

SRI LANKA'S STRENGTH AS AN INTERNATIONAL INDUSTRIAL LOCATION: A THEORETICAL EXAMINATION

M. Rajaratne¹ and P.W. Tennekoon²

Abstract

Sri Lanka, in 1978, introduced outward looking export oriented industrialization (OL-EOI) policy with heavy reliance on foreign direct investment (FDI) against the three decade long inward looking import substitution industrialization (IL-ISI) policy that had caused serious impediments to economic development. Although four decades have passed since then, theoretically founded analyses to assess Sri Lanka's locational soundness are scarce. Thus, this study adopts the Investment Development Path (IDP) framework of John Dunning and Rajnish Narula (1996) for assessing the strength of Sri Lanka as an international industrial location. This study primarily traces the investment development path of Sri Lanka for the past seven decades (1950-2015) covering two policy regimes, namely; relatively closed economic policy regime (1950-1977) and the open economic policy regime (1978-2015). The findings reveal that Sri Lanka has only been able to reach the early second stage of the IDP. This fact can be appropriated to insignificant FDI inflows in consequent to meager supply of location specific created assets (L_{ca}) in contrast to heavy reliance on location specific natural assets (L_{na}).

Keywords: Foreign Direct Investment, Investment Development Path, location specific natural assets, location specific created assets

1. Introduction

The outward looking development policy has heavily replaced the self-reliant inward looking development policy and become a predominant development policy in the entire world. This development framework is essentially characterized by trade and investment liberalization with the underlying conviction that trade and direct investments are 'engines of growth' (United Nations, 1992). Direct investment primarily engages in manufacturing, exports and later, through material

¹ Department of Operations Management, Faculty of Management, University of Peradeniya, Peradeniya, Sri Lanka. Corresponding author. E-mail: milraj@outlook.com

² Department of Operations Management, Faculty of Management, University of Peradeniya, Peradeniya, Sri Lanka.

imports and output exports, intra-firm-trade. It is these investment and trade effects that gradually transform economies from the state of underdevelopment to that of development (Dunning, 1996).

Sri Lanka adopted FDI-reliant export oriented industrialization policy in 1978 and chose to follow the development model of the Newly Industrialized countries (NICs) in East and Southeast Asia. This new policy continued for almost four decades to date since then withstanding political changes that took place in the latter half of that period. It is the general impression that Sri Lanka has only meagerly benefited from the FDI-reliant policy. This notion promotes the following general conclusions also: (a) FDI inflow is insignificant, (b) FDI is heavily concentrated in the garment industry (Atapattu, 1997), (c) local content of FDI-based industries is too low, (d) FDI-based industries are labor intensive, (e) FDI based industries have provided jobs mainly for unskilled and semi-skilled female workers and a very few graduates have been employed (Karunathilake, 1987), (f) technology transfer is low (Perera, C and Dasanayake, S; 2004) and (g) Sri Lanka has failed while East Asia succeeded in FDI-reliant policy. It is obvious that these pessimistic conclusions relating to the FDI-reliant development have been derived without relying much on theoretical foundation and thus require theoretical explanations.

On the contrary, Athukorala and Rajapathirana (2004) systematically surveyed the outcomes of investment liberalization in Sri Lanka and identified that the export oriented foreign direct investment had produced significant development effects. They noted that *“the ability of a country to capture the full benefits of trade and investment liberalization depends crucially on the existence of a favorable macroeconomic environment and political stability. In the Sri Lankan case, these pre-conditions were largely missing for much of the post-reform period, except for two sub-periods between 1977-82 and 1990-94. Any analysis of the outcome of the significant trade and investment liberalization in Sri Lanka needs to be qualified for this lacuna in the overall investment climate”* (Athukorala and Rajapathirana, 2004:71).

Further, providing numerical evidence on effects of capital formation, trade, economic growth, and employment they have challenged the notion that Sri Lanka has failed. This was followed by the debut of a unique observation on the FDI-reliant development in Sri Lanka by Athukorala (1997). He noted that *“it is common place to draw upon the experience of the NICs as a standard in assessing Sri Lanka’s achievements. Such practice leads to confusion because the role of FDI in export expansion varies depending on the nature, timing, and topological characteristics of the host country such as the degree of industrialization and the stage of entrepreneurial development”* (Athukorala, 1997:387). In support of this argument, Kelegama (2006) pointed out that Sri Lanka could be pushed to the NIC status through attracting ‘large-scale FDI’ if Sri Lanka had attained macroeconomic stability, political stability, better infrastructure, technical skills, improved local entrepreneurship, and modern factories for multinational corporations. While these studies connote that Sri Lanka has fared well in the FDI-reliant development policy

despite the fact that certain crucial factors required for achieving FDI-reliant development are either weak or absent.

