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INVESTMENT POLICY REVIEW

SRI LANKA



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Investment Policy Review

Sri Lanka



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A slash (/) between dates representing years – for example, 1994/95, indicates a financial year.

Use of a dash (–) between dates representing years – for example, 1998–1999 – signifies the full period involved, including the beginning and end years.

Reference to "dollars" (\$) means United States dollars, unless otherwise indicated.

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PREFACE

The UNCTAD Investment Policy Reviews are intended to help countries improve their investment policies and to familiarize Governments and the international private sector with an individual country's investment environment. The reviews are considered at the UNCTAD Commission on Investment, Technology and Related Financial Issues.

The Investment Policy Review of Sri Lanka, initiated at the request of the Government, was carried out through a fact-finding mission in March 2003 and is based on information current at that date. The mission received the full cooperation of the relevant Ministries and agencies, in particular the Sri Lanka Board of Investment. The mission also had the benefit of the views of the private sector, foreign and domestic; civil society; and the resident international community, particularly bilateral donors and development agencies. A preliminary version of this report was discussed with stakeholders at a national workshop in Colombo on 15 September 2003.

The review was carried out jointly by UNCTAD and the UNDP Office in Sri Lanka, as a core activity of UNDP's Invest-in-Peace Project. UNDP provided financial support and collaborated closely with the UNCTAD team. The Invest-in-Peace Project aims to stimulate private investment to secure the peace process and drive Sri Lanka's socio-economic development.

This report was prepared by Rory Allan, Jon Church, Joseph Mathews, Azizul Islam, Lena Chia and Shuvojit Banerjee under the direction of Joerg Simon and Khalil Hamdani. Collaborators in Sri Lanka included Miguel Bermeo and Russell Sunshine of UNDP, and legal assistance was provided by Paul Ratnayeke, Punyakanthi Navaratne and Amrit Rajapakse. Mohammed Elkeiy and Lang Dinh provided research assistance. Beatrice Abel and Deborah Wolde-Berhan provided production support.

It is hoped that the analysis and recommendations of this review will contribute to improved policies, promote dialogue among stakeholders and catalyse investment in Sri Lanka.

Geneva, February 2004

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ABBREVIATIONS

BII	Bureau of Infrastructure Investment
BIT	bilateral investment treaty
BOI	Board of Investment
BOO	Build-operate-own
BOT	Build-operate-transfer
CEO	Chief Executive Officer
DTT	double tax treaty
DWT	dividend withholding tax
EDB	Economic Development Board (Singapore)
EGO	external gateway operator
EPF	Employees' Provident Fund
EPZ	export processing zone
ETF	Employees' Trust Fund
FCBU	Foreign Currency Banking Unit
FDI	foreign direct investment
GDP	gross domestic product
GNP	gross national product
GFCF	gross fixed capital formation
ICSID	International Centre for Settlement of Investment Disputes
IDA	Investment and Development Agency (Ireland)
ILO	International Labour Organization
IMF	International Monetary Fund
ITC	International Trade Centre
IPA	Investment promotion agency
IPR	Intellectual property rights
IPS	Institute of Policy Studies
IT	Information technology
MW	megawatts
PERC	Public Enterprises Reform Commission
P&P	Policy and Planning
REDC	Regional Economic Development Commission
RHQ	regional headquarters (scheme)
SIERA	Share Investment External Rupee Account
SMEs	small and medium-size enterprises
SOE	state-owned enterprise
TEWA	Termination of Employment of Workmen Act
TDC	Tourism Development Council
TNC	Transnational corporation
TRIPS	Trade-Related Aspects of Intellectual Property Rights (Agreement on)
UNCTAD	United Nations Conference on Trade and Development
VAT	value-added tax
WTO	World Trade Organization
\$	United States dollar(s)

SRI LANKA

Sri Lanka, an island situated off the southern tip of India, has an area of 65,000 square kilometres and a population of 19 million. It became independent in 1948. The Executive consists of the President, who is elected by direct suffrage and appoints the Prime Minister, chairs Cabinet meetings and retains the right to dissolve Parliament. The Parliament comprises 225 representatives who are elected through proportional representation.

At independence, Sri Lanka's economy was dependent on three major primary commodities: tea, rubber and coconut. Today the economy includes a number of industrial and services sectors. Textiles and garments and tourism are particularly important.



Key Economic and Social Indicators

Indicator	1970	1980	1990	1995	1999	2000	2002
Population (millions)	12.5	14.7	17.0	18.1	18.4	18.5	19.0
GDP at market prices (billions current \$)	2.3	4.0	8.0	13.0	15.7	16.3	16.6
Annual GDP growth (per cent)	3.9	5.9	6.4	5.5	4.3	6.0	4.0
Annual growth in exports of goods and services (per cent)	4.3	3.6	6.7	2.9	4.0	18.0	5.6
Inflation (per cent)	5.9	26.1	21.5	7.7	4.7	6.2	9.6
GDP per capita (dollars)	184	271	470	718	851	881	874
GDP by sector (per cent)							
Agriculture	28.3	27.6	26.3	23.0	20.7	19.5	20.1
Industry of which	23.8	29.6	26.0	26.5	27.3	27.5	26.3
- Manufacturing	16.7	17.7	14.8	15.7	16.4	16.9	15.9
Services	47.9	42.8	47.7	50.5	52.1	53.0	53.6
FDI inflows (millions \$)	-0.3	43.0	43.4	65.0	201.0	178.0	242.0
Exports of goods and services (per cent of GDP)	25.5	32.2	29.2	35.5	35.5	39.7	36.2
Imports of goods and services (per cent of GDP)	28.6	54.8	38.0	45.9	43.3	50.5	42.9
Gross domestic investment (per cent of GDP)	17.3	31.0	22.3	25.6	27.3	28.0	21.0
Human development ranking ^a	..	89	89	89	89	89	89
Adult illiteracy rate (per cent of people aged 15 and above)	19.5	14.7	11.3	9.8	8.6	8.4	8.0

Sources: UNCTAD FDI/TNC database, UNDP 2003, World Bank 2003.

^a Total number of countries ranked is 173.

INTRODUCTION

The Government has launched an agenda for vigorous growth titled *Regaining Sri Lanka*. There the private sector is given a central role in driving the nation's economic recovery. The prospect of internal peace provides a springboard to undertake the improvements necessary for Sri Lanka to compete effectively with the best investment and growth performers in Asia.

This report considers the improvements and reforms needed for private investment to accelerate and foreign direct investment (FDI) inflows to expand markedly.

Chapter I assesses Sri Lanka's performance in generating private investment. Economic growth and private investment, including FDI, have been low by the standards of the best performers in Asia. Poor policies inhibited private investment from independence in 1948 until 1977. A fitful easing of restrictive business-related policies began in the late 1970s. Notable events were the creation of the Board of Investment, or BOI (as it is now known), the formation of economic zones and the successful 1990s privatization programme. FDI increased sharply in the 1990s, but it is still narrowly based and reliant on one-off privatization opportunities. Moreover, it remains below the levels achieved in the more dynamic regional countries. As a consequence of these trends, Sri Lanka's economic structure has shifted little towards higher value-adding manufacturing and services, although there are notable success stories such as the emergence of a competitive textiles and garments industry. Yet a capable established business sector is poised to increase investment and could provide a good platform for joint ventures with dynamic foreign investors. The country's good educational system is a sound base for providing skilled managers and professionals and trainable labour. But shortcomings in physical infrastructure have to be overcome to capitalize on the human resources that Sri Lanka offers. With suitable improvements and policy reforms, FDI inflows could at least double from recent levels.

Chapter II reviews the investment framework, outlining reforms that can lead to a more attractive investment climate. The legacy of past restrictive policies is still reflected in some legislation – for example, in land regulation – but administrative practice is often better. The Government has already reformed important areas of business regulation, including competition law and protection of intellectual property rights. This builds on sound sector regulatory regimes developed earlier (e.g. in mining and telecommunications). The major extant weaknesses are the restrictions on labour severance and a business taxation system that requires case-by-case grant of incentives and is biased against smaller investors. A package of balanced labour measures is proposed. Taxation should be reformed to provide an accessible and competitive fiscal regime for all investors. Easing of FDI entry restrictions should continue. Moves underway to abolish foreign exchange controls are endorsed, and current good business immigration practices can be formalized and promoted. An important theme is that the haven of good regulation and administrative practice afforded to larger investors under the BOI's extensive powers should become the norm throughout the economy. All these changes would facilitate Sri Lanka's goal of becoming an international business hub.

Chapter III focuses on the future role of the Board of Investment, the main institution for shaping and implementing investment strategy. It recommends reorienting the institution from being an investment facilitator for large investors to becoming an investment generator targeting all investors. This calls for strengthening four main functions: (i) the attraction of FDI; (ii) research, policy, planning and advocacy to enhance the business climate; (iii) assistance to national investors, especially those in the regions who have hitherto been neglected; and (iv) regulation of FDI entry. Currently the BOI devotes insufficient resources to these key functions. Its large staff is mostly occupied with providing regulatory services such as customs clearance facilities in lieu of the line agencies, and in the development and management of economic zones. These functions reflect the wide powers granted to the BOI at its inception. Such activities should wind down as the private sector and the mainstream agencies become able to take them over. The final investment promotion outcome should be a smaller institution but one with greater capacity to fulfil key functions, along the lines of leading agencies in other countries. The changes are wide reaching and must be implemented and phased in with due regard for the interests of the BOI's current clients and of its staff.

Chapter IV provides the main findings and recommendations as summarized above.

I. PRIVATE INVESTMENT: TRENDS AND IMPACT

Until 1965, Sri Lanka's economic performance surpassed that of many of today's East Asian dynamic economies. It subsequently lagged behind, while the East Asian economies accelerated, fuelled mainly by high growth in private domestic investment and FDI. With Government policy now emphasizing private-sector-led growth, Sri Lanka could yet witness dynamism similar to that in East Asia.

A. Comparative perspective

At the time of independence in 1948, Sri Lanka's development indicators compared favourably with those of other South Asian countries and most of the East and South-East Asian countries. Even as late as 1965, the per capita income of Sri Lanka was higher than those of Indonesia, the Republic of Korea and Thailand.

Since 1965, Sri Lanka's economic growth has only matched that of the slower-moving South Asian countries and has fallen far behind that of East and South-East Asia. There has been no marked acceleration despite the more liberal policies adopted since 1978 (see Table I.1).

Table I.1. GDP growth rates of selected Asian countries, 1965-1997

(Per cent)

	1965-1980	1980-1990	1990-1997 ^a	Per capita income, 1997, as multiple of 1965
South Asia				
Sri Lanka	4.7	4.4	5.5	5.0
Bangladesh	2.3	4.5	4.8	3.9
India	3.1	5.9	5.5	3.9
Nepal	2.1	4.1	5.2	3.0
Pakistan	5.8	6.6	4.2	4.5
East/South-East Asia				
Indonesia	7.0	6.6	7.6	37.0
Malaysia	7.3	6.2	9.2	14.6
Republic of Korea	9.9	9.5	7.2	81.2
Singapore	10.4	7.7	7.3	62.1
Thailand	7.7	7.6	7.4	21.5
Viet Nam	..	2.5	8.0	..

Sources: World Bank 1992, 1999 and 2003.

.. not available.

^a The terminal year chosen is 1997 to avoid the abnormalities caused by the economic crisis that affected all of the above East/South-East Asian countries in the second half of 1997.

Sri Lanka's per capita income level in 1997 was five times as high as in 1965, and this was the highest multiple among South Asian countries. However, in East/South-East Asian countries, the corresponding multiples were much higher, ranging from 14.6 for Malaysia to 81.2 for the Republic of Korea (see Table I.1).

Moreover, since 1970 Sri Lanka has undergone the least structural transformation among selected Asian comparators (see Table I.2). The shift from agriculture to higher-value-added manufacturing and services, which characterizes development, is negligible, despite some diversification in manufacturing. It might be argued that Sri Lanka had a relatively low share of agriculture in 1970 and that therefore the scope for further reduction was limited. However, both Malaysia and Thailand, where agriculture's contribution to national output in 1970 was comparable, recorded a much greater fall in the share of agriculture and a corresponding increase in the share of manufacturing.

Table I.2. Structure of output of selected Asian countries, 1970, 1980 and 1997
(Per cent shares in GDP)

	Agriculture			Manufacturing			Services		
	1970	1980	1997	1970	1980	1997	1970	1980	1997
South Asia									
Sri Lanka	28	28	22	17	18	16	48	43	51
Bangladesh	55	50	25	6	11	15	37	34	51
India	46	39	28	14	16	17	33	37	45
Nepal	67	62	41	4	4	10	21	26	36
Pakistan	37	30	27	16	16	16	41	46	50
East/South-East Asia									
Indonesia	45	24	16	10	13	27	36	34	43
Malaysia	29	23	11	12	22	28	43	36	44
Republic of Korea	27	15	5	21	28	29	43	45	52
Singapore	3	2	0	20	29	23	68	61	66
Thailand	26	23	11	16	22	29	49	48	51

Sources: World Bank 1995a and 1999.

The divergence with Asian comparators is also visible in a comparison of investment performance (see Table I.3). If the growth experience of East/South-East Asian countries is any guide, Sri Lanka's investment/GDP ratio needs to rise to well over 30 per cent from its current level (in recent years it has hovered around 25 per cent).¹ This ratio includes government investment, which in Sri Lanka is around 5 per cent of GDP. Official projections suggest that government investment will rise to a little under 7 per cent by 2005. Thus the private sector will have to play a leading role in generating future investment.

¹ In more recent years, Sri Lanka's investment/GDP ratio was even lower – 22 per cent in 2001 and 21 per cent in 2002.

Table I.3. Investment/GDP ratio of selected Asian countries
(Per cent)

	1970	1980	1990	1997
South Asia				
Sri Lanka	19	34	23	24
Bangladesh	11	15	17	21
India	16	19	24	23
Nepal	6	18	18	25
Pakistan	16	18	19	18
East/South-East Asia				
Indonesia	16	24	31	32
Malaysia	20	27	32	43
Republic of Korea	25	32	38	34
Singapore	39	46	37	39
Thailand	26	29	41	34
Viet Nam	13	28

Sources: World Bank 1995a and 2003; Asian Development Bank 1996.
.. not available.

Sri Lanka has numerous attractions for investors. As in several of the Asian comparators, there is the potential to build on the country's rich natural resource base to develop higher-value-added agricultural and manufacturing products and tourism and related services. In addition, Sri Lanka offers an abundant supply of highly trainable workers. The adult literacy rate of 92 per cent is the highest in South Asia, higher than Malaysia's and comparable to that in Viet Nam (see Table I.4), which is admirable considering the country's per capita income level of only \$800. Moreover, access to education among provinces is reasonably well distributed, and literacy rates in the rural areas are almost as high as in the towns and cities. The country's life expectancy of 71, the highest in South and South-East Asia, points to high health standards (see Table I.4).

Nevertheless, improvements are required in training to improve knowledge of complex and business-relevant skills. Gross enrolment rates for higher education at 3 per cent are lower than the Asian average of 7 to 8 per cent, owing to a shortage of places.² Also, especially at higher educational levels, the system is not fully attuned to the requirements of employers. Although the country has more than 1,000 vocational centres, facilities are often inadequate and curricula are not focused sufficiently on business needs.³

² ADB 2000.

³ ADB 2003.

Table I.4. Human development and infrastructure indicators of selected Asian countries

Countries	Life Expectancy (2001)	Adult literacy rate (2001)	Electricity use (per capita Kwh, 1997)	Per cent of paved roads		Main line telephone per 1,000 inhabitants (1998)
				1970	1996	
South Asia						
Sri Lanka	72	92	227	70	40	28
Bangladesh	61	41	76	..	7	3
India	63	58	363	35	50	22
Pakistan	60	44	333	56	57	19
South East Asia						
Malaysia	73	88	2 352	85	75	198
Thailand	72	96	1 360	61	98	84
Viet Nam	69	93	203	27	25	26

Source: World Bank 2003; International Road Federation 1996 and 2003.

Furthermore, there are inadequacies in infrastructure (see comparative data in Table I.4 on electricity consumption, main line telephone connections and quality of roads). Sri Lanka compares poorly with Malaysia and Thailand for all the infrastructure indicators, and also with India and Pakistan in terms of electricity consumption and proportion of paved roads. Transport deficiencies have contributed to investment not being more geographically dispersed in the country.⁴ The road network has grown only slightly over the past two decades (in 1984 it was 86,218 km and in 1996 it was 99,200 km).⁵ The proportion of paved roads in recent years has also been much lower than in 1970. Private investment is being introduced to help relieve infrastructural bottlenecks. Telecommunications has begun to see the effects of such a development. The purchase of part of Sri Lanka Telecom by NTT of Japan in 1997 and the granting of two fixed-access licences in 1996 led to a more than doubling of the number of fixed telephone lines installed between 1996 and 1999 (OECD 2001).

B. Phases of Sri Lanka's private investment policies

In the period since independence, two distinct phases of Government policy towards private investment can be detected. These explain much of the slow growth and low structural change. They are still important background to explaining much of today's regulations and institutions dealing with private investment.

In the first phase (from 1948 to 1977), the public sector absorbed or controlled an increasing share of the country's resources. Government intervention in the economy became pervasive. Investment approvals and licensing and associated red tape were common. Employment decisions were heavily regulated, controls on land ownership were imposed, access by the private sector to finance was restricted, and trade incentives were biased against exports. The resulting business climate was inimical to private investment in general and FDI in particular. By one estimate, as much as 70 per cent of the national economy was in the public domain in 1973 (World Bank 1995b:4). In 1978, gross domestic investment was a low 19 per cent of GDP, of which the private sector contributed less than half (45 per cent).

⁴ See European Commission 2001.

⁵ International Road Federation 1998 and 2003.

During this phase, mixed policies were pursued, and they are instructive in showing that private investment in Sri Lanka reacts to changed regulatory conditions. For example, during the second half of the 1960s there was a partial liberalization that generated better conditions for the private sector. This had a beneficial impact on GDP growth, which averaged 5.3 per cent during the period 1966–1970. The period 1971–1977 saw a reversal of intensified government intervention and several policy measures that were adverse for private-sector investment. As a result, GDP growth sharply decelerated to an annual average of 2.9 per cent during 1971–1977.

The second phase of Government policy was marked by liberalization. The poor economic performance of 1971–1977 prompted a policy reorientation in 1977 to the pursuit of private-sector-led, export-oriented development, including a greater role for FDI. Initially some of the most severe controls were removed for all investors. These included dismantling of trade and payment barriers, unification of the exchange rate, restructuring of agricultural and export taxes, adjustment of administered prices, liberalization of interest rates and reduced restrictions on pricing and investment by the private sector (IMF Institute 1996 and World Bank 1995b).

Later policies (including the issuance of the Industrialization Policy Statement in 1989) introduced reforms to the tariff system (to lower tariff rates and reduce dispersion) and the tax system (to reduce exemptions and lower rates).

However, comprehensive reforms of the regulations, taxes and administrative machinery weighing down private investment were not tackled at the start. Instead the Greater Colombo Economic Commission [which was reconstituted as the Board of Investment (BOI) in 1992] was created in 1978 with wide powers of tax relief and administrative discretion for larger or priority investors. No doubt this partial approach to liberalization was judged to be the only feasible approach at the time.

