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PROGRAM WEEK SUBMISSION (PWS)

1988

USAID/SRI LANKA

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PWS CONTENTS

I. OVERVIEW

This past year has seen a dramatic shift in the prospects for sustained development only to have them set back by renewed violence. The signing of the Peace Accords six months ago gave many hope that the years of violence had come to a close. It took most donors by surprise, but all were prepared to contribute in some way to rehabilitating those areas affected by the protracted struggles. At the GSL's request the World Bank took the lead in analysing the situation and presenting a reconstruction and rehabilitation program. Unfortunately, fighting flared up shortly after the Bank completed its report and continues today. For the most part donors, however, have moved ahead in preparing projects in response to the program developed by the Bank. Despite the continued violence, project planning cannot wait for the last shot to be fired. The broad outlines of a settlement are known as are the needs of the people affected. With that knowledge donors continue their program development work preparing themselves to act quickly once that peace is firm.

The United States, at the Paris Consultative Group meeting, pledged $75 million in additional assistance for the rehabilitation effort. The design and development of that program has been and will continue to be a major preoccupation of this Mission this fiscal year. The Rehabilitation Assistance Program (RAP), 383-0107 will build on our current program strategy and expand USAID programs into the North and East covering irrigation rehabilitation, provision of essential inputs to revive agricultural productivity, restore private sector productive enterprise and repair and rebuild damaged or destroyed housing throughout the area. No policy reform is expected in association with RAP because of the immediate nature of a rehabilitation program and the fact that RAP is involved in the same sectors as the ongoing development assistance program where an active policy dialogue continues.

While we are optimistic about the ability to implement a rehabilitation program, we remain concerned with the overall growth of the economy. The economic setting in which our development program functions continues to worsen as national growth slows, terms of trade continue to decline, budget discipline weakens and inflation accelerates. Unemployment has become a very serious economic issue as new entrants to the labor force number far more than the new jobs the economy can currently generate. Security concerns overshadow any economic initiatives, and it is unlikely that any substantial growth can occur until the security situation settles sufficiently to restore private sector confidence. The uncertainty associated with coming elections also contributes to the unease affecting investment choices. It is important now to set appropriate policies and mechanisms in place to facilitate sustained and substantial economic growth once peace is really here.

Our ongoing program is designed to do just that. No change in our basic strategy is envisioned, as we will continue to work toward increasing rural incomes and productivity and enhancing the private sector role in development. Expanding income producing opportunities remains the paramount development problem as described in last years CDSS Update, and a program focussed on both rural productivity and private sector development remains the best use of USAID resources toward that end. Our program addressing rural productivity unchanged from last year has a focus on agricultural diversification, research, water management and rural enterprise. We have, however,over the course of the past year, further defined our private sector development objective to include: Supporting the GSL's continuing efforts to fully implement major economic reforms put into effect since 1977, privatizing state-owned enterprises, strengthening capital markets, and stimulating rural enterprise development. In support of this strategy we maintain a vigorous policy dialogue dealing with those issues critical to our objectives and key to development progress across our portfolio. We have been relatively successful with our policy dialogue agenda, and it remains dynamic and responsive to our progress throughout the program. We have proposed new projects to carry out additional aspects related to these objectives in the later years of this planning period.

This coming year promises to be an exciting one to the extent peace becomes a reality, elections are held and development again becomes the nation's first priority. In this Program Week Submission we have addressed the modifications to our strategy that are appropriate in such a setting. Our policy dialogue agenda has been refined, the private sector objective refocussed and a rehabilitation effort begun. The policy agenda and private sector objective are covered here. The Rehabilitation Assistance Project is detailed in the accompanying PID. However, should the major opposition party -- which traditionally has had a socialist orientation -- came to power, some modification to our basic strategy may be necessary. This year with three major projects to be designed and initiated and a substantial program to implement under that strategy the Mission will be in "overdrive" for most of the year. Some additional staffing, possibly PSCs will need to be considered.

II. RECENT ECONOMIC TRENDS

While summary data on Sri Lanka's economic performance in 1987 are not yet available, all indications are that growth has slowed further from the average of 6.2 percent achieved during the period 1977-82. The latest available estimate places GDP growth for 1987 at about 3 percent, following a 4.3 percent growth rate in 1986, and 5.1 and 5.0 percent for 1984 and 1985 respectively. At this rate, per capita GDP would have grown at a paltry 1.3 percent or so in 1987. Inflation may have accelerated somewhat; data for the first half of 1987 indicate slightly higher rates than for the corresponding period in 1986, which overall registered a relatively modest 8 percent.[1]

The terms of trade appear to have continued their decline in 1987. Even so, the growth in exports (in rupee terms) in the first half of the year exceeded that of imports, but the difference probably did not suffice to stem a further widening of the trade deficit. Tea as well as rubber exports were affected by the drought, with tea exports falling slightly in volume terms, although rupee revenues were up by 14 percent. Budget discipline weakened, in part a victim of the exigencies of trying to contain ethnic violence. According to the latest available figures, the actual budget deficit in 1987 at Rs.29.2 billion (or almost US $1 billion at the current exchange rate) exceeded the target by over 11 percent.

