AGENCY FOR INTERNATIONAL DEVELOPMENT

Washington, D. C. 20523

PROJECT PAPER

SRI LANKA: Private Sector Policy Support (383-0100)

July 20, 1988

APPENDIX 3A, Attachment 1
Chapter 3, Handbook 3 (TM 3:43)

AGENCY FOR INTERNATIONAL DEVELOPMENT
PROJECT DATA SHEET

1. TRANSACTION CODE: A (A = Add, C = Change, D = Delete)
Amendment Number:
DOCUMENT CODE: 3

2. COUNTRY/ENTITY: Sri Lanka
3. PROJECT NUMBER: 383-0100
4. BUREAU/OFFICE: Asia/Near East
5. PROJECT TITLE (maximum 40 characters): Private Sector Policy Support
6. PROJECT ASSISTANCE COMPLETION DATE (PACD): MM DD YY 07 31 93
7. ESTIMATED DATE OF OBLIGATION (Under 'B.' below, enter 1, 2, 3, or 4)
A. Initial FY 88 B. Quarter 4 C. Final FY 93

8. COSTS ($000 OR EQUIVALENT $1 =)

A. FUNDING SOURCE	FIRST FY 88 B. FX	C. L/C	D. Total	LIFE OF PROJECT E. FX	F. L/C	G. Total
AID Appropriated Total	2,450	800	3,250	5,700	9,300	15,000
(Grant)	(2,450)	(800)	(3,250)	(5,700)	(9,300)	(15,000)
(Loan)	(--)	(--)	(--)	(--)	(--)	(--)
Other U.S. 1.	--	--	--	--	--	--
Other U.S. 2.	--	--	--	--	--	--
Host Country	--	--	--	--	17,943	17,943
Other Donor(s)	--	--	--	--	--	--
TOTALS	2,450	800	3,250	5,700	27,243	32,943

9. SCHEDULE OF AID FUNDING ($000)

A. APPROPRIATION	B. PRIMARY PURPOSE CODE	C. PRIMARY TECH. CODE 1. Grant	C. 2. Loan	D. OBLIGATIONS TO DATE 1. Grant	D. 2. Loan	E. AMOUNT APPROVED THIS ACTION 1. Grant	E. 2. Loan	F. LIFE OF PROJECT 1. Grant	F. 2. Loan
(1) SDA	700	840		--	--	3,250	--	15,000	--
(2)									
(3)									
(4)									
TOTALS				--	--	3,250	--	15,000	

10. SECONDARY TECHNICAL CODES (maximum 6 codes of 3 positions each): 810 | 820 | 830
11. SECONDARY PURPOSE CODE: 650

12. SPECIAL CONCERNS CODES (maximum 7 codes of 4 positions each)

A. Code	RGEN	EQTY
B. Amount	2,500	1,500

13. PROJECT PURPOSE (maximum 480 characters)

"To strengthen the private sector's contribution to the formulation, appraisal and implementation of market-oriented economic policies; to assist the privatization of state-owned enterprises to a broad spectrum of private investors; to improve the operation of the Colombo Securities Exchange and broaden participation by small investors, and to demonstrate the viability of equity participation through venture-capital companies"

14. SCHEDULED EVALUATIONS
Interim MM YY 01 91 | MM YY | Final MM YY 05 93

15. SOURCE/ORIGIN OF GOODS AND SERVICES
[X] 000 [ ] 941 [X] Local [ ] Other (Specify)

16. AMENDMENTS/NATURE OF CHANGE PROPOSED (This is page 1 of a ____ page PP Amendment.)

Clearance:CTR:RHartwell 12/6/87

17. APPROVED BY
Signature: Gary Nelson
Title: GARY L. NELSON
ACTING DIRECTOR
Date Signed MM DD YY 07 20 88

18. DATE DOCUMENT RECEIVED IN AID/W, OR FOR AID/W DOCUMENTS, DATE OF DISTRIBUTION
MM DD YY

PRIVATE SECTOR POLICY SUPPORT
PROJECT PAPER

TABLE OF CONTENTS

ACRONYMS

ADB	Asian Development Bank
AID	Agency for International Development
AID/W	AID/Washington
ANPAC	Asia/Near East Project Advisory Committee
CBA	Colombo Brokers Association
CDS	Central Depository System
CDSS	Country Development Strategy Statement
Coop.Ag.	Cooperative Agreement
CSC	Colombo Securites Council
CSE	Colombo Securities Exchange
CY	Calender Year
CWE	Co-operative Wholesale Establishment
DFCC	Development Finance Corporation of Ceylon
DFIs	Development Finance Institutions
ERD	External Resources Department, Ministry of Finance & Planning
FY	Financial Year
GDP	Gross Domestic Product
GOBUs	Government Owned Business Undertakings
GSL	Government of Sri Lanka
HC	Host Country
IPC	Industrial Policy Committee
IQC	Indefinite Quantity Contract
Invst	Investment
Inst	Institute
ISTI	International Science & Technology Institute, Inc.
KEC	Kenya Equity Capital
L/T	Long Term
LT/TA	Long Term Technical Assistance
MD	Managing Director
MF&P	Ministry of Finance & Planning
Mission	USAID Mission
PACD	Project Assistance Completion Date
PCP	Presidential Commission on Privatization
PD	Policy Determination
PEPP	Private Enterprise Promotion Project
PID	Project Identification Document
PIL	Project Implementation Letter
PIO/T	Project Implementation Order/Technical
PM	Per Month
PP	Project Paper
PRE/PD	Private Enterprise Bureau/Project Development
PSOs	Private Sector Organizations
PSPS	Private Sector Policy Support (Project)
Pub Ed	Public Education
RFP	Request for Proposals
RFTP	Request for Technical Proposals
SC	Securities Council
SLBDC	Sri Lanka Business Development Center
SOEs	State Owned Enterprises
ST	Short Term
TA	Technical Assistance
Trng	Training
USAID	United States Agency for International Development
VCC	Venture Capital Company

UNITED STATES A. I. D. MISSION TO SRI LANKA
P.O. Box 106
Colombo 3, Sri Lanka.
Telephone : 21271 - 21532

PROJECT AUTHORIZATION

SRI LANKA

Name of Project: Private Sector Policy Support

Number of Project: 383-0100

1. Pursuant to Section 106 of the Foreign Assistance Act of 1961, as amended, I hereby authorize the Private Sector Policy Support Project involving planned obligations of not to exceed $15,000,000 in grant funds over a five year period from date of authorization subject to the availability of funds in accordance with the A.I.D. OYB/allotment process, to help in financing foreign exchange and local currency costs for the project. The planned life of the project is five years from the date of initial obligation. This authorization is subject to the notification of the project to Congress and expiration of the notification period without objection.

2. The project consists of assisting the Cooperating Country to establish more effective policies for industrial growth, to reduce the state role in the economy and to expand capital markets, through support to (a) chambers and other private organizations for policy analysis and dialogue (b) the Presidential Commission for Privatization; (c) the Securities Council and Colombo Securities Exchange, and (d) a private venture capital company. The project provides funding for technical assistance, selected commodities and training, and operational costs of the project. The project also provides funds for costs associated with the divestiture of state-owned enterprises.

3. The Project Agreement(s) which may be negotiated and executed by the officer(s) to whom such authority is delegated in accordance with A.I.D. regulations and Delegations of Authority shall be subject to the following essential terms and covenants and major conditions, together with such other terms and conditions as A.I.D. may deem appropriate.

4. a. Source and Origin of Commodities, Nationality of Services

Commodities financed by A.I.D. under the project shall have their source and origin in the Cooperating Country or in the United States except as A.I.D. may otherwise agree in writing. Except for ocean shipping, the suppliers of commodities or services shall have the Cooperating Country or the United States as their place of nationality, except as A.I.D. may otherwise agree in writing.

Ocean shipping financed by A.I.D. under the project shall, except as A.I.D. may otherwise agree in writing, be financed only on flag vessels of the United States.

H'

b. Other

Prior to any disbursement, or the issuance of any commitment documents under the Project Agreement to finance the procurement of computer equipment for the Central Depository System of the Colombo Securities Exchange, the Cooperating Country shall furnish in form and substance acceptable to A.I.D., evidence that all legal requirements to operate the system have been met, and that a means of revenue generation has been established to meet the recurrent costs of the system.

Prior to disbursement of funds, or the issuance of any commitment documents under the Project Agreement to provide funds for a venture capital company, the venture capital company ("VCC") shall furnish, in form and substance satisfactory to A.I.D., evidence:

(i) that the VCC has been incorporated and that a minimum of Rs.30 million in initial capital has been paid in by the VCC sponsors;

(ii) of a business plan for broad-based ownership of the VCC, limitations on government participation, criteria for investment which gives preference to new and innovative activities, and policies and procedures for exit from investments, and

(iii) after two years of A.I.D. funding, that the capital base has reached at least Rs.100 million.

c. Waivers

The following waiver to A.I.D. regulations is hereby approved: A.I.D. funds may be used for the international travel costs of participants.

Clearances: Date:

A.	T.Penner, PSD	July 19, 1988
B.	J.Pinney, ENG	7/19/88
C.	J.Flynn, AGR	7/19/88
D.	D.Tsitsos, HSG	7/20/88
E.	N.Cohen, A/PRJ	July 19, 1988
F.	U.Ernst, A/PRM	7/19/88
G.	R.Hartwell, CTR	7/19/88

Signature Gary Nelson
Gary Nelson
Acting Mission Director

Date July 20, 1988

Drafted:RLA:LChiles

5

I. SUMMARY OF RECOMMENDATIONS

A. Recommendation

That a development grant of $15,000,000 be authorized to the Government of Sri Lanka for the Private Sector Policy Support Project to be disbursed over a period of five years.

B. Project Description

1. Background In 1977, a newly-elected government in Sri Lanka began moving away from the socialist-oriented policy environment and embarked upon a liberalization of the economy which involved a series of reforms of industrial and trade policies. To strengthen the role of market forces in the economy, the government reduced price controls and subsidies, and opened the economy to international competition through devaluation of the currency, doing away with multiple exchange rates, liberalizing import policy, promoting exports and attracting foreign banks and investment.

In response to growing macroeconomic problems of budget and balance of payment deficits and to the need for improving economic growth rates, the government has recently embarked on a second round of policy reforms aimed at revitalizing the economy. They have chosen three primary targets. (a) industrial policies affecting private sector investment, competitiveness and efficiency; (b) rationalization of the public enterprise portfolio; and (c) expansion of the capital market. These three policy thrusts are congruent with requirements of the donor community for economic revitalization and have met with support from the Asian Development Bank, the World Bank and the International Monetary Fund. As the proposals complement USAID's country development strategy statement and our approach to private sector development we initiated discussion on the creation of a project to support the activities. The Private Sector Policy Support Project (PSPS) is the result of those discussions.

2. Project Purposes The project's purposes are to (a) strengthen the capacity of private sector chambers and organizations to conduct policy research, analysis and dialogue on issues of concern to the Sri Lankan private business community, (b) assist the Presidential Commission on Privatization to plan and implement the GSL's medium-term privatization program, and (c) to develop the capital market to broaden public equity participation, provide the financial safeguards necessary for private investment and increase the amount of capital resources available for investment.

3. Specific Activities

To achieve these purposes the project has four activities.

(a) To strengthen the private sector's contribution to the formulation, appraisal and implementation of market oriented economic policies, AID will provide technical and financial assistance to organizations which are representative of various elements of the private business community to build their capability to identify, analyze and advocate policy and regulatory issues of key importance to their memberships. Total spending is $2.9 million.

(b) To support the privatization effort AID will provide $7.9 million in technical and financial assistance to the Presidential Commission on Privatization and its secretariat; $1.3 million of this is for technical assistance in analyzing and preparing for privatization while $6.6 million will be available to assist in preparations for divestiture and reduce the impact of privatizations' likely reduction in employment. Funds will be used to defray the costs of audits, valuation, promotion, severance payments and some retraining programs.

(c) To assist in capital market development AID will provide $1.9 million in technical and financial assistance to (1) the Securities Council to create the environment necessary to expand the private capital market and (2) the Colombo Securities Exchange to assist in improving its operations and preparing for anticipated growth in exchange activity.

(d) To stimulate the establishment of a privately owned venture capital company, AID will provide up to $.5 million in technical and financial support to assist in the start-up costs of a new concept in equity financing, the purpose of which is to catalyze new enterprise starts utilizing equity funds and professional management.

C. Budget

The project's $15 million will be allocated such that $2.9 million is for policy support, $7.9 million for privatization, $1.9 million for capital market development, and $0.5 million for the venture capital company. The balance is for monitoring evaluation, contingencies and inflation. The GSL contribution is estimated at $13.9 million, mainly in the form of their support for privatization. The private sector's support is $4 million, the bulk of which is equity for the venture capital company.

D. Summary Findings

1. ANPAC Review ANPAC reviewed the PID on October 15, 1987 and approved it, delegating project authorization to the Mission with the qualification that the planned project component for the venture capital company undergo further AID/W review prior to project authorization. On May 24, 1988, the Project Review Committee met and reviewed the venture capital company, and concluded that the Mission may proceed to authorize the project including the venture capital company. All the concerns expressed in the review cable, 87 State 341617 and 88 State 205142, have been considered in the PP. A detailed description is contained in Chapter VII, "ANPAC Review and Design Guidelines".

2. Other

Based on the analyses in this Project Paper, the project is judged as technically, economically, financially and administratively sound and ready for implementation. The design of the project derives from previous activities of the Private Sector Office, especially the Private Enterprise Promotion Project. Most of the detailed project analysis sections of the Project Paper were substantially written and reviewed by the organizations directly affected. Thus, this project represents a thoroughly collaborative effort between Mission, government and private sector personnel.

I.

E. CONTRIBUTORS TO PROJECT DEVELOPMENT

GSL:

C. Chanmugam, Secretary to the Treasury
G. Cumaranatunge, Deputy Secretary to the Treasury
Baku Mahadeva, Director General, National Planning
Akiel Mohamed, Director, External Resources Dept.
S. Kuruppu, Additional Director, External Resources Dept.
P. Randeni, Director, Economic Affairs
Kumar Fernando, Director, International Economic Co-operation Div.
Lloyd Fernando, Director, National Planning Division
Justin Dias, Secretary, Ministry of Industries & Scientific Affairs

Private Sector:

C. P. de Silva, Chairman, Aitken Spence & Co. Ltd
Lal Jayasundera, Chairman, Hayleys Ltd
Stanley Jayawardena, Chairman, Shaw Wallace & Hedges Ltd
Gamini Wijesinghe, Director/Partner, Ford Rhodes & Thornton
Mano Selvanathan, Director, Sri Krishna Corporation
Milinda Moragoda, Director, Mercantile Credit Ltd
Ajit Jayaratne, Chairman, Forbes & Walker Ltd
Chris de Saram, Managing Director, IESC
Percy de Soyza, Consultant, Colombo Securities Exchange

Other:

Chandra Cooray, Chairman, National Development Bank
M. R. Prelis, General Manager, Development Finance Corporation of Ceylon
Nimal Sanderatne, Chairman, Bank of Ceylon
Asoka de Lanerolle, Chairman, Export Development Bank
S. Jayawickrema, Secretary, Ceylon Chamber of Commerce

8

Consultants:

Louis Berger International, Inc.
-- Donald C. Marsden
-- Gilbert Lane
-- John Curtin

International Science & Technology Institute, Washington D.C.
-- Robert Otto
-- Robert Parra
-- David Miller
-- Dhayalan Tharmaratnam
-- Leigh Miller

Regional International Financial Institutions:

World Bank office in Sri Lanka
Asian Development Bank officers on Mission to Sri Lanka
UNDP office, Sri Lanka

USAID Colombo:

Peter J. Bloom	- Director USAID
Gary L. Nelson	- Deputy Director
Alexander Shapleigh	- Private Sector Development
Talbot Penner	- " " "
Ranjit Ratnayake	- " " "
Dennis Zvinakis	- Projects
Neal Cohen	- "
Lisa Chiles	- Regional Legal Advisor
U. Ernst	- Program
Jan Emmert	- "
Richard McLaughlin	- "
Richard Albores	- Controller
George Fernando	- Controllers Office

9

II. PROJECT RATIONALE AND DESCRIPTION

A. Background and Rationale. In 1977, a newly elected Government of Sri Lanka (GSL) moved away from a socialist-oriented policy environment and embarked upon a sweeping liberalization of the economy, involving a series of reforms of industrial and trade policies. To strengthen the role of market forces in the economy, the GSL reduced price controls and subsidies, devalued the rupee and rationalized exchange rate policy, liberalized imports, promoted exports and attracted foreign investment. Tariff structures were reformed to remove disincentives to manufactured exports, a new development bank was established to facilitate access to financing by private investors, foreign commercial banks were welcomed, and other investment incentives were put in place.

In combination with an accelerated capital investment program financed largely by multilateral and bilateral donors, the result was unprecedented growth in the economy. Between 1977 and 1983, GDP grew at an average annual rate of 6.0% in real terms, compared to 2.9% per year between 1970 and 1977. Unemployment in the same period dropped from over 25% to 10-12%. However, since 1983, the pace has slowed markedly due to a number of factors. The insurgency in the north and violence which has affected other parts of the country have contributed to increased budget deficits, reduced foreign investment, and a generally cautious attitude by private investors. The massive current account deficit reflects sustained high levels of imports, deteriorating terms of trade, declining tourism revenues and remittances from abroad, and the still unimpressive performance of manufactured exports (with the notable exception of the garment industry). The debt service ratio is now approaching the critical level of 30 percent. The budget deficit has remained high, currently around 11% of GDP with the attendant negative impacts on inflation, interest rates, and exchange rates. Unemployment is again closer to 20%, and growth in real GDP has declined sharply to 4.3% in 1986 and 1.5% in 1987.

Sri Lanka has taken many of the "right steps" toward a liberalized policy regime, but has yet to make the successful transition to an outward-oriented, dynamic economy. Although relatively low tariff barriers have turned Sri Lanka into one of Asia's most open economies, the World Bank continues to rank the country as a "moderately inward-oriented economy". Similarly, while the Government has created a host of incentives for private investors, it has nullified many of these incentives by maintaining effective control of several sectors through its state-owned enterprises. In fact, the failure of the Government to curtail its role as an active participant in productive activities is at the root of many of the remaining distortions in the economy.

10

The precarious security situation overshadows all other factors influencing economic behavior. It has shattered investor confidence, and sapped the Government's strength and commitment to pursue economic development. The continuing ethnic and ideological violence makes it difficult to judge whether the current policy framework is appropriate to the needs of private-sector led growth based on the performance of the economy. In terms of what conventional wisdom now accepts as the "right" policy framework, what has worked in recent "success stories," Sri Lanka has done exceptionally well in many areas, but still has a long way to go elsewhere. The main weaknesses derive from the persistent imbalance between the Government and the private sector. Public ownership of productive enterprises, hesitant promotion of competition and competitiveness, and the curious mix of overambitious regulation and inadequate enforcement undermine whatever potential the "right" policies have created.

Overcoming these weaknesses will improve prospects for dynamic growth. The macroeconomic overview (Annex L) identifies several major shortcomings that linger in the wake of the economic policy reforms since 1977. The overriding concern remains the large public sector which absorbs a huge share of the country's human and financial resources without commensurate returns. With respect to the economic policy framework that translates into three related issues:

- excessive involvement of the state in directly productive activities with strong indications that the efficiency of these activities is inadequate;
- market distortions that can be traced to the Government's attempts to maintain some financial viability of inefficient state-owned enterprises, or to protect a government monopoly for other reasons;
- severe biases in financial markets, partly a direct consequence of the exigencies of financing the budget deficit, that make it easier to mobilize debt rather than equity capital.

In addition, the country's dirigiste traditions have shaped social norms and have created institutional rigidities that hamper an effective expansion of the entrepreneurial class. The private sector often seems content to accept the Government's leadership in economic matters. Entrepreneurship is alive and well in Sri Lanka, but it still seems to depend on the crutches of Government sponsorship and guarantees to move forward.

Focusing on these weaknesses, USAID/Sri Lanka made the strengthening of the private sector a cornerstone of its Country Development Strategy. The January 1987 CDSS update states the overall program goal as follows:.

- increase the role of the private sector in the economy and conversely, decrease the role of the state.

Since private sector development proceeds in many dimensions, the CDSS seeks to capture the major dimensions by translating the overall program goal into a series of four intermediate objectives (still at a fairly high level of aggregation):

1 <u>Stimulate the establishment and growth of private sector enterprises</u>;

2 <u>Stimulate the privatization of state-owned enterprises</u>: USAID/Sri Lanka pursues both direct privatization of public enterprises, that is, the sale of a majority of their stock to private investors, and the indirect privatization of key sectors of the economy through the removal of government monopolies and encouragement of private competition;

3 <u>Strengthen the capital markets and enhance the availability of capital</u>, both debt and equity, to meet the requirements of the private sector and to facilitate privatization. Policies on money credit generally, and specifically the measures taken to finance the chronic budget deficits, appear to be inadequate to promote rapid private sector growth. Monetary policies and financial market institutions need to move toward greater flexibility to make long-term debt and equity capital available to private investors.

4 <u>Strengthen institutions that promote the private sector</u>, with specific attention to the need for better coordination among the private sector institutions to increase their collective influence on national economic issues. While the Government will continue to play a key role through its overall economic policies, leadership and support for private sector development must come increasingly from the private sector itself.

In formulating these intermediate objectives, USAID/Sri Lanka sought to respond to needs it perceived as most pressing. At the same time, these objectives also delineate USAID's role vis-a-vis other donors active in the policy arena, primarily the World Bank and the Asian Development Bank, and to some extent the International Monetary Fund.

The World Bank has taken the lead in administrative and industrial policy reform, specifically the overall restructuring of the public sector mapped out in the 1987 report of the Government Administrative Reform Committee, and the continued liberalization of the trade regime. The Asian Development Bank in turn has become engaged in the reform of the financial sector, focusing on support for Government institutions, or institutions with Government participation, to modernize their operations and make them more responsive to the needs of the private sector in the process of accelerated expansion.

12

Given its more limited resources, USAID/Sri Lanka has focused its activities on high-priority, high-payoff areas that are either not adequately addressed by the other policy-oriented donors, or where our comparative advantage makes complementary action appropriate. Support for private sector activities permeates our entire portfolio. Our pursuit of financial sector reforms in the context of the Housing Guaranty program has contributed significantly to the formulation of rational interest rate policies. It has also played a role in the search for innovations in the financing of the budget deficit that may make an increasing share of financial resources held by major Government institutions available for development investments. In its Private Enterprise Promotion Project (383-0082), USAID/Sri Lanka has financed a number of activities aimed primarily at the first intermediate objective, the stimulation of the formation and growth of private enterprises. It also sought to strengthen private sector institutions (intermediate objective 4). The lessons of that project will be reflected in the Mahaweli Enterprise Development Project (383-0090), to concentrate on comprehensive support for private enterprise in the Mahaweli region, both to bring new investments into the area and to improve prospects for survival and growth existing businesses.

The project proposed here seeks to complement these USAID activities by pursuing specifically intermediate objectives 2 through 4 -- privatization, improvements of equity markets, and strengthening of private sector institutions. The activities under this project will support specific GSL initiatives that have been launched over the past year or so, and will complement these initiatives on the government side by promoting the role of private sector organizations in economic policy formulation and appraisal.

The GSL initiatives to be supported under this project address the privatization of state-owned enterprises and the strengthening of equity markets, in particular the Colombo Securities Exchange. These initiatives form part of a somewhat eclectic approach in implementing the recommendations of the report of the Industrial Policy Committee, comprising high-level Government and private sector representatives, endorsed by the Cabinet in March 1987. (Other areas of activity include trade policy, with the support of the World Bank.)

In May 1987, the GSL took the first concrete steps to pursue its long-mooted privatization agenda in a systematic fashion by establishing the Presidential Commission on Privatization. The Commission's mandate went beyond general progress in privatization: it was to produce tangible results prior to the scheduled 1989 general elections. The Commission is made up of one high-level (just below Cabinet rank) representative each of the three key ministries, Finance and Planning, Trade and Shipping, and Industries and Scientific Affairs, and of three top-level private sector leaders. The Commission reports directly to the President; a new privatization division located in the Ministry of Finance and Planning will provide staff support to the Commission.

13

To promote the stable growth of equity markets, the GSL has established the Securities Council, composed of six members appointed by the Minister of Finance and Planning together with ex officio members from the Central Bank, the Treasury, the Registrar of Companies, and the Institute of Chartered Accountants. Activated in September 1987, the Council has been charged under the Securities Council Act No. 36 of 1987 with the responsibility for regulating the securities market (in particular the Colombo Securities Exchange and its listed companies), protecting the interests of investors, and developing and promoting the securities market in particular and capital markets in general. With a limited budget and expertise in capital and securities market affairs, the Council has developed a program of action designed to create the policy environment and infrastructural requirements for substantial growth in private investment in a healthy capital market.

These two GSL initiatives tally directly with USAID's priorities and objectives. Technical assistance and related support for the two institutions charged with the responsibility of promoting privatization and securities markets thus form the core of the proposed project. These activities are complemented by limited support for an innovative attempt to mobilize equity capital through a venture capital company. Finally, the project will work with private sector organizations in bolstering the private sector role in the process of economic policy making.

Government and private sector leaders have approached USAID Colombo for assistance in each of the specified project areas and have worked closely with the Mission to structure this project to supply the technical and financial assistance needed to implement key operational elements. The Mission has reviewed the project components, finds that they are consistent with its country development strategy and complementary to its private sector program, and proposes to enter into agreements with both the public and private sectors to assist in their implementation.

B. Project Objectives

Project Goal The goal of the project is to increase national employment and income by the creation of an economic policy environment conducive to private sector growth.

Project Purposes: The project has three interrelated purposes:

(1) to strengthen the contribution of the private sector to the formulation, appraisal and implementation of market oriented economic policies;

(2) to contribute to the successful privatization of a significant number of state-owned enterprises to a broad spectrum of private investors;

14

(3) to develop the capacity of the Sri Lankan capital market to broaden public equity participation in the economy and increase capital resources for investment.

Objectives: The project's four interrelated component activities have the following objectives:

- a private sector policy dialogue component with the objectives of building the capability in private sector representative groups to identify and undertake policy research and policy advocacy activities, and to achieve enhanced public/private sector policy dialogue;

- a privatization support component with the objectives of assisting the implementation of the GSL's medium term privatization program by mobilizing and institutionalizing the capability to carry out privatization activities;

- a capital markets support component with the objectives of building both broader public equity participation in the economy and mobilizing capital resources for investment in new and/or expanding business opportunities; and

- a venture capital component, which has as its objective the establishment of a successful private sector entity which will stimulate specific new and expanded enterprises through participation in equity and management.

The above four components have a degree of interdependency which will serve to reinforce the project as a whole. Support to the private sector organizations will help to develop an informed constituency for greater private sector participation in economic activities. This will reinforce the work of the Privatization Commission, which in turn will depend on the efficient workings of the capital markets to allow broad based ownership of divested enterprises. The capital markets component will provide the necessary safeguards to the investing public to make share ownership less subject to abuse, while at the same time educating both entrepreneur and investor in the appropriate use of equity instruments. And, finally, the venture capital component is designed to demonstrate the practicality of financing new ventures by emerging entrepreneurs through equity. As all four components begin to function, there should be a broad shift in public awareness of the advantages of a system which opens participation in productive enterprises to more and more individuals.

C. Project Components and End of Project Status

Policy Support

This component will develop an informed constituency in the private sector to continue the dialogue on increased private sector participation in the economy. There are approximately 75 active PSOs in Sri Lanka, representing very narrow to very broad interests

15

depending on the membership of each organization. The most senior and broad-based private sector organization is the Ceylon Chamber of Commerce, founded in 1839. Among the other larger chambers are the Ceylon National Chamber of Commerce and the Ceylon National Chamber of Industries, both formed after independence in 1948. The Employers Federation of Ceylon was formed in 1927. An example of one of Sri Lanka's many established professional associations is the Institute of Chartered Accountants, founded in 1959. A survey of thirteen representative PSOs indicated that all were interested in pursuing some aspect of economic analysis in order to better understand the economy, and to present a more clearly articulated policy position. However, few have the resources and the experience to undertake such activities.

A U.S. firm or organization experienced in working with Private Sector Organizations ("PSOs") will be competitively selected and employed under the project to establish a "policy support unit" that will assist PSOs. The firm or organization, referred to herein as the "unit", will be hired through a Cooperative Agreement and established in Colombo with a long term expatriate consultant and a small number of local staff.

The overall role of the unit will be to strengthen the capacity of participating PSOs to carry out policy work. The unit's specific functions will be providing general guidance to PSOs on the policy process, receiving and evaluating proposals by PSOs for subgrants, and administering the approved subgrants.

The unit will be a focal point for PSO support. It will, over time, become a source of information, including which actors on the government as well as private sides of the policy dialogue are engaged in specific policy agenda activities, and which donor-funded programs are supporting which actors. With funding for operating and short term technical assistance costs of up to $1.4 million, the unit will assist Sri Lankan chambers and associations to develop their organizations, define their policy agenda, organize their in-house research capabilities and/or contract for external expertise, and develop their analyses for presentation.

The policy support unit will also manage a fund of $1.5 million for sub-grants to Sri Lankan PSOs. About 15-20 PSOs are likely to participate as subgrantees in the PSPS project. The objective of the subgrants will be to provide specific support to individual PSOs in carrying out policy studies and in strengthening their capacities to conduct policy dialogue.

The unit will solicit proposals for specific subgrants from PSOs and prepare them for review by USAID. The proposals will be evaluated against approval criteria agreed to by USAID and the GSL. Once a subgrant proposal has been approved and authorized by USAID, the unit will be responsible for entering into subgrants with the PSOs and for the actual administration of the subgrant. Depending on the specific financing arrangements of each subgrant, the unit will provide for all subgrant accounting and assist in various procurements by the subgrantees.

16

The subgrants will provide funds for short-term technical assistance consultancies (both local and expatriate), training and study tours, equipment and other direct costs of the PSOs. The size of the subgrants will vary considerably from the $10,000-20,000 range for small and short- duration subgrants up to $150,000-200,000 for larger, multi-year subgrants. Appropriate financial contributions by the PSOs will be required as part of the criteria for subgrant approval.

At the end of the project, the capacity of the PSOs to conduct policy research, analysis, and dialogue on issues of concern to the Sri Lankan private business community will have been strengthened. This will manifest itself in an enhanced capacity of individual PSOs and the PSO community at large to participate effectively in influencing business and economic policy. This component of the project will achieve these results by working with fifteen to twenty individual PSOs to develop specific programs of research and analysis, and guiding the PSO through the presentation of the resulting conclusions. Another five to ten workshops will be held to develop the skills of groups of PSOs with similar interests, to provide a basis for effective collaboration.

Privatization Program - AID will provide $7.9 million for technical and financial assistance to the Presidential Commission on Privatization and its MF&P-based secretariat to implement its medium term privatization program. This program, developed by the GSL, includes twenty four identified SOEs which are considered appropriate for divestiture at the present time. Two companies have been identified for immediate sale to the public through publicly quoted share issues on the Colombo Securities Exchange. The remainder will be sold either to individual bidders or to the public at large. The Commission anticipates that the majority of the SOEs will be sold to the public through share issues, in order to honor their mandate for broadly based ownership. The twenty-four SOEs are largely in manufacturing, with a few service companies which include the tourist industry, motor sales, trading, and advertising. A complete list appears on page 7 of Annex B.

AID assistance will be directed toward three stages in the privatization process: (1) technical assistance, equipment and other direct support for the Presidential Commission on Privatization, (2) expenses of the Commission associated with the preparation of SOEs for divestiture, and (3) costs of actual divestiture, including severance payments for redundant labor.

1. Support for the Presidential Commission on Privatization.

A mix of expatriates and local short-term technical specialists and one long-term expatriate advisor is planned. The long-term advisor will be attached to the Secretariat for a period of three years to provide overall technical expertise and guidance in planning, preparing and executing privatization actions. Because of the complexity of the privatization process and the requirement for many and varied forms of technical know-how, project funds will also be used to fund an additional 20 person-months of short-term expatriate advisory services and 60 person-months of short-term local advisors and technicians. This diverse package of short-term technical assistance will be coupled with the long-term advisor in a single institutional contract.

The long-term advisor, as Chief of Party for the contractor, will be responsible for working with the Commission to define the specific terms of reference for the short-term specialists, identify multiple expatriate and local candidates for the tasks (for selection by the Commission), guide the progress of their work, and submit timely and accurate reports on all uses of contract funds. The contractor will also arrange for the overseas training/study tours planned for the project.

The contractor will maintain separate offices outside the Commission secretariat's office which is located in the Ministry of Finance and Planning. The contract budget will include funds for office rental, procurement of office furnishings and equipment, utilities, telecommunications, and secretarial and other operating costs.

AID project funds for technical assistance will be $1.3 million. The GSL contribution is estimated at $120,000.

In addition to technical assistance, certain capital costs of office equipment and furniture will be provided for the secretariate using AID project funds. Equipment will include appropriate computer systems for use in word processing, financial analysis and data base management tasks, a medium-capacity copying machine and telecommunications equipment. One vehicle for use by the long-term contract advisor will also be purchased and following the advisor's departure be assigned to the Secretariat. All annual recurrent operating costs of the Secretariat will be met by the GSL. AID project funds for capital costs will be $40,000. The GSL contribution over the five year period is estimated at $200,000.

Finally a mix of public education and publicity campaigns carried out by the Commission related to the opportunities and risks of the privatization program in general will be supported by the project. The Commission will stage seminars and workshops, prepare publications and lectures, and use media advertising and programing opportunities to familiarize the Sri Lankan public with the process of privatization, the benefits to be gained from it, and the whys and hows of equity share ownership. AID project funds totalling $200,000 are budgeted for these activities.

2. Preparation of SOEs for Divestiture.

In preparing SOEs for divestiture, the Commission may be required to take a number of actions, such as providing a detailed independent accounting audit of the SOE, establishing the value of the capital structure of the SOE, and providing for the legal formation of the new company. AID funds will be provided to offset the costs of such preparatory work, as long as there is a reasonable expectation that the SOE will be divested. Use of AID funds therefore will be subject to the following criteria:

18

- submission by the Commission of a detailed plan and schedule for the divestiture of the SOE in question;

- evidence in the plan that a controlling interest in the SOE is to be divested, defined as at least 51% of the shares plus further evidence that actual control of the privatized company will pass to the new private owners and that government will not retain any indirect control, e.g., via controls over raw material supplies or markets of the privatized company; and

- if only a part of an SOE is to be privatized, evidence that the parent SOE (if it remains in operation) will exercise no indirect control over the new company.

The estimated total cost of the preparatory steps for 22 of the 24 targeted SOEs (the first two have been covered by the Private Enterprise Promotion Project) is $2.0 million. All work contemplated in this category involves local consultant and media services. Any requirement for expatriate technical advice on the preparatory steps will be covered by the technical assistance contract. Costs will be met by AID project funds and GSL contributions in roughly a 75%/25% proportion. GSL contributions will be paid either by the SOEs themselves or by the Commission from funds it may generate on the sale of SOE shares.

In addition to the costs of preparation, the GSL will incur the cost of commission fees or other charges paid to the brokers or other organizations which transact the sale of shares. The maximum cost, assuming a 2.5% fee against the total value of shares sold, is $2.6 million.

3. Redundancy Costs/Post-Privatization Supports.

This category of support includes payments associated with redundant labor. It also includes several schemes which will be put in place by the Commission to cushion the transition through management consulting assistance and worker training to the newly privatized firms.

The Commission estimates that the 20-25% redundancy in the current labor force of the 24 targeted SOEs will require severance pay compensation amounting to about $7.3 million. The magnitude of the sums involved will vary from case to case. Because of labor laws which protect rights of workers in private firms, it is most likely that the severance of redundant labor will occur prior to the divestiture of the SOE, although it also possible that severances associated with the privatization could be made by the new owners. In either case, lump sum payments will be made, up to a maximum of eighteen months of salary depending on the longevity of service of the employee. However, only in the case where the severance occurs while the enterprise is still owned by the GSL will project funds be used to reimburse severance payments. Further, payments will only be made after the divestiture has occured, as defined above. The total estimated severance liability for all 24 SOEs is $7.4 million. AID project funds will be used to meet severance payments up to a maximum of $4.4 million.

Gratuity payments are entitlements connected with employee retirement benefits. The gratuity payment for SOE employees is calculated at a rate of one-half month of salary for every year of service of the first five years of uninterrupted employment. These payments may be made at the time the SOE's legal status is changed, or possibly as contributions into a retirement fund. If the liability is passed on to the privatized company, the GSL will pay the cost indirectly through a reduction in the share price. The GSL will cover all of the gratuity payments.

A total of $150,000 in AID project funds has been set aside to pay for management consulting services for privatized companies. The need for such services will be identified during the management survey work done by the Commission prior to privatization and in consultation with the new owners of the company. Areas where consulting assistance may be needed include business planning, new product or market development, design of financial control systems, implementation of employee relations and employee stock ownership programs, research and development, and quality improvement and control.

The Commission, in cooperation with the privatized firm, will also identify weaknesses in labor capabilities and identify training requirements. The training would be carried out by the new company using local training and consulting firms. A total of $250,000 in AID project funds has been set aside to pay for assessment of training needs, development of training curricula and presentation of courses.

At the end of the project, it is anticipated that the equivalent of all twenty-four enterprises will have been divested, with the understanding that some companies will be dropped from the list while others are added, due to changing economic and political considerations. This will represent a transfer of approximately US$100 million of productive assets from public sector control to private sector ownership. The 29,500 employees of the twenty four SOEs, in making this transition, will be critical to the success of the undertaking. Project funds have been allocated to assist in their becoming more efficient if they stay with the enterprise, and to assist in their move to another area of endeavor if they are redundant. The results of this shift of assets and manpower, which is large enough to be noticed by a significant portion of the nation, will be to enhance the public's appreciation of the relative roles of government and private sector in productive enterprises. It will also institutionalize the mechanisms for privatization within the GSL.

Capital Markets Development

This component will develop the capital market mechanisms to build broader public equity participation and mobilize capital resources both for the privatization effort and overall investment. The Colombo Securities Exchange was established in 1984, and drew together several local exchanges to form one national trading operation. Volume has been climbing rapidly, but from a very low base. Average daily turnover has increased from approximately $20,000 to around $65,000 over the last three years, which though still far from meeting its potential indicates a healthy beginning. The Securities Council was established in 1987 to provide regulatory support to an equities market, and has started to address the needs of an expanding market. Currently, the Exchange has

174 listed companies, with applications for listing from another 26. There is also the prospect of up to 24 new listings being generated through the GSL's privatization program. In order to cope with an increasing volume of shares, and to prepare the public to appreciate both the risks and the rewards of equity ownership, the Colombo Securities Exchange and the Securities Council will need to develop quickly. AID will provide $1.9 million in technical and financial assistance to the Securities Council and to the Colombo Securities Exchange to assist them to meet the demands of an expanded capital market.

A total of $1,200,000 for long and short-term advisors and technicians is planned. One long-term advisor will be posted with the Securities Council for a period of three years to assist the Director General and to help improve exchange monitoring procedures and use of the equipment and facilities of the stock exchange. The advisor will also assist the Council in its efforts to develop the equity capital side of the Sri Lankan Market. Six person-months of short-term expatriate and twelve person-months of short-term local technical services are also planned to prepare policy analyses, recommend necessary policy reforms, design new financial instruments (such as unit trusts, mutual funds and syndications), prepare technical regulations and provide support to various activities of the Council as needed.

The Colombo Securities Exchange will receive one long-term technical advisor for a period of eighteen months. This advisor will work with the management of the Exchange (and in coordination with the Director General of the Securities Council) to smooth the transition from the existing trade recording and reporting system to a new, more efficient operation for handling stock trades. In addition, six person-months of short term expatriate and 12 person-months of short-term local technical assistance will be provided to the Exchange to further assist in special requirements related to the installation of equipment, the setting up of the Exchange's Central Depository System, the transfer of technology from other stock exchanges in the region, in-country training for brokers/dealers aimed at streamlining their operations, and other supporting services for brokerage firms. All technical assistance for this component will be provided under a single contract.

A total of $350,000 will be expended on the production and distribution of materials designed to increase the familiarity of the investing public, listed firms, and students with the operations and functions of the securities exchange and the capital market. Elements of this program include public seminars on the securities market as well as publication of general information booklets, the Exchange's rules and procedures, and a school text for advanced students in business and accounting courses. A public relations component is also planned which will include production of a television documentary for use in schools, other educational television programs, appearances by Council and Exchange members on TV panel shows and a press campaign in English, Sinhala and Tamil language newspapers.

21

AID will provide $245,000 for the purchase of publishing, telecommunications, training, office, and computerized record-keeping and reporting equipment for both the Council and the Exchange.

Procurement and installation of equipment will be accompanied by a substantial overhauling of the Exchange's operations to help it expand its capabilities and reduce transaction times. Two separate computer systems will be purchased and installed in the offices of the Exchange. The first will be used to automate the Exchange's trade recording and reporting system, and the second system will be used to automate the proposed Central Depository System (CDS). Because of security requirements, the CDS hardware will be physically segregated from the trade recording and reporting system in a secured office. Project funds will also be used to purchase communications equipment, printing equipment, general office equipment, and training equipment.

The Securities Council will receive project-funded equipment including a micro computer system for word-processing and financial analysis, appropriate software, a medium-volume photocopier and an offset lithograph printer with plate maker. Equipment will be installed in the offices of the Director General.

A total of $45,000 will be used to finance familiarization and consultation travel for Council and Exchange managers to securities exchanges in other countries of the region and travel to participate in professional meetings. During their training, managers will review operating procedures with an eye to transferring useful innovations to the Colombo Exchange.

At the end of the project, an improved regulatory climate is expected to inspire investor confidence, and an improved understanding of the risks and rewards of share ownership should significantly broaden equity participation in the economy. The expanded market for quality share issues will attract increasing numbers of enterprises to consider the Exchange as useful means of raising equity capital, and thus transform some perceptible increment of savings into investment in private enterprise.

Venture Capital Company

This final component introduces a new concept to the Sri Lankan capital market structure with emphasis on higher risk investments spread across numerous investors with careful management. Over the last two years, several prominent Sri Lankans have been working on the concept of a venture capital company owned by a number of interests sufficiently broad to encourage new entrepreneurs rather than finance in-house projects of any one group. At present, a core group including several local investors and the Development Finance Corporation of Ceylon, have started the process of incorporation, and are pressing ahead with the formation of company which will raise $1 million in initial capital, and a further $2.3 million by the end of the second year of operation. Project funds will be provided to support the start-up of this Venture Capital Company (VCC) in its early years. The funds will be used for four purposes;

22

capital equipment costs (about $80,000); a contribution toward VCC operating costs during the VCC's first four years of operation (about $160,000); short-term expatriate and local technical assistance to strengthen VCC management, investigate subprojects and support portfolio companies (about $180,000); and training/promotional activities to expose VCC management as well as the Sri Lankan investment community to venture capital practices (about $180,000).

The VCC will be privately controlled and be capitalized by its sponsors at a minimum level of Rs.30 million in paid-in shares. A Cooperative Agreement will be executed between USAID and the VCC when the VCC has been incorporated, a minimum of Rs.30 million in initial capital has been paid in (not callable capital) by the company sponsors, and the Managing Director has been hired. Further, USAID concurrence with terms of the VCC articles of association, operating policies, financial and business plans, investment criteria and exit mechanisms will be required as a condition precedent to disbursement of funds for operating support. Continued access to funds after two years will be further conditioned on the VCC's capital base having reached at least Rs.100 million, and a successful review by USAID of VCC activities up to that point. There will be periodic reports to AID on the use of funds and VCC progress, but AID will play no role in any approvals of VCC Board decisions, investment decisions or other operational business decisions.

The VCC will contract for technical services and equipment following the applicable rules for cooperative agreement recipients, and customs duties and taxes will be paid by the VCC.

The VCC will make equity investments in some fifteen to twenty subprojects when fully capitalized. It will help introduce a new type of financial institution to Sri Lanka, demonstrate the advantage to companies to broaden their capital base as a means of company expansion without losing control, and expand the sharemarket through encouraging its portfolio companies to go public. The VCC investments will leverage Rs.10 in total investment for each Rs. invested by the VCC and have positive social and economic impacts through increased jobs and incomes. Projections over the first five years of operation indicate that a total of $2.5 million will be invested in as many as twenty new projects, the total equity and loan investment in which will be in the region of $25 million. A conservative estimate of the number of jobs created is in excess of 2,000.

III. COST ESTIMATE AND FINANCIAL PLAN

A. Budget Summary/Cost Estimates

The total estimated cost of the project is $33 million as presented in Table III-1. AID will provide $15.0 million (45%) over the five-year life-of-project. Host country contributions from the GSL are estimated at $14 million (43%) and from the private sector at $4.0 million (12%). The breakdown of costs by project component is also given in Table III-1. Considering base costs before contingencies and inflation, the total estimated costs per component are: Policy Support, $3.2 million or 11%; Privatization Support, $21.6 million or 69%; Capital Markets Development, $2.4 million or 8%; and Venture Capital Company, $3.8 million or 12%.

