

USAID/Sri Lanka

# Action Plan 1989

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# Overview: The making of a strategy

## Strategic choices

As USAID/Sri Lanka is preparing for a new CDSS, we can build on a solid base, an effective and flexible strategy that has evolved through deliberate choices in response to changing needs and opportunities. In what represents something of a transition period in both Colombo and Washington, we have taken a close look at our overall strategy, and our strategies in key sectors, examined their premises, assessed their impacts and performance, and reflected on options for the future. This strategy appraisal not only helped us clarify common themes and strengthen linkages, it also suggested some lessons about strategic choices and consistency in a changing policy environment. This Action Plan (AP) seeks to summarize the results of this assessment, and outline its implications for the process of articulating our strategy for the 1990's.

The evolution of USAID/Sri Lanka's strategy over the past decade reflects three major forces: impacts of changes in the policy context; planned adjustments as we moved from one phase to the next as part of a logical progression; and course corrections as we learned more about what worked best. In the process of shaping our strategy, we have gradually concentrated on fewer sectors, and have increasingly focused our efforts in those sectors. We left the health sector, and completed our involvement in forestry. In irrigation, USAID/Sri Lanka financed the construction of major canals, and shifted subsequently to support for better management of existing systems, with particular emphasis on decentralization and cost recovery, integrating our efforts into the agriculture and rural development program. This process laid the groundwork for our strategic shift into private sector development, focusing on greater reliance on market forces throughout our portfolio.

We have also succeeded in fully integrating non-project activities into our program. The Housing Guaranty (HG) program has been critical to the support of financial markets development; PL 480 Title I self-help measures complement and strengthen our policy dialogue.

Our strategic themes have emerged gradually. Following the relatively brief, although financially significant, involvement in major capital investments in irrigation, our strategic approach initially focused on helping institutions function better — more effectively and

more efficiently. In the agriculture sector, this focus led to the formulation of the National Agriculture, Food and Nutrition Strategy; in the private sector, we have looked to build and strengthen business and capital markets institutions. As institutional capabilities expanded, our assistance shifted to improving the generation and dissemination of knowledge — research for agricultural diversification, market research, and promotion of science and technology. This concern expands to work directly with producers (farmers and entrepreneurs) to strengthen linkages of technological and market information — our principal approach to the employment-income problem.

## A focus on employment and income

By consolidating our portfolio, we have crafted a solid *core strategy*, focused on employment and income, that leaves sufficient flexibility to respond to specific needs and opportunities related to our program and policy agenda. The core strategy, designed to remain viable and effective as the policy environment may change, integrates our efforts in the key sectors of our portfolio and provides the frame of reference for policy-oriented interventions and responses to emerging needs.

As it has evolved, our core strategy emphasizes strengthening the *technology-producer-market links* in agriculture and rural environments, in (small) urban areas, and in the modern private sector. Support for institutional development — the formulation of major government strategies, the creation of suitable regulatory oversight for financial markets development, or the promotion of measures to implement regulations safeguarding environmental and natural resources for sustainable development — complements this employment-income focus. The strategy governs our entire range of program activities.

## Recent progress on the policy agenda

The past year has been difficult for Sri Lanka. While violence in the North and East subsided somewhat, economic problems and discontent over perceived election delays fueled violence in the South that left its mark on the economy. Moreover, the election campaign absorbed considerable energies and encouraged resort to politically expedient solutions.

Like everything else in the country, USAID/Sri Lanka's program was affected by the turmoil of 1988. Implementation of some projects slowed, policy actions were put on hold until after the elections, and many officials moved cautiously to wait for the broad outlines of policy to become clearer. At the same time, though, we did register significant progress

on the policy front: the Government adopted new approaches in irrigation and agriculture. In financial markets, we improved consistency of principles and approaches across our portfolio, and achieved clear gains toward a more efficient system. The Government went ahead with the work needed to create the framework for a more effective equities market, as well as with some of the activities related to privatization, although the actual privatization of the first two companies was postponed until 1989.

## Future directions

The review of our sectoral strategies has pointed to the need for reexamining key premises. These needs are reflected in our *Analytical Agenda* (attached to this Action Plan as Annex A). The review has also demonstrated the increasing importance of direct linkages and interdependencies among our key sectors. USAID/Sri Lanka's program in agriculture and rural development will increasingly incorporate elements of market-based employment creation in urban areas (small towns) pursued under the Mission's private sector and urban strategies. Similarly, progress and performance in agriculture determine opportunities and constraints in other sectors. Financial markets improvements in turn will affect performance across our entire portfolio. We have begun to outline principles and priorities here in the form of a financial markets development strategy. We expect that linkages among our key sectors and common approaches will become more prominent and more instrumental in our strategy as we are preparing for the next CDSS period.

# Part I: A changing country environment

## Liberalization under adversity

The past few years in Sri Lanka have demonstrated a basic truism: economic growth and development depend not only on the "right" policies that favor competition and market forces. Growth and development also require a measure of political stability.

In the late 1970's, Sri Lanka seemed well on its way to becoming yet another success story of liberalization. Faced with severe shortages of consumer goods following eight years of textbook *dirigiste* policies that sought to address the problems one set of controls created by introducing yet another layer of controls and directives, the people voted in 1977 overwhelmingly for a new economic program. The new government wasted little time in introducing sweeping reforms — devaluing the rupee, liberalizing foreign trade and exchange transactions, raising interest rates, abolishing (some) government monopolies and controls, and simplifying the fiscal regime. The government also sought to boost exports by establishing free trade zones.

As a result of these reforms, Sri Lanka still has South Asia's most open economy, although structural weaknesses remain. The authorities acknowledged these weaknesses, and mapped out a program to resolve these issues in an *Industrial Policy Statement* adopted in early 1987, and in a *Policy Framework Paper* (PFP) prepared in late 1987 with the cooperation of the IMF and the World Bank. These policy documents demonstrate a clear understanding of what is needed to complete the liberalization agenda.

Despite the remaining weaknesses, the economy on the whole responded well, registering record growth rates in the late 1970's and early 1980's. The rapid growth tapered off to about 5 percent in 1985-86. Drought and ethnic unrest curtailed agricultural production in 1987, dragging overall growth to a disappointing 1.5 percent. After a good start marked by better agricultural performance, 1988 suffered from the effects of the chaos preceding the Presidential elections in December that are likely to have depressed GDP growth again.

While the liberalization agenda was left unfinished, and economic policies at times were misguided or inappropriate, the political turmoil the country experienced would have stifled economic growth even with perfect policies. The island-wide flareup of the centuries-old

enmity between Tamils and Sinhalese in 1983 and the continuing fighting in the North and East for an independent Tamil homeland, followed in 1988 by a resurgence of violence and sabotage by a militant Sinhalese faction in the South, sapped investor confidence and government resolve. In any talks with private sector representatives or potential investors, the lack of political stability soon emerges as a key obstacle to productive investment and sustained growth. What investment does take place is largely in service sectors or industries that can fairly quickly pull up stakes and move elsewhere, or in ventures with the shortest possible payback, but not necessarily the biggest overall return.

## 1987: The Peace Accord

Following an attempt to solve the problem of Tamil separatism by military means, which ran afoul of Indian sympathies and interests in the North, the Sri Lankan Government negotiated a Peace Accord with India — signed in July 1987 — that granted considerable autonomy to the newly established Provincial Councils, including a joint one for the North and East. The merger of the Northern and Eastern Provinces, a key demand of the Tamil militants, was to be confirmed or rejected in a referendum to be held later. Some 50,000 Indian troops — the Indian Peace Keeping Force (IPKF) — sought to provide security in the North and East.

The Accord changed the framework for development to some extent. It may have boosted economic prospects and investor confidence, but only briefly. More importantly, it triggered a favorable donor response, generating roughly \$500 million in pledges for the reconstruction of the North and East. These pledges promised to ease the foreign exchange situation, since a good portion of the reconstruction effort involved local currency financing. Continued fighting between militants and Indian troops has not permitted the reconstruction effort to go ahead as rapidly as planned. (See the review of USAID/Sri Lanka's Rehabilitation Assistance Project below.) Consequently, foreign exchange needs remain critical.

## 1988-89: Elections marred by violence

A backlash against the Peace Accord among hard-line Sinhalese nationalists combined with widespread dissatisfaction about the Government's hesitancy to schedule Presidential and parliamentary elections, and prompted an active campaign of resistance and terror in the South. The campaign was led by a political party, the JVP (People's Liberation Front), that has been in and out of legality. Following its bloody defeat in a 1971 insurrection, it

had regrouped by recruiting from the ranks of disenchanted university students and unemployed youth. The JVP, with at least initial support from the general population in the South, pressed its campaign against the Government through targeted killings of politicians — both those seen to be supportive of the perceived sell-out to Sri Lankan Tamils and “Indian expansionists,” and those offering a democratic alternative to the party in power. General strikes, typically enforced through an effective campaign of intimidation, sabotage of basic services, disruptions of transport and markets, and threats and actions against ordinary citizens striving to maintain normalcy reached a crescendo in November and December as the date of the Presidential elections approached.

The former Prime Minister and candidate of the ruling United National Party, Ranasinghe Premadasa, won the three-way Presidential elections with 50.4 percent of the vote. His ascendancy marked a departure from past tradition. A devout Buddhist and self-made man with village roots outside the colonial-style elite, Premadasa had built broad-based support through his highly visible leadership of the Million House Program. He was also seen as critical of the Indo-Sri Lanka Peace Accord — effectively boycotting the 1987 signing ceremonies — with the avowed intention of sending the JPKF home.

In the parliamentary elections in February 1989, the United National Party, in power with a five-sixths majority since 1977, won 125 of the 225 seats in Parliament. The Sri Lanka Freedom Party under former Prime Minister Sirimavo Bandaranaike captured 67 seats, with the balance going to smaller parties, including a coalition close to the Tamil militants in the North. These results have raised hopes that a reinvigorated Parliament could establish itself as the principal arena for political debate. Meanwhile, Tamil militants and their allies in Parliament are still pressing for independence of the North-East Province; the Provincial Council for the North-East also pursues greater autonomy; and the campaign against the Government proceeds in the South, fueled by resentment of the lack of economic opportunities as much as by a disdain for democratic institutions.

President Premadasa built his and his party's campaigns around economic issues. A radical program of a monthly stipend to all families on foodstamps (close to 50 percent of the population) for two years, combined with a rather hefty lumpsum payment for a self-employment scheme at the end of those two years forms the core of the new Government's agenda. This poverty alleviation program (PAP)<sup>1</sup> played a central role in the election campaigns, possibly accounting for the margin(s) of victory, and has raised hopes among the poor. It also presents the new Government with extremely difficult budgetary choices.

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<sup>1</sup> The term “poverty alleviation program (PAP)” is being used consistently in English-language communications; program proponents argue that the Sinhala name of the program, *Janasaviya*, roughly “mobilization of people's strength,” better conveys the program's intent to invest in human resources and provide startup capital for self-employment schemes and small businesses.

Following the recent parliamentary elections, some of the changes in the structure of government may affect our program in a positive manner. Both Agriculture and Mahaweli emerged from the reorganization with stronger central leadership, overcoming some of the fragmentation of policy making functions that prevailed in the past.

## Economic prospects

Political turmoil and the aftermath of the violence preceding the elections overshadow the country's economic fortunes. Economic sabotage in the last quarter was effective; its repercussions will be felt throughout 1989. It seemed carefully orchestrated to maximize economic damage by targeting key activities such as infrastructure (electricity, Colombo port); transportation (railroads, public and private buses, and trucking); and finance (both state and private banks). Disrupting economic activity and the distribution of consumer goods, especially food and fuel, strikes and disturbances also interfered with planting in the dry zone. Largely because of these disruptions, the 1989 Maha harvest (the main rice crop) is expected to fall far short of original projections.

The damage to the economy extended across key sectors. In tourism, the Government decided in early December to advise tourists to leave the island. In other industries and in government offices, workers came late or not at all, and left early. Government tax collection during the critical final quarter of the fiscal year — when many businesses normally pay the major share of their taxes — came to a virtual standstill. In addition, private industry demanded compensation for the losses caused by the violence. Finally, inflation sharply accelerated in the last quarter, but settled back down in the first few months of 1989.

Economic activity seemed to rebound quickly after the Presidential elections. Government officials and private sector representatives have sought to maintain a positive attitude ("Things will be back to normal after the elections..."). Even so, prospects for a full recovery in 1989 look troubled.

Inadequate rains have exacerbated the problems. With the expansion of cultivated area, investments in irrigation and use of high yielding technologies, the country has been moving toward self-sufficiency in rice. But at the beginning of 1989, the overall food situation looks difficult. Drought and political unrest during the planting season are expected to cause a shortfall of approximately 186,000 MT of rice. In many areas, the drought has also severely affected production of rainfed upland crops of maize and millet, staple foods for poorer segment of the population. With low irrigation water reserves

threatening to curtail the Yala (April-June) production, the food deficit for the year may prove to be much larger than just the shortfall in Maha production.

## Poverty alleviation and economic policy

The UNP manifesto, published as part of the Presidential election campaign, seemed to reaffirm support for many of the policies that have moved Sri Lanka over the last decade toward a more open economy. For example, the manifesto supported a form of privatization of state-owned enterprises — under the rather unfortunate moniker of “peoplization.” Similarly, it offered verbal support for an open trade regime and an expanded role of the private sector. (In contrast, the SLFP had promised to do away with many of the policies that had been introduced to rely more on market forces in the mobilization and allocation of resources, and to re-introduce the full range of statist controls and subsidies.)

But the poverty alleviation program has dominated the new Government’s agenda: for a period of two years, each poor household, that is, foodstamp recipient, is to be given a monthly stipend of Rs. 2,500 (an amount close to the median household income for the country), partly in cash or kind for consumption and partly in the form of deposits in a savings account. After two years, the accumulated savings would amount to Rs. 25,000, sufficient — at least in 1987 rupees — to serve as startup capital for a small business. Emphasizing the investment aspect, the program requires each recipient to submit, either separately or jointly with others, a project proposal for a small-scale enterprise that would be funded with the savings.

The exact parameters of the program appear to be still subject to some change, with eligible households said to range anywhere from 600,000 to 1.4 million. That range would correspond to an annual program cost of between Rs. 18 and Rs. 42 billion. By comparison, total projected current receipts for 1988 were Rs. 48.7 billion; the projected net cash deficit for 1988 was equal to Rs. 26.3 billion. In addition, the implementation of the program may trigger a new round of wage demands, adding to inflationary pressures. The financing of the program apparently has yet to be worked out. The authorities have already begun to squeeze budgets elsewhere, including funds for development projects. Even so, deficits are likely to rise. While many observers remain skeptical about the ultimate feasibility of the program, the Government’s commitment seems firm. Once the new budget is submitted and negotiations with the IMF and the World Bank over the stipulations of the Policy Framework Paper advance, we will be in a better position to assess macroeconomic prospects.

The poverty alleviation program is likely to put additional pressures on food supplies. It will entail a sizeable increase in demand for basic foodstuffs. Increased food imports seem essential to meet the production shortfalls, satisfy increased demand and contain price escalations. These pressures are bound to increase the balance of payment deficit and strain foreign exchange reserves.

Recent consultations with the World Bank — the first since November 1988<sup>2</sup> — have remained somewhat inconclusive; while the Bank team expressed its concerns over the direction of economic policy and over the likely cost of the poverty alleviation program, they were apparently also prepared to make some allowances for the rhetoric of electoral politics. Over the coming months, the Bank and the IMF will be examining closely the economic program of the new administration now that the dust of the election campaign has settled. Basically, the Sri Lankan authorities will have to satisfy the Fund that it intends to pursue the course laid out in the Policy Framework Paper and incorporated into the Structural Adjustment Facility (the next tranche of which is due in March). Perhaps more importantly, the GSL will also have to present a credible economic program to the Donor Group meeting in June.

