Economic Freedom Summit

Attracting FDI – “Freedom to Invest”

Lessons Learnt from 30 years of Investment Promotion

Keynote Speech

By Thilan Wijesinghe

Chairman/CEO

TWCorp Private Limited

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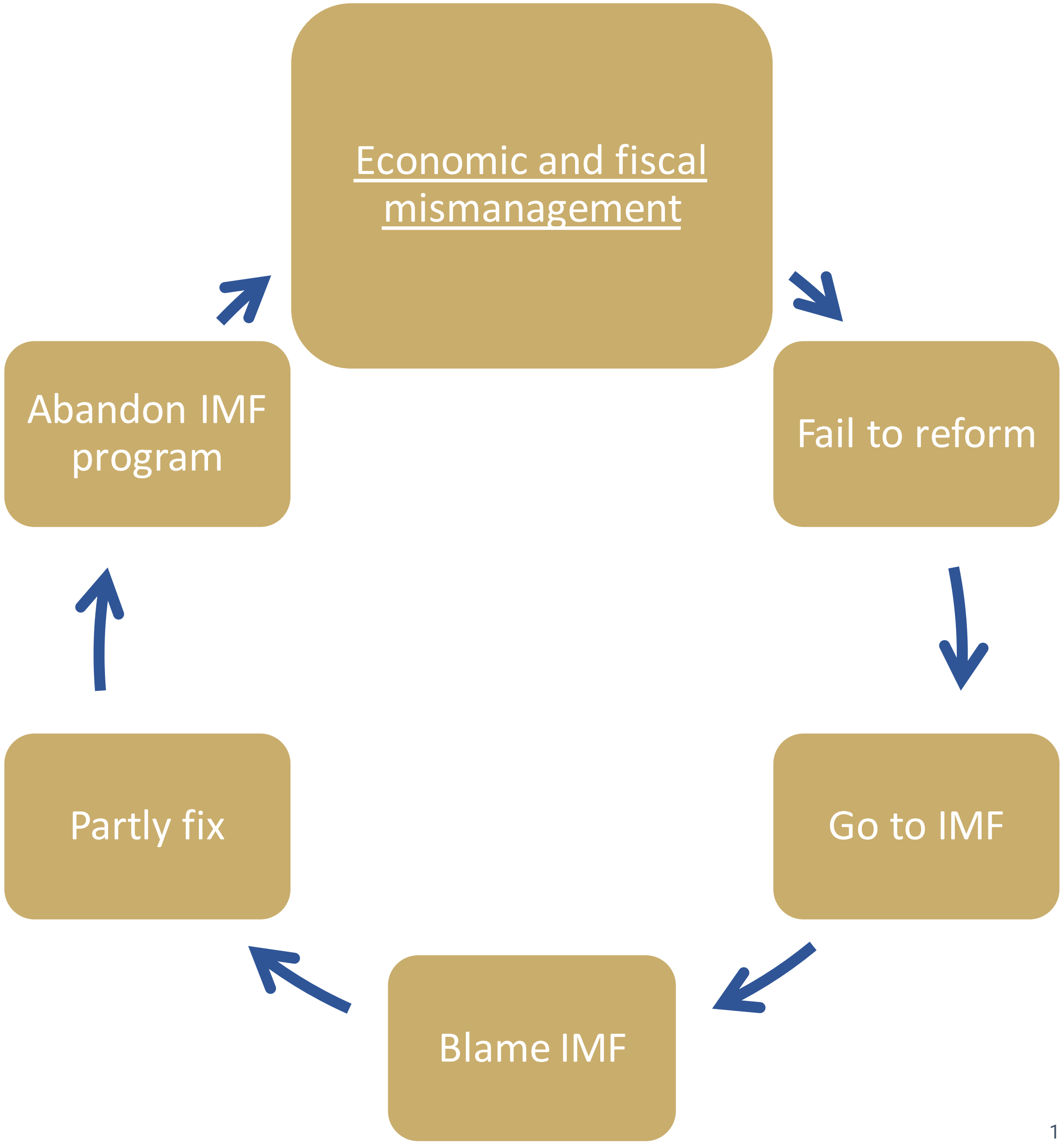
Inspired Investment Banking

Start by not repeating the "Unvirtuous Cycle" of Economic Management

- There is no better indicator to highlight our inability to manage the economy prudently than the perpetual cycle of getting in and out of IMF programs and refusal to acknowledge how consistently our economic ideology & approach has failed.

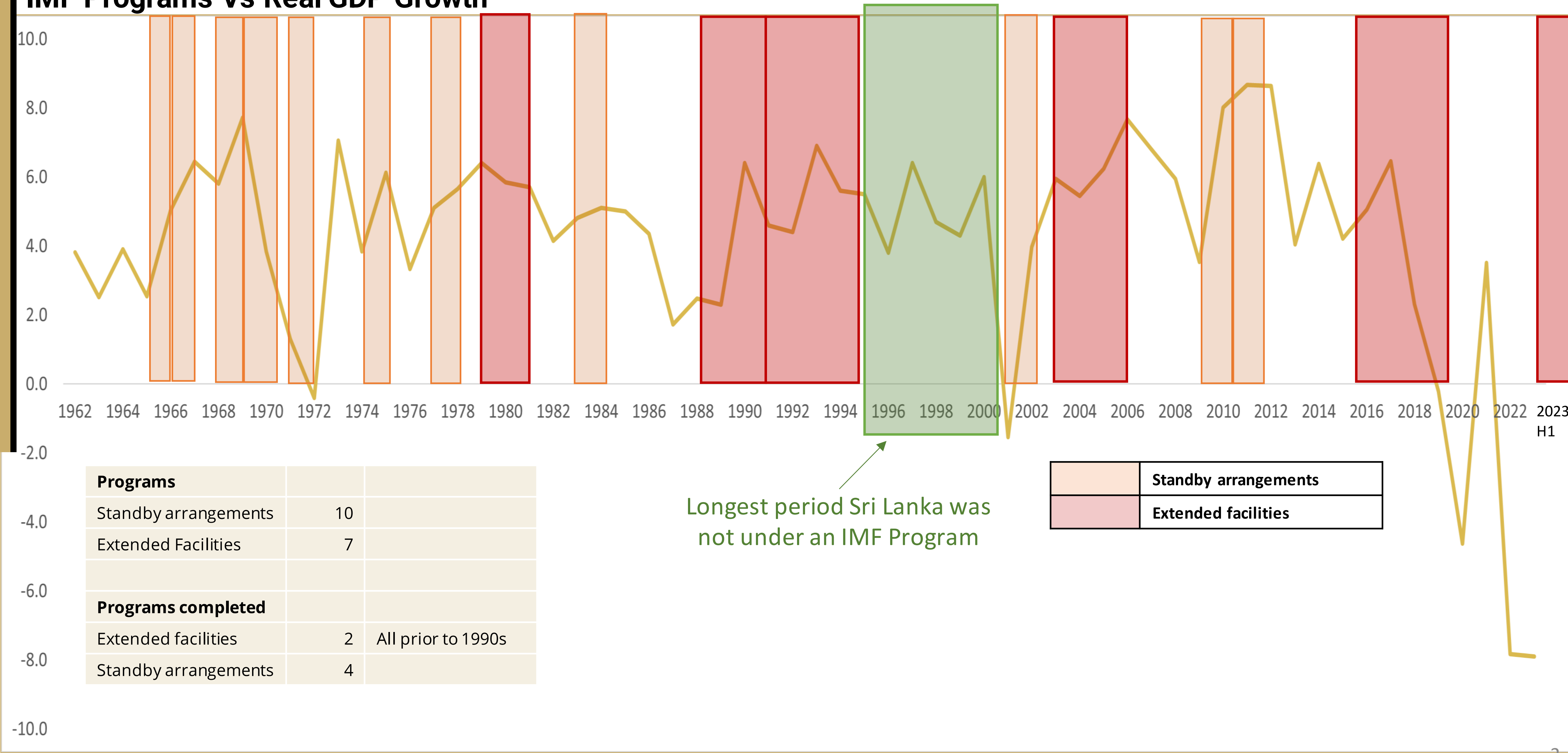
- Successive Governments have typically reached out to the IMF for support to overcome balance of payment issues that have been caused by pretty much the same short-sighted approach to managing the economy.