The detailed basis for cost estimates in each of the respective components is detailed in Annexes A through D. The only other cost item is the estimated $300,000 for monitoring and evaluations, which is based on $12,000 for establishing a monitoring system at the start of the project and six person-months of expatriate technical assistance at $20,000/mo. and 12 person-months of local technical assistance at $2,000/mo. for each of two comprehensive evaluations of the overall project at mid-term (January 1991) and end (May 1993) of project.

Table III-2 summarizes estimated expenditures of AID project funds by U.S. fiscal year and breakdown by component, showing that costs are spread fairly evenly over the five years.

Table III-3 divides total base costs by input category and by source of funds. The breakdown ($000) is $3,996 (13%) for technical assistance; $255 (1%) for training/study tours; $407 (1%) for equipment; $1,290 (4%) for operating costs; $1,500 (5%) for policy support subgrants; $570 (2%) for privatization and capital markets promotion activities; $19,700 (63%) for preparation of SOEs for divestiture, severance and gratuity payments, and post-privatization costs; and $3,333 (11%) for VCC capitalization.

B. AID Obligation Schedule

The AID contribution to the project will be obligated periodically from FY 88 through FY 92, as indicated in Table III-4. All funds will be from the Selected Development Activities account.

24

Table III-1: Cost Summary and Financial Plan ($000)

Component	AID	GSL	Private Sector	Total
Policy Support	2,896	--	350	3,246
Privatization Support	7,862	13,720	--	21,582
Capital Markets Development	1,900	225	315	2,440
Venture Capital Company	500	--	3,333	3,833
Evaluation	300	--	--	300
Subtotal	13,458	13,945	3,998	31,401
Contingency*	792	--	--	792
Inflation	750	--	--	750
Total (Rounded)	15,000	13,945	3,998	32,943

* AID contingency of approximately 10% and inflation of 10% calculated against all costs except fixed amount for subgrants in policy support component ($1,500), severance payments in privatization component ($4,400) and VCC component ($500).

Table III-2: Project Expenditure by U.S. Fiscal Year (000)
(AID Project Funds only)

Component	FY 89	FY 90	FY 91	FY 92	FY 93	Total
Policy Support	196	625	725	725	625	2,896
Privatization Support	1,520	1,780	1,780	1,522	1,260	7,862
Capital Markets Development	630	660	450	160	--	1,900
Venture Capital Company	125	125	125	125	--	500
Monitoring and Evaluation	12	--	144	--	144	300
Subtotal	2,483	3,190	3,224	2,532	2,029	13,458
Contingency	82	230	196	128	156	792
Inflation	135	180	180	140	115	750
Total	2,700	3,600	3,600	2,800	2,300	15,000

Table III-3: Cost Summary by Input Categories ($000)
Project Components

Input Category	Policy Support	Privatization Support	Capital Markets Development	Venture Capital Company	Evalutation	Total
Technical Assistance	$1,046 AID - -	$ 1,150 AID 120 GSL -	$1,200 AID - -	$ 180 AID - -	$ 300 AID - -	$ 3,876 AID 120 GSL -
Training/Study Tours	100 AID - -	50 AID - -	45 AID - -	60 AID - -	- - -	255 AID - -
Equipment	30 AID - -	52 AID - -	245 AID - -	80 AID - -	- - -	407 AID - -
Operating Costs	220 AID - -	110 AID 200 GSL -	60 AID 225 GSL 315 PS	160 AID - -	- - -	550 AID 425 GSL 315 PS
Subgrants	1,500 AID - 350 PS	- - -	- - -	- - -	- - -	1,500 AID - 350 PS
Privatization Costs	- - -	6,300 AID 13,400 GSL -	- - -	- - -	- - -	6,300 AID 13,400 GSL -
Promotion Activities	- - -	200 AID - -	350 AID - -	20 AID - -	- - -	570 AID - -
VCC Capitalization	- - -	- - -	- - -	- - 3,333 PS	- - -	- - 3,333 PS
Total	$2,896 AID -GSL 350 PS	$ 7,862 AID 13,720 GSL -PS	$1,900 AID 225 GSL 315 PS	$ 500 AID - GSL 3,333 PS	$ 300 AID - GSL - PS	$13,458 AID 13,945 GSL 3,998 PS
	$3,246	$21,582	$2,440	$3,833	$ 300	$31,401

26

Table III-4: AID Obligation and Expenditure Schedule by Fiscal Year ($000)

	FY 88	FY 89	FY 90	FY 91	FY 92	FY 93
OBLIGATIONS						
By year	$3,250	$3,150	$2,800	$ 3,800	$ 2,000	$ - 0 -
Cumulative	$3,250	$6,400	$9,200	$13,000	$15,000	$15,000
ESTIMATED EXPENDITURES						
By Year	-0-	$2,700	$3,600	$ 3,600	$ 2,800	$ 2,300
Cumulative	-0-	$2,700	$6,300	$ 9,900	$12,700	$15,000

C. Host Country Contributions/Financial Analysis

The overall host country contribution is $17.9 million or 55% of total estimated costs. For two of the four components, the contribution far exceeds AID's reference rate of 25%: the contribution (base costs) by the GSL to Privatization Support is 64% and the contribution by private sector investors to the VCC is 87%. On the other hand, the host country contribution by the private sector chambers and associations to the base costs of the Policy Support component is only 11%, and the combined contributions by the GSL Securities Council and the private Colombo Securities Exchange to the Capital Markets Development component is 22%. In the latter two cases, even though the contributions are lower than AID's reference rate, the levels are considered substantial and significant relative to the entities involved, and therefore justified per AID Policy Determination No. 16 (see Section 4.C of Annex A).

The financial capacity of the various participating GSL and private sector entities to meet their contributions to the project and to continue to meet relevant new recurrent expenditures after the project is completed is discussed in detail in the technical annexes. In summary, the private sector chambers and associations will be required to make both in-kind and financial contributions as a criterion for receiving subgrants under the Policy Support component; the estimated total amount of $350,000 is judged to be within their capacity to commit. Further, the policy support unit is designed as a delivery mechanism to assist for a limited period of time in the development of policy analysis capabilities within the private sector. Once it has completed its task, there is no further need for this service, and the cooperative agreement is designed to terminate at that point. For Privatization Support, the substantial GSL costs involved will need to be financed from the proceeds of sale of the SOEs; Table B-8 in Annex B provides the cash flow projections by year for the planned privatization program and the financial analysis in Section 4.C of Annex B concludes that there will be a positive cash flow.

In the Capital Markets Development component, the contribution by the GSL Securities Council represents continued annual budgetary support at constant 1988 levels over the life-of-project, which the GSL is expected to provide. For the Colombo Securities Exchange, the expansion of its functions through the installation of the Central Depository System (CDS) will entail new recurrent costs and a concommitant need for an additional source of revenue; the options to establish the new revenue source are discussed in the financial analysis of the Exchange in Section 4.C of Annex C and this will be the subject of a Condition Precedent to disbursement of funds for the procurement of the CDS computer equipment. Lastly, the financial viability of the Venture Capital Company is detailed in Annex D, and indicates that given the relatively conservative assumptions on which the projections were made, the VCC should reach break-even by year three, and show modest projects thereafter.

D. Audit Procedures

There are three major areas of audit activity which require attention in this project.

Technical Assistance - Technical assistance financed by AID is subject to audit by AID/IG. To minimize vulnerability, the Mission Controller will conduct periodic examination of records in support of disbursements and as part of its voucher examination program. The Mission Controller will also have to ascertain that the various entities participating in the Project components have satisfactory accounting procedures and documentation. This will apply to the recipients of cooperative agreements (Ceylon Chamber of Commerce, policy support unit, and the venture capital company). This will also apply to the Ministry of Finance and Planning, Secretariat for the Presidential Commission on Privatization, and to the Securities Council and the Colombo Securities Exchange.

Reimbursement of Privatization Costs - A significant portion of project funds will be used to reimburse the GSL for preparation of SOEs for divestiture, and for severance payments to redundant labor. The Ministry of Finance and Planning in collaboration with the Mission Controller, will establish a system for documenting these payments which will be subject to AID/IG audit.

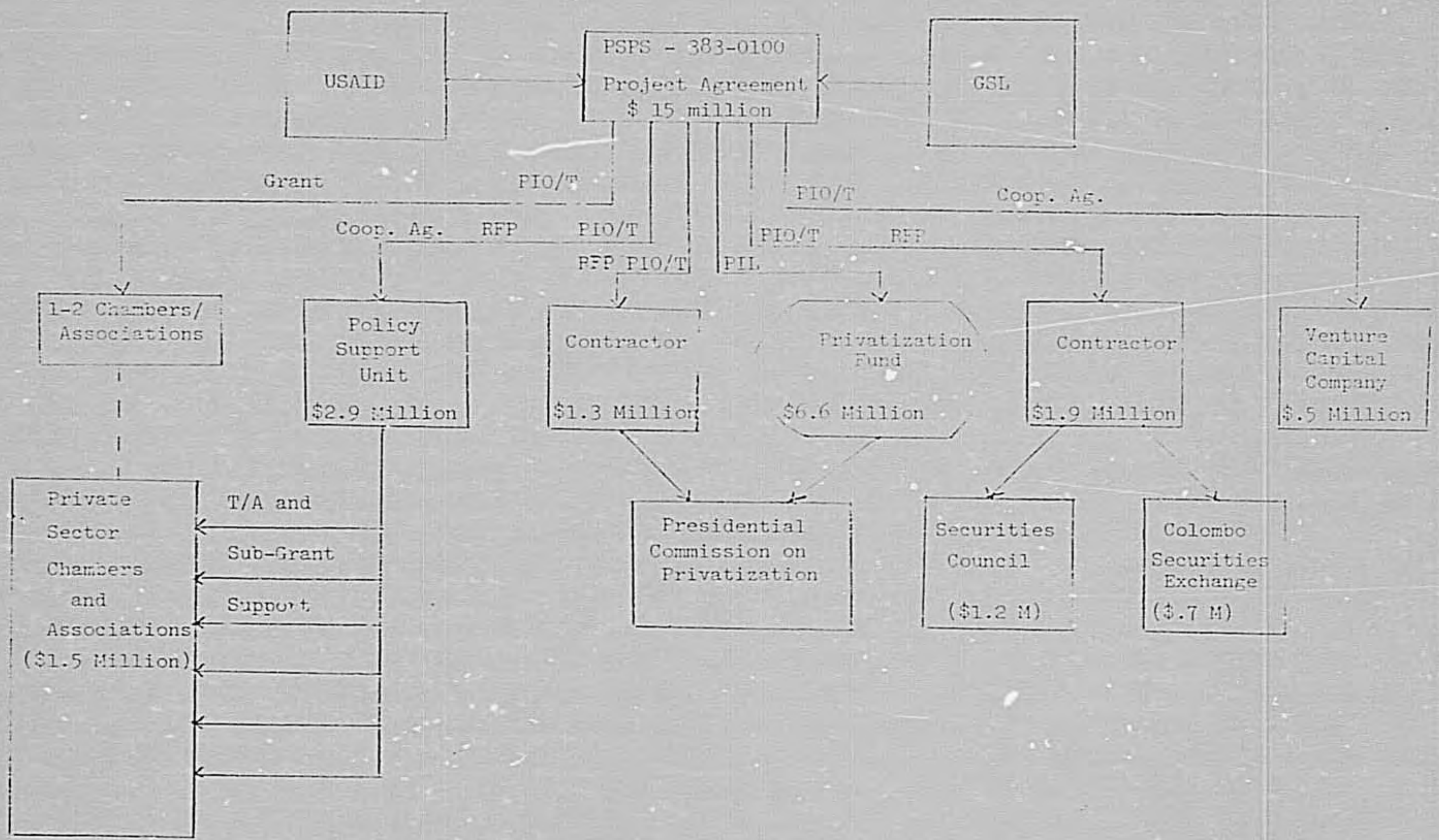
External Audits - The Venture Capital Company and the Colombo Securities Exchange, as privately owned for profit enterprises, will be subject to annual audit by chartered accountants acceptable to the Mission Controller. In both instances, AID funds will be identified in the statement of accounts. Subgrantees which receive more than $10,000 under the policy support component will be required to have funds provided by the subgrant audited by an independent auditor.

IV. IMPLEMENTATION PLAN

A. Implementation Arrangements

The project will be obligated by a Project Grant Agreement signed by AID and the GSL. The four project components are designed to be implemented independently, although accomplishments in each component will reinforce

FIGURE IV-1: PROJECT ORGANIZATION CHART



activities in the other components and all components will contribute toward the achievement of the project purposes. For example, the strengthening of the capital markets will serve the needs of the privatization program and the venture capital company; the VCC will develop new ventures which will in turn enhance the growth of equity markets; and policy research and dialogue undertaken by the private sector chambers and associations may contribute toward broad privatization objectives such as the demonopolization of economic sectors currently dominated by SOEs.

There will be no steering committee for the overall project. The specific relationships among the various agencies involved in implementing each individual component are detailed in the technical annexes. An overall project organization chart is in Figure IV-1. In summary, the Policy Support component will entail the establishment of a "policy support unit" through an AID-funded cooperative agreement signed by USAID with a U.S. firm, which in turn will be responsible for administering a program of 15-20 subgrants with participating private sector organizations. The Privatization Support component will be implemented by the Presidential Commission on Privatization including support from an AID-funded technical assistance (TA) contract. The Capital Markets Development component will be implemented by both the Securities Council and the Colombo Securities Exchange and includes a single AID-funded TA contract to support both entities. The VCC component will be carried out by the VCC with support from an AID-funded cooperative agreement. All of the major implementation actions in the project (two cooperative agreements and two contracts) will be financed with AID project funds and will be negotiated directly between USAID and the entities involved. Competitive procedures will be followed in all cases except for the cooperative agreement with the VCC.

The Office of Private Sector Development of USAID/Sri Lanka will monitor implementation of each of the four project components as well as the project as whole (see Section V). Copies of formal evaluations and periodic progress reports will be provided as desired to the GSL Department of External Resources.

B. Administrative Analysis

The capacities of the implementing agencies in each component are assessed in detail in the technical annexes. For the Policy Support component, an independent survey of chambers, associations and other private sector organizations (PSOs) was undertaken during project design. The survey included an analysis of 13 PSOs out of approximately 75 active PSOs in Sri Lanka. It formed the basis of the rationale for establishing a policy support unit which could assist a wide range of PSOs, and it demonstrated that in the range of 15-20 PSOs will have the capacity to participate in the project through the subgrant program. Virtually all of the other implementing agencies are only recently established--the Presidential Commission on Privatization (1987), the Securities Council (1987), the Colombo Securities Exchange (1984) and the VCC (1988, anticipated). The agenda before each institution are challenging but in each case within the capacity of the institution to carry out with the technical assistance and other support financed by the project.

Table IV-1: Private Sector Policy Support Project
Composite Implementation Schedule

Date	Policy Support	Privatization Support	Capital Markets Development	Venture Capital Company	Date
7/88	PSPS Project Grant Agreement signed...	PSPS Project Agreement signed..	PSPS Project Agreement signed.....	PSPS Project Agreement signed	7/88
9/88	Conditions Precedent met............	Conditions Precedent met.......	Conditions Precedent met..........	Conditions Precedent met	9/88
9/88	Grant (s) to PSOs with fully developed proposals				
10/88		Request for Proposals issued for technical assistance contract	Request for Proposals issued for technical assistance contract	VCC formed with Rs.30M capital	10/88
11/88	Request for Proposals issued for Cooperative Agreement		Technical assistance proposals reviewed		11/88
12/88		Proposals reviewed		Cooperative ageeement signed with VCC	12/88
1/89	Proposals reviewed		Technical assistance contract signed		1/89
2/89		Technical assistance contract signed	Long-term advisors to Director General & Exchange arrive		2/89
3/89	Cooperative Agreement signed				
4/89		Contractor mobilized	Computer systems specifications completed		4/89
5/89	Recipient's team mobilized				
6/89			Computer systems procurements completed		6/89
7/89	Policy Support Unit fully operational				7/89
7/89	1-2 PSO subgrants approved				7/89
12/89		5 SOEs privatized			12/89
7/90	5-6 PSO subgrants approved			VCC investments reach Rs.24 M	7/90
8/90			Long-term advisor to Exchange departs		8/90
12/90		5 SOEs privatized		VCC capital reaches Rs.100 M	12/90
1/91	Mid-term evaluation..................	Mid-term evaluation.............	Mid-term evaluation..............	Mid-term evaluation.............	1/91
7/91	5-6 PSO subgrants approved			VCC investments reach Rs.50 M	7/91
12/91		5 SOEs privatized			12/91
2/92			Long-term advisor to DG departs		2/92
7/92	5-6 PSO subgrants approved			VCC investments reach Rs.80 M	7/92
12/92		5 SOEs privatized			12/92
5/93	Final Evaluation......................	Final Evaluation.................	Final Evaluation..................	Final evaluation	5/93
7/93		4 SOEs privatized			7/93
7/93	PACD................................	PACD...........................	PACD............................	PACD	7/93

31

Table IV-2: Payment Procedures
(AID Project Costs Only)

Input Category	Method of Implementation	Method of Financing	Approximate Amount ($'000)
Policy Support			
Support for Ceylon Chamber of Commerce	AID Direct Cooperative Agreement	Direct Payment	$ 200
Policy Support Unit	AID Direct Cooperative Agreement	Direct Payment	2,696
Privatization Support			
Technical Assistance	AID Direct Contract	Direct Payment	1,322
Support for Presidential Commission	GSL Arrangements	Reimbursement	6,540
Capital Markets Development			
Technical Assistance	AID Direct Contract	Direct Payment	1,900
Venture Capital Company			
Technical Assistance	AID Direct Cooperative Agreement	Direct Payment	500
Monitoring & Evaluation	AID Direct Contracts	Direct Payments	300
			$13,458

32

C. Implementation Schedule

The composite implementation schedule for the overall project, consisting of the four implementation schedules for the respective components, is in Table IV-1. It calls for all of the major TA procurements to be completed by mid-1989 at the latest and for the project's principal equipment procurement (computer equipment for the Colombo Securities Exchange and the Securities Council) to be completed in the same time frame. The four components will be formally evaluated together at mid-term and end-of-project. The key milestones for measuring accomplishments of outputs in each component are indicated in the respective annexes.

D. Procurement Plans

The Private Sector Policy Support project will be grant-funded; thus, AID Geographic Code 000 (United States only) and Sri Lanka are the eligible source/origin countries for AID-funded project procurements.

The detailed procurement plans for each component are in the technical annexes. Requests for Proposals (RFPs) will be issued for each of the competitive procurements for TA services involving U.S. firms, preceded in each instance by announcements in the U.S. Commerce Business Daily. The cooperative agreement with the VCC will be negotiated directly between USAID and the VCC, following which the VCC will negotiate a TA contract to provide the expatriate TA services and overseas training required by the VCC.

Local currency procurements using AID project funds will in some instances be included in the TA procurements, e.g., local long-term and short-term consultants, local operating or administrative expenses or local equipment purchases. Other local currency procurements will be made directly by the various implementing agencies (including the PSO subgrantees under the policy support component), and where necessary advance accounts will be established to facilitate the cash flow of the respective agencies.

Offshore equipment procurements will be pursued when off-shelf procurement in Sri Lanka is not available. The offshore procurements will be made under the TA contracts or by the cooperative agreement recipients. This includes the three vehicles to be purchased with AID project funds for use by the policy support unit (1), the TA contractor for privatization (1) and the VCC (1).

Table IV-2 provides a summary of the proposed methods of implementation and methods of financing of the principal parts of the project by input category (refer also to Table III-3).

V. : MONITORING AND EVALUATION PLAN

Summary

Considerable data should be available from the project components to allow monitoring at both the output and purpose levels. A locally contracted consultancy is planned early in the project to develop the monitoring plan for higher level indicators for which administrative data will not be produced in the course of implementing the project. This plan may include several low-cost, locally contracted special studies to assess project impact. Two formal evaluations are planned, one early in the project and one near the PACD. Performance indicators at the national level will be used to monitor overall effect.

Policy Component

Of the project components, the mechanism for monitoring should be least problematic for the policy component. A separate contractor will be hired to administer the program of grants to business and professional associations and provide assistance in planning policy-related activities. The regular reporting of the grantees to the contractor and, in turn, the contractor to USAID will record the number and stages of progress of the various policy activities supported (i.e., discrete research activities, seminars, workshops, etc.). The development of the capacity of PSOs to effectively conduct policy research and engage in policy dialogue will be demonstrated by their record in actually conducting the activities. The impact of such activities (e.g., on changed government policies) will also be reported to the extent possible by the contractor.

Privatization Component

Similarly, under the privatization component, an advisor will be assigned to the Presidential Commission for Privatization. If the planning for the initial privatizations is a reliable indication, considerable information will be gathered on those firms which are privatized. The advisor will design and regularly report on the progress of the privatization program. Much of this information will be required prior to any disbursement of funds to the GSL. At any point during the project, it should be possible to report the most basic information, the number of firms at different stages of privatization. Data will also be compiled on such factors as the extent of ownership transferred to the private sector, the number of investors purchasing shares, the number of shares purchased, value of assets transferred to the privatized firm, the number of workers in the firm before and after privatization, compensation paid to employees who lose their jobs, etc.

Capital Markets Component

Technical assistance will be assigned for part of the project period to work with the Columbo Securities Exchange and the Securities Council. During this period, monitoring at the output level (e.g., related to computerization of exchange operations) is not expected to be difficult.

Similarly, monitoring the venture capital company at the output level will be relatively simple, using the cooperative agreement to establish reporting requirements, audit verification, and consultants' reports.

Some of the purpose level indicators may not be easily quantified. Monitoring the improvement in functioning of the exchange or the effectiveness of the use of the new computers to report sales and register transactions may have to be done descriptively. Other indicators will be available from routine reports of the Securities Exchange and the Central Bank. Greater equity investment in private enterprises will be measured by the number of shares traded, the number of new issues, and the number of shares listed on the exchange. It may not be possible from administrative data to monitor changes in the number of private persons or firms purchasing shares; a special mini-survey may be conducted at several points during the project to monitor such changes as well as the characteristics of those invested in stock. The adoption of new methods of equity financing (such as unit trusts or venture capital companies) will be monitored directly by the Private Sector Development Office of USAID.

Evaluations and Special Studies

A major project evaluation is planned by the end of the second year to examine the implementation of all components and the progress in achieving the several project purposes. Because of the possibility that the different components will be implemented at different rates and be affected by different factors, a major purpose of this evaluation will be to reassess the relative emphases given to the components.

The second formal evaluation is planned to be near the end of project implementation. This evaluation will examine the extent to which the project has achieved its purposes. Because USAID and agency work in private sectoral development still has an experimental character, determining lessons learned under each project component will be a second major focus.

Because the implementation of the different project components may vary considerably, it is possible that management would decide to have one or more special mini-evaluations of a particular component in addition to the two planned evaluations of the overall project. Sufficient funds have been allowed in the evaluation budget for such mini-evaluations or narrowly focused analyses of factors affecting the progress or impact of any project component.

Performance Indicators

At the national level of income and employment, the overall performance indicators for increasing the role of the private sector have been developed in USAID/Colombo's 1988 Annual Budget Submission, and reproduced in Annex K. To summarize, the program indicators are grouped into four sets under the following objectives:

1. Formation and growth of private sector enterprises:

   a. Ratio of average nominal tariffs for selected imported equipment to establish the degree of discrimination against private sector enterprises
   b. Sectoral rates of effective protection
   c. Incidence of export promotion measures

2. Privatization of state owned enterprises.

   a. Number actually privatized
   b. Growth rates in manufacturing sector, public vs. private
   c. Share of selected business subgroups in private hands

3. Strengthen capital markets and enhance availability of capital.

   a. Annual operating subsidies for public enterprises
   b. Annual capital transfers to public enterprises
   c. Net lending to public enterprises
   d. Percentage of Treasury bonds with "non-captive" sector
   e. Percentage of assets in investments other than government securities

4. Strengthening private sector institutions (monitored at project level).

   a. Number of institution assisted
   b. Evaluation of policy dialogue

VI. SUMMARIES OF ANALYSIS

Economic Analysis Summary

The economic analysis of the individual project components has to cope with the fact that many of the hoped-for impacts are not the result of direct linkages. Instead, they will be the outcome of a complex interplay of forces, economic policies, political developments, trends in international markets, and many more. In view of that, the economic analysis - rather than trying to estimate the economic value of any expected impacts - backed into the project appraisal by asking what magnitude the impacts should have to make the effort worthwhile. Given that, one can then judge whether the project is likely to contribute that much to the measures used as criteria.

Using illustrative examples and quantitative assumptions designed to capture orders of magnitude, the economic analysis concludes that

- an improved contribution of the private sector to policy formulation would have to lead to only an extremely small gain in the growth rate of private sector GDP (somewhere around five one-thousandths of a percentage point) to yield benefits commensurate with costs;
- in the capital markets component, the growth in the value of the stock traded would have to increase by about one-quarter of a percentage point to have the Project "break even";
- the privatization component should increase the probability of success for the Government's privatization campaign by some 50 percentage points to generate benefits comparable to costs;
- if the investments expected in the financial plan of the venture capital component materialize, the economic benefits will outweigh costs by a reasonable margin.

Given these findings, we conclude that the probability that the project is economically sound and will contribute to economic growth is sufficiently high.

2. Social Analysis Summary

There are three primary social issues to be analyzed for each major project component: are there social factors which argue for or against the attempt to achieve the project purposes; who will benefit and who will bear the costs/risks; and to what extent can the various participants be expected to behave the way the project design assumes they will.

The analysis of the project indicated that widespread social benefits from the four components of the project will be indirect and may involve a time lag beyond the life of project. There may well be dislocations, especially associated with privatization. However, if the constraints are successfully addressed, the potential for more rapid growth led by the private sector is substantial.

The beneficiary analysis indicated that initially professional and business associations, new owners of privatized companies, the investing public at large, and the founders and investors involved in the venture capital company would benefit from the project. However, with the possibility of gain will come the risks associated with a more open, less protected economy Some of the costs of privatization will be borne by redundant employees, though the project is designed to ameliorate some of the adverse effects.

The participant analysis points out the experimental nature of the policy support component, noting that the response of various associations is not easily predicted. The same will hold true for investors, and the GSL commitment to privatization.

The gender analysis concluded that the long range impacts on the economy should benefit both men and women substantially. The project will also contribute to our Women in Development agenda, for example, through support for the Women's Chamber of Industry and Commerce.

VI. CONDITIONS AND COVENANTS

A. Project Grant Agreement between A.I.D. and the GSL Conditions Precedent to Disbursement

1. The standard conditions precedent to disbursement for designation of authorized representatives shall apply. In addition to representatives from the GSL Department of External Resources, in PIL No. 1 it will be recommended that the GSL appoint representatives from the Presidential Commission on Privatization and the Securities Council for matters pertaining to their respective roles in the project.

2. Other specific conditions precedent to disbursement of project funds are recommended as follows:

(a) Prior to any disbursements for the Capital Markets Development component, the GSL will appoint a Director General of the Securities Council.

(b) Prior to disbursements under the Capital Markets Development component for the procurement of computer equipment related to the Central Depository System (CDS) of the Colombo Securities Exchange, the GSL shall provide evidence that: (1) all legal requirements for the Exchange to establish and operate the Central Depository System have been met; and (2) a means of revenue generation to meet the incremental recurrent operating costs of the Central Depository System has been established.

B. Covenants

1. The standard covenants on project evaluation shall apply.
2. Other specific covenants are recommended as follows:

The GSL will agree that title to the CDS and other commodities for the Colombo Securities Exchange will be in the name of the Securities Exchange, and that the GSL will provide exemptions or pay for taxes, duties or any other charges on items purchased with A.I.D. funds.

C. Cooperative Agreement between the VCC and A.I.D

1. Prior to the subobligation of funds under Venture Capital Company component, i.e., the signing of the cooperative agreement with the VCC, the VCC shall provide evidence that: (1) the VCC has been incorporated; (2) a minimum of Rs. 30 million in initial capital has been paid in by the company sponsors; and (3) the VCC managing director has been hired.

2. Prior to disbursement of funds, the VCC will present a business plan in form and substance acceptable to A.I.D., which details steps to be taken to achieve broad based ownership of the VCC including employees' stock options, limitations on government participation, criteria for investment which will give preference to new enterprises and innovative activities, and a clear policy for exit procedures.

3. Prior to continued disbursement of funds to the VCC after two years of the cooperative agreement have elapsed, the VCC shall provide evidence that their capital base has reached at least Rs. 100 million.

39

VII. ANPAC Review Concerns and Design Guidelines

The ANPAC reviewed the Private Sector Policy Support Project on October 13, 1987. 87 State 341617 formally approved the PID and delegated project authorization to the field. This was subject to having the Venture Capital Company (VCC) component of the project "undergo further AID/W review prior to project authorization". A number of additional items were of concern to the ANPAC review. For these they provided additional recommendations and guidelines.

Following are the concerns of the 1987 ANPAC review and how the PP design team handled the issues.

(1) Donor coordination: "Mission should seek to lead donor efforts in [privatization] and to ensure that the GSL receives consistent policy guidance, especially between ourselves and the Bank."

USAID/Colombo has worked closely with the Presidential Commission on Privatization, and has established a lead role in this area. The World Bank and other donors are still interested in seeing that SOEs become more efficient; however, USAID does not see that as necessarily inconsistant with our position, given the magnitude of SOEs and the realistic selection by the GSL of twenty-four as a medium term target. In addition, other donors (especially the World Bank) are increasingly interested in the privatization effort. As an example, the World Bank took their Public Enterprise Rationalization Project out of their Industrial Development Project (IDP III), and are awaiting clarification of the GSL privatization strategy which is being developed under this component of PSPS.

(2) GSL privatization strategy: "...important strategic issues remain to be addressed in a comprehensive privatization strategy...[which includes] absorptive capacity of the local investors and managers...a schedule" of privatization which ensures "complete private control of the enterprises in question."

The Privatization Commission has developed a schedule of firms to privatize (which is included in the PP). This is only a medium-term schedule because no firms have yet been privatized by the Commission. They expect to frequently review the list to ascertain which are the appropriate next firms. Their strategy is to privatize those firms which compete with the private sector, for which there is no good reason to remain in the public sector and which will present the least problems. After initial successes, the more difficult cases will be addressed. The Commission does not feel it would be wise to address the difficult issues until more experience is gained.

40

As a pre-project initiation activity Mission has been analyzing the ability of the capital markets to absorb the share issues both with respect to available capital and expertise. The development of new investment opportunities including unit trusts, portfolio management and easier access of foreign capital for new share issues ought to ease the difficulty of finding the capital to purchase newly privatized enterprises.

A distinction needs to be made between the need for managers for the privatized firms and the need for entrepreneurs for the Venture Capital Company. There has been little doubt that there are sufficient good managers in the country and thus the newly privatized firms will be able to be run effectively. Analysis done for the VCC indicates that there are more entrepreneurs than previously realized who are anxious to expand production or develop new activities.

(3) Privatization fund: "Mission should estimate potential total costs of privatization program and magnitude and distribution of impacts on affected workers."

The Presidential Commission, with USAID support, has estimated the potential total cost of their medium term privatization program, together with the magnitude of impact on affected workers. The estimate of 22 1/2% redundancy for a work force of 29,500 has been quantified in terms of initial cost to the GSL and the project. As part of the analysis of each individual firm prior to privatization, the Commission will analyze the work force to determine an appropriate level of staffing, what impact redundancy will have, and what should be done to assist those who are redundant.

(4) Contracting mechanism: "AID/W suggests mission consider the appropriateness of using a single TA contractor."

Mission concurs with AID/W guidance on this subject and will not be using a single TA contractor.

(5) Monitoring and evaluation: "PP should be more specific on how the project will collect data on its impact on industrial deregulation, privatization of SOEs and development of capital markets, and on how such impacts affect national income and employment."

The monitoring and evaluation section of the PP as well as the economic analysis provide detail on what data needs to be collected on the impact of the project. Special attention has been paid to performance indicators at the national level in USAID/Sri Lanka Annual Budget Submission of May 27, 1988. This is summarized in Chapter V, Monitoring and Evaluation Plan.

(6) Minority business utilization: Mission should "indicate in PP what consideration is to be given to Gray Amendment entities in the contracting process including possibility of an historically black college/university providing short term training."

USAID/Colombo feels that minority businesses will provide some of the technical assistance required by the project, as much of the preliminary analysis was successfully done by an 8-A firm. However, it is not felt that any college or university can provide the type of short term training needed by the project. This training will be provided by the firms providing the technical assistance and at least one of these contractors will likely be a firm that qualifies under the Gray Amendment.

In 88 State 205142 AID/W reviewed the VCC and approved the Mission's proceeding "to authorize the project including the VCC component, subject to guidance provided" in the cable.

(1) Support for a single Venture Capital Company only: "AID support should benefit private Sri Lankan venture capitalism generally, rather than providing an advantage to one specific private venture capital company or its owners....Mission support should [meet] those costs associated with its disadvantaged position and unusual risk of being the first privately-held venture capital entity in Sri Lanka."

The nature of USAID's assistance to the VCC is to provide assistance to it because it is the first of its kind. While there are other venture capital entities in country, the VCC will be the first which has owners from a wide variety of companies and not from just one group of companies. In addition, the VCC will be investing primarily in activities which its members do not own or control. For these reasons it will be different from other venture capital entities in country. The projections for the VCC indicate that, on reasonably conservative assumptions, breakeven will be achieved in year three, with modest profits thereafter. If the VCC can better these projections, it will provide a model for others to follow, and in that sense the benefits conferred initially on the VCC will have worked to the advantage of others interested in the concept. Mission support is designed to meet a portion of the start up costs, which is deemed the period of greatest risk. Projections indicate that even with USAID support of $500,000 over four years, the VCC will not yield a return to the investors even approaching that of annually compounded interest earned on savings.

(2) Financing of capital equipment: "Mission is advised to consider the...elimination of proposed AID financing of fixed assets...to avoid inappropriate subsidy."

42

USAID's assistance to the VCC in the form of capital equipment is limited to a maximum of $80,000. It is part of a package of support designed around the immediate needs of a start-up situation, the purpose of which is to finance extraordinary start-up costs, not currently being considered by other, "in-house" venture capital activities now being initiated. By assisting in the financing of both capital and operating costs during the start-up period, the project intends to demonstrate that these extra risks are worth taking if the enterprises which are started are carefully planned and professionally managed, even though they come from outside the VCC owners' own companies.

(3) Greater oversight: "Mission may want to explore... delivering start-up support for VCC via a cooperative agreement, which conveys a higher degree of Mission oversight responsibility."

USAID agrees with this suggestion and will use a cooperative agreement for implementation of the VCC component.

(4) Role of DFCC: ANPAC was concerned because DFCC will hold one-third of the shares of the VCC and DFCC is 41% owned by state-owned banks. Recommendation is that when the capital is expanded from Rs.30 million to Rs.100 million that DFCC's share ought to be reduced. Further that no one entity ought to be able to have more than 33% of the ownership now or 25% or 20% at the time of expansion.

USAID agrees with this recommendation and will develop suitable covenants to address this issue in the Cooperative Agreement with the VCC.

(5) Ownership by firms with public sector ownership: "After initial start-up, no entities with public-sector ownership should be permitted to participate in the VCC as investors." "Mission may wish to encourage the VCC group to offer VCC employees a stock option plan as part of their compensation."

Mission agrees that as a general principle, state owned companies should not participate in the VCC as investors. However, many Sri Lankan companies have a small portion of their equity held by state pension funds or other government owned financial institutions. The Mission does not wish to eliminate a significant number of potential investors if GSL participation in their equity is not reflected in their management. Mission will be particularly vigilant in keeping the VCC a private sector institution through the mechanism of the cooperative agreement "substantial participation". USAID agrees with the second suggestion of providing shares of the VCC as part of the compensation package of VCC employees.

(6) Investment Criteria: In addition to initial activities being economically and financially viable, USAID should play a strong role in developing criteria which would:

a) require that all investments be in wholly privately-owned enterprises,

b) give preference to investments
   i) outside the VCC core group,
   ii) in activities that are innovative, high risk and not expansions of existing activities,
   iii) that comply with applicable GSL environmental, health and safety regulations and
   iv) benefit all ethnic and religious communities and women.

c) be open to consideration of joint ventures with foreign partners.

The VCC will have to develop a business plan prior to disbursement of funds. The recommendations of the RC review will be conveyed to the VCC board as indicative of the type of investments USAID would like, to the extent possible, to support.

(7) USAID concurrence in VCC charter: As a condition precedent to disbursement of funds, USAID must concur with the VCC's charter, bylaws, operating policies, investment criteria and exit mechanisms.

USAID agrees with the need for concurrence and will make it a C.P. to disbursement.

44

ANNEX A

POLICY SUPPORT

1. OBJECTIVE AND CAPSULE DESCRIPTION

The objective of this component is to improve the contribution of private sector institutions to market-oriented economic policy formulation and implementation, through better capabilities in formulating and appraising economic policies.

This will be accomplished through a specially structured program involving an estimated 15-20 activities over the life of the project carried out by individual private sector chambers and associations, referred to herein as "private sector organizations" (PSOs). Project Assistance will be made against a carefully defined set of approval criteria focussed on the policy work which the participating PSOs propose to undertake. The project will fund a mix of technical assistance, training, seminars and limited equipment procurements. A separate U.S. firm or organization will be employed by USAID under a Cooperative Agreement to administer this component of the project and to carry out various tasks required to support or enhance the PSOs' general ability to conduct effective policy analysis and dialogue with government decision-making agencies. The total cost of this component is estimated at $3.25 million.

2. BACKGROUND/RATIONALE

A. The Policy Agenda: In a mixed economy where the private sector is expected to play a major role, the policy environment within which the private business community operates is a fundamental determinant affecting private sector investment, employment creation and growth. The premise underlying this component of the project is that the private sector must carefully analyze various policies and their implication for both the private sector and the nation as a whole before asserting itself on policy issues, in order to develop the necessary confidence and competence to assume a leadership position in the productive portion of the economy. This means not only analyzing government policy initiatives but taking an active role in developing programs which will improve the economy. While government ultimately sets business and economic policy, the policy-making process can be significantly enriched by convincing analyses made by respected private sector organizations.

While privatization of SOEs, moves to strengthen the capital markets, and efforts to expand equity investment through venture capital are the subjects of other PSPS components, this component will support policy research, analysis and dialogue by Sri Lankan PSOs on a broad range of these and other policy issues of concern to the private sector. "Policy" as employed here covers the gamut from macroeconomic and sectoral policies to micro concerns such as regulations and interpretations of rules and procedures. In Sri Lanka, the macroeconomic "open economy" policies promulgated since 1977 have produced a basically positive and favorable policy environment for private sector participation, which is reflected in statistics on the absolute and relative overall growth of the private sector share in GDP. The current macroeconomic policy framework as summarized in Annex "L" describes the reversal from the dirigiste policies in place prior to 1977 and the progress made on trade, exchange rate, tax, monetary, pricing, market deregulation, and foreign investment policies in the past ten years. Much still remains to be done, however, to further encourage and expand private sector activity. This was highlighted in the report of the Industrial Policy Committee (IPC) adopted by the government in early 1987. The IPC report calls for additional changes and consolidation of policies related to the tariff regime, export incentives, tax credits, equity finance, technology development, labor laws, land acquisition, debt recovery, the role of state-owned enterprises and a host of other key policy areas. Throughout, the IPC report emphasizes the lead role which the private sector is expected to play and the need to establish a coherent policy framework.

B. Policy Actors: Except for self-policing measures which PSOs might adopt to set rules of behavior for their own memberships, business and economic policies can be influenced by PSOs but are ultimately made by government ministries and their dependent agencies, boards or commissions. The most important ministry in setting macroeconomic policy and in guiding policy formulation in general is the Ministry of Finance and Planning, including the Central Bank. The line ministries also engage in sector specific policy-making and regulations in areas within their purview. Perhaps the most influential among the line ministries in terms of impact on the business community are the Ministry of Trade and Shipping and the Ministry of Industries and Scientific Affairs. The Ministry of Lands and Land Development, through the Land Reform Commission, controls leases of crown land and other land-related policies, the Ministry of Labor governs labor laws, and so on. On the other side of the policy dialogue the private sector, like its government counterparts, is fragmented with a large number of chambers and associations representing very broad to very narrow interests depending on the membership constituency of each organization. The most senior and broad-based private sector organization is the Ceylon Chamber of Commerce, founded in 1839. Among the other larger chambers are the Ceylon National Chamber of Commerce and the Ceylon National Chamber of Industries, both formed after independence in 1948. The Employers Federation of Ceylon was formed in 1927. An example of one of Sri Lanka's many established professional associations is the Institute of Chartered Accountants, founded in 1959. Altogether a survey commissioned by USAID/Sri Lanka in early April 1988 identified some 75 active PSOs, among which about 15-20 are likely to participate as subgrants in the PSPS project (see summary of survey findings in Section 3.A., below).

As a rule, the government takes the initiative in the policy-making process in Sri Lanka. The individual PSOs have tended to adopt a reactive posture with some notable exceptions such as the successful initiative led by the Ceylon Chamber of Commerce to reopen the insurance business to the private sector. To be sure, the government at times actively seeks private sector input prior to settling on a particular policy position; an example cited in the PSO survey is the relationship between the Inland Revenue Service and the private Income Tax Payers Association. The government has occasionally issued the equivalent of "white papers" to PSOs seeking their reactions to proposed policies; this sometimes results in the government's taking a second look at issues which prove controversial. An example is the recently proposed transferable tax credit scheme which was criticized by several leading chambers whose views were sought following its announcement as part of the Industrial Policy Committee report.

The government has more explicitly moved to engage the private sector in policy formulation through the appointment of several high-level public sector/private sector commissions. The private sector representative on these commissions are, as a rule, respected senior business executives, often past or current leaders in various PSOs. The foremost examples of existing commissions of this nature are the Presidential Tariff Commission, the Export Development Board, the Fair Trading Commission, the Presidential Commission on Privatization, and the Securities Council. These commissions, focussed in each case on specific policy topics and agendas, have been successful deliberative and policy-making bodies. Naturally, not all policies or decisions by the commissions have been favorably welcomed by all PSOs, particularly those with more narrow self-interests (e.g., import-substituting local manufacturers usually protest against the lowering of tariffs on finished products), but the presence of senior business leaders on the commissions has helped express the broad interests of the private sector.

From time to time there have also been attempts both by the private sector and/or the government to set up "apex organizations" to serve as conduits for national-level policy dialogue across a broad spectrum of issues. Experience has shown that such apex organizations do not work particularly well and that attempts to "institutionalize " the policy dialogue in this way are not practical. In the 1970s the Federation of Chambers of Commerce and Industry of Sri Lanka was established, at a time when the private sector was under heavy pressure and the fragmented PSOs sought a means to deal in a unified way with government. For a time this appeared to serve a useful purpose.

However, with the new orientation of government since 1977 the federation has ceased to play any significant role due in part to internal organizational difficulties but more so to the inherent problem of representing the view points of its diverse 10-15 member PSOs with a single voice.

Beginning in 1983, USAID became involved in an alternative attempt to build an apex organization through the Private Enterprise Promotion Project (PEPP, 383-0082), by establishing the Sri Lanka Business Development Center (SLBDC). The SLBDC was viewed initially as an organization which could investigate national policy issues on behalf of the private sector as a whole and provide a forum for policy dialogue with the government. As with the federation, in practice that objective was not achieved, although the SLBDC as an independent PSO has conducted a number of useful policy studies, and was instrumental in leading the working committees and conducting follow-up seminars on behalf of the Industrial Policy Committee. The IPC itself provides still another example of the elusiveness in trying to unite several groups, this time government agencies, into a single decision-making body. While the IPC succeeded (after over two years) in producing a "consensus" report outlining a long agenda of policy work, the "Industrial Development Committee" which it recommended be set up to guide this work in the future and oversee the implementation of new policy reforms has not yet materialized. Rather, the follow-up has been left to the various joint commissions and the individual government ministries to perform. The conclusion drawn at this point is that apex organizations do not work and that real policy dialogue will continue to occur directly among the established organizations.

C. Policy Matrix for Next Five Years: In the design of this component, USAID analyzed the "Matrix" of principal policy subject areas that will be on the policy agenda during the next five years. The matrix is presented in Table A-1. It is by no means exhaustive but serves to identify the policy areas as well as the government and private sector actors in the policy dialogue including all known donor-funded support programs for the various actors. In particular, the detailed plans of the two major donors engaged in policy support activities, the World Bank and the Asian Development Bank, have been fully considered and divisions of labor defined vis-a-vis USAID's activities in the PSPS project. The analysis displayed by the matrix reveals that USAID and other donor programs are positioned to provide substantial support to the government actors in the policy dialogue over the forthcoming period. This includes continued World Bank and ADB support available to the Tariff Commission and the Export Development Board and USAID support via PSPS for the Privatization Commission and the Securities Council. It also includes support by the Dutch government for the government-sponsored Institute of Policy Studies, a "think tank" organization affiliated with the National Planning Division within the Ministry of Finance and Planning. Where there still may be gaps on the government side, USAID's Development Studies and Training Project (DS&T, 383-0085) is already positioned to fund policy studies or related support for government organizations, e.g., for policy investigations by the yet to be formed Industrial Development Committee should it materialize in the future. The critical gap that emerged from the matrix is on the private sector side. Except for a small grant by the West German Friedrich Naumann Foundation for the Federation of Chambers of Commerce and Industry, no support is planned for the PSOs. This is the gap that PSPS will fill.

