Perpetuating the Inequality between Foreign and Domestic Investors through Crisis-Driven Legislation: Insights from Sri Lanka's Economic Transformation Act

By:

Dilini Pathirana

08 May 2025

Introduction

While marking the worst economic crisis in its history, Sri Lanka declared a sovereign debt default in April 2022. This was followed by a temporary suspension on the country's external debt repayments, becoming the first State in the Asia-Pacific region to enter sovereign default in the 21st century. Sri Lanka's 2022 economic crisis caused significant human suffering and resulted in an unprecedented domestic political crisis while requiring the country to navigate a complex geopolitical rivalry between China, India, and the West. Meanwhile, Sri Lanka approached to International Monetary Fund (IMF) for a bailout. Approaching the IMF made it essential for Sri Lanka to restructure its public debt and to restore debt sustainability and pave the path for rebalancing the country's shattered economy. In tandem with debt restructuring, Sri Lanka is required to undertake profound reforms which are deemed essential in transforming the country's economy while preventing the 2022 economic crisis from persisting. The reform agenda, inter alia, focuses on enhancing the competitiveness and productivity of the Sri Lankan economy, as well as streamlining the country's trade and investment environments. These endeavors are supposed to be undertaken within a national policy outlined in the Economic Transformation Act No. 45 of 2024 (the Act or the ET Act). This law was introduced in May 2024 and became effective in August 2024.

The national policy outlined in the ET Act identifies promoting foreign investment as a key driver in Sri Lanka's economic transformation. It further underscores the need to attract export-oriented foreign direct investment (FDI) to support the 'growth of non-debt creating inflows to the economy'. The policy sets forth two specific investment goals. The first is to increase the country's net FDI inflow to at least five per cent of Gross Domestic Production by the year 2030. The second is to ensure that at least forty per cent of the country's net FDI is in exports of goods or services by the same year. Achieving these goals requires Sri Lanka to create a conducive business environment. The preamble to the ET Act also emphasizes the need for a law that fosters an investment-friendly environment within the country. It further affirms Sri Lanka's commitment to establish 'a transparent, inclusive, and rules-based system that promotes fair and equitable treatment' for both domestic and foreign investors. To that effect, the ET Act provides for a comprehensive set of investment guarantees. Yet, they mainly focus on protecting the interests of foreign investors and placing them in an advantaged position relative to domestic investors. The idea behind prioritizing investor protection is to ostensibly promote FDI which has been identified as a key driver of Sri Lanka's economic growth in the post-economic crisis era.

Against this backdrop, this note demonstrates how the ET Act prioritizes foreign investors and their interests over those of domestic investors and places them in an advantaged position, leading to inequality between these two groups of investors. My claim is that the ET Act manifests the structural biases inherent in international law on foreign investment while perpetuating the long-standing power disparity between foreign and domestic investors by embedding it within Sri Lanka's domestic legal system. International law on foreign investment or international investment law is a controversial part of international law. It has been criticized for protecting private interests of foreign investors at the expense of public interests of States hosting them and undermining the State right to regulate in the public interests. Critics further argue that it privileges foreign investors over domestic investors by providing the former group with special rights and legal protection under international investment agreements (IIAs) – the building blocks of the contemporary investment treaty regime. IIAs stipulate both substantive and procedural standards that safeguard cross-border capital investments, notably allowing foreign investors recourse to international arbitration against allegedly infringing host States. Thus, the investment treaty regime is an imbalanced system that needs to be reformed to strike a better balance between private and public interests, while addressing biases and power imbalances inherent in it, including the inequality between foreign and domestic investors.

Making 'Positive Differentiation' between Domestic and Foreign Investors Possible

Chapter IX of the ET Act provides several substantive investment guarantees, and they mirror the treatment standards commonplace in IIAs. National treatment is one of them. Section 37(1)(a) of the Act states that '[f]oreign investments and returns on investments of foreign investors shall be accorded treatment not less favourable than that accorded to domestic investors, in like circumstances…'. Section 37(1)(b) makes it clear that the 'in like circumstances' should be decided on a case-by-case basis, objectively assessing all circumstances including factors such as the sector and location of investments concerned. As such, the ET Act obliges Sri Lanka to extend to foreign investments/investors (hereinafter collectively referred to as 'foreign entities') treatment at least as favourable as that it accorded to similarly circumstanced domestic investments/investors. Legally, it holds merit because the guarantee on national treatment prohibits nationality-based discrimination between comparable domestic and foreign entities. In my view it is important to eliminate 'distortions in competition' by assuring a 'degree of competitive equality’ between domestic and foreign investors. From a policy perspective, however, treating foreign and domestic entities with equivalence could be both an economically sensitive issue and politically controversial matter, particularly in developing countries like Sri Lanka. It is hard to deny the ‘economic asymmetry’ between foreign and domestic entities in a context where foreign investors are transnational corporations while domestic investors may be merely emerging entrepreneurs or ‘infant’ industries.