Private investment responded to these reforms, rising by an average of 13 per cent a year within four years. However, the momentum of policy reforms and the associated buoyancy of the private sector could not be sustained through much of the 1980s. To a great extent, this was caused by the onset of civil war in 1983 (Kelegama 2002). It is undeniable that private investment in Sri Lanka would have been stronger but for the prolonged civil war, which ceased only recently.

C. Trends and pattern of FDI

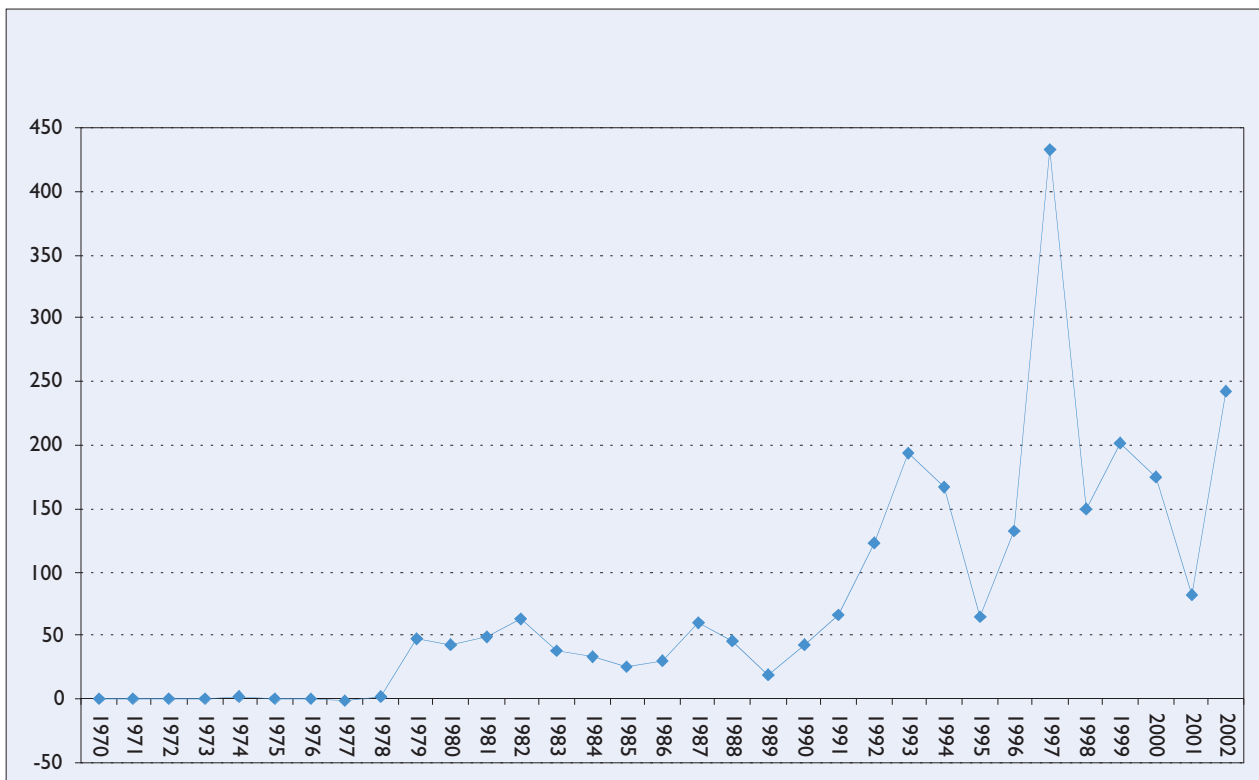
FDI inflows have been strongly influenced by the different phases of economic policy.

I. Size and growth

At the time of independence in 1948, the country had a predominantly agricultural economy with a modern plantation sector, much of which was owned by foreign investors. The agricultural sector directly contributed 40 per cent of national income in 1948. About one-third of GNP originated in the plantation sector (Kaldor 1959). The plantation sector had a major impact on the activities of other sectors such as trade and commerce, banking, insurance and transport. The small manufacturing sector, owned mainly by the private sector, centred around the processing of tea, coconut oil and rubber.⁶ However, the plantation sector was nationalized in the early 1970s.

FDI was negligible until the 1980s, when it picked up to about \$50 million per year (see Figure I.1). There have been two significant developments in the investment environment since the liberalization phase began in 1977.

Figure I.1. FDI inflows into Sri Lanka, including privatization, 1970–2002
(Millions of dollars)



Source: UNCTAD/TNC database.

⁶ However, during World War II, the pre-independence Government had set up some plywood, paper, drug, glassware and ceramic factories (IBRD 1953).

The role of Export Processing Zones (EPZs) has been important in the attraction of export-oriented foreign firms. An enabling regime for EPZs was set up in 1977 as part of the creation of the Greater Colombo Economic Commission, and eight are currently in operation. They offer vacant sites for exporting investors and come with utilities and central services such as security and waste treatment. With the exception of two zones, one in the South and one in the Central Province, all are within 65 kilometres of Colombo. EPZs contribute a significant share of Sri Lanka's industrial export earnings. The share of export earnings derived from EPZ enterprises in relation to national total industrial export earnings increased from 8.7 per cent in 1980 to 30.5 per cent by 1999 (Business Lanka 2000). The 110,000 workers currently employed in the zones represent 10 per cent of the total national workforce engaged in manufacturing. Foreign investors account for 69 per cent of total investment in the EPZs and have invested more than \$200 million. Initial interest in the zones was in garment production. In recent years there has been some shift in investor interest to other activities such as electronics and electrical goods and rubber products. Some local firms in garments manufactures have also made outward investments into Madagascar and Mexico.

Another notable feature is the adoption of an ambitious privatization programme. Privatization was announced as a state policy in 1987 with the objective of reducing the burden on the budget created by the operations of the State-owned enterprises (SOEs) and improving efficiency and profitability. It is now the responsibility of the Public Enterprises Reform Commission (PERC), which was set up in 1996 under the Public Enterprises Reform Commission Act of that year. Between 1989 and 2002, 84 public enterprises were privatized through the divestiture of the entirety or a portion of ownership (Central Bank 2003, Table 75). This opened to private investment activities previously reserved for the public sector, and it has served as a significant channel for FDI entry (see the next section).

FDI performance in the 1990s⁷ looks more encouraging, and in historical terms it is. Privatization-related FDI has been a bright spot, accounting for a least one-third of FDI in the 1990s.⁷ The largest 20 foreign investors in Sri Lanka all arrived in the 1990s. They are making a difference in telecommunications, power, ports, and other areas of services and manufacturing.

⁷ 1997 saw a one-off jump in FDI due to the privatization sale of 35 per cent of Sri Lanka Telecom to NTT of Japan for \$220 million. Since then FDI has declined, partly because of lower privatization receipts.

Nevertheless, Sri Lanka is far behind all but the slower-moving South Asian countries in the attraction of FDI, as shown in Table I.5, by international comparisons of FDI per capita and FDI as a proportion of gross fixed capital formation (GFCF). Despite the strong pick-up in FDI to Sri Lanka in the 1990s, it was hugely outperformed in per capita FDI attraction by Malaysia, Thailand and Viet Nam.

The cumulative result of decades of low FDI attraction is shown by the per capita stock of FDI in 2002. Malaysia, which has a similar-sized population, had attracted 20 times as much FDI as Sri Lanka.

Table I.5. Comparative FDI performance of Sri Lanka, 1981–2002
(Dollars and per cent)

Country	ABSOLUTE PERFORMANCE					RELATIVE PERFORMANCE									
	FDI inflows per year Millions of dollars				FDI Stock Millions of dollars	FDI inflows per capita Dollars				FDI inflows as per cent of GFCF				FDI Stock	
	1981 1985	1986 1990	1991 1995	1996 2002		2002	1981 1985	1986 1990	1991 1995	1996 2002	1981 1985	1986 1990	1991 1995	1996 2002	Per capita (\$) 2002
Sri Lanka	41.9	39.6	123.1	202.3	2 713.0	2.8	2.4	7.0	10.8	3.0	2.5	4.7	5.3	140.6	165.1
Bangladesh	1.1	2.2	6.4	132.5	1 107.0	0.0	0.0	0.1	1.0	0.2	0.1	0.1	1.4	7.7	23.6
India	59.0	182.0	796.8	2 873.7	25 768.0	0.1	0.2	0.9	2.9	0.1	0.3	1.0	2.9	24.7	51.3
Malaysia	1 082.9	1 182.0	5 063.6	3 967.7	56 505.0	73.5	68.1	264.0	185.6	11.0	10.7	19.7	14.5	2 452.9	593.8
Pakistan	60.9	154.1	417.0	597.3	6 359.0	0.7	1.5	3.5	4.4	1.3	2.5	4.5	6.8	42.8	97.6
Thailand	282.3	1 214.6	1 889.2	4 004.7	30 226.0	5.8	22.5	33.1	64.9	2.6	5.1	3.8	13.6	469.8	239.1
Viet Nam	11.0	39.3	1 100.1	1 623.4	17 124.0	0.2	0.6	15.4	21.2	..	4.5	36.0	23.2	213.4	502.5

Source: UNCTAD/ TNC database (WIR 2003)

2. Forms of FDI

FDI into the country⁸ has been mainly through 100 per cent foreign ownership rather than joint ventures. Between 1979 and 2000, wholly foreign owned enterprises accounted for about 60 per cent of estimated FDI by value and 45 per cent by number of projects.

However, the important feature of this statistic is that national investor participation in joint ventures is unusually high given Sri Lanka's comparatively low per capita income. To some extent this might reflect the preference for joint ventures in foreign investment policy and in some privatizations. But it also suggests that Sri Lanka has a local private sector with the technical and financial capability to provide strong partnerships with foreign investors.

Privatization has been an important channel of FDI into Sri Lanka. The 11 largest privatization transactions between 1990 and 2000 accounted for \$609 million of the \$1,791 million in FDI during the period. Cumulative data for the period February 1990–June 2001 shows that a little more than two-thirds of privatization proceeds was raised from these foreign investors (Central Bank 2002, Table 74). A list of major foreign investments through privatization is provided in Table I.6

⁸ In the subsequent discussion of the features of FDI, foreign investment considered is that which occurred under section 17 of the previous BOI Act. FDI could enter under sections 16 or 17 of the old Act. Under section 17, the BOI was empowered to grant special concessions to companies satisfying specific eligibility criteria. Section 16 permitted FDI entry under the normal laws of the country. Cumulative data on projects in commercial operation during the period 1979–2000 shows that 91 per cent of foreign investment occurred under section 17 (BOI 2001, Table 3.2). The rest of the analysis will be conducted in terms of FDI under section 17. It should be noted that the data and associated discussion in Tables I.7, I.8, I.10 and I.11 are derived solely from BOI-sponsored projects and exclude some FDI from privatization. However, Table I.9 includes FDI arising from privatization.

Table I.6. Profile of privatizations with major foreign investment

Privatized enterprise	Date of privatization	Amount realized (\$ millions)			Percentage privatized
		Local	Foreign	Total	
Manufacturing					
Puttalam Cement	Dec. 1993	18.9	23.1	42.0	100
Colombo Gas Company	Dec. 1995	-	38.9	38.9	51
Ceylon Steel Corporation	Dec. 1996	-	15.4	15.4	90
Prima Ceylon Ltd.	June 2001	-	65.7	65.7	100
Financial services					
National Development Bank	March 1993	10.4	91.8	102.2	55.3
Other services					
Asian Hotels Corporation	Jan. 1992	8.1	13.6	21.8	91.4
Trans Asia Hotel (Ramada)	May 1993	11.6	11.6	23.3	86.9
Lanka Lubricants	July 1994	11.1	14.1	25.2	100
Orient Lanka	May 1996	-	31.5	31.5	100
Sri Lanka Telecom	Aug. 1997	-	226.9	226.9	38.5
Air Lanka	March 1998	-	77.1	77.1	40
TOTAL		60.1	609.7	669.9	

Source: Central Bank of Sri Lanka 2003, Table 75.

3. Distribution by sector, origin and geographical location

Until recently FDI was concentrated in manufacturing production. By 2000, FDI in services had overtaken manufacturing (see Table I.7) as measured by value of investment. This trend began in the second half of the 1990s as opportunities opened for FDI in property development and telecommunications. There is little FDI in agriculture.

Table I.7. Sectoral distribution of cumulative FDI projects and GDP, as at end 2000

(Per cent)

Sector	Number of FDI Projects	Amount of FDI	GDP
Manufacturing	60.7	41.7	17.4
Agriculture	8.3	2.7	20.4
Services	31	55.6	53.3

Source: BOI 2001, Table 3.6; Institute of Policy Studies 2003.

FDI in services has been focused in the communications area, which absorbed over 50 per cent of services FDI. Tourism FDI has been negligible. One-half of manufacturing FDI has gone to the textiles- and garments-related sector. Other areas of significant manufacturing FDI have been tyres, tubes, gloves and toys; porcelain products and tiles; jewellery and lapidary; and electronic goods. The sectoral structure of manufacturing FDI contrasts with total national manufacturing production in terms of its greater concentration in textiles and its lack of involvement in the other major national sector – food, drink and tobacco.

FDI in Sri Lanka is dominated by seven home countries, which represent 36 per cent of projects and about 80 per cent of investment by value invested (as is shown in Table I.8). Cumulatively, Singapore is the largest investor, with activities in a variety of sectors. The United Kingdom is the second largest investor and the largest western investor, primarily because of its historical links with the country. It has a particularly strong presence in garments, construction and IT (European Commission 2001). The other major investors, all from the Asia-Pacific region, are Japan, the Republic of Korea, Hong Kong (China) and Australia. In the past, Asian companies have been attracted by the garment industry as they moved out of their own countries in response to quota and cost pressures. Recent activity has been in the infrastructure and construction sectors. Australian investment was spurred by the entry of Ansell International (a subsidiary of Pacific Dunlop) in 1990. Australian investors are now present in a wide range of industries.

India has recently become an important investor as a result of the India-Sri Lanka Free Trade Agreement. This agreement has huge potential for generating FDI focused on the Indian market. Indeed, India was the largest investor in Sri Lanka in 2002. The principal sectors for Indian investment are steel, cement, rubber products, tourism, computer software, IT training and other professional services. An attraction for Indian investors has been the ability to re-export to India while benefiting from lower tariffs on raw materials in Sri Lanka. Other foreign investors have also expressed interest in investing in Sri Lanka to export to the Indian market.

Table I.8. Home country distribution of FDI in Sri Lanka, cumulative, 1979–2000
(Per cent)

Home country ^a	Share in the number of projects	Share in total FDI
Singapore	3.9	16.5
United Kingdom	5.4	13.9
Japan	6.0	12.1
Republic of Korea	10.6	11.5
Hong Kong, China	6.6	10.0
British Virgin Islands	0.6	8.0
Australia	2.4	7.5

Source: BOI 2001, Table 3.11.

^a Ranked by share in total FDI.

Analysis of the 20 largest foreign investors in the country provides some detail to the aggregate findings (see Table I.9). Astonishingly all of the 20 largest foreign investors started operations in the 1990s. The great majority of the enterprises (16 out of 20) are in the services sector, including construction, power, telecommunications, trading and ports, illustrating the importance and relatively large value of services investment over recent years. Manufacturing is the second largest group (four enterprises).

Table I.9. Top 20 foreign investments, cumulative investment as at end 2002

Rank	Enterprise	Product	Home country	Cumulative investment (\$ million)	Ownership status
1	Sri Lanka Telecom (1997)	Fixed-line telecom	Japan	236	Joint venture
2	Lanka Bell (1997)	Wireless telecom network	Singapore and United Kingdom	148	Joint venture
3	Colombo Power (2000)	Barge-mounted power plant	Japan	141	Wholly-owned
4	Lanka Cellular (1993)	Cellular phone services	Singapore	141	Joint venture
5	South Asia Gateway Terminals (1999)	Port services	Australia and United Kingdom	131	Joint venture
6	JAIC Lanka (1997)	Apartments	Japan	127	Wholly owned
7	Overseas Realty (1996)	Property development	Hong Kong and Singapore	119	Joint venture
8	Kabool Lanka (1990)	Yarn	Republic of Korea	118	Wholly owned
9	MTN Networks (1995)	Cellular phone network	British Virgin Islands and Finland	117	Joint venture
10	AES Kelanitissa (Pvt) Ltd. (1999)	Power generation	United States	107	Joint venture
11	Shell (1995)	Gas	Netherlands	103	Joint venture
12	Ansell Lanka (1990)	Surgical gloves	Australia	96	Wholly owned
13	Air Lanka (1998)	Airline	United Arab Emirates	77	Joint venture
14	Prima Ceylon Ltd. (2001)	Food processing	Singapore	70	Joint venture
15	Asia Power (1998)	Power generation	United Kingdom	64	Wholly owned
16	Suntel (1996)	Wireless telecom network	Sweden	50	Joint venture
17	Colombo Dockyard	Port services	Japan	43	Joint venture
18	Ace Power Generation (1999)	Utility	Finland and United Kingdom	33	Joint venture
19	Orient Lanka (1996)	Trading	United Kingdom	31	Wholly owned
20	North Pole Lanka (Pte) Ltd. (1992)	PVC manufacture	Korea	27	Wholly owned

Source: BOI, Research Department, 2003 (as amended by UNCTAD).

Notes: The figure in parentheses is the year the commercial operation commenced.

The exchange rate used is at year of entry.

"Wholly owned" ventures may include minority shareholdings by financial investors and employees.

The geographic distribution of FDI in Sri Lanka is highly concentrated (see Table I.10 on data for the leading seven districts in FDI attraction). Two districts, Colombo and Gampaha, accounted for nearly 70 per cent of projects by number and 80 per cent of investment by value.

Table I.10. Distribution of FDI in operation by districts, cumulative as at end 2000
(Per cent)

District ^a	Share in the number of projects	Share in FDI
Colombo	33.2	46.1
Gampaha	35.7	33.8
Galle	3.2	6.7
Kalutara	5.9	4
Kurunagala	3.2	2.7
Kandy	3.5	2.2
Puttalam	4.1	1.9

Source: BOI 2001, Table 3.9.

^a Ranked by share in FDI.

D. Impact of FDI

The impact of FDI on an economy can be considered in terms of a number of indicators. FDI clearly brings investment finance and can contribute to employment. Developing countries also seek FDI for its potential contribution to:

- technology and skills;
- pioneering of new industries and export markets;
- formation of new clusters as anchor investors; and
- creation of linkages with, and associated upgrading of, competencies of local enterprises.

Several of the new wave of foreign investors in Sri Lanka since the 1990s have brought with them benefits that contribute to enhancing national competitiveness. Three of these are profiled in the boxes that follow.

I. Technology and skills

Technology and skills transfer is perceived as one of the major benefits of FDI. Sri Lanka is in a good position to benefit from such transfer owing to the potential of its workforce. In the absence of extensive analysis dedicated to the subject, it is difficult to provide an overall picture of the contribution of FDI to such transfer in Sri Lanka. However, scattered evidence suggests that the impact may be substantial.

Box I.1 illustrates a case in which the foreign investor was able to achieve skills transfer to such an extent that almost all the workers in a highly technical industry were localized. Box I.2 also illustrates notable intra-firm technology and skills transfer through the introduction of equipment and training. Textured Jersey of the United Kingdom has sent a group of over 10 managers, as well as introducing modern technology, to its affiliate Textured Jersey Lanka. These managers are training Sri Lankan counterparts who are expected to take over from the expatriates within three to five years.

