Foreign Direct Investment and the role of the State : Some Lessons for Sri Lanka

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(1) Introduction

There is a popular belief that foreign direct investment (FDI) catalyzes economic development. Poor countries are encouraged to liberalize their laws to maximize such investment. Any foreign investment is regarded as "good", and any foreign investor is welcomed into the country. Often the foreign investor has been granted concessions and privileges over and above the local investor.

There has been little critical ex-post assessment of the nature and consequences of such foreign investment. Has it all been beneficial to the country and, if so, in what way? How sustainable and enduring in terms of, say, enhanced technological know-how for local industry, increased employment, output, local value addition and net foreign exchange earnings, have these benefits been? Have there been any adverse implications of such investment, particularly on local industry? If so, what? What has been the experience of other countries which are major industrial powers today? What role, if any, did the State play in encouraging FDI? How far, and in what way, did the State act to contain any adverse implications of FDI and protect local industry? Can Sri Lanka learn from these policies and experiences? In this context, it is useful to begin by examining the case of Japan.

(2) Japan's Approach [1]

The foundations for Japan's industrialization were laid by the Meiji restoration in 1868. The early Meiji leaders were wary of foreign investment in Japanese mining, industry or agriculture, especially until the turn of the century. A German farmer who had established a model farm in Hokkaido at the invitation of the Shogunate was bought out by the Meiji. Foreigners were restricted by law from owning land or operating mines, although they could participate in Japanese companies so engaged. Foreign shipping companies were barred from trade between the principal Japanese ports after 1894 and were excluded altogether from coastwise trade after 1911, unless on a continuous voyage from a foreign country. Similar laws prevailed in the Japanese colonies.

This is not to say that foreign technology, expertise or links were rejected outright. Indeed, quite the contrary. If these could be harnessed for the country's benefit, they were actively sought after. The new Meiji Emperor, on assuming the throne in 1868, declared that "intellect and learning should be sought for throughout the world, in order to establish the foundations of the empire". Students were sent abroad to study British textiles and metallurgy, American railways, French law and German military science. Foreign equity investment was allowed on a limited scale in strategic sectors, where technology could be transferred. For instance, the General Electric Company was allowed to acquire an interest in the Tokyo Electric Light Company in 1905. This connection enabled the latter to introduce the Mazda lamp in Japan. Armstrong Vickers was allowed to invest 45% in Nippon Seiko (Japan Steel) and this helped pioneer new metallurgical processes.

The Government itself took an active role in trying to foster the transfer of technology. It furnished capital, introduced foreign experts, if needed, and established technical schools. It began a model silk filature at Tomioka, bought 20,000 spindles from England to establish machine spinning, started production of cement, glass and paper, developed new mines and shipyards and encouraged the manufacture of sugar, tobacco products, beer, paint, machinery, matches and artificial fertilizer.

In all these cases, where foreign investment and expertise were sought, there was a clear State objective of promoting the transfer of technology. Foreign investment and expertise were encouraged only in so far as they could meet this objective and benefit the country. Once the Japanese had mastered the required techniques, foreign expertise was dispensed with Rudyard Kipling on his second visit to Japan in 1892 noted that "In Tokyo live the steadily diminishing staff of Europeans employed by the Emperor as engineers, railway experts, professors in the colleges and so forth. Before many years they will all be dispensed with and the country will set forth among the nations alone and in its own responsibility".[2] Another notable instance is that of shipping. In 1884, Japan's leading shipping company, the Nippon Yusen Kaisha (NYK) employed 174 foreigners, operating a fleet of 74 steamers aggregating 60,000 tons. The number of foreign officers rose to 224 during the Sino-Japanese War (1894), but declined thereafter, as the Japanese themselves learnt the techniques of modern navigation. By 1920, there were no foreign officers employed on Japanese vessels.

A closer examination of the growth of the shipping and ship building industries is instructive, as it illustrates the role the Japanese State played in developing the indigenous base. Initially, the Meiji governments built, purchased and operated vessels themselves, or gave them outright, or leased them to subsidized private sector entities, like the Mitsubishi company. By 1881, the State seems to have decided against government ownership itself in this field. Instead, the State was to play a key role in fostering and guiding the local private sector. The State encouraged the small private shipping companies (many operating at a loss) to consolidate themselves into several larger ones. Various guarantees and subsidies were offered. In 1884/1885, the Osaka Shoshen Kaisha (OSK) and the Nippon Yusen Kaisha (NYK) were formed, the latter through a merger of State and private interests and with a government guaranteed dividend of 8%. The government sponsored formation of NYK was also designed to halt a ruinous fare-cutting battle between Mitsubishi and Mitsui. These new lines extended services from Vladivostok to Bombay during the next decade. NYK also pioneered services to Europe, the USA and Australia and played an important role in the wars with China (1894) and Russia (1904).

The local shipping industry was fostered through a number of navigation and construction bounty laws enacted in 1896. Restrictions were placed on foreign shipping companies. Japanese companies were favoured through administrative preferences granted them by government agencies. They were awarded operating subsidies annually in the form of postal contracts. Japanese built vessels were favoured in the award of navigation bounties after 1899.

State policies were carefully designed to encourage the development of the local industry. In 1909 navigation subsidies were restricted to Japanese vessels of 3,000 tons, 15 knots speed or more and those less than 15 years of age. Thus the State encouraged the construction of newer, faster ships, especially if built in Japan and according to government specifications. Japanese companies were thereby helped to

modernize their fleets and extend their ocean services. In these early years, the government subsidies formed a major part of the earnings, especially of the larger Japanese shipping companies. Between 1900 and 1914 the subsidies accounted for 122 million yen (or 77%) of the total net earnings of 158 million yen of all Japanese shipping companies with an authorized capital of over 300,000 yen. With the advent of the First World War, the shipping of the major powers involved was hit, freight rates soared, and the Japanese lines prospered. Launching of Japanese steam vessels rose from 52,000 tons in 1909-1913 to 646,000 tons in 1919. The Japanese merchant fleet almost doubled in size. Thus, after 1915 the need for subsidies was eliminated, although they were subsequently revived on a small scale (averaging 11-12 million yen per annum).

