PD-AAX-341

A C T I O N P L A N

FY 1987

SRI LANKA

FEBRUARY 1986

Agency for International Development
Washington, D.C. 20523

BEST AVAILABLE

FY87 ACTION PLAN
TABLE OF CONTENTS

I. Introductory Overview 1

II. Performance and Plans 2

A. Programmatic Objectives, Benchmarks and Performance 2

1. FY85-86 Benchmarks and Performance 2
a. Improved Agricultural Productivity and Farm Income
b. Increased Off-Farm Employment and Rural Enterprise
c. Development of the Mahaweli Region
d. Additional Programs of Interest
e. Mission Management Issues

2. FY86-87 Benchmarks 10
a. Improved Agricultural Productivity and Farm Incomes
b. Increased Off-Farm Employment and Rural Enterprise
c. Development of the Mahaweli Region
d. Other Programs
e. Mission Management Objectives

B. Actions for the Coming Year 12

1. Key Policy Actions
2. Key Implementation Actions
3. Key Evaluation and other Study Actions

C. Narrative Report 17

1. Improved Agricultural Productivity and Farm Incomes
2. Increased Off-Farm Employment and Rural Enterprise
3. Development of the Mahaweli Region
4. Additional Programs of Interest
5. Mission Management
6. The Role of Evaluation

D. New Project Descriptions 20
Rural Development Sector

III. Special Considerations 23

A. Financial Issues and Anticipated Actions 23
B. Evaluation Plan 25
C. PL480 26
D. Work Force Issues 27
E. Gray Amendment 29
F. Summary Budget Tables 30

Annexes
A. List of Acronyms
B. Policy Dialogue Paper

I. INTRODUCTORY OVERVIEW

Over the past year we have taken significant steps toward setting the strategy in action. We have further focussed the program towards the two primary goals of improving agricultural productivity and farm income and increasing off-farm employment and rural enterprise. Ongoing projects were fully funded to the extent possible in FY 1985 to allow for new project activity in FY 1986 providing strong support for achieving our programmatic objectives. To provide needed support in the Mahaweli area, activities will be undertaken there. We will use the Mahaweli as a testing ground to develop interventions that can be effective island wide. We will continue to concentrate our efforts on these two major program goals over the next year. This concentration will include limiting our efforts in other sectors and giving priority to those PVO projects related to these goals.

Project implementation has been an important area of concern over the past year and will continue to be one over the next. As the security situation has deteriorated, the GSL has devoted more time and resources on it. The increasing military expenditures have contributed to a rapidly increasing budget deficit and decreased funds available for development efforts. Assuring the necessary GSL attention and financing to carry projects through successfully has been a formidable task. Nevertheless, most projects have made satisfactory progress over the year. 1986 will be another year in which efforts will be required to keep GSL inputs at adequate levels to assure implementation progress.

Major project design work over FY 86 will center on a significant structural change high on the Mission's priorities list. Privatization of the many parastatals is needed to both stimulate private sector growth and relieve the budget strain. A program titled Rural Enterprise Development Sector (REDS) is being developed to assist the GSL in the divestiture of state owned enterprises and to foster the growth of privately owned, rural-based enterprises. While privatization is gaining interest here, there remains a significant resistance among influential GSL bodies. This effort will be a difficult policy dialogue undertaking, but it is an important one for Sri Lanka's future.

We have also begun the effort of reorganizing the Mission itself to better meet the objectives of the program. Along with these changes has been an increase in electronic data processing capability to enhance our productivity. These efforts will continue through the next year.

II. PERFORMANCE AND PLANS

A. PROGRAMMATIC OBJECTIVES, BENCHMARKS AND PERFORMANCE

1. FY85-86 Benchmarks and Performance

a. Improved Agricultural Productivity and Farm Income.

1) A Qualified and Functioning Agricultural Research Capability in Subsidiary Field Crops (E)

* TA Contract Signed and the Team in Place: The contract for DARP 383-0053, was signed with Development Alternatives, Inc., and work began in October 1985.

* Base Line Surveys completed: Preparations began in December 1985 for the surveys to be conducted in February 1986 to coincide with the major cropping season. Work underway includes designing questionnaires, selecting representative samples, etc.

* Construction of Facilities Initiated: A&E proposals were solicited. Negotiations are now underway with the top technical firm. Contract is expected to be signed in February 1986. Designs are to be ready by mid-1986.

* 20 Long-Term Participant Training Programs started: A training plan for 1986 specifying the mix of U.S., Sri Lankan and 3rd country programs has been developed, and candidates applications for the first 33 programs are being reviewed. The first two long-term training programs started in January 1986

* 60 person-months of short-term training completed: 10 person-months have been completed. Another 50 pms are scheduled between January-September 1986.

* Recommendations developed for field crop research: Recommendations are being developed for the 1986-87 crop season and are to be completed by April 1986.

2) An Effective Agricultural Planning and Policy Formulation Capability (E)

* Research and feasibility work completed on liabilities and constraints to increased agricultural productivity: The last NAFNS related studies on agricultural statistics and land use compatibility were completed in November 1985. A new project in Agricultural Planning and Analysis (AGPLAN) 383-0083 will provide the basis for further research and feasibility work.

* NAFNS continues to serve as a forum for inter-ministerial policy dialogue: A three day USAID sponsored Strategy Implementation Workshop was convened by the Finance and Planning Ministry in August 1985, in which seven agricultural line ministries participated. Each ministry was asked to prioritize its programs and projects on the basis of the guidelines in the NAFNS. A number of inter-ministerial group discussions were also held on special topics such as agricultural pricing, credit and research.

* Project development work for the new Agricultural Planning and Analysis (AGPLAN) project completed and an Agreement signed: A draft PP was reviewed in the Mission in December 1985. Final drafting of the Project Paper is now in process and will be completed by February 1986. Negotiations on this project are complicated by the "50%" Rule.(Discussed in Section II.C.1).

3) A Viable Agricultural Development Program and Support Services Management Capability(E)

* Project development work for the new Development Management & Training, 383-0085 completed and a DM&T Project Agreement signed: A revised Project Paper is nearing completion reflecting USAID and GSL desire to scale back the applied management component from the multi-institutional effort proposed by the design team to a small-scale pilot activity in the Ministry of Agriculture. USAID authorization is planned for May 1986, and the Project Agreement will be signed in June, although this project could be effected by the "50%" Rule (see Section II.C.2).

* 15 specific agriculture/rural development management improvement training programs initiated: No programs have been initiated because the DM&T project has not yet been authorized.

* The Agricultural Education Development project completed having created a functional capability to provide graduate level education in agriculture: 39 participants, 14 have completed their training and returned to work in Sri Lanka, and 18 are still in training. The other seven completed training for Ph.Ds but did not return to Sri Lanka. The GSL and USAID are exploring legal and other action to help assure the return of those still in training and to recover costs for the seven lost to the program to date. Other elements of the project are essentially completed. The PACD is 30 September, 1986.

* An analysis and strategy for agricultural education completed based on the Agricultural Manpower Study: The manpower study was delayed over six months because of the difficulties in identifying specialists acceptable to both the GSL and USAID. The completed study is now under review as the basis for the strategy.

4) Cost-Effective Rehabilitation and Maintenance Systems for the Extensive Irrigation Networks (E).

* Water Management project completed with the Gal Oya left bank fully rehabilitated: The Water Management project was completed on 31 December 1985. Rehabilitation work is only 85% complete, but the GSL has agreed to complete the work with its own resources.

* Project development work for the new Irrigation Systems Management (ISM) project completed and a Project Agreement signed: The Project Paper has been completed and the project is under final review by the GSL. USAID authorization is dependent on certain conditions which have not yet been fully satisfied by the GSL. We expect these matters to be resolved to allow obligations as early as end February 1986.

* Long-Term diagnostic analyses completed on four irrigation systems: No analyses have been completed. GSL support was provided very slowly, and only two seasonal reports on two systems have been completed to date. Second season data collection is underway for the same two systems. Work on the remaining two systems is to be conducted under the ISM project.

* Final evaluation of the Water Management project completed: The evaluation was done in November/December 1985 and a draft PES prepared.

5) Reduced Constraints to Improved Private Sector Agriculture Marketing and Distribution (E)

* A study undertaken to identify the critical constraints to the marketing of rice, coarse grains, pulses and vegetables: A scope of work has been drawn up for the study of subsidiary food crops and vegetables but has not been funded yet because of other priorities.

6) Utilization of the PL480 Title I Resources to Meet Programmatic Objectives (E)

* Project design work for the new PL480 Title III program completed and a Project Agreement signed: A PID was completed and reviewed by the Mission in July 1985. However, very limited interest on the part of the GSL in a Title III program, and other considerations led Mission to decide not to proceed further with program development work.

* Better integration of the PL480 resource into strategic objectives: The self-help terms and conditions of the FY86 Title I program were strengthened to enhance the Mission's efforts at improving agriculture productivity. The requirements for a) an implementation plan for the NAFNS, b) an implementation plan for crop diversification and c) a study of irrigation systems to determine actual costs per acre to maintain irrigation systems are requirements under the Title I self-help provisions. In addition, local currency counterpart has been directed to those same areas of interest and to stimulation of private sector development.

* A comprehensive report on self-help measures undertaken and a waiver of repayment (conversion to Title III) authorized: No report or waiver are needed as no Title III program has been initiated.

b. <u>Increased Off-Farm Employment and Rural Enterprise.</u>

1) A Planning and Policy Formulation Capacity, in Both Public and Private Sectors, to Deal with Rural Employment and Business Development (E).

* Mid-term evaluation of the Private Enterprise Promotion (PEP) project completed: Full implementation of the project began in late 1984 following one year of organizational work to establish the SLBDC and initiate operations. The project will reach an appropriate point for an evaluation in the fall of 1986, and has been rescheduled accordingly.

* A study completed on the feasibility of further developing the food technology industry in Sri Lanka: The study will be completed in June 1986.

* Sri Lanka Business Development Center (SLBDC) financially self-sufficient and able to cover its basic "core budget" operating costs: The SLBDC met its 20% portion of operating costs in the year ended 30 September 1985. At present rates of income, the SLBDC should be able to maintain 50% of its operating costs, the target for this operational year.

* The private sector more actively engaged in macro-economic development strategy formulation, and specifically in industrial development policy formulation, and actively supported in these endeavors by the SLBDC: The private sector (including the SLBDC) participates with the GSL on an industrial policy committee; an SLBDC-sponsored tax policy is now underway: However, in general, there has been, as yet, no real influence on other major macro-economic development issues.

2) A Professional Information Development and Dissemination Capability providing accurate Economic Data and Informational Services for Business Decision Making (E).

* Investor services (market studies, pre-feasibility studies, promotion activities) provided to business clients and contributing to increased investment by the private sector: The SLBDC has completed or is preparing 30 investment project profiles. Investor based (cost-shared) pre-feasibility studies are underway or planned for four investment projects, and one market study is under preparation.

3) A Capability to Provide Practical, High Quality Management Education (E).

* A program of rural entrepreneur development and related business promotion services introduced in 10 or more interior districts: The program has begun in nine districts.

* A program of management training and development initiated and geared to the specific needs of the private sector: The program is in operation providing specific training to private sector clients with courses on the practice of management and individual in-company programs.

* 15 specific management improvement training courses initiated: Because of the delay in initiating the program, only eight courses have been given to date.

c. Development of the Mahaweli Region.

1) Settlement of 115,000 people on 23,000 hectares of Left Bank irrigated land in System B of the Maduru Oya (E).

* 7,000 farm families settled: 7,023 families were settled.

* Project development work for the new Mahaweli Agriculture and Rural Development (MARD) project completed and a project agreement signed: Rather than a Mahaweli specific project, the Mission is planning to focus attention on the Mahaweli through projects designed to increase agricultural diversification, increase rural enterprises and reduce rural under-employment, and establish an effective Water Management Program.