Some of the Government's recent steps seem difficult to reconcile with the policy directions outlined in the PFP, notably the decision to appreciate the rupee, albeit in rather marginal fashion. Although the authorities cited an abating inflation rate (not surprisingly, after the sharp upturn in last quarter of 1988) as the reason for this action, considerations of easing the burden of expected food imports related to PAP are likely to have played a role. In short, the economic policy line of the new Government has yet to emerge. Until then, we will be working with our counterparts to assess trends, and seeking to influence directions through our policy dialogue as well as our continuing project work.

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<sup>2</sup> Regrettably, neither the IMF nor the World Bank had any presence in the country during December or early January, as many of the guidelines of economic policy under the new Government were discussed.

## Part II: Program performance in 1988 – progress in spite of it all

### Introduction

Like everything else in the country, USAID/Sri Lanka's program was affected by the turmoil of 1988. Project implementation slowed, policy actions were put on hold until after the elections, and many officials moved cautiously to wait for the broad outlines of policy to become clearer. At the same time, though, we registered further progress on the policy front: in irrigation, after many years of debate and gentle prodding (including negotiations on self-help measures under PL 480 Title I), the Government adopted management principles emphasizing decentralization, reliance on farmer organizations, and cost recovery. In agriculture, the Government followed through on its commitment to allow for greater private-sector participation in the marketing of paddy seed. USAID/Sri Lanka provided the stimulus for this process through a combination of project activities under the Diversified Agricultural Research Project (DARP) and a self-help measure under PL 480. The work needed to create the framework for a more effective equities market continued, as did some of the activities related to privatization, although the actual privatization of the first two companies was postponed to remove the issue as a campaign topic.

At the same time, our policy dialogue did suffer a major setback when the Government decided to demonstrate its promised largesse by effectively forgiving loans to the poorest of the poor under the Million Houses Program.<sup>3</sup> The chaotic conditions of the last quarter may also have nullified any progress on other measures that we have selected as program performance indicators, such as annual operating subsidies from the government to non-financial public enterprises, annual capital transfers from the government to non-financial public enterprises, or (net) lending to enterprises. We shall examine these aspects as the information becomes available later in the year.

For most of the year, our projects (and project design) proceeded at a virtually normal pace. In the last quarter of 1988, however, USAID/Sri Lanka experienced some delays and

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<sup>3</sup> These loans will of course be ineligible for reimbursement under our Housing Guaranty program. We are using this particular step by the Government to press for innovative solutions in housing finance that may make program performance less subject to abrupt policy shifts.

interruptions. In Colombo, dealing with counterparts in the Government and the private sector became difficult in late November and early December, as people had difficulties getting to work. In addition, we did observe a cautious pre-election "wait-and-see" attitude among our principal contacts. Finally, disruptions in basic services (electricity, water, transportation) persuaded field-based TA personnel for the Mahaweli Agriculture and Rural Development project (MARD), DARP, and the Irrigation Systems Management project (ISM) to leave their respective stations in Mahaweli System B, Kandy, and Pollonaruwa for several weeks, using the break primarily for advance planning. Construction work on several projects experienced delays. USAID staff postponed visits to project field sites during November and December because of security concerns and uncertainty about the availability of services and fuel. With few exceptions, we also rescheduled TDY's of A.I.D./W and consultant personnel until after the Presidential elections.

The following brief summary of the scorecards for USAID/Sri Lanka's major sectors indicates that, *on balance, we succeeded in moving forward on our core strategy, and in most policy areas.*

## Agriculture and irrigation

In agriculture and irrigation, we have been able to register critical progress in working with the Government to improve the policy environment. In the irrigation sector, we have entered into an effective policy dialogue in the sphere of farmer organizations, participatory management, and cost recovery. Adopting many of the principles we have consistently advocated, the Government has proposed legislation to give farmer organizations the legal status needed to take on the official responsibility for water delivery, maintenance, and fee collection, and to assure official representation of farmer water user groups in Government water and fee allocations.

Progress on agricultural policies included the first steps on opening paddy seed marketing, until now a government monopoly, to competition from private providers. Research under DARP identified options for change, our policy dialogue with the Government explored these options further, and a self-help measure under PL 480 Title I provided the final impetus to test these options in a real-world setting. As part of the startup activities for MARD/MDS, we worked with the Government in establishing a concrete policy agenda that will be monitored and expanded as the projects progress.

With our support and cooperation, the Government has embarked on a new initiative to reexamine and update the National Agriculture, Food and Nutrition Strategy (NAFNS).

Under the Agricultural Planning and Analysis Project (APAP — 303-0083), it established the *Agricultural Planning Group* to begin the analytical work leading up to the revision of the NAFNS. USAID/Sri Lanka regards the APAP as a key element in our evolving policy agenda on agricultural development.

In the area of land tenure policy and related issues, we have broadened our policy dialogue with the Government beyond support for expedited land titling under a PL 480 self-help measure. In pursuing USAID's analytical agenda, we have begun to explore with GSL officials options for a comprehensive assessment of the pertinent land tenure issues in agriculture and rural development. As noted below, in negotiations during the development of the Mahaweli Enterprise Development project (MED — 383-0090), USAID was able to obtain agreement on land transfers to encourage small-scale enterprise.

On the negative side, water user charges were a highly visible target for candidates' promises during the election campaign. Although the most generous program, that of the SLFP promising free water for everyone, did not carry the day, farmers' expectations were undoubtedly raised. The campaign rhetoric may make increased reliance on adequate cost recovery more difficult.

Related to water management issues, USAID's Water Supply and Sanitation Sector project (WSS — 383-0088) achieved major improvement in the institutional capabilities of the Water Supply and Drainage Board (NWSDB) to plan, design, rehabilitate/construct, operate and maintain water and sanitation systems through Sri Lanka. The organizational consolidation, decentralization, and increased emphasis on improved operations and maintenance have lowered NWSDB's unit operations and maintenance costs and have increased revenues considerably. It has also encouraged the ADB to provide significant funding for further capital expansion, relying on the improved institutional setting. The Science and Technology Bureau has cited the WSSS as a cost recovery model for other countries.

## Private sector development

Project development and implementation in USAID's private sector portfolio advanced our policy agenda, although action on politically contentious issues was put on hold during the election campaign. For example, privatization was delayed pending the elections, but the new government has instructed the Presidential Commission for Privatization to sell the first two enterprises on the list of 24 slated for privatization. The government has reversed a previous decision to privatize telecommunications, however.

As part of the development of the MED project, the new government has agreed to transfer 750 plots to private entrepreneurs in the Mahaweli, in a change of standard policy.

USAID was successful in negotiating two additional Section 108 programs with the GSL as part of our PL 480 Title I agreements, bringing the total amount for lending directly to the private sector to \$4 million for FY 87-89. These programs complemented progress in our policy agenda for financial markets development, as detailed further below. On the negative side, disbursements under the FY 87 agreement — targeted largely, though not exclusively at the private tea industry in the South — were slower than expected, reflecting a reluctance to invest in the face of a precarious security situation.

Even with the security problems, however, USAID-sponsored support for private businesses continued. Despite long periods of disruption, the International Executive Service Corps (IESC) fielded some 15 volunteers. The Sri Lanka Business Development Centre (SLBDC) is moving into its final year under USAID auspices with strong private-sector and multilateral donor support. It has emerged as strong support institution for new and established small and medium-scale enterprises.

## Financial markets development

Over the past year, USAID/Sri Lanka has increasingly focused on our direct and indirect involvement in financial markets. In recognition of the importance of the performance of the financial system and of related policies for our project portfolio, we have begun to articulate more systematically a coherent approach in this area. A draft financial markets development strategy is currently under review. Summarized as part of the strategy appraisal in Part III of this document, the financial markets development strategy adapts A.I.D.'s overall strategy to the needs and opportunities in Sri Lanka, outlining the basic principles and identifying priorities for our policy agenda. The financial markets development strategy discussion in the Mission is also reflected in our *Analytical agenda* presented in Annex A to this Action Plan.

While we cannot point to any sweeping reforms of financial markets policies in 1988, we made clear progress on our policy agenda, often in close coordination and cooperation with other donors, notably the multilateral development banks. Early in the year, a consultancy to examine the structure of interest rates served as the catalyst for a workshop bringing together key decision makers in the Government and in the private sector to explore options for improving the mobilization and allocation of financial resources for low-income housing. This workshop raised several of the themes that we have been pursuing since with the appropriate authorities, including options for grant-loan separation.

The Development Studies and Training project (DS&T — 383-0085) financed technical assistance to the Central Bank on the critical issue of non-bank supervision, specifically of finance companies. As part of the financial liberalization after 1977, the Government had passed legislation to ease the establishment of finance companies, adding to diversity and competition in financial markets. Unfortunately, an inadequate regulatory framework and insufficient staff resources led to poor supervision, permitting some finance companies to continue on shaky financial grounds. Several of these finance companies collapsed in the wake of a slow-down of the economy in the mid-1980's. Others came close. The USAID-sponsored consultant helped the Central Bank to design a strategy to deal with the emergency, strengthen its supervisory role, and — most importantly — resist the temptation to take over bankrupt finance companies, hiring private management instead. DS&T-financed technical assistance to the Central Bank also covered such areas as improvements in foreign exchange dealings.

Our private-sector portfolio emphasizes improvements in equity markets; one of the key components of the Private Sector Policy Support project (PSPS — 383-0100) is support to the newly established Securities Council and the Colombo Securities Exchange. In anticipation of that assistance, DS&T financed consultancies to explore needed measures to deepen capital markets, and to help the Securities Council in structuring its agenda, and review pertinent legislation and recommend revisions.

## The Rehabilitation Assistance Project in 1988

Although delayed by continuing violence, the GSL Emergency Rehabilitation and Reconstruction Programme (ERRP) has achieved measurable progress. By the end of 1988 firm agreements had been signed with bilateral and multilateral aid agencies for a total of \$312 million, or about 63 percent of pledges made at the December 1987 Aid Group meeting in Paris. Through the Rehabilitation Assistance Project (RAP — 383-0107), authorized in July 1988, as well as through special allocations of PL-480 and HG authority, the United States emerged as the leading bilateral donor and by far the largest grant donor to the ERRP. Of the \$75 million pledged by the U.S. at the special Paris Donor Group Meeting, \$10 million in DA grant funds and \$10 million in PL-480 Title I were obligated in FY 88 and another \$20 million (\$10 million in DA and \$10 million in Title I) is scheduled for obligation in FY 89, leaving a balance of \$20 million to be obligated in FY 90 (assuming a DA level of \$26.8 million; \$10 million in DA and \$10 million in Title I). The full \$15 million in HG loan funds were authorized in FY 88.

The GSL has organized for the rehabilitation effort by establishing a National Reconstruction Steering Committee (NRSC) within the central government, and eight District Reconstruction Coordinating Committees (DRCC) in the affected districts of Jaffna, Kilinochchi, Mullaitivu, Mannar, Vavuniya, Trincomalee, Batticaloa and Amparai. Funding for the NRSC secretariat and key staff positions at the district level has come from the UNDP. USAID's contribution to the ERRP is directed substantially to the housing and productive enterprise (including agriculture) grant components of the ERRP, which have been packaged by the GSL with other grant programs under the Unified Assistance Scheme (UAS), a standardized assistance program with a remarkably detailed system of documentation and financial accountability.

The GSL has virtually completed a survey of 400,000 families who were adversely affected by the six years of violence between 1983 and 1988, registering them as eligible for the various kinds of UAS grant or loan assistance. Nearly 263,000 families had been surveyed as of December 31, of which 74,000 had received the registration cards that give them a formal claim on the various types of UAS assistance, 68,000 had received productive enterprise grants, and nearly 35,000 had received the first installment of their housing grants. Based on 1988 expenditures, the GSL has requested USAID reimbursement for \$3.85 million out of the total \$16.4 million allocated to the UAS-related components of our project. Accrued expenditures are reported to be in the \$7 million range.

The RAP also provides funds for rehabilitation of irrigation systems in the North and East. As with other repairs to infrastructure such as public buildings, roads, schools and health facilities, little construction occurred in 1988 although a good deal of preliminary work such as design engineering and tendering for equipment and construction services has been completed. USAID has earmarked \$500,000 for reimbursement of last year's irrigation rehabilitation and is preparing initial specifications for procurement of commodities and equipment to carry out additional work in 1989, with as much as \$3 million in construction now scheduled.

Donor coordination has been effective on rehabilitation matters, and we have played a significant role here. Nearly all donors praised the World Bank for its high quality war damages assessment report, which was prepared with support from OFDA-funded and USAID/Sri Lanka technical experts. Subsequently, USAID and USAID-sponsored technical assistance played the key role in developing the UAS, helping to limit disruptions of the financial system, and providing equal treatment across sectors and districts. Donor coordination here included convincing the World Bank to shift from its support for a heavily subsidized loan scheme incorporated in its ERRP loan to the grant-loan approach of the UAS. Throughout the design and implementation, USAID has held direct meetings

with several other donors to review options and strengthen a common approach. In the case of the Japanese, we took the lead in convincing the Japanese Overseas Economic Cooperation Fund (OECF) to depart from its usual programming approach and redirect unspent local currency from previous commodity loans to support housing grants under the UAS. Also, in support of coordination efforts, USAID funded a study of the capabilities of indigenous PVO's in the North and the East to participate in the implementation of ERRP. The study includes an indication as to which PVO's are best suited to work with the various Tamil groups. We also funded a housing needs and options survey carried out by CARE.

## Part III: An appraisal of strategies

### A focused core strategy and broader policy agenda

USAID/Sri Lanka has crafted a deliberate strategy structured around a core of projects addressing the country's problems in employment and income. The core strategy emphasizes *income growth* by promoting private enterprise, involving farmers in agriculture as well as entrepreneurs elsewhere. Our analysis of the problems and experience with alternative approaches convinced us that interventions designed to strengthen the technology-producer-market linkages offer the greatest potential for raising incomes and maintaining an acceptable income distribution.

As we are implementing this core strategy, linkages among the key sectors of USAID/Sri Lanka's portfolio are becoming increasingly important. Technological advances in agriculture — needed to raise incomes — depend not only on the readiness of farmers to adopt innovations and their ability to manage the adoption. They also depend on adequate demand for the (new) products, and on expanding employment opportunities outside of agriculture. In exploring strategic options for the future as part of our CDSS design process, we see support for (urban) small-town development under the Mission's Housing Guaranty (HG) program as a promising link between the two major elements of our core strategy in agriculture and the private sector. Such an approach could help accelerate the agricultural transformation and advance our goal of creating employment in the private sector. It would also effectively integrate the HG program into our core strategy focused on employment and income.

A broader policy agenda complements this core strategy, seeking to shape the policy environment through close coordination of program activities, including project interventions in support of institutional development, in particular analytical and policy making capabilities, policy-oriented research as part of particular projects or conducted or supervised by USAID, and policy dialogue initiatives using different vehicles, complementing our project-related agenda effectively with self-help measures under the PL 480 Title I program, and conditionality and technical assistance under the HG program. While our policy agenda covers a broad range of areas, including trade and investment policies, we

have concluded that improvements in the functioning of financial markets could contribute significantly to our core strategy goals. USAID/Sri Lanka has therefore begun to focus more explicitly on financial markets development, to develop consistent approaches across the full range of our program portfolio, and identify priorities for new initiatives. The strategic assessment in this section therefore looks not only at our major sectors of activity, but also highlights program issues in financial markets development.