The State also played an active role in encouraging the shipbuilding industry. Benefits were targeted at local firms. Construction bounties were granted to Japanese shipyards and those using Japanese inputs. Here again, policies were tailored to encourage the development of the national industry and the construction of larger, faster ships. From 1896 to 1917 construction bounties were limited to ships of a certain minimum size. Higher rates were granted for the construction of larger, speedier ships and those using Japanese equipment and materials. In 1906 customs duties were remitted on imports used in ship construction. In 1917, in a move to encourage the local steel industry, subsidies were replaced by bounties on the use of Japanese steel on ship construction.

The Japanese State followed a conscious policy of favouring her own firms and those using her own resources and products in fostering her ship building industry and shipping services. These measures helped Japan emerge as a major maritime nation by the advent of the First World War. The Japanese merchant fleet of steam vessels expanded threefold between 1896 and 1913. Japanese lines were able to secure a large share of key routes. In 1896, for instance, NYK (with the support of Japanese cotton spinners) forced its way into the Bombay-Japan shipping conference. The Peninsular and Oriental (P and O) Steam Navigation Company, which then held 66% of the trade, had to cede 18% to the Japanese. By 1913,P and O's share had contracted to 28%, whilst the Japanese rose to 40%. The First World War, which discouraged traders from using the ships of major belligerent countries, allowed Japan further scope for expansion. In 1921, a new agreement eliminated the Continental European lines altogether from the Japan-India trade and awarded 66% to the Japanese and 33% to P and O. In 1929, the Japanese share rose further to 80%, leaving P and O only 20%. By this time two thirds of all Japan's foreign trade was carried in her own ships.

With the expansion of trade after 1931, Japanese shipbuilding and fleet modernization proceeded apace. This process was carefully guided by the State, so that faster larger craft could be developed. In 1932 a "scrap and build" programme was introduced, by which two tons of ship over 25 years of age had to be scrapped for every new ton built in Japan under subsidy. Moreover, subsidies were reserved for ships of over 4,000 tons and a speed of 13.5 knots or more. The Government contributed about 20% towards the construction costs under this programme, allocating about 11 million yen towards it. The programme was repeated in 1935 and 1936.

These programmes, over the period 1932 to 1937, meant the replacement of 500,000 tons of old ship by 48 new ships, totaling 300,000 tons altogether. By 1937 Japan had a steam and motor fleet of four million tons, of which three million comprised larger vessels of over 3,000 tons each. Half of these larger vessels could manage speeds of 14 knots or more. Due to state sponsorship, by the advent of the Second World War, Japan had more modern tonnage (under five years of age) than any other national fleet. The faster, larger and more modern vessels, helped Japan play a key role in world shipping and were a valuable support to her armed forces in the Second World War. Japan won and held a large, far-flung maritime Empire, largely through her maritime power during the period 1941-1944.

Thus, both in shipbuilding and in capturing shipping lanes, the Japanese State followed a very explicit policy of nurturing the local private sector and guiding it through appropriate subsidies and incentives to develop in the form it desired. The large conglomerates that emerged were in turn an asset to the State in helping it to project its economic, political and military power abroad.

Following the Second World War, the allies attempted to impose several policies on the Japanese State, particularly the dismantling of the power of the zaibatsu (the interconnected families which dominated the large conglomerates). [4] The zaibatsu were seen by the allies as instrumental in the country's earlier militarism. Consequently, the zaibatsu families were forced to sell their shares in the conglomerates. However, the old system soon re-emerged in a more dynamic form; the keiretsu. Young managers from the universities who made their own contacts with shareholders, arranged exchanges of shares and took effective control of the combines. They established close links with their fellow university graduates in the Ministry of Trade and Investment (MITI) and other arms of the bureaucracy.

The Japanese State selected a small group of powerful firms to be protected from both domestic, and especially foreign, competition. These firms were given tax credits and subsidies. Infant Japanese industries were protected against both imported goods and foreign firms that wished to establish subsidiaries. The Foreign Exchange Control and Foreign Investment Laws gave the Government wide powers to control FDI. Licences were needed and the Government was wary of the possibility of foreign industrial control. Licence applications were decided on a case by case basis, requiring strong justification in terms of the technical benefits for Japanese industry. Equity participation in joint ventures was generally held to 35% or less, and very rarely permitted to exceed 50%. In existing companies, the foreign purchase of company shares was limited to 10% to 15% of the outstanding stock.

The Japanese State also encouraged technological innovation through the promotion of co-operative research programmes and other means. Once technology had advanced to a certain level, the State encouraged domestic, but not foreign, competition, so as to increase firms' efficiency. There was special support for basic industries like steel and generic technology, like materials research.

With this highly explicit State support, Japan's production and export profile has become increasingly sophisticated technologically. Whilst her exports comprised textiles and low technology products in the 1950s, they were more capital intensive (steel, cars and ships) in the 1960s and 1970s and very high technology (optical fibres, semi-conductors and electronic goods) after the 1980s.

In shifting resources into high technology industries, MITI has played a key role. With consultancy input from leading firms, trade unions, banks and universities, MITI evolves a consensus on the most appropriate polices to pursue. Thereafter, industries targeted for specific support have received trade protection, foreign exchange allocations, research and development subsidies, loans at interest rates below the market, loans that need repayment only if a firm becomes profitable, favourable tax treatment and joint government-industry research projects to develop promising technologies. Not all sectors targeted by MITI proved successful. However, State support was probably crucial in the eventual competitiveness of the Japanese semi-

conductor, telecommunications equipment, fibre optics and machine tool industries.

