The Export Processing Zone as a Component of the new Economic policy

H. N. S. Karunatilake

Deputy Governor, Central Bank of Ceylon

A proposal to establish an Export Processing Zone apart from having its own merits and national benefits symbolises a significant change in the content and direction of economic policy. The previous S.L.F.P. government too was interested in setting up an Export Processing Zone in Sri Lanka, and the fact that this proposal was considered within the framework of a system of rigid controls is a virtual admission that the earlier economic policy based on increasing restrictions and state intervention had proved to be a miserable failure. The new economic policy of the present government must be looked at in the light of the policies of successive governments since 1956 and consequently the need for a complete reorientation of strategy. After 1970, the economy became rigid, dominated by inward-looking policies and an extensive system of controls which tended to debilitate the economy and create a very unfavourable climate for domestic and foreign investment.

Increasing Controls

Sri Lanka inherited a system of controls from the Second World War and was also committed to a wide range of welfare expenditure from about the same time. These have been the major obstacles to rapid economic growth in the last two decades and has contributed to virtual stagnation in certain sectors and an inward looking approach to economic development. The most important controls introduced in the war years were on foreign exchange. After the end of the war, these controls continued to be in operation for the purpose of conserving foreign exchange. Import controls were introduced in the early fifties with the object of ceylonising foreign trade, where licences were issued primarily to Ceylonese businessmen and firms. After 1960, the administration believed that the adoption of extensive controls would help to improve the balance of payments situation and promote investment in industry. This was the outcome of a static view of the balance of payments, where it was believed that the country's foreign exchange earnings can only come from existing exports and through import savings and not through export diversification and the attraction of foreign investment.

Thus a liberal and free economy which existed in the early fifties gave way to one of increasing controls. The administration did not realise that in the context of dwindling foreign exchange reserves an alternative course of action would have been to invite foreign investment without resorting to restrictions. Had the economy become less restrictive and state interference in the economic life of the nation kept to a minimum the development process in Sri Lanka would have taken a different course. Foreign investors kept away after 1956 because the economic climate for investment became increasingly hostile, especially with the policy of nationalising both local and foreign enterprise. The only way of diversifying the economy and making it more export-oriented was through greater liberalisation, and not within an increasingly restrictive framework.

The proposal to establish a Free Trade Zone must be evaluated in the light of the contribution it would make to diversify and promote exports and the new overseas market opportunities it would open for domestic industry. In the last 17 years, Sri Lanka's development has had a heavy bias towards industry. Despite the appreciable progress in agriculture, the central planners have been largely preoccupied with the welfare of the new urban manufacturing industries. From the outset these were given a wide range of tax and other incentives. Although there are more than 2,500 new industries of varying sizes, most of them have survived because of the heavy protection afforded to them in the internal market. Domestic sales have been very profitable because of the high protective tariffs and severe import restrictions that fully insulated them from foreign competition.

Export Performance

In a protected market, under the conditions of scarcity, industrialists are able to determine the prices at which they sell, their profit margins and the quality of their products. Even with incentives offered to exporters such as FEECs, the Convertible Rupee Accounts, low tariffs on raw materials and machinery, duty rebates on exports and handsome foreign exchange allocations, most industrialists in Sri Lanka have not been able to export. Even the establishment of specialised agencies like the Export Promotion Secretariat have not made much difference to Sri Lanka's export performance. The export figures for industrial and manufactured goods show that the bulk of the earnings in this category still come from the exports of refined petroleum products. In 1976, out of a total of Rs. 755.7 million of manufactured exports, petroleum products amounted to about Rs. 505.2 million which shows that manufacturers only contributed Rs. 250.5 million, which was about 5 per cent of total exports and only about 30 per cent of exports of industrial goods. The relatively unimpressive export performance of manufacturers has been due to several factors. The quality of the products have not always stood up to the exacting requirements of foreign buyers and industrialists have not found it easy to secure sustained export orders. This is partly because they have not been able to tie themselves up with recognised international firms who have well established markets and sell their products under popular brand names.