Such unevenness makes it difficult for domestic investors to compete with financially and technologically powerful foreign investors, gradually pushing them aside, perhaps leading to foreign entities dominating the market. Therefore, States hosting foreign investments are inclined to preserve their policy space to maintain ‘a degree of flexibility’ in the treatment of investment with exceptions to national treatment. Preserving such policy space is crucial if a State ponders the growth of domestic industries is key to its economic development over the long term. Yet, the ET Act leaves Sri Lanka with a narrow policy space to provide domestic investors with particular advantages or privileges as Section 37(1)(a) guarantees the equality of treatment between domestic and foreign entities insofar as they are in ‘like circumstances’. The qualification of ‘like circumstances’ is not the most suitable choice to provide the country with a greater policy space to differentiate foreign and domestic entities where necessary. It is important only in limiting the factual situations to which the guarantee of national treatment should be extended. Thus, the fact that domestic and foreign entities are comparable is sufficient to preclude Sri Lanka from granting any particular advantage or privilege to domestic entities, even if such benefits are devised to increase their competitiveness and stimulate growth. This, in turn, could make upholding the ‘operative equality’ between foreign and domestic entities challenging, questioning Sri Lanka’s ability to foster the growth of domestic enterprises in the context of its economic transformation, as well as the country’s long-term economic development.

These concerns are furthered by the fact that Section 37(1)(a) of the ET Act states ‘no less favourable’ as the standard of comparison by which the treatment of comparable domestic and foreign entities should be assessed. At its foundation, this formulation guarantees that foreign entities will be treated at least as favourable as comparable domestic investors/investments. It prohibits 'negative discrimination' between foreign and domestic investors. In doing so, the Act ensures promoting the position of foreign entities to the level of comparable domestic entities. At times, however, treating foreign entities with equivalence to comparable domestic investors provides no meaningful protection for them if the host State treats its own entities badly. Nor does it provide particular benefit to foreign entities if domestic entities have the least rights and privileges under their national laws. Such scenarios provoked one of the highly contested notions in international law, with different views held by developed and developing countries, the minimum standard of treatment under customary international law. It has been advocated by developed capital-exporting countries to ensure that the treatment of foreign entities does not fall below a certain minimum, despite 'any relevant relative comparison'. Buttressing this aim, national treatment standards in most IIAs, including Sri Lanka's investment treaties, stipulate the treatment to be 'no less favourable'.

The formulation of 'no less favourable' not only prohibits 'negative discrimination' between comparable domestic and foreign entities but also makes 'positive differentiation' between them possible. Such a possibility arises when the national law of the host State is less protective than the so-called international minimum standard of treatment under customary international law. This explains the reason why the formulation of 'no less favourable' has been portrayed as a means that offers 'the possibility not only of equal treatment but also of better treatment for foreign investors'. In contrast, formulations such as 'same' or 'as favourable as' only suggest offering foreign investors treatment that is 'no better than' that received by domestic investors, preventing the possibility of foreign investors claiming preferential treatment. Yet, the ET Act, by embracing the formulation of 'no less favourable', keeps the possibility of granting preferential treatment to foreign investors open, regardless of its potential discriminatory effects on comparable domestic investors. The ability of these domestic investors to seek legal remedies is questionable since the ET Act has made it lawful to differentiate between comparable domestic and foreign entities as a matter of Sri Lanka's statutory obligation. Thus, Section 37(1)(a) of the ET Act is an illustration of how structural biases inherent in the conventional investment treaty regime are represented in and reinforced through the Sri Lanka's law on economic transformation by making it possible–and even obligatory–to grant foreign entities preferential treatment over domestic ones.