- **Prudent macro-economic management a sine-qua-non for investment promotion and attracting FDI**



Sri Lanka at the17th IMF Program

IMF Programs Vs Real GDP Growth



Programs		
Standby arrangements	10	
Extended Facilities	7	
Programs completed		
Extended facilities	2	All prior to 1990s
Standby arrangements	4	

Sri Lanka's Economic Growth

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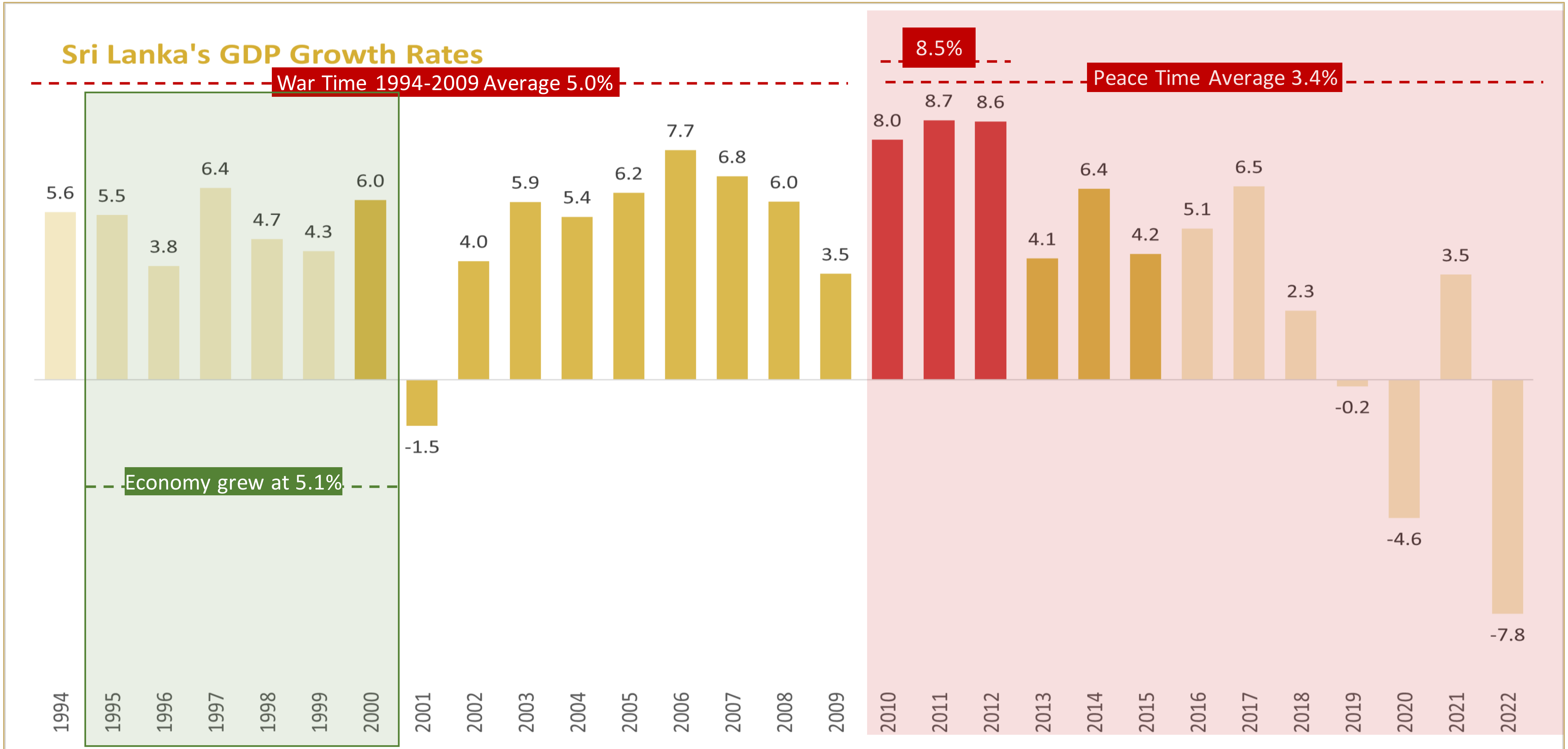
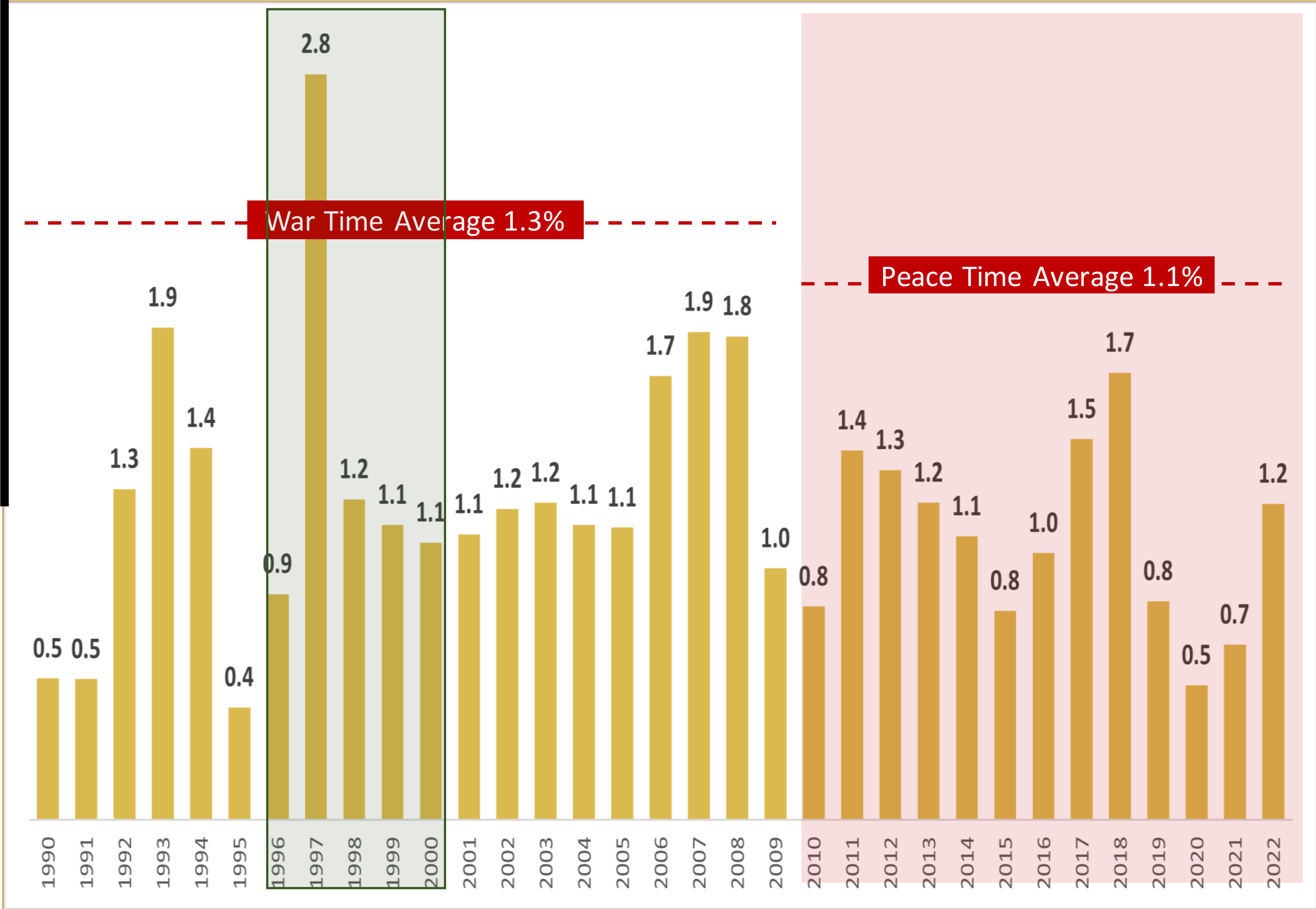


