Honoured Member of Parliament / Minister,

_The way forward for the Proposed Colombo Port City Economic Commission Bill_

The Advocata Institute wishes to make the following observations on the proposed Port City Economic Commission Bill (the "Bill"). The Bill in its present state has weaknesses that must be addressed in order to maximise economic opportunities and outcomes. We would like to emphasize that the Port City could form an important step forward for the country but to be successful it must address the shortcomings highlighted below. We call upon all parliamentarians from all parties to work together to address these issues.

I. **A Case for Special Economic Zones in Sri Lanka**

1.1 Special Economic Zones (SEZs) are a tried and tested means of bringing in positive value addition to an economy. They also have the potential to accelerate economic growth. This is best reflected in how SEZs such as Shenzhen in China, the Dubai International Financial Centre and Luban IBFC in Malaysia have grown into booming global financial, manufacturing and technological hubs. If implemented with the right policies and a globally accepted regulatory framework, the Colombo Port City is capable of achieving such outcomes.

1.2 According to our analysis SEZs benefit an economy by acting as:

   a) A magnet to attract Foreign Direct Investment.
   b) A laboratory of experimentation to achieve a particular objective and then scale it up.
   c) A catalyst for structural transformations and ultimately diversify the local economy.
   d) A regional pressure valve to increase employment in disadvantaged areas.

1.3 However, the success of an SEZ can only be determined by evaluating the linkages generated within the local economy. In other words, they can only be considered a successful policy tool if they encourage technology spillovers or knowledge diffusion that enable the local economy to acquire new productive capabilities. Following this rationale the Colombo Port City must be
developed as a stepping stone to enhancing productivity, upgrading industrialization, and achieving export diversification.

1.4 The productive capabilities of SEZs lie in how they allow governments to provide all the conditions necessary to attract investment within a limited budget. In their ideal form, SEZs are places that have all the facilities that firms need to thrive. Since each industry needs many complementary (public) assets to succeed, SEZs can play an important role in creating the right conditions for industrial success. This might include suitable land plots, hard infrastructure, and site-specific policies or clearances. Moreover, firms in SEZs can benefit from each other’s proximity – they can be each other’s suppliers and customers – thereby making a strong case for Sri Lanka to utilise SEZs to achieve economic growth.

1.5 Given the thicket of red tape in Sri Lanka, in order to become truly effective SEZs require a degree of plenipotentiary powers. Following the literal rule of interpretation, plenipotentiary powers can be defined as “someone who is fully authorized to represent a government as a prerogative or having full powers”. The provision of such powers allows SEZs to operate independently and achieve productive targets without having to deal with tedious and time-consuming processes that hobble businesses in the rest of the country. This is why SEZs can effectively accelerate economic growth, while also being an incentive for Foreign Direct Investments.

1.6 Sri Lanka has resorted to the use of plenipotentiary powers as a policy tool in 3 previous legislations. These are the Gal Oya Development Board Act No 51 of 1948, River Valley Development Board No 4 of 1975 and Greater Colombo Economic Commission Act No 4 of 1978. To understand what these plenipotentiary powers are, see Annexure 1. Hence, the use of plenipotentiary powers as seen in the Bill is not new to Sri Lanka. The Greater Colombo Economic Commission Act, which forms the precursor to the current BOI Act, provides the legal framework for these economic zones to act independently and prerogatively to achieve economic outcomes. According to a study by Boyenge (2007), in 1980 the zones accounted for only 8.8 per cent of total industrial exporters, however, by 1991 their share had risen to 44 per cent. By 2007, Export Processing Zones (EPZs) were contributing 38 per cent of the country’s total 9 exports in terms of value. A more recent overview of EPZs in Sri Lanka (Japan Development Institute, 2011) showed that 1,726 projects were in operation in the 12 zones, generating 346,516 employment opportunities.

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2. Japan Development Institute
Therefore in our view the Colombo Port City Economic Commission having plenipotentiary powers streamlined towards the achievement of economic goals, satisfies a timely requirement.

II. **Tax concessions**

2.1 Taxes are the most important source of revenue for the government to fund essential public goods and services. However, in 2020, tax revenue fell to 8.1% of GDP exacerbating Sri Lanka’s already precarious fiscal situation. With a history of fiscal deficits, the compounding effects of debt financing has snowballed into serious concerns regarding debt sustainability. In 2020, central government debt is estimated at 101% of GDP and is expected to worsen in the coming years.