While these studies have shed light into various perspectives of FDI-reliant development and described the past experience logically, it is also obvious that they lack theoretical explanations to Sri Lanka's strength as a location for international production system organized by multinational corporations through FDI. Different nations serve as internationally integrated production centers in the present production system organized by multinational corporations. The qualification to enter the system is explained through the 'Location specific advantage' (Dunning, 1982) of individual countries. The entry alone does not guarantee locational success and thus attention is required to its sustainability and sustainability depends on the strengths of location specific advantages. Strength of a location is determined by two factors; they are (1) location specific natural assets and (2) location specific created assets.

Therefore, measuring success or failure of FDI-reliant development strategy in terms of value of FDI, employment generated, foreign exchanged earned etc. is incomplete as all these are consequent to the degrees of strengths of location specific advantages that a country possesses. In this backdrop, we find a gap in the concurrent analytical approach and thus adopt the theoretical tool Investment Development Path devised by John Dunning (1982) to examine Sri Lanka's strength as an industrial location in the global production system. The unique feature of this approach is that it introduces new and broad based method of analysis and measures country's locational strength instead of consequences of FDI-reliant development strategy. The findings based on such analytical approach are widely valid and thus they can guide FDI-reliant development policy of the country. Particularly, the analysis relating to different political and policy regimes, as described below, will help recognize the role of the government in created asset augmentation.

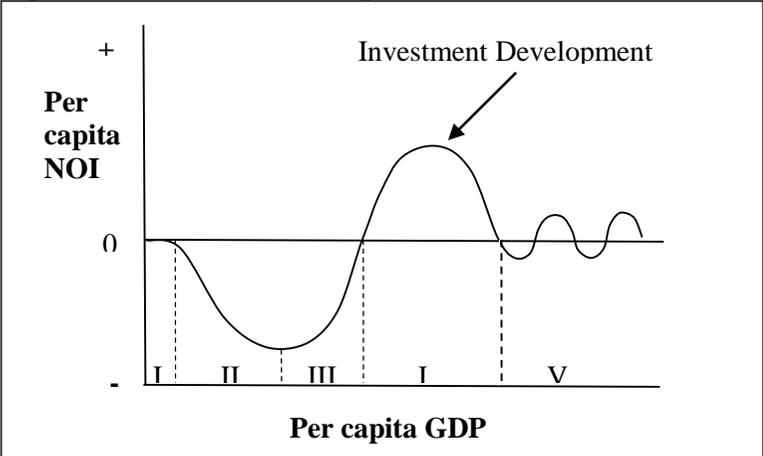
2. Theoretical Framework and Method

Above arguments and conclusions can only be confirmed through theoretical evidence of the development experience of the FDI-reliant development strategy. A widely known theoretical framework for assessing FDI-reliant development can be traced to the Investment Development Path (IDP), originally proposed by John Dunning (1982) and sophisticated by Rajnish Narula (1996). Proven test results and properties (Dunning and Narula, 1996:31), the IDP proposition is adopted as the analytical tool for the purpose of this study. The IDP is characteristically a measure of overall development position of countries in connection to FDI. The distinctive feature of this tool is that it can, on the whole, measure the status and vitality of the FDI-reliant development systematically connecting net outward investment (NOI) and gross domestic product (GDP) in per capita terms.

Net outward investment is the difference between inward and outward direct investment. The NOI and GDP are normalized by dividing by the population of the country concerned and hence the per capita NOI and per capita GDP are derived. The investment development path hypothesis was elaborated by several subsequent studies (Narula, 1996; Dunning and Narula 1996) and now it proposes five distinctive stages of the investment and development. The IDP suggests that the stages of the development path are determined by the response of Multinational Corporations (MNC) to the types and extent of advantages provided to them by the host country. The MNC would engage in international operations through mobilizing their internalization (I) skills in order to benefit from their ownerships (O) in cross-border locations. For this, healthy location specific advantages (L) are imperative. On one hand, the locations that would not provide advantages will not be conducive for MNC and thus internalization will not take place at such locations¹. On the other hand, the higher the location advantage the more intensive will be the internalization in such locations.

