protection was a central priority. Labour market policies have remained largely unchanged over the decades and still reflect this view.

Whilst the strength of trade unions threaten to pose obstacles to private investment, the more serious and immediate impediment to investors lie in terms of labour redundancy and associated costs. As per the Termination of Employment of Workmen (Special Provisions) Act (TEWA) of 1971, employers require consent from the Commissioner of Labour, with the exemption of dismissal on serious disciplinary infraction. It is also noted that severance pay associated with redundancy dismissal is highly excessive, particularly considering the levels established by Sri Lanka's peers (see Table 10.1). The above elements of labour market rigidities lead to two forms of difficulties for investors. Firstly, investors lack the flexibility to restructure their labour force in response to future market conditions and technological change, since redundancy costs are too high. Secondly, investors are unable to assess the true cost of labour as restructuring and exit costs are unknown and may be very high. These impediments can be detrimental in attracting export-oriented FDI in labour-intensive manufacture, given that these enterprises operate in a highly volatile global environment and thus require the flexibility to restructure their operations in response to global events in order to remain competitive.

10.4.4 Institutional, Regulatory and Infrastructure Quality

In terms of institutional and regulatory quality indicators, Sri Lanka's position is mediocre. Bureaucratic red tape and corruption are areas of concern. The judicial system in particular is marred by excessive delays, prompting investors to often pursue out-of-court settlements. Obtaining access to essential infrastructure services is subject to considerable delay (see Table 10.1). Considering these and other institutional and regulatory impediments, Sri Lanka's ranking in terms of the 'Ease of Doing Business' index is poor, coming a distant 102 out of 183 countries surveyed by the World Bank.[7]

10.4.5 Foreign Investment Regime and Policy Induced Incentives

Sri Lanka's average measures of openness to foreign equity ownership are comparatively liberal. Another notable area where Sri Lanka has progressed pertains to the strength of laws enacted to safeguard the interests of foreign investors. In other aspects of FDI regulation however, Sri Lanka is lagging well behind its peers. In terms of the time involved in setting up a fully-fledged foreign venture, the ease of establishing a foreign venture, and judicial assistance extended to foreign enterprises in arbitrating commercial disputes, Sri Lanka's standing is markedly poor (see Table 10.1).

The prevailing foreign investment approval process gives preferences to projects investing substantial amounts of capital, are agree-

[6] Athukorala, P., and S. Rajapatirana (2000), *Liberalisation and Industrial Transformation: Sri Lanka in International Perspective*, Oxford University Press, New Delhi.

[7] World Bank (2012), *Doing Business in a More Transparent World: Comparing Regulation for Domestic Firms in 183 Economies*, World Bank, Washington, D.C.

able to undertake high-levels of domestic value addition and the willingness of investors to locate in difficult regions (i.e., North and East provinces) of the country whilst ignoring a project's capability to generate employment, technology spill-over and its export potential. FDI in services are given prominence over manufacturing with IT, BPO and tourism receiving the greatest prominence in terms of investment promotion and qualification for special incentives. This however, neglects the potential of export-oriented manufacturing in linking Sri Lanka to the global economy.

There can also be other adverse signals to investors. In November 2011, Sri Lanka enacted legislation titled 'Revival of Underperforming Enterprises and Underutilized Assets' in Parliament. Under the Act, the control of underperforming and underutilized assets of 37 private companies is to be transferred to the government. Whilst Sri Lanka currently provides constitutional provisions against expropriation of foreign-owned assets, such legislation is bound to give an undesirable signal, undermining confidence of both, domestic and foreign investors.

Sri Lanka offers a host of fiscal incentives to foreign investors setting up export-oriented ventures through the BOI. These include tax holidays, the duty free importation of project-related capital goods and raw material, and exemption from exchange control requirements for companies engaged in the export of more than 90 per cent of its output. For investors to qualify for BOI concessions, a minimum paid-in capital threshold of Rs. 50 million (approximately US$ 380,000) has been stipulated. Furthermore, access to these incentives also depends on meeting a 35 per cent domestic content requirement.