2) Improved Inter-Ministerial Coordination on Mahaweli Development Programs (E).

* An assessment of the health status and needs of the Mahaweli settlement areas completed: The assessment was completed in November 1985. The assessment will serve as the basis for further MASL-MOH cooperation on health programs in the Mahaweli region.

* Two additional studies or pilot activities designed to foster inter-ministerial cooperation: The MASL has been working with the Ministry of Finance & Planning and with several private sector organizations, including the SLBDC, to develop a program to promote rural enterprises in the Mahaweli. This cooperation will lead to a major segment of the new USAID project - REDS. No other study or pilot activity is yet underway or planned.

3) The Mahaweli Authority in a Planning and Policy Formulation Role and Less of an Implementation One (E).

* Evaluation of the Mahaweli I, II and Sector Support projects completed: A major evaluation on all three projects was finished in June 1985

* Project redesign authorized to include additional work in Zone 4 of System B and assistance in planning and budgeting: Because of security concerns, the GSL was unable to carry out a soil survey necessary for determining the economic return on the additional work. An office photogrammetic enhanced soil survey was finally done in December, however, the mission has postponed plans to fund additional construction in Zone 4B.

* An assessment undertaken on planning and financial management capabilities within the Mahaweli Authority and recommendations on means to improve them: As both the GSL and USAID were not satisfied with the TA provided in the assessment, and the GSL wanted to re-think their need for this type of assistance, the assessment was suspended. No specific time-frame has been established for resuming.

* A groundwater feasibility study carried out in System B: The GSL has requested that the ground water study not be carried out due to the higher priority need to finance rural enterprise planning.

* A study of employment generation potential in the Mahaweli region completed: In cooperation with the SLBDC and the Ministry of Finance and Planning the MASL carried out, or financed, private sector studies on a series of inter-related issues. These studies are now being integrated into a final strategy on employment generation. These studies will form the basis for a major portion of the new USAID REDS project.

* Three workshops undertaken to develop a) a policy handbook for the Dept. of Wildlife Construction, b) resource maps for the four wildlife parks and c) a management plan for one of the parks: The workshop and draft policy handbook were completed in February 1985. The draft management plan for the Madura Oya park was completed in October 1985. Progress on compilation of the park resource maps has been delayed due to security considerations.

* An evaluation of the Mahaweli Environment project completed: The mid-term evaluation was completed in December 1985, recommending some major changes in project implementation.

4) Infrastructure Essential to Developing the Mahaweli (E).

* 1400 acres of park habitat improved: 700 acres of habitat have been improved. Progress has been slow because of project administrative problems.

* 20 miles of road, a bridge and 20,000 sq.ft. of buildings for the Mahaweli parks completed: Due to project administrating contracting and security problems, only 7 miles of roads and 2,000 sq.ft. of buildings have been completed to date.

* 100 additional kilometers of farm-to-market roads completed: Only 35 additional kilometers of road have been completed. GSL efforts have been limited by the security threat, particularly to equipment.

* 53 kilometers of main canal and 87 kms of branch canals constructed: 53 kilometers of main canal work was done thus completing all main canal work. 63 kms of work was done on branch canals.

d. Additional Programs of Interest

1) Health and Nutrition (E).

* AID's participation in the School Feeding Program reduced by 50%: The number of beneficiaries has been reduced by only one-third (from 750,000 to 500,000) based on the new phase out schedule.

* An evaluation of the National Institute of Health Sciences (NIHS) project completed: Because of delays caused by irregularities in the construction contracting and the necessity to rebid, further delayed by GSL foot-dragging, the project is behind schedule. The evaluation has been rescheduled for August 1986.

* Deob-reob made from the cancelled Market Town Water Supply Project: Deobligations have been made and documentation for reobligation of that portion to be used has been prepared. Reobligation awaits clearance from AID/W.

* A plan developed for the information and education campaign of the Malaria Control project: The baseline survey of attitudes regarding malathion spraying was completed in July 1985. Plans for the mass media campaign are nearing completion.

* Workplans developed for the management and evaluation components of the Malaria Control project: A plan for developing a computer-based management information center was completed in December 1985. Computer equipment purchases were initiated in early January 1986. However, little progress has been made yet on the evaluation workplan as GSL and contractor attention have been focussed on the management component as the prerequiste first step.

* Initiate arrangements for overseas training of staff in specialized/newer malaria control techniques: Two senior staff of the Anti-Malaria Campaign (AMC) have received specialized training at the University of South Carolina vector control program, one epidemiologist was trained in basic malariology in New Delhi National Institute of Communicable Diseases, and seven public health inspectors are currently in training in Malaysia and Thailand. Training will continue throughout the project.

* Technical assistance contract awarded and contractor fully mobilized for the Water Supply and Sanitation Sector (WS&SS) project: The contract was awarded in February and initial mobilization began in April 1985.

* Construction/renovations designs completed, contracts awarded and work initiated for facilities under the WS&SS project: Work on this project has been delayed because of difficulties in finalizing plans for the NWSDB reorganization program. Designs are not yet complete, and no contracts have been awarded.

* Water supply and latrine construction/rehabilitation sub-project selection, pre-feasibility, feasibility and design work completed: For the reasons given above, work has been delayed. Selection and prefeasibility work is in progress.

* Initial two-year health education training completed: The health training curriculum is in development and is dependent on sub-project selection (see above).

2) An Improved National Resources Management Capability (N)

* Drafting work completed on a Sri Lankan National Conservation Strategy and follow-up actions initiated: 22 of 25 background papers are completed. Consultant performance has been less than planned, delaying completion of the strategy.

* An agreement signed and work begun on a National Coastal Resource Management Plan: The Agreement was signed in November 1985. Work began in January 1986.

* A second environmental impact assessment workshop undertaken: The follow-up (2nd) workshop on Environmental Assessment Procedures Development and Implementation was held successfully in August 1985.

* Forestry Extension Service Division established: The Division has been established and a U.S. trained participant has been assigned to head it.

* Construction of AID-financed Forestry College facilities completed: Because of its location in an remote area of high security risk, the Forest College was closed in May and construction at the original college site (China Bay) was stopped. A proposal for relocation of the college near Nuwara Eliya has been submitted to USAID for approval. That approval is pending GSL clarification on several issues raised by USAID.

3) Reduction of Development Constraints Particular to Women (E)

* An assessment of the role of women in irrigation and water management completed. The final report was submitted in December 1985 and results will be incorporated in the new ISM project.

* Rigorous analysis of the role of effect on women included in all project design work carried out: The coverage of women has been addressed in the design stage of each of the three proposed FY 86 projects.

* Collection of sex-disaggregated data done as an integral part of all data gathering efforts under USAID projects: Several efforts recently completed or now underway have attempted to provide sex-disaggregated data. Examples include management culture in Sri Lanka, Mahaweli Enterprise Strategy Development and Employment and Unemployment in Sri Lanka.

4) Develop the Capability to Provide and Finance Affordable Low Cost Housing and Related Services (E)

* Draft national housing policy paper: On October 4, 1985 the GSL housing authorities forwarded the draft policy paper to USAID. The draft, which will now be cleared through GSL, is basically acceptable to AID and increases the private sector's role in the housing sector.

* Revise and update Subsidy Reduction Study demonstrating the real cost to GSL of existing housing sector subsidies: AID financed short-term studies convinced the GSL that significant savings could be made through the use of private sector institutions such as the Thrift and Credit Cooperative Societies. The GSL has carried out a small pilot program with such societies in the Kandy area and has begun the reduction of subsidies in making and collecting loans through public entities. The Prime Minister has pledged to further privatize the entire housing program.

* Update the Shelter Strategy Statement: An updated Shelter Strategy Statement was prepared by the Mission and RHUDO/Asia and is now with PRE/H for finalization and approval.

* Formulate savings and lending procedures and strategies for the private and public housing finance institutions including an expansion to rural housing in the Mahaweli settlement areas: Work has been successful with the Thrift and Savings Societies, increasing their role in the housing program. Discussion underway with the MASL and Hatton Bank (the only Sri Lankan owned, private commercial bank) to conduct a test program in System H-5 with Hatton Bank as the primary lender.

* Develop plans to rationalize urban low income housing and basic infrastructure services: Based on AID funded studies, the GSL has merged the two agencies dealing with urban housing and services. The new unit was significantly strengthened to deal with its responsibilities with a competent officer was assigned to head it, and the GSL has requested AID assistance in privatizing a significant portion of the urban housing program.

* Assist the newly created Land Commission in revising legislation adversely effecting the housing sector: USAID has begun a dialogue with the Commission, but since the Commission was not set up till late in the year no significant achievements have been made.

* Design the Phase III Housing Guaranty program: The Mission-prepared PP for Phase III was approved in AID/W on 2 August 1985 and negotiations are underway for conclusion of the Phase III agreement.

5) Private Voluntary Organizations Able to Carry Out Programs which Allow the Poor to Participate in Their Own Development (E)

* PVO grants valued at $2,250,000 signed for new activities under the PVO Co-Financing project: Since January 1985 six new grants valued at $625,666 have been signed, and an additional four for $ 688,000 are in various stages of approval. Two approved grants totalling $675,000 had to be withdrawn when the PVO International Human Assistance Program (IHAP) decided to close its program in Sri Lanka.

* A selective reorientation of PVO grants to more closely integrate PVO programs into the Mission's strategic objectives: The Mission has adopted a policy that PVO grants contribute directly to a CDSS objective, and all proposals are being reviewed on that basis.

* An evaluation of the PVO Co-Financing project completed: Given program considerations, the evaluation has been rescheduled to June 1986.

* A workshop for PVO's to increase evaluation capability was held during January 1986 with 20 PVO's in attendance.

e. <u>Mission Management Issues</u>

1) Improved Mission Organization Reflecting changing Priorities and Conditions (E)

* Reduction of two positions completed: A General Development Officer position and an Assistant Program Officer Position have been eliminated.

2) Improve program support services (E)

* MACS put into full operational status: MACS is not yet fully operational. Environmental conditions for hardware required several modifications to the original plan, including some architectural changes. Data loading has now begun and is proceeding satisfactorily.

* Eighteen computer work stations are being brought on line throughout USAID: Thirteen stations are now operational and benefit all elements of the Mission.

II.A.

2. FY86-87 Benchmarks
(Benchmarks are indicated by an asterik "*")

a. Improved Agricultural Productivity and Farm Incomes

1) Small farmer incomes increasing by 5% or more in real terms by 1990 (N)
* A 2% increase in real small farmer income in 1986.

2) Paddy (rice) production increasing 5% annually from 1985 to 1986 (N)
* A 5% increase in paddy production for 1986.
* A 3% increase in per acre paddy yields for 1986.

3) Gross production of subsidiary field crops (SFC) increasing by a 15% annual average from 1985 to 1990 (N)
* A SFC baseline survey completed in 1986.

4) Per acre production of SFC increasing by 10% annually from 1987 to 1990 (N).
* An SFC research program initiated with efforts under way by the end of 1986 in improved SFC varieties and production practices, improved SFC seed production and marketing, and increased understanding of SFC cropping patterns.
* A set of clearly defined and quantified benchmarks established by November 1986 for SFC productivity development.

b. Increased Off-Farm Employment and Rural Enterprise

1) Underemployment levels in the Mahaweli region reduced from 40% to 25% or less by 1991 (N)
* No increase in the rate of underemployment in the Mahaweli region during 1986.
* Investment initiated on five agro industrial enterprises for the Mahaweli region by December 1986.
* Rural enterprise and employment planning activities in full operation within the MASL by the end of 1986.

2) 400,000 new private sector jobs created by 1990 (N)
* Private sector employment increased by 45,000 jobs in 1986.
* The SLBDC playing an active role in encouraging private sector investment.
* 20,000 private sector-financed and constructed/improved housing units in rural areas in 1986.

3) Selective reversion of state-owned enterprises to the private sector (N)
* Draft strategy for USAID support to the GSL privatization effort established by September 1986.

