
RESEARCH ARTICLE

Determinants of foreign direct investment in Sri Lanka

S. D. Jayasekara

Central Bank of Sri Lanka, 30, Janadhipathi Mawatha, Colombo 1, Sri Lanka

Abstract: Sri Lanka is moving towards achieving a per capita income of US\$ 4,000 by 2016 and it has to maintain a growth rate around 8 per cent per year to realise the expected target. However, internal investment capability of the country is limited due to low domestic savings. Therefore, Sri Lanka has to rely on external finance such as foreign Direct Investment to achieve expected prosperity. This paper investigates the determinants of Foreign Direct Investment in Sri Lanka and evaluates the attractiveness of India, Sri Lanka, Bangladesh and Pakistan for foreign direct investment during the period of 1975-2012. Fully modified least squares (FM-OLS) regression model was fitted to estimate the determinants of foreign direct investment. Attractiveness of the selected countries for foreign direct investment was evaluated using an index. Empirical results revealed that GDP growth rate, inflation, infrastructure quality, lending interest rate, labour force, exchange rate, and corporate income tax were significant determinants of FDI in Sri Lanka during the period of 1975 -2012. Main feature of the variables which are determinants of FDI is that they are directly associated with the cost of production of the investors. Therefore, it can be interpreted that the main motive of the foreign investors in Sri Lanka is to reduce the cost of production by improving the efficiency of operations. FDI index suggests that India and Bangladesh were more attractive for FDI inflows over Sri Lanka and Pakistan. Market seeking investors are keen on the potential large market size of India and Bangladesh over Sri Lanka. Therefore, the motive of the investors is important in evaluating determinants of foreign direct investments in a country.

Keywords: Foreign Direct Investment, economic growth, inflation, lending interest rate, infrastructure quality, labour force, income tax

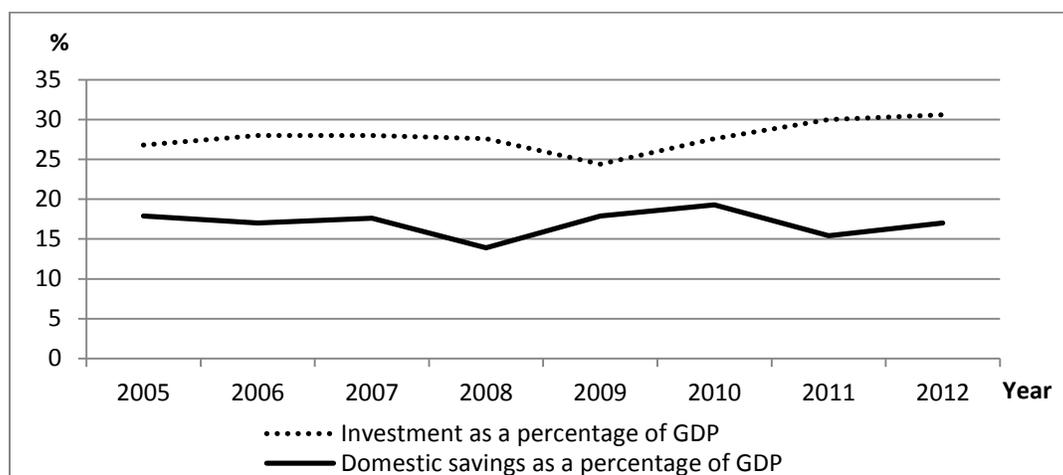
Introduction

Global volume of Foreign Direct Investment (FDI) has increased dramatically over the second half of the 20th century because of changing global economic and political environment. The aggregate net inflows of FDI of Sri Lanka have followed the global trend by increasing net inflows nearly by five times (US\$ 43 million in 1988; US\$ 201 million in 1999 (WDI, 2010)). Further, the growth rate of FDI flows has been accelerated with the beginning of the 21st century. In 2012, Sri Lanka has recorded its highest FDI inflow

of US\$ 1,338 million (Central Bank, 2012). The ending of prevailed civil war in the north and east of 30 years in 2009 has given a great opportunity for Sri Lanka to move forward as a fast growing country. However, internal investment capability of the country is limited as result of low rate of domestic savings and high cost of accessing global capital markets. Investment and savings positions of the country during the last eight years are shown in the Figure 1.