## Agricultural/rural development strategy

### **USAID's program has accomplished much**

USAID/Sri Lanka's agricultural and development strategy has consistently pursued the goal of increasing rural incomes, productivity and food consumption. This goal has shaped our current portfolio which combines:

- (a) support for the improved performance of irrigation systems;
- (b) assistance to efforts to diversify agricultural production (mainly involving non-rice field crops); and
- (c) an evolving policy dialogue arguing in favor of market-based policies to promote rural income growth, supported by the development of enhanced institutional capabilities for policy analysis, and buttressed by reforms linked to specific project initiatives and self-help measures under our PL 480 Title I program.

Sri Lanka's agriculture has registered sizeable advances over the last decade, notably increases in rice production, the country's staple food. Successes in rice breeding and dissemination of high-yielding technologies of the Green Revolution have brought the country close to self-sufficiency in rice. This progress has influenced the evolution of USAID's strategy for agricultural and rural development: originally concentrating on raising rice production and on developing the institutional structure to support agricultural development, the Mission has moved to a more deliberate and focused effort to increase both farm and non-farm incomes and productivity.

Consistent with the emphasis on basic food crop production and institutional development in A.I.D.'s agricultural strategy, our program has both shaped and responded to emerging GSL priorities. As national rice self-sufficiency has become near-reality, the GSL —

recognizing the barriers to entering the international rice market — has opted for a strategy of crop diversification to promote rural economic development and enhance farm income. USAID's involvement in and technical support for the formulation of the National Agriculture, Food and Nutrition Strategy helped the Government in articulating its response to the new challenges.

USAID/Sri Lanka support for agricultural diversification seeks to redress imbalances that are the result of a historical bias in the allocation of investments and other resources in favor of rice, tea and rubber. Diversification provides a means to enhance the stability of earnings, improve nutrition, increase the profitability of farm enterprises, and make better use of scarce resources, in particular irrigation water. Our portfolio provides substantial support to:

- the formulation of GSL diversification policies — the National Agriculture, Food and Nutrition Strategy (NAFNS), and the Agricultural Planning and Analysis Project (APAP — 383-0083);
- the development of improved production technologies for non-rice field crops — the Diversified Agriculture Research Project (DARP — 383-0058); and
- efforts to promote production and marketing of high-value export crops — the Mahaweli Agriculture and Rural Development project (MARD — 383-0086), and the Mahaweli Enterprise Development project (MED — 383-0090).

USAID's portfolio has emphasized food crop technologies, institutional development and irrigation management, areas of comparative advantage for U.S. assistance. This orientation implies a focus on annual crop agriculture, which in turn makes it easier to skirt the problems of Sri Lanka's fragmented agricultural bureaucracy. By concentrating our activities, and resisting the temptation to expand into livestock, fisheries, and perennial crops, we avoided having to spread our efforts across a wide range of Ministries and Departments, which would dilute the program's impacts and result in a heavy management burden.<sup>4</sup>

In the *irrigation* subsector, our strategy has evolved over the last decade from a focus on construction to its current emphasis on management and institutional development to improve the performance of existing systems. This shift reflects shrinking opportunities

<sup>4</sup> The recent reorganization may have overcome some of that fragmentation; in any case, it promises to provide stronger central leadership in the agricultural bureaucracy.

for physical expansion of irrigation agriculture, escalating constructions costs, a reduced need for expansion of irrigation to support increased rice production, and a growing recognition that improving the performance of existing systems is more efficient than building new ones. Our current project portfolio covering the irrigation subsector, comprises the Mahaweli Downstream Support project (MDS), the Irrigation Systems Management project (ISM) and the Mahaweli Agriculture and Rural Development project (MARD); these projects complement each other in implementing our strategy to:

- promote farmer organization involvement in irrigation system management and administration; and
- encourage user fees and cost recovery for irrigation system operation and maintenance.

### **Sri Lanka's agriculture is at a critical juncture**

Progress over the past decade has created its own problems. Following a period of impressive growth, the agricultural sector has begun to stagnate — despite the availability of improved agricultural technology and a relatively free marketing system. The causes are complex, but we can identify some of the underlying factors:

- a relatively weak demand for basic agricultural commodities tends to choke off farmer incentives to adopt yield-enhancing technologies; at current prices and incomes, production already meets domestic demand, especially for subsidiary field crops;
- complex land tenure arrangements coupled with small farm sizes (average of 2.17 acres/household) prevent farmers from adopting more efficient, scale-based production and marketing strategies essential to raising incomes; and
- an open trade regime provides no protection for domestic producers, even during the critical early stages of moving into new markets, before efficiencies increase as a result of scale economies and learning by doing.

These factors do not invalidate the basic premise of the diversification strategy, but do suggest changes in the approach. The diversification strategy initially targeted some fifteen field and horticultural crops known in Sri Lanka as subsidiary field crops. Since then, we

have identified constraints to rapid increases in their production. Weak demand leaves only limited scope for import substitution. Others (maize, soybeans) cost considerably more to produce than imports and do not achieve the same quality. As in the case of rice, domestic prices of most subsidiary field crops are above world prices; their poor quality makes them unacceptable to the world market. Finally, the production base of several subsidiary field crops (sesame, maize) is upland, in areas that are often illegally cultivated under environmentally destructive slash-and-burn cultivation.

USAID's current portfolio seeks to lift these constraints by developing approaches to raise productivity and lower unit costs of production (DARP, MARD, MDS, ISM), improve product quality (DARP, MARD, and the Development of Agricultural Marketing Systems project, DAMS — 383-0091), and enhance marketing efficiencies. Policy reforms are needed to complement these technical interventions in making some of these subsidiary field crops competitive and attractive to farmers. Reforms may include temporary measures to provide a modicum of protection to allow domestic production to reach the needed economies of scale. Even then, the constraints cited above make a rapid and widespread diversification to the subsidiary field crops unlikely — barring a rapid increase in incomes in the non-agricultural sector.

Under existing conditions, growth of agriculture for domestic consumption is unlikely to continue at a rate higher than that of long-term population growth. Only export markets offer opportunities for inducing technological innovation and stimulating productivity in the food crop sector. The size of Sri Lanka's economy favors this approach to realize economies of scale by tapping trade as a tool for development. USAID/Sri Lanka is already expanding support to export market development through our MED and MARD projects, and is planning to strengthen this support through DAMS.

Our rural development efforts have also benefited from the rural component of the Government's Million Houses Program, supported under our Housing Guaranty program. The program directly and substantially contributed to a strengthening of rural financial markets; our policy dialogue succeeded in moving the program to greater reliance on private financial institutions, specifically the Thrift and Credit Cooperative Societies, boosting their role and the growth of the system. In addition, support for housing construction also provided valuable lessons in capital formation and uses of formal credit for low-income rural families.

### **Strategic directions for the 1990's**

Our future strategy will be characterized by further integration of project-level interventions focusing on strengthening farmer-technology-markets links, more effective food assistance, and policy dialogue.

Efforts to increase agricultural productivity through technological transformation and increased efficiencies in marketing, cropping diversification, efficient use of irrigation resources and encouragement of agro-based industries will continue to dominate USAID/Sri Lanka's portfolio. To bring these efforts to fruition will require utilizing projects, PL 480 resources and policy dialogue increasingly as complementary and interdependent means. Projects will provide experience and a focus for policy discussions, while PL 480 resources will support policy change and complement project activities to maximize impact and lead toward better use of productive resources. Our PL 480 program will undergo close scrutiny during CDSS development. We will explore options for a multi-year food aid plan, including the possibility of a multi-year program of self-help measures.

Lessons from MARD on promoting linkages between farmers, markets and production technology, including irrigation management and support services, will likely inspire the USAID/Sri Lanka program for a number of years. Judging from recent experience, commercialization of peasant agriculture will emerge as a programmatic theme. We will place increasing emphasis on merging irrigation management into a package of income-enhancing agricultural technologies and commercial market opportunities.

Any strategy for raising agricultural productivity and incomes must increasingly emphasize the economic transition of the entire rural economy, including its urban components, the small towns. Higher incomes in agriculture require expanded employment opportunities in other sectors and in off-farm locations; more pointedly, a successful agricultural/rural strategy may have to be complemented by a non-agricultural/urban employment strategy. Our research and thinking on this issue, in conjunction with our work on small-scale enterprise development under the private-sector strategy, over the coming year should help clarify our position and our response.

# Urban sector strategy and housing

## **The urban sector and USAID involvement**

Only 23 percent of Sri Lanka's population live in urban areas, and the rate of urban growth has been decreasing in recent years, in part because (temporary) emigration for work in the Middle East absorbed some of the urbanization pressures. The country has not faced the problems traditionally associated with rapid urban expansion, though the capital of Colombo (est pop. 600,000) is experiencing some of those problems.

There are early signs that the factors accounting for Sri Lanka's low urbanization rate may be changing, however, and that rural-urban migration may increase during the 1990's. More importantly, we see reasons to believe that Sri Lanka ought to be urbanizing at a faster rate, and that its failure to do so — aided by the deliberately rural/agricultural focus of GSL (and most donor) policies — may hamper faster economic growth.

Sri Lanka has a history of strong urban centers throughout the island. What is emerging now is a need for economic activity currently concentrated in the Colombo area to be more widely dispersed as well as increased overall. More rapid urban development could assist rural development by decreasing population pressures on increasingly scarce agricultural land by developing markets and other rural support systems and services in small towns, with populations as low as 5,000. As the spatial aspects of growth become of more interest, these small urban centers are likely to receive more attention.

The shelter sector provides a basis and a complement for such an initiative. It has an explicitly urban element: the Urban Housing Subprogram (UHSP) of the Million Houses Program (MHP), now supported with Housing Guaranty (HG) resources. Experience in the UHSP, the focus of which has been mainly in Colombo, indicates that larger urban areas need special approaches and that trying to transplant what works in rural areas does not necessarily succeed in urban areas. A considerable amount of analytical work is required to develop those approaches, both for the on-going housing program and for any new efforts to be undertaken in larger urban areas, especially Colombo. Some of this work will be done as part of our 1992-96 CDSS development effort. USAID and the Regional Housing and Urban Development Office (RHUDO) have discussed a new shelter/urban sector strategy exercise which would be timed to provide CDSS input as well as for development of the next steps of the housing program.

In exploring options for bringing HG experience and resources into play in any urban initiative to strengthen links between our agricultural and private-sector strategies, we need

to consider the lessons of the HG program in Sri Lanka, in addition to its impacts in financial markets development, examined further below.

### **The Housing Guaranty program: Progress and future options**

The current Sri Lankan housing program started as the Hundred Thousand Houses Program, a fairly traditional low income housing construction program which encountered the same problems that such programs have virtually everywhere: high costs, limited production, and middle income beneficiaries. Sri Lanka, however, learned quickly from its experience, and when the National Housing Development Authority (NHDA) began implementation of the MHP in 1984, they realized that to reach one million households, a very different approach would have to be taken. Their solution was to offer a program of small home improvement loans (Rs.3,000 - Rs.15,000, or \$91-145), first at no interest, but moving gradually to the current interest rates of 6 percent in rural areas and 9 percent in urban areas.

The innovative aspect of the MHP was its use of beneficiary input, not only in actual construction where feasible, but in deciding what type of construction would be used and in planning of community upgrading projects. The concept was to use housing as a way of getting communities to organize themselves for development. It proved to be enormously popular politically as well, as the loan components reached hundreds of thousands of households.

In supporting the MHP with HG loans, USAID's policy agenda has focused on the financial aspects of the program, that is, interest rates and loan recoveries. Sometimes that focus has led us to overlook the importance of substantive accomplishments. Getting governments to reduce unrealistic building standards to make housing affordable to low income households and to involve beneficiaries in their own housing solutions remains the policy agenda in other countries. There is little doubt that the MHP has succeeded in achieving both objectives. Although some income-ineligible households may have benefited from the program, we know that the loans themselves are affordable to below-median income beneficiaries and that the program has reached many more such households than public housing programs in most developing countries.

Urban areas have proved to be more problematic from a number of angles: cost recovery is worse in the UHSP, and urban areas lack a system that effectively bridges the gap between formal and informal financial markets, like the Thrift and Credit Cooperative Societies (TCCS) system in rural areas. Infrastructure financing for the urban upgrading sites under

the MHP is difficult, resulting in settlements that have decent houses but inadequate water and waste disposal services. The lowered standards have produced housing affordable to poor households, but have also resulted in environmental problems that may eventually impair community health in the urban sites.

Slower progress on the financial aspect of the UHSP, where the direction our policy dialogue ought to take is less clear than in the rural component, has also meant less attention, particularly as the focus of other sectors of USAID's program has been so rural. Nevertheless, urban housing and infrastructure are perhaps the more serious problems from the perspective of national well-being. USAID believes it must continue to address the need through the HG with some limited grant support.

Under the housing program we have learned the following lessons:

- Political popularity is a two-edged sword; during the recent Presidential campaign, both candidates promised relief from loan repayments, and even before the election low income holders of MHP loans were told they did not have to pay them back. Predictably, the gradual gains in recovery rates made over the years were wiped out.
- Even more serious, however, was the damage done to some of the new thrift societies, which had been formed largely to handle the housing program, underlining the risks to private sector institutions which take on partnerships with the public sector. Adequate safeguards need to be provided for both parties if the partnership is to work.
- Market interest rates for credit programs will require more than encouraging public sector policy makers to raise rates. Sectoral credit policies must consider how the sector is constrained by the larger financial market, how resources can be mobilized within those constraints, and how the cost of mobilizing funds relates to interest rates to the ultimate borrower. Policy dialogue should focus on solutions which are integrated into financial, political and social context within which the housing sector functions.
- Project or program-based lending may not be the most effective means of affecting shelter policy development. Temporary setbacks due to political exigencies may become inordinately obstructive, even if they do not represent true policy reversal.

Looking forward, we will be seeking ways to derive more progress in improving shelter conditions for low income households for the same or fewer resources. Although we may not be able to predict with precision where the GSL will go next with its housing program, we will be examining the following directions:

1. Policy changes which will make the low cost housing sector more market-oriented;
2. use of public sector incentives to attract more private investment in low and moderate income housing;
3. development of public regulatory role to bring about constructive change in the shelter sector;
4. use of the HG resource to support the above steps, with particular attention to disbursements based on policy changes rather than project specific activities; and
5. increased focus on the urban sector, both for shelter and community development activities and on the role of these activities in poverty alleviation.

## Private sector development strategy

### **Our strategic orientation**

Looking to assist Sri Lanka to achieve increased incomes and employment, the 1987 CDSS update targeted the expansion of the private sector's role in the economy. This focus was based on the belief that the private sector is a more efficient user of resources to generate growth, and that the GSL was committed to private-sector led growth. It was buttressed by the observation that Sri Lanka's private sector potential was underutilized, and that with a favorable political environment, significantly increased exports and economically viable import substitution could be achieved. The CDSS update identified two specific fields of opportunity to increase the contribution of the private sector to the nation's wealth:

- Privatization of GSL-owned commercial operations to relieve them of bureaucratic inefficiency, resulting in increased incomes and employment; and

- translation of liberalized policy proclamations into action, with similar increases in incomes and employment. Three particular areas were chosen: industrial policy, privatization, and capital markets.

Given the market-oriented policies of the GSL, the Mission sought to launch initiatives to support the private sector that would have immediate impact, but also build sufficient momentum to convince any subsequent government of the private sector's potential for growth, employment, and income generation. The private sector strategy comprises a variety of project interventions which would stimulate private sector investment once the ethnic problems abated. The approach in this portfolio employs increasingly the same core approach that shapes our agricultural activities: focusing on the technology-producer-market linkage, both in small-scale enterprise promotion and in support for the modern sector.