Impact on Exports.

One of the major objectives of setting up an Export Processing Zone would be to get recognised industrial firms to manufacture goods with or without local collaboration so that they may be assured of export markets and would produce goods of high quality. In India, a large number of industries producing goods for the domestic market and for export have tied themselves up with leading manufacturers in the U.S.A., U.K., Germany, France and Japan. Much of the success in India in the export of manufactures has been largely the outcome of these tie-ups. Unless this is done, it is most unlikely that Sri Lanka can make sufficient headway in pushing exports of manufactures. The objective should be to step up exports of industrial products from the present level of Rs. 250 million to at least Rs. 1,000 million. For instance, in 1976, tea, a traditional product, brought in Rs. 2,100 million in foreign exchange.

Once the Export Processing Zone becomes operative, the investors in the zone would become the principal means of promoting exports because they would be in a better position to expand sales overseas than the official agencies like the Export Promotion Secretariat on account of their superior knowledge of foreign markets, techniques of marketing and preparing and packaging products for export. However, existing export promotion agencies would have a role to play in Sri Lanka because they would still have to pay attention to exports from outside the Export Processing Zone.

The inward-looking approach to industrial development and the limited size of the Sri Lanka's market has considerably precluded industrial expansion. At the present level of incomes and the demand for manufactured goods, one or two medium or large units could supply the entire requirements of the country. In some cases, large units both in the public and private sector are unable to work continuously to capacity because of the limited size of the market and the latter does not provide scope for expansion. Both money and real income levels in Sri Lanka have not gone up appreciably to provide for the expansion of purchasing power to boost internal demand. People still tend to spend the bulk of their income on basic essentials, mainly food and clothing. Furthermore, increasing inflation in the last 4 to 5 years has also made inroads into real income and consumer demand for manufactured goods has not increased in proportion to the rise in money incomes.

Within the present framework more employment in industry could largely come through expanded markets and higher levels of production, either through greater capacity utilisation or through the establishment of new industries. A substantial increase in the demand for Sri Lanka manufacturers could result from a much higher level of exports than through a rise in domestic demand. So far, private and public sector industries have provided employment for only some 150,000 persons out of a total workforceof 5.2 million, which is around 2 per cent. The contribution of manufacturing to both the Gross National Product and to the generation of new employment has been very limited and the total industrial workforce has hardly increased in the last few years. The labour absorptive capacity of industries has been very low due to excess capacity and very often to the use of inapproapriate technology. In the present circumstances, an Export Processing Zone could act as a catalyst and provide the momentum to activate a virtually dormant manufacturing sector.

The success of the Zone and the facility with which foreign investments could be attracted would depend on appropriate policies and the concessions which the government would provide. Move to liberalise the economy through the relaxation of controls and the introduction of a more realistic exchange rate that would help to boost exports apart from creating a favourable investment climate, will make investors feel that there will be fewer bureaucratic controls and a greater freedom to take decisions on their own. This would give confidence and an assurance to the investor that government interference would be at a minimum.

Characteristics and Impact of Industries.

Local industrialists have had a wide range of incentives and concessions to develop their industries. By now, most of the industries set up in the sixties and early seventies have utilised their tax holidays, development rebates and other incentives upon which they were able to grow and survive. There is a fear among local, industrialists that investments in the Export Processing Zone would tend to wipe them out. This is unwarranted because it is unlikely that investors in the Export Processing Zone would get greater concessions than other export-oriented industries in the rest of the country. At the most, they would get a tax holiday plus all the concessions that industries in Sri Lanka enjoyed in their initial year. Beyond this, the main advantage of the Export Processing Zone is that the investor will be in a position to carry on his business with practically no bureaucratic controls and administrative delays and will be largely free of customs procedures which normally apply to the rest of the country. Industries in the Expor Processing Zone would only compete with other export industries and not with those producing goods for the domestic market. Export industries are relatively more efficient than those that cater to the local market. Furthermore, goods produced in the Zone will normally not enter the country, and even if they do, the usual customs duties and turnover taxes will have to be paid. This will afford protection to industries in the rest of the country.