*Corresponding author: sisiradj@accmail.com

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Source: Central Bank of Sri Lanka, Annual Reports (2013)
 Figure 1. Investment and domestic savings of Sri Lanka

Maintaining at least 30% of investment to Gross Domestic Product (GDP) ratio is required to sustain an economic growth at around 8%. Sri Lanka has reached around 30 per cent by 2011(inclusive of the government investment). However, still Sri Lanka has to motivate FDI since the inflow of FDI is expected to improve efficiency and productivity in a developing country as a result of new technology, export expansion, employment opportunities and development of human capital. Further, FDI is very important and sensitive to a developing country as FDI flows contribute in building strong economic links between developed and developing countries. Having identified the importance of FDI, the governments offer various tax concessions and incentives to attract more FDI. Therefore, Sri Lanka has to motivate FDI inflows to achieve economic development goals. Empirical studies on the area of FDI are very broad. FDI inflows are determined by various political, social, economic and cultural factors. Sri Lanka shows a substantial increase in FDI inflows in recent years, however, it is relatively low compared to other Asian countries (ADB, 2011). Therefore, Sri Lanka needs to identify principal factors that determine FDI inflows or the factors, which are attractive for FDI inflows. Considering above facts, the main objective of this study was to investigate the determinants of foreign direct investment in Sri Lanka. In addition to the main objective, attractiveness of some selected countries in south Asian region for FDI was evaluated by using an FDI index.

Previous studies have viewed FDI in different perspectives such as FDI in respect of Multinational

Corporations (MNCs), home countries, and host countries. Analysis of the literature of FDI reveals that there isn't a single theory which explains the determinants of FDI, but a variety of theoretical models attempting to explain FDI and the location decisions. Subsequent to the Second World War, there have been some attempts to explain FDI in terms of the motives for international production. Macdougall (1960) used the concept of capital arbitrage in a perfectly competitive environment to explain the transfer of capital across borders. This Neoclassical trade theory, which explained international capital trade due to differences in returns on capital, was heavily criticized (Hymer, 1976) because of its assumption of perfect competition. Then, Hymer (1976) suggested that MNCs are oligopolistic firms that need to locate their production in various countries to compete against rivals. This became a landmark in the study of FDI and it explained ownership of specific assets using variables derived from the market failures to explain FDI. Theories of FDI developed extensively based on the foundation of Hymer's work. Since then, two groups of theories were developed based on the classification of Hymer's two variables. One group framed within location decisions of MNCs and the other group focused on internalisation process. Buckley and Casson (1976) and Rugman (1981) extended the Coasian theory of the firm to explain why and how the production decisions are made among MNCs. Buckley and Casson (1991) explained that market failure was more prevalent in an international framework and so MNCs organised an internal market to avoid excessive transaction costs (Williams, 1997).

Vernon (1966 and 1979) explained movement of production operations from one country to another in search of markets and lower cost production bases using product life cycle concept. However, Dunning's (1977, 1981 and 1993) eclectic paradigm framework was proved to be a better approach of explaining FDI. This is also known as the OLI framework. OLI framework combined ownership, location and internalisation advantages as determinants of FDI, which were previously discussed in separate theories. In brief, ownership advantage explains who will undertake FDI; location advantage explains where FDI flows to; and the internalisation advantage explains how the FDI flows or the mode in which international production will take place. Previous studies have identified four main reasons for MNCs to undertake international production activities –market seeking, resource seeking, efficiency seeking, and strategic asset seeking (UNCTAD, 1998; Mallampally and Sauvart, 1999; Dunning, 2000). The aim of this study is to identify the distinctive determinants in respect of a host country. Sri Lanka has shown a substantial increase in FDI inflows in recent years. However, it is relatively low compared to other Asian countries (ADB, 2011). Therefore, Sri Lanka needs to identify the principal factors that determine FDI inflows or the factors, which are attractive for FDI inflows. The following propositions are made based on previous studies for the purpose of identifying the determinants of FDI in Sri Lanka.