#### **The program is well on target**

USAID/Sri Lanka has succeeded in incorporating a private sector focus into our entire portfolio: The PL 480 Section 108 program of local currency loans to the private sector; the privatization of the seed industry through the DARP project; the transition of the Million Houses Program from a government agency to a private network of 3,000 thrift and credit societies; the PVO co-financing sub-projects which encourage small scale industries; the MARD project to increase the role of private sector marketing in the Mahaweli areas; and the productive enterprises component under RAP.

Current project activities which directly address private sector development include the Private Enterprise Promotion Project (PEPP — 383-0082), the Private Sector Policy Support project (PSPS — 383-0100), and the Mahaweli Basin Development I project (MBD I — 383-0056). PEPP helped establish the Sri Lanka Business Development Center — an active, broad based organization that can make practical as well as theoretical contributions to private productivity, and that has matured considerably over the last two years. Under PSPS, USAID will sponsor a unit to provide support in policy analysis to private-sector chambers and associations; scheduled to begin in 1989, this analytical support unit is expected to act as a catalyst in helping private-sector organizations articulate their stance on economic policy issues. With support under PSPS, the Presidential Commission on Privatization is ready and able to start a significant move toward private ownership of twenty four state-owned enterprises. The new Government has given the go-ahead on the sale of two of them. The capital markets development program under PSPS is scheduled to begin in the spring of 1989, with some useful work already underway, drawing on the resources of the Development Studies and Training Project.

The design of the Mahaweli Enterprise Development project (MED) has been completed, but supporting activities have, in fact, been operational under MBD I for two years; MBD I has provided assistance to efforts to increase the role of privately owned businesses in the Mahaweli areas. Although still in the early stages of implementation, our portfolio is well on target for private sector policy improvement, expansion and privatization. As a result, USAID/Sri Lanka is ideally positioned to assist the new GSL leadership in meeting the challenges ahead.

### **Options for the future**

Sustainable and equitable income growth hinges on a broad-based, rapid growth of employment opportunities as part of a broad structural transformation of the economy. A key task ahead for the USAID private sector portfolio will be to use existing and planned activities to demonstrate convincingly that the private sector can and should play a lead role in this structural transformation. The dualistic nature of Sri Lanka's economy, small-scale and relatively inefficient enterprises existing alongside sophisticated manufacturing operations using modern capital-intensive technologies, suggests a two-pronged strategy for USAID:

- support to accelerate the formation and growth of viable micro- and small-scale enterprises that thrive in a market environment; and
- assistance to improve the competitiveness of Sri Lankan industry by shaping an appropriate policy environment, and by encouraging the development and adaptation of efficient technologies.

This formulation of the two major thrusts of our private-sector strategy builds on our current activities, seeking to reinforce and extend the impacts expected. A variety of mechanisms already in place as part of our portfolio can assist the GSL to develop analyses and policies to encourage a more open market economy and greater productivity.

The new government has reaffirmed the commitment to market-oriented development with a leading role for the private sector. Small-scale enterprise, micro-enterprise and self-employment schemes form an important aspect of the poverty alleviation program. While the poverty alleviation effort planned by the government may claim some of the resources needed for development projects with a longer-term payoff, the program may also provide resources for economically productive investments.

Recognizing the uncertainties, USAID/Sri Lanka will continue to build the capacity for course correction into its private sector portfolio. Our projects stress policy analysis and effective monitoring and evaluation. We also need to examine further what actions are most effective in stimulating private initiative and channeling it toward rapid and equitable growth.

A good deal more needs to be known about the distribution and activity of the labor force. The Central Bank annual report of 1987 states that only 1.5 million jobs can be identified, 1.2 million of which are in the public sector. (The economically active population was estimated at 5.7 million in 1984.) That suggests a vast array of small scale operations around the country, contributing much to GNP without being part of the formal economic system. This is an area of particular concern to both the GSL and USAID, and a field in which USAID can make a substantial contribution through the Mahaweli Enterprise Development project.

To a large extent, our agricultural strategy's emphasis on strengthening the technology-producer-markets linkages also applies to our activities in the private sector. Consequently, USAID/Sri Lanka is developing an intervention to assist in technology development and transfer. Sri Lanka has not been able to keep up the pace of modernization necessary to break into competitive world markets. However, advances made in the late seventies and early eighties seem to be holding, and there are indications that both Sri Lanka and foreign firms are prepared to invest in new productivity if the political situation improves.

In order to achieve this next stage of enterprise, a number of components will need restoration. The country has lost trained technicians and experienced managers who have left for employment in the Middle East or have emigrated due to the ethnic conflict. It has also witnessed a slowdown of training, due to the closure of schools, colleges and universities. And, institutions responsible for R&D support have not succeeded in sustaining excellence. In order to accelerate a resurgence of competitive enterprises, USAID has embarked on the initial investigations into what industry needs, but is lacking, in the areas of technology and scientific support. The U.S. is particularly well suited to assist Sri Lanka in the transfer and development of technology, and our current, modest program of International Executive Service Corps volunteers (approximately 15 volunteers per year) shows how effective the right kind of assistance can be. The proposed new project, Science and Technology Initiative for the Private Sector, will draw on our experience and national strengths to provide a program of targeted assistance to industry and agro-processing during the 1990's.

## Financial markets development strategy

USAID/Sri Lanka's program looks to enhance the contribution of financial markets to development overall, and specifically to the achievement of our own strategic goals, income growth and stronger market structures. The Mission's financial markets development strategy is of course a compromise between what we would like to see happen, that is, what we think would make the financial system contribute more efficiently and effectively to economic development, and what we can reasonably pursue within the context of our portfolio and within the realm of credibility of our policy dialogue. The balance between the strength of our convictions and the reach of our influence varies. Our strategy therefore acknowledges that we are more likely to have an impact by concentrating on specific areas, even if questions about financial policies elsewhere remain.

The basic principle guiding our financial markets development strategy is simple. To promote economic development, financial markets should ensure that scarce financial resources are drawn from less productive uses and shifted to activities with the highest return. To achieve that mandate, financial markets work best if they are:

- *integrated*, that is, if resources can flow freely from one segment to another in response to the most attractive investment opportunities;
- *transparent*, that is, information about alternative investment opportunities is readily available to savers, investors, and financial intermediaries; and
- *undistorted*, that is, the process of mobilizing and rationing financial resources relies on market mechanisms rather than administrative fiat.

Properly promoted and protected, market forces will maximize the contribution of the financial sector to economic growth. Distortions of market signals will lower the overall return. While such distortions may appear justified for distributional or national security reasons, their cost must be clearly understood.

In fact, with respect to (re)distributional objectives, what we have learned about the costs of different approaches suggests that the financial system is an inefficient delivery mechanism for resource or income transfers. Subsidized interest rates, in the form of ceilings, preferential treatment of certain population groups (acceptance of higher risks and transaction costs for the same interest rates), and similar interventions typically fail to achieve the welfare objectives, but entail high costs in terms of an institutionalized mis-

allocation of resources. Resource or income transfers are legitimate elements of government policy. To do the most good, however, they should be open and direct. Grants should be grants and loans should be loans.

So far, much of USAID's direct involvement in financial markets development has been limited historically. We have sponsored research, consultancies and training on financial issues under both DS&T and our HG program. In addition, new projects — MARD, MED, PSPS — directly address weaknesses in financial markets. Our major direct involvement in financial markets has been through the HG program. The Section 108 program represents another example of direct involvement, but very recent and at a more modest scale.

In the Million Houses Program, USAID's interest has concentrated on making it more self-sustaining by encouraging higher interest rates and increasing the rates of recovery of the loans. Thus far, our major policy advance has been the privatization of part of the loan origination and servicing functions by channeling some MHP loans through the TCCS system. Loans handled by the TCCS's, so far almost all in rural areas, have had recovery rates approaching 80 percent, compared to the less than 50 percent recovery rates achieved by the program overall. The TCCS's' success in the financial aspects of housing has been due, at least in part, to its use of less onerous lending practices than banks and other formal sector lenders, enabling them to fill a credit market niche that the other formal financial institutions were not interested in, but which has demonstrated itself to be creditworthy under the right circumstances. Under HG project 004, we are trying to move farther toward financial sustainability by moving to a clearer separation of grant and loan components of the program and to further liberalization of interest rates. The TCCS system is key to both.

Generally, USAID/Sri Lanka's proposed financial markets development strategy comprises four major thrusts:

- 1) technical and direct assistance in efforts to separate grants and loans.
- 2) support for attempts to strengthen the integration of financial markets by developing equity markets, and by fostering linkages between formal and informal components of the financial system;
- 3) technical assistance, training and related support for initiatives to improve the prudent regulation and supervision of financial markets; and
- 4) technical assistance and training to financial institutions, primarily

private institutions, in areas such as loan appraisal and development of alternative safeguards for loan contracts and innovative financial instruments.

At the same time, USAID/Sri Lanka's financial markets development strategy also recognizes that the success of these initiatives in improving the performance of financial markets depends on policies beyond the range of project interventions. These policies typically reflect deeply held beliefs about the goals and role of monetary and related policies. In these cases, we can stake out a position — based on careful analysis — and represent such a position in our policy dialogue. Although further analysis remains to be done, we have identified three critical weaknesses that do or can hamper financial development:

- 1) legislation stifling financial intermediation by making possession of collateral in case of a default on a loan a cumbersome and time-consuming process;
- 2) taxation of transactions among financial institutions that hampers full integration; and
- 3) inflexible exchange rate policies that allowed for a significant appreciation of the real effective exchange rate prior to 1986, affecting real returns in financial markets.

We are planning to study these issues and examine relevant opportunities for our policy dialogue.

## Natural resources and environmental strategy

### **Sustainable economic growth is key objective**

USAID/Sri Lanka's strategy toward natural resources and the environment rests on the premise that sustainable growth cannot be achieved unless the environment is managed so as to allow it to be passed on in a viable condition to the next generation. To meet this strategic objective of sustainable economic growth, the Mission will assist Sri Lanka formulate national policies and programs that more effectively manage natural resources, discourage harmful practices and stimulate local management approaches to natural resource conservation and protection. Given the influence of environment across all

sectors, our strategy will focus on assisting Sri Lanka identify and solve environmental problems by strengthening the scientific, management and policy formulation capacities of both public and private environmental agencies.

### **Consistency in donor policies**

In carrying out this strategy, the Mission has an important subsidiary objective to collaborate with bilateral and multilateral donors to achieve consistent policies in complementary programs and encourage projects that have a positive environmental influence. To achieve this sub-objective, the Mission takes its donor coordination responsibilities seriously. Since the last Action Plan, we have recruited an FSN environmental specialist who conducts in-house environmental reviews of the major projects of other multilateral donors, and also advises bilateral donors on their projects when requested. We were, as a result of our analysis of the original proposals, in part responsible for the decision of the GSL to defer a major power (coal) project on the East Coast and the World Bank's decision to re-examine environmental implications under the proposed IDA Forestry II project.

### **Environmental laws, regulations and institutions are in place**

Since the early 1970's, donor organizations have supported and initiated environmental programs in Sri Lanka. Among the most important: agencies of the United Nations, the World Bank, Asian Development Bank, Canada, Germany, Netherlands, Norway, United Kingdom and the United States (under the Mahaweli Environmental Protection project, MEP — 383-0075). This support has helped Sri Lanka establish the laws, regulations, and core institutions needed to protect its environment.

A Central Environmental Authority (CEA) oversees government policies and problems and is beginning an environmental impact assessment (EIA) process for industrial development projects. A system of wildlife parks and reserves covers about 10 percent of the country. Land use planning for environmental protection has been applied to state land sale and settlement programs. Parliament recently established a comprehensive law requiring regulations and permits to control air, water and land pollution. Universities provide significant expertise and non-governmental organizations (NGO's) influence GSL decisions on energy, forestry, and industrial development. Despite the ethnic strife, the media give almost daily attention to environmental issues.

### **Gap between goals and achievements is widening**

In spite of the GSL's commendable environmental protection efforts to date, the gap between Sri Lanka's environmental goals and actual achievements has been widening. Rapid reduction of natural forests and erosion of soil diminish sustainable economic growth opportunities. Thus, the primary objective of our Environmental and Natural Resource strategy is to actively promote environmentally sound, long-term economic growth by assisting Sri Lanka conserve and protect the environment and promote sustainable economic growth.

### **Institutional constraints: Greater interagency cooperation needed**

In translating the Mission's overall objectives to reality we recognize that Sri Lanka has a number of country specific institutional constraints which must be directly addressed. The first is that environmental policies and priorities, while sensible, are not yet sufficiently articulated and integrated into government-wide planning and budgeting. Government agencies with overall environmental policy responsibility have suffered from lack of financial and human resources and a subordinate position within the government. Furthermore, the CEA — and other agencies as well — cannot rely on a steady stream of trained graduates in the environmental field because most training is handled in an ad hoc manner. Finally, although current Sri Lankan legislation has mandated that EIA's be done for all major projects, the mechanism has suffered due to the lack of trained staff, weak environmental assessment units within the major operating agencies, and the inability of the few available CEA staff to provide adequate oversight. These deficiencies are recognized by the GSL, and a higher level environmental authority has been recommended by Sri Lanka's Administrative Reform Committee.

Additionally, program coordination has not yet reached the point to effectively apply existing resources, staff, and budgets to the most pressing natural resources protection problems, including law enforcement. For example, while a strong coastal program has been established — with support under the A.I.D. centrally-funded Coastal Resources project — effective coastal resource management has suffered from poor mobilization of existing institutional capabilities. In this case, greater cooperation is needed between the excellent but thinly staffed Coast Conservation Department (CCD) and the National Aquatic Resources and Research Agency (NARA).

These constraints in the public sector apply to the private sector as well. Public participation in environmental planning, management, and enforcement has not been maximized

and sometimes even discouraged. However, opportunities for remedial actions and public involvement are promising under the National Environmental Act amendments of 1988. As a result, public interest in environmental matters has recently increased.

### **Need for better data**

Data on the environment are also inadequate, particularly for air and water pollution, and the functions and values of coastal estuaries, wetlands, and natural forests. Public policy decisions for economic development suffer from a lack of environmental information needed to assess impacts and the costs and benefits of development. Decisions concerning industrial sites, and the use of forests, wetlands, and other natural resources could be expedited and costly mistakes avoided with a concerted program to identify environmental data needs and establish research programs and priorities.

### **Future directions**

In helping the GSL protect its environment and promote sustainable growth, our strategy will be directed to areas where we believe A.I.D. and USAID have a comparative advantage — training and technical assistance to strengthen institutions charged with environmental protection, and to raise awareness and understanding of environmental issues elsewhere.

## **Women in Development**

Throughout USAID/Sri Lanka's portfolio, especially in our work with small farmers and producers, Women-in-Development (WID) issues are receiving considerable attention. We are now ready to consolidate these efforts, and are submitting, along with this Action Plan, our first "WID Action Agenda", as required in 88 STATE 365414. (See Annex B.)

That agenda is built around the highest priority WID effort in 1989, developing the WID portion of next year's CDSS. We will select several WID themes for attention during the strategy period that relate to the overall Mission strategic focus, and sponsor or prepare background analytical or issues papers on them. Themes under consideration now include: (a) the employment of women in GSL field/extension positions related to USAID projects, (b) women's access to credit for agricultural and business activity; and (c) factors affecting women's involvement in diversified agricultural production and marketing.

A second priority for the WID effort during the coming year is to improve the collection, analysis, and use of gender disaggregated data in project design and project management. In the design of the new Mahaweli Enterprise Development project (MED), we made use of gender disaggregated data from a baseline survey. Of existing projects, data collection and reporting systems in three projects will be analyzed to determine whether gender disaggregated data is appropriately being gathered and reported. Also, the need for gender disaggregated data will be carefully considered in other projects.