Source – World Bank

Net FDI Inflows

In 2000, 55% of manufactured exports were generated by companies with foreign equity.



Source – CBSL, World Bank

FDI net inflows are the value of inward direct investment made by non-resident investors, including reinvested earnings and intra-company loans, net of repatriation of capital and repayment of loans.

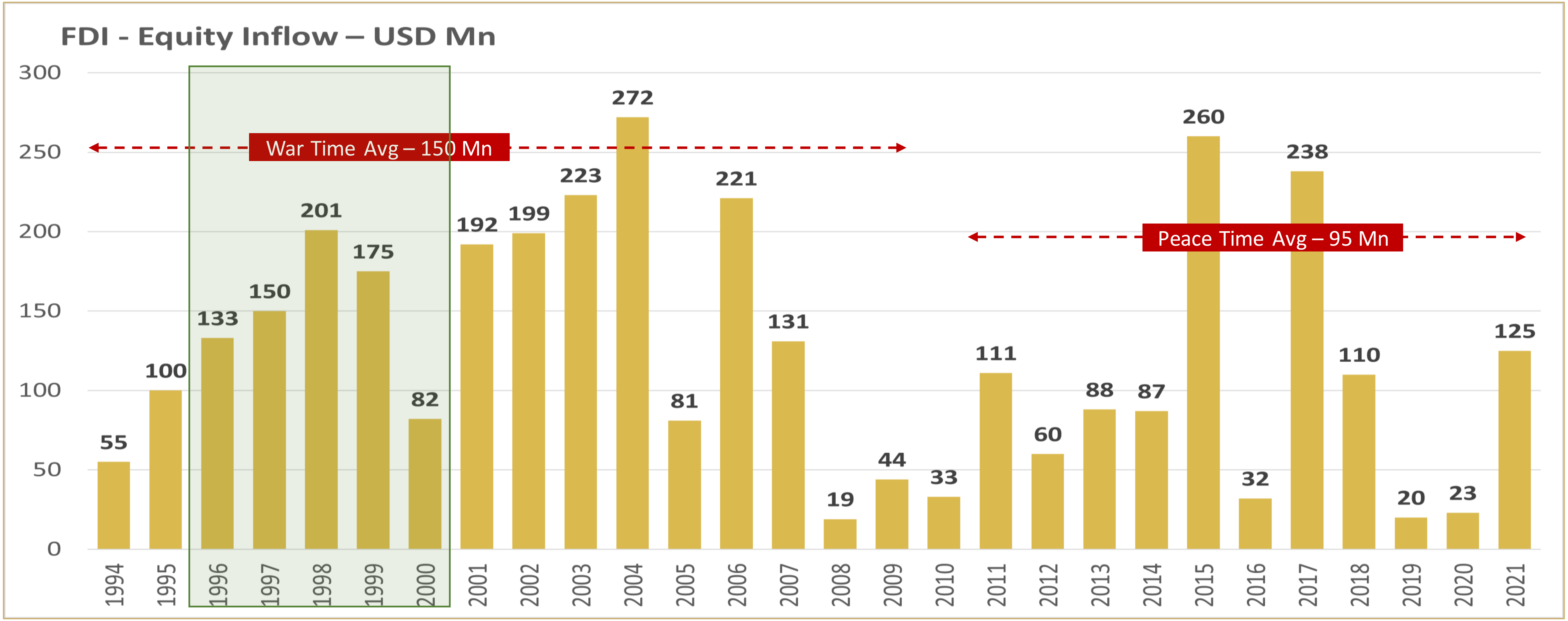
Sri Lanka's FDI net inflows as percentage of GDP has remained stagnant for over two decades and has not grown after the end of the conflict in 2009.

FDI net inflows during the 20 years prior to the end of the conflict averaged 1.3% of GDP. In the 10 years after end of the conflict the average **declined** to 1.1 % of GDP

FDI net inflows as a percentage of GDP reached an all-time peak in 1997. This was due to inflows from PPP projects such as SAGT and divestiture of Sri Lanka Telecom.