Proposition 1: High growth rate of potential market encourages FDI

Size of the host country market is a very important factor for potential investors. Previous studies have used GDP as a proxy to measure the market size of an economy (Janicki et al., 2004; Mohamed et al., 2010; Tsikata, 2000). Accordingly, GDP growth rate can be considered as the growth of market potential. A growing market would increase the prospects of market potential and a large market size would generate economies of scale (Bhattacharya et al., 1996). Further, having studied the contribution of inward FDI to China's recent rapid economic growth, Whalley and Xin (2009) suggested that the sustainability of both China's export and overall economic growth might be questionable if inward FDI plateaus in the future. Therefore, the economies that maintain a higher GDP growth rate are very attractive for foreign investors. GDP growth rate of Sri Lanka during last couple of years were around 7% to 8%. This is a good indicator of the market

potential for investors and, in return, it is very sensitive for FDI inflows since many previous studies have confirmed that FDI has a positive relationship with the GDP and GDP growth rate (Frenkel, 2004; Janicki et al., 2004; Mohamed et al., 2010; Tsikata, 2000).

Proposition 2: High rate of inflation discourages FDI
Inflation indicates some potential economic risks. High inflation discourages investments as a result of deteriorating real value of investment as well as return on investment. Frenkel (2004) having studied the bilateral FDI flows in emerging economies, found a strong negative relationship of FDI with inflation and this negative relationship has been confirmed in some other studies (Mohamed et al., 2010; Yang et al., 2000).

Proposition 3: High government consumption expenditure discourages FDI

Government capital expenditure is a good motivator for investors since it enhances the quality of the infrastructure of a country. However, high proportion of government expenditure in many developing countries comprises of consumption expenditure and in many instances, total government income is not sufficient to meet at least current expenditure. Therefore, high government consumption expenditure is assumed as an indicator of macro-economic instability. Negative fiscal impacts crowd out foreign investments and hamper the prospects of socio-economic development (Vadlamannati, 2008). Some studies have found that FDI has a negative relationship with government consumption expenditure (Mohamed et al., 2010; Yang et al., 2000).

Proposition 4: High interest rates discourage FDI

Today, many investors seek third party funds in addition to their own funds to invest in projects. Developed capital markets and sound financial systems encourage investors to leverage their risk exposures as a result of easy access to third party funds. Therefore, lending interest rates are very sensitive for foreign investors, high lending rates may increase the cost of capital of projects, and it discourages FDI inflows. A negative relationship of FDI with lending interest rates has been revealed in previous studies (Yang et al., 2000; Tsikata et al., 2000). However, Wei (2005), having studied the differences of FDI in India and China, found a positive relationship for India and a negative relationship for China.

Proposition 5: High trade volume of a country encourages FDI

Trade policies of a country is also important for FDI flows. Free trade policies and high trade openness of a country may motivate FDI inflows. Some studies have used total value of imports and exports to measure the trade volume of an economy. A significant positive relationship of FDI with international trade volume has been found in those studies (Bhavan et al., 2011; Asiedu, 2002; Yang et al., 2000; Gastanga et al., 1998).

Proposition 5a: Deficit in trade balance discourages FDI

In contrast to the trade volume, deficits in trade balance indicate some instability for investors. Long prevailed deficits discourage FDI.

Proposition 6: High rates of taxes on international trade discourage FDI

Taxes on international trade affects potential FDI flows due to the decrease of profitability of projects as a result of high tax rates on imports and exports. Therefore, FDI has a negative relationship with tax on international trade (Wei, 2005; Gastanga et al., 1998).