## Working with and through institutions

### **Donor coordination: New opportunities**

The principal donors in Sri Lanka are: Japan, the World Bank, the International Monetary Fund, the Asian Development Bank, the U.S., the UK., Canada, the UN Group, the Federal Republic of Germany, Sweden, the Netherlands, India, Norway and France. Of these, only the first five are consistently major donors. Japan, the largest donor, has provided assistance mostly for large infrastructure projects. It responds to GSL requests for assistance and does not yet operate against a specific long-term strategy and does not apply policy conditionality. We recently learned, however, that the Japanese may now be interested in a more active role at the policy level. This change in posture needs to be reinforced in Colombo as well as in Tokyo, particularly since Japanese ODA pledged at the Aid Group Meeting in Paris in 1988 equalled \$275 million, or about half of all OECD donor aid pledged. We hope the lessons of recent joint A.I.D.-Japan Aid programming efforts in Bangladesh, India, Indonesia and the Philippines will soon be reflected in Japanese aid planning here.

The International Bank for Reconstruction and Development (the World Bank) is active in all areas of USAID's strategic focus: agricultural diversification, irrigation (with an increasing emphasis on irrigation management), water supply, and private sector development. In addition, the World Bank is active in transport system development and management, the health sector, energy policy and in reconstruction in the war-torn areas of the North and the East. A recent development in the Bank's policy-oriented lending has been the support for public sector restructuring.

As elsewhere, the World Bank has taken a leadership role in policy dialogue, largely through chairing the annual Aid Group meetings in Paris and coordinating donor activities



Issues in donor coordination

in Colombo. The thrust of the Bank's policy dialogue and conditionality have been generally in line with USAID's own policies. We are maintaining close contact with the Bank. In the course of these contacts, we have been able to assure coordination in areas of mutual interest. We have also been able to identify possible problems or areas of conflict which generally have been resolved to mutual satisfaction. Cases in point concern reforestation, salary supplements for health professionals, and financial assistance arrangements under the rehabilitation program for the North and East. Similarly, our strategic planning and project design efforts have benefited as a result of the close working relationship we have with the Bank.

The Asian Development Bank (ADB) has a wide range of projects in Sri Lanka. Areas which relate closely to the USAID strategic focus include agricultural diversification, irrigation (infrastructure construction and irrigation management), water supply, and private sector development (particularly small and medium industries). Sectors of ADB project activity in which USAID is not involved are technical education, school (re)construction, power distribution, and road construction and maintenance. Virtually all projects are loans at concessional rates from the Asian Development Fund (ADF). Limited grant funds have been used for technical assistance in project development or for sectoral studies (e.g., in rural credit).

In some sectors, the ADB has been increasingly involved in considering areas of policy conditionally. For example, in irrigation they have begun to explore actively cost recovery and farmer organization issues. In construction (particularly roads), they are moving toward requiring construction by private sector firms, rather than public sector organizations. Although the ADB has no staff based in Sri Lanka, USAID has very frequent interaction with visiting missions, particularly in the sectors where our assistance is related. Given the magnitude of the ADB program, we have raised with visiting ADB teams the possibility of assigning a full time resident representative in Colombo. We were advised that this possibility is currently under consideration, with the ADB trying to set priorities among several recipient countries.

Only the "big five" donors apply any real policy conditionality. The other donors will occasionally have project level conditions associated with their individual projects, but do not generally venture much beyond that on the economic front. However, Canada plans to now play a larger role in policy dialogue in the near future, particularly in the area of Women-in-Development. U.K. ODA officials have also expressed interest in taking part in policy dialogue, particularly in the area of private sector development and privatization. We see opportunities for collaboration with CIDA on raising gender issues with the GSL and with ODA on privatization efforts.

Our position and expertise in that field give us a lead role in donor coordination on environmental issues. We have focused on activities by multilateral development banks to achieve greater consistency regarding environmental implications of development projects.

### **PVO's/NGO's: An underutilized resource?**

A recent informal survey (carried out with the assistance of a Peace Corps volunteer) of eight other donors showed that in comparison, USAID has a narrower strategic focus for PVO activities; has a larger budget than any other single donor; has a minimum and average grant size significantly larger than any other donor; requires a more significant contribution from the recipient; and has more rigorous monitoring procedures and reporting requirements.

PVO collaboration works in Sri Lanka ... sometimes. It works when there are quantifiable benefits like grants available. But, Sri Lankan PVO's do not seem to be roused by the more nebulous benefits of collaboration. We have to dig a little deeper during the development of our 1992-96 CDSS to discover what makes PVO collaboration work in order to make it work better. Where collaboration already exists, there may be opportunities for USAID. For example, we may seek to:

- Enhance the effectiveness of existing special interest umbrella organizations like the Water Supply and Sanitation Decade Service by providing additional funding for their microgrants program currently funded by British WaterAid; and
- Identify and support consortia like the *Innovations et reseaux pour le développement* (IRED or Development Innovations and Networks) that support programs encouraging communication and coordination among small PVO's.

GSL planning for the PAP is still in progress. Preliminary implementation guidelines identify PVO representatives as change agents working with external and internal change agents in teams of three at the village. As of late March 1989, the Ministry of Home Affairs was soliciting proposals from various PVO representatives concerning the nature of PVO involvement in the program. Undoubtedly PVO's will be involved in some way, but so far we find mostly speculation.

## **USAID-Peace Corps collaboration: A growing relationship**

Over the past several years the composition of assignments undertaken by Peace Corps Volunteers (PCV's) in Sri Lanka has changed from predominantly English language instruction to the current approximately even mix of English language instruction and the provision of business/agriculture technical assistance. With the proposed arrival of new business/agriculture trainees in July 1989, there should be an increased potential for future collaboration between USAID and the Peace Corps in technical areas required by the USAID project portfolio.

Currently, seven PCV's are assigned as small animal husbandry and small business advisers with the Mahaweli Authority. In addition to bringing technical expertise to their own job assignments, these PCV's provided assistance at the design stage of the MED project. Furthermore, several trainees arriving in July will be assigned to similar positions, thereby insuring a continued Peace Corps involvement parallel to the MED project. Under the Peace Corps Small Projects Assistance (SPA) Program, USAID increased its 1988 commitment of \$12,000 to \$20,000 in 1989. In 1988, PCV's initiated four SPA projects in the areas of water management, small income generation, community development and environmental protection. With the increased USAID commitment, PCV's will have to make a comparable effort to identify fundable projects. Volunteers are encouraged to apply for SPA funds: the three-month pre-service training program includes a special small projects design workshop in which trainees learn how to identify projects (including those which may be funded by SPA) and to write a project proposal.

In response to a renewed commitment on the part of Peace Corps/Washington to develop new collaborative programs with PVO's, Peace Corps is investigating the possible placement of business and agriculture PCV's with indigenous PVO's. Currently, Peace Corps staff favors placing PCV's in organizations funded through USAID's PVO Co-Financing projects because those organizations would have the resources required to carry out substantive activities. PCV's, again, would provide technical assistance and could assist PVO's in meeting its project objectives.

Although the Peace Corps has not placed volunteers in the urban sector to date, it is reviewing this sector now with the idea of placing business volunteers in appropriate urban situations. Possibilities for USAID/Peace Corps cooperation exist here as well, particularly under the HG program.

Finally, both USAID and Peace Corps share a common Women-in-Development (WID) mandate and interest. Peace Corps's WID Committee is establishing links with indigenous women's organizations, encouraging volunteers to initiate secondary projects with a WID

orientation and assembling a series of case studies on successful volunteer projects with a WID orientation. At a four-day Peace Corps conference planned for August 1989, to include other foreign volunteer organizations as well, the WID Committee hopes to program a WID session to include representatives from women's organizations and donors like USAID, and CIDA, that have a strong mandate. Both PVO Co-Financing subprojects have a strong WID orientation as well; in the future, it may be possible to assign PCV's to women's PVO's like the YWCA or Lanka Mahila Samiti who are also implementing USAID-funded subprojects.

USAID and Peace Corps have established good lines of communication: Peace Corps staff and volunteers periodically meet with USAID technical staff to exchange technical and other information. In the future, fora like the proposed WID session at the all volunteer conference should be encouraged. Also, wherever possible, the advice of PCV's will be solicited in the design and implementation of USAID-funded projects.

## Part IV: Program management

### Project management/implementation issues

Given USAID/Colombo's portfolio in 1986, a major project design effort was essential to implement the development strategy and CDSS. Responding to that, the Mission is nearing completion of an intensive three-year design effort which included the design of nine projects with a cumulative total of US \$141 million. Now that we have obligated those projects and nearly all of them have reached a critical take-off point, it is appropriate that we give increased attention to project implementation.

This is especially important given that in Fiscal Year 1988 the Mission expended US \$14.46 million and five projects accounted for US \$10.81(75%) of the Mission's expenditures: Diversified Agriculture Research, Reforestation, Irrigation Systems Management, Mahaweli Basin Development II, Water Supply & Sanitation, and Malaria Control. Two projects — Mahaweli Basin II and Malaria Control — will close out in FY 1989.

The Mission anticipated the implementation consequences from that recent design effort and a portfolio composition geared to technical assistance, training, institutional development and policy analysis. To disburse our project funds as quickly as possible in the future we have taken the steps described below to ensure accelerated implementation and increased expenditure levels:

1. *Project reviews:* The Mission continues having regular issue-oriented quarterly project reviews of all projects in the portfolio. At the same time we continue to refine our internal reviews, underlying project data base and supporting management information systems. Recent changes completed or underway include: a continually updated comprehensive master database of key dates and core project information, more intensive review of those projects which are experiencing implementation difficulties and deeper financial analysis of project financial data. In addition, we will continue our yearly budgetary review with the GSL to flag problems and make acceptable adjustments.

2. *Internal project reviews:* The Mission has recently begun a highly productive process of intensive reviews of projects experiencing implementation constraints. Our approach is

to create a core review team in the Mission composed of various offices under the chairmanship of the Deputy Director. This team in turn looks at a project in a comprehensive, intensive way and then makes a series of recommendations which are reviewed and negotiated with the GSL. The most recent exercise was done for the Irrigation Systems Management project (383-0080) and resulted in a number of adjustments to the project which were accepted by the USAID project manager, the project team assistance team and the GSL. Given this recent encouraging experience with the ISM project, we plan to continue this intensive interdisciplinary assessment approach on other projects when needed. For example, in an effort to develop effective steps to improve the management of the PVO Co-Financing II project, we are considering the possibility of carrying out an internal assessment of that project during May/June of this year.

3. *Personnel management.* During the FY-85-FY87 period, USAID assistance levels were cut by 60 percent and the USDH staff levels were reduced from 25 to 19. In FY88, although our workload increased as a result of the heavy policy content of our program and the RAP design and startup, our USDH staff level remained at 19. We have been able to increase the time USDH staff is devoting to our policy and analytical substantially by building an exceptionally strong FSN professional (and support) staff; five Sri Lankan professionals (PSC's) have joined our staff since the last action plan. The progress on our policy agenda in difficult times demonstrates the positive impacts of these actions.

4. *Project procedures and controls.* In 1986, at the same time that we began designing a number of new projects, the Mission launched an intensive review of the Mission's operational environment for project implementation. The end objective of this review is a Project Officer's Handbook consisting of a completely revised series of Mission Orders, procedures, costing estimates, and implementation guidelines. This exercise is largely complete with the only additional work being revisions to our procedures of financial accountability to be completed by the newly arrived Controller. Our intent here has not been to rewrite the AID Handbooks but rather to position key areas of project implementation into the operational setting of USAID/Sri Lanka. Among the items covered in the Handbook are specific Mission-wide redelegations and clearance procedures, Mission-wide contract procedures, responsibilities for monitoring host country budget contributions, guidance on drafting PIO/Ts, etc. With this exercise essentially complete, the Mission has a comprehensive guide to project implementation that should facilitate faster and more professional implementation of our projects.

5. *Implementation seminar.* In connection with the increased emphasis on project implementation, the Mission has begun a regular weekly series of Project Implementation Seminars to continue throughout the CY 1989. The Mission regards this as the most relevant approach to integrating the large number of new staff as quickly as possible into

the management and implementation culture of AID. The purpose is to educate Mission staff on the procedures and strategy and tactics of project implementation. The Mission is using the Project Officers Handbook as the basic document for this seminar. Approximately 25 members of the Mission staff, both FSN and USDH officers are attending the course on a regular basis. Topics covered include delegation of authority, contracting, budgeting, and financial management.

6. *Accelerating project procurement* The slow pace of commodity procurement is an endemic problem restraining project implementation and indeed in most AID Missions resulting in intensive management of implementation and slower than anticipated disbursement. Under current GSL regulations, for example, the GSL requires that nearly all procurement be formally tendered, and the procurement of over \$180,000 be reviewed and approved by GSL Cabinet appointed tender boards. While this has resulted in generally good controls and accounting for commodities, all of the steps take time beyond most reasonable levels.

The Mission is taking steps to address these constraints. We have just completed a historical review of our procurement experience together with an analysis of GSL policies on commodity procurement and in so doing have identified and forwarded to the GSL a number of suggestions to rationalize and accelerate the process. The suggestions include increasing the limits for procurement at various approval authorities to reflect the increased inflation and the devaluation of the rupee. Where possible and in accordance with AID regulations, procurement will also be broken into smaller tranches, while larger ones will be consolidated and planned even further in advance throughout project implementation.

In addition to GSL practices, the Mission is exploring alternatives to the traditional system of GSL tendered procurement. For example, we are currently using one of our projects as a test case to do limited direct procurement under a Procurement Services Agent. If this type of effort does accelerate procurement, we will be selectively using it in some of our other projects as well.

7. *Automation systems* Related to increased project implementation is the Mission's own operating environment. In this regard, we have come to the end of the first phase of a major procurement of automation equipment. The installation of a new Wang VS system will mean a significant increase in terminals throughout the Mission as well as the ability to transfer data from office to office. We expect that this will have a positive effect on implementation as documentation can be drafted and reviewed more quickly. At the same time, the Mission's standard protocols for the use of this equipment now under draft will encourage quicker project implementation.

## Implementation of PL 480 and HG programs

The Mission has taken steps to streamline the administration of its PL 480 program and improve the effectiveness of monitoring. A food aid management plan, drafted and approved in the first quarter of FY 1989, responds to the growing complexity of the program. It clarifies the responsibilities of different offices with respect food aid programming, Titles I and II, self-help measures, Section 108 (including 108(f)), and related issues. On self-help measures, USAID/Sri Lanka is pursuing the establishment of a standing GSL committee, as a counterpart in our efforts to formulate and approve self-help measures in preparation for, rather than during, the actual negotiations of the Title I agreement. Such a committee would also be critical to shifting to a multi-year food aid program.

For our growing Section 108 program, we have established a simple reporting system to track disbursements and uses of funds.

As part of our effort to improve monitoring of the HG program, the Mission has hired an FSN professional and is developing a computerized tracking system for disbursements and recoveries.

## Resource requirements

Our highest resource priorities at this time are: (a) the Title I supplemental request to compensate for crop failure in the Maha season, and (b) meeting our \$75 million pledge for rehabilitation and reconstruction activities.