Today, the zaibatsu have been replaced by a new but similar set of conglomerates; the keiretsu who dominate Japanese business. At the heart of every keiretsu is a major bank that supplies credit and plays a key role in policy formulation. Informal ties amongst a keiretsu's member firms are reinforced by overlapping directorates, mutual stock ownership and other mechanisms. Mutual trust reduces transaction costs. Information exchange within the keiretsu reduces uncertainty and conduces to innovation. Intra-group cross-shareholdings protects members against hostile takeovers and reduces the cost of capital. Moreover, the exclusive nature of the keiretsu system limits foreigh access to Japan's markets. It also makes it very difficult for foreigners to "takeover" Japanese firms and gives the latter a huge advantage in corporate expansion. Whereas keiretsu firms can easily purchase non-Japanese firms, so as to acquire technology or gain market access, it is difficult for the latter to purchase Japanese firms for the same purposes. Moreover, the keiretsu's control of distribution channels effectively excludes non-Japanese firms from much of the Japanese market. The keiretsu whilst acting as a barrier to trade and FDI in Japan, has been a major factor in Japan's post-war economic success. And in the re-emergence of the (keiretsu) conglomerates (with their close interaction with the bureaucracy), the Japanese State has played a key conscious and explicit role.

(3) FDI, Industrial and Trade Policy in the Modern International Context

Another Asian State, China, has seen rapid (often double digit) growth in output and exports in the last two decades. This "success" has been attributed to FDI. However, the Chinese industrial base that has evolved cannot be termed as intrinsically as "solid" as the Japanese. It has been called a "hollow" economy in that a large portion of China's trade surplus with the world has been generated by non-Chinese firms; subsidiaries of mainly American, Japanese and Taiwanese multinationals that directly and indirectly account for about three quarters of the country's exports. [5] Thus, most of the profits from these firms have accrued to other nations, whilst China has gained a relatively small proportion in taxes and wages.[6] More significantly, most of this FDI has been in process or assembly plants in low technology, low value added industries, with many technologically sophisticated components for the final products being imported. [7] Thus China has not developed an indigenous technological base to the extent Japan has.

The Chinese authorities are now aware of the need to address this weakness. It has been a recurrent theme in recent Government pronouncements. In March 2006, the Minister of Railways declared that China would rely on its own technology in the construction of high speed rail links between Beijing and Shanghai and Shanghai and HangZhou; this, despite strong lobbies by German, Japanese and French firms for involvement in these projects. [8] Under the "National Medium and Long Term Programme for Scientific and Technological Development (2006 –2020), there is to be an increase in research and development spending from the current 1.23% of GDP to 2.5% by 2020, putting China in the same range as OECD members. [9] Credit, tax and exchange rate policies are to be tailored appropriately, so that China's dependence on imported technology is reduced to 30% or less by 2020. A leading figure at the Chinese Academy of Sciences noted that foreign firms reap more than 60% of the profits from China's high technology exports. For local industry to reap a larger share, an indigenous technological base has to be formed, and the Chinese Government, aware of this, is taking steps to address it.

Today, most countries impose some form of control over foreign investment in their economies, as this can threaten national sovereignty. Several countries, for instance, restrict foreign investment in the banking sector, as this can provide a lever to gain control over local industry. In China foreigners cannot own more than 25% of any bank [10], and in Russia, one issue stalling entry into the WTO is the Government's refusal to ease restrictions on foreign bank branches [11]. Foreign investment in Indian banks has to be limited to banks being restructured and must be slowly phased in, according to a February 2005 directive.[12] Moreover, the 31 foreign banks active in the Indian market are allowed to open no more than 12 branches a year between them. [13]

India continues to impose restrictions on foreign investment in several other sectors; notably, insurance, aviation, coal mining, media and multi-brand retailing. Foreign portfolio investors can also buy no more than 49% in companies managing distressed assets in an offer for sale, with single buyers limited to 10%. [14] Moreover, a rule known as Press Note 18 gives Indian firms a veto over their foreign joint-venture partners' other investments in India. [15] These policies may at least partly explain why India has developed more of an autonomous indigenous technological base (like Japan) than China. As one comparison has noted, India "fostered genuine entrepreneurship in some industries by favouring domestic investment over foreign " and this has helped it to produce "IT firms such as Infosys, Wipco and Tata Consultancy Services that are among the world's best", something not achieved by China. [16]

The foreign takeover of local industry is almost invariably viewed with suspicion. China's Deputy Director of the Industrial Damage Investigation Department was reported as saying that foreign takeovers would be more closely regulated to preserve the country's "industrial and economic integrity." [17] Arcelor, the then European firm which wanted to buy a 38% state in Laiwa Steel, was prevented from doing so through a merger of the latter with Jinan Steel. The French firm, Danone, was stopped from raising its 20% stake in Bright Dairy to a controlling one through a merger of the latter with three other state food groups. Private equity groups attempts to takeover local firms have been stalled or delayed. One such group, CVA Asia Pacific, was prevented from taking a 30% stake in Chenming, a leading paper mill, in July 2006. Similarly, Carlyle, another such group, has had to wait since October 2005 for regulatory approval for its US $ 375 million acquisition of Xugong, a machinery maker, although the sector is open to foreign investment under WTO rules.

