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Contents

Foreign direct investment as a catalyst for domestic firm development: the case of Sri Lanka

Palitha Konara and Yingqi Wei*

Foreign direct investment (FDI) carried out by multinational enterprises (MNEs) is recognized as a mechanism through which domestic firms can learn and improve competitiveness. Unlike the extant literature, which tends to focus on the aggregate effects of FDI in Sri Lanka, we investigate the role of FDI for domestic firm development at the firm level. Using World Bank Enterprise Survey data supplemented by industry data, preliminary investigation reveals that, compared with domestic firms, MNEs are larger, more productive, more profitable and more active in research and development (R&D). MNEs hire higher proportions of skilled workers and undertake more in-house training programs. They are also more export-oriented but rely more on inputs of foreign origin. The gaps between foreign and domestic firms indicate the potential that Sri Lankan firms can learn from MNEs and from FDI. The econometric study on firm-level productivity indicates positive direct effects and negative spillover effects of FDI on domestic firms. The findings have important policy implications.

Key words: foreign direct investment, multinational enterprises, Sri Lanka, productivity, spillovers

1. Introduction

In recent decades, countries around the globe have been competing to attract foreign direct investment (FDI) with the view that FDI is an engine of economic growth and FDI and its agent, multinational enterprises (MNEs), exert positive effects on domestic firms in a host country (Wei & Balasubramanyam, 2004). MNEs possess firm-specific assets such as advanced technologies, knowledge and know-how which are much desired by domestic firms, particularly those in developing countries. FDI is seen as the fastest and most efficient way to access these assets because domestic firms can be in direct contact with MNEs in the host country, which makes learning easier.

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FDI can potentially improve the productivity of domestic firms through direct effects on MNE's local affiliates and through indirect or spillover effects on other domestic firms. However, this interest is not without concern that MNEs and FDI may negatively impact on domestic firms (Nam and Young, 2004). A number of reasons have been put forward, including that MNEs extort high rents; generate negative competition and monopoly effects; and bring resources, assets and practices into the host country that are inappropriate in the country context (Moosa, 2002).

There has been vibrant empirical investigation of the effects of FDI on domestic firms (see survey articles such as Iršová and Havránek (2013), Meyer and Sinani (2009) and Wooster and Diebel (2010)). The studies have produced a mixed bag of results. This has been partially attributed to different country contexts. Host-country-specific characteristics including the size of the country, its history, its stage of development, the quality of institutions and organizations, and the structure and quality of resources and capabilities embrace the gamut of characteristics affecting the role of FDI in domestic firm development. It is therefore essential to place the study of FDI in a specific country context. Against this background, we investigate FDI in Sri Lanka using firm-level data. The paper aims to answer the following question: to what extent do domestic firms differ from MNEs' local subsidiaries and benefit from FDI conducted by MNEs in Sri Lanka? Though a handful of studies have looked at FDI in the context of Sri Lanka, there is no study that compares foreign and domestic firms and examines the impact of FDI on domestic firms in Sri Lanka using firm-level data. This paper aims to fill that research gap.

Sri Lanka has long been considered, a country with excellent prospects for economic development. Post-independence, Sri Lanka was one of Asia's most promising new nations (UNCTAD, 2004). It was one of the early liberalizers in the developing world, embarking on an economic liberalization process in 1977 after a period of implementing inward-oriented policies (Athukorala, 2012; Athukorala and Rajapatirana, 2000). The reforms are fairly comprehensive, ranging from the dismantling of trade and foreign investment barriers, the unification of the exchange rate, the liberalization of interest rates and the removal of price and investment controls, to the restructuring of the tariff system and the tax system (UNCTAD, 2004). Thanks to these outward-oriented policies, the situation of FDI was turned around from a period of slow growth or even divestment during 1966-1976, according to data published by UNCTAD (figure 1). In the 1980s, FDI jumped to an average of about US$40 million per year. This further increased to US$158 million in the 1990s. Unfortunately, the liberalization process suffered a significant setback when the Sri Lanka Freedom Party (SLFP) came to power in 2004 and started to follow statist economic policies advocating more state involvement in economic activities (Athukorala, 2012). In 2011, the Sri Lankan Government passed a controversial law in the parliament – the Revival of Under Performing Enterprises or Under Utilized Assets Act of Sri Lanka – and a few MNEs were expropriated (The Economist, 2011). This has clearly undermined Sri Lanka as an attractive location of FDI and may suggest that discomfort with and suspicion of MNEs and FDI are regaining place in policy circles. It is therefore paramount to evaluate the role of MNEs and FDI in domestic firm development in Sri Lanka and to draw policy implications based on empirical investigation.

Figure 1: FDI in Sri Lanka, US$ million