Cultivating the Pearl

Australia's Economic Relations with Sri Lanka

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and
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Institute of Policy Studies

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Abbreviations and Acronyms

ACIAR	Australian Council for International Agricultural Research
AusAID	Australian Agency for International Development
BIE	Bureau of Industry Economics, Australia
BOI	Board of Investment, Sri Lanka
DAC	Development Assistance Committee (of the Organisation for Economic Corporation and Development)
ADB	Asian Development Bank
DFCC	Development Finance Corporation of Ceylon, Sri Lanka
DIFF	Developmental Import Finance Facility (of AusAID)
EAAU	East Asia Analytical Unit (of Department of Foreign Affairs and Trade, Australia)
EPZ	Export Processing Zone
FDI	Foreign Direct Investment
FIAC	Foreign Investment Advisory Committee
IC	Industry Commission, Australia
GCEC	Greater Colombo Economic Commission
GIS	General Incentive Scheme (of BOI, Sri Lanka)
MNE	Multinational Enterprise
NIE	Newly Industrialised Economies
ODA	Overseas Development Assistance
OECD	Organisation for Economic Corporation and Development
PNG	Papua New Guinea
SIS	Special Incentive Scheme (of BOI, Sri Lanka)
SITC	Standard International Trade Classification
SLEDB	Sri Lanka Export Development Board
UN	United Nations
WTO	World Trade Organisation

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Foreword

In 1995, a three-year contract was signed between the Australian Agency for International Development (AusAID) and the Australia South Asia Research Centre (ASARC) of the Research School of Pacific and Asian Studies, The Australian National University, for ASARC to undertake research on South Asia within a South Asian Research Project (SARP). In the project, AusAID and ASARC would agree on a series of high priority aid issues on which ASARC would focus research work and which would provide an intellectual and analytical underpinning to the work of AusAID, while matching ASARC's own research priorities in South Asia.

In the period of the contract, two major projects were selected, of which this is the first to reach fruition. This study, *Cultivating the Pearl: Australia's Economic Relations with Sri Lanka*, aims to fill a major gap in knowledge of the economic of the bilateral relationship between the two countries. As such it is a complementary study to the path-breaking social history of Sri Lankans in Australia, *Links Between Sri Lanka and Australia* by Dr. Wickrama Weerasooriya, former Sri Lankan High Commissioner to Australia (1988).

We hope that this study will not only enrich knowledge of the economics of the bilateral relationship between the two countries, but, given the wider context in which the study is placed, will serve as a model for other such studies of Australia's bilateral relationships with countries of significance to us. In particular, the detailed case study of Australian firms in Sri Lanka adds to the sparse literature on overseas operations of Australian firms.

Most importantly, the study attempts to highlight the key determinants of the trade, investment and aid components of the economic relationship which, it is hoped, will be of assistance to policy makers, businessmen and academics of both countries.

This study is a contribution to the Australian Government's Year of South Asia.

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Executive Summary

This study aims to assist policy making bodies and the business community in both Australia and Sri Lanka to devise strategies and policies to promote mutually beneficial trade, investment and aid relations between the two countries. Towards this end, it undertakes an in-depth inquiry into the nature and evolution of Australia - Sri Lanka economic relations in the context of economic liberalisation policy reforms in Sri Lanka since 1977. Particular emphasis is placed on the scope and operation of the Australian aid program to Sri Lanka and special contributions made by Australia within it towards economic and human resource development in Sri Lanka.

Sri Lankan Economy: Profile and Policy Trends

In a regional context Sri Lanka is comparatively better off than its South Asian neighbours in terms of per capita income, and in a range of social welfare indicators such as life expectancy, literacy and income inequality. The industrial resource base of Sri Lanka is narrow, but the country has a relatively well-educated labour force which can play a pivotal role in rapid industrialisation through internationalisation of production. While labour shortages have begun to emerge in recent years in some skill categories, Sri Lanka still remains a surplus-labour country, and wages and salaries are low by international standards.

As in other countries in South Asia, state-led import substitution industrialisation (ISI) was the basic tenet of the national development strategy during the early post-independence period. By the mid-1970s Sri Lanka had one of the most regulated economies outside of the communist block. Against this background, in 1977 Sri Lanka embarked on an extensive economic liberalisation reform process, becoming the first in the region to make a clear policy departure from the closed-economy regime phase. After two decades of policy reforms, Sri Lanka is now one of the most open and market oriented economies in the developing world.

The tariff regime has become less distortionary and more liberal during successive rounds of reforms. There are no foreign exchange restrictions on current account transactions in the balance of payments. On capital account transactions, repatriation of proceeds from sales of shares in Sri Lankan companies are permitted without prior approval of the Controller of Exchange and authorised foreign exchange dealers are permitted to approve applications for such remittances. Foreign investors are also allowed by the Controller of Exchange to repatriate their capital contributions in the equity of a company on the sale or liquidation of the investment, after settlement of local liabilities like taxes. Transfer of shares are freely permitted if they do not increase the ratio of non-resident shareholdings originally approved. The Central Bank has generally been successful in maintaining the external value of the Sri Lankan currency, the rupee, at realistic levels under a managed floating exchange rate regime.

Trends and Patterns of Foreign Direct Investment

The response of foreign investors to market-oriented policy reforms in Sri Lanka has been swift and remarkable. Total annual net capital inflow increased from US$ 0.2 million in 1970-77 to US$ 41 million in 1978-1983, recorded a modest decline (to US$35 million) during the turbulent years of 1984-1989, and thereafter increased to US$120 million during 1990-94. During 1967-77, a total of 82 foreign firms were set up in Sri Lanka manufacturing. Of these, only 13 were export-oriented ventures. By contrast, during 1978-95, over 850 firms were set up and the majority (over 500) were fully export oriented.

Manufacturing of labour intensive consumer goods has been the dominant area of activity for foreign investors. There are also a number of firms involved in labour intensive assembly production in high-tech industries. Resource-based manufacturing or manufacturing activities which involve further processing of primary products (tea, rubber and coconut fibre) previously exported in a raw state is the third area of export-oriented production.

Foreign firms have been the engine of manufactured export growth over the past two decades. The share of manufacturing in total commodity exports from

Sri Lanka increased from less than 5 per cent in the late 1980s to over 70 per cent by the mid-1990s. Local employment (ie total employment net of expatriates) in export-oriented ventures recorded a twenty-fold increase, from 10,538 to 223,367, between 1980 and 1995. Over 85 per cent of employment opportunities are in foreign firms.

Profiles, Performance and Perceptions of Australian Firms in Sri Lanka

In terms of number of foreign manufacturing ventures set up during 1978-95 in Sri Lanka, Australia ranked sixth largest among developed country investors and eighth largest among all investing countries. In terms of relative contribution to total foreign investment (15 per cent), Australia is the second largest investor among all source countries and the largest among developed countries. When the relative share in total investment (foreign plus local) is used as the ranking criterion, Australia (13 per cent) ranks third after Korea (28 per cent) and Japan (14 per cent). Australia's relatively high ranking as a source country has come from a single large project (Ansell Lanka) which accounts for over 80 per cent of total Australian investment in the country.

The entry of Australian firms into the Sri Lankan economy through direct investment is a comparatively recent phenomenon. The first recorded case of Australian investment in the country was in 1980. During 1980-95, a total of 60 projects with Australian capital participation were approved by the investment approval bodies in Sri Lanka.

There are 23 Australian firms in commercial operation, comprising 17 in manufacturing and 6 in various services industries. Of the 17 manufacturing firms, 12 are export-oriented ventures and the rest produce solely for the domestic market. The product lines of export-oriented firms include furniture, terra cotta pottery, electrical accessories, ladies undergarments and lingerie, knitting, dyeing and finishing, diamond cutting/polishing, surgical gloves and condoms, packaging products (woven synthetic bags) and rubber locomotive

components. Domestic market oriented firms are involved in the production of recycled paper products, telecommunication cables, cookies and cosmetics.

Firms in infrastructure and service sectors are involved in building construction, project management, import and marketing of solar products, turnkey project development in energy, supply of electro-medical equipment, telecommunications, water supply, electricity, roads and highways, and supply of avionics equipment. Two companies have been set up to sell consultancy services to Australian firms. In addition, there is one major Australian bank of long standing.

Numbers employed by all Australian firms totalled 4,271 in 1996 (about 2 per cent of employees of all foreign firms set up during 1978-95 and in operation at the time of the study), the largest firm employing 53 per cent of the total.

The export-oriented firms predominantly use Sri Lanka as an export platform to penetrate markets in the other parts of the world. In the aggregate, the export share to Australia is 3 per cent. Among all Australian manufacturing firms, two sourced all inputs from Australia/New Zealand. Two relied entirely on other countries, while the remaining firms obtained inputs from a wide range of sources with Australia as a minor supplier. In the aggregate, the share of total material inputs procured from Australia is probably around 10 per cent.

There was a striking difference between export-oriented and domestic market oriented firms governing their decisions to locate production in Sri Lanka. The former identified the availability of cheap and trainable labour; the tax holiday and other investment incentives; availability of raw materials; a liberal trade and investment regime; and infrastructure services of reasonable quality as the key considerations. For the latter, naturally, the predominant consideration has been future domestic market potential in Sri Lanka for their products.

A common complaint of domestic oriented firms was that the existing incentive structure generally discriminates against them compared to their export-oriented counterparts. They specifically expressed concern about high income and

turnover tax rates and import duties, lack of access to overseas borrowing and discriminatory lending policies of domestic financial market institutions. In the absence of access to foreign borrowing, money market instability, in particular unpredictable borrowing rates, due primarily to massive government borrowing, were identified as problems for financial management.

As regards the general investment climate, all firms expressed concern about binding infrastructure bottlenecks, particularly uncertain electric-power supply and the congested road network. The majority of firms also considered the current state of telecommunication facilities as a moderate to strong disincentive to the expansion of operations. Problems with environmental regulations were generally moderate. Broadly, there was a perception of lack of certainty about future directions of government policy. Government policy was seen as being particularly arbitrary and cumbersome in the areas of labour legislation, taxation (defence levy) and import duties.

Production plans of Australian firms in Sri Lanka over the next two years, with few exceptions, are generally positive. Ten of the twelve firms who responded to the relevant question indicated that they intended to expand operations and two of these firms indicated they would also diversify production in the course of production expansion.

As regards long-term production plans, the largest Australian firm with substantial sunk fixed investment is still proceeding with investment expansion. However, most of those which are not already committed to large scale investment plans seem to prefer not to proceed with long-term investment until the security situation improves and policy directions of the government become clear. Thus, by and large, there is clearly a "wait and see" approach to further investment. This reluctance is naturally compounded when firms have options to invest in other Asian countries with better, more certain prospects.

Australia-Sri Lanka Trade Links

Structural transformation in the Sri Lanka economy over the past two decades under an outward-oriented policy stance has brought about significant changes in

the structure of its foreign trade. These changes have enhanced *potential* trade complementarity between Sri Lanka and Australia.

Sri Lanka is no longer a predominantly primary exporter. Her growing labour-intensive manufacturing industries have the potential to penetrate the expanding Australian markets in these product lines. As for export potential for Australia, there are growing market opportunities in Sri Lanka for machinery, transport equipment and industrial raw materials. Import demand in Sri Lanka for various high value processed agricultural products such as meat, milk and milk products is also continuously rising with increases in domestic income levels. However, these potential trade complementarities have not yet been reflected in actual bilateral trade patterns between the two nations. Both Australia's share in total commodity imports of Sri Lanka and the share of exports to Australia in total Sri Lankan exports have continued to decline over the years.

The share of imports from Australia in total Sri Lankan imports has continuously declined from about 5 per cent in the early 1960s to a little over 1 per cent in the mid 1990s. From Australia's point of view, bilateral trade between the two countries has been even less significant throughout. Bilateral import and export ratios in Australian trade have remained less than 0.05 per cent over the past two decades.

Interestingly, the expanding involvement of Australian manufacturing firms in Sri Lanka does not appear as yet to have made a significant impact on Sri Lanka-Australia trade patterns. As noted earlier, most of these firms use Sri Lanka as an export platform to penetrate markets in other countries.

Australian Aid to Sri Lanka

Since the inauguration of the Colombo Plan in 1951, Australia has been a regular, though modest, source of aid to Sri Lanka. Following the market-oriented policy reforms in 1977, aid flows to Sri Lanka increased significantly. However, for the past two decades, the Australian share in total Development Assistance Committee (DAC) aid flows to Sri Lanka has varied around 1 per cent. This low commitment to Sri Lanka probably reflects the close trade-aid links in Australian foreign

economic relations, and the corresponding bias in aid allocation towards countries in Oceania and the South and North Eastern Asian Pacific regions.

The share of aid to Sri Lanka in total Australian overseas development assistance has remained at about 0.7 per cent for the past five years. Among the five major South Asian countries, Sri Lanka is the fourth largest recipient of Australian aid (after Bangladesh, India and Pakistan), but is the largest recipient in *per capita* terms.

The largest concentration of Australian aid in Sri Lanka is in technical training and higher education (over 65 per cent of total aid flows). The other significant aid category was food aid. Little aid has been channelled towards agricultural and manufacturing production or infrastructure development. A modest amount has been channelled through multi-sector projects. Some technical and project assistance has been made available through the Australian Centre for International Agricultural Research. The share of food aid in total aid to Sri Lanka (4.8 per cent) is much lower than for other South Asian countries. In fact, there has been a continuous decline in Australian food aid to Sri Lanka, as it has approached food self sufficiency. Compared to other South Asian countries, the share of aid to Sri Lanka in the form of technical support for industry, agriculture and fishing is very small.

It is widely acknowledged in developmental circles in Sri Lanka that Australian aid for technical and further education for Sri Lankans in Australia over the past four decades has made a significant contribution to human capital development. Moreover, Sri Lankans who benefited from Australian educational aid have provided a substantial underpinning to wider mutually beneficial bilateral economic relations between the two countries.

There has been a shift in priorities in the Australian aid program to Sri Lanka away from assistance for economic development (infrastructure and production sectors) towards social development, particularly through education. The reasons for this shift are not clear and deserve further study. In any case, the shift appears to reflect a declining linkage between Australia's aid program with

the trade and investment components of the economic relationship with Sri Lanka. To this extent, the parallel may be with South East Asian countries which are also placing a heavy emphasis on building up human capital as a key building block for further sustained and increasingly sophisticated economic development under liberalised, open regimes. In this sense, Sri Lanka leads the way in South Asia.

Policy Inferences

The Sri Lankan economy has responded well to gradual but steady liberalisation of trade and investment regimes over the past two decades. Greater exposure to foreign trade and interaction with foreign firms which have set up production plants in the country have set the stage for the private sector to emerge as the major force driving economic expansion. In this context the bipartisan acceptance of an outward-oriented policy stance as the major plank of national development policy is a landmark development in Sri Lanka's post-independence policy history.

There are still, however, some policy inconsistencies in the incentive structure which hinder private sector performance. One such anomaly, which was brought into sharp focus in our survey of Australian firms, is the incentive bias against domestic market oriented firms in domestic and import taxation, and access to domestic financial institutions. The aim of continuing liberalisation reforms has been to achieve greater efficiency in domestic resource allocation through exposure of domestic industry to world competition. In this context, whether a firm is producing for the domestic or export market should have become less relevant from a policy viewpoint.

This study clearly suggests that the recent decline in foreign direct investment inflow and the general setback in private sector performance cannot be ascribed to the escalation of ethnic violence alone. Even with the ongoing war, performance would have been much better had it not been for the prevailing policy uncertainty and adverse labour market developments, and in particular, the unsettled issues relating to the debate over the *Workers' Charter*.

Australian firms in Sri Lanka are predominantly (if not solely) involved in the production of goods (and services) which are neither feasible nor economically viable to export from Australia. Thus it is unlikely that their offshore operations have led to a reduction in exports from Australia. On the contrary they do contribute to economic expansion in Australia by importing (albeit a small volume of) inputs. In sum, Australian firms operating in Sri Lanka seem to add to Australian national wealth, rather than contributing to a reduction in national exports, employment and output.

As noted, only a small fraction of inputs used by Australian firms in Sri Lanka are imported from Australia. Available studies on the operation of Australian firms in other countries have also come up with similar findings. This pattern is largely inconsistent with the import procurement practices of off-shore affiliates of firms from major investing countries such as Japan, USA, Germany and UK. One explanation of the difference seems to be that, unlike firms from the latter countries, most of the Australian firms located in other countries are not vertically integrated global conglomerates.

The failure of Australian traders to exploit satisfactorily the market potential in Sri Lanka's post-reform economy as well as the lack-lustre performance of Sri Lankan producers in penetrating the Australian market can be ascribed at least partly to the weak information base. There is a clear need for action by both Sri Lanka and Australia to establish and develop a satisfactory information base to set the stage for enhancing trade and investment relations between the two countries. One potential area where Australia can effectively assist the Sri Lankan government (as part of its overseas development assistance program) is in the development of a foreign investment data base at the Board of Investment in Sri Lanka.

1. INTRODUCTION: PURPOSE AND SCOPE OF THE STUDY

As an outcome of the reform process initiated in 1977, the Sri Lankan economy has become increasingly internationalised over time, creating lucrative opportunities for trade and investment. Foreign trade turnover (imports and exports) as a share of GDP increased from about 35 per cent in the mid-1970s to over 70 per cent by the early 1990s. The overall export orientation of manufacturing, as measured by the ratio of exports to gross manufacturing output, increased from a mere 3 per cent in 1977 to 55 per cent in 1993 accompanied by an increase in the share of manufacturing in total exports from 4 per cent to 60 per cent over this period. Foreign direct investment (FDI) has played a pivotal role in the expansion of export-oriented industrialisation. A large number of export-oriented foreign firms have taken advantage of the special incentives and concessions provided by the Sri Lankan government. In particular, the Sri Lankan export processing zones (EPZs) near Colombo, which provide physical and commercial infrastructure of reasonable quality at internationally competitive prices, have been very attractive to foreign manufacturers seeking low-cost production bases for labour intensive manufactured goods. By the mid-1990s, over 360 export-oriented foreign firms were in commercial production in Sri Lanka's manufacturing sector. The share of foreign firms in total exports of manufactures from the country increased from 24 per cent in 1977 to over 80 per cent in 1994. Penetration of foreign direct investment into the infrastructure and services sectors has been relatively low, but is expanding.

After almost two decades of policy reform, Sri Lanka is now one of the most open and market-oriented countries in the developing world. There are clear indications that the basic thrust of the outward-looking policy stance of the country will not change whatever regime comes to power in the foreseeable future. Indeed, the most dramatic change in the Sri Lankan political landscape in recent years has been the convergence in broad economic policies among the major political parties and groupings. Achieving greater openness and liberalisation is now bipartisan policy in Sri Lanka. While much

remains to be done in the area of economic policy and institutional reforms, Sri Lanka now has the potential for building on the substantial achievements over the past two decades to exploit emerging growth opportunities in the global economy.

This study aims to explore the nature and significance of trade and investment opportunities, Australia's aid contribution in Sri Lanka in the light of this transformation and to identify emerging patterns of trade complementarity between Sri Lanka and Australia, with a view to assisting policy making bodies and the business community in both Australia and Sri Lanka to devise strategies and policies to promote mutually beneficial trade and investment relations between the two countries. The key objectives of the study are to:

(a) document and review market-oriented policy reforms in Sri Lanka and assess the commercial potential for Australia emanating from the greater outward orientation of the Sri Lankan economy;
(b) examine patterns of trade and investment relations between the two countries with emphasis on the implications of structural changes in the Sri Lankan economy for opportunities for Australian investors and for trade complementarity;
(c) study the experience and perception of Australian companies doing business in Sri Lanka with a view to understanding factors underlying business success and failure in the Sri Lankan context and to develop policy recommendations and strategies to maximise mutual benefits from trade and investment relations, and
(d) examine trends and patterns of Australian aid to Sri Lanka with a focus on the extent to which aid flows have influenced bilateral trade relations and Australian investment in Sri Lanka.

The research strategy of the study comprises two key components; (a) a study of policy reforms in Sri Lanka since 1977 through library research and (b) a detailed survey of Australian firms operating in Sri Lanka. The firm-level study involved compilation and analysis of information from official records of

the Board of Investment of Sri Lanka and firm-level trade records maintained by Sri Lanka Customs Department, and questionnaire-based interviews which were conducted with the management of Australian affiliated firms.

The study is arranged in seven chapters. Chapter 1 provides a profile of the Sri Lankan economy with emphasis on its salient features compared with other South Asian countries, resource endowment, growth and structural changes. Chapter 2 surveys trade and investment policies in Sri Lanka. After identifying the key policy trends over the post-independence period, the chapter examines in detail policy reforms since 1977 focusing on trade policy, exchange rate and exchange controls and policy towards foreign direct investment and privatisation. Trends and patterns of foreign investment, with emphasis on the relative importance of Australia as a source country, and the role of foreign investment in economic transformation since 1977 are the subject matter of Chapter 3. Chapter 4 provides a detailed study of the profile and performance of Australian companies in Sri Lanka, their perception of Sri Lanka's investment climate, and perceived constraints on future business expansion. Chapter 5 examines foreign trade relations between the two countries, focusing on historical trends in overall trade, changes in import and export structures and emerging trade complementarity. Chapter 6 reviews the trends and patterns of Australian aid to Sri Lanka in the context of Australian aid by economic sectors of destination from 1990 to 1995 and of the literature on the relationship between overseas aid and economic development in developing countries. A final chapter summarises the main findings of the study and draws policy inferences.

2. SRI LANKA: A PROFILE OF THE ECONOMY

This chapter provides a profile of the Sri Lankan economy to set the stage for the ensuing discussion of trade, investment and aid relations between Australia and Sri Lanka. It begins with a brief discussion of policy trends and stages of development of Sri Lanka in the South Asian context. This is followed by a survey of resource endowments, growth and structural changes of the Sri Lankan economy.

2.1 Sri Lanka in a South Asian Context

Sri Lanka, an island nation located less than 50 kilometres away from the extreme southern tip of India, is the smallest of the main South Asian countries in terms of land area and population (Table 2.1). In a regional context, it is comparatively better off than its neighbours in terms of per capita income, and in a range of social welfare indicators such as life expectancy and literacy. Further, it has a more even income distribution, and a relatively less pronounced gender bias, as seen in higher female life expectancy and a more equitable access to education.

Until recently, Sri Lanka was also an oasis of peace and tranquillity in the region with a stable, well functioning parliamentary democracy. This situation, however, changed dramatically in the past two decades. The relationship between the majority Sinhalese (who account for about 75 per cent of the population) and the largest ethnic minority, Tamils (18 per cent), has always been a significant factor in the social, political, and economic life of Sri Lanka. In particular, since Independence relations between the two communities have been characterised by rivalry, with outbursts of anti-Tamil violence in 1958 and 1977. This long-standing rivalry escalated into sustained and widespread violence in July 1983. The ethnic war has dominated the policy agenda ever since, and has caused considerable damage to economic performance and quality of life. These unfortunate political developments mask a series of positive developments in trade and investment policy that have taken place in recent years which, given the restoration of some degree of political stability and a conducive international environment, could place rapid growth firmly back on the agenda.

Table 2.1: Sri Lanka in a South Asian Context, 1994*

	Bangladesh	India	Nepal	Pakistan	Sri Lanka
Land area (sq. Km '000)	114	3288	148	796	66
Population (million), Mid-1994	117.9	913.6	20.9	126.3	17.9
GNP per capita ($)	220	320	200	430	640
Growth of real GNP per capita (1985-94), %	2.0	2.9	2.3	1.3	2.9
GNP per capita: ICP[(a)], ($)	1330	1280	1230	2130	3160
Life expectancy at birth, years	57	64	54	60	72
Infant mortality, per 1000 live births	81	70	95	92	16
Adult illiteracy, % of age group	62	48	73	62	10
Females in secondary schools, % of age group	12	38	NA	8	78

Notes: [(a)] International Comparisons Programme (ICP) of the United Nations which adjusts GNP estimates for purchasing power of currencies

Source: World Bank, World Development Report-1996, Washington, DC.

As in other countries in South Asia (and many other new nations which have emerged from the colonial era) state-led import substitution industrialisation (ISI) was the basic tenet of the national development strategy during the early post-independence period. In fact, in Sri Lanka's attempts to expand and consolidate the role of the state in the economy (and consequently to marginalise the private sector), Sri Lanka went far beyond such attempts in neighbouring India. By the mid-1970s Sri Lanka had one of the most regulated economies outside the communist block. Against this background, in 1977 Sri Lanka embarked on an extensive economic liberalisation reform process, becoming the first in the region to make a clear policy departure from the closed-economy (import substitution) policy stance. The initial focus of the reforms was on trade policy, focusing largely on manufacturing. The liberalisation attempts have, however, become broad-based over the years with the objective of redressing distortions on an economy-wide basis and harmonising competitive conditions across sectors. Indeed with its market-oriented reforms sustained for over almost two decades, Sri Lanka stands out as one of the most open (outward-oriented) economies in the developing world. Despite the political unrest since 1983, gains from economic reforms have been remarkable, so much so that continued commitment to liberalisation is now bipartisan policy.

Table 2.2 presents, for selected Asian countries, the Index of Economic Freedom (IEF) recently developed by the Heritage Foundation (USA) (1995). The index measures how well a given country scores among 101 countries (including all developed market economies) based on a list of ten economic factors (see notes to the Table) which impinge on freedom for private-sector policy makers. A higher score denotes greater government interference in the economy (and less economic freedom). In terms of the index, Sri Lanka's overall policy regime and the investment climate are superior to those of the other three South Asian countries (Pakistan, India and Bangladesh) covered in the study. Interestingly, Sri Lanka's ranking is well above that of Indonesia which is now classified as a High Performing Asian Economy (HPEA) by the World Bank. Among all 101 countries Sri Lanka occupies 35th position. In a truncated sample, which excludes all developed-market economies but retains all reforming economies in the former Soviet block, Sri Lanka's ranking improves to 12th.

Table 2.2: Heritage Foundation Index of Economic Freedom for Private-sector Policy Makers in Selected Asian Countries

	Index*	Country Ranking**
Hong Kong	1.25	1
Singapore	1.25	1
Taiwan	1.95	2
South Korea	2.15	13
Thailand	2.30	19
Sri Lanka	2.80	34
Pakistan	3.15	57
Philippines	3.30	66
Indonesia	3.35	70
India	3.70	86
Bangladesh	3.90	89

Notes:* The index measures how well countries score on a list of ten economic factors: (1) Trade policy, (2) Taxation policy, (3) Government consumption of economic output, (4) Monetary policy, (5) Capital flow and foreign investment, (6) Banking, (7) Wage and price controls, (8) Property rights, (9) Regulation, (10) Black market. The higher the score, the more government interference in the economy (hence the less economic freedom there is). The study covered 101 countries (including all developed market economies).