The need for supplemental Title I assistance this year notwithstanding, the GSL's competent management of PL 480 resources in the past should be a factor in the DCC decision making process. The GSL manages the procurement and shipping well; it is amenable to establishing self-help measures, and follows up on their implementation; a Section 108 program is in operation (Sri Lanka was the first country to start a 108 program); and the GSL recently agreed to the establishment of a Section 108 (f) program, which is being managed by the Regional Agricultural Attache in New Delhi. At this writing, we understand that the DCC is considering a supplemental Title I. We ask that the DCC give full consideration to our \$20 million request. Sri Lanka needs the additional \$10 million; moreover, \$20 million now will yield more effective policy dialogue opportunities

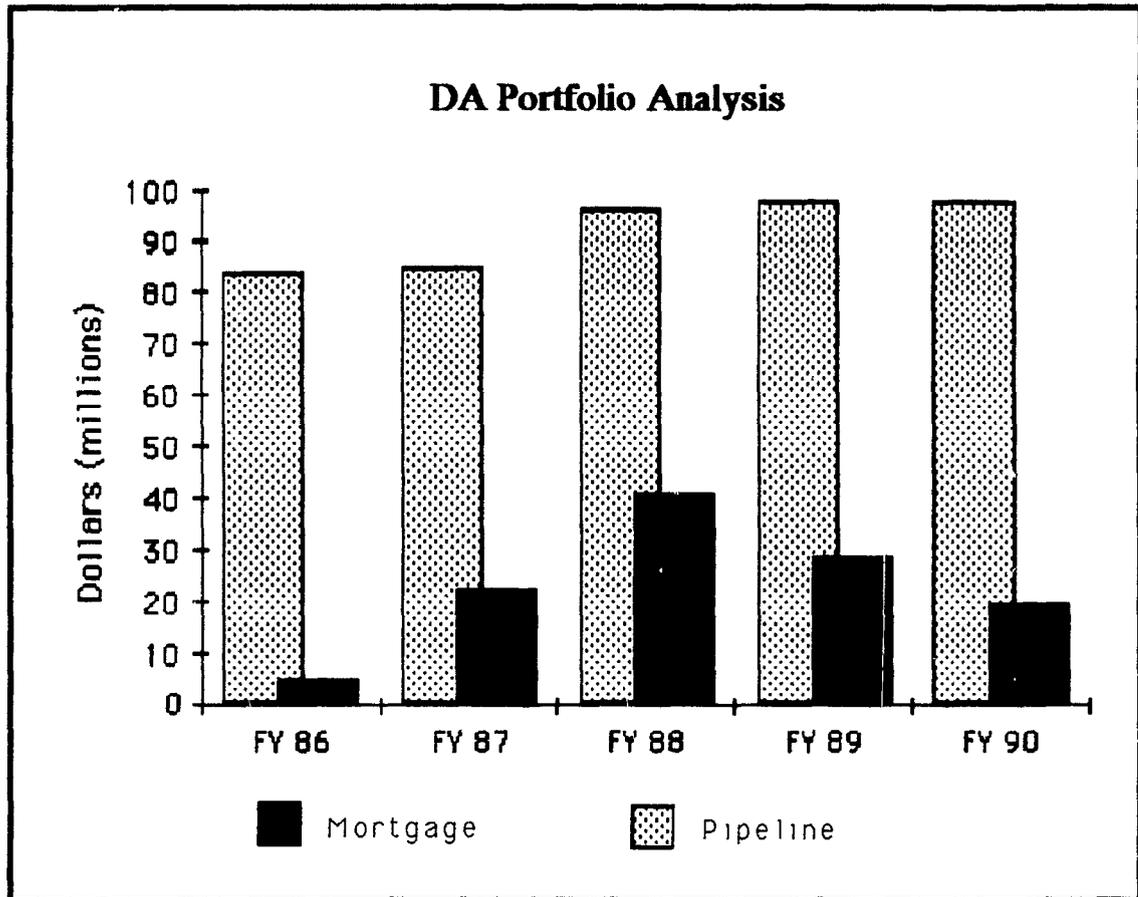
and greater political gains with the new Government than just \$10 million, or \$10 million now and \$10 million later this year.

In response to the Peace Accord, the U.S.G. pledged \$75 million for rehabilitation and reconstruction at the Aid Group meeting in Paris on December 7, 1987. When the pledge was made it was planned that at least \$30 million would come from DA resources (\$10 million a year over three years — FY88-90 — with the balance from PL 480 and HG resources). As a result, our annual DA level was increased to \$26.8 million for the FY 88-90 period. During the FY 90 budget exercise, however, the planning level was pushed down to \$18 million. We believe we have a convincing case to bring the FY 90 level back up to \$26.8 million and then over the FY91-FY94 period, gradually reduce DA levels while increasing PL 480 to make up for the reduction. First, in support of our argument for restoring the FY90 DA level of \$26.8 million, there is a strong argument for meeting our pledge. There is the obvious political argument, and there is also the policy dialogue argument. Our significant pledge got us a firm place at the policy dialogue table and we would like to keep it that way. Second, expenditures under the RAP project during the first and second quarters of FY89 accelerated. We expect that at the current rate of expenditure the full \$20 million in DA obligated to date will be expended by early FY 90. Third, we come to this year's program week with our FY88 DA project portfolio 100% obligated. Please note the graph below which demonstrates that we do not have a mortgage problem and our pipeline is manageable. We believe performance should also be an important factor in AID/W's consideration of our FY 90 DA reclama.

As indicated in the donor coordination section, the U.S. is still considered a major donor. Along with our membership in this informal "major donor club" come certain benefits. The most significant benefit is having a place at the policy dialogue table with the GSL and with multilateral banks. Another major benefit is the access we have to officials at all levels in the government and in the private sector. Our \$100 million HG program has involved us in policy discussions at high levels of government, and has given us full access to all individuals planning further housing initiatives for the new Government. We firmly believe that continuing our program at current levels will maintain our major donor status and position of influence. We recognize that maintaining an annual DA level of more than \$20 million after FY90 is an unlikely possibility. Therefore, we are recommending that future decreases in our DA level be offset by increases in PL 480 so our major donor position can be assured and we can continue to have a significant role in policy dialogue efforts. With the significant gains in our agriculture and private sector policy agendas, we are well positioned to "make a difference" with the new Government. Our proposed budget levels for FY90-FY94 are below.

**FY 1990-94 Proposed Budget Levels (\$ Millions)**

Type of assistance	FY 1990	FY 1991	FY 1992	FY 1993	FY 1994
Development assistance	26.8	22.0	20.0	20.0	20.0
Food aid —					
PL 480 Title I	24.0	28.0	30.0	30.0	30.0
PL 480 Title II	0.5	1.0	1.5	2.0	2.0
Housing Guaranty	15.0	15.0	15.0	15.0	15.0
<b>TOTAL</b>	<b>66.3</b>	<b>66.0</b>	<b>66.5</b>	<b>67.0</b>	<b>67.0</b>



# Part V: Growth in an equity-oriented society – directions for the next CDSS

## Introduction

To launch the preparation of the 1990 Country Development Strategy Statement (CDSS), USAID/Sri Lanka conducted an intensive review of its current strategy and explored major strategic options for the CDSS period (1992-96) during a two-day workshop in early January 1989. This section attempts to summarize the discussions and serve (after suitable critique and revision) as a framework for the development of the key sections of the new CDSS.

## Program goals

USAID's new CDSS will pursue two major program goals, income growth and increased reliance on market forces. These two goals represent extensions and refinements of the goals that have shaped our current strategy.

### **Increased incomes**

Income growth with equity remains a principal goal. Although Sri Lanka's average growth performance over the past decade surpasses A.I.D.'s overall strategic goal of per capita GDP growth of at least 2 percent per year, it has failed to make much of a dent in the poverty problem. Moreover, the apparent slowdown in growth following the encouraging spurt in the late 1970's and early 1980's may have eroded some of the earlier gains. Thus, USAID's strategy will seek accelerated growth in aggregate income.

In addition to the average level of income, its *distribution* will receive greater attention. Preliminary evidence suggests that the income distribution has worsened since the early 1980's, with real per capita incomes in the lowest income decile registering barely any increase between 1980 and 1985, while that for the highest income decile more than doubled. In addition, the absence of real income gains for the poor may also have

worsened the problem of *malnutrition*; in any case, the problem remains rampant. Income distribution has emerged not only as an issue across income groups, but also among ethnic segments and regions of the country. These inequities in sharing the fruits of economic liberalization may have contributed to a worsening of social and political tensions. They may share part of the blame for the violence that has rocked the country, and has sapped its economic strength. Our concern with distributional aspects of income growth therefore also reflects their importance in shaping the social climate in the country, a key factor in maintaining growth.

Finally, *intergenerational equity* has emerged as an issue over the last decade. The accelerating degradation of environmental resources jeopardizes the long-term sustainability of growth, shifting much of the cost of current consumption to future generations.

### **Functioning markets**

Given the dismal performance of attempts to mobilize and allocate resources by administrative fiat anywhere, the 1980's have witnessed an increasing recognition that increased reliance on market forces can help accelerate growth and improve welfare. All too often, though, increased reliance on market forces is erroneously interpreted as a "hands-off" prescription - establishing *laissez-faire* economic policies. Instead, well-functioning markets require an active government to safeguard competition by curbing any restrictions as a result of monopolies or collusion among a few firms, assure adequate information flows, and protect participants against abuses.

In the Sri Lankan context, as elsewhere, that role implies a radical change in philosophy and functional emphasis. The transition from direct involvement in the allocation of economic resources to a regulatory and supervisory role requires political commitment to a new vision of government, and great skills in re-orienting a bureaucracy that often sees its *raison-d'etre* in doing better than market forces to decide what groups or activities should have the first claim on resources. USAID will encourage the debate necessary for strengthening any political commitment, provide support for key efforts to bolster market forces, and promote greater confidence in market-oriented policies by developing and trying out innovative approaches to rely more on market mechanisms, and publicizing the results.

We believe that market forces need to be strengthened in all areas to improve resource mobilization and allocation, but our strategy will focus on two areas:

- the mobilization and allocation of financial resources, as outlined in detail in USAID/Sri Lanka's financial markets development strategy;

- the allocation and use of land and water, in particular irrigation resources.

Our policy dialogue may cover other areas, in particular competition in manufacturing and services, where monopolies or collusive oligopolies exist, and where small enterprises may encounter some discrimination.<sup>5</sup>

## Sectoral highlights

### **Agriculture**

Although the Sri Lankan economy is undergoing significant structural shifts, agriculture remains dominant; that will not change over the CDSS period. The performance of the agricultural sector will determine aggregate income growth. USAID/Sri Lanka has supported agricultural growth in the past primarily through technology (including new products) development and adaptation to promote higher productivity and diversification, and through improvements of the structure and management of irrigation systems.

The preparation of the CDSS offers an opportunity to rethink some of the premises of our agricultural strategy. Further progress may face constraints of scale, both at the level of total effective demand, and at the level of the individual farm. While the domestic market is by no means insignificant, it does not offer much more room for appreciable expansion in total production volume in both paddy and subsidiary food crops.

With a relatively stagnant market and the number of farm households remaining level or increasing, incomes per household have little potential for needed gains. Moreover, the small farm sizes implied by steady or increasing numbers of farm households severely restrain the potential for further technology improvements. Thus, any strategy for raising agricultural productivity and incomes must incorporate elements of promoting the economic transition of the rural economy — to expand employment opportunities in other sectors and in off-farm locations; more pointedly, a successful agricultural/rural strategy will have to be complemented by a non-agricultural/urban employment strategy. Our research and thinking on this issue, in conjunction with our work on small-scale enterprise development under the private-sector strategy, over the coming year should help clarify our position and our response.

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<sup>5</sup> In following through on our analytical agenda over the next year, we will examine the importance of restrictive business practices and assess our options for supporting efforts to remedy observed weaknesses.

## **Private sector**

Given likely constraints on the growth of agriculture by itself, sustainable and equitable income growth hinges on a broad-based, rapid growth of employment opportunities elsewhere. The dualistic nature of Sri Lanka's economy, small-scale and relatively inefficient enterprises existing alongside sophisticated manufacturing operations using modern capital-intensive technologies, suggests a two-pronged strategy for USAID:

- support to accelerate the formation and growth of viable micro- and small-scale enterprises;
- assistance to improve the competitiveness of Sri Lankan industry by shaping an appropriate policy environment, and by encouraging the development and adaptation of efficient technologies.

This formulation of the two major thrusts of our private-sector strategy builds on our current activities, seeking to reinforce and extend the impacts expected. It rests, of course, on conjectures about the underlying causes of sluggish growth, and about the likely effectiveness of USAID interventions. These conjectures need to be examined carefully, as relevant information becomes available. Three major questions in particular need to be answered:

- Has the competitiveness of Sri Lankan industry, both domestically and in international markets been hampered by inadequate access to and use of modern, efficient technologies?
- Will the markets for all of the small-scale enterprises needed to make an appreciable impact on the employment problem exist?
- Can the relatively labor-intensive methods of promoting small-scale enterprise formation and growth generate employment opportunities in a reasonably efficient manner?

The first two questions will be examined more closely during CDSS development. The last one will be a key issue in monitoring and evaluating current initiatives, which should provide further inputs into later strategic decisions.

### **The urban sector and housing**

USAID's Housing Guaranty (HG) program has contributed to a major government effort to use a transfer program to promote capital formation — in the form of housing investments — by poor households, and to develop the ability of financial markets to meet the housing finance needs of low-income households. Its range could, and should, go beyond that, though. Sri Lankan polity has been equity-focused, often more concerned about redistributing the pie than about making it bigger. Although the emphasis is shifting, redistributive policies, income transfers in one form or another, will remain important. They will continue to play a central role in part because not enough thinking has been done to determine whether the generally laudable social goals of these programs can be achieved in different ways, relying more on individual initiative than government handouts with their vast bureaucratic backup.

The housing program, some recent backsliding notwithstanding, has made some progress over the last five years to stimulate movement toward creating public-private partnerships that will use subsidies more sparingly and more efficiently, and create fewer distortions in financial markets. To develop these ideas further and work with the Government to test them will require careful study of both goals and mechanisms. The housing program is expected to take a lead in this area.

### **Environmental resources**

The protection of environmental resources has been a key, though relatively minor, element of USAID's portfolio for some time. As environmental degradation has accelerated and has begun to jeopardize the country's ability to sustain increases in agricultural production and productivity, USAID has decided that a broader and more systematic approach was required. Our project initiative in this area, now under development, will help establish an appropriate institutional and regulatory framework for promoting solutions to the protection and efficient use of natural and environmental resources. Our strategy will build on this initiative.

### **Population and nutrition**

Sri Lanka's low population growth rate reflects its accomplishments in education and health, but also demonstrates the success of its population programs. USAID has provided continuing support to these programs, primarily through centrally funded projects at a level compatible with the task of maintaining the accomplishments so far, rather than expanding the domain of family planning services. Although recent trends suggest that maintaining

past accomplishments will become harder, our thinking on USAID's future involvement in this area tends toward a continuation of the focused support provided under our current strategy.

We have noted ominous signs that the incidence of chronic and acute malnutrition may be increasing. In any case, the current level of incidence indicates a problem of staggering proportions that neither well-meaning government programs, nor efforts by PVO's (with some support from USAID) or other donors seem to address adequately. Our discussions at the CDSS workshop evinced concern. We will be looking at this issue further to fashion the most appropriate response within the framework of our strategy.

## Analytical agenda

This outline of our current thinking on the CDSS demonstrates continuity in the basic thrust of the program, but also a need for information gathering, analysis, and reflection on many of the facets of our program. These concerns are reflected in USAID/Sri Lanka's analytical agenda. A brief summary may suffice here.

Both of our major program goals require further research and analysis to understand their dimensions and their implications for program planning. Thus, with respect to income growth, the Mission is planning specific studies on poverty, on employment and unemployment, and on the extent and incidence of malnutrition. We will also draw on newly available survey data to obtain a better handle on income distribution characteristics. Regarding stronger market forces, we expect to carry out studies on financial markets, as we refine our financial markets development strategy, on issues related to land tenure, and on further improvement in the management of irrigation resources.