3. PROJECT ACTIVITIES

A. PSOs in Sri Lanka/Institutional Analysis

According to results of the survey completed in April 1988, there are at least 75 PSOs currently active in Sri Lanka that are representing the private sector. They include 13 chambers of commerce or industry, 35 producer, manufacturer, exporter and other associations serving a particular business sector, and 20 professional associations and other private sector promotion organizations. The list of PSOs is in Table A-2. Many of the PSOs are well established having been in existence for thirty or more years, the oldest being the Ceylon Chamber of Commerce. They represent a spectrum ranging from very broad business constituencies to fairly narrow special interest groups. All PSOs are governed by voluntary boards of directors elected by their members. The voluntary nature of the PSOs is both a strength--through the leadership talent represented by the board members--and a constraint--given the other demands on their time and their inability to devote full-time energy to the work of the PSO. Some of the PSOs have sufficient sources of income to employ permanent professional staff, however, most do not.

From the list of 75 PSOs, interviews were held with thirteen selected as representative of the group. In addition, extended work has been done with the Ceylon Chamber of Commerce to develop a specific policy support activity which serves as prototype for larger institutions. A summary of findings and conclusions from the survey follows.

The PSU survey found that staffing and funding limitations have prevented most PSUs from producing or commissioning background policy studies on any systematic basis, for use in making representations to government on policy issues. Even where the PSU has professional staff these individuals are usually engaged in other duties and responsibilities and often may not have the expertise to research the policy issue at hand. There are, of course, exceptions, such as the policy research work cited in the survey by the staffs of Employers Federation of Ceylon and the Sri Lanka Council of the International Chamber of Commerce. The best policy research and analysis appears to be produced by the PSU board members themselves who have periodically formed subcommittees of members to undertake tasks requiring a specialist input. A notable example from the survey was the study by the Chairman of the Gem Traders Association on resuscitating the gem industry in Sri Lanka. PSUs as a rule have not commissioned outside consultants to perform policy studies on their behalf, due primarily to lack of financial resources and at times to a lack of appreciation on how such studies could be utilized.

The survey found that all PSUs, regardless of limitations on time and resources available for research and analysis of policy issues, engage in some form of representation to government in areas of special concern to their membership. Examples of policy issues on both the micro (regulatory) and sector or macro levels on which past representations have been made by PSUs are cited in the survey. The representation process takes several forms. The most formal method involves an issue being raised by an individual or group of members, usually after a government policy or regulation has been announced. The PSU then forms a subcommittee of concerned members specializing in a particular area to research the issue at hand and prepare a paper. The paper is then presented to a policy maker in government. A less formalized approach has been through placement of commentary on a specific issue in the annual report of the PSU to be read at the annual general meeting of the association or chamber to which government policy makers are invited, often as guest speakers. The least structured and probably most frequent method is a direct representation made by individual members of the PSU based on their personal contacts with government officials and aimed at specific relief from particular legislation or procedures.

Government's response to the PSU's representations has been mixed. The survey revealed several instances of positive outcomes and speculates that the key variable for success was the direct contacts of individual PSU members either as members of joint commissions appointed by government to oversee specific policy areas or via close rapport with officials in government. Four examples cited are: the National Chamber of Commerce's successful representations in the areas of duty rebates and freight rates; the Ceylon National Chamber of Industries' assessment of large scale smuggling of textiles and garments from the Free Trade Zone and the Duty Free Complex on the basis of which tighter government security was introduced; the Finance Houses Association's advice on the drafting of legislation for the Consumer Credit Act resulting in many of its recommendations being incorporated in the legislation; and the Institute of Chartered Accountants and Income Tax Payers Association's success in influencing current policy on privatization, company law and income tax legislation. Another example referred to earlier was the demonopolization of the state-controlled insurance sector through the initiative led by the Ceylon Chamber of Commerce.

On the other hand, there are at least as many instances where the representations failed. This is of course due at times to a legitimate conclusion by the policy decision-maker that the PSO's position was unreasonable because it advocated measures that if entertained for one sector in the economy could have adverse effects on another, or because its request was too narrow or self-serving, or for other reasons could not be accepted by government regardless of how well the PSO made its case. However, the survey also points out many reasons for unsuccessful outcomes that should be more within the control of the PSOs themselves. These include: (1) lack of homework by the PSO in its research and analysis on the issue; (2) fragmentation among the PSOs where absence of a coordinated approach by several PSOs concerned with the same issue results in unnecessarily conflicting representations; (3) lack of effective follow-up on issues due to indecision within the PSO on who should make the representation and how; (4) confusion as to which government bodies and decision makers should be approached; and (5) a suspicion by some in government of the motives and bona fides of some PSOs.

The PSO survey probed specifically whether or not there was scope for improved performance by the PSOs and how receptive the PSOs would be, assuming appropriate resources could be made available, to taking on a more active and forward-looking approach to setting policy agendas, conducting more thorough research and analysis and enhancing their role in follow-up policy dialogue with the government. It was apparent, on the one hand, that the PSOs are cautious about their built-in limitations. Except for four or five well established PSOs, it would be inappropriate for the PSOs to attempt to set up permanent research units within their organizations due to lack of finances to carry recurrent costs. Some PSOs also expressed reluctance to become involved in long range policies due to the unstable political situation in the country. Still others are unsure of their ability to influence government based on a perception by the PSO's members that policy reforms are not within their province. On the other hand, the survey confirmed that at least half of the PSOs interviewed intend to work on policy issues in the future and already have outlines of their tentative agendas. The survey concluded that many PSOs are likely to participate in the project and will be able to meet the criteria to receive support through subgrants. Moreover, PSOs need not have large budgets or permanent staffs of their own to take advantage of the policy support activities planned for this project.

B. Policy Support Unit

A U.S. firm or organization experienced in working with PSOs will be employed under the project to establish a "policy support unit" that will assist participating PSOs. The firm or organization, referred to herein as the "recipient", will be hired through a Cooperative Agreement rather than a contract, principally because A.I.D. rules allow for subgrants to be made under a Cooperative Agreement but not under a contract. The recipient will be one and the same as the policy support unit and the unit will cease to function when the Cooperative Agreement ends at the close of the project. The Cooperative Agreement will be awarded through competitive procedures to a U.S. firm or organization. The recipient will establish the policy support unit office in Colombo with a small staff and related logistical support.

The overall role of the unit will be to strengthen the capacity of participating PSOs to carry out policy work. The unit's specific functions can be divided into three parts.

- Providing general guidance to PSOs on the policy process.
- Receiving and evaluating proposals by PSOs for subgrants.
- Administering the approved subgrants.

Providing General Guidance to PSOs on the Policy Process

The unit will be a focal point for PSO support. It will, over time, become a source of information on the "policy matrix" including which actors on the government as well as private sides of the policy dialogue are engaged in specific policy agenda activities, and which donor-funded programs are supporting which actors. It will work directly with eligible PSOs to strengthen their policy work programs. Among the support tasks will be:

- to establish contacts with the PSOs, government agencies, and donors involved in the policy matrix;
- to develop an active plan, with targets and benchmarks, for contacting eligible PSOs, developing programs of support, prioritizing activities, and tracking implementation and results. The plan will be approved by USAID, and provide quarterly updates for project review.
- to maintain a list of all registered PSOs representing the private productive sector in Sri Lanka including relevant file information on staffing, budgets, membership, annual reports, etc.
- to understand the policy development process in Sri Lanka;
- to maintain an updated matrix of the policy agendas being worked on by PSOs;
- to advise PSOs on establishing policy agendas consistent with their members' priority concerns;
- to provide technical assistance, seminars and training opportunities to groups of PSO boards and staff on the workings of the policy process in general and how PSOs can strengthen their organizations to play a larger part;
- to advise PSOs on the methodologies and effective use of policy research and analysis and to help define relevant terms of reference for consultants needed for specific PSO subgrants;

- to maintain a roster of local consultants (both individuals and organizations) qualified to undertake studies and presentations on policy issues under subgrants to PSOs;

- to advise PSOs on how to engage government counterparts effectively in policy dialogue, how to make most effective use of seminars and workshops, and how to use other means of constructive discussion to address policy options; and

- to identify common areas of concern and facilitate cooperation among PSOs and governmental bodies to undertake joint policy research, analysis and dialogue whenever relevant.

Receiving and Evaluating Proposals by PSOs

The unit will solicit proposals for specific subgrants from PSOs. Subgrant proposals will be entertained against a set of approval criteria. A preliminary draft of the approval criteria is in Section 3.C., subject to revision and approval by USAID prior to the start of the subgrant solicitation process. The detailed process through which subgrants will be approved and authorized is outlined in Section 5.A. The tasks of the unit in this part of its job will be:

- to "market" the policy support program including detailed criteria and procedures among eligible PSOs;

- to advise PSOs on the formulation of proposals and to take the time necessary to ensure that proposals are well thought through, well presented, and carry broad support from PSO membership;

- to receive and maintain records on all formal proposals;

- to send all proposals which have met the units' criteria to USAID for review; and

- to relate interim and final decisions on the status of subgrant proposals to the PSOs involved.

Administering the Approved Subgrants

Once a subgrant proposal has been approved and authorized by USAID, the unit will be responsible for the actual administration of the subgrant. Separate funds will be included in the Cooperative Agreement for the purpose of making subgrants. The unit will enter into direct subgrants with the individual PSOs. Depending on the specific financing arrangements of each subgrant, the unit will also provide for all subgrant accounting and assist in various procurements by the subgrantees. The specific tasks will be:

- to prepare, negotiate and sign authorized subgrants with PSOs;

- for local currency expenditures under the subgrants, to make direct reimbursements to subgrantees for local currency expenditures against documented subgrantee vouchers; or, if required by the subgrantee, to advance funds and liquidate advances against subgrantee vouchers; or, at the subgrantee's request, to make direct payments to local suppliers of technical assistance or commodities upon presentation of invoices forwarded through the subgrantee;

- for foreign currency expenditures related to overseas participant training or study tours included within a subgrant, to arrange the training or tours at the request of the subgrantee, make related payments, and follow the standard procedures on training containing in A.I.D. Handbook 10;

- for foreign currency expenditures for short-term expatriate consultants included within a subgrant, to provide such consultants directly (through the recipient organization itself) based on selection by the subgrantee from among various proposed candidates, with charges for such consultants made by the recipient against subgrant funds; and

- to provide a full accounting of all subgrant expenditures.

See Section 5.C for further details on subgrant procurement procedures.

To carry out the three combined sets of tasks, the unit will be staffed by one long-term expatriate advisor and one senior Sri Lankan advisor. The two advisors will work as a team and either individual may be designated chief-of-party at the discretion of the recipient. The Sri Lankan advisor must be an experienced individual already directly familiar with the policy process in Sri Lanka. The expatriate advisor must have a relevant background with private sector organizations in his/her home country including prior experience in third world environments. In addition, the unit will employ a full-time local administrative/financial assistant to manage the multiple document and payment transactions called for in the Cooperative Agreement.

In designing the role and functions of the policy support unit, the choice of a Cooperative Agreement with an outside firm or organization for this purpose is the only viable approach. The alternative of offering this role to one of the established PSOs in Sri Lanka was considered but found unattractive by the PSOs who were approached. It was also not desirable to create a new PSO. A neutral entity in the form of an outside party will be best positioned to work without prejudice or conflict of interest with the PSO community as a whole.

C. <u>Subgrants</u>

About 15-20 subgrants to PSOs will be implemented during the project. The objective of the subgrants is to provide specific support to individual PSOs in carrying out policy studies and in strengthening their capacities to conduct policy dialogue.

The subgrants will provide funds for short-term technical assistance consultancies (both local and expatriate), training and study tours, equipment and other direct costs of the PSOs. The size of the subgrants will vary considerably from the $10,000-20,000 range for small and short-duration subgrants up to $150,000-200,000 for larger, multi-year subgrants. Illustrative examples of subgrants and their cost elements are given in Section 4.b. Appropriate financial contributions by the PSOs will be required as part of the criteria for subgrant approval.

A disciplined review process will be instituted requiring close adherence to the approval criteria but offering opportunities for as many PSOs as are eligible to submit proposals. The recommended criteria are as follows:

- Objective of subgrant related to the PSOs policy agenda: the subgrant must have a direct bearing on the medium-term (two-year forecast) policy agenda of the subgrantee and strengthen its long-term institutional capacity to carry out policy work, which in term will lead directly or indirectly to improved economic performance;

- Specific outputs: In addition to the subgrant's intended effect on institutional strengthening of the PSO, the planned measurable outputs of the subgrant will be described, e.g., policy studies completed, seminars held, policies changed, and scheduled against specific time frames;

- Broad area of concern: The policy issue(s) to be addressed through the subgrant must be of general concern to the broad membership of the PSO; narrow, self-serving or vested interests should not be present which in any way will influence the objectivity of the work undertaken;

- PSO management commitment: The PSO must appoint and identify a committee of its members and/or staff who will be responsible for managing the subgrant from initiation through completion;

- Research methodology: Proposed policy studies must be accompanied by terms of reference citing the methodologies to be used and the planned roles of PSO members, PSO staff and outside consultants;

- Dialogue plan: The PSO will present its plan to engage government decision-makers, other PSOs and other interested parties in dialogue on the issues studied;

- Joint proposals: Where relevant, the PSO will indicate how other PSOs will participate in the research or dialogue phases of the subgrant and/or will make a joint proposal with one or more PSOs;

- Accounting capacity: The PSO must demonstrate a capacity to account for all expenditures of subgrant funds;

- A.I.D. Standard Provisions: The PSO must become familiar with and agree to abide by all A.I.D. standard provisions which shall be incorporated into each subgrant;

- Justification for inputs: The PSO will list the cost elements (inputs) of the subgrant together with estimated total cost, the magnitude of inputs must relate directly to the subgrant outputs and objectives; and

- Contribution by PSO: An appropriate contribution by the PSO including a valuation of in-kind contributions but also at least some financial contribution must be committed toward the total cost of the activities which the subgrant supports.

D. Outputs

The combined outputs for the component as a whole through the work of the policy support unit (recipient) and the subgrants (PSOs) are:

- Between 15-20 analytical activities will be carried out in which the participating PSOs will have researched and analyzed policy issues; and

- At least 15-20 dissemination activities (including various combinations of seminars, workshops, publications, etc.) will be carried out by PSOs as part of a dialogue process on the issues that have been researched; and

- Another 5-10 workshops or seminars will be provided to groups of PSOs by the policy support unit.

E. End-of-Project Status

At the end of the project, the following conditions will prevail as indicators that the project purpose has been accomplished:

- There will be an enhanced capacity of individual PSOs and the PSO community as a whole to participate effectively in influencing business and economic policy;

- There will be an accompanying enhanced credibility of PSOs on the part of the government and the public;

- The private sector's ability to engage in dialogue will have been strengthened, characterized by objective analysis and decision-making on the merits of the issues and options discussed; and

- PSOs will be contributing in more active and substantive ways in shaping the sectoral and national economic development plans and agendas for the country.

Table A-1: POLICY MATRIX 1988-1993

Policy areas	PSO actors	Government actors	Donor involvement
Tariffs	Chambers Manufacturer Associations	PTC, MTS, MF&P, MISA	WB under IDP III
Export incentives	Chambers Exporter associations	EDB	ADB-for EDB under SMI III WB-for EDB under IDP III
SOEs		PCP, MF&P, MISA, MTS	WB-SOE restructuring under SMI III and future WB project USAID-for PCP support under PSPS
Capital markets/equity/credit	CSE VCC	SC CDIC NDB	USAID-for SC, unit trusts under DS&T USAID-for SC, CSE, VCC under PSPS ADB-for SC, CDIC, unit trusts under IDP III WB-for CB and PCIs under SMI III/IDP III
Other finance/banking exchange rates	Finance/banking associations	Central Bank	ADB under Rural Credit Project
Technology development	Chambers Associations	CISIR, NARA, SLSI, NERDC MISA	WB-under SMI III IDP III USAID - future S & T project
Land policy	Chambers Associations	MLLD MASL	USAID through MARD, MED
Labor law	Chambers EFC	ML	
Tax Policy	ICA Tax Payers Association	MF&P, IRS	IMF through SAF
Sector specific policy	Associations	MF&P, MISA, MTS	
Government Investments	Chambers/Associations	PCP, Line Ministries	WB through PERP, USAID through PSPS
General	SLBDC	IPS, IDC*	USAID -for SLBDC to 9/30/89 under PEPP Netherlands - for IPS support WB/IMF through PFP

Abbreviations:

ADB	Asian Development Bank	MF&P	Ministry of Finance & Planning	PFP	Policy Framework Paper
CDIC	Capital Development & Investment Co	MISA	Ministry of Finance & Planning	PTC	Presidential Tariff Commission
CISIR	Ceylon Inst. of Sci. & Ind. Research	ML	Ministry of Labor	SC	Securities Council
CSE	Colombo Securities Exchange	MLLD	Ministry of Lands & Land Dev.	SLBDC	Sri Lanka Business Development Center
DS&T	Development Studies & Training Project	MTS	Ministry of Trade & Shipping.	SLSI	Sri Lanka Standards Institute
EFC	Employers Federation of Ceylon	NARA	National Acquatic Resources Agency	SMI III	Small & Medium Industry III Project
ICA	Institute of Chartered Accountants	NERDC	National Engineering Research & Development Centre	SOE	State-Owned Enterprise
IDC	Industrial Devel. Committee (*if formed)			S&T	Science & Technology Project
IDP III	Industrial Development Program III	PCP	Presidential Comm. on Privatization	VCC	Venture Capital Company
IPS	Institute of Policy Studies	PCI	Participating Credit Institutions	WB	World Bank
IRS	Inland Revenue Service	PEPP	Private Enterprise Promotion Project		
MASL	Mahaweli Authority of Sri Lanka	PERP	Public Expenditure Restructuring Project		

Table A-2 Private Sector Organizations in Sri Lanka

1. Chambers

Ceylon Trade Chamber
Ceylon Chamber of Commerce
Ceylon Moor Chamber of Commerce
Ceylon Merchants Chamber
Ceylon National Chamber of Industries
Chettiar Chamber of Commerce
Federation of Chambers of Commerce and Industry of Sri Lanka
Mercantile Chamber of Ceylon
National Chamber of Commerce of Sri Lanka
North Ceylon Chamber of Industries
Sri Lanka Chamber of Small Industry
Sri Lanka National Council of the International Chamber of Commerce
Women's Chamber of Industry and Commerce

2. Producer, Manufacturer, Exporter & Other Business Associations

All Ceylon Printers Association
Association of Producers, Processors and Exporters of Oil Seeds and Pulses
Association of Sri Lanka Electrical and Electronic Goods Manufacturers and Exporters
Cardamom Traders Association
Ceylon Association of Manufacturers
Ceylon Association of Steamer Agents
Ceylon Engineering Trades Association
Ceylon Hardware Merchants Association
Ceylon Motor Traders Association
Ceylon Textile Manufacturers Association
Ceylon Tyre Traders Association
Coconut Products Exporters Association
Colombo Tea Traders Association
Colombo Rubber Traders Association
Exporters of Spices and other Products
Federation of Exporters Associations of Sri Lanka
Finance Houses Association of Sri Lanka
Pacific Area Travel Association of Sri Lanka
Sea Food Exporters Association
Spices and Allied Products Traders Association
Sri Lanka Association of Producers and Exporters of Spices and other Productss
Sri Lanka Apparel Exporters Association
Sri Lanka Fruit & Vegetable Producers, Processors and Exporters Association

57

Sri Lanka Leather Products Exporters Association
Sri Lanka Gem Traders Association
Sri Lanka Importers, Exporters and Manufacturers Association
Sri Lanka Industrialists Association
Sri Lanka Jewellers and Gem Merchants Federation
Sri Lanka Jewellery Manufacturers Exporters Association
Sri Lanka Lapidarists Association
Sri Lanka Pharmaceutical Manufacturers Association
Sri Lanka Shippers Council
Sri Lanka Tourist Association
Sri Lanka Wooden Furniture and Wood Products Exporters Association
Tourist Hotels Association of Sri Lanka
Travel Agents Association of Ceylon

3. Professional Associations

Association of Chartered Secretaries
Association of Consulting Engineers
Bar Association of Sri Lanka
Ceylon Association for the Advancement of Science
Income Tax Payers Association of Ceylon
Institute of Architects
Institute of Bankers
Institute of Chartered Accountants of Sri Lanka
Institute of Engineers
Institute of Management Services
Institute of Personnel Management
Planters Association of Ceylon
Productivity Association of Sri Lanka
Organization of Professionals Association
SLISSCO Management Center
Sri Lanka Association of Economists
Sri Lanka Bankers Association
Sri Lanka Branch of the Institute of Cost and Management Accountants (UK)
Sri Lanka Institute of Marketing
Sri Lanka Management Association
Sri Lanka Management and Productivity Association

4. Other Associations/Organizations

Business Council
Colombo Securities Exchange
Employers Federation of Ceylon
Joint Agricultural Consultative Committee
Small Business Promotion Institute
Sri Lanka Business Development Center

56

4. FINANCIAL PLAN AND ANALYSIS

A. Budget Summary

The total estimated cost of this component is $3.25 million. Of this total, A.I.D. will contribute $2.9 million or 89% of all costs; contributions by PSUs in cash or in-kind through the subgrants are $ 0.35 million (11% of all costs and 19% of subgrant costs).

Table A-3: Cost Estimate and Financial Plan ($ 000)

	A.I.D.	PSUs	Total
Policy Support Unit	$1,396	--	$1,396
Subgrants	1,500	$350	1,850
Total	$2,896	$350	$3,246

By fiscal year expenditures, assuming one large subgrant and one small subgrant are awarded prior to the scheduled signing of the Cooperative Agreement and setting up of the unit in mid-1989, estimated expenditures should be as follows:

Table A-4: Estimated Expenditures by Fiscal Year ($ 000)

		Fiscal Year					
		89	90	91	92	93	Total
Policy Support Unit	A.I.D.	96	325	325	325	325	1,396
Subgrants	A.I.D.	100	300	400	400	300	1,500
	PSUs	75	50	75	75	75	350
	Total	271	675	800	800	700	3,246

B. Basis for Cost Estimates

The costs of the policy support unit will be incurred by the recipient of the Cooperative Agreement. Allowing one year for the completion of preparatory steps, issuance of the Request for Proposals, the competitive selection of the recipient and the establishment of the unit, a four-year budget for the unit covering years 2-5 of the project is calculated as follows:

TABLE A-5: Estimated Costs of Policy Support Unit

L/T expatriate (4 years @ $200,000/yr)	$ 800,000
L/T local professional (4 yrs @ $30,000/yr)	120,000
L/T local assistant (4 yrs @ $20,000/yr)	80,000
Other staff support	60,000
Office space/utilities	80,000
Equipment and Furniture	20,000
Vehicle (1)	10,000
Plus	
S/T expatriate TA (6 pm @ $20,000/pm)	120,000
S/T local TA (12 pm @ $2,500/pm)	30,000
Participant training (20 x $3,800)	76,000
	$1,396,000

59

A standard cost factor of $200,000/yr. is used for the long-term expatriate advisor and includes estimated overheads, fees, and all standard allowances and applicable support costs (housing, etc.). The short-term expatriate cost per person month is costed at $20,000 inclusive of salary, travel, per diem and overheads/fees. Participant training is based on average travel, per diem and tuition costs for training in the U.S. and/or other locations. Local long-term and short-term personnel costs are based on competitive rates in Sri Lanka and also include calculations for overheads and fees. Other local cost estimates are based on competitive costs in Colombo for the office space, support staff and other requirements of the unit.

The subgrant costs will consist of varying amounts in each subgrant for short-term consultancies (both local and expatriate), participant training, equipment and other direct costs of the PSUs. For illustrative purposes total A.I.D. costs per subgrant will be $10,000-20,000 for small subgrants, $50,000-100,000 for medium subgrants, and $150,000-200,000 for large subgrants. Cost factors for local and expatriate consultancies and participant training procured under subgrants are the same as cited for the policy support unit. One firm cost estimate for a large subgrant has been developed for a potential multi-year program supporting an economic research unit in the Ceylon Chamber of Commerce. The estimated A.I.D. and PSU contributions toward such a subgrant would be:

A.I.D. Contribution		Ceylon Chamber of Commerce Contribution	
Computer equipment	$ 35,000	Economists' salaries (3 yrs)	$ 35,000
Office equipment	20,000	Staff	14,000
Office furniture	5,000	Computer maintenance	5,000
Audio visual equipment	7,000	Support costs	20,000
Technical assistance	88,000		
Library, periodicals and information services	45,000	Rent	26,000
Total	$200,000		$100,000

Illustrative budgets for other likely subgrants in the medium and small range are projected as follows, assuming in each case PSUs with little or no staff.

Medium Programs

A.I.D. Contribution		PSU Contribution	
S/T expat TA	$24,000	Seminars	$2,000
S/T local TA	15,000	Other	6,000
Training	10,000		
Equipment	10,000		
	$59,000		$8,000

Small Programs

A.I.D. Contribution		PSU Contribution	
S/T local TA	$ 7,500	Seminars	$1,000
Equipment	3,500	Other	1,500
Other	4,000		
	$15,000		$2,500

ld

The larger type of program may require a lengthy period of development, to judge by the experice with the Ceylon Chamber of Commerce and the rudimentary proposals on file for other institutions. A realistic goal for the policy support unit would be to assist in the development, funding and execution of two to three programs per year.

The project should plan for a total of five large programs at the $200,00 level. Another five smaller programs can be expected, at a cost of beteen $50,000 and $100,000 over the life of project. These too will require lengthy periods of development. And, finally, several small activities may also emerge which, though not significant in money terms, may have substantial impact. A realistic target here would be ten over the life of project. The implementating organization will receive a budget of $1,500,000 for these three general categories of direct assistance which will be chanelled through the policy support unit. Funds may be used for office equipment, hardware, software, information services, specialized consultancies, travel and additional technical assistance where needed. Funds will not be available for vehicles.

A summary of sub-obligations based on the above estimates appears below. The final year would in this illustration be devoted to implementation.

	Year 1	Year 2	Year 3	Year 4	Year 5
Large Programs (5) ($100-200,000)	$200,000	$300,000	$300,000	$200,000	-
Medium Programs (5)	$ 50,000	$100,000	$100,000	$ 50,000	-
Small Programs (10) ($50,000 or less)	$ 50,000	$ 50,000	$ 50,000	$ 50,000	-
	$300,00	$450,000	$450,000	$300,000	-

C. PSO Contributions

PSO contributions should be at a reasonable level consistent with the financial resources and sources of income of each PSO. For a PSO such as the Ceylon Chamber of Commerce, a substantial contribution is possible in the form of actual cash costs associated with operating an economic research unit over a three-year period. There is no calculation for additional in-kind contributions or payments to cover the costs of seminars in this example, which when added will increase the total PSO contribution. The two hypothetical budgets for medium and small programs assume PSOs with only minor if any contributions in staff costs and heavier reliance on seminar and "other" costs. Seminar costs could be paid by the PSO but be partially recovered by charges to seminar participants. The "other" category could be in-kind contributions by PSO members, but in every subgrant it is preferable that at least some of the contribution reflect actual cash payments by the PSO (in addition to seminar expenses).

A.I.D. Policy Determination No. 16 (PD-16) dated October 1987 addresses financing arrangements with independent organizations. PD-16 states that the "financial participation" (defined to include valuations of in-kind contributions) of such organizations toward an AID-assisted activity should be the "largest reasonable" amount consistent with the organization's financial resources. The reference point cited in PD-16 is 25% of total costs of the activity, but higher or lower rates could be sought. PD-16 states that "a financial participation less than 25% may be both significant, in terms of the entity's financial resources, and appropriate, in terms of A.I.D.'s objectives ... in the assistance activity". Small, non-profit institutions are specifically cited as an example. In the PSPS project, PSO contributions may exceed the 25% level in a few cases but in most cases are likely to be well below that level. The illustrative budgets for medium and small subgrants predicts a level of 10-15%.

Two other issues concern recurrent costs and sustainability. Recurrent costs are especially relevant when a subgrant involves any AID-funded contribution toward operating costs which would need to be continued in the future. As a principle, subgrant funds will not be used for direct staff or other operating costs of PSOs. In the case of new equipment being installed, the PSO should budget during the subgrant period to cover its own incremental equipment maintenance costs and demonstrate a financial capacity to continue doing so into the future. "Sustainability" is a different concern and less quantifiable. The objective is that the PSOs will benefit institutionaly by the subgrants and sustain their performance at a higher level of capacity and credibility in the future. The qualitative change in the PSO will determine whether or not this occurs.

5. IMPLEMENTATION PLAN

A. Implementation Arrangements

The policy support unit will have the primary responsibility for project implementation. The unit will support the institutional development requirements of PSOs generally as they engage in the policy process, and the unit will enter into direct subgrants with 15-20 PSOs over the course of the project to fund specific policy work.

The approval process for PSO subgrant proposals will be as follows:

1. The PSO will present a formal proposal to the policy support unit. If the unit finds the proposal to be complete (sufficiently well documented and addressing all criteria), the unit will forward the proposal to USAID with a written analysis and its endorsement. If the policy support unit cannot endorse the proposal, it will bring this to the attention of USAID for guidance.

2. USAID review will be done by the PSD office, and if there are issues of substance these will be brought to the attention of the Director, Deputy Director, and relevant senior staff. The PSD office will endeavor to conclude the review within two weeks, and advise the unit whether or not the proposal has been approved.

3. Following approval the unit will enter into a subgrant agreement with the successful PSO.

An exception to the above procedures will be made in those instances, prior to the arrival of the policy support unit, when a PSO has a sufficiently developed proposal and the wherewithal to proceed to implementation immediately and without outside assistance other than the sub-grant. In such cases, a sub-grant will be made directly to the PSO, and will be monitored by USAID until the policy support unit is in place. After that, the unit will assume primary responsibility for monitoring.

b. <u>Schedule</u>

The implementation schedule over the five-year life-of-project is as follows:

7/88:	PSPS Project Grant Agreement signed
8/88:	Conditions Precedent met
9/88:	Grants to eligible PSOs.
11/88:	Request for Proposals issued for Cooperative Agreement
1/89:	Proposals reviewed
3/89:	Cooperative Agreement signed
5/89:	Recipients team mobilized
10/88 7/89:	1-2 PSO subgrants approved
7/89:	Policy Support Unit fully operational
8/89 - 7/90:	5-6 PSO subgrants approved
8/90 - 7/91:	5-6 PSO subgrants approved
1/91:	Mid-term evaluation
8/91 - 7/92:	5-6 PSO subgrants approved
5/93:	Final evaluation
7/93:	PACD

C. <u>Procurement Plans</u>

<u>Cooperative Agreement:</u> A Cooperative Agreement between USAID and a U.S firm or organization ("recipient"), will be awarded through standard A.I.D. competitive selection procedures. USAID staff will prepare the Request for Proposals (RFP) via a PIO/T countersigned by the GSL. The technical review of proposals received pursuant to the RFP will be done by USAID/Colombo. The AID Contracting Officer/New Delhi will negotiate the final Cooperative Agreement with the successful proposer.

The Cooperative Agreement will include all estimated costs of the recipient in establishing and operating the policy support unit, including long-term personnel as well as short-term technical assistance or training activity organized for groups of PSUs, i.e., outside the context of the individual PSU subgrants.

Subgrants: The Cooperative Agreement will also contain all funds estimated for expenditure via the subgrants, except for an amount reserved outside the Cooperative Agreement for the funding of one or more subgrants with PSUs directly by USAID prior to the policy support unit's start of operations. Thereafter the unit will negotiate, sign and administer all subgrants according to the terms of the approved subgrant proposals and instructions from USAID. The subgrants themselves will have various cost elements involving different procurements and involving both local currency and foreign exchange expenditures.

All local currency procurements, e.g., for short-term local technical assistance consultancies, seminars, publications, equipment, etc., will be made by the subgrantees pursuant to standard A.I.D. procurement rules. Direct reimbursement, including advances if necessary, and/or direct payment procedures will be followed. The recipient will be ineligible to compete for or provide any local technical assistance or other locally procured services included in the subgrants.

Foreign exchange procurements, e.g., for short-term expatriate technical assistance or overseas participant training, will on the other hand be arranged for and provided directly by the recipient on behalf of the subgrantees. These costs will be charged to the subgrant and paid to the recipient. A ceiling for short-term expatriate technical assistance will be indicated in the Cooperative Agreement to avoid any possible overuse of this resource, and the successful recipient will have described in its proposal its ability to recruit suitable expatriate consultants for the types of assignments anticipated in the subgrants.

ANNEX B

PRIVATIZATION SUPPORT

1. OBJECTIVE AND CAPSULE DESCRIPTION

The objective of this component is to contribute to the successful privatization of a significant number of state-owned enterprises to a broad spectrum of private investors, by mobilizing and institutionalizing the GSL's capacity to carry out privatization activities.

A.I.D will provide $7.9 million in grant funds for technical and financial assistance to the Presidential Commission on Privatization to enable it to plan and implement the privatization program over a five-year period. Long and short-term technical assistance and office equipment will be provided, a general privatization promotion campaign will be designed and financed, and part of the preparation and post-privatization costs of divesting up to 24 state-owned enterprises (SOEs) will be reimbursed. The GSL contribution to the program is $13.7 million out of a total estimated cost of $21.6 million.

2. BACKGROUND/RATIONALE

As part of the GSL's ongoing thrust toward economic restructuring, a Presidential Commission on Privatization, supported by a staff secretariat headquartered in the Ministry of Finance & Planning, wasestablished in August 1987 to help foster the process of rationalizing the state role in the economy through the privatization of a large number of SOEs. The six-member commission consists of the Director General of the Ministry of Finance & Planning, the Secretaries of Trade and Shipping, and Industry and Scientific Affairs, plus three top-level private sector leaders. Reporting directly to the President, the Commission has begun to take its first steps toward implementing the expressed policy of the GSL to reduce the dominance of SOEs as a factor in the economy.

The mandate of the Commission is to advance the government's economic reform and industrial policy agenda by privatizing SOEs across a broad spectrum of sectors including industry, trade, finance, agriculture and services. It envisions the benefits arising from privatization to be:

- removal of a serious drain on the fiscal budget;
- generation of cash for the fiscal budget through the sale of shares to the public;
- development of economic competition and efficiency in industry;
- stimulation of capital market development and mobilization of private capital for productive purposes;

65

- reduction of the GSL's management burden in handling the operations of SOEs, thus allowing the GSL to focus its best management talent on other priorities; and

- achievement of political objectives, e.g., shifting the burden of economic development to the private sector and encouraging broad-based ownership of shares in the privatized SOEs.

Currently the state sector in Sri Lanka controls at least 103 non-financial productive enterprises in the form of state corporations, government-owned business undertakings (GOBUs), and government-controlled limited liability companies. There are another 13 financial entities that are SOEs and some 28 revenue-generating government statutory boards and agencies. Table B-1 presents a list of the SOEs. Information on key indicators such as employees, gross revenue, profit/loss, assets and liabilities will be developed during the early part of the project.

It is generally accepted that SOEs are less efficiently managed than private companies. In 1985, with funding under USAID's Private Enterprise Promotion Project (PEPP, 383-0082), Coopers & Lybrand produced a comprehensive study entitled "A Policy and Targetting Analysis for Private Sector Development in Sri Lanka", which concluded that "private sector companies make more efficient use of capital than public sector companies, add more value, create more jobs, generate more new exports, and produce more developmental potential per rupee invested". In calculating performance, using 1980 data, it was determined that the value added return on capital in the private sector was approximately four times that of the public sector. It is not possible to forecast with precision what a given shift in ownership from government to the private sector will yield in increased productivity; however, it is probable that the increase in certain sectors will be significant.

In addition to the low productivity of SOEs as a group, their natural recourse to government favor has led to several distortions impeding economic growth. The principal distortions are access to government finance to cover SOE deficits, tariff protection against foreign competition, protection of SOE market shares against private domestic competitors, and control over raw materials (e.g., leather hides) to create effective barriers to entry.

The effect which privatization may have on the government budget will depend on a number of factors. On the one hand, after all costs of the privatization of the first 24 SOEs (see below) are deducted, the net revenue to the treasury from the sale of these SOEs may be in the range of $80-90 million (Rs.2.4-2.7 billion). This will reduce the government budget deficits in the short term, but the decrease in the deficit over the long term will depend on how the privatization actions have helped to expand competition and economic efficiency.

Table B-1: State-Owned Enterprises (SOEs) in Sri Lanka

SOE

NON-FINANCIAL PRODUCTIVE ENTERPRISES

1. State Corporations

Agro Industrial Corp
All Ceylon Automobile Corp
Asian Hotel Corp
Ayurvedic Drug Corp
Building Materials Corp
Building Materials Manf. Corp
Ceylon Broadcasting Corp
Ceylon Cement Corp
Ceylon Ceramic Corp
Ceylon Fertilizer Corp
Ceylon Fisheries Corp
Ceylon Fisheries Harbour Corp
Ceylon Hotels Corp
Ceylon Leather Products Corp
Ceylon Mineral Sands Corp
Ceylon Oils and Fats Corp
Ceylon Petroleum Corp
Ceylon Plywood Corp
Ceylon Shipping Corp
Ceylon State Hardware Corp
Ceylon Steel Corp
Ceylon Tyre Corp
Elephant Lite Corp
Jute Industries Corp
Janatha Estates Dev. Board
National Paper Corp
National Salt Corp
National Small Ind. Corp
National Textile Corp
Palmyrah Corp
Paranthan Chemicals Corp
Pharmaceuticals Corp (of Sri Lanka)
Rubber Manufacturing Corp
Sri Lanka Cashew Corp
Sri Lanka State Plantation Corp
Sri Lanka State Trading (Consol Expo) Corp
Sri Lanka State Trading (Gen) Corp
Sri Lanka State Trading (Tractor) Corp
Sri Lanka Sugar Corp
Sri Lanka Television Corp
Sri Lanka Tobacco Industries Corp
Sri Lanka Trading (Textile) Corp
State Development and Construction Corp
State Distilleries Corp
State Engineering Corp

67

State Dev. and Construction Corp
State Distilleries Corp
State Engineering Corp
State Fertilizer Manf Corp
State Film Corp
State Gem Corp
State Graphite Corp
State Mining & Mineral Dev. Corp
State Pharmaceutical Manf Corp
State Printing Corp
State Timber Corp
Weaving Supplies Corp

2. Government-Owned Business Undertakings (GOBUs)

British Ceylon Corp Ltd
Ceylon Oxygen Ltd
Ceylon Manf & Merchants Ltd
Colombo Gas and Water Co. Ltd
Colombo Commercial Co. (Engineers) Ltd
Colombo Commercial Co. (Fertz) Ltd
Colombo Commercial Co. (Teas) Ltd
Consolidated Commercial Agencies Ltd
Essential Oils (Ceylon) Ltd
Heavyquip Ltd
Hotel Buhari
Hunas Falls Hotels Ltd
Independant Television Network Ltd
National Textile Mill: Mattegama
National Textile Mill: Pugoda
National Textile Mill Thulhiriya
National Textile Mill: Veyangoda
United Motors Ltd

3. Limited Liability Companies

Air Lanka Ltd
Air Lanka Catering Services Ltd
Airports & Aviation Services Co. Ltd
Asbestos Cement Industries Ltd
Associated Newspapers of Ceylon Ltd
Automobile Assembly & Manfr Ltd
Bogala Graphite Ltd
Ceylon Bulbs and Electricals Ltd
Ceylon Cycle Industries Ltd
Ceylon Extraction Corp Ltd
Ceylon Glass Co. Ltd
Ceylon Hotel Services
Ceylon Silks Ltd
Colombo Dockyard Ltd
Contact Ltd (commercial agency)
Cooperative Wholesale Establishment
Jafferjee Brothers Fishing Ind. Ltd

68

Jafferjee Brothers Textile Ind. Ltd
Lanka Milk Foods (CWE) Ltd
Lanka Pineapple Co.
Lanka Porcelain Ltd
Lanka Wall Tiles Ltd
Libra Industries Ltd (Textiles)
Noorani Tile Works
Orient Co. Ltd
Sedawatta Exports Ltd
Shaw Industries Ltd
Taos Ltd (Boats)
Wijya Tiles Ltd

FINANCIAL ENTITIES

Acland Finance & Invst. Ltd (GOBU)
Bank of Ceylon
Capital Invst. & Dev. Corp
Employees Trust Fund
Insurance Corp of Sri Lanka
National Development Bank
National Insurance Corp
National Savings Bank
People's Bank
Sri Lanka Export Credit Ins. Corp
State Mortgage & Investment Bank

REVENUE GENERATING STATUTORY BOARDS/AGENCIES

Agro Insurance Board
Central Freight Bureau of Sri Lanka
Ceylon Electricity Board
Ceylon Transport Board
Ceylon Tourist Board
Ceynor Development Foundation (GOBU)
Colombo Land Reclamation & Dev. Board
National Eng. Research and Dev. Center
National Housing Dev. Authority
National Institute of Business Management
National Institute of Management
National Institute of Plantation Management
National Livestock Dev. Board
National Lotteries Board
National Milk Board
National Water Supply & Drainage Board
Paddy Marketing Board
Posts and Telecommunications
Railways
Silk Allied Products Dev. Authority
Sri Lanka Coop Marketing Federation
Sri Lanka Fruit Board
Sri Lanka Handicraft Board
Sri Lanka Port Authority
Sri Lanka Tea Board
State Management Board
Tea Small Holdings Dev. Authority

69

Prior to formation of the Commission in mid-1987, the GSL had taken several preliminary steps pointing toward the implementation of a broader and more comprehensive privatization strategy. These included:

- approval of enabling legislation by Parliament via Act. No. 23 of 1987 entitled "Conversion of Public Corporations or Government Owned Business Undertakings into Public Companies", which provides the legal framework for conversion of SOEs to public limited liability companies with the intention of selling shares to the public;

- the spinning off of subsidiaries of larger establishments prior to sale;

- the contracting out to the private sector of construction and other activities that were once the province of state sector firms;

- the removal of state sector monopolies in the areas of insurance and transport;

- the closing of unprofitable and non-performing SOEs which have no prospect of successful operations in the private sector; and,

- the awarding of management contracts for four large state-owned textile mills to foreign managing agents.

In its first year of operation, the Commission has adopted a general plan for privatization, initiated action on an immediate program to privatize two SOEs in 1988, and established a medium-term program to privatize another 22 SOEs (see Table B-2). To put this in perspective, these companies employ 5% of the nation's manufacturing labor force and their net assets are equivalent to approximately one-seventh of the market value of all companies currently listed on the Colombo Securities Exchange. The method used to privatize a given SOE will be chosen on a case by case basis incorporating technical analysis and political assessment. The preferred objective of the Commission is to convert the targetted SOEs to public companies and then divest a controlling interest if not all shares to the public. Other options include shutting down operations and liquidating assets, entering into management contracts (privatization of management) prior to the sale of shares to the public, sale by private treaty of blocks of shares to Sri Lankan or foreign companies or, in cases of especially great political sensitivity, sale of a minority interest in the SOE while retaining the controlling interest. As a rule, however, the approach will be in the direction of total divestiture wherever possible.

The following strategic guidelines have been adopted by the Commission regarding the selection of SOEs and the sequencing of privatization actions:

10

Table B-2: Immediate and Medium-Term Privatization Program

	State-Owned Enterprise	Employment	Net Assets (Million Rs.)
I.	**Immediate Privatization Program**		
1.	State Distilleries Corporation	1966	212.6
2.	United Motors Ltd.	535	65.6
II.	**Medium-Term Privatization Program**		
3.	Ceylon Oxygen Ltd.	419	142.4
4.	Hunas Falls Hotel	31	5.2
5.	Hotel de Buhari	103	5.3
6.	State Trading (General) Corporation	495	73.4
7.	State Printing Corporation	499	84.5
8.	Ceylon Leather Products Corp.	1054	70.9
9.	Ceylon Oils & Fats Corporation	1022	259.9
10.	Sri Lanka Sugar Corporation	8420	777.8
11.	Sri Lanka State Trading (Consul Expo) Corporation	525	45.3
12.	Independent Television Network	135	30.7
13.	Veyangoda Textile Mills	2074	(37.4)
14.	Tile Factories run by Ceylon Ceramics Corporation	1254	28.8
15.	Sri Lanka Paper Corporation	3940	298.3
16.	Ceylon Ceramics Corporation	3426	299.2
17.	Colombo Comm. Co. (Teas)	278	9.6
18.	Colombo Comm. Co. (Engineering)	1481	63.0
19.	Colombo Comm. Co. (Fertilizer)	502	91.2
20.	Ceylon Mfg. & Merchants Ltd.	116	10.2
21.	Acland Finance Ltd.	27	12.9
22.	Heavyquip Ltd.	35	(0.1)
23.	British Ceylon Corporation	1145	(34.8)
24.	Orient Company Ltd.	50	26.8
		29,532	Rs.2,541.3

71

- Firms to be privatized should be potentially successful in the context of the Sri Lankan private sector. Particularly for the first round of privatizations, the SOEs should be visibly profitable and require no major restructuring;

- Sale of interests in the enterprises through public issues should be designed such that the widest possible ownership base is achieved (a maximum of 5% of shares to any one buyer is tentatively indicated);

- Sales of shares should be made only as the capital market is able to absorb new issues;

- Initial privatization actions should be focused on firms that are least likely to result in major and contentious problems with labor. To aid in avoiding the negative displacement effects of labor force rationalization (the Commission estimates that 20-25% of employees in the targetted SOEs will be made redundant), severance schemes and supplementary retraining programs must be planned in tandem with privatization actions;

- Privatization actions are to be preceded by a campaign of public education to promote public approval/acceptance of the privatization concept and an understanding of the value of equity investments;

- SOEs performing strategic or security-related functions should be excluded from the program; and

- Loss-making SOEs, while as a rule excluded from the initial list, could be included as part of the long-term strategy pending decisions on the viability of preparing them for privatization through capital and management restructuring.