** Ranking among 101 countries (including all developed-market economies).

Source: The Heritage Foundation (1995), The Index of Economic Freedom, Washington, DC.

2.2 Land and Resources

About 60 per cent of Sri Lanka's land area of 64,454 square kilometres is cultivable, and about 35 per cent is under cultivation. Paddy (rice), the main staple crop, accounts for about 45 per cent of the land under cultivation, while tea, rubber, and coconut occupy about 42 per cent. Widespread adoption of modern high-yielding varieties and chemical inputs, as well as bringing new land under cultivation under government-funded irrigation projects, has raised rice production to a point where Sri Lanka is now close to self-sufficiency in rice.

Reserves of economically exploitable mineral resources include semi-precious gems, graphite, mica, mineral sand, phosphate and several types of clay. Gems, graphite and mineral sands are mined chiefly for export (and together account for about 4 per cent of total earnings from commodity exports), while the other minerals either remain unexploited or are used mainly in local industry. No deposits of major industrial minerals such as coal, copper, iron, lead, zinc have been discovered. There are no proven oil deposits and hence the entire oil requirement of the country is met by imports. There is a vast potential for generating hydro-electricity, which at present accounts for about over 70 per cent of Sri Lanka's total electricity production and 30 per cent of total energy usage. The coastal lagoons and the coral reefs surrounding many parts of the island abound with fish, another potentially important, yet largely unexploited, resource endowment of the country.[1]

Given the narrow industrial resource base, the most important resource available for integrating Sri Lanka into the global economy through internationalisation of production is her relatively well-educated labour force. The total labour force of the country is estimated at 9.8 million (55 per cent of the population). With a literacy rate of 93 per cent and a secondary education enrolment rate of over 75 per cent and the widespread use of English in business, the quality of manpower in Sri Lanka is considered to be superior to that in most of the low-income countries in the world. While labour shortages

[1] For a thorough discussion on the physical resource base of Sri Lanka see Pieris (1996), Chapter 5.

have begun to emerge in recent years in some skill categories (owing to rapid expansion of export-oriented manufacturing, migration for temporary overseas employment and emigration for permanent settlement), Sri Lanka still has a vast pool of surplus labour. According to official estimates the current (1994) unemployment rate is 12.1 per cent (male: 9.8 per cent, female 17.0) (Central Bank 1995a). Reflecting the surplus-labour situation, wages and salaries are low by international standards (Table 2.3).

Table 2.3: Salaries and Wages in Sri Lanka by Occupation

Occupation	Wage/salary range (US$ per month)
Accountant	350-660
Middle Manager	250-400
Engineer	200-400
Supervisor	90-120
Skilled worker	60- 70
Unskilled worker	45- 55

Source: Board of Investment (1996), Sri Lanka: Investment Policy and Incentives, Colombo

2.3 The Structure of the Economy

At the time of independence in 1948, Sri Lanka was a prime example of an economy heavily dependent on a limited range of agricultural export commodities. The main tree plantation crops (tea, rubber and coconut) accounted for over 30 per cent of GDP and 95 per cent of total export earnings. The production pattern of the economy exhibited only limited structural change during the post-independence period up to the early 1970s. Structural changes since then have been marked, but the agricultural sector still constitutes a fifth of GDP (Table 2.4 and Figure 2.1), and It provides employment for about 40 per cent of the labour force, surpassing the contribution of any other major sector. About 65 per cent of the country's population are largely dependent on agriculture for their livelihood. Within the agricultural sector, the output share of plantation agriculture (tea, rubber and coconut production and related processing activities), the mainstay of the classical export economy of Sri Lanka, has declined sharply, from over 30 per cent in the 1950s to a mere 3.4 per cent in the mid-1990s. In terms of its

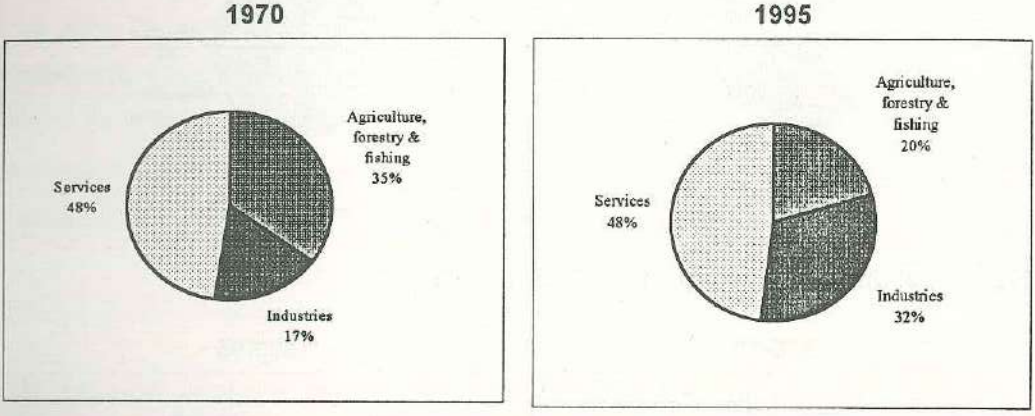
relative contribution to GDP, nonplantation agriculture is now far more important than plantation agriculture.

Table 2.4: Sectoral Composition of GDP (%)

	1950	1960	1970	1980	1995
Agriculture, forestry and fishing	46.6	46.1	35.1	33.7	23.0
Plantation agriculture#	29.8	27.7	15.8	14.0	3.4
Industries	11.2	10.3	17.0	23.6	26.5
Manufacturing	7.2	8.2	9.9	11.6	15.7
Services	42.3	43.6	48.0	42.8	50.5
Total	100	100	100	100	100

Excluding processing of plantation products (tea, rubber and coconut).
Source: Compiled from Central Bank, Annual Report (various issues).

Figure 2.1: Sectoral Composition of GDP, 1970 and 1995



The share of agricultural products in total exports declined from over 94 per cent in the early 1970s to 24 per cent in the mid-1990s (Figure 2.2). The underlying factors included a decline in production in public sector plantations, rapid growth in the absorption of rubber in domestic industry and the expansion of manufacturing exports (especially garments). This decline, which is measured in terms of gross export earnings, however, hides the continued importance of tea and other agricultural products in the balance of payments. As many of the manufacturing exports are based on domestic processing of imported inputs (garments and diamonds in particular), in terms of net foreign exchange earnings, agriculture is much more important than is indicated by the data on the value of exports (Athukorala and Bandara 1990).

Sri Lanka is the leading tea exporting country in the world, accounting for over 20 per cent of the world tea trade. In other agricultural product markets, Sri Lanka is a minor player. Agricultural imports (proxied here by food and drinks plus wheat) accounted for 13 per cent of total commodity imports in 1993-95 (Figure 2.3). The main import items were sugar (3.3 per cent), flour (0.2 per cent) wheat (2.6 per cent) and rice (0.8 per cent).

Figure 2.2: Export Structure, 1970-72 and 1993-95

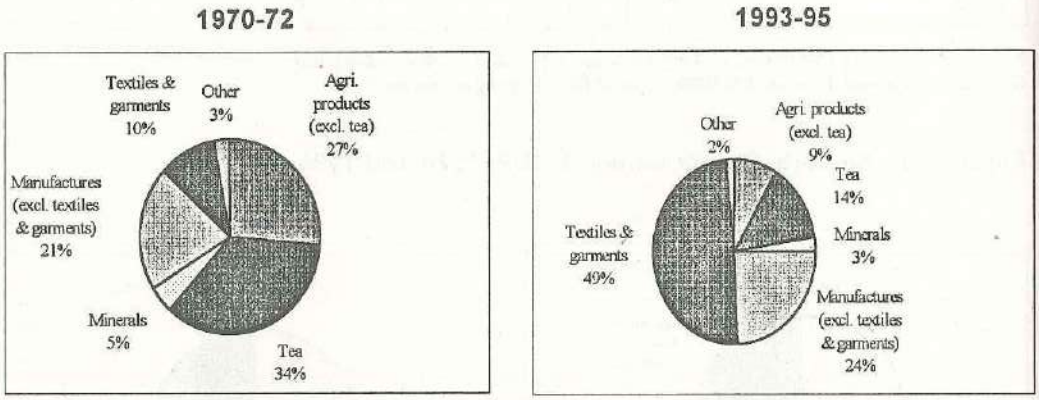
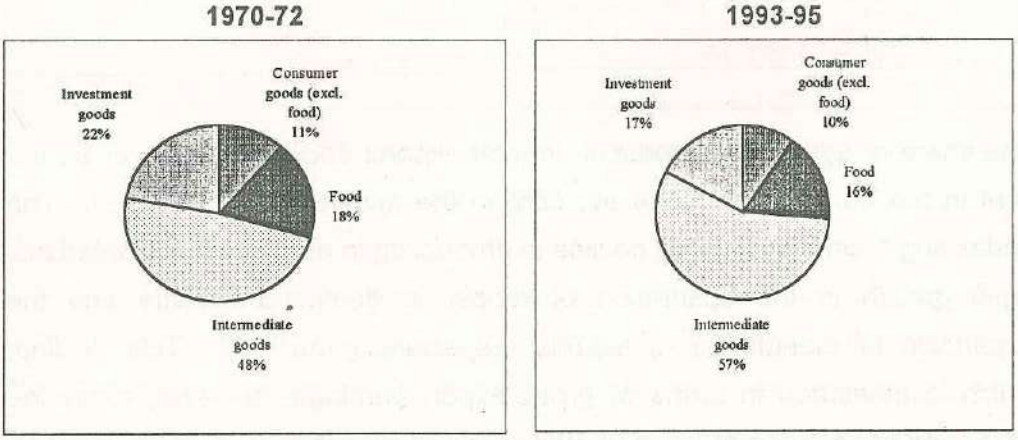


Figure 2.3: Import Structure, 1970-72 and 1993-95



3. TRADE AND INVESTMENT POLICY

This chapter surveys trade and investment policies in Sri Lanka. After identifying the key policy trends over the post-independence period, the chapter examines in detail policy reforms since 1977 focusing on trade policy, exchange rate and exchange controls, and policy towards direct foreign investment and privatisation.

3.1 Policy Trends Since Independence

At independence in 1948, Sri Lanka inherited a market economy heavily geared to international trade, which was not only by far the most prosperous economy in the South Asian region, but also one of the richest in Asia. At that time, by conventional economic indicators, Sri Lanka was well placed for continuing economic achievements and was thus regarded by some as "the best bet in Asia". During the first decade or so after independence, Sri Lanka continued as an open trading economy with only relatively minor trade or exchange restrictions, and liberal domestic policies. In line with this general policy stance, an extremely liberal policy was pursued in connection with the approval of foreign direct investment inflows.

From the late 1950s, a combination of balance of payments difficulties and an ideological and policy shift led to the adoption of a state-led import substitution industrialisation strategy. By the early 1970s this policy shift had transformed the Sri Lankan economy into one of the most highly regulated, inward oriented, *statist* economies outside the centrally planned economies. Significant and ever increasing segments of trade, industry and banking were owned and managed by inefficient state-owned enterprises (SOEs).

The import substitution strategy pursued in the 1960s and 1970s was "successful" in reducing imports of consumer goods substantially, but this was achieved at the expense of increased reliance of domestic industry on imported capital and intermediate goods, and contrary to expectations, resulted in an even more rigid overall dependence on imports and export

stagnation. Thus, unanticipated import curtailments brought about by foreign exchange scarcity, turned out to be the main constraint on industrial expansion from the late 1960s. General dissatisfaction with stagnant economic growth, deterioration in the provision of social services, rising unemployment, shortages of consumer goods and widespread rationing of these goods set the stage for a change in political leadership.

At the general elections of July 1977 the United National Party (UNP) scored an unprecedented and sweeping victory on a platform of opening up the economy and revitalising the private sector. The new government chose export-oriented industrialisation within the framework of a liberalised trade regime as the centre piece of its economic policy and embarked on a reform process aimed at undoing the legacy of import substitution policies and removing the distortions in domestic prices.

The first round of reforms carried out during 1977-79 included significant trade liberalisation, revamping of the foreign investment approval and monitoring process with new incentives for investors, significant interest rate reforms and the opening of the banking sector to foreign banks, exchange rate realignment and limits on public sector participation in the economy. The impact of these policy initiatives on economic growth was impressive, but performance tended to deteriorate in subsequent years, primarily because of a collapse of political stability. From 1983 onwards, Sri Lanka has been subjected to a secessionist war in the Northern and the Eastern provinces, while a radical youth uprising gripped the rest of the country in the late 1980s. Political instability resulted in severe economic dislocation and a sharp escalation of defence expenditure, which in turn, led to widening fiscal deficits, growing macroeconomic problems and erosion of international competitiveness of the tradeable sectors. Apart from continued fiscal expansion triggered by the civil war, the drying up of official capital inflows (with the completion of aid-funded public sector investment projects) also contributed to major macroeconomic imbalances.

By the end of 1989, the Government had crushed the southern rebellion and contained the ethnic conflict mostly within the Northern and Eastern provinces. This was followed by a significant move toward further market-oriented reforms under a structural adjustment package agreed to with the International Monetary Fund and the World Bank. This 'second-wave' of liberalisation included an ambitious privatisation program, further tariff cuts and simplification of the tariff structure, removal of exchange controls on current account transactions, commitment to a policy of flexible exchange rate management, and initiatives to cut the fiscal deficit. The economy rebounded with an average growth rate of over 6 per cent during 1990-94. As the significant reforms of the foreign investment regime coincided with a dramatic move towards relocation of labour intensive production overseas by newly industrialising countries in East Asia, foreign direct investment flows began to make a strong impact on manufactured exports and employment.

After 17 years in government, the UNP lost power at the 1994 general elections to the Peoples' Alliance (PA), a loose coalition of the Sri Lanka Freedom Party (SLFP), which ruled the country during most of the closed-economy era, the (greatly weakened) traditional left parties, and a number of other left-wingers and splinter groups from the UNP. During the election campaign it became clear that an unprecedented consensus had emerged across all mainstream political groups over the superiority of market-oriented polices pursued since 1977 and the need for continuation of pro-market, liberal economic policies to achieve economic development. In this context, the election result was largely determined by the growing disenchantment with the trend towards authoritarian methods of rule and a culture of 'crony capitalism', the continuing civil war, political violence and rampant corruption. The election promises of the PA included the pursuit of a peaceful solution to the civil war, ending corruption, and freeing the bureaucracy from political interference, while continuing with the outward-oriented development strategy with a 'human face'. The inaugural policy statement of the new Government provided assurance that economic policy would in general be market friendly and the private sector would be considered as the principal engine of growth.

However, the optimism that the change of government would be the harbinger of a lasting solution to the violent ethnic conflict quickly dissipated in early 1995 with the collapse of peace talks between the Government and Liberation Tigers of Tamil Elam (LTTE). Since then the Government's strategy has been to weaken the LTTE militarily with a view to forcing them to reach eventually a peaceful solution. While Government forces have scored some victories (including the capture of Jaffna, the former capital of the LTTE stronghold, and Killinochchi, the jungle town to which the LTTE moved their headquarters from Jaffna), there is still no end in sight to the ethnic conflict. The Northern and large parts of the Eastern provinces (which together account for one-third of Sri Lanka's total land area) remain cut off from the national economy. Even in the rest of the country, the prospect of attracting foreign investment, particularly in long term ventures, is seriously hampered by the lingering fear of sporadic attacks by the Tamil secessionists. The economy continues to be burdened by the massive defence expenditure (5% of GDP in 1995) and its consequences for macroeconomic instability. In late 1996, the Government indicated that further tariff reductions would be delayed given the serious fiscal deficit and cost-pressures on domestic industries emanating from the continuing high military expenditures.

With this background we now discuss in detail the key elements of the trade and foreign investment policy in Sri Lanka as they have evolved since 1977.

3.2 Trade Policy

Trade policy reform was the key element of the economic liberalisation policy package introduced in 1977. In November 1977 quantitative import restrictions on imports were supplanted by a revised system of tariffs, retaining only 280 items under license. This far reaching change was accompanied by the removal of most price controls on domestic trade. While many of the tariff changes involved a gazetted increase in the rate, the tariffication obviously involved a dramatic reduction in the degree of protection provided previously by stringent quantitative restrictions (QRs).

There is evidence that, in the process of subsequent fine tuning of tariff rates, a few items whose free importation had a "damaging" impact on state-owned enterprises (SOEs) were returned to the licensing list. There have also been some moderate revenue-oriented across-the-board duty increases in some years. These limitations notwithstanding, trade liberalisation initiatives since 1977 have reinforced the role of tariffs as the central instrument regulating Sri Lanka's merchandise trade. The tariff regime has also become less distortionary during successive rounds of reforms. It currently relies on a three-pronged structure with rates of 10, 20, and 35 per cent. In 1994, the unweighted average, across 6050 tariff items, was in the order of 20 per cent and the ratio of actual duty revenue to imports was even lower (about 11 per cent)[2] (WTO 1995a).

Export duties on all plantation products were removed with effect from December 1992, thus correcting a long standing anomaly in the taxation of traditional exports vis-a-vis non-traditional exports. Since then taxation of exports has been limited to various surcharges and cesses which are applied at moderate rates. The proceeds from these surcharges and cesses are ploughed back into the export sector in the form of selective incentives, replanting subsidies and start-up subsidies for new exporters.[3] Export taxes (duties + cesses + other surcharges) as a ratio of export earnings, which were as high as 25.2 per cent in the early 1980s, declined to 0.05 per cent in 1993 (PCTT, 1994). There are no quantitative restrictions on exports, apart from licensing requirements on a limited number of minor items on grounds of cultural value and health implications.

Estimates of nominal and effective protection to domestic manufacturing and agriculture are reported in Table 3.1. The nominal protection coefficient (NPC) for import competing agricultural crops is 1.33 which suggests that the prices paid by Sri Lankan consumers for these goods are, on average, 33 per cent higher than in the absence of trade protection. The effective protection

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2 The difference between the gazetted rate and the actual rate may be due to the operation of tariff exemptions and waivers and the deterrent effects of high tariffs on trade in the relevant items.

3 For a detailed listing of these charges see WTO, 1995, Table IV 7 (p. 47).

Table 3.1: Nominal and Effective Protection to Manufacturing and Agriculture

ISIC code		NPC (%)	EPC (%)
30	***Manufacturing***	1.43	1.78
31	Food, beverages and tobacco	1.47	1.68
32	Textile, wearing apparel and leather	1.46	1.84
33	Wood products and furniture	1.37	1.52
34	Paper, paper products and printing	1.46	2.06
35	Chemicals, petroleum and coal products	1.42	1.69
36	Non-metallic mineral industries	1.35	1.59
37	Basic metal products	1.41	2.04
38	Fabricated metal products and equipment	1.45	1.95
39	Other manufacturing	1.50	2.15
	Agriculture	1.24	---
	Import-competing agriculture	1.53	1.33
	Export-oriented agriculture	1.02	---

Notes:--- Not available.
ISIC - International Standard Industry Classification.
NRP - Nominal protection coefficient -the ratio of domestic price over border equivalent (world) price.
EPC - Effective protection coefficient - the ratio of value added under existing trade policy intervention to value added at border price.

Source: Estimates for the manufacturing sector are from Ministry of Finance, Report of the Presidential Commission on Tariffs and Trade - 1994 (Table 5.4), Colombo, and those for agriculture are from World Bank (1995)

coefficient for import competing agriculture is 1.53, with rice and other subsidiary food crops showings coefficients of 1.36 and 1.70 respectively. The fact that the magnitude of EPCs for these products differs little from respective NPCs suggests that trade restrictions play a more important role than the various supports on traded inputs (subsidised credit, fertiliser subsidy etc.) in providing incentives to the farmers. The degree of protection enjoyed by export agriculture is well below the levels observed for import competing agriculture. Following the abolition of export duties in 1992, plantation agriculture now operates under virtually free trade conditions.

According to these estimates, protection given to import-competing manufacturing varies from 52 per cent for wood products to 115 per cent for 'other manufacturing' (that is mainly final consumer goods). It is important to note that these estimates (which cover only domestic market oriented firms) exaggerate the degree of protection enjoyed by the manufacturing sector in general and the anti-agricultural bias embodied in the overall incentive structure of the economy. As a result of the industrial adjustment process

brought about by liberalisation reform since 1977, the share of *export-oriented* production in the manufacturing sector has increased significantly, exceeding 60 per cent by the mid 1990s. Apart from some subsidies given to firms located in export processing zones, export oriented production receives little direct government assistance ("trade protection"). On these grounds, the World Bank (1995) estimated a weighted-average EPC for *total* manufacturing of 1.30, assuming an EPC coefficient of 1.00 and 60 per cent output share for export-oriented production. According to this estimate, the manufacturing sector is largely at par with agriculture in terms of the degree of protection enjoyed. Even this estimate may perhaps overstate the current level of manufacturing protection for two reasons. First, in the presence of various tariff exemptions and loopholes in tariff administration, the gazetted rates (on which the PCTT estimates are based) are normally much higher than the actual rates.[4] Second, these estimates predate the significant cuts in tariffs on manufactured goods introduced in the 1995 Budget.

3.3 Exchange Control

Despite significant relaxation of restrictions on commodity imports in 1977, the Sri Lanka rupee was not made fully convertible on services account transactions. As part of the 'second-wave' liberalisation in 1990, foreign exchange restrictions on these transactions were removed in successive stages culminating in the abolition of the foreign exchange surrender requirement on export transactions in March 1993. These policy steps made Sri Lanka eligible for Article VIII status of the International Monetary Fund (IMF). Following the 1993 reforms, the black market premium on foreign currency virtually disappeared and there is now a Singapore-style competitive retail market (with independent foreign exchange dealers competing directly with commercial banks in foreign exchange dealings) for foreign exchange.

[4] In 1994, the weighted average import duty rate was only 20 per cent compared to an unweighted average of over 40 per cent.

The lifting of many restrictions on capital transactions was an important element in the 1977 reform package. Repatriation of proceeds from sales of shares in Sri Lankan companies was permitted without prior approval of the Controller of Exchange and authorised foreign exchange dealers were permitted to approve applications for such remittances. Moreover, foreign investors were allowed by the Controller of Exchange to repatriate their capital contribution in the equity of a company on the sale or liquidation of the investment after settlement of local liabilities like taxes. Transfers of shares were freely permitted if they did not increase the ratio of non-resident shareholdings originally approved. Despite these noteworthy reforms, the rupee is still not fully convertible on capital account transactions; the prohibition on overseas capital transfers by Sri Lankan citizens has remained intact. As in the past, they are not permitted to invest abroad, to maintain accounts with banks abroad, or to raise capital in foreign markets for domestic investment without prior approval. However, it is important to note that the abolition of the foreign exchange surrender requirement on exporters is tantamount to a *de facto* relaxation of these restrictions. Sri Lankans can now remit investible funds overseas through exporters.

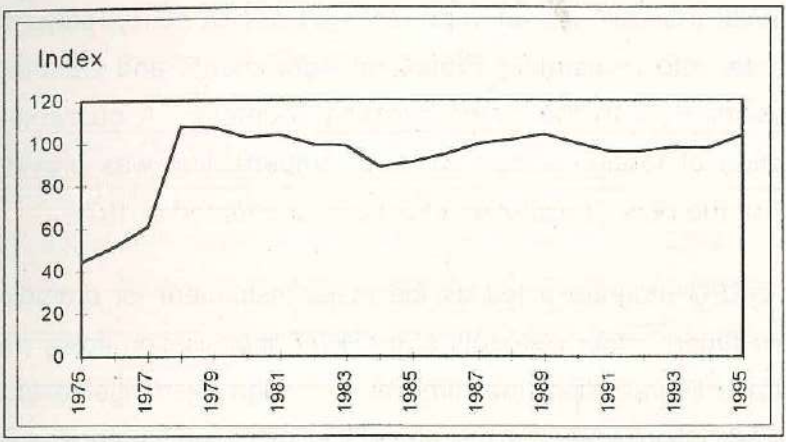
3.4 Exchange Rate Policies

As part of the 1977 policy reforms the dual exchange rate system which was in operation since May 1968, was abandoned, and a unified exchange rate system was established, with an initial par value being fixed at Rs 16 = US$ 1. Following unification, the rupee was allowed to float reflecting demand and supply conditions in the foreign exchange market. Central Bank intervention through the buying and selling of foreign exchange was limited at first, but was intensified in the first half of 1981 and in November 1982 abandoned the daily determination of the exchange rate. Reflecting this policy shift, which was motivated by a desire to contain inflationary pressure, the real exchange rate tended to appreciate subsequently.

Commitment to a flexible exchange rate policy aimed at restoring international competitiveness was a key element of the 1989 reform package. Reflecting the

new policy, the Sri Lankan rupee depreciated *vis a vis* the US dollar, the intervention currency, by 17.4 per cent in 1989 (based on an end-of-year comparison). Following this substantial nominal devaluation, the Central Bank has continued to adjust the exchange rate daily, taking into account developments in the foreign exchange market. Thanks to this active exchange rate management policy, in recent years the degree of nominal depreciation has more than compensated for inflation differentials between Sri Lanka and her trading partner countries to maintain international competitiveness of traded good production in the country as measured by the real exchange rate (Figure 3.1).

Figure 3.1: Real Effective Exchange Rate Index (1990=100)



Note on Methodology:

The real exchange rate index has been constructed by compiling a trade-weighted index of trading partners' nominal exchange rates and then adjusting it with an index of relative prices between trading partner countries and Sri Lanka, compiled using the same trade weights. In this construction, the nominal exchange rate has been defined as 'the domestic currency price of foreign currency'. Thus an increase (decrease) in the index implies real depreciation (appreciation) or improvement (deterioration) in international competitiveness.

Source: Athukorala and Jayasuriya (1996)

3.5 Foreign Investment Policy

The promotion of foreign investment, particularly in export-oriented manufacturing has been a pivotal element of Sri Lanka's market-oriented policy reforms since 1977. The most important aspect of the new foreign investment policy was the establishment of the Greater Colombo Economic Commission (GCEC) in 1978 with wide-ranging powers to establish and

operate Export Processing Zones (EPZs).[5] The first investment promotion zone, at Katunayake near the Colombo International Airport (henceforth KEPZ) was opened in June 1978. The remarkable success of the KEPZ paved the way for a second EPZ in Biyagama (BEPZ) in 1982 and a third in Koggala (KGEPZ) in June 1991. The investment promotion policy package offered to EPZ investors included complete foreign ownership of investment projects, a tax holiday for up to 10 years with complete tax exemption on remuneration of foreign personnel employed, royalties, and dividends of shareholders during that period, duty exemption on import of inputs and assistance with customs clearances; industrial services at subsidised rates and unlimited access to foreign-currency credit at interest rates prevailing in world financial markets. As an important part of FDI policy, steps were also taken to enter into Investment Protection Agreements and Double Taxation Relief Agreements with the major investing countries. A guarantee against nationalisation of foreign assets without compensation was provided under Article 157 of the new Constitution of Sri Lanka adopted in 1978.