Proposition 7: Exchange rate stability encourages FDI

The stability of currency of a country is also an important factor for FDI. Continuous fluctuations of exchange rate denote instability of the currency of a country. Drake and Caves (1992) found the real exchange rate that influenced the Japanese share of foreign investment transactions in US manufacturing industry. Wihlborg (1978) suggested that, for a risk-averse firm, higher volatility lowered the certainty equivalent value of the investing firm. Hence, FDI decreased as exchange rate volatility increased. By contrast, Goldberg and Kolstad (1995) illustrated the importance of considering the post- FDI changes in the exposure of a firm's profits to exchange rate risk. If the investing firm could choose to serve foreign markets via exports or FDI, then an increase in exchange rate volatility might lead the firm to substitute FDI for exports, since FDI activity reduces the exposure of its profits to exchange rate risk. Lin et al. (2010) examined how exchange rate uncertainty influences the timing of FDI using firm-level data on Taiwanese firms' outward FDI into China over the period between 1987 and 2002. They concluded that exchange rate uncertainty tends to delay the FDI

activity of a market-seeking firm and, it may accelerate the FDI activity of an export-substituting firm if the degree of risk aversion of the firm is high enough. Therefore, the results reveal that the relationship between exchange rate uncertainty and FDI crucially depends on the motives of the investing firms. Lower exchange rate in the host country means higher purchasing power of investing country's currency in the host country.

Proposition 8: High quality of infrastructure encourages FDI

Quality of infrastructure is an important determinant of FDI when developing countries compete for FDI. The country that is best prepared to address infrastructure bottlenecks will secure a greater amount of FDI. Some studies show a positive impact of infrastructure facilities on FDI inflows (Wheeler and Mody, 1992; Asiedu, 2002; Mohamed et al., 2010). Different studies have used different variables as a proxy to measure Infrastructure quality as it is a broad concept to measure. Mohamed et al., (2010) have used the number of telephone lines per 1000 people to measure the infrastructure quality. A higher value implies greater productive efficiency and thus greater returns.

Proposition 9: High rates of corporate taxes discourage FDI

High rate of corporate taxes in host countries reduces the amount of return available for foreign investors. Some previous studies have hypothesised that higher taxes discourage FDI (De Mooij et al., 2003 and Blonigen, 2005). However, the effects of taxes on FDI can vary substantially by type of taxes, measurement of FDI activity, and tax treatment in the host and parent countries Blonigen (2005).

Proposition 10: High quality human capital encourages FDI

Labour force represents the human capital of a country. Wang et al. (2009) states that FDI drives technological progress only when there is a sufficient level of human capital in the host country. Noorbakhsh et al. (2001) empirically tested the hypothesis that the level of human capital in host countries may affect the geographical distribution of FDI. They found that human capital was a statistically significant determinant of FDI inflows and quality of human capital had some influence on FDI flows.

Proposition 11: Poor socio- economic conditions of a country discourage FDI

Population growth rate and literacy rate of labour force are used as proxies to measure socio- economic condition of the country. The literature shows strong support for the conjecture that redistributive social welfare state policies are valued by multinationals, because they signal a government’s commitment to social stability (Gorg et al., 2007). Vadlamannati et al. (2009) having studied the volatility of FDI in Southeast Asian countries found that poor socio-economic conditions (literacy rate and death rate) in those emerging economies hinder attracting FDI. Higher literacy rate means greater productivity, thus higher returns to investment.

According to the above review, there are number of factors which have been identified in a number of studies, theoretically and empirically, as determinants of FDI in a country. Bitzenis et al. (2009) stated the significance and magnitude of their impact on FDI could vary in terms of their national political, economic and legal cultures, traditions and infrastructures, together with the economic objectives and policies pursued by host governments.