Included in the Commission's overall privatization strategy is the development of the capital market to absorb the new share offerings generated by the privatization scheme. With funding under PEPP the Commission is already working closely with the Securities Council and the Colombo Securities Exchange (CSE) in conducting a survey of public attitudes toward share ownership and privatization which it will use as an input for designing a public education/publicity campaign to stimulate public interest in purchasing shares of privatized firms. The general publicity campaign will be funded by PSPS; another PSPS component is aimed at capital market development and stimulation of the CSE.

The test cases are the two SOEs scheduled for privatization in 1988, namely the State Distilleries Corporation and the GOBU of United Motors Ltd. By mid-1988, much of the preparatory work had been completed, drawing in part on expatriate technical assistance provided by both USAID and the ongoing consultancy services which the GSL has been utilizing from the Lazard Freres/S.G. Warburg/Shearson-Lehman investment advisory group. The Commission had used

12

local consulting firms to complete independent audits, valuations of assets and management, labor redundancy and salary structure reviews of the two SOEs. The process has thus far turned out to be very labor intensive. The marketing plan for sale of shares is now being developed. Final decisions on share price, advertising of share offerings, preparation of detailed prospectuses, registrations of the share issues, and defining and carrying out the mechanics of the actual sale of shares to the public through brokers, banks and other intermediaries are steps yet to be taken and will be equally time-consuming and demanding.

3. PROJECT ACTIVITIES

A. Privatization Commission/Institutional Analysis:

The Commission has been in operation since August 1987. The senior level of its six members and its status as a presidentially appointed entity give it recognized authority, although key decisions such as the timing of when to proceed with the first two privatizations are referred to higher government authority. The six Commissioners represent a broad knowledge and experience base. Privatization, however, especially on the scale now contemplated, is virtually new territory. As government policy, the program that is now emerging is the result of at least two years of gestation and debate (still continuing) on the merits and pitfalls of privatization in which most if not all of the Commissioners have actively participated. Privatization has been the theme of several seminars and other fora such as the annual sessions of the Institute of Chartered Accountants. Key officials in the MF&P and one of the private sector members of the Commission attended the AID-sponsored International Conference on Privatization in February 1986 in Washington, D.C. Two members of the Commission attended a privatization seminar organized by the Adam Smith Institute in London June 1987, and others participated in a private sector advisory group convened by USAID in the early stages of considering the costs and support requirements to implement a privatization program.

The term of the present Commission is limited by law to two years, after which it is anticipated that the appointment will continue in two-year increments. The Commission is supported by a staff secretariat located in the MF&P. The secretariat's functions are to provide general services to the Commission, evaluate divestiture proposals, plan the details of divestiture activities, enter into contracts with service firms to prepare corporations and GOBUs for divestiture and generally implement the directives of the President and the Commission. The secretariat is staffed by a Director, two deputies and a support staff of five persons. The Director is an experienced career civil servant seconded to the secretariat by the MF&P. The two deputies have also been seconded by other government institutions. The secretariat's operating budget for 1988 totals approximately $40,000 for salaries, travel, office costs, maintenance and equipment (including a vehicle).

13

As with the Commissioners, the staff of the secretariat are also on new ground. USAID has funded some privatization-related training for the secretariat via seminars in the U.S. and the U.K, but most of the strengthening of the secretariat's and the Commission's capacity to accomplish their objectives will come through a process of learning by doing. Occasional overseas seminars will be useful adjuncts, while short-term expatriate consultants with relevant prior experience elsewhere, serving alongside the Commission on specific assignments in Colombo, will be the primary means to build experience.

The strengths of the Commission are evidenced by the privatization program outlined to date and the steps already completed in preparing the first two SOEs for divestiture. As a new institution, the Commission is well positioned to tackle the work it has set out to do and to take full advantage of the support which the PSPS project will provide.

B. Support Program

A.I.D. and GSL funds totalling an estimated $21.6 million will be provided over the 1988-1993 period to cover the costs of three categories of expenditure at different stages in the privatization process: (1) provision of technical assistance, equipment and other direct support for the Commission in planning and implementing its general program for privatization ($1.9 million); (2) provision of local consulting and media services to meet the direct expenses of the Commission associated with preparing the individual SOEs for divestiture ($2.0 million) plus an additional cost for the "share expenses" paid to brokers or other organizations handling the actual share transactions ($2.6 million); and (3) coverage of the social costs of privatization including gratuity and severance payments for redundant labor and various post-privatization support expenses ($15.1 million). There is some overlap among the three categories as presented below, principally the application of some of the expatriate technical assistance discussed as part of the general support program to tasks in the specific divestiture preparations and post-privatization activities. Estimated AID project funds and GSL contributions are indicated for each activity. The cost analysis is in Section 4.B.

1. General Program for Privatization: This support will include long-term and short-term technical assistance, capital and recurrent costs of the Commission, and generic privatization promotion activities.

Technical Assistance: A mix of expatriate and local short-term technical specialists and one long-term expatriate advisor is planned. The long-term advisor will be attached to the secretariat for a period of three years to provide overall technical expertise and guidance in planning, preparing and executing privatization actions. The draft terms of reference for the long-term advisor are in Attachment B-1. Because of the complexity of the privatization process and the requirement for many and varied forms of technical know-how, project funds will also be used to fund an additional 20 person-months of short-term expatriate advisory services and 60

14

person-months of short-term local advisors and technicians. The short-term advisors will assist in:

- preparation of a comprehensive inventory of the SOE portfolios for use by the Privatization Commission and containing all information relevant to privatization;

- the design of public education, general publicity campaign, and the campaigns for the sale of shares of SOEs;

- analysis of management and capital requirements of SOEs targeted for privatization;

- drafting of implementing legislation as needed to advance the privatization process;

- the devising of model schemes for employee stock ownership programs;

- the design of detailed plans for the post-privatization stage; and

- other duties that may devolve to the Commission and that are essential to the implementation of the GSL's privatization strategy.

This diverse package of short-term technical assistance will be coupled with the long-term advisor in a single institutional contract. The contractor will be competitively selected, on the basis of the ability to provide the Presidential Commission with a wide selection of suitably qualified technicians. The contractor profile envisaged by the Commission is more of a "search and find" organization than one with a larger number of staff already on its payroll. The long-term advisor, as Chief of Party for the contractor, will be responsible for working with the Commission to define the specific terms of reference for the short-term specialists, identify multiple expatriate and local candidates for the tasks (for selection by the Commission), guide the progress of their work, and submit timely and accurate reports on all uses of contract funds. The contractor will also arrange for the overseas training/study tours planned for the project.

The contractor will maintain separate offices outside the Commission secretariat's office which is located in the Ministry of Finance and Planning. The contract budget will include funds for office rental, procurement of office furnishings and equipment, utilities, telecommunications, and secretarial and other operating costs.

USAID expects that in addition to the USAID-funded technical assistance, the GSL will continue to use the advisory services of the Lazard Freres/S. G. Warburg/Shearson-Lehman group on various privatization issues and tasks during the course of the project.

AID project funds for technical assistance will be \$1.3 million. The GSL contribution is estimated at \$120,000.

75

<u>Capital and Recurrent Costs of the Commission:</u> A limited budget for capital costs of office equipment and furniture will be provided for the secretariat using AID project funds. Equipment will include appropriate computer systems for use in word processing, financial analysis and data base management tasks, a medium-capacity copying machine and telecommunications equipment. One vehicle for use by the long-term contract advisor will also be purchased and following the advisor's departure be assigned to the secretariat. All annual recurrent operating costs of the secretariat will be met by the GSL.

AID project funds for capital costs will be $40,000. The GSL contribution over the five year period is estimated at $200,000.

<u>Generic Privatization Promotion Activities:</u> A mix of public education and publicity campaigns carried out by the Commission related to the opportunities and risks of the privatization program in general will be supported by the project. The Commission will stage seminars and workshops, prepare publications and lectures, and use media advertising and programming opportunites to familiarize the Sri Lankan public with the process of privatization, the benefits to be gained from it, and the ways and hows of equity share ownership.

AID project funds totalling $200,000 are budgeted for these activities.

2. <u>Preparation of SOEs for Divestiture:</u> This support encompasses the following seven identified steps to be carried out in preparation for the sale of shares of each SOE targetted in the project:

- a detailed independent accounting audit of the SOE;

- a valuation of the capital structure of the SOE (gross assets, liabilities, net assets);

- preparation of the Memorandum of Association and Articles of Association of the public limited liability company created at the time of conversion of the SOE from a state corporation or GOBU;

- legal formation of the new company and other legal matters connected with privatization.

- salary structure reviews and related management/labor reviews of the SOE's workforce;

- extensive advertising of the public offering of the share issue, and

- registration of the share issue including charges for services provided by share brokers.

76

Use of AID project funds by the Commission for expenses related to the above steps (or other preparatory steps that may be required) will be subject to the satisfaction of the following criteria:

- submission by the Commission of a detailed plan and schedule for the divestiture of the SOE in question;

- evidence in the plan that a controlling interest in the SOE is to be divested, defined as at least 51% of the shares plus further evidence that actual control of the privatized company will pass to the new private owners and that government will not retain any indirect control, e.g., via controls over raw material supplies or markets of the privatized company; and

- if only a part of an SOE is to be privatized, evidence that the parent SOE (if it remains in operation) will exercise no indirect control over the new company.

The estimated total cost of the preparatory steps for 22 of the 24 targeted SOEs (the first two have been covered by PEPP) is $2.0 million. All work contemplated in this category involves local consultant and media services. Any requirement for expatriate technical advice on the preparatory steps will be covered by the technical assistance contract. Costs will be met by AID project funds and GSL contributions in roughly a 75%/25% proportion. GSL contributions will be paid either by the SOEs themselves or by the Commission, in the latter case using part of the funds that the Commission will receive incident to its contemplated charge of 1-2% on the sale of SOE shares (see Financial Analysis in Section 4.C).

In addition to the costs of preparation, the GSL will incur the cost of commission fees or other charges paid to the brokers or other organizations which transact the sale of shares. The maximum cost assuming a 2.5% fee against the total value of shares sold is $2.6 million.

3. Social Costs/Post-Privatization Support: This category of support includes severance and gratuity payments associated with redundant labor and/or the transfer of employees with rights to retirement gratuities from an SOE to a newly privatized firm. It also includes several schemes which will be put in place by the Commission to cushion the transition through management consulting assistance and worker training to the newly privatized firms.

Severance and Gratuity Payments The Commission estimates that the 20-25% redundancy in the current labor force of the 24 targeted SOEs will require severance pay compensation amounting to about $7.3 million. The magnitude of the sums involved will vary from case to case. The preferred course is to have the severance of redundant labor occur prior to the divestiture of the SOE, although it is also possible that severances associated with the privatization could be made by the new owners. Lump sum payments will be made, up to a maximum of eighteen months of salary depending on the longevity of service of the employee. Only employees in jobs where there is substantial overstaffing or clearly no need for the job function would be eligible for voluntary separation from service. The Commission will utilize project funds to make the studies necessary for them to determine appropriate staffing levels.

Gratuity payments are entitlements connected with employee retirement benefits. The gratuity payment for SOE employees is calculated at a rate of one-half month of salary for every year of service of the first five years of uninterrupted employment. Under current law, the Gratuity Act specifies that SOE employees will have the right to claim their gratuity benefit at the time the firm's legal status is changed from a SOE to a public company. Thus, it is possible that some employees will elect to claim a lump sum gratuity payment for their prior years of service at the point of conversion; alternatively, they would elect not to do so but the retirement liability (gratuity payment still due) would be passed on to the privatized company. In the latter case, the GSL will still pay the cost indirectly through the calculation of the contingent liability in the assessment of the net assets of the SOE and a consequent lower share price when the SOE is divested. Another possibility is that a special retirement fund would be established at the time of privatization into which the accumulated gratuities would be deposited by the GSL to the benefit of the eligible employees. The total number of employees in the 24 targetted SOEs is about 29,500. The estimated total gratuity payment liability is $7.4 million. Detailed cost analysis for the estimates of both severance and gratuity payments and the GSL cash flow projections to meet these payments are in Section 4. AID project funds will be used to meet of severance payments up to a maximum of $4.4 million. The GSL will cover the remaining severance payments and all of the gratuity payments. If as projected 22 1/2% of the labor force is redundant, it is estimated that the project will cover 60% of severance payments, while the GSL will directly or indirectly cover the remaining 40% of severance and 100% of gratuity payments.

Management Assistance to Newly Privatized Firms: Managing their firm for survival and growth in the competitive private sector may in some cases present a special challenge or added responsibilities for newly recruited and/or retained former SOE managers such that they will need special support immediately prior to or shortly after privatization. Consequently, a total of $150,000 in AID project funds has been set aside to pay for management consulting services. The need for such services will be identified during the management survey work done by the Commission prior to privatization and in later consultation with the new owners of the company. Areas where consulting assistance may be needed include business planning, new product or market development, design of financial control systems, implementation of employee relations and employee stock ownership programs, research and development, and quality improvement and control.

Worker Training Programs: The Commission, in cooperation with the privatized firm, will also identify weaknesses in labor capabilities and identify training requirements. The training would be carried

78

out by the new company using local training and consulting firms. A total of $250,000 in AID project funds has been set aside to pay for assessment of training needs, development of training curricula and presentation of courses.

C. Outputs

The combined outputs for the privatization support component as a whole are:

- A controlling interest (51% or more) of up to 24 SOEs will be divested from the government to the private sector;

- Additional management assistance and worker training programs will be delivered to the managers, employees and/or former employees of the privatized SOEs.

D. End of Project Status

At the end of the project, the following conditions will prevail as indicators that the project purpose has been accomplished.

- The private sector will be contributing to greater efficiency and productivity in the national economy;

- The public at large will have an enhanced and positive appreciation of the relative roles of the government and the private sector in owning/managing productive enterprises, and the advantages of well planned privatizations;

- A greater number of Sri Lankan citizens will own shares in the privatized SOEs;

- The private business sector will be more assured in regard to policy on government vs. private sector roles in various economic sectors, leading to greater private sector confidence in making long-term investments; and

- The process of planning and carrying out the privatization of SOEs will have become well understood through experience, including a well established institutional capacity within the GSL.

4. FINANCIAL PLAN AND ANALYSIS

A. Budget Summary

The total estimated cost of the component is $21.6 million. A.I.D. will contribute $7.9 million (37%) and the GSL $13.7 million (63%).

19

Table B-3: Cost Estimate and Financial Plan ($000)

Program for Privatization	A.I.D.	GSL	Total
Technical Assistance	$1,322	$ 120	$ 1,442
Secretariat Costs	40	200	240
Promotion Activities	200	--	200
Preparation for Divestiture	1,500	500	2,000
Share Sales Expenses		2,600	2,600
Social Costs/Severance & Gratuity	4,400	10,300	14,700
Post-Privatization	400	-	400
Total	$7,862	$13,720	$21,582

Estimated fiscal year expenditures, assuming a three-year technical assistance contract starting mid-FY 1989 with privatizations spread evenly over FY89-FY93 are as follows:

Table B-4: Estimated Expenditures by Fiscal Year ($000)

(A.I.D. Costs only)

	89	90	91	92	93	Total
General Program for Privatization	260	520	520	262	--	1,562
Preparation for Divestiture	300	300	300	300	300	1,500
Social Costs/Post-Privatization	960	960	960	960	960	4,800
	1,520	1,780	1,780	1,522	1,260	7,862

B. Basis for Cost Estimates

Technical Assistance

The costs of the technical assistance contract are detailed in Table B-5. A standard cost factor of $200,000/yr is used for the long-term expatriate advisor and includes estimated overheads, fees, and all standard allowances and applicable support costs (housing, etc.). The short-term expatriate cost per person-month is costed at $20,000 inclusive of salary, travel, per diem and overheads/fees. Participant training is based on average travel, per diem and tuition costs for training in the U. S. and/or other locations. Local short-term consultant costs are based on competitive rates in Sri Lanka and also include calculations for overheads and fees. Other local cost estimates are based on competitive costs in Colombo for the office space, support staff and other requirements of the contractor.

Table B-5: Estimated Costs of Technical Assistance Contract

L/T expatriate (3 years @ $200,000/yr)	$ 600,000
S/T expatriate TA (20 pm @ $20,000/pm)	400,000
S/T local TA (60 pm @ $2,500/pm)	150,000
Office staff support	60,000
Office space/utilities	50,000
Equipment and furniture	12,000
Participant training (10 x $5,000)	50,000
Total AID Project Funds	$1,322,000
Consultants (Troika) paid by GSL	$ 120,000
Total T/A	$1,442,000

40

Secretariate Costs

The one-time capital expenditure on equipment and furniture for the Commission is estimated in Table B-6. The table also details the secretariat's actual capital and recurrent operating costs for 1988; estimated recurrent costs for the 1989-1993 period have been kept at $40,000 per year on average, assuming that the amount spent for equipment in 1988 will not be repeated in the following years but would be replaced by additional staff and support costs.

Table B-6: Capital and Recurrent Costs of the Privatization Secretariat

Capital costs (one-time) - AID Project Funds

Computer equipment	$10,000
Photocopy equipment	10,000
Telecommunications	8,000
Vehicle (1)	12,000
	$ 40,000

Recurrent Costs (1988 budget shown) - GSL

Salaries	Rs. 521,900	
Travel/per diem	302,000	
Office supplies	62,500	
Maintenance	20,000	
Equipment	270,000	
	Rs.1,176,400	$40,000 approx.
	x 5 years =	$200,000
	Total Secretariat costs	$240,000

Promotion Activities:

The cost basis for the generic privatization promotion program is an estimate by the Secretariat of the total cost for a mix of publications, media advertising, seminars, workshops and other activities to be carried out over the five-year period, in the amount of $200,000.

Preparation for Divestiture:

Costs estimated for steps involved in the preparation of individual SOEs for divestiture have been developed based on the actual and/or planned costs associated with the Commission's first two privatization exercises for the State Distilleries Corporation and United Motors Ltd. The secretariat has produced cost estimates per preparatory step for each of the other 22 targetted SOEs and arrived at the totals listed in Table B-7. To this a contingency amount for other preparatory steps that may be needed has been added to reach a round number total estimate of $2.0 million, of which AID project funds will meed $1.5 million and the GSL $.5 million.

98

Table B-7: Estimated Cost of Preparation for Divestiture
(22 Companies)

Company Audits		$ 56,000
Valuation of Assets		32,000
Memoranda and Articles of Association		75,000
Company Formations		13,000
Salary Structure Studies		52,000
Advertisements for Sales		1,400,000
Fees to the Registrars of Shares		264,000
	Subtotal	$1,872,000
	Contingency	128,000
	Total	$2,000,000

Share Sales Expense:

Assuming a 2.5% fee for the sale of all shares, the loss to GSL from gross sales will be $2.5 million if all shares are sold through the Colombo Securities Exchange. This is considered a GSL contribution to the total project cost.

Social Costs:

The cost estimate for severance payments is based on calculations provided by the secretariat. An average 12.5% of 29,532 employees in the 24 targeted SOEs was assumed to be redundant and would receive in severance pay an average 16.5 months salary at an average salary of Rs.2,000 per month. The resulting calculation is Rs.219,275,100 or $7.3 million. Of this amount, AID project funds will cover 60% or $4.4 million and the GSL will cover 40% or $2.9 million.

Gratuity payments will be borne entirely by the GSL, but are calculated here to reflect their contribution to this component of the project. The cost estimate for gratuity payments is based on the same 29 532 employees and average Rs.2,000 per month salary assumptions as in the case of severance pay. Based on the Gratuity Act which stipulates 1/2-month salary for each year of service after five years of uninterrupted employment, an estimate of gratuity payments eventually due was derived as follows:

-- One fourth of the employees (7,383) are not eligible for gratuity pay. They are relatively recent hires or they have interrupted service.

Amount due = $ 0.00

-- One fourth (7,383) have the minimum service (5 years) and are eligible for 2.5 months salary.

Amount due = 7,383 x 2.5 x Rs.2,000/30 =$1,230,500

92

-- One fourth (7,383) have 10 years service and are eligible for 5 months salary.

Amount due = 7,383 x 5 x Rs.2,000/30 =$2,461,000

-- One fourth (7,383) have 15 years service and are eligible for 7.5 months salary.

Amount due = 7,383 x 7.5 x Rs.2,000/30 =$3,691,500

Total calculation for gratuities, to be met $7,383,000

or $7.4 million

Post Privatization:

Cost estimates for the two post-privatization activities included in the project are based on 60 person-months of local consultants at $2,500 per month for management assistance, and a rough estimate for worker training at $100 per worker and 2,500 workers trained.

C. GSL Contributions/Financial Analysis

Total GSL contributions for the privatization support component are $13.7 million or Rs.411 million. By far the heaviest expenditures included as a direct contribution are the non-reimbursed portion of estimated severence payments ($2.9 million) and the entirety of estimated gratuity payments ($7.4 million) for a combined $10.3 million or 75% of the GSL contribution. The share expenses for sales of shares are $2.6 million or 19%. The GSL contributions toward divestiture preparation, technical assistance and annual operating costs of the Commission are $0.8 million or 6%.

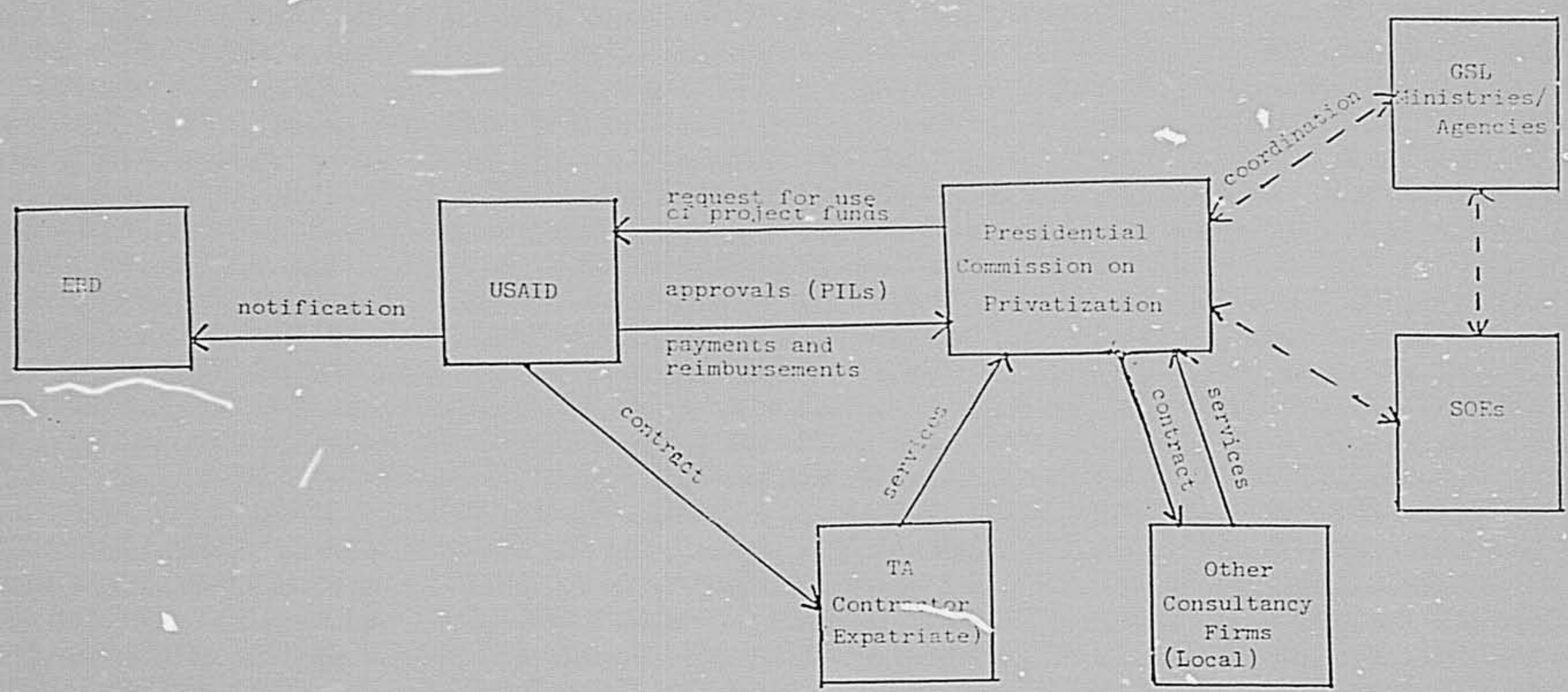
Except for the small amounts already allocated from general funds to pay for the early start-up of the Commission, some of the initial preparatory steps for the first two privatizations, and use of the GSL's ongoing investment advisory services, the major costs in the future will need to be financed from the cash flow generated by the privatization program itself. The cash flow projections by year based on the successful privatization of the 24 targetted SOEs during 1989-1993 are in Table B-8. The Commission projects sales on the basis of net asset value plus a 20% factor for goodwill. Assuming 100% divestiture (proceeds of sale equal to final valuation), deducting all costs, and adding back costs reimbursed by AID gives a balance of funds received by the GSL. Using the cost assumptions outlined earlier and the proposed A.I.D. reimbursements with PSPS project funds, the total balance is $86.1 million after all 24 SOEs have been fully divested. It has been further assumed that the timing of the privatizations will be at an even pace throughout the five-year period and the total amounts have been straight-lined at 20% for each of the five years, with annual balances of $ 17.2 million.

83

Table B-8: Medium-Term Privatization Program (24 SOEs)
Cash Flow Projections for 1989-1993 ($ Million)

	1989 Total	1989 (AID)	1990 Total	1990 (AID)	1991 Total	1991 (AID)	1992 Total	1992 (AID)	1993 Total	1993 (AID)	1989-1993 Total	1989-1993 (AID)	
1. Gross Assets	43.1		43.1		43.1		43.1		43.1		215.5		1.
2. Liabilities	25.7		25.7		25.7		25.7		25.7		128.5		2.
3. Net Assets (1-2)	17.4		17.4		17.4		17.4		17.4		87.0		3.
4. 20% Goodwill	3.5		3.5		3.5		3.5		3.5		17.5		4.
5. Final Valuation (3+4)	20.9		20.9		20.9		20.9		20.9		104.5		5.
6. Proceeds from Sale	20.9		20.9		20.9		20.9		20.9		104.5		6.
7. Preparation Costs	.4	(.4)	.4	(.4)	.4	(.4)	.4	(.3)	.4	--	2.0	(1.5)	7.
8. Share Expenses	.5	--	.5	--	.6	--	.5	--	.5	--	2.6	--	8.
9. Cost of Sales (7+8)	.9	(.4)	.9	(.4)	1.0	(.4)	.9	(.3)	.9	--	4.6	(1.5)	9.
10. Severance	1.4	(1.4)	1.4	(1.4)	1.5	(1.5)	1.5	(.1)	1.5	--	7.3	(4.4)	10.
11. Gratuity	1.4	--	1.5	--	1.5	--	1.5	--	1.5	--	7.4	--	11.
12. Post-Privatization Costs	.1	(.1)	.1	(.1)	.1	(.1)	.05	(.05)	.05	(.05)	.4	(.4)	12.
13. Social Costs (10+11+12)	2.9	(1.5)	3.0	(1.5)	3.1	(1.6)	3.05	(.15)	3.05	(.05)	15.1	(4.8)	13.
14. Commission Costs	.08	(.04)	.04	--	.04	--	.04	--	.04	--	.24	(.04)	14.
15. Technical Assistance	.46	(.44)	.46	(.44)	.46	(.44)	.03	--	.03	--	1.44	(1.32)	15.
16. Publicity Campaign	.05	(.05)	.05	(.05)	.05	(.05)	.05	(.05)	--	--	.2	(.2)	16.
17. General Costs (14+15+16)	.59	(.53)	.55	(.49)	.55	(.49)	.12	(.05)	.07	--	1.83	(1.54)	17.
18. Total Cost (9+13+17)	4.39	(2.43)	4.45	(2.39)	4.65	(2.49)	4.07	(.50)	4.02	(.05)	21.58	(7.86)	18.
19. AID Reimbursement (brackets)	(2.43)		(2.39)		(2.49)		(.50)		(.05)		(7.86)		19.
20. Adjusted Cost (18-19)	1.96		2.06		2.16		3.57		3.97		13.72		20.
21. Balance (6-20)	18.94		18.84		18.74		17.33		16.93		90.78		21.
Proceeds x 2%	.4		.4		.4		.4		.5		2.1		

Figure B-1: Organization Chart for Privatization Support



It is recommended that an assessment be made on the proceeds of same and be paid by the GSL into a fund managed directly by the Commission. This is calculated at 2% in Table B-8, a rate sufficient to cover the GSL's share of all of the relatively minor costs associated with privatization, i.e., with the exception of share expenses and severance and gratuity payments. The cost items involved (lines 7, 14 and 15) are also for expenses which the Commission is in the best position to pay directly. The share expense costs would be deducted by brokers at the time of sale. The much larger obligations for severance and gratuity payments will need to be budgeted, and can be paid directly from the Treasury.

The creation of some type of GSL fund is necessary to provide a mechanism for the Commission to pay directly for the cost items for which the GSL is responsible. The use of a percentage assessment against proceeds of sale would seem a logical way to link the source of these funds to the privatization program, but they could just as easily be advanced to the Commission directly from the Treasury.

5. Implementation Plan

A. Implementation Arrangements

The privatization program will be managed by the Commission on behalf of the GSL. Other GSL ministries and agencies as well as the SOEs themselves will interrelate with the Commission on various matters as decisions are made on specific actions. The Commission will be assisted by a technical assistance contractor for a period of three years. The Commission will also utilize numerous local consultants and firms to provide various services. USAID, in addition to meeting the costs of the technical assistance contractor, will approve the use of AID project funds for other items in the project budget via consideration of requests made by the Commission and approval through Project Implementation Letters. An organization chart depicting these relationships is in Figure B-1.

The criteria for use of AID project funds will vary depending on the budget items concerned. A Condition Precedent for access to all funds will be evidence of formal approval by the GSL authorizing the Commission to commence implementation of the Medium-Term Privatization Program. No further conditions need be meet for access to funds for budget items under the General Program for Privatization category, i.e., for proceeding with the technical assistance contract, equipment procurements for the Commission, or the general publicity campaign. The criteria for access to funds in the Preparation for Divestiture category are listed in Section 3.

Those criteria deal with evidence of specific plans to divest a controlling interest in each targetted SOE to the private sector. The criterion for access to AID reimbursements of expenditures in the third budget category i.e., Social Costs/Post-Privatization Activities is evidence that the divestiture of a controlling interest in the SOE has actually taken place.

96

B. Implementation Schedule

The implementation schedule over the five-year life-of-project is as follows:

7/88: PSPS Project Grant Agreement signed
10/88: Conditions Precedent met
10/88: Request for Proposals issued for technical assistance contract
12/88: Proposals reviewed
2/89: Technical assistance contract signed
4/89: Contractor mobilized
7/88-12/89: 5 SOEs privatized
1/90-12/90: 5 SOEs privatized
1/91: Mid-term evaluation
1/91-12/91: 5 SOEs privatized
1/92-12/92: 5 SOEs Privatized
1/93- 7/93: 4 SOEs privatized
5/93: Final Evaluation
7/93: PACD

C. Procurement Plans/Reimbursements

Technical Assistance Contract: A direct A.I.D. contract between USAID and a U.S. firm, possibly in joint venture with a Sri Lankan firm, will be awarded through standard A.I.D. competitive selection procedures. USAID staff will prepare the draft Request for Proposals (RFP) in conjunction with the Commission secretariat. Upon approval of the RFP by the Commission, the final RFP will be issued via a PIO/T countersigned by the GSL. The Commission will participate alongside USAID in the technical review of proposals received pursuant to the RFP. Given the critical requirement that the contractor's long-term Chief-of-Party be the correct individual for the job, it is anticipated that the candidate(s) for this position proposed by the firms with whom negotiations are conducted will be interviewed in Colombo. The AID Contracting Officer/New Delhi will negotiate the final contract with the successful proposer.

After the contract is signed, the contractor will provide services to the Commission pursuant to the terms of reference. Billings (invoices) will be submitted monthly to USAID; payments will be made after verification by the Commission that the services have been provided as stated.

Advance Account for AID Project Funds: The Commission has already established a fund for deposit of advances of PEPP funds. PSPS local currency funds will be advanced to the same account (or to a similar account to segregate PSPS funds from PEPP funds due to the overlap between the two projects prior to the PEPP PACD of September 30, 1989). The advance account will be used for procurements by the Commission of capital equipment, goods and services related to general publicity campaigns (publications, media advertising, seminars), consultant services and media advertising related to the preparation of SOEs for divestiture, and consultant, training and other services involved in the post-privatization activities.

47

Requests for advances will indicate the estimated costs of planned activities for 90-day periods and be accompanied by documentation to show that the relevant criteria for access to funds have been met. Advances will be liquidated through monthly vouchers submitted to USAID. The Commission may also elect to use its own funds to procure goods and services eligible for AID project funding and then seek reimbursement, i.e., without using the advance account.

With regard to severance payments, the Commission will submit detailed documentation on payments that have actually been made, together with evidence that divestiture of a controlling interest in the SOE has been achieved. If the severance payments occur prior to the divestiture, which is likely to be the case, reimbursements from A.I.D. will still not be eligible until the divestiture itself is completed. A.I.D. project funds will be used to reimburse 60% of eligible severance payments up to a maximum amount of $4.4 million.

Attachment B-1

Terms of Reference for the Long Term Advisor to the Presidential Commission on Privatization

Background: In 1987, the Government of Sri Lanka (GSL) established the Presidential Commision on Privatization as the principal institution for designing and implementing a program of divestiture of government-owned corporations and business units. A six-member commission was appointed consisting of the Secretaries of the Ministries of Finance and Planning, Trade and Shipping and Industry and Scientific Affairs plus three top-level private sector leaders. Reporting directly to the President, the Commission has begun to take its first steps toward implementing the expressed policy of the GSL to reduce the dominance of public enterprise as a factor in the economy.

The Commission is served by a small secretariat located in the Ministry of Finance and Planning with a Director, two Deputy Directors and a small support staff. Its task is to help implement the GSL's industrial policy agenda by divesting a number of firms in a broad spectrum of sectors including manufacturing, trade, finance, agriculture and services. Generally speaking, the strategy for divestiture is to convert selected state-owned enterprises (SOEs) to public limited liability companies and then to divest all shares through sales to the public. While other forms of divestiture such as partial divestiture, sale by private treaty, or closure of the SOE and sale of assets are options for the Commission, the preferred objective is total divestiture.

The Commission has developed a plan of action which lays out the details of its strategy including a listing of 24 SOEs indicated for divestiture in a Medium-Term Privatization Program. Two SOEs are scheduled for divestiture in 1988 with another 22 SOEs to follow over the next five years.

The U.S. Agency for International Development is assisting the Commission in the facilitation and institutionalization of the privatization process. Part of this assistance will involve the provision of long-term and short-term technical advisors over a three-year period.

Scope of Services Required: The long-term advisor to the Presidential Commission on Privatization will provide technical assistance to the Commission and the secretariat on matters of privatization strategy and tactics with special reference to technical aspects of the divestiture of SOEs identified as part of the Medium-Term Privatization Program.

89

Working with the Director of the secretariat the long-term advisor will:

1. Assist the Director to carry out the objective, powers and functions of the Commission;

2. Assist in addressing all technical and programmatic issues on privatization including review and selection of companies to be divested, design of methods of divestiture for specific firms and participation in the preparation for and execution of divestitures;

3. Assist in the institutionalization of the privatization process within the GSL; and

4. Assist the secretariat in defining needs for both expatriate and local short-term technical assistance to be provided under the contract, identify candidates and, upon approval of candidates by the secretariat, supervise work carried out by the short-term advisors.

Acting as the contractor's Chief-of-Party, the long-term advisor will oversee the provision of all services planned for the Commission under the contract. The advisor will prepare quarterly reports for submission to the Commission and to US AID on the progress of contract implementation. The advisor will work in Colombo, Sri Lanka in offices to be established using contract funds.

Term of Services Required: The long-term advisor is to assist the Commission over a three-year period begining in early 1989.

Qualifications: The long-term advisor will have had adequate exposure to the privatization process preferably including experience in Asian countries. He/she should be familiar with the administration and operations of SOEs as well as privately owned and operated enterprises and how they differ. He/she must be well grounded in the divestiture process either through prior experience in divestitures of SOEs or through substantive participation in supporting merger and/or acquisition activities in the private sector. He/she must have an excellent grounding in the sale of shares of companies. He/she must be familiar with audit and accounting procedures, valuation of assets, business and marketing analysis, organizational design and have proven successful managerial skills. He/she must be able to relate well to others, with a capacity to listen with patience and to explain, discuss and effectively communicate with and educate others.

CAPITAL MARKETS DEVELOPMENT

1. OBJECTIVE AND CAPSULE DESCRIPTION

The objective of AID's assistance for capital markets is to facilitate both broader public equity participation in the economy and increased capital resources for investment in new and/or expanding business opportunities, through the development of improved market mechanisms and appropriate regulatory environment.

With $1.9 million in grant funds, AID will finance technical and financial assistance for implementation of a number of key measures designed to facilitate growth of capital markets in general and the securities market in particular. All funds will be spent over a four year period. Funds will be used to provide the Securities Council (SC) with technical advisors and equipment and to cover some of the direct costs of the Council's capital market development and securities market management programs. Funds will also be used to assist the Colombo Securities Exchange (CSE) to adopt new operating procedures and technologies that will make the Exchange an important and integral part of an expanding Sri Lankan capital market.

2. BACKGROUND/RATIONALE

Improved capabilities of the Sri Lankan financial intermediation system are critical for mobilizing domestic and foreign capital resources, allocating them more efficiently, and enhancing the effectiveness of monetary policies. The facilitation of the supply of funds to fuel private sector growth and development from points of excess liquidity is a hallmark of the free market system, and the capital market's ability to deliver to the market place a range of financial services and resources at reasonable costs is essential to accelerating the growth of a private sector-led economy.

Perhaps the most often cited roadblock to business development in Sri Lanka is the limited availability of equity funding. The issue of capital availability in Sri Lanka is not a matter of the absence of capital or liquidity. Rather it is a matter of capital not being available in a form needed for business expansion - equity capital.

One cause of this lacuna is the behavior typical of a relatively small private sector dominated by a small group of investors. Closely held family-owned companies tend to be reluctant to expand their capital base by opening up shareholding opportunities to a wider group. Only recently have Sri Lankan companies begun to overcome this reluctance. Another often cited cause concerns "structural" features related to macro-economic financial policies. For example, both the explicit and the implicit cost of debt capital may encourage borrowing vs. equity investments: the explicit cost (interest rates) have been relatively high, leading investors to keep deposits in savings accounts vs. more risky investments in shares; on the other hand the implicit costs of borrowing are low, due to the absence of effective debt recovery laws in Sri Lanka, tending to reinforce companies in their preference for borrowing since in worst case scenarios they may be able to avoid repayments to lenders for long periods.

At the same time, the institutional structure needed to prompt the expansion of the capital market has been inadequate. Until the Securities Council was established in 1987, there was a neglect of the systems of regulation needed to insure stability in the market place and strengthen investor confidence against unfair trading practices and possible fraud or misdealing. The Colombo Securities Exchange is also in a nascent stage, having been established only in 1984. Other financial institutions such as unit trusts and venture capital companies are just beginning to emerge to provide avenues for intermediation between sources and users of capital.

Since 1984, there has been a marked increase in interest in the securities market. While the average Sri Lankan with surplus capital continues to place his money in interest bearing certificates of deposit and other relatively secure income-oriented instruments, the number of investors who are prepared to invest in more risky equity instruments has increased substantially. This change in attitude is documented by a dramatic rise in share trading activities. From 1984 to 1987 the rupee value of shares traded rose by over 900%, from Rs. 32.9 million to Rs. 333.5 million. The number of shares traded grew by 450%, from 3.13 million to 17.32 million during that same period. Similarly, the number of sales transacted escalated by 444%, from 2,776 in 1984 to a toal of 14,964 in 1987. Average daily turnover on the Colombo Securities Exchange is now at the Rs. 2 million level vs. only about Rs. 500,000 three years ago.

In addition to trading in existing shares, there have been a number of successful new share issues in the recent past. Noteworthy examples are the public issues by two new private commercial banks and a new private insurance company. This growth of interest in raising capital through share issues has prompted leaders in the business community to launch investment companies, unit trusts and mutual funds to facilitate the investments of the general public. Currently, there are six listed private investment trusts operating as closed end mutual funds with listed share holdings. The government-owned Capital Investment and Development Corporation is also trading in shares and taking equity in new projects. Looking to the future, the Securities Council is investigating with assistance from the Asian Development Bank the ways and means of fostering the formation of more broad-based domestic unit trusts to be owned and administered by the private sector. With AID assistance under the PSPS project, a private venture capital company is in the process of formation (see Annex D), and other venture capital companies are now emerging as sources of equity to back promising business projects.

92

That there should be such signs of vitality in the securities segment of the capital market is encouraging. However, it is now necessary that the market develop mechanisms to handle an increased volume and variety of equity instruments in order to prevent blockage of the system. Currently, the Exchange has 174 listed companies out of nearly 14,000 incorporated limited liability companies. It has received applications from 26 others. When the GSL's privatization program gets under way in earnest, a large quantity of shares in as many as 24 new companies will be released, selling directly into the market over several years. The estimated net asset value (plus 20% goodwill) for the 24 SOEs included in the Medium-Term Privatization Program (see Annex B) is Rs. 2,614 million which is about 30% of the par value of all shares of the 174 companies currently listed on the Exchange. Looked at another way, the sale of up to Rs. 2,614 million in new shares through the Exchange would be eight times the current annual volume (Rs. 333.5 million) of shares traded.

Continued growth in share trading will quickly draw attention to an area in which the Exchange is currently experiencing some of its greatest operational problems. The time required to handle interbroker clearing, registration of buyers, reissuance of share certificates and other steps in the process of transferring shares has increased to the point where it now takes three to six months to settle some transactions. If the shares are traded again during this interval, problems of misdirected dividend checks, notification of shareholder meetings and other problems are compounded, giving rise to an increasing number of complaints to the Exchange and general investor dissatisfaction.

It is therefore crucial, both for the sake of capital market growth and for the success of the GSL's privatization strategy, that the Exchange be equipped and geared to handle a larger volume of business and to provide better service to a larger number of customers. To deal with this problem, the Exchange plans to adopt a system of share transfer known in the trade as the Central Depository System (CDS). Used successfully by many of the region's stock exchanges, the CDS reduces the number of parties involved and the number of steps required in the share transfer process. Errors are reduced and transfer times are kept to a matter of days. While the Exchange is very keen to adopt the system, the transferring of the CDS technology to Colombo will require both technical expertise and financial resources which in the initial stages are beyond the reach of the Exchange.

3. PROJECT ACTIVITIES

A. Institutional Analysis: In view of the need to expand the Sri Lankan capital market and in response to the requests for assistance from the Securities Council and the Colombo Securities Exchange, the project will provide technical and financial support for these two institutions over a four year period.

93

1. Securities Council: Under the Securities Council Act No. 36 of 1987, the GSL has formed the Securities Council. It has been operational since September 10, 1987 with the following mandate:

- to regulate the activities of the Colombo Securities Exchange, stock brokers and stock dealers to ensure that securities are traded in an orderly manner in the market with proper professional standards;

- to protect the interests of investors; and,

- to develop and promote the growth of the securities market in particular and the capital market in general.

The Council consists of ten members from both the public and private sectors appointed by the Ministry of Finance and Planning. With an operating budget of $62,000 per year, the Council is proceeding with implementation of a program of action built around four main activities:

- the establishment of proper procedures and rules to regulate the activities of the stock exchange, stock brokers, and listed companies;

- the establishment of adequate facilities at the Exchange to service investors in securities;

- the development of a securities market; and,

- the development of a capital market.