Box I.1. An example of fast localization: Lanka Bell

Lanka Bell is the largest greenfield foreign investor in Sri Lanka. It is almost a wholly foreign-owned company with less than 1 per cent of its shares held by Sri Lankan individuals. The company provides telecommunications services, including fixed-line and data services. It began operations in 1997 with an initial investment of about \$110 million.

The company employed some 40 expatriate professionals at the time it started operations. By 1999 – that is, within two years of start-up – all expatriate professionals but one had been replaced by Sri Lankan personnel. At present only the managing director is an expatriate.

The company has a continuing internal training programme for its employees, and it sometimes brings in foreign consultants to conduct training. It is thus contributing to technology transfer to Sri Lankan nationals.

The company believes that the competition generated by Lanka Bell has contributed to improvements in telecommunications services to customers. For example, Sri Lanka Telecom, which used to take a week or more for a repair job, now takes less than a day. The backlog of pending applications for new telephone connections has been eliminated. Lanka Bell has already opened several Internet cafes and hopes to raise the number to 40 or 50 within the next three to six months.

Source: Investor interview.

There are also indications of potential or actual skills and technology transfer to enterprises outside the firm. The system of engagement of Sri Lankan doctors as consultants and the training of Sri Lankan nationals as nurses by Apollo Hospital (Colombo) may lead to substantial transfer of health care technology to other hospitals as and when these doctors or nurses take up employment elsewhere (see Box I.3). Domestic firms in the porcelain and cement industry have also benefited considerably from the examples of pioneering foreign investors. Unilever, which is a wholly owned foreign enterprise in Sri Lanka, appears to have made considerable contributions to transfer of management and marketing technologies. It is understood that many professionals in these fields who are working with Sri Lankan companies are former employees of Unilever.

2. Employment and linkages

In terms of employment, FDI has made a notable contribution in Sri Lanka. As of end 2000, it is estimated that foreign affiliates (wholly owned and joint ventures) employed some 200,000 people, compared with total private-sector employment of 2,707,000.⁹ Thus, the proportion of private-sector employment accounted for by foreign affiliates is about 7.4 per cent. This understates the total contribution of FDI because it does not take into account the employment created in activities linked to affiliates' outputs, including procurement, transportation, and the like.

However, it appears that in some areas FDI has not had as significant an effect in terms of such linkages to domestic companies. An important example is the lack of development in backward linkages between the clothing and textile sectors. There is limited integration between the sectors with the majority of textiles being imported. Reasons offered for the lack of success in forming supplier industries in the past include high cost of machinery, lack of local raw material, and electricity charges (ITC 2002). However the recent establishment of a number of textile and accessory manufacturers is improving the picture. Box I.2 provides one example of increased vertical integration through the formation of a knitted fabric manufacturer as a joint venture between a foreign investor and leading local firms.

Box I.2. Creating backward linkages: Textured Jersey Lanka

About 70 per cent of Sri Lanka's fabric requirement is imported, and Textured Jersey Lanka was set up to establish a degree of vertical integration for garment manufacturing in Sri Lanka. It is a joint venture enterprise between Textured Jersey of the United Kingdom (50 per cent share) and MAS Holdings (33 per cent share) and Phoenix Ventures (17 per cent share) of Sri Lanka.

The company started commercial production in October 2001 following an investment of \$25 million. During the first full year of operation the company engaged 306 employees and had a turnover of \$10.6 million. It manufactures weft fabric for intimate apparel, ladies' casual wear, men's underwear and sportswear. It currently supplies major customers in US and UK markets, including Marks and Spencer, NEXT, Gap and Victoria's Secret.

The company made an initial investment of \$230,000 for technical training and has an arrangement with Leeds University (United Kingdom) for meeting its training needs. With well-trained human resources and a highly automated production and processing system, the company hopes to become known internationally as one of the best weft-knit fabric manufacturers in the world.

Source: Investor interview.

⁹ Based on data in Table 5.3 of BOI 2001 and Table 47 of Central Bank 2002.

3. Diversification of output and exports

FDI has made a major contribution to Sri Lanka's exports. During the years 1996-2000, exports by foreign affiliates were consistently in the order of one-third of the country's total exports (see Table I.11). Moreover, FDI has been important in diversifying Sri Lanka's export base. The share of exports of manufactures in total exports, which was 15 per cent in 1978, had risen to more than 75 per cent by the mid-1990s. Garments represented the leading sector of this industrial export growth, accounting for more than half of the country's export earnings by the mid-1990s. FDI in garments has led the country's diversification in this manufacturing sector. The sector's growth was in response to the liberalization programme, quota opportunities under the Multi-Fibre Agreement, the availability of cheap and educated labour, and convenient geographical location in international transportation networks (IPS 2001).

Furthermore, Sri Lanka has received FDI in import-substituting activities, including services such as health care (see Box I.3). This is an interesting example of utilizing Sri Lanka as a regional hub for services.

Table I.11. Exports by foreign affiliates and total exports, 1996-2000
(Millions of dollars and per cent)

Year	Total exports	Export by foreign affiliates ^a	Affiliate exports as percentage of total
1996	4,101	1,444	35.2
1997	4,647	1,465	31.5
1998	4,805	1,593	33.1
1999	4,619	1,645	35.6
2000	5,544	1,952	35.2

Sources: BOI 2001, Table 4.2; Central Bank of Sri Lanka 2002, Table 78; World Bank 2000.

^a Includes wholly owned and joint venture affiliates.

Box I.3. Pioneering new private services: Apollo Hospital, Colombo

Prompted by the large number of Sri Lankan patients receiving treatment in hospitals in India, Apollo Hospitals Group of India, which owns or manages some 30 hospitals in India, decided to set up an establishment in Colombo. The Lanka Hospital Corporation (Pvt.) Ltd. was formed as a joint venture, with Apollo Hospitals Group owning about 35 per cent of shares and the rest owned by the International Finance Corporation (a private-sector arm of the World Bank), the National Development Bank, the Insurance Corporation of Sri Lanka and several other local investors. With an initial investment of over \$40 million and a 500-bed capacity, Apollo Hospital in Colombo is the largest private-sector project approved by the BOI in the health sector.

The hospital started construction in December 1999 and began operation within 24 months. It is a multi-specialty hospital equipped with state-of-the-art technology to offer an extensive range of diagnostic and therapeutic health care facilities. In addition to direct provision of health care, Apollo Hospital is contributing to the development of human resources in the health sector by engaging local doctors as consultants in association with some 50 Indian and 60 Sri Lankan expatriate doctors employed by the hospital. In February 2003, with 100 women students, the hospital started the first private-sector nursing school, which will confer a three-year diploma. The students are obliged to serve with the hospital for three-year bonds, after which they will be free to work elsewhere.

Since its opening the hospital has performed some 350 open-heart surgeries. The hospital authorities estimate that such surgery in the United States or the United Kingdom costs about \$40,000. In Apollo Hospital, Colombo, it costs about \$3,000. The hospital has thus contributed to foreign exchange savings. Further, the hospital was conceived to provide services to the region, in particular to countries in the Indian Ocean area.

Source: Investor interview.

E. Assessment

Since independence in 1948, conditions have never permitted the private sector to flourish in Sri Lanka. Anti-private enterprise policies were pursued until the late 1970s, and the benefits of partial reforms thereafter were stymied by the outbreak of civil war. Economic growth and private investment have been low by the standards of the best performers in Asia. Sri Lanka is still a very low-income country, with an economic structure not far removed from that of the colonial era.

There are grounds for concluding, albeit cautiously, that the future for private investment may be much brighter:

- Private investment has in the past responded quickly to initiatives.
- FDI responded reasonably well to new opportunities in the 1990s, although it is still narrowly based, flattered by one-off privatization opportunities and, in aggregate, well below inflows achieved in comparable countries. Excellent policies and promotional efforts will be needed in order to increase and diversify FDI.

- The economy's low degree of structural transformation and the negligible amounts of FDI prior to the 1990s raise questions about the business competencies of much of the extant private sector. On the other hand, the high level of joint ventures associated with the (modest) inflows of FDI suggests a business and financial capability to move with the times. Local capacity to form joint ventures could be especially important in hotel and related tourist ventures, in transport and logistics, and in business and professional services. It is already being demonstrated in export manufacturing and will be increasingly so, as free-trade privileges open up with India and perhaps the United States.
- The business community believes that there are skill shortages, although local labour is highly trainable. Standards of general education are much better than would be expected in a country with a per capita income of only \$800. It will be vital to improve the poor infrastructure in order to capitalize fully on the skills base.

On balance, there is reason to be optimistic that private investment can grow strongly once peace is fully restored. FDI should accelerate. Sri Lanka should be looking to **attract at least \$350 million a year in FDI** judged by the international comparisons presented above (double the amount attracted per year in the 1990s). Even then, per capita FDI inflows would only match those in Viet Nam. They would need to double again to approach Thailand's performance in per capita terms. Chapters II and III of this report assess the regulatory, tax and institutional improvements needed to realize this potential.

II. THE INVESTMENT FRAMEWORK

Sri Lanka was among the first countries in South Asia to liberalize its economy and open up to foreign investment. While these reforms certainly improved the business climate, by today's standards they did not create a liberal investment framework for all investors.

A. Introduction

A new investor reading the business laws of Sri Lanka could understandably conclude that much of Sri Lanka's regulatory environment is archaic and unhelpful to business. In most respects current practice is better. This environment arises both from the activities of the BOI, which is an administering authority for much sensitive regulation, and from the good sense employed elsewhere in the line ministries. In most cases key ministries are headed by competent individuals who are fully aware of modern practice and business needs. Moreover, the Government has a full pipeline of new legislation to modernize business regulation.

The Greater Colombo Economic Commission (now the BOI) was established in 1978 with plenipotentiary powers to offer superior regulatory, tax and administrative treatment to eligible investors, usually large ones. All other investors are subjected to the general regime and to administration by the line ministries and agencies. The outcome was the creation of a dual regime.

Over time the BOI has become a powerful presence in the Sri Lankan business world. It is seen as being particularly helpful to new large investors. Almost all FDI in Sri Lanka (apart from some privatizations) enters through the BOI "gateway".

Since the initial liberalization of the investment framework in the late 1970s, there have been further improvements for non-BOI investors, but systematically or across the board.

B. Entry, treatment and protection of FDI

I. Entry and establishment of FDI

FDI is permitted in most sectors, and Sri Lanka on the whole presents a welcoming attitude to FDI. However, Sri Lanka has a long "negative list" of sectors where FDI is barred completely or may only take a minority stake in an enterprise (see Box II.1).

Restrictions on FDI are imposed through the Exchange Control Act. In practice, FDI applications are referred for approval by the Controller of Foreign Exchange to the BOI. Under its Act, the BOI has the power to exempt any enterprise from the Exchange Control Act. The BOI is, in effect, the FDI regulator.

Box II.1. Businesses reserved for national investors (the FDI negative list)

Under exchange control powers, the following businesses are wholly or partially reserved for national investors:

No FDI permitted:

- Money lending
- Pawn broking
- Retail trade with a capital of less than \$1 million
- Coastal fishing

FDI permitted only up to 40 per cent ownership unless otherwise approved by the BOI:

- Production of export goods subject to international quota
- Growing and primary processing of tea, rubber, coconut, cocoa, rice, sugar and spices
- Mining and primary processing of non-renewable national resources
- Timber-based industries using local timber
- Fishing (deep sea)
- Mass communications
- Education
- Freight forwarding
- Travel agencies
- Shipping agencies

FDI permitted only up to a level of ownership determined on a case-by-case basis by the BOI:

- Air transport
- Coastal shipping
- Industrial undertaking in the second schedule of the Industrial Promotion Act, No. 46 of 1990, namely, any industry manufacturing arms, ammunitions, explosives, military vehicles and equipment, aircraft and other military hardware; any industry manufacturing poisons, narcotics, alcohols, dangerous drugs and toxic, hazardous or carcinogenic materials; and any industry producing currency, coins or security documents
- Large-scale mechanized mining of gems
- Lotteries

Source: Notice under the Exchange Control Act No. 1232/14 dated April 2000.

The rationale, scope and modalities of regulating the entry of FDI to Sri Lanka need overhauling. The current approach is not consistent with the enhanced growth and productivity goals of *Regaining Sri Lanka*.

FDI brings a package of capital, advanced management and technology and, sometimes, new industries and access to new markets to developing countries. It is also valuable as a source of fresh competition to established business. Increasingly, it is customary to restrict FDI entry only to areas dominated by small business where foreign investors might put undue competitive pressure on fledgling local entrepreneurs or might be a source of unwanted economic immigration.

Sri Lanka's negative list goes beyond these principles, especially in the activities where enterprise ownership limitations are placed on FDI (the second and third categories in Box II.1).¹⁰ Established operators – which can be quite large – are protected from new foreign entrants in many of the established business sectors in the economy. This is not helpful in upgrading Sri Lanka's business competence or improving national competitiveness. Certain restrictions appear to be in conflict with priority areas for investment attraction. For example, the FDI restriction on air transportation is not consistent with the goal (as set out in the new BOI law) of promoting Sri Lanka as an international business hub.

Other FDI restrictions are highly unusual and lack any apparent rationale. For example, restricting FDI in large-scale mining is extremely unusual except in countries where government ownership prevails in this sector. Applying FDI restrictions, under the rubric of national security, to an expanded list that includes the manufacture of dangerous drugs and alcohol is inappropriate regulation. Manufacturing processes and distribution of such materials should be regulated, not the ownership of the enterprise.

Finally, non-resident Sri Lankan citizens are treated as foreign investors in the application of these restrictions. This may simply be a technical implication of implementing an FDI regime through foreign exchange control regulations.

Typically such negative lists grow over the years in response to events and pressures from narrow interests rather than through clear and consistent national policy. Sri Lanka's negative list has the hallmarks of this typical development. Two remedial steps are proposed:

- Consider adopting a "ground-zero" approach to all activities currently on the negative list. In such an approach, all activities would be removed and specific activities would be reinserted only if this was justified by national policy objectives. In 2002 an important step was made in this direction by removing professional services from the negative list. Thus policy is developing in a direction that is more compatible with the goal of positioning Sri Lanka as a business hub.
- Develop a new legal framework for administering FDI entry and formulating related policy.

As was mentioned, the legal vehicle for administering FDI entry has hitherto been the foreign exchange control regulations. This instrument is technically unsuitable, as it addresses transactions with non-residents rather than with foreign investors (and the two are not necessarily equivalent).¹¹ In any event, exchange control reform is likely to remove foreign equity controls, and a new legal device is needed if indeed Sri Lanka wishes to restrict FDI in some activities.

¹⁰ Although minority ownership is permitted, excluding foreign investors from exercising voting control is tantamount to excluding many serious investors.

¹¹ Many resident enterprises are foreign-owned. At the same time, non-resident enterprises can be owned by Sri Lankan citizens.

There are three options for a new legal vehicle to regulate FDI entry restrictions:

- Introduce necessary restrictions into sectoral licensing laws;
- Introduce an FDI law; or
- Amend the BOI law.

The sectoral law approach could lead once again to a list of piecemeal restrictions that fail to take full account of wide national objectives; therefore, it is not recommended. An FDI law would set out the principles for restricting FDI, and it would provide for a single administrator and for appropriate safeguards. FDI laws typically also set out good standards of treatment and protection of foreign investors in a highly welcoming format. However, Sri Lanka already has an extensive network of bilateral investment treaties (BITs) that provide good standards of FDI treatment and protection (see next section).

In these circumstances, the simplest solution is recommended: amendment of the BOI law to incorporate modern FDI entry principles and procedures. The proposed amendment should introduce a transparent process in which FDI entry restrictions are imposed only if (a) additional FDI would damage small local enterprises; (b) competition in the activity is adequate from the consumer interests perspective; and (c) no harm to the overall climate for foreign investment would result. There should be the flexibility to permit established local investors to take in a foreign joint venture partner on a case-by-case basis to expand or modernize.

The Cabinet of Ministers should decide the composition of the negative list. Applications by individual foreign investors to co-invest in nationally owned businesses on the negative list should be decided by the BOI. FDI in activities not on the negative list should not require prior approval.

The amended regime should permit citizens to invest freely through non-resident vehicles, and to enjoy the guarantees of treatment and protection accorded to foreign investors. This approach will comfort diaspora investors, who are likely to have concerns similar to those of conventional foreign investors (e.g. in relation to funds transfer, dispute settlement and expropriation).

These changes will produce a streamlined foreign investor gateway to Sri Lanka. At the same time, the process will be fully responsive to national policy considerations.

2. Treatment and protection of FDI

Sri Lanka does not set out principles of foreign investor treatment and protection in national law. However, it has an extensive BIT network, including treaties with almost all major FDI home countries (24 in total). These BITs guarantee *fair and equitable treatment* and full protection and security of the investment. Both *national treatment* (post-establishment) and *most-favoured-nation treatment* are guaranteed. In practice these standards are adhered to.¹²

¹² Official practice in relation to employee severance compensation is potentially troublesome. In two retrenchment exercises involving foreign affiliates in Sri Lanka, the compensation package was arguably higher than what would have been imposed on local employers. The Government denies that its assessment of capacity to pay is related to the size of the company globally. Nevertheless, suspicions exist that affiliates of large TNCs are regarded as having deeper pockets. (This issue was discussed in the above section on labour regulation.)

The BITs guarantee investor protection against nationalization, expropriation or restrictions that amount to constructive expropriation, except for a public purpose, and in such an event they guarantee “prompt, adequate and effective compensation” based on the market value of expropriated property before the expropriation was effected or such an eventuality became public knowledge. The affected investor also has the right to judicial review. There have not been any recent instances of expropriation. Sri Lanka is a member of the Multilateral Investment Guarantee Agency.

Repatriation of capital and profits is guaranteed, but in a weak format in that transfers are subject to the exigencies of foreign exchange. In practice there is ready access to foreign exchange and the prospect of nearly full abolition of exchange controls.

There are no discernible performance requirements placed solely on foreign investors as a condition of entry into Sri Lanka.

In relation to *dispute settlement*, Sri Lanka has ratified the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID). The BITs provide for referral to ICSID if any dispute cannot be resolved through negotiations in a reasonable time. Foreign arbitral awards are enforced in Sri Lanka. A local Commercial Mediation Centre was established in 2000 to settle commercial disputes through mediation and/or arbitration.

C. General measures for regulating business

I. Taxation

The principal taxes that affect business in Sri Lanka are taxes on corporate profits and dividends; value-added tax (VAT); and import and excise duties.

In the standard direct tax regime, profits are taxed at 30 per cent, with reasonably rapid depreciation allowances and loss carry forward of six years. Dividends distributed to residents are subject to a final tax of 10 per cent. Non-resident dividend withholding tax (DWT) is also 10 per cent. Sri Lanka has a wide network of double tax treaties (DTTs).¹³ Personal taxation is in three bands of 10, 20 and 30 per cent respectively, with an allowance providing relief from tax on incomes up to the equivalent of about \$2,500 a year. This threshold is at least twice as high as average wages in manufacturing and higher than many typical wages in administrative positions.

¹³ By the end of 2001 there were 30 DTTs in force and another seven pending. They cover all the principal FDI home countries.

Import duties are moderate by regional standards. Typical standard rates are 2.5 per cent to 10 per cent for industrial plant and office equipment and 20 to 25 per cent for building materials and office furniture. Vehicle import and excise duties combined are in the range of 40 to 60 per cent.