Materials and methods

This study is primarily based on the country level secondary data for the period from 1975 to 2012. Fully modified least squares (FM-OLS) regression, which was originally designed in work by Phillips and Hansen (1990), is used for empirical analysis since it provides optimal estimates of cointegrating regressions. The method modifies least squares to account for serial correlation effects and for the endogeneity in the regressors those results from the existence of a cointegrating relationship. This method employs a semi-parametric correction to eliminate the problems caused by the long run correlation between the cointegrating equation and stochastic regressors innovations. Therefore, FM-OLS estimator is asymptotically unbiased and has fully efficient mixture of normal asymptotics allowing for standard Wald tests using asymptotic Chi-square statistical inference. The FM-OLS estimator employs preliminary estimates of the symmetric and one-sided long run covariance matrices of the residuals. Considering the above, equation (1) is fitted using FM-OLS model.

$$FDI = b_0 + b_1 GDP + b_2 INF + b_3 GCE + b_4 LIR + b_5 ITV + b_6 TRB + b_7 TIT + b_8 OEX + b_9 INQ + b_{10} LAF + b_{11} INT + b_{12} POG + b_{13} LRL + e \quad (1)$$

Table 1. Variables, Description, Measurement and Sources

Variable	Description	Measurement	Source
FDI	Inward foreign direct investment	Absolute values of FDI inflows in US\$	1
GDP	Growth rate of Gross Domestic Product	GDP growth rate = $(GDP_t / GDP_{t-1}) - 1$	2
INF	Inflation	Changes in consumer price index	2
GCE	Government consumption expenditure	General government final consumption expenditure as a percentage of GDP	2
LIR	Lending interest rate	Nominal lending interest rate	2
ITV	International trade volume	Sum of imports and exports as a percentage of GDP	2
TRB	Trade balance	Difference between exports and imports of goods and services as a percentage of GDP	2
TIT	Taxes on international trade	Taxes and duties on exports and imports as a percentage of total government tax revenue	2
OEX	Official exchange rate	Value of the United States dollars (US \$) in terms of Sri Lankan Rupees (LKR)	2
INQ	Infrastructure quality	The number of telephone lines per 100 people in the country (a proxy)	2
LAF	Labour force	The total population at the ages between 15 – 64 as a percentage of total population.	2
INT	Income tax	Corporate tax rate of the country	2
POG	Population growth rate	Population growth rate = $(Population_t / Population_{t-1}) - 1$	2
LRL	Literacy rate of labour force	Literate labour force as a percentage of the total labour force of the country	2
CON	Consumption	Final consumption of the country as a percentage of GDP	2

Sources: 1. UNCTAD Stat data base compiled by United Nations Conference on Trade and Development

2. World Development Indicators (WDI) data base compiled by the World Bank.

$$\text{FDI Index} = \sqrt{\delta^2(\text{GDP}) + \delta^2(\text{CON}) + \delta^2(\text{INF}) + \delta^2(\text{GCE}) + \delta^2(\text{LIR}) + \delta^2(\text{ITV}) + \delta^2(\text{TIT}) + \delta^2(\text{OEX})} \text{ --- (2)}$$

In addition, FDI index given in equation (2) is used to compare the attractiveness of selected south Asian countries for FDI. Proposed index is not similar to the two indices compiled by the UNCTAD for avoiding the comparison of the absolute values of FDI inflows into host countries. Even though the purpose of the proposed index and the two indices of UNCTAD is the same, the proposed index considers the macroeconomic stability view of a country, whereas the Inward Foreign direct investment Performance Index considers the market size of the host country and potential index considers the unweighted average of the normalized values of eight variables. According to the UNCTAD (2002), the

Results and Discussion

Summary of the sample statistics of the study is given in Table 2. Empirical results generated by equation (1) show a reasonable fit of the equation as given by R^2 . Accordingly, 91.06% of FDI inflows of Sri Lanka is explained by the selected independent variables. The Durbin –Watson statistic indicates that there is no first-order serial correlation. The results confirm six propositions out of twelve which were established for the study. The empirical results of the equation (1) are given in the Table 3.

