

## **DIRECT FOREIGN INVESTMENT AND MANUFACTURED EXPORT EXPANSION: THE CASE OF SRI LANKA**

*by*

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### **1. Introduction**

The promotion of direct foreign investment in export-oriented industries has been an element in the export development policy of Sri Lanka since the late 1960s. Policy interest in this sphere has received renewed importance in the light of policy reforms initiated in 1977. The success of the new export-led development strategy depends crucially on the ability of domestic industries to penetrate advanced-country markets. The usual belief of the policy-makers is that product expertise and marketing skill gained through foreign collaboration has an indispensable role to play in this effort,

This paper attempts to throw some light on the export behaviour of firms with foreign capital participation ("foreign firms" for short) in the light of recent export experience of Sri Lanka. Starting with a brief discussion on the history of government policy towards foreign investment, the paper goes on to examine the pattern of foreign investment in the manufacturing sector. Then, the attention will be placed on empirical identification of the relative contribution of foreign firms to total exports and selected export categories. Finally, an attempt will be made to identify "specific market" advantages the country has gained through the promotion of export oriented direct foreign investment.

### **2. Direct Foreign Investment Policy**

During the first decade or so after independence, the Government of Sri Lanka pursued a fairly liberal policy on the approval of direct foreign investment, "the contribution to domestic technical and managerial skill" being the only criteria which received explicit mentioning in related policy documents (Ministry of Finance, 1955 : 1-2). With the on-set of the foreign exchange crisis since the late-1950s, foreign exchange savings (in gross-terms) through domestic production of hitherto imported items came to be an additional, perhaps the most important, criterion.

The role of foreign capital in the export development drive received official recognition for the first time in the White Paper on foreign investment issued in 1966 (Ministry of Planning and Economic Affairs, 1966). After mentioning about possible contribution of direct foreign investment to mana-

gerial and technical skill and to import savings, the White Paper emphasised that "foreign capital will help to increase export capacity and relieve the strain on the balance of payments, arising from the need to augment imports of capital goods as development proceeds" (p. 3), "Export potential" was thus added to the list of criteria on foreign investment approval. The Foreign Investment Approval Committee was set up at the Ministry of Planning in 1966 to function as the official body in charge of approving and monitoring direct foreign investment.

Apart from various tax concessions and facilities to foreign investors spelled out in the White Paper, an important step taken during the late 1960s towards the promotion of foreign investment was the initiation of entering into Investment Guarantee Agreements with major capital exporting countries. The first of these agreements was entered into on 3-3-1966 with the USA. This was shortly followed by a similar agreement with the Federal Republic of Germany. The Government also announced the relaxation of the moratorium on the remittance of dividends, interest, and profit which had been in force since 1963 due to balance of payments reasons.

With the change of Government in 1970, the foreign investment approval procedure turned out to be more selective and stringent. However, in line with the Government's commitment to the export diversification drive, export-oriented foreign investment was accorded preferential treatment. "Ability to export a greater part of output" was among the three alternative eligibility criteria laid down in the White Paper on foreign investment of 1972 for the approval of new foreign investment projects (Ministry of Planning and Employment, 1972). Another noteworthy feature of the foreign investment policy during this period was the active interest shown by the Government in establishing export oriented joint-ventures with capital participation of Government Corporations and foreign manufacturing firms.

The post-1977 policy reforms have placed an unprecedented emphasis on the role of direct foreign investment in achieving the objective of export-oriented industrialisation. A number of policy steps, which a Far Eastern Economic Review Survey calls "more than normally attractive"<sup>1</sup> has been taken in an attempt to provide an environment conducive to foreign investment.

The most important element in this policy package is the setting up of the Greater Colombo Economic Commission (GCEC) in 1978, with the main assigned task of establishing and operating Investment Processing Zones.

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1. "Sri Lanka 81", Far Eastern Economic Review, October 1981 (as quoted in Lakshman and Athukorala, 1983).

By the GCEC Law No. 4 of 1978, the GCEC has been given the power to grant exemption from certain existing laws of the country, or modify their application, in order to offer investors a suitable and attractive investment atmosphere (GCEC, 1979). The incentive package offered by the GCEC to investors includes, allowing 100 per cent foreign ownership in investment projects; a tax holiday for upto 10 years with complete tax exemption for remuneration of foreign personnel employed, royalties, and dividends of shareholders during that period; and duty exemption for the importation of equipment, construction material and production inputs.

The Foreign Investment Advisory Committee (FIAC) has been allowed to continue its operation in approving and monitoring foreign investment outside the non-GCEC areas. Unlike the GCEC which approves only export oriented projects, FIAC is empowered to approve import-substitution projects too, on the basis of criteria such as employment generation, net import saving and contribution to domestic technology. However, the potential contribution towards export development is usually taken as a major criterion. With regard to existing production and export incentives, FIAC approved projects are treated equally with locally-owned firms.

As a part of the policy package, attempts have been taken to enter into Investment Protection Agreements and Double Taxation Relief Agreements with major investing countries. Investment Protection Agreements have been signed with the US, the FRG, the UK, the Republic of Korea, France, Hong Kong, Romania, Switzerland, Japan, Netherlands, Malaysia, Sweden, and the Belgium-Luxemburg Economic Union. These agreements are guaranteed further by Article 157 of the Constitution of Sri Lanka. Double Taxation Relief Agreements have been entered into with India, Pakistan, Sweden, Denmark, Norway, the FRG, Singapore, the UK, Japan, Malaysia and Czechoslovakia.