4) An industrial development policy for Sri Lanka established by 1987 giving priority attention to the private sector (N)
   * The SLBDC and other private sector organizations playing an active role in formulation of the industrial policy.

c. Development of the Mahaweli Region

1) 117,000 hectares of land under cultivation in the Mahaweli by 1987 of which 53,000 hectares will be irrigated land (E)
   * The number of hectares under cultivation increased by 12,000 in 1986 for total of 53,000 hectares.
   * 87 kms of branch canals constructed and opened for irrigation use thus increasing the hectares with irrigation by 4,000 in 1986.
   * Operation and maintenance plans proposed, adopted and in effect by 1986.

2) 690,000 new settlers established in the Mahaweli region by 1987 (E)
   * 8,000 new farm families and 1,200 non farm families established in System B during 1986.

3) An average annual farm family income in the Mahaweli of Rs.16,000 by 1987 (E)
   * Average annual farm family income at Rs 12,000 by the end of 1986.
   * 1986 Benchmarks for agricultural productivity and rural enterprise development met.

4) Three Mahaweli national parks established and providing employment opportunities to 2,000 local residents in park construction, maintenance and tourism by 1988 (E)
   * Mid-term evaluation recommends reduction to three parks until security improves.
   * 10% reduction in wildlife inflicted crop damage through improved wildlife management practices (1986).
   * Park infrastructure 10% completed in 1986.
   * 200 new employment opportunities created in 1986.

5) The MASL operating as a planning and policy formulation agency with implementation responsibilities placed in the line ministries (E)
   * The MASL playing an active role in formulating the new RED project and in coordinating its execution with other ministries and private sector organizations.

d. Other Programs

1) Reduction of malaria to fewer than 35,000 annual cases by 1987 (E)
   * Number of malaria cases reported for 1986 totalling less than 38,000.
   * GSL contributing 60% of the costs of purchasing the 1986 malathion requirement.

2) By 1990, a reduction of 25% in the morbidity and mortality rates due to water-borne diseases (E)
   * Improved inter-institutional collaboration/coordination in water supply and sanitation sector activities.
   * Improved NWSDB financial viability through increased revenue generation, cost control and operational efficiency (continual progress).
   * Improved NWSDB operational performance through improved policies and procedures and training in same (continual progress), and decentralized and consolidated organizational structure.

3) A capability established to manage natural resources effectively in support of sustainable development (N)
* A 10% increase from 1980 in the forest cover of the upper Mahaweli catchment area by the end of 1986.
* A 2% increase from 1980 in the total acreage under permanent forest cover by the end of 1986.

e. Mission Management Objectives

1) A Mission organizational structure appropriate to the type and size of program (N)
* All technical staff reorganized into divisions of a single office focussed on implementation responsibilities by December 1986.
* A set of contingency plans for reorganization/staff reduction, by April 1986, in preparation for possible program changes resulting from USG deficit reduction efforts.
* An appropriate program/staff level determined by FY 88 ABS reviews in mid-1986.

2) USAID physical facilities meeting the Mission needs and security requirements by 1987
* The security enhancement program 100% completed by the end of 1986.
* MACS and computerization program including a WANG 65 computer to provide total inter-communications between offices of the Mission and MACS fully operational.
* It is also intended that telecommunication connection with AID/Washington be accomplished during this period.

II. B. ACTIONS FOR THE COMING YEAR

1. Key Policy Actions

a. Overview: In the Policy Dialogue Paper prepared to supplement the FY87 CDSS, the Mission identified and defined a series of policy issues to be pursued over the planning period of the CDSS. That paper is included with this Action Plan as Annex B.

Within that policy dialogue framework, we will be focussing this year on six major issues: 1) Selective reversion of state run enterprises to the private sector, 2) establishment of an industrial development policy which provides clear guidelines for private sector involvement, 3) establishment of an agricultural diversification strategy, 4) coordination of agricultural research based on a clear set of established priorities, 5) commitment to operations and maintenance programs for irrigation systems throughout the country, and 6) increases in the rate of interest and repayment for nationally-supported housing programs.

b. Macro-economic policy: The macro-economic setting in Sri Lanka is a critical factor in achievement of our strategic goals. The GSL budget deficit is a primary macro-economic concern, and almost all parastatals are a drain on the budget. A major policy action will be directed at reversion of state run enterprises to the private sector, and we are currently designing a project to provide budgetary support (program assistance) to the GSL in response to their

divestiture of government owned and operated enterprises. There appears to be sufficient GSL interest at this point to warrant such an effort. While public statements have indicated a preference for private management under public ownership, we expect our involvement to help stimulate a complete reversion to the private sector of selective enterprises. Specific actions planned this year center on developing the project and are:

* Complete and approve PID by April 1986 (PD).
* Complete a co-operatively developed Project Paper including a clear set of criteria for divestiture and have both the GSL and USAID authorize the project by September 1986 (PD).
* Assure the GSL counterpart contributions to USAID supported projects remain adequately covered despite budget deficit reduction efforts. This assurance should include USAID funded items appearing in the budget as well as the GSL's own contribution (PD).

c. Improved Agricultural Productivity and Farm Incomes. Our efforts towards this objective for FY86-87 will be focussed on the diversification program, water/management and agricultural planning. The policy actions are:

* Establish an agricultural diversification plan by December 1986 (PD/IB).
* Establish a clear set of priorities for coordinated agricultural research by October 1986 (PD/IB).
* Complete by October 1986,a study on the policies, incentives and institutional arrangements necessary to improve the competitive structure and efficiency of the private agricultural marketing structure (PD/IB).
* Get GSL authorization of an official, permanent cadre of institutional organizers to establish farmer/water user associations for irrigation systems (PD/IB).

d. Increased Off-farm Employment and Rural Enterprises. The principal efforts in this area will be the project design work for the Rural Enterprise Development Sector (REDS) project mentioned earlier under macro-economic policy. The additional policy actions planned are:

* Establish a schedule for completion of a national industrial development policy linked to the REDS project (PD).
* Pursue GSL adoption of a National Housing Policy which stresses private sector participation in the housing sector (PD).

e. Development of the Mahaweli Region. This period, FY86-87, will see a further integration of our planned efforts in the Mahaweli Region into activities relevant to national development of Sri Lanka. In that respect, most of the policy issues of the Mahaweli are covered under previous and following objectives, however, Mahaweli specific policy actions are planned:

* Monitor that settlement is being done on an equitable basis according to the original GSL guidelines established for the Mahaweli Settlement Scheme (PD).
* Assure that agricultural development is sustainable through more national resource utilization policies/programs.
* Assure that an effective O&M program is established in system B.
* Design a rural enterprise sector activity to commence in the Mahaweli area.

f. Additional Programs of Interest. We will be limiting our involvement in additional sectors and basically be completing ongoing projects. The Mission will endeavor to encourage appropriate officials to consider increased attention to preventive health, fee for services, and child survival including oral rehydration in concert with and support of UNICEF.

2.Key Implementation Actions

a. Improved Agricultural Productivity and Farm Incomes

1)A Qualified and Functioning Agricultural Research Capability in Subsidiary Field Crops (SFC)

* Complete and approve LOP work plans for DARP, 383-0058, by June 1986 (TT).
* Complete and publish the baseline surveys on crop diversification by June 1986 (IB).
* Construction plans completed July 1986 and contracts let November 1986.
* Conduct a workshop on farming systems research and extension by August 1986 (TT).
* Complete 60 pm short-term technical training (TT).

2)An Effective Agricultural Planning and Policy Formulation Capability

* Complete the PP by February and sign Project Agreement for AGPLAN, 383-0083, by June 1986 (IB/TT).
* Initiate the technical assistance contract for AGPLAN by November 1986 (TT).
* Initiate AGPLAN long-term training programs by September 1986 (TT).

3)A Viable Agricultural Development & Support Services Management Capability

* Complete the Agriculture Education Development, 383-0049, project with the final 18 participants all returned to appropriate positions by September 1986(TT/IB).
* Complete the Development Management & Training, 383-0085, PP by April and sign the Project Agreement by June 1986 (TT).
* Set up an Applied Management Steering Committee and a DM&T Secretariat in the MADR by July 1986 (IB).
* Initiate the technical assistance contract for DM&T by October 1986 (TT).
* Initiate a pilot agricultural/rural development management improvement program in the Dept. of Agriculture by November 1986 (TT).
* Launch minimum of three management-oriented DM&T sub-projects by December 1986.

4)Cost Effective Rehabilitation & Maintenance Systems for the Extensive Irrigation Networks

* Get a GSL budget supplemental approved to provide counterpart funding and cover U.S.-funded inputs for ISM (IB).
* Sign the ISM, 383-0080, Project Agreement by April 1986 (IB/TT).
* Initiate the technical assistance contract for ISM by September 1986 (TT).
* Establish and approve an operational plan for testing various rehabilitation methodologies by December 1986 (IB/TT).
* Complete the long-term diagnostic analysis on two irrigation systems by July 1986 (IB).
* Conduct "programmatic" diagnostic analysis studies in two additional systems in Yala 1986.

5)Utilization of PL480 Title I Resources to Meet Programmatic Objectives

* Complete the FY87 Title I negotiations by August 1986 in order to fit with the GSL budget cycle (IB).
* Further direct the self-help measures under Title I to specific programmatic objectives (IB/TT/PS/PD).

b.Increased Off-farm Employment and Rural Enterprise

1)A Planning and Policy Formulation Capacity, in Both the Public and Private Sectors, to Deal with Rural Employment and Business Development

* Amend the Authorization for the Mahaweli Basin Development I, 383-0056, project to include assistance for employment generation and rural enterprise development (IB).

* Sign an amended Mahaweli Basin Development I Project Agreement by June 1986 (IB).
* Initiate the technical assistance contract for the MBD I extension by October 1986 (TT).
* Engage the private sector more actively in macro-economic development strategy formulation, specifically on industrial policy, tax policy and privatization (PS).
* Get the SLBDC to the point of being able to fully cover 100% of its basic operating costs (IB/PS).

2)A Professional Information Development & Dissemination Service for Business Decision Making
* Conduct an effective, ongoing program of investor services in both the SLBDC and the new MASL unit (IB/PS).
* Initiate five new private sector investment projects on the basis of investor services.
* Establish an effective coordination between the Ministry of Agriculture, the SLBDC and MASL to utilize the agricultural marketing study to stimulate private sector investment in marketing, particularly in the Mahaweli region (IB/PS).

3)A Practical, High-Quality Management Education Capability
* Extend the ongoing SLBDC-led entrepreneur development program to a total of 12 districts (IB/PS).

4)A Rural-centered Housing and Infrastructure Program which stimulates Off-Farm Employment and Rural Enterprise
* Design and implement by September 1986 a model private sector housing finance program for the Mahaweli region (IB/TT/PS).
* Develop methodologies for housing finance institutions to raise money through means other than treasury debentures by September 1986 (IB/TT).
* Develop a pilot privatization model for the urban housing program by November 1986 (IB/TT/PS).
* Negotiate and sign the Phase III Shelter Program Agreement by February 1986 (IB/PS).
* Provide short-term technical assistance to further the privatization of the rural housing program using Thrift and Credit Cooperative Societies (TT).

c. <u>Development of the Mahaweli Region</u>

1)Effective Inter-Ministerial Coordination on Mahaweli Programs
* Complete two additional studies or pilot activities related to Mahaweli development which require inter-ministerial cooperation (IB).
* Have MASL participate as an active member of the newly established Agriculture Planning Group (IB).

2) Foster increase in Planning & Policy Formulation Role by MASL and Reducing Its Implementation Responsibilities
* Develop the REDS project (previously noted in Section II.B.1).
* Undertake DWLC workshops to develop a) a management system for Mahaweli protected areas b) management plans for each Mahaweli park, c) a wildlife conservation awareness/education program, d) a DWLC training program, and e) enhanced environmental management through effective community participation (IB/TT).
* Initiate a wildlife monitoring program for threatened and endangered species in the Mahaweli region (IB).
* Reassess progress in the Mahaweli Environment Project to determine if extension of PACD is appropriate (December 1986).
* PASA with National Park Service amended by June 1986 to include position of resident NPS advisor as recommended by evaluation.