GDP growth rate shows a positive significant relationship as hypothesised. Therefore, GDP growth rate is a good indicator of growing market potential as well as economic prosperity of a country. This hypothesis has been confirmed by some other studies in developing countries (Frenkel, 2004; Janicki et al., 2004; Mohamed et al., 2010; Tsikata, 2000). FDI does not hold the expected relationship with inflation. However, it reveals a significant positive relationship. High rate of inflation is an indicator of macro-economic instability of a country. Proposition 2 may be rejected due to the fact that many foreign investors are concentrated in export processing zones and they are not exposed to the local market. Hence, inflation is a motivator for FDI in Sri Lanka since it provides a competitive advantage to foreign investors over the domestic investors due to the disparity of cost structures. However, many previous studies have found significant negative relationship of FDI with the inflation (Frenkel, 2004; Yang et al., 2000; Mohamed et al., 2010). Proposition 3 is rejected since GCE does not hold the expected relationship. Fiscal

two indices are intended neither to provide a comprehensive model explaining the locational decisions of MNCs nor to measure the impact of FDI on host economies. Therefore, the proposed index will be very useful to measure the attractiveness of countries for FDI in terms of the stability aspects of a country. Attractiveness of foreign direct investment to Sri Lanka, India, Pakistan and Bangladesh was measured based on the proposed FDI index and the countries were ranked based on its value. It was concluded that a country was more attractive over the others when it had a lower value of the index. FDI index was calculated using equation (2). Description of data is given in Table 1.

imbalances generated by budget deficits may lead to macro-economic instabilities of the country and in return it will badly affect investors. Therefore, investors are reluctant to invest in countries where the economies are not stable. This has been confirmed by some other studies (Vadlamannati, 2008; Mohamed et al., 2010). The results confirm the Proposition 4. Relationship of FDI with lending interest rates shows a significant negative relationship. This is in line with the results of some previous studies (Wei, 2005; Yang et al., 2000; Tsikata et al., 2000). Therefore, availability of funds in domestic capital market is a pre-requirement for FDI inflows.

Propositions 5 and 5a are rejected since they do not hold the expected relationship. However, some previous studies have confirmed a positive significant relationship of FDI with international trade volume (Bhavan et al., 2011; Asiedu, 2002; Yang et al., 2000; Gastanga et al., 1998). Proposition 6 is rejected since it does not hold the expected relationship. However, previous studies in some other countries have confirmed a negative relationship (Wei, 2005; and Gastanga et al., 1998). Proposition 7 is accepted. Exchange rate stability is a major concern for investors. It affects the value of investment as well as the remittance of profits. However, previous studies have shown mixed results in respect of the relationship of FDI with official exchange rate. A positive relationship of FDI with official exchange rate was found in some studies (Gastanga et al., 1998; Yang et al., 2000; Drake and Caves, 1992; Lin et al., 2010). In contrast, some other studies found a negative relationship (Blonigen, 1995; Wei, 2005; Tsikata et al., 2000).

Table 2. Summary of sample statistics

Variable	Mean	Median	Std. Deviation	Min.	Max.
FDI	158.1	67.0	180.3	1.0	752.0
GDP	4.8	5.1	1.7	(1.5)	7.6
INF	10.8	10.7	5.7	1.2	26.1
GCE	10.6	9.9	2.4	7.4	17.6
LIR	15.6	16.2	3.2	9.5	20.2
ITV	70.6	73.5	10.4	48.9	88.6
TRB	(10.6)	(10.4)	4.0	(22.7)	(4.4)
TIT	16.2	15.2	4.2	10.9	26.0
OEX	52.4	43.8	34.5	7.0	114.9
INQ	3.1	0.8	4.5	0.3	17.0
INT	13.6	12.9	2.3	9.8	18.4
LAF	63.7	63.2	3.4	58.7	68.6
POG	1.2	1.2	0.4	0.4	1.9
LRL	89.9	90.6	1.6	86.7	90.8

Proposition 8 is accepted. Infrastructure quality helps to smooth supply chain management activities of investors. Quality facilities reduce the cost of investors and finally increase the return on investments. Therefore, high infrastructure quality is a good motivator for FDI and this has been confirmed by some previous studies (Bhavan et al., 2011; Bitzenis et al., 2009).