While the GCEC program acted as the major instrument for promoting export oriented investment, other elements of the 1977 liberalisation policy package, in particular trade liberalisation, the removal of foreign exchange restrictions and currency depreciation, were also instrumental in improving the general investment climate for export-oriented production in the country. In addition, a wide range of schemes pitched at export promotion was introduced under a newly established Export Development Board (EDB). In 1980, the duty rebate scheme (originally introduced in 1964 and revised in 1969) was completely reformulated with a more flexible implementation procedure to cover almost all non-traditional exports which use imported inputs. The coverage of the duty rebate scheme was expanded in 1982 to include sales to EPZs.[6] A scheme of manufacture-in-bond for exporters importing material for re-exporting as a part of a finished good, a cash grant

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[5] An area of approximately 160 square miles north of Colombo was demarcated for the GCEC. The Foreign Investment Advisory Committee (FIAC), set up in 1966 was to continue to approve and monitor foreign investment (in both export-oriented and import-substitution projects) outside the GCEC area. In 1991 the two institutions were amalgamated to form the Board of Investment (BOI).

[6] This revision was intended to provide a inducement to strengthen 'backward linkages' of EPZ activities.

scheme based on annual export increments, and concessionary credit for exporters were among other EDB incentives. A five-year tax holiday was introduced in the 1978 Budget Speech for export-oriented companies. With regard to these concessions and incentives, non-GCEC (FIAC-approved) joint venture firms were treated equally with locally owned firms.

There was no major change in policy towards foreign ventures which did not meet the criterion of "full" export orientation. Such projects had to go through the normal approval procedure of the FIAC. Majority local ownership continued to be the general rule for approving such projects. However, under the new policy emphasis on export-oriented industrialisation, the FIAC was empowered to adopt more liberal ownership criteria (even up to 100 per cent foreign ownership) depending on the export potential of the project.

As part of the second-wave liberalisation, a new *Investment Policy Statement* announced in 1990 introduced several important changes to the foreign investment policy framework in line with the increased outward orientation of the economy. These included abolition of various restrictions on the ownership structures of joint-venture projects outside EPZs, providing free-trade-zone status to export-oriented foreign ventures in all parts of the country (in addition to the area demarcated by the original GCEC Act), and the amalgamation of the activities of the FIAC and GCEC under a new Board of Investment (BOI) in order to facilitate and speed up investment approval within a unified policy framework applicable to both import-substituting and export-oriented investors.

A detailed listing of incentives currently offered in Sri Lanka to foreign investors is provided in *Appendix* 1.

3.6 Privatisation

The 1977 policy reform package envisaged that "the public sector will concentrate on essential areas that are not attractive to the private entrepreneur either because the investment involved is too large or because

the financial rate of return is not attractive" (*Budget Speech*, 1978). Privatisation or closure of uneconomic and inefficient SOEs was thus a key element of the declared policy. This policy however, lost much of its rigour in the process of implementation. Contrary to declared policy, a number of SOEs were accorded preferential treatment including higher tariff protection.

The reluctance to privatise state enterprises was certainly not due to any ideological opposition to privatisation, nor was it due to any fear of the political and industrial resistance from state sector trade unions. The primary reason was that state enterprises provided an effective and ready made vehicle for dispensing political patronage (Jayasuriya and Knight 1997). In particular, they could be used to provide employment to those whom the government wanted to reward. This was a factor of paramount political importance given the government's election promises to its supporters, particularly to the youth. On the other hand there was no revenue-based inducement for privatisation as the budgetary position was amply strengthened by massive concessionary aid flows in the aftermath of the reforms. In the early years of the new government, Sri Lanka was the recipient of a massive aid flow - the highest level of aid on a per capita basis in the world at the time - as international donor agencies and Western governments flocked to provide financial assistance to the pro-Western and pro-market government. Released from the pressures of fiscal stringency, the government was able to pursue its policy of expanding employment in state enterprises, while ignoring the heavy economic costs of such a policy. The role of state enterprises in the economy was little affected by a decade of liberalisation. By the late 1980s, they still accounted for some 40 per cent of value added even in the manufacturing sector.

Under the second-wave of liberalisation in 1990, privatisation was given a central role in an effort to redress the massive macroeconomic imbalance in the economy by reducing the fiscal deficit (Kelegama 1995). The new privatisation strategy calls for majority shareholdings in given SOEs to be divested through the stock market or through open tender to a corporate

investor. To make privatisation politically acceptable, 10 per cent of shares are given free of charge to the employees. Between 1989 and 1995, over sixty public enterprises were divested or sold (Central Bank, 1995b). In the public transport sector, all bus depots, except those in the Northern Province and some parts of the Eastern Province were fully privatised. The sale of the Colombo Gas Company (the government owned gas and lubricant oil monopoly) in 1995 to the oil giant Shell, was a landmark decision in public enterprise policy in Sri Lanka. It marked the first entry of an oil company into Sri Lanka after the controversial seizure of the operations of British and American oil companies (including Shell) by the Sri Lankan government in 1962.[7]

In March 1995, the process of public enterprise reform was brought under the purview of a newly created Public Enterprise Reform Commission (PERC). The 1995 Budget contained a proposal for restructuring the management of state-owned plantations under long-term (50 year lease) management contracts which assure a financial stake for private sector management companies. This initiative recognised that privatisation in some form is the best way of revitalising the tree crop plantations. Under the management contract system, introduced by the previous government in 1992, there was some improvement in agronomic practices and management in the plantation sector. However, the management contracts, due to the short time period involved, failed to provide appropriate incentives for private companies to invest their own resources in rehabilitating the estates. The new scheme aimed to redress this limitation.

[7] By nationalising oil trade in 1962, Sri Lanka became the first (and so far the only) country against which the Hickenlooper Amendment, requiring the suspension of American aid to any country expropriating American property without compensation, has ever been formally applied. This nationalisation also had adverse repercussions on aid flows to Sri Lanka from other Western countries as well as from international organisation, in particular the World Bank (Olson 1977).

4. TRENDS AND PATTERNS OF FOREIGN DIRECT INVESTMENT

This chapter examines trends and patterns of foreign direct investment (FDI) in Sri Lanka since 1977 with emphasis on the relative importance of Australia as a source country of FDI. Other key themes considered include the compatibility of the emerging trends of FDI with Sri Lanka's comparative advantage in international production, and the role of FDI in export diversification and employment expansion during the post reform period.

4.1 Trends

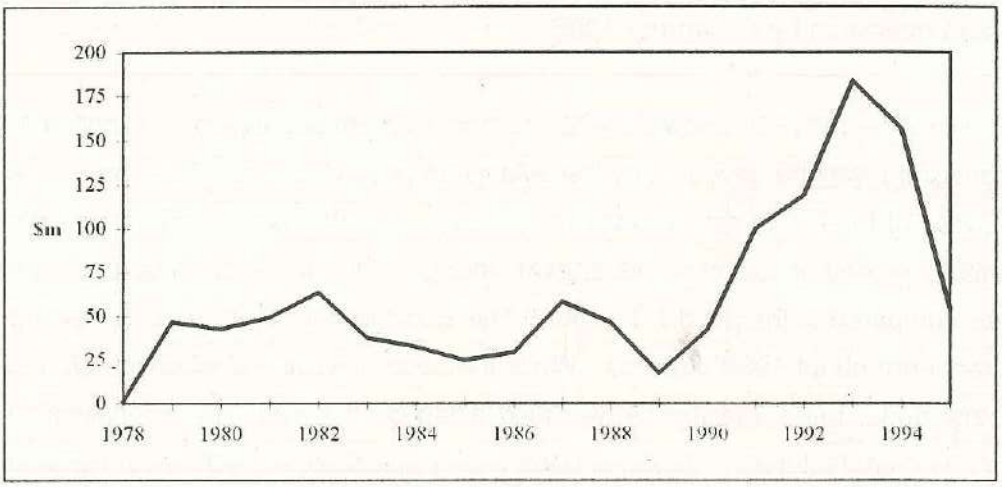
Like many other developing countries (DCs), Sri Lanka does not maintain systematic records of foreign direct investment (FDI) stocks and flows. The only data available for the analysis of overall trends in FDI are outflow and inflow data compiled as part of the Central Bank's balance of payments recording system and records of investment approvals maintained by the foreign investment approval agencies (FIAC and GCEC up to 1992 and BOI since then).[8]

According to balance of payments data, the response of foreign investors to the 1977 policy reform was swift and remarkable (Figure 4.1). Total annual net capital inflow increased from US$ 0.2 million in 1970-77 to US$ 41 million in 1978-1983, recorded a modest decline (to US$35 million) during the turbulent years of 1984-1989, and then increased to US$120 million during 1990-94. The relative contribution of FDI to private sector fixed capital formation in the country increased from a mere 0.1 per cent during 1970-77 to over 7 per cent during 1978-1995 (10 per cent when six years between 1984-89 are excluded). There has been a marked decline in FDI flows, both in

[8] There are two alternative series of declared investment in BOI (formerly GCEC) projects: investment in "approved projects" and that in "projects for which contracts were signed". While both are rough proxies to actual investment, the latter is the more appropriate. According to the recording procedure of this agency, the declaration of intention to invest is normally adequate for a firm to be entered in the list of approved projects. The FIAC published (for the period 1977-1991) a single series under the label "approved projects". According to the procedure followed by FIAC "approval" involved "signing of the contract".

absolute terms and in relation to fixed capital formation and total net capital inflows following the change in political leadership in 1994.

Figure 4.1: Net Foreign Direct Investment Flows ($m)



Source: Based on data compiled from Central Bank, Annual Report (various issues)

In an international comparison, Sri Lanka's performance record in attracting FDI appears impressive (UNCTC 1995). The share of global FDI going to DCs declined from about 25 per cent in the early 1980s to about 17 per cent in the early 1990s, and many developing countries, particularly those belonging to the IMF country grouping of "low income countries" (which includes Sri Lanka) experienced a decline even in absolute terms. In the late 1980s, FDI accounted for well under 1 per cent of gross domestic investment in all but seven low income countries.

During 1967-77, a total of 82 foreign firms were set up in Sri Lanka's manufacturing sector. Of these, only 13 were export-oriented ventures (garments 9; gem cutting 2; ceramic-ware 1; wall-tiles 1) (Athukorala 1995). By contrast, during 1978-95, the BOI (formerly GCEC) signed contracts under the Section 17 of the BOI Law (Special Incentive Scheme for export-oriented firms) to set up 1136 firms of which 835 had foreign capital participation. Of these contracted 'foreign projects', 368 were in commercial operation, 104 under construction and 20 awaiting production by the end of 1995

(Henceforth, these firms are referred to as "Special Incentive Scheme" firms, or SIS firms.) Projects approved by the FIAC (and BOI since late 1993) under the Inland Revenue and Tax Related Laws (General Incentive Scheme) ("GIS firms") during this period numbered 670. Over 350 of these projects were in operation by the end of 1995.

The overall trend in FDI inflow as reflected in investment approval data (Table 4.1) is consistent with that revealed by the balance of payments data. The impressive response of foreign investors to the market oriented reforms from the late 1970s gradually waned in the mid-1980s, even though FDI inflows continued at high levels compared to the pre-1977 period. This was followed by a surge in investor interest from about 1989 onwards. While the second-wave liberalisation reforms set the stage, the surge in FDI was also aided by the new internationalisation move by manufacturers in Japan and the Newly Industrialised Countries (NIEs) in East Asia (in particular Korea) in response to massive exchange rate appreciations and domestic wage increases (NRI & ISEAS, 1995).

Data for the past three years point to a disturbing trend. The total number of projects (excluding 200 garment factories) contracted by BOI declined from 327 in 1993 to 270 in 1994. In 1995 only 139 projects were contracted. It is important to note that the aggregate figures reported here for recent years give a misleading picture of the country's success or failure in attracting *foreign* investment. This is because, after the liberalisation of investment approval procedure in November 1993, fully locally-owned firms were also eligible for approval by the BOI provided they met the stipulated export performance criterion. While data on fully local contracted-projects are not available on an annual basis, there is clear evidence that, in the past three years, the movements in official aggregate figures on *total* contracted projects have been dominated by such projects. For instance, of 220 projects under construction by the end of 1995, 116 were fully local ones (BOI 1995). Also, the foreign component of total estimated investment in contracted projects had declined dramatically, from over 77 per cent during 1989-92 to less that 45 per cent during 1993-95. A comparison of the Sri Lanka experience with that of other FDI receiving countries in Asia (such as Malaysia, Thailand,

Indonesia, Vietnam, and even India) suggests that this significant decline in FDI in Sri Lanka is predominantly an isolated 'home-grown' phenomenon, and not part of a regional pattern. In these other countries, FDI flows have continued to expand since 1992, following a mild decline in 1991 (NRI & ISEAS 1995, Athukorala and Menon 1995, UNCTAD 1995).

Table 4. 1. Sri Lanka: Envisaged Investment in Contracted Projects, 1977-1992

	SIS Projects[#]			GIS Projects[##]		
	Number	Investment (Rs. mn)	Foreign Share (%)	Number	Investment (Rs. mn)	Foreign share (%)
1977	–	–	–	11	66	19.7
1978	30	377	55.1	15	85	62.3
1979	13	626	83.8	65	1461	54.8
1980	25	1266	74.5	75	4328	70.3
1981	9	493	63.2	82	5777	60.5
1982	12	2296	86.0	70	1740	56.7
1983	10	1312	72.3	92	7317	72.1
1984	13	597	63.5	67	1738	35.8
1985	7	200	67.5	48	650	42.1
1986	7	142	64.1	87	1192	34.0
1987	12	463	76.7	68	1277	30.0
1988	26	1478	62.4	82	1911	27.5
1989	14	1753	75.0	57	1502	42.7
1990	16	1080	80.2	74	1541	27.4
1991	52	3402	88.6	107	2152	40.3
1992	154	25246	63.7	82	1722	48.2
1993	327	24143	37.6	89	1724	63.8
1994	270	43215	53.4	26	7403	59.4
1995	139	13917	43.6	62	32000	46.8

Projects approved under Section 17 (Special Incentive Scheme) of the BOI (formerly GCEC) Law.
Projects approved under the general Internal revenue and Tax Related Laws (General Incentive Scheme).
.. Not available.

Sources: SIS data: Central Bank, Bulletin, January, 1993, Table 73 (data supplied by the GCEC), GIS data: Ministry of Finance and Planning, Public Investment (various issues) and Sri Lanka Industrial Statistics- 1993 , supplemented with BOI records.

4.2 Sectoral Composition of FDI Projects

Data on the industry profile of FDI projects approved under general incentive provisions (GIS firms) and special (export-oriented) incentive provisions (SIS firms) are reported in Tables 4.2 and 4.3 respectively. The GIS data relate to total approved projects and therefore exaggerate the actual volume of

investment.[9] SIS data are relatively more accurate as they relate to projects in commercial operation. This difference notwithstanding, the data are useful for understanding the industry profile of FDI, and in particular, differences in the sectoral distribution of import-substitution and export-oriented foreign investment in Sri Lanka. The GIS list does contain some export-oriented firms,[10] but in the main, the projects included therein are predominantly domestic market oriented, whereas the SIS list contains only export-oriented manufacturing firms and firms involved in the provision of export-related services.

Of the 582 approved between 1978-93 under the general incentive provisions, 345 (60 per cent) are in manufacturing and the rest are in construction and services sectors (Table 4.2). The relative importance of manufacturing firms is greater in the SIS list: of 354 firms in commercial operation at the end of 1995, 290 were in manufacturing, 54 in construction and services sectors and 10 firms in export-oriented agriculture (ornamental plants and cut-flower). There is a clear difference between the two types of firms in terms of industry composition. GIS firms are largely concentrated in import-substitution production in food processing, chemical, pharmaceutical, and machinery and transport equipment sectors (Table 4.2). The investment decisions of these firms appeared to have been based on factors such as import tariffs, and the need to modify production to suit consumption patterns and purchasing power of local consumers than by the comparative advantage of Sri Lanka in export production. By contrast the industry profile of SIS firms is consistent with international market opportunities available for a late starter in the sphere of export-led industrialisation (Table 4.3). These latter firms fall into three broad categories; (1) 'resource-based' manufacturing activities which involve further processing of materials previously exported in raw state (food products, beverages and tobacco, rubber products and coir products), (2) standard (light) consumer goods (textiles and garments, toys, shoes, and sporting goods), and (3) component

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[9] According to BOI officials, the actual implementation rate of projects for which contracts are signed is about 60-70 per cent.

[10] According to a survey conducted in the late 1980s, about 35 per cent of GIS firms exported some of their output, but only about 10 per cent of them were 'export-oriented' (i.e. exported more than 50 per cent of their output (FIAC 1988).

production and assembly within vertically integrated world production systems (fabricated metal products, electronics and electrical goods and transport equipment). Production operations in the latter two categories generally involve the use of domestic labour with imported inputs.

Table 4.2: Industry Profile of Foreign Direct Investment: Projects Approved Under the General Incentive Scheme, 1978-1993*

	No. of projects	Planned investment US$mn.	FDI share in planned investment (%)
Manufacturing	345	258.1	51.7
Textile, garments and leather products	72	30.6	33.6
Food, beverages and tobacco	56	121.7	68.4
Wood, paper products, printing and publishing	29	5.7	39.8
Chemical, rubber and plastic products	64	17.5	40.1
Non-metallic mineral products	25	25.3	43.0
Metal products, machinery and transport equipment	58	35.1	41.0
Other manufacturing	61	22.2	24.4
Construction and services	237	176.0	64.5
Total	582	692.2	55.0

* Total number of projects approved during 1978-93.
Source: Ministry of Finance and Planning (1995), Sri Lanka Industrial Statistics- 1993, Colombo.

Most firms in the resource-based product category are involved in activities making extensive use of the major primary agricultural products exported from Sri Lanka (tea, rubber and coconut fibre). An added reason for the location decision of gem cutting and polishing firms has been the restriction imposed by the government on the export of uncut/unpolished gem stones. Until 1991, export duties levied on tea, rubber and coir fibre artificially lowered their domestic user-price for any manufacturing activity using them as raw materials. This also acted as an added incentive for the entry of foreign firms into such product areas.

In the area of standardised consumer goods (category 2), the garment industry has continued to be the major area of attraction to foreign investors. However, since late 1980s there has been a noticeable increase in the number of foreign firms entering into other labour intensive product areas such as leather goods, footwear, toys, plastic products and diamond cutting

Table 4.3: Industry Profile of Foreign Direct Investment: Projects Approved Under the Special Incentive (BOI) Scheme, 1978-1995*

	No. of firms	Total Planned investment US$ mn.	FDI share in total planned investment (%)	Top three source countries**
Horticulture	10	6.0	1.2	Netherlands (4,63.7), Japan (3,26.6), Norway (1,5.8)
Manufacturing	303	464.9	95.0	Korea(73,27.5), Japan (41,13.9), Australia (14, 13.3)
Food Products	15	10.8	2.2	Japan (3,29.1), Belgium (2,23.5), Seychelles (1,22.5)
Beverages & Tobacco	3	2.5	0.5	BV Island (1,60.6),N'lands(1, 30.4),Belgium (1, 9.6)
Textiles	18	91.7	18.8	Korea(6,38.2), Hong Kong(1,25.8), Indonesia(1, 13.9)
Wearing apparel	63	67.5	13.8	Hong Kong (23,43.3), Japan (3,11.5), Korea (8, 9.9)
Leather goods	7	4.3	0.9	Hong Kong (1,17.2), Korea (3,70.2), Canada (1,5.6)
Footwear	6	5.2	1.1	Korea (2,54.0), Italy (2,17.2), Malta (1,23.3)
Wood Products	10	2.4	0.5	Sweden (2,21.9), Korea (2,19.0), Switzerland (1,16.4)
Paper & Paper Products	3	3.6	0.7	Netherlands (1,63.2), Korea(1,19.1), Italy (1,17.7)
Printing	2	2.6	0.5	UK (1, 79.9), Hong Kong (1, 20.1)
Rubber Products	16	51.6	10.6	Germany (2, 35.5), Australia (1, 30.7), Korea (8,16.3)
PVC Products	22	18.2	3.7	Korea (10,48.3), Taiwan (2,22.4), Belgium (2,11.9)
Plastic products	6	3.6	0.7	Hong Kong (2, 70.3), Korea (2,12.2), Singapore (1,7.1)
Non-metallic mineral products	10	13.6	2.8	Austria (1, 25.3), Canada (1, 25.3), Korea (3,12.2)
Fabricated Metal Products	10	29.8	6.1	Australia (2,61.2), Japan (2,18.8), Denmark (1,16.5)
Electronics and electrical goods	19	40.6	8.3	Korea (5,73.9), Sweden (4,8.0), Japan (4,7.5)
Transport equipment	3	1.9	0.4	Japan (1, 90.1), Germany (1, 9.9)
Toys (except wooden toys)	9	7.5	1.5	Korea (8, 95.5), Japan (1, 4.5)
Coir Products	8	4.1	0.8	UK (3, 51.8), Australia (1,20.8), Belgium (2,11.9)
Jewellery & Lapidary	24	19.7	4.0	Belgium (4,34.2), Japan (6, 26.1), Pakistan(1, 19.4)
Fishing Gear & Accessories	3	0.5	0.1	Taiwan (1,45.0), Singapore (1,43.1), Norway (1,12.0)
Other manufactures	14	10.8	2.2	Korea (5, 50.6), Germany (3,15.8), UK (1,9.7)
Services	56	96.4	19.7	Germany (4, 22.9), Japan (6,30.4), USA (5,6.6)
Total		489.1	100.0	

Notes: * Projects in commercial operation as at 31 December 1995.

** Countries are ranked by the share in total investment in each product category. First figure in brackets is the number of firms and the second figure is the share in total investment.

Source: Compiled using official records of BOI.

and jewellery. At the early stage, the dominant factor behind the surge of FDI in the garment industry was the quota restrictions imposed by developed countries on garment imports from "traditional" DC producers in East Asia under the Multi Fibre Arrangement (MFA). This is clearly evident in the predominance of firms from Hong Kong (the major developing-country exporter of garments) in Sri Lanka's export-oriented garment industry. By about 1983, garment exports from Sri Lanka had come under stringent quota restrictions. Since then most of the new ventures in the garment industry have been involved in the production of items which are not subject to MFA quotas. These investors as well those in other product areas have come to Sri Lanka because of its attraction as a relatively low-cost export base in terms of both the availability of cheap and trainable labour and the attractiveness of investment incentives.

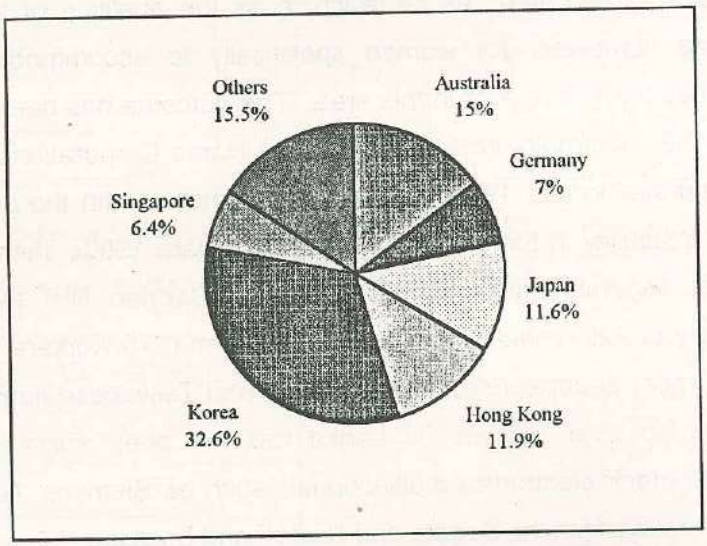
Sri Lanka's overseas investment promotion campaign has placed heavy emphasis on courting assembly production in high-tech industries. The government has even taken steps as far-reaching as the abolition of the ILO convention banning night-work for women specifically to accommodate the requirements of prospective investors in this area. The outcome has been rather mixed. Two major US electronic firms (Motorola and Harris Corporations) who obtained GCEC approval in late 1979, subsequently withdrew with the onset of political and policy instability in the early 1980s. Until the late 1980s, there were only two electronic assembly firms in the KEPZ- a German firm (with an employment capacity of 225 workers) and a Japanese firm (275 workers). Since the late 1980s a number of Japanese, Korean, Swiss and Taiwanese firms have been established. However, as yet Sri Lanka has not been successful in attracting any of the major electronics multinationals such as Siemens, National Semiconductors, Motorola, Hitachi, Segate and Nixdorf and Ericsson.

4.3 Source-country Composition of FDI

Data relating to the source-country composition of foreign direct investment in Sri Lanka show that slightly more than a half (191 out of 368) of firms set up during 1978-95 have developed-country parentage (Table 4.4, Figure 4.2).

However, in terms of the relative contribution to the value of both total foreign investment (58 per cent) and total investment in firms with foreign capital participation (53 per cent), developing-country investors are relatively more important. Korea is by far the largest investor, with capital participation in 73 firms, and accounting for 33 per cent of total foreign investment and 27 per cent of total investment. The Korean dominance in FDI in Sri Lanka is a relatively new phenomenon. Until the mid-1985s, there were only three Korean manufacturing firms operating in Sri Lanka. The number increased significantly following Korea's removal of restrictions on outward investment in 1984 which coincided with the rapid appreciation of the won and increases in domestic manufacturing wages in Korea (Menon and Athukorala 1995). Until the early 1990s Hong Kong was the largest source country, reflecting the early influx of 'quota-hopping' Hong Kong firms into the garment industry.

Figure 4.2: Source Country Composition of Foreign Direct Investment, 1978-95



Source: Compiled using unpublished data provided by the Board of Investment.

In terms of relative contribution to total foreign investment (15 per cent), Australia is the second largest investor among all source countries and the largest among developed countries. When the relative share in total investment is used as the ranking criterion, Australia (13 per cent) ranks third

after Korea (28 per cent) and Japan (14 per cent). Australia's relatively high ranking as a source country is due to a single large project (Ansell Lanka) which accounts for over 80 per cent of total Australian investment in the country. Ranked in terms of the number of projects, Australia is sixth among developed countries and eighth among all source countries.