3) Essential Infrastructure in Place for Mahaweli Development

* Construct 87 kms of branch canal (IB/TT).
* Complete the MBD II project and prepare a PACR (IB/TT).
* Develop and implement an irrigation O&M plan for System B by July 1986 (IB).
* Develop and implement a training plan to meet irrigation O&M technical training needs by April 1986 (TT).
* Establish by September 1986, a systems monitoring plan for System B (IB).
* Improve 700 acres of wildlife park habitat with emphasis on enhanced park buffer zone development (IB).
* Plans and designs for Mahaweli parks infrastructure construction completed (August), construction contracts awarded (October 1986).

d. Additional Programs of Interest

1) Health/Nutrition

* Reduce AID's participation in the School Feeding program by another 250,000 beneficiaries (IB/PD).
* Place the Information & Education Campaign of the AMC in full operation by September 1986 (IB/TT).
* Begin operation of an AMC computerized management information system by July 1986 (IB/TT).
* Prepare the draft of a new AMC strategy by March 1986 (IB/PD).
* Under DM&T, prepare a strategy to strengthen the academic and research programs of the NIHS (TT/IB).
* Construct 80% of the NWSDB support facilities for the WS&SS, project (IB).
* Complete the selection and design of six water supply and latrine construction/rehabilitation sub-projects under WS&SS and initiate six reconstruction/rehabilitation activities by December 1986 (IB).
* Initiate implementation of a new manpower development plan for the NWSDB project (TT).
* Under WS&SS, establish financial viability of the NWSDB through effective billing and collection procedures, rationalized water tariff policies, improved design and operational performance and strengthened financial planning, management and control (IB).
* Establish improved operational performance through development and implementation of improved policies and procedures for all NWSDB operational areas.
* Complete the curriculum development for the two-year health education training program by October 1986 and initiate implementation (TT/IB).

2) Improved Natural Resources Management

* Approve a new Reforestation & Watershed Management, 383-0055, project implementation plan based on the changes made following the project evaluation (IB/TT).
* Decide on USAID participation in the relocation of the Forestry College (IB/PD).
* If USAID will participate, complete 60% of the AID financed construction (IB).
* Establish three mobile reforestation extension units by August 1986 (IB).
* Begin implementation of the Conservation Awareness Program by September 1986 (IB).
* Complete by December 1986, the final draft Sri Lanka National Conservation Strategy (IB/TT).
* Prepare Sri Lanka National Coastal Resources Management Plan by October 1986 (IB/TT).

3)Women in Development
* Improve on the collection of sex-disaggregated data in USAID financed collection efforts (IB).

4)Private and Voluntary Agencies
* Sign $1,800,000 in new PVO grants under the PVO Co-Financing, 383-0060 project (IB/TT/PS).
* Carry out a workshop on evaluation techniques for PVOs operating in Sri Lanka (IB).
* Complete and close out five earlier PVO grants under PVO Co-Financing (IB/TT/PS).

3. Key Evaluation and other Study Actions

Two evaluations recently completed have been used in new project design efforts and one scheduled will have an impact on further design work in that sector. The Water Management (383-0057) End of Project evaluation was used to make adjustments to the ISM (383-0080), Project Paper. This evaluation was particularly helpful in determining the weaknesses in the project which could be corrected in the follow on project implementation.
In an evaluation done on the Mahaweli Sector Support (383-0078), project last June, the advantages and disadvantages of a balance of payments support type of program loan tied to specific local currency uses were highlighted. These findings have been used in developing the Rural Enterprise Development (383-0090) project in relation to its program assistance component. Through the Housing Guaranty program the Mission continues to assist in the development of Sri Lanka's private and public housing finance institutions particularly those serving low income households in rural areas. Housing Guaranty projects 383-HG-002 and HG-003 will be evaluated in 1986 to determine the success of a number of initiatives, including the privatization of the Million Houses Progra through the use of rural thrift and credit societies. The evaluation will also seek data on the extent of female headed households granted housing credit. The findings in this evaluation will be critical to further efforts in the housing sector.

II.C. Narrative Report

1. Improved Agricultural Productivity and Farm Incomes

Our major concern in reaching the objectives set for this and other sector goals has been the interest and priority given by the GSL. We have been slowed in meeting project design benchmarks because of a frequent lack of GSL attention and a hesitancy to take steps we consider necessary to allow for a project to be successful. Project implementation has been held up because GSL budgets, either for counterpart or USAID contributions which go through the budget, were not adequate. While institutional capacity is sometimes the problem, it is more often a case of institutional will.

The security situation in the country continues to be a drain of both resources and the time of decision makers. The GSL has had to make development a second priority. As this situation will continue over the Action Plan period, we have had to take it into consideration in setting our targets for the coming year. Our budgetary support/privatization program will help in this effort, if the GSL follows through on divestitute of its many parastatals.

A particular issue recently came to the fore. In order to increase the concessionality of the foreign assistance it receives, the GSL has decided that no more than 50% of any grant assistance can be for technical assistance. Their intention is that more commodities or training be grant financed so that the TA comes out less than half of total grant assistance. Because few other donors mix loan and grant financing in a single project, we are the only donor seriously affected by this decision. We have advised the GSL that our project designs are based on what is needed and what AID is willing to loan or grant finance, based on the host country's development status, and we are not in a position to comply with arbitrary percentage levels. The GSL has stated that it will review projects on a case by case basis. Therefore, while we expect an acceptable arrangement to emerge, the "50% Rule" has caused a delay in negotiating some project activity.

We have reviewed the approved strategy and concluded that improving agricultural productivity and farm incomes should remain a primary goal. We believe our efforts to create the institutional capacity to plan and carry out an agricultural diversification program remain our most effective way of contributing to that goal.

2. Increased Off-Farm Employment and Rural Enterprise

The decreased importance of the development effort because of the security situation in the country has also had an effect on our efforts toward this goal. In this sector, however, our more difficult task will be changing the GSL's attitude on its role in the economy. This government has rhetorically encouraged the growth of the private sector, but has not taken any real steps beyond that first important one of acknowledging recognition of the need for a vigorous private sector.

Government owned enterprise still account for over 50% of GDP although very few are profitable. Major elements within the government recognize the strain these enterprises put on GSL's ability to finance its more appropriate activities. Recent serious budget imbalances have brought the privatization issue to the fore. The concept of divestiture, however, does not yet enjoy full GSL support, and that will be a major policy dialogue issue over the coming year. A significant reduction in current program levels will certainly hamper our ability to influence the divestiture program.

3. Development of the Mahaweli Region

The Mahaweli remains a priority of the GSL and USAID; but by dealing with it more as a proving ground for program priorities with nationwide applicability with regard to agricultural productivity and rural enterprise development, we hope to accelerate creation of institutional abilities to deal with these efforts in other parts of the country.

One problem we will face in this effort will be the attitude of the Mahaweli Authority of Sri Lanka (MASL). Although MASL's self proclaimed goal is to reduce its own implementation role, it still takes a very proprietary view of the Mahaweli region. Cooperation with other government organizations has been improving but is still modest. We hope to carry out cooperative efforts which strengthen the line ministries, ease MASL into a more appropriate planning role and get the job done.

4. Additional Programs of Interest

Sri Lanka has already surpassed many of the health goals set by AID (although in some categories the country's position has deteriorated), the Ministry of Health (MOH) does not share AID's interest in other goals and the MOH has daunting management problems. For these reasons we will continue to limit our involvement in that sector.

In the current setting the GSL is giving low priority in practical terms to the natural resources conservation effort. We do not expect to do more than complete those projects we now have in progress. Successfully finishing them within the time frames set will be a major achievement in itself.

5. Mission Management

Likely program and OE funding availabilities make imperative increased focussing of our program in a more limited number of interrelated activities. This will be manifested also in reduction of centrally funded activities unless clearly related to the approved bilateral strategy and projects are less demanding on USAID staff time. A further reduction of USAID staffing seems inevitable.

6. The Role of Evaluation

Evaluations conducted in FY85 and the two completed thus far in FY 1986 have indicated that the civil strife has had a negative impact on the implementation of the projects to varying degrees. The evaluation of the Mahaweli Development I and II projects indicated that the construction of the main and branch canals in system B of the Mahaweli are nearly on target but that claim and arbitration actions as a result of civil strife may result in higher contract costs.

As noted in the Reforestation evaluation, if the conflict escalated in the fuelwood and Forest College areas project activities would be impeded. In the past year, the Forest College has closed down and dryland plantations in the Trincomalee and Batticaloa districts have been discontinued. The Mahaweli Environment evaluation team recommended discontinuing the development of one of the proposed national park for security reasons.

In the CDSS, the Mission proposed a contingency program of program assistance. The Mahaweli Sector Support evaluation, which looked at the future role of sector support, found that the assistance played a major role in increasing the Mahaweli Authority of Sri Lanka operational budget levels for downstream activities. The team recommended continuing program (including food) aid. The findings of the evaluation reinforced our thinking and are reflected in the Mission's program assistance proposal.

The final evaluation of the Water Management project was designed to assess the GSL capacity to manage large irrigation schemes and to determine the effectiveness of farmer organizations. In addition, the Mission was interested in learning the advantages or disadvantages of using a host country contract rather than a direct contract. The substantive findings of the evaluation were used in finalizing the Irrigation Systems Management project.

The evaluation of the Mahaweli Basin Development II recommends that the O&M technical assistance be used to strengthened the planning, budgeting and reporting system in MASL to make this institution more action and decision oriented. The project may be amended to include long-term TA.

II.D. New Project Descriptions

RURAL ENTERPRISE DEVELOPMENT SECTOR (REDS) 383-0090

1. Introduction and Background

When the current government came to power in Sri Lanka in 1977, it liberalized its economy and made the creation of jobs its central focus. While the GSL has made significant progress in these areas, about half of Sri Lanka's GDP is still created by the state sector. State corporations have received subsidies on the order of $ 1.5 billion since 1977, about the same as the cost of the entire Mahaweli program thus far. In his latest budget speech, the Minister of Finance noted that the losses incurred by the state corporations are greater than the entire sum spent annually on food stamps, free education and health and stressed the need to get the government out of businesses that could be better run by the private sector. The Minister is serious in his desire to privatize state corporations and his ministry has already analyzed more than ninety state corporations and placed them into four categories: (1) those which would be retained due to security reasons, (2) those that are profit making, (3) those incurring losses but which can be rehabilitated, and (4) those which are beyond rehabilitation and need to be closed.

2. The Problems to be Addressed by the Sector Program

One of the fundamental problems inhibiting further expansion of the economy is the large role of the public sector. Its impact is felt through its constraining impact on the private sector and through its contribution to the budget deficit which in 1986 is expected to exceed a projection of 14percent of GDP. The Mission believes that the GSL should continue to place high priority on expanding private sector activity, decreasing the budget deficit through the privatization of state corporations and enhancing rural incomes through job creation. Progress on enhancing the private sector's role in the economy should also increase competition in the economy with the elimination of current advantages given to state-owned enterprises.

3. The AID Sector Program

We see our future sector program as having two main tracks, one being assistance to the Ministry of Finance and Planning in privatizing the government's huge portfolio of public enterprises and the second focussing on improving agricultural productivity and rural employment. We see this two pronged attack as furthering economic development activities by decreasing the budget deficit through the privatization of state corporations , improving the climate for private sector development and ennancing rural incomes through diversified agriculture and off-farm job creation.