VAT was introduced in 2002 to replace two other forms of sales tax. Rates are two-tier – 10 per cent on essentials and 20 per cent on non-essentials. Exports are zero-rated. The registration threshold is about \$20,000 a year (high for a low-income country). However, the effective implementation of VAT has been delayed owing to a challenge as to whether the imposition of VAT on retail and wholesale trade is consistent with the sales tax prerogatives of Provincial Councils.

Fiscal incentives are available to approved investors for a wide range of business activities. The objectives and present scope of these incentives are summarized in Box II.2. Fiscal incentives typically take the form of:

- An initial tax holiday, often for five years, followed by a short period of a concessional income tax rate (e.g. 10 per cent for two years), and finally a long-term concessional rate, varying from 15 to 20 per cent depending on the industry;
- Zero-dividend tax and DWT during the tax holiday period and for one year thereafter;
- Import duty exemptions on capital equipment in some industries and zero duties on raw materials in export manufacturing; and
- A fiscal stability agreement issued by the BOI binding the Government to these arrangements.

The above summary describes the current form of tax incentives. The regime is constantly changing. The most recent changes (2003) broadened the application of the tax holiday period.

A minimum investment is usually required in order to qualify for incentives. Eligibility is assessed by the BOI, which directly administers the import and excise duty concessions and monitors adherence to the investment obligations that give rise to the incentives. Until the 2002 revision to its statute, the BOI could also provide bespoke incentives. Since its inception the BOI has approved incentives for nearly 1,900 projects, including almost all foreign investments.

Box II.2. Objectives and scope of fiscal incentives for investment

The objectives of these incentives are summarized by the BOI (2003) as:

- Promoting diversification of Sri Lanka's industry and services, with a focus on advanced technology, and adding value.
- Promoting investments in large-scale projects with a particular emphasis on infrastructure.
- Exploiting regional opportunities and Sri Lanka's comparative advantages.

Activity	Minimum investment size (\$000)	Activity	Minimum investment size (\$000)
1. Non-traditional export manufacturing by a new enterprise	150	9. Agriculture or agro-processing other than black tea	10
2. Export-oriented services of a new enterprise	150	10. Export trading house/re-exporter. Three schemes based on turnover size.	Minimum turnover
3. Expansion of either 1 or 2 above by an existing enterprise	500	11. Large-scale projects	12,500
4. Small-scale infrastructure	500	12. Large-scale infrastructure	10,000
5. Manufacture of machine tools or machinery	150	13. Non-performing or under-performing enterprises in export of services or non-traditional manufactures	10
6. IT services and training	Minimum employment or students enrolled	14. R&D	50
7. New industrial, agricultural, construction or service activity as approved by BOI	5,000	15. Regional headquarters	NA
8. Expansion of non-traditional exports	500		

This kind of fiscal approach is quite common. The general fiscal regime is perceived to be uncompetitive for particular kinds of investments. It is relieved by selective incentives rather than by addressing the uncompetitive elements in the general fiscal regime. Investors who obtain the incentives are satisfied, but in Sri Lanka, as elsewhere, the approach involves a number of pitfalls:

- It discriminates against small and medium-size enterprises (SMEs) in most cases of incentives (see the minimum investment thresholds in Box II.2). Yet investors not eligible for incentives face a tax burden that is 50 to 100 per cent higher than that of incentive companies.¹⁴

¹⁴ This estimate is derived from the comparative tax survey results presented in Figure II.1.

- It requires a substantial bureaucracy to approve and monitor size-based incentives. Any lowering of thresholds to curb discrimination against SMEs would increase the bureaucracy.
- It has masked the true investment attraction performance of the BOI. Many investors would approach the BOI as a gateway to incentives and not because of leads generated by the BOI. This further encourages the BOI to recommend incentives in marginal cases. For example, a large headquarters building constructed in Colombo by a leading bank is structured as a “BOI company” to gain tax incentives.
- It has almost certainly led to structuring of business so as to reduce tax in unanticipated ways. For example, there is an obvious incentive for banks to lend to zone companies (deemed to be non-residents) through their tax-advantaged Foreign Currency Banking Units (FCBU).¹⁵
- The BOI does not provide facilitation services to SMEs because they are too small to become “BOI companies” via an entitlement to tax incentives.

The BOI enters into a fiscal stability agreement with the investor guaranteeing the fiscal incentives for the life of the enterprise. It is highly unusual to grant contractual fiscal stability on a routine basis in perpetuity. Moreover, the BOI-investor agreements are drafted so as to completely exclude the investor from the application of the Inland Revenue Act during the initial tax holiday period. Most “BOI companies” do not file tax returns in this period. This undermines the authority of the Department of Inland Revenue and makes assessment more difficult when the tax holiday is over.

Overall fiscal strategy is beyond the remit of this report. However, the application of broad tax concessions to most large investors over many years undoubtedly contributes to weak budget revenues and a high fiscal deficit. This results in clearly inadequate public expenditures on infrastructure, which must be a serious constraint on private investment.

An alternative approach to the design of competitive taxes for all investors should be considered. There seems to be scope for rebalancing elements of the fiscal regime to achieve a package that is both revenue-positive and investor-friendly. The guiding principle should be that taxation is not a determinant of the international location of investment, but that prospective investors attracted by the economic fundamentals of a country may be deterred by uncompetitive taxation arrangements. Accordingly, the questions to be addressed should be:

- How competitive is Sri Lanka's standard fiscal regime and its incentives for investors?
- What are the elements of an alternative approach that avoids the weaknesses of the current approach but does not undermine revenue collection?

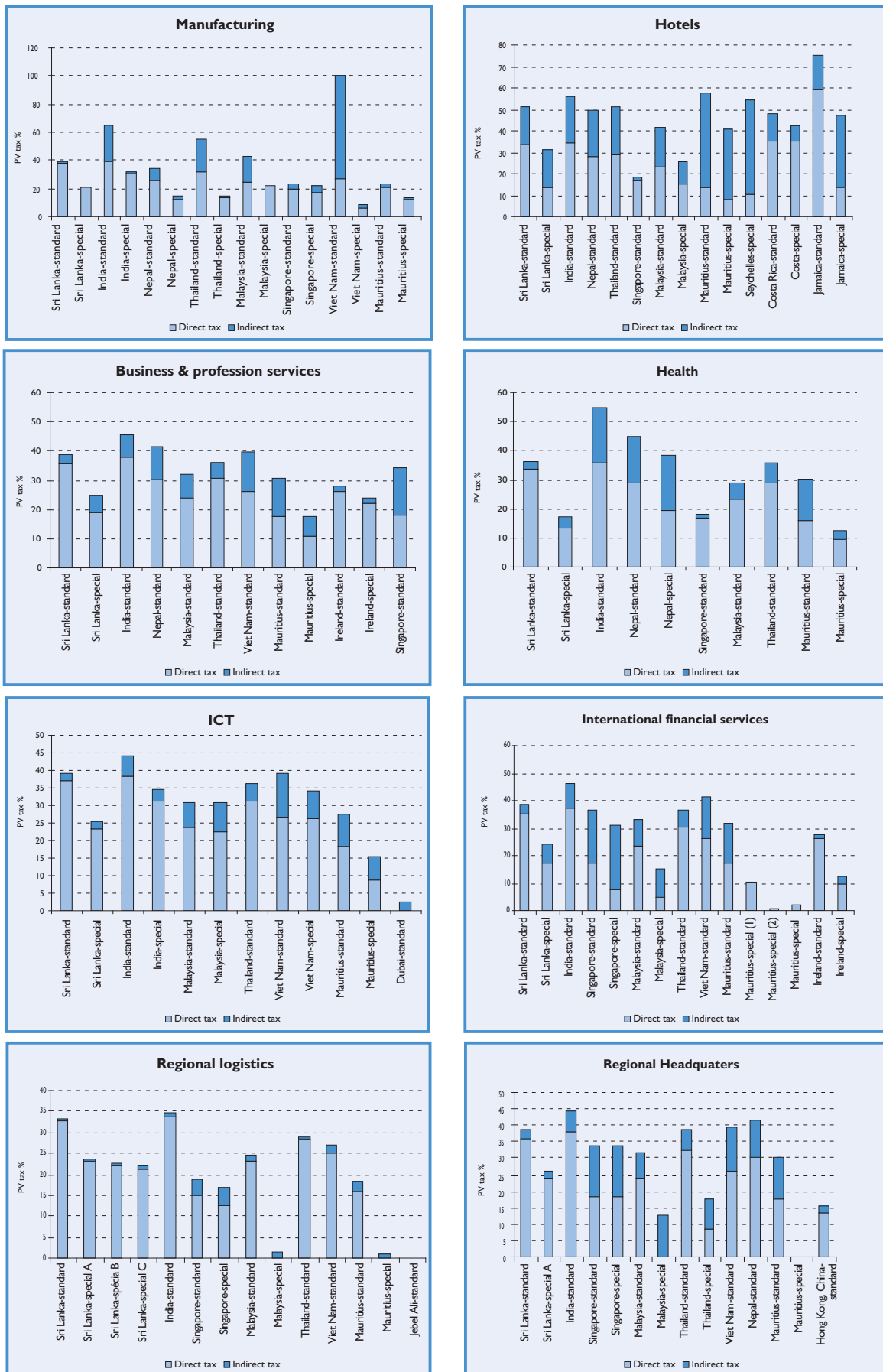
¹⁵ The recent accounts of one bank show a loss on domestic banking services (taxable at 30 percent of profits) and a profit in the FCBU (which has relief on profit and dividend taxes).

Figure II.1 compares Sri Lanka's taxation of investment in a number of sectors and activities with that of neighbouring countries and international leaders in attracting investment in the sectors concerned. The burden of direct and indirect taxes on investor cash flow is measured as the discounted present value of tax paid as a percentage of investor cash flow before tax (referred to hereafter as "PV tax per cent" and explained more fully in Annex I).¹⁶ The higher the percentage tax "take" (expressed as "PV tax per cent"), the less competitive the fiscal regime.

In Figure II.1, for each sector and for each country as applicable, the tax impacts of both the standard fiscal regime and the special regime are shown. For Sri Lanka, the special regime is the BOI incentives package available under the schemes listed in Box II.2 above.

¹⁶ The tax comparisons use a methodology developed by UNCTAD. See Annex I for details.

Figure II.1. Sri Lanka's comparative taxation of investment



On a sector and activity basis, the conclusions drawn from comparisons with other countries are summarized in Box II.3

Box II.3. Comparative tax survey implications

- In *manufacturing*, Sri Lanka's standard regime is highly competitive with the comparator standard regimes. Corporate taxes are moderate, and customs duties on industrial plant and machinery are low. However, many countries have introduced a special regime for export manufacturing that includes extensive customs duty relief and, sometimes, lengthy tax holidays. Sri Lanka has broadly followed suit, although it is relatively more reliant on taxing dividends than corporate profits. There is no scope for increasing the tax burden on export manufacturers.
- In *hotels*, competitors frequently provide special regimes with low direct taxes but high indirect taxes. Sri Lanka's standard and special regimes are more competitive in this regard. There could be scope to remove the income and dividend tax holiday, possibly in return for improved buildings depreciation, while remaining competitive and making the scheme available to all investors.
- In *business and professional services*, the standard and special (services exports) regimes are competitive within the region. The principal special scheme for export services is aimed largely at the garment and transportation industries. Services exports could also aim to attract foreign investors to base themselves in Sri Lanka in order to provide services in the region. There should be scope for harmonizing the taxation of domestic sales and exports of business and professional services at a lower common corporate tax rate.
- In *information and communication technologies (ICT)*, India has led the race, providing exceptional ICT incentives. In Sri Lanka there is no minimum investment threshold, although 15 technically qualified people must be employed or 300 students enrolled in training.
- In *health*, there is scope for rationalizing the standard and special regimes in a single competitive regime, as few regional competitors have provided special regimes, with the exception of Singapore.
- In *regional logistics*, Sri Lanka has a special regime for Export Trading Houses, including re-exporters. However, this scheme does not capture the exceptionally low tax regime required to be competitive in freeport activities. Location of these activities is highly tax sensitive and competitive, and Sri Lanka should review its approach – possibly in conjunction with the proposed development of a transshipment port on the south-east coast.
- In *international financial services*, Sri Lanka does not have a specially calibrated fiscal regime designed to attract such services, compared to countries that have seriously attempted to develop an offshore financial sector. Sri Lanka has permitted foreign currency banking units for many years, but these have not developed fully into true offshore services.
- In *regional headquarters schemes (RHQs)*, Sri Lanka has a dedicated special regime, but this is probably not competitive with aggressive alternative locations.

The current approach to tax design is characterized by an uncompetitive standard fiscal regime that is relieved by a patchwork of discriminatory and bureaucratic incentives. An alternative approach would be to reform the standard regime so that it is attractive for most investors but has the flexibility to provide special regimes on a sector or activity basis where warranted to ensure international competitiveness. The principal changes this would entail for Sri Lanka are detailed below.

1. Reform of the standard tax regime

Consider cutting the headline profits tax rate to 15 per cent (certainly no more than 20 per cent). Retain other key elements of the corporate tax regime, including rapid rates of depreciation allowances and 10 per cent tax on dividends. This may well ensure that Sri Lanka's direct taxation is competitive without the need for special regimes in most sectors. Exceptions are listed in point 2 below.

Sri Lanka's standard rates of import duty and excise are already moderate in comparison with those of most regional countries, with the exception of Singapore. Nevertheless, certain rates (especially on building materials and office furniture) are high in absolute terms. These affect investment costs in all sectors and constitute a bias against services compared with manufacturing. Given that Sri Lanka wants to position itself as a competitive provider of goods and services to the region and beyond, it should begin to adopt a Singapore-type strategy whereby local businesses can access imported inputs at globally competitive costs. Implementing such a strategy could affect local suppliers that depend on import protection, and gradual adoption is therefore usually advisable.

2. Development of special regimes

Special regimes should be developed, where still required after reform of the standard regime. Highly tax sensitive sectors include the following:

- *IT: Aggressive fiscal incentives* are currently being offered in this "hot" sector. India recently decided to retain its incentives.
- *Regional logistics: Freeport activity* is strongly tax driven.
- *International financial services: Strong incentives* are being offered by other countries to attract providers of specialized offshore financial services. Even within this sector, investment attraction in some activities is more tax sensitive than in others. A carefully segmented approach is needed.
- *Regional headquarters: These schemes* are usually highly tax advantaged. Countries offer very attractive corporate tax regimes, knowing that RHQs are run as cost centres and not as profit centres.

These suggestions do not imply that Sri Lanka necessarily has the potential to strongly attract investment in these activities. Development of special tax regimes should go hand in hand with assessment of investment potential and, in some cases, with the development of special regulatory regimes.

3. *Development of special measures to attract talented diaspora members*

These could include improved tax treatment of offshore-sourced passive income, neutral tax treatment of offshore pension arrangements, income tax concessions for gains from exercise of stock options, and measures to cushion the impact of low personal relief thresholds on very high earners.

4. *Review of fiscal stability agreements*

Fiscal stability certificates should no longer be required for new investments except in the case of major projects, especially those requiring substantial debt financing (e.g. large-scale mining and infrastructure projects). Existing agreements should, of course, be honoured.

This approach would make competitive tax arrangements available to all investors and would reduce the need for case-by-case approval.

The suggestions above are an outline of the approach. Implementation would require the following steps:

- Detailed design and comparative analysis of the proposed standard regime and new special regimes to ensure that they are indeed competitive.
- Assessment of the budget revenue implications.
- Compensatory measures to cover shortfalls in revenue, if any.¹⁷ Wider VAT coverage and reduced personal tax exemptions would be logical places to start.
- Certain sectors or activities require major regulatory and promotional infrastructure in order to meet national objectives. Market research should be done to identify market segments with potential and to target special tax regimes to that end. Tax policy should be prepared in tandem with such work. The Foreign Currency Banking Units (FCBUs) are an example of providing "incentives" that may facilitate tax avoidance rather than substantive business development.

2. **Foreign exchange arrangements**

Access to foreign exchange presents no difficulties for investors in Sri Lanka. The existing regulations contained in the Exchange Control Act are old-fashioned and highly restrictive. Like much of the Sri Lankan investment framework, the reality is more accommodating for investors.

In 1994 Sri Lanka accepted Article VIII of the International Monetary Fund (IMF) giving formal convertibility on the current account. Moreover, exporters may retain proceeds in offshore or local foreign currency accounts. Earlier the BOI Act enabled the BOI to grant approved companies exemption from foreign exchange controls.

¹⁷ Given the widespread and sometimes indiscriminate grant of incentives currently, it is possible that the Budget revenue effect would be neutral or positive. An analysis of this kind is beyond the scope of this review.

The issue of shares to non-residents and subsequent remittance of dividends or repatriation of sales proceeds must be conducted through a Share Investment External Rupee Account (SIERA) opened in a commercial bank. This procedure has all the appearance of a control device to limit foreign currency repatriation to the amount of equity invested. However, it appears to be not an "account" but a record-keeping device. It is potentially misleading and should be removed as a central feature in describing foreign exchange arrangements for foreign investors.

A modern foreign exchange management law is being developed in consultation with the private sector to entrench current good practice. It is likely to propose the abolition of equity controls and further liberalization of debt controls. The main impediment to complete abolition of foreign exchange control in these reforms is a desire to restrain volatile foreign debt flows. As elsewhere in the region, memories of the Asian financial crisis are still fresh.

For investors, the complete abolition of exchange controls would be a very positive step. This would also boost Sri Lanka's chances of positioning itself as an international business hub in the region.

3. Labour regulation

The tenor of much of the labour law reflects a historical view that a strong role for government is needed to protect workers.¹⁸ Sri Lanka also has industrially active and politically influential trade unions. Trade union activities can be driven by political agendas and can be confrontational.¹⁹ In turn, some employers almost certainly have outdated views on labour relations. More modern management practice is to regard employees as a valuable asset to be nurtured and managed in a collaborative atmosphere. Interviews with employers conducted for this report found evidence of both approaches.

The relatively poor state of relationships between employers and organized labour is well illustrated by the BOI's efforts to keep its EPZs free of union activity in favour of workers' councils (see Box II.4).

Investors' principal interests in labour regulation are to have (a) impartial and speedy mechanisms for settling industrial grievances and disputes; (b) no undue regulatory impositions on labour costs; and (c) the ability to hire and fire employees as commercial needs dictate.

The Industrial Disputes Act includes comprehensive machinery for resolving industrial disputes. However, decisions are slow and many employers feel that the system and its administration favour the interests of employees.

¹⁸ This background has led to dozens of laws dealing with different aspects of labour practices. A pruning and unification of labour laws would certainly contribute to reducing red tape.

¹⁹ This potential is exacerbated by the fact that a mere seven employees can form a recognized union and there are an astonishing 1,600 registered unions.

Box II.4. Labour union rights to organize in EPZs

Employers are required to recognize and deal with trade unions where union membership is more than 40 per cent of the total workforce. The private sector has expressed dissatisfaction regarding the enactment of this provision without reciprocal guarantees from trade unions for responsible conduct.

The unionization rate in the country is approximately 25 per cent.

Under the law, workers in Sri Lanka's EPZs have the same rights to join unions as other workers. The rate of unionization in the EPZs is much lower than the national rate. Labour representatives allege that the BOI, which manages the EPZs, has discouraged union activity and restricts access by union organizers to the Zones. Instead of unions, EPZ enterprises have workers' councils, which only have the power to make recommendations. While employers in the EPZs generally offer higher wages and better working conditions than employers elsewhere, workers have other concerns, such as security, housing and sexual harassment.

