

ISSUES PAPERSRI LANKA: MAHAWELI ENTERPRISE DEVELOPMENT (282-0090)
PROJECT IDENTIFICATION DOCUMENT

LOP Funding: \$15 million, ARDN
\$9.6 million grant, \$5.4 million loan
HC Contribution: \$7 million
Initial FY: 1988
Final FY: 1992
PACD: 1994

A. Summary Project Description

The purpose of this proposed project is to increase rural employment and income in the Mahaweli region through expansion of private sector enterprises, both farm-based and off-farm. The project aims to implement policies and programs needed to stimulate both small-scale and medium/large enterprises in the four major systems of the Mahaweli region.

The project addresses an income disparity between rural residents of the Mahaweli region and the country as a whole. To remedy this problem, the Mahaweli economy -- now based almost exclusively on paddy -- requires diversification into other family farm crops as well as commercial-scale farming, cottage industries and larger enterprises, such as agricultural processing, that will employ wage labor.

The project proposes three, possibly four, categories of activity:

- 1) Support for farm-based and off-farm small-scale enterprise;
- 2) Promotion of medium-larger scale enterprises;
- 3) Institutional support to the Office of Employment, Investment and Enterprise Development of the Mahaweli Authority; and
- 4) Possibly, a credit fund.

Specific activities proposed for each category are summarized below.

- 1) Support for farm-based and off-farm small-scale enterprises. This component will provide assistance to entities, both existing and new, generally having fewer than 10 employees and aiming at local markets. Up to nine "Small Enterprise Development Units" (SEDUs) will be developed in

Mahaweli market towns; each will have production and warehouse facilities and will offer training programs and advisory services. AID will partially support costs of the facilities and of personnel, most of whom will be local contractors. Peace Corps Volunteers will also serve as business advisors.

2) Promotion of Medium/Larger Scale Enterprises (MLEs). This component will support the development (or expansion, although there are few existing now) of entities employing between 20 and 200 persons and producing for the larger domestic and export market. Such enterprises may be commercial-scale farms as well as agro-processing industries, agricultural services (i.e., transport, storage and handling) firms, input suppliers and trading companies.

Problems of remoteness, limited infrastructure and high risk currently impede private investment in medium and large-scale enterprises in the Mahaweli. The MED project will therefore offer incentives for business development in the form of cost-sharing of feasibility studies, reimbursement for certain infrastructure development costs through a GSL-administered "investment action grant" program, possible support for construction of one industrial estate (as a pilot in anticipation of up to six others to be constructed independent of AID) and limited start-up support such as R & D, training, market research and insurance schemes.

3) Institutional support to MASL/EIED. The Mahaweli Authority of Sri Lanka (MASL) has established an Office of Employment, Investment and Enterprise Development (EIED) to promote off-farm economic activities in the Mahaweli. As a central coordinating body, MASL/EIED requires assistance with policy formulation, information development and dissemination, monitoring and evaluation, and management. This component of the project will provide technical assistance, training and limited commodity procurement aimed at these areas. Key issues for policy determination are land and water use.

4) Credit Fund. Pending the results of analyses to be carried out during project design, MED may include a component to channel credit to small-scale enterprises through a financial intermediary.

B. Issues

The Project Review Committee met on Monday, October 5. It was the consensus of the meeting that the PID should be approved and project approval authority should be delegated to the Mission, subject to the caveats and limitations described under issues #2, 3 and 5, below. If the ANPAC agrees with the PRC's recommendations, a PID supplement will be required on one or

more issues. If more than one issue is involved, all should be submitted to AID/W for approval as a single supplement. In any event, the PID supplement should be submitted not less than eight weeks prior to planned project authorization (tentatively scheduled, per the PID, for April 30, 1988).

The PRC discussed the following issues:

1. Is MASL/EIED an Appropriate Counterpart Agency?

Issue: The PID proposes that a GSL agency -- the Employment, Investment and Enterprise Development (EIED) Division of the Mahaweli Authority of Sri Lanka (MASL) -- be the key counterpart agency.

Since the geographic focus of the project is the Mahaweli resettlement region -- where infrastructure, services and private-sector entities are underdeveloped and most land with commercial potential remains in government hands, and where construction, settlement and economic development are coordinated by the Mahaweli Authority -- it is the Mission's view that there is no viable alternative to working with MASL/EIED. Although a young division of MASL, EIED has made a reasonable start (with AID support under the Mahaweli Basin Development I Project) on carrying out its mandate to promote private enterprise in the Mahaweli. It is now led by a director recruited from the private sector who is demonstrating a commitment to creating a hospitable policy climate for business. MASL/EIED's proposed role can best be characterized as that of an infrastructure provider and an "enterprise extension service."

Recommendation: AID/W concurs that MASL/EIED is an appropriate counterpart agency, but believes the Mission should endeavor during project design to maximize direct private-sector roles in all project activities to the greatest practical extent, with a corresponding reduction of MASL/EIED's role, as appropriate.