The Council is in the process of establishing a secretariat headed by a full time executive in the position of Director General. A Director General has been recruited and will assume office in mid-1988. He will serve as the chief executive officer of the Council and be tasked with implementing the Council's program of action. The Director General will be responsible for day-to-day policing of the trading action on the Exchange, the carrying out of actions designed to expand the securities market, and other measures to create a regularized market with appropriate protective mechanisms for the investing public. An outline of the principal duties of the Director General is as follows:

- to assist the Chairman in carrying out the objectives, powers and functions of the Securities Council;

- to develop criteria for licensing stock brokers and stock exchanges;

- to develop and implement an investors compensation fund to protect investors in securities from fraudulent practices of brokerages, offering companies and/or company registrars;

- to undertake the review, revision and formulation of stock market trading regulations;

94

- to undertake the review, revision and formulation of securities listing regulations,

- to prepare procedures for inspection of stock brokerages and stock brokers;

- to prepare a code of conduct for parties engaged in takeover situations,

- to prepare procedures for control and disclosure of insider trading activities;

- to develop and implement procedures for surveillance and supervision of securities market participants including investors, brokers, Exchange personnel, offering companies and their agents; and

- to conduct day-to-day oversight of the operations of the Exchange and the Sri Lankan securities market.

B. Colombo Securities Exchange: Although Sri Lanka has had a small share market since 1896 (serviced by the Colombo Brokers Association (CBA) and connected closely with the plantation sector), the market has only very recently begun to grow. The objective of setting up a formal stock exchange to assume the share trading activities of the CBA was pursued for several years in the early 1980s, resulting finally in the creation in 1984 of the Colombo Securities Exchange. The Exchange was organized as a private limited liability (guarantee) company. Its essentially nonprofit nature has earned it a reduced corporate tax rate of 20% by special exemption of the MF&P. It is owned and controlled by its eight private member firms who also are the brokerage firms trading on it. The Exchange trades in common shares, some preferred issues, and a small number of debentures. It does not support transactions in corporate bonds, syndicated partnerships, index futures, or commodities. The bulk of transactions are buy and sell orders for class A common shares.

The Exchange performs the following major functions:

- listing of companies desiring to be traded on the Exchange. The Exchange, through its Capital Issues Committee, is required to review the qualifications of all firms requesting a listing with it;

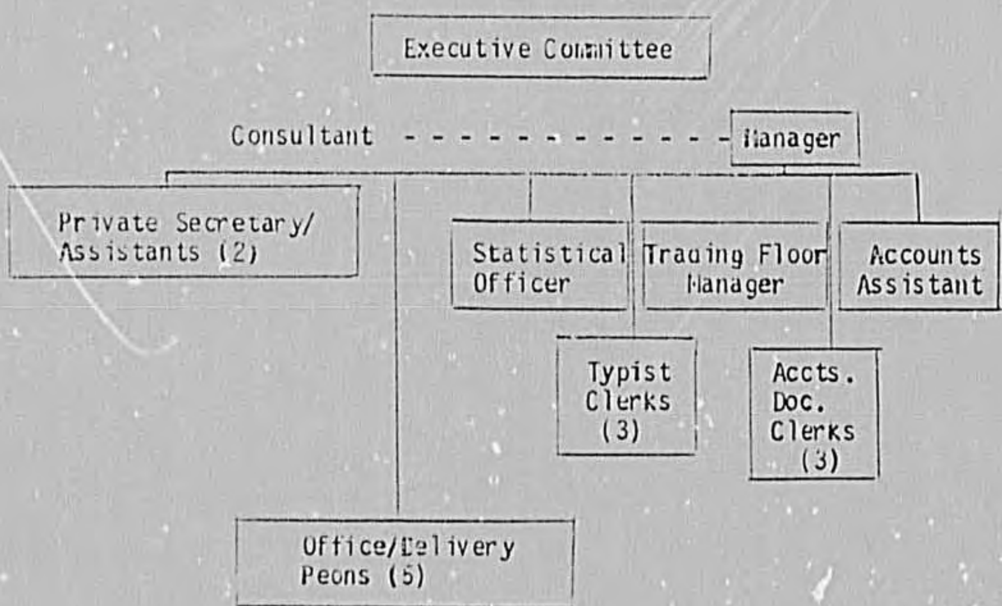
- supervising listed firms' compliance with listing requirements, assuring that required annual and quarterly reports are filed, earnings and dividend distributions are reported, etc;

- reviewing and addressing the rights of shareholders, responding to investor and broker complaints concerning earnings reporting, dividend distributions, etc;

- running the trading floor of the Exchange and assuring that trades are conducted according to Exchange procedures;
- recording all share transactions as they occur daily - first on paper and then transcribed to a computer data base;
- reporting transactions including number of shares traded, prices of the shares traded, and overall movement of the market. Reports are delivered to the public through the press and to member firms;
- publishing daily, weekly, quarterly and annual reports, including stock quotations, shares transactions, and annual summaries;
- maintaining the registrar of companies for listed firms; and
- performing some back office functions for broker/members including payment clearing functions.

To perform these functions, the Exchange has a staff of 18 organized along the lines as shown in Figure C-1.

Figure C-1: Organization Chart of The Colombo Securities Exchange (Gte) Ltd.



In addition to staff, the Exchange has several committees of owner/brokers which perform various functions including the review of listing applications, the investigation of complaints against listed firms and brokers, supervision of compliance of listed firms with Exchange regulations and general executive oversight duties as required. The most senior of these committees is the Executive Committee which serves as the board of directors for the Exchange.

The activites of the Exchange itself are regulated by the Securities Council. The Director General of the Council will be the de facto senior supervisor of Exchange operations on a continuing basis, providing resident oversight from an office adjoining the trading floor and offices of the Exchange. Through him, the Council will also provide oversight to assure that the Exchange is effectively performing its functions by policing brokers, assuring reasonably rapid and accurate transactions, and following general fair trading practices.

The Exchange's relationship with the brokerages is particularly complex. The brokers are the owners and operators of the Exchange; they provide operating income (via fees) to the Exchange and serve on its Executive Committee. They also provide the forum for deciding on and imposing appropriate sanctions for brokers' conduct antithetical to the interests of the Exchange and the market place. In that sense, they are expected to be a self-policing body.

The Exchange and its member brokers provide a guarantee for limited contingent liability claims against the Exchange by aggrieved investors. This is achieved by establishing a non-cancellable bank credit line which can be utilized to correct problems arising from the financial failure of broker firms and for proven acts of malfeasance. (This guarantee is distinct from the investors compensation fund which when mandated by Parliament will be managed by the Securities Council).

The eight member brokerage firms, organized in most instances as subsidiaries of their larger parent commercial/trading companies, are said to operate currently at break-even or below because of the limited amount of share transactions. Even with the recent rapid growth in turnover, and a 3% fee per transaction, the average annual gross receipts for the eight member firms was the equivalent of $41,000 per firm during 1987.

B. Support Program

AID funds totalling $1.9 million will be used to support the implementation of a number of key measures designed to facilitate growth of capital markets in general and the securities market in particular. These include:

- long and short-term technical assistance to assist the Council in its capital markets development and oversight functions and the Exchange in reorganizing its operations;

- training and familiarization of market managers (both public and private) in modern exchange operations;

- encouraging more companies to seek listings on the Exchange;

- preparation of educational materials, seminars, conferences, and other events for the purpose of improving public and investor familiarity with the benefits and functions of the securities market;

- preparation of advertising materials for public consumption designed to attract investors to the market place; and,

- provision of equipment required to improve operations.

A description of AID-funded project inputs follows:

Technical Assistance: A total of $1,200,000 for long and short-term advisors and technicians is planned. One long-term advisor will be posted with the Securities Council for a period of three years to assist the Director General and to help improve exchange monitoring procedures and use of the equipment and facilities of the stock exchange. The advisor will also assist the Council in its efforts to develop the equity capital side of the Sri Lankan market. The draft job description for this position is in Attachment C-1.

Six person-months of short-term expatriate and twelve person-months of short-term local technical services are also planned to prepare policy analyses, recommend necessary policy reforms, design new financial instruments (such as unit trusts, mutual funds and syndications), prepare technical regulations and provide support to various activities of the Council as needed.

The Colombo Securities Exchange will receive one long-term technical advisor for a period of eighteen months to assist the Exchange in modernizing its operations and integrating new equipment and procedures (see draft job description in Attachment C-2). This advisor will work with the management of the Exchange (and in coordination with the Director General of the Securities Council) to smooth the transition from the existing trade recording and reporting system to a new, more efficient operation for handling stock trades. He/she will provide technical assessments of computer systems operations, oversee the final preparation of specifications of all computer equipment to be procured for use by the Exchange, prepare computer systems software for Exchange uses, take charge of the setting up and run-in of the new computer systems in parallel with the existing largely manual system, and train the Exchange's computer systems manager and operators in data input, data management, systems maintenance, and planning of data systems security procedures.

In addition, six person-months of short term expatriate and 12 person-months of short-term local technical assistance will be provided to the Exchange to further assist in special requirements related to the installation of equipment, the setting up of the Exchange's Central Depository System, the transfer of technology from other stock exchanges in the region, in-country training for brokers/dealers aimed at streamlining their operations, and other supporting services for brokerage firms.

All technical assistance will be provided under a single contract, as explained in Section 5.

<u>Public/Investor Education Program</u>: A total of $350,000 will be expended on the production and distribution of materials designed to increase the familiarity of the investing public, listed firms, and students with the operations and functions of the securities exchange and the capital market. Elements of this program include public seminars on the securities market as well as publication of general information booklets, the Exchange's rules and procedures, and a school text for advanced students in business and accounting courses. In addition to the educational function of this program, a public relations component is planned which will include production of a television documentary for use in schools, other educational television programs, appearances by Council and Exchange members on TV panel shows and a press campaign in English, Sinhala and Tamil language newspapers.

<u>Commodity Procurement</u>: AID will provide $245,000 for the purchase of publishing, telecommunications, training, office, and computerized record-keeping and reporting equipment for both the Council and the Exchange. Procurement and installation of the equipment will be accompanied by a substantial overhauling of the Exchange's operations to help it expand its capabilities and reduce transaction times. The detailed equipment list is in Attachment C-3.

Two separate computer systems will be purchased and installed in the offices of the Exchange. The first will be used to automate the Exchange's trade recording and reporting system. This system will be designed around a small local area network of advanced microcomputers. A file server/host computer will be located in the main office of the Exchange and six terminals will be located on the trading floor (2), in the accounting section (2), in the office of the Exchange Manager (1), and in the office of the Director General (1). The system will be equipped with software that will facilitate real time recording and reporting of stock transactions and will support the publication of a number of reports (including daily, weekly, and quarterly as well as annual reference numbers). The system will be equipped with high volume, high speed printing equipment including both impact and page printers and, if possible, will be linked with the Exchange's offset printing equipment.

The second system will be used to automate the proposed Central Depository System (CDS). Because of security requirements, the CDS hardware will be physically segregated from the trade recording and reporting system in a secured office. The equipment will be configured as a small local area network with three terminals available only to CDS personnel. It will be equipped with data base management and reporting software and have large scale storage capacity and heavy duty printing equipment.

Because both systems are to be of critical importance to the operations of the Exchange, they must be capable of being in operation at all times during the trading day. Consequently, substantial redundancy will be built in with key components procured in duplicate.

The configuration and specifications of both systems will be examined in detail by a computer systems specialist prior to procurement. This specialist will prepare a report containing procurement specifications and a review of services and products available locally (see Section 5.C).

Project funds will also be used to purchase communications equipment (a new telephone system, a telex machine and a facsimile unit), printing equipment (a high volume copier and an offset press), general office equipment, and training equipment including white boards, a VCR/TV unit, and an overhead projector.

The Securities Council will receive project-funded equipment including a micro computer system for word processing and financial analysis, appropriate software, a medium-volume photocopier and an offset lithograph printer with plate maker. Equipment will be installed in the offices of the Director General.

Training: A total of $45,000 will be used to finance familiarization and consultation travel for Council and Exchange managers to securities exchanges in other countries of the region and travel to participate in professional meetings. During their training, managers will review operating procedures with an eye to transferring useful innovations to the Colombo exchange.

C. Outputs

Project assistance will encourage and facilitate the expansion of private investment in productive enterprise through improved capital market conditions. The planned outputs are:

-- an operative regulatory unit (the Securities Council) for the securities market.

-- two computer systems installed in the Exchange.

-- a modernized operating regime for the Exchange capable of handling the increasing workload of the share market for the foreseeable future.

D. End of Project Status

At the end of the project, the following conditions will prevail as indicators that the project purpose has been accomplished:

-- The regulatory climate of publicly traded shares will inspire confidence among investors and the public at large;

-- Increased mobilization of funds will result in greater equity investment in private productive enterprises;

-- The ownership of equity instruments will become more broadly based;

-- New methods of financing will be developed through the Colombo Securities Exchange.

4. FINANCIAL PLAN AND ANALYSIS

A. Budget Summary

The total cost of the capital markets development component is $2.44 million. AID will contribute $1.9 million (78%), the Colombo Securities Exchange will contribute $0.32 million(13%) and the Securities Council will contribute $0.22 million (9%). A consolidated summary budget for assistance by category of expenditure is given in Table C-1.

Table C-1: Cost Estimate and Financial Plan ($ 000)

	A.I.D.	Host Country	Total
Long-Term Technical Assistance	$ 900	--	$ 900
Short-Term Technical Assistance	300	--	300
Training	45	--	45
Equipment	245	--	245
Public Education Campaign	350	--	350
Contract Administration Expense	60	--	60
Recipient Operating Expenses	--	$540	540
Total	$1,900	$540	$2,440

Tables C-2 and C-3 show the planned sources and uses of funds separately for the Securities Council and the Exchange. The estimated expenditures of AID project funds by fiscal year is in Table C-4.

Table C-2: Funding for the Securities Council ($ 000)

	AID	GSL/Other	Total
Long-Term Technical Assistance	$ 600	-	$ 600
Short-Term Technical Assistance	150	-	150
Training	10	-	10
Equipment	35	-	35
Public Education Campaign	350	-	350
Contract Administration Expenses	60	-	60
Operating Expenses -	-	225	225
Total	$1,205	$225	$1,430

101

Table C-3: Funding for the Colombo Securities Exchange ($ 000)

	AID	CSE	Total
Long-Term Technical Assistance	$300	--	$ 300
Short-term Technical Assistance	150	--	150
Training	35	--	35
Equipment	210	--	210
Operating Costs	-	$315	315
Total	$695	$315	$1,010

Table C-4: Estimated Expenditure by Fiscal Year ($ 000)
(AID Project Funds Only)

Colombo Securities Exchange

FY	LTTA	STTA	Trng.	Equip.	Total
1989	100	50	10	210	370
1990	200	50	15	-	265
1991	-	50	10	-	60
Total	300	150	35	210	695

Securities Council

FY	LTTA	STTA	Trng.	Equip.	Pub Ed.	Contract Adm.	Total
1989	100	50	5	35	60	10	260
1990	200	50	5	-	120	20	395
1991	200	50	-	-	120	20	390
1992	100	-	-	-	50	10	160
Total	600	150	10	35	350	60	1,205

B. Basis for Cost Estimates

A standard cost factor of $200,000/yr. is used for the long-term expatriate advisors and includes estimated overheads, fees, and all standard allowances and applicable support costs (housing, etc.). The short-term expatriate cost per person-month is costed at $20,000 inclusive of salary, travel, per diem and overheads/fees. Local short-term consultant costs are estimated at $2,500 per person-month and also include calculations for overheads and fees. Training costs are based on average travel and per diem expenses of $2,500 per study tour in the U.S. or other locations and 18 study tours. Equipment cost estimates are in Attachment C-3.

The operating costs listed for the Council are based on a constant budget of $62,000/yr. for three years and eight months. The Council's budget is covered by allocations from the GSL. The operating costs of the Exchange are based on a continuation of the Exchange's current expenditure at $60,000/yr. over the same period plus an additional $32,000 per year for three years which represents the estimated new annual recurrent costs the Exchange will incur as a result of expanded operations (see financial analysis below).

C. Financial Analysis of the Colombo Securities Exchange (Gte) Ltd.

Since 1984, the Colombo Securities Exchange (Gte.) Ltd. has been operating as a for-profit limited liability company engaged in the facilitation of trading shares and debentures of publicly owned companies as well as government paper. It is owned and operated by the eight share brokerage firms which use its trading facilities.

A review of its income statement and balance sheet for the period ending March 31, 1987 shows a picture of a small company with adequate coverage of current liabilities and long-term liabilities limited to deposits and advance payments.

The Exchange has several lines of revenue including listing fees, quotation fees, brokers fees and the sale of an annual Rupee Company Handbook which it publishes and distributes. Total revenues for the year ending March 31, 1987 were Rs.1,922,687 ($66,422). Expenditures for the same period were Rs.1,810,761 ($60,358) leaving a small profit before taxes of Rs.181,920 ($6,064).

From a review of the accounts and discussions with principals at the Exchange, it would appear that there are no developing conditions which will affect the Exchange's ability to continue operations for the foreseeable future. The recent reduction of the Exchange's tax bracket from 50% to 20% should help it to maintain its modest profitability.

Project resources will be used to finance the capital costs of developing a new profit center for the Exchange. When in operation, the Central Depository System (CDS) will provide the Exchange with

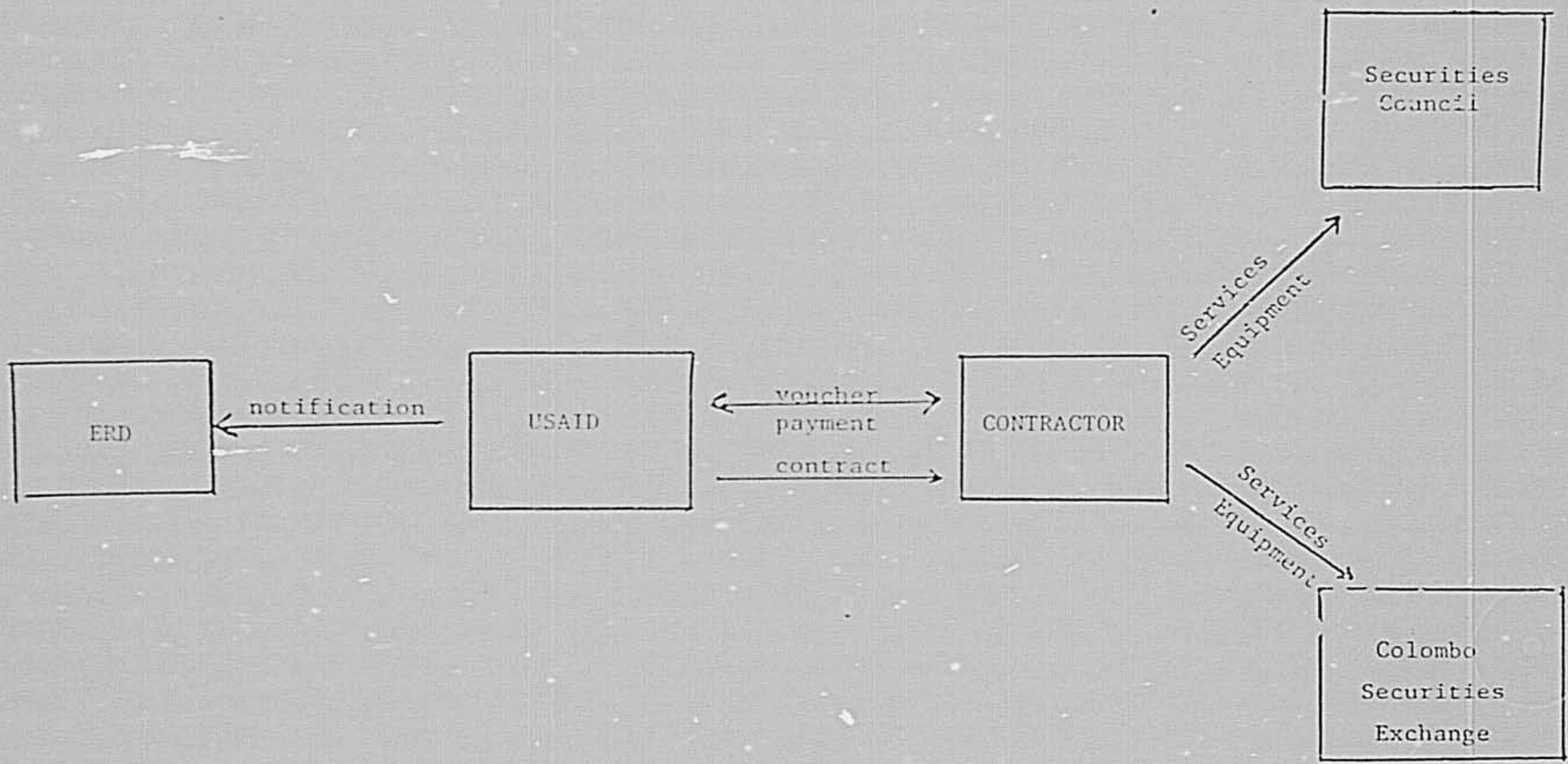
103

an incremental stream of revenues of approximately Rs.1,665,000 ($55,500) per annum. The income will be derived from a proposed one-half of one percent (0.5%) charge on the value of shares processed through the CDS, assuming an annual trading volume equivalent to that of 1987 of Rs.333,000,000 ($11,100,000). In addition to the processing charge, the CDS will reduce errors and other problems in stock transfers which presumably have a dampening effect on the investing public's interest in buying and selling shares and thereby depress the Exchange's volume. The CDS should help to reduce the amount of error processing which must be handled on an exceptions basis, thereby reducing the number of employee hours needed for that purpose.

Costs for operating the CDS are relatively low when compared with the current system of handling share transfers. Staff requirements are limited to a systems manager and two data entry clerks working a single shift and provision for security on an around-the-clock basis. Estimated annual costs for personnel, including fringe benefits, taxes and gratuities are Rs.480,000 ($16,000). (Management staff for the exchange is sufficient to provide oversight without adding additional personnel.) Other expenses include utilities and rent for office space adjacent to the offices of the Exchange at an annual rate of Rs.105,000 ($3,500). Assuming Rs.300,000 ($10,000) per annum costs for office supplies and costs of printed forms used in the clearing process, postal fees and messenger costs and a contingency of 10% for incidental expenses not currently foreseen, the total incremental cost of operations will be around Rs.973,500 ($32,450) per annum. Net revenue from the CDS operations before taxes should therefore be Rs.691,500 ($23,050) per annum.

As currently proposed, the 0.5% charge by the Exchange for its CDS services would be offset by reducing the current 1% stamp duty paid to the GSL on share transactions and transferring the 0.5% saved to the Exchange. The Securities Council is currently reviewing the proposal for the change in the stamp duty scheme and will be presenting its position to the Department of Inland Revenue. Should the GSL not accept the proposal, an alternative plan to place a direct fee on transaction processing to be paid by buying and selling brokers will be proposed. Yet another alternative could be to raise the annual fees which the Exchange charges its members. Given that the CDS represents an opportunity for substantial savings for brokers by reducing the amount of back office overhead needed for transaction processing, the acceptability of a charge to them as a source of income seems reasonably certain. In any event, a condition will be imposed on the Exchange that it will have a carefully worked out plan and will have established a source of income for the CDS, both acceptable to USAID, prior to disbursement of AID funds for procurement of equipment.

Figure C-2: Organization Chart for Capital Markets Development



5. IMPLEMENTATION PLAN

A. Implementation Arrangements

The full $1.9 million A.I.D. contribution for the capital markets development component will be obligated through the Project Grant Agreement for the PSPS Project. The activities in this component will be carried out by the Securities Council and the Colombo Securities Exchange. All technical assistance and other services provided with AID project funds will be delivered through a single competitively bid contract which will be negotiated and signed by USAID with a U.S. firm, possibly in joint venture with a Sri Lankan firm. The contractor will provide all of the long-term and short-term technical assistance, arrange for all overseas training/study tours, and procure all equipment needed for both the Council and the Exchange. The contractor will assign the two long-term advisors to work directly for the Director General of the Council and the Manager of the Exchange on location at their respective offices. Details of the contracting process and the procurement of other inputs in the component are outlined in Section 5.C. Figure C-2 shows the organization chart for the component.

B. Implementation Schedule

The implementation schedule for this componennt is as follows:

7/88: PSPS Project Grant Agreement signed
9/88: Conditions Precedent met
9/88: Request for Proposals issued for technical assistance contract
11/88: Technical assistance proposals reviewed
1/89: Technical assistance contract signed
2/89: Long-term advisors to Director General (3-years) and Exchange (1-year) arrive
4/89: Computer systems specifications completed
6/89: Computer systems procurements completed
8/90: Long-term advisor to Exchange departs
1/91: Mid-term evaluation
2/92: Long-term Advisor to Director General departs
5/93: Final evaluation
7/93: PACD

The activities involving AID-funded inputs will be completed about three years and eight months after the signing of the Project Grant Agreement, but the continuing performance of the Council and the Exchange as well as the achievement of other capital markets development objectives will be evaluated as part of the PSPS project's final evaluation in mid-1993.

C. Procurement Plans

TA Contract: The funds for the TA contract ($1.9 million) will be earmarked via a PIO/T countersigned by both the Council and the Exchange. The PIO/T will contain the Request for Proposals (RFP). The Council and the Exchange will participate alongside USAID both in drafting and approving the final RFP and in the technical review of the proposals received pursuant to the RFP. Given the critical requirement that the long-term advisor to the Director General be the correct individual for the job, it is anticipated that the candidate(s) for this position proposed by the firms with whom negotiations are conducted will be interviewed in Colombo. This individual will also serve as the contractor's Chief-of-Party. The AID Contracting Officer/New Delhi will negotiate the final contract in Colombo with the successful proposer.

After the contract is signed, the contractor will provide services to the Council and the Exchange according to the terms of reference. All short-term consultants, overseas training/study tours, equipment procurements (see below) and procurements of services related to the public education campaign will be provided by the contractor based on specific requests of the Council and the Exchange. The contractor will insure that all standard AID procurement regulations are followed. Billings (invoices) will be submitted monthly to USAID; payments will be made by USAID after verification by the Council and/or the Exchange that the services have been provided as stated.

Computer Equipment Procurements: As soon as possible after the signing of the contract, the contractor will assign a short-term computer equipment specialist to work alongside the long-term advisor to the Exchange to review the preliminary computer equipment requirements outlined in Attachment C-3, make final recommendations on all procurements, perform final preparation of specifications, review sources and origin of the required systems hardware, software and service contracts, and present a comprehensive procurement plan. Upon approval by the Exchange of the final procurement plan the contractor will proceed with the procurements. It is anticipated that procurements will be made off-shelf from local suppliers and/or via AID's commodity procurement facility in Singapore. Because the computer procurement will exceed $100,000, the contractor will also be required to prepare with USAID a presentation of the final procurement plan to AID/W for approval prior to initiation of purchases. In addition, there will be Conditions Precedent attached to the procurement of computer equipment related to the Central Depository System (CDS) for the Exchange, namely that (1) all legal requirements to establish and operate the CDS have been met and (2) a means of revenue generation to meet the incremental recurrent costs of the CDS has been established.

Attachment C-1

Terms of Reference for Long-term Advisor to the
Director General of the Securities Council of Sri Lanka

Background: The Securities Council was established in 1987 as the principal institution for promotion and regulation of the Sri Lankan capital market, with special reference to facilitating the expansion of the securities market. The Council is made up of a Chairman and six members from the public and private sectors and has a small Secretariat led by a Director General. As its Chief Executive Officer, the Director General is expected to have:

1. Detailed knowledge and experience of the workings of stock exchanges and brokerage houses and all aspects of securities including the trading of shares, bonds, commercial and government paper;

2. A thorough knowledge backed by experience of securities underwriting from initial public offerings to secondary markets;

3. Knowledge of ways to mobilize capital for use by potential entrepreneurs;

4. Sufficient experience and technical capability to carry out the objectives of the Securities Council including:

   a. oversight of the operations of the Colombo Securities Exchange and the Sri Lankan capital market;

   b. the development and implementation of procedures for surveillance and supervision of securities market participants including investors, brokers, exchange personnel, offering companies and regulators;

   c. the review, revision and formulation of stock market trading regulations, including procedures for control and disclosure of insider trading activities;

   d. the review, revision and formulation of securities listing regulations;

   e. development of criteria for licensing stock brokers;

   f. preparation of procedures for inspection of stock brokerage firms and brokers; and

   g. the development and implementation of an investor compensation fund to protect securities investors from fraudulent practices.

5. An ability to ensure an effective interaction between the Council and relevant public and private sector institutions;

6. An ability to advise the Chairman of the Council on all matters relating to the oversight and development of the Sri Lankan securities industry;

7. An awareness of the differing needs within a developing capital markets environment with a flexible attitude to respond effectively to those needs, together with the requisite sensitivity toward cultural considerations; and,

8. The personal skills and flexibility necessary to maintain the respect of the financial communities throughout Sri Lanka.

USAID and the Securities Council agree that it is highly advisable to provide the Director General with training and technical support to aid him in discharging his many duties. Therefore, USAID has agreed to provide a long-term advisor to the Director General who will provide technical assistance over a three-year period begining in early 1989.

Scope of Services Required: The principal task of the advisor will be to help and guide the Director General of the Securities Council in understanding the Securities Council Act and his role as the Chief Executive Officer of the Council. The advisor will be required to assist the Director General in developing an understanding of how the capital market system should function and how the securities market should be improved. The advisor should help to establish the authority of the Director General without supplanting him.

At the onset, efforts will be concentrated on establishing a positive and constructive relationship between the Director General and the Colombo Securities Exchange and amongst brokers. This will necessitate establishing procedures and systems in the Exchange with identified and accepted professional standards. The advisor will work with the Director General to:

1. Assist the Director General to carry out the objectives, powers and functions of the Securities Council;

2. Recommend criteria for granting licenses to stock brokers;

3. Assist in the development of an investor compensation fund;

4. Examine stock market trading regulations and recommend changes as required;

5. Examine listing regulations and recommend changes;

6. Prepare a draft manual for establishing the professional standards of stock brokers;

7. Advise the Director General of potential securities market malpractices including those related to insider trading, mergers and acquisitions, underwriting and sales/brokering;

8. Recommend an appropriate code of conduct for all parties engaged in securities trading including investors, brokers, listed companies and market regulators; and,

9. Recommend procedures for surveillance and supervision of stock market participants.

Acting as the contractor's Chief of Party, the advisor will also coordinate and supervise all short-term consultants utilized under the contract and arrange for all overseas training/study tours planned for both the Securities Council and the Colombo Securities Exchange. The advisor will prepare quarterly reports for submission to AID on contract activities and the progress of project implementation. The advisor will work in the offices of the Director General in Colombo, Sri Lanka. Office space and secretarial and other supporting services as needed will be provided by the Council.

Term of Services Required: The advisor is to assist the Director General over a three-year period beginning in early 1989.

Qualifications: The advisor will have expert knowledge in the functioning of capital markets with working experience and knowledge of the different kinds of capital and securities markets in developing countries. He/she should be senior both in professional stature and personal demeanor. He/she must have the ability to relate well to others, with a capacity to listen with patience and to explain, discuss and effectively communicate and educate. Experience in developing countries, preferably in Asian countries, will be a definite asset. Advanced academic credentials in finance, business administration or economics are desirable.

110

Attachment C-2

Terms of Reference for Long-Term Advisor to the Managing Director, Colombo Securities Exchange

Background: The Colombo Securities Exchange (CSE) was established in 1984 to serve as Sri Lanka's only licensed stock market. It has a staff of 18 employees who facilitate trading in common shares, debentures and government paper. It is owned and operated by eight member brokerage firms which pay membership and transaction fees to support its operations.

While still a very small exchange with only 171 listed firms (of which only 50 to 60 firms are actively traded), indications are that share trading volume will sharply increase over the next three to five years. Some of the factors involved in the growth are:

- the CSE has received listing applications from 26 new firms;
- the expected addition of up to 24 state-owned enterprises which will be privatized and sold through the exchange;
- increasing interest in shares as investment vehicles;
- a generally very high level of liquidity in the banking system which should lead to diversification;
- the prospect that firms will enter the equity capital market for recapitalization leading to an increase in the number of new public offerings; and
- a continuation of the trend over the past three years during which the CSE has achieved a growth of 450% in the number of shares traded to a record in 1987 of 17.32 million shares.

To prepare for a similar and possibly greater level of growth in shares traded in the coming years, the CSE, with financial assistance from AID, will be undertaking a major revamping of its operations to automate its share trading, clearing and market reporting processes. It has need for both long and short-term technical assistance to implement these changes and has requested AID's assistance for both commodity procurement and funding of advisors.

Part of AID's package of technical and financial assistance to the CSE will be the design, procurement and installation of a Central Depository System (CDS), an automated system for clearing transfers of shares between buyers and sellers. Once installed and operating, the CDS will relieve a serious backlog of share transfers, reduce errors in transfer documentation and reduce or eliminate the number of opportunities for engaging in corrupt or unethical trading practices.

Scope of Services Required: The CSE requires a technical advisor to assist it in systems design and installation, process automation, staff training and software development.

Initially, the advisor will prepare an analysis of the proposed automation of the operations of the Exchange, design appropriate system, based on IBM compatible micro computer equipment, identify and procure the necessary equipment, and supervise and participate in the set up and installation of two local area networks--one to serve trade recording and reporting needs and the other to serve the CDS. He/she will install available off-the-shelf software and, if necessary, prepare software to serve network, data base management, stockmarket transaction management, word processing, business graphics telecommunications and publishing purposes. He/she will demonstrate systems hardware and software and train exchange personnel in all aspects of systems operations including use and maintenance.

During the initial installation of the equipment, the advisor, working with CSE staff members, will run the automated trade recording and reporting system and the CDS in parallel with the existing manual process until all personnel are familiar with equipment, software and procedures to the degree that trouble-free operations are assured.

The advisor will work closely with the manager of the CSE and the CSE staff member designated to be the computer system administrator to develop operating routines that provide error free, secure and rapid processing of information. Together they will develop and document the operating procedures to be followed that are best suited to the tasks of the CSE, its installed equipment and the capabilities of CSE personnel.

When and if necessary, the advisor will identify and specify other technical assistance requirements of a specialized nature. He/she may accompany exchange personnel on trips within the South Asia and Far Eastern region for purposes of systems review or training.

Qualifications: The advisor must have at least five years experience with development, operation and problem solving in an IBM compatiable micro computer environment. He/she must have at least three years of experience in working with small scale local area networks. It is highly desirable that the advisor have experience with managing computer-based brokerage or stock market transaction systems. He/she must have experience in using DBase III plus or similar database management software in a data processing or transactional environment. It is highly desirable that the advisor have experience in writing small programs in higher level languages such as Basic, C, Pascal and the like.

He/she must have experience with task analysis, systems development, and systems trouble shooting. He/she must have experience in training others in software and hardware use and maintenance.

112

He/she must be familiar with data and program security systems and at least a working familiarity with desktop publishing software such as Ventura or similarly configured programs.

Reporting Requirements: The advisor will be expected to undertake the tasks listed in this terms of reference under his own direction. He/she will report directly to the Manger of the CSE and, through him, to the CSE Executive Committee. He/she will work colleagially with the designated computer systems manager of the CSE. He/she will look to the advisor to the Director General of the Securities Council (the Chief of Party for the technical assistance contractor) for administrative guidance concerning all issues related to supplemental procurement of system hardware, software and supplies and for recruitment of short term technical specialists.

Terms and Place of Service: The advisor will work with the Colombo Securities Exchange at their offices in Colombo, Sri Lanka for a term of eighteen months.

Attachment C-3

Draft Equipment List for Procurements by the Securities Council and the Colombo Securities Exchange

The computer systems requirements for the project are defined by the following imperatives:

- The systems must be capable of operating during working hours. A break of more than 10 minutes in operations due to machine failure is unacceptable;
- Data security is very important. A means of providing continuous or near continuous duplicate data copies is essential. Hard copy records of processed transactions would be helpful;
- Systems security is very important, especially for the Central Depository System. Protection from electronic/physical tampering must be assured;
- Operating costs should be kept low;
- The limited availability of expert computer systems operators should be kept in mind;
- The networks should be built around file servers which are both fast and have expanded memory potential. The 80386 chip in a IBM PS/2 model 80 and Compaq 386/20 are considered to be the size adequate to the task. Two mini computer systems like the Wang VS are considered to be too expensive (both initial and operating costs).

Illustrative Equipment List

(Quantity) No	Item	(CSE or SC) User	Est. Unit Cost	Total Cost
4	80386-based computers with large hard drives, extra, memory, tape back-up or removable memory media	CSE	$ 15,000	$ 60,000
3	Local area networks	CSE	12,000	36,000
2	NEC Model 835-type Laser-printers	CSE	5,000	10,000
3	Terminals for CDS	CSE	1,500	4,500
7	Terminals for trading offices	CSE	1,500	10,500
1	NEC P7-type printers with sheet and tractor feeds	CSE	1,000	1,000
6	Cabling and net-work boards for terminals, (trading offices)	CSE	1,000	6,000
1	Okidata (industrial style) printer	CSE	1,500	1,500
	Software for Networks, WP, Data-base, Spread sheets, publishing, utilities, Telecom, Accounting	CSE	10,000	10,000
1	Modem w/software and cabling	CSE	1,000	1,000
3	UPS	CSE	3,000	9,000
1	Generator w/installation	CSE	6,000	6,000
1	AC/Dehumidifier for computer room	CSE	1,000	1,000
1	80286-based computer W/HD and expanded memory	SC	5,000	5,000
1	Printer	SC	1,000	1,000

	Software for WP, Data base, publishing, utilities, accounting	SC	2,000	2,000
	Computer supplies (disks, ribbons, paper, cables, etc.)	SC	750	750
	Computer supplies (Laser cartridges and drums, disks, paper, ribbons, etc.)	CSE	2,000	2,000
	SUBTOTAL			$167,250
1	One year service contract on computer system equipment	CSE	10% of $ 140,500	14,050
1	"	SC	10% of $ 8,000	800
	Contingency for proprietary software for CSE and/or CDS			10,000
	TOTAL FOR COMPUTER SYSTEMS			$192,100

1	High volume copier with color facility	CSE	9,000	9,000
1	Medium volume copier	SC	6,000	6,500
2	Offset lithograph Printer w/plate and maker	SC CSE	9,000	18,000
	Roneo machine	CSE	500	500
1	Telex	CSE	3,500	3,500
1	Facsimile machine	CSE	2,250	2,250
1	Telephone switchboard	CSE	8,000	8,000
1	Stamp Impressing Machine	CSE	750	750
1	VCR/TV w/camera for training	CSE	2,000	2,000
1	Overhead projector	CSE	500	500

116

1	Office supplies	SC		500	500
2	Magi board and SC	CSE		250	500
	SUBTOTAL FOR OTHER EQUIPMENT				$ 52,000
	GRAND TOTAL				$244,100

ANNEX D

VENTURE CAPITAL COMPANY

1. OBJECTIVE AND CAPSULE DESCRIPTION

The objective of this component of the project is to demonstrate the viability and profitability of equity capital for investment in promising private business enterprises through the introduction of the venture capital concept in Sri Lanka and start-up support for a private venture capital company (VCC).

AID grant funds totalling $0.5 million will be used to help finance the costs of technical assistance, training, promotion, equipment and a portion of operating expenses of the VCC during its early start-up years. The VCC will be privately controlled and be capitalized by its sponsors at a minimum level of Rs. 30 million in paid-in shares. A Cooperative Agreement will be executed between USAID and the VCC, with a condition that the capital of the VCC must increase to at least Rs. 100 million within a maximum of two years in order for A.I.D. funds to continue to be accessed. The VCC should be broad based and its shareholders are likely to include individual investors and domestic and foreign institutional investors in addition to the initial sponsors.

2. BACKGROUND/RATIONALE

This component conforms closely with the Mission's strategy to expand the capital markets by broadening the base of equity financing for private sector investment and encouraging Sri Lankan companies to raise capital through public issues of shares on the Colombo Securities Exchange. The VCC will play a direct role in accomplishing this purpose by encouraging both the supply of and demand for equity finance: supply of equity will be directly increased, in the first instance, by the capital raised by the VCC itself including an anticipated public issue of shares, and subsequently by VCC encouragement of its portfolio companies to go public; demand for equity will be directly increased by the VCC's investment of a minimum contemplated Rs. 80 million in the shares of portfolio companies.

Venture capital will help solve the problem of limited sources of equity capital available to project sponsors in Sri Lanka. This shortage inhibits investment and means that growth in the number and size of potentially highly profitable productive enterprises in Sri Lanka is slower than optimal. The normal minimum gearing ratio for banks to consider debt finance for qualified investment projects is 60:40 or a 40% equity requirement. The inability by project sponsors to raise equity from their own resources, from other private or family sources, or from retained earnings if the investment is an expansion or diversification of an existing company is often a principal obstacle to a project going ahead. Public offering of shares is an option which is occasionally viable in the current sharemarket, but this as a rule is limited to well established companies and not suited to totally new start-ups. On the other hand, institutional sources of equity capital are also very limited in

118

Sri Lanka. A few entities, such as the two development banks, provide equity on an ad hoc basis to particularly promising projects in which they are also the prime lender.

The VCC will meet several interrelated objectives: (1) it will help introduce a new type of financial institution which will increase the availability of equity capital for private sector investment; (2) it will, as a full partner in the projects in which it invests, insist on competent management in its portfolio projects, thereby increasing their prospects for success; (3) it will, through its contacts with foreign business and networking with other venture capital firms overseas, provide increased access to foreign partners for Sri Lankan ventures and related access to foreign technology and markets; (4) it will have a positive impact on social and economic development by the increased jobs and income levels generated as a result of the VCC investments; (5) it will leverage up to Rs. 10 in total investment for every Rs. 1 invested by the VCC, assuming a minimum 25% shareholding in its portfolio companies and a 60:40 gearing ratio; (6) it will demonstrate the advantages to companies to broaden their capital base as a means of company expansion without losing control; (7) it will encourage its portfolio companies to go public as a means for the VCC to exit from its investments, and in so doing help expand the sharemarket; and (8) it will if successful be a model for the formation of subsequent venture capital companies in Sri Lanka.

The VCC is closely related to the broader capital markets development component of the PSPS project. Through planned support to the Securities Council and the Colombo Securities Exchange, the project will carry out multiple activities aimed at improved regulation of the share market, streamlined transactions on the exchange, promotion of greater use of equity shares and other instruments to raise capital, education of the public on how to participate in the capital markets, encouragement of unit trusts, etc. The VCC may also relate to the privatization component of PSPS if it were to consider investing in a privatized company.

A detailed assessment of the feasibility of the proposed VCC is contained in a report completed in March 1988 entitled "Establishment of Venture Capital Company in Sri Lanka". The report was prepared for the Mission under an IQC work order with International Science and Technology Institute, Inc. (ISTI). A second reference document is the A.I.D. policy paper on Private Sector Development (March 1985 revised) which contains guidelines relevant to the proposed AID grant support for the VCC. A third principal reference document is the project paper for the USAID/Kenya Private Enterprise Development Project (615-0238). This project contains support for a venture capital company in Kenya, Kenya Equity Capital Ltd., which in size and structure is a company strikingly similar to the proposed Sri Lankan VCC although the form of AID's support recommended for the Sri Lankan company is smaller and much less complex. Other experience with venture capital in both the developed and developing countries relevant to the design of the VCC in Sri Lanka was assembled as part of the 1988 ISTI report, including reviews of the status of the AID-supported VCC in Thailand and Asian Development Bank experience. Finally, other background documents are the earlier reports by ISTI completed in May 1987 on the concept of the VCC in Sri Lanka and the report prepared for PRE/PD by Arthur Young International entitled "Venture Capital Process."

3. PROJECT DESCRIPTION

Details of the capitalization, investor group, management, investment criteria/policies, and pro forma cash flows/profit and loss projections of the VCC as it is now likely to emerge are discussed below and in the financial analysis in Section 4.

A. Capitalization: The VCC will start with a minimum level of Rs. 30 million ($1.0 million) in paid-in capital. This level may be exceeded but is the minimum level to start. However, a viable VCC in Sri Lanka must reach a level of Rs. 100 million ($ 3.3 million) in paid-in capital. Among the conditions precedent to AID's initial grant support for the VCC will be evidence that Rs. 30 million has been paid in and that there is an achievable plan to expand to Rs. 100 million after a maximum of two years. Continued AID support after two years of VCC operations will be contingent on the capital base having grown to the Rs. 100 million level.

B. Investor Group: A core group of investors will subscribe to the initial Rs. 30 million investment. This group will be the incorporators of the VCC, establish the company's memorandum and articles of association, appoint a Board of Directors, and through the Board adopt a business plan and hire the managing director of the VCC. The investor group will consist of Sri Lankan private companies and banks and may also include the Development Finance Corporation of Ceylon. No one company, bank, or group of investors in the core group will have a controlling interest, which is defined to mean that the maximum shareholding by any one party would be 33%. It is desirable to get between 5-10 investors to subscribe to the initial Rs. 30 million. With regard to raising the capital level to Rs. 100 million, there are several likely sources. One privately managed international equity investment fund has already committed itself in writing to investing Rs. 10 million in the VCC. Another international fund has expressed verbally an interest in investing a similar amount. There is also good potential that the VCC could successfully undertake a public issue in Sri Lanka aimed at local individual and institutional investors. The core group itself is likely to retain rights to additional shareholdings.