Source: UNCTAD interviews

The Government, recognizing that delays are an impediment to business, has introduced recent legislative amendments to set deadlines for procedural matters and decisions. However, it remains to be seen if these have any practical effect. Imposing mandatory deadlines for government decisions is no substitute for implementing the required operational reforms.

With respect to labour costs, minimum wages exist for a wide range of industries and occupational levels. Statutory minimum wage rates (about \$25 to \$30 per month) appear to genuinely set the floor for wages, as actual wages paid tend to be considerably higher. (For example, manufacturing wages average about \$90 per month.) Real minimum wage levels have fallen in recent years.

Employers are required to contribute to two statutory employee welfare funds. Pensions are provided by the Employees' Provident Fund (EPF), to which both employers (12 per cent of wages) and employees (8 per cent) contribute. Employers' contributions are known (unlike with a defined benefit fund) and are not excessive by international standards. It is understood that at current yield the EPF can pay a pension of around 25 per cent of the final wage to men and 20 per cent to women.²⁰

Sri Lanka has also established an unusual vehicle, the Employees' Trust Fund (ETF). This is funded entirely by employer contributions (3 per cent of salary). Part of its original purpose was to fund employee share ownership. Its principal use is to provide a form of unemployment benefit for workers between jobs.

A very serious impediment for investors lies in the Termination of Employment of Workmen (Special Provisions) Act (TEWA) of 1971, as amended. Under TEWA, an employer cannot dismiss an employee, except for serious disciplinary infractions, unless there is prior written consent by the employee or prior written approval by the Labour Commissioner.

²⁰ Unofficial estimates supplied to UNCTAD.

In effect, an investor does not have the commercial freedom to reduce its workforce without the consent either of the affected employees or of the Labour Commissioner. Moreover, compensation for termination is determined on a case-by-case basis by the Labour Commissioner and includes consideration of the employer's capacity to pay.

The Labour Commissioner has absolute discretion to approve involuntary terminations and to determine the compensation payable. Any employer who acts in contravention of TEWA commits an offence and is liable to pay not only wages and benefits but penalties as well. The scope of TEWA is as follows:

- It applies to employers with 15 or more employees.
- It applies to employees who have completed one or more years of service.
- It does not apply to governmental or semi-governmental (federal and local) institutions or cooperative societies or to corporations wholly owned by the State.²¹
- It does not cover seasonal or short-term workers or most workers in agriculture. In practice, it does not cover workers under fixed-term contract, because an employee's signature of a contract of employment is deemed to be acceptance of dismissal at the conclusion of the contract.
- TEWA is estimated to cover 1 million out of a workforce of 7 million.

The Labour Commissioner's decisions can take a long time even though TEWA stipulates a maximum period of three months. Affected employees remain on the payroll until the decision is made. The decision is final and cannot be appealed.

TEWA creates two severe difficulties for investors:

- Uncertainty as to their ability to restructure their labour force in response to changed future market conditions or technological change. Employers estimate that at least 10 per cent of the current private-sector workforce continues to be employed because TEWA makes it impossible or too expensive to retrench them.
- Uncertainty, when planning their investments, as to the true cost of labour (a significant operating cost in most sectors), because restructuring and exit costs are unknown and may be very high. Moreover, there are usually substantial delays in obtaining the necessary government decisions.

Box II.5 illustrates straightforward business cases (a closure and an acquisition) in which investors were required to pay unusually large labour severance payments.

²¹ Parallel legislation applies to governmental institutions and state-owned enterprises.

Box II.5. Examples of labour severance payments

In 1997, when the Dutch airline KLM ceased flights to Colombo, seven employees complained about their termination. Although none had been employed for longer than two years, they were awarded compensation payments of between two and six months' salary. The highest payments went to two employees who had not found new employment. The awards appear to have invoked TEWA even though it does not legally apply to companies employing less than 15 staff members.

In the same year, Carson Airline Services, KLM's Sri Lankan agent, terminated 17 employees who had serviced KLM's local operations. These employees were awarded compensation of between eight months' salary (for those who had served less than two years) and five years' salary (for service of 19 years and over).

In 2000, Standard Chartered Bank had redundant staff after it acquired the Sri Lankan business of ANZ Grindlays. The ANZ Bank group had sold its operations throughout Asia to Standard Chartered. The compensation awarded averaged 85 months per employee. Several other foreign banks, including ABN-Amro, American Express and SocGen, have withdrawn from Sri Lanka, and it is believed that compensation awards averaged three months per year of service.

Source: ILO 2001.

Such practices harm the investment climate. They unnecessarily increase business risks and thus, by raising the rate of return required by investors, reduce the amount of investment committed to the economy and the number of jobs created. They add unnecessarily to the risks and worries of responsible investors. Their intrusive and arbitrary nature does not signal government commitment to an appropriately regulated business environment. They put Sri Lanka at a competitive disadvantage in attracting FDI, even in comparison with South Asian destinations (as is shown in Table II.1).

Table II.1 shows labour severance rules in neighbouring and regional competitors for FDI. All provide investors with certainty regarding the amount of compensation payable to redundant workers. These countries' norms for redundancy payment are all within the range of typical international practice. Sri Lanka provides no such certainty, and, as the examples in Box II.5 show, the payments mandated can be many multiples higher than is usual internationally.

Table II.1. Collective redundancies: statutory requirements

Country	Administrative authorization required?	Statutory redundancy payment per year of service
Sri Lanka	Yes, if over 15 employees.	Not fixed; case-by-case.
Bangladesh	No	30 days
India	Yes, if over 100 employees in enterprise. Not applicable to managerial or administrative employees.	15 days
Malaysia	No	10-20 days
Pakistan	Yes, if closing down or retrenching more than 50 per cent of workers.	20 days
Thailand	No	Approximately 30 days; capped at 180 days total.
Viet Nam	No	2 weeks

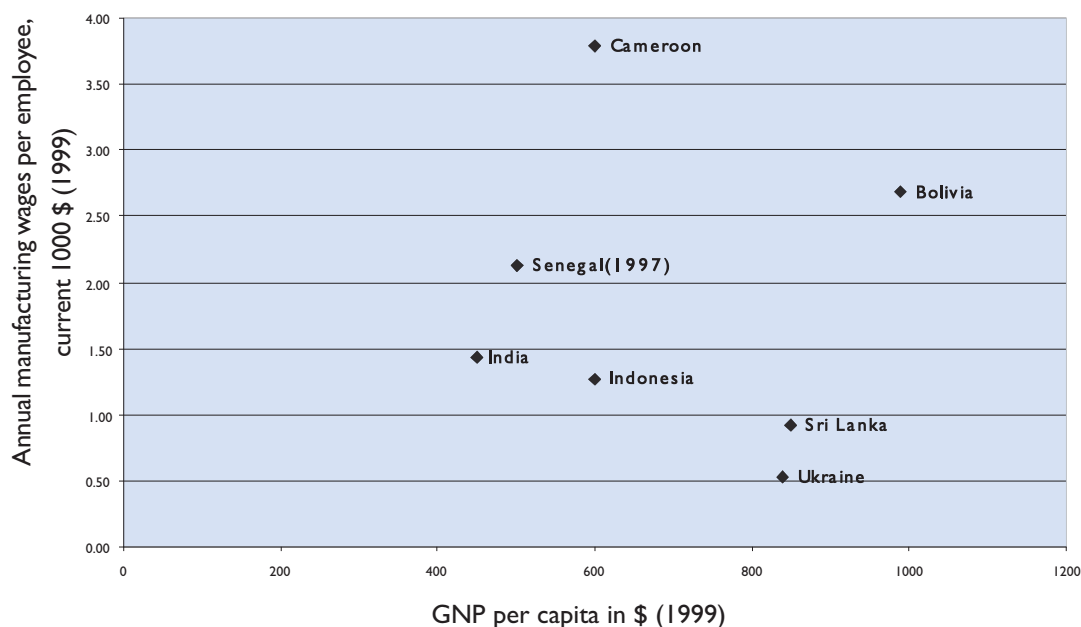
Sources: ILO 2000.

A trade union representative interviewed for this report suggested that wages in Sri Lanka are so low that business has factored the cost of the retrenchment package into the wage rate offer. Employers do not agree, but the claim may be true. Uncertainty about the ability to retrench and the size of the retrenchment package could result in pressure on the wage rate. Investors are liable to discount heavily for an unknown degree of risk. The system as currently structured might not be the best bargain for the workforce either.

Figure II.2 compares manufacturing wages in Sri Lanka with those of other countries with a per capita yearly GNP below \$1,000.²² A reasonable degree of correlation should be expected between manufacturing wage rates and GNP per capita. Sri Lanka's wage rate is unusually low in relation to GNP per capita. All the other countries²³ have fixed statutory rates of severance (generally 15 to 30 days' pay for a year of service). It is also interesting to note that government approval of retrenchment is not required in all the higher-wage countries depicted in the figure (Bolivia, Cameroon and Senegal), while it is required in comparatively low-wage countries such as India, Indonesia and Sri Lanka. The sample is small, and many other factors come into play, but this evidence certainly does not contradict the notion that the Sri Lankan labour market is adjusting for the unknowns of labour severance.

²² Comparable international wage data are scarce, which accounts for the relatively few observations.

²³ With the exception of Ukraine, for which information was not available.

Figure II.2. Manufacturing wages and GNP per capita (1999)

Sources: World Bank 2001 and UNIDO 2003.

The key provisions of TEWA must be changed if private investment is to play its full part in Sri Lanka's development. It is an inappropriate imposition on private investors to make their staff retrenchment decisions dependent on government approval. It is inappropriate for the Government to set severance payments on an unfettered case-by-case basis depending in part on a non-transparent assessment of capacity to pay.

There is evidence of exceptionally high severance awards to employees of well-known TNCs (see Box II.5). The labour authorities deny that the global financial condition of large TNCs is taken into account in determining their Sri Lankan affiliates' capacity to pay. However, it would not be human nature to disregard the international standing of major corporations. New foreign investors will assess that there is substantial risk of poor treatment. Higher awards for employees of foreign affiliates would, if proven, constitute a breach of Sri Lanka's national treatment obligations under its bilateral investment treaties.

Attempts have been made since at least 1978 to soften the impact of the severance provisions on business, but not to change their essential character. In 1978 a white paper proposed a universal severance pay formula unrelated to capacity to pay. Although generous by international standards, it failed because of union opposition. The most recent attempt (in 2002) succeeded only in setting time limits for making decisions. There have been other suggestions, including exemption of employers in Zones, exemption of new employers and a higher exemption ceiling on small enterprises. None of these approaches has addressed the central issues, and they would create inequities between workers and between investors.

It is recommended that the Government do not try to finesse this issue in keeping with past reform attempts. It should address the problems directly and in a manner that satisfies both investors' needs and the labour movement's concerns.

The labour movement (and possibly the community at large) values income security and, consciously or not, trades off greater income security for lower wage rates. This trade-off can be made explicit in such a way that the uncertainty discount is removed from wage setting. If there is such a social contract, its terms can be improved for all concerned.

Accordingly, a package of reforms such as the following is recommended:

- (i) The requirement for government approval of terminations should be revoked. Employers would be obliged to consult with the workforce prior to substantial lay-offs, in accordance with ILO conventions. Individuals dismissed for misconduct would have access to an appeals procedure but would be released in the interim.
- (ii) A standard minimum notice period (or payment in lieu of notice) and a severance payment formula should be established across industry. Severance payments should be based only on recent wages and length of service, not on the employer's assessed capacity to pay. Statutory notice periods could be at the long end of international practice and severance payments at the high end of international practice. Both of these could be tapered to give a greater cushion to lower-paid employees.
- (iii) Employers should contribute an amount equivalent to, say, 10 per cent of wages to a gratuity fund earmarked for employees and payable tax free upon involuntary separation or retirement. Funds set aside in this way protect employees' benefits even in cases where they are retrenched as a result of bankruptcy of their employer. The ETF could be expanded for this purpose. Alternatively, the scheme could be administered by the EPF, and the ETF abolished to reduce administrative costs to employers. Exempting the payment from tax would recognize the community interest in providing income security.
- (iv) The above should apply to establishments of any size, with some discretion for very small companies in relation to item (iii).
- (v) Restrictions on labour union rights to organize and be recognized in Zones should be removed.

4. Employment of foreigners

Sri Lanka's work and residence permit system for foreign employees is remarkably straightforward. This is competitively significant, because such a system can be a serious impediment to doing business in low-income countries.

The Department of Immigration and Emigration issues one-year renewable residence visas, which include authorization to work, upon recommendation of the relevant line ministry or the BOI (in the case of its clients). The sponsoring agency assesses whether hiring of a foreigner is justified by a lack of available qualified citizens. It recommends both that the position should be open for foreign hiring and the candidate for the position. The Department says that visas are approved on the day of application. Dependents are also issued residence visas, but without work authorization.

The Department acts on the recommendation of the BOI or line Ministries. Neither the Department nor the sponsoring agencies appear to have guidelines. Over the years, however, the BOI has formulated a policy that there should be a minimum investment of \$50,000. This is presumably to discourage economic migration. In fact, the BOI sponsors over 80 per cent of the holders of 7,500 residence visas for business on issue. Thus, as in many other aspects of investment regulation, the BOI is the policy front-runner.

There is also the Resident Guest Scheme, whereby a self-employed investor who invests \$200,000, or a foreign professional with exceptional skills needed in Sri Lanka, is granted a five-year resident visa.

One unusual feature of Sri Lanka's approach is that citizen-training obligations are not attached to the issue of residence visas containing work authorization. In principle, one-year visas are too short to inspire confidence in investors and are especially problematic for self-employed investors. Yet overall the business community finds the visa schemes entirely satisfactory.

These arrangements suggest that Sri Lanka is very confident that it has a pool of talented citizens from which investors will naturally draw, without the need for elaborate labour market testing or localization programmes. The example of Lanka Bell (in Box I.1), which rapidly localized its workforce and provides training, seems to confirm this.

Sri Lanka should build on the positive features of its work and residence permitting system and market them as highly attractive elements in its investment climate. Sri Lanka has the opportunity to differentiate itself as an investment destination from other low-income countries and indeed from competitors such as Malaysia and Thailand. This would combine neatly with the generally safe and hospitable living environment that Sri Lanka presents for foreign executives and professionals.

Policy developments could include:

- Increasing the residence visa term to three years, renewable;
- Providing work authorization for dependents under suitable guidelines;
- Retaining the procedure of agency sponsorship but developing categories of occupation and profession for which foreign hire will be sponsored on a routine basis; and
- Developing the Resident Guest Scheme into a green visa approach in which particular categories of skills are actively sought in employment and self-employment (only 38 Resident Guest Scheme visas were issued in 2002). Australia and Canada provide examples of such schemes.

Sri Lanka will undoubtedly need specialized skills to pioneer advanced manufacturing and services (e.g. financial services) and to develop into an international business hub. Its progressive system for foreigners' work and residence procedures can contribute to the achievement of these goals if the system is improved with modest regulatory amendments.

5. Land regulation

Investors should have access to clear, safe and marketable title to land. In a formal sense, much of Sri Lanka's land regulation fails this test, but practice has evolved to cope with investors' needs. The land system has gone through the full gamut of changes in political systems and fashions and has emerged with a marginally workable patchwork of practices. Investors and banks report no significant impediments in obtaining bankable title. A plus in Sri Lanka is that in general land title transfers do not require government approval. This step can be a major bottleneck in some countries.

The colonial power initially alienated much land for plantation agriculture. On land not used for plantations, leases were issued to small farmers or to regularize encroachment on unoccupied state land. As recently as the 1970s, swinging restrictions on private land ownership were put in place. The Land Reform Act (1972) placed ceilings on the size of private land holdings and empowered the Land Reform Commission to dispose of "excess" holdings. Plantations owned by public companies were nationalized. Plantation nationalization was then reversed in the 1990s as privatization of plantation lands on 50-year leases was inaugurated. Ceilings on agricultural land holdings still apply.

Approximately 80 per cent of land in Sri Lanka is now state owned and is either granted or leased for private use or vested in local authorities. The remaining land is in private hands and is governed by many distinct sets of personal laws, including Roman-Dutch law and customary law.

One constant in the cycles of change is the retention of strong powers of the Government to compulsorily acquire land for the purposes in current vogue. The Land Acquisition Act remains in place. It authorizes the Government to acquire land from private holders for any "deemed" public purpose. There is no right of appeal (except in relation to compensation), although an aggrieved party can seek judicial review of the administrative action taken. Compulsory land acquisition powers have been extended to statutory bodies:

- The BOI can compulsorily acquire land for any deemed public purpose. Moreover, the compensation for the unimproved land value is fixed as at the date of the inception of the BOI in 1978! The 2003 amendment to the BOI Act extends this power to the Regional Economic Development Commissions.
- The Tourism Development Council (TDC), under 2002 legislation (which is yet to be certified), is able to decide that land is necessary for a tourism project and may have it compulsorily acquired. The value for compensation excludes taking into account the possible use of the land for a tourism venture.

Sri Lanka's land acquisition powers are unduly wide and ill defined. Under international best practice, “public purpose” is normally understood to be for the provision of public infrastructure. In Sri Lanka, these powers have been used for economic policy purposes since colonial times – that is, for the governing authority to transfer land from one set of commercial uses to another it deems more suitable. This is a market function, and the Government should not intervene unless there is evidence of market failure. The breadth of the powers is a threat to investors' safe title. Moreover, the forced sellers of land do not obtain full market value with respect to BOI or TDC acquisitions; an element of confiscation is involved. It is not clear whether the excess value so derived is passed on to the new owners of the title or retained by the statutory bodies concerned.

It is understood that compulsory acquisition is not widespread and is not perceived as a threat to the investment climate. However, the extent of the power is inappropriate. Government intervention should be limited to the conventional meaning of public purpose.

A second constant in the history of land regulation is a lack of proper records and clear title, especially in rural areas. It appears that successive governments have lacked the capacity to issue adequate title. The current system of ascertaining the legality of tenure entails the cumbersome examination of a series of transactions spread over decades. The Registration of Title Act (1998) provides an appropriate legal framework. The challenge now is to devote sufficient resources to the enormous catch-up that is underway with World Bank assistance.

6. Corporate governance and the rule of law

Sri Lanka's commercial laws are comprehensive and based on English law. They are adequate for business, although company law is very detailed and rigid in its requirements. Some commentators lament the absence of bankruptcy provisions akin to Chapter 11 proceedings in the United States, which allow companies to seek court protection from creditors in order to facilitate corporate reorganization. There is no international consensus on exactly where to strike the balance between the interests of companies in distress and their creditors.

The sanctity of contract and the rule of law are generally accepted. Disputes can be taken to the courts, and the judiciary is independent in business matters. However, justice is slow. Investors report that court proceedings are fraught with injunctions, postponements and other delaying tactics. Thus, business generally prefers to avoid this route.

7. Competition regulation

Competition regulation is in a state of transition. In 2003 the Consumer Affairs Authority Act was introduced to consolidate previous legislation dealing separately with consumer protection, price controls, restrictive business practices and anti-monopoly controls. The Act streamlines procedures and provides for a professional administrative machinery.

The Act appears to have repealed the principal legislation for the control of monopolies, administered by the Fair Trade Commission, but without renewing these provisions in the new Act. Alleged abuses of market dominance can be referred to the new Consumer Affairs Authority. This means that the Government will not take an ex-ante view of whether a merger or acquisition will lead to undue market dominance. It will only react to abuses of market dominance. This new approach has been controversial. It is not necessarily the wrong approach, provided that the Government remains strongly committed to ensuring that market dominance does not lead to abuse or constitute a barrier to entry of new investors. The key requirement is to ensure that the administrative machinery is vigilant and responds professionally to complaints.