Investors in the Zone will have the liberty to decide on the technologies they employ, the methods of production and the quality of their products. Presumably, investors will have the freedom to produce whatever goods they want, provided they are exported. The applicability of labour laws and regulations could be less stringent. Since production is for export, manufacturers will have to keep abreast of technological advancements in the rest of the world if they are to permanently establish themselves in export markets. It does not necessarily follow that labour-intensive technologies would be employed uniformly in the Zone. Especially in the fields such as electronic goods, vehicle and machinery components and chemicals, sophisticated equipment might be brought in and the employment opportunities generated in these industries could be less than what is expected. In other areas such as garments, the assembly of products, confectionery, food canning and agro-based industries, there is considerable scope for the employment of labour. All industries could not be expected to use labour-intensive technologies.

The Zone would, therefore, have a mix of industries, some based on sophisticated technology and others using more labour. However, since a large number of industries would come here to take advantage of the considerably lower labour costs, many of them on balance are likely to use labour-intensive methods of production and choose investments where labour can be employed profitably. This is one factor which could help to attract the kind of industries which the government would prefer to have. On this basis, within a period of about 18 months the amount of direct employment in the Zone could well exceed 50,000. If the Western countries do not intensify quota restrictions on textile products, a larger number of garment manufacturers already operating in other countries would be interested in coming here. In the first year, if 10 garment manufacturing units are set up in the Zone, as many as 30,000 to 40,000 jobs could be found in these industries alone.

Additionally, an equal amount of jobs may be found in the rest of the country as a result of primary employment in the Zone. These will largely be in services such as transportation, communications, advertising, packaging, maintenance and the supply of food and raw materials and entertainment. The salaries and wages paid to labour in the Zone would tend to be higher than in the rest of the country, and all this money would be spent here by the Sri Lanka national working in the Zone. Industries that want to get started as soon as possible will tend to take the most skilled and talented workers from other industries in the country and to do this they will have to pay them higher wages. The movement of skilled labour into the Zone will open up new avenues of training and employment in older established industries in the rest of the country. Through this process, there will be much greater diffusion of skills and middle management expertise. The employment generating effects of the Zone in more than one way would thus tend to spread to other areas in the country and will not be confined to the Zone itself.

Business activity in the Export Processing Zone would not be limited to manufacture. The functions of the Zone could progressively increase as it expands and new activities especially in the area of finance, banking and entreport trade could emerge. The concessions in the Zone could provide a stimulus for the development of these other activities. Foreign goods may be brought into the Zone without payment of customs duty for trans-shipment, re-exportation, for further processing for export or with a view to ultimate importation into the local market. Firms operating in the Zone could engage in the assembly, manufacture or the storage of knocked down components in order to get relief from customs duties and other levies. Since most countries, including Sri Lanka, levy very high customs duties and taxes, imports into the Export Processing Zone would be free of taxation, tariff laws and similar regulations which normally apply to the rest of the country.

Limitations on Operations

Although duties and concessions would apply to firms operating in the Export Processing Zone, the latter would be subject to the civil, commercial and banking laws of the country. These would include the registration of commercial and banking companies, laws pertaining to public health, security, penal offences, and the preservation of the environment, etc. Business and personnel taxes would also be applicable within the Zone. Direct revenue to the host country would accrue through personal taxes and levies such as a small turnover-tax on manufactured goods. As the Zone expands, these would be a substantial source of income and much revenue could also accrue from turnover taxes levied on the multiplicity of services provided. Duties on goods exported from the Zone to the rest of the country become payable when they cross the boundaries which will have to be clearly demarcated. Normally some kind of customs surveillance exists on the perimeters of the Zone in order to prevent smuggling and illicit trading activities.