The Mission would like to assist the GSL in its move towards privatizing the state-owned enterprises. We think that our assistance could be instrumental in turning the Minister's ideas into action. We propose a sector assistance program whereby we essentially reimburse the GSL for privatizing corporations on the basis of x dollars in return for y value of assets privatized. The extent to which we would be involved in negotiations regarding which enterprises would be privatized would be decided at the program design stage. The uses of the foreign exchange would be unspecified, but some of the local currencies generated by such an effort would be transferred to the Development Finance Corporation of Ceylon to establish a fund to be used to help finance the private sector's purchase of the state corporations. Our assistance would be tranched and disbursements tied to actual privatizations or closing of public enterprises. The GSL would have to make available funding for the initial purchase of a privatized corporation in order to initiate the process. While the sector program would be loan funded, some grant funds would be provided for technical assistance leading to actual privatization decisions and actions, i.e., determination of the enterprises that are to be transferred to the private sector and the actual terms, conditions and procedures for such transfers. Because privatization is such a politically charged issue, the Mission foresees our program as being initiated with analytical assistance for the first year or two and only after such analyses are completed, would we be able to move large amounts of money tied to actual privatizations.

Local currency generations will also be used to support the second broad element of the sector program which will be continued assistance to the Mahaweli with special emphasis on agricultural productivity and enterprise development. This element will integrate our proposed further assistance to the Mahaweli areas, rural development sector activities and rural enterprise development. The Mahaweli area will serve as a proving ground for development approaches relevant more generally throughout Sri Lanka, be they private sector initiatives, agricultural diversification or rural credit improvements. Our sector program will place primary emphasis on the Mahaweli because 1) the potential is great, 2) the administrative infrastructure is in place, 3) GSL resources are relatively well assured, 4) we want to contribute to making the overall investment in the Mahaweli a success, and 5) we believe successful application in the Mahaweli area is likely to lead to adoption of similar programs elsewhere in Sri Lanka.

With the major infrastructural development work on the Mahaweli largely completed, the difficult task of raising incomes now needs to be addressed in earnest. The GSL has been designing its development activity in this area and has proposed a program which seeks as its goals to increase incomes and off-farm employment opportunities, to increase private investment and to accelerate the rate of technological change in the Mahaweli areas. The Mahaweli Authority has identified four strategic cornerstones - modified policies, a comprehensive financial incentives package, support for industrial infrastructure and an attractive investment/institutional

environment - as the foundations upon which the GSL intends to construct economic growth centers in the Mahaweli. Components of such a program would include: comprehensive extension programs to settler families, adaptive agricultural research, marketing facilities and information systems, expanded and improved credit facilities, management training and entrepreneur development, additional investments in agro-industrial infrastructure, and promotional activities to attract an accelerating rate of private investment.

4. Consistency of AID's Development Assistance Program

This two pronged sector program will assist in enhancing the role of the private sector in Sri Lanka in two ways -- one, by changing the macro policy environment which encourages the proliferation of public enterprises and two, at the micro level, by assisting the enterprise development phase of the Mahaweli. The program approach will allow us to concentrate AID funds in a larger unit than any series of specific project interventions would permit. It will allow us to direct our policy dialogue at the Ministry of Finance and Planning, and by concentration of our assistance program in one package with primary focus in the Ministry of Finance as regards the foreign exchange resources provided (with local currency resources under the control of Finance and the Mahaweli Authority, respectively), we think that through a more sectoral approach, the GSL will more highly value the program and utilize resources mobilized by it more rapidly and effectively.

5. Program Implementation

The program would be implemented by the Ministry of Finance and Planning and the Mahaweli Authority of Sri Lanka. The end of project status of the privatization component would be x number of public enterprises closed or sold to the private sector. The EOPS for the enterprise development phase would be the doubling of real per capita incomes in the Mahaweli G and H areas within five years and the establishment of agro-industries, including at least five "nucleus farm" enterprises in the Mahaweli B and C areas within the same time frame. Both of these approaches involve major policy changes. In the Mahaweli areas, for example, national land policy will have to be altered to permit longer lease periods and leases of larger extents of land. The privatization element will require implementation of a major philosophical change in the government's attitude towards its role in the economy.

This new sector approach will build on our existing portfolio and is supportive of that portfolio. Lessons learned from existing projects, such as Water Management, will be integrated into the sector program. In addition, we plan to negotiate for the inclusion of PL 480, Title I local currency generations into the activities sponsored by the sector program. Through a greater concentration of resources under the control of the Ministry of Finance in a period of budgetary stringency and balance of payment strains, the approach is designed to provide maximum support and increased leverage to our policy dialogue with particular emphasis on private enterprise approaches to rural development. In order to carry out such a program, the Mission ideally foresees the need for at least $20 million a year over five to seven years. In order to enter the privatization arena, in a noticeable way, we estimate that at least $10 million a year will be required. The GSL's initial proposal for the enterprise development phase of the Mahaweli amounts to $100 million over five years. We would like to be a major participant in that program and have programmed $10 million a year over five years.

III. SPECIAL CONSIDERATIONS

A. FINANCIAL ISSUES AND ANTICIPATED ACTIONS

1. Financial Issues: Any significant decrease in funding levels will jeopardize the program as now planned. Four new starts are scheduled for FY 86: three new projects (ISM, AGPLAN and DM&T) and one sector program (REDS). The sector program REDS will require a minimum initial funding level of $10 million to have an impact on the structural changes needed. Initial funding for the three new projects and project mortgage requirements will require at least $16 million. Program level decreases following on USG efforts at deficit reduction would mean delay one or more of our new starts.

   We have little mortgage at present. All but two ongoing projects received full LOP funding by the end of FY 85. The remaining two (PVO CO-FI and WS&SS) will reach full LOP funding levels with FY86 obligations. Our current pipeline is approximately $80 million or 2.6 times our FY86 program level. With approximately $50 million projected in expenditures in FY86 as major canal construction work comes to an end, we should see a major reduction in the pipeline. If obligations are reduced, expenditures will also decrease due to the virtual completion of the major construction works in the Mahaweli area but are nevertheless estimated to a significant $63 million in FY87 and 88. The pipeline does not include any significant amount of funds obligated over three years ago.

   The loan-grant split for 1985 was 54.4% loan and 45.6% grant. The percentage split for FY86 and FY87 programs as currently planned respectively are: Loan 59.4% grant 40.6%; Loan 68.1%, grant 31.9%. Loan levels remain at approximately two-thirds of the program which is appropriate for Sri Lanka and its development status.

2. Obligation schedules for FY 1986 and FY 1987

		FY 86	FY 87
383-0060	PVO Co-FI	March 1986	-
383-0080	ISM	April 1986	1st Quarter
383-0083	AGPLAN	June 1986	1st Quarter
383-0085	DM&T	June 1986	1st Quarter
383-0088	WS&SS	February 1986	-
383-0090	REDS	September 1986	2nd Quarter

3. Deob-Reob Plans

   At present the Mission has no specific deob-reob plans but as final payments are completed on the Market Town Water (383-0063) projects some additional funds are expected to be available here in the health functional account. The terminated Water Management (383-0057) project will also be examined for excess funding. Any extra funding resulting from the completion of the MBD projects will be applied to the planned extensions of those projects.

The Mission deobligated 6.4 million dollars in FY 1985 with the intention of re-obligating the funds to mission projects. $500,000 of deobligated Malaria Control funds were reobligated to Water Supply and Sanitation in late FY 85. The remaining balance of $5.9 million will be obligated for the following projects once AID/W advises that the deob-reob funds are available.

	DEOBLIGATIONS			REOBLIGATIONS	
	LOAN	GRANT		LOAN	GRANT
Food & Agriculture					
0044 DS&T	-	.750	0080 Irrig.System Mgt	-	.750
0057 Water Mgt	2.000	.300	0080 Irrig.System Mgt	2.000	.300
Health					
0062 N.I.H.S.	-	.300	0060 PVO Co-Financing	-	.300
0063 Jaffna Water Supp.	2.558	-	0068 Water Supply San.	.900	-
			0038 Water Supply San. amendment	1.658	-
Total	4.558	1.350		4.558	1.350

III.B. EVALUATION PLAN

1. Evaluations Scheduled for FY 1986 and FY 1987

a. FY 1986

Mahaweli Environment (383-0075) Mid-term	November 1985
*Water Management (383-0057) End-of-project	November 1985
Malaria Control (383-0043) Mid-term	March 1986
PVO Co-financing (383-0060) Mid-term	June 1986
National Institute of Health Sciences (383-0062) end-of-project	August 1986
*Housing Guarantees (383-HG-002 & 003)	September 1986
Private Enterprise Promotion (383-0082) Mid-term	September 1986

b. FY 1987

Agriculture Education Development (383-0049) End-of-project	October 1986
Diversified Agriculture Research (383-0058) Mid-term	April 1987
Water Supply & Sanitation (383-0088) Mid-term	August 1987
Reforest. and Watershed Mgt. (383-0055) End-of-Project	May 1986
Mahaweli Environment (383-0075) Project status	December 1986

2. Evaluations Completed in FY 1985

Reforestation and Watershed Management (383-0055) Mid-term	December 1985
Mahaweli Basin Development 1 (383-0056) Mid-term	June 1985
Mahaweli Basin Development 11 (383-0073) Mid-term	June 1985
*Mahaweli Sector Support (383-0078) End-of-project	June 1985

* Undertaken prior to new project design activities.

III.C. PL 480 TITLE I

The recently approved FY 1987 Sri Lanka CDSS highlighted certain of the above areas for priority AID involvement, prominent among them: research, marketing, irrigation management, and agricultural program planning and management. Local currencies generated by the PL 480 Title I program will support the USAID strategy in the areas of agricultural diversification, improved research management, irrigation and water management, agricultural credit and liquidity, market information and analysis, and enterprise development.

The GSL would have to agree to analyze and improve the policy environment affecting the objective of increased agricultural production. Specific areas of concern are land tenure, a strategy for agricultural diversification, coordinated agricultural research, planning as an effective instrument of decision making, private sector involvement in the provision of agricultural inputs and services, incentives for the production of agricultural exports and agriculture prices and subsidies.

Although Sri Lanka is coming nearer to self-sufficiency in rice, the country will continue to need to import wheat. The GSL will be constrained from increasing its commercial purchases by the large budget deficits which are growing in past due to increased defense expenditures. As our yearly Title I analyses show, there are no bottlenecks in the wheat storage and distribution systems/facilities. Further, our analysis show that wheat imports have not been a disincentive to major grain production in Sri Lanka.

III.D. Work Force Issues

With the budget cuts for the Sri Lankan program arising from adoption of the Gramm-Rudman legislation, the Mission will probably have to absorb a reduction in staff in the future. Mission recommendations will be made as soon as a valid assessment can be made of the full effect of program reductions due to Gramm-Rudman.

1986
USAID SRI LANKA STAFFING
FY & CY YEARS

OFFICE	USDH	FN	PPT	PSC US	PSC FN
Director	3	2	0	0	0
Executive	1	4	1*	1	16
Reg Leg Adv	1	0	1	0	1
Reg Hsg Off	1	0	0	0	1
Program	2	3	0	0	2
Controller	2	5	0	0	6
Proj Dev & Spec Progs	4	3	0	1	3
Agri & Rural Dev.	3	3	0	0	6
Health, Pop & Human Res.	1	1	0	0	2
Mahaweli & Water Res	4	2	0	0	6
SUB TOTALS	22	23	2*	2	43
IDI	2	0	0	0	0
TOTALS	24	23	2*	2	43

* 1 Vacancy

1987
USAID SRI LANKA STAFFING
FY & CY YEARS
(subject to revision)

OFFICE	USDH	FN	PPT	PSC US	PSC FN
Director	3	2	0	0	0
Executive	1	4	1*	1	16
Reg Leg Adv	1	0	1	0	1
Reg Hsg Off	1	0	0	0	1
Program	2	3	0	0	2
Controller	2	5	0	0	6
Proj Dev & Spec Progs	4	3	0	1	3
Agri & Rural Dev.	3	3	0	0	6
Health, Pop & Human Res.	1	1	0	0	2
Mahaweli & Water Res	4	2	0	0	6
SUB TOTALS	22	23	2*	2	43
IDI	2	0	0	0	0
TOTALS	24	23	2*	2	43

* 1 Vacancy

III.E. GRAY AMENDMENT

1. PROGRESS INDICATORS

Mission progress in meeting Gray Amendment objectives has been steady since mid-1984 when it signed a $3m. technical assistance (TA) contract with a Gray Amendment firm. Over the past 14 months, the Mission has provided $2.23m. to Gray Amendment organizations through new contracts and contract amendments.