### **3 Direct Foreign Investment :** **Pattern and Composition**

Table I presents data on the sector-wise distribution of the number of manufacturing firms established with foreign capital participation during the period 1948-82. The data is arranged under 4 sub-periods to highlight impact of changes in Government policy.

For the first decade after independence, there were only 9 instances of foreign capital participation in the manufacturing sector. During this period the major driving force behind direct investment flows from the developed countries to manufacturing industries of developing countries was the "tariff-jumping motive"—the desire to protect the markets of the latter.



countries in face of their attempts to promote import-substitution industrialisation under import restrictions (Lall and Streeten, 1977). However, unlike most of the developing countries, Sri Lanka continued to maintain a highly liberalised trade regime upto about the late 1950s. Therefore manufacturing multinationals were able to continue to dominate Sri Lankan market without establishing local production units.

**TABLE 1**  
**Sector-wise Distribution of Manufacturing Firms with Foreign Capital Participation**  
**Established During the Periods 1932-1959, 1960-1970,**  
**1970-1977 and 1978-1982**

ISIC Categories	1948-1959	1960-1964	1970-1977	1978-1982	
				FIAC Project (4)	GCEC Projects (5)
	(1)	(2)	(3)		
Food, drink and tobacco ..	—	5	2	8	2
Textiles and clothing ..	2	4	12	37	32
Footwear ..	1	—	—	—	—
Wood, pulp, paper and paper products ..	—	2	—	5	2
Rubber goods ..	1	—	—	10	6
Chemicals and chemical products ..	5	10	—	15	—
Non-metallic mineral products ..	1	—	4	6	7 <sup>a</sup>
Basic metal products ..	—	3	2	14	—
Machinery and equipment ..	—	15	—	1	3
Other industries ..	—	1	—	3	9 <sup>b</sup>
Total ..	<u>9</u>	<u>40</u>	<u>20</u>	<u>99</u>	<u>61</u>

*Source :* (1) Ministry of Industries and Scientific Affairs, Official files (columns 1 through 3).

(2) Ministry of Finance and Planning (1982), *Field survey of projects approved by The Foreign Investment Advisory Committee*, International Economic Co-operation Division (column 4)

(3) GCEC (column 5)

*Note :* (a) Includes one firm situated outside IPZ.

(b) Includes three firms situated outside IPZ.

From the late 1950s, Sri Lanka gradually moved into a regime of severe exchange control and import restrictions as a result of the continual deterioration in the balance of payments position. In response to this new policy orientation, multinational Corporations which had been dominating the local market through branch offices and/or local agents, resorted to setting up local plants to undertake local production and/or processing of hitherto imported commodities (Fernando, 1972). Total number of Foreign-affiliated producing firms set up during the period 1960-70 was 40. As can be seen in Table 1, chemicals, machinery and equipment, and food and drink (mainly milkfood) were the major areas of attraction to the foreign investors. These were the product lines which were most affected by strict import restrictions.

The period 1970–77 showed a marked decline in direct foreign investment. The number of firms set up with foreign capital during this period was 20. Unfavourable atmosphere for private investment generated by nationalisation attempts and related legal enactments (mainly the Business Undertaking (Acquisition) Act of 1971), and stringent criteria adopted in approving investment projects are often cited as explanations for this decline. Another possible, perhaps more relevant, contributory factor would have been that by the 1970s investment opportunities in import-substitution type activities had almost exhausted. In fact, the number of new foreign firms entering the manufacturing sector had tended to decline since the mid-1960s. For instance out of the 40 firms which belong to 1960–1969 only 6 were set up after 1965.

A noteworthy feature of foreign investment during the period 1970–77 was the high degree of export orientation. For instance, out of the 12 textile and clothing firms established during this period, 9 firms<sup>1</sup> were mainly for export production. The four firms in the non-metallic mineral group included two public-sector joint-ventures to produce ceramic-ware and walltiles, and two private sector joint-ventures to produce cut-and-polished gems, for the export market.

There has been a rapid upsurge in foreign investment following the policy reform initiated in 1977. During the period 1978–82, 99 FIAC-approved projects commenced production. The number of projects operating in the GCEC area had reached 61 by July 1983. Out of these, 57 were in the Katunayake IPZ.

For both IPZ investors and FIAC investors, textile and clothing (garments) has been the major industry of attraction. As is well known, there are two major factors which have contributed to this pattern; the imposition of stringent quota restrictions by major consuming countries on garment imports from “traditional developing-country producers” generating a potential market for “new-comers,” and the comparative advantage Sri Lanka enjoys in the production of garments (and other light-manufactured goods) in the face of increase in cost of labour in other major garment producing countries in Asia. The importance of “getting round the quota” motive for the upsurge in foreign investment in the garment sector is clearly evident from the predominance of Hong Kong owned firms in this sector (see Tables 4

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1. Out of these, seven firms are still among the leading garment exporters. Their combined export earnings in 1982 counted for 24 per cent of total export earnings of garment manufactures outside FTZ. The other two firms (Garment Industries Ceylon-Japan Limited, and Mayura Garment Industries Limited) were closed down in 1980 due to managerial problems. In 1980 their share in total garment export from outside IPZ was 15 per cent. (Figures are from Customs Returns).

and 5). Throughout the period since the mid-1970s, the strictest US quotas have been those against Hong Kong—the major developing—country garment exporter. Apart from garments, the other areas of production in the IPZ, in the order of magnitude, are nonmetallic minerals (lapidary and jewellery) rubber goods and other labour intensive products such as footwear, toys, and electrical appliances.