Table 4.4: Source-country Profile of Foreign Direct Investment in Sri Lanka, 1978-1995*

Country/country group	Number of Projects	Foreign investment US$mn	%	Total Investment US$mn.	%	Foreign/ total %
Developed Countries	191(85)	179.81	42.15	255.47	47.25	70.38
Australia	14 (7)	63.84	14.97	71.65	13.25	89.09
Austria	1 (1)	0.07	0.02	0.07	0.01	100
Belgium-Luxemburg	16 (7)	6.03	1.41	11.34	2.10	53.17
Canada	2 (1)	0.11	0.03	3.13	0.58	3.51
Denmark	1 (1)	0.24	0.06	0.24	0.04	100
Germany	30 (15)	29.79	6.98	39.37	7.28	75.67
France	4 (1)	0.13	0.03	0.25	0.05	52.00
Italy	6 (3)	1.35	0.32	1.66	0.31	81.33
Japan	41 (17)	49.59	11.62	75.19	13.91	65.95
Netherlands	14 (8)	3.50	0.82	9.32	1.72	37.55
Norway	3 (1)	2.14	0.50	2.24	0.41	95.53
Russia	2 (0)	0.26	0.06	0.54	0.10	48.15
Sweden	10 (5)	9.12	2.14	17.40	3.22	52.41
Switzerland	6 (2)	2.96	0.69	3.45	0.63	85.80
UK	20 (7)	5.85	1.37	6.83	1.26	85.65
USA	21 (9)	4.83	1.13	12.78	2.36	37.79
Developing Countries	177 (102)	246.79	57.85	285.17	52.75	86.54
China	6 (3)	2.21	0.52	2.48	0.46	57.34
Hong Kong	47 (20)	50.84	11.92	66.44	12.29	76.52
India	10 (1)	5.21	1.22	5.55	1.03	93.87
Indonesia	2 (1)	11.14	2.61	11.14	2.06	100
Korea	73 (57)	139.32	32.66	148.69	27.50	93.70
Malaysia	3 (1)	0.90	0.21	1.46	0.27	61.44
Maldives	1 (1)	0.16	0.04	0.16	0.03	100
Malta	1 (0)	1.66	0.39	2.12	0.39	78.30
Pakistan	8 (3)	3.62	0.85	4.30	0.80	84.19
Singapore	13 (9)	27.33	6.41	37.42	6.92	73.03
Taiwan	6 (4)	2.65	0.62	2.65	0.49	100
Other**	7 (2)	1.79	0.42	2.76	0.51	64.85
Total	368 (187)	426.60	100	540.64	100	78.91

Notes: * Projects approved by BOI (formerly GCEC) (under Section 17 (special provisions) of the BOI Law) which were in commercial operation as at 31 December 1995.

** B.V. Island, Burmuda, UAE, Yugoslavia, Dubai, Bahamas and Seychelles.

Source: Compiled using unpublished data provided by the Board of Investment.

4.4 Ownership Structure

As noted in Chapter 3, 100 per cent foreign ownership was an added privilege offered to export-oriented investors under BOI law. However, partnership, rather than full foreign ownership, is the general pattern across firms in operation (Table 4.3). Of 368 foreign firms in operation at the end of 1995, only 187 were fully owned by foreign investors. There is no noteworthy difference between developed- and developing-country investors in terms of their preference for majority ownership *vis-a-vis* joint venture operation. However, at a disaggregated level, joint-ventures are common only in low technology, light manufactured good industries, and in most of these cases the foreign partners are from other developing countries. Firms involved in component assembly industries, both from developed and developing countries, are generally wholly-owned subsidiaries.

4.5 FDI and Manufactured Exports

The export structure of Sri Lanka, as it evolved during the colonial era, was characterised by an extremely heavy reliance on a limited range of primary commodities. By the time of the 1977 policy reforms, the share of manufactures (excluding petroleum products) in total merchandise exports was only 4 per cent (Table 4.5). Since then, manufactured exports have emerged as the most dynamic element in the export structure. Exports of manufactures grew (in current US$ terms) at an annual compound rate of 32 per cent during 1978-95, and by the mid-1990s their share in total merchandise exports was over 70 per cent. During 1980-92, Sri Lanka was among the top 5 low-income countries in terms of both average annual growth in earnings from manufactured exports and the growth in manufacturing share in total merchandise exports.

Table 4.5: Foreign Firms' Contributions to Manufactured Export Expansion, 1976-1995.

(Three-year averages)

	Manufactured exports		Foreign firms' contribution to manufactured exports	
	US$ Millions	Share in total merchandise exports (%)	All foreign firms# (%)	BOI firms (%)
1975-77	24.8	4.0	23.2	n.a.
1978-80	102.7	10.4	30.2	n.a.
1981-83	234.9	22.1	43.7	30.6
1984-86	421.2	31.9	47.4	35.5
1987-89	653.5	44.2	58.2	43.5
1990-92	1083.1	56.6	65.8	47.6
1993	1949.5	70.1	66.3	49.1
1994	2256.2	72.3	81.2	76.8
1995	2641.0	73.2	82.3	79.1

Notes: # Combined export share of GCEC and Non-GCEC foreign firms.
n.a. Not applicable.

Source: Athukorala (1995) (updated to 1995 using the same data sources).

FDI has undoubtedly been the engine of manufactured export growth over the past two decades (Table 4.6). There is a close correlation between the growth of manufactured exports and the share of foreign firms in these exports. The share of foreign firms in total exports of manufactures increased from 24 per cent in 1977 to over 80 per cent in the mid-1990s. The contribution of foreign firms to the total increment in manufactured exports increased from 46 per cent between 1978 and 1985 to 85 per cent between 1985 and 1995.

4.6 FDI and Employment

The emphasis on export oriented FDI (EOFDI) in Sri Lanka, as in other developing countries, is usually related to the expectation of significant benefits in employment generation and increasing foreign exchange earnings. Of these two objectives, employment generation has been by far the most important under the "employment first, employment second and employment third" motto of development policy since 1977 (Jayawardene 1978).

Table 4.6: Employment in Projects Approved Under the Special Incentive Scheme, 1978- 1995

	Number of units in commercial operation	Actual local employment as at end of year
1978	-	261
1979	13	5876
1980	25	10538
1981	42	19727
1982	52	24926
1983	67	28705
1984	81	32725
1985	77	35786
1986	91	45047
1987	96	50743
1988	101	54626
1989	118	61429
1990	127	71358
1991	153	85457
1992	211	104220
1993	305	122165
1994	442	205660
1995	533	223367

Source: Central Bank, Bulletin, March 1996, Table 74 (based on BOI data).

There has been a remarkable increase in the number of employment opportunities generated by FDI projects. Local employment (ie total employment net of expatriates) in BOI firms recorded a ten-fold increase, from 10,538 to 223,367, between 1980 and in 1995 (Table 4.6). Over 95 per cent of these employment opportunities are in the manufacturing sector and the contribution of foreign firms is about 87 per cent. There are no time series data on employment in non-BOI foreign firms. According to periodic sample surveys conducted by the FIAC, total employment in non-BOI projects approved after 1977 increased from about 2,500 in 1978 to about 50,000 by 1988. Roughly 50 per cent of these employment opportunities are in export-oriented manufacturing, with the balance from import-substituting manufacturing (25 per cent), tourism and other services (12 per cent), and agriculture and animal husbandry. The share of export-oriented foreign firms in total employment in the organised manufacturing sector of the country increased from 10 per cent in the early 1980s to over 50 per cent by the early 1990s. Table 4.7 provides data on occupational and sex composition of employment in SIS firms. The majority of jobs offered are of the assembly

type which require no major skills. The predominance of females in the work force, a universal feature of employment in EPZs across the world (ILO/UNCTC 1988), is also clearly brought out by this data. Female workers are clustered in lower skilled (hence lower paid) jobs than men.

Table 4.7: Employment Profile of Foreign Firms[#] (as at end of September 1991)

Employment category		Total employment	Female share (%)
1.	Local employment	81412	78.2
1.1	Manual labour	71570	82.9
	Trainees	17720	89.9
	Unskilled	13104	72.5
	Semiskilled	30557	92.2
	Skilled	10189	56.3
1.2	Supervisory staff	2927	57.4
1.3	Technical staff	1119	20.1
1.4	Administrative staff	747	24.5
1.5	Clerical staff	3331	57.5
1.6	Other	1724	17.8
2.	Expatriate staff	550	20.7
2.1	Technical staff	416	21.9
2.2	Administrative staff	134	17.2

Note: # Includes employment in projects located in KEPZ, BEPZ, LGEPZ and firms outside the three EPZs which were approved with concessions under Section 7 of the GCEC Law.

Source: Athukorala (1995) (compiled from BOI records).

5. AUSTRALIAN FIRMS IN SRI LANKA: PROFILES, PERFORMANCE AND PERCEPTIONS

The previous chapter showed that Australia has been an important source country of FDI for Sri Lanka. In terms of the relative contribution to total foreign investment in FDI projects in commercial operations by the end of 1995, Australia, with a relative share of 15 per cent, was the second largest investor among all source countries and the largest among developed countries. In terms of the relative share in total investment (ie foreign investment + contribution by local partners), Australia (13 per cent) ranked third after Korea (28 per cent) and Japan (14 per cent). In a ranking based on the number of projects, Australia was the sixth largest investor among developed countries and the eight largest among all source countries.

This chapter examines in detail operations of Australian firms in Sri Lanka with emphasis on their perceptions of Sri Lanka as an investment location, plans for future expansion and perceived constraints to business. The analysis uses data from two main sources: unpublished firm-level records maintained by the Board of Investment of Sri Lanka and a questionnaire-based survey of Australian firms. The survey was conducted in September 1995-January 1996 and was followed up by a series of interviews with respondent firms. The questionnaire used in the survey is reproduced in Appendix B.

5.1 A Profile of Australian Firms

The entry of Australian firms into the Sri Lankan economy through direct investment is a comparatively recent phenomenon. The first recorded case of Australian investment in the country was a rubber band manufacturing firm (Plymouth Rubber Enterprises (Ceylon) Ltd.) set up with GCEC approval in 1980. This fully export-oriented venture had an 80 per cent capital participation of an entrepreneur from Western Australia. It was closed down in

1981 because of management problems following the sudden death of the Sri Lankan partner.[11]

During 1979-95, a total of 60 projects with Australian capital participation were approved by the investment approval bodies in Sri Lanka. Of these 27 were approved under the special incentive scheme (SIS firms) and 33 under the general incentive scheme (GIS firms). Of these, 18 firms (all in the GIS category) were not implemented (Table 5.1). Of the remaining 42 ventures, 23 were in commercial operation and the balance (19) were at various stages of implementation at the time of the survey (January 1996).

The investment approval authorities in Sri Lanka do not maintain follow-up records on unsuccessful project proposals. It is therefore difficult to undertake a systematic analysis of underlying causes of failures. BOI officials put the overall success rate of project applications at about 50 per cent. In terms of this criterion, the dropout rate for Australian investors at 18 out of 60 project proposals (30 per cent), seems below average. Interviews with Australian firms in operation and BOI officials involved in project approval suggested that most of these failures were due to a lack of prior understanding of local conditions such as power supply and infrastructure bottlenecks. High cost of domestic supplementary capital, and frustration caused by unexpected delays in the evaluation/approval process were other factors. Those with prior business experience in the developing world, and in particular, with a prior understanding of the Sri Lankan investment climate and institutional environment, have generally succeeded. Interestingly, the bulk of projects which failed after the preliminary approval stage were small scale with capital participation from individual investors.

Information from BOI records on key operational characteristics of firms in operation and under implementation are summarised in Table 5.2. To preserve confidentiality of information, individual firms are identified in terms

[11] According to BOI records Plymouth Rubber Enterprises operated as a highly successful exporting firm for nearly two years. At the time of closure the total employment of the firm was over 300 hundred.

Table 5.1: Cancelled/Aborted Australian Projects in Sri Lanka

	Year of approval	Product line	Market orientation[1]	Approval status[2]	Nature of ownership[3]	Planned investment		Planned employment
						Rs. mn	Aust. share (%)	
1	1989	leather accessories	EX	GIS	JOW	1.4	34.1	18
2	1982	growing/canning passion fruit	EX	GIS	FAW	3.3	33.3	13
3	1987	yeast	DM	GIS	FAW	106.9	19.6	37
4	1989	lapidary	EX	GIS	JOW	1.3	7.4	20
5	1990	computer software	EX	GIS	JOW	1.24	60.0	91
6	1979	construction	DM	GIS	JOW	26.4	97.1	30
7	1980	building construction	DM	GIS	JOW	1.68	58.3	173
8	1979	construction	DM	GIS	JOW	3.0	96.7	27
9	1993	pre-fabricated buildings	DM	GIS	FAW	0.5	100.0	40
10	1991	tea boutique	DM	GIS	JOW	3.0	96.7	2
11	1987	plant tissue culture	DM	GIS	JOW	19.9	17.5	7
12	1988	computer centre	DM	GIS	JOW	4.0	49.0	6
13	1985	fishing and trawling research	DM	GIS	JOW	12.5	84.4	55
14	1986	construction	DM	GIS	JOW	5.4	96.1	n.a.
15	1988	restaurant	DM	GIS	JOW	2.0	22.5	18
16	1992	cartography and advertising	DM	GIS	JOW	2.2	68.2	5
17	1992	business security systems	DM	GIS	JOW	9.0	100.0	16
18	1992	residential construction	DM	GIS	JOW	13.0	25.0	90

Notes

1 EX: the majority of output is exported. DM : output is sold mostly in the domestic market .

2 GIS: firms approved under general incentive scheme (i.e. under the provisions of the Inland Revenue Act). None of the projects approved under the Section 17 (Special Provisions) of the BOI Act has been cancelled.

3 FAW: full Australian ownership. JOW: Joint ownership (in all cases the joint venture partners are from Sri Lanka).

Source: Compiled from the official records of the Board of Investment of Sri Lanka.

of an apha-numeral code (ASF: 'Australia Sri Lanka firm' + serial number), and these codes are used in the ensuing discussion.

The 23 ventures in commercial operation comprise 17 manufacturing firms and 6 firms in various service industries. The oldest existing Australian manufacturing firm commenced in 1985 and by 1990 there were five firms in operation. Another twelve commenced between 1991 and 1994. One sought to start in 1996 and another plans to commence in 1997.

Market Orientation and Areas of Activity

Of the 17 manufacturing firms, 12 are export-oriented ventures and the rest produce solely for the domestic market. The product lines of export-oriented firms are diverse and include furniture, terra cotta pottery, electrical accessories, ladies undergarments and lingerie, knitting, dyeing and finishing, diamond cutting/polishing, surgical gloves and condoms, packaging products (woven synthetic bags) and rubber-based locomotive components. Domestic-market oriented firms are involved in the production of recycled paper products, telecommunication cables, cookies and cosmetics.

Firms in the infrastructure and service sectors are involved in building construction, project management, import and sales of solar products, turnkey project development in energy, supply of electro-medical equipment, telecommunications, and water supply, electricity, roads and highways and avionics (sales and services of avionics equipment for aircraft and the aerospace industry). Two companies have set up consultancy businesses to service Australian firms.

In addition to the firms listed in Table 5.2, there is one major Australian bank of long standing. Entry of an Australian firm into major port construction appears imminent while a third firm has taken the initiative in identifying relevant Australian private sector firms with a capacity to contribute to the development of economic and social infrastructure with high-tech products and highly efficient services. It has established links in a variety of specific

Table 5.2: Australian Firms in Sri Lanka: Summary Data (as at August 1996)

Code	Years of Approval/ stating operation	Product line/s	Market orientation	Legal status	Nature of ownership and partner-country of joint ventures	Planned investment		Planned employment
						Rs. mn	Aust share (%)	
1. Projects in Operation								
1.1 Manufacturing								
ASF1	1992/94	Dyed/finished textile	EO	SIS	JOW: S. L.	193.8	57.0	162
ASF2	1992/93	Fabrics, collars and bands	EO	SIS	JOW: S.L.	121.3	65.4	1133
ASF3	1992/1994	Ladies garments	EO	SIS	JOW: S.L.	46.2	74.0	182
ASF4	1990/n.a.	Garments	EO	GIS	JOW: Hong Kong,	34.8	49.3	263
ASF5	1982/85	Leather and cane toys and sport goods	EO	SIS	JOW: Germany,	4.2	67.0	120
ASF6	1993/93	Wooden furniture, terra cotta pottery	EO	SIS	JOW: Dubai	10.7	100.0	45
ASF7	1988/90	Surgical gloves, condoms	EO	SIS	FAW	857.0	65.5	625
ASF8	1993/95	Woven/knit bags and packaging material	EO	SIS	JOW: S. L.	61.9	16.1	283
ASF9	1992/94	Rubber automotive components	EO	SIS	JOW: S. L, UK	23.1	51.5	55
ASF10	1991/92	Processing scrap metal	EO	SIS	JOW: S.L.	14.5	75.4	286
ASF11	1989/90	Cutting/polishing sapphire	EO	SIS	FAW	206.6	84.7	487
ASF12	1992/93	Toys/sport goods	EO	SIS	JOW: Hong Kong,	46.2	90.9	234
ASF13	1991/93	Hardboard coater/placements	EO	GIS	FAW	3.0	100.0	5
ASF14	1993/n.a.	Recycled paper products	DM	GIS	FAW	0.5	100.0	39
ASF15	1991/n.a.	Cookies	DM	GIS	JOW: S.L.	29.3	49.0	14
ASF16	1986/n.a.	Cosmetics	DM	GIS	JOW: S.L.			
ASF17	1993/94	Telecom. cables	DM	GIS	JOW: S.L.	3.0	96.7	27
1.2 Construction and Services								
ASF18	1994/1994	Management	DM	SIS	JOW: S.L.	2.6	80.0	8
ASF19	1993/1995	Trading house	DM	SIS	FAW	74.7	100.0	18
ASF20	1993/1993	Telephone network	DM	SIS	FAW	180.0	100.0	23
ASF21	1991/	Restaurant	DM	GIS	JOW: S.L.	4.6	30.0	29
ASF22	1988	Construction	DM	GIS	FAW			
ASF23	1987	Management consultancy	DM	GIS	JOW: S.L.			

Code	Years of Approval/ stating operation	Product line/s	Market orientation	Legal status	Nature of ownership and partner-country of joint ventures	Planned investment		Planned employment
						Rs. mn	Aust share (%)	
2. Projects under implementation*								
2.1 Manufacturing								
ASF24*	1993/1993/....	Shrimp culturing	DM	SIS	JOW: France, S.L.	200.0	50.0	324
ASF25	1993/..../.....	Processing/canning food	DM	SIS	JOW:.S.L.	7.5	26.7	24
ASF26	1993/..../....	concrete panels	DM	SIS	JOW: S.L.	30.0	55.0	36
ASF27*	1992/1992	Gold refining	DM	SIS	FAW	68.5	96.9	21
ASF28*	1995/	chicken fertiliser	DM	GIS	JOW: S.L.	160.0	50.0	57
ASF29	1995/	melting scrap iron	EO	SIS	JOW: S.L.	35.0	71.4	75
ASF30	1993/	Socks	EO	GIS	JOW: S.L.	40.5	6.2	115
ASF31*	1980/	Glass Bottomed boats	EO	GIS	JOW: S.L.	1.6	33.8	11
2.2 Construction and services								
ASF32*	1992/1993/	Management consultancy	DM	SIS	FAW	0.7	100.0	7
ASF33*	1992/1993	Management consultancy	DM	SIS	FAW	0.8	100.0	5
ASF34	1993/	Office complex	DM	SIS	FAW	102.7	100.0	8
ASF35	1995/	Residential apartments	DM	SIS	FAW	177.5	100.0	n.a.
ASF36	1994/	Leisure park	DM	SIS	FAW	50.0	100.0	80
ASF37	1993/	Solar hot water	DM	SIS	FAW: S.L.	20.3	22.2	18
ASF38	1992/	computer ribbons	DM	GIS	JOW: S.L.	8.2	87.8	36
ASF39	1994/	sales outlet	DM	GIS	FAW	50.0	100.0	n.a.
ASF40	1994/	warehouse complex	DM	GIS	JOW: S.L	110.0	54.5	120
ASF41	1995/	barter and trade exchange	DM	GIS	JOW: S.L.	21.2	11.3	56
ASF42	1991/	Business studies	DM	GIS	JOW: S.L.	2.7	40.0	15

Notes:

1 EX: Majority of output is exported. DM : Output is sold mostly in the domestic market .

2 SIS: Firms approved under the special incentive scheme (the Section 17 (Special Provisions) of the BOI Act. GIS: Firms approved under general incentive scheme (under the provisions of the Inland Revenue Act).

3 FAW: Full Australian ownership, JOW: Joint ownership; S.L: Sri Lanka.

* Projects under construction

Source: Compiled from the official records of the Board of Investment of Sri Lanka.

areas ranging from power and energy, aerospace/aviation (services and maintenance of aircraft communications and avionics systems); telecommunications, roads and water development; and medical and educational services. A large proportion of this Australian involvement is through contracts with various Sri Lankan government departments and agencies.

Location

Special incentives offered by the BOI are not restricted by a firm's location, but the BOI does offer special infrastructural services at subsidised charges to firms locating within an Export Processing Zone (EPZ). However, only one Australian firm is located in an EPZ. Its location decision was primarily based on the special facilities offered there. Three firms are located within the Colombo Metropolitan Area while the rest are located outside. Factors determining location included availability of labor, port access, adequate space, infrastructure facilities and services. Many firms are only partially satisfied with their location. For example, there are cases where land is adequate but services are not. One firm is located at Kelaniya, 10 kms. outside Colombo city limits, where the site is suitable but there are problems in communications (telephone etc.) and road congestion.

Legal Status

The majority of Australian firms are joint ventures. Four joint venture firms have partners from other countries (Germany, Dubai, Hong Kong, UK) and all others have Sri Lankan partners. There are four fully Australian owned firms including the largest Australian venture (ASF7). The majority are private limited liability companies. There is one publicly listed company. Two firms operate as branch offices of Australian parent firms. There is one widely diversified joint venture conglomerate with a holding company as an umbrella for companies in the group.

Size Distribution

Size of Australian firms in terms of total fixed assets ranges from small to very large. Several have assets well below US$ one million but range to one of the largest foreign firms (ASF7) in Sri Lanka at US$ 46 million (AUD 61.2 million) in 1996. When ASF7 is excluded, the size distribution (in terms of total assets) of Australian forms is generally comparable with those of all other foreign firms. Value of sales in 1994-95 varied from well below AUD one million for four firms, to between $1 and $5 million for four firms, $5 to $10 million for 4 firms, $15 million for one and $52.5 million for the largest firm.

Employment

Numbers employed in 14 firms (including all manufacturing firms) totalled 4,271 in 1996, with the largest firm employing 53 per cent of the total. Four firms employed less than 100, nine employed between 100 and 500, and the largest employed over 2,000. Of the total, 54 per cent were male and 46 per cent were females. Almost all employees were employed full time. Notably, the number of expatriates attached in Sri Lanka to the firms was generally small. Four had none, seven had one only and three had between two and four. In 1996, total employment in Australian firms (4271) amounted to about 2 per cent of total employment in all foreign firms set up under BOI approval during 1978-95.

In Table 5.3, the occupational composition of employment in Australian firms is compared with that of total employment in all SIS firms. The percentage of female workers in the work force of Australian firms (43.9 per cent) is significantly lower than that in the total work force of SIS firms (72.1 per cent). The explanation lies in differences in industry composition. Female workers are mostly employed in garment and electronics industries. There are only two (medium-scale) garment-producing firms (ASF3 and ASF4) while there are no Australian electronics firms. It is important to note that Australian firms (like their counterparts from other countries operating in Sri Lanka) rely

Table 5.3: Employment Profile of all SIS Firms and Australian Firms

	SIS firms		Aust. firms		ASF1	ASF2	ASF3	ASF4	ASF6	ASF7	ASF9	ASF11	ASF12	ASF20
	No.	%	No.	%										
Total employment	147050	100.0	3246	100.0	158	46	81	81	121	2201	123	132	230	73
Local	145947	99.2	3226	99.4	156	43	81	78	120	2196	123	131	227	71
Male	39880	27.1	1800	55.5	135	36	22	2	101	1202	117	11	122	52
Female	106067	72.1	1426	43.9	21	7	59	76	19	994	6	120	105	19
Local Employment by Skill Category	145947	99.2	3226	99.4	156	43	81	78	120	2196	123	131	227	71
Trainees	21728	14.8	261	8.0	21	11	8	26	0	22	76	7	90	0
Unskilled	24679	16.8	1903	58.6	74	20	19	31	57	1666	28	0	6	2
Semiskilled	56524	38.4	237	7.3	0	0	6	11	41	49	2	93	28	7
Skilled	22391	15.2	226	7.0	10	4	27	0	15	81	3	0	78	8
Supervisory staff	5820	4.0	149	4.6	9	2	5	4	3	99	3	14	8	2
Technical staff	3097	2.1	150	4.6	9	0	2	0	0	117	6	4	1	11
Administrative staff	2388	1.6	65	2.0	15	0	3	3	1	29	2	1	2	9
Clerical and allied	5741	3.9	102	3.1	13	1	1	1	2	58	3	3	11	9
Other	3579	2.4	128	3.9	5	5	10	2	1	75	0	9	3	18
Expatriate employment	1103	0.8	21	0.6	2	3	0	3	1	6	0	1	3	2
Male	857	0.6	20	0.6	2	3		2	1	6	0	1	3	2
Female	246	0.2	1	0.0	0	0		1	0	0	0	0	0	0
			0	0.0										
Expatriate Employment by Skill Category	1103	0.8	20	0.6	2	3	0	3	1	5	0	1	3	2
Technical	795	0.5	12	0.4	1	2		0	1	5	0	0	2	1
Managerial	307	0.2	8	0.2	1	1		3	0	0	0	1	1	1

Source: Compiled from BOI records

overwhelmingly on the domestic labour market for skilled labour requirements in all occupational categories. The total workforce of the 10 Australian firms (3246) given in Table 5.3 contains only 20 expatriates. Indeed, the low reliance on expatriate managerial and technical staff is a common pattern observable across all firms regardless of the nature of their production process. It is common managerial policy in Australian companies to train local technical and managerial staff to replace expatriates within the shortest possible time period. This policy has been facilitated by the availability of qualified and easily-trainable labor in Sri Lanka.

FDI-Trade Nexus

The geographic profile of exports by Australian firms in Sri Lanka, compiled from firm level customs records (Table 5.4) show that only two firms (ASF3: garments; and ASF8: woven bags and packing material) ship more than 90 per cent of their exports to Australia. The other two firms with significant home-bound exports are ASF6 (terra cotta pottery, 26 per cent of exports) and ASF13 (hardboard coater, 46 per cent of exports). All other firms ship less that 1 per cent of total exports to Australia. For all firms, the export share to Australia is 3 per cent.