2. Appropriate Public/Private Roles in Promoting Small-Scale Enterprises (SSEs)

Issue: The project's SSE component will support development and operation of Small Enterprise Development Units (SEDUs) to provide entrepreneur training, business advisory services and production facilities -- i.e., temporary "incubator" sites -- for start-up of small-scale enterprises. The PID states that private firms will actually deliver the entrepreneur training and business advisory services. The PID also indicates that while MASL/EIED will not be directly involved in productive enterprises, it will (at least initially) own the land and structures for the productive facilities and will play a role in their management.

Several PRC members pointed out that success of the third part of the SEDU concept -- the production facilities -- can best be ensured by building in a role for the private sector from the outset in their management, with a view toward eventual private ownership of the facilities.

Recommendation: It was the sense of the PRC that the Mission should attempt to identify or help organize NGOs or private firms to manage the SEDU production facilities, and should also examine possibilities of lease/purchase options for the private sector. In the meeting and in subsequent discussions among PRC members, two possible scenarios emerged from which the ANPAC may wish to choose:

A. The SEDU component is approved, subject to the Mission exploring the private-sector options for production facilities described above before arriving at a final design. In addition, AID/W will provide the Mission with additional information on experience in other countries with this type of small enterprise development facility, in order to form the basis for a Washington/field dialogue aimed at helping the Mission in its design effort.

OR...

B. The level of discomfort with the SEDU production facilities is sufficiently great to preclude approval of this project component of the PID. Prior to project authorization, the Mission should communicate its design for SEDU production facilities by cable as a PID supplement to AID/W for approval.

3. Support for a Pilot Industrial Estate

Issue: MASL/EIED plans development of several industrial estates to attract MLEs to the Mahaweli region. The estates would be owned by MASL/EIED and occupied by private companies under lease. As presently planned, the MED project would support a single pilot estate.

Several PRC members questioned the advisability of this activity, given the poor record of government-owned and managed industrial estates as investment promotion devices. The Mission has not yet decided whether to include this activity in the project, and will make its decision following feasibility investigations undertaken during project design.

Recommendation: In exploring alternatives regarding government-owned industrial estates for MLEs, USAID should negotiate with MASL/EIED to make AID support for a pilot facility conditional at least on private management of the estates, as well as the possibility of the private sector owning the estates either from the outset or at some point in the future. As with Issue #2 above, there are two options for the ANPAC:

A. The PID concept for support of a pilot industrial estate is approved under the condition described just above.

OR...

B. The Mission should communicate its plans for support of a pilot industrial estate, if any, to AID/W by cable as a PID supplement for approval.

4. Risks and Incentives

Issue: The PID indicates that remoteness, lack of infrastructure and uncertain markets make entrepreneurial activity in the Mahaweli region very risky in the view of potential investors, and that MASL/EIED is designing incentive packages to help overcome such risks. The PRC debated the following questions:

To what extent are the risks actual constraints, or to what extent are they a problem of perception that can be alleviated through information programs rather than tangible incentives?

To the extent that they are real, are the proposed activities (e.g., co-financing for feasibility studies, TA, infrastructure development grants) sufficient to address the risks?

Do the incentives, at the same time, present a danger of distorting investment decisions by tipping the balance in favor of investments with low potential returns by means of subsidies, hidden or otherwise?

Is the proposed grant-based cost-sharing of feasibility studies for specific profit-making ventures consistent with AID policy?

The Mission plans to carry out several analyses during project design that should shed considerably more light on the risk problems and appropriate remedies for them. A survey is already underway to identify all existing enterprises in the Mahaweli region, as well as to estimate the level and nature of interest in new start-ups, the actual and perceived constraints on such start-ups, and the potential demand for business development assistance.

It is not uncommon, of course, for governments to offer incentives in order to encourage business location in specific geographic areas. The PRC did not question the basic idea, but sought to avoid creation of market distortions through such incentives. Relevant interest-rate and land-ownership issues are discussed below, under Issue #5 and Concern #1, respectively.

On cost-sharing for enterprise feasibility studies that would produce proprietary information, some PRC members were concerned that grant financing of such studies constitutes concessional assistance to private profit-making entities; as such, it is subject to AID policy which permits such assistance only in exceptional cases. Examples of such cases might include instances in which there are significant technical innovations and associated risks, or in which the purpose of the assistance is to initiate an entirely new venture or activity from which benefits accrue beyond the enterprise itself and reach AID target groups that would not otherwise be reached.

Recommendation: The Mission should subject to close scrutiny during PP design both the perceptions and the realities of risks and barriers that impede Mahaweli-based business development, and consider the options for incentives to overcome these risks and barriers with a view to minimizing intervention in market-based decision-making by the private sector.

On the question of cost-sharing for feasibility studies, the Mission should require reimbursement of the cost of studies that lead to actual start-ups within a year of the completion of the study. Under such an arrangement, the information contained in the study would be made public after the one-year period.

