Pathfinder Economic Flash

Balancing Investor Friendly Land Policies and the National Interest.

Land: A Crucial Determinant of Economic Prospects.

As a factor of production, land is a crucial determinant of a country's economic prospects. Under-utilized land undermines opportunities for gainful employment and wealth creation. It is important to recognize that the real value of land is not in itself but in the economic activity it facilitates. It also self-evident that land cannot be taken out of the country. In an economy, which is characterized by both a savings-investment gap and a deficit in the current account of the balance of payments, it can be counter-productive to introduce legislation which would deter foreign investment that can release the full value of large extents of under-utilized land. Discouraging foreign investment in a crucial factor of production, such as land, can transmit negative signals more broadly which will discourage much needed non debt-creating external inflows which are essential to achieve the government's growth targets. It is a matter of concern, therefore, that the government is bringing forward legislation which could reduce foreign investment which can address the savings gap and the current account deficit in a sustainable manner.

The growth rates set out in the government's medium-term Road Map cannot be met without a significant increase in foreign investment. Sri Lanka's debt dynamics are such that the country's growth model needs to become less dependent on foreign commercial borrowing and more on foreign investment. The Pathfinder Foundation (PF) is returning to the land policy theme for a third time because the twin objectives of releasing the full value of land and attracting significantly more foreign investment are crucial for realizing the country's economic potential. This has to be an important part of the recipe of breaking-out of the legacy of mediocre economic performance that has characterized Sri Lanka's post-independence era. More detailed treatment of these issues can be found in the PF's 27th & 33rd Economic Flashes at www.pathfinderfoundation.org

Complexity and Sensitivity of Land Issues.

With economic modernization, land-related issues become more complex and sensitive. It becomes more 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 priority to environmental sustainability. For these reasons, land is an extremely emotional issue everywhere, particularly in small countries. It is imperative, therefore, to take a holistic view of the challenges related to land policy and undertake a constructive discussion on the subject. It should not be forgotten that land was one of the key issues underlying the separatist conflict that plagued the country.

As Sri Lanka is a small island nation, one can make a case for introducing some limitations on foreigners acquiring land. However, this argument needs to be balanced by the fact that the state continues to own about 80% of the land and there are large tracts of under-utilized land in the country. Foreign investment can assist in realizing the potential of this mostly under-utilized asset. In the rural sector, there is scope to review land-use patterns and crop mixes (particularly cultivation of high value crops for export). In urban areas, the potential exists to release state-owned land, particularly those belonging to government departments, such as the railways and the postal department. This would also serve to mobilize funds to strengthen the government balance sheet. The PF has advocated the establishment of a land bank supported by an online site.

Can Sri Lanka Afford to Transmit Negative Signals to Foreign Investors?

The proposed legislation is expected to prohibit freehold transfer of land to foreigners (non-citizens); foreign companies incorporated abroad; and companies incorporated in Sri Lanka where foreign shareholders account for more of the capital, unless they have been operating in Sri Lanka for 10 consecutive years. The last provision creates uncertainty regarding its practical implications, as a Sri Lankan company floated on the stock exchange can become a majority foreign owned company at any given time. Uncertainty is created when this is taken together with the proposal that the legal validity of a transfer of land to a locally incorporated company with less than 50% foreign shareholding will only be maintained if the foreign shareholding remains below 50% for a minimum of 20 consecutive years. Hence, if the ownership structure changes through legitimate share market operations whereby foreign ownership exceeds the 50% threshold, a previously legal land deal is invalidated. It is important, therefore, that the legislation is drafted in a manner which takes into account the nature of stock market operations. Failure to do so, will create uncertainty that deters both domestic and foreign investment (both FDI and foreign flows into the stock market).

The proposed legislation is also expected to introduce a Land Lease Tax of 15% on land transfers to the three categories of foreign entities specified above. It involves an one-off upfront payment based on the lease value of the land. It is 7 ½% for companies which are locally incorporated where the foreign shareholding is above 50%, provided such a company has been operating in Sri Lanka for a minimum of 10 consecutive years, as well as for condominia, based on conditions which have been specified in relation to the length of the lease. The lease of land in the BOI zones; tourist development areas; industrial estates; and other areas stipulated by the Minister concerned will also be subject to the reduced 7.5% tax.

The Land Lease Tax will raise prices and discourage purchases resulting in inflationary implications for the property market and the construction industry with consequences for overall growth, employment and incomes in the economy.

Throwing the Baby out With the Bathwater.

The proposed legislation on foreign ownership of land imposes restrictions which are likely to deter foreign investment. While a number of important exemptions have been built-in to the legislation, and the Minister responsible for land along with the Cabinet of Ministers, have the discretion to grant further exemptions, the overall message is likely to be negative. In a world where almost all countries are competing for internationally mobile capital, introducing restrictions, uncertainty and unpredictability through legislation reduces the competitiveness of a country as an investment destination. The proposed Land Lease Tax has to be seen as a tax on all foreign direct investment as it will inflate land/property prices which are an important determinant of the destination of a large proportion of FDI. Domestic businesses will also be adversely affected by the increase in the price of land. Large and small businesses will be discouraged by this trend with particularly negative consequences for start-up and expansion plans.

Measures, which discourage or deter foreign investment in a country with twin savings and foreign exchange gaps (and concerning debt dynamics), can well be seen as a case of 'throwing the baby out with the bathwater'.

This is the Fifty First Economic Flash published by the Pathfinder Foundation. Readers' comments are welcome at www.pathfinderfoundation.org