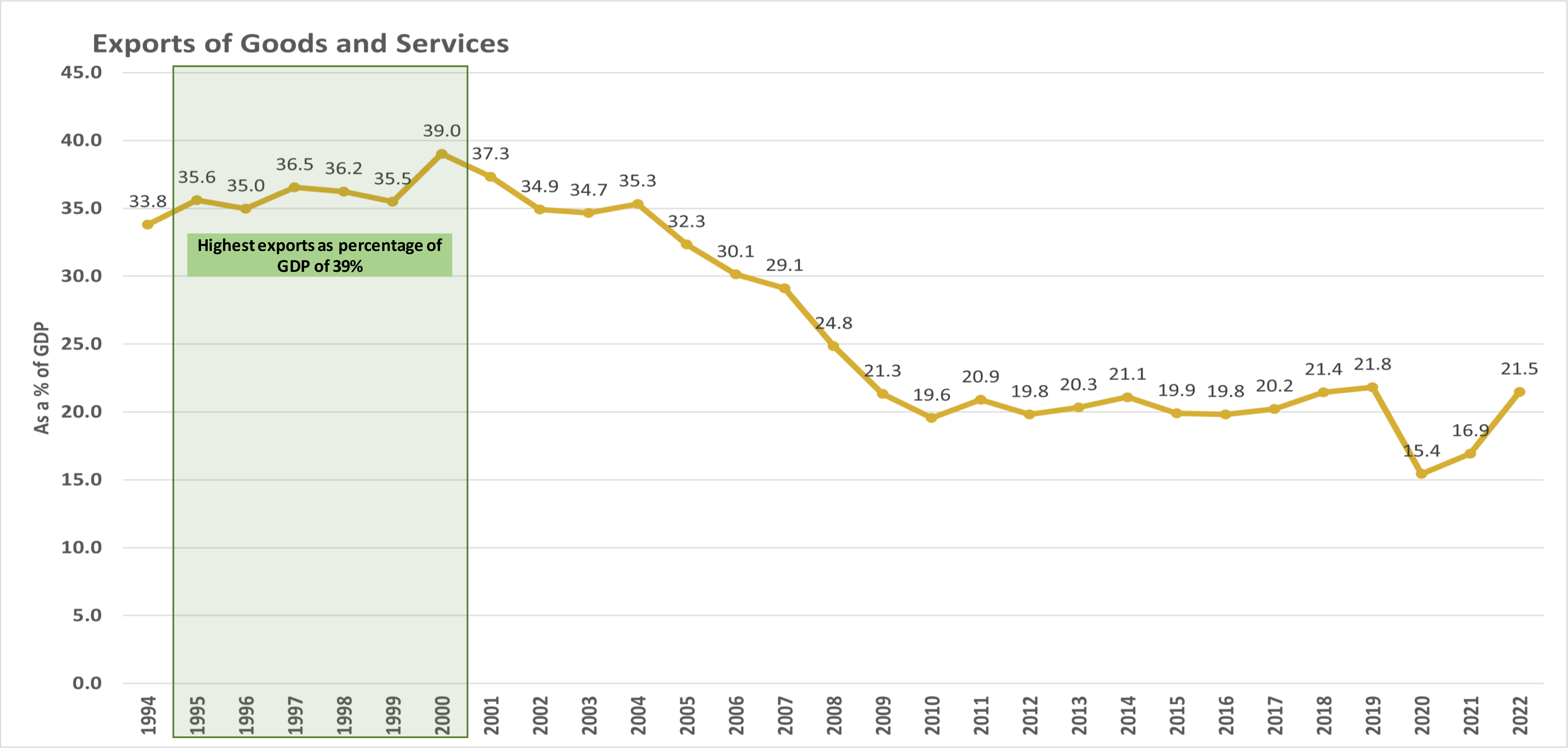
Annual Avg. Equity FDI investments after end of conflict is lower than during the conflict years

As the number of companies with foreign equity increases over time, retained earnings re-invested will also increase. Therefore, foreign equity inflows is good indicator of quality of FDI's inflows, particularly for new projects. **Sri Lanka has performed very poorly in attracting equity FDI in the last 10 years, with post conflict average being significantly lower.**



Source – CBSL

Exports as percentage of GDP peaked in 2000, and has dropped almost continuously since then



Source – World Bank Development Indicators

FDI-linked Investments of Over USD 10 Mn (1996 – 2001)

Direct and indirect exports:

- Textured Jersey (USA),
- YKK (Japan),
- Loadstar now owned by Michelin Tyre (Belgium)
- Mast Industries (Martin Trust, MAS & Brandix) – 10 projects (USA & Sri Lanka)

Services

- Aman Resorts (Singapore)
- Victoria Golf Course
- Virtusa (USA)
- IFS (Sweden)
- Millenium Information Technology (Malabe)
- Appolo Hospital

Infrastructure

- South Asia Gateway Terminal (P&O UK, Australia, Maersk, JKH)
- AES Corporation (USA) (Kelani Tissa 110 MW)
- Mitsui Power (Japan);
- KHD (Germany)
- Shell Terminals (U.K.)
- Telia/Suntel and Mobitel (Sweden);
- Transmarco/Lanka Bell (Indonesia)
- NTT/SLT (Japan)
- Hutchison (Hong Kong)

Manufacturing (Non-export)

- Holderbank/Puttalam Cement (Switzerland)
- Hanjung/Steele Corporation (South Korea)
- ETA/Serendib Flour Milling (Dubai)

Infrastructure support to investors

- Quadrupling of private hospital beds
- Implementing Sri Lanka's largest middle income housing projects
- Making WTC an IT Park
- Declaring Malabe as an education zone
- Created SLIIT with grant funding from BOI
- Township development program for mature zones

Creative investment policy making and investor targeting

- Government Chief Valuer's valuation (two envelop and other methods)
- Accelerating ICT exports
- New policy for golf courses to encourage golf tourism
- Private investment in power sector (75MW of Mini hydro and 420MW of thermal)
- Creating competition within port of Sri Lanka
- No unsolicited proposals
- Donor support for technical assistance

Industrial land area available almost tripled compared to 1995 by 2001

Export Processing Zone	Year of Establishment
Katunayake	1978
Biyagama	1985
Koggala	1991
Kandy	1995
Malwatta	1997
Wathupitiwala	1998
Mirigama	1999
Horana	1999
Seethawaka	1999
Mirijjawela/Hambantota	1999
Mawathagama	2000
Polgahawela	2000

Source – BOI Annual Reports

Administrative Action Taken to Provide "Freedom to Invest" (1995 – 2001)

- Targeted incentive package and **reconstitution of the board of the BOI**
- Created Bureau of Infrastructure Investments (BII) as PPP unit of the Government. Introduced PPP procurement guidelines
- Created PERC and PSIDC (and created synergies with BOI and BII)
- Attracted private sector professionals
- Created an Inter-Ministerial Investment Facilitation Committee chaired by Chairman/BOI
- Set up Research Department including a division to provide support for Free Trade Agreement negotiations
- Marketed the sanctity of the BOI Agreement
- 10-fold increase in BOI's infrastructure budget to provide "plug and play" infrastructure (speed-to-market)
- Process mapping to streamline implementation of investment (the 3-week record)

750 new private investment projects were implemented under Section 17 of the BOI Law for 5 years ending March 2001. This represented a nearly doubling of the number of projects operating, though this was achieved over a 17-year period commencing 1978 when the BOI was set up.

