# Promoting Investments in Developing Countries: A Case of Sri Lanka

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## ABSTRACT

**Sri Lanka is ranked as the most liberalized economy in the South Asia and it remains as one of the attractive investment destinations in the Asia Pacific region. Being the first in the South Asian region to promote foreign investment, it has been using different methods to promote investments. However, the effectiveness of them may not be similar. Therefore this research attempts to determine the most favorable factors that attract investors to invest in Sri Lanka. Outcome of this research may be used to enhance investments. Data were collected by questionnaire method and sample is consisted of firms invested under Board of Investment of Sri Lanka. The study developed a ranking of investor attraction factors and the results show that investment incentives, restrictions, approval procedure complexity, political stability, economy, FDI history, labour factors, joint venture facility, production cost, adequate technology level, doing business ranking and change in GDP are influential.**

**KEYWORDS: Board of Investment, FDI, Investment Promotion, Incentives, Sri Lanka**

## INTRODUCTION

Due to the geographical location of Sri Lanka, it remains as one of the most attractive investment destinations in the Asia Pacific Region. Therefore, as a developing country, Sri Lanka has the opportunity to gain national economy by promoting investments.

Currently, Board of Investment (BOI) uses several methods to promote investments by way of incentives, investment policies etc. These incentives are available for both foreign and domestic investors in various industries, industry scales and categories. Also, the climate of the country may influence the decision of investors.

Thus, each incentive may not be equally attractive to investors. BOI may not reach its objectives, and Sri Lanka may not be able to capitalize the opportunity for national development. Yet, the issue of attractiveness of factors towards investment has not received an adequate attention of scholars.

Essentially this research attempts to identify favorable and attractive factors to appeal investors to invest in Sri Lanka. By doing so, this study plans to identify the factors which are attractive to investors. Our contribution will help developing an effective investment promotion strategy and climate in Sri Lanka. Further, its contribution will be significant to the national economic development.

## LITERATURE REVIEW

It is widely accepted that the trend towards globalized production and marketing has major implications for developing countries' attractiveness to foreign direct investments (FDIs). At the same time, scholars argue that the determinants of and motivations for FDIs in developing countries have changed in the process of globalization (Kokko, 2002). At present, exploiting prospects through FDI has become a fad in developing countries.

The governments are supposed to pay their careful attention on issues related to attracting and screening investments.

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According to UNICAD, the problem with screening rules is exacerbated by two general factors namely, the natural selection bias and information problems. Due to the selection bias, incentives would likely attract below-average quality FDIs. Also, the effect of lack of information is higher. Therefore, predetermined characters such as size and industry affiliations of investors become key in screening decision. Thus, screening focuses on overcoming this issue, and selecting above-average quality investments (UNICAD, 1996).

There are several determinants of investments. The market size of the host country is one of paramount. According to the market size hypothesis, multinationals tend to invest in larger countries in order to exploit economies of scale (Marr, 1997). Further, research and development (R&D) investment provides a competitive advantage to a country (Pavitt and Patel, 1988). Investments in R&D enhance the firm's ability to develop and exploit technological know-how that in turn is critical to the development of future innovations (Dierickx and Cool, 1989). Thus, by helping to create unique resources and by increasing future innovative capabilities, firm R&D intensity will be a factor in attracting alliance capital from corporate partners (Deeds, DeCarolis and Coombs, 1997). Furthermore, as there is a trade-off between granting of incentives and other policy measures, the efficiency of incentives can be strongly questioned, and the potentially significant opportunity costs is highlighted (Driffield, 2000).

It is not surprising that economic factors play a role in the decision making process of foreign direct investment, due to the fact that economic factors want a return to their investment and profit maximization is a major incentive for investors. However, the impact of political factors in countries where investment capital is coming in or going out is also salient. A country with high political unrest or instability internal and external conflict, corruption and ethnic tensions, law and order, democratic accountability of government and quality of bureaucracy counts higher risk and uncertain, making it less attractive for investments. This is especially important when looking at developing countries that are largely characterized by an unstable political environment (Büthe and Milner, 2008; Globerman and Shapiro, 2002). Due to the political environment of countries, FDIs are unequally distributed across countries.

Also some researchers found that the effect that a country's business regulatory environment has on the amount of foreign direct investment it attracts. They used the World Bank's Ease of Doing Business ranking to capture the costs that firms face when operating in a country. Several interesting results emerge. Firstly, the Doing Business rank is highly significant when included in a standard empirical FDI model estimated on data averaged over the period 2004-2009. Secondly, the significance of the overall Doing Business is driven by the Ease of Trading across Borders component. Finally, they found no evidence that the Ease of Doing Business of nearby countries has an effect on the FDI that a country gets in general. However, in terms of attracting FDIs from the US, it helps to be near countries with good trade regulation and bad regulation in other respects (Corcoran and Gillanders, 2012).

