Pathfinder Economic Flash

From Underutilized Asset to Economic Blessing

Utilizing land for wealth and job creation

Any grossly underutilized factor of production, whether it be land, labour or capital is equivalent to an economic crime as it deprives people from opportunities for wealth creation and gainful employment.

The Pathfinder Foundation (PF) addressed land related issues in its 27th Economic Flash. We are returning to this theme as recent discussion on proposed legislation on the transfer of land to foreigners has made it useful to address these issues again.

It must be recognized that land is an emotional issue everywhere in the world, particularly in small countries. As an economy modernizes, land-related issues become more complex and sensitive. It becomes increasingly difficult to balance the competing claims of food security; equity considerations related to asset ownership; shelter; provision of essential services; and releasing economic value, while attaching high priority to environmental sustainability. It is imperative, therefore, to take a holistic view of the challenges related to land policy and undertake a constructive debate on the subject.

From Underutilized Land to High Value Land with Investment Projects

Land policies, in Sri Lanka, are currently unpredictable and opaque. They act as a major deterrent to investment and thereby constrain the development prospects of the country. As the owner of 80% of the land, the state has the primary responsibility for creating an environment that is conducive for generating maximum value from the land as a factor of production and a source of shelter.

In this context, it is important that any proposed legislation on the transfer of land to foreigners for investment purposes should not add to the complexity and uncertainty attached to the land market. On the one hand, there is now a consensus that foreign investment will have to play a crucial role in the economic transformation, particularly the export growth, which is necessary to attain the government's growth targets. On the other hand, almost all countries globally, from the US and China to the poorest and smallest countries, are still competing aggressively to be destinations for FDI. In such a context, policies that serve to add to uncertainty regarding a country's commitment to foreign investment are likely to be counterproductive. The upshot is that the return on the massive investment that is being made in infrastructure development would be reduced significantly if FDI is discouraged through inappropriate policies that increase the cost of land. It is important that the need for government revenue and/or pandering to primordial sentiments do not result in deterring foreign investment as well as opportunities for local investors (including joint ventures and supply chain penetration) and workers.

Foreign Shareholdings, Foreigners, Condos, Taxes: Encouraging Investment or..?

It is being said that the proposed legislation will prohibit freehold outright transfer of land to foreigners (non citizens), foreign companies (incorporated abroad) and companies incorporated in Sri Lanka where foreign shareholding accounts for 50% or more of the capital. However, if the land transfer has taken place 10 years before a company acquires 50% or more foreign shareholding the transfer is expected to remain valid. Of course, this means that any transfer that has taken place within less than 10 years would be deemed invalid.

It has been indicated that exemptions include: companies which have foreign shareholdings of 50% or above, where they have been in operation in Sri Lanka for a period of 10 consecutive years; and condominia on or above the 4th floor (excluding the ground level floor and any floor dedicated for parking). However, there is some opacity regarding the practical implications of these exemptions. For instance, a Sri Lankan company quoted on the stock exchange can become a majority foreign owned entity at any given time. This raises questions about the status of any land it may have acquired within 10 years of such a change in its ownership status in terms of the specifications contained in the proposed legislation. Furthermore, it is also possible that the Company concerned reverts to being a Sri Lankan company if foreigners sell some of their shares. All this is a recipe for uncertainty, unpredictability and confusion.

The benefits of the exemption granted to foreigners to purchase condominia, on or above the 4th floor, are also mitigated by the tax of a minimum of 15% that is expected to be levied on such purchases. This would raise prices and discourage such purchases with deflationary implications for the building industry and the property market.

Discretion: In the Interest of the National Economy

It is also expected that there will be provision for discretion to be exercised by the Minister of Finance, in consultation with the Minister responsible for the subject of land and with prior approval of the cabinet, to grant exemptions to land transfers deemed to be in the "interest of the national economy" provided there is a substantial inward remittance for the purchase of the land concerned. Such exemption is also expected to be available for enterprises that seek to purchase land to locate or relocate their global or regional operations in the country.

It is expected that there will be a tax payable on freehold outright transfers to parties that are granted exemptions from the proposed restrictions. The applicable rates of such a transfer tax will be set by the Minister of Finance. In this instance, the Minister does not have discretion with regard to granting exemptions from the transfer tax except where the transfer is to enterprises of international repute which wish to purchase land to locate or relocate their global or regional operations.

While foreigners and foreign companies are prohibited from acquiring freehold outright transfer of land (except in the case of exemptions specified above), land may be leased to them up to a maximum tenure of 99 years. Such leases will also be subject to a tax. Exemptions from this tax are expected to be the same as those that apply to the transfer tax on freehold property. The general rate applicable is set to be a minimum of 15%, with a concessional rate of 7.5% to properties situated in a BOI/industrial/tourism zone. Here again, potential foreign investors are likely to perceive the tax imposed as a deterrent.

In assessing the merits of the proposed legislation, it is important to recognize that there is provision for the Minister of Finance to exercise discretion to grant exemptions from the restrictions imposed by the proposed legislation on foreign ownership of land. However, in a world where competition for foreign investment is very intense, relying on discretion creates uncertainty and unpredictability which reduces the competitiveness of the country as an investment destination. Furthermore, it is also necessary to take cognizance of the fact that many of the foreign investors who could come to Sri Lanka would be small and medium sized entrepreneurs (in the global sense) who would not qualify for exemptions provided under the proposed legislation. For them, land prices would be an important determinant of the destination of their investment. Hence, any measure that increased land prices will serve to deter much needed foreign investment in a world where almost all countries are competing for internationally mobile capital.

Increasing Value and Job Creation from Rural, Urban Land and State Owned Land

The PF would also like to take this opportunity to reiterate some key messages that were conveyed in the previous Economic Flash on the issue of land. In the rural sector, the time has come to review land use patterns and crop mixes (particularly the cultivation of high value products for exports). In urban areas, considerable value can be created by releasing large tracts of underutilized state-owned lands, particularly those belonging to government departments, such as the railways and postal department. Such land sales can also generate funds that can assist in addressing the twin fiscal challenges of the budget deficit and the public debt. There is also a strong case for establishing a land bank supported by an online site which provides information on “cleared” land and the purposes for which they can be utilized.

Towards a Land Policy that Promotes Investment, Employment and Wealth.

The PF would like to emphasize again that the real value of the land is not in itself but in the economic activity it facilitates. It is also important to realize that land cannot be taken out of the country. In such a context, it is counterproductive to introduce measures that constrain the release of the full value of large extents of underutilized land by discouraging foreign investment. It is clearly important to attach high priority to obtaining fair value for state lands. However, the market should not be distorted to the point where high land prices suppress economic activity.

As Sri Lanka is a small island nation there may be a case, though debatable for introducing limitations with regard to foreigners buying and selling land with no plans for making gainful investments. However, *it is important not to throw the baby out with the bath water.*

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