….An in 1998-99 BOI was Globally Recognized

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Awards won

(a) In recognition of **"Olympian Efforts of Investment Promotion Agencies in 1999",** BOI received the "runner-up" award for the **Top National Investment Agency in Asia** based on a ranking by Corporate Location magazine of UK. Since the inception of the BOI in 1978, this was the first and only occasion that the agency has been conferred an international award.

(a) Directed the launching of the first ever Website by **<u>any</u>** Government Agency in February 1996. The Website was ranked as the **21st best in the world out of 500 sites** of investment promotion agencies surveyed by Corporate Location Magazine of the USA (July/August 1998 issue), ahead of Singapore and several other developed countries.

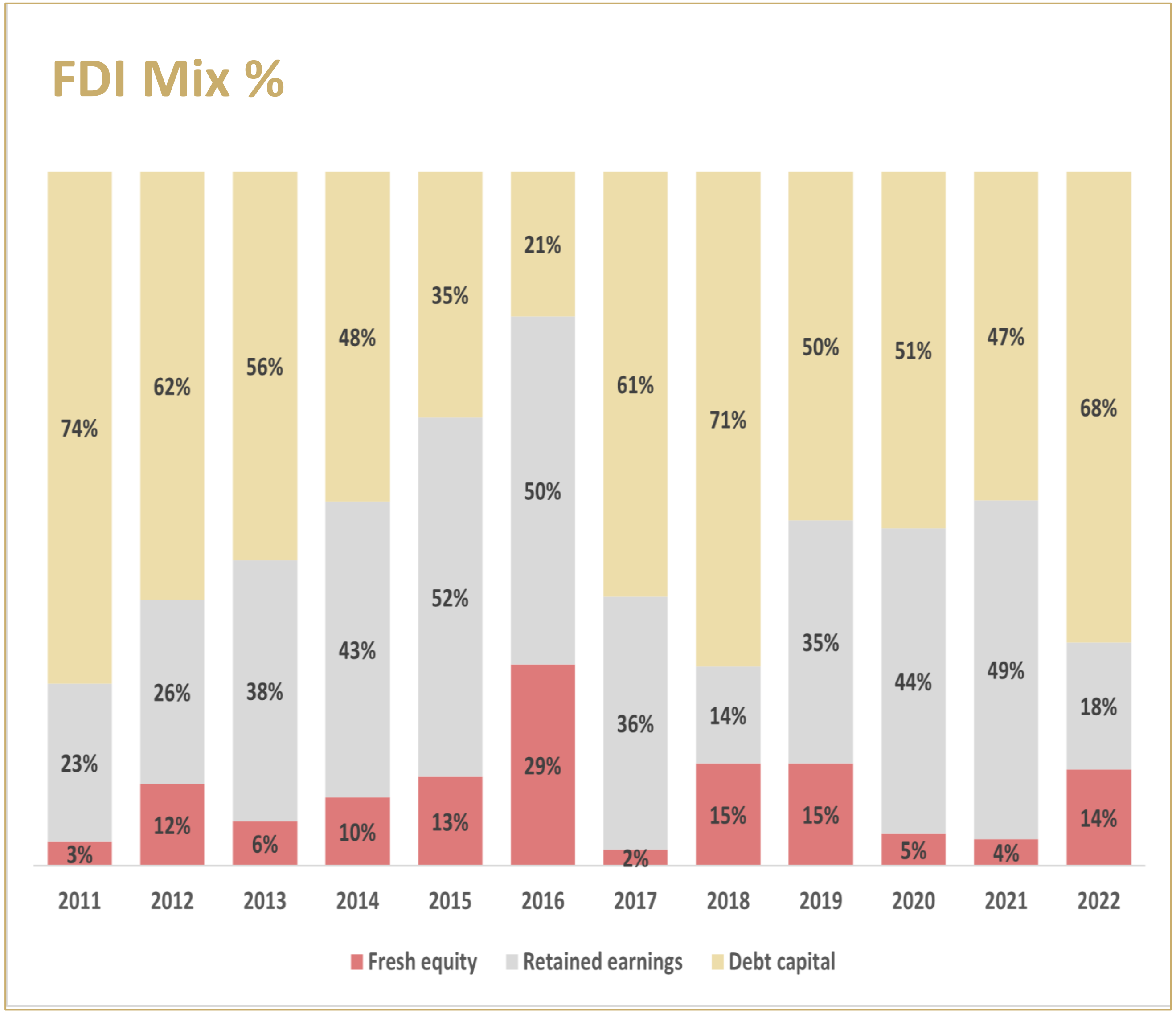
Fundamental Change in FDI Composition from mid 2000s

FDI mix in last 10 years

The chart demonstrates that 90% of FDI reported in Sri Lanka over the last 10 years has been debt and retained earnings re-invested.