In the past decades, international investors were attracted by the abundant large natural resources and cheap labor forces in the ASEAN countries. Most ASEAN countries except Singapore and Burney are countries with relatively low or very low labor costs. (Phuc, 2005). As an example wages and salaries in Jakarta even half the amount of that in Beijing (JETRO, 2002). Therefore, compared with China labor costs in Vietnam and Indonesia are now much cheaper. Therefore more international investors are attracted by Vietnam and Indonesia.

One of the many influences on FDI activity is the behavior of exchange rates. Exchange rates, defined as the domestic currency price of a foreign currency, matter both in terms of their levels and their volatility. Exchange rates can influence both the total amount of foreign direct investment that takes place and the allocation of this investment spending across a range of countries. When a currency depreciates, meaning that its value declines relative to the value of another currency, this exchange rate movement has two potential implications for FDI. First, it reduces the country's wages and production costs relative to those of its foreign counterparts. All else equal, the country experiencing real currency depreciation has enhanced "location advantage" or attractiveness as a location for receiving productive capacity investments (Linda, 2006).

The importance of FDIs has increased almost in all countries with the globalization process intensified with 1980s due to their positive impact on economic growth. There are several studies aiming to analyze the effect of FDI inflow on Gross Domestic Production (GDP) growth in ECO region show that FDI inflow has an utmost importance for the region. According to the results of the two causality tests notify a strong positive relation between FDI inflow with GDP (Sandalcilar, 2011).

Obligatory screening and approval procedures can be used to limit FDI though their constraining effects depend on the implementation of such practices. Stipulations that foreign investors must show economic benefits can increase the cost of entry and therefore may discourage the inflow of foreign capital (OECD, 2002).

Also historical factors that motive FDI before turning to a more contemporary discussion of current causes that may help explain the recent surge in foreign investment (Alenka, William and Roger, 1990).

FDI restrictions and, to a lesser extent, tariff barriers are significant in FDI. Limits to foreign ownership and governance discourage the activity of foreign affiliates, especially in some important non-manufacturing industries such as electricity, transport and telecoms (OECD, 2002).

## RESEARCH PROBLEM

The investment climate in Sri Lanka has become favorable due to the end of war in 2009, thus it focuses on rebuilding the country's economy and infrastructure. The government has set ambitious goals for economic development.

With a relatively open investment climate and financial system, moderately stable monetary policy, improving infrastructure, and world-class local companies, Sri Lanka possesses sound ingredients for economic advancement. For foreign investors including some U.S. investors, Sri Lanka's frontier market has been fertile ground for both direct and capital investments. Also Sri Lanka offers the most friendly business climate and is ranked as the most liberalized economy in South Asia. As a result of that, Sri Lanka remains as an attractive destination for investors.

Further, Sri Lanka offers a ranges of incentives to stimulate investments aiming at both local and foreign investors. However these incentives may not be equally attractive to all investors. Thus it is important to analyze and understand investor attraction factors. This knowledge helps carefully choose incentives and finally attract quality investors. Therefore, this paper attempts to identify the factors that attract investors to invest in Sri Lanka.

## METHODOLOGY

This study investigates the factors influencing investors in investing in Sri Lanka. This study selected investors who registered under Board of Investment of Sri Lanka. The factors influencing investors' decision were chosen based on literature.

The structured questionnaire method was adapted to collect data from randomly selected 90 investors. Sample includes both foreign and domestic investors. Also, sample consists with investors from several sectors such as manufacturing, agricultural and services. The sample is characterized by small-scale, medium-scale and large-scale investors. Questionnaire was developed focusing on identified thirteen factors and included fifteen open ended, presence /absence, rank ordering, and multiple responses questions. The response rate was 95.5 percent. Descriptive analysis, non-parametric tests such as Kruskal Wallis test, and chi-square test were used to analyze the data.

## DATA ANALYSIS

The 60 % of the sample consists of domestic investors and the rest includes foreign investors thus, local investors dominate the investment in Sri Lanka. Investors in the sample present three sectors: manufacturing firms 59, agricultural firms 5, and service producing firms 22. Out of 59 manufacturing firms 33 are local investments and 26 foreign investments. There are 19 local service producing firms, 3 service producing foreign firms. All investments in agricultural sector are foreign.

The sample includes 15, 37, 35 small scale (investment: LKR 25-50 million), medium scale (investment: LKR 50-300 million), and large scale (investment: over LKR 300 million) firms respectively. Majority of local investors are medium scale investors and majority of foreign investors are large scale investors.

Analysis shows that foreign investors' attention is greater on doing business ranking than local investors. Our analysis on political stability as an investor attraction factor reveals that 83 investors (out of 86) consider it as an investor attraction factor.

**Table 1: Economic Factors Frequencies**

| Economic Factors | Responses | |
|---|---|---|
| | N | Percentages |
| Inflation | 74 | 27.0% |
| Balance of Payment | 16 | 5.8% |
| Budget Balance | 23 | 8.4% |
| GDP | 32 | 11.7% |
| Exports | 38 | 13.9% |
| Exchange Rates | 59 | 21.5% |
| Imports | 32 | 11.7% |

The highest percentage (27%) of investors, considers inflation of the country, and 21.5% of investors consider exchange rates. 13.9% of investors consider exports and 11.7% from total investors consider both GDP of the country and imports as investor attraction factors. Least number of investors consider budget balance.

