

Property Rights and Capital Formation: A Requisite for Economic Growth and Development of Sri Lanka

Introduction

A fundamental requirement of capitalist economic growth and development is property rights. Property rights encourage people to generate capital, and thereby, create wealth. The United States of America (USA) and the Western European countries have become developed nations in the world, as they succeeded in establishing clearly defined property rights (De Soto, 2000). The developing countries which attempted to emulate the capitalist model without its fundamental requirements failed in reaching the Western development standards. In the cases where they made moderate progress, development has not been widespread and been limited to few geographical areas (such as metropolis) and to few production sectors.

The purpose of this essay is to examine the importance of clearly defined and enforced property rights as a fundamental requirement of capitalist economic growth and development in Sri Lanka. Even with favourable initial conditions that Sri Lanka inherited from the colonial past,¹ the country experienced slow growth and failed in achieving capitalist economic development. Thus, Sri Lanka provides one of the best case studies to investigate and analyse the failure of achieving capitalist economic growth and development.

Property Rights and Capital Formation

A property is a physical asset which has the potential to generate capital. According to De Soto (2000), "capital is the force that raises the productivity of labour and creates the wealth of nations". As economic growth models explain, the key to achieve sustained economic growth is the *increase in capital*

per unit of labour, which also makes labour more productive. However, the ability of an asset to generate capital depends on the rights of assets ownership.

Property right is the legal entitlement to own an asset and to make use of the asset at the owner's will. The legal ownership alone does not determine the property right, if the owner does not have the authority to determine the use of the property. As Alchain (undated) explains, property right is the 'exclusive authority' of the owner to determine the use of the asset. Therefore, property rights include, not only the ownership of property, but also the rights to use property, to gain from property, to transfer or sell property, and to exclude others' interference.

Whether or not a nation has the capacity to generate capital out of the assets depends on whether the property rights are clearly defined and enforced. According to the types of property ownership, there are private properties owned by individuals or companies and, public properties, owned by government. In addition, there can also be properties which do not belong to anyone. In each of these cases, people behave differently in making use of property as their behaviour is conditioned by the prevailing property rights:

- People treat their private property differently, resulting in differences in capital formation. People who have the exclusive authority over their private property have the ability to make use of property to generate capital than others who do not have exclusive authority as such.
- People care more about their own property than public property or no one's property. They make use of the properties which do not belong to them

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for private gain, when the property rights are not enforced, excluding the illegal private gains. But, they are not in a position to generate capital as properties are not their own.

People do not contribute to capital formation, when do not have the legal ownership of and control over assets. Soto (2000) explains that "...the total value of the real estate held but not legally owned by the poor of the Third World and former communist nations is at least USD 9.3 trillion". This is more than twenty times the total foreign direct investment into all these countries in the ten years after 1989, forty six times as much as all the World Bank loans of the past three decades after 1970, and ninety three times as much as all development assistance from all advanced countries in the same period. In spite of the greater potential of the assets held by the poor in these countries, many of them failed to foster growth and development. The lack of clearly defined property rights stimulate corruption and lead to high transaction costs. This is one of the reasons why most of the Third World and former communist nations are less free from corruption which leads to less economic freedom (Gwartney and Lawson, 2008). Lack of property rights also creates distortions in the market value of assets, affecting the ability to generate capital. Since part of the assets of the country are subject to ill-defined property rights, the market price of the assets coming under well-defined property rights naturally increases.

Land Ownership in Sri Lanka

The history of capital formation out of agricultural land in Sri Lanka shows

that how plantation agriculture generated capital, compared with domestic agriculture consisting of paddy, vegetables and other food crops which actually consumed part of the plantation surplus. During the colonial times, the British planters acquired land from peasants for plantation of tea, rubber and coconuts, while the colonial government granted the legal rights to the planters. According to a World Bank mission that visited Sri Lanka in 1951, the contemporary economic prosperity - as they called it "one of the highest in Asia" - was due to the "revolution" in plantation agriculture (International Bank for Reconstruction and Development (IBRD), 1953). The plantation sector continued to be the backbone of the Sri Lankan economy until the 1980s as it contributed to capital formation by both private and public sectors, which helped the country to develop its infrastructure and related service sectors (Snodgrass 1966). In contrast, the domestic agriculture sector generated neither private capital for investment nor government revenue for public expenditure.