Even in the EU, where the Commission is trying to encourage greater economic integration amongst member states, national considerations remain. When Banco Bilbao Vizcaya Argentaria (BBVA) of Spain and ABN Amro of the Netherlands launched bids for two Italian banks (Banco Nazionale del Lavoro and Banca Antonveneta) respectively in 2005, the Bank of Italy tried to prevent this, by promoting rival domestic bids. [18] When Enel, a large Italian electricity firm launched a hostile bid for Suez, a French utility recently, the French Government brokered a deal between the latter company and Gaz de France (GDF) (a French gas company) to prevent this. [19] Currently, despite commercial (shareholder) and political (European Commission) obstacles, the French Government is in the process of attempting to reduce its stake in GDF from 80% to 34%, so that a merger of this company with Suez can be effected, and a takeover by Enel, prevented. [20] This type of approach has much public support. A national opinion poll found that 69% of those surveyed in France approved of their governments' intervention against hostile bids (such as Enel's) from abroad. There was only some reservation about the fact that in the Enel/ Suez/GDF case, it involved an element of privatisation. [21]

France has been especially wary of foreign ownership of its firms. At the end of 2005, Mr. de Villepin, the French Prime Minister, introduced new legislation to protect businesses from foreign takeovers in all security related sectors. [22] He also indicated that he had compiled a list of ten of the 40 largest French companies that were to be kept under French

ownership. This list included Danone, a food company, Carrefour, a supermarket chain, and Societe'-Generale, a bank. To further augment the national stake in French companies, a state owned bank, Caisse des Depots et Consignations, was mobilized to increase its Euro 25 billion investment in French equities. The French Parliament also approved an amendment to the EU takeover directive, making it easier to introduce a "poison pill" defense to ward of hostile bids, particularly if these were from foreigners.

Again, the Spanish Government is believed to feel that it needs a national energy company, similar to France's Electricite de France and Germany's RWE, and therefore supported a bid by Gas Natural, a Spanish gas company, for Endesa, another Spanish company, in September 2005.[23] Although Germany's EON made a better offer of Euro 29.1 billion to Gas Natural's Euro 22.5 billion, and although both the Spanish anti-trust authority and European Commission approved the former bid in April 2006, the Spanish Government is attempting to block this through its energy regulator, CNE. CNE imposed 19 conditions on EON's bid for Endessa, and the matter remains unresolved at the time of writing.

Governments often try to protect their "national champions" from foreign takeovers, even when they are in financial difficulties and require state subsidies. In 2004 when the German Siemens expressed an interest in buying the troubled French engineering firm, Alstom's turbine business, the French State averted this through a rescue package for the latter.[24] On this occasion, the French Finance Minister, Mr Sarkozy, declared that the State has not only the right, but also the "duty" to help industry and create national champions.[25]

The "national interest" is frequently invoked. When Novartis, a Swiss drug firm, expressed an interest in bidding for the French drug firm, Aventis (which was already subject to a hostile bid from another French firm, Sanoti-Synthelabo), the French Prime Minister said that any bid would have to serve the "national interest."[26] This was seen as a warning to the Swiss firm not to proceed any further, as France was supposed to need its own vaccine producer to counter the possibility of bio-terrorism.

Despite its free-market rhetoric, the US administration too is very sensitive to foreign investment. Protests in Congress forced the China National Offshore Oil Company (CNOOC) to withdraw its bid for a US refiner, Unocal, in 2005.[27] Similarly, although the Government's Committee on Foreign Investment in the US (CFIUS) approved the acquisition of P and O, a British firm operating several ports in the US, by Dubai Ports World, in February 2006, this was only after the latter agreed to spin off the US operations to a US company.[28]

Sometimes a country may try to bar foreigners from holding positions in key industries. In the case of airlines, even where foreign capital owns as much as 49% in a US company, foreigners are barred from holding the top executive positions therein.[29]

Disguised favouritism and protectionism exist in various sectors. In the US and France, foreign reinsurance firms writing cross-border business are required to post more collateral than local firms.[30] Trade remedy legislation is carefully framed to protect domestic industry per se. In the US strict criteria relating to the extent and source of capital, investment, technical expertise, employment, the origin of parts, value added and other costs are used to decide whether a company constitutes part of domestic industry.[31] By these means the US affiliates of foreign companies can be denied the benefits of trade remedy legislation that US firms could claim.

Under the Byrd amendment, US firms which file anti-dumping complaints can also collect the proceeds of penalties.[32] Although this was ruled illegal by the WTO, and subsequently repealed by Congress, it continues to be effective until October 2007. This has been put to good use by US shrimp producers. Anti-dumping duties imposed by the US on shrimp imports from China, Thailand, India, Brazil, Ecuador and Vietnam had not curtailed these. In early 2006, the Southern Shrimp Alliance (an umbrella group representing US shrimp producers and processors) requested a review of duties paid by all exporters in the six countries accused of dumping; approximately 700-800 firms.

In trying to assess the extent of dumping, the US Commerce Department has traditionally examined the three largest exporters in each country and applied a weighted average of their tariff rates to all others. Recently the Department has been using a different approach. In the case of Chinese brake rotors and Canadian lumber, the three target companies were chosen by lottery.

This posed a major threat to the larger shrimp exporters. As most shrimp exporters were small and may not have responded to the US Commerce Department's request, they risked a punitive duty of 50% or more, forcing a major rise in the average duty levied on all exporters.

To preclude this possibility and avoid a reappraisal of duties, the exporters came to a settlement with the Southern Shrimp Alliance. In exchange for a fee (said to be upto 2% of export value), the Southern Shrimp Alliance agreed to withdraw the request for a duty reappraisal. By July 2006, over 100 exporters to the US, accounting for the majority of all exports, had agreed to this deal.

Thus, using the prevailing US legal framework and administrative machinery, the US producers were able to protect their interests and secure major financial benefits from their foreign rivals. The Southern Shrimp Alliance was able, not only to secure the settlement fee, but also the proceeds of the dumping duties themselves under the Byrd amendment.