Placing Foreign Investors in an Advantaged Position regarding Dispute Settlement and Prevention

The ET Act provides procedural investment guarantees, stipulated in Chapter X on ‘Transparency and Dispute Settlement’. Section 44(1) of the Act requires that investment disputes be settled promptly and amicably through consultations and negotiations between the parties. Should they not resolve the dispute amicably, Section 44(2) vests ‘any investor’ with the right to use ‘all other remedies’ under the laws of Sri Lanka. The phrase ‘any investor’ brings both domestic and foreign investors under the purview of Section 44(2). It is important in ensuring the inclusiveness of the ET Act whose preamble refers to both domestic and foreign investors, emphasizing the need to have a law that treats both groups of investors fairly and equally. At the same time, remedies available for investors under Sri Lanka’s law include options such as litigation, arbitration and mediation. Regarding the settlement of foreign investment-related disputes, however, the Proviso to Section 44(2) specifically mentions the possibility of resorting to alternative dispute resolution (ADR) mechanisms, including foreign arbitration. To be precise, it states that parties to a dispute between a foreign investor and the State may agree to settle it through ADR mechanisms, including ad hoc arbitration and institutional arbitration. The Act further assures the recognition and enforceability of foreign arbitral awards in Sri Lanka. In doing so, the ET Act aims at courting foreign investors by explicitly highlighting their ability to bypass Sri Lanka’s national court system in settling investment disputes with Sri Lanka.

It further aims at addressing concerns that are allegedly associated with resolving investment disputes through domestic litigation, such as possible prejudices against foreign investors and the ineffectiveness of national court systems. This explains why typical IIAs, including Sri Lanka’s investment treaties, generally allow foreign investors to access international arbitration instead of resorting to domestic courts of the host States to resolve their disputes. In doing so, international investment law privileges foreign over domestic investors who are not give a similar right under IIAs in a manner which distorts the legal equilibrium between them. The Proviso to Section 44(2) which specifically mentions foreign investors’ ability to resort to foreign arbitration largely resonates with the rationale of disputes settlement clauses in IIAs and represents their privileged position even under Sri Lanka's domestic legal system. The Act furthers their privileged position by granting foreign investors special legal advantage regarding dispute prevention. To be precise, Section 43(1) of the Act mandates establishing 'a Grievance Committee to which a foreign investor may refer any grievance arising from any dispute, difference, disagreement or any matter between the foreign investor and the State…for settlement through a consultative process'. By limiting its access only to foreign investors, the ET Act completely overlooks domestic investors, focusing exclusively on prevention of foreign investment-related disputes. As such, Proviso to Section 44(2) and Section 43(1) of the ET Act are clear illustrations of how structural biases inherent in the investment treaty regime are manifested in Sri Lanka's law on economic transformation by privileging foreign investors in settling investment disputes and leaving domestic investors behind in preventing such disputes.

Conclusion

The 2022 economic crisis marks a turning point in Sri Lanka's law and policy landscapes, notably with respect to the economy. The ET Act, which was brought as a part of the country's economic recovery programme supported by the IMF, is intended to serve as the framework within which Sri Lanka's economy should be revived during the post-crisis era. The national policy on economic transformation outlined in the ET Act identifies FDI as one of key drivers of the country's economic growth, embodying the core principles of the Washington Consensus. One of the goals of the Washington Consensus is the promotion of foreign investment as a means to boost productivity and increase competitiveness of developing economies like Sri Lanka. Investment guarantees, both substantive and procedural, are expected to play an important role in making Sri Lanka an investment-friendly destination, and thus the ET Act provides for a set of investment protection rules rooted in conventional IIAs. These rules, however, are often blamed for being imbalanced and prioritizing foreign over domestic entities, leading to inequality between these two groups of investors under international law on foreign investment. This long-standing inequality is patently manifested in the ET Act – not only in provisions that mirror the conventional investment protection rules such as the national treatment and settling investment disputes through international arbitration but also in innovative provisions such as the prevention of investment disputes. In doing so, the Act exemplifies how structural biases and power imbalances inherent in the conventional investment treaty regime are embedded in Sri Lanka's law on economic transformation while reinforcing and perpetuating the systematic inequality between domestic and foreign investors at the domestic level.

* I developed this post during my time as the Global South Visiting Fellow (January-April 2025) at the Peter A. Allard School of Law, University of British Columbia. I am sincerely thankful for this fellowship, which has been an academically enriching experience. Views expressed are my own.

View online: Perpetuating the Inequality between Foreign and Domestic Investors through Crisis-Driven Legislation: Insights from Sri Lanka's Economic Transformation Act