Recent governments have been less than fully committed to competition. Many privatizations have occurred under conditions of market exclusivity for a period following the sale. Restrictions on competition for limited periods are common in the privatizations of major utilities such as telecommunications (to attract strong bidders and to underpin network expansion obligations). Sri Lanka has offered these conditions more widely. For example, Caltex is reported to have been offered market exclusivity in the privatization of a lubricants facility.

Telecommunications regulations promote competition as an objective. By contrast, the policy on introducing private competition in the electricity sector is distinctly timid. As a further example, enterprises in Sri Lanka may not place their insurance abroad (although the ubiquitous BOI may arrange for companies with which it has agreements to be exempted from this restriction). Finally, the pending tourism law permits the Government to set minimum accommodation charges.

Thus there are instances in which the Government itself has promoted a non-competitive environment. It should itself initiate a review of these restrictive policies as an early task of the new Authority.

8. Intellectual property law

Sri Lanka is a founder member of the World Trade Organization (WTO), and the country's intellectual property rights (IPR) laws comply with its WTO obligations under the Agreement on Trade Related Intellectual Property Rights (TRIPS). Both process and product patents are recognized, and the patent period also complies with international standards.

Trade and service marks can be registered and renewed at specified intervals. Copyright protection is available, and the period of protection conforms to international standards. A recent legal amendment extends copyright protection to computer programmes. However, Sri Lanka is yet to join some conventions for the protection of rights in such as in the performing arts.

Enforcement of IPR is a different matter. The Government is not regarded as pro-active in enforcing IPR. It does act when Sri Lankan business interests are threatened and business draws its attention to problems. Copyright infringement, especially with regard to compact disks, is a problem area and draws frequent complaints. The production and import of counterfeit goods is growing but is not as prevalent as in other Asian jurisdictions. The Government is aware of these matters and is understood to be working on new regulations to increase IPR protection and improve enforcement.²⁴

9. Administrative issues

By the standards of low-income countries, and of other South Asian countries, Sri Lanka presents an adequate good-governance profile to private investors. Administrative practice is often better than the underlying regulation. Some corruption exists, but it is not systemic or a serious business impediment. A strong point is that the bureaucracy is accessible, most Ministry heads are well aware of good practice, and senior officials and Ministers are willing to be involved in troubleshooting investors' problems.

This accessibility has a downside: senior government officials are caught up in a facilitation role. This should be the function of designated facilitators such as the BOI. Ministers and senior officials should be resolving policy and structural issues in the investment framework. Their work should be informed by systematic monitoring of agency performance. Chapter III suggests that the BOI's facilitation reach should be extended and that it play a central role in red tape monitoring and whistle blowing as part of a strengthened advocacy function.

Investor interviews suggest that there are some areas of relatively poor governance. Revenue administration – both income tax and customs – was singled out. The BOI was created in part to provide an alternative solution to governance issues that seemed intractable at the time. However, it is not sufficient to provide a solution only for BOI clients. All private investors ought to be able to function in a climate of good governance. Chapter III discusses these issues further.

A second downside of accessibility is a perception in business of undue political involvement in operational matters. It is difficult to pinpoint how serious this problem is. However, one confidence-building step would be to rationalize the scope of powers and guidelines on appointments and dismissals of boards of statutory authorities. In many instances there are no guidelines for qualifications of the members. Members can be dismissed without assigning any reason. Ministers should be determining policy and relying on qualified and independent board members to carry out the policy.

²⁴ The new regulations were not available for review during the fieldwork for this report. Parliament recently passed a new law but is yet to establish the implementation regime.

In summary, the “good governance” aspects of Sri Lanka’s investment climate can be characterized as adequate and workable in relation to (rather low) regional standards. However, they are below the standards that would be expected of a country seeking to strongly promote itself as a regional business hub.

10. Selected sectoral regulation

Since 1990s, good progress has been made in modernizing sectoral law. The regulatory environment for investors in selected sectors is reviewed below. In addition, tourism regulation has recently been overhauled, although the new version is not finalized. The development of offshore financial services as foreshadowed in the new BOI Act will require greater regulatory and fiscal development.

1. Mining

Sri Lanka has a small minerals industry. The best-known product, semi-precious stones, accounts for only \$63 million of exports annually. The remaining industry produces industrial minerals, mostly for the local fertilizer, ceramics and cement industries. There seems to be some promise of increased production of rutile group minerals and phosphates.

Mineral sector regulation was overhauled in 1992 and provides a generally well-crafted framework with distinct regimes to meet the differing requirements of artisanal and large-scale mining. Large investors have clear and exclusive licence rights to explore and to mine and sell products. Investors' title rights are balanced by public-interest considerations of appropriate resource utilization and the usual environmental and other safeguards. The regulations explicitly accommodate investors' requirements to enter into development agreements to obtain contractual certainty of operation, and fiscal conditions so as to obtain finance.

Since 1997, large miners have been required to obtain special government authorization to export minerals. This is a backward step. It is an inappropriate intrusion on commercial freedoms and could too readily be misapplied. The requirement should be restricted to minerals whose export involves a clear public interest (e.g. the export of uranium if this were discovered in commercial quantities in Sri Lanka).

2. Telecommunication

Sri Lanka was an early mover among developing countries in telecommunications liberalization. In 1991 an independent telecommunications regulatory system was legislated. The Telecommunications Regulatory Commission was established in 1996. These developments paved the way for partial privatization in 1997 of the state operator (now known as Sri Lanka Telecom). A benefit of this early initiative is that Sri Lanka Telecom's exclusivity period for international services ended in August 2002. In February 2003, specialized international operators, known as External Gateway Operators (EGOs), were officially recognized and licensed. There are two additional fixed-access domestic operators and four mobile operators.

Sri Lanka's international call rates have declined substantially since privatization but need to fall further (rates are currently 21 cents/minute to the United States, Europe, Singapore and Japan) to promote Sri Lanka effectively as a business hub. The nimble EGOs will be handicapped in providing highly competitive inbound call rates by a high charge for local termination and by a network development charge to be levied by the Government to finance domestic network expansion and IT initiatives (quite apart from the \$50,000 EGO licence fee). Although these fixed charges will decline substantially over the following five years, they appear to be overgenerous to domestic operators and are an inappropriate levy on users (rather than the general taxpayer) to finance development goals. Mobile services also appear to be low quality in reception and customer services – in part, it is reported, because some operators have been insufficiently capitalized to maintain network capacity in the face of rapid demand.

Notwithstanding these issues, the telecommunications sector is well placed to become increasingly competitive and to reap the benefits of early liberalization.

3. Electricity

A comprehensive electricity reform law was adopted in 2002. This is the culmination of a lengthy change process in which state ownership of generation and transmission was corporatized under the Ceylon Electricity Board (CEB) in 1969, followed by the corporatization of distribution under the Lanka Electricity Company between 1983 and 1992. Opportunities for private investment in power generation were opened up in the 1990s. Nevertheless, the CEB is the dominant generator, although it has not been profitable since 1998. Sri Lanka experiences power shortages, forcing major users to install standby capacity. However, installed capacity is now rising quickly, including new private thermal plants. Industrial-user power costs are relatively high at around 7 to 7.5 cents/kilowatt hour.

The new sector regulations will unbundle generation, transmission and distribution in the now conventional format and mandate a new regulator, the Public Utilities Commission. The announced policy objectives²⁵ emphasize a commitment to ensuring competitive power supply consistent with economic cost and providing for private-sector participation. The reality is likely to be less bold in providing a central role for private investment. This is surprising in the light of the Government's own estimates that investment of around \$1.5 billion in generation and \$1 billion in transmission and distribution will be needed to meet demand in the current decade. The private sector will be excluded from investing in hydropower generation projects of over 50MW capacity and from transmission and distribution ownership.

²⁵ Ministry of Power and Energy 2002.

D. Conclusion

Sri Lanka's investment framework presents a clear picture of actions that should be taken at both ends of the spectrum of problems and opportunities.

At the **problems** end, resolution of the labour severance issue must be the major priority. Taxation should also be rationalized so as to provide competitive arrangements for all investors, including specially designed regimes for highly tax-sensitive activities. The scope of restrictions on FDI entry should continue to be reviewed, as they may no longer be compatible with Sri Lanka's objectives. At the **opportunities** end, the abolition of foreign exchange controls and the formalization of good practice in business immigration could become strong points in promoting Sri Lanka as an international business hub.

In the middle of this spectrum is a grey area of regulations where policy has not made a decisive break with the past. This includes sweeping powers of land acquisition and lingering elements of anti-competitive protection. The latter dilute some of the progress made in modernizing sectoral law. While administrative practice is much sounder than the statutory rules owing to sensible direction from senior levels, day-to-day administration (especially of revenue matters) still relies for many investors on a superior service or exemption provided by the BOI. This is not a satisfactory long-term solution for optimizing the regulatory framework, and it is important to note that a policy reform process is underway. This initiative is strongly endorsed by this report.

III. INVESTMENT STRATEGY AND THE ROLE OF THE BOARD OF INVESTMENT

Sri Lanka's goal to be the South Asian region's first-choice base for business operations is achievable if appropriate policy actions are taken. Success will ensure a significant increase in the quantity and quality of FDI attracted. Preferential trade access to India and possibly the United States will make Sri Lanka more attractive to international businesses. The country will, however, need to be pro-active by providing a superb investment climate (through regulatory and tax reforms) and more effective investment generation (through institutional reforms). The institutional reforms will include revitalizing the BOI to play a leading role in achieving the country's development objectives, which is the subject of this chapter.

A. Review

I. Background

The BOI, created in 1978 as the Greater Colombo Economic Commission, was entrusted with implementing the country's strategy on investment promotion. The new Government that came to power in 1977 wanted to promote private investment, particularly export-oriented manufacturing industries. Rather than change a host of policies and procedures that discouraged investment, the Commission was created as an expeditious means to relieve investors of onerous taxes, regulations and red tape. With such powers, and with direct access to the Prime Minister, the Commission came to play a central role both in the public sector and in the economy. The Commission's name was changed to the Board of Investment in 1992 as part of an effort to increase its effectiveness in attracting FDI.

The BOI is many organizations in one: an export processing zone and industrial park owner, developer and manager; a facilities developer; an FDI regulator and promoter; an investment facilitator; a regulator with respect to building, town planning, and environmental permits for its clients; a customs authority for its clients; and a fiscal incentives administrator. Recently, with the new BOI Act, it acquired a yet-to-be-fully-defined role as a regional economic development organization. Annex 2 outlines the current departmental structure of the BOI.

At the start of 2003, the BOI had a total of 1,303 staff positions in 15 departments. Half of the staff is dedicated to Export Processing Zone (EPZ) and industrial park (IP) operations across Sri Lanka. The balance is located at Head Office in Colombo. The annual budget is approximately \$14 million. There is probably no other investment promotion agency (IPA) in the world with so many functions, and few have more staff members.

Chapter I showed that Sri Lanka's performance in generating national private investment and attracting FDI has been poor even since the establishment of the BOI. What contribution, then, has the BOI made? Its key contribution is likely to have been the provision of an enabling environment for new larger investors – for example, it strongly supported the pioneering textile and garments industry. Almost all its activities listed above are enabling activities and are focused on larger investors. FDI in particular would have been lower without the BOI's presence.

But the BOI has probably been weak in two areas that are visible in the investment performance record. First, it has not been a strong attractor of FDI but has rather facilitated (and very well) those investors who prospected in Sri Lanka of their own initiative or that of local business partners. Second, it has not helped to improve the regulatory, tax and operating conditions of small- to medium-scale Sri Lankan investors. To an extent it may have even undermined the economy-wide improvements that are required by perpetuating a dual regime in which large investors obtained treatment far superior to that available to small and medium investors.

The Government has requested advice on the mandate and structure that the BOI should have in order to implement the objectives of *Regaining Sri Lanka*. This chapter will suggest measures to redress the current focus of the BOI in the light of:

- The regulatory reforms proposed in Chapter II;
- The interests of all investors, including smaller investors;
- The Government's investment policy objectives, including the BOI's strengthened decentralization mandate in the recently revised BOI Act;
- Sri Lanka's evident need to boost private investment, including FDI; and
- International experience in investment attraction and facilitation.

2. The Government's objectives in investment attraction and facilitation

The most recent statement of the Government's view of the objectives of the BOI is the revised BOI Act passed by Parliament in December 2002.²⁶ Its key features are set out in Box III. I.

²⁶ At the date of this report, the amended BOI Act had not been certified by the Speaker and accordingly had not come into effect.

Box III.1. Summary of BOI objectives

Objectives:

- To encourage, promote and facilitate investment throughout Sri Lanka.
- To formulate investment policies, plans, incentives and strategies to stimulate investment.
- To diversify foreign exchange sources and increase exports.
- To promote Sri Lanka as a regional business hub and provider of international financial services.
- To initiate training schemes to upgrade workers' skills.
- To "regulate, co-ordinate and monitor" the new regional commissions (see below).

The new regional commissions:

- Each of five regions (Western, Southern, North-East, Central, and North-West) is to have a Regional Economic Development Commission (REDC) with the mandate to promote investment and generate economic development.
- Each REDC is to be governed by a board consisting of a Chairman, a Director General (CEO) and three others.
- The REDCs are to have access to the "funds and resources" of the BOI.

Source: Amended BOI Act, December 2002.

The new BOI Act left intact the uniquely broad historical mandates and powers of the BOI with the exception of the right to grant bespoke fiscal incentives (known as the Section 17 power under the earlier Act). The latter was withdrawn, and only incentives in the general fiscal laws can be granted. Once the new Act is certified, the BOI will continue to screen applications for incentives under the general fiscal laws and enshrine them in agreements with investors.

The REDCs' operational powers parallel some of those long established at the BOI – namely, to develop and manage zones and other business infrastructure, and to compulsorily acquire land.

3. Choices in investment agencies

The Government has essentially two choices in the kind of investment agency it wants:

- A small, largely reactive agency that responds to investor queries but does not comprehensively promote the country or generate investment leads.
- A large, pro-active agency that aggressively markets the country, generates investor leads and assists investors through to start-up and beyond; also, one that assists local investors and stimulates their linkages with foreign investors.

Most countries have small and mainly reactive investment agencies, although all try to emphasize some level of active investment generation. The average staff size of investment agencies is only 29 (UNCTAD 2000).

The median investment agency employs 10 professional staff members and has an annual budget of under \$450,000. Emerging evidence is that small agencies are not particularly effective in enhancing FDI inflows. Their greatest impact comes from advocating better regulatory policies on behalf of both national and foreign investors (Morisset 2003).

On the other hand, a pro-active agency is large and not cheap. Model investment promotion agencies (including in Ireland, Malaysia, Singapore and Thailand) have staffs of 300–500 when regional and overseas offices are included. The Irish agency spends \$35 million yearly on promotion and overheads.

There are good – probably compelling – reasons for Sri Lanka to choose to have a pro-active investment agency. *Regaining Sri Lanka* requires reaching out far more effectively to three groups of investors:

- **Foreign investors:** Sri Lanka has fallen far behind in FDI attraction and needs to begin an aggressive catch-up. Keeping pace with other regional locations for FDI will be difficult enough. Malaysia, equal in population to Sri Lanka, already has a stock of FDI 20 times larger.
- **Small and medium-sized national investors who have hitherto been neglected by the BOI:** The political instinct to take the BOI to the regions is right, but a substantial institution is needed to deliver investor services.
- **The diaspora:** Peace and stability enable this resource to be tapped more effectively. Ireland's renaissance owes more than is realized to this source of FDI.

The recommendations developed below assume that the Government chooses to have a pro-active investment agency in keeping with model agencies in countries with notable success in attracting FDI.

Assuming the Government accepts the merit of a large, pro-active investment agency, the BOI is not currently structured so as to deliver the expected results. Its governing legislation gives the BOI too many functions, many of which are not central to the core mandate of a model pro-active investment agency. Some obfuscate the measure of its true performance in investment attraction. From this standpoint, the BOI is too large overall, too large in the "wrong" places and too small in the right places.

In keeping with international practice and the conclusions of the regulatory review in Chapter II, it is recommended that the BOI focus on four deliverables only:

1. Foreign investment attraction
2. Research, policy, planning and advocacy (P&P)
3. Regional services – facilitation of national investors
4. Regulation of FDI entry

These would be the *core functions of the BOI*. The following existing activities of the BOI would therefore be divested or fall away:

1. Development and management of Zones and industrial parks
2. Investor regulatory services
3. Granting and administering of fiscal incentives

The latter three would therefore constitute the *non-core functions of the BOI*. This is not to say that these activities are unimportant, only that they should be handled differently and not necessarily in the BOI.

The “new BOI”, strengthened as needed in its core functions, would require a total staff of around 250. This does not include regional services field staff or international representatives. This compares with the total existing establishment of 1,303 posts, of which about 1,100 are currently filled.

The first two core functions are currently under-developed and under-resourced. Taken together, they represent less than 5 per cent of the BOI's total staff. The proposals presented below would boost this staffing to one third of total headquarters personnel.

In contrast, the Zones/parks function and the investor regulatory services function are excessively developed and resourced. Together, they now account for two thirds of the BOI's total staff.

The budget required has not been estimated. However, it will need to come from the Treasury, as current internal revenues come principally from performing non-core functions. This is consistent with the approach in most countries, as investment promotion is considered a public good and is therefore a government activity funded by the Treasury. Some investment agencies try to supplement their revenues from other sources, but these are typically small and unreliable. For example, it is not wise to charge for facilitation services, as this would entail asking investors to pay one government agency to obtain an adequate level of service from other government agencies.

Each function is now reviewed to explain (i) why core functions should be retained and how they should be shaped, and (ii) why and how non-core functions should be dispensed with. Recommendations are divided into:

- *Policy recommendations*, which entail government decisions; and
- *Operational implications*, which entail BOI management actions.

Recommendations regarding the appropriate organization and staffing of core functions are guided by the practices of “model” investment agencies in other countries, especially those in Ireland, Malaysia, Singapore and Thailand. There is of course no one perfect model for an investment agency, and indeed these model agencies sometimes undergo restructuring themselves. Nevertheless, they do provide useful templates for Sri Lanka.

B. Core functions of the new BOI

I. Core function I: Foreign investment attraction

The current Promotion Department should be renamed, strengthened and reorganized in order to properly fulfil the very specific mandate of increasing FDI inflows.

Two **policy recommendations** are made:

- That attraction focus on *foreign investment*. Local investors will know more than a government agency about business opportunities at home. By contrast, foreign investors know far less about Sri Lanka, and there is a case for spending public funds to inform them of Sri Lanka's potential.
- That foreign investment attraction be confined for the time being to a head office activity. Generally speaking, investment attraction works more readily as a centralized function, provided that regions are fairly represented in investor marketing. On practical grounds as well, it is premature to provide for an attraction function in the field when it is not yet properly organized at the head office level. In due course, one or more regions may push for a direct attraction capability.