Of 36 new contracts, 14 were signed with small and minority firms. However, the dollar value was relatively modest ($830,384 out of a possible $12.3m. awarded in new USAID-funded direct and host country contracts.) Awards to Gray Amendment organizations included (a) a $99,000 TA subcontract under a host country prime contract with a U.S. firm and, (b) a subcontract in excess of $400,000 made by an 8(a) prime contractor to an 8(a), woman-owned procurement services firm. The latter was prompted by language in the prime contract which stipulated a preference for subcontracting with small and disadvantaged firms.

Of nine contract amendments executed by the Mission during the reporting period, seven provided increased funding to Gray Amendment organizations ($1.5m. out of $5.1m.).

USAID ability to meet Gray Amendment objectives is limited by the degree to which the Mission can control, or influence, the contracting process. Thus, the Mission has been successful in contracting with several Gray Amendment firms for design and evaluation services ($50,000 to $100,000) and for personal services ($5,000 to $25,000 range), but has been less successful in the award of large, long-term contracts to such firms.

USAID project committees continue to review assistance needs for possible set-asides. However, each recommendation has to be strongly justified to allay GSL concerns about restricting or eliminating competition. Mission must also contend with growing Sri Lanka resistance to high cost expatriate technical assistance.

By not forcing the issue with the GSL, USAID has been able to maintain a general GSL preference for AID-direct contracts. This has allowed requests for proposals to encourage subcontracting with small and minority-owned businesses. While the subcontract element carries little weight in the total evaluation of overall technical proposals, the Mission is encouraged by the number of firms willing to commit themselves to doing business with Gray Amendment organizations.

2. FY 1986-1987 BENCHMARKS

The Mission will continue to contract with small and disadvantaged organizations where it has the authority, and will encourage maximum subcontracting with Gray Amendment organizations under existing and future TA contracts. Toward this end, we are actively engaged in seeking information on capability, including LDC performance, of Gray Amendment organizations in connection with our proposed FY 1986 and 1987 projects. In addition, we are considering the possibility of designating some components of new projects as 8(a) set asides (subject to host country concurrence) and will continue to maximize use of Gray Amendment organizations in design and evaluation work where procurement is more readily controlled by AID. Based on this course of action, the Mission believes it will be in a strong position to continue assisting the Agency in meeting Gray Amendment objectives, including dollar targets.

III.F. SUMMARY BUDGET TABLE
($000s)

Project No	Project Title	FY 86 Loan	FY 86 Grant	FY 87 Loan	FY 87 Grant
ARDN					
383-0073	MBD II, ext		2,000	-	-
383-0080	ISM	5,000	3,525	5,845	1,245
383-0083	AGPLAN	1,500	1,625	1,800	275
383-0085	DM&T	1,500	1,200	-	4,080
383-0090	REDS	11,000	1,000	14,155	3,600
HE					
383-0088	WS&S	-	2,000	-	-
EH					
383-0060	PVO Co-Financing	-	100	-	-
SD					
383-0060	PVO Co-Financing	-	750	-	-
383-0085	DM&T	-	800	-	1,000
	DA Sub-Totals	19,000	13,000	21,800	10,200
EPF	(No Program)				
PL 480					
38300099	Title I	26,000	-	25,000	-
383-0094	Title II	-	3,500	-	2,548
383-0095	Title III	-	-	-	-
HG					
383-HG-004	HG Phase IV	-	-	20,000	-
	COUNTRY TOTALS	45,000	16,500	66,800	12,748

ACRONYMS

AGPLAN	Agriculture Planning & Analysis (383-0083)
AMC	Anti Malaria Campaign
BTT	Business Turnover Tax
CDSS	Country Development Strategy Statement
COPE	Committee on Public Enterprise
DOA	Department of Agriculture
DM&T	Development Management & Training (383-0085)
DWLC	Department of Wildlife Conservation
EOP	End of Project
FY	Fiscal Year
GDP	Gross Domestic Product
GSL	Government of Sri Lanka
IHAP	International Human Assistance Program (a PVO)
ISM	Irrigation Systems Management (383-0080)
LOP	Length of Project
MASL	Mahaweli Authority of Sri Lanka
MARD	Mahaweli Agriculture & Rural Development (383-0086)
MBD I	Mahaweli Basin Development I (383-0056)
MOH	Medical Officer of Health
NAFNS	National Agriculture Food & Nutrition Strategy
NEDAC	National Economic Development Advisory Council
NIHS	National Institute of Health Science (383-0062)
OE	Operating Expenses
NWSDB	National Water Supply & Drainage Board
O&M	Office and Management
PACR	Project Activity Completion Report
PES	Program Evaluation System
PID	Project Implementation Document
PVO	Private Voluntary Organization
REDS	Rural Enterprise Development Sector (383-0090)
SFC	Subsidiary Field Crops
SLDBC	Sri Lanka Business Development Center
TA	Technical Assistance
TDY	Temporary Duty
UNDP	United Nations Development Program
USAID	United States Agency for International Development
USG	United States Government
WS&SS	Water Supply & Sanitation Sector (383-0088)

POLICY DIALOGUE FRAME WORK FOR SRI LANKA

1. Introduction:

The major development issues facing Sri Lanka over the medium term will be reducing the public sector share of the economy and increasing the productive capacity of the non-governmental sector. As elaborated below, this Mission believes these issues will be best addressed through tightly controlled restrictive fiscal policy and moderate monetary policy at the macro-economic level. While the AID Program in Sri Lanka is in itself not sufficient incentive to bring about major restructuring of the economy, the AID Program can be a positive influence for decisions which lead to creating a more productive economy, especially when taken together with programs of the IMF, the World Bank, Asian Development Bank, and other donors.

2. Macro-Economic Policy Setting:

Given the current economic situation (reviewed in Annex) Sri Lankan policy makers are limited to three macro-economic policy options. All three require a realistic exchange rate and result from different combinations of fiscal and monetary policies. They are: (a) restrictive fiscal and monetary policy combination; (b) expansionary fiscal and restrictive monetary policy combination; and (c) restrictive fiscal and expansionary monetary policy combination.

(a) Restrictive fiscal and monetary policy combination:

From an economic management point of view, the most logical option is a restrictive fiscal and monetary policy combination. If Sri Lankan policy makers decide to pursue this option, a significant improvement in GSL budgetary discipline could be expected as public spending would be largely limited to available resources. The budget deficit as a share of GDP would not likely exceed 8% and would be financed from foreign grants and concessionary loans. There would be no borrowings for budget financing and the government would gradually reduce its liabilities to the commercial banking system and the Central Bank which currently amount to over Rs.15.0 billion.

A restrictive monetary policy calls for very tight credit controls to contain money supply growth. The commercial banking system would be required to limit its lending only to productive areas as directed by the Central Bank. Bank lending would be severely curtailed to trade (both wholesale and retail), services, financing of imports and consumption. The commercial interest rate is likely to be lower because of the limited lending capacity of the commercial banking system. Under this option both savings and investment would be relatively low.

This option offers the least attraction to the GSL as it leads to a deflationary situation, particularly in the short run, accompanied by reduced economic activities and lower economic growth. Moreover, despite credit restrictions, the GSL will confront serious difficulties in controlling money supply because of the role of financial intermediaries. If financial intermediaries are not brought under Central Bank control, the economy is likely to experience lower economic growth, along with increased money supply and relatively high inflation during the medium-term.

(b) Expansionary Fiscal Policy and Restrictive Monetary Policy Combination:

This option calls for a greater government role in the economy similar to the experience

of the immediate past. In addition to focusing on continuing development projects, the government would have to undertake new development projects to maintain growth momentum in the economy and to achieve projected growth targets. Annual budgets would reflect the growing nature of public expenditure programs, and even if the revenue base is improved, there are likely to be budget deficits of substantial magnitude requiring the government to depend on extra-budgetary resources such as bank and commercial borrowings. Also, concerted efforts (as in option (a) above) would have to be made by the government to maintain a restrictive monetary policy, and reduce the rate of growth in money supply.

The fiscal and monetary policy combination that the government is currently pursuing is quite similar to this option. It offers relatively high growth prospects in the short run. However, with growing budget deficits, (exceeding 20% as a ratio to GDP), economic management will be extremely difficult. Moreover, maintaining a restrictive monetary policy will be even more difficult with an expansionary fiscal policy because of high public spending supported by borrowings. These developments will, in turn exert strong pressures on the balance of payments. Continued reliance on external borrowings, in addition to the use of external reserves, would be inevitable. In the medium-term, economic growth would be slowed down and inflation would remain high. Within a short period the government would have to consider seriously the implementation of option (a).

(c) Restrictive Fiscal and Expansionary Monetary Policy Combination

The most promising growth outlook, particularly in the medium-term, is embodied in a combination of a restrictive fiscal and a moderately expansionary monetary policy. Under this option, the focus of public spending would be on (a) the completion of ongoing development projects, (b) improvement of physical, economic and social infrastructure, and (c) maintenance of physical and economic assets. The level of spending would be determined largely by the flow of financial resources available to the government from domestic revenue as well as external concessionary sources. The budget deficit, which would be expected to remain around 8% to 10% of GDP, would be entirely financed from concessionary external support. In addition, efforts would be made to contain the rapid growth in recurrent expenditure by better management of existing assets and resources of the public sector. The government would also adopt very tight financial regulations with regard to public sector corporations and undertake divestiture of non-profitable businesses as expeditiously as possible.

This option allows the monetary policy to be moderately expansionary. The main purpose of pursuing an expansionary policy would be to allow the private sector to get actively involved in growth promotion through credit facilities from the banking system. Because of the restrictive fiscal policy, the pressure from the public sector on the banking system is either minimized or totally eliminated, and this allows the banking system to provide necessary capital to the private sector for activities related to higher domestic production and export promotion. Although money supply is likely to go up, it can be more easily controlled and kept within desired targets. The annual increase of the rate of inflation would be likely to remain around 10% to 12%.

Under this option, economic growth in the short run would be expected to be somewhat lower than the 5% to 5.5% presently projected by the GSL because of the reduced government role in the economy in terms of public spending. The main focus of public spending would be on improving the existing economic resource base and improving productivity. These efforts together with the active role of the private sector should lead to a high growth path in the medium-term along with reduced pressure on the balance of payments, relatively low inflation and higher levels of both savings and

investment.

As noted earlier, all three policy options require a realistic exchange rate policy. A realistic exchange rate simply means the selection of an exchange rate which could bring down the deficit in the current account of the balance of payments to match normal capital flows such as private foreign investments and foreign grants and concessionary disbursements but excluding commercial borrowings either medium or short term. When defined in this context, the selected exchange rate should result in higher export earnings, reduced imports or both. A floating exchange rate approach is perhaps the ideal system to establish a realistic rate as the imperfections in exchange rates are eliminated through market mechanisms. However, a floating exchange rate is the least popular policy in most developing countries because of its direct and unpredictable consequences on domestic prices. The price adjustments associated with a floating exchange rate system are difficult to control since movements in exchange rates are directly reflected in the prices on imported consumer, intermediate and investment goods.

Avoiding a floating system leaves the foreign exchange rate adjustment to be implemented through a devaluation. The amount of devaluation necessary to bring the exchange rate to realistic levels is difficult to determine, given the complex factors involved in the determination. Most economists who support a devaluation under present circumstances in Sri Lanka tend to believe that a rupee devaluation in the magnitude of 25% against the U.S. dollar should eliminate almost all the distortions currently prevailing in the foreign exchange market.