The operations of MNC in a particular country (location) are governed by two sets of assets. They are location-specific natural assets (*L-na*) and location-specific created assets (*L-ca*). Nature, availability, and augmentation of these assets at a certain location determine the likelihood and the degree of it to become a host country for cross-border operations of MNC. Accumulation of these assets pushes countries from the host country status to investor country status along the transformation of the economy. This, in turn, determines the inflow and outflow patterns of direct investment to and from that country. It is, thus, obvious that these assets at a time absorb FDI while at other times emit FDI causing the phenomenon of FDI inflow and outflow cycle (Rajaratne, 1998). When FDI inflow exceeds outflow, a country will experience negative net outward investment (NOI) position. The reverse of this relationship will result in positive NOI position.

Figure 1: Investment Development Path



Source: Narula (1996:22)

Countries in stage-I opt for self-reliant development policy and refuse economic liberalization and FDI-reliant development policy. In consequence, these countries receive a negligible amount of FDI and exhibit zero or near-zero NOI position along with a low per capita income. Though these countries may possess natural asset related advantages, the paucity of created assets limit the use of the natural assets by MNC. The countries indicated in the Stage-II, pursue liberal and FDI friendly policies. In response, these countries begin to receive FDI and as a result their NOI position will deepen. In other words, these countries will continue to receive more FDI than what outflows from them resulting in a large negative net outflow of FDI. The degree of NOI in this stage is appropriated to the supply of location specific advantages which can be identified as natural and created assets that together push the NOI position further downward. Correspondingly, in these nations per capita GDP will grow.

In the Stage-III, NOI starts to bottom out as these countries begin to invest outward significantly while still receive large sums of FDI. This phenomenon is caused by the depletion or scarcity of natural assets but augmentation of created assets. At this stage, the host country runs out of advantages in natural assets and finds itself disadvantageous as far as natural assets are concerned. Yet, the gradually augmented created assets now opportune for the firms (domestic and foreign) to engage in cross-border operations to benefit from the firm specific ownership assets. At this stage, industrial sophistication intensifies and as a result the per capita income improves. With extensive internalization drive of domestic MNCs (together with foreign MNCs), these countries eventually complete the FDI-in-out-cycle (Rajaratne, 1998) and move to a positive NOI position indicated in the Stage IV. At this stage industrial structure is sophisticated and high per capita income level is reached. Finally, at the Stage-V, backed by an advanced liberalization move also, countries tend to mutually rely on direct investment where cross border mergers and acquisitions become prominent. Created assets will almost completely determine the FDI flow amounts and patterns among the involving countries which have already gained economic development at this stage.

Dunning and Narula (1996) identified technology homogeneity, market homogeneity, product and technology collaboration, joint research and development (J-R and D), mergers and acquisitions (M and A), alliance capitalism, and inter-firm stake ownership as the causes of this phenomenon. At this stage, knowledge intensive industrial structure with high economic development level is achieved (Rajaratne, 2006). With these properties, the IDP proposition can be identified as the most appropriate tool for examining the investment-development relationship. The IDP has been proven to be significant and an acceptable tool by the comprehensive tests carried out by Dunning (1982, 1996) and Narula (1996) for a sample of 88 countries and separate samples for natural-asset-rich countries and created-asset-rich countries (Dunning and Narula, 1996:31).