Our sectoral agenda requires further research on the issues raised in the discussion of options for agricultural growth and development, and USAID's role in that process. Needed research on market prospects for small-scale enterprises relates directly to the agricultural policy issues, since both ends are relevant to the question of what approaches are most likely to speed up the transition of rural economies.

Further research is needed on the role of science and technology in Sri Lankan industry to gain a better appreciation of the impact of deficiencies in this area for domestic and international competitiveness. In housing, research needed for the CDSS formulation will focus on options to increase the separation of grant and loan components. Finally, as noted in conjunction with research on our major program goals, we will conduct a systematic review of the evidence on malnutrition.

USAID/Sri Lanka

# Analytical Agenda

March 1989

Annex A

# Analytical Agenda

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## Background

This paper summarizes USAID/Sri Lanka's analytical agenda for roughly the next year. A major task during this period is the preparation of a new CDSS, scheduled for submission to A.I.D./Washington in early 1990. Consequently, the information needs for our strategic choices dominate the analytical agenda.

This document represents the culmination of a deliberate process of winnowing from a broad range of ideas and issues prepared by the technical offices. A first summary paper (August 15, 1988) compiled these ideas and suggestions and put them in a common structure; this document served as a basis for Mission-wide discussion of priorities and common threads. Based on these discussions, a second draft of the analytical agenda (November 17, 1988) outlined some possible themes for the upcoming CDSS as a means of structuring and focusing the agenda. We used this draft as a background paper for the discussions at a two-day Mission retreat in mid-January which kicked off the CDSS development process. The present document seeks to reflect the consensus reached in those discussions.

## Program goals for the CDSS

USAID's new CDSS will be structured around two major program goals, income growth and increased reliance on market forces. These two goals represent extensions and refinements of the goals that have shaped our current strategy.

*Increased incomes:* USAID's strategy will pursue *accelerated growth* in aggregate income through an expansion of employment opportunities. But increases in aggregate income must be complemented by improvements in its *distribution*. Available evidence suggests that the income distribution has worsened since the early '80's. The absence of real income gains for the poor may have worsened the problem of malnutrition. Real or suspected inequities in the income distribution among ethnic segments and regions of the country have also emerged as a major issue. These inequities in sharing the fruits of economic liberalization may have contributed to a worsening of social and political tensions, thus sharing the blame for the violence that has sapped the country's economic strength.

Finally, the accelerating degradation of environmental resources is beginning to shift much of the costs of current consumption to future generations, thereby raising problems of *inter-generational equity*. Sustainability thus becomes a critical dimension of the goal of income growth.

*Functioning markets.* Increased reliance on market forces, critical to accelerating growth and improving welfare, also represents a goal in itself. Functioning markets can be viewed as the economic counterpart to systems of democratic choice in the political arena. As in politics, effective markets require an active government to safeguard competition by curbing any restrictions that may result from monopolies or collusion among a few firms, assuring adequate information flows, and protecting participants against abuses.

In Sri Lanka, market forces need to be strengthened in all areas to improve resource mobilization and allocation, but our strategy will focus on two priorities:

- the mobilization and allocation of financial resources, as outlined in detail in USAID/Sri Lanka's financial markets development strategy; and
- the allocation and use of land and water, in particular irrigation resources.

Functioning markets will also be targets in other areas, in particular competition in manufacturing and services, where monopolies or collusive oligopolies exist, and where small enterprises may encounter some discrimination.

We will continue to examine gender issues in studying problems of poverty, income distribution, access to economic resources and opportunities, and options for program intervention.

## Project-related research activities

The USAID Mission is engaged in three types of research activity related to program development, one undertaken in the context of projects now underway, one linked to the development of specific new projects that have already been identified, and one responding to the information needs of USAID program planning and design that are not met under the first two categories.

### Research under existing projects

A number of current projects involve research of considerable programmatic interest. In the agriculture sector, both the **Diversified Agricultural Research Project** (DARP — 383-0058) and the **Mahaweli Agricultural and Rural Development** project (MARD — 383-0086) will contribute further to our understanding of agricultural policy issues and their implications for our program. DARP supports agronomic and socioeconomic research to

but need to be better understood before we can reach decisions whether we want to deal with them directly in our strategy. Characterized here as "subsidiary issues," they will be of lower priority, the subject of limited effort until their dimensions and their potential role in our strategy become clearer.

### Issues related to program goals

Our knowledge of Sri Lanka's key development problem and our understanding of USAID's relative strengths is sufficient to define the broad program goals for the CDSS period, as outlined in the introductory section. But the formulation of a coherent strategy combining the various program elements and resources requires a better appreciation of the dimensions of the problems we seek to address. The elements of the analytical agenda related to the two major program goals focus on the critical facets of the income problem and constraints on market forces.

**Poverty, income and employment:** With respect to the program goal of accelerated income growth and improved distribution, USAID/Colombo will sponsor or conduct three studies:

- a study of the *poverty* phenomenon will attempt a synthesis of available information, buttressed by a statistical analysis of relevant survey data expected to become available within the few months, to assess the magnitude and incidence of the problem; this analysis will be complemented by an assessment of the problem of acute and chronic malnutrition, a serious problem that may have taken a turn for the worse over the last decade, overall gains in income levels notwithstanding;
- an *employment* study will pursue a similar synthesis of available evidence on the problems of employment and unemployment in the country; building on available research and possibly newly available data, the study will combine as detailed a description of the incidence and other characteristics of unemployment as possible with an appraisal of alternative generic strategies to make a dent into these problems by accelerating employment generation;
- since *self-employment schemes and micro-enterprises* are often promoted as effective means of addressing the overall employment problem, we will examine the employment and income benefits generated by such activities,

Finally, the design of the Mission's **Natural Resources and Environment** project (NRE — 383-0109) will provide an opportunity to assess systematically the issue of sustainable development, and identify the policies and actions needed to implement approaches to achieve a better balance between short and long-term benefits in the allocation of natural and environmental resources. For the project itself, the analysis will focus on the institutional and legal requirements of making existing mechanisms and regulations more effective. But it will cover other issues important for structuring and shaping our broader programmatic approach to this issue.

In addition to these three projects, preparations are also underway for future agreements under our **Housing Guaranty** (HG) program. Tying into our financial markets agenda, design work for the HG program will include research on questions regarding the mobilization of non-budgetary resources for low-income housing, opportunities for private-public partnerships in improving access to financial housing resources for low-income households, and policies needed to facilitate innovative financial approaches.

## "Non-project" research

The major strength of project-related research lies in the ability to ask specific questions related to feasible interventions. This action-oriented perspective also may imply some weakness: project-level analysis makes it often difficult to come to terms with the policy environment in which the project will be operating, even though this environment will be critical in determining the success of project interventions. Specific policy concerns emerge, but need to be related to a broader framework. Similarly, a broader programmatic framework is required to view the project as part of a range of program activities (including other projects, program-level assistance, and policy dialogue) and as part of a sequence of activities over time. The elements of USAID's analytical agenda outlined in this section tend to reflect a more general policy and program perspective. As a rule, they may not easily relate to possible interventions, although the research may of course spawn ideas for projects.

We expect that much of this research not linked to specific project interventions will in fact be carried out under a project, the **Development Studies and Training** project (DS&T — 383-0085), which has been designed as a vehicle for supporting research of common interest to the GSL and USAID/Sri Lanka.

The discussion here divides the "non-project" research agenda into two sets of planned analytical work. Issues related to the program goals define the core of our analytical agenda. In addition, we have identified two areas of concern that relate to our market promotion goal,

develop and extend crop diversification alternatives to rice production. In support of the GSL initiative to restructure the government seed industry to increase private sector participation, DARP also undertakes background research and policy analysis. MARD supports adaptive agronomic, horticultural and economic research targeted to promote growing of high-value export crops in the Mahaweli System B area. MARD also funds research and analysis required for our policy dialogue on such issues as reduction of recurrent costs, land tenure, water management, farmer organizations, and encouragement of the private sector.

The **Private Sector Policy Support** project (PSPS — 383-0100) is expected to yield useful insights into economic policy issues and options through research undertaken or sponsored by private sector organizations, assisted by project resources. USAID/Sri Lanka expects that the project-funded policy support will work with private sector organizations to formulate a general research agenda that will also reflect some of the policy concerns that matter in our policy dialogue.

Similarly, the **Mahaweli Enterprise Development** project (MED — 383-0090) incorporates a policy appraisal and development component that will enhance our grasp of policy issues and alternatives. Based on the work undertaken during project development, project-sponsored research and monitoring will advance our understanding of policy options and their effectiveness in the three areas targeted by the project. *Programmatic support activities* will focus on the appraisal of general policy barriers to the transformation of a rural economy based entirely on agriculture, and the development of measures to turn any such barriers into structural support for development. Monitoring project activities designed to *attract outside (medium and large-scale) investors* into the Mahaweli economy by building on identified competitive advantages will help us in adapting general recommendations for investment promotion to Sri Lankan conditions. Finally, we expect that research related to project support for *small-scale (and micro-) enterprise promotion* will contribute to a better understanding of effective policies to foster this component of a viable rural economy. New research into these issues worldwide promises to provide new insights into policy issues related to this sector. USAID/Sri Lanka expects to participate in this dialogue, using activities under the MED project as a source of useful information on the strengths and weaknesses of particular approaches relative to a given policy environment.

The **Agriculture Planning and Analysis Project** (APAP — 383-0083) will support research needed for the appraisal and revision of the *National Agriculture, Food and Nutrition Strategy*.

## Research for project development

USAID/Sri Lanka has launched project development activities for three new projects, one in agriculture, one for industry, and one concerned with natural and environmental resources. Research conducted as part of the design of these three projects will play a major role in advancing USAID's analytical agenda, and in contributing to our understanding of critical elements of our development strategy. The design of the **Development of Agricultural Marketing Systems** project (DAMS — 383-0093) will yield a better understanding of the functioning and effectiveness of input and output markets in agricultural subsectors as they are defined in terms of product, technology and location. Research may be needed on constraints on both internal and export markets for agricultural products, on support needs for the private sector, and on ways of alleviating constraints imposed by an actual or perceived lack of effective demand on agricultural transformation. The research may include issues related to the interface between agricultural marketing systems and financial markets.

Looking at agricultural marketing systems and their role in the economic transition of rural areas may also require a closer look at the interaction between small towns (market centers for both inputs and outputs) and their rural hinterlands. Market-oriented interventions aimed at strengthening the effective interaction of supply and demand as a means to accelerate productivity and income growth in agriculture need to be region-specific, responsive to the characteristics of the agricultural economy proper as well as to its relations to other sectors.

The **Science and Technology Initiative for the Private Sector** project (STIPS — 383-0108) is based on the premise that inadequate access to and utilization of scientific and technological resources is hampering the competitiveness of Sri Lanka's industry, both domestically and in international markets. To formulate our programmatic stance regarding this area of industrial policy, and to design an appropriate project intervention, we need to review the evidence for inefficiencies in Sri Lankan industrial operations that can be attributed to inadequate or obsolete technology. In addition, the research related to the STIPS design will identify opportunities for industrial diversification, both for domestic and international markets, that target sectors in which technology — both "high" and traditional — plays a key role. Examples include software development or biotechnology.

The analysis here will also cover an assessment of the factors that have retarded technology adaptation and utilization in industry, as well as industrial diversification into new technologies. We expect that the overall policy environment matters more than specific shortcomings in technology resources. The policy environment establishes incentives and disincentives and erects barriers to a more effective role of technology in accelerating the economic transformation of the country.

and look at the determinants of success and failure of small and micro-level economic endeavors; we expect to benefit here from the centrally funded work on micro-enterprises.

**Markets I — Financial markets:** Over the past year, USAID/Sri Lanka has identified improvements in financial markets as a major concern of its program portfolio. Financial markets performance plays a key role in many projects in agriculture and the private sector. Similarly, financial markets determine accomplishments in our support for the housing sector, and in our PL 480 Section 108 lending program to the private sector. USAID has therefore set out to formulate a financial markets development strategy, adapting key elements of A.I.D.'s overall strategy regarding financial markets to the particular needs and conditions of Sri Lanka's economy. While USAID/Sri Lanka's financial markets development strategy is still under review, its major priorities are clear, helping us in identifying required research:

- *small-scale credit and informal financial markets* represent critical issues regarding USAID's options for supporting employment generation in small-scale enterprises; as already noted in conjunction with the discussion of monitoring and research under the MED project, efforts to link small-scale borrowers and informal financial markets more effectively to the formal financial sector are likely to remain a major concern in our portfolio (provided monitoring and analysis substantiate our current optimism); the analysis of this issue will also draw on the experience with housing finance supported through the Housing Guaranty program to study the features of the informal housing credit system, and relate them to general characteristics of informal financial markets, and to the extent and nature of any interface with the formal sector;
- *savings behavior and resource mobilization* a better understanding of the determinants of savings in its various forms is critical to developing financial markets interventions that improve access to financial resources on a sustainable basis; some general evidence on these issues has been collected (for example, data on savings responses to changes in real deposit rates), but more detailed work is needed;
- financial liberalization calls for better *bank and non-bank supervision* to protect savers, borrowers and financial institutions themselves against abuses of new opportunities created by the lifting of direct controls; USAID/Sri Lanka has provided support to the Central Bank to improve the supervision of non-bank financial institutions; building on this work, this study will broadly assess the adequacy of existing regulations and enforcement mechanisms under alternative financial liberalization scenarios;

- policy elements that have led to financial repression — specifically through interest rate ceilings and credit controls necessitated by such ceilings — frequently reflect social objectives deemed worthy of resource transfers, that is, grants and subsidies; financial liberalization requires that such ceilings and controls be lifted, and that intended subsidies be provided in a form that does not distort market signals; to make the case for more efficient and ultimately more effective alternatives to current policies, we need to understand the magnitude and incidence of subsidies provided through existing credit schemes, and to identify policy options that would allow for *grant-loan separation* without jeopardizing the social objectives of existing programs.

The analytical agenda on financial markets will also benefit from the research related to both project development for the STIPS project and design work for future HG programs. Analytical requirements for the STIPS project include an assessment of the performance of financial markets related to the replacement of existing technology or expansion into new technologies; our work so far on venture capital suggests that the performance to date has hampered development.

**Markets II — Land tenure:** Land tenure issues have emerged as dominant concerns across USAID/Sri Lanka's portfolio, in agricultural and rural development efforts, in support for small-scale enterprise, in irrigation policy, and in housing and urban development. The problems associated with inadequate land tenure provisions are the same as elsewhere — reduced inclination to invest, lack of collateral for credit, cultivation practices that may accelerate land degradation, and generally a destabilizing factor in (primarily rural) economies. USAID/Sri Lanka has long pursued improvements in land tenure policy, primarily through its policy dialogue. Accelerated land titling was included as a self-help measure in the FY 1987 PL 480 Title I Agreement. Monitoring GSL performance under this self-help measure suggested that our understanding of the issues surrounding land titling needed improvement.

An appraisal of the land tenure situation and relevant practices and policies is critical to define feasible positions for our policy dialogue and formulate approaches to move us toward our objectives. Since conditions differ greatly between rural and urban environments, USAID/Sri Lanka has scheduled *two studies of land tenure policies*, one focusing on aspects that affect agricultural and rural development (including small-scale enterprise development in rural areas, and problems related to upland slash-and-burn cultivation), the other approaching the subject from a perspective shaped by housing and urban development concerns.