5. Credit Fund

Issue: The Mission is considering inclusion of a credit fund for small-scale enterprises, but will not decide finally on whether to include credit in the project until studies are carried out to determine whether there is a gap in credit and other financial services available to the target group, small entrepreneurs in the Mahaweli region. The PID provides no details on the proposed credit component.

The PRC noted that there is a growing consensus within the Agency that rural credit programs targetted at low-income borrowers, often involving subsidized interest rates channeled through public-sector intermediaries and not tied to savings mobilization efforts, have generally failed to meet their objectives and have had poor repayment rates.

In general, the PRC felt that rural credit programs pose significant policy questions. Specific questions asked were:

How can the MED credit program, if it comes about, avoid the failures of the past?

Is it appropriate to direct a credit program only to small-scale enterprises, or can a case be made for including medium and large enterprises (who have more wherewithal to repay) as well?

In raising these questions, the PRC also noted that the Mission is currently addressing Mahaweli financial services needs and availabilities in connection with two other activities -- the Mahaweli Agriculture and Rural Development (MARD) Project and the HG Program. It may be helpful to all three activities to carry out an overall assessment of financial markets in the area.

Recommendation: ANPAC approval of a credit component for the MED project should be deferred. The Mission may want to consider commissioning an assessment of rural financial markets in the Mahaweli region and should consider ways to encourage the development of diversified financial services to meet both the saving and borrowing needs of farmers, entrepreneurs and homeowners. If a credit (or financial services) component is included in the project, the Mission should ensure that, at a minimum, credit is provided at positive real interest rates at or near market-determined levels and that private financial intermediaries be designated to carry out the program. The Mission should cable a PID supplement on the credit component, if any, to AID/W for approval.

6. Delegation of PP Authority

Issue: The PRC did not reach a consensus on whether or not to delegate project approval authority to the Mission. Most ANE representatives felt that the project described in the PID was well within the requirements for normal delegation of authority under the Bureau's decentralization procedures. The PPC representative felt, however, that questions discussed under Issues #1 and #3 above were sufficiently significant to warrant an exception to usual ANE practices. The ANE/DP representative expressed partial support for this view. Since the PRC, the Mission's representative and ANE/PD staff have met informally with PPC and have agreed to recommend to the ANPAC that AID/W delegate PP authority to the field but reserve the prerogative to review information on specific issues that would be cabled in prior to authorization in the field. These issues are: 1) strategy with respect to the production facilities of SEDUs; 2) possible support of and arrangements for ownership and management MLE industrial estates; and 3) the possible credit component.

Recommendation: The Mission may approve the PP subject to the caveat described above.

C. Concerns

1. Land Tenure. The Mission has identified land tenure regulations as a key topic for policy dialogue and analysis. Mahaweli settlers' lack of full title to their land grants impedes development of a functional land market and purchases and sales necessary for efficient land use by both entrepreneurs and farmer-settlers. The PRC strongly endorsed the Mission's efforts in this project (as well as in companion Mahaweli projects) to resolve these land tenure issues and ensure that settlers ultimately enjoy full ownership rights.

2. Bumpers/Lautenberg Amendments. To the extent that the MED project aims to increase Sri Lankan exports and includes support for feasibility studies for export-oriented businesses, it is possible that instances might arise in which import-sensitive manufactured products or U.S. exports of agricultural commodities might be affected. GC/ANE reminds the Mission of the requirements of FAA Section 611, FY 87 Appropriations Act Section 558, FY 88 first CR, and AID Policy Determination #15.

3. Ethnic Conflict. Despite the conclusion of a peace accord in July, there are recent indications that conflicts between Tamil and Sinhalese ethnic groups may continue. The GSL has a stated policy of ensuring that settlement in the Mahaweli region is carried out in proportion to each group's share of total national population, but to date most settlers have been Sinhalese. Newer settlement areas are closer to the Eastern Province and are expected to include more Tamils. The MED project's scope covers the entire Mahaweli settlement area. The Mission is encouraged to convey to the GSL its expectation that all ethnic groups will enjoy equal access to the project's activities and benefits.

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PERSONS ATTENDING PRC MEETING FOR
MAHAWELI ENTERPRISE DEVELOPMENT PROJECT (383-0090)
October 5, 1987

USAID/Colombo, Alexander Shapleigh
ANE/PD, Bruce Odell
ANE/PD/SA, Pamela Baldwin
ANE/PD/PE, David Hagon
ANE/SA, David Garms
ANE/DP, Mark Gallagher
ANE/DP/E, Anne Dammarell
ANE/TR/ARD, Mike Korin
ANE/TR/ARD, Richard Suttor
ANE/TR/ARD, Gary Lewis
GC/ANE, John Power
PPC/PB, Linda LeDuc
PPC/PDPR, Thomas Dailey
S&T/RD, Michael Farbman
S&T/RD, Bob Young