Pathfinder Economic Flash

The Strategic Development Act: Is it a Success or Should it be Reviewed?

All governments have attached high priority to Foreign Direct Investment (FDI) since the 1970s. It is important to understand why this has been the case and pose the question whether the Strategic Development Act (SDA) contributes to creating an investor friendly environment.

Development is a multidimensional process involving economic, political and structural factors. However, enhancing productivity through increased and improved investment is an extremely integral part of this process. It is increased productivity that enables sustained non-inflationary rises in incomes which are fundamental for increasing prosperity.

Why we Need FDI?

Investment can be increased to achieve a higher growth trajectory by raising domestic savings through squeezing consumption or attracting foreign savings in the form of FDI, foreign portfolio investment and/or external commercial borrowing. Squeezing domestic consumption has an adverse impact on the quality of life of the people. Of the external sources of savings, FDI is superior as it is usually associated with access to new markets, technology and management skills. Furthermore, outflows are paid out of profits. In the case of external borrowing repayments have to be effected whether or not profits are earned. Foreign borrowings are also constrained by considerations related to credit worthiness (i.e. the capacity to repay) which are determinants of terms and conditions of such borrowing.

Given the clear benefits of FDI, it is not surprising that almost all countries around the world attach high priority to attracting such inflows. All the success stories of East and Southeast Asia (e.g. Japan, South Korea, China, Taiwan, Singapore, Hong Kong, Malaysia, Thailand, Indonesia and Vietnam) have benefited from large FDI inflows which have accelerated their development process. Such flows have generated employment opportunities; contributed to raising incomes; upgraded technology; improved marketing/branding; and led to more sophisticated management.

Domestic Political Consensus on Promoting FDI

It is not surprising therefore, that Sri Lanka has also attached high priority to attracting FDI from the 1970s. Some of the earliest foreign investments included Noritake and Cyntex (Mitsui) took place at that time. However, the push for FDI came too late in that political cycle to create a conducive environment for the reforms that were necessary (there is a time lag between the pain and gains associated with such structural reforms).

The change of government, in 1977, saw a strong emphasis being placed on attracting FDI from the very beginning of the new political cycle. The Greater Colombo Economic Commission (GCEC) was established as a supra agency with considerable powers. The first Free Trade Zone (FTZ) was established in Katunayake. The GCEC had overriding authority over certain other government agencies in the FTZs, including the Inland Revenue Department and Customs. At this time, there was a sharp increase in FDI, particularly in the apparel sector, which was driven by the quota system established under the Multi-Fiber Agreement which was in existence then.

An Opportunity Squandered.

However, Sri Lanka was not able to reap the full benefits of the FDI – friendly dispensation created by the GCEC Act due to the escalating ethnic conflict. In fact, Sri Lanka lost a massive opportunity. Following the sharp appreciation of the Yen as a consequence of the G7 Plaza and Louvre Accords, Japan initiated a strategy to export capital to take advantage of their strong currency and to mitigate the protectionist pressures that were being generated by Japanese export successes in the US and Europe (their main markets). The objective was for Japanese companies to export to these markets from other Asian destinations. Indonesia, Malaysia, Sri Lanka and Thailand were identified as the four countries where Japanese FDI would create new export capacity. Sadly, a major Japanese business delegation was in Colombo at the time of the 1983 communal disturbances and Sri Lanka lost this enormous opportunity. The other three countries achieved a transformative leap forward in their development processes during the 1980s. Japanese FDI was a major contributor to these successes.

As time went on, the GCEC metamorphosed into the Board of Investment (BoI). Sri Lanka fell into line with many other countries by making one agency responsible for foreign investment both within the FTZs and outside them. This meant that the Foreign Investment Advisory Committee (FIAC) which had been responsible for foreign FDI outside the FTZs was merged with the GCEC. This single agency continued to enjoy considerable powers over the policies and processes connected with foreign investment within and outside the FTZs. However, the persistence of the conflict for over 25 years meant that Sri Lanka had a poor record in relation to attracting FDI. Though successive governments continued to attach high priority to FDI, the concessions they offered and the relatively streamlined processes could not offset the war-risk premium attached to the Sri Lankan economy during the conflict period.

Are we Squandering Another Opportunity?

The end of the war has transformed the business climate. However, it is disappointing that at the very time when the prospects for attracting FDI have improved significantly, Controversial Supreme Court activism partly triggered the legislative changes resulting in the SDA. These were well intentioned and designed to offer greater protection to Ministers and officials responsible for large-scale FDI projects. At the same time, it should also be recognized that the BOI had become increasingly ineffective in providing a one-stop-shop service to foreign investors. It also lacked the capacity to drive through the mega projects that became possible in post-war Sri Lanka. While there were serious issues regarding the effectiveness of the BOI, an unintended consequence of the new legislation was a reduction in the investor friendliness of the overall framework.

The SDA provides for obtaining Parliamentary Approval for investments effected under it. The upshot has been that large-scale foreign investments which have the potential to have a transformative impact on the Sri Lankan economy in terms of employment, incomes, tax revenue, technology transfer, export markets and management skills have now been dragged into the vortex of adversarial party politics in Sri Lanka which is driven almost entirely by short-term expedience. It is difficult to think of any other country where individual projects are subject to Parliamentary Approval as a matter of course- however large their size. Parliamentary scrutiny of government policies is at the very heart of any democratic system. However, scrutiny of individual projects in the context of highly adversarial politics creates a dynamic which is extremely inimical to investor confidence. It can give undue exposure to commercially sensitive information. It also transgresses some basic principles related to long-term stability which are essential for a business climate that is conducive for large-scale foreign investment crucial for Sri Lanka’s development. At some point soon, Sri Lanka will have to reduce its dependence on foreign commercial borrowing and perform much better in terms of FDI. It is extremely disappointing that five years after the end of the war FDI flows, in 2013, were still below $1 billion (excluding foreign loans).

The Way Forward

It has been argued above that FDI played a crucial role in the development successes of East and Southeast Asia. Sri Lanka fell behind on this front due to lost opportunities as a result of the war. Today, the country is in danger of squandering new opportunities due to a legislative framework (SDA) which was a triggered by Controversial judicial activism. The time has now come to initiate a review of the SDA. A discussion needs to be had regarding the balancing of the compulsions of the need for transparency with the dynamics associated with an investor friendly business climate. The private sector has to be brave enough to play a major role in this discourse.

It is important to recall that the GCEC was established as a supra agency under the Executive President as the Government apparatus existing at that time was not able to deliver the expected results. Both domestic and foreign investors perceive the current situation as being as bad, or even worse, in this regard. Priority should therefore, be attached to creating an apex institutional structure that is ‘fit for purpose’ under the purview of the highest authority in the land. In designing the new structure, it is important to recognize that neither the GCEC nor the BOI was able to deliver an effective one-stop-shop for foreign investors. The annual reports of this agency should be subject to the normal oversight processes to introduce accountability into the process.

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