C. Management: The VCC will be led by a locally recruited Sri Lankan Managing Director (MD). This will be a key appointment which will occur as soon as possible following incorporation. The MD will be involved in all investment decisions by the VCC and will make the recommendations to the Board on investments. The MD will be supported by a small local staff which will grow as circumstances warrant. An attractive remuneration package complemented by performance incentives linked to VCC profits will be offered to the MD. A careful selection process should result in appointment of a well qualified MD, who will also be the principal beneficiary of the training and technical assistance provided to the VCC by the AID grant. The management performance of the MD is clearly a critical aspect for its success, requiring a high level of competence, confidence by the Board of Directors, and over time a track record of investment decisions that prove profitable and meet the VCC's targets.

In designing this approach to management the alternative of contracting with a professional foreign venture capital management company was also considered. This is an often used approach, e.g., by the Asian Development Bank in its

120

planned VCC project in Thailand and by Kenya Equity Capital Ltd in Kenya. The conclusions were that reliance on a foreign management company would be prohibitively expensive, that it would retard or delay the emergence of seasoned local management which ultimately should be in charge, and that there was no certainty that such an approach would produce better performance than local management recruited from the outset and supported by short-term expatriate management assistance, appropriate overseas training including networking with VCC's in other countries, and other short-term start-up support in the VCC's early years.

D. Functions: The four principal functions of management will be: (1) generating an ongoing deal flow; (2) due diligence investigation of potential investments; (3) "value adding" through management support to portfolio companies; and (4) exit from VCC investments. These functions are well described in the ISTI report and other documents in the literature on venture capital. Deal flow will be generated on an active rather than a passive basis, in which the VCC will actively identify and pursue investment opportunities with both domestic and foreign sponsors. It is expected that for every twenty investment projects investigated (due diligence) only one will result in an actual VCC investment. Management and technical assistance via the AID grant will be made available to help establish correct procedures and handle workloads in this phase of VCC operations. In addition to participating in the full feasibility investigation of the most promising subprojects, the VCC is likely to play a direct role in arranging debt finance and various GSL investment approvals (including available incentives) applicable to its portfolio companies. Fees for such services should become a source of income over time. The value adding function is a relatively new concept in Sri Lanka and will involve inputs by the VCC to the management of portfolio companies aimed at ensuring their profitability. AID grant funds will also be used to support this post-investment assistance, which normally would be co-financed by the portfolio companies on a 50% cost share basis. Lastly, the VCC cannot ultimately achieve its own profit objectives unless it defines the means for and actually succeeds in divesting its shares in portfolio companies. To the maximum degree possible, the VCC will encourage portfolio companies to be listed on the Colombo Securities Exchange. Other forms of exit including sale of shares to the subproject sponsors will be determined.

E. Investment Criteria/Policies: The detailed criteria for selection of investments will be adopted by the Managing Director and the VCC Board. It is anticipated that the initial investments will be relatively small and that no single investment will exceed more than 10-15% of VCC capital. All investments will be in companies that are majority owned and controlled by the private sector. There will be a prudent ratio between new start-ups and expansions/diversifications of ongoing businesses. Sectoral and geographic concentration are other factors to be determined. As a condition of USAID support, a detailed set of investment criteria will be developed by the VCC, which address to the satisfaction of their shareholders and USAID, the following:

-- Wholly private ownership and control.

-- Ownership without participation by the VCC investor group (unless VCC ownership becomes sufficiently widespread to make this a handicap, in which case VCC investors would be required to declare their interest and absent themselves from the investment decision process).

121

-- Preference for new ventures or innovative activities.

-- Compliance with GSL environmental, health and safety regulations.

-- No impediment to participation due to ethnic origin, religious preference, or sex.

-- Consideration of foreign partners.

Minimum levels of after tax returns will also be a key criterion as will be projected levels and timing of dividends and capital gains via exit. VCC shareholding in each portfolio company is expected to range from 25-49%. The VCC would invest a maximum of 80% of its capital in its portfolio while retaining at least 20% in reserves to help cover operating costs and unforseen expenses. The average VCC investment per subproject will be in the Rs. 2-5 million range with lower average investments in the first years and a higher average as the VCC capital base expands. As highlighted in the ISTI report, the purpose of the investment criteria will be to produce a balanced portfolio that can yield desired returns in a manner that reduces risk. The skill and experienced judgement of the Managing Director and the VCC Board will be the critical variables.

4. FINANCIAL PLAN OF THE PROJECT COMPONENT

A. Budget Summary

AID grant funds are essential to support the start-up of the VCC in its early years and AID's support recognizes explicitly the ground-breaking nature of the new company. The funds will be used for four purposes: capital equipment costs (about $80,000); a contribution toward VCC operating costs during the VCC's first four years of operation (about $160,000); short-term expatriate and local technical assistance to strengthen VCC management, investigate subprojects and support portfolio companies (about $180,000); and training/promotional activities to expose VCC management as well as the Sri Lankan investment community to venture capital practices (about $80,000).

Table D-1 presents a summary of the budget plan for the component and Table D-2 provides the estimated expenditures by fiscal year. The basis for the cost estimates are as follows: the capital equipment costs are one-time expenditures of the VCC and are listed with estimated costs in Attachment D-1; the annual VCC operating costs over its initial four years are projected at an average of $80,000 per year as illustrated in Table D-4 and will be covered on a 50:50 basis by the AID funds; short-term technical assistance is estimated at six person months at $20,000 per month for expatriate TA and at 24 person months at $2,500 for local TA; overseas training or studies tours will require about $60,000 at an average of $5,000 per month for twelve programs in the U.S. as well as third countries, and $20,000 is budgeted for local promotion work, seminars, etc.

Table D-1: Cost Estimate and Financial Plan ($ 000)

	A.I.D.	VCC	Total
Short-term Technical Assistance	$160	--	$ 160
Training/Promotion	80	--	80
VCC Operating Costs	160	--*	160
Capital Equipment	80	--	80
VCC Capitalization	--	$3,333	$3,333
Total	$500	$3,333	$3,833

*Note: The VCC's contribution toward operating costs will be derived from interest income on VCC capital reserves.

Table D-2: Estimated Expenditure by Fiscal Year ($ 000)
(AID Project Funds Only)

	TA	Trng.	Op.Costs	Equip.	Total
FY 89	$ 45	$20	$ 40	$20	$125
FY 90	45	20	40	20	125
FY 91	45	20	40	20	125
FY 92	45	20	40	20	125
Total	$180	$80	$160	$80	$500

A series of financial scenarios were presented by the ISTI team to a core group of Sri Lankan investors to assist them in arriving at a final decision in regard to making an investment in the VCC. From the eleven scenarios presented, the core group developed an initial plan to proceed with an investment based on the following assumptions:

o The core group of investors would continue to work towards the formation of a VCC starting with an initial investment of Rs. 30 million as an upfront, fully paid in share contribution.

o The VCC would operate initially at a minimum level of cost without sacrificing operational capability. From the relevant scenarious, an annual operational cost of approximately Rs.2.4 million was selected as being realistic and prudent.

o For the VCC to be sustainable the ISTI team showed that capitalization on the order of Rs. 100 million would be required. The core group agreed that it would be necessary to increase paid in capital to Rs. 100 million before the end of the second year of operations.

123

- o Based on other recent investments by DFIs and an analysis of small company performance on the Colombo Securities Exchange, it was felt that a yield of 30% to 40% return on equity (before tax) would be possible over a 5-9 year period.

- o It was determined that as a reserve for contingencies only 80% of the portfolio would be invested while the remainder would be deposited at interest as an earning base to cover operational costs. For the purposes of projections, 15% p.a. was selected as realistic.

- o The earliest time in which the company would be able to operate at a profit would be the 5th year of operations. This will require skillful management, and an improvement in the overall economic performance of the country.

- o Initial investments in sub-projects should be made in carefully selected, high yielding and relatively quick gestating investments, while at the same time stimulating new and innovative ventures. The DFCC which is one of the core group would help by recommending some of the sub-projects for this purpose, thus passing on the benefits of its own due-diligence to the VCC.

The core group is now in the process of putting together a compatible group of initial investors. They are also reworking the financial projections to accomodate changes in the investment climate, perceptions of potential new ventures, and other variables.

5. PRE-FEASIBILITY ANALYSIS

A composit pro-forma financial plan has been produced and included at the end of this section to illustrate the broad outline of the VCC at the time the core group decided to move ahead. The bottom line, based on the assumptions detailed in the proceding section, indicates that the VCC is viable and should be in the black (with USAID assistance) by year three. The reason for showing a relatively early profit is entirely the function of interest earned on deposits; that is, the 20% of capitalization set aside as a researve and not invested in new ventures. It should be noted that although apparently profitable, the VCC falls short of attaining the equivalent interest income should the entire capitalization be placed on deposit. From the investors' point of view, if they put in Rs. 30 million initially and Rs. 70 million in year two, the projected value of their investment in the VCC in year ten is Rs.265 million. However, using the same interest rate (15% p.a.) and schedule of investment, a savings account would yield Rs.336 million in year ten, with considerably less risk.

The core group, though determined to go ahead with the VCC, is currently looking at ways of increasing the return on their investments, paring expenses, and developing alternative sources of income such as service fees, brokerage charges, and other activities which fit within the VCC concept. This will stimulate the investigation of new financial services which if implemented will improve the capital market mechanism.

Prior to entering into a cooperative agreement with the VCC, it will be necessary for the core group to refine the business plan and financial projections to take into account a wider selection of variables, such as interest rates, likely investments, costs of operation, and alternative

SCENARIO (WITH USAID INPUT)

PROPOSED INVESTMENT COMPANY OF SRI LANKA

(1)

PROJECTED
OPERATING STATEMENT

(In Rs 000's)

		YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	YEAR 8	YEAR 9	YEAR 10
INCOME											
DIVIDENDS - NON TAXABLE											
- TAXABLE		0	0	2,500	9,500	21,500	14,500	10,000	10,000	10,000	5,000
INTEREST INCOME											
- DEPOSITS		1,125	926	3,926	4,610	5,424	6,189	8,303	9,723	9,723	11,757
- DEBENTURES											
UNDERWRITING COMMISSIONS											
PROFIT ON SALES OF SHARES							35,000	25,000	0	0	30,000
TOTAL INCOME		1,125	926	6,426	14,110	26,924	55,689	43,303	19,723	19,723	46,757
EXPENDITURE											
TURNOVER TAX	0.01	11	9	64	141	269	557	433	197	197	468
OFFICE RENT		180	180	180	600	600	600	600	600	600	600
SALARIES											
- MANAGING DIRECTOR		720	720	720	720	720	720	720	720	720	720
- SECRETARIES		108	108	108	108	108	108	108	108	108	108
- RECEPTIONIST/TYPIST		72	72	72	72	72	72	72	72	72	72
- MANAGER ANALYST		0	0	0	0	240	240	240	240	240	240
JANITORIAL SERVICES		0	0	0	54	54	54	54	54	54	54
DIRECTORS FEES		0	0	0	0	0	10	10	10	10	10
LEGAL FEES		60	60	60	10	10	10	10	10	10	10
COMPANY SECRETARIAL FEES		30	30	30	30	30	30	30	30	30	30
CONSULTANCY SERVICES		120	120	120	200	200	200	300	300	300	300
TRAVEL & SUBSISTENCE											
PETROL & MAINTENANCE OF CARS											
		1,301	1,299	1,354	1,935	2,303	2,601	2,577	2,341	2,341	2,612

Table D-3

124

PROPOSED INVESTMENT COMPANY OF SRI LANKA (2)

SCENARIO (WITH USAID INPUT)

PROJECTED
OPERATING STATEMENT

(In Rs 000's)

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	YEAR 8	YEAR 9	YEAR 10
EXPENDITURE B/D	1,301	1,299	1,354	1,935	2,303	2,601	2,577	2,341	2,341	2,612
PROMOTIONAL	0	0	0	0	250	250	250	250	250	250
OFFICE SUPPLIES & STATIONERY	180	180	180	180	180	180	180	180	180	180
INSURANCE	12	12	12	12	12	12	12	12	12	12
ELECTRICITY	250	250	250	250	250	250	250	250	250	250
POSTAGE, TELEPHONE, TELEX, CABLE & FAX	180	180	180	180	180	180	180	180	180	180
EQUIPMENT MAINTENANCE	60	60	60	60	60	60	60	60	60	60
OFFICE MAINTENANCE	60	60	60	100	100	100	100	100	100	100
DEPRECIATION										
- OFFICE FURNITURE (10%)	5	5	5	5	5	5	5	5	5	4
- OFFICE EQUIPMENT (25%)	74	74	74	73	0	0	0	0	0	0
- MOTOR VEHICLES (25%)	225	225	225	224	0	0	0	0	0	0
GENERAL EXPENSES	60	60	60	60	100	100	100	100	100	100
CONTINGENCIES	120	120	120							
TOTAL EXPENDITURE	2,527	2,525	2,580	3,079	3,440	3,738	3,714	3,478	3,478	3,748
NET PROFIT/(LOSS) BEFORE TAX	(1,402)	(1,600)	3,845	11,020	22,484	51,951	39,588	16,245	16,245	43,009

Table D-4

D-8

126

PROPOSED INVESTMENT COMPANY OF SRI LANKA (3)

SCENARIO (WITH USAID INPUT)

PROJECTED
OPERATING STATEMENT

(In Rs 000's)

		YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	YEAR 8	YEAR 9	YEAR 10
NET PROFIT/(LOSS) BEFORE TAX		(1,402)	(1,600)	3,845	11,030	23,484	51,951	39,588	16,245	16,245	43,009
		(1,402)	(1,402)	(3,002)	0	0	0	0	0	0	0
INCOME TAX @	0.4	0	0	337	4,412	9,394	20,780	15,835	6,498	6,498	17,204
NET PROFIT/(LOSS) AFTER TAX		(1,402)	(1,600)	3,508	6,618	14,090	31,171	23,753	9,747	9,747	25,806
PROFIT AVAILABLE FOR APPROPRIATION		0	0	506	7,124	21,214	52,385	63,638	58,385	50,132	55,938
APPROPRIATED AS FOLLOWS:											
- RESERVES											
- DIVIDENDS (GROSS)							12,500	15,000	18,000	20,000	25,000
ACCUMULATED PROFITS/(LOSSES) CARRIED FORWARD		(1,402)	(3,002)	506	7,124	21,214	39,885	48,638	40,385	30,132	30,938

Table D-5

127

SCENARIO (WITH USAID INPUT)

PROPOSED INVESTMENT COMPANY OF SRI LANKA (4)

PROJECTED BALANCE SHEET

(In Rs 000's)

SHARE CAPITAL AND RESERVES	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	YEAR 8	YEAR 9	YEAR 10
AUTHORISED SHARE CAPITAL	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000	500,000
ISSUED AND FULLY PAID	30,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000
UNAPPROPRIATED PROFITS	(1,402)	(3,002)	506	7,124	21,214	39,885	48,638	40,385	30,132	30,938
SHAREHOLDERS FUNDS	28,598	96,998	100,506	107,124	121,214	139,885	148,638	140,385	130,132	130,938
GRANTS & AID (US $ 125/YR FOR 4 YEARS ONLY)	3,875	7,750	11,625	15,500	15,500	15,500	15,500	15,500	15,500	15,500
	32,473	104,748	112,131	122,624	136,714	155,385	164,138	155,885	145,632	146,438

Table D-10

SCENARIO (WITH USAID INPUT)

PROPOSED INVESTMENT COMPANY OF SRI LANKA (5)

PROJECTED BALANCE SHEET

(In Rs 000's)

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	YEAR 8	YEAR 9	YEAR 10
REPRESENTED BY:										
PROJECT FINANCING										
ORDINARY SHARES	20,000	75,000	75,000	75,000	75,000	75,000	55,000	75,000	35,000	35,000
PREFERENCE SHARES										
DEBENTURES										
	20,000	75,000	75,000	75,000	75,000	75,000	55,000	75,000	35,000	35,000
PRE-INCORPORATION EXPENSES	55	55	55	55	55	55	55	55	55	55
FIXED ASSETS										
MOTOR VEHICLES	900	900	900	900	900	900	900	900	900	900
OFFICE EQUIPMENT	325	325	325	325	325	325	325	325	325	325
OFFICE FURNITURE	55	55	55	55	55	55	55	55	55	55
	1,280	1,280	1,280	1,280	1,280	1,280	1,280	1,280	1,280	1,280
LESS: ACCUMULATED DEPRECIATION	304	608	912	1,214	1,219	1,224	1,229	1,234	1,239	1,243
	976	672	368	66	61	56	51	46	41	37
CURRENT ASSETS										
CASH IN HAND	4,492	2,071	2.158	3,903	9,498	12,024	30,332	2,084	9,236	2,046
CASH IN DEPOSIT - FIXED	5,000	25,000	25,000	25,000	25,000	36,000	44,000	44,000	44,000	52,000
CASH IN DEPOSIT - CALL	1,950	1,950	9,550	18,600	27,100	32,250	34,700	34,700	57,300	57,300
	11,442	29,021	36,708	47,503	61,598	80,274	109,032	80,784	110,536	111,346
LESS: CURRENT LIABILITIES										
ACCRUED EXPENSES										
	0	0	0	0	0	0	0	0	0	0
NET CURRENT ASSETS	11.442	29,021	36.708	47,503	61,598	80,274	109,032	80,784	110,536	111,346
NET ASSETS	32,473	104,748	112,131	122,624	136,714	155,385	164,138	155,885	145,632	146,438

D-11
Table D-7

129

PROPOSED INVESTMENT COMPANY OF SRI LANKA (6)

SCENARIO (WITH USAID INPUT)

PROJECTED CASH FLOW
(In Rs 000's)

	YR 0	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6	YEAR 7	YEAR 8	YEAR 9	YEAR 10
CASH INFLOW											
NET PROFIT BEFORE INCOME TAX (EXCLUDING INTEREST INCOME)	0	(2,527)	(2,525)	(80)	6,421	18,060	45,762	31,286	6,522	6,522	31,252
ADD: DEPRECIATION	0	304	304	304	302	5	5	5	5	5	4
ISSUED & FULLY PAID SHARES	30000		70,000								
GRANTS & AID (US $ 125/YR)	0	3,875	3,875	3,875	3,875	0	0	0	0	0	0
LOANS											
INTEREST FROM DEPOSITS	375	750	926	3,926	4,610	5,424	6,189	8,303	9,723	9,723	11,757
SALE OF - SHARES (COST)								50,000	70,000	70,000	
TOTAL CASH INFLOW	30375	2,402	72,579	8,024	15,207	23,489	51,956	89,593	86,250	86,250	43,013
CASH OUTFLOW											
PROJECT FINANCING:											
- ORDINARY SHARES	0	20,000	55,000					30,000	90,000	30,000	0
- PREFERENCE SHARES											
- LOAN											
INCORPORATION EXPENSES	55										
PLACEMENTS IN INTEREST BEARING DEPOSITS - FIXED	5000		20,000	0	0	0	11,000	8,000	0	0	8,000
- CALL		1400	0	7600	9050	8500	5150	2450	0	22600	
PURCHASE OF FIXED ASSETS:											
- MOTOR VEHICLES	900										
- OFFICE EQUIPMENT	325										
- OFFICE FURNITURE	55										
WORKING CAPITAL	550										
DIVIDEND PAID	0	0	0	0	0	0	12,500	15,000	18,000	20,000	25,000
TAXATION PAID:		0	0	337	4,412	9,394	20,780	15,835	6,498	6,498	17,204
TOTAL CASH OUTFLOW	6885	21,400	75,000	7,937	13,462	17,894	49,420	71,285	114,498	79,098	50,204
NET CASHFLOW	23490	(18,998)	(2,421)	87	1,745	5,595	2,526	18,308	(28,248)	7,152	(7,190)
CUMULATIVE CASHFLOW	23490	4,492	2,071	2,158	3,903	9,498	12,024	30,232	2.084	9,236	2,046

Table D-8

sources of income. The ISTI team left with the core group a financial model, which a local consultant is versed in using. The core group, at their own expense, will be expected to develop plan and projections for their own use and for review and acceptance by USAID prior to project support.

6. IMPLEMENTATION PLAN

A. Implementation Arrangements

The VCC component will be implemented through a Cooperative Agreement negotiated between AID and the VCC. The agreement will be executed by the AID Contracting Officer/New Delhi pursuant to a USAID-issued PIO/T. The agreement will not be executed until the VCC has been incorporated, a minimum of Rs. 30 million in initial capital has been paid in (not callable capital) by the company sponsors, and the Managing Director has been hired. Further, USAID concurrence with terms of the VCC articles of association, operating policies, financial and business plans, investment criteria and exit mechanisms will be required as a condition precedent to disbursement of funds for operating support. As stated earlier, continued access to funds after two years will be further conditioned on the VCC's capital base having reached at least Rs. 100 million, and a successful review by USAID of VCC activities up to that point. There will be periodic reports to AID on the use of funds and VCC progress, but AID will play no role in any approvals of VCC Board decisions, investment decisions or other operational business decisions.

B. Implementation Schedule

The implementation schedule over the five-year life-of-project is as follows:

7/88:	PSPS Project Grant Agreement signed
9/88:	Conditions Precedent met
10/88:	VCC formed with Rs. 30 million capital
12/88:	Cooperative Agreement signed with VCC
2/89:	RFTP issued
6/89:	Contract signed by VCC with U.S. firm
7/90:	VCC investments reach Rs.24 million
12/90:	VCC capital reaches Rs.100 million
1/91:	Mid-term evaluation
7/91:	VCC investments reach Rs.50 million
7/92:	VCC investments reach Rs.80 million
5/93:	Final evaluation
7/93:	PACD

C. Procurement Plans

Funds in the Cooperative Agreement will be disbursed (a) through reimbursement to the VCC of eligible local cost expenditures under the terms of the agreement and (b) for foreign exchange expenditures for expatriate technical assistance and training through a contract negotiated by the VCC with a U.S. firm specialized in venture capital support services. If necessary, USAID will establish an advance account for local cost expenditures (equipment, operating costs, local short-term TA, local promotion activities) which the VCC will liquidate through monthly submission of documented invoices. The contract will be competitively procured by the VCC and following procedures in A.I.D. Handbook 13. The RFTP will contain the terms of reference for the contractor as developed by the VCC. The successful contractor will work directly for and submit its invoices to the VCC. The VCC will then forward the invoices and supporting documentation to USAID for payment to the contractor. The contractor will be directed to consider Bumpers, Lautenberg, and environmental requirements as defined in the U.S. Foreign Assistance Act and by U.S. regulations, submit to USAID a determination on a case-by-case basis for USAID concurrence.

Equipment procurements are anticipated to be off-shelf from Sri Lankan suppliers, with the exception of one vehicle. The vehicle will be procured by the VCC and be consigned to the VCC. Any customs duties on equipment procurements will be paid by the VCC.

7. JUSTIFICATION FOR A.I.D. GRANT SUPPORT

The Mission has carefully reviewed the A.I.D. Policy Paper on Private Enterprise Development (March 1985, revised). A close review was also made of the recently approved AID support for Kenya Equity Capital, Ltd (KEC), a venture capital company assisted by USAID/Kenya under its Private Enterprise Development Project (615-0238). The total capital investment by the KEC sponsors is to be Kenyan shillings 32 million (about $2 million), i.e., in the same range as the Sri Lankan VCC. The venture capital model which the Mission is introducing to Sri Lanka is likewise very similar to KEC, but the AID support for KEC includes a $4 million line of credit in addition to grant support, and the amount of grant support is just over $2 million compared to one-fourth that amount ($500,000) recommended for the Sri Lankan VCC.

With reference to the A.I.D. Policy Paper, the following justification is made for AID grant support to the VCC in Sri Lanka:

(1) Externalities: The VCC concept is virtually new to Sri Lanka. It will be a pioneering financial institution in the country. The VCC will be both private-owned and profit-oriented. One anticipated externality is that its success will demonstrate the viability of the VCC concept and thereby encourage other venture capital companies to emerge. Another externality is the positive effect predicted on the share market through expanded public issues of shares on the Colombo Securities Exchange, including the VCC's own shares and those of its portfolio companies and, indirectly, other share issues as the advantages of raising equity capital become more apparent to private Sri Lankan companies. A further externality should be the positive demonstration effect of the additional foreign joint ventures which the VCC will generate in its portfolio investments, which would help attract other foreign investment to Sri Lanka. It can also be argued that the expected successful attraction of investments in the VCC by international investment groups will constitute a positive externality.

(2) Extraordinary Costs and Delayed Profits: Because positive returns to VCC shareholders are not expected to be distributed until the sixth year, the cash flow problem this presents and the risks associated with the very newness of starting the VCC in Sri Lanka make it appropriate for AID to assist the VCC in its start-up phase. The ISTI report is predicated on keeping operating costs at Rs. 2-3 million level in the early years. AID start-up support will cover equipment expenditures and a portion (50%) of operational management costs over the first four years. A similar 50% average formula was applied for KEC management/operating costs in Kenya. The VCC will employ a portion of its own capital to generate the balance of operating costs during this period and, combined with other sources of income, all operating costs thereafter. The balance of AID's support for technical assistance and training is viewed as essential in developing and supporting the capacities required for effective VCC management.

The $500,000 is in reasonable balance with the capital invested by the VCC sponsors. Rs.30 million of the sponsors' own funds will be at risk and the presence of the AID funds should not lead to any distortion of sound business management practices. Reinforcement of such practices will be a principal focus of AID's contemplated management assistance.

The Mission views the recommended package as an essential piece in the launching of the new company. This up-front support and the risk-sharing element it represents, following upon AID's catalytic role in introducing the concept, is succeeding in attracting risk capital from the initial investors at a 2:1 ratio (Rs. 30 million level) and eventually an over 6:1 ratio (Rs. 100 million level). AID's role as a development institution will be to help show the way, overcome barriers to establishing a developmentally important entity, and then to withdraw once the concept has been successfully introduced.

Lautenberg and Bumpers Amendments: The Lautenberg amendment does not apply because AID's intent is to support the VCC's institutional development and the general development of private enterprise in Sri lanka. There are no identifiable ultimate beneficiaries which AID is intending to support. In addition, AID will not have authority to approve or disapprove investments made by the VCC. AID's assistance is principally in the form of technical assistance, training and commodities and will be approximately one-sixth of the capital investment by VCC shareholders. Therefore, as a legal matter, the Mission concludes that the Lautenberg amendment will not apply.

With regard to the Bumpers amendment, it is the Mission's understanding that the statute does not apply to projects that are not specifically and principally designed to increase agricultural exports. AID's purpose in supporting the VCC is to assist in the institutional development of the organization and to stimulate the availability of capital for private investment. Technical assistance funded by AID will assist the VCC to evaluate potential investments, but AID will not have approval authority over the investments of the VCC. AID does not intend to direct the VCC to particular types of investment such as agricultural exports as opposed to other types of private enterprise.

However, in accordance with AID/W guidance, the technical assistance contractor will be charged with the responsibility of reviewing all support in light of the provisions of the U.S. Foreign Assistance Act, and will be required to submit a determination for USAID concurrence on a case-by-case basis that assistance to VCC investments is in compliance with the intent of Congress.

Attachment D-1

VCC EQUIPMENT LIST

Typewriters (2) $1,000 each	$ 2,000
Computer system	23,000
Terminals, keyboards and monitors	3,000
Printers (4) $250 each	1,000
Software package	6,000
Air-conditioners	8,000
Photo-copier	4,000
Sedan	12,000
Office furniture	8,000
Telephone system	2,000
Telex and facsimile machine	3,000
Contingency	8,000
Total	$80,000

135

ECONOMIC ANALYSIS

Introduction

Institution-building and policy projects of the type outlined in this document are notorious for "not lending themselves to standard economic appraisal methods". That is only partially true. A standard performance measure, such as an (economic) internal rate of return or a net present value, may in fact be inappropriate or at best uninformative. But the basic question of economic appraisals of projects still needs to be answered: can the resources spent on the project be expected to generate commensurate benefits? Answering that question even tentatively requires some (more or less - mostly more - crude) model building to identify and compare the "with" and "without project" outcomes. Although the numbers themselves may often be of dubious value, the exercise helps to understand the project and get some handle on its potential value. Alternatively, it may help in determining what magnitude impacts should have to make the project worthwhile.

The impacts we are concerned with in this context are clearly in the "end-of-project-status" (EOPS) category. While the Project design identifies a series of specific outputs, which will be relevant for Project monitoring and evaluation, it does not attach any economic dimension to many of these outputs, such as people trained or organizations strengthened. Even in the EOPS category, an economic analysis must step beyond the hoped-for impacts to explore their economic consequences. In that sense, the economic analysis presented here is little more than a systematic exploration of the possible variations in the economic performance of the systems that the Project will be dealing with.

One other question should be addressed in this exploration of likely economic impacts: is the Project creating something that would not otherwise exist, or is it primarily concerned with speeding up something that we expect would happen anyway? Across the four Project components, that is not an easy question to answer. Ultimately, even without the Project, we would expect better arguments and greater assertiveness on the part of the private sector in the policy process, a functioning stock market that has earned investor confidence, a greatly reduced role of the state in directly productive activities, or effective venture financing mechanisms. In that sense, the economic impacts of the Project will be limited in time - the Project only brings these effects sooner. At the same time, though any real progress without the Project might be impossible any time. For example, if the privatization process is mishandled initially, it may doom like efforts for many years into the future. In that case, privatization under the "without project" scenario may not just come later, it may not come at all. The analysis should therefore at least speculate about the time patterns of net impacts.

Overview

Using illustrative examples and quantitative assumptions designed to capture orders of magnitude, the analysis concludes that

* an improved contribution of the private sector to policy formulation would have to lead to only an extremely small gain in the growth rate of private-sector GDP (somewhere around five one-thousandths of a percentage point) to yield benefits commensurate with costs;

* in the capital markets component, the growth in the value of the stock traded would have to increase by about one-quarter of a percentage point to have the Project "break even";

* the privatization component should increase the probability of success for the Government's privatization campaign by some 50 percentage points to generate benefits comparable to costs;

* if the investments expected in the financial plan of the venture capital component materialize, the economic benefits will by far outweigh costs.

Private sector organizations

The private sector organizations component of the Project is expected to improve the contribution of private sector organizations (PSOs) to the formulation, appraisal and implementation of economic policies. Ultimately, making the voice of the private sector better heard and better respected aims at making policies more responsive to the needs of private entrepreneurs. Better policies in turn should lead to higher profits, increased private investment, and faster growth of output and employment. All of these aspects translate into an increased contribution of the private sector to GDP over time. The link between Project activities and such changes in an aggregate measure is of course extremely difficult - if not impossible - to ascertain. Even so, we get some handle on the potential contribution of the Project by determining what changes in private-sector GDP growth would be required to balance total expenditures on this Project component.

The financing plan shows a total cost of $3.2 million for the PSO component with AID contributing close to $2.9 million and the PSOs themselves $350,000. These funds are to be spent over the 5-year LOP at a fairly regular rate. At a discount rate of 15 percent, the present value of this expenditure stream over the five years is $2.15 million.

Now suppose that the downstream effects of the Project can be summarized in terms of an acceleration in the growth rate of the private-sector contribution to the GDP, as investment responds to better incentives and efficiency improves. Over time, such as acceleration (between the "with" and "without" scenarios) would probably build up gradually over the life of the Project and subsequently disappear within a few years, as the incremental effects of the Project become diffused throughout the system. At the end of this period, the extra push provided by the Project will have run its course; beyond that point, the growth rate would be the same for both scenarios, albeit applied to a different base.

Graphically, this assumption can be illustrated as shown in Figure 1 for two different base cases. What should the difference between the two growth rates

137

be, say, at the highest point, to generate a benefit stream in terms of increased value added roughly equal to the Project cost? Miniscule, as it turns out. Total GDP in 1987 in current prices has been estimated at Rs.177.7 billion. Subtracting the contribution of sectors that would probably not be affected by an improved contribution of the private sector to the policy-making process (agriculture, ownership of dwellings, and public administration and defense) leaves about $3.8 billion at current exchange rates. The private sector has been estimated to account for about two-thirds of non-agricultural output. Applying that percentage to value added yields a private-sector GDP of roughly $2.5 billion. For such figures, it does not take much of a change in the average annual growth rate to yield discounted net benefit streams commensurate with Project expenditures on strengthening PSOs.

As an example, assume that private sector GDP is growing at 10 percent a year not an unreasonable estimate, given the recent growth performance of the economy. If that rate were to change by five one-thousandths of a percentage point, from 10 to 10.005 percent, the discounted (at 15 percent) value of the incremental growth in GDP over a 10 year period would be in the neighborhood of $4.5 million, for a benefit-cost ratio of about 2.[1]

Clearly, a change by five one-thousandths in the growth rate is difficult to detect, and even more difficult to attribute to any particular factor. For all intents and purposes, such a miniscule change gets lost in the noise. But the example serves to illustrate the potential of an improved policy environment as a result of better and weightier arguments contributed by the private sector. All that would have to happen is a very small, virtually undetectable increase in private sector performance to yield benefits commensurate with the resources proposed for the PSO component of the Project.

Securities Council and Colombo Securities Exchange

The major impacts of Project support for the Securities Council and the Colombo Securities Exchange will comprise a more vibrant exchange with greater protection for the individual investor. Specifically, under the "with project" scenario we would expect faster growth in the volume of shares traded, faster growth in the average share price because of increased effective demand, and less volatility in share prices. These net differences are likely to disappear over time, as capabilities grow through experience. The Project impact therefore is limited to these temporary differences in gross benefit streams between the "with" and "without Project" scenarios.

Technically, increased volume, higher share prices, and lower investor risk cannot be regarded as net economic benefits. They may engender such economic benefits by steering resources into more productive uses, that is, by improving overall efficiency and thereby creating a net gain in value added, and possibly by redistributing wealth and income by making it feasible for the small investor to participate in the stock market. However, how and whether

[1] At an average annual growth rate of 5 percent, the differential would have to be somewhere between six and seven one-thousandths of a percentage point to obtain the same benefit-cost ratio; in other words, the baseline growth rate matters little.

these ultimate impacts materialize is difficult to establish, even if we are willing to take heroic assumptions as normal, as we do throughout this analysis. Thus, the analysis treats changes in the total value of securities traded as an indicator of benefits attributable to the Project intervention.

The total costs for the Securities Council/Colombo Securities Exchange component of the Project have been estimated at $2.44 million over a period of about 3 1/2 years - corresponding to a discounted (at 15 percent) present value of $1.8 million. In 1987, the total value of shares traded was equivalent to $11.1 million. For illustration's sake, assume that both the number of shares traded and the average value would increase on the average by 10 percent a year in the absence of the Project - presumably a fairly conservative estimate. Assume further that the Project boosts the growth rates for both elements of total turnover for five years, that is, one or two years after the assistance provided under the Project ends, turnover under the "with" and "without" scenarios would grow again at the same rates.

Under these assumptions, how big would the boost have to be to yield a present value of benefits (the turnover differential) over, say, ten years equivalent to the present value of costs? Although greater than for the PSO component, the Project impact could still be fairly small to make it worthwhile: an increase of less than one-fourth of a percentage point - 0.22 percent, to be exact - would yield the increase in benefit streams equivalent to the resources expended.

Verifying such an impact ex post facto may be easier than in the case of the PSO component, but only marginally so. The main problem is of course that the contributions of the Project will be confounded with changes in financial sector policies in general and management of the securities market in particular. After all, the Project is part and parcel of a comprehensive reform. Even such techniques as interrupted time series design will be unable to separate out the various reform elements.

Privatization of State-owned Enterprises

Efficiency gains and distributional effects combine to generate the net economic benefits of the support provided under the Project for the Presidential Commission on Privatization. The estimation of these effects in themselves is difficult enough, as the discussion below shows. It is further complicated by the attribution issue: what role will the Project play in shaping the ultimate outcomes, what share of the benefits should be attributed to resources expended under the Project? We have chosen here to approach this issue in a probability framework. Basically, the difference between the "with" and "without Project" scenarios is defined in terms of the risk of failure - that privatization fails to deliver the benefits at all. The probability of such a failure can be assumed to be greater without the technical and related assistance to be provided under the Project. In this interpretation, the net benefits of the Project are defined in terms of the differences in expected gross benefits between the "with" and "without" cases.

To estimate benefits under either scenario, we have to consider the likely efficiency gains to the economy (a question for comparative static analysis), possible differences in the growth performance of public and privatized enterprises, and any distributional impacts. The net distributional impacts in turn are made up of any uncompensated losses to workers laid off in the process of restructuring and privatization, and the gains to people who are becoming stockholders in the privatized companies as a result of efforts to promote broad-based ownership.

What are the likely efficiency gains? Defining and measuring efficiency presents some complex problems. Probably the most reasonable definition expresses efficiency as the ratio of value added (at border prices) to the sum of labor and capital services, both valued at their shadow (economic) price. The available evidence suggests that privately owned enterprises are more efficient than their state-owned counterparts, other things being equal. If we could in fact quantify such efficiency differences, we could estimate the likely economic impact of privatization of state-owned enterprises simply by comparing the projected performance of these enterprises under public and private ownership.

Unfortunately, we are far from being able to pursue this option seriously. Estimating the value added of public (and comparable private) enterprises at border prices is no trivial task. Similarly, accounting for labor and capital inputs at their shadow prices requires detailed data and analyses which, if they have been done for Sri Lanka, are not accessible.[2] We therefore have to fall back on a more illustrative example which sketches the type and level of impact required to make this component of the overall Project economically attractive.

The illustrative financial analysis in the description of this component assumes that under the Project some Rs.6 billion of assets in state-owned enterprises will be privatized over a period of five years. These enterprises employ some 27,000 people. While the value added per employee is not known, we can assume that it exceeds the Rs.35,000 obtained for industrial enterprises employing at least five workers in the 1983 industry Census. After inflation, that would correspond today to about Rs.50,000 per worker. Since many of the public enterprises are larger and better equipped with capital, we would expect that actual value added per worker is higher than that. The basic contention of privatization argues that resources employed in these enterprises could be used more productively elsewhere in the economy. The estimates of "overstaffing" provide some measure of the possible efficiency gains (although, as just noted, it is far from satisfactory). Suppose we accept the argument used in the calculation of severance pay demands that some 22 percent of the workforce are in excess, that is, that the enterprises could produce the same amount with 22 percent fewer workers were they managed according to efficiency criteria - to be accomplished through privatization. In that case, each remaining worker would become roughly 28 percent more productive.

[2]Some of these estimates could conceivably be derived from the report of the Presidential Tariff Commission on its investigation of effective protection and domestic resource costs which has not yet been released in final form.

140

However, the critical assumption does not concern the - more productive - workers remaining in the enterprises. The value added contributed by the enterprises would increase only if the productivity of these workers were to increase beyond the 28 percent required to make up for the workers expected to be laid off. But the big contribution would come from the workers no longer needed in the now-privatized enterprises. In principle, their productivity should also increase as they move to other activities. In that sense, the severance payments can be viewed as investment funds, either to finance the job search or to provide starting capital for other activities. If successful, these investments would contribute to the creation of value added by these laid-off workers. Thus, as a - conceivably generous - working hypothesis, we may assume that the average productivity of the laid-off workers will correspond to that of the other workers, as they are absorbed into the private sector.

The net present value of the total cost of the privatization component of the Project is close to $20 million, again at our discount rate of 15 percent. If the productivity of the state-owned enterprises physical and human assets increases by the 28 percent just derived when they are transferred to private ownership, the present value of the additional value added generated over a period of 10 years would be in the neighborhood of $42 million. That would imply that the Project should raise the probability of success of the privatization campaign by approximately 50 percentage points - from 25 to 75, or from 50 to 100 - to generate benefits commensurate with total costs.

Venture Capital Company.

The financial feasibility analysis of the venture capital company (VCC) component of the Project provides an adequate basis for assessing its economic viability. It suggets that the financial and economic impacts of the investments to be financed through the paid-in capital will generate benefits far exceeding total costs. Since the main effect of assistance under this project will be to speed up the formation of the VCC and its initial investments, the net benefits attributable to the resources provided under the project are defined in terms of the accelerated incidence of net benefits--jobs and income will be generated earlier. A quick comparison of the range of discounted net benefit streams with project costs suggests that this project component is worthwhile under the assumptions outlined in the VCC analysis.

PSPS SOCIAL ANALYSIS

There are three primary social issues to be analyzed for each major project component: (1) are there social factors which argue for or against the attempt to achieve the project purposes? (2) who will benefit? and who will bear the costs/risks for each project components? and (3) to what extent can the various groups of project participants be expected to behave/respond the way the project design assumes they will behave? That is, are there any social factors which would appear to prevent the project from achieving its purposes?

The first issue will be discussed briefly for the project as a whole; the second and third will be discussed separately for each major component: policy support, privatization, and capital markets. This will be followed by a brief gender analysis.

1. The Overall Project

Inherent in all the project components is the assumption that there is a set of identifiable factors which limit the growth of the economy. These relate to an inadequate policy framework for private sector growth, the dominance of the state sector in the economy, and the limited capital markets. However, if the constraints are successfully addressed, the potential for more rapid growth led by the private sector is substantial. Widespread social benefits are expected to result from the economic growth, particularly increased employment, incomes, and quality of life.

The widespread social benefits expected from the project will be indirect and may involve a time lag beyond the life of project. In fact, if the privatization component proceeds according to plan, there will be immediate social costs, namely loss of employment for some public sector employees. These costs are presumed to be outweighed in the long run by increased employment resulting from more viable and profitable firms under private management and ownership. The GSL has given considerable attention to ameliorating such social costs.

The immediate beneficiaries of all three project components will not be the unemployed or under-employed population, who are intended long range beneficiaries. Rather the immediate beneficiaries will be members of the various chambers (i.e., owners and managers of business and industry), those operating and regulating the stock exchange, and potential investors or entrepreneurs (in privatized industry or in firms whose shares are/will be sold on the stock market).

2. The Policy Support Component

(a) Beneficiary Analysis

The policy support component will provide technical and financial assistance to private chambers of commerce and industry or other business and

142

professional associations. It will build their capacity to analyze and formulate policies that affect their respective sectors. A policy agenda for the project is not laid out in advance, so it is not possible to analyze now who will benefit or lose for particular policy changes which may directly or indirectly result from the project.

The immediate beneficiaries of this component are intended to be the members of the various private business and professional associations whose capacities are to be enhanced. It can be assumed that the associations will focus efforts on policy changes which they presume to be useful to make their respective industries/business profit and expand more.

If policy changes they advocate are adopted by the government, presumably those industries will grow, their owners will profit, and more people will be employed.

There are no obvious losers for this project component. However, policy changes beneficial to one association's member may be at the expense of another association's members. For example, importers and domestic manufacturers of the same product may have competing interests. Policies formulated and promoted by an industry may not be beneficial for the general public or the private sector as a whole.

(b) Participation Analysis

The relevant direct participants for this components are (1) the business and professional associations some of which are expected to be interested in using project assistance for policy analysis, various policy related activities, and dialogue with the government, (2) the US firm hired to administer this component and provide the technical assistance, and (3) a range of government officials who are presumed to be receptive to careful analysis relevant to policy decisions and open to dialogue about existing policy.

There is an experimental quality to attempts to promote policy dialogue on private sector issues even though USAID already has some experience with this under an earlier project. Though there is a long list of associations which are potential recipients of assistance under this component, and several have indicated interest, there is uncertainty how many will be active participants and what degree of effort would be directed toward policy dialogue.

Under the Private Enterprise Promotion Project (383-0082) the Sri Lanka Business Development Centre (SLBDC) was expected to serve as a neutral forum for private sector policy discussions and analysis, as well as private sector policy dialogue with the government. There were some successes (such as SLBDCs role on the Industrial Policy Commission). But generally performance of the policy component did not meet USAID's original expectations. This project will be taking a slightly different approach.

One (cultural) factor which may not change quickly, is that the private sector supporters of SLBDC were very cautious about using or establishing a public forum for policy discussion which might appear critical of the government. Furthermore, whatever its other virtues may have been, SLBDC was not accepted by all as the legitimate spearhead of policy dialogue for the private sector as a whole. In the absence of any other broad based locus for policy activity, this project adopts strategy of supporting policy development activities from the perspective of more narrowly defined interest groups.

3. The Privatization Component

(a) Beneficiary Analysis

The benefits of the government's planned privatization program are somewhat diffuse socially real beneficiaries are not readily identified. The benefits are related to decreased public outlays for operating subsidies, more efficient and competitive firms when operating under private management and incentives, and reduced requirements for management and incentives, and reduced requirements for government borrowing. Ultimately the firms and the economy as a whole are expected to benefit, by removing a factor which limits the growth of the economy. The long range effect should be a increased contribution to economic growth and employment.

In addition, the new owners or stockholders of privatized firms can be presumed beneficiaries of the policy. Yet they will pay for the benefits they receive, and they will assume ownership risks; they will not be receiving something for nothing.

Though the benefits are somewhat diffuse, the costs or risks are not. Privatization, and the resultants responsiveness to profitability, is expected to require short-term reductions in work force in some, if not most, cases. Employees who lose their jobs will bear some of the costs of the privatization. Though there may well be observable patterns in the selection of employees who will lose their jobs, such patterns are not yet apparent.