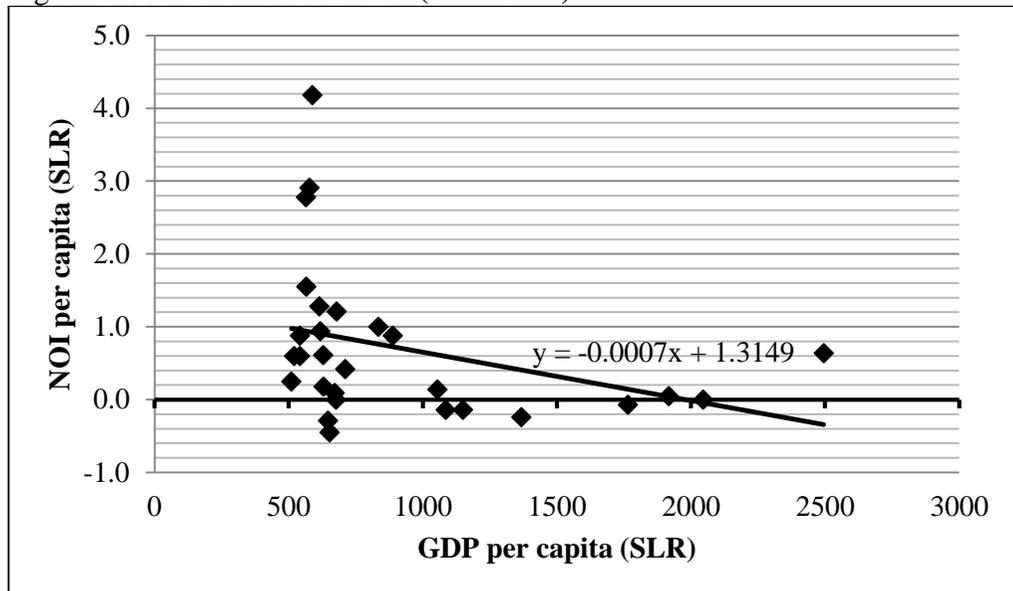
The IDP position of Sri Lanka is calculated for three different periods separately. Firstly, IDP position of Sri Lanka for the whole seven decades since 1950 is calculated to determine the long run pattern of FDI-reliant development without considering differences of policy regimes. Secondly, IDP for the period between 1950 and 1977 is derived to explain the investment-development pattern of the country in a non-liberalized relatively closed market regime (basically). Thirdly, the IDP is derived for the liberalized regime between 1978 and 2015. Time series data published by the Central Bank of Sri Lanka on per capita GDP at current factor cost prices and per capita NOI at current prices in Sri Lanka Rupees (see, Table 1), are used in the study.

3. Data and Discussion

Data are compiled and tested for five different periods in this study based on FDI related policy regimes and political regimes. The first period is marked as the inward-looking import substitution industrial (IL-ISI) policy which generally existed between 1950 and 1977. The second period begins in 1978 with outward looking exports-led industrialization (OL-EOI) and continues until the date of this research i.e. 2015. The third period spreads between 1978 and 1994 which signifies the political regime of the UNP government that propagated FDI-reliant development strategy with open market policy. The fourth period extends from 1995 to 2015 which is SLFP regime that proposed a ‘human face to open economy’ with barriers to multinational corporations. The last period is the post war period that starts in 2010 with a new strong government. These demarcations are also meant for describing variations of location specific created assets between the periods

Sri Lanka shifted from inward-looking import substitution industrial (IL-ISI) policy to that of outward looking exports-led industrialization (OL-EOI) in the year 1978. Until that year since Independence, self-reliant development was followed. However, the prospective role of FDI in economic development had been recognized as early as 1949 in the first budget speech of independent Sri Lanka². Subsequent policy formulation for FDI under IL-ISI policy appeared in the white paper on FDI in 1955, and the policy statements of 1966 and 1972 (Vidanapathirana, 1986). The liberal stance for FDI that prevailed from 1948 through 1955 was undermined by the Ten Year Development Plan in 1956 which propagated a strong self-reliant IL-ISI policy. And FDI hostile policy continued well until 1977 with some exceptions during 1965-70. Thus until 1977, Sri Lanka remained an unimportant FDI recipient country due to moratorium law³ and other unfavorable policies (Colombage and Karunaratne, 1986) and Hicken Looper law enforcement by the USA. As a result, Sri Lanka remained in the Stage-I of the Investment Development Path for a period of three decades with insignificant relationship between NOI and GDP at the slope of zero as depicted in the Figure 2.