2.2 The tax concessions as provided for in the Bill can create **distortions** within the economy while seriously impairing **fiscal sustainability**. For instance, in the labour market, it could lead to higher attrition rates in enterprises located outside the Port City due to tax concessions to local employees not being offered outside the SEZ. Businesses located within the Port City will also benefit from agglomeration effects of being in the Port City and having access to world class transport systems, utility services, preferential access to the highway and maintenance services. Therefore an investment in the Port City should yield a much higher return, thus not requiring further fiscal incentives. There is of course a need for the zone to be competitive vis-a-vis other zones but the generous tax incentives being offered over and above the tax concessions already provided for under the Inland Revenue Act No.24 of 2017 will further compromise the progressivity of the tax system and affect competitive neutrality.

2.3 There are however, instances when **fiscal incentives** (tax credits, grants etc.) may be warranted, for example where private returns are below the cost of capital but social returns (positive externalities) can be generated. However, the existing Inland Revenue Act provides for such incentives- we recommend that the power to grant fiscal incentives be retained within the Ministry of Finance. Hence, we call upon the government to make the necessary amendments to the Bill to establish fiscal accountability under the Ministry of Finance.

2.4 Research also suggests that the effectiveness of tax incentives in attracting FDI is low. The list of priority factors for investors is highlighted in Annexure 2. Tax incentives are marginally effective in terms of attracting FDI in comparison to other factors.
III. Financial Regulations

3.1 Developing a fully fledged OFC (Offshore Financial Centre) requires the relaxation of capital controls to permit free movement of capital improving the ability to compete globally. However, given Sri Lanka's current status of debt sustainability, sovereign rating downgrade, and foreign exchange crisis, it may not be the most appropriate time to set up an OFC. Stringent foreign exchange controls in place as of now may not allow the relaxation of capital controls. Hence, it is prudent to delay the setting up of an OFC within the Port City, or risk the entire project failing.

3.2 The success of a financial center depends on the confidence and trust that it evokes in investors and customers. The key to building this trust and confidence is dependent on two factors. First, the governance structure in place, i.e., the laws, rules and regulations governing financial products and services. Second, the way in which the regulatory authority/ies apply and enforce the regulations. Further, these regulations must conform to international best practices set out by institutions such as the Basel Committee on Banking Supervision (BCBS) and Financial Action Taskforce (FATF) recommendations on anti-money laundering and combating the financing of terrorism and proliferation (AML/CFT), to ensure global acceptance. Any attempts to circumvent these standards could have adverse impacts on financial institutions operating in the rest of the country as well. There is, however, a case for moving from a rules based financial regulation, as is currently in place, to a more principle based financial regulation. Such a move encourages financial innovation and facilitates the expansion of financial services in a dynamic global environment. There is also a case for unified regulation of financial services (a single omnibus legislation which has been adopted by other financial centres). The Bill only refers to regulation of banks and capital market institutions. It is silent on whether insurance companies would be allowed to operate within this jurisdiction and who would regulate that sector. It is of vital importance that this issue be addressed if the Port City is to be operated as an OFC.

3.3 According to the draft Bill, licensing (Section 42(4)) and regulating (Section 45) for offshore banking businesses is done by the Commission with the concurrence of the Monetary Board under the Banking Act No.30 of 1988. However, as per the bill the examination of such entities would be undertaken by a “competent authority” appointed by the Port City Commission (Section 49) and the Monetary Board may only call for information and reports from these entities through the Commission (Section 51). But the Bill is silent on whether insurance companies would be allowed to operate within this jurisdiction and who would regulate that sector. Our recommendation is that until a separate financial regulatory framework for the OFC is set up in the Port City, and until
persons with the necessary capabilities are recruited, the existing regulators must undertake both the regulation and supervision of financial institutions set up within the Port City.

3.4 We also call upon members of Parliament to make an addition to clause 5, as subsection (k) reading “Uphold laws and regulations on anti-money laundering and terrorism financing” in light of the above mentioned AML/CFT issues.

IV. Labour Regulations

4.1 The Colombo Port City expects to operate as a service-oriented SEZ that propels Sri Lanka to be a major trading and services hub within the Indian Ocean. It hopes to attract top-notch IT, financial service firms and types of businesses and economic activity that will be highly innovative. In order for such firms to thrive and grow, a labour environment that accommodates failure, mistakes and high rates of experimentation is crucial.

4.2 This requires a flexible labour market with low redundancy and restructuring costs that promotes swift adaptability to market changes. Prioritizing labour solutions over capital will result in job creation that will ultimately benefit the country. However, the labour regulations in operation in Sri Lanka does not facilitate the same.

4.3 For instance, the Termination of Employment of Workmen Act (TEWA)3 was enacted in the early 1970s when the government in power at that time promoted inward-looking economic policies.4 It regulates the termination of workmen by employers with 15 or more workers employed and applies to only around 15% of the labour force in Sri Lanka. TEWA has been identified to pose two main issues: making dismissal of employees too difficult and expensive.5 The high severance costs TEWA imposes along with EPF payments for the formal sector are prohibitively expensive for employers. Hence, TEWA is challenged as an impediment to healthy development of the labour market, preventing the private sector from adjusting to the globalized economy. The rigid conditions imposed by TEWA has acted as a catalyst for the creation of a large informal sector that amounts to almost 70% out of total jobs in Sri Lanka.