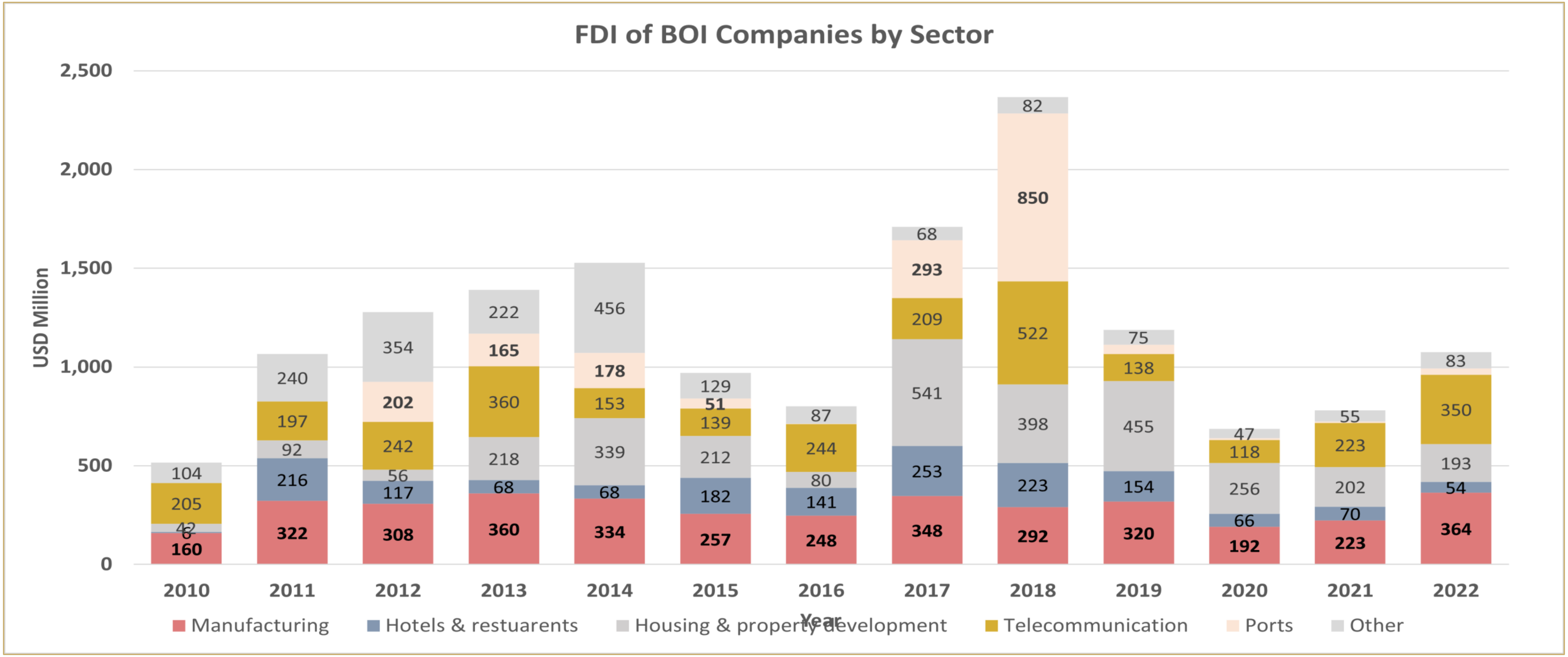
Retained earnings improves forex retension as such earnings are not used to pay dividends.

53% of FDI reported is retained earnings reinvested by existing companies. Also 37% is foreign debt taken by foreign companies.



From 2010, the quality of FDI is impacted due to low FDI in manufacturing

Average manufacturing FDI (the tradable sector that generates export growth) has been only 24% of aggregate FDI. Eliminating the Hambantota port divestiture as a one-off transaction in 2017 and 2018, the non-tradable sector FDI on average was around 60% of total FDI over the last 10 years. Hence FDI in last 10 years has been poor from a foreign exchange generation perspective.



Year	Manufacturing	Hotels & restuarents	Housing & property development	Telecommunication	Ports	Other
2010	160	6	42	205		104
2011	322	216	92	197		240
2012	308	117	56	242	202	354
2013	360	68	218	360	165	222
2014	334	68	339	153	178	456
2015	257	182	212	139	51	129
2016	248	141	80	244		87
2017	348	253	541	209	293	68
2018	292	223	398	522	850	82
2019	320	154	455	138		75
2020	192	66	256	118		47
2021	223	70	202	223		55
2022	364	54	193	350		83

Source – CBSL

Investment Incentives…

Analysis of SDP investments

- The SDP Act was introduced in 2007 as a panacea for attracting large scale FDI of strategic importance.
- 100% of investments of over $100 Mn that commenced after 2009 has been under SDP Act.
- **Of the 25 or so SDP projects approved or implemented, not even one is in export manufacturing.**
- 75% of SDP projects are in non-tradable sectors such as real estate.
- 20% are in export of services (port terminals and HCL software project).
- Only 2 foreign companies that started construction after 1st Jan 2015 has invested over $100 Mn (Hambantota and West Container Terminal).
- If Hambantota is excluded as a "one-off" investment, 84% of FDI reported in 2017 originated from companies signing agreements prior to 2015.

Tax deterrents to FDI (Computed in 2018)

- Income tax holidays or accelerated depreciation is not the main criteria in the “go no-go” decision for a large investment. It is the VERY high upfront taxes (Para tariffs). This impacts on project IRR the most.
- Among other reasons for low FDI is applicability of upfront taxes (excluding customs duty on positive list imports and VAT) prior to generating any revenue

  (a) 14% (on manufacturing)

  (b) Over 20% (on real estate)
- On a typical real estate project of over $250 mn, SDP incentives contribute to a 7-10 percentage point improvement in project IRR. Therefore, it is likely that many SDP projects would not have been implemented without SDP status.
- Typical up-front tax on $250 Mn mixed development construction project **(without customs duties on imports other than on “negative list” items and with S-VAT)**

  (a) The upfront tax on materials is between 14% - 33% of the total construction cost

  (b) The upfront tax on materials is between 23% - 57% of the total material costs

  (c) Taxes on Negative list material is between 10 % - 23% of the total construction cost.
- The Income tax at rate of 28% and dividend withholding tax at 14% (combined tax rate of over 40%) also has a negative impact on investment sentiment and rates of return to shareholders.

SDP vs BOI Tax Regime

	SDP	BOI	
Corporate income tax	√	×	28%
Tax on dividend	√	×	14%
Withholding tax	√	×	14%
PAYE Tax	√	×	4%-24%
VAT	√	×	15%
PAL	√	×	7.5%
Excise Duties	√	×	Varying rates
Cess	√	×	5%-35%
NBT	√	×	2%
Customs Duties	√	√	5%, 15%, 30%
ESC	√	×	0.5%
Stamp duty	×	×	Sale: 4%, Lease 1%

What is the right balance in formulating legislation and investment incentives to facilitate FDI investment?

Payment of Corporate Tax by BOI Companies (Vast majority are currently paying income taxes at normal rates)						
Sector	No. of Projects in Commercial Operation as at 6/01/2014	No. of Projects Liable to pay Tax as at end 2013	Additional No. of Companies Liable to pay Tax by end 2014	Additional No. of Companies Liable to pay Tax by end 2015	Additional No. of Companies Liable to pay Tax by end 2016	Additional No. of Companies Liable to pay Tax beyond 2016
Agriculture, Fisheries & Foresting	96	67	7	1	7	14
Apparel	423	317	12	11	25	58
Education	25	7	2	2	2	12
Infrastructure	175	118	17	11	8	21
Knowledge Services	132	81	11	16	4	20
Other Manufacturing	382	253	17	10	9	93
Regional Programs & Export Oriented Services	218	75	17	20	8	98
Tourism	142	84	2	11	3	42
Utilities	130	54	10	19	5	42
Total	1723	1056	95	101	71	400
Source: Sector Officers/MIS BOI 6th Jan 2014						
Assumptions:						
Tax Liability commences at ;						
- the expiry of Full tax holiday period						
- beginning of Partial Tax Exemption period						
In respect of 200 Garment projects, total no. of companies includes expansions as separate Units						
For projects not issued with tax certificates; 2 years from commencement of Commercial operation date was taken as the date of commencement of tax holiday						

IMF Diagnostic Report of September 2023 on SDP Status

- **To quote from Para 194 of the IMF Report:** "The Department of Fiscal Policy (DoFP) is a focal point in shaping the tax system, guiding the reform of most taxes, except for the special commodity levy and customs duties, which are under the authority of the Department of Investment and Trade."