In addition to protecting their own local industries both from what is termed "unfair" competition and takeovers, many states have sought to encourage their own national companies to expand overseas, especially in the field of strategic energy and mineral resources. China has been investing in oil exploration, extraction and refining throughout the world. Petro-China, Sinopec and CNOOC are building pipelines across Central Asia and are present in more than a dozen countries; CNOOC being Indonesia's largest off-shore oil producer.[33] In 2005, China National Petroleum Corporation acquired Petro-Kazakhstan, a Central Asian refiner, and in 2006, it took a stake in Rosneft, the Russian oil group.[34] In these cases the Chinese state bankrolled bids. Even in the case of Unocal, US $ 7 billion of the US $ 20 billion came from the government owned parent and US $ 6 billion as loans from four state banks[35].

China has also been active in the field of metals. In late 2004, Baosteel, China's largest steel maker, established a joint venture with Companhia Vale do Rio Dolce (CVRD), the world's largest producer of iron one (a vital ingredient in steel manufacture) in Brazil. In 2005 Minmetals, China's state owned base metal producer, attempted, albeit unsuccessfully, to purchase Canada's Noranda, one of the world largest zinc, nickel and copper producers.

Another country which has been encouraging its state owned companies to expand abroad is Brazil. Petrobras (Petroleo Brasileiro) the Brazilian national oil company, with its experience in offshore exploration and production off the country's Atlantic coast has used this to win contracts to develop deep water fields in Angola and Nigeria.[36]

Singapore's Temasek (a wholly government owned investment company) has large stakes in DBS Bank, Singapore Airlines, Singapore Telecommunications and several other companies, together accounting for 34% of the country's stock market capitalisation.[37] In

recent years it has started investing aboard, including in India,[38] although this is often more in the nature of portfolio investment with a less active role than the FDI and joint ventures such as those of China.

Some countries encourage their private sector companies to expand abroad through tax incentives and other subtle means. Spain, for instance, deems goodwill acquired during foreign takeovers as tax deductible.[39] This could be one factor in the expansion of Spanish companies in Latin America over the last decade.

In all these cases of increased foreign investment, the investing companies and states are able to acquire much more than immediate commercial benefits. The increased foreign exposure allows the investor to project its wider political, economic and strategies interests. The Indian Oil Corporation's investment in Sri Lanka is one striking example here.

There are other foreign companies that have been encouraged by their home governments to enter, and in some cases, dominate, their sectors in Sri Lanka, perhaps for more than purely commercial reasons. Norsk Hydro/Yara, the Norwegian producer of industrial gases, which purchased the Government's stake in Ceylon Oxygen and Dialog Telecomm, a subsidiary of the Malaysian parent telecommunication firm, are some notable instances in this context.

Certain states subsidised their firms involved in strategic industries in order to develop a national technology base (which can have beneficial "spillover" effects). The US and EU, for instance, accorded Boeing and Airbus respectively substantial state assistance; so much so that an agreement had to be reached in 1992 limiting production subsidies and government contracts, to prevent a dispute arising at the WTO.[40] The collapse of this deal resulted in suits being filed by both parties on this issue in 2005.

Again, Japan envisages about US $ 1.6 billion of aid through the Japanese Aircraft Development Corporation (JADC) to assist a consortium led by the Mitsubishi, Kawasaki and Fuji heavy industry arms in the construction of the Boeing 787. The aircraft is to be made almost entirely of new ultralight composite materials, and about 70% of it will be built outside the USA; about 35% by Japanese companies. Boeing is awarding the design and production of key parts of the wings to the Japanese consortium on a risk-sharing basis. By entering this field, the Japanese consortium acquires valuable expertise and experience, which can later be used to develop the nations own aircraft industry (and perhaps even undercut Boeing and Airbus at some stage).

Indeed, Mitsubishi Industry already has plans to start manufacturing its own mid-sized commercial jets; a segment currently dominated by Canada's Bombardier and Brazil's Embraer. This has been facilitated by the experience of Mitsubishi in a consortium of about 20 Japanese firms in building the A 380, Airbus' new jumbo jet. Meanwhile Mitsubishi is also co-operating with the U.S. on missile defence, and is leading the country's attempts to put commercial satellites into orbit. Much of this private sector technological development is underpinned by state support at some stage. For instance, both the EU and Japan offer their aircraft manufacturers special loans for research and development, which can be written off if the final product fails to sell.

Thus, even today, the nation state plays a major role in fostering an indigenous technological base; this, both in the developed and developing world. Local industries are specifically and explicitly assisted through state subsidies, the encouragement of appropriate joint ventures, expansion abroad and protection from "unfair" competition and predatory foreign investment or takeovers.

What are the lessons in this for Sri Lanka? How far have we developed an indigenous technological base and strong national companies? How far does the country's legal framework and administration protect and enhance the capacity of local producers? Are there any lacunae? If so, how can these be addressed? What role can business or civil society play? It is these issues that we now turn to.

4. FDI in Sri Lanka

FDI, concentrated in the export sector and in a liberal economic policy framework, has been seen as instrumental in Sri Lanka's growth in the post 1977 era. Whilst there is some truth in this view, FDI does not seem to have contributed to a stronger indigenous technological base or skill composition of the labour force. Indeed one study found that the share of high skill exports to total manufactured exports actually decreased from 11.6% to 7.6% between 1977 and 1992 in Sri Lanka, whilst that of low skill exports rose from 88.4% to 92.4% during this period. [41] In contrast, the share of high skill exports to total manufactured exports in some other Asian countries rose rapidly over this period; from 38.2% to 64.6% in South Korea, 41.4% to 57.1% in Taiwan and 25.9% to 43.2% in Thailand .[42] This may be partly due to the very activist industrial policy followed by these Asian states.