Firms set up under the approval of FIAC during the period 1978–83 show a relatively higher degree of dispersion across the given production sectors compared with the historical pattern of foreign investment as well as the investment pattern of the IPZ. Apart from textile and clothing, the other major areas of attraction have been chemicals and chemicals products, basic metal, and rubber goods. Even in the case of remaining sectors, the number of firms are greater than that in the IPZ. The major reason for this pattern seems to be the relatively more liberal and broader criteria adopted by the FIAC in approving new projects. Even totally domestic-market based (“import-substitution type”) projects have the chance of getting approval depending on their contribution to employment generation, contribution to domestic technology and import saving.

**TABLE 2**  
**1977-1982 FIAC Approved Firms:**  
**A Sector-wise Comparison of Firms in Operation With**  
**the Number Appearing in Customs Export Records**  
**for the year 1982**

	<i>Number of Firms in operation</i>	<i>Number of Exporting firms</i>
1. Food, drink and Tobacco	8	5
2. Textile and clothing	37	22
3. Wood, Paper and printing	5	0
4. Rubber goods	10	5
5. Chemicals and chemical-products	15	3
6. Non-metallic minerals	6	2
7. Basic metal products, Machinery and equipment	15	5
8. Other industries	3	3
9. Total	99	45

*SOURCE:* Ministry of Finance and Planning (1983),  
Field survey of Projects Approved by  
the FIAC, 1977-1982, FIAC  
and  
Sri Lanka Customs Returns-  
Exportwise records for 1982.

Table 2 shows the sectorwise distribution of exporting firms out of the total number of FIAC approved firms in operation. According to the table, out of the total number of firms (99), only 45 exported at least a portion of their output in 1982. Firms in sectors such as wood, pulp and paper; chemicals, basic metal products are mainly of import-substitution type.



Table 3 presents estimates of the nationality-wise ownership of equity capital in the manufacturing industry (outside IPZ) for 1971 and 1982. 1971 was the earliest year for which data required for this type of an analysis was readily available (see Note (a) of the Table). For the purpose of highlighting changes in ownership structure since then, a similar estimate was done for the year 1982 using information obtained from individual company records available at the Company Registrar's Department. An important feature of the foreign investment approval procedure pursued since the mid-1960s has been to allow foreign capital participation only in locally incorporated limited liability companies. Moreover, the Companies (Special Provision) Law No. 19 of 1974 required all foreign-owned business undertakings which had not been incorporated upto then to do so.<sup>1</sup> Therefore, Company Registrar's records provide a comprehensive coverage of foreign equity ownership in business undertakings of Sri Lanka.

According to the table, foreign equity capital in the manufacturing industry has indicated a seven-fold increase in current rupee terms (from Rs. 200.9 Mn. to 888.2 Mn) between 1971 and 1982. The most striking structural change one can observe in the nationality-wise distribution pattern is the sharp increase in the position of LDC investors in terms of both the number of firms and the aggregate equity investment. Their percentage share in total equity investment increased from 3.16 per cent in 1971 to 26.65 in 1982. Among the DC investors, there is a well-marked erosion (from 70.31 per cent to 18.35) in the relative position of the UK. Equity share of Japan has also declined from 10.71 per cent to 6.32 per cent. Relative positions of EEC (other than UK) and EFTA have improved significantly. Among the LDC investors, Singapore occupied the predominant position in 1982 accounting for 23.17 of total foreign equity investment. This exceptionally high figure is mainly due to investment by this country in a fully-owned gigantic flour-milling project.<sup>2</sup> With regard to total investment in other sectors, relative positions of the three major LDC investors—Hong Kong, Singapore and India—appear more or less equal.

Investment data pertaining to firms in GCEC is not available. However, judged by the nationality-wise ownership of these firms (Table 5), it seems that the pattern of increase in the relative position of LDC equity ownership observed in the previous paragraph would remain unchanged even when this data is included in the analysis. Out of the 61 firms in the GCEC area, 29 firms had capital participation from LDCs. Hong Kong occupied the predominant position among the LDC investors, having capital participation in 13 firms.

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1. For further details see Weeraratne (1982), chapter 1.