A variety of goods could be brought into the zone, but this would not include goods that are normally prohibited in the host country. Narcotics, dangerous drugs, fire-arms, explosives, precious metals and precious stones which are normally denied free entry into the host country would not be permitted into the Export Processing Zone, unless these items are required for industrial purposes. Within the Export Processing Zone, retail trade in goods manufactured in the Zone is prohibited and even if such sales are allowed they would be subject to the regulations that would apply to them in the rest of the country.

An Export Processing Zone should not be confused with a free port where consumer goods could be purchased free of customs duties and other taxes. The Zone might house a few duty free shops to cater to tourists and foreign visitors who would make purchases in foreign currency. Furthermore, people are not encouraged to live in an Export Processing Zone unless they happen to be the owners of business enterprises or are senior technical, managerial and specialised personnel. Workers usually commute to the Zone and residence is discouraged because the Zone would not cover an extensive area; since land values are high and it would be wasteful to set up housing colonies with in the Zone. Moreover, with fewer residents living in the area it would be easy to police the Zone and maintain security. The proposed Export Processing Zone area around Katunayake would be largely earmarked for medium and smallscale industries and residential housing with in the area would be discourag- although housing colonies would have to come up in the adjacent areas.

Benefits to the Investor

To the foreign investor, the Export Processing Zone offers a wide range of benefits. Most important of these is that the businessman and trader will find that they could economise on the use of funds by not blocking them for the payment of customs duties, import taxes and for goods in bond. He could take advantage of low prices for raw materials in world markets and import in bulk because foreign exchange would not be a problem. The Export Processing Zone could have industries with facilities for refining raw materials or processing them further for export. In such cases, there would be an increase in value added and the improvement in quality would result in considerable saving in freight and duty for the importing country if the duties are leviable on a specific rather than on an ad-valorem basis and the exporter would get better prices. The Zone would be the ideal place for packeting, marketing and labelling of goods in accordance with customers' preferences, and it could be a centre for manufacturers to assemble and prepare goods according to specifications for particular markets. It could operate as a wholesale supply centre and thereby could help to reduce the time lag between the placement of an order and the date of delivery. Improved local delivery schedules could be achieved by firms in the Zone if they carry stocks of raw materials and finished goods in anticipation of orders which would be forthcoming from the host country. The Export Processing Zone could also act as a shop window to attract buyers because it could have a permanent exhibition of the wide range of goods it produces. Foreign buyers would prefer to open up agencies in the area so that they could keep abreast with the new products which are being put out by manufacturers and also endure that manufactures conform to specifications.

Planning the Infrastructure

The experience of a large number of other Asian countries shows that the Export Processing Zone could produce substantial results provided flexible economic policies are put into operation to give investors in the Zone maximum assistance and facilities. The administration of the Zone should be vested in an autonomous agency. The Zone Authority should have over-riding powers over other organisations in order to ensure that the infrastructure will be quickly made available. It should not be faced with the obstacles that normally confront government corporations. It should be able to operate free of bureaucratic controls and take decisions without any hindrance and have the power to get jobs done by other government agencies and departments on a priority basis. The success of the Zone would largely depend on the quality of the basic infrastructure and the wide range of ancillary services it will be able to provide. The Zone authority should be in a position to provide the prospective investor with a complete record of data and other relevant information on investment. It should have documents spelling out the financial laws and other details pertaining to investment in the country.

International private investment today is very competitive and it is extremely sensitive to conditions in the local environment. The foreign investor normally has a large number of options and he would prefer to locate his industry under ideal conditions. It is precisely these conditions that the Authority should endeavour to provide, in the other words, the quality of the services provided in the Zone should be superior to those in other locations. It is fruitless to think that foreign investors would come to Sri Lanka regardless of disabilities and unfavourable conditions prevailing in the economy unless it has some compensation in the high quality of services offered in the Zone.