Security concerns overshadowed both economic and political developments. Although GDP growth continued, largely because economic activity is concentrated in areas outside the troubled North and East, investment has fallen far short of the level required to create jobs at the rate required to make a dent into the rapidly worsening unemployment problem.

While the true extent of the unemployment problem has not been quantified recently, its importance as <u>the</u> economic policy problem is uncontested. With some 159,000 new entrants into the labor force each year, accelerated job creation has become the key to economic growth as well as social peace.[2]

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[1] These rates are based on the Colombo Consumer Price Index: the GDP deflator for 1986 was about 9.1 percent.

[2] Even a cursory assessment of the level of investment required to absorb the new entrants into the labor force is hampered somewhat by the dearth of information on capital-labor ratios. Available data suggest a figure somewhere between Rs.26,000 (for investments approved in 1986 by the Local Investment Advisory Committee) and (contd)

Public investment, in particular through the Accelerated Mahaweli Program, has provided the major impetus in the past. With the cutbacks in capital expenditures, it can no longer play that role. Private investment, in turn, has not been forthcoming at the rate needed -- both directly and indirectly a result of the security situation. Directly, security problems shape the perceived risk. Indirectly, the preoccupation with the ethnic and ideological violence has sapped the Government's commitment to curtail its economic dominance and aggressively promote growth through private sector investment.[3]

Economic liberalization, a heavy emphasis on major infrastructure investments with a relatively long gestation period, and the worsening security situation together may explain an apparent shift towards a less equitable income distribution. Recent data indicate that the income share of of the poorest segments of the population has declined significantly. At the same time, chronic as well as acute malnutrition among children is on the increase. These disturbing trends will command increasingly the attention of the Sri Lankan polity.

Debt service claims a large share of the Government's budget; in 1987, interest payments on total public debt accounted for some 27 percent of recurrent capital expenses. This ratio is projected to increase to 31 percent in 1988; on the capital side, debt amortization (at Rs.4.3 billion) has begun to demand an increasing share as well, projected at close to 10 percent in 1988. Gains from the possible reduction of defense expenditures have been virtually absorbed by the first phase of a (long overdue) salary increase for the civil service.[4]

Rs.335,000 (for foreign investments approved by the Foreign Investment Advisory Committee over the period 1977 to June 1986. Creating 159,000 new jobs thus might cost anywhere from 2.5 to 32 percent of GDP.

[3] The success of the Million-Houses Program vividly demonstrates the potential of full Government commitment to a particular course of action.

[4] To be implemented in two phases -- half in 1988 and half in 1989 -- the salary increase is part of a reform package that also involves cuts in public sector employment; current plans call for these reductions to be achieved through attrition.

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With these developments, the maneuvering room for budget management has narrowed further. With the possible exception of continuing capital subsidies to state-owned enterprises, the capital budget has been pared down to a point where further cuts are bound to jeopardize development prospects. Deficiencies in the physical infrastructure, transport and communications, already hinder business development. With little opportunity for further cuts in the capital budget and an increasing percentage of recurrent expenditures accounted for by debt service, the Government will be hard pressed to meet its commitment to reduce the budget deficit to 9 percent of GDP over a three-year period.

In spite of both external (deteriorating terms of trade) and internal problems, Sri Lanka's trade performance shows some positive signs. Non-traditional exports registered the largest percentage gains. In gross foreign exchange earnings, garments surpassed tea for the first time in 1986. However, with an import content of roughly 50 percent, garments are still far behind as net foreign exchange earners. The decline in tourism receipts seems to have leveled off somewhat, albeit at a level of less than 40 percent of the 1982 peak. Private transfers from abroad have been falling in SDR terms (1986: SDR 277 million, 1985: SDR 288 million), although that translated into an increase in rupee terms as a consequence of exchange rate adjustments.

Asian countries (other than the People's Republic of China which registered little change) are becoming more important as Sri Lankan trading partners. The declining importance of Middle Eastern countries is partly a result of lower tea prices. Europe and North America became more important as destinations of exports and less important as sources of imports; together these two regions accounted for some 55 percent of all exports and 23 percent of total imports in 1986; for 1985, these percentages were 53 and 29 percent, respectively. The U.S. alone accounted for 25 percent of Sri Lanka's exports and 6 percent of total imports; Sri Lanka registered a trade surplus with the U.S. of about $150 million.