2. This is Prima (Ceylon) Ltd. The total equity investment in this project is Rs. 200 million.

Rs. '000

TABLE 3

## Foreign Equity Capital Participation in the Manufacturing Industry Outside GCEC area, 1971 and 1982

	1971				1982			
	Number of projects	Total equity	Foreign equity	Country share in foreign equity	Number of projects	Total equity	Foreign equity	Country shares in foreign equity
Developed countries ..	..	..	..	..	..	..	..	..
U.K.	34	192,533	117,450	96.35	114	914,479	651,422	73.35
U.S.A.	15	146,194	81,962	70.31	25	203,558	162,993	18.35
Japan ..	4	6,416	5,870	4.81	18	92,180	64,481	7.26
EEC <sup>a</sup> (Other than U.K.)	10	21,825	14,653	12.02	30	196,133	56,138	6.32
EFTA <sup>b</sup>	1	2,929	2,450	2.00	7	31,793	22,573	2.54
Other ..	3	14,269	11,815	9.69	15	329,639	310,948	35.01
Other ..	1	1,000	700	0.57	19	61,196	34,289	3.86
Less Developed Countries	7	8,412	4,444	3.65	47	316,779	236,752	26.65
Hong Kong	3	4,252	2,454	2.02	11	48,686	13,691	1.56
Singapore	..	..	..	..	14	219,693	205,806	23.17
India	4	1,160	1,990	1.63	12	25,862	10,896	1.22
Other ..	..	..	..	..	10	22,538	6,359	0.71
<b>Total ..</b>	<b>41</b>	<b>200,945</b>	<b>121,894</b>	<b>100.00</b>	<b>161</b>	<b>1,231,258</b>	<b>888,174</b>	<b>100.00</b>

Notes : (a) Belgium, France, West Germany, Italy, Luxembourg, Netherlands, Denmark.

(b) Denmark, Norway, Portugal, Sweden, Switzerland and Austria.

Source : 1971 —Based on an unpublished list of direct foreign investment in the manufacturing industry available at the Policy Division of the Ministry of Industries and Scientific Affairs.

1982 —Computed from company annual returns available at the Company Registrar's Department.



TABLE 4

## Sector-wise Distribution of Direct Investment by Major Investing Countries; Number of Projects and Sectoral Percentages of Investment, 1982

	Food, drink and tobacco	Textile and clothing	Wood, pulp and printing	Rubber goods	Chemicals	Non- metallic minerals	Basic metal product	Machinery and equipment	Other industries	Total
Developed countries (a)	9	36	4	9	18	9	3	14	10	112
U.K. (b)	60.88	12.39	0.10	3.24	9.17	3.50	0.27	9.33	1.09	651,422
U.S.A. (a)	5	4	—	1	11	—	—	3	1	25
(b)	64.47	8.93	—	1.12	22.43	—	—	2.74	0.31	162,993
Japan (a)	—	4	1	2	3	—	—	3	5	18
(b)	—	27.02	0.12	3.17	8.41	—	—	55.43	5.83	64,481
E.E.C. (a)	—	13	2	2	—	4	3	6	—	30
other than U.K. (b)	—	38.42	0.72	1.65	—	22.03	3.20	33.95	—	65,138
E.F.T.A. (a)	—	2	—	1	—	1	—	2	1	7
(b)	—	30.31	—	32.50	—	30.27	—	6.67	0.02	22,573
Other (a)	4	3	1	—	2	3	—	—	2	15
(b)	93.76	0.12	0.06	—	4.47	1.11	—	—	0.45	310,968
Other (a)	—	10	—	3	2	1	—	—	1	17
(b)	—	58.05	—	26.24	10.16	0.45	—	—	—	34,289
Less Developed- countries (a)	5	12	3	6	7	3	3	2	6	—
(b)	85.21	4.73	0.46	2.50	2.90	0.54	1.58	0.43	1.74	236,752
Hong Kong (a)	—	6	1	3	—	—	1	—	—	11
(b)	—	69.94	2.16	26.93	—	—	2.92	—	—	13,691
Singapore (a)	3	3	2	1	1	—	1	—	3	14
(b)	97.25	0.48	0.39	0.05	0.19	—	—	—	1.57	205,806
India (a)	—	2	—	1	5	1	1	2	—	12
(b)	—	3.73	—	2.56	54.02	0.40	29.72	9.56	—	10,896
Other (a)	2	1	—	1	1	2	—	—	3	10
(b)	23.81	3.31	—	29.01	9.12	19.49	1.91	—	14.24	6,359
TOTAL (a)	14	48	7	15	25	12	6	16	16	159
(b)	67.37	10.34	0.20	3.04	7.50	2.71	0.63	6.96	1.27	888,174

Note: For each country (and country group), raw "a" and raw "b" indicate number of projects and sectoral percentages of equity-capital investment respectively.

Source: as for table 5.3



Table 6 present sector-wise weighted average foreign capital shares in GCEC and non-GCEC firms. It is interesting to note that, even—though full foreign ownership is permitted, the highest weighed average foreign share recorded for a given sector in the GCEC area is only 73.32 per cent. Data for individual firms (not reported here) show that, among the GCEC firms in operation, there are only two with 100 per cent foreign ownership. It is therefore evident that the opportunity to have full ownership is only rarely considered by the foreign investor as an added incentive in deciding to invest in the GCEC area. However, the average foreign capital share in GCEC firms (59%) is significantly higher than that of non-GCEC firms (40%). Among the non-GCEC firms, firms in the three sectors—food, drink and tobacco; chemicals; and metal products and machinery — indicate above average foreign shares.

**TABLE 6**  
**Weighted Average Foreign Equity Shares (%)**  
**in Firms with Direct Foreign Capital**  
**Participation in Various Product Sectors.**

	<i>Non-GCEC Firms</i>	<i>GCEC Firms</i>
Food, drink and tobacco	97.13	47.50
Textiles and clothing	34.70	73.32
Wood, pulp and paper	29.75	55.35
Rubber products	37.73	42.79
Chemicals	64.51	—
Non-metallic minerals	27.91	48.35
Metal products, machinery and equipment	70.78	68.38
Other industries	40.95	63.25
All sectors	40.35	59.35

*SOURCE:* Compiled from unpublished records available at Company Registrar's Department and the G.C.E.C.