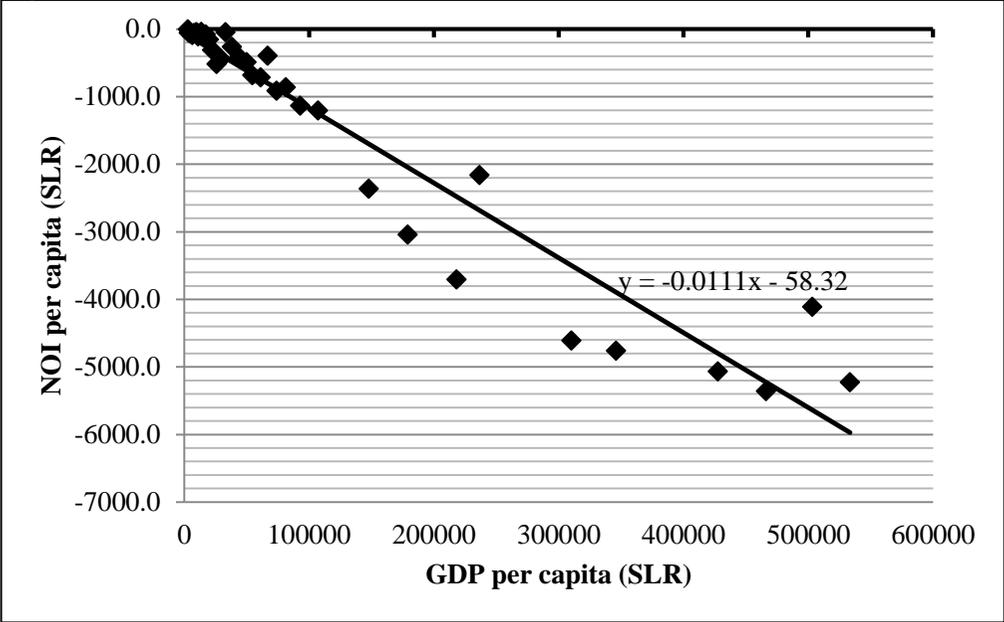
Figure 2: The IDP of Sri Lanka (1950-1977)



Source: Appended Table 1

The outward looking export-oriented industrialization (OL-EOI) policy itself has been a favorable and prominent created asset of the country in receiving inward FDI since 1978. From this year onward, Sri Lanka has continued to receive larger sums of FDI compared to the previous policy regime. As a result of this fundamental change in the created asset structure, Sri Lanka managed to immediately enter the Stage-II of the IDP as the NOI position began to deepen gradually. Sri Lanka's per capita NOI jumped to SLR -51 in 1979 from mere -1.70 in 1978 and it has reached SLR -5,223 today (see Table I). In dollar terms, during the last four decades Sri Lanka's NOI has increased by mere US\$-1 per year to reach US\$-38 in 2015. These statistics reveal that Sri Lanka's IDP has been generally flat throughout the whole period except for the very first few years since 1978 where the slope of IDP was high. Figure-3 illustrates that Sri Lanka has taken ten years to reach NOI level of SLR-5000 from SLR-2000 level. This has caused long run low NOI-GDP relationship at the slope of -0.011. Though this slope is a highly significant slope compared to close market regime that existed prior to 1978 the increase of Sri Lanka's per capita GDP during the past several years cannot be explained by IDP. The rapid increase of GDP during the past several years must be due to increase in other sources of income such as foreign loans and remittances.

Figure 3: The IDP of Sri Lanka (1978-2015)



Source: Appended Table 1

The question that Sri Lanka is a poor FDI recipient country has generally been raised as a major problem of the FDI-reliant development policy of Sri Lanka (Lakshman, 1997). Figure 2 confirms that before 1977 Sri Lanka’s IDP remained in the stage-I and Figure-3 depicts that it has entered stage-II. However, it did not rapidly improve during the past four decades due to insignificant annual receipts of FDI. This drawback is due to Sri Lanka’s inability to sufficiently bestow location specific advantages to the MNC. This drawback primarily involves diminishing advantage of natural assets. Price hike and poor supply of natural resources, wage rate hikes, problems in labor supply, and low labor productivity have caused to diminish the advantage of natural assets. Secondly, Sri Lanka’s created assets such as markets, labor skills, supply and cost of capital, industrial structure, support industries, infrastructure and its quality, logistics, industrial peace, economic policy, macroeconomic management, and politics and governance have not competitively enhanced Sri Lanka’s created assets position. Thirdly, some of the created assets of Sri Lanka were paradoxical to her investment and business climate. They include the political climate and industrial relations. Fourthly, the closure of the sectors such as retail business, distribution, transport and insurance, etc., for FDI has undoubtedly led to location specific disadvantage. The progress in IDP can be achieved through both endowment of natural asset and the competitiveness in the created assets.