In 1986, the external debt service ratio (as a percent of exports of goods and non-factor services) increased to over 26 percent, as compared to 21 percent in 1985. In 1987 both export performance and debt management probably have prevented a similarly sharp increase over 1987.

Overall, the last two years have demonstrated considerable resilience in the Sri Lankan economy in the face of considerable adversity. But the trend is down. A growth rate of less than 1.5 percent for per capita GDP is simply not sufficient in a country that is among the poorest in Asia. To accelerate growth will require both repairing the damage to the country's economic (as well as social) fabric done over the last few years of ethnic violence, and an effective response to the rapidly worsening unemployment situation. Restoring and strengthening the economic base in the North and East in the wake of the peace accord will be critical. At the same time, employment generation is urgently needed elsewhere on the island, especially in the impoverished South, as the employment effects of the massive public investment program of the late 1970's and early 1980's are fading. Given the continuing strain on public resources, it will be up to the private sector to meet the employment challenge. The Government will have to pursue its policies to promote private sector development with renewed vigor.

III. POLICY AGENDA

While our program, exclusive of the Rehabilitation of the North and East, is no longer the largest assistance program in Sri Lanka, we believe that we continue to be influential on policy issues. Our choice of issues, in-depth analysis of options and recommendations, careful coordination with other donors and ability to establish on-going relationships with senior officials on an informal as well as formal basis, enhances our role in policy dialogue. In addition, the fiscal realities of the current situation have fostered increased awareness of the need for reforms among influential Sri Lankans.

Our policy dialogue agenda remains much the same as last year's. We have further refined some issues as we progressed through the dialogue throughout the year. Other issues have advanced little from where we were then, but we continue to work on them. We have not set any policy objectives for the Rehabilitation Assistance Program (RAP) due to the emergency nature of this assistance. Also, the RAP has been designed as an extension of our ongoing development assistance effort, and the principal policy issues will be the same as those addressed in the on-going program.

The overall policy setting in Sri Lanka is favorable to our objectives of enhancing private sector growth and improving rural incomes and productivity. No shift in ideological persuasion is necessary, but further adjustment of the policy framework is needed to assure optimum developmental benefits from donor assistance programs.

THE MACROECONOMIC POLICY FRAMEWORK

The Current Situation

Economic policies pursued by the Government since 1977 have succeeded in turning Sri Lanka into one of Asia's most open economies. What is lacking now is a real and widely recognized improvement in the country's security situation. Judging from the business reaction to the short-lived lull in violence following the July Peace Accord,[5] a lasting improvement could well launch a vigorous economic revival, propelling Sri Lanka into the ranks of Asia's modernizing countries.

By 1977, following decades of more or less doctrinaire *dirigiste*[6] policies, Sri Lankans had become accustomed to standing in line for the most basic necessities. Many consumer items no longer were available anywhere. The economy lurched along, its growth in real terms barely staying abreast of population growth. The sweeping economic reforms since 1977 brought about a dramatic reversal. The economy soared as the new government toppled the pillars of *dirigisme* (and as foreign aid tripled). Sri Lanka seemed on its way to become yet another success story of market-oriented economic policies.

The outbreak of ethnic violence in 1983 dashed those hopes. Since then, Sri Lanka has seen private foreign investment as well as tourism dwindle to less than half of the peaks in 1982. Overall, development was hamstrung by the domestic strife. In turn, the economic hardships for people in the North and East ravaged by the war and the economy's failure elsewhere to maintain the pace set in the late 1970's and early 1980's have been feeding the discontent manifesting itself in ethnic and ideological violence. Breaking that vicious circle hinges on finding a political *modus vivendi*. Without a lasting political settlement, the opportunities offered by the country's open economy cannot and will not be realized.

The security situation overshadows all other factors influencing economic behavior, making it difficult to appraise the soundness of economic policies proper in terms of their impacts on economic activity, i.e., the response of the economy. Instead, any appraisal

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5 Several foreign investors proceeded with projects that had been pending for some time. Overall, some 1,026 new companies registered in 1987, up from 875 in 1986 -- and three times as many as the pre-1977 peak of 338.

6 Dirigiste: directed or state controlled economy ("etatist").

at this point must rely on more general criteria -- what conventional wisdom now accepts as the "right" policy framework or what has worked in recent "success stories." By those standards, Sri Lanka has done exceptionally well, with some important exceptions, as a brief review of structural reforms over the last decade and of the current situation demonstrates.