**Markets III — Mobilization and allocation of irrigation resources:** In its continuing campaign for greater reliance on market forces, USAID/Sri Lanka has supported the development of market-like mechanisms in mobilizing resources and allocating them in the management of irrigation systems. Our efforts in this area have met with considerable success, with GSL authorities moving more and more toward management approaches that give major responsibility to farmer organizations, and that use mechanisms akin to pricing (user fees and related charges) to cover maintenance costs and assist in the allocation of irrigation resources. The Mission's planned *Irrigation Policy Support Activity*, likely to be conducted under our DS&T project, will combine further research, and monitoring of efforts underway with training and technical assistance to move this process ahead.

### Subsidiary issues

**Markets IV — Restrictive business practices:** More or less casual observation and limited statistical evidence suggests that many branches of economic activity in Sri Lanka may enjoy protection against domestic as well as foreign competitors. Neither the rationale nor the methods for protection against domestic competition are fully understood. We expect that the research related to the design of the STIPS project will help us in clarifying the nature and extent of any *restrictive business practices* (RBP) in domestic industry. Based on that assessment, we may seek to put together an inventory of RBP legislation and actions as a basis for weighing the desirability of further initiatives toward improving competition in domestic markets.

**Markets V — Rural-urban market linkages:** The conceptual work on both the MED and the DAMS projects seem to point to the need for considering rural-urban market linkages in a more explicit fashion in formulating overall strategies for promoting the transformation of rural economies into more diversified systems that yield higher incomes for rural residents. Small towns serve as the first market layer for their rural hinterlands, providing outlets for agricultural produce, offering processing services, generating off-farm employment opportunities, and supplying needed inputs and services. Although USAID's portfolio during the CDSS period may eschew specific interventions to strengthen rural-urban market linkages, aimed at small-town development, a better understanding of these linkages and of the ways in which these small towns tie into broader urban hierarchies is essential to place our project interventions targeting the development of small-scale enterprise or the transformation of traditional agriculture into an appropriate perspective. A continuing consultancy is helping the Mission in thinking through these issues. We expect that this conceptual exploration will be complemented by an intensive (though very limited) effort to put together some of the relevant data that would allow us to understand these economic relationships better.

## Summary of studies

Table 1 provides an overview of the studies that have been included in USAID/Colombo's analytical agenda. Duration, timing, and implementation remain tentative and may change as individual studies are being developed and refined further.

## Resources and implementation

To carry out the analytical work outlined in this agenda, USAID/Sri Lanka will be able to draw on three major sets of resources. Research, including monitoring and evaluation, under on-going projects will be financed out of project resources. Project-related research during the design phase (DAMS, STIPS, and NRE) will be part of the project design effort, financed from PD&S funds.

PD&S funds may also be used to finance some of the studies listed under "non-project" research. For example, PD&S have been set aside for our study on poverty; similarly, a continuing consultancy financed under our FY 1988 PD&S program is helping us with the effort to come to grips with the issue of rural-urban linkages and their possible role in our program. Other elements of the agenda remain candidates for PD&S funding.

For major agenda items, though, the Mission's DS&T project offers an opportunity to work with GSL counterparts in structuring and conducting the analysis relevant to our CDSS. The obvious advantage of using the development of such studies to arrive at a common understanding of policy issues may be in part offset by the inevitable delays in formulating and implementing the study agenda, especially during a time of fundamental reorganization and reorientation of GSL agencies.

In the area of the employment study, USAID/Sri Lanka has provided a consultant to the Department of Census and Statistics to assist in the preparation of a periodic employment survey that would finally provide the data needed for tracking employment and unemployment trends over time.

Our major efforts under DS&T, however, relate to the key items on our agenda of financial markets, land tenure, and irrigation policy. In these areas, the interests of USAID and the GSL appear to overlap sufficiently to pursue a common research agenda. On financial markets issues, USAID has already provided a number of consultants under DS&T to various GSL as

well as private-sector institutions. These issues have included capital markets development, foreign exchange management by the Central Bank, non-bank supervision, and securities market oversight. We expect that the analytical agenda and USAID/Sri Lanka's financial markets development strategy will provide a framework for structuring our work with GSL and private-sector counterparts.

Similarly, a consultant, financed under DS&T, has begun to work with GSL agencies to define a research program on land tenure issues in rural and agricultural environments. The Mission is now in the process of pursuing these leads with the appropriate institutions. We have also begun to develop the scope of work with GSL counterparts to look at land tenure issues relevant to urban and housing policies.

In irrigation policy, USAID Sri Lanka is exploring options building on earlier ISPAN work; the planned Irrigation Policy Support Activity, expected to be structured as an activity under DS&T, would strengthen our involvement in policy-oriented research in this area.

The responsibility for the implementation of the various studies is largely determined by the subject matter. Consequently, the technical offices will play the central role in following through. Of the projects now underway, DARP and MARD are administered out of USAID's Office of Food and Agriculture Development, which also handles the DAMS design effort, while the Office of Private Sector Development manages PSPS and MED, as well as the STIPS design. The NRE design is managed by the Office of Projects.

The Office of Program is responsible for the poverty and unemployment studies, with the Office of Projects taking the lead on malnutrition aspects. The Program Office also oversees the financial markets research, with key inputs and lead responsibilities for individual pieces by the Office of Food and Agriculture Development (small-scale credit and informal markets), the Office of Housing Development (savings behavior and resource mobilization, grant-loan separation), the Office of Private Sector Development (all), and the Projects Office (all) which manages the DS&T project.

Agriculture and Housing are taking the lead on the respective land tenure studies, while Agriculture and Engineering will manage the development of the Irrigation Policy Support Activity. Finally, the Program Office conducts the work on the subsidiary issues, rural-urban linkages and restrictive business practices.

**Table 1: Overview of research activities under  
USAID/Sri Lanka's analytical agenda**

	<b>Time frame</b>	<b>Key issues</b>
<b>Projects now underway</b>		
DARP	1990 +	Technical aspects of agricultural diversification
MARD	1990 +	Agricultural transformation in Mahaweli, System B
PSPS	1990 +	Macroeconomic policy issues; securities markets
MED	1990 +	Investment promotion; small-scale enterprise development
<b>Project development</b>		
DAMS	1989	Ag input and product markets
STIPS	1989	Role of technology in SL industry's competitiveness
NRE	1989	Mechanisms to protect/allocate natural & environmental resources
HG	1989	Mobilization of non-budgetary resources for low-income housing
<b>"Non-project" research</b>		
Poverty	1989	Extent and incidence of poverty; malnutrition
Employment and unemployment	1989	Severity and distribution of unemployment; employment generation
• employment/earnings in small-scale enterprises	1989	Capital and labor use in SSE's; income and employment generation
<i>Financial markets</i>		
• small-scale credit and informal markets	1989-90	Linkages between formal and informal financial markets
• savings behavior and resource mobilization	1989-90	Determinants of asset accumulation
• bank and non-bank supervision	1989-90	Principles and effectiveness of supervision
• grant-loan separation	1989	Magnitude and incidence of interest rate subsidies; alternatives
<i>Land tenure</i>		
• land tenure in agricultural systems	1989-90	Tenurial problems and impacts
• land tenure in housing and urban development	1989-90	Tenurial problems and impacts
Irrigation Policy Support Activity	1990 +	Management and financing of irrigation resources
Restrictive business practices	1990 +	Inventory of regulations and enforcement
Rural-urban linkages	1989-90	Market-based linkages between small towns and rural hinterlands

## ANNEX B

# WID Action Agenda for 1989

### I. Introduction

This is the first year that USAID/Sri Lanka is submitting a WID (Women in Development) Action Agenda. The agenda identifies key program and project-related WID actions the Mission plans to take during CY 1989. These include various activities where gender analysis is important or where the collection and monitoring of gender disaggregated data must be considered.

This action agenda is organized below around the following four types of Mission activities for 1989:

- A) Preparation of a new CDSS.
- B) Designing new projects.
- C) Evaluation and Monitoring.
- D) USAID Staff Training/Review of Mission WID procedures.

Since the Mission will be drafting a new CDSS during the coming year, and since four projects are at varying stages of the project design process, actions in the two categories will have high priority for this year.

The final section of the document is a chronological implementation plan consolidating all four categories.

### II. CDSS Preparation

*Discussion:* In FY 1990, the Mission will submit a new Country Development Strategy Statement (CDSS) for the 1992-96 planning period. Thus, among WID actions, those which lead to the formulation of the WID portion of the Mission strategy will have high priority.

Developing the WID section of the CDSS will involve wide participation of Mission staff at several points to identify areas of focus. It will also involve contracting of at least one

issue or analytical paper on gender dimensions of central themes in the Mission strategy. Limited PD&S funds available will rule out any major collection of new systematic data; priority will be given to contracting locally.

Several topics which cut across the Mission portfolio are being considered as areas of special focus: (a) women's access to credit for agricultural and business activity; (b) factors affecting women's involvement in diversified agricultural production and marketing; and (c) the employment of women in field/extension positions related to USAID projects.

### **Specific Actions**

- \*\* Discussion of WID strategy issues took place at Mission retreat to initiate development of new CDSS. *January 1989.*
- \*\* Convened an *ad hoc* Mission WID committee to advise on development of the "WID Action Agenda," and consider data analysis efforts which would be useful for CDSS and project development. *February 1989.*
- \*\* Development of a household/farm model for Mahaweli System B farm settlers will include gender disaggregation of contributions (time and decisionmaking) to household production and incomes. (MARD project). *March-May 1989.*
- \*\* Complete SOW and contract for the preparation of at least one analytical/concept paper on a WID issue related to the Mission strategy. *April 1989.*
- \*\* Draft of WID Strategy Portion of CDSS. *November 1989.*
- \*\* Review of CDSS WID draft by WID Committee. *December 1989.*

### **III. New Project Designs**

*Discussion:* The Mission has three project designs in progress. The collection of gender disaggregated data will be considered early in the design of all three projects, as will the need for any special strategies to include women as participants or beneficiaries of the projects. In addition, a fourth nearly completed project design included gender consideration.

1) *Mahaweli Enterprise Development* (MED — 383-0090): Design work has already been completed and the project is expected to be authorized in March 1989. Data collected for project design included some gender disaggregated data, which have been incorporated into the Project Paper analysis.

2) *Development of Agricultural Marketing Systems* (DAMS, 383-0093): We plan to complete the PID in-house during 1989 and the PP during FY90. Much background research is already completed. The PID WID assessment will determine whether any further gender disaggregated data is needed. A substantial minority of small traders in rural periodical markets (*polas*) are women, who would benefit from the project. Basic design decision still to be made, however, will determine whether traders at that level will be active project participants.

3) *Natural Resources and Environment* (383-0109): PID submission is scheduled for April and PP completion and authorization by early FY1990. PID assessment will consider whether collection of any gender disaggregated data makes sense for this project.

4) *Science and Technology Initiative for the Private Sector* (383-0108). Now in the very early design stage, but the PID should be completed during FY1989 with PP completion and authorization in FY 1990. The PID will assess the need for gender disaggregated data in PP design.

### **Specific Actions**

- \*\* Incorporation of gender disaggregated data in Project Paper for MED, and identification of factors which will affect women's involvement as small entrepreneurs in Mahaweli settlements. *February 1989.*
- \*\* WID assessment in DAMS project PID to determine whether any additional gender disaggregated data will be gathered for project paper. *April 1989.*
- \*\* WID assessment in PID for Natural Resources and Environment project to determine whether additional gender disaggregated data is needed or whether any gender issues need to be addressed in project design. *April 1989.*
- \*\* WID assessment in PID for Science and Technology for the Private Sector project to determine whether collection of any gender disaggregated data is needed and whether any particular gender issues need to be addressed in project design. *August 1989.*

#### **IV. Evaluation and monitoring**

*Discussion:* Currently only one project evaluation is planned for CY 1989: the Diversified Agriculture Research Project (DARP — 383-0058), though the PVO Co-Financing Projects I and II (383-0060 and 383-0101) may also be evaluated late in the year. Another in a series of field-based policy assessments of Mahaweli settlements will also be conducted by anthropologist Thayer Scudder. All of these evaluations will include gender-related questions in the SOW.

In addition, the Mission will begin a review of the existing project portfolio to determine whether gender disaggregated data are being collected and monitored in each case where it is appropriate. At a minimum, data collection and reporting of three existing projects will be analyzed; this would be an in-house activity. However, as result of recent discussions with ANE/TR/HR and PPC/WID, the Mission is considering an alternate approach of doing a gender review of the full project portfolio, using an external consultant funded in part by special funds recently appropriated for such activities. Regular reporting in PIRs of participant training by gender will be established.

#### **Specific Actions**

- \*\* DARP evaluation will include gender questions. *March-April 1989.*
- \*\* SOW to be completed for a portfolio review and funding possibilities/contracting arranged with PPC/WID. *March-April 1989.*
- \*\* PIRs submitted to AID/W to include participant training data by gender for the first time. *April 1989.*
- \*\* Portfolio review to be carried out. *May 1989.*
- \*\* Policy assessment of Mahaweli settlements experience will address gender questions. *September 1989.*
- \*\* Evaluation of PVO Co-Financing project will include gender impact questions. *November 1989.*

## V. USAID Staff Training

*Discussion:* Agency policy strongly encourages training Mission staff in the use of gender disaggregated data and incorporation of analyses identifying opportunities and constraints for the participation of both men and women in assistance activities. The priority attached to CDSS development this year, as well as the severe shortage of OE funds, places a practical limitation on how much can be accomplished this year.

At the same time, the CDSS strategy formulation process presents opportunities for informal WID "training." During the coming year, the discussion process involved in developing the CDSS is expected to have some of the same benefits as in-house WID training for Mission staff. This process has already included special session on WID issues at the CDSS workshop in January 1989 and is continuing with the establishment of a WID committee to guide analytical preparations for the CDSS, and the solicitation of suggestions from Mission staff on identification of possible WID foci. Only one formal training activity is planned, as indicated below.

### Specific Actions

- \*\* Rural Development Officer/WID Officer to attend PPC/WID Workshop in conjunction with Agricultural and Rural Development conference in Rabat, Morocco. *February 1989.*

## VI. Implementation plan

Below is the consolidated chronological summary of planned actions, indicating the respective action office.

### USAID/Sri Lanka WID Agenda Implementation Plan 1989

DATE	ACTION	OFFICE RESPONSIBLE
January	CDSS Workshop: Discuss WID issues	PRM
January	Gender Questions in DARP Eval SOW	AGR/PRM

February	Ad hoc WID committee to discuss Action Agenda & preparation for CDSS	WID Committee
February	MED project paper gender analysis and use of gender disaggregated data from baseline survey.	PSD/PRJ
February	WID/Rural Development Officer to attend PPC/WID training at ARDO conference	PRM
March	SOW for Mahaweli Settlements Assessment: Include gender questions	PRM
March	Natural Resources & Environment PID: Assess need for gender disaggregated data in PP design	PRJ
Mar/April	SOW for portfolio review	PRM
Mar/April	DARP Project Evaluation: Includes gender questions.	AGR/PRM
Mar/May	Development of household/farm model for MARD project	MARD Contractor
April	PIRS to include participant training data by gender.	Project Officers
April	Complete SOWs & contract for two CDSS WID analyses	PRM
April	DAMS PID. Assess whether further gender disaggregated data needed for PP.	AGR/PRM
May	Portfolio review of data/monitoring/reporting systems of projects	PRM/PRJ WID Committee Possibly PPC/WID
August	Science & Technology for Private Sector PID: plan gender analysis & assess need for gender disaggregated data	PSD/PRM

August	SOW for PVO Co-Fi Evaluation: Gender Questions	PRM
August	Participate in Peace Corps WID conference	PRM/AGR
September	Mahaweli Settlements Assessment	PRM
November	1st Draft of WID section of CDSS	PRM
November	PVO Co-Financing Project Evaluation	PRM
December	Review CDSS WID draft	WID Committee

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