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3. Termination of Employment of Workmen Act No. 45 of 1971
4. Import-substitution industrialization, strict exchange controls, price controls on goods and large-scale nationalization of firms.
5. Section 3, TEWA
6. Obtain consent of employee or the Commissioner of Labour, Section 2, TEWA
7. Sri Lanka has the second highest redundancy cost in the world, Section 6D, TEWA
4.4 The formal sector offers many benefits, in comparison to the informal sector, that outweigh its costs. They are higher productivity, lower capital costs, increased access to finance, social insurance benefits like health insurance, pensions and most importantly higher pay. Hence, formal jobs need to be encouraged within the Port City by making its compliance standards more flexible. Unemployment is a social problem and its burden and economic costs must be borne by the society in totality instead of the retrenching firms alone. Such costs weaken them and leave less room for them to restructure and expand their firms. Therefore, the option of an Unemployment Insurance Scheme is a better mechanism to provide unemployment benefits funded through monthly contributions similar to the EPF and ETF.

V. Recommendations on Parliamentary oversight and Accountability Ensuring accountability

5.1 At present, the Bill states that the Commission should submit to the President or Minister in Charge, an annual report setting out the status of operations, income and expenditure of the Commission. Alongside this, it also provides for the audit of accounts of the Commission. However, as the main parliamentary oversight mechanisms in place to examine the activities of the government bodies responsible for public accounts and public enterprises are the COPA and the COPE, we recommend that the Port City Commission be made accountable to these committees.

5.2 In relation to the composition of the Commission, it is our recommendation that the Secretary to the Treasury be appointed as an ex-officio to the Commission since this would allow for fiscal accountability.

5.3 We believe that the nationality of the Commissioners should not be prescribed to avoid the exclusion of global talent. However, at the maximum, to only have it restricted to the appointment of a majority of Sri Lankan nationals. We also believe that the Director General of the Commission should be the best executive talent and therefore, should not be restricted to being a Sri Lankan national.

5.4 We also believe that staggered appointments to the committee would ensure institutional stability, preserve institutional memory and political representation. This process entails the availability of a vacancy every year, allowing the government in power to make an appointment
subject to procedures whilst ensuring that there is continuity as well as working across party lines.

5.5 To be in line with the international governance standards, Advocata also recommends affirmative action to ensure that the Commission mandates a minimum of 1, preferably 2, qualified women to be appointed to the Commission.

By approaching the Colombo Port City Economic Commission Bill from such an analytical perspective, and with the specific conditions of Sri Lanka in mind, at the minimum, the Advocata Institute recommends the consideration of the reforms outlined above to achieve maximum economic outcomes.

Yours Sincerely,

Murtaza Jafferjee
Chairman
Advocata Institute

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Chief Operating Officer
Advocata Institute
Annexure

Annexure 1

a) Gal Oya Development Board Act No 51 of 1948

By way of Plenipotentiary powers the Gal Oya Development Board could:

- Article (5) - The Board being given absolute power to appoint officers and servants.
- Article (9) - Authority over roads and irrigation
- Article (10) - Determine fees and levies over the supply of water.
- Article (14) - Establish own departments
- Article (15) - Power over crown land
- Article (16) - Power over the acquisition of land.
- Article (21) and Article (22) Power to make laws and bylaws.

b) River Valley Development Board Act No 4 of 1975

By way of Plenipotentiary powers the River Valley Development Board could:

- Article (4) - Power over the appointment of officers and servants
- Article (20) - Special powers over the administration of underdeveloped areas.
- Article (21) - Power to make rules
- Article (22) - Power to make laws

c) Greater Colombo Economic Commission Act No 4 of 1978

By way of Plenipotentiary powers the Greater Colombo Economic Commission could:

Article 16
- Implement the objectives of the commission
- Acquire, lease or sell land
- Lay out industrial estates for sale or lease
- To enter into agreements with enterprises
- Exercise, discharge powers and duties.
- Carry out general duties

Article 17
- (1) Power to enter into agreements with any enterprise in and outside the authority and to grant exemptions from any law referred to in schedule B.
Article 25
- (1) Power to authorize any enterprise carrying on the business of banking.
- (2) Authorize the operation of the banking business.

Annexure 2

List of factors that are more important than tax incentives for investors - study done by the United Nations Industrial Development Organisation (UNIDO) in 2010:

1. Economic stability
2. Political stability
3. Costs of raw materials
4. Local markets
5. Transparency of legal framework
6. Availability of skilled labour
7. Labour costs
8. Quality of life for expatriate staff
9. Availability of local suppliers