Whatever the options that Sri Lanka selects of the three mentioned, there will be some economic and social costs. The Mission believes the third option to be the most appropriate in the present context despite its slower growth prospects in the short run. The fiscal and monetary policy combination proposed in option (c) would lead to a stable economy and much improved growth performance during the medium-term. In either the absence of adjustment policies or the selection of inappropriate policies such as option (b), current problems are likely to be intensified in the medium-term, and more difficult and painful adjustment policies would be required later to bring some stability to the economy. It is this restrictive fiscal and moderately expansionary monetary policy which USAID will advocate in our macro-economic policy dialogue. In this effort we expect to be working with the IMF, World Bank and other bilateral donors.

3. Policy Dialogue Plan:

The tighter fiscal policy of option (c) will require that the GSL bring down the budget deficit substantially. While enhanced revenue generation would contribute to reducing the budget deficit, the Mission would argue against revenue increases likely to dampen private investment initiatives. Thus, even with moderate revenue increases, further reductions in the operational accounts will be necessary and capital programs will have to be eliminated or delayed. Without the expansionary fiscal policies that have been followed over the past eight years, it will be difficult to maintain, over the near-term, the 5% to 5.5% growth rates projected by the government. However, stabilizing the economy should allow for improvements in private sector confidence and export competitiveness accompanied by a return to respectable growth rates in the medium-term.

The set of macro-economic policies recommended by the Mission (and other donors) for achieving stable growth over the rest of this decade will require that more be done with existing resources. These policies set the framework within which the USAID strategy

will provide direct support to the development effort. The major policy issues that will occupy the attention of the Mission over the next three to five years are:

- A rationalization of the GSL bureaucratic structure.
- Selective reversion of state-run enterprises to the private sector.
- Establishment of an industrial development policy which provides clear guidelines for private sector involvement.
- Establishment of an agricultural diversification strategy (within the overall Agriculture, Food and Nutrition Strategy) which reduces the bias for rice among GSL support services.
- Coordination of agricultural research based on a clear set of established priorities.
- Reform of agricultural pricing and subsidies policies to allow for a more open and market regulated commerce in agricultural inputs and outputs.
- Reform of the land tenure system to efficiently legalize land holdings and to provide for holdings of adequate size to be commercially viable.
- Development of the private sector through adoption of measures to facilitate private investment and assure competitiveness.
- Commitment to operations and maintenance programs for irrigation schemes throughout the country including the participation and support of water users and the collection of user fees.
- Increases in the rates of interest and repayment for nationally-supported housing programs.
- Integration of planning into decision making for the program areas in which USAID is operating.
- Commitment by the Ministry of Health to the need for preventive health programs rather than curative facilities.
- Improvement in the conditions for private sector credit, especially in the rural areas.
- Incentives for management improvement.

One of the Mission's principal policy objectives is a rationalization of the GSL's bureaucratic structure. There are presently 45 Ministries, over 160 autonomous agencies and untold numbers of committees, councils and other such bodies. The functions and responsibilities of these organizations overlap severely yet little, if any, coordination takes place. The Mission, therefore, will be recommending that an appropriate way to reduce the budget deficit through reduced expenditures will be the elimination of bureaucracies duplicating functions and responsibilities best carried out in another government organization. The World Bank is now developing a project to be directed at improving management and efficiency within the government. We will add our voice to theirs at the policy level to help bring about needed changes. In addition, bureaucratic reforms will be pursued within the organizations directly affected by our project activity. For example, the effort to develop a planning and financial management capability within the Mahaweli Authority of Sri Lanka (MASL) will allow the Mission to argue for organizational changes both within and outside the MASL where overlapping or unnecesary functions can be eliminated.

The need to return publicly run enterprises, both agricultural and industrial, to private ownership has long been recognized as a policy issue. The AID program in Sri Lanka has not been sufficiently large for AID to take on this issue directly. That remains the case today. Donors have raised the question of de-nationalization on government-held estates. The GSL remains unwilling to do that in any significant way, and the private sector seems unwilling to re-enter the field in view of massive investments needed and fear of subsequent renationalization. In any case, with the World Bank and the ADB providing

substantial assistance to rehabilitate the estate sector, there seems little opportunity to pursue this issue further.

The Mission will continue to support divestiture of the publicly owned corporations such as those in steel, cement, paper products, building materials, hardware, and telecommunications to name but a few. In some cases, such as telecommunications, the dialogue within the GSL has begun. We would also argue for the closure of loss making corporations if there is no private sector interest in a takeover. Realistically we cannot expect the AID program to provide sufficient leverage to put these industries into private hands, but we can use the program to support the case. Through the Sri Lanka Business Development Center (SLBDC), as one means, the government can be presented with a series of well supported arguments to show that decisions to divest should be made sooner rather than later. This case can be based on the need to reduce the budget deficit and the strain placed on the budget by the continuing losses incurred by the state-run corporations and, equally important, the prospects for profitable operations with ownership in private hands. The USAID will use appropriate opportunities to bring this argument before high-level government officials, but our most effective means to deal with this policy issue will be in strengthening institutions, such as the SLBDC, representing the private sector in the policy dialogue with the government.

Since state-owned enterprises still generate over half of industrial output and dominate several industrial sectors, there is a lingering and often very real antagonism between powerful vested interests in the government, on one hand, and the private sector interests on the other, regarding the role which each should play in a given industry. This antagonism creates enough doubts about government intentions (or its ability to resist vested interests) for prudent private investors to be cautious when contemplating investments which may become vulnerable to government decisions to protect or otherwise favor competing state enterprises.

The fundamental issue can be reduced to the GSL's intentions (and actions) on "privatization" of state-owned corporations. Several studies by USAID (1983 A.D. Little private sector assessment), UNDP, and the World Bank have addressed the advantages to be gained through various privatization moves, ranging from outright divestiture (favored by the Mission) to retention of state corporations, but on a truly equal competitive footing with the private sector. To date there has been much verbal commitment to act on recommendations made in these studies, and a special GSL-appointed Committee on Public Enterprises (COPE) has been established to guide the government's decisions. However, no state corporation has yet been disposed of by the government. The most concrete actions which have been taken are several management contracts (most notably for the state textile mills) under which foreign private managers have been brought in to turn around ailing state enterprises, or instances in which a previously state-monopolized sector (e.g., bus transport) has been opened up to private sector competition.

In this environment it is essential that the government decide upon and convincingly implement, through visible actions, an overall privatization plan for continued operation of state-owned enterprises and the advantages (ideally none) which they are to have in competing with the private sector. At a minimum, the private sector community must become convinced that vested interests committed to protecting the state's role can be contained, that new state enterprises are unlikely to start up, and that a future wave of nationalization will not occur.

Since mid-1984, the government has formally recognized the need for a national industrial development policy and has brought into being a high-level joint

government-private sector Industrial Policy Committee to work toward the establishment and implementation of such a policy. The Committee as a whole, and in particular the private sector leadership on this Committee, can and should be supported by USAID in reaching its objectives. Ultimately, what is needed is three-fold: (1) a well-articulated overall industrial development policy providing a framework to guide and encourage investment decisions; (2) sector-by-sector, and subsector-by-subsector, industrial development strategies which spell out in very specific terms the future roles for both the private and state sectors, including any specific guidance for foreign investment; and (3) implementation of the program with primary attention to concrete privatization action where such action is called for. Such a policy statement will be a primary objective of our private sector program.

In agriculture sectoral policy, there is currently a clear public bias towards rice, in terms of interest, resource allocation and infrastructure development relative to other field crops, This bias is understandable given the importance of rice to both consumers and producers. Rice self-sufficiency has been the GSL's number one agricultural sector goal and is now within reach. Further extension of the rice production margin at this point, however, would not be an optimal allocation of resources. While continued investment in rice research, production and marketing is clearly needed, it also is necessary for the GSL to adopt and support a clear strategy of rational agricultural diversification.

Apart from the lack of an overall strategy, there are no significant policies adversely affecting agricultural diversification. The quantity and timing of imports have been a problem but are not a policy issue. This problem can be handled through better market intelligence, forward planning and more timely action, all of which should result from a comprehensive agricultural diversification plan. There are no effective product subsidies relative to the subsidiary field crops (SFC); prices are determined by the market and the impact of the two major input subsidies (fertilizer and irrigation water) is negligible, since most SFC are produced without chemical fertilizers under rain fed conditions. Seed is another subsidized input discussed below. Diversification is dependent on increased investment (public and private) in research and market development and a commitment on the part of the GSL to support rational alternatives rather than continue to push rice production beyond the boundaries of economic rationality (at the likely cost of renewed producer and/or consumer subsidies and price controls). In conjunction with our efforts in diversified agricultural research (383-0058) and agricultural policy and planning (383-0083), the Mission will attempt to get a rational agricultural diversification strategy/policy statement.

Production and marketing of improved field crop seed is now entirely in the hands of the Department of Agriculture. Costs to farmers are subsidized. As long as quality seed cannot be sold at a price reflective of its true costs of production, significant private sector investment in the seed industry is unlikely. A change in GSL policy toward more rational seed pricing appears warranted, from the perspective of both more realistic resource allocation and promotion of private investment. The Department of Agriculture is in accord with this view; the problem lies in the political realm. USAID and the Netherlands are currently involved in the seed production/marketing area (USAID, through the Diversified Agriculture Research Project) and are working together to promote a more realistic seed pricing and production policy on the part of the GSL.

A large number of institutions are engaged in agricultural research in Sri Lanka. Consequently, it is highly fragmented, and the minute sub-division of research has led to problems of poor planning and resource management at the national level. Resources for agricultural research are not allocated on the basis of clearly defined research

priorities, as there is no mechanism to do so. Another serious concern is the lack of inter-institutional coordination of research; though farming system research (which involves more than one agency) is widely discussed, there is no evidence of it being practiced anywhere in the country. Maximizing farm income through the optimal use of land and water resources clearly requires improved coordination of agricultural research activities.

The Mission has initiated a project on Diversified Agricultural Research (383-0058) which will provide for improvement in the technical aspects of agriculture research carried out within the Department of Agriculture (DOA). An integral part of that project is the dialogue leading to improved coordination and the setting of research priorities for the institutions within the DOA. Through that project and the PL480 Title I/III program, we also will be encouraging better coordination among the DOA and institutions outside the DOA. The NAFNS recommended the establishment of a Council for Agricultural Research Policy to advise the GSL on research priorities and the promotion of inter-institutional research projects. The Mission will support the development of this council if it is to be given real authority and actively carries out the intended role.

With market forces determining the prices of agricultural outputs and inputs, the agricultural pricing policy of the GSL continues to remain largely inconsistent with its open economic policies. The government's role in agricultural pricing is essentially limited to setting floor prices in rice and 14 subsidiary crops. It also determines the prices for sugar and wheat on a "No-profit, No-loss" basis. All other agricultural prices are determined by market forces. The government occasionally intervenes in the domestic rice market, through buffer stock operations, to stabilize prices. Among agricultural inputs, the fertilizer price is to some extent influenced by the government's subsidy, but its role is gradually diminishing as the fertilizer subsidy has been fixed at Rs 1.0 billion in current prices since 1981. The government plays no role in setting prices of other farm inputs and wages, and its role in rural credit through state owned banks is also declining due to a high incidence of default. An increasing share of rural credit is being provided to the farmers by private lenders but at much higher interest rates.

The macro-economic environment which has prevailed since about 1980 has produced considerable distortions in agricultural pricing. While rapid inflation resulted in a manifold increase in production costs, the overvalued exchange rate caused the domestic prices of agricultural goods to remain low or to stagnate because of substitution from under-valued food imports such as wheat. The growing disparity in production costs and prices of farm produce is being reflected in the deterioration of profit margins in farm production. This situation warrants serious consideration as it could become a major constraint to the promotion of food production. Inadequate and imperfect marketing information is another issue hindering agricultural production and particularly crop diversification. This shortcoming often leads to over production in some crops and shortages in others.