**Table 2: Labour Related Factors**

| Factors | Responses | Percent |
|---|---|---|
| Labour Availability | 65 | 24.0% |
| Cost | 75 | 27.7% |
| Skills | 67 | 24.7% |
| Attitudes and Behaviors | 34 | 12.5% |
| Laws | 30 | 11.1% |
| Total | 27 | 100.0% |

According to Table 2 the highest percentage of investors (27.7%) considers labour cost before investing in a country. 24.7% of investors considers labour skills and 24% considers labour availability. Least number of investors consider labour laws and regulations.

**Table 3: Kruskal Wallis Test**

| | Attraction Factors |
|---|---|
| Chi-Square | 195.969 |
| df | 11 |
| Asymp. Sig. | .000 |

Hypothesis:

$H_0$-All medians of investor attraction factors are equal

$H_1$-At least one median is different

Table 3 shows that the P value is (.000) less than significance level .05 at the 95% confidence interval. Null hypothesis is not accepted. Therefore at least one median of investor attraction factors is different at 95% confident interval. Therefore there is enough evidence to conclude that all the factors do not affect the investor attraction in same level.

**Table 4: Ranking of Factors Which Influence Investor Attraction**

| Group | Mean Rank |
|---|---|
| Investment Incentives | 610 |
| Restrictions | 610 |
| Approval Procedure Complexity | 598 |
| Consider Political Stability | 592 |
| Consider Economy | 580 |
| FDI History | 544 |
| Labour factors | 520 |
| Joint venture Facility | 520 |
| Production Cost | 454 |
| Adequate Technology Level | 430 |
| Doing Business Ranking | 394 |
| Change in GDP | 346 |

Table 4 presents the ranking by mean. Investor attraction factors were identified based on mean ranking.

**Table 5: Chi-square Test for Investor Attraction Factors**

| | Signifi -cance | Investor Attraction Factor |
|---|---|---|
| Doing Business Ranking | .131 | No |
| Political Stability | .000 | Yes |
| Consider Economy | .000 | Yes |
| Technology Level | .005 | Yes |
| Labour factors | .000 | Yes |
| Production Cost | .000 | Yes |
| Change in GDP | .829 | No |
| Joint Venture Facility | .000 | Yes |
| Approval Procedure Complexity | .000 | Yes |
| FDI History | .000 | Yes |
| Incentives | .000 | Yes |
| Lower restrictions | .000 | Yes |

Table 5 presents the results of Chi-square test for investor attraction factors. Accordingly this study finds factors which determine investor attraction. It shows that all factors except doing business ranking and change in GDP are detrimental in attracting investors.

## RESULTS AND DISCUSSION

Most of the respondents are domestic investors registered under BOI. Though the doing business ranking is recognized as an important factor in making investment decision, our analysis contradictory finding. The main reason for this may be scant knowledge of domestic investors on doing business ranking. However most of foreign investors consider it as an investor attraction factor.

According to the analysis, favorable incentives attract investors. Tax holidays attract investors but, trade restrictions do not have adverse impact on investment decisions. This may be since there are no tough trade barriers in Sri Lankan investment market. Efficiency in approval procedure is one of the most important investor attraction factor thus, enhancement of efficiency in approval process is salient.

Both political and economic stability affect investors' decisions. Also, joint venture facilities are very important for investors. Therefore joint venture facilities should promote among investors who cannot obtain approvals to invest in Sri Lanka.

## CONCLUSION

Following are the conclusions of this study.

- According to the analysis most of the respondents are domestic investors registered under BOI.
- Most of the investors choose manufacturing sector for their investments.
- Majority of local investors are medium scale investors and majority of foreign investors are large scale investors.
- Investors mostly consider economic factors such as inflation of the country exchange rates, GDP of the country and imports. Economy of the country should be stable to attract investors.
- Most of the investors point out tax holidays as their favorable incentive.
- Trade restrictions are not accept as an investor attraction factor.
- Approval procedure efficiency is one of the most important factor.
- Political instability affect investors' decision.
- Investors prefer joint venture facilities.
- Finally, the ranking of investor attraction factors are presented in Table 6.

**Table 6: Investor Attraction Factor Ranking**

| Investor Attraction Factors | Ranking |
|---|---|
| • Investment Incentives | 1 |
| • Restrictions | 1 |
| • Approval Procedure Complexity | 2 |
| • Consider Political Stability | 3 |
| • Consider Economy | 4 |
| • FDI History | 5 |
| • Labour factors | 6 |
| • Joint venture Facility | 7 |
| • Production Cost | 8 |
| • Adequate Technology Level | 9 |
| • Doing Business Ranking | 10 |
| • Change in GDP | 11 |

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