- **To quote from Para 200 of the IMF Report:** "There is no definition of what criteria need to be satisfied for a project to be of strategic relevance, and the revenue forgone from such projects is not systematically contrasted against their potential benefit in a transparent process. Crucially, the DoFP is not involved in the selection or evaluation of projects, and any data that may exist is not shared with the department."

- **To quote from Para 201 of the IMF Report:** "The SDP Act should be abolished or suspended **until the structures and processes are in place to evaluate the effectiveness of the offered incentives**…..While the BoI is likely well positioned to understand the investment potential of specific projects, it lacks an understanding of the wider fiscal framework and budgetary needs which are necessary to evaluate the net social value of a specific project.

- **Preparing the necessary structures, including data sharing protocols and legal documents that assign authority to the DoFP will take time and no further projects should be approved until then."**

- **Conclusion by IMF:** "abolish or suspend the SDP act until explicit criteria are established to evaluate all proposals, including the provision of public information on projected benefits and costs, and a transparent process is defined to apply the criteria."

Where do we go from here?

Reasons for poor FDI performance in manufacturing and tradable sectors

Market & Policy Environment

Limited market access:

- Vietnam – 13 FTAs, Sri Lanka - Only 3 active FTAs and GSP+ Expiring

Time consuming line agency approvals

Ad hoc changes to policies

- E.g. Foreign exchange regulations, policy changes, restrictions to incorporating foreign owned companies etc.

Lack of coordination between Treasury, line Ministries and BOI

Ineffective central PPP unit for systematic implementation of PPP projects

Legal & Regulatory Environment

Erosion of power vested in the BOI Act

- Failure to strengthen BOI Law and particularly Schedule B relating to tax incentives and Exemptions from foreign exchange provisions

Failure to upgrade BOI Law and/or introduce SEZ law in Hambantota.

Weaknesses in Port City Law

Flexible and modern investment related laws required such as bankruptcy law

Infrastructure & Labor

Lack of specialize workforce for certain skills

Uneven geographical distribution of factory footprint to attract labor – Western Province account for 70% of BOI industrial footprint

Lack of investment in new industrial zone capacity with required social infrastructure

Poor transport and social infrastructure for labor mobility

Enabling Factors

Lack of implementation of National Export Strategies

Lack of progress in improving Ease of Doing Business index for Sri Lanka

Delays in obtaining lands and environmental approvals

Insufficient industry clusters

- Vietnam – 326, Sri Lanka – 12

High cost & non availability of electricity and factor cost

Erosion of One-stop-shop concept at BOI and sanctity of BOI Agreement

Recognize PPPs as an important source of FDI

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- **Around 75% of developing countries have central PPP units either within the Finance Ministry or under the Prime Minister/Head of State**
- Sri Lanka has had PPP units under the finance ministry on 3 occasions (1992-95) and (2016 – 2020) and from 2022. A specialized PPP unit functioned under the BOI from 1996-2004.
- **However, successive governments have either dismantled the central PPP units or appointed unqualified persons/political appointees to run them**
- There is ample evidence that proffessionally run central PPP units within the Finance Ministry or BOI, under Head of State of Finance Minister has been proven successful.
- **When the PPP unit was functing under the BOI, Sri Lanka attracted over 40% of FDI through PPPs**
- The shutting down of the PPP unit in the Finance Ministry in 2020 deprived the BOI from taking this unit over along with its trained staff.
- Consequently only 1 or 2 investors submitted a qualifying bid for the 2 most recent PPPs launched by the Gotabaya Rajapaksa Government due to poor quality of bid documents

No major power capacity added in last 7 years.