Five firms rely mostly (two of them exclusively) on developed country markets (ASF2, ASF4, ASF5 and ASF9, ASF12), while for the remaining firms, both developed and developing country markets are equally important. In the aggregate, developed (excluding Australia) and developing country shares in total exports are 48.9 per cent and 47.9 per cent respectively. Overall, Australian FDI in Sri Lanka has not yet made a significant contribution towards opening up the Australian market to manufactured exports from Sri Lanka. Australian firms predominantly make use of Sri Lanka as an export platform to penetrate markets in other parts of the world. Finally, it is interesting to note the importance of developing country markets for ASF7 - the giant Australian producer of surgical gloves and condoms. According to disaggregated trade flow data (not reported), over 40 per cent

of its exports, amounting to over 50 million US dollars, finds markets in East and Southeast Asia.

It might be expected that Australian firms would use Australia (and New Zealand) as a major source of inputs. In practice, only two firms sourced all inputs from Australia/New Zealand. Two relied entirely on other countries, while the remaining firms obtained inputs from a wide range of country sources, and Australia was a minor supplier.

5.2 Determinants of Australian Investment in Sri Lanka

Incentives

As discussed in Chapter 2, the BOI offers special incentives to manufacturers setting up in the country to produce for export markets. They include tax holidays varying from 5 to 15 or more years, duty free imports of capital goods, raw materials and building materials. Of the thirteen firms in operation in 1996, seven were eligible under BOI regulations and were receiving these concessions. All seven firms (SIS firms) stated that they would not have established operations in Sri Lanka without these concessions. Thus around one half of Australian firms set up in Sri Lanka as a direct consequence of these concessions.

The other six were GIS firms. Goods (and services) produced by these firms are sold solely on the domestic market. They include steel building material for industrial, commercial and residential markets; power and communication cables; all areas of construction, building, project management, and infrastructure privatisation; electrical accessories; organic fertilisers and mining. Only two firms in this group received special incentives (5 year tax holiday). One of them would not have established itself in Sri Lanka without the tax concessions.

Table 5.4: Direction of Exports of Australian Firms, 1995 (Percentage composition of total export value)

Company code	Product line/s	Australia	Developed countries*	Developing countries	Total US$ '000
ASF2	Collars and band	0.0	99.7	0.3	435.6
ASF3	Ladies' garments	99.2	0.8	0.0	1135.8
ASF4	Garments	0.2	98.9	0.9	3520.7
ASF5	Leather and cane toys	0.0	100.0	0.0	31.6
ASF6	Furniture and terra cotta pottery	26.6	47.0	26.5	262.6
ASF7	Surgical gloves, condoms	1.1	47.2	51.7	54993.7
ASF8	Woven/knit bags and packing material	91.7	8.3	0.0	384.0
ASF9	Rubber automotive components	0.0	100.0	0.0	1819.5
ASF10	Processed scrap metal	0.0	7.2	92.8	3331.0
ASF11	Sapphires	0.9	38.2	60.9	1835.2
ASF12	Toys/sport goods made of carbon fibre	0.2	75.7	24.1	1223.3
ASF13	Hardboard coater	43.5	4.5	52.0	59.8
	Total exports	3.2	48.9	47.9	69032.8

* Excluding Australia

Source: Compiled from computerised firm-level customs records held by the Sri Lanka Export Development Board

Cost of Labor

One of the advantages claimed for investment in Sri Lanka is the availability of cheap labor. Firms generally indicated that labor was indeed cheap compared with other developed countries and Australia. When asked about the relative attractiveness of Sri Lanka's wages compared to other developing countries, a fairly typical response was that Sri Lanka's wage levels were about on a par with those of competing Third World countries such as Vietnam, China and India, Philippines and Indonesia. However, some firms viewed Sri Lankan labor as much cheaper than in other alternative locations. Those who did not have operations elsewhere made their comparison only with developed countries where labor costs were obviously much higher. Thus overall, the low cost of labor in Sri Lanka is not an unqualified advantage except for those few firms which saw a comparative advantage when compared with high wage levels of equivalent workers in Australia or other developed countries.

Quality of labor was also an important consideration for the sample firms. Views were ranging from high efficiency to lower quality, the majority opinion being "as efficient as foreign competitors". In comparison with Australia, quality was put on par with unskilled migrant workers but much lower than skilled workers. The main weaknesses of Sri Lankan workers were said to be lack of required skills, poor work attitudes, absence of work ethics, and high absenteeism. A number of firms considered these limitations, which contribute to low labour productivity, as being largely influenced by the relaxed rules on workplace behaviour in the public sector, which is still by far the biggest employer in the country. A culture of productivity is emerging in the private sector, but on the other hand unions are strong and often a constraint on company policies aiming at increasing productivity. Following the change of government in 1994, unions have begun to enter even BOI-approved firms against the rules, and some firms expressed concern about lack of clear government policy on this issue.

Quality of Other Inputs and Import Procurement

With the exception of ASF7 (whose main input is locally-produced latex), Australian manufacturing firms import most of their raw materials. Four firms import all material inputs, the rest import two thirds or more of their inputs. They are therefore only concerned with other direct inputs such as power and financial services to be obtained locally. There were criticisms that the quality of service inputs is generally inferior and that electricity supply is unreliable. ASF7 sources its latex locally which is cheaper. Overall, it imports 67 per cent of its other inputs. This firm considers its cost of production to be considerably lower than that of its Malaysian, US and Mexican counterparts. Cost of production in Sri Lanka could be reduced further and become more internationally competitive with higher work standards. Australian manufacturers producing for the local market raised few problems about costs of other inputs.

5.3 Business Environment

Regulations

Investment licensing has not been a serious constraint on Australian firms in setting up operations in Sri Lanka. A time period of about 4 weeks or less was required for registration and approval of applications. Three firms experienced long delays due to complications relating to the length of the period of tax holiday and to final Ministry clearance. The relative assessment by firms of the constraining effects of various aspects of the regulatory system is summarised in Table 5.5.

Table 5.5: Constraining Effects of Sri Lanka's Regulatory Procedures on Respondents (%)*

	% Respondents						
	None 1	2	Moderate 3	4	Strong 5	No Response	Total
Investment licensing	31	31	31	0	8	8	100
Export regulations	23	38	15	15	8	0	100
Import regulations	31	23	23	8	15	0	100
Tax regulations	23	15	23	8	31	0	100
Labour legislations	8	8	23	23	38	0	100
Land regulations	31	23	23	8	15	8	100
Environmetal regulations	8	31	46	15	0	8	100
Anti-trust regulations.	69	15	15	0	0	0	100

* Constraining effects were given a scale of between 0 and 5 according to intensity.
Source: Questionnaire Survey

Constraining effects of labor regulations were considered to be moderate to strong, with five (38 per cent) of firms reporting strong constraints. Under EPZ rules, unions are not allowed to operate and this legal provision mostly insulates foreign investors from labor problems. In practice, 'in-house' workers' associations do operate with highly variable results. The largest Australian firm (which is also the only Australian firm in the SIS group which is located in an EPZ) faced labour disputes in the immediate aftermath of the 1994 general election. These were resolved through informal meetings between management and unions. Two other SIS firms have been involved in labor disputes over the past three years. In one case, a financial settlement was imposed. In the second, the dispute remained unresolved at the time of the survey. The other firms have not experienced any labor dispute.

Two of the six GIS firms recorded labor disputes. In one case, an agreement was reached between the management and an 'unofficial' union with government involvement at the highest political level. In the second, the firm reported that it was pushed into a settlement by an "informal" notice from the Labor Commission. Conditions imposed by the Commission were most unsatisfactory to this firm.

There is also a problem with dismissals. A law exists which provides for termination of employment, but it remains virtually unused because of the power of trade unions and the government's half-hearted standing on labour disputes. Therefore in practice, compromises are reached. The most prevalent form of termination of employment is dismissals with compensation.

Suggestions were offered by some firms for improvements of practices on resolution of disputes. One was to establish an arbitration system that is quick (by law) and transparent in operation. A second was to establish a separate commercial court with a BOI legal service. There is now a High Court judge appointed for commercial disputes (including labor disputes) and there are also two district courts, but these cannot clear the backlog. A third was to reduce political interference in dispute settlement.

Import regulations are generally favourable, especially for SIS status firms. However, there were some complaints over administration of customs. Some SIS projects reported serious customs problems on incoming goods caused by the absence of transparent and strict rules. At times, the BOI breaks its own rules because of political interference. The existing import clearance practices are particularly cumbersome when it come to the computation of duty and documentation when demurrage applies.

Problems with environmental regulations were generally moderate. However, for one firm producing fabrics, environmental considerations have become a major consideration. The plant had to be located near a major river (Kalu Ganga) to ensure easy access to water. However, this particular location has posed severe problems in terms of disposal of solids and dyeing chemicals. It takes about one month to break down solids (using ponds and chemicals) for

safe disposal in compliance with environmental regulations. This disposal problem significantly increased costs of production in Sri Lanka. The parent firm in Australia had no such problems as its urban location enabled it to empty industry waste into the city disposal system.

Taxation

Taxation levels were not considered to be a serious constraint on expansion of operations. Three GIS firms claimed tax levels are too high but only one gave specific reasons. This firm complained of cascading taxes, applying at every point which makes it difficult for a non-BOI firm to operate. Company taxes, at 40 per cent, are not regarded as a problem but the tax system is not transparent. In particular, changes in the defence fund levy are unpredictable. All SIS firms enjoys tax holidays ranging from 10 to 15 years.

Firms with SIS status clearly rated import duty concessions as incentives to expand operations. However, there are no concessions for GIS firms, eg. on equipment imports, and high import duties represent a substantial tax by comparison with the concessions given to BOI firms. Consequently, GIS firms which import equipment rated import duties as a moderate to strong constraint on expanding operations.

A common concern expressed by GIS firms was that the incentive structure was highly unfavourable to production geared to the domestic market compared to export-oriented production. SIS firms obtain BOI approval for imported inputs whereas GIS firms receive such exemption only under very special circumstances unless they have strong political backing. Some SIS firms sell duty-free imported goods in the domestic market and this poses a formidable threat to GIS firms which produce them locally (with duty on imported inputs). There is no Pioneer status awarded to firms producing for the domestic market. As GIS firms cannot borrow overseas, they are directly exposed to high local interest rates (20 per cent) and periodic credit restrictions imposed by banks. Taxes are cascading and apply at many points in the market chain.

Infrastructure

Unreliability of electricity services was considered as a moderate to strong constraint by 84 per cent (11 of 13) of firms (Table 5.6). There were two problems. One specific problem was that firms at certain locations were connected to the electricity grid. Firms choosing such locations had to purchase generators. This was not a problem in EPZs and industrial estates, but such locations do not suit all firms. The more pressing problem is the periodic and increasing power cut-offs affecting all locations, as overall supply is falling behind growing demand. This has necessitated substantial investment in generators by some firms, particularly by the largest which is located in an EPZ.

Table 5.6: Infrastructure Constraints (%)*

	% Respondents						Total
	None 1	2	Moderate 3	4	Strong 5	No response	
Reliability of electricity	0	15	31	15	38	0	100
Road quality	0	15	31	38	15	0	100
Rail capacity	23	15	15	23	23	0	100
Port capacity	31	23	31	8	0	8	100
Container capacity	23	23	38	8	0	8	100
Air port	23	23	38	0	0	15	100
Public telecommunication	23	15	15	31	15	0	100

* Constraining effects were given a scale of between 0 and 5 according to intensity
Source: Questionnaire Survey

The government-owned electricity monopoly (Sri Lanka Electricity Board) has not been able to cater for power demand which has expanded at a compound rate of 10 per cent per year over the past ten years. Supply problems are being addressed, but given the huge backlog, success of such attempts will depend crucially on the availability of foreign finance. The government is therefore trying to entice foreign investment in the power sector. There are opportunities for investments from Australia in coal-fired power generation which are being explored.

Road transport is grossly inadequate and is the worst infrastructure problem, with no imminent prospects for improvement. Eleven of the 13 Australian firms rated inadequacy of road transport as a moderate to strong disincentive

for the expansion of their operations. Four rated it as a strong disincentive for further investment.

Sixty one per cent of respondents considered the current state of telecommunications as a moderate to strong disincentive to expand their operations. The government plans to solve this problem by improving the existing central exchange line system with the assistance of the Asian Development Bank and the World Bank. It plans to increase the use of alternatives to standard exchange lines (cellular and loop systems) through the participation of private sector telecommunication firms. The government also intends to privatise Sri Lanka Telecom. There is currently strong opposition to the privatisation proposal. The issue awaits decision.

Capital Market

Access to short term domestic borrowing was not considered by Australian firms to be a constraint (Table 5.7). But money market instability, in particular unpredictable borrowing rates due primarily to government borrowing, causes problems for private-sector firms in financial management. Long term domestic finance is available in Sri Lanka to all private sector manufacturing firms (including joint-ventures with foreign firms) from the Development Finance Corporation of Ceylon (DFCC), the prime source of investment financing for the private sector. DFCC has no limit on borrowing internationally for joint venture investment with the private sector. There is, however, a lack of Australian interest in the areas where DFCC operates.

Table 5.7: Capital Market Problems (%)*

	% Respondents						Total
	None 1	2	Moderate 3	4	Strong 5	No Response	
Access to domestic sources	31	31	23	8	8	0	100
Access to offshore sources	23	46	23	0	8	0	100
Cost of finance	8	8	23	23	38	0	100
Access to foreign exchange	8	46	15	23	8	0	100

* Constraining effects were given a scale of between 0 and 5 according to intensity.
Source: Questionnaire Survey

Policy Uncertainty and Macroeconomic Instability

Uncertainty about the future directions of government policy was reported to be a strong constraint to expansion of operations by 5 firms, and a moderate to strong constraint by all but one firm (Table 5.8). One criticism was that there is no master plan for the economy. There is a high expectation of the government's role, but there is no system to identify and rectify defects. In particular, policy making is seen as an arbitrary process and unpredictable in the cases of taxes (defence levies) and power supply.

Broadly, there is a perception of a lack of policy direction in government and a lack of strong leadership. This is interpreted as arising partly as a result of the proportional representation (PR) system in elections, which prevents any one elected party from taking decisive action and has allowed unions to exert considerable power, in particular by opposing privatisation and the activities of multi national enterprises (MNEs). The government has advocated a Workers' Charter for union rights which is causing concern in the private sector. There is also concern over leftist influences in government and their implications for future directions of government policy towards the encouragement of foreign investment.

Table 5.8: Policy Uncertainty, Law and Order and Price Instability (%)*

	% Respondents						Total
	None 1	2	Moderate 3	4	Strong 5	No Response	
Policy uncertainty	0	8	38	15	38	0	100
Law and order	23	15	23	15	23	0	100
Price instability	8	46	23	8	15	0	100

* Constraining effects were given a scale of between 0 and 5 according to intensity.
Source: Questionnaire Survey

Operations are also difficult where there is uncertainty about tariffs and other levies on imported inputs. Uncertainty about the future exchange rate also has this effect. This makes it difficult to price the product. This is a key issue for one firm which imports copper as its major input. One firm expressed concern that the Central Bank is not independent of government as it is in Australia, and as a result, issues such as the exchange rate rest very much with government.

Eight of the 13 reporting firms indicated the continuing ethnic conflict in the country was influencing future investment decisions, but with mixed reactions as described below. There was no distinction between SIS and GIS firms in this connection.

5.4 Sri Lanka as an Alternative Investment Location

Australian manufacturers in Sri Lanka with business operations in other developing countries were asked to compare Sri Lanka's business environment. Five firms responded.

The first, with wide Asian involvement, ranked its investment in Sri Lanka as being high risk owing to the prevailing political problems. However, it was confident that, in the long term, business would grow significantly. A second firm ranked Sri Lanka with India, regards Laos as less attractive but easier, Thailand as more advanced, Vietnam as more difficult and others as far easier and more predictable. A third compared Sri Lanka with Australia, China and Indonesia on a range of criteria. This information is summarised in Table 5.9. According to this comparison, Sri Lanka compares favourably on almost all counts with two large competing developing countries. Not surprisingly, Australia comes out ahead on most counts.

Table 5.9: Sri Lanka as an Investment Location Compared to Australia, China and Indonesia

	Australia	China	Indonesia
Labor quality	better	similar	similar
Productivity	worse	better	similar
Legal aspects	worse	better	better
Banking and other financial services	worse	better	better
Port facilities	better	better	better
Surface transport	worse	worse	worse
Telecommunications	worse	better	better
Cultural	worse	better	better

Source: Questionnaire survey.

According to the criteria of labor inputs, service inputs, infrastructure and cultural environment, Australia as a developed country, is obviously considered superior in services and infrastructure, except for port facilities. Labor productivity is considered lower but its quality is better in Sri Lanka. Interestingly, Sri Lanka compares favourably with China for all criteria except surface transport, for which it is worse and labor quality which is similar. The comparison with Indonesia was similar to that with China except for a similarity in labor productivity.

5.5 Production and Investment plans

Production plans of the Australian firms in Sri Lanka over the next two years, with few exceptions, are generally positive. Ten of the twelve firms who responded to the relevant question indicated that they intended to expand operations. Two of these ten firms indicated they would also diversify production in the course of production expansion. Five of the ten have operations in other countries and are experienced in international operations, particularly in South and South East Asia. Additionally, two new firms are moving into the production phase in the next two years and, on present indications, will also expand their operations.

Of the two firms which have no plans to expand production, one will maintain production at current levels and the other intends to reduce current production levels. Both are GIS (non-BOI) firms which are influenced by the current political uncertainty and by many other factors considered to be strong constraints to any expansion of operations as listed below. One firm considered political uncertainty as the main constraint but added a list of other factors: unfavourable import taxes, labor and land regulations, high import duties, unreliability of power supplies, low capacity of road and rail infrastructure, high cost of finance, difficulty of access to foreign exchange, lack of access to qualified labor and managers and poor effort of workers, difficult labor relations, uncertainty of policy and law and order problems. The other GIS firm which intends only to maintain production levels over the next two years saw strong constraints to expansion of operations in heavy

regulations, disincentives for GIS firms in the level of taxation and import duties, poor infrastructure services, high cost of finance, the broader uncertainties of policy and prices, poor labor relations and law and order. Importantly, there was a view that the current political climate is discouraging new and "faint hearted" firms.

Overall, the constraints most frequently considered to be strongest against expansion of operations were labor regulations, import duties (GIS firms), unreliability of electricity supply, low carrying capacities of road and rail transport, the poorly developed telecommunication systems, cost of finance, restricted access to foreign financing, lack of qualified managers, labor relations, policy uncertainty and breaches of law and order. These constraints were not, however sufficiently strong to dissuade the majority of Australian firms from expanding their production over the next two years.

Political instability caused by the continuing ethnic conflict is undoubtedly having adverse implications for long-term business investment. The largest Australian firm with substantial sunk fixed investment is still proceeding with investment expansion. However, most of those which are not already committed to large scale investments prefer not to proceed with future investment until the security situation improves and the political climate becomes more settled. This is clearly a "wait and see" approach to investment. This reluctance is naturally compounded when firms have options to invest in other Asian countries with better prospects.

6 AUSTRALIA-SRI LANKA TRADE LINKS

In this chapter trade links between Australia and Sri Lanka are discussed from an historical perspective.[12] The emphasis is on implications of structural changes in the Sri Lankan economy brought about by the market-oriented policy reforms initiated in 1977 for trade complementarity between the two nations.

6.1 Overall Trends

Data on total Sri Lankan exports to and imports from Australia and their relative shares point to a persistent decline in the importance of Australia as a trading partner for Sri Lanka over the post independence period (Table 6.1 and Figure 6.1). The share of exports to Australia in total exports from Sri Lanka was about 6 per cent in the late 1950s. This declined to about 3 per cent in the early 1970s, to around 1 per cent in the late 1980s and remained virtually unchanged in the 1990s. Imports from Australia accounted for about 5 per cent of Sri Lanka's total imports in the late 1950s and remained around this level until the mid-1970s. Since then, there has been a significant decline in the share despite a significant absolute increase in Sri Lanka's imports following the trade liberalisation reforms initiated in 1977. It remained at a little over 1 per cent in the 1990s apart from an exceptional increase in 1994.

From the Australian point of view, bilateral trade between the two countries has been even less significant throughout. Even in the late 1950s (the earliest years for which data are readily available), exports to Sri Lanka and imports from Sri Lanka accounted for less than 1 per cent of total exports and imports. The decline in these shares since the mid 1960s has been much sharper than from the Sri Lankan perspective. By the late 1980s, bilateral import and export ratios were less than 0.05 per cent. Since then there has been some increase in the share of exports to Sri Lanka in total exports reflecting the impact of trade

[12] The trade links between Australia and Sri Lanka are rooted in their common British colonial heritage, and go back to the earliest period of European settlement of Australia. Many aspects of the history of Australia-Sri Lanka links, including the history of some of the economic links, have been detailed by Weerasooria (1988). According to sources cited by Weerasooria, there was a Sri Lankan on the First Fleet!

liberalisation in Sri Lanka, but the import share has remained below 0.05 per cent.

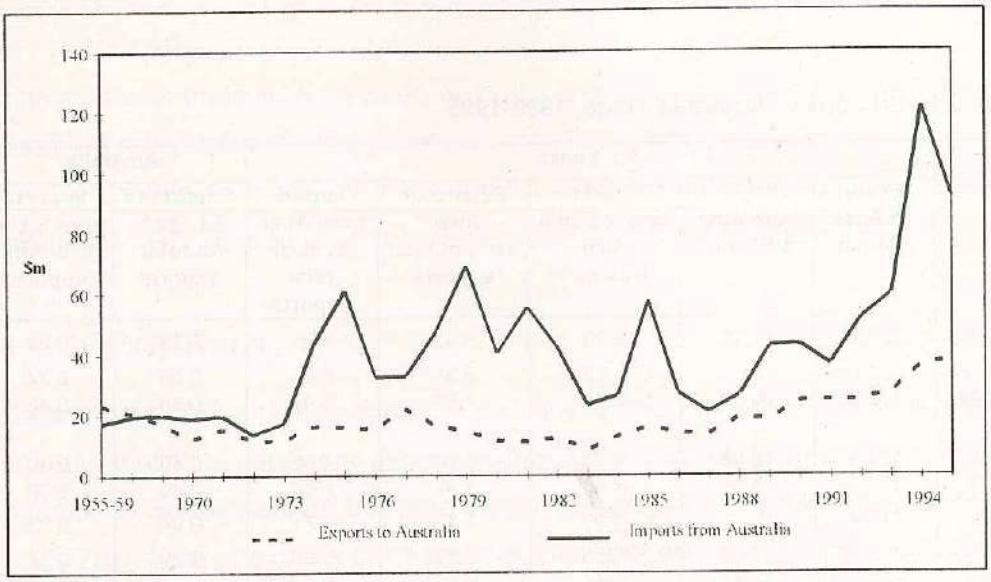
Table 6.1: Sri Lanka - Australia Trade, 1958-1995

	Sri Lanka					Australia	
	Export to Aust US$ mn.	Import from Aust. US$ mn.	Trade balance with Aust US$ mn.	Exports to Aust. as % of total exports	Import from Aust. as % of total imports	Exports to S.L. as % of total exports	Imports from S.L as % of total imports
1955-59	23.30	17.10	6.20	6.42	4.21	0.73	0.81
1960-64	20.80	19.50	1.30	5.34	5.63	0.68	0.74
1965-69	17.20	20.30	-3.10	4.83	5.48	0.48	0.46
1970	12.09	18.84	-6.75	3.54	4.88	0.40	0.30
1971	15.26	19.78	-4.52	4.44	5.59	0.40	0.38
1972	11.74	13.67	-1.93	3.47	3.71	0.24	0.33
1973	11.54	17.19	-5.65	2.81	3.98	0.29	0.32
1974	16.23	43.83	-27.6	3.08	6.11	1.05	0.28
1975	15.84	61.22	-45.38	2.80	8.25	0.61	0.25
1976	15.41	32.39	-16.98	2.68	5.56	0.43	0.19
1977	21.94	32.73	-10.79	2.96	4.79	0.23	0.20
1978	16.40	47.31	-30.91	1.94	4.89	0.19	0.14
1979	14.65	69.24	-54.59	1.49	4.77	0.25	0.10
1980	11.47	40.13	-28.66	1.08	1.95	0.21	0.07
1981	10.88	55.50	-44.62	1.00	2.92	0.35	0.07
1982	12.56	41.93	-29.37	1.22	2.08	0.16	0.05
1983	8.02	23.06	-15.04	0.75	1.19	0.09	0.03
1984	12.93	26.29	-13.36	0.88	1.41	0.12	0.05
1985	15.83	57.60	-41.77	1.19	2.89	0.17	0.03
1986	14.00	27.37	-13.37	1.15	1.41	0.04	0.02
1987	13.59	20.87	-7.28	0.97	1.02	0.05	0.03
1988	19.05	26.20	-7.15	1.29	1.17	0.03	0.04
1989	18.55	42.66	-24.11	1.19	1.92	0.05	0.03
1990	24.23	43.40	-19.17	1.27	1.61	0.06	0.04
1991	24.44	36.57	-12.13	1.23	1.19	0.05	0.04
1992	24.39	51.72	-27.33	0.99	1.48	0.06	0.04
1993	27.24	59.78	-32.54	0.95	1.49	0.06	0.03
1994	36.36	121.45	-85.09	1.13	2.54	0.12	0.04
1995	37.80	91.79	-53.99	..	..	--	--

– Not available.

Source: Compiled using data reported in IMF, Direction of Trade, Washington DC.: IMF (various issues)

Figure 6.1: Sri Lanka-Australia Trade



Source: Based on data compiled from IMF, Direction of Trade, Washington DC.: IMF (various issues).

Until about the mid-1960s, the balance of bilateral merchandise trade between the two countries was generally in Sri Lanka's favour. The pattern has, however, changed and 1966 was the last year to record a surplus in favour of Sri Lanka. Since then the trade deficit has widened continuously. In the first half of the 1990s, Sri Lanka's exports to Australia amounted to only one half or less than her imports from Australia.

In order to understand the underlying forces behind the dismal bilateral trade performance between the two countries, it is necessary to look at disaggregated data on the commodity composition of national and bilateral trade. These data are summarised in Tables 6.2 to 6.6.