The government is giving considerable attention to ameliorating the effects on those who lose employment. Various types of benefits in the form of severance payments will attempt to compensate employees who lose jobs. Indeed, the Sri Lankan political culture makes it virtually unthinkable for a government to embark on such a course without addressing such short-term social costs. The economic costs of ameliorating these social costs will be major expenses for the government in privatizing.

(b) Participation Analysis

There are a number of questions about the response of direct and indirect participants in privatization.

Will the government remain supportive of privatization? The leadership of the current government has given its blessing, but such support may not continue if forthcoming elections result in a change in the majority party.

Will the workers who lose jobs go quietly? Or will there be strikes or other efforts to block privatization and keep their jobs? What will be the public response, given the strong undercurrent of socialism which continues to be an important part of the political culture? The government has a strong motivation to select firms initially for privatization where the least controversy is likely. So if strong negative employee or public reactions are provoked, they would seem more likely to occur later in the program.

149

Will investors step in to purchase (or purchase shares in) Privatized business or industries? Again, the first firms selected for privatization are likely to be those for which considerable investor interest is expected, to assure that the program gets off to a successful start. However, if terms under which businesses or industries are offered for sale are not attractive or if investors have any doubt that the firms they purchase will not be re-nationalized, no one would be surprised if buyers did not step forward.

4. Capital Markets Component

(a) Beneficiary Analysis

This component seeks to improve the operation of capital markets in the country through technical assistance, training, and computer assistance for the new stock exchange and the regulatory Securities Council. Again the benefits are expected to be somewhat diffuse socially. Improved operation of the target institutions should help entrepreneurs get access to capital and make it fairly easy for the public to invest in new or growing businesses. As in the other components, this should encourage investment, economic growth, and ultimately increased employment and incomes.

(b) Participation Analysis

The relevant participants in this component are those who buy shares, and firms who offer stock to be traded on the exchange, as well as those actually working in the Exchange or the Council.

The rapid growth of the stock exchange during its short existence provides strong evidence that investors will invest through the market and that businesses will use publicly traded stock as a means of attracting capital.

The project component itself will be more concerned about the "nuts and bolts" of operating and regulating the exchange. So at the component input/output level, the participation issues are likely to revolve around whether the Exchange and Council really desire and will make use of the training and technical assistance and whether they will be organizationally able to absorb the technologies (particularly computerization) that could make the operation much more efficient.

With respect to technical assistance and training, there seems little question that both the Exchange and the Council desire them and seek to make use of them. With respect to computerization, the organizational issues may be more complex as the Exchange switches to a more automated system, with oversight functions for the Council. Whether there is an appreciation of the organizational impact and requirements of these new systems is less certain. Technical assistance may be very important in this respect, not only in the selection, installation, and management of the suitable technologies, but in the use of the technologies to improve effectiveness and efficiency.

5. Gender Analysis

The institutions with which this project will work are predominantly male institutions, a reality which this project will not change. For the policy component, most, but not all, of the relevant business and professional associations are virtually all male organizations. For the few organizations oriented to business and professional women, there is no apparent reason why they would be disadvantaged in seeking policy-related assistance under the project.

Similarly, for the privatization component, the current managers of government owned businesses and the likely managers under private ownership are virtually all men. No data is available breaking down employment by gender in the businesses and industries eligible for privatization. And little is known about how employment in privatized industries would be reduced. Thus there is no current grounds for assessing whether men or women will bear a disproportionate share of the lost employment.

In general the long range impacts on the economy of increasing investment, growth, and employment should benefit both men and women substantially. However, these social benefits will be diffuse enough that any detailed gender analysis of purpose level effects of the project will be difficult.

ANNEX G

දුරකථනය / தொலைபேசி / Telephone: 24183
විදුලි පණිවුඩ / தந்தி / Telegrams: FORAID
ටෙලෙක්ස් / டெலெக்ஸ் / Telex: FORAID Colombo 21232

විදේශ සම්පත් දෙපාර්තමේන්තුව
මුදල් හා ක්‍රම සම්පාදන අමාත්‍යංශය
வெளிநாட்டு வள திணைக்களம்
நிதி, திட்டமிடல் அமைச்சு
DEPARTMENT OF EXTERNAL RESOURCES
Ministry of Finance and Planning

මහලේකම් කාර්යාලය, (3වැනි මහල)
செயலகம், (3ம் தட்டு)
The Secretariat, (3rd Floor)
තැ. පෙ. 277, කොළඹ 1
த. பெ. இல. 277, கொழும்பு 1
P. O. Box 277, Colombo 1

මගේ අංකය / எனது இல. / My No.: CA 9/9/143 B
ඔබේ අංකය / உமது இல. / Your No.:

1988.07. 19

Mr. Gary Nelson,
Acting Director,
USAID.

Dear Mr. Nelson,

On behalf of the Government of Sri Lanka I wish to submit a formal request for USAID Grant Assistance in a sum of around US $. 15 million, to assist the Government in the creation of a policy environment conducive to private sector growth.

As you are aware the Government is committed to the creation of a strong and viable private sector in order to stimulate and expedite the rate of growth of the manufacturing sector and enhance its contribution to the Gross Domestic Product. Accordingly, it is proposed to strengthen the capacity of private sector chambers and organisations to conduct policy research, analysis and dialogue on the issues of concern to the private business community.

In support of this objective and also to assist the Presidential Commission on Privatisation to plan and carry out the Government's Medium Term Privatisation Programme we shall be glad if you could recommend to AID/Washington the grant of the USAID support requested above.

Thanking you for your kind co-operation.

Yours sincerely,

(Mrs. S.L. Kuruppu)
for Director of
External Resources.

147

AID INFO AMB DCM ECON CHRON

NOV 03 1987 5

ZCZCCMO035EHU296
RR RUEHCM
DE RUEHC #1617/01 3062239
ZNR UUUUU ZZH
R 022239Z NOV 87
FM SECSTATE WASHDC
TO AMEMBASSY COLOMBO 1464
BT
UNCLAS SECTION 01 OF 02 STATE 341617

LOC: 222 474
03 NOV 87 0047
CN: 33275
CHRG: AID
DIST: AID

OFFICIAL FILE COPY

AIDAC

E.O. 12356: N/A
TAGS: N/A
SUBJECT: PRIVATE SECTOR POLICY SUPPORT (383-0100): ANPAC REVIEW OF PID

OFFICE	ACT	INFO
DIR		✓
D/D		✓
PDS		
H&G		✓
PPM		
EXO		
CTR		✓
PRJ		
AGR		
HPHR		
ENG		X
PSD		
C & R		
DUE DATE		
ACT TAKEN		

1. SUMMARY: ANPAC MET ON 13 OCTOBER WITH DAA/ANE NORRIS CHAIRING TO REVIEW SUBJECT PID. SUBJECT TO GUIDANCE PROVIDED IN THIS MESSAGE, ANPAC APPROVES PID AND DELEGATES PROJECT AUTHORIZATION TO THE MISSION WITH QUALIFICATION THAT PLANNED PROJECT COMPONENT FOR VENTURE CAPITAL COMPANY (VCC) UNDERGO FURTHER AID/W REVIEW PRIOR TO PROJECT AUTHORIZATION (FOLLOWING DETAILED FEASIBILITY ANALYSIS NOW GETTING UNDERWAY IN THE MISSION.). ANPAC RECOGNIZED THAT POSSIBLE CO-FINANCING OF VCC COMPONENT BY PRE BUREAU WILL BE SUBJECT OF PRE REVIEW, BUT WISHES TO CLARIFY THAT ANE BUREAU WILL ALSO NEED TO REVIEW DETAILED VCC PLAN IRRESPECTIVE OF PRE BUREAU'S DECISION ON WHETHER TO PARTICIPATE. IF PRE REVIEW IS HELD, ANE WILL PARTICIPATE IN JOINT REVIEW; IF NO PRE REVIEW IS HELD AND MISSION WISHES TO PROCEED WITH VCC COMPONENT WITHOUT PRE FUNDS, SEPARATE ANE REVIEW WILL BE HELD. THE MISSION MAY, ON THE OTHER HAND, ELECT TO PROCEED WITH PROJECT WITHOUT VCC COMPONENT. END SUMMARY.

2. OCTOBER 13 ANPAC DISCUSSION OF PRIVATE SECTOR POLICY SUPPORT PROJECT WAS RELATIVELY BRIEF, REFLECTING GOOD RECEPTION PID RECEIVED IN PRC. DISCUSSION INCORPORATED BY REFERENCE MOST RECOMMENDATIONS MADE BY PROJECT REVIEW COMMITTEE ON SPECIFIC ISSUES. THOSE RECOMMENDATIONS, ALONG WITH ADDITIONAL GUIDANCE ON PRC AND/OR ANPAC CONCERNS, FOLLOW IN PARAS. 3 THROUGH 7, BELOW.

3. DONOR COORDINATION VIS-A-VIS PRIVATIZATION: ANPAC NOTED THAT USAID HAS COORDINATED WITH THE WORLD BANK, IMF AND ADB IN ITS APPROACH TO INDUSTRIAL POLICY AND PRIVATIZATION, BUT THAT AID MAY BE TAKING A SOMEWHAT BOLDER STANCE THAN THE MULTILATERAL INSTITUTIONS WITH RESPECT TO PRIVATIZATION. MISSION REPRESENTATIVE SHAPLEIGH INDICATED THAT A NEW WORLD BANK INDUSTRIAL-SECTOR LOAN MAY INCLUDE A COMPONENT AIMED AT QUOTE RESTRUCTURING UNQUOTE STATEOWNED ENTERPRISES (SOE'S), I.E., IMPROVING THEIR EFFICIENCY TO REDUCE FISCAL BURDENS AND POSSIBLY (BUT NOT NECESSARILY) TO PREPARE FOR EVENTUAL DIVESTITURE. AS MISSION MAY BE

NB

AWARE, DIFFERENCES BETWEEN AID AND IBRD APPROACHES TO PRIVATIZATION (E.G., OUR POSITION THAT STRENGTHENING OR MAKING SOE'S MORE EFFICIENT IS NOT CONSIDERED A SUBSTITUTE FOR PRIVATIZATION) HAS BEEN THE SUBJECT OF A NUMBER OF INFORMAL WORLD BANK/AID DISCUSSIONS IN WASHINGTON, IN BOTH COUNTRYSPECIFIC AND GENERAL CONTEXTS. IN DESIGNING PRIVATIZATION COMPONENT OF PSPS PROJECT, MISSION SHOULD SEEK TO LEAD DONOR EFFORTS IN THIS AREA AND TO ENSURE THAT THE GSL RECEIVES CONSISTENT POLICY GUIDANCE, ESPECIALLY BETWEEN OURSELVES AND THE BANK.

4. GSL PRIVATIZATION STRATEGY: ANPAC NOTED THAT THE GSL HAS MADE A GOOD START ON PRIVATIZATION OF SOES WITH ESTABLISHMENT OF THE PRESIDENTIAL COMMISSION ON PRIVATIZATION, INCLUSION OF PRIVATIZATION AS A MAJOR COMPONENT OF THE RECENT REPORT OF THE INDUSTRIAL POLICY COMMITTEE, AND IDENTIFICATION OF INITIAL DIVESTITURE TARGETS. ANPAC MEMBERS ALSO FELT, HOWEVER, THAT IMPORTANT STRATEGIC ISSUES REMAIN TO BE ADDRESSED IN A COMPREHENSIVE PRIVATIZATION STRATEGY. (SUCH A STRATEGY WOULD CONSIDER SUCH ISSUES AS THE ABSORPTIVE CAPACITY OF THE LOCAL INVESTORS AND MANAGERS TO CAPITALIZE AND MANAGE SOES AND THE IMPACTS OF PRIVATIZATION ON EMPLOYMENT AND COMPETITIVENESS.) IT WOULD ALSO INCLUDE A SCHEDULE LEADING EVENTUALLY TO TOTAL DIVESTITURE (OR CLOSURE) OF SOES, AND SHOULD SEEK TO ENSURE THAT PRIVATIZATION RESULTS IN COMPLETE PRIVATE CONTROL OF THE ENTERPRISES IN QUESTION. ANPAC SUGGESTS THAT THE MISSION CONSIDER WHETHER TO REQUIRE THAT THE GSL DEVELOP AND PUBLISH A FORMAL PRIVATIZATION STRATEGY AS A CONDITION PRECEDENT TO DISBURSEMENT OF THE PRIVATIZATION FUND (SEE PARA. 5 BELOW).

5. PRIVATIZATION FUND: ANPAC GENERALLY ENDORSED CONCEPT OF PRIVATIZATION FUND WITH DISBURSEMENTS TO BE TRIGGERED EX POST FACTO AS REIMBURSEMENT TO GSL FOR ACTUAL COSTS ASSOCIATED WITH COMPLETED PRIVATIZATION ACTIONS. SUCH COSTS, ANPAC UNDERSTOOD, MIGHT INCLUDE RETRAINING, SEVERANCE PAYMENTS AND TEMPORARY SOCIAL SERVICES FOR WORKERS MADE REDUNDANT BY EFFICIENCY IMPROVEMENTS. IN DEVELOPING THIS COMPONENT OF PROJECT, MISSION SHOULD ESTIMATE POTENTIAL TOTAL COSTS OF PRIVATIZATION PROGRAM AND MAGNITUDE AND DISTRIBUTION (IF POSSIBLE BY SECTOR, GEOGRAPHIC DISTRICT AND INCOME GROUP) OF IMPACTS ON AFFECTED WORKERS. MISSION IS ALSO URGED TO EXPLORE POSSIBILITY OF UTILIZING PL-480 RESOURCES, PARTICULARLY TITLE II, FOR THIS PURPOSE.

6. VENTURE CAPITAL COMPANY (VCC):
BT
#617

NNNN

149

A. DESIGN PROCEDURE: ANPAC RECOGNIZED THAT IMPORTANT DETAILS REMAIN TO BE WORKED OUT IN THE PLANS FOR A NEW PRIVATE SRI LANKAN INVESTMENT COMPANY THAT WOULD RECEIVE SOME START-UP SUPPORT FROM AID IN A JOINT MISSION/PRE EFFORT, THAT DETAILED FEASIBILITY ANALYSIS IS NOW GETTING UNDERWAY IN THE MISSION, AND THAT FURTHER PRE BUREAU REVIEW WILL BE UNDERTAKEN ON COMPLETION OF THAT ANALYSIS IF PRE DECIDES TO ADVANCE TO FORMAL CONSIDERATION OF CO-FINANCING VCC WITH PRE FUNDS. IT WAS ANPAC'S VIEW THAT ANE BUREAU WILL ALSO NEED TO REVIEW DETAILED VCC PLAN IRRESPECTIVE OF PRE BUREAU'S DECISION ON WHETHER TO PARTICIPATE. IF PRE REVIEW IS HELD, ANE WILL PARTICIPATE IN JOINT REVIEW; IF NO PRE REVIEW IS HELD AND MISSION WISHES TO PROCEED WITH VCC COMPONENT WITHOUT PRE FUNDS, SEPARATE ANE REVIEW WILL BE HELD AND WILL BE BASED ON DETAILED DESIGN FOR VCC TO BE PROVIDED TO AID/W BY MISSION.

B. RELATIONSHIP TO A.I.D. POLICY: ANPAC NOTED THAT IN THE PID, THE MISSION'S CONTRIBUTION TO THE VCC IS PLANNED AS A GRANT. WHILE ANPAC RECOGNIZED THAT THE PID DESCRIBES PROPOSED ASSISTANCE TO VCC AS TA AND GUARANTY, ANPAC REQUESTS MISSION, WHEN PREPARING DETAILED VCC PLAN, TO REFER TO AID POLICY PAPER ON PRIVATE ENTERPRISE DEVELOPMENT, WHICH GENERALLY DOES NOT PERMIT EQUITY CONTRIBUTIONS TO PROFITMAKING ENTERPRISES, AND WHICH DESCRIBES LIMITED CIRCUMSTANCES IN WHICH GRANT ASSISTANCE TO SUCH ENTERPRISES MAY BE JUSTIFIED. SUCH JUSTIFICATION SHOULD BE INCLUDED IN THE VCC PLAN THAT WILL BE REVIEWED IN AID/W IF MISSION ELECTS TO INCLUDE VCC COMPONENT IN PROJECT AS A GRANT. ANOTHER ISSUE TO BE ADDRESSED IN THE VCC PLAN IS A DISCUSSION OF THE IMPLICATIONS OF THE VCC'S SUB-PROJECTS FOR AID COMPLIANCE WITH REQUIREMENTS OF BUMPERS AND LAUTENBERG AMENDMENTS TO FAA.

7. ADDITIONAL GUIDANCE:

A. CONTRACTING MECHANISMS: PRC NOTED THAT THE THREE PROJECT COMPONENTS INCLUDE PLANS FOR A CONSIDERABLE RANGE OF TA SERVICES (TECHNICAL, FINANCIAL, LEGAL) AND THAT PID PROPOSES USE OF A SINGLE TA CONTRACTOR. PRC MEMBERS QUESTIONED WHETHER THE VARIED TYPES OF EXPERTISE REQUIRED COULD BEST BE PROCURED FROM A SINGLE FIRM, OR WHETHER SUCH AN ARRANGEMENT MIGHT CREATE CONFLICT-OF-INTEREST SITUATIONS, ESPECIALLY IN CASES OF PRIVATIZATION IN WHICH CONTRACTOR MIGHT ASSIST WITH VALUATION OF SOE ASSETS IN PREPARATION FOR PUBLIC OFFERING, WHILE ALSO ASSISTING PRIVATE PARTIES INTERESTED IN ACQUIRING PRIVATIZED COMPANIES. IN DESIGNING IMPLEMENTATION PLAN, AID/W SUGGESTS MISSION CONSIDER THE APPROPRIATENESS OF USING A SINGLE TA CONTRACTOR.

B. MONITORING AND EVALUATION: PID CITES NEED FOR CLOSE PROJECT MONITORING, LISTS POSSIBLE KEY VARIABLES TO MONITOR, AND BUDGETS FOR EVALUATION UNDER A GENERAL LINE

10

ITEM THAT ALSO INCLUDES INFLATION AND CONTINGENCIES. AID/W BELIEVES THE PP SHOULD BE MORE SPECIFIC ON HOW THE PROJECT WILL COLLECT DATA ON ITS IMPACT ON INDUSTRIAL DEREGULATION, PRIVATIZATION OF SOE'S AND DEVELOPMENT OF CAPITAL MARKETS, AND ON HOW SUCH IMPACTS AFFECT NATIONAL INCOME AND EMPLOYMENT. AID/W RECOMMENDS THAT A MEMBER OF PP DESIGN TEAM ADDRESS THE EVALUATION ISSUES, DEVELOP A MONITORING AND EVALUATION SYSTEM AND DEVELOP A BUDGET FOR THE EVALUATION PLAN USING THE AGENCY GUIDELINES AS STATED IN DOCUMENT ENTITLED QUOTE GUIDELINES FOR DATA COLLECTION, MONITORING AND EVALUATION PLANS FOR AID-ASSISTED PROJECTS, UNQUOTE.

C. MINORITY BUSINESS UTILIZATION: PER SHAPLEIGH DISCUSSION WITH ANE/PD/MBO (HEMP), AID/W REQUESTS THAT MISSION INDICATE IN PP WHAT CONSIDERATION IS TO BE GIVEN TO GRAY AMENDMENT ENTITIES IN THE CONTRACTING PROCESS, INCLUDING POSSIBILITY OF AN HISTORICALLY BLACK COLLEGE/UNIVERSITY PROVIDING SHORT TERM TRAINING.

SHULTZ

BT

#1617

NNNN

157

AID INFO AMB DCM ECON CHRON

VZCZCCMO086EHU323
PP RUEHCM
DE RUEHC #5142/01 1770744
ZNR UUUUU ZZH
P 250741Z JUN 88
FM SECSTATE WASHDC
TO AMEMBASSY COLOMBO PRIORITY 4241
BT
UNCLAS SECTION 01 OF 03 STATE 205142

LOC: 149 447
27 JUN 88 0306
CN: 19625
CHRG: AID
DIST: AID

JUN 27 1988

AIDAC

E.O. 12356: N/A
TAGS:
SUBJECT: PRIVATE SECTOR POLICY SUPPORT (383-0100): VENTURE CAPITAL COMPONENT

OFFICE	ACT	INFO
D, DD		✓
RLA		
HSG		
PM		✓
SYO		
CTR		
PRJ		✓
AGR		
ENG		
PSD	X	
C&R		
DUE DATE 6/30		
ACT. TAKEN		
FILE STA		
NAN		
INITIALS		

REF: (A) 87 STATE 341617 (B) COLOMBO 3037

1. PROJECT REVIEW COMMITTEE (PRC) MET ON 24 MAY TO DISCUSS REFTEL B DESCRIPTION OF SUBJECT PROJECT PAPER COMPONENT. PRC APPRECIATED MISSION'S ANALYSIS OF THE KEY ISSUES RAISED IN OCTOBER 1987 PID REVIEW, PARTICULARLY ON RELATIONSHIP OF PROPOSED VENTURE CAPITAL COMPANY (VCC) TO REQUIREMENTS OF AID POLICY PAPER ON PRIVATE ENTERPRISE WITH RESPECT TO AID-FUNDED CONCESSIONAL SUPPORT OF PROFIT-MAKING ENTERPRISES. KEY ISSUES DISCUSSED BY PRC INCLUDED: JUSTIFIABILITY OF GRANT SUPPORT TO VCC; COMPOSITION OF CORE INVESTOR GROUP AND ITS EVENTUAL EXPANSION; ROLE OF THE DEVELOPMENT FINANCE COMPANY OF CEYLON (DFCC); INVESTMENT CRITERIA; EXIT MECHANISM AND PROSPECTS FOR TIMELY DIVESTITURE OF PORTFOLIO COMPANIES; APPLICABILITY OF BUMPERS, LAUTENBERG AND ENVIRONMENTAL STATUTORY REQUIREMENTS; PERFORMANCE CRITERIA FOR SECOND DISBURSEMENT TRANCHE; AND IMPLEMENTATION MECHANISMS. AFTER EXTENDED

DISCUSSION OF THESE ISSUES, PRC RECOMMENDED AND AA/ANE CONCURS THAT MISSION MAY PROCEED TO AUTHORIZE PROJECT INCLUDING VCC COMPONENT, SUBJECT TO GUIDANCE PROVIDED BELOW.

2. JUSTIFIABILITY OF GRANT SUPPORT TO VCC

A. PRC GENERALLY FELT THAT MISSION HAD PROVIDED ADEQUATE CASE FOR GRANT SUPPORT TO VCC, CONSISTENT WITH AID POLICY PAPER ON PRIVATE ENTERPRISE. THIS VIEW WAS BASED ON THE PERSPECTIVE THAT VCC ACTIVITY CONSTITUTES AN EXPERIMENTAL INTERVENTION INTO THE SRI LANKAN CAPITAL MARKETS IN ORDER TO REMEDY A DEFICIENCY IN THOSE MARKETS (I.E., A SHORTAGE OF EQUITY CAPITAL FOR NEW OR INNOVATIVE ENTERPRISES). PRC FELT THAT AID SUPPORT SHOULD BENEFIT PRIVATE SRI LANKAN VENTURE CAPITALISM GENERALLY, RATHER THAN PROVIDING AN ADVANTAGE TO ONE SPECIFIC PRIVATE VENTURE CAPITAL COMPANY OR ITS OWNERS. PRC FELT ESPECIALLY THAT OTHER PRIVATE AGENTS WHO MIGHT

152

WISH TO FORM VENTURE CAPITAL ENTITIES OR CLOSE SUBSTITUTES SHOULD BE ENSURED A LEVEL PLAYING FIELD. HENCE MISSION SUPPORT FOR START-UP COSTS OF VCC SHOULD AVOID PROVIDING SPECIAL ADVANTAGE TO THIS GROUP AND SHOULD AIM, INSTEAD, AT MEETING ONLY THOSE COSTS ASSOCIATED WITH ITS DISADVANTAGED POSITION AND UNUSUAL RISK IN BEING THE FIRST PRIVATELY-HELD VENTURE CAPITAL ENTITY IN SRI LANKA. MISSION MAY WANT TO CONSIDER SOME SORT OF FLEXIBLE AID FINANCING INSTRUMENT SUCH AS VARIABLE TERMS LINKED TO VCC'S SUCCESS, IN LIEU OF STRAIGHT GRANT TERMS; PRC RECOGNIZES, HOWEVER, THAT THE RELATIVELY SMALL AND PILOT NATURE OF THIS ENTERPRISE MAY MAKE THE DESIGN AND NEGOTIATION OF SUCH INSTRUMENTS NOT WORTHWHILE.

B. PRC FELT THAT THE NEED TO AVOID INAPPROPRIATE SUBSIDY MIGHT CALL FOR ELIMINATION OF PROPOSED AID FINANCING OF FIXED ASSETS SUCH AS CAPITAL EQUIPMENT FOR VCC OPERATION; MISSION IS ADVISED TO CONSIDER THIS OPTION CAREFULLY AND TO AVOID FINANCING EQUIPMENT WITH GRANT FUNDS THAT COULD YIELD A LONG-TERM COMPETITIVE ADVANTAGE FOR THE VCC. AID SUPPORT FOR TECHNICAL ASSISTANCE AND TRAINING SHOULD, ON THE OTHER HAND, HAVE SPIN-OFF BENEFITS TO OTHER ACTORS AND ENTITIES IN THE FINANCIAL COMMUNITY AND TO FUTURE VENTURE CAPITAL ENTITIES.

C. AS THE VCC IS A HIGH-PROFILE, HIGH-RISK VENTURE, MISSION MAY WANT TO EXPLORE POSSIBLE ADVANTAGES OF

DELIVERING START-UP SUPPORT FOR VCC VIA A COOPERATIVE AGREEMENT, WHICH CONVEYS A HIGHER DEGREE OF MISSION OVERSIGHT RESPONSIBILITY, RATHER THAN A GRANT AGREEMENT. COOPERATIVE AGREEMENTS HAVE BEEN USED IN SIMILAR ACTIVITIES IN LAC BUREAU, AND HAVE ALLOWED AID TO REMEDY IMPLEMENTATION PROBLEMS THROUGH ACTIVE PERFORMANCE MONITORING.

3. ROLE OF THE DEVELOPMENT FINANCE CORPORATION (DFCC)

A. PRC CONTINUES TO BE CONCERNED ABOUT THE ONE-THIRD OWNERSHIP OF THE VCC BY THE DFCC, WHICH IS ITSELF 41 OWNED BY STATE-HELD BANKS. WHILE RECOGNIZING THAT THIS IS ONLY A MINORITY GOVERNMENT HOLDING AND IS FURTHER MITIGATED BY THE DFCC'S AUTONOMY AND PRIVATE STYLE OF OPERATION, THE PRC NONETHELESS FELT THAT MISSION SHOULD BE AWARE OF THE POWERFUL ROLE THE DFCC IS LIKELY TO PLAY ON THE VCC BOARD AND SHOULD ENDEAVOR TO DILUTE ITS STRENGTH AND ENSURE THAT GSL HOLDINGS DECLINE AS A PERCENTAGE OF TOTAL EQUITY AT THE TIME OF THE CAPITAL EXPANSION FROM RS. 30 MILLION TO RS. 100 MILLION WITHIN
BT
#5142

NNNN

THE FIRST TWO YEARS OF OPERATION. BASIC POLICY REQUIREMENT SHOULD BE PREVENTION OF GSL, OR ITS AGENTS, FROM DOMINATING VCC BOARD.

[illegible]. BROAD OWNERSHIP OF THE VCC SHOULD BE AN OBJECTIVE OF THE PROJECT. ASSUMING USAID WILL HAVE AN OPPORTUNITY TO REVIEW AND EFFECTIVELY APPROVE VCC CHARTER (OR OTHER APPROPRIATE FOUNDING DOCUMENTS) BEFORE COMMITTING AID FUNDS TO ITS SUPPORT, PRC SUGGESTS THAT MISSION REQUIRE VCC CHARTER INVESTORS TO OFFER VCC SHARES TO OUTSIDERS FIRST AT TIME OF EXPANSION, AND THAT 30 PERCENT LIMIT ON HOLDINGS BY ANY ONE PARTY BE REDUCED AT TIME OF EXPANSION TO LOWER FIGURE SUCH AS 25 OR EVEN 20 PERCENT. IN ADDITION TO REDUCING POSSIBILITY OF EXCESSIVE DFCC OR OTHER GOVERNMENT INFLUENCE ON VCC, SUCH A BROADENING WOULD FURTHER ENSURE THAT AID SUPPORT BENEFITS VENTURE CAPITALISM GENERALLY, RATHER THAN A SMALL AND PRIVILEGED GROUP OF CAPITAL INVESTORS OF GOVERNMENT-CONTROLLED INVESTMENT BANKS.

4. OTHER EQUITY PARTICIPATION ISSUES

A. EXPANSION OF VCC'S CAPITAL BASE MAY ALSO RAISE THE POSSIBILITY OF EQUITY PARTICIPATION IN VCC BY PRIVATIZED COMPANIES IN WHICH THE GSL STILL HOLDS A MINORITY OWNERSHIP POSITION. PRC RECOMMENDED THAT AFTER INITIAL START-UP, NO ENTITIES WITH PUBLIC-SECTOR OWNERSHIP

(OTHER THAN DFCC, WHOSE INFLUENCE SHOULD BE PHASED OUT STARTING WITH EXPANSION OF OWNERSHIP BASE TO RS. 100 MILLION) BE PERMITTED TO PARTICIPATE IN THE VCC AS INVESTORS. TO PERMIT OTHERWISE COULD RISK FAILURE TO ACHIEVE THE PRIVATE-SECTOR INTENT OF THE PROJECT.

B. MISSION MAY WISH TO ENCOURAGE THE VCC GROUP TO OFFER VCC EMPLOYEES A STOCK OPTION PLAN AS PART OF THEIR COMPENSATION. FOR THE MANAGING DIRECTOR, ESPECIALLY, SUCH AN OPTION COULD PROVIDE AN ATTRACTIVE PERFORMANCE INCENTIVE AND A MEANS OF AUGMENTING SALARY TO ATTRACT EXPERIENCED ENTREPRENEURIAL TALENT. THIS APPROACH HAS BEEN QUITE SUCCESSFUL IN OTHER VENTURE CAPITAL ENTERPRISES.

5. INVESTMENT CRITERIA

A. PRC FELT STRONGLY THAT WHILE USAID WILL NOT HAVE A ROLE IN APPROVAL OF SPECIFIC SUBPROJECT INVESTMENTS MADE BY THE VCC, IT SHOULD, AS A CONDITION FOR ITS SUPPORT, PLAY A STRONG ROLE IN THE INITIAL DEVELOPMENT OF CRITERIA FOR SELECTION OF VCC INVESTMENTS. AMONG THE CRITERIA THE MISSION SHOULD MANDATE (IN ADDITION TO THE OBVIOUS CRITERION OF ECONOMIC AND FINANCIAL VIABILITY) ARE: WHOLLY PRIVATE OWNERSHIP OF THE CANDIDATE COMPANY (THUS ELIMINATING ANY PARTIALLY PRIVATIZED COMPANY); OWNERSHIP WITHOUT PARTICIPATION BY INDIVIDUAL MEMBERS OR MEMBER INSTITUTIONS OF THE VCC INVESTOR GROUP (I.E., NO INSIDER DEALS); PREFERENCE TO INVESTMENT IN NEW ENTITIES OR IN NEW AND INNOVATIVE (I.E., HIGH-RISK) ACTIVITIES OF

154

PORTFOLIO COMPANIES.

7. APPLICABILITY OF BUMPERS, LAUTENBERG AND ENVIRONMENTAL REQUIREMENTS OF FAA

PRC, WITH CONCURRENCE OF GC/ANE, AGREES WITH MISSION THAT BUMPERS AND LAUTENBERG REQUIREMENTS ARE NOT CURRENTLY RELEVANT TO AID SUPPORT FOR VCC. HOWEVER, BECAUSE OF PLANNED TA FOR PRE-INVESTMENT AND, OF GREATER CONCERN, POST-INVESTMENT QUOTE VALUE ADDING UNQUOTE ASSISTANCE, AID FUNDS COULD BE USED FOR DIRECT TECHNICAL ASSISTANCE TO ACTIVITIES WITH IMPLICATIONS FOR BUMPERS AND/OR LAUTENBERG, AS WELL AS ENVIRONMENTAL ASSESSMENT REQUIREMENTS. PRC SUGGESTS THAT TA CONTRACTOR BE DIRECTED TO CONSIDER POSSIBLE APPLICABILITY OF THESE REQUIREMENTS ON A CASE-BY-CASE BASIS BEFORE UNDERTAKING UCH INVESTMENT ASSISTANCE ACTIVITIES AND SUBMIT TO USAID A DETERMINATION FOR MISSION CONCURRENCE REGARDING SUCH APPLICABILITY AND COMPLIANCE PLANS.

8. PERFORMANCE CRITERIA FOR SECOND AND SUBSEQUENT TRANCHES

REFTEL B INDICATES THAT AID GRANT SUPPORT FOR VCC BEYOND INITIAL TRANCHE WILL BE CONDITIONED UPON FINDING THAT INITIAL CAPITAL SUBSCRIPTION OF RS. [illegible] MILLION HAS BEEN EXPANDED TO RS. 100 MILLION. PRC RECOMMENDS THAT MISSION CONSIDER ADDITIONAL PERFORMANCE CRITERIA SUCH AS COMPLETION OF INVESTMENT OF SPECIFIED PORTION OF

EXISTING CAPITAL AND MECHANISM FOR EXPANSION OF OWNERSHIP BASE ALONG WITH INCREASE IN CAPITAL. INTERIM EVALUATION PRIOR TO RELEASE OF SECOND TRANCHE SHOULD LOOK CLOSELY AT QUESTIONS OF IMPACT AND [illegible] TO INSURE THE AID SUPPORT IS HAVING INTENDED POSITIVE EFFECT ON BROADER CAPITAL MARKETS, THAT OTHER GROUPS INTERESTED IN PROMOTING VENTURE CAPITAL ARE NOT DISADVANTAGED BY AID SUPPORT FOR THIS INITIAL ENTITY, AND THAT NO POPULATION GROUP IS DISADVANTAGED IN TERMS OF ACCESS TO VCC RESOURCES OR SERVICES

EXISTING ENTITIES, SUCH AS DEVELOPMENT OF A WHOLLY NEW PRODUCT LINE OR ENTRY INTO A NEW MARKET; COMPLIANCE WITH APPLICABLE GSL ENVIRONMENTAL, HEALTH AND SAFETY REGULATIONS; POTENTIAL BENEFIT (OR AT LEAST NO IMPEDIMENT) TO ALL ETHNIC/RELIGIOUS COMMUNITIES AND TO WOMEN. WHILE REFTEL B INDICATES THAT THE VCC WILL INITIALLY BE A WHOLLY INDIGENOUS ENTITY, PRC ASSUMES THAT FOREIGN PARTICIPATION IN PORTFOLIO VENTURES WILL NOT BE PRECLUDED. MISSION MAY WISH TO ENCOURAGE VCC MANAGERS TO INCLUDE JOINT VENTURES WITH FOREIGN PARTNERS AS A POSITIVE FACTOR (BUT NOT A REQUIREMENT) AMONG INVESTMENT CRITERIA.

5. PRC RECOMMENDS THAT USAID CONCURRENCE WITH TERMS OF VCC CHARTER, BY-LAWS, OPERATING POLICIES, INVESTMENT CRITERIA AND EXIT MECHANISMS BE A CONDITION PRECEDENT TO DISBURSEMENT OF AID GRANT FUNDS FOR OPERATING SUPPORT OF THE VCC.

6. EXIT MECHANISMS AND PROSPECTS FOR TIMELY DIVESTITURE OF PORTFOLIO COMPANIES

[illegible] ENCE WITH SIMILAR VENTURES IN LATIN AMERICA [illegible] IS DANGER OF VCC BECOMING A HOLDING

B. REGARDING PROCUREMENT OF COMMODITIES, AS INDICATED IN PARA. 2 ABOVE, SOME PRC MEMBERS QUESTIONED WHETHER AID FUNDS SHOULD BE USED FOR CAPITAL EQUIPMENT. IF MISSION ELECTS TO SUPPORT SUCH PROCUREMENT, IT MAY BE MOST EFFICIENT TO LEAVE ACTUAL PROCUREMENT TO VCC ITSELF ON A REIMBURSABLE BASIS. SUCH A COURSE WOULD REQUIRE, OF COURSE, THAT VCC HAVE IN PLACE PROCUREMENT AND ACCOUNTING PROCEDURES AND POLICIES ACCEPTABLE TO AID. SHULTZ
BT
#5142

NNN

LOG FRAME FOR PRIVATE SECTOR POLICY SUPPORT PROJECT

Narrative Summary	Verifiable Indicators	Means of Verification	Assumptions
Goal: To assist the GSL to increase national employment and incomes by the creation of a policy environment conducive to private sector growth.	Growth rate in the manufacturing sector - 5% decrease in public enterprises; 18% increase in private sector.	Central Bank reports and statistics on national accounts and trade	Private Sector investment increases in response to policy changes and other PSPS stimuli. Relatively stable political/security environment.
Purpose: (3) 1. To strengthen the contribution of the private sector to the formulation, appraisal and implementation of market oriented economic policies;	1a. Enhanced capacity of individual PSOs and PSO community to participate effectively in influencing business and economic policy. 1b. Enhanced credibility of PSOs on part of GSL and public. 1c. PSO ability to engage in dialogue strengthened. 1d. Increased PSO contribution to national economic development plans.	1. Project designed reporting by contractor, and project evaluation.	1. Active participation by public and private institutions in PSPS.
2. To contribute to the successful privatization of a significant number of state-owned enterprises to a broad spectrum of private investors;	2a. Private Sector contributing to greater efficiency and productivity. 2b. Enhanced appreciation of relative roles of government and private sector in productive enterprises. 2c. More investors will own shares in SOEs. 2d. Increased private sector confidence 2e. Established institutional capacity in GSL for privatization.	2. Project designed reporting by contractor, and project evaluation.	2. Political will to carry out established program.

3. To develop the capacity of the Sri Lankan capital market to broaden public equity participation in the economy and increase capital resources for investment.	3a. Regulatory climate will inspire confidence. 3b. Greater equity investment in private enterprise. 3c. More broadly based ownership of equity instruments. 3d. New methods of financing. 3e. Formation of new enterprises.	Central Bank reports, Colombo Securities Exchange reports, and project evaluation.	3. Political climate continues to improve, and private sector actively participates.
Outputs			
1. Industrial and commercial policies conducive to economic growth formulated and instituted.	1a. 15-20 analytical activities of policy research and by PSOs. 1b. 15-20 desimination activities (seminars,workshops) 1c. 5-10 workshops or seminars for groups of PSOs to develop skills to deal with policy issues.	1-4. Contractor reports, field inspection by USAID, evaluations, GSL reports, audits, and project monitoring systems.	1-4. GSL, private sector organizations, and USAID inputs forthcoming in timely fashion. Private sector receptive to programs and willing/able to participate. GSL willing/able to implement recommended policies.
2. GSL privatization program well advanced, with significant number of SOEs actually divested.	2a. Controlling interest divested to private sector: 2 SOEs in CY88; 10 SOEs by end of CY90; Up to 24 SOEs by PACD. 2b. Additional management assistance and worker training delivered to privatized SOEs.		
3. Securities Council operational; Colombo Securities Exchange playing expanded role in serving capital markets.	3a. Securities Council in full operation. 3b. 2 computer systems installed in CSE. 3c. Modernized operating regime in CSE.		
4. Venture Capital Company established,profitable, and divesting portfolio to public.	4a. Establishment of VCC 4b. 10 new investments. 4c. 1-2 holdings divested to public.		

5C(2) - PROJECT CHECKLIST

Listed below are statutory criteria applicable to projects. This section is divided into two parts. Part A includes criteria applicable to all projects. Part B applies to projects funded from specific sources only: B(1) applies to all projects funded with Development Assistance; B(2) applies to projects funded with Development Assistance loans; and B(3) applies to projects funded from ESF.

CROSS REFERENCES: IS COUNTRY CHECKLIST UP TO DATE? HAS STANDARD ITEM CHECKLIST BEEN REVIEWED FOR THIS PROJECT?

A. GENERAL CRITERIA FOR PROJECT

1. FY 1988 Continuing Resolution Sec. 523; FAA Sec. 634A. If money is sought to obligated for an activity not previously justified to Congress, or for an amount in excess of amount previously justified to Congress, has Congress been properly notified? — Yes via CN

2. FAA Sec. 611(a)(1). Prior to an obligation in excess of $500,000, will there be (a) engineering, financial or other plans necessary to carry out the assistance, and (b) a reasonably firm estimate of the cost to the U.S. of the assistance? — Yes

3. FAA Sec. 611(a)(2). If legislative action is required within recipient country, what is the basis for a reasonable expectation that such action will be completed in time to permit orderly accomplishment of the purpose of the assistance? — N/A

4. FAA Sec. 611(b); FY 1988 Continuing Resolution Sec. 501. If project is for water or water-related land resource construction, have benefits and costs been computed to the extent practicable in accordance with the principles, standards, and procedures established pursuant to the Water Resources Planning Act (42 U.S.C. 1962, et seq.)? (See A.I.D. Handbook 3 for guidelines.)

   N.A.

5. FAA Sec. 611(e). If project is capital assistance (e.g., construction), and total U.S. assistance for it will exceed $1 million, has Mission Director certified and Regional Assistant Administrator taken into consideration the country's capability to maintain and utilize the project effectively?

   N.A.

6. FAA Sec. 209. Is project susceptible to execution as part of regional or multilateral project? If so, why is project not so executed? Information and conclusion whether assistance will encourage regional development programs.

   N.A.

7. FAA Sec. 601(a). Information and conclusions on whether projects will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture and commerce; and (f) strengthen free labor unions.

   Project will foster policy reforms leading to a greater reliance on free market mechanisms, encourage the development of private business organizations, privatize state enterprises and reduce government involvement in private business activities.

8. FAA Sec. 601(b). Information and conclusions on how project will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise).

   U.S. commodities and services will be procured.

9. FAA Secs. 612(b), 636(h). Describe steps taken to assure that, to the maximum extent possible, the country is contributing local currencies to meet the cost of contractual and other services, and foreign currencies owned by the U.S. are utilized in lieu of dollars.

   Government and private sector contributions are an estimated 55% of direct project costs.

10. FAA Sec. 612(d). Does the U.S. own excess foreign currency of the country and, if so, what arrangements have been made for its release? — No

11. FY 1988 Continuing Resolution Sec. 521. If assistance is for the production of any commodity for export, is the commodity likely to be in surplus on world markets at the time the resulting productive capacity becomes operative, and is such assistance likely to cause substantial injury to U.S. producers of the same, similar or competing commodity? — N.A.

12. FY 1988 Continuing Resolution Sec. 553. Will the assistance (except for programs in Caribbean Basin Initiative countries under U.S. Tariff Schedule "Section 807," which allows reduced tariffs on articles assembled abroad from U.S.-made components) be used directly to procure feasibility studies, prefeasibility studies, or project profiles of potential investment in, or to assist the establishment of facilities specifically designed for, the manufacture for export to the United States or to third country markets in direct competition with U.S. exports, of textiles, apparel, footwear, handbags, flat goods (such as wallets or coin purses worn on the person), work gloves or leather wearing apparel? — No

13. FAA Sec. 119(g)(4)-(6). Will the assistance (a) support training and education efforts which improve the capacity of recipient countries to prevent loss of biological diversity; (b) be provided under a long-term agreement in which the recipient country agrees to protect ecosystems or other wildlife habitats; (c) support efforts to identify and survey ecosystems in recipient countries worthy of protection; or (d) by any direct or indirect means significantly degrade national parks or similar protected areas or introduce exotic plants or animals into such areas? — No

14. FAA 121(d). If a Sahel project, has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of project funds (either dollars or local currency generated therefrom)? N.A.

15. FY 1988 Continuing Resolution. If assistance is to be made to a United States PVO (other than a cooperative development organization), does it obtain at least 20 percent of its total annual funding for international activities from sources other than the United States Government? N.A.

16. FY Continuing Resolution Sec. 541. If assistance is being made available to a PVO, has that organization provided upon timely request any document, file, or record necessary to the auditing requirements of A.I.D., and is the PVO registered with A.I.D.? N.A.

17. FY 1988 Continuing Resolution Sec. 514. If funds are being obligated under an appropriation account to which they were not appropriated, has prior approval of the Appropriations Committees of Congress been obtained? N.A.

18. FY Continuing Resolution Sec. 515. If deob/reob authority is sought to be exercised in the provision of assistance, are the funds being obligated for the same general purpose, and for countries within the same general region as originally obligated, and have the Appropriations Committees of both Houses of Congress been properly notified? N.A.

19. State Authorization Sec. 139 (as interpreted by conference report). Has confirmation of the date of signing of the project agreement, including the amount involved, been cabled to State L/T and A.I.D. LEG within 60 days of the agreement's entry into force with respect to the United States, and has the full text of the agreement been pouched to those same offices? (See Handbook 3, Appendix 6G for agreements covered by this provision). N.A.