Considering that Sri Lanka has to compete with other developing nations for FDI, it is crucial that policy-induced incentives are utilized to make the country more attractive to foreign investors. However, the minimum paid-in capital requirement seems excessive given the thresholds established by other developing countries (see Table 10.1). Further, the domestic content requirement of 35 per cent, too, seems inconsistent given the degree of international production sharing, and Sri Lanka's prospects in attracting export-oriented FDI in labor-intensive component assembly/manufacturing within vertically integrated and/or tightly controlled production systems.

10.5 Conclusion and Policy Recommendation

Sri Lanka, in light of on-going changes in the international organization of production and its comparative advantage in international production in labor-intensive manufacture, has the potential to sustain and enhance its growth potential by attracting export-oriented FDI. In order to achieve this objective, it is vital to build on the liberalization reforms carried out and sustained during the past three decades. In this regard, rationalization of the country's external trade policy regime is needed to make exports more competitive. The FDI approval process must be made more accommodative of other considerations such as a potential of a project to generate employment and technology spill-over, whilst the process must also be streamlined and made more transparent to minimize hindrances to foreign investors. Further, eligibility criteria for investors to qualify for BOI concessions must be re-assessed to more appropriate levels. In other aspects of the investment climate, any constraints posed by regulations pertaining to labour laws, bureaucratic red tape and corruption must be addressed to enhance the ease of doing business, in order to make Sri Lanka a more attractive destination for foreign investors

Table 10.1
Key Indicators for an Attractive FDI Destination

Indicator	Bangladesh	Sri Lanka	Vietnam	Philippines	Thailand	Indonesia	Malaysia
Labour Market Indicators							
Severance pay for redundancy dismissal (weeks of salary)	26.3	54.2	23.1	23.1	31.7	57.8	17.2
Notice period for redundancy dismissal (weeks of salary)	4.3	4.3	0.0	2.4	1.3	0.0	6.7
Third party approval if 1 worker is dismissed?	No	Yes	Yes	No	No	Yes	No
Governance Indicators							
Corruption Perception Index (0-Worst Score, 10 – Best Score)	2.4	3.2	2.7	2.4	3.5	2.8	4.4
Rule of Law (0-Worst Score, 10 – Best Score)	26.5	52.6	38.9	34.6	49.8	31.3	65.4
Government effectiveness (0-Worst Score, 10 – Best Score)	21.5	49.3	44.0	57.1	58.4	47.8	82.3
Regulatory quality (0-Worst Score, 10 – Best Score)	21.5	45.5	31.0	44.0	56.5	39.7	71.3
Access to Essential Infrastructure							
Dealing with construction permits [No. of procedures/ (Time –Days)]	11/(201)	18/(217)	10/(200)	30/(85)	8/(157)	13/(158)	22/(260)
Obtaining electricity [No. of procedures/ (Time –Days)]	7/(372)	4/(132)	5/(142)	5/(50)	9/(35)	7/(108)	6/(51)
Registering property [No. of procedures/ (Time –Days)]	8/(245)	8/(83)	4/(47)	8/(39)	2/(2)	6/(22)	5/(48)
Establishing a Foreign Venture							
Starting a foreign business [No. of procedures/ (Time –Days)]	55/(9)	6/(65)	94/(12)	17/(80)	9/(34)	12/(86)	11/(14)
Ease of Establishment Index (0-Worst Score, 100 – Best Score)	55.3	47.9	57.9	57.9	60.5	52.6	60.5
Strength of Laws index (0-Worst Score, 100 – Best Score)	84.9	95.4	84.9	95.4	84.9	95.4	94.9
Ease of Process Index (0-Worst Score, 100 – Best Score)	67.5	71.9	81.8	87	81.8	81.8	81.8
Extent of Judicial Assistance index (0-Worst Score, 100 – Best Score)	55.3	38.0	57.5	33.7	93.5	41.3	66.7
Minimum paid in capital requirements (~US$)	0	380,000	0	200,000	92,800	N/A	N/A

Source: Transparency International (2011), *Corruption Perception Index: 2011*; World Bank (2010), *Investing Across Borders 2010: Indicators of Foreign Direct Investment Regulation in 87 Economies*; World Bank (2011), *World Governance Indicators Database*; World Bank (2012), *Doing Business in a More Transparent World: Comparing Regulation for Domestic Firms in 183 Economies*.