Proposition 9 is rejected since it does not hold the expected negative relationship. But it shows a statistically significant positive relationship. This is mainly due to the benefits realised by the foreign investors as a result of various tax concessions which are not available for local investors. Therefore, high corporate tax rates are incentives for foreign investors when tax concessions are available to them. However, in tax neutral situations, taxes discourage FDI (De Mooij et al., 2003; Blonigen, 2005). However, the effects of taxes on FDI can vary substantially by type of taxes, measurement of FDI activity, and tax treatment in the host and parent countries Blonigen (2005). Proposition 10 and 11 are accepted as they hold the expected relationship. Labour force of the country is trainable and the

Table 3. Empirical results of equation (1)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Intercept	-6261.111	1015.461	4.765135	0.0001*
GDP	14.07109	2.952925	4.765135	0.0001*
INF	3.568392	1.110304	3.213888	0.0044*
GCE	-7.970913	5.404093	-1.474977	0.1558
LIR	-7.276845	6.878425	1.606739	0.1238
ITV	0.959199	0.946376	1.013550	0.3229
TRB	-0.789042	1.508971	-0.522901	0.6068
TIT	-1.729021	4.715178	-0.366693	0.7177
OEX	-10.32521	1.560575	-6.616287	0.0000*
INQ	34.06136	4.903220	6.946733	0.0000*
INT	43.27238	7.522286	5.752557	0.0000*
LAF	83.19266	15.45110	5.384256	0.0000*
POG	77.39429	34.70754	2.229899	0.0374**
LRL	11.05183	6.878425	1.606739	0.1238

R² 0.910691: Durbin-Watson Stat 2.185539
 *Significant at 1 % level, ** Significant at 5% Level

efficiency of it can be improved due to the high literacy rate. Further, growth rate of the population is par with some developed countries. Therefore, better socio economic environment motivates foreign investors. Results of FDI index is useful to measure the attractiveness of countries for FDI since it shows the stability of a country based on the factors considered for the index. Results of the FDI index for the selected countries in South Asian region are shown in Table 4. According to Table 4, India shows the lowest score of the index indicating a high level of attractiveness over the other countries. It follows Bangladesh, Sri Lanka and Pakistan, respectively. This result justifies current inflow of FDI in south Asian countries. Low value of FDI index reflects the low variability of factors, i.e., it measures the economic stability of a country based on the variables considered for the index. India shows a high stability over the other countries attracting more FDI as a result of the stability. However, FDI is determined by the various economic, social, legal, cultural and political factors. Therefore, the usefulness of FDI index can be enhanced by using wide range of variables to develop an index for the purpose of measuring attractiveness of countries for FDI.

Table 4. Results of the FDI index

Country	Value of FDI index	Rank
India	21.51	1
Bangladesh	22.38	2
Sri Lanka	37.32	3
Pakistan	43.88	4

Conclusion

The primary objective of the study was to investigate the determinants of foreign direct investment in Sri Lanka and the secondary objective was to evaluate attractiveness of some selected countries in south Asian region for FDI. Fully modified least squares regression model was used to achieve the main objective of the study and the proposed FDI index was used to evaluate the attractiveness of countries for FDI. The results suggest that GDP growth rate, government expenditure, lending interest rate, trade balance, and corporate income tax were significant determinants of FDI in Sri Lanka during the period of 1975 -2012. Empirical results revealed statistically significant positive relationship of FDI with GDP growth rate, inflation, infrastructure quality income tax, labour force, lending interest rate, official exchange rate, and population growth rate, GDP growth rate was used as a proxy to measure market potential. Therefore, FDI in Sri Lanka is focussed on the domestic market in addition to highly export-oriented investments. Availability of domestic fund at an affordable interest rate is a motivator to attract more FDI to the country. Tax concessions and benefits had motivated FDI flows in Sri Lanka during the period of study. Foreign investors do not expect tax neutrality in a host country and they expect more benefits over the domestic investors.

FDI showed a statistically significant negative relationship with lending interest rates and official exchange rate. This shows the interest of foreign investors on the local capital market and currency stability of the economy. Further, currency stability is a major concern since it affects the value of investments and return on investments According to the findings, it can be concluded that the main motive of foreign investors in Sri Lanka is to improve the efficiency.

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