B. FUNDING CRITERIA FOR PROJECT

1. Development Assistance Project Criteria

a. FY 1988 Continuing Resolution Sec. 552 (as interpreted by conference report). If assistance is for agricultural development activities (specifically, any testing or breeding feasibility study, variety improvement or introduction, consultancy, publication, conference, or training), are such activities (a) specifically and principally designed to increase agricultural exports by the host country to a country other than the United States, where the export would lead to direct competition in that third country with exports of a similar commodity grown or produced in the United States, and can the activities reasonably be expected to cause substantial injury to U.S. exporters of a similar agricultural commodity; or (b) in support of research that is intended primarily to benefit U.S. producers?

N.A.

b. FAA Secs. 102(b), 111, 113, 281(a). Describe extent to which activity will (a) effectively involve the poor in development by extending access to economy at local level, increasing labor-intensive production and the use of appropriate technology, dispersing investment from cities to small towns and rural areas, and

While no project funds will be used for direct interventions vis a vis, geographic distribution, technological diversity, gender specific support or administrative decentralization, the effects of the planned project activities on promoting free market development will lead to such impacts where financially viable. Project activities are keyed to promoting Sri Lanka's capacity for economic development at home and in the international market place.

insuring wide participation of the poor in the benefits of development on a sustained basis, using appropriate U.S. institutions; (b) help develop cooperatives, especially by technical assistance, to assist rural and urban poor to help themselves toward a better life, and otherwise encourage democratic private and local governmental institutions; (c) support the self-help efforts of developing countries; (d) promote the participation of women in the national economies of developing countries and the improvement of women's status; and (e) utilize and encourage regional cooperation by developing countries.

c. <u>FAA Secs. 103, 103A, 104, 105, 106, 120-21</u>. Does the project fit the criteria for the source of funds (functional account) being used?

Yes

d. <u>FAA Sec. 107</u>. Is emphasis placed on use of appropriate technology (relatively smaller, cost-saving, labor-using technologies that are generally most appropriate for the small farms, small businesses, and small incomes of the poor)?

N.A.

e. <u>FAA Secs. 110, 124(d)</u>. Will the recipient country provide at least 25 percent of the costs of the program, project, or activity with respect to which the assistance is to be furnished (or is the latter cost-sharing requirement being waived for a "relatively least developed" country)?

Yes. An estimated 55% of the direct costs.

f. <u>FAA Sec. 128(b)</u>. If the activity attempts to increase the institutional capabilities of private organizations or the government of the country, or if it attempts to stimulate scientific and technological research, has it been designed and will it be monitored to ensure that the ultimate beneficiaries are the poor majority?

Yes. The Project is designed to enhance the capabilities of private business organizations. The Project is designed to promote economic expansion in part through economic reforms that will benefit all strata of Sri Lankan society - including the poor majority by increasing domestic investment and employment.

g. FAA Sec. 281(b). Describe extent to which program recognizes the particular needs, desires, and capacities of the people of the country; utilizes the country's intellectual resources to encourage institutional development; and supports civil education and training in skills required for effective participation in governmental processes essential to self-government.

The Project is designed to respond to local needs and capabilities by providing TA, training and information services to Sri Lankans affected by government policies. The project was designed in collaboration with institutions with which it will work.

h. FY 1988 Continuing Resolution Sec. 538. Are any of the funds to be used for the performance of abortions as a method of family planning or to motivate or coerce any person to practice abortions?

No

Are any of the funds to be used to pay for the performance of involuntary sterilization as a method of family planning or to coerce or provide any financial incentive to any person to undergo sterilizations?

No

Are any of the funds to be used to pay for any biomedical research which relates, in whole or in part, to methods of, or the performance of, abortions or involuntary sterilization as a means of family planning?

No

i. FY 1988 Continuing Resolution. Is the assistance being made available to any organization or program which has been determined to support or participate in the management of a program of coercive abortion or involuntary sterilization?

No

If assistance is from the population functional account, are any of the funds to be made available to voluntary family planning projects which do not offer, either directly or through referral to or information about access to, a broad range of family planning methods and services?

N.A.

j. FAA Sec. 601(e). Will the project utilize competitive selection procedures for the awarding of contracts, except where applicable procurement rules allow otherwise?

Yes

k. FY 1988 Continuing Resolution. What portion of the funds will be available only for activities of economically and socially disadvantaged enterprises, historically black colleges and universities, colleges and universities having a student body in which more than 20 percent of the students are Hispanic Americans, and private and voluntary organizations which are controlled by individuals who are black Americans, Hispanic Americans, or Native Americans, or who are economically or socially disadvantaged (including women)?

None

l. FAA Sec. 118(c). Does the assistance comply with the environmental procedures set forth in A.I.D. Regulation 16? Does the assistance place a high priority on conservation and sustainable management of tropical forests? Specifically, does the assistance, to the fullest extent feasible: (a) stress the importance of conserving and sustainably managing forest resources; (b) support activities which offer employment and income alternatives to those who otherwise would cause destruction and loss of forests, and help countries identify and implement alternatives to colonizing forested areas; (c) support training programs, educational efforts, and the establishment or strengthening of institutions to improve forest management; (d) help end destructive slash-and-burn agriculture by supporting stable and productive farming practices; (e) help conserve forests which have not yet been degraded by helping to increase production on lands already cleared

Yes re compliance; assistance deemed subject to categorial exclusion as unrelated to natural resource management issues.

or degraded; (f) conserve forested watersheds and rehabilitate those which have been deforested; (g) support training, research, and other actions which lead to sustainable and more environmentally sound practices for timber harvesting, removal, and processing; (h) support research to expand knowledge of tropical forests and identify alternatives which will prevent forest destruction, loss, or degradation; (i) conserve biological diversity in forest areas by supporting efforts to identify, establish, and maintain a representative network of protected tropical forest ecosystems on a worldwide basis, by making the establishment of protected areas a condition of support for activities involving forest clearance or degradation, and by helping to identify tropical forest ecosystems and species in need of protection and establish and maintain appropriate protected areas; (j) seek to increase the awareness of U.S. government agencies and other donors of the immediate and long-term value of tropical forests; and (k)/utilize the resources and abilities of all relevant U.S. government agencies?

m. FAA Sec. 118(c)(13). If the assistance will support a program or project significantly affecting tropical forests (including projects involving the planting of exotic plant species), will the program or project (a) be based upon careful analysis of the alternatives available to achieve the best sustainable use of the land, and (b)/take full account of the environmental impacts of the proposed activities on biological diversity? — N.A.

n. FAA Sec. 118(c)(14). Will assistance be used for (a) the procurement or use of logging equipment, unless an environmental assessment indicates that all timber harvesting operations involved will be conducted in an environmentally sound manner and that the proposed activity will produce positive economic benefits and sustainable forest management systems; or (b) actions which will significantly degrade national parks or similar protected areas which contain tropical forests, or introduce exotic plants or animals into such areas? — No

o. FAA Sec. 118(c)(15). Will assistance be used for (a) activities which would result in the conversion of forest lands to the rearing of livestock; (b) the construction, upgrading, or maintenance of roads (including temporary haul roads for logging or other extractive industries) which pass through relatively undegraded forest lands; (c) the colonization of forest lands; or (d) the construction of dams or other water control structures which flood relatively undegraded forest lands, unless with respect to each such activity an environmental assessment indicates that the activity will contribute significantly and directly to improving the livelihood of the rural poor and will be conducted in an environmentally sound manner which supports sustainable development? — No

p. FY 1988 Continuing Resolution If assistance will come from the Sub-Saharan Africa DA account, is it (a) to be used to help the poor majority in Sub-Saharan Africa through a process of long-term development and economic growth that is equitable, participatory, environmentally sustainable, and self-reliant; (b) being provided in — N.A.

accordance with the policies contained in section 102 of the FAA; (c) being provided, when conistent with the objectives of such assistance, through African, United States and other PVOs that have demonstrated effectiveness in the promotion of local grassroots activities on behalf of long-term development in Sub-Saharan Africa; (d) being used to help overcome shorter-term constraints to long-term development, to promote reform of sectoral economic policies, to support the critical sector priorities of agricultural production and natural resources, health, voluntary family planning services, education, and income generating opportunities, to bring about appropriate sectoral restructuring of the Sub-Saharan African economies, to support reform in public administration and finances and to establish a favorable environment for individual enterprise and self-sustaining development, and to take into account, in assisted policy reforms, the need to protect vulnerable groups; (e) being used to increase agricultural production in ways that protect and restore the natural resource base, especially food production, to maintain and improve basic transportation and communication networks, to maintain and restore the natural resource base in ways that increase agricultural production, to improve health conditions with special emphasis on meeting the health needs of mothers and children, including the establishment of self-sustaining primary health care systems that give priority to preventive care, to provide increased access to voluntary family planning services, to improve basic literacy and mathematics especially to those outside the formal educational system and to improve primary education, and to develop income-generating opportunities for the unemployed and underemployed in urban and rural areas?

2. Development Assistance Project Criteria (Loans Only)

a. FAA Sec. 122(b). Information and conclusion on capacity of the country to repay the loan at a reasonable rate of interest. N.A.

b. FAA Sec. 620(d). If assistance is for any productive enterprise which will compete with U.S. enterprises, is there an agreement by the recipient country to prevent export to the U.S. of more than 20 percent of the enterprise's annual production during the life of the loan, or has the requirement to enter into such an agreement been waived by the President because of a national security interest? N.A.

c. FY 1988 Continuing Resolution. If for a loan to a private sector institution from funds made available to carry out the provisions of FAA Sections 103 through 106, will loan be provided, to the maximum extent practicable, at or near the prevailing interest rate paid on Treasury obligations of similar maturity at the time of obligating such funds? N.A.

d. FAA Sec. 122(b). Does the activity give reasonable promise of assisting long-range plans and programs designed to develop economic resources and increase productive capacities? N.A.

170

3. Economic Support Fund Project Criteria

a. FAA Sec. 531(a). Will this assistance promote economic and political stability? To the maximum extent feasible, is this assistance consistent with the policy directions, purposes, and programs of Part I of the FAA? N.A.

b. FAA Sec. 531(e). Will this assistance be used for military or paramilitary purposes? N.A.

c. FAA Sec. 609. If commodities are to be granted so that sale proceeds will accrue to the recipient country, have Special Account (counterpart) arrangements been made? N.A.

Annex K

PERFORMANCE INDICATORS FOR INCREASING THE ROLE OF THE PRIVATE SECTOR

A. Introduction: Program Objectives

The January 1987 CDSS update outlines the principal objectives of the Mission's private sector agenda. The overall strategic objective is to increase the role of the private sector in the economy and conversely, decrease the role of the state.

Private sector development proceeds in many dimensions. Translating the overall program into a series of four objectives, at a fairly high level of aggregation, seeks to capture the major dimensions:

1. Stimulate specific private sector enterprise undertakings: this objective focuses on the formation of new and the growth of existing private sector enterprises.

2. Stimulate the privatization of state-owned enterprises: subsidies for inefficient state-owned enterprises contribute to Sri Lanka's budget problems. Perhaps more importantly, protection for these enterprises against competition from abroad (through the trade regime) and from within (through the granting of monopolies) continues as the major source of market distortions that hamper private sector development. The Mission pursues both direct privatization of enterprises, the sale of a majority of the stock to private investors, and the indirect privatization of key sectors of the economy through the removal of government monopolies and encouragement of private competition.

3. Strengthen the capital markets and enhance the availability of capital, to meet the requirements of the private sector and to facilitate privatization: policies on money and credit, including the financing of chronic budget deficits, have been found inadequate to promote rapid private sector growth. Monetary policies need to move toward greater flexibility to make long-term debt and equity capital available to private investors. A financial sector more attuned to the needs of private sector development will also require more dynamic institutions, in particular in equity markets and among institutional investors.

172

4. Strengthen institutions that promote the private sector, with specific attention to the need for better coordination among the private sector institutions to increase their collective influence on national economic issues: with some significant exceptions, cultural and political traditions in Sri Lanka have led to the voluntary acceptance of government primacy and guidance of the private sector. While the government will continue to play a key role through its overall economic policies, leadership and support for private sector development must come increasingly from the private sector itself.

The Mission's program pursues these objectives both through targeted interventions within the existing policy environment, and through the promotion of improvements in the policy framework. At the level of the four intermediate objectives, the import of contributions of the program varies relative to other factors, such as political or climatic conditions.

Given the nature of the Mission's private sector portfolio, project-level objectives and associated indicators often cover or describe program objectives. Monitoring program performance therefore will rely to some extent on project monitoring and evaluation, as outlined below.

B. Development of Indicators

1. Strategic Indicators: Private Sector

The overall goal indicator for our private sector policy agenda should provide information on the growth of the private sector relative to that of the economy as a whole. Unfortunately, available statistics do not allow for a breakdown of measures such as value added or investment between private-sector and state-owned enterprises. The Mission recently commissioned an effort to obtain a baseline description, but considerable uncertainty remains. As an interim measure, we have therefore adopted the relative growth of private to public enterprises in the manufacturing sector, included as an indicator under the privatization objective. Progress means that the public sector is shrinking and the private sector growing at a healthy rate. Targets are discussed under the privatization heading.

173

2. Program Indicators

a. Formation and growth of private sector enterprises (#1)

USAID cannot expect to influence the formation and growth of private enterprises across the economy significantly. Instead, it has targeted the Mahaweli for such direct impacts under its Mahaweli Enterprise Development Project (MED - 383-0090) now in the final design stage. The final project design will include specific benchmarks regarding the creation of new enterprises, the growth of existing establishments, and the impact of these project-induced changes on regional employment and income.

Across the economy as a whole, the Mission pursues the first program objective by seeking the reduction and elimination of policy-induced distortions that discriminate against small-scale enterprises in the private sector, potentially the major force in creating jobs and raising (rural as well as urban) incomes. Thus relevant performance indicators describe the extent of existing distortions and changes in them over time.

Three indicators serve to characterize the extent of policy discrimination against small-scale enterprises, and to measure progress toward a more favorable policy regime.

* sectoral rates of effective protection versus firm size distribution to measure the extent to which the trade regime favors larger firms

* the incidence of export promotion measures administered by the Export Development Board (EDB) and related programs by firm size, in indication of the relative benefits accruing to small-scale export-oriented businesses. .

* the ratio of average nominal rates of tariffs for imported capital equipment between large and small-scale production establishments, with any bias typically a result of classifying capital equipment used by micro-enterprises as consumer goods.

The first performance indicator will build on the work done by the Presidential Tariff Commission (PTC) with assistance from the World Bank, expected to be made available to the Mission in the near future. The PTC has estimated effective protection rates for key sectors,

174

which can be arrayed against descriptors of sectoral firm size distribution. Using changes in nominal tariffs to update estimates of effective protection, and annual enterprise surveys to update measures of size distribution will allow us to track performance in this area. Performance targets will be set in terms of movement toward neutrality in effective protection versus firm size distribution. USAID contribution to the achievement of these targets will include work with private sector organizations under the Private Sector Support Project (PSPS -- 383-0100), macroeconomic analysis and policy dialogue with GSL institutions, monitoring of and support for initiatives by multilateral donors, in particular the World Bank, and possibly the use of PL 480 self-help measures.

The second performance indicator will be constructed and monitored based on information provided by the Export Development Board (EDB). Here performance targets will be stated as movement toward service delivery commensurate with share in total exports. In addition to the program interventions referred to in the preceding paragraph, the Mission will also seek to improve the treatment of small-scale exporters through its MED Project.

For the third measure, we are in the process of constructing a basket of "representative capital goods" for small-scale enterprises and for their medium and large counterparts in three key sectors: food and beverages, garments and textiles, and wood and wood products. Trade-weighted nominal tariffs for imported equipment likely to be used in small-scale production will then be expressed as a ratio of the corresponding trade-weighted tariffs for larger operations. For example, import duties on sewing machines "certified by the Ministry of Industries and Scientific Affairs as industrial type" are 5 percent, plus the 1- percent business turnover tax (BTT). For other sewing machines, the duty is 25 percent, plus the 10 percent BTT yielding a ratio of 35/15 = 2.33. Performance targets will be stated in terms of moving this ratio toward unity, that is, equal treatment for enterprises of all sizes. We will target a ratio of 1.5 for 1990 as a benchmark and expect unity by 1992. The Mission will pursue these targets through policy analysis and dialogue, possibly through support for policy studies under the Development Studies and Training Project (DS&T - 383-0085) and project-level interventions in the context of the MED Project.

175

b. Privatization of state-owned enterprises (#2)

The principal performance indicator for the privatization objective is the actual divestiture of government-owned or controlled enterprises to private investors, defined as the transfer of a controlling interest to the private sector. The Mission will pursue this objective primarily through its support to the Presidential Commission on Privatization under the PSPS and DS&T projects. These project-level interventions will be complemented by our policy dialogue with the GSL and with other donors, notably the World Bank, where we have been (quite successfully) encouraging more attention to privatization as part of the structural adjustment process. We expect to have two SOEs privatized by 1988 and 10 turned over by 1990.

Another important indicator is the contribution of public enterprises to total employment and output which reflects any success of indirect privatization through policy regimes that favor the growth of private enterprise. In pursuing this aspect of the second objective, the Mission has complemented its policy dialogue with self-help measures under its PL 480 Title I program, specifically one aimed at breaking up the public monopoly in the seed industry. We will also monitor developments in other sectors, such as the insurance sector, until recently a monopoly of state-owned enterprises, and follow the changing distribution between public and private insurance companies which have just started. Manufacturing sector growth rates by 1990 for the public and private sectors should be down 5% and up 18% respectively. Private insurance companies should account for 15% of the market by the same year.

c. Strengthen capital markets and enhance the availability of capital (#3)

Analysis of Sri Lanka's financial sector has identified two major issues relevant to the Mission's private sector strategy -- the preferential treatment of the public sector, and the institutional weakness of equity markets. The Private Sector Policy Support Project directly addresses the latter with its support for the Securities Council and the Colombo Securities Exchange. Performance indicators in that Project focus on the improvements in the quantity and quality of stock market transactions. With respect to the preferential treatment of the public sector, the Mission's program is concerned with the advantages public enterprises enjoy in their access to capital, and with the degree to which the Government is monopolizing capital markets.

176

(1) Capital market distortions: subsidies for public enterprises

Ultimately, public enterprises should be privatized. Until then, curtailing special privileges, such as low capital costs because of subsidies and government guarantees, should improve their efficiency, and more importantly, create new opportunities for private enterprises. Together with other donors, the Mission is encouraging the Government to reduce direct and indirect subsidies. Progress on this front can be described in terms of three indicators of direct subsidies:

* annual operating subsidies from the government to non-financial public enterprises (expected to be not more than Rs. 1.2 billion by 1990 as measured in 1982 rupees);

* annual capital transfers from the government to non-financial public enterprises (expected to be not more than Rs. 5.4 billion by 1990 as measured in 1982 rupees).

* (net) lending to enterprises (expected to be not more than Rs. 1.5 billion by 1990 as measured in 1982 rupees).

The Mission is pursuing this subobjective through its policy dialogue, to be enhanced by the technical assistance to the Privatization Commission under the PSPS Project.

(2) Capital market distortions: financing the budget deficit

Weaknesses of financial markets are often a consequence of restrictions designed to assure financing of the budget deficit. Relaxing this tight grip on key elements of the financial sector is essential for increased flexibility and improved performance. Key descriptors of existing restrictions relate to the placement of Treasury bills and the options for major mobilizers of funds.

* The percentage of Treasury bills placed with the "non-captive" sector, providing some measure of the shift to open market operations; this indicator may also be a proxy for movement toward market-determined interest rates led by Treasury bill auctions. The benchmark is 25% by 1990;

* the percentage of the assets of three major mobilizers of funds, the National Savings Bank (NSB), the Employees' Provident Fund (EPF), and the Employees' Trust Fund (ETF) in investments other than government securities. The benchmark is 10% for each institution by 1990.

The Mission has been pursuing this subobjective primarily through its policy dialogue and conditionality under its Housing Guarantee program, focusing on rationalizing interest rate structures through reduced government control and increased open-market financing of the deficit.

d. Strengthening private sector institutions (#4)

The Mission has been pursuing this objective through financial and technical assistance to private-sector institutions under the Private Enterprise Promotion Project, cooperative agreements with institutions such as the Sri Lanka Business Development Center, and its policy dialogue. Efforts in this area will be significantly enhanced by the PSPS Project, which will establish specific benchmarks, through assistance to a broad range of private sector institutions. Program performance will therefore be monitored at the PSPS Project level.

C. Assessment of Program Impact

Formation and growth of private sector enterprises

Recent economic policy reforms, in particular the continuing liberalization of the trade regime, are likely to have reduced biases against small-scale enterprises. Since the Mission's attention has only recently shifted to this particular area, its direct contribution to any progress has been marginal. The Mission program has contributed to the formation and growth of individual enterprises through its support for the Sri Lanka Business Development Center, the Employment, Investment and Enterprise Development Division of the Mahaweli Authority, and the International Executive Service Corps.

Privatization of state-owned enterprises

Progress in this areas has been limited to the sale of some assets and the arrangement of management contracts. More significant is perhaps progress in establishing the groundwork for a systematic privatization of state-owned enterprises. In its policy dialogue, for example, in the framework of the Donor Group Meetings, USAID has been pressing the Government for a detailed "blueprint" for privatization. Such a blueprint has in fact emerged from the work of the Privatization Commission. USAID has also contributed to this process by providing technical assistance.

178

Strengthen capital markets and enhance the availability of capital

Exhibit I shows the behavior of the three performance indicators of subsidies to public enterprises over the last 6 years. The patterns suggest relatively little change, except in capital transfers in 1987, when they dropped by some 29 percent in real terms. The direct contribution of the program to this change is of course difficult to assess, but both economic necessities and donor encouragement have played a role in the Government's determination to curtail access to cheap capital for public enterprises.

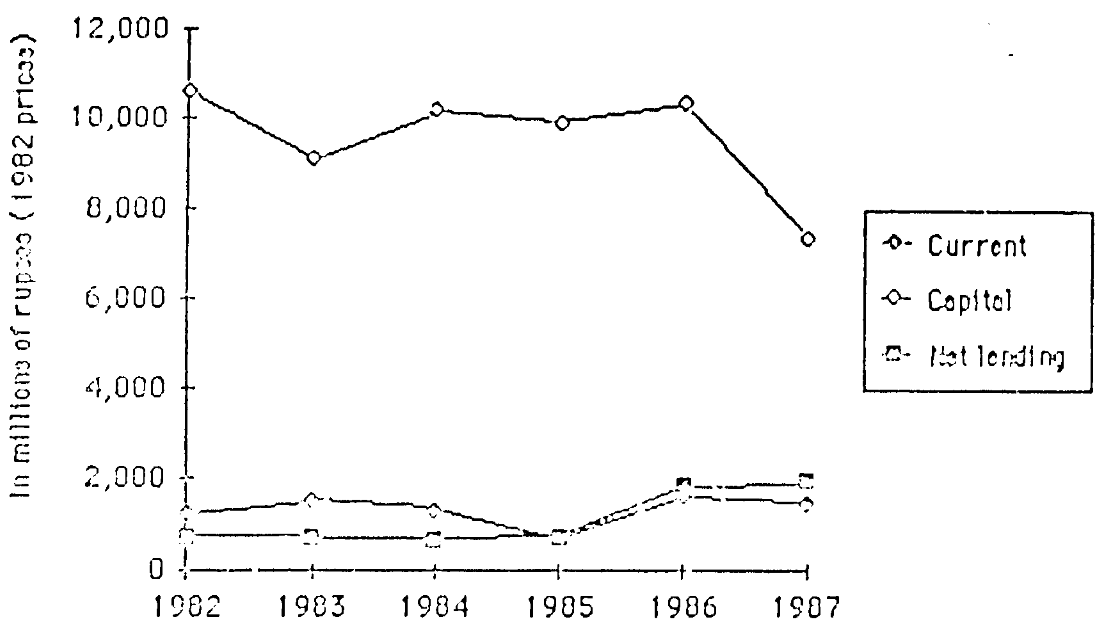
With respect to the other two performance measures, a significant shift has been the introduction of open auctions for Treasury bills in early 1987. The effects of this innovation are beginning to take hold, with the possibility that the auction rates will lead a system of market-oriented interest rates. USAID has supported this process through analysis and HG conditionality.

Strengthening private sector institutions

The principal tangible accomplishment here has been the establishment and emergence of the Sri Lanka Business Development Center. Other achievements have been of a more qualitative nature, such as the participation of private sector representatives in policy formulation and appraisal.

PRMU0007

Exhibit I
Assistance to public enterprises



120

Performance Indicators	Baseline (1987)	Target 1988	Target 1990	Observations/notes
Program objective 1: Formation and growth of private sector enterprises				-
1. Ratio of average nominal tariffs for imported capital equipment between large and small-scale enterprises	2.33	2	1.5	Baseline ratio based example (sewing machines), to be updated with basket
2. Sectoral rates of effective protection versus firm size by industry	???	???	???	Implementation dependent on access to EPR study by PTC/World Bank
3. Incidence of export promotion measures administered by the EDB between large and small-scale enterprises	???	???	???	Data sought from Export Development Board
Program objective 2: Privatization of state-owned enterprises				
4. State-owned enterprises privatized (Transfer of controlling interest to private investors)	0	2	10	
5. Growth rates in the manufacturing sector - Public enterprises - Private sector	 -1% 15%	 -5% 18%	 -5% 18%	
6. Share of private insurance companies in total insurance business	0%	5%	15%	The insurance monopoly of the government was relaxed in 1987
Program objective 3: Strengthen capital markets and enhance availability of capital				
7. Annual operating subsidies for PE's	Rs. 1,491 mn.	Rs. 1,350 mn	Rs. 1,200 mn.	In 1982 rupees
8. Annual capital transfers to PE's	Rs. 7,371 mn.	Rs. 6,650 mn.	Rs. 5,400 mn.	In 1982 rupees
9. Net lending to public enterprises	Rs. 1,968 mn.	Rs. 1,780	Rs. 1,500 mn.	In 1982 rupees
10. Percentage of Treasury bonds placed with "non-captive" sector	15.70%	19%	25%	1987 figure average for Oct. 1986-Sept. 1987
11. Percentage of assets in investments other than government securities: - National Savings Bank - Employee Provident Fund - Employees' Trust Fund	 0% 0% 0%	 10% 10% 10%	 10% 10% 10%	Baseline data and legal feasibility of targets need to be assessed further. Target for 1988 reflects NSB intentions

(81)

MACROECONOMIC POLICY FRAMEWORK

Overview

Paradoxes characterize Sri Lanka's macroeconomic framework. The country has taken many of the "right steps" toward a liberalized policy regime, but has yet to make the successful transition to an outward-oriented, dynamic economy. Although relatively low tariff barriers have turned Sri Lanka into one of Asia's most open economies, the World Bank continues to rank the country as a "moderately inward-oriented economy". Similarly, while the Government has created a slew of incentives for private investors, it has nullified many of these incentives by maintaining effective control of several sectors through its state-owned enterprises. In fact, the failure of the Government to curtail its role as an active participant in productive activities is at the root of many of the remaining distortions in the economy.

The sorry state of Sri Lanka's economy, following decades of at best benign neglect but more often outright sabotage of the private sector, became the main issue in the 1977 election campaign. By then, Sri Lankans had become accustomed to standing in line for the most basic necessities. Many consumer items were frequently not available at all. The economy lurched along, its growth in real terms barely staying abreast of population growth. Elected largely on the strength of its economic reform program, the new government wasted little time to enact sweeping economic policy changes. Buoyed by the new openness, and by a tripling of foreign aid, the economy soared. Sri Lanka seemed well on its way to become yet another success story of market-oriented economic policies.

The outbreak of ethnic violence in 1983 dashed those hopes. Investor confidence ebbed, tourists stayed away in droves, and normal economic activity in the North and East was disrupted. Overall, development became hamstrung by the domestic strife. The economic hardships in turn fostered further discontent, thereby contributing to ethnic and ideological violence. Without a lasting political settlement, hopes for accelerated economic growth will recede into the future.

The security situation overshadows all other factors influencing economic behavior, making it difficult to appraise the soundness of economic policies proper in terms of their impacts on economic activity, that is, in terms of the response of the economy. Even so, one can assess the adequacy of the existing framework and identify areas for improvement by comparing the existing situation to what conventional wisdom now accepts as the "right" policy framework, or what has worked in recent "success stories". By those standards, Sri Lanka has done exceptionally well in many areas, but still has some way to go to establish the proper balance between the government and the private sector. Public ownership of productive enterprises, hesitant promotion of competition, and overambitious regulation coupled with inadequate enforcement undermine the economy's potential created by other elements of the policy framework. To put these weaknesses in perspective, a brief review of the nature and extent of the post-1977 reforms is instructive.

182

Major Reforms

Trade Policy: Sri Lanka has moved from high levels of protection to one of the lowest average tariff walls in Asia. Average nominal tariffs amount to about 20 and 24 percent for intermediate and capital goods, respectively, and 33 percent for manufactured goods. A relatively high rate, 56 percent, for consumer goods provides higher protection to agriculture. These rates compares favorably with nominal tariff rates for other Asian countries. They are quite similar to those of Thailand, for example, and substantially below those for two other South Asian countries, India and Pakistan. Even so, significant pockets of excessive protection remain, especially with respect to some public enterprises.[1] The liberalization of the trade regime continues; the Government's 1988 budget outlines further simplifications and reductions to move to a four-tier tariff structure, with nominal rates of 10, 20, 25 and 40 percent.[2]

Liberalization of imports has been accompanied by a series of measures to encourage exports. The overall goal has been to put exporters on an equal footing with competitors in other countries, e.g., through duty-free access to imported inputs, and to compensate them for any disadvantages vis-a-vis import competing industries. The incentives provided include the free trade zones managed by the GCEC, customs duty rebates, exemption from custom duties and BTT (business turnover tax), easier access to credit and credit insurance, tax holidays of up to ten years, investment credits and related fiscal inducements, and sometimes direct equity participation by government entities.[3] Some gaps remain - availability of short-term credit for working capital needs has been a problem, export marketing support remains weak - but exporters can currently draw on a wide spectrum of assistance, both services and incentives.

Exchange rates: Perhaps the most dramatic shift in economic policies manifested itself in changes in the exchange rate regime. Since 1977, Sri Lanka has moved from a dual exchange rate structure and a heavily overvalued rupee to an open and flexible foreign exchange regime. Moreover, since 1982, the Central Bank's role in foreign exchange transactions is limited to the purchase and sale of spot US dollars.

---

[1] Sri Lanka's tariff rates show greater dispersion than those of Thailand, indicating instances of relative high protection for specific subsectors, and sometimes individual enterprises.

[2] This new tariff structure would substantially reduce protection for agriculture (by about half), and increase tariffs for equipment and finished goods for production or industrial purposes.

[3] Another tax incentive currently mooted is the transferable tax credit (TTC) which offers some advantages (equal treatment for exporting and import-substitution activities), but also considerable drawbacks, such as possibly heavy revenue losses, and the imposition of countervailing duties by importing countries.

183

Following the depreciation in 1978, the real effective exchange rate was allowed to drift upward. However, the authorities took action in 1986 to depreciate the rupee gradually to restore the country's competitiveness in export markets. Even so, Sri Lanka's principal competitors have tended to devalue even faster, maintaining some pressure on the rupee. Even so, neither limited access to foreign exchange nor an overvalued rupee represent real barriers to export growth.

Tax Policy: As most other countries at similar levels of development, Sri Lanka relies quite heavily on indirect taxes. Taxes on income, profit, and capital gains account for only 15 percent of total tax revenue. The Government relies primarily on the Business Turnover Tax (BTT), a generalized sales tax, and taxes on external trade. Although Sri Lanka's import tariffs are low, the level of imports combined with significant export duties, primarily on traditional treecrop exports, yield a high percentage of revenue from duties on foreign trade.

Tax expenditures (tax incentives to industry) may have contributed to an income tax structure that appears to be inelastic with respect to GDP; over the period 1950-85, each 1-percent increase in GDP increased tax revenues by only 0.85 percent. In order to maintain revenues at some 20 percent of GDP, the Government had to draw on other revenue sources.[4] In recent years, the share of non-tax revenues has increased, but is still lower than in other countries.

Between tax holidays and a relatively low top income tax rate - the maximum personal income tax rate was reduced to 40 percent in the 1988 budget - income taxes are unlikely to dampen private sector growth. In fact, current developments in Sri Lanka mirror those in other countries - the Government is seeking to reduce tax rates and eliminate special provisions and tax expenditures (such as exemptions or tax holidays).[5]

Monetary and financial policy: Sri Lanka today has a financial system and monetary policy that is geared toward the mobilization of resources and the provision of - for a country at this stage of development - more than satisfactory banking services for industrial expansion. Further reforms and improvements are needed, but can build on a sound basis.

The 1977 reforms in the financial and monetary area addressed two weaknesses; inadequate savings mobilization and a poor performance of the banking system. The main response to the first problem was the shift to a high-interest rate policy, primarily intended to encourage domestic savings. In 1977, the Central Bank doubled the nominal deposit rate on 12-months time deposit, from 7.5 to 15 percent, and raised it further to 20 percent in 1980. This policy resulted in positive real interest rates in all but one of the years since 1977.

---

[4]Thus, by introducing additional revenue sources, the Government kept the buoyancy of the tax structure, changes in total revenue relative to changes in GDP, close to unity, even though the elasticity of existing revenue sources was below one.

[5]The Sri Lankan Government clearly is hoping for effects similar to those in other countries - increased tax revenue as fewer loopholes encourage better compliance.

184

A number of reforms strengthened the banking sector. One major factor was the liberalization of the foreign exchange regime which formed part of a concerted effort by the Government to expand the foreign banking sector in Sri Lanka. Foreign banks now account for some 20 percent of total financial transactions. The Government also engineered some (albeit limited) deregulation of the financial sector to allow for and encourage the formation of finance companies and merchant banks.[6]

In spite of the growing maturity of the banking system, the Central Bank continues to rely on both adjustment of reserve ratios, coupled with a high penal rate, and the imposition of credit ceilings to regulate the expansion of credit and advances to the private sector. The credit ceilings, though, have not been relevant lately, since effective demand for credit has fallen short of allowable levels. Since early 1987, the Central Bank has introduced public auctions of a portion of the Treasury bills issued, in part to establish the interest rate. These auctions may launch a market-driven approach to setting overall interest rates.

With respect to equity markets, the Government has taken steps to support the formation of investment banks. Elsewhere, this document describes the background for the proposed activities under this Project to support initiatives to improve the regulation and operation of the securities exchange. Finally, capital gains taxes - although still too high - have been lowered to encourage secondary markets in equity instruments.

The greatest remaining weaknesses in the financial arena are direct consequences of the Government's budget performance. Financing the budget deficit led to a sharp acceleration of inflation in the early 1980's, with a corresponding appreciation in the real effective exchange rate. Since then, a slight slackening of aggregate demand kept inflation in the single-digit figures, but recent signs point to a sharp upturn in the annual rate - which is likely to affect interest rates and thereby the private sector's demand for equity funds.

Pricing and market deregulation: Price controls in force before 1977 have been almost completely abolished. Price fixing by the Government is now virtually limited to areas in which the Government maintains a monopoly, for whatever reason. The most important price distortions that do remain include subsidies to agricultural inputs and taxes on certain consumer products, notably petroleum products.

---

[6] As discussed further below, "deregulation" involved primarily the lifting of barriers to entry. Unfortunately, the required regulatory oversight of new financial institutions lacks both an adequate legislative base and sufficient administrative capacity and experience. Lack of effective controls has contributed to the widely reported difficulties of some of the finance companies.

Reforms of pricing policies have played a key role in the restructuring of agricultural policies. Raising of the floor price for paddy and increasing fertilizer subsidies improved the profitability of paddy production and contributed to a substantial increase in national production. These changes in pricing policies were accompanied by the systematic dismantling of the Government monopoly in paddy procurement, distribution and marketing.

Several other initiatives have been undertaken to relax existing public sector monopolies. One of the more successful ones has been the public transit system in the country, which was a Government monopoly until 1978. By now, privately operated buses account for some 50 percent of total passenger traffic. Similarly, the insurance industry has recently been opened to private companies who have started to move in aggressively.

Foreign investment: On the legislative front, Sri Lanka has eliminated virtually all barriers to foreign investment. The country not only welcomes foreign investment, but pursues it actively and energetically. Until the deterioration of the security situation, the response had been good, especially in the two free trade (or export promotion) zones. The constitution itself guarantees protection of foreign investors. These guarantees have been spelled out in a series of bilateral agreements. In a few instances, the Government itself has teamed up with foreign investors in joint ventures. Even so, potential foreign investors still face many hurdles in obtaining approval of their projects.

Remaining Weaknesses and Targeted Interventions

Although the accomplishments of Sri Lanka's policy reforms are impressive, several serious weaknesses remain. These weaknesses have combined with the country's security problems to produce an overall lackluster performance of the industrial sector, maintaining the economy's dependence on agricultural performance and world market prices for traditional treecrop exports.

A bloated public sector: The major one is the Government's continuing role as an highly active economic player, in particular through its management of state-owned enterprises. Generally, the bloated public sector claims a major share of resources without adequate economic return. The policy framework formulated by the Government with the assistance of the World Bank acknowledges this problem. The Administrative Reform Committee's report submitted in late 1987 maps out a program to restructure the public sector to improve its efficiency and to reorganize its operations in view of the planned devolution of powers to the Provincial Councils. This restructuring will involve a streamlining of the Central Government's role in the economy. During the transition period, the necessary adjustments in salary structures to support this restructuring process will put increased pressures on the budget.

196

Public Enterprises: The Sri Lankan polity has sought to pursue a host of economic and non-economic objectives through direct involvement in productive activities in the form of management of state-owned enterprises. Diffuse objectives made it often difficult to assure the financial viability of these enterprises. The pressure to keep them financially afloat in spite of the non-economic ballast has been used to justify various kinds of market distortions, mostly to maintain high effective protection against both foreign and domestic competition. Therefore, moves to get the Government out of operating productive manufacturing enterprises through privatization are critical not only improved efficiency of these enterprises, but also to broader industrial policy concerns.

Such moves do not necessarily conflict with efforts to improve the operating performance of the enterprises in a competitive environment. But they do clash with the sometimes tempting option of improving financial performance by granting special privileges--by increasing protection. Consequently, the preparation and implementation of a broad privatization strategy present extremely difficult challenges. Success goes beyond the "simple' divestiture of the enterprise. It includes laying the groundwork for an operation that can survive and prosper in a competitive environment.

The Promotion of Competition: Overall, the competitive environment in Sri Lanka can use some strengthening. While legislation exists to control restrictive business practices, enforcement has generally been less than stringent. Since the Government traditionally took it upon itself to enter the fray as an active participant, it never developed an effective role as a referee, and has been suspect in that role. Markets were often manipulated to protect public investments or domestic entrepreneurs. This attitude explains much of the still relatively high levels of effective protection [7], and the monopolistic or oligopolistic structures of many subsectors of the economy.

Promotion of competition involves a number of aspects. Perhaps the most important one is the opening of the economy to competition from outside, in the form of imports. In this respect, Sri Lanka has made great strides since 1977; reforms are continuing with the Presidential Tariff Commission in cooperation with the World Bank taking the lead. Rates of effective protection are being brought down to expose more of Sri Lanka's industry to real competition.

[7] Until the recent tariff reforms, the average level of effective protection was close to 100 percent.

187

With respect to domestic competition, much remains to be done. The establishment of the Fair Trading Commission as a watchdog over restrictive business practices is a step in the right direction. However, so far it has not been given sufficient powers to allow it to assume a leading role in controlling restrictive business practices and promote effective competition within and among sectors of the economy.

Other signs for policy lacunae in the area of promoting competition include the virtual absence of any debate over opportunities to strengthen competition in sectors now dominated by state-owned enterprises as part of any privatization strategy. Weaknesses also remain with regard to protecting the competitive position of small enterprises: leveling the playing field for them remains an important task of industrial policies. We cannot see much thought being given to this issue either by the Government or by other donors active in the policy arena. USAID itself, however, is actively addressing issues related to the competitive position of small-scale enterprises in the context of the Mahaweli Enterprise Development Project (383-0090)

Financial Markets: Competition and efficiency also remain concerns in financial markets, even though the post-1977 reforms have improved conditions in these markets considerably, both with respect to debt and equity markets. In debt markets, banking competition has been overshadowed by the dominance of two state-owned commercial banks. While a dynamic private banking sector has been emerging, the often privileged position of the Bank of Ceylon and the People's Bank often make it difficult for private banks to compete in certain sectors or for certain services. Banking competition has also been affected by the legal and regulatory environment which makes it very difficult, for example, to recover delinquent loans. The Asian Development Bank (ADB) has become engaged in several efforts, partly in conjunction with the World Bank, to improve competition and efficiency in the banking sector.

Debt financing overall tends to be easier than raising equity finance. Government policies aimed at mobilizing savings by maintaining positive real interest rates have been reasonably successful over the last decade. However, they have made equity investments relatively less attractive. At the same time, many of the larger entrepreneurs who would provide the mode for others have sought outside equity financing often only as a last resort. In many instances, outside participation was virtually limited to the participation by state-owned or controlled institutions, primarily as a means to secure government support and more favorable treatment. Although the Colombo Securities Exchange (CSE) has registered impressive growth in recent years, its role as an effective market for equity transactions remains limited, in part because of internal constraints, in part because of a rather feeble framework of oversight and management. In its discussions with the two other principal donors in the policy field, USAID has agreed to focus its assistance on strengthening the capacities of the CSE and the development of an appropriate--neither lax nor stifling--regulatory framework and effective oversight.

188

Institutional Rigidities: In addition to specific policies, the development of the private sector in Sri Lanka is of course also shaped by customs, social norms and existing institutions. These factors are often critical, although they do not lend themselves to direct intervention. Donors have supported some activities aimed at these issues, such as entrepreneur development programs supported by the International Labor Office and others, but results have failed to convince.

Our analysis of the situation suggests that some of the existing rigidities are linked to the perceived role of the state in guiding and managing the economy. Even private sector representatives typically look to "the state" for inspiration and leadership in formulating and launching economic policies and approaches to the solution of economic problems. To redress this balance, broad-based private sector institutions will have to become much more active in shaping and effectively representing their membership's views on economic policy issues. As far as we know, no other donor has contemplated options to develop and strengthen the leadership capabilities of private sector organizations as part of a strategy to overcome institutional rigidities and provide a counterweight to the all-pervasive influence of public sector.

Summary

The arguments presented in this review of the macroeconomic background and policy agenda can be summarized in tabular form as shown in Table 1, which arrays policy development issues against donor interests and activities. While a few other donors work in the fringes of the policy agenda, the major players so far are the World Bank, the Asian Development Bank and USAID.

ANNEX M

Private Sector Policy Support
Project No. 383-0100

Environmental Determination

The project will support three major components: private sector policy, privatization and capital markets development. the major activities planned under these components include technical assistance, participant training, commodities procurement, severance payments to workers affected by privatization, publications, policy formulation and operational support for a venture capital company. Activities financed by the venture capital company will not be subject to the control of A.I.D. As such, no activities are planned under the project which may result in significant nefative environmental consequences. Accordingly, these activities fall within the classes of actions that are categorically excluded from the procedures set forth in 22 C.F.R. 216.3, in accordance with 22 C.F.R. 216.2(c)(1) and (2).

Gary Nelson
Gary L. Nelson
Acting Mission Director

July 20, 1988
Date

190

Table 1 - Policy/Donor Matrix

● PRIMARY
o SECONDARY

	WORLD BANK					IMF		ADB			N'LANDS	USAID					
	IDP III	SMI III	PSRP/PPF	PERP	PFP	SAF	PFP	IDP III	SMI III	RURAL CREDIT	IPS	HIG	PL 480	MARD/MDS	PEPP	PSPS	MED
PROMOTION OF COMPETITION AND COMPETITIVENESS																	
1. Lowering Import Tariffs	o	o			o	o	o	o	o		o						
2. Relaxation of Import Controls	o	o			o	o	o	o	o		o						
3. Export Promotion	o	o			o		o	o	o		o				o	o	
4. Control of Restrictive Business Practices					o		o				o						
5. Small Scale Enterprise Promotion	o	o						o	o		o				o		●
6. Science & Technology Development	o	o			o		o	o	o		o				o		
RATIONALIZATION OF PUBLIC SECTOR																	
1. Administrative Reform			o		o	o	o				o						
2. Devolution of Power			o		o	o	o				o	o					
3. Privatization of SOEs	o		o	o	o	o	o	o			o					●	
4. Rationalization of Parastatals																	
5. Rationalization of Public Investment & Budget Control																	
STRENGTHENING FINANCIAL MARKETS																	
1. Controls on Money and Credit					o	o	o					o					
2. Improved Rural Credit		o							o	o		o	o	o			
3. Improved Legal Framework					o	o	o			o		o		o	o		
4. Strengthen Equity Markets	o			o	o	o	o								o		
RELAXATION OF INSTITUTIONAL RIGIDITIES																	
1. Entrepreneur Development			o						o	o					o	o	o
2. Strengthen PSOs																o	o