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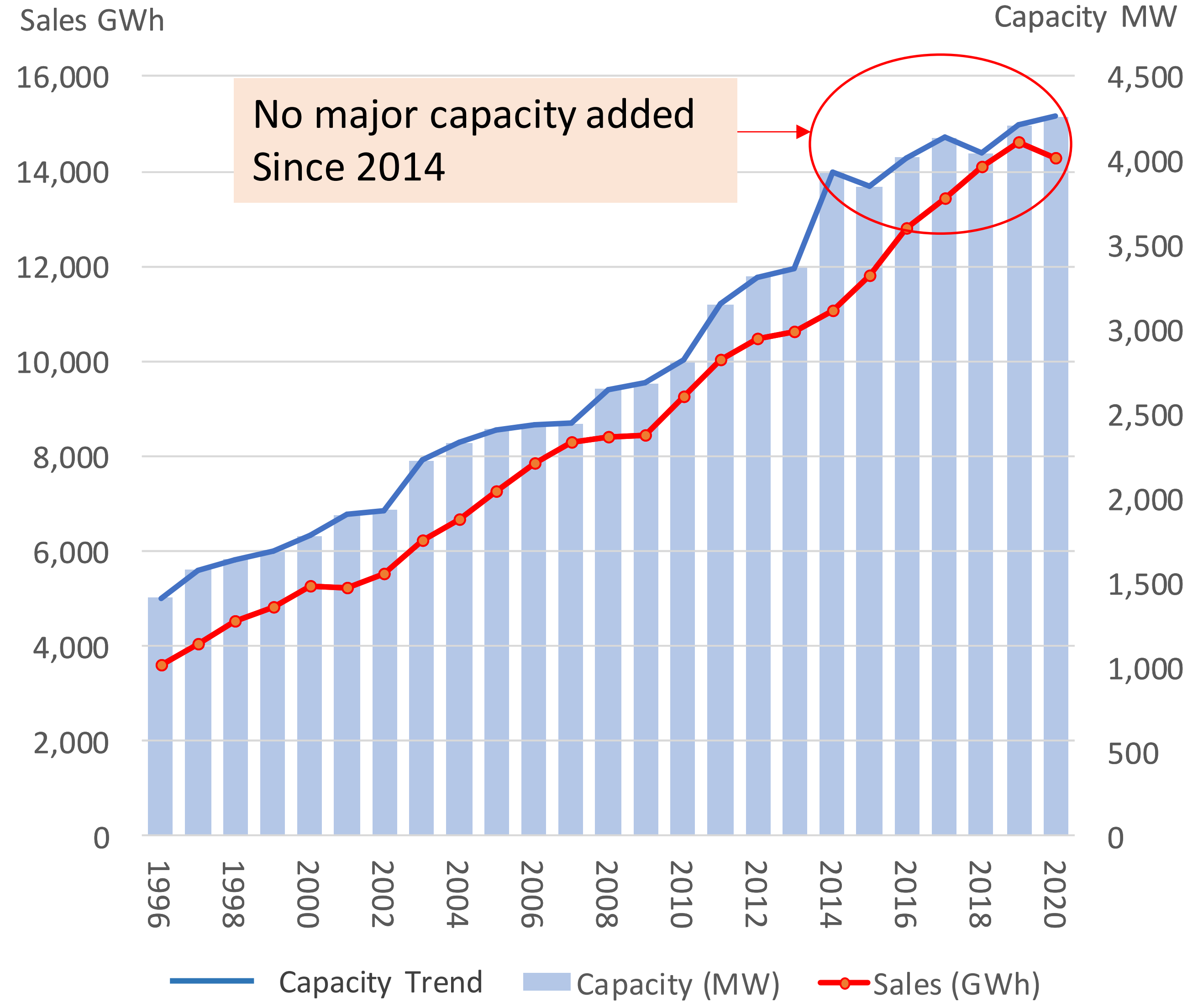
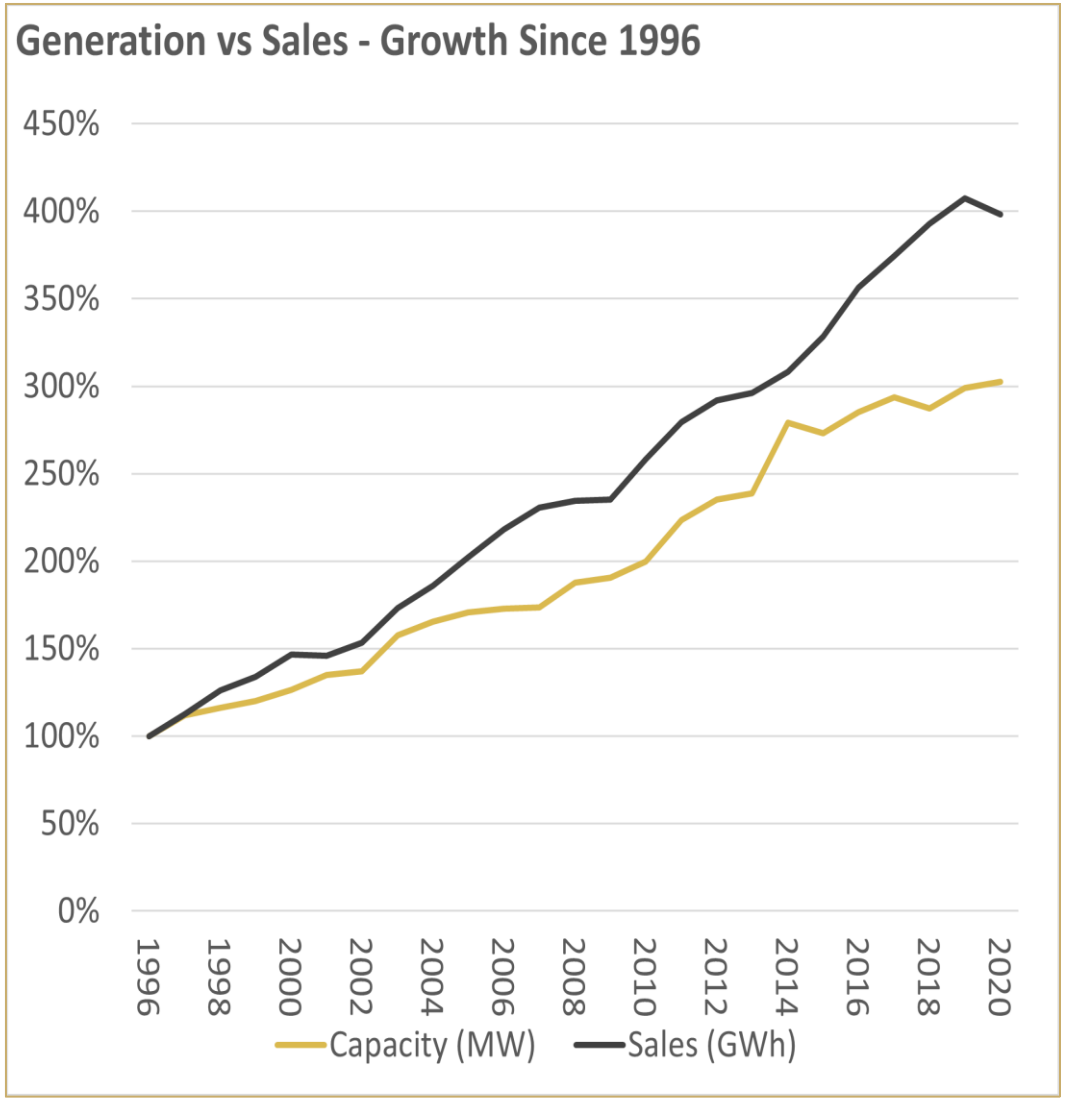
Generation Capacity & Sale of Electricity





Suggestions going forward (based on ground reality)

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- Introduce PPP Law and update guidelines.
- Rethink investment incentives with external specialists AND in consultation with Finance Ministry and IMF.
- Introduce interim changes to the BOI Law (before overarching new law).
- Relook at merging provisions in SDP Act with BOI Law. (Schedule B in particular)
- BOI Law to migrate to a SEZ Law (e.g. Hambantota and Trincomalee).
- Consider new types of SEZs. E.g. agri-business, logistics, tourism SEZs such as marinas and cruise terminals. SEZs or EPZs under PPP structures won't work without considerable GOSL financial support.
- Revamp Port City Law.
- Coordination between BOI, NAPPP, SOERU, Port City Commission & Ministry of Finance
- Enhance the infrastructure budgets for "plug and play" investments
- Forge donor linkages for technical assistance (PPPs, land cadastre)
- Strengthen research and processes for FTAs (Accelerate ECTA and China FTA)
- Introduce anti-corruption provisions in all laws and digitize the investment approval process
- Make public service attractive again for capable private sector individuals

Proposals to attract required skill sets to identified government ministries and agencies.

- The required skills shall be very precisely and narrowly defined to limiting the pool of applicants/qualifying persons in each category from say 25 – 100. This can be done based on specific years of experience, achievements in the chosen field, qualifications etc.

- When such skill categories are selected, a new salary scale to be established for each such skill that is benchmarked with average private sector salary scales.

- When defining such professions/skills, the specific risks to health, safety, security, financial system, SOEs, economy from losing or not attracting such qualified categories of persons should be identified along with cost/benefit analysis of paying such identified professions higher salaries or allowances than currently being paid

- Appointments to be based on performance based contracts

- Seek donor assistance where possible

- The above should approved by Management Services Department and Cabinet of Ministers

Thank You