The success of the Export Processing Zone and its capacity to attract foreign investment will depend essentially on how much planning has gone into location and the making of the infrastructure. Investors look far ahead and they would make a careful study of overall economic policy and the general environment of Zone. They will examine the relative advantages and disadvantages of the Zone as against facilities available elsewhere. They would, at the very outset, expect a basic statement of policy, not only in regard to the Zone, but also, indicating the attitudeof the government towards foreign investment, and what safeguards would be given to the foreign investor. The promotion of the Zone will have to involve an extended publicity campaign overseas. There has been very little publicity given to economic activity here in the leading overseas financial journals and magazines. Without publicity, at an international level prospective investors may not know what Sri Lanka has to offer and such publicity should be undertaken well in advance.

The infrastructure will have to be carefully planned and in particular the land earmarked for the Zone would have to be advantageously located and clearly demarcated because it will have to satisfy a large number of requirements not only at the beginning but later on. It would have to have proper drainage, should not get water logged and should be easily accessible to the network of major roads: adequate land must be available in the vicinity for housing colonies and sattelite towns. There should be ready means of access to ports and airports and the communication nerve centres. Although a considerable amount of land may not be required in the initial stages, it is reasonable to assume that 30 to 40 factory units may be operating in the first year to 18 months and the initial land area required may be 500 acres although at least another 1,500 acres may be earmarked for further expansion.

The government will have to decide at the outset whether physical planning of the Zone will be entrusted to the private sector or the goverment departments. Problems faced by private industrialists all over the Island is the lack of a stable electricity and water supply and efficient telecommunication facilities. These three services will have to be given greatest priority. The supply of electricity should be good enough so that most factories would be able to operate without standby supplies. In regard to water, a permanent water purification scheme may have to be installed for water not only to industries but also the housing colonies around the Zone. If the Zone is going to be located at Katunayake, it may not be advisable to link it to the Colombo supply because it does not have the capacity to meet the requirements of Colombo and the Zone. The water supply to the Zone may have to be based on separate purification plants linked to the Kelani Ganga and situated to the north of the river.

With regard to factory buildings and installation of plant, a large number of services would have to gear itself to meet the relatively short deadlines for construction and installation given by foreign investors. They would be normally accustomed to sophisticated construction techniques in their own countries and would be unfamiliar with the methods used here and may not be satisfied with the slow pace at which construction takes place in Sri Lanka. In view of this, it may be necessary for construction firms, particularly those in the private sector, to gear themselves to meet the exacting requirements of the foreign investor. As the programme goes a head shortages of certain skills may occur both at the construction stage and later on for industries within the Zone. On account of the heavy drain of technicians and skilled workers to the Middle East, schemes may have to be launched to train technicians of all varieties and personnel of middle management grades in order to cater to the skills required for industries in the Zone.

The bulk of the equipment and raw materials for industries in the Zone will have to come through the Colombo harbour, even though it is possible for some part of the light industrial raw materials to come by air. This will involve efficiency at two points. There will have to be a very efficient system of transport between Colombo and Katunayake, moving raw materials one way and finished products on the other. What is even more important is that the services of the Colombo port would have to be pepped up to meet the needs of the Zone. It is clear enough that the Colombo port as it is presently organised cannot cater to the needs of the Zone. Apart from frequent labour problems and management inefficiencies there are also inadequate berths and unsatisfactory loading and unloading facilities. Additional warehousing space will have to be built to handle cargo to and from the Zone which would probably keep on arriving or leaving on a continuing basis. Furthermore, as the Zone gets more sophisticated, the bulk of the cargo will either arrive or leave in containerised form and the Colombo port does not have a single container berth. All this calls for immediate improvement to the facilities in the port and such improvements should be affected well in advance so that the investor would not have second thoughts about his investment here. He will realise that if he does not have excellent facilities for the movement of his raw materials and finished products he would be at a great disadvantage.