Much of the FDI Sri Lanka attracted in the immediate post 1977 era was by footloose East Asian garment producers who relocated here to take advantage of our quotas and preferential duty access to the EU and US. Such investment and production had a low value added content, little or no technology transfer to local partners and limited skill enhancement for the local labour force. In approving such investment there appears to have been no medium or long-term national industrial plan or vision that many of the other more successful Asian countries (such as Japan, and South Korea) had.

Successive Sri Lankan governments have professed their desire to assist and develop local industry. However, these words have not been matched by appropriate action; perhaps inadvertently. Continuously running large fiscal deficits, Sri Lankan governments have not been able to harness the budgetary resources to provide the type of targeted subsidies Japan used to foster her shipbuilding industry (1868-1939) and some countries today repeat with their aircraft business. No major state corporations have been nurtured on the lines of, say, the U.K's British Petroleum, Norway's Stat Oil/Norsk Hydro, Malaysia's Telecommunication Network or Singapore's Temasek, to explore overseas opportunities. Indeed, the larger Sri Lankan state corporations that do exist have been overstaffed and mismanaged, so that they are merely a drain on the Exchequer.

The Sri Lankan state has even failed to step in as a "customer" to generate demand for new local products and assist fledgling industries. In the 1990s, for instance, a pioneering local bus-building venture was forced into bankruptcy, as the government failed to meet pre-arranged orders. Today, there is no local bus-building industry with a high value added context, and virtually all the new buses plying on the road are imported.

Indeed, due to budgetary and foreign exchange constraints (largely of their own making), Sri Lankan government have resorted to "soft loans" from so-called "donors" for the import of capital equipment. These loans have generally been tied to the purchase of goods specifically from the so-called "donor", thus helping to generate demand and markets for that entities' industries. Thus, the Sri Lankan taxpayer finances the development of foreign industries, generating output and employment overseas, rather than in the home base. (A careful analysis of these "soft loans" may also reveal that their hidden costs outweigh their benefits).

Despite this unfavourable environment, Sri Lanka has produced some innovative ventures. One such venture is Haycarb, a public quoted company whose ownership is dispersed amongst a large cross-section of Sri Lankan society. Haycarb was the local pioneer producer of activated carbon, a key ingredient in various purification processes and solvent and gold recovery.[43] Activated carbon is produced in Sri Lanka using coconut shell charcoal and now there is a shortage of this raw material locally. The country's total production of coconut shell charcoal has never exceeded 40-50,000 tons per year, whereas the five local producers, now operating, have the capacity to use 60,000 metric tons annually.

Despite this limited supply base and overcapacity and despite being prewarned, the Board of Investment (BOI) recently approved yet another foreign investment in this field, threatening the viability of existing local firms. "The government approves a foreign owned company which doesn't bring in foreign cash, but borrows heavily from local banks who provide them facilities that even we don't get like rescheduling of debts," noted the Haycarb/ Hayleys Chairman.

More significant was "the belief that there could be an internal conspiracy to kill the technology that the local firm has perfected and [is] accepted across the world as the best. 'It could be some international competitor trying to takeover markets; I don't know. But there seems to be a strategy, '[the Chairman] said and implied that our authorities may be unwittingly falling for this. He cited a case where a month before their factory was hit by a month long strike, another international buyer asked a Hayleys partner overseas whether he had heard that there was a strike on at the factory. 'There was no strike then but one month later it happened. Was this buyer tipped in advance? How did he know [?]' [the Chairman] said, adding that this incident reinforced their view that there was some conspiracy to kill local industry."

Due to the BOI approval of yet another foreign entrant into the activated carbon production field, the current shortage of the key raw material, coconut shell charcoal, is likely to get exacerbated. As one commentator noted, "..... if the price of coconut shell charcoal makes its conversion to activated carbon here unviable and all manufacturers lose money, then what? It is not outside the bounds of possibility that there may be players willing to lose money for some years to drive their competitors out of business and thereafter dictate the price they will pay for their raw material. That's the way that 'dumping' works. A producer/manufacturer with the necessary financial resources and even possibly governmental backing can sell below cost in a market he's looking at. After competitors are driven out of business and the market is wide open for a monopoly, he can dictate prices and make a killing." [44]

These views were echoed by the Haycarb Chairman. In a letter to the BOI he noted that the foreign investor bought and stockpiled more than a years supply of activated carbon by paying US $ 300 per tonne,US $ 100-150 more than anywhere else in the world. [45] (Stock piling had begun even before approval had been given). He continued, "[t]he intentions are clear. By writing off consequent losses in the first year, they send less strategically funded local competitors to the wall and retrenchment will be greater than the employment created. Having thus gained a monopoly both of markets and raw material prices, they can recover the loss in a year by price dictation on both, moreso the latter. No profit will be retained in the country, instead remitted overseas tax free.."

Another case of allegedly harmful FDI reported in the press recently concerns Merbok MDF Lanka Private Ltd. The company, which began operations in 2000 under a BOI agreement, was reportedly "given 437 acres of land at an extra-ordinary premium of one dollar per acre and an annual ground rent of one dollar per acre and a special CEB tariff subsidy. Further, the BOI had agreed to pay the full cost of two generators, while extra land was given free of charge .....