As the agricultural pricing policy functions within a macro-economic environment, an improvement in macro-economic management, through an appropriate mix of fiscal, monetary and exchange rate policies, should be the major focus at the present time. The macro policy mix should place priority on relatively low inflation and elimination of exchange rate distortions, and macro-economic option (c) recommended by the Mission is in conformity with these objectives. These changes are likely to push agricultural prices up by about 20 %. To help protect the low income household from rising prices, early implementation of the proposed revisions to the food stamp scheme is important. A

gradual removal of the fertilizer subsidy is another important step that should be taken by the government and should be implemented within an appropriate macro policy setting, as in option (c), to reduce the adversities of subsidy removal on production costs and prices. These issues are being discussed with the GSL in the context of the PL 480 Title I/III program and the ongoing work of the National Agriculture Food and Nutrition Strategy (NAFNS). They will also be a focus of the proposed Agriculture Policy and Planning Project (383-0083) which will follow the NAFNS effort. Agricultural pricing and subsidies are also affected by other priority agricultural development needs on which the USAID will be working, and the Mission strongly feels that the GSL should place its investment priority in agriculture on (a) agricultural research, including crop diversification, (b) improvements in marketing and extension net works, and (c) better water management.

Land tenure is particularly important to increasing the small farmer's productivity - especially in field and minor export crops - as he will be less willing to undertake innovations and, in most cases, incure the debt necessary to be innovative without secure title to his land. GSL policy supports the "regularization" of tenure on public lands, but bureaucratic practice lags far behind. Improvements in the process of land titling must be made together with a policy decision to grant clear title. The land tenure issue will be a primary concern of the entire agriculture and rural development program and will also be addressed by the PL 480 Title I/III program.

Farm size and structure are a critical issue, particularly with the large-scale settlements currently being implemented in the Mahaweli area. In the settlements each farmer is being alloted 2 1/2 acres of lowland and a half acre of highland (homestead), regardless of his location in the soil catena. This policy ignores soil type and hydrology and the productive capability of the land. Some farmers may benefit substantially while others can do little better than subsistence farming. Consequently, the settlement policy needs to be carefully assessed in terms of its likely impact on the quality of income. The question of scale of settlement is pivotal to creating commercial-vs-subsistence agriculture. In the System B area of the Mahaweli, which is still in the pre-settlement stage, AID is in a position to address it directly. Priority will be given to assessing the income potential of different soil types and sand classes and to identifying viable options and alternatives for settlement. Through ongoing Mahaweli development programs the USAID will carry on the dialogue to demonstrate to the GSL that given the wide range of soil types and agroclimatic conditions over different areas of the country, the policy of implementing a standardized unit of settlement across the board is not the best policy. The new Mahaweli Agriculture and Rural Development Project (383-0086) will incorporate the findings of the land size studies.

The government appears to be committed to more direct private sector participation in national-level planning, but how this commitment can evolve institutionally will depend mainly on the private sector's own organizational initiatives. At present the private sector is too fragmented in its organization to be as strong a voice as it could be in influencing government policy. There are five or six principal chambers and also a Federation of Chambers of Commerce and Industry. While each has articulate spokesmen who have been able to project its membership's particular views to the government on issues of the moment, there is no single organization that has constantly, comprehensively and successfully represented the private sector's position on the overriding policy issues affecting national development.

What is needed ultimately was expressed in the 1983 A.D. Little study as a private sector "National Economic Development Advisory Council" (NEDAC), which would be recognized by the President, represent a true cross-section of private business organizations and interests across the country, and be supported by a competent full-time secretariat. The secretariat would conduct studies, prepare reports, arrange for dialogue on key issues, provide inputs to national economic development strategies, and help implement the NEDAC's agenda. One opportunity to move toward the establishment of a group like the proposed NEDAC, and which is now receiving USAID support, is the newly-incorporated Sri Lanka Business Development Center (SLBDC). The SLBDC has a Business and Economic Policy Division which is geared to undertake policy studies for the private sector under the guidance of an advisory group consisting of representatives of the principal private sector chambers and other business leaders. This advisory group, (whose work is only just beginning) could, if well managed, evolve into a more formally constituted organization, i.e., an "NEDAC", with the SLBDC providing the secretariat until such time as the organization spun off completely and had a secretariat of its own.

This opportunity will be pursued during the next several years, while at the same time other approaches to coordinating or organizing the private sector for better articulation on policy issues will be investigated.

A much larger concern regarding the role of the private sector and its productive participation in the economy arises from economic factors. Frequently voiced issues by the private sector include: (a) high market interest rates, (b) burdensome administrative procedures and delays in obtaining relatively low cost medium-term funds made available by the World Bank through the domestic banking system, (c) high rate of inflation, (d) unfair import competition due to either over-valued exchange rate or lower import tariff, and (e) high rate of domestic taxation, particularly, the Business Turnover Tax (BTT), which must be paid even under the circumstances of production losses. Despite efforts to promote the private sector to assume a greater role in the economy, the success is bound to be severely limited if due consideration is not given to these issues. Moreover, business confidence on the economy and government policies is likely to deteriorate if measures are not taken to deal with these issues and constraints. In our opinion, the solution, to a greater extent, lies with an appropriate macro policy mix.

The GSL policy of providing free or nearly free water to the farmer for agricultural production is the largest subsidy in the agricultural sector. Over 46% of the GSL public investment budget goes to the agricultural sector. Over 60% of the agricultural budget goes to support irrigated agriculture, most of which is for construction, operation and maintenance of irrigation systems. Since so much of the agricultural budget goes toward providing free or nearly free water to the farmer, development of a system of cost recovery to pay for irrigated agriculture on a sustaining basis is an urgent priority which the Government acknowledges. The Mission's efforts in this regard have been substantial and some progress is being made.

Two policy issues which represent major constraints; (1) the inability of the present irrigation system to provide the correct amount of water to the right place when needed at minimum cost; and (2) no system for providing the required funds to properly manage, operate and maintain the irrigation systems. In the first, the need is to establish clearly a system of operations and maintenance that will keep the irrigation systems operating at efficient and effective levels. Technical assistance is now being provided to the GSL in the first

stages of developing such a policy. A commitment to follow through on the policy will be critical to continuing U.S. assistance in this area.

Another policy concern is the participation of the water users, principally small farmers, in managing the systems. Under the ongoing Water Management project (383-0057), water user associations have been formed and found to be a successful way to involve the farmer in decisions on water use. The continuation of this program has run into problems which may reflect a lack of full commitment by the GSL. The collection of water user fees to recover the costs of operating and maintaining the irrigation systems is linked with the user associations. The GSL has initiated fees for irrigation water; while there are still bureaucratic mechanisms to be worked out, that major policy decision has been made. However, the water user associations are important in educating farmers on why the fee is needed and allowing them a voice in how it is spent. The Mission remains convinced that water user associations are important if the irrigation systems are to operate efficiently. Therefore, a GSL commitment to institutionalize the program fully will be a condition to future projects in water management.

While subsidies are a feature of many of Sri Lanka's public sector programs, the Mission has paid particular attention to the problems of the shelter sector and has worked with the GSL to identify and gradually minimize existing subsidies. Shelter sector subsidies tend to be located either in building prices (which do not reflect actual cost), interest rates levied (which may range from zero upwards) or lack of commitment to collect amounts due or to take punitive action for non-performance.

When AID entered the shelter sector in 1980, it began a series of negotiations with the GSL to identify major issues. As a result of these discussions and AID's production of a Shelter Sector Assessment, four topics were chosen for further study: finance, subsidies, housing needs, and management. Of these, housing subsidy was found to be the key element, and a principal objective of the subsequent $100 million Sri Lanka Housing Guarantee program was deemed to be progress on reducing the extent of subsidy. AID embarked on a technical assistance and training effort with the GSL to remedy some of the outstanding problems: building standards and types were radically changed so that the actual costs were affordable. Programs were developed to introduce the private sector as the "turnkey" builder. Through a process of strenuous negotiation and incremental implementation, interest rates were levied on public housing units and raised from 3% to 6% to 9% and at present to 10% on certain types of loans. Finally, an innovative and vigorous collections effort was mounted using techniques and technologies transferred from the United States. Although much work remains to be done, selected districts in Sri Lanka are achieving rates of over 80% collections for housing programs in which USAID was involved - a significant performance for this type of program. The Mission will continue to seek a raise in interest rates toward real market rates, currently in the 16 to 22% range, and acceptable (over 90%) collection rates for all national programs. Interest and collection rates in these magnitudes will allow the private sector to re-enter the housing market.

Recently, with AID support, the GSL has prepared a National Agriculture Food and Nutrition Strategy (NAFNS), but despite the NAFNS effort, planning throughout the GSL is still perceived as project preparation, often in response to donor initiatives. Priority is given to developing new ideas into projects rather than careful management of limited resources. Planning is little used by senior officials in deciding policy and operational objectives. The reason

may be the "chicken and egg" predicament. Is planning weak because it has no role in decision-making or does planning have no role because of weak technical skills?

The Mission plans to build upon the NAFNS to foster institutionalization of the planning and policy formulation capacity within the relevant agriculture and rural development organizations. We will work to convince policy makers of the need for good planning, and the use of planning in the decision-making process will be a specific objective of our work in agriculture policy and planning, and in the further programs in the Mahaweli region.

Improvement in the availability of credit, particularly in the rural areas, will be a crucial factor for the development efforts to be undertaken through the rest of this decade. Credit will be needed to make effective use of the available land, water and labor resources in agriculture, as well as to increase investment in rural enterprises. Currently almost all rural credit schemes are developed at the national level with no design input from the local level. Hence, programs are often ill-suited for areas they are intended to serve.

The USAID, through programs in agricultural planning and rural enterprises, will encourage the development of credit plans specifically geared to the region/district targetted. These plans should identify and assess the credit needs of the area and propose suitable arrangements to finance those needs. Further study will be supported and appropriate policies will be proposed through those studies.

The improvement in the macro-economic climate is also an influencing factor on the availability of rural credit. Reducing the GSL budget deficit and its borrowings in the domestic credit market coupled with mildly expanding money supply should allow for greater availability of credit at reasonable cost. Together with private investors, the confidence of bankers and other financial intermediaries should increase with economic stabilization, thus loosening credit bounds.

In the health area the Mission policy will be to encourage the Ministry to introduce the internal, administrative reforms that will permit a more effective use of manpower and financial resources, to encourage the government to put health programs on a self-financing basis, and to support the government's policy of improving the preventive health care system. While donor assistance can be helpful in identifying problems and recommending policy changes, only the Ministry can carry out the basic reforms which are needed. The Mission, therefore, will continue to make limited technical assistance available to help the Ministry address critical problems; however, with the anticipated budget stringency in world wide U.S. development programs and the slim prospects of early payoff in the field of administrative improvements in the Health Ministry, this is not likely to be an area of major effort for the Mission in the future.

A universally recognized constraint to development in Sri Lanka is poor management, and the resolution lies in provision of performance incentives for better management. The NAFNS identified four factors responsible for poor public sector management: 1) past policies of public sector employment practices, 2) low salaries in the public sector, 3) limited training opportunities, and 4) few incentives to improve the caliber of management. The AID program can do litle about the "spoils" system of the past, and we are

unlikly to have any influence in raising salaries, particularly in light of the need to hold down public expenditures. The World Bank project on administrative reform is expected to deal with these issues, and the Mission would support improvements in these areas. We can, however, have some direct impact in the area of training. We are insisting now that training be clearly related to improving management or technical capabilities in specific fields relative to our program and that training under our sponsorship be part of an established plan and set of priorities of the GoL. On the fourth point, the Mission will be attempting to build in non-monetary management incentives to project activity to stimulate an interest in improving management practices. Such incentives could include increased authority/status, training opportunities, access to technology and others to be developed under the Development Training and Support project (383-0085).