The reason for this is that most of the firms in these sectors have a history dating back to the 1950s or early 1960s when the limiting of foreign ownership was not a deliberate objective of the foreign investment approval process. For the remaining product sectors, which are in general relatively new areas of attraction for the foreign investor, respective foreign capital shares remains below average (40 per cent). This reflects the impact of deliberate attempts by the FLAC to limit the foreign equity ownership in approving new projects since the late 1960s.

#### **4. Export Performance of Firms with Direct Foreign Capital Participation**

##### *4.1 Relative Contribution to Exports*

This section attempt to identify empirically the relative importance of direct "foreign" involvement in determining recent trends in Sri Lanka's



**TABLE 7**  
**Relative Contribution of Firms with Direct Foreign Capital to Total Exports and Major Export Categories,**  
**1979 and 1982**

Export Category and total exports	1979						1982						
	Total exports (Rs. million)	Share of foreign trading companies		Share of foreign manufacturing companies		Total foreign exports share of (2)+(5)	Total exports (Rs. million)	Share of foreign trading companies		Share of foreign manufacturing companies		Total foreign exports share of (3)+(4)+(5)	
		(1)	(2)	(3)	(4)			(5)	(6)	(1)	(2)		(3)
Primary products	..	9,588.8	23.73	—	7.10	7.10	30.83	9,731.1	22.68	0.84	1.34	2.18	24.86
Tea	..	5,722.3						6,341.2	28.98	0.16	0.21	0.36	29.34
Bulk Tea	..	2,586.7						4,871.6	35.00	0.03	0.04	0.08	35.03
Tea in packets	..	912.8	25.61					1,368.1	5.05	0.07	0.12	0.19	5.24
Processed teab	..	22.6						101.5	63.84	7.06	9.28	16.34	80.18
Rubber	..	2,493.0	7.81	—	—	—	7.81	2,047.2	7.83	2.68	1.66	4.89	12.72
Other	..	487.6	16.38	—	8.68	—	25.06	1,342.8	15.51	1.12	6.24	7.48	22.99
Gems	..	490.1	—	0.14	3.57	12.82	12.82	684.7	—	0.41	32.9	32.60	33.01
Manufacturers	..	3,713.4	6.34	4.09	11.15	15.24	15.58	7,631.0	0.08	19.41	8.40	27.81	27.87
Food, drink and tobacco	..	376.5	—	—	9.72	9.72	9.72	616.5	—	1.21	4.58	5.79	5.79
Fish products	..	307.6	0.22	—	11.61	11.83	11.83	433.7	—	—	6.57	6.57	6.57
Textiles and clothing	..	1,119.2	—	12.94	24.59	37.53	37.53	3,482.1	—	37.11	11.71	48.81	48.81
Chemicals	..	45.3	7.31	—	4.35	4.35	11.66	48.2	—	0.14	27.85	27.99	27.99
Manufactured rubber, goods	..	8.5	—	14.11	5.75	19.85	19.85	96.0	—	47.60	11.63	59.19	59.19
Articles of leather	..	1.2	—	—	—	—	—	4.1	—	—	76.73	76.73	76.73

Wooden products ..	27.7	—	—	—	—	56.9	0.19	5.36	—	5.36	5.55
Footwear ..	13.9	—	—	82.61	82.61	48.0	—	65.75	19.63	85.38	85.38
Ceramic products ..	96.6	—	—	46.68	46.68	129.4	0.09	0.36	89.91	90.28	90.37
Jewellery ..	3.6	—	1.13	—	1.13	22.2	0.08	67.34	1.43	68.77	68.85
Toys and sports equipment ..	—	—	—	—	—	27.2	—	83.61	8.03	91.64	91.64
Machinery and equipment ..	78.3	2.03	—	2.28	4.31	1,140.2	3.84	22.71	9.11	31.82	35.66
Other manufactures ..	719.1	0.98	0.82	5.75	7.56	1,164.6	—	3.20	0.88	4.08	4.08
Total exports ..	13,302.2	17.20	1.14	3.54	21.88	18,046.9	12.26	8.68	5.50	14.18	26.44

Notes : Spaces indicate zero value, — indicates values less than 0.01 per cent.

(a) Total exports excluding petroleum products.

(b) Tea bags and instant tea.

Source : Customs Department, unpublished firm-wise export records.

export trade. The analysis is based on firm-wise customs data for the two years 1979 and 1982. It is only the export performance of manufacturing firms which is directly relevant to the major theme of this chapter. However in an attempt to throw light on total "foreign involvement" in Sri Lanka export trade, trading firms with foreign capital<sup>1</sup> were also included as a separate group in the analysis. Estimates of the contribution of these two groups of firms to total exports and to separate export categories are summarised in Table 7.