Sri Lanka's IDP has been disturbed several times and has caused deterioration in the created assets of political nature. First, the widespread communal violence erupted in 1983 caused a serious drawback in the flow of FDI as the investors found Sri Lanka an unsafe location. Big investors such as Motorola of the USA discontinued projects due to the outbreak of communal violence (Vidanapathirana, 1986). He further observed that the project approval to project contract ratio during this period was 2:1 while capital involvement was 7:4. The second downturn in FDI inflow occurred during 1988 to 1989 period due to widespread antagonism of the patriotic movement. In consequence, per capita NOI dropped from SLR-105.15 in 1987 to SLR-38.63 in 1989. The third down turn occurred during 1994 to 1995 due to anti-open economy sentiments of the new government in 1994. The NOI per capita in 1993 stood at SLR-512.66 but it dropped to SLR-45.30 in 1995. Then, the national insecurity in 2001 weakened FDI inflow and the per capita NOI dropped from SLR-712.40 in 2000 to SLR-391.85 in 2001. International insurance companies imposed an insurance surcharge for the airplanes and ships that arrive in Sri Lanka after LTTE attack on the Sri Lanka's international airport in year 2000. Further, major air-liners and sea-liners refrained from entering the country. In view of these developments, foreign investors found Sri Lanka's investment climate deteriorated and they refrained from investing. These incidents not only disturbed FDI inflows but also changed the course of the IDP.

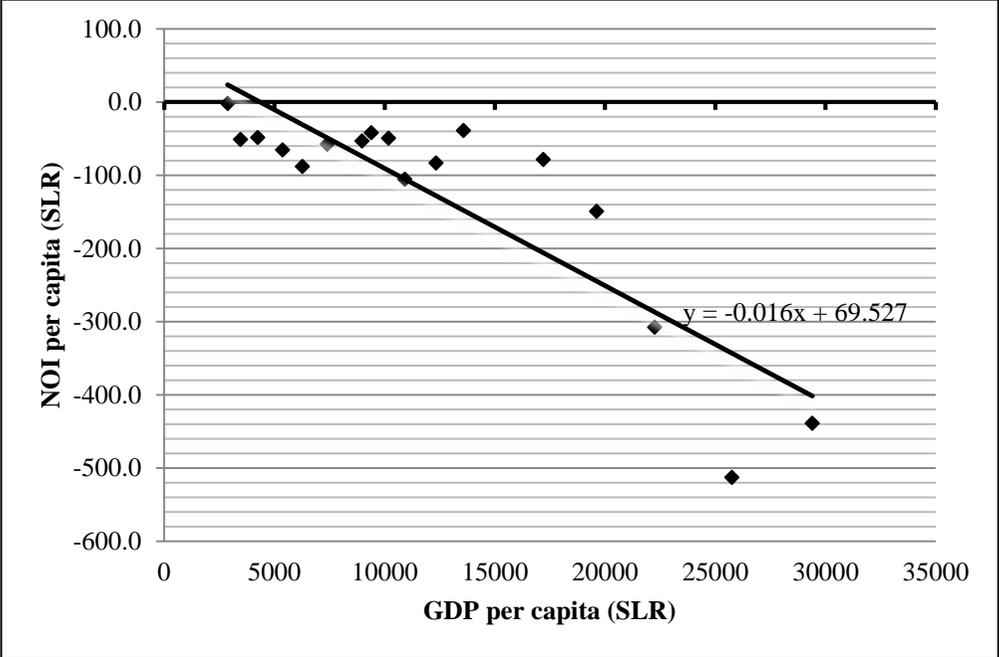
The second question, which requires special examination, is whether Sri Lanka has failed in the FDI-reliant development strategy. Views such as "*FDI concentrates in garment industry has created lopsided development in the manufacturing ...*" (Atapattu, 1997:84) are prominent critiques. Several other ailments diagnosed in Sri Lanka's FDI-reliant policy include labor intensity of production, light manufacturing, insufficient local content, industry concentration, absence of technology transfer, and insufficient employment, etc. On the contrary, Athukorala (1997) observes that FDI-reliant policy of Sri Lanka has significant and favorable effects on employment, information related externality, and trade. Rajaratne (2009) found that while Sri Lanka's NOI position was insignificant but the effects of FDI-reliant policy were significant as Sri Lanka's industry and exports were revolutionized through it during the 1980s and 1990s.

The degree of economic development needs to be connected to the endowment of natural and augmentation of created assets. In the context of Sri Lanka, there have been predominant weaknesses in the created asset structure and as a result, the IDP has slowed down. But, Sri Lanka's investment-development scenario is neither withered nor failed. What can most correctly be said is that Sri Lanka's investment-development relationship is insignificant at the slope of -0.011 between the two during the past seven decades. The income growth of the country thus is less explained by NOI position it being relatively flat. Sri Lanka has not lined up in the catching up course along the regional industrial hierarchy proposed by Kojima (1973) and Ozawa (1993). Any acceleration to this catching-up process

requires wide-ranging correction to the created assets structure to improve the NOI position of the country.