6.2 Sri Lanka's Exports to Australia

Given the dramatic changes in the export structure brought about by market-oriented policy reforms since 1977, Sri Lanka can no longer be treated as a

Table 6.2: Sri Lanka: Composition of Exports (%)

	1970	1975	1980	1985	1990	1994
Primary products (0 + 1 + 3 + 4)	92.46	88.48	65.92	58.26	52.30	25.35
0 Food	65.19	58.02	45.58	44.01	41.60	19.73
0312-13 Fish preparations	-	0.52	0.07	1.37	1.49	1.97
04 Serials and preparations	-	-	-	-	0.02	0.26
0517-9 Preserved fruit	5.12	5.22	4.58	4.03	3.16	1.55
0542-9 Preserved vegetables	-	-	-	0.01	0.55	0.45
0619 Syrups	-	-	-	0.00	0.00	0.00
0711 Coffee	-	-	0.14	0.19	0.71	0.24
0741 Tea	56.68	49.24	35.68	34.80	32.73	13.06
0752 Spices	2.34	1.65	2.77	1.32	2.43	1.13
1 Beverages and tobacco	-	-	0.15	0.17	0.42	1.24
2 Crude material excl. fuel	27.27	25.59	19.88	11.27	9.77	4.25
2311 Natural rubber	22.28	16.66	14.98	7.51	5.10	2.27
2658 Coconut fibre	2.42	2.02	2.15	1.34	1.16	0.61
2762 Graphite	0.45	0.32	0.46	0.36	0.29	0.06
2926 Crude vegetable material	-	-	-	0.01	0.16	0.11
4 Animal and veg. oils	-	4.87	0.30	2.82	0.51	0.13
4223 Coconut oil	-	-	-	-	0.47	0.12
Manufactures (5 + 6 + 7 + 8)	1.43	3.82	18.58	32.61	67.27	72.55
5 Chemicals and related products	0.34	1.87	3.07	2.75	2.26	1.35
6 Basic manufactures	0.56	0.83	4.28	4.83	16.86	15.52
6673 Rubber goods	0.00	-	2.65	1.64	4.86	2.48
63 Wood products	0.05	0.09	0.05	0.01	0.05	0.07
65 Textile yarn and fabrics	0.01	0.02	0.03	0.30	0.10	0.71
666 Porcelain/ceramic wear	-	0.34	0.69	0.42	0.96	1.20
7 Machinery and transport equipment	-	0.26	0.41	0.61	2.32	2.26
8 Misc. manufactures	0.53	0.85	10.82	24.42	45.82	53.42
8310 Travel goods	-	0.02	0.05	0.04	0.15	1.43
84 Clothing	-	-	0.03	22.07	41.90	45.19
851 Footwear	0.05	-	-	0.33	0.66	1.20
Total exports	100	100	100	100	100	100
US$ mn.	331.6	557.7	1043.0	1246.2	1506.3	3191.9

Source: Compiled using UN trade data (Series D) tapes (held by the International Economic Data Bank, Australian National University).

'classical primary exporter' as characterised in Snodgrass (1967). Since the early 1980s, there has been a clear shift in the export composition of Sri Lanka away from the three traditional primary commodities (tea, rubber and coconut products) and towards light manufactured goods, in particular clothing. For instance the share of manufactured goods (defined as the sum of commodity classes 5

through 8 in the Standard International Trade Classification, SITC) in Sri Lanka's exports increased from around 7 per cent in the late 1970s to over 70 per cent in the mid-1990s (Table 6.2).

The commodity composition of Sri Lanka's exports to Australia too has changed significantly, but this structural shift is not as dramatic as in total exports (Table 6.3). In 1994, primary commodities still amounted to over 60 per cent of Sri Lanka's exports to Australia (as against 25 per cent in total exports), with tea alone accounting for 35 per cent (13 per cent in total exports). Manufactured exports accounted for only 34 per cent compared to 73 per cent in total Sri Lankan exports.

This mismatch between the overall export structures and the composition of Sri Lanka-Australia export trade can be partly explained in terms of institutional arrangements governing world trade in clothing (garments), the single most important commodity category in the recent expansion of manufactured exports from Sri Lanka (Table 6.2). The market opportunities for the expansion of clothing exports from Sri Lanka were largely generated by the country-based quota allocation system adopted by the USA, the EC and the Scandinavian Countries under the Multi-Fibre Arrangement. This quota allocation system compelled importers from these countries to diversify their import markets to cover new suppliers like Sri Lanka in line with the availability of export quotas. Unlike other minor importing countries, Australia has continued to control clothing imports by issuing quotas to importers (not to exporting countries). Under this alternative quota allocation system, the buyer who receives a quota entitlement has the freedom to choose its own procurement sources. In the absence of a quota-propelled compulsion to turn to new markets, Australian importers have continued to rely on their conventional suppliers in East Asia.

The relative low share of manufactured goods in Sri Lanka's exports to Australia cannot be explained in terms of these institutional factors (governing garment trade) alone. Apart from garments, a number of other manufactured goods such as rubber goods, ceramic and porcelain goods and toys have become

Table 6.3: Sri Lanka: Commodity Composition of Exports to Australia (%)

	1970	1975	1980	1985	1990	1994
Primary products	99.5	97.5	89.3	74.5	63.5	64.19
0 Food	94.26	92.39	83.04	68.56	51.90	43.82
0312-13 Fish preparations	-	0.29	0.01	0.65	0.64	0.10
04 Serials and preparations	-	-	-	0.01	0.15	0.24
0517-39 Preserved fruits	2.17	1.81	2.52	7.32	8.28	0.03
o542-9 Preserved vegetables	-	-	-	0.07	0.34	0.00
0619 Syrups	-	-	-	0.01	0.04	0.01
0711 Coffee	-	-	0.98	1.84	1.52	0.69
0741 Tea	91.61	89.67	77.15	55.28	38.95	33.57
0752 Spices	0.43	0.56	1.04	0.97	1.26	1.19
0990 Misc. edible products	0.03	0.12	0.53	1.34	1.93	1.01
1 Beverages and tobacco	0.00	0.00	0.02	0.08	0.02	0.09
02 Crude material excluding fuel	5.27	4.98	6.19	4.90	2.02	2.99
2311 Natural rubber	0.65	0.34	0.81	1.08	0.22	0.13
2658 Coir fibre	4.07	3.50	3.41	2.44	1.34	1.40
2762 Graphite	0.56	0.36	1.73	1.31	0.23	0.45
269 Crude veg material	-	0.08	0.25	0.02	0.18	-
04 Animal and vegetable oil	0.00	0.10	0.09	0.01	0.03	0.04
4223 Coconut oil		0.09	0.09	0.01	0.03	
Manufactures	0.50	2.50	10.70	25.50	36.50	35.81
5 Chemicals and related products	0.24	0.10	0.10	3.68	4.14	3.26
6 Basic manufactures	0.23	1.29	7.16	3.67	7.32	7.26
6299 Rubber goods	-	-	0.04	0.51	0.30	0.49
63 Wood products	0.02	0.23	0.09	0.41	1.76	1.49
65 Textile yarns and fabrics	0.01	0.01	0.03	0.44	2.04	0.85
666 Porcelain and ceramic ware	0.07	0.84	6.66	2.39	3.22	4.41
7 Machinery and Transport equipment	0.00	0.49	0.58	0.21	0.91	1.04
8 Misc. manufactures	0.03	0.62	2.86	17.94	24.13	24.25
8310 Travel goods	-	0.29	1.42	0.11	0.20	0.55
84 Clothing and accessories	-	-	1.12	1.61	6.62	6.57
851 Footwear	0.02	-	-	1.44	1.17	0.50
89 Misc. manufactures nes	0.01	0.30	0.20	15.51	12.01	8.51
Total Exp	100	100	100	100	100	100
	11.9	15.6	11.4	15.6	19.7	28.1
	3.58	2.80	1.09	1.25	1.31	0.88

Source: Compiled using UN trade data (Series D) tapes (held by the International Economic Data Bank, Australian National University).

increasingly important in Sri Lanka's overall trade growth in recent years, but there has not been any noteworthy increase in the share of these products in exports to Australia (Table 6.3).

Table 6.4: Sri Lanka: Exports to Australia as a Share of Total Exports by Commodity Category (%)

	1970	1975	1980	1985	1990	1994
0 Food	5.19	4.46	1.99	1.95	1.64	1.95
0312 Fish preparation	-	6.50	0.14	4.73	2.51	3.30
0517-9 Preserved fruits	1.50	0.22	0.31	2.45	0.96	0.84
0542-9 Preserved vegetable	-	-	-	-	0.07	2.13
0619 Syrups	-	-	-	50.00	58.33	12.00
0711 Coffee	-	-	7.92	11.89	2.83	2.54
0741 Tea	5.80	5.10	2.37	1.99	1.56	2.25
0752 Spices	0.66	0.96	0.40	0.79	0.64	0.93
1 Beverages and tobacco	-	-	0.06	0.62	0.02	0.06
2 Crude material excluding fuel	0.69	0.55	0.34	0.54	0.27	0.62
2311 Natural rubber	0.10	0.06	0.06	0.18	0.06	0.05
2658 Coir fibre	6.03	4.86	1.73	2.28	1.52	2.01
2762 Graphite	4.46	3.22	4.10	4.61	1.05	6.40
2962 Crude vege. material	-	-	-	4.41	0.04	0.03
4 Animal and vegetable oil	-	0.06	0.31	0.00	0.08	0.26
4223 Coconut oil	-	-			0.04	0.03
5 Chemicals and related products	2.50	0.15	0.03	1.67	4.18	3.42
6 Basic manufactures	1.28	4.39	1.83	1.22	1.31	1.27
6299 Rubber goods	-	-	2.12	2.88	0.92	0.99
63 Wood products	1.20	7.42	0.80	1.20	0.70	2.94
65 Yarn and fabrics	5.56	0.76	1.72	0.08	0.94	0.42
666 Porcelain/ceramic ware	-	6.94	12.66	1.97	4.06	3.45
7 Machinery and transport equipment	-	5.27	1.56	0.44	0.51	0.40
8 Misc. manufactures	0.23	2.04	0.29	0.92	0.61	0.40
8310 Travel goods	-	-	-	1.55	2.06	0.01
84 Clothing	-	-	0.12	0.07	0.19	0.19
851 Footwear	-	-	-	5.53	2.34	0.37
Exports to Australia/total export	3.59	2.80	1.09	1.25	1.31	0.88

Source: Compiled using UN trade data (Series D) tapes (held by the International Economic Data Bank, Australian National University).

Interestingly, as yet the expanding involvement of Australian firms in Sri Lankan manufacturing has not had a significant impact on Sri Lanka-Australia trade patterns. As noted in Chapter 4, most of these manufacturing firms use Sri Lanka as an export platform to penetrate markets in other countries. Exceptionally, two Australian firms in the Sri Lankan garment industry export a significant portion of their output to Australia, but these exports are minuscule compared to the massive import flows of these products to Australia from East Asia and China.

6.3 Sri Lanka's Imports from Australia

The import structure of Sri Lanka also has undergone significant structural change over the past two decades. The share of manufactured goods in total imports increased from 47 per cent in 1970 to over 76 per cent in 1994. This change was the cumulative outcome of a decline in food imports as a result of achieving near self sufficiency in rice, the staple food, and a rapid expansion of imports of raw materials and machinery for the growing domestic manufacturing, and machinery imports for massive construction projects.

In Sri Lankan imports, there is a clear contrast between the rapidly changing overall import pattern of Sri Lanka and the composition of imports from Australia. The share of manufactures in Sri Lanka's total imports from Australia has increased significantly, from 11 per cent in 1970 to over 41 per cent in 1994, but primary commodities still dominate import trade (Table 6.6). In 1994, primary commodities accounted for 58 per cent of total imports, down from 89 per cent in 1970. Food items account for over 95 per cent of total primary imports.

In a number of product categories within the broader category of food (for instance, milk and cream, fruits and fruit preparations, and animal and vegetable oils) Australia's share in the Sri Lanka market has recorded a significant improvement in recent years. Australia's shares in most manufactured good categories in Sri Lankan imports have either declined or remained stagnant throughout, despite significant increases in manufactured exports in Australia's overall export performance.

Table 6.5: Sri Lanka: Composition of Total Imports (%)

SICT Code	Commodity	1970	1975	1980	1985	1990	1994
Primary products		52.26	53.22	21.95	43.55	33.64	23.87
0	Food	46.31	50.01	20.04	18.98	18.13	14.09
011	Meat	-	-	-	-	0.01	0.01
022	Milk and cream	1.86	1.49	1.39	1.30	2.09	1.80
0240	Cheese and curd	0.07	-	0.02	0.03	0.03	0.04
041	Wheat unmilled	0.54	2.59	1.65	5.89	3.34	-
048	Cereal preparations	0.01	0.06	0.03	0.01	0.02	0.02
1	Beverages and tobacco	0.24	0.24	0.18	0.30	0.41	1.06
2	Crude material excluding fuel	2.60	2.71	1.57	2.50	2.46	2.49
3	Mineral fuels	2.68	-	-	21.77	12.64	6.26
4	Animal and vegetable oil	0.43	0.17	0.16	0.65	0.50	0.62
4113	Animal oil	0.20	0.10	0.08	0.24	0.09	0.08
4311	Preserved vegetable oil	-	0.01	0.02	0.21	0.03	0.02
		-	-	-	-	-	-
Manufactures		47.41	46.78	78.05	56.45	66.36	76.15
5	Chemicals and related products	9.11	9.71	8.37	9.18	11.76	8.62
51	Organic chemicals	0.29	0.99	0.47	0.42	0.97	0.60
533	Pigments and paints	0.04	0.05	0.09	0.12	0.16	0.11
541	Medicine	1.04	1.10	1.12	1.12	1.27	1.20
58	Plastic material	0.73	-	0.83	1.28	1.73	1.67
6	Basic manufactures	19.21	10.07	17.37	21.70	30.83	37.52
62	Rubber manufactures	0.58	0.39	0.38	0.57	0.52	0.40
64	Paper and paper board	0.50	0.67	0.26	0.58	1.48	1.38
67	Iron and steel	0.55	0.14	0.50	0.38	0.37	0.40
68	Metal manufactures	0.33	0.32	0.69	0.46	0.35	0.30
7	Machinery and transport equipment	17.68	8.59	24.88	20.62	18.98	23.36
71	Power generating equipment	4.05	1.81	4.57	4.40	3.81	3.91
72	Machines for special industries	2.36	1.55	3.95	3.96	4.16	5.48
73	Metal working machs	1.50	0.82	0.52	1.87	1.76	2.99
8	Misce. manufactures	0.01	0.01	0.03	0.12	0.04	0.07
Total		100	100	100	100	100	100
US$ mn.		386.6	744.6	2035.4	1786.3	2631.5	4454.8

Source: Compiled using UN trade data (Series D) tapes (held by the International Economic Data Bank, Australian National University).

Table 6.6: Sri Lanka: Composition of Imports from Australia (%)

	1970	1975	1980	1985	1990	1994
Primary Products	88.79	95.51	75.35	87.53	64.94	58.10
0 Food	81.60	93.97	69.56	80.14	58.38	50.33
011 Meat	0.02	0.01	0.06	0.07	0.65	0.62
022 Milk and cream	12.55	10.12	25.50	2.91	30.68	14.09
0240 Cheese and curd	0.61	0.01	0.74	0.60	1.90	1.51
041 Wheat unmilled	11.00	29.31	15.47	72.34	14.11	16.59
048 Cereal preparations	5.11	1.19	5.34	1.15	7.21	2.05
05 Fruits and fruit preparations	0.17	0.01	0.60	0.91	4.11	8.11
1 Beverages and tobacco	0.01	0.02	0.20	0.11	0.48	0.31
2 Crude material excl. fuel	2.23	0.33	0.80	0.62	0.68	3.20
3 Mineral fuels	1.45	-	-	0.47	1.43	0.53
4 Animal and vegetable oil	3.50	1.20	4.73	6.14	3.97	3.73
4113 Animal oil	3.46	1.19	4.34	6.14	3.94	3.69
4311 Processed vegi. oil	0.03	0.01	0.39	0.01	0.02	0.03
Manufactures	11.21	4.49	24.65	12.47	35.06	41.90
5 Chemicals and related products	2.32	1.06	4.14	4.22	8.74	8.27
51 Organic chemicals	0.61	0.70	2.25	0.94	2.10	3.74
533 Pigments and paints	0.06	0.05	0.68	0.90	3.31	0.48
5417 Medicaments	0.66	0.25	0.79	1.19	1.71	1.00
58 Plastic material	0.02	-	0.05	0.65	0.51	0.45
6 Basic manufactures	5.71	1.50	11.94	3.34	14.54	16.78
62 Rubber manufactures	0.05	0.06	0.05	0.05	0.11	0.20
64 Paper and paper board	0.38	0.06	0.68	0.05	1.08	0.32
67 Iron and steel	0.35	0.04	0.05	0.04	3.73	1.01
68 Metal manufactures	0.35	0.18	0.08	0.17	1.44	0.77
7 Machinery and transport equipment	2.95	1.76	7.29	1.03	9.33	13.55
71 Power generating equipment	1.08	0.97	1.71	0.32	3.62	2.37
72 Machs for special industries	0.30	0.05	2.05	0.26	3.51	9.89
73 Metal working machs.	0.98	0.25	0.29	0.04	0.11	0.03
8 Misc manufactures	0.24	0.17	1.29	3.88	2.45	3.30
Total	100	100	100	100	100	100
US$ mn.	18.9	60.9	39.5	57.1	43.4	91.8

Source: Compiled using UN trade data (Series D) tapes (held by the International Economic Data Bank, Australian National University).

Table 6.7: Sri Lanka: Imports from Australia as % of Total Imports by Category (%)

	1970	1975	1980	1985	1990	1994
0 Food	8.62	15.37	6.74	13.50	5.31	7.36
011 Meat	50.00	26.67	91.67	30.89	71.02	82.58
022 Milk and cream	19.54	51.15	29.88	3.50	22.88	15.67
024 Cheese and curd	44.06	22.73	74.87	55.83	91.26	77.06
041 Wheat unmilled	100.00	92.54	18.26	39.31	6.96	-
048 Cereal preparation	1.85	0.78	4.05	4.35	0.59	16.10
1 Beverages and tobacco	0.11	0.66	2.18	1.16	1.92	0.60
2 Crude material excl. fuel	4.18	0.99	0.99	0.80	0.45	2.65
3 Mineral fuel	2.65	-	-	0.07	0.19	0.18
4 Animal and vege. oil	40.21	59.30	56.29	30.14	13.02	12.29
4113 Animal oil	83.63	99.72	99.42	80.99	71.81	97.38
4311 Vegetable oil	54.55	8.33	48.28	0.08	1.07	2.51
5 Chemicals and related products	1.24	0.89	0.96	1.47	1.23	1.98
51 Organic chemicals	1.99	3.78	0.20	0.04	0.55	0.62
533 Pigments and paints	6.55	9.32	14.94	24.64	34.78	9.36
541 Medicine	3.09	1.83	0.00	3.39	2.22	1.73
Masic manufactures	1.45	1.21	1.33	0.49	0.78	0.92
62 Rubber goods	2.97	9.14	0.32	0.07	0.24	0.31
64 Paper and paper boards	5.63	0.84	5.74	0.44	2.14	0.62
67 Iron and steel	3.39	3.33	0.08	0.04	9.91	4.93
68 Metal manufactures	1.59	3.33	0.08	0.18	5.26	4.29
Machinery and transport equipment	0.82	1.68	0.57	0.16	0.81	1.19
71 Power generating machines	3.77	1.74	0.03	0.03	0.02	0.10
72 Industrial machinery	1.41	0.49	0.25	0.38	0.08	0.55
73 Metal working machinery	4.01	1.58	1.08	0.03	0.07	0.03
8 Misc. Manufactures	0.68	1.25	0.90	3.16	0.97	1.15
Total imports	4.89	8.18	1.94	3.20	1.65	2.06
Total	18.91	60.90	39.54	57.14	43.40	91.76
	386.61	744.60	2035.40	1786.30	2631.52	4454.81

Source: Compiled using UN trade data (Series D) tapes (held by the International Economic Data Bank, Australian National University).

6.4 Conclusion

In conclusion, structural changes in Sri Lanka over the past two decades have brought about significant changes in her trade structure which have enhanced *potential* trade complementarity between Sri Lanka and Australia. Sri Lanka is no longer a predominantly a primary exporter, and her growing labour-intensive manufacturing industries have the potential to penetrate the expanding Australian markets in these product lines. There are also increasing market opportunities in Sri Lanka for Australian exports of machinery, transport equipment and industrial raw materials. This calls for a reassessment of the potential for expanding two-way trade between Australia and Sri Lanka in areas which reflect the transformation of export patterns from both countries.

In Sri Lanka, the demand for high value agricultural products such as meat, milk and milk products has tended to increase rapidly with increases in domestic incomes in general and rapid increases in urban incomes as part of the industrialisation process. However, there has not been a commensurate increase in the domestic supply of these products as has occurred in many other developing countries, where shifts in economic structure towards manufacturing and away from agriculture, have been accompanied by a significant diversification of domestic agriculture away from traditional food grains towards high value agriculture. The reasons are probably the long-standing policy emphasis on rice self-sufficiency and the nature of agricultural resource base. This demand-supply configuration, coupled with a clear commitment to an open trade regime, have created lucrative market opportunities in Sri Lanka for processed food exports from Australia.

7. AUSTRALIAN AID TO SRI LANKA

Since the inauguration of the Colombo Plan[13] in 1951, Australia has been a regular, though modest, source of aid to Sri Lanka. Activities supported over the years by Australian aid have encompassed education, health, environment conservation, agricultural research, reforestation, marine resource development, railway reconstruction, developmental food aid, and emergency and distress relief. In particular, the impact of the educational program under which opportunities are made available for Sri Lankans for higher education and technical training in Australia has dominated the area of development assistance of Australia-Sri Lanka economic relations.

This chapter examines trends and changes in the composition of Australian aid to Sri Lanka, focussing on Sri Lanka's relative position in Australia's global aid program and the importance of Australia to Sri Lanka among source countries. An attempt is made to shed light on the aid-trade-investment nexus, but no attempt is made to address explicitly the issue of *aid effectiveness* (the extent to which Australian aid has assisted development in Sri Lanka). Overseas aid is one small element in the more complex process of national development and no clear connection between aid and development can reliably be made (particularly when we consider aid from a small donor country) using available macro-level data. However, a clear understanding of the patterns and composition of aid flows and the terms and conditions underlying aid allocation permits some general inferences about their developmental implications.

To place the discussion in context, this chapter begins with a brief look at Australia's role as a donor nation in a global context. The relative position of aid

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13 The setting up of the Colombo Plan, as a co-operative venture for the economic and social upliftment of the people of South and South-East Asia, was proposed at a conference of Commonwealth Foreign Ministers held in Colombo in January 1950. It was the outcome of an individual initiative taken by Mr. J.R. Jayawardene and Mr. Percy Spender, Ceylon's Finance Minister and Australia's Foreign Minister respectively at the time. Following the adoption of a new Constitution in December 1977, its name was changed to 'The Colombo Plan for Co-operative Economic and Social Development in Asia and the Pacific' to represent the expanded geographical composition of its enlarged membership and the scope of its activities. For an interesting account of the events leading up to the plan see Weerasooriya, 1988, Chapter 18.

to Sri Lanka as a recipient country in Australia's overseas aid program, the relative importance of Australian aid in total aid received by Sri Lanka and its sectoral composition are discussed in subsequent sections.

7.1 Australia as a Donor Nation

Among the member countries of the Development Assistant Committee (DAC) of the Organisation for Economic Corporation and Development (OECD), Australia belongs to the league of small donors. In 1994, Australia occupied 14th position among the 21 DAC countries, with a total volume of official development assistance (ODA) of A$ 1,088 million (1.8 per cent of total ODA from DAC countries).[14] In that year Australia's total ODA amounted to 0.35 per cent of Australian GDP. In terms of this performance criterion (the conventional measure of aid intensity), Australia occupied 9th position after Norway (1.01), Denmark (1.03), Sweden (0.96), Netherlands (0.76), France (0.64), Canada (0.43) Luxemburg (0.40) and Switzerland (0.36), and Japan (0.29) and USA (0.15). The total volume of Australian ODA (in current prices) increased from A$180 million in 1970/71 to A$ 568.0 million in 1980/81, and then to A$1483.7 million in 1994/95. Thus, when the size of the economy (measured by GDP) is taken into account in the comparison, Australia is an 'above-average' performer in the ODA league.

Throughout, Australian policy (unlike that of many donor nations) has been to provide almost the entire amount of its ODA commitment as outright grants (rather than loans). Thus from the viewpoint of recipient countries, the value of Australian aid may be greater than the numbers imply.

As in other DAC countries, the Australian overseas aid program (officially known as the Australian Overseas Development Cooperation program) has two sub-programs: country (or bilateral) programs and a global program.[15] The country program involves a development cooporation strategy which matches recipient-

[14] Figures reported in this chapter unless otherwise stated are from AUSAID, *Statistical Summary* (various issues).

[15] The annual aid budget has a third item, corporate services, which mainly comprises the running cost of the Australian aid administration (Australian Agency for International Development, AUSAID) and the Australian Council for International Agricultural Research (ACIAR).

country needs with Australia's objectives of international economic relations and capacity to assist. Long-term strategies for the major recipients of Australian's aid are agreed with the partner countries, often during high-level consultations. Under the global program, Australia provides development assistance to international development institutions for the implementation of their development lending programs. The recipient institutions include various United Nation's development agencies, multilateral development banks (mainly the concessional lending arms of the World Bank and the Asian Development Bank), development activities, international health and environment programs, and international non-governmental organisation. Of the total overseas aid budget of A$ 1484 million in 1994/95, 57.8 per cent was disbursed through country programs, 33.6 per cent was channelled through the global program, and the balance (8.7 per cent) represented the local institutional and administrative expenses of the aid program.

Over the past one-and-a-half decades there have been two noteworthy developments in the structure of the Australian aid program. The first was the increased emphasis placed on community (non-governmental) programs (as part of the global program) in aid allocation. This was part of a long-term international and Australian trend which reflected policy makers' belief that "non-governmental organisations can make a significant contribution to grass roots development through harnessing governmental funds to private funds in development" (Viviani, 1995, p. 205). The new emphasis on international non-governmental organisations has been reflected in an increase in the share in total aid disbursement of the global program, from about 25 per cent in the early 1980s to over 33 per cent by the mid-1990s, and a corresponding decline in the share of the country programs from about 70 per cent to 58 per cent.