The key **operational implications** of reshaping foreign investment attraction are the following:

- The current Promotion Department should be renamed the Foreign Investment Attraction Department in order to emphasize that it should be engaged in a pro-active investor search. It should have a more aggressive and competitive corporate culture. *Investment promotion and attraction are expensive activities. They can be justified only if they bring to Sri Lanka a quantity and quality of FDI that would not come in their absence.*
- The new department would have three functions: (i) promotion – that is, image building or marketing the country as a site for investment; (ii) investment generation – developing and closing investment leads through targeting specific sectors and companies; and (iii) investor facilitation – services that assist the investor with information and necessary approvals through to start-up and during operations. Facilitation services should be integrated in one department so as to provide a seamless service to the investor. Large investors should have an account executive service.
- The department should be organized into three units:
 - Marketing and Communications
 - Investment Generation
 - International Support

- Staffing of the proposed department should be strengthened by adding 16 professional staffers to the current 14 professional and 19 support staff members. All additional staffers should be deployed in the Investment Generation Unit.

The **Marketing and Communications unit** (currently the Media and Public Relations unit) has several constituencies: prospective foreign investors; the local business community; and the BOI's own employees. Given this diverse audience, there is no uniform international practice as to where this function is located in an investment agency.²⁷ However, the marketing of Sri Lanka to foreign investors as a site for investment in the new era of peace should be the pre-eminent function. Accordingly the unit is best attached to the Foreign Investment Attraction Department.

The new unit must improve in-house capacity to work with economic and business data and to turn it into persuasive business-case messages intended for investors. The Research Department now provides data, but the new unit must take responsibility for ensuring that outputs are on message and on target. Thus, it is recommended that this unit have an additional four professional staff members: a senior Assistant Director responsible for the preparation of annual marketing strategies and the in-house development of internationally competitive messages and products; an analyst capable of manipulating business data and crafting messages for business audiences; an English writer familiar with the language of business; and, for the domestic audience, writers in the major national languages. It is not recommended that the marketing and communications function be outsourced to a marketing agency. Marketing Sri Lanka to business executives is different from marketing consumer products. The BOI should develop its dedicated in-house capacity. However, the cost effectiveness of outsourcing the latter two requirements could be examined.

The head of the unit should be a full member of the Senior Management Committee. The senior new appointee must be able to lead the design of a targeted and cost-effective *marketing strategy*. Generic investment promotion can be very expensive, but there are ways of delivering messages at reasonable cost.

The **Investment Generation unit** should provide the capacity found in model investment agencies to perform “investor targeting”. Targeting requires a group of industry specialists who can track industry trends, access sources of corporate intelligence, identify opportunities, and prepare and present the business case for investing in Sri Lanka. The same individuals, working with overseas representatives if available, can serve as “account executives”, building relationships with clients, encouraging their visiting Sri Lanka to see opportunities first hand, closing the deal, and assisting with implementation. A more junior “project officer” with the skills to assist with corporate research and provide facilitation services for new foreign investor clients should support each sector specialist. Strong facilitation capacity must continue to be offered by the BOI.

²⁷ Singapore's EDB has it as part of Administration. Thailand's BOI has its marketing division reporting directly to the Director General. Ireland's IDA has its marketing resources within its attraction unit and a separate Media and Public Relations group attached to the CEO's office. However, most IPAs locate the marketing and communications function in the Investment Promotion Department.

It appears that at present only the Bureau of Infrastructure Investment (BII) employs a full-time sector specialist. The BII should continue to operate. The legal and financial skills required to structure public-private finance partnerships are usually scarce in government, and a centre of expertise is needed.

A preliminary recommendation is that this unit requires additional 16 professional staff members, not including dedicated overseas representation. However, this is based on a contestable assumption that the current attraction priorities will remain. These are:

- A. The priority sectors currently identified by the BOI:
 1. Information and communication technologies
 2. Garments and accessories
 3. Manufacturing (excluding garments and accessories but including chemicals and pharmaceuticals)
 4. Agriculture and agro-industries
 5. Tourism and services
 6. Infrastructure (excluding telecommunications and hotels)
- B. The additional priorities specified in the new BOI Act:
 1. Offshore financial centre
 2. International business hub

Investor targeting is expensive and time consuming. It is possible that there are too many “priorities”. They appear to encompass most of the economy. Cost-effective investment attraction begins with a clear strategy setting out priorities, objectives and performance indicators. No such strategy currently exists, although the new BOI Act will require one.

Moreover, even if some sectors or activities are national priorities, it does not follow that the BOI should be the primary attraction agency. It is quite possible to dedicate other lead agencies to FDI attraction and facilitation in particular sectors or activities. As cases in point:

- Tourism investment could be handled by the Tourism Development Council.
- If the development of regional logistics (part of a business hub) and international financial services is a priority and is feasible, precedents suggest that these specialized activities are best promoted by dedicated agencies (a free port authority and an offshore financial services agency, respectively).

The **International Support unit** should help generate leads by organizing outward marketing missions and hosting inward missions, by responding to enquiries, and by supporting overseas representatives. It should also assist foreign clients wishing to establish operations in Sri Lanka. The BOI now has nine country/regional desks. These are the core of the existing Promotion Department, which is largely organized on a “country desk” basis. These positions should remain and should become attached to the International Support unit.

International representation is a particularly challenging issue and potentially a very expensive one. Should the BOI utilize established diplomatic/trade representatives or freelance representatives²⁸ as an extended sales force, or should it have dedicated overseas representatives? An overseas office can cost as much as \$300,000 to \$1,500,000 annually to operate. The model agencies all devote substantial resources to dedicated representative offices.²⁹

It is recommended that the BOI have dedicated overseas representation in key investment markets in due course. This is consistent with adopting a highly pro-active approach to investment generation. However, this should take place only when the following preconditions have been met: peace is sealed; the key regulatory reform – in labour – is completed; and the other elements of the Foreign Investment Attraction Department have been re-organized and strengthened as proposed. Dedicated representation in source countries is a long-term commitment and should only be entered into when Sri Lanka can market itself from the strongest possible position.

The recommended investment attraction strategy should identify the FDI source countries with greatest promise for Sri Lanka³⁰ and propose locations, budgets and operational matters relevant to these offices.

2. Core function 2: Research, policy, planning and advocacy

Currently this function involves mostly the in-house provision of marketing materials, research, statistics and reports, located in the Research Department and the Planning and Statistical units. A relatively small staff (representing 2 per cent of the BOI's employees) does these functions well. However, little policy advocacy is performed. Also, the strategic planning function has not gotten beyond a document that simply describes the roles of the various departments.

This function should be substantially strengthened and reoriented, especially to give the BOI new capacities in strategic planning, investment climate monitoring and policy advocacy. Why is it important to develop these new capacities?

(i) Strategic planning gives the Government the opportunity to decide what the nation's priorities and uses of public funds ought to be in promoting, attracting and facilitating investment. It enables the Government to decide what role should be played by dedicated agencies such as the BOI and the REDCs and by the line agencies, and it provides tools for monitoring their performance.

²⁸ Free-lance representatives can include professional consultants, retired home country ambassadors and retired or working business executives serving as "business ambassadors".

²⁹ Singapore's EDB has 17 overseas offices – 7 in the United States, 5 in the Asia/Pacific region and 5 in Europe. Thailand's BOI has 4 overseas offices (New York, Paris, Frankfurt and Tokyo), all within diplomatic and trade missions. Ireland's IDA has 14 overseas offices – 6 in the United States, 3 in Europe, 4 in Asia and 1 in Australia.

³⁰ This should include taking into account the location of the Sri Lankan diaspora.

(ii) Investment climate monitoring (hereafter termed “benchmarking”) provides timely information to the Government on where the nation's competitiveness profile is slipping in absolute terms and in relation to competitors. It highlights areas needing corrective action.

(iii) Policy advocacy, which is based on benchmarking results and other research, proposes policy actions to improve the investment climate. It is not a policy-making function but presses for policy actions in a constructive and persistent manner. Research evidence suggests that policy advocacy is one of the most important functions of an investment agency.

Following are the key **policy recommendations**:

- The BOI should submit an investment policy statement, an investment strategy and an operational plan for government approval. (This is already envisaged in the new BOI Act.)
- The BOI should continuously monitor the investment climate (policies, business costs and business regulation) and point out deficiencies in relation to best practices elsewhere. The BOI would advocate new policies but would not make new policies. In part its role is to be a thorn in the side of government when it spots poor policies or unhelpful bureaucracy.
- The above two activities should not be replicated in the regional offices of the BOI.

In short, the reoriented BOI should, on the one hand, be more accountable to the Government for its performance and, on the other, hold the Government more directly to account for failings in the investment climate. This would be a significant cultural change for the BOI, which since 1978 has been built to provide a haven for larger investors from poor regulatory policy and practice. In the future it should focus on contributing to an improved investment climate for all.

The main **operational implications** of strengthening and reorienting this function are the following:

- The current Research Department should be renamed the Research, Policy, Planning and Advocacy Department (P&P) to emphasize its expanded role.
- Given its limited staffing, the Research Department has produced an impressive array of industry sector reports, inputs into promotional products and policy papers. However, senior staff members require the support of a greater range of expertise when advising on policies, assessing the factors that make up Sri Lanka's investment climate, or supporting others within the corporation. The staff (presently 20) should be substantially augmented by 22, including six senior professionals (economists, lawyers, MBAs); six young graduates with supplementary skills; and 10 economic and business analysts.

3. Core function 3: Regional economic development

It could be argued that regional economic development has been part of the BOI's mandate throughout its 25-year history. The new BOI Act elevates it to an explicit core function and well beyond the current "land acquisition and provision" role played by the small Regional Development Department within the BOI.

The new Act provides for the creation of five REDCs. The REDCs have an important political mandate, and the scope of their powers is ultimately a political matter. The following recommendations are proposed from a technical standpoint.

Delivery of the regional economic development function does not equate with replication of all BOI functions at the regional level.³¹ "Decentralization", while very much the term used within the BOI, is not a particularly helpful one because it suggests that functions now performed at the Head Office will be relocated to regional offices. A more original perspective is needed in determining the nature of the BOI's presence outside Colombo.

It is recommended that none of the other three proposed core functions be replicated in the regions – that is, FDI attraction, policy and planning, and regulation of FDI entry. They are more efficiently handled as a centralized activity with *appropriate regional collaboration*. Moreover, neither the FDI attraction function nor the policy and planning function is operating optimally as a headquarters-level activity, let alone being currently viable as an REDC function.

It is acknowledged that in due course some regions may push for an FDI attraction function, especially if BOI headquarters is perceived as only weakly marketing the investment opportunities in a region.

The key **policy recommendation** is that the regional services function be the primary point of BOI interaction with national investors. Key activities should be:

- Facilitation of regulatory permitting;
- Facilitation of linkages with foreign investors; and
- Delivery of the training and skills development mandate set out in the new Act.

The main **operational implications** are that the BOI should create a new Regional Operations Department to provide these services, coordinate planning and support to the REDCs, and monitor programme implementation and performance. It will also need to ensure that individual regions' comparative attributes as investment locations are presented professionally and fairly to prospective new foreign investors.

³¹ The Chairman of one REDC believes that most BOI functions should be decentralized to the REDCs, which should have substantial autonomy.

The fundamental difference between this approach and current practice is that the BOI now provides these services only to (mostly) larger investors who qualify for fiscal incentives and to investors operating in BOI Zones and parks. “BOI companies” are looked after; smaller investors fend for themselves. The BOI undoubtedly has investor facilitation skills; these should now be offered to all investors and deployed mainly through the regional offices.

Both Thailand and Malaysia offer close-to-home experience with regional offices, their mandates and activities. Malaysia in particular has had success in promoting linkages between major investors and local suppliers.

Regional services should not extend to regulatory services or to the development of new zones, which (as is recommended below) should be regarded as non-core functions of the BOI.

The field staff needs of the Regional Operations Department have not been estimated. Two issues are outstanding. One is the scope of the regional services mandate, as discussed above. The other is that several government and non-government organizations (e.g. Chambers of Commerce) offer some level of facilitation and training help to national businesses in the regions. The size and strength of BOI services needed to add value to existing services needs to be much better understood. Based on international experience, additions to field staff could exceed 100.

At a minimum, the Colombo office of Regional Operations will require an estimated 21 positions: an Executive Director; three officers per region and five support staff. It will also require an explicit understanding between Regional Operations and other Head Office units, including P&P and those involved with Zones administration and services, regarding the division of responsibilities on matters of mutual interest.

It is important that the regional CEOs and the Executive Director for Regional Operations be appointed as quickly as possible. Otherwise, P&P will by default have to play an interim role in both the regions and the Head Office, as it is faced with the need to prepare foundation documents for Ministers, with the resulting need to disentangle roles and resources later.

4. Core function 4: Regulation of foreign investment entry

In Chapter II the **policy recommendation** was made that FDI entry should require prior approval only where it impinged on a limited “negative list” of restricted activities.

The major **operational implication** is that all proposed FDI need not be screened, as now, by the BOI to approve its entry into Sri Lanka. Only proposed joint ventures on the negative list would require approval. In principle, resources devoted to this function could be reduced. BOI responsibilities would also include coordinating related policy matters, such as adding activities to or removing them from the negative list.

It is difficult to pinpoint the reduction in staffing that could be entailed, as the Investment Department of the BOI considers applications for incentives and FDI approval jointly. Almost all foreign investors will seek incentives. Moreover, the Investment Department deals with both domestic and foreign investors and joint ventures.

The statistics show that in 2001, the BOI processed 474 applications of which 263 were approved under Section 17 of the BOI Act. Also that year, the BOI reached 149 agreements with investors, most of whom were domestic/local. By estimated value of the investments, over 80 per cent were by local investors. Preliminary numbers for 2002 are 299 approvals and 177 agreements, but with an almost 50–50 distribution between foreign and domestic investors, by value.

Staffing levels should decrease as activity under the incentives function is reduced.

It is not proposed to add or retain staff specifically to carry out FDI regulation. Unless experience in due course shows otherwise, it is expected that the proposed FDI Attraction Department can handle the (reduced) administrative burden of FDI approvals, while the strengthened P&P Department can handle the policy issues.

C. Non-core functions of the BOI

It is recommended that the following three activities of the BOI be designated as non-core functions and arrangements be made to dispense with them:

- EPZ and IP development and management
- Investor regulatory services
- Approval and monitoring of investment incentives

In this context, two important notes should be kept in mind.

First, these three functions currently absorb as much as 75 per cent of the BOI's total staff. The ensuing discussion includes estimates of the BOI staff reductions that would result from complete disposal of non-core functions. But reduction in BOI head count should not be the driving issue. Historically, the BOI developed a large staff to provide, in the short term, approved investors with a haven from poor treatment in the economy at large. The aim now is to provide a good investment climate for all investors and thus to make the remaining BOI functions redundant.

Second, all three functions are well established within the BOI. Many private-sector BOI clients value them. Some functions generate revenues for BOI operations. They have been a feature of the business landscape for 25 years. Time and careful planning will be needed to wind them down without damaging government relationships with larger investors.

I. Non-core function I: Development and management of Zones and industrial parks

The Zones' function is that of a landlord, involving the ownership, development and management of 12 EPZs and IPs. Today the 12 EPZs and IPs in various parts of Sri Lanka are a base for the employment of over 110,000 people in 260 enterprises. Each Zone has a full complement of on-site staff providing management, engineering, maintenance, monitoring (auditing), security and related services.

Zones offer investors a package of relatively high-quality infrastructure and services as compared to that available outside the Zones, and at below-market rates. How much below is unknown, but the rates are too low to permit cost recovery. The true financial picture of the Zones is not well known, but the majority operate at a loss. When capital costs are accounted for, all operate at a substantial loss. Most one-off capital costs are direct budget items, funded by the Treasury. The Zones generate revenues for the BOI, but they cost more to develop and to operate.

The responsible BOI department has a staff of approximately 525, not including regulatory services such as customs administration.

In principle, EPZs and IPs can have one or more of three rationales:

- Ease of administration of special fiscal regimes, especially duty-free materials for export processing
- Facilitation of competitive and readily available infrastructure and utilities when mainstream provision is weak
- Opportunities for developing industrial clusters

None of these functions obliges the *public* sector to develop and manage the facilities. BOI sponsorship may have been necessary historically. Today, if a sufficient number of tenants want to locate in a Zone, this should be judged a private-developer opportunity. Public services such as customs clearance can still be provided as part of a Zones package. Some export-manufacturing investors are now choosing to locate outside BOI Zones.

The only exception to this approach is a case where commercial developers find the risks to be too high and there are compelling regional development grounds for the public sector to be involved. Even such involvement can take the form of co-investment or public subsidy to a private developer.

Nearly one half of all BOI staff members are engaged in this function, which diverts management focus from the core functions that only the public sector can provide. Less than 10 per cent of investment agencies worldwide are involved in zone sponsorship.

Accordingly, the ***policy recommendations*** are to:

- Place a moratorium on BOI sponsorship of new Zones and parks (with the flexibility to consider exceptions as described above); and
- Divest the existing Zones and parks, requiring the BOI to prepare a divestiture plan in collaboration with PERC (which has experience and statutory responsibilities for state commercial asset divestiture).

Zones and parks should, to the extent feasible, be divested to private owners, which could include a consortia of tenants. Some soundings suggest that tenants would be interested, although they currently enjoy facilities at below-market cost. It is not recommended that the Zones and parks be handed to a special public authority. This would only result in renewed empire building. The focus should be on the exit of the public sector.

Finally, while disposal of Zones and parks by the BOI is desirable for the reasons given, it should not absorb an undue portion of BOI management's energy, given the other restructuring demands it will have. Zones and parks are functional parts of the investment regime and do not urgently need "fixing".

2. Non-core function 2: Investor regulatory services

The BOI provides customs clearance and a range of permitting services directly to its clients. A dual structure operates: the BOI is the administering authority for investors large enough to qualify for incentives or willing to operate in BOI Zones and parks; other investors deal with the line agencies.

The regulatory powers of the BOI with respect to its approved investors are:

- Customs clearance, including duty and VAT collection
- Building permits
- Foreign exchange control approvals
- Environmental permits
- Land acquisition

Regulatory services are delivered primarily by the Investor Services Department but also involve several other departments. The Investor Services Department has a staff of 245, including 106 at the Head Office and 139 based at the EPZs, the Container Verification Terminal at Orugodawatta and the Air Cargo Village Unit at Katunayake for airfreight cargo.

The BOI's regulatory services are reportedly much appreciated by its clients. Many prefer its regulatory services to dealing with line ministries and agencies. For example, Sri Lanka Customs is perceived to be adversarial and unable to offer the level of service that investors have come to expect. The BOI handles at least half of all customs clearances.

From the BOI's standpoint, there is no obvious reason to change. The BOI is widely regarded as a more efficient provider of regulatory services. Moreover, these services generate fees for the BOI.

From a national standpoint, the perspective is different. The BOI was created as a provider of regulatory services on the assumption that line agencies could not be relied on and adverse legislation could not be changed. This justification for dual administration of regulations has persisted ever since. That was the 1978 approach. The 2003 approach should be that all investors are entitled to efficient discharge of government functions. This matters because Sri Lanka wants to position itself as a competitive business hub. High-quality governance holds the key to achieving this. Investors should not have to apply and qualify for effective, timely government service.

The **policy recommendations** are that:

- The BOI's regulatory services be mainstreamed to the line agencies; and
- Mainstreaming only take place when the line agencies are capable of providing high-quality service.

Implementation of mainstreaming depends on the Government's actions rather than those of the BOI. The divestiture of BOI regulatory services is a natural consequence of the reforms. It should not be a question of forcing BOI clients to accept lower standards in the narrower interests of BOI restructuring.

Thus, the Government must lead this process and set the timetable. BOI relinquishment of regulatory services will follow. Then the BOI will assume its proper role of monitoring regulatory performance through benchmarking and investor surveys.