The period between 1978 and 2015 comprises the UNP regime from 1978 to 1994 and SLFP regime from 1995 to 2015. Special attention is given to the post war period from 2010 to 2015. The aim of this classification is to pursue a closer inquiry into the IDP trends during different policy regimes as well as the post war period. The post war period has been especially taken into consideration because many analysts and policy specialists maintained the notion that Sri Lanka’s FDI position did not improve due to the internal war.

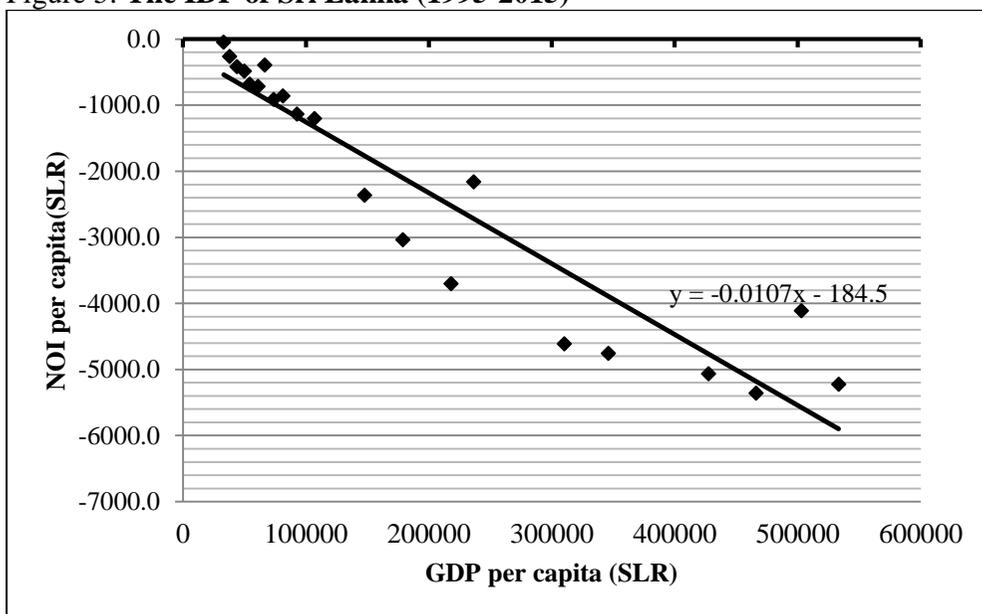
Figure 4: The IDP of Sri Lanka (1978-94)



Source: Appended Table 1

Figure 4 presents the trend of IDP for the period between 1978 and 1994. This period is characterized by open market economy and FDI-reliant export oriented industrial policy. The slope of the IDP during the UNP regime (1978-94) remained at -0.016 which is the best relationship between FDI and GDP ever recorded in Sri Lanka. Although the IDP continued to deepen during 1978 and 1994 period it began to flatten thereafter during the SLFP regime between 1995 and 2015 at the slope of -0.010 (Figure 5) witnessing to the FDI hostility policy.

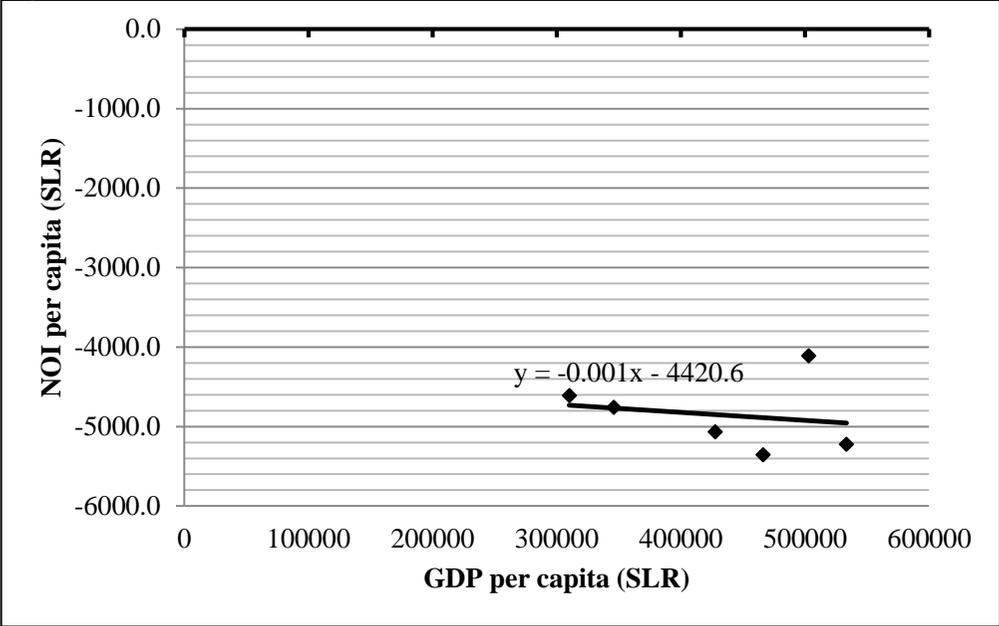
Figure 5: The IDP of Sri Lanka (1995-2015)



