The Pathfinder Economic Alert

Are we serious about private investment?

Confidence: the Most Critical Element of the Business Climate

Need of the Hour

Investment needs to increase from 28% (2010) to 34% of GDP to attain the government's growth target of 8%, as Sri Lanka's incremental capital output ratio is 4.2. Public investment has been capped at 6% - 7% of GDP. This means that private investment, both domestic and foreign, needs to increase from the current 21% of GDP to 27-28%. It is, therefore, important to create a conducive business climate that encourages private investors to fill this gap. Failure to do so will mean that the government's growth target will not be met on a sustained basis. Attempts to circumvent the lack of private investment by raising the level of public investment are likely to undermine the government's own fiscal consolidation targets and thereby have an adverse impact on the country's macroeconomic fundamentals. As a lower-middle-income country with an increasing exposure to capital markets, Sri Lanka cannot afford to allow this to happen.

Despite the end of the war, the response of private investors has, so far, not been as robust as one would have hoped. Both domestic and foreign investment has been more muted than necessary to meet the government's growth targets.

Positives

The government, led by the Central Bank of Sri Lanka (CBSL), has implemented a concerted programme to improve Sri Lanka's position on the World Bank's Doing Business Index (DBI). This initiative has been successful in improving Sri Lanka's ranking to 89 out of 183 countries this year, an improvement of 9 places. This is attributed to: strengthened investor protection, through more stringent disclosure requirements for interested transactions; and reduced costs of paying taxes. The DBI also indicates that there is room for improvement in areas such as paying taxes; registering property; and enforcing contracts. However, the overall improvement is a very notable achievement.

Necessary but Not a Sufficient Condition

While it is necessary to improve the country's performance on the DBI, it is not a sufficient condition for strengthening the overall investment climate to meet the government's goals. The DBI, which is process oriented, does not include important aspects of the overall investment climate, including land policy, labour market policies, macroeconomic stability, the skill level of the workforce, the strength of financial systems and corruption. Above all, it does not capture the relationship between investor confidence and consistent and predictable government policies.

Consistency & Predictability of Government Policies and Decisions or Else…………

A number of international surveys clearly indicate that the consistency and predictability of government policies and decisions are the most important determinant of investor behaviour, both local and foreign. It is more important than tax concessions or even the robustness of a country's macroeconomic fundamentals. A lack of confidence in the stability of government policies and decisions reduces risk appetites and discourages investors from increasing the time horizons for the expected return on their investment. Without this, it is not possible to build up the productive capacity of the economy and to create the high value employment that will improve the living standards of the people on a sustainable basis, as envisaged in the Mahinda Chintana. The investor confidence that is generated by consistent and predictable policies is, therefore, crucial for implementing the five hubs based vision embedded in the Mahinda Chintana. Measures that undermine investor confidence will, therefore, undermine the objectives of the Mahinda Chintana.

It is also important to have clarity regarding the space that is available to the business sector at a time when organs of the state are moving into activities that could be in the realm of private enterprise. In most instances, the private sector would not be able to compete on a level playing field with entities that are sponsored by the state.

Will the Law on Under-utilised State Assets be Counterproductive?

In this connection, the **draft Bill titled "An Act to provide for the vesting in the State identified Under-performing Enterprises and Under-utilised Assts"** has the potential to create considerable uncertainty and undermine business confidence. The proposed legislation, which has been presented to the Supreme Court as an Urgent Bill, has not benefited from the usual round of consultations. It is contended that the legislation will be a one-off measure targeted at a specific list of entities. However, using legislation to expropriate assets at a time when Sri Lanka is seeking to accelerate its growth trajectory through enhanced private investment would be counterproductive. **A more investor-friendly option would be to incorporate US-style Chapter 11 restructuring provisions into the Companies Act. Another market-friendly approach would be for the Government to infuse equity into enterprises that can be resuscitated on the basis of well formulated restructuring programmes and subsequently dispose of its holdings at a profit. This method has been used successfully in**

Europe and the US to support the banking and auto sectors recently. There is merit in exploring whether these approaches can be adapted to meet the government's objective of enhancing the performance of under-utilised assets.

It is possible that a lack of stakeholder consultation is leading to greater uncertainty than is warranted. It is a fact, however, that perceptions matter when it comes to investor confidence, both domestic and foreign. Lack of clarity in relation to this sort of legislation reduces risk appetites and discourages investors from taking the longer-term perspective that is necessary to achieve the country's goals in terms of investment, growth and high value employment.

Unlocking the Value of Under-utilised State Land

The current uncertainty and unpredictability regarding government land policy is also undermining the investment climate. Much of the ongoing debate is based on an emotional attachment to land. Such sentiments are not confined to Sri Lanka alone. However, investment is required to unlock the value of any land. For instance, the land occupied by the Defence Ministry, for 30 years, in Galle Face, constituted a gross under-utilisation of a very valuable asset. The decision to sell some of the land will now generate economic activity, employment and tax revenues that will assist in funding basic services delivery and infrastructure development. It must also be recognized that even if land is sold to foreigners they cannot take it out of the country. It will always be possible for Sri Lanka to benefit from the productive use of it.

It is important that the Government adopts clear and consistent land policies. Ad hoc decisions and policy reversals undermine business confidence and deprive the country from realizing the full value of a precious asset. Any land policy must be designed in the national interest. However, it must be pragmatic and hard-headed rather than dogmatic and emotional. National priorities must be identified clearly and should be the basis of the formulation and implementation of consistent and predictable land policies.

Where land sales entail involuntary resettlement, it is important that international best practice is pursued. There is a National Involuntary Resettlement Policy already in place. It was developed in relation to the Southern Highway Project.

Contracts

The sanctity of signed contracts is also important for building investor confidence. Failure to follow through on signed agreements is likely to increase uncertainty and discourage private investment.

Conclusion

In a context where distances have shrunk remarkably through the advance of technology, news of measures that undermine the business climate and investor confidence are quickly transmitted around the world and can have an extremely adverse impact on the country and its people. This is amplified at a time when global uncertainty is resulting in a reduction in risk appetites as well as capital flows to emerging economies.

This is the Sixteenth in the series of Economic Alerts issued by the Pathfinder Foundation.

Readers' comments via email to pm@pathfinderfoundation.org are welcome.