The Strong Points

Trade Policy: Sri Lanka has moved from high levels of effective protection to one of the lowest average levels in Asia. Average nominal tariffs amount to about 20 and 24 percent for intermediate and capital goods, respectively, and 33 percent for manufacturing goods. A relatively high rate, 56 percent for consumer goods provides higher protection to agriculture. These rates compare favorably with nominal tariff rates for other Asian countries. As illustrated in Figure 1, Sri Lanka's average nominal tariffs for the four commodity groups are quite similar to those of Thailand, and substantially below those for two other South Asian countries. Although significant pockets of excessive protection remain, especially with respect to some public enterprises[7] the overall picture is that of an open economy. The liberalization of the trade regime continues; the Government's 1988 budget outlines further simplifications and reductions to move to a four-tier tariff structure, with nominal rates of 10, 20, 25 and 40 percent.[8]

Liberalization of imports has been accompanied by a series of measures to encourage exports. The overall goal has been to put exporters on an equal footing with competitors in other countries,

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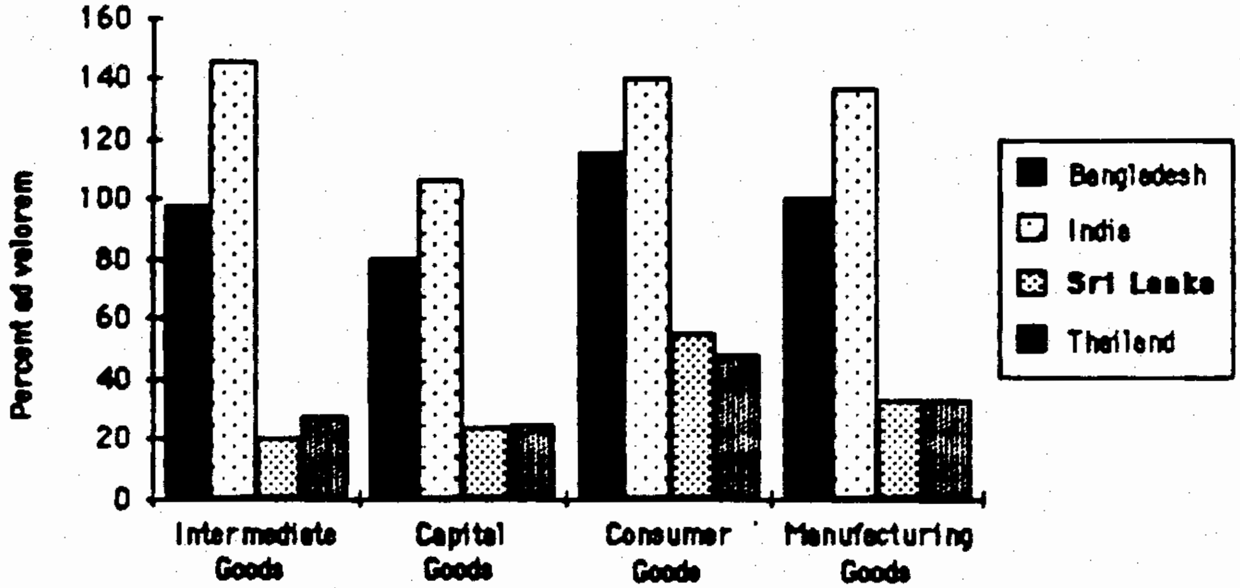
[7] Sri Lanka's tariff rates show greater dispersion than those of Thailand, indicating instances of relative high protection for specific subsectors and sometimes individual enterprises.

[8] This new tariff structure would substantially reduce protection for agriculture (by about half), and increase tariffs for equipment and finished goods for production or industrial purposes.

Figure 1:

Average Nominal Tariff Rates



Source: World Bank (data for 1985)

e.g., through duty-free access to imported inputs, and to compensate them for any disadvantages vis-a-vis import competing industries. The incentives provided include the free trade zones managed by the GCEC, customs duty rebates, exemption from custom duties and BTT (Business Turnover Tax), easier access to credit and credit insurance, tax holidays of up to ten years, and investment credits and related fiscal inducements.[9] Some gaps remain -- availability of short-term credit for working capital needs has been a problem, export marketing support remains weak -- but exporters can currently draw on a wide spectrum of assistance, both services and incentives.

Exchange Rates: Perhaps the most dramatic shift in economic policies manifested itself in changes in the exchange rate regime. Since 1977, Sri Lanka has moved from a dual exchange regime to a single rate, devaluing the rupee significantly in the process. Moreover, since 1982, the Central Bank's role in foreign exchange transactions is limited to the purchase and sale of spot U.S. dollars. Following the devaluation in 1978, the real effective exchange rate was allowed to drift upward, as illustrated in Figure 2. However, the authorities took action in 1986 to depreciate the rupee gradually to restore the country's competitiveness in export markets. However, Sri Lanka's principal competitors have tended to devalue even faster, maintaining some pressure on the rupee. Even so, neither limited access to foreign exchange nor an over valued rupee represent real barriers to export growth.

Tax Policy: As most other countries at similar levels of development, Sri Lanka relies quite heavily on indirect taxes. Taxes on income, profit, and capital gains account for only 15

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