..... Under the agreement, Merbok was to manufacture 300,000 cubic metres per annum of wood based fibre board and associated value products. It was given exclusive rights for 10 years to export products from local rubber wood while others were barred from using rubber wood resources within a radius of 150 km from the Horana Zone in excess of 400,000 cubic metres – a decision that saw furniture manufacturers complaining about the project because there was already a shortage of raw material ..... Local rubber wood based industrialists have been struggling as the primary source material for their industry, rubber wood, has been in short supply due to Merbok Lanka's excessive consumption of the material. About 500 small industries manufacturing products such as brush blocks, wooden toys, pallets, furniture and other similar products both for the local and export market and about 150 saw mills have all closed down after Merbok began production." [46]

This again highlights the need for a more careful screening of FDI. In the current activated carbon case it is asserted that the foreign investor "had no manufacturing experience before setting up factories in Sri Lanka and therefore brought no new technology into the country." [47] Post approval monitoring of investment also appears to be weak. "In 1990, the BOI approved another carbon plant whose investors claimed to bring different technology and sell only to China. That never happened. The machines were also faulty and they were exporting to the same markets as [the local producers]. Subsequently the firm went bust but not before the foreign investors had taken their money away." [48]

The footloose nature of foreign investment has been noted elsewhere. In a study of Indonesia it was found that over a 15 year period, for a given level of size and efficiency, the closure rate of foreign owned factories was 20% higher than the local [49]. In Sri Lanka how many of the East Asian garment manufacturers who relocated production here post 1977 (to exploit our preferential access to the US and EU) have remained, especially with the expiry of the quota regime in 2005? And how far were our own Sri Lanka companies able to capitalize on the preferences that the country was afforded?

FDI has even been associated with deliberate fraud. So called foreign "investors" have located operations in Sri Lanka using funds borrowed from local banks, pledging as collateral the land leased to them by the BOI. They have then imported almost finished goods from sources subject to heavy duties in the developed world, assembled them here and re-exported them as goods "made in Sri Lanka." These operations have been designed to circumvent rules of origin and exploit Sri Lanka's preferential access to certain developed markets like the EU. Such operations have provided little or no employment or technology transfer to Sri Lanka. Moreover, as they are illegal, the country and the industry are placed in danger. There is always the risk that, if suspected or discovered, the entire product range can be embargoed. Thus, not only the culprits, but the honest Sri Lankan exporter too, can be hit by a ban on imports by the importing entity offering the preferential duties. As many of these rogue "investors" have invested little or no capital of their own in Sri Lanka, they can cease operations overnight and disappear, leaving the local banks, whose funds they have utilized, to bear the loss. There have been instances reported in the press of foreign "investors" leaving in this way, without even settling their EPF and ETF obligations to their employees. In some cases they have even deducted these dues from their employees' wages and appropriated them, themselves.

These developments call for an immediate and comprehensive ex-post evaluation of FDI in

Sri Lanka, and the legal and administrative framework enabling it. How beneficial has it been for the country in terms of output, employment, and an enhanced technological and skill base? How has it affected local industry? When a project proposal is made to the BOI, is the impact on other local firms and sectors considered? It appears that in the case of activated carbon and rubber wood, this has not been done comprehensively. If local resources are employed, is any consideration given to alternative foreign exchange earning uses to which these could be put? In the assessment, approval and monitoring process, which arms of the bureaucracy are involved, and how efficient and well – co-ordinated are they? In particular, does the BOI itself have too much power as a "one – stop shop" and should its role be reduced? Sometimes, due to lethargy, outside pressures or personal considerations, key elements in the political and administrative frame work may not act in the national interest. In such an event, what can be done?

The role played by the Centre for Science and Environment (CSE) a research and lobbying group based in Delhi, India can be usefully examined in this context [50]. In 2003, the CSE found pesticide traces in Pepsi - Co and Coca-Cola products. This led to the establishment of a joint Parliamentary Committee to investigate the findings. The Committee found that there were indeed pesticides in the carbonated drinks, and directed the Government to draw up standards. The Government Bureau of Indian Standards (BIS) did so, but the standards were not implemented, allegedly due to inaction on the part of the Health Ministry, due to pressure from the firms concerned. This led to the CSE conducting a follow – up study. The results of this (revealed on 2nd August 2006) showed that the soft drinks sold by Pepsi-Co and Coca-Cola in various parts of India, tested in the CSE laboratory, contained pesticide residues for above the limits recommended by the BIS. Subsequently, several State Governments banned the sale of Pepsi-Co and Coca-Cola products in schools and offices. One state, Kerala, went so far as to introduce total prohibition.

In Sri Lanka the Haycarb and Merbok issues call for State action, as in India. Both cases have received much media attention, and are before court at the time of writing. Whatever the outcome, they highlight wider issues regarding FDI in Sri Lanka, and the need for the State to reassess whatever industrial policy it has.

5. Conclusion

To sum up, it is clear that many states that successfully developed their industrial base, did so not through unfettered reliance on FDI, or the vagaries of a so-called free market alone. The State played a conscious and explicit role in controlling the extent and degree of FDI, and afforded targeted assistance, specifically to local industry, to develop. This policy was most successfully followed by Japan, first following the Meiji restoration (1868 – 1939) and then, in rebuilding her post – war economy. In more recent years, some of the newly industrializing countries of East Asia have followed a modified, though similar, approach. Moreover, many of the developed states, although professing the virtues of a "free market" and "open economy", have been fierce in the defence of their own "national" industries.

Sri Lanka, although opening its economy as early as 1977, does not appear to have developed an indigenous technological base or a strong and autonomous industrial sector, on anything approaching the scale of Japan. Even firms that have succeeded to some extent are threatened due to the lack of a coherent industrial policy and an appropriate administrative and legislative framework. Whilst blind emulation of the Japanese post Meiji (1868 – 1939) approach is not possible due to TRIMS and international pressures in the WTO framework, Sri Lanka has one advantage. As a small and poor country, accounting for a negligible proportion of imports into the developed markets in any sector, it need not attract the type of hostility that Japan did in the early 1990s from the Clinton Administration, or China, India and Vietnam do in, say, the garment, footwear and shrimp industries today. Thus, she has some scope for manouverability, although caution in negotiating bilateral free trade agreements is required.

It is the duty of Sri Lankan policy makers to reassess the current situation and evolve a more coherent industrial strategy. This should target local industry per se, so that the country can benefit in a more comprehensive and sustainable manner than it has so far. Where this is not effected, either through lethargy, or outside pressures, there may be scope for civil society or interest groups to act, as in the case of the CSE in India.