The question is then, why the domestic agriculture sector did not contribute to capital formation as the plantation sector. The successive governments carried out land reforms and colonisation schemes under which farmers received small plots of land varying 1 - 2 hectares, with no proper deeds and land rights. Therefore, the Sri Lankan domestic agriculture is characterised by a 'small land holding system' which does not permit the sector to gain from 'economies of scale'. Secondly, farmers cannot buy or sell or enlarge or mortgage their plots of land. Thirdly, from generation to generation, the small plots of land become even smaller as the farmers divide them among their children. In all respects, the land used for domestic

agriculture was not convertible into productive assets that can generate capital. As the domestic agriculture sector is non-competitive, the government, while bearing the cost of maintaining the irrigation system, continued to provide fertiliser subsidies and income-supporting transfers to sustain it. In this way, the domestic agriculture sector continued to drain part of the surplus generated in other sectors, including the plantation sector which was absorbed by the government as its tax revenue.

Private Gains from Public Property

Loosely defined public property rights and weaknesses in law enforcement prevent capital formation from public property. The government is the biggest land-owner of Sri Lanka, but failed to make use of the property to generate capital. In addition to agricultural and barren land, it also owns large part of land in the country as reservations for roads, railway networks, water reservoirs, public parks, and forests as public property. The problem is that the government-owned land is encroached by people for private gains in building residential houses, without proper approvals and carrying out businesses without registrations.

These properties cannot be converted into productive assets for a number of reasons. First the government has no capacity to make use of them to generate capital. Secondly, the government is in a difficult position to facilitate business expansion and living conditions of public by utilising the property to provide necessary infrastructure once they are occupied by private parties. Thirdly, the occupants are not in a position to generate capital due to risk and uncertainty, though they make use of

public property to generate 'dead surplus'.

Corruption, Transaction Costs and Market Distortions

The lack of clearly defined property rights leads to high corruption and excessive transaction costs. In Sri Lanka, the users of government-owned land for private gains are not eligible by law to receive public utilities such as water, electricity and even a mailing address with a house number. But, the reality is that, they have got access to them, overcoming the legal barriers through connections to politicians and public servants. Even for the politicians, granting plots of government-owned agricultural and barren land to the poor is a lucrative business to maximise votes. Privatisation of public property is another issue leading to corruption. According to the Transparency International (2008), Sri Lanka's position is ranked as 92 out of 180 countries in terms of Corruption Perception Index. According to the World Bank (2008), Sri Lanka's position is ranked as 101 out of 178 countries in terms of ease of doing business in the country.

Lack of clear property rights by distorting the market value of property makes capital formation even more difficult. The market price of an asset is influenced by the ability of that asset to generate capital. The private properties protected by property rights have a relatively high market value, affecting the business competitiveness. In contrast, the private properties without clear ownership and right to use have a relatively low market value as their ability to generate capital is

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low and uncertain. When there is a difference between the supply of properties protected by property rights and those not protected by property rights, then the limited supply of the former leads to even higher market price reducing the profit margin.

Conclusion

Property rights establish a fundamental requirement of capitalist development as property is the base for generating capital. However, in most of the developing countries, property rights do not guarantee the ownership of assets and the ability to use them. There are private properties with no legal ownership and the authority to use them. There are government-owned properties used for private gains with risk and uncertainty. The confusion in property rights does not set the fundamental requirement for capital formation, which continues to delay capitalist economic growth and development. Rather, they lead to high levels of corruption, impose high

transaction costs and distort the market value of property. These problems undermine business confidence and erode competitiveness constraining capital formation.

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Footnote:

¹ These favourable initial conditions included a prosperous economy based on thriving plantation exports, health and educational standards comparable to those in high-income countries, a democratic political system, efficient civil administration and an independent judiciary (Abeyratne and Rodrigo, 2006). ■