Source: Appended Table 1

It is obvious that during the last six-year period (2010-15), Sri Lanka’s annual FDI receipt jumped to near one billion US dollars but it did not progress from thereupon and as a result the IDP did not deepen any further. Figure 6 indicates that during the last six-year period the IDP has flattened at the slope of -0.001. This should not be interpreted as the bottoming out of the IDP which normally occurs after heavy FDI receipts for a long period of time and high GDP in consequence and hence a turnaround in the assets structure and rise of local MNCs. The per capita FDI at US\$ 38 and per capita income near US\$ 4000 at present are not much correlated. With low per capita FDI, Sri Lanka remains in the early stage-II of the IDP while it corresponds to high per capita income. This phenomenon only occurs when the per capita income is generated from other sources of revenues rather than FDI-reliant production.

Figure 6: The IDP of Sri Lanka (2010-2015)



Source: Appended Table 1

4. Conclusion

Sri Lanka’s development policy shifted from IL-ISI to that of an OL-EOI in the year 1978. Heavy reliance on FDI (Dunham and Abeysekera, 1987) and widespread economic liberalization were major features of this new policy. Numerous incentive schemes, including export processing zones and tax concessions, were implemented to attract FDI. In this policy, FDI was assigned the task of alleviating the resource gap, foreign exchange gap, technology gap and employment gap for bringing about economic development. The FDI-reliant policy has been in place for nearly four decades and it has been heavily criticized that it has failed in satisfactorily achieving those objectives due to failure in augmentation of locational advantages sought by foreign multinational corporations.

In order to assess the augmentation of locational advantages in Sri Lanka, the IDP model was used and Sri Lanka’s absolute IDP position was derived in this study. The absolute IDP of Sri Lanka has been disturbed in four consecutive occasions and a shallow IDP has been resulted in. It is also obvious that Sri Lanka has just drifted from the Stage-I of the IDP and entered the initial phase of the Stage-II. During the early years of the FDI-reliant development strategy, industries that seek natural assets have been established. However, the production structure has not progressively transformed since then due to failure in the asset structure transformation. This reflects the exhaustion of natural assets and poor supply of created assets for the industries to enter capital, technology and knowledge intensive production. Theoretically, natural assets help deepen the NOI in the initial

stage of the IDP while created assets help progress of it in the later stages. Therefore, Sri Lanka's further progress along the IDP will owe to dynamic configuration of the created asset base. While the early phase of the stage-II of the IDP still requires supply of natural assets the latter phase of it and latter stages of IDP indispensably require steady supply of created assets. For multinational companies to induce advanced production structure through FDI it is imperative for Sri Lanka to redesign its EOI policy in the direction of enhancing location specific created asset base targeting production intensiveness in capital, technology and knowledge progressively.

Endnotes

¹ The eclectic paradigm proposed by John Dunning explains the relevance of OLI factors in international operations of the firm.

² In the Budget Speech of 1949, J.R. Jayewardene (the Minister of Finance) mentioned "... investment of foreign capital would be particularly welcoming industrial investments because industrial development cannot take place without scientific, technical and industrial knowledge, ... the government has framed its policy not only to enable further foreign capital to be invested in Ceylon, on particular fields of investment in which the aid of foreign investment is desirable, and under conditions which safeguard the mutual interests of this country and of the foreign investors..."

³ In the Budget Speech of 1964-65, N.M. Pereira (the Minister of Finance) mentioned "... considering the present critical position of the country's foreign exchange resources, I have decided to declare a moratorium on all remittances, of profits, dividends, interests and other investment income for a period of one year in the first instance..."