FOOTNOTES

(1) Unless otherwise stated, this section drawn from Lockwood "The Economic Development of Japan" Princeton University Press, 1968, especially Chapters 1, 2, 6, 7 and 10 and the Supplement.

(2) Sampson, Anthony "Company Man: The Rise and Fall of Corporate Life" Harper – Collins, 1995, Page 32

(3) Ibid pps 32 – 33

(4) In addition to Lockwood "The Economic Development of Japan' Princeton University Press, 1968, the following discussion of Japan's post-war trade and industrial strategy draws on Gilpin, Robert " Global Political Economy: Understanding the International Economic Order," Princeton University Press, 2001, Chapter 7, Sampson, Anthony "Company Man: The Rise and Fall of Corporate Life", Harper – Collins, 1995, Chapter 11, Carbaugh, Robert J; "International Economics," South – Western, 2002, Chapter 7 and Gilpin, Robert, "The Challenge of Global Capitalism : The World Economy in the 21st Century." Princeton University Press, 2000, Chapters 6, 8 and 9.

(5) Gilpin, Robert: "The Challenge of Global Capitalism: The World Economy in the 21st Century," pps. 283 – 84

(6) Ibid

(7) Ibid

(8) Economist, 25 March 2006, page 69, and 1 April 2006, pages 25 – 26

(9) Economist, 5 August 2006, pps. 26 – 27, provides background for this and the rest of the paragraph.

(10) Economist, 20 May 2006, "A Survey of International Banking," page 21

(11) Ibid, page 16

(12) Economist, 21 May 2005, "A Survey of International Banking," page 18

(13) Economist, 20 May 2006, "A Survey of International Banking," page 13

(14) Economist, 10 December 2005, page 78

(15) Economist, 5 March 2005, "A Survey of India and China," page 10

(16) Ibid

(17) Economist, 5 August 2006, page 66 provides background for this and the rest of the paragraph.

(18) Economist, 20 May 2006, "A Survey of International Banking," page 13.

(19) Economist, 29 July 2006, page 65

(20) Economist, 26 August 2006, page 50

(21) Economist, 25 March 2006, page 71

(22) Ibid, for the remainder of this paragraph

(23) Economist, 2 September 2006, page 54, for this and the remainder of the paragraph

(24) Economist, 22 May 2004, page 55

(25) Economist, 8 May 2004, page 60

(26) Economist, 27 March 2004, page 60

(27) Economist, 5 August 2006, page 66 and Economist, 6 August 2005, pages 49 – 50

(28) Economist, 6 May 2006, page 65

(29) Economist, 12 November 2005, "Special Report: World Airlines", page 15

(30) Economist, 12 August 2006, pps. 13 – 14 and page 62

(31) ITC/UNCTAD/WTO "Business Guide to Trade Remedies in the United States," Technical Paper, 2001, pages 171 – 172

(32) For more details of this and the anti-dumping case described here, see the Economist, 5 August 2006, pps 31 – 34

(33) Far Eastern Economic Review, 28 March 2002, pages 30 – 33

(34) Economist, 5 August 2006, page 66

(35) Economist, 2 July 2005, "Special Report : Chinese Companies Abroad", pps 59 – 61 provides background for this and the next paragraph.

(36) Economist, 12 August 2006, page 57

(37) Far Eastern Economic Review, 21 October 2004, pps 50 – 51

(38) Ibid

(39) Economist, 18 February 2006, page 58

(40) Economist, 25 June 2005, "Special Report: Boeing vs. Airbus," pps. 67 – 69, and Economist, 17 December 2005, "Special Report, The Future of Japanese Business," pps 59 – 61 provide background for this paragraph and the next two.

(41) Meewalaarachchi, S Mangalika, "Globalization, Export led Industrialization and Economic Growth: Evidence from Sri Lanka's Experience," Sri Lanka Journal of Management, Vol 9, Nos 1 and 2, January – June 2004

(42) Ibid, citing Lall, S and Wignaraja G: "Foreign Involvemkent by European Firms and Garment Exports by Developing Countries," Development Studies, Working Paper No. 54, Oxford University, 1992

(43) Sunday Times, Financial Times, 4 June 2006, pps 1 – 2 and the Editorial provides details for this and the next two paragraphs, unless otherwise stated.

(44) Sunday Island, 16 July 2006, Editorial

(45) Gunaratne, Natasha "Jacobi says discrimination against foreign investors" in the Sunday Times, Financial Times, Probe, 17 September 2006, page 9, forms the basis for this and the remainder of this paragraph.

(46) Dissanayake Chaturi, "Malaysian firm moves court," in the Sunday Times, Financial Times, 20 August 2006.

(47) Gunaratne, Natasha "Jacobi says discrimination against foreign investors" in the Sunday Times, Financial Times, Probe 17 September 2006, page 9.

(48) Sunday Times, Financial Times, 4 June 2006, Editorial. On checking, it was found that the firm which went bankrupt was a collaborative venture between a local and foreign partner and some local banks. Marketing was handled by the foreign partner and there is reason to suspect that transfer pricing was resorted to, with the Sri Lankan output being sold below cost. Naturally, the local operation ran at a loss, with funds transferred out of the country. The firm that began operations in 1990 was not approved by the BOI, but is still operating.

(49) Bernard and Sjoholm "Foreign Owners and Plant Survival", NBER Working Paper 10039, cited in the Economist, 27 March 2004, "Economics Focus: Footloose Firms," page 75.

(50) Economist, 26 August 2006, Page 51, provides details for this paragraph. ■

opportunities for members to participate in a social community at large. The strength of a cooperative absence of effective social safety nets. ■