For the year 1982, the aggregate contribution of foreign firms<sup>2</sup> to total export earnings (excluding earnings from Petroleum exports) was 26.44 per cent compared with 21.88 per cent in 1979. This increase was due to the increase in the relative contribution of foreign manufacturing firms, which compensated for the decrease in the relative contribution of foreign trading firms. The share of the former group increased to 14.18 in 1982 from 4.68 in 1979, while the share of the latter group indicated a marked decline from 17.20 in 1979 to 12.26 in 1982. This noteworthy increase in the relative position of manufacturing firms was the combined effect of the increase in relative importance of manufactured exports in total exports (from 28% to 42%) and the increase in the relative position of foreign firms in total manufactured exports (from 15.24 to 27.81).

The decline in the relative position of foreign trading firms was almost totally due to the decline in the share of primary exports in total exports. The data shows that the relative position of these firms in total primary exports<sup>3</sup> remained more or less stable between the two years.

The increase in the share of foreign firms in total manufactured exports is closely related with the expansion in production activities of IPZ. It is noteworthy that the relative share of non-IPZ firms in total manufactured exports declined from 11.15 per cent in 1979 to 8.40 per cent in 1982. On the other hand, the share of IPZ firms increased from 4.09 to 19.41 between these two years. This increase was predominated by the rapid expansion in garment exports.

Despite the rapid expansion in the involvement of foreign firms, fully locally-owned firms ("local firms" for short) still account for the overwhelming share of manufactured exports. This share was about 72 per cent in 1982

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1. The list of trading firms used is from Lakshman and Athukorala (1983), Appendix Table A-1 (Group A 1).
  2. Henceforth, for convenience, the term "foreign firm" is used instead of "firm with foreign capital participation".
  3. A detail analysis of the role of foreign firms in primary commodity trade of Sri Lanka is beyond the scope of this study. The interested reader is referred to Wickramasekera (1983), and Lakshman and Athukorala (1983).



compared with 85 per cent in 1979<sup>1</sup>. Out of the product groups given in the table, it is only with respect to footwear, jewellery, toys and sportswear and rubber that relative export shares of foreign firms appears to be significantly higher than that of local firms. In these cases the initiative of foreign capital seems to have been instrumental in breaking into the export market. However, foreign firms show limited involvement, or none at all, in most of the other export categories. In particular, despite the fact that all of the garment producing firms in the IPZ had commenced commercial production by 1982, the total foreign share of garment exports in that year was only 48 per cent reflecting still-predominant position of local initiative in this industry. Given the existing system of allocating export quotas, it is even debatable whether the above reported foreign share (48%) could be considered as a "genuine" indicator of the relative strength of foreign firms vis-a-vis local firms. Over the past four years, the practice of the Ministry of Textile Industries with regard to the allocation of export quota has been to reserve about 50 per cent of the US quota for the IPZ. On the other hand, records at the Ministry shows that local firms are as equally efficient as (or even more efficient than) IPZ producers in utilizing allocated quota. Another important related point that emerges from Table 7 is that local garment manufacturing firms have been relatively more efficient than non-IPZ firms in preserving their relative position in face of the rapid expansion of exports from the IPZ. The share of non-IPZ firms in total garment exports declined nearly by 100 per cent (from 25 per cent to 12 per cent) between 1979 and 1982, whereas the respective decline for local firms was only from 62 per cent to 52 per cent.

#### 4.2 *Commodity Composition of Exports*

Table 8 provides data on the commodity composition of exports of foreign firms in 1979 and 1982. For both years, exports of non-IPZ firms show a relatively higher degree of dispersion across various commodity categories compared with exports of IPZ firms. The well-known "garment bias" of IPZ export operation is well reflected in the table. However, this bias has somewhat reduced in 1982 compared with 1979 reflecting gradual diversification of IPZ investment into other areas of production. For instance garment share of these exports was 83 per cent in 1982 compared with 95 per cent in 1979 with regard to non-IPZ firms, in addition to garment cut-and-polished gems and ceramic products have emerged as an important export item in recent years. Shares of these items in non-IPZ exports in 1982 were 22 per cent and 12 respectively.

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1. The list of firms used in compiling Table 5.7 provides an almost 100 per cent coverage of the firms with foreign capital participation. Therefore, for total exports and export sub-categories, the difference between the value given for foreign firms (column 6) and total reported exports in column 1 reflects the contribution by local firms.

The table reveals that both IPZ and non-IPZ firms engage in the exportation of unprocessed primary products—such as raw rubber, bulk tea and other agricultural raw materials in addition to their usual exporting activities. Depending on the authenticity of customs records, at least as far as the IPZ enterprises are concerned, this is invariably an unexpected practice which reduces net national gains from their operation. Customs data for individual IPZ firms shows that this practice is almost totally confined to firms with capital participation from Hong Kong.