The second development relates to the increased commercialisation of aid program or the strengthening of the relationship between official aid and Australian commercial interests. In the 1970s, the Australian government was in the forefront of international moves to untie aid (Viviani, 1995). In a noteworthy departure from this policy stance, the early 1980s witnessed a significant policy

shift in favour of accommodating domestic commercial interests in the aid program as part of the new policy emphasis on industrial restructuring through greater internationalisation. Limited commercialisation of aid was identified as a means of facilitating expanding exports to Asia. Under this policy orientation the Development Import Finance Facility (DIFF), which was inaugurated in 1980, received increased attention. DIFF was a form of mixed credit arrangement in which aid funds were given in conjunction with soft loans (through the Export Finance Insurance Corporation) for specific development projects with the entire import requirements of the project tied wholly to Australian supply.[16]

Aid flows from Australia are characterised by a high degree of geographic concentration. Papua New Guinea, Australia's former colony has continued to be the predominant recipient of Australian aid. Even though the share of aid to PNG has declined steadily over the years, it still amounted to over 21 per cent by the mid-1990s (Table 7.1). The decline in PNG's share has been paralleled by an increase in aid to Southeast Asia (mainly to Indonesia and the Philippines) and North Asia (mainly China). In general the program has a strong focus on developing countries of the Asia-Pacific region, in line with the Australian Government's strategy of closer engagement with countries in this region.

7.2 Trends in Australian Aid to Sri Lanka

Following the market-oriented policy reforms initiated by Sri Lanka in 1977, aid inflows increased significantly. Annual aid commitments increased from an average annual level of around US$25 million during the 1970-77 period to over US$580 million by the mid-1980s when Sri Lanka became the largest recipient of foreign aid among developing countries on a per capita basis (Athukorala and Jayasuriya 1994). Despite some slowing down in subsequent years (due both to the completion of some major aid funded development projects and political instability), total annual aid flows have continued at significant levels, amounting on average to over 4 per cent of GDP, throughout the post-reform period.

[16] Following a heated debate on its merits, the DIFF was finally dropped from the Australian overseas aid program in June 1996. For an insightful critique of this most contentious innovation in Australian aid history see McLeod and Cuthbertson (1996).

Table 7.1: Geographic Profile of Australian Overseas Aid, 1984/85 - 1994/95 (A$ million)

	1988/ 89	1989/ 90	1990/ 91	1991/ 92	1992/ 93	1993/ 94	1994/ 95	1988/89 - 1994/95
Oceania	422.1	443.0	440.9	455.8	451.5	464.0	446.9	3124.2
	(35.4)	(37.9)	(35.0)	(34.2)	(32.7)	(32.9)	(30.1)	(33.8)
Papua New Guinea	314.5	338.0	331.7	336.0	333.7	339.0	319.2	2312.1
	(26.4)	(28.9)	(26.3)	(25.2)	(24.1)	(24.1)	(21.5)	(25.0)
Southeast Asia	255.2	260.8	269.5	283.1	342.6	359.8	394.4	2165.4
	(21.4)	(22.3)	(21.4)	(21.2)	(24.8)	(25.5)	(26.6)	(23.5)
North Asia	39.1	48.8	45.4	64.5	79.0	90.3	92.7	459.8
	(3.3)	(4.2)	(3.6)	(4.8)	(5.7)	(6.4)	(6.2)	(5.0)
South Asia	68.6	88.2	82.5	77.1	60.5	69.9	76.6	523.4
	(5.7)	(7.5)	(6.5)	(5.8)	(4.4)	(5.0)	(5.2)	(5.7)
Bangladesh	34.3	36.1	21.0	31.7	16.6	24.8	25.2	189.7
	(2.9)	(3.1)	(1.7)	(2.4)	(1.2)	(1.8)	(1.7)	(2.1)
India	8.5	28.8	38.3	23.0	18.9	15.8	20.5	153.8
	(0.7)	(2.5)	(3.0)	(1.7)	(1.4)	(1.1)	(1.4)	(1.7)
Nepal	3.6	3.2	3.2	3.6	9.0	5.9	7.5	36.0
	(0.3)	(0.3)	(0.3)	(0.3)	(0.7)	(0.4)	(0.5)	(0.4)
Pakistan	12.1	10.5	6.1	8.3	4.3	8.2	6.4	55.9
	(1.0)	(0.9)	(0.5)	(0.6)	(0.3)	(0.6)	(0.4)	(0.6)
Sri Lanka	6.1	5.3	6.2	7.2	8.7	10.1	9.4	53.0
	(0.5)	(0.5)	(0.5)	(0.5)	(0.6)	(0.7)	(0.6)	(0.6)
Africa, South of Sahara	76.5	96.4	77.8	109.1	106.3	89.3	98.4	653.8
	(6.4)	(8.2)	(6.2)	(8.2)	(7.7)	(6.3)	(6.6)	(7.1)
North Africa & Middle East	21.6	22.9	22.7	21.5	8.9	18.3	20.3	136.2
	(1.8)	(2.0)	(1.8)	(1.6)	(0.6)	(1.3)	(1.4)	(1.5)
TOTAL	1,193.3	1,169.6	1,260.1	1334.4	1381.9	1409.4	1483.7	9232.4
	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)

Notes: * Figures in brackets are percentages in total aid under the country program.
... Negligible.

Source: Australian Agency for International Development, (1995) Australia's Overseas Aid Program - Official Expenditure (various issues), Canberra: AGPS.

Australia's overseas aid to Sri Lanka expanded by more than 50 per cent over the 6 years from 1988/89 to 1994/95, from around AUD 6 million to nearly AUD 10 million (Table 7.1). However, in relative terms the growth of Australian aid has not kept pace with that from other donor nations. Consequently Australia's share in total flows has declined or remained stagnant in most years (Table 7.2). For the past two decades, on average, the share of net financial flows from Australia in total Development Assistance Committee (DAC) inflows to Sri Lanka has varied around 1 per cent. This low aid commitment to Sri Lanka probably reflects the close trade-aid link in Australian

Table 7.2: Australia's Contribution to Net Aid Flows to Sri Lanka#

	1970	1977	1980	1985	1987	1988	1989	1990	1991	1992	1993	1994
Total inflow*	84.6	85.0	483.9	584.0	544.0	580.6	744.9	737.8	868.4	666.2	816.4	665.7
of which, from DAC countries	52.4	30.3	334.6	432.4	369.4	431.9	591.5	420.2	443.9	285.8	482.7	412.8
Inflow from Australia	1.0	3.0	3.6	2.2	1.2	2.5	7.4	5.0	6.4	13.2	5.8	5.3
As a % of total inflow	1.69	3.5	0.74	0.37	0.22	0.43	1.00	0.74	0.73	1.98	0.71	0.80
As a % of DAC inflow	1.91	9.9	1.08	0.52	0.32	0.57	1.25	1.19	1.44	4.61	1.20	1.28

Values in million US$. The data on inflow from Australian reported here do not tally with those reported in Table 7.1 which include total aid (both aid through DAC and direct bilateral aid).

* Foreign aid and loans by donor governments and multilateral lending agencies.

DAC = Development Assistance Committee

Source: OECD, Geographical Distribution of Financial Flows to Developing Countries , Paris (various issues).

foreign economic relations, and the corresponding bias in aid flows to the countries in Oceania and the Asian Pacific region.

The share of Australia's aid to Sri Lanka in the total value of overseas development assistance has remained around 0.7 per cent for the past five years, except in 1992 (Table 7.2). Among the five major south Asian countries, Sri Lanka is the fourth largest recipient of Australian aid after Bangladesh, India and Pakistan. However, in per capita terms Sri Lanka is the largest recipient (A$ 0.45) followed by Nepal (A$0.25), Bangladesh (A$0.23), Pakistan (A$ 0.07) and India (A$0.03).[17] This raises the profile of Australian aid to Sri Lanka and the importance of the contribution of that aid to national development.

7.3 Composition of Australian Aid to Sri Lanka

The largest concentration of Australian aid in Sri Lanka is in education, and within that, for undergraduate training under the Australian Development Cooperation Scholarship scheme (ADCOS, Table 7.3). There has also been a substantial expansion in allocations for postgraduate training (ASTAS). In all, the education aid budget reached AUD 5.8 million, or 61.5 per cent of total aid by 1994-95. The other significant aid category was food aid. Little aid has been provided for the production sectors of agriculture and manufacturing, nor for infrastructure development. A modest amount has been channelled through multi-sector projects. Technical and project assistance also has been available through the Australian Centre for International Agricultural Research (ACIAR).

The food aid for development program is Australia's only large scale development-oriented aid program in Sri Lanka. Cash generated through food assistance has been utilised to finance a number of mutually agreed projects in Sri Lanka. A project of considerable importance under this program is the Dry

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[17] Figures in brackets are annual average per capita aid for the period 1988/89 - 1994/95.

Table 7.3: Percentage Distribution of Australia's Development Assistance to Sri Lanka by Type of Aid, 1988/89 to 1994/95

Type	1988/89	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	1988/89 to 1994/95
Social infrastructure	28.0	42.3	54.4	66.0	65.2	55.3	63.2	55.5
Education	25.8	36.7	52.6	64.1	61.4	54.3	61.5	53.0
Health	0.9	4.8	1.8	1.9	2.8	---	---	1.5
Economic infrastructure	20.0	11.7	---	---	---	0.1	---	3.5
Production sectors	3.5	4.1	2.8	2.4	2.2	12.9	3.8	5.0
Multi-sector	20.7	13.2	14.5	8.7	3.1	12.1	6.9	10.7
Food aid	21.4	23.1	19.9	16.1	23.3	12.9	17.4	22.6
Program assistance	---	---	---	---	---	---	---	---
Emergency assistance (other than food aid)	3.3	---	5.6	4.2	4.0	4.6	5.9	4.1
Other (unallocated and miscellaneous)	2.7	3.3	2.7	2.6	2.2	2.1	2.2	2.5
Total	100	100	100	100	100	100	100	100
A$ '000	6,137.0	5,337.2	6,193.4	7,158.0	8,737.0	10,145.1	9435.4	53743.1

Notes:

1. Social infrastructure includes education and training, health, water supply and sanitation, population, public administration, development and planning services and other social infrastructure and services
2. Economic infrastructure and services includes transport and communications, river development, energy and productivity and management
3. Production sectors include agriculture, forestry and fishing, manufacturing, extractive industries and construction, trade and promotion, and banking
4. Multi-Sector includes regional development and multisector
5. Program assistance includes donor-specified goods and services, general purpose contributions and administrative budgets
6. Food aid includes developmental food aid and emergency food aid
7. --- Zero or negligible.

Source: Australian Agency for International Development, (1995) Australia's Overseas Aid Program - Official Expenditure (various issues).

Land Farming Project (Muthukandiya Project). This project, nestled in the lower Uva area has the Muthukandiya Reservoir as its nexus and involves the development of 6,400 acres of land and settlement of 800 families. This is a 'model' project aimed at developing techniques and methodologies for stabilising upland cultivation on a settled basis.[18] Also, Australia is co-financing a large scale forestry planting scheme with the Asian Development Bank (ADB) using a food voucher system in collaboration with the World Food Program.

In the first half of the 1980s, Australia provided financial support for the implementation of the Accelerated Mahaweli Development Project[19] under the newly introduced DIFF scheme . Australian aid was used to finance Zone 1 and 5 of System B of this massive river-valley development project. With DIFF funds the total aid commitment to Sri Lanka reached an historical height of $8.87m in1982/83. The other projects funding under DIFF included a project to supply concrete sleepers to Sri Lanka Railways and a solar power project, each costing $1.2 million. These DIFF projects triggered the entry of a number of Australian companies into the Sri Lankan construction industry in the first half of 1980s (Chapter 5). Over the past five years, there has been no aid commitment to Sri Lanka under DIFF.

In Table 7.4, the sectoral composition of Australian aid to Sri Lanka is compared with that in total Australian aid and also with aid to South Asian countries. In studying the sectoral patterns of Australian aid it is important to highlight and

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18 The dominant form of upland cultivation in the dry zone of Sri Lanka is *chena* cultivation - a form of 'shifting cultivation' which involves periodic changes in the cultivation venue with cyclically occurring periods of fallow interspersed with periods of use of a given site. The length of the periods of fallow and farming are determined largely by the availability of land in relation to demand. *Chena* cultivation has, throughout the recent past, been constantly in a milieu of uncertainty because the limited supply of land. Moreover, when land is scarce, each cycle of land rotation invariably tends to be short, leading to soil degradation and other adverse environmental consequences. (See Peiris 1996, pp. 88-90 for details). The aim of this model project is to find a viable alternative to *chena* which does not suffer from these limitations.

19 The Mahaweli project, the biggest multipurpose river-valley development project ever undertaken in Sri Lanka, dates back to the 1950s. The feasibility of the project was first considered by a joint Sri Lanka/USA mission in 1958 and explored further by the World Bank in 1961. A master plan, which detailed a three-phase, thirty-year program of implementation was prepared by a UNDP/FAO team between 1965-1968. Work on the first phase of the project began in 1970. The UNP government which came to power in 1977 redesigned the project plan to complete the entire project in six years (at an estimated cost of US$610 million) as the Accelerated Mahaweli Development Project.

distinguish the unique composition of aid to PNG, the major recipient which accounts for the lion's share of total Australian aid. In 1994/95, over 76 per cent of aid to PNG took the form of program assistance (mostly as direct budget support) and this amounted to almost 20 per cent of the total aid budget. For this reason, we have reported data on the sectoral composition of total aid excluding aid to PNG. For South Asia, both aggregate and individual country data are reported.

Table 7.4 clearly shows the very high concentration of aid to Sri Lanka in social infrastructure activities and to education in particular. During the five year period 1990/91 to 1994/95, 59 per cent of Australian aid to Sri Lanka was for education compared with 18 per cent at the global level (excluding PNG) and with the South Asian average of 27 per cent. In contrast, the share of food aid in total aid to Sri Lanka (12.7 per cent) is much lower than that in total aid, and in aid to South Asia as a whole (32 per cent). Annual data for the past two decades (not reported here), in fact, point to continuous decline in food aid to Sri Lanka from the late1970s, as the country approached food self sufficiency. Another noticeable difference in Sri Lanka's aid pattern in the South Asian context is the relatively low share of aid related to production sectors (technical support for industry, agriculture and fishing). The share of this aid category for Sri Lanka was 5.3 per cent compared to 48.0 per cent for India, 35 per cent for Nepal and 23 per cent for Pakistan.

Underlying causes of this unique pattern require further analysis, but a possible explanation seem to be the singularly greater emphasis placed on education by the Sri Lankan government in aid negotiations. For Bangladesh the share of aid to production sectors was low (1.5 per cent) simply reflecting the heavy priority given to food aid, mostly as emergency relief (65.4 per cent).

7.4 Concluding Remarks

In terms of the volume of annual flows, Australia has been a marginal aid donor to Sri Lanka. The sums involved have obviously been too small to have had a significant overall impact on the development process of the Sri Lankan

Table. 7.4: **Percentage Disbursements of Australia's Development Assistance by Sectors of Destination, (Total for 1990/91 to 1994/95)***

	World	PNG	World Excluding PNG	South Asia					
				Total #	Bangladesh	India	Nepal	Pakistan	Sri Lanka
Social infrastructure	16.6	13.1	17.7	26.7	17.8	22.5	34.2	27.3	61.1
Education	--	5.7	9.5	17.9	7.7	10.4	27.7	24.0	58.9
Health	--	1.1	1.3	2.0	0.8	2.9	4.8	1.8	1.2
Economic Infrastructure	9.6	2.4	11.9	2.3	0.2	0.9	22.6	0.6	0.0
Production Sectors	9.6	2.0	12.1	22.3	1.7	48.0	34.6	23.1	5.3
Multi-sector	1.3	0.5	1.5	3.5	1.5	3.5	4.8	3.6	8.9
Program Aid	33.2	76.6	19.3	0.0	0.0	0.0	0.0	0.0	0.0
Food aid	7.1	0.0	9.4	32.1	65.4	14.8	0.0	14.7	12.7
Emergency assistance (except food aid)	15.4	0.4	20.2	2.6	4.1	0.5	2.1	1.8	4.8
Other (unallocated and miscellaneous)	7.2	5.0	7.8	1.4	0.8	1.3	1.7	3.0	2.3
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
A$ million	6844.9	1659.6	5185.3	351.2	130.5	116.6	29.2	33.3	41.6

Notes
* For details on sectoral disaggregation see notes to Table 7.3.
\# Total aid to Bangladesh, India, Nepal, Pakistan and Sri Lanka only.
-- Negligible (less than 0.05 per cent).

Source: Australian Agency for International Development, (1995) *Australia's Overseas Aid Program*: Official Expenditure, Canberra: AGPS.

economy. However, the importance of Australian aid to Sri Lanka has probably been much greater than the numbers suggest partly because the entire volume of aid has been given as outright grants and partly because of the dominance of the educational component of the aid program. It is widely acknowledged in developmental circles in Sri Lanka that Australian aid in technical and further education in Australia for Sri Lankans over the past four decades has made a significant contribution to human capital development in Sri Lanka. Of course, Australia too has benefited from the program; a significant number of Sri Lankans trained through the program have returned to Australia for permanent settlement. Nevertheless it is clear at least from anecdotal evidence that these settlers have provided a substantial underpinning to wider and mutually beneficial bilateral economic relations between the two countries.

A contentious issue in the wider debate on the distribution of gains from aid between the donor and recipient countries is the degree of commercialisation of aid (tying aid to Australian business). As noted earlier there has been a tendency towards greater commercialisation of Australian aid since the late 1980s. Under tied aid, the related transactions normally occur at a price arbitrarily set by the Australian supplier which is normally higher than the international market price. To that extent, the value of aid to the recipient is diminished and the price margin turns out to be a rent absorbed by the Australian supplier at the expense of the Australian tax payer. According to some available estimates, by the early 1990s, the proportion of total Australian aid tied to Australian business was as high as 87 per cent (Rummery 1993, p. 19). Moreover, some tentative estimates suggest that the cost to the recipient country of tying aid may be as high as 20 to 30 per cent depending on the type of goods and supply sources (Viviani 1995, p. 214). These considerations, however, appear to be of limited relevance in an assessment of Australian aid to Sri Lanka, given the large share (over 65 per cent) of educational aid in total Australian aid to Sri Lanka. Even though educational aid is directly tied to the educational institutions in Australia, the applicability of the 'arbitrary pricing' argument (generally levelled against aid-related commodity transactions) for the costing of educational facilities is highly questionable. Of the rest of the aid budget, only some minor programs related

with NGO activities can be considered purely untied and the rest may involve some hidden 'cost' of arbitrary pricing. However, the bottom line is that Australian aid is entirely composed of outright grants and when the human capital element of educational aid and other hidden gains from the enhancement of bilateral relations are appropriately allowed for, the net gain to Sri Lanka should invariably add up to significantly more than zero.

8 POLICY IMPLICATIONS

The purpose of this study has been to assist policy making bodies and the business community in both Australia and Sri Lanka to devise strategies and policies to promote mutually beneficial trade, investment and aid relations between the two countries. Towards this end, it has undertaken an in-depth inquiry into the nature and evolution of Australia - Sri Lanka economic relations in the context of economic liberalisation policy reforms in Sri Lanka since 1977. Particular emphasis has been placed on the scope and operation of the Australian aid program to Sri Lanka and special contributions made by Australia within it towards economic development in Sri Lanka. This final chapter presents the key findings of the study and derives policy inferences.

In South Asian terms, the Sri Lankan economy has undergone a most radical structural transformation over the past two decades. Sri Lanka is now one of the most open and market-oriented economies in the developing world, and there are clear indications that the basic thrust of the outward-looking policy stance of the country will remain unchanged whatever political party comes to power in the foreseeable future. The most dramatic change in the Sri Lankan political landscape in recent years has been the convergence in broad economic policies among the major political parties and groupings.

The Sri Lankan economy has responded well to the liberalisation of trade and investment policy regimes. The response of foreign investors to the new policy orientation has been swift and remarkable, and they have contributed significantly to manufactured export expansion and employment generation. Greater exposure to foreign trade and interaction with foreign firms has set the stage for the private sector to emerge as the major force driving economic expansion.

Sri Lanka's ability to reap benefits from this dramatic policy transformation has been constrained first by the continuing ethnic conflict since 1983 which

interupted the liberalisation process for some years, and second by recent political and uncertainty following the change of government in 1994. Despite these constraints, Sri Lanka's achievements through outward orientation have been remarkable. With a dramatic transformation of the classical colonial export economy structure, the Sri Lankan economy is no longer a primary commodity exporter and manufacturing has emerged as the key growth sector and there have been significant employment gains primarily through the expansion of export-oriented manufacturing. A competitive business culture has clearly emerged as the private sector has expanded and domestic firms have become accustomed to foreign competition.

A key lesson from the Sri Lankan reforms for other developing countries relates to the complementarity achieved between trade liberalisation and liberalisation of the foreign investment regime. Unlike many other developing countries which have embarked on liberalisation reforms, policy reforms in these two areas in Sri Lanka have proceeded hand in hand. The outcome has been remarkable. In the liberalised economy, foreign direct investment has been the engine of manufactured export expansion and employment generation. In fact, the impressive employment outcome of FDI-led export-oriented industrialisation has been the catalyst in making a political commitment to liberalisation a bipartisan policy. Continuation of the pro-FDI policy stance of the previous regime was a key election promise of the centre-left Peoples' Alliance at the general elections in December 1994.

As a result of rapid structural transformation and increased trade orientation, potential complementarity in trade between Sri Lanka and Australia has been enhanced. Sri Lanka's labour intensive manufacturing industries have the potential to penetrate the growing Australian markets in these product lines. In Sri Lanka there are growing market opportunities for Australian exports of machinery, transport equipment, building materials and industrial raw materials. Sri Lanka's demand for various processed food items is also continuously expanding as domestic income levels increases. However, these potential trade

complementarities are yet to materialise in actual bilateral trade between the two nations which clearly require investigation by the governments and private sectors of both countries.

There are signs that manufactured exports from Sri Lanka to Australia will continue to expand in the future, given the presence of Australian firms in Sri Lankan manufacturing. However, with the stringent competition from Southeast Asian and Chinese exports, it is unlikely that Australia will become a significant market except perhaps in some niche markets such as porcelain and jewellery.

Gains from FDI linkages look more promising. A significant number of Australian companies (in particular Pacific Dunlop and BHP) have already entered Sri Lanka, and with business success there, Sri Lanka has the potential to become a significant low-cost production base for Australian manufacturers. The strengthening of links due to the presence of a substantial number of entrepreneurial Sri Lankan migrants in Australia may provide some additional linkages and stimulus to the bilateral trade and investment links. There is considerable anecdotal evidence that Sri Lanka migrants in Australia are undertaking a range of investments in Sri Lanka at present.

Production plans of Australian firms in Sri Lanka over the next two years, with few exceptions, are generally positive. Ten of the twelve firms which responded to the relevant question indicated that they intended to expand production. Two of these ten firms indicated they would also diversify production in the course of production expansion. Of the two firms which had no plans to expand, one will maintain production at current levels and only one intends to reduce current production levels.

Political instability caused by the continuing ethnic conflict is undoubtedly having adverse implications for long-term business investment. The largest Australian firm with substantial sunk fixed investment is still proceeding with investment expansion. However, most of those which have not already committed themselves to large scale past investment appear to prefer to

defer future investment until the security situation improves and the political climate is more settled. This is clearly a "wait and see" approach to investment. This reluctance is naturally compounded when firms have options to invest in other Asian countries with better and more certain prospects.

The shift in policy focus in Sri Lanka away from an inward orientation towards greater integration within the global economy opens up new opportunities for achieving national developmental objectives. At the same time, under an outward orientation, maintaining international competitiveness as an international production location poses a much stiffer test for national economic management than managing a slow moving closed and regulated economy. Harmonising the key elements of the incentive regime with those in other competing countries, maintaining macroeconomic stability, ensuring policy continuity and certainty, and of course political stability and social harmony are essential ingredients of success through an outward orientation.

While Sri Lanka had made remarkable progress in unwinding a control regime developed during the first three decades of the post independence period, there are still some anomalies in the incentive structure which hinder private sector performance. One such anomaly, which was brought into sharp focus in our survey of Australian firms, is the bias in the incentive regime against domestic market oriented firms in the existing system of domestic and import taxation, and access to domestic financial institutions. The adverse impacts of these discriminatory treatments on private sector performance have been aggravated by the uncertain and highly volatile macroeconomic environment characterised by high interest rates and rampant inflation. Export-oriented firms are not only favoured by the existing incentive regime, but are also naturally less exposed to these adverse macroeconomic developments. The aim of liberalisation reforms has been to achieve greater efficiency in domestic resource allocation by exposing domestic industry to world competition. In this context whether a firm is producing for the domestic or export market has and should become less

relevant from a policy viewpoint. The existing discriminatory elements in the incentive structure are thus inconsistent with the overall policy thrust of the outward-oriented policy regime.

The findings of this study clearly suggest that the recent decline in foreign investment inflow to the country and the general setback in private sector performance cannot be ascribed to the escalation of ethnic violence alone. Of course, firms are concerned about the political risk involved. However, it is important to note that the majority of Australian firms established production bases in Sri Lanka after the onset of ethnic violence in 1983 and periodic escalation of violence has been a part of the political scene of the country during the ensuing years. Even with the ongoing war, the performance record would have been a lot better had it not been for the existing and prevailing policy uncertainty and adverse labour market developments, and in particular, the unsettled issues relating to the debate over the *Workers' Charter.*

The role of tax holidays and other specific incentives for foreign investors remains a controversial issue in foreign investment policy in Sri Lanka (and in other developing countries). For instance, a recent ADB study on industry policy in Sri Lanka has argued against such incentives on the ground that they add to the difficulties involved in fiscal management without any appreciable impact on investor perception. According to this view what is required to attract foreign investment is macroeconomic policy which removes distortions in factor markets, and in particular, in the labour market. Our findings suggest that, while macroeconomic stability and orderly factor market conditions are essential ingredients of a successful foreign investment promotion strategy, tax holidays and other specific incentives do matter to the investor in making decisions on export-oriented production. This finding is consistent with the available recent empirical evidence on factors affecting the location of export oriented FDI (Caves 1996, pp. 219-22, Woodward and Rolfe 1993). Survey results have suggested that much of the prevailing confusion on this subject has originated in the mixing of export-oriented and

domestic market-oriented firms in studying the determinants of investment locations.

In the context of rapid growth in offshore investments from Australia since the late 1980s, national gains from such investments have become an important and controversial topic in the national economic policy debate (IC 1996, EAAU 1994, Edwards 1994)). While there is consensus that internationalisation of production is a *sine qua non* for business success for many firms in a rapidly integrating competitive world market, critics argue that offshore investment by national firms may be at the expense of Australia's exports and employment.