3. Non-core function 3: Granting of fiscal incentives

In Chapter II, an alternative approach was recommended for achieving competitive tax arrangements for investors. It would rely much less on case-by-case grant and monitoring of incentives through a BOI gateway. Rather, it would rely on more standard arrangements for sectors and activities that would automatically be available in the fiscal legislation to all investors. The recent revision of the BOI Act took a step in this direction by removing the BOI's powers to grant bespoke incentives.

The granting and monitoring of case-by-case incentives is, if done diligently, highly resource-intensive, especially if incentives change frequently. In addition to screening applications, the BOI's Investment Department currently works with the Legal Department to negotiate agreements that include the provision of fiscal incentives in exchange for performance commitments. It verifies or approves lists of any duty-free imports. It works with the Monitoring Department to check investor compliance with agreements.

Since there are 1,500 investors currently under BOI incentive regimes (including 326 new investors added in the last two years), it is highly unlikely that all are actively monitored by the existing 34 professional and I I support staff members dedicated to this activity.

Notwithstanding the proposed standardization of the fiscal regime, there will still be elements that could involve case-by-case confirmation that a particular regime will apply. For example, investors might want pre-investment assurance that duty relief will apply on specified capital imports. As far as possible, such assurances should in the future be obtained directly from the line agency concerned. The BOI's role should be to facilitate such confirmations. This role should be performed by the FDI Attraction Department or the Regional Operations Department as required.

Removal of the BOI's role as an incentives gateway will make its investment attraction and facilitation performance much more transparent. It will have fewer “walk-in” investors based on its ability to approve incentives.

There will still be a role for concluding investment agreements that stabilize fiscal terms. This activity – in a simplified and standardized format – could remain with the BOI, under suitable policy guidelines, where it is the designated lead agency in a sector. This should not prevent any other designated lead agency (e.g. in tourism or offshore financial services) from having a similar role in the relevant sector or activity.

Thus the **policy recommendations** are:

- The BOI should no longer have powers to approve fiscal incentives;
- Confirmation of applicable fiscal regimes and monitoring of investor adherence to investment conditions should in the future rest with the revenue agencies; and
- The BOI should continue to execute fiscal stability agreements on behalf of the State in sectors where it is the lead attraction or facilitation agency.

The **operational implications** are two-fold:

- Current staffing could be reduced to four professionals and seven support staff. These staff would handle residual issues arising from existing agreements.
- A BOI revenue source would be reduced. The BOI currently generates revenues through charging “agreement and processing fees” and “annual registration fees”.

D. Management recommendations and resources summary

The preceding recommendations entail a major restructuring of the BOI and a turnaround in its culture. Its FDI attraction function needs to be boosted and its performance judged on its merits. The BOI's role as a haven from, and an institutional beneficiary of, poor regulatory practice in the economy at large needs to be transformed into a position of leading advocate of reforms and whistleblower for all investors. The BOI also needs to reach out to smaller investors whom it has hitherto ignored in order to facilitate their business growth.

It is **recommended** that two new Deputy Director General (DDG) positions be created. One DDG should be responsible for the first two core functions (Attraction and P&P); the second for the new Regional Development Department, Corporate Services, and winding down the non-core functions. An Executive Director should manage each major function under a DDG.

This management recommendation is consistent with international best practice. In most model IPAs, the Director General or CEO is supported by two or more deputies. At Malaysia's MIDA there are two, as is the case with Ireland's IDA. Thailand's BOI has three Deputy Directors General. Singapore's EDB has one Deputy Managing Director and three Assistant Managing Directors reporting to the Managing Director.

The "new BOI", strengthened as needed in its core functions, would require a total staff of 250, including management and corporate services staff. This does not include regional services field staff or international representatives. In comparison, the total current establishment has 1,100 - 1,300 staff members.

Table III.1 below sets out the likely head-count implications of the proposals.

Table III.1. Staffing implications of the proposed restructuring

Function	Target	Staff Now		Staff Proposed		Staff Change	
		Prof.	Support	Prof.	Support	Prof.	Support
Core							
FDI attraction	Foreign investors	14	19	30	19	+ 16	-
Research, policy, planning & advocacy	Foreign and national investors	11	9	33	9	+ 22	-
Regional economic development HQ	National investors. Linkages	0	0	16	5	+ 16	+ 5
FDI regulation	Foreign investors	14	8	0	0	- 14	- 8
Management, professional and corporate services		108	140	56	72	- 52	- 68
Non-core							
Zones		166	653	0	0	- 166	- 653
Investor services		51	65	0	0	- 51	- 65
Fiscal incentives		34	11	6*	4*	- 28	- 7
TOTAL		398	905	141	109	- 257	- 796

* For monitoring of existing grants or incentives.

More details of proposed staffing levels for the Head Office consistent with the recommendations are provided in Annex 3.

The budget required has not been estimated. However, as with all model agencies, the budget will need to come from the Treasury. The BOI's current revenue-generating activities will largely wind down.

E. Implementation and timetable

The next step is to decide whether to proceed with BOI restructuring and associated regulatory changes. This requires government decisions on the policy recommendations made above, in tandem with a calculation of the budgetary implications. These policy recommendations are collected and summarized in Box III.2.

Box III.2. Summary of policy-level recommendations on the BOI

1. The goal: a pro-active investment agency with Treasury funding.
2. BOI functions to be divided into four core and three non-core deliverables.
3. FDI attraction to be a core function and to be boosted at the Head Office.
4. Research, policy, planning and advocacy (P&P) to be a core function, and to be expanded and strengthened.
5. The principal thrust of decentralization to be facilitation and other support of national investors, and this to be a core function.
6. Regulation of FDI and associated policy development to be the fourth core function.
7. FDI attraction, P&P and FDI regulation to be executed at headquarters only, with appropriate regional inputs.
8. The BOI's development and management of Zones and parks to be discontinued (apart from exceptional cases) and divested with PERC.
9. The BOI's regulatory services to be mainstreamed when line agencies complete improvement programmes.
10. The BOI's incentive-granting and -monitoring function to be wound down as the fiscal strategy changes.
11. Two Deputy Directors General to be appointed.

There are no international precedents to guide the implementation of the restructuring of an investment agency with the size and powers of Sri Lanka's BOI. There are many things to do and many interests are involved, not least those of current BOI clients.

At least one attempt has been made in the past to restructure the BOI, in particular an effort to mainstream its regulatory services functions. It is understood that this effort was abandoned owing to resistance by the BOI's clients. They feared poorer treatment at the hands of the line ministries and agencies. This time the focus must be on improving the performance of the mainstream agencies for all investors. BOI divestiture should follow as a natural consequence in due course.

Once a decision has been made to proceed, the following steps will be required:

1. Announce the changes in two statements addressed to different audiences:
 - To *foreign investors* that:
 - The BOI is being boosted to attract more FDI; and
 - The entry of FDI is being liberalized.
 - To *national investors* that:
 - The BOI is being tasked to help all investors and not just large companies and will locate services closer to investors in the regions;
 - The administration of business regulations, taxes and customs will be improved for all investors;
 - The BOI will cease on an orderly basis to administer regulations and will instead become a watchdog monitoring the performance of agencies; and
 - Taxation will be simplified and made more competitive to benefit all investors, not just BOI companies.
2. Appoint the two proposed DDGs in the BOI.
3. Convene a high-level government commission to improve and mainstream the administration of regulations, taxes and customs.
4. Require from the BOI by year's end:
 - A regional services blueprint and staff being mobilized to implement it;
 - A foreign investment strategy with targets set for attraction and staff on board to meet them (include recommendations on whether special agencies are best placed to mobilize investment in regional logistics and international financial services); and
 - A review of FDI entry restrictions and proposals to bring FDI regulation directly within the BOI Act.
5. Present to Parliament necessary amendments to the BOI Act to implement the above.
6. Immediately commission a review of the fiscal regime for investment, with results in 12 months. (The BOI should have input but not give major management attention to this review.)
7. Co-opt PERC to work with BOI management and clients on a plan to divest Zones and parks. (However, this should be lower priority for BOI management.)

Implementation of *core function* recommendations should be accomplished by the middle of 2005. Changes to *non-core functions* are more complex and will require detailed multi-year plans. An ambitious but reasonable target for complete implementation is an additional 18 months.

IV. SUMMARY OF FINDINGS AND RECOMMENDATIONS

Since independence in 1948, conditions have never permitted national or foreign private investment to flourish for sustained periods in Sri Lanka. The statistics show that Sri Lanka is still a very low-income country with an economic structure not far removed from that of the colonial era. Fortunately, the local skills base in both general education and business disciplines is much better than would be expected in a country with a per capita income of only \$800. There is a well-established national private sector. There are good grounds for believing that private investment will respond well to the prospects of greater stability and to reforms in the investment framework. Sri Lanka's ambition to be an international business hub is realizable if regulatory, tax and institutional reforms are made and Sri Lanka's strong points are developed and promoted well. Preferential trade access to India and possibly to the United States presents enormous opportunities.

Sri Lanka should aim high. There will be a substantial payoff in the size and quality of private investment to the first South Asian country to implement a vision of becoming the first-choice base for regional business operations. To be the first choice, Sri Lanka, a relatively small country, must deliver a superb investment climate and highly effective investment generation.

The immediate areas to tackle in implementing such a vision are the weak points in the regulatory and tax environment for private investment:

- (i) Over-regulation and unpredictable administration of labour severance. This is by far the most serious negative factor. A package of reforms is recommended. If fundamental reforms are not made, any ambition to be the first-choice regional business hub will have fallen at the first hurdle.
- (ii) A business taxation system that is not competitive for all investors and is insufficiently developed to cater to highly tax-sensitive activities. An overhaul of business taxation is recommended to correct this.
- (iii) Weaknesses in pro-competition policies, as manifested in sectoral and other legislation, and a protectionist (but liberalizing) stance in FDI policy. The new Consumer Affairs Authority should be tasked to investigate. All FDI entry restrictions should be re-examined.
- (iv) A continuing legacy of intrusive State powers in commercial matters (e.g. in land powers).
- (v) Provision of high-quality regulatory services through the BOI only for larger investors, in contrast to services available to small- and medium-scale investors from the line agencies.

Complementary steps will be needed to develop the strong points in the investment framework, which include:

- (i) Prospective full foreign exchange control liberalization.
- (ii) Confident attitudes to the entry of foreign skills, complementing an attractive living environment.
- (iii) A relatively low level of administrative corruption by regional standards. (However, the *status quo* will not suffice. A comprehensive good governance programme to lift Sri Lanka well above regional standards is required.)
- (iv) Modern regulation of many sectors and a track record of implementing privatization. (However, specialized regimes for important opportunities such as financial services, regional headquarters, regional logistics and attraction of diaspora investment have yet to be adequately developed.)

The report recommends reforms to reduce the weaknesses and to develop the strengths as promotional tools.

The BOI is a large and important organization in Sri Lanka's business world. Yet private investment performance has been weak. The BOI is a strong *facilitator* for its large investor clients. However, for reasons wholly explicable by its charter, it has weak capacity in two areas important for investment *generation*:

- a. *Investment attraction*: As the gateway for investment incentives, the BOI's transactional flow has been a captive market. Rationalization of business taxation, especially reductions in discretionary incentives, will require the BOI to generate investment leads on its merits.
- b. *Policy advocacy*: The BOI is naturally uninterested in contributing to an improved climate for all investors because its rationale has always been to provide superior services to selected investors.

A bold reorientation in these vital areas will entail a major change in the BOI's structure and culture. It is recommended that the BOI focus on four deliverables only:

- (i) *Foreign investment attraction* – promoting Sri Lanka and actively targeting foreign investors in areas of potential and economic significance.
- (ii) *Research, policy, planning and advocacy (P&P)* – helping to achieve the superb investment climate needed to make Sri Lanka a first-choice regional hub.
- (iii) *Regional services* – facilitating the operations of national investors and helping them to form linkages with foreign investors.
- (iv) *Regulation of FDI entry* consistent with national policy.

These would be the **core functions of the BOI**. The following existing activities of the BOI would therefore be divested or fall away:

- Development and management of zones and industrial parks
- Investor regulatory services
- Granting and administering of fiscal incentives

These three functions should be designated as **non-core functions of the BOI**. This is not to say that these activities are unimportant, but they should be divested by the BOI in an orderly manner consistent with its obligations to existing clients and the ability of mainstream agencies to improve their administrative performance.

The “new BOI”, strengthened as needed in its core functions, would require a total staff of 250 compared with the current staffing of about 1,300 positions. This is still a large agency but similar in size to the highly pro-active agencies that are models for Sri Lanka. This total does not include regional services field staff or international representatives. The budget required has not been estimated. However, as with all model agencies, it will need to come from the Treasury. The BOI's current revenue-generating activities will largely wind down.

ANNEX I: METHODOLOGY OF INTERNATIONAL TAX COMPARISONS

The Comparative Taxation Survey compares taxation on investment in several sectors in Sri Lanka with taxation in other selected countries – neighbours and countries elsewhere that have succeeded in attracting FDI to the sectors concerned. These comparisons enable Sri Lanka to assess the competitiveness of its taxation.

Taxation affects the cost of investment and its profitability, and thus the return on investment. This impact is not just a question of looking at the headline rate of tax on profits. The tax burden on the investor depends on a number of factors and their interaction, including expenses allowed, rates of capital allowances (tax depreciation), availability of tax credits, investment allowances and tax holidays, loss-carry-forward provisions and taxation of dividends, among other things. Moreover, customs and excise duties affect the cost of investment and operating margins. Together these make up the overall fiscal regime that affects the cost of and return on investment.

Comparative tax modelling is a method of taking into account the most important of these variables in the fiscal regime in a manner that facilitates comparison between countries. The tax variables included in the analysis are:

- Corporate income tax
- Rate of tax, including tax holidays, if any
- Loss-carry-forward provisions
- Capital allowances, investment allowances and investment credits
- Tax on dividends
- Customs import duties and excise duties on business inputs

Sales tax is not considered in the analysis because it is to be replaced by VAT. A correctly administered VAT falls on the consumer and is not a tax burden on business.

Financial models of project investment and financing, revenues and expenses are utilized for a hypothetical business in each sector. These are based on typical costs and revenues experienced in such businesses in a developing economy. The business models cover a selected business within each sector.

The fiscal regime in Sri Lanka and the chosen comparator countries for each sector is applied to the standard business model for each sector over 10 years beginning with the initial investment. The financial models calculate net cash flow to the investor assuming that the company pays out all residual profits after tax (100 per cent dividend pay-out) and that the investor gains the residual value of the company, which is sold after 10 years for an amount equal to its balance sheet value.

The impact of the fiscal regime is presented as the *Present value of tax (PV tax per cent)*. PV tax per cent is the total of taxes and duties collected by government over the 10 years as a percentage of the project cash flow pre-tax and post-finance, where both cash flows are discounted to a present value at a rate of 10 per cent yearly. PV tax per cent thus measures how much of an investor's potential project return is taken by the government in taxes and duties. The higher the PV tax per cent, the more the fiscal regime burdens investors and reduces the incentive to invest.

ANNEX 2: CURRENT BOI DEPARTMENTS AND FUNCTIONS

Department	Function
Promotion	<p>First point of contact for investors.</p> <p>Briefs inward missions.</p> <p>Assists in the preparation of the investor application.</p>
Bureau of Infrastructure Investment (BII)	<p>Promotes private-sector investment in Sri Lanka's infrastructure.</p> <p>Structures BOO and BOOT investments.</p>
Research	<p>Formulation of research to promote investment.</p> <p>Carries out research studies in relation to sectors, WTO-related issues, free trade agreements, investment protection agreements, double taxation agreements, etc., with a view to marketing Sri Lanka at large and to targeting sectors in particular.</p> <p>Preparation and dissemination of statistical and other information.</p>
Investment	<p>Evaluates and approves projects with the agreement of line ministries, if necessary.</p> <p>Issues letters of approval.</p> <p>Evaluates applications for fiscal incentives.</p> <p>Approves lists of any free imports.</p>
Investor Services	<p>Assists with all procedures relating to the import of construction material and equipment, as well as the installation of communication facilities.</p> <p>Provides ongoing assistance in customs procedures for the import of raw materials and export of the final product.</p>
Project Implementation	<p>Provides information relating to the availability of lands for projects.</p> <p>Functions as the secretariat for the Inter-Ministerial Advisory Board appointed to clear project-related bottlenecks.</p> <p>Facilitates the acquisition of infrastructure such as electricity and telephone lines for projects located outside the Zones.</p> <p>Facilitates approval and clearances required from outside agencies.</p>
Regional Development	<p>Availability of lands/acquisition of lands.</p>
Monitoring	<p>Ensures that implementation of projects conforms with terms and conditions stipulated in investment agreements.</p> <p>Issues reporting guidelines to enterprises; requests submission of quarterly and annual financial statements and employment statistics.</p>

ANNEX 2: CURRENT BOI DEPARTMENTS AND FUNCTIONS

Environment	<p>Conducts environment assessment of projects.</p> <p>Works with the Engineering Department to provide recommendations on the suitability of sites.</p> <p>Provides assistance in implementing environmental safeguards.</p> <p>Issues Environmental Protection Licences.</p>
Corporate Services (Personnel, HRD, Administration, IT, Finance)	<p>Provides human resource functions and training.</p> <p>Performs general administration functions including transport and supplies.</p> <p>Manages IT resources.</p> <p>Maintains systems of financial controls, internal controls, budgetary controls; collection of revenue; payments, etc.; maintains account books.</p>
Zones	<p>Develops and administers EPZs and Ips.</p>
Technical Services	<p>Grants site approvals.</p> <p>Provides basic infrastructure requirements to EPZs managed by BOI.</p> <p>Facilitates provision of water, power, telecommunications, wastewater treatment, access roads, etc.</p> <p>Approves factory building plans and monitors progress during the construction phase.</p>
Industrial Relations	<p>Advises and assists investors on matters relating to labour relations.</p> <p>Assists in the recruitment of staff at all levels, if required.</p>
Legal	<p>Reviews memoranda and articles of the company and joint venture agreements.</p> <p>Drafts main and supplementary agreements.</p> <p>Advises investors on general legal issues.</p>
Internal Audit	<p>Performs internal audits.</p>

ANNEX 3: PROPOSED BOI HEAD OFFICE DEPARTMENTS, STAFFING AND FUNCTIONS

Department	Number of Staff	Functions
Director General	13	Chairs Board of Directors CEO Chairs Implementation Council
Deputy DG FDI Attraction and P&P	5	Implements restructuring Oversees preparation of foundation documents Oversees attraction strategies General management and planning
Deputy DG Regional Operations/Corporate Services	5	Implements restructuring Chairs Corporate Planning Committee Oversees plans and performance of regional operations and offices
Foreign Investment Attraction	49	Attracts FDI and diaspora investment Marketing Investment generation Source country targeting Facilitation services FDI entry screening
Policy and Planning	42	Investment policy and international agreement advice Strategic planning and preparation of foundation documents Research, benchmarking, investor surveys Investment climate advocacy
Regional Operations Head Office	21	Plans and coordinates support to REDCs Cooperates with REDCs in preparation of annual regional investment planning Compiles regional inputs to foundation documents
Corporate and Professional Services (Legal, Monitor, Internal Audit, Finance, Personnel, Administration)	115	General administration Manages human, financial, IT resources Legal advice Monitoring Internal audit
Total Head Office Staff	250	

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