**TABLE 8**  
**Commodity Composition of Exports by Manufacturing Firms**  
**with Direct Foreign Capital Participation**

	1979			1982		
	<i>IPZ</i>	<i>Non-IPZ</i>	<i>Total</i>	<i>IPZ</i>	<i>Non-IPZ</i>	<i>Total</i>
Primary products		12.92	9.79	5.22	13.20	8.72
Tea				0.65	1.34	0.91
Bulk tea				0.11	0.22	0.16
Tea in packets				0.01	0.15	0.10
Processed tea				0.45	0.95	0.64
Rubber				3.51	3.42	3.83
Other		12.92	9.97	1.05	8.44	3.91
Gems (cut and polished)	0.46	0.50	0.49	0.18	22.21	8.69
Manufacturers	99.54	86.58	89.72	94.59	64.57	82.68
Food, drink and tobacco		7.65	5.44	0.47	2.84	1.15
Fish products		7.48	5.79		2.84	1.09
Textiles and clothing	94.84	57.53	66.57	82.51	41.02	66.22
Chemicals		0.41	0.31	—	1.35	0.52
Rubber goods	0.78	0.10	0.26	2.91	1.12	2.21
Articles of leather				—	0.31	0.12
Wooden products				0.19	—	0.11
Footwear		2.40	1.81	2.01	0.95	1.60
Ceramic products		9.49	7.14	0.03	11.73	4.55
Jewellery	0.02	—	0.01	0.95	—	0.11
Toys and sports equipment				1.45	0.21	0.97
Machinery and equipment		0.37	0.28	1.65	1.04	1.37
Other manufactures	3.87	8.65	7.50	2.38	1.03	1.85
Total (Rs. million)	152.8	478.3	631.0	1,566.1	992.4	2,566.9

Notes and Source — as for Table 5.7

### 3. *Geographical Distribution of Exports*

We mentioned at the outset of this chapter that foreign investment is envisaged to ensure “easy access to foreign markets” in the process of manufactured export expansion. The usual explanation of this favourable impact goes as follows. Unlike locally-owned firms, firms with foreign capital can often draw on direct experience of foreign collaborators with regard to market conditions in other parts of the world. They tend to have better access to personnel skilled in overseas marketing, to information on



overseas market and export promotion facilities, and can often make use of established distribution channels. And to the extent that foreign interests are represented in importing countries, these firms are better able to defend access to markets from protectionist pressures (Monton and Tulloch, 1978: 212).

A simple, albeit rough, test of the existence of this envisaged marked advantage is to compare the geographic pattern of exports of foreign firms with that of local firms. This is done in Table 9 for Sri Lanka's major manufactured export item, garments. The table presents the geographical pattern of exports in terms of 9 well-defined geographic regions. IPZ firms and non-IPZ foreign firms have been sub-grouped according to the country/geographic region of investment. In addition to the percentage export shares of the selected geographic regions, percentage share of exports to the country of investment is also given in a separate column (1) to highlight the link between "origin of investment" and export flows.

A number of important points emerges from the Table. As can be expected *a priori*, exports of firms with capital participation from LDCs (both in the IPZ and outside IPZ) almost totally destined to developed country markets. Among these firms, the most striking feature of the Hong Kong owned firms is their dependence on the US market for more than 83 per cent of total exports. On the contrary, data on garment exports from Hong Kong indicates a clear tendency towards market diversification reducing the dependence on the US market. For instance, in 1981, Hong Kong exported 53 per cent of her garments to USA while the EEC and OPEC market absorbed 19 and 23 per cent respectively.<sup>1</sup>

When these two pieces of information are taken together, we can conclude that the major motive behind investment by Hong Kong firms has been to exploit Sri Lanka's export quota to the US market, and Sri Lanka has not benefited from marketing expertise of these firms in other parts of the world, notably in the highly dynamic non-quota market in OPEC countries.

In general, firms with capital participation from developed countries seem to export most of their output to their mother countries. This indicates that investment from developed countries has generally contributed towards strengthening market links. The share of exports to the mother country is the highest for US-owned firms. This possibly reflect the impact of special import duty concessions enjoyed by US importers on imports from related parties under the US Offshore Essembly (807) Scheme (Sharpton, 1975).<sup>2</sup>

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1. Calculated using data obtained from UN, *Yearbook of International Trade Statistics*, 1981.
  2. Under the provisions of this scheme, with regard to related party imports, importers are liable to pay duties only the "value added abroad" in the product while the value of US parts or materials incorporated in the product are exempt from duties (see Sharpton 1975).



**TABLE 9**

**Comparison of Geographic Pattern of Garment Exports  
from Sri Lanka by Foreign and Local Firms — 1981**

	<i>Investing country</i> (1)	<i>U.S.A.</i> (2)	<i>Canada</i> (3)	<i>Japan</i> (4)	<i>E.E.C.</i> (5)	<i>E.F.T.A.</i> (6)
IPZ Firms	19.92	74.48	0.24	0.12	20.13	0.21
Hong Kong (ii)	3.90	83.36	0.35	0.03	11.21	0.72
Other Asian Countries (4)		71.60			26.20	0.50
W.S.A. (3)	98.89	67.62	2.46	0.84	28.14	
U.K. (1)	61.28	5.67			94.33	0.62
E.E.C. (5)	54.49	29.53	0.20		66.02	
Non IPZ Foreign Firms	18.97	43.75	0.37	2.32	47.31	1.36
Hong Kong (3)	0.44	89.55	2.12		6.53	0.92
Singapore (3)	—	27.24		0.22	51.47	0.75
U.S.A. (2)	61.63	61.63			32.13	6.20
Japan (5)	27.51	45.21	1.73	27.57	24.78	
E.E.C. (5)	52.35	16.00	0.24		83.17	0.57
Fully locally owned firms*		58.35	2.05	0.05	27.86	
Total exports fro Sri Lanka		60.17	1.90	0.66	28.29	2.77
	<i>Other DCs</i> (7)	<i>Total DCs (2) Thro, (7) (8)</i>	<i>O.P.E.C.</i> (9)	<i>Other LDCs</i> (10)	<i>Total LDCs (9) + (10)( (11)</i>	<i>Total exports Rs.M.) (12)</i>
	0.79	96.76	0.17	3.07	3.29	808.0
	3.29	98.90	0	1.10	1.10	808.0
	1.09	0.02	0.0	0.51	0.59	158.1
				0.80	0.80	129.2
						20.5
						20.5
			0.05	1.97	2.02	151.2
		94.93	0.11	4.38	4.49	
			0.43	0.43	0.88	94.7
			20.78		20.78	80.4
		100.00				15.7
		100.0				32.3
		100.0				124.2
		88.31	5.37	6.32	11.69	
		93.79	2.36	3.66	6.02	

*NOTE:* \* The data relates to a sample of 20 selected from the top 50 firms.

*SOURCE:* Customs Department, unpublished firm-wise export records.

The only exception to the general pattern observed in the previous paragraph are the firms with Japanese capital. In 1982, these firms (five firms operating outside IPZ) exported only 27 per cent combined output to Japan; this shows that Japanese investment in the garment sector has not generated a significant benefit in terms of opening the highly lucrative Japanese market for garment exports from Sri Lanka.

Compared with foreign firms, local firms have exported a relatively higher share to the LDCs, mainly to the OPEC countries. However for the predominant portion of their total exports, (about 92) these firms too depend on DC markets mainly USA and EEC. Thus, the data amply supports the view that "foreign investment link" is not a *sine quo non* for the successful penetration into developed-country markets.

A detail investigation of the factors behind the market penetration of local firms is beyond the scope of this study. However, it seems that in this connection an increasingly important supportive role is being played by international buying groups.

International buying groups are world-wide purchasing organisations of large retailing firms in developed countries, which specialise in the purchase of labour intensive light manufactured goods, such as garments, toys, sport goods, etc. These groups perform a valuable intermediary function to relieve the difficulties and disadvantages developing country exporters face in entering export markets by providing them with product specifications, sometimes under licensed brand-names and patents, and undertaking the task of marketing such output on a contractual basis. Most of the orders they place are on a subcontracting basis under which the producer is provided with inputs required in the production process too. The results of recent empirical work carried out in other developing countries suggest that this intermediary role of buying groups has played an important role in the promotion of light manufactured exports leaving production to domestic entrepreneurs (see, for instance, Hone (1974), Westphal *et. al.* 1981; Morawetz (1981), Nayarr (1978) ).

During the past four-to-six years, most of the leading buying groups such as Sears-Roebuck (USA), Marks and Spenser (UK), Sanyo (Japan), Mondial (Holland), Miles (West Germany), Dodwell (UK), Banaras House (West Germany), May Departmental Stores (USA) have established liaison offices in Sri Lanka, while many others operate through their branch offices in Hong Kong. The impression we have gained through interviews with established garment exporters is that buying groups constitute their most important, and for a fair number of them, the sole, source of market contact.<sup>1</sup>

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1. The drawback of this kind of market contact is that, in a context where local firms rely heavily on buying groups, the latter is often in a position to press down prices thereby reducing the benefits of export orders to the firm and to the host country (Hone, 1974).

## **5.5 Summary**

The major important points arising from the foregoing analysis can be summarised as follows :

- (1) Direct foreign investment began to have some importance in Sri Lanka's export diversification drive since the early 1970s. The policy reforms initiated in 1977 have led to a marked upsurge in export-oriented foreign investment in the manufacturing industry. However, investment flows to non-GCEC areas still seem to have an import-substitution bias.
- (2) The recent investment upsurge has brought about a significant structural change in the nationality-wise ownership pattern of foreign investment in the manufacturing industry. The share of LDC investors increased from 4 per cent in 1971 to 27 per cent in 1982. This increase was reflected mainly in a decline in the shares of the traditional investor, U.K., (from 70 to 19) and that of Japan (from 12 to 6).
- (3) The share of foreign firms in total non-petroleum exports of Sri Lanka increased from 22 per cent in 1979 to 26 percent in 1982. This was due to the increase in the share of these firms in manufactured exports from 15 per cent to 27 per cent which well compensated for the decline in the share in primary exports from 31 per cent to 25 per cent.
- (4) With regard to manufactured exports, foreign firms account for a significantly higher export share compared with local firms in the product areas of footwear, jewellery, toys and sportswear, processed tea and rubber goods. In the case of garments, their share, though significant, is still lower than that of fully locally owned firms. In other product areas these firms have limited involvement or none at all.

All in all, the calculations presented in this chapter show that the role of direct foreign investment as a major source of expansion in manufactured exports from Sri Lanka has been somewhat exaggerated.
- (5) In the case of the garment industry, direct foreign investment from developed countries (other than Japan) seems to have the favourable impact of strengthening market links. (However, one should take into account the well-known possibilities for price manipulations in "related-party" trade, in highlighting this beneficial effect). The involvement of Hong Kong investors in Sri Lankan garment industry has been propelled by the "getting round the quota" motive, and the gain to the country in terms of their "market expertise" seems to have been rather minimal. Local firms appear to be equally, or even more, satisfactory in penetrating developed-country markets, possibly because of the important intermediary role played by international buying groups.



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