The findings of our survey of Australian firms largely run counter to this pessimistic view. The majority of Australian firms in Sri Lanka are fully export-oriented ventures which make use of Sri Lanka as a low-cost production base to penetrate world markets. Judging from the nature of commodities they produce, there is nothing to suggest that these firms replace Australian exports in third country markets. All these firms have set up production bases in Sri Lanka to take advantage of the availability of inputs (raw material and/or cheap labour) which are not available in Australia. Therefore it cannot be argued that the goods they produce in Sri Lanka could have been produced and exported from Australia.

Only a small portion (about 3 per cent) of goods produced by these firms found markets in Australia. Moreover these products are mostly highly labour intensive consumer goods which are unlikely to pose a competitive threat to domestic producers. The location decisions of domestic-market oriented (import-substituting) Australian firms in Sri Lanka are predominantly (if not solely) involved in the production of goods (and services) which are neither feasible nor economic to export from Australia. Thus it is unlikely that their offshore operations leads to a reduction in exports from Australia. In support, they do import (albeit a small volume of) inputs from Australia. In sum,

Australian firms operating in Sri Lanka add to national wealth[20] rather than contribute to a reduction in national exports, employment and output.

As noted, only a small fraction of inputs used by Australian firms in Sri Lanka are imported from Australia. The available literature on the operation of Australian firms in other countries have come up with similar findings (EAAU 1994, IC 1995). This pattern is largely inconsistent with the import procurement practices of off-shore affiliates of firms from major investing countries such as Japan, USA, Germany and UK (Caves, Chapter 9). One explanation of the difference seems to be that, unlike firms from the latter countries, most of the Australian firms located in other countries are not vertically integrated global conglomerates. As noted in Chapter 5, the majority of Australian firms are small scale ventures with no intra-firm links with firms located in Australia. Another, and perhaps the most important, reason is that the majority of Australian firms in Sri Lanka are export-oriented ventures which, by their very nature, must purchase inputs from least cost and high quality sources. For these firms, sourcing inputs from Australia on a sustained basis may not be a viable policy even if they desire to do so. A recent study by the East Asia Analytical Unit of the Department of Foreign Affairs and Trade on the operation of Australian firms in South-East Asia (EAAU 1994) has suggested 'better networking among firms' as a means of enhancing the trade effect of overseas investment. The nature and modalities of the proposal have not been clearly spelled out in the study, but, we have our doubts about the effectiveness of such direct initiatives when it come to enhancing trade effects of investment in Sri Lanka where the overwhelming majority of Australian firms are involved in export-oriented production.

The evidence of 'dropouts' among Australian investors who had an original interest in investing in Sri Lanka points to the importance of providing adequate business information as a prerequisite for successful investment

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[20] Profits earned from offshore production by Australian firms add to the wealth of Australia, irrespective of when they are repatriated.

promotion. The failure of Australian traders to exploit satisfactorily the market potential in Sri Lanka's post-reform economy as well as the lack-lustre performance of Sri Lankan producers in penetrating the Australian market can also be ascribed at least partly to a weak information base.[21] Thus there is a clear need for action by both Sri Lanka and Australia to establish and develop a satisfactory information base to set the stage for further expansion of trade and investment relations between the two countries. One potential area where Australia can effectively assist the Sri Lankan government is in the development of a foreign investment data base at the Board of Investment in Sri Lanka. As part of the process of screening and monitoring of foreign investment projects, the BOI gathers a large volume of information on these projects. For each firm in operation, the BOI also maintains an activity report, comprising data on investment, production, exports and employment, on a continuing basis. Most of these valuable data remain largely unexploited as a source and basis for generating valuable information for both the BOI management, individual investors and policy makers in Australia.

Collection and organisation of these data in the form of a user-friendly computerised data base should yield valuable information for BOI management, individual investors and policy makers in Australia. It could help to lift the level of Australian investment in Sri Lanka. Quite apart from potential information gains, the involvement in a project of this nature should provide the Australian government with an opportunity to contribute to policy dialogue on investment policy in Sri Lanka.

There has been a shift in priorities in the Australian aid program to Sri Lanka away from assistance for economic development (infrastructure and production sectors) towards social development, particularly through education. The reasons for this shift are not clear and deserve further study. In any case, the shift appears to reflect a declining linkage between

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21 Dearth of information has also been identified as a major constraint on the expansion of overseas investment by Australian companies and the business success of offshore operation by a number of recent studies in this area (eg. EAAU 1994 and 1992, IC 1995 and 1996, Edwards and Buckley 1995).

Australia's aid program with the trade and investment components of the economic relationship with Sri Lanka. To this extent, the parallel may be with South East Asian countries which are also placing a heavy emphasis on building up human capital as a key building block for further sustained and increasingly sophisticated economic development under liberalised, open regimes. In this sense, Sri Lanka leads the way in South Asia.

For the present there is a strong need for a high concessional component in educational aid to Sri Lanka as incomes are, on average, still low. But as they rise, and become more equitably distributed, the need for scholarships will decline and foreign education will become more market oriented.

For the time being, it appears that the shift in priorities is an expression of felt needs and priorities on the Sri Lankan side. So long as the benefits of Australian educational aid are returned to Sri Lanka, this aid will significantly contribute to the development process.

Overall, considerable progress has been, and is being, made in the economic relationships between the two countries. Australia's direct involvement in development through direct investment by the private sector rates highly, but could expand further with better information and with an improvement in the political climate. The aid program, through redirection into primarily educational channels, is making a significant, if modest, contribution which could be expanded. It is only in the area of bilateral trade that little progress has been made. It is suggested here that this could be rectified through two way exchanges at government and private sector levels.

Appendix A

Australian-Sri Lankan Economic Relations: Survey of Australian Firms with Business Interests in Sri Lanka

Company Name: _____

Interviewees and Titles: _____

Date of Interview: _____

Remember to:

Cite Purpose of Survey
Ensure Confidentiality
Get copy of Annual Report and other relevant published documents

A. BASIC INFORMATION

1. Year Sri Lankan subsidiary was formed: _____

2. Legal Status:
   - ☐ fully owned subsidiary
   - ☐ partnership (joint venture*)
   - ☐ private limited liability
   - ☐ public (quoted) limited liability
   - ☐ public (non-quoted) limited liability

* If joint venture:

Name of local partner_____

3. What are your main areas of activity?

   _____
   _____
   _____

4. Where are your plants located?

   Inside Colombo Metropolitan Area? YES NO

   In an EPZ? YES NO

Outside Colombo Metropolitan Area? YES NO

5. Plain reason for choice of location

_____

_____

6. What is the company's main source of long-term (investment) capital?

_____

7. What is the company's main source of short-term (working) capital?

_____

8. What is the value of:

_____

Total fixed assets as at date:

_____

9. How many people are employed?

Full time		Part-time or		contract		Expatriates	
Male___	Fem___	Male___	Fem___	Male___	Fem___	Male___	Fem___

10. How does the cost of labor compare to the countries of your major foreign competitors? Please comment:

_____

_____

11. How does the quality of labor compare to countries of your major foreign competitors? Please comment:

_____

_____

12. For the other inputs, how does the cost in Sri Lanka compare to countries of your major foreign competitors? Please comment.

_____

_____

13. What was the value of your sales in the most recent fiscal year?

_____ million Rs.

14. What percentage of your inputs are:

Imported _____%
Sourced domestically _____%

15. What percentage of your products or services are sold in:

Export markets _____%
Domestic markets _____%

16. In starting your business, how many weeks passed between the time you decided to register until the time you successfully completed the regulatory process?

_____ weeks

What was the approximate total cost of registration, fees, and any payments for services? ____US$

If time to complete the process was more than 4 weeks, what caused the most difficulty to become registered?

_____

17. Of all the agencies that you deal with, which is the most difficult to deal with, and why?

_____

18. Have you received any incentives such as tax holidays or import concessions? YES NO

If yes, specifically which concessions did you receive?:

_____

_____

_____

If you HAD NOT received these concessions, would you have made the investment anyway? YES NO

19. In the past three years, have you been involved in any commercial/legal/labour disputes? YES NO

If yes, how was the dispute resolved?

_____

_____

20. What, if any, improvements are needed in procedures for resolving commercial disputes?

_____

21. Have you ever tried to close all or part of your operations?

YES NO

If yes, were you successful?

YES NO

22. What are your production plans over the next two years?
Keep production at current level;

Expand production; or

Reduce production

23. Do you have plans to expand your overseas export market. YES NO

24. In the next two years, do you plan to diversify into other lines of business?

YES NO

If yes, what are your plans?

_____

If no, why not?

_____

25. Do you have operations in other developing countries? YES NO

If yes, which countries.

_____

_____

If yes. How does the Sri Lankan business environment compare with them. Please comment on each country.

_____

_____

_____

_____

26. Do you have competitors in Sri Lanka? YES NO

Local YES NO

Foreign YES NO

Do you find you are at an advantage/disadvantage by comparison. Please explain.

_____

_____

_____

27. Do the political uncertainties in Sri Lanka affect your investment decision
YES NO Please comment.

_____

_____

_____

OVERVIEW OF CONSTRAINTS TO EXPAND OPERATIONS

	None		Moderate		Strong
1. REGULATIONS					
Investment licensing	1	2	3	4	5
Export regulations	1	2	3	4	5
Import regulations	1	2	3	4	5
Tax regulations	1	2	3	4	5
Labor regulations	1	2	3	4	5
Land regulations (titling, restrictions on use)	1	2	3	4	5
Environmental regulations	1	2	3	4	5
Anti-trust regulations	1	2	3	4	5

	None		Moderate		Strong
2. INCENTIVES					
Level of Taxation	1	2	3	4	5
Import Duties/Quotas	1	2	3	4	5
EPZ Concessions	1	2	3	4	5
Other (specify)	1	2	3	4	5
3. INFRASTRUCTURE SERVICES					
Reliability of publicly supplied electric power	1	2	3	4	5
Capacity of transportation					
Roads	1	2	3	4	5
Rail	1	2	3	4	5
Port facilities	1	2	3	4	5
Containers	1	2	3	4	5
Air transport	1	2	3	4	5
Reliability of publicly supplied telecommunications	1	2	3	4	5
4. CAPITAL MARKET					
Access to finance: Domestic sources	1	2	3	4	5
offshore financing	1	2	3	4	5
Cost of finance	1	2	3	4	5
Access to foreign exchange	1	2	3	4	5
5. LABOR MARKET					
Access to qualified labor	1	2	3	4	5
Access to qualified managers	1	2	3	4	5
Effort of workers	1	2	3	4	5

	None		Moderate		Strong
6. LAND MARKET					
Access to Land	1	2	3	4	5
Rental level	1	2	3	4	5
7. MACROECONOMIC/POLITICAL/SOCIAL					
Labor Relations	1	2	3	4	5
Policy uncertainty	1	2	3	4	5
Law & Order	1	2	3	4	5
Price uncertainty	1	2	3	4	5

Appendix B

Investment Incentives in Sri Lanka*

The Sri Lankan government offers a wide range of incentives for investors, both domestic and foreign. There is no incentive bias between the foreign and local investor. The incentives offered belong to two classes or "regimes", and the enterprise may become eligible for incentives offered by either of these two regimes. The two regimes are:

A. BOI Incentives Under Section 17 of the BOI Act

B. General Incentives Under the Normal Laws of the Country

A. Incentives Under Section 17 of the Board of Investment (BOI) Act

The incentives offered under this regime are also available to both local and foreign investors. Firms that do not qualify for concessions under Section 17 of the BOI Act may seek incentives available under the normal laws of the country such as Inland Revenue Act, Turnover Act, Excise (Special Provisions) Act and Customs Ordinance. Foreign investment entry to operate under the normal laws is conferred under Section 16 of the BOI Act which entitles the enterprise to repatriate profits and dividends attributable to foreign shareholders.

The BOI is responsible for the approval of all foreign direct investment. Foreign investors need to invest at least US$50,000 in the equity of the enterprise in order to qualify for approval under Sections 16 or 17 of the BOI Law.

Enterprises which satisfy specific eligibility criteria qualify for incentives under Section 17 of the BOI Act. The incentives offered by the BOI were expanded in November 1995. The new incentives represent a two pronged strategy: diversification of exports towards advanced technology and value addition, and investments in large scale projects including infrastructure.

For the purpose of granting the new incentives, "advanced technology" has been identified as follows by the Ministry of Finance.

i Technology which introduces a new design, formula or process for the manufacture of an article or in the provision of a service, resulting in one or more of the following:

Source: Board of Investment (1996), Sri Lanka: Investment Policy and Incentives

a Higher productivity resulting in lower cost of production
b quality improvement of product/ service
c Better utilisation of raw materials
d Upgrading of technical skills
e Minimises/ controls environmental pollution and/ or wastage

ii Manufacture of products using a technology hitherto not applied in Sri Lanka (excluding technology involving only simple processing)

iii Technology for the local processing of raw materials, which are currently imported in processed form, excluding simple types of processing

iv Technology hitherto unutilised in Sri Lanka that would make use of local resources to provide public utilities and infrastructure services.

Given below is a list of the types of investment that qualify for incentives under Section 17 of the BOI Law, with applicable conditions. It should be noted that all enterprises qualifying for concessions would also be:

- exempt from income tax on capital gains due to transfer of shares (however, stamp duty shall be payable;
- exempt from the provisions in the Import and Export Control Act;
- subject to the National Security Levy (currently 2% on imported capital goods);
- entitled to repatriate profits and dividends.

Investments in Non-Traditional Export-Oriented Manufacturing

A new company that manufactures non-traditional goods* and exports 90% of its output overseas or sells 90% of its output to a BOI approved direct exporter is considered an Export Oriented Manufacturing Company. A new export company with a minimum project cost of Rs 12.5 million or more is entitled to certain BOI concessions. These projects will benefit from a concessionary tax rate of 15% for twenty years and are exempt from exchange control. They are also exempt from duties, turnover tax and excise duty on project related goods imported or purchased locally.

However, a new export-oriented manufacturing company with a minimum project cost of Rs 50 million and providing employment to at least 50 persons and using "advanced technology" as defined earlier will be granted a five year tax holiday (effective from the commencement of business) followed by a concessionary tax rate of 15% for fifteen years thereafter.

* Non-traditional goods are defined to include goods other than black tea sold in bulk, crepe, sheet and scrap, rubber, coconut oil, copra, fresh coconuts, coconut fibre, uncut gemstone or such other commodities as may be specified by the Minister of Finance.

An existing BOI approved export-oriented company undertaking an incremental investment of not less than Rs 2.5 million and qualifying under the advanced technology criteria as defined will be granted incentives under the Inland Revenue Law. (See latter part of this appendix for details.)

Additional Incentives for the Electronics Sector

In order to encourage investors in the field of advanced technology electronics, the BOI has formulated a special scheme of financial assistance. This takes the form of direct financial grants to eligible enterprises through a special Technology Transfer Fund administered by the BOI. Companies qualifying for direct grants under this scheme would be engaged in the export of advanced electronic components, usually manufactured within a "clear room" environment. Assistance under this scheme, granted on a case by case basis and a formula established by the BOI, can take the form of financial grants linked to incremental export turnover and/ or reimbursement of costs associated with training, acquiring equipment for testing and calibrating, manufacture of prototypes, dies and moulds and developing programmes pertaining to quality assurance.

Investments in Export-Oriented Services

A service company where 70% of total output rendered to non-residents for payment in foreign currency is considered export oriented for the purpose of qualifying for BOI incentives (eg ship repair, software). A company providing a service, in excess of 70% of total output, to improve/ enhance the quality/ character of exportable products of a BOI approved export oriented company is classified as an indirect exporter of services (eg garment washing plant, quality testing services).

Except in the case of ship repairing and ship breaking, where a minimum project cost of Rs 10 million shall apply, a minimum investment criteria does not apply to companies exporting services, directly or indirectly. These projects will be entitled to a concessionary tax rate of 15% for twenty years and are exempt from exchange control. They are also exempt from import duties and excise duty on project related articles imported or purchased locally. However, an enterprise engaged in direct or indirect export of services will be liable to turnover tax on sales and raw materials and assets imported or purchased locally.

A new company undertaking direct and/ or indirect export of services, employing at least 25 persons and using advanced technology as defined,

will be eligible for a five year tax holiday, effective from the commencement of business, followed by a concessionary income tax rate of 15% for fifteen years thereafter.

An existing BOI approved company engaged in the export of services undertaking an incremental investment of not less than Rs 2.5 million and qualifying under the advance technology criteria as defined will be granted incentives under the Inland Revenue Law. (See latter part of this appendix for details.)

Large Scale Projects

New enterprises with a total project cost exceeding Rs 500 million are classified as Large Scale Projects eligible for tax holiday periods varying according to the size of the investment.

The tax holiday period applicable for the respective investment schemes is shown below. Note that the tax holiday and Exchange Control exemption would be available for both export and non-export oriented projects. Furthermore, manufacturing projects must employ at least 100 persons to become eligible for concessions.

Project size	Tax holiday period
Rs 500–1499 million	10 years
Rs 1500–2499 million	12 years
Rs 2500–4999 million	15 years
Above Rs 5000 million	20 years

Export oriented projects are free of import duties, turnover tax and excise duties on imports of machinery and raw materials for the life of the project. They also enjoy a further concessionary tax rate of 15% after the total tax holiday up to a cumulative period of 20 years.

The above concessions to non-export oriented enterprises however will apply only during the project implementation period as determined by the BOI. If the project is less than Rs 2,500 million expatriate employees are subject to a concessionary tax at 15% during the first five of employment.

Projects with an investment of above Rs 2,500 million qualify for further incentives, as "flagship" companies under the Inland Revenue Act and Turnover Tax Act. These are:

- Lower rate of 15% on income tax of expatriate employees, throughout the company tax holiday period.

- Non-resident consultants to such companies providing certain specified services are exempt from Sri Lankan income tax in excess of tax in their home country for the services rendered.

- No-resident consultants providing certain specified services are free of turnover tax on fees, commissions and other charges.

- All project related imports are exempt from turnover tax.

Small Scale Infrastructure Projects

This category of investment includes investments in warehouses, environment improvement, data and voice transmission, power generation, industrial estates and housing. The minimum project size to qualify for incentives is Rs 50 million for housing and power projects and Rs 125 million for other activities. Housing projects should produce at least 100 units in a maximum of four locations. The preferential tax rates offered are:

- For projects size between Rs 125 million and Rs 249 million — income tax of 15% for seven years.

- For projects size between Rs 250 million and Rs 499 million — income tax of 15% for ten years. (Projects above Rs 500 million would qualify for incentives under Large Scale Projects.)

- For housing projects with an investment of more than Rs 50 million — income tax of 15% for seven years.

Other benefits include exemption from import and excise duties on operational and construction machinery, equipment and construction materials during the project implementation period. Expatriate employees are eligible for a 15% reduced income tax for the first three years of employment. Note that infrastructure projects where total project cost exceeds Rs 500 million will qualify for incentives under Large Scale Projects.

Tourism, Recreation and Leisure Projects

A preferential tax rate of 15% for fifteen years applies to investments of more than Rs 10 million in hotels, recreational complexes, golf courses and other projects related to tourism and leisure. Such projects may also import equipment and construction materials free of import and excise duties during the project implementation period. Expatriate employees may enjoy a reduced tax rate of 15% during the first three years of employment.

This category of enterprises may also obtain foreign loans to meet cost of imports with the prior approval of the Controller of Exchange. Note that

tourism, recreation and leisure projects where total project cost exceeds Rs 500 million will qualify for incentives under Large Scale Projects.

Agriculture Sector Projects, Fisheries, Dairy and Livestock Development Projects

Firms in animal husbandry, dairy, non-traditional crops, marine and inland fisheries, agro-processing and the collection and storage of agricultural produce are entitled to a tax holiday and certain other concessions. The project investment should be a maximum of Rs 7.5 million for foreign investors and Rs 2.5 million for local investors. A minimum investment of Rs 10 million is required in the dairy sector. Firms should employ more than fifty persons if they are in manufacturing. They should also be located outside the Colombo district.

The incentives provided are a tax holiday of five years. A 15% concessionary tax thereafter for a period of fifteen years is available only for investments that export more than 90% of output. The export oriented companies will also enjoy concessions on imports, such as exemption from import duties, turnover tax and excise duties.

Institutions Providing Training Facilities

Tax concessions are also available for institutions providing training facilities to approved sectors. The sectors chosen for this purpose are information technology, technical training, management and garments and textiles. Other sectors too, depending on the contribution to the national economy, may be approved by the BOI. These institutions are eligible for a preferential tax rate of 15% for ten years. They are exempt from import duty and excise duties on the import of machinery and other inputs during the project establishment period. Expatriate employees enjoy a reduced 15% income tax for the first three years of employment.

Mining and Processing of Non-Renewable Resources

Concessions applicable to such projects will be decided on a case by case basis by the Board in consultation with the Ministry of Industrial Development and within the given framework of regulations published under the BOI Law, Mines and Minerals Act and other related Acts.

All enterprises which have entered into an Agreement under Section 17 of the BOI Law after November 1993 and have created an additional 100 permanent jobs after November 8, 1995 will be eligible to import a passenger vehicle free of import duty up to a value US$30,000. A special application has to be submitted for the purpose. The BOI may also consider the approval of duty free import of off-road vehicles on an individual basis depending on project requirements. Specialised project-related vehicles such as

ambulances (for hospitals), freezer trucks (for food processing operations) are approved for duty free importation automatically.

B. General Incentives Under the Normal Laws of the Country

Local or foreign investors not qualifying incentives under Section 17 of the BOI Act can take advantage of incentives available under the normal laws of the country. Concessions under the general incentives regime fall into the following broad categories:

- Incentives for industry and services using advanced technology, and
- Incentives for direct and indirect exports.

These are described below in greater detail.

Incentives for Investments in Advanced Technology

For companies not satisfying export orientation criteria and/ or minimum investment criteria under the BOI Law and using advanced technology as defined may apply for incentives under the normal laws through the Fiscal Incentives Committee serviced by the Ministry of Industrial Development. The incentives are available to industry and services. There is no minimum export requirement.

Under this regime, new firms in the manufacturing and services sectors which

- use advanced technology
- employ a minimum of fifty persons
- invest a minimum of Rs 10 million on machinery
- are approved by the Minister of Finance

are entitled to tax and import duty concessions that include a:

- five year tax holiday
- tax free dividends if paid out of exempt profits during tax holiday and one year thereafter
- import duty waiver and corresponding turnover tax exemption on machinery and equipment imported for the purpose, within one year of approval by the Fiscal Incentives Committee.

Existing firms, which meet the same criteria are eligible for all concessions where the corporate tax exemption will be on incremental profits. If the investment in machinery is lower than Rs 10 million but not less than Rs 2.5 million for an existing company, the benefits are limited to the import duty waiver and corresponding turnover tax exemption. To be eligible for

incentives for advanced technology, investors must submit applications prior to 30th September 1996.

Incentives for Direct and Indirect Exporters

Incentives are available under the Inland Revenue Law to exporters not qualifying for concessions under Section 17 of the BOI Law. These concessions are briefly outlined below.

- Profits attributable to the export of non-traditional goods by an undertaking are made liable to income tax at 15% till 1 April 2014. Dividends declared will be subject to a 15% tax.

- Enterprises that supply to export enterprises also benefit from a 15% tax on the profits of such sales till 1 April 2014. Dividends are also taxed at 15%. Manufactured items supplied to an exporter are exempt from turnover tax, if such supplies are covered by domestic letters of credit, or backed by international letters of credit or confirmed export orders.

- Profits attributable to the performance of any of the following services for payment in foreign currency are made liable to income tax at a maximum rate of 15%: ship repair, ship breaking, repair and refurbishment of marine cargo containers, computer software.

- Companies that export gems and jewellery enjoy an open-ended exemption from income tax on its profits and income.

- Companies that operate and maintain facilities for the storage of specified goods brought into the island for re-export and operate yachts and pleasure crafts registered with the Director Merchant Shipping are exempt from taxes on profits and income.

- Offshore companies that earn profits and income through the use of a Sri Lanka registered ship in international operations are exempt from income tax in respect of profits other than those arising from operations to and from a Sri Lankan port.

- Firms in the agricultural and fisheries sectors are entitled to a five year tax holiday on profits and income.

Other general benefits include accelerated depreciation allowances and exemption from turnover tax on inputs and export sales.

Several schemes help exporters to obtain duty free access to imports and local purchases, if they form an input for export production. These facilities are administered by the Committee on Exemption of Fiscal Levies serviced by the Export Development Board. These include following.

General Exemption on Fiscal Levies on Import of Capital and Intermediate Goods

Full entitlement if production is for 90% export, 50% entitlement if 50–90% is exported.

Inward Processing Scheme

Clearing of imports simply by submitting a block bank guarantee of 25% of duties payable, a personal bond for the balance.

Manufacture-in-Bond Scheme

Using customs approval bonded warehouses for duty free clearance of goods against a block bank guarantee of 25% of duties payable on such goods not converted for export purposes.

Customs Duty Rebate Scheme

Exporters who have paid duty for export production other than in garments, can receive this rebate if they have not benefited from any other exemption scheme.

Direct Financial Assistance to Sri Lankan Exporters

The Export Development Board (EDB) offers further schemes to assist local exporters, regardless of whether such exporters meet BOI criteria.

Direct Financial Assistance

The EDB invests in the equity of export ventures of innovative and pioneering nature. Such investment does not exceed 30% of equity. The EDB also grants "pioneering status" to some types of projects, in which it may invest in equity. Such projects also benefit from the reimbursement by the EDB of some types of expenses. Examples are the cost of feasibility studies, design and technical expertise, overseas market exploration and media promotion expenses.

The status of "Pioneering Project" can be given by the EDB to an enterprise considering the export of a new product. Such ventures will then be eligible for assistance up to 80% of the cost of product or market research with a limit of Rs 200,000. Assistance for the expansion of exports in the short term is available up to Rs 1 million to manufacturing and processing exporters.

Small scale export oriented manufacturers can receive low interest loans from the EDB up to Rs 250,000 for machinery, training and research and development. Small and medium scale exporters receive financial assistance

to execute orders prior to trade fairs, up to Rs 500,000. Low interest loans are also available to resolve special needs of exporters who are not eligible for other schemes.

Product Oriented Special Financial Assistance

The following product categories receive incentives and assistance from the EDB:

- Diamond cutting
- Handloom textiles
- Gems and jewellery
- Electronics
- Rubber products
- Horticulture
- Spices and essential oils
- Coir products.

Financial Assistance for Market Development and Promotion

The EDB also offers assistance to exporters for participation in overseas trade fairs and exhibition, and to establish marketing outlets overseas. Support is also provided to establish a quality assurance system conforming to ISO 9000.

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