

PD-AAW-675
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ISSUES PAPER

SRI LANKA: PRIVATE SECTOR POLICY SUPPORT (383-0100)
PROJECT IDENTIFICATION DOCUMENT

A. Summary Project Description

Proposed LOP Funding: \$15 million, SD Grant
GSL Contribution: \$ 5 million
Initial FY: 1988
Final FY: 1992
PACD: 1993

The proposed Private Sector Policy Support (PSPS, or PS²) Project seeks to facilitate policy changes affecting the Sri Lankan economy in order to increase national employment, income and foreign exchange earnings by stimulating private sector growth.

The Project's three purposes are 1) to establish more effective incentives for rapid private industrial growth through further liberalization of the economy, including deregulation to encourage competition; 2) to reduce the state role in the economy through privatization of state-owned enterprises; and 3) to expand capital markets by creating a climate conducive to equity investment and encouraging both supply and demand for broad-based equity instruments.

As these objectives suggest, the project will have three major components:

1. Industrial Policy Reform

This component of the project will provide assistance to the newly-formed Industrial Development Committee -- which is made up of both public- and private-sector representatives -- and counterpart private-sector organizations, possibly the Ceylon Chamber of Commerce and the Federation of Chambers of Commerce and Industry of Sri Lanka. Support to these groups will aim at 1) deregulation; 2) rationalization of incentives to private entrepreneurs; and 3) promulgation and enforcement of non-restrictive business practice rules. It will take the form of technical assistance, training and information to strengthen local capabilities in industrial policy formulation and implementation, as well as specific analytical studies.

2. Privatization Support

This component will support the efforts of the Presidential Commission on Privatization to promote divestiture of State-Owned Enterprises (SOEs). The project will help with the development of an overall privatization strategy as well as with preparation for specific divestiture actions, and will seek to mitigate specific financial burdens associated with

such actions. A substantial technical assistance package will provide highly specialized financial and technical advisory services required to prepare SOEs for public offering and private-sector operation. A \$5 million Privatization Fund would be used to reimburse the GSL ex post facto for costs of worker retraining and redundancy payments made as a result of privatizations.

3. Capital Markets Development

This component will strengthen Sri Lankan equity markets by building the capabilities of the private Colombo Securities Exchange and the GSL Securities Council through provision of technical assistance, training, equipment and library acquisitions. Training and TA will cover regulatory matters, information management and dissemination, brokerage practices, etc.

In addition, this component will provide support (in collaboration with the PRE Bureau) for a new private venture capital company (VCC) in Sri Lanka. The VCC aims to stimulate investment by taking equity positions in new export-oriented enterprises (sub-projects), including joint ventures between foreign and domestic entrepreneurs. It also seeks to help develop equity markets through public subscription to the VCC shares and through eventual sale to the public of VCC equity in its sub-projects. Working with a group of Sri Lankan investors, the Mission and PRE have carried out preliminary design work for the VCC and are currently completing the scope of work for a detailed feasibility study.

B. Issues

The PRC meeting for this project included a wide-ranging substantive discussion on Sri Lankan policies, privatization plans and capital markets matters as they affect plans for the PS² project, but did not produce serious issues in need of ANPAC resolution. The Committee would have waived the ANPAC review had the ANPAC not been scheduled to meet anyway to review the Mahaweli Enterprise Development Project.

The PRC recommends approval of the PID and delegation of PP authority to the Mission. However, the Venture Capital Company component will be subject to additional analysis and justification before AID/W approval to proceed to project authorization. (See Issue #4.)

If ANPAC members concur, the following highlights of PRC discussion will be included in the cable to the Mission:

1. Donor Coordination

Issue: It was noted that USAID has coordinated with the World Bank, IMF and ADB in its approach to industrial policy and privatization, but that AID appears to be taking a somewhat bolder stance than the multilateral institutions with respect to privatization. The Mission representative indicated that a new World Bank industrial-sector loan may include a component aimed at "restructuring" SOEs, i.e., improving their efficiency to reduce fiscal burdens and possibly prepare for eventual divestiture.

Recommendation: The Mission should continue its efforts to ensure that other donors' programs support our efforts to encourage sound industrial policies and privatization.

2. GSL Privatization Strategy

Issue: The GSL has made a good start on privatization of SOEs with the establishment of the Presidential Commission on Privatization, the inclusion of privatization as a major component of the recent report of the Industrial Policy Committee, and the identification of initial divestiture targets. Important strategic issues remain to be addressed, however, in a comprehensive privatization strategy. Such a strategy should consider such issues as the absorptive capacity of the local investors and managers to take over and manage SOEs and the impacts on employment and competitiveness. It should also include a schedule leading eventually to total divestiture (or closure) of SOEs, and should ensure that privatization results in complete private control of the enterprises in question.

Recommendation: The Mission should require that the GSL develop and publish a privatization strategy as a condition precedent to disbursement of the Privatization Fund (see below).

3. Privatization Fund: Uses and Conditions

Issue: The Mission and the GSL recognize that privatization and related efficiency improvements may result in loss of job security or actual dislocations for substantial numbers of workers, and that this reality could be problematic in terms of sustaining the political will to reduce state control of the economy, particularly in a pre-election period.

The PS² project includes a \$5 million Privatization Fund aimed at mitigating these impacts, primarily by reimbursing GSL costs for retraining and severance payments or temporary social services. PRC members suggested that the Mission also explore the possibility of using PL-480 Title II as a mechanism for providing assistance to laid-off employees.

Recommendation: The Mission should assess the likely costs of privatization and the severity of impacts on affected workers as it determines the appropriate uses and conditions to be attached to the Privatization Fund. It should explore the possibility of supplementing DA funds with PL-480 resources for this purpose.

4. Venture Capital Company

Issue: 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. In the PID, the Mission's contribution is included in the PS² project as a grant. AID policy does not permit equity contributions, and grant assistance to a for-profit enterprise must be justified. A jointly-funded feasibility analysis will evaluate various options for capitalization, structure, management, types of ventures to be financed, etc. Other issues that must be addressed include Bumpers/Lautenberg implications of the VCC's sub-projects.

Recommendation: Further AID/W review of the detailed VCC business plan should be carried out. Grant funding and alternatives must be resolved. ANE will coordinate with PRE in vetting this element prior to PS² project approval.

5. Contracting Mechanisms

Concern: The three project components include plans for a considerable range of TA services -- technical, financial, legal, etc. The PID proposes use of a single TA contractor, the PRC members questioned whether the varied types of expertise required could be procured from a single firm, and whether it could create a conflict of interest.

Recommendation: In designing its implementation plan, the Mission should reconsider the appropriateness of using a single TA contractor.

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PERSONS ATTENDING PROJECT REVIEW COMMITTEE FOR
PRIVATE SECTOR POLICY SUPPORT (383-0100)
OCTOBER 7, 1987

USAID/Colombo, Alexander Shapleigh
ANE/PD/SA, Tom Rishoi
ANE/PD/SA, Pamela Baldwin
ANE/PD/SA, Harold Boykin
ANE/PD/PE, David Hagen
ANE/SA, David Garms
ANE/DP, Mark Gallagher
ANE/DP/E, Anne Dammarell
ANE/TR/ARD, Richard Suttor
GC/ANE, John Power
PPC/PB; Linda LeDuc
PPC/PDPR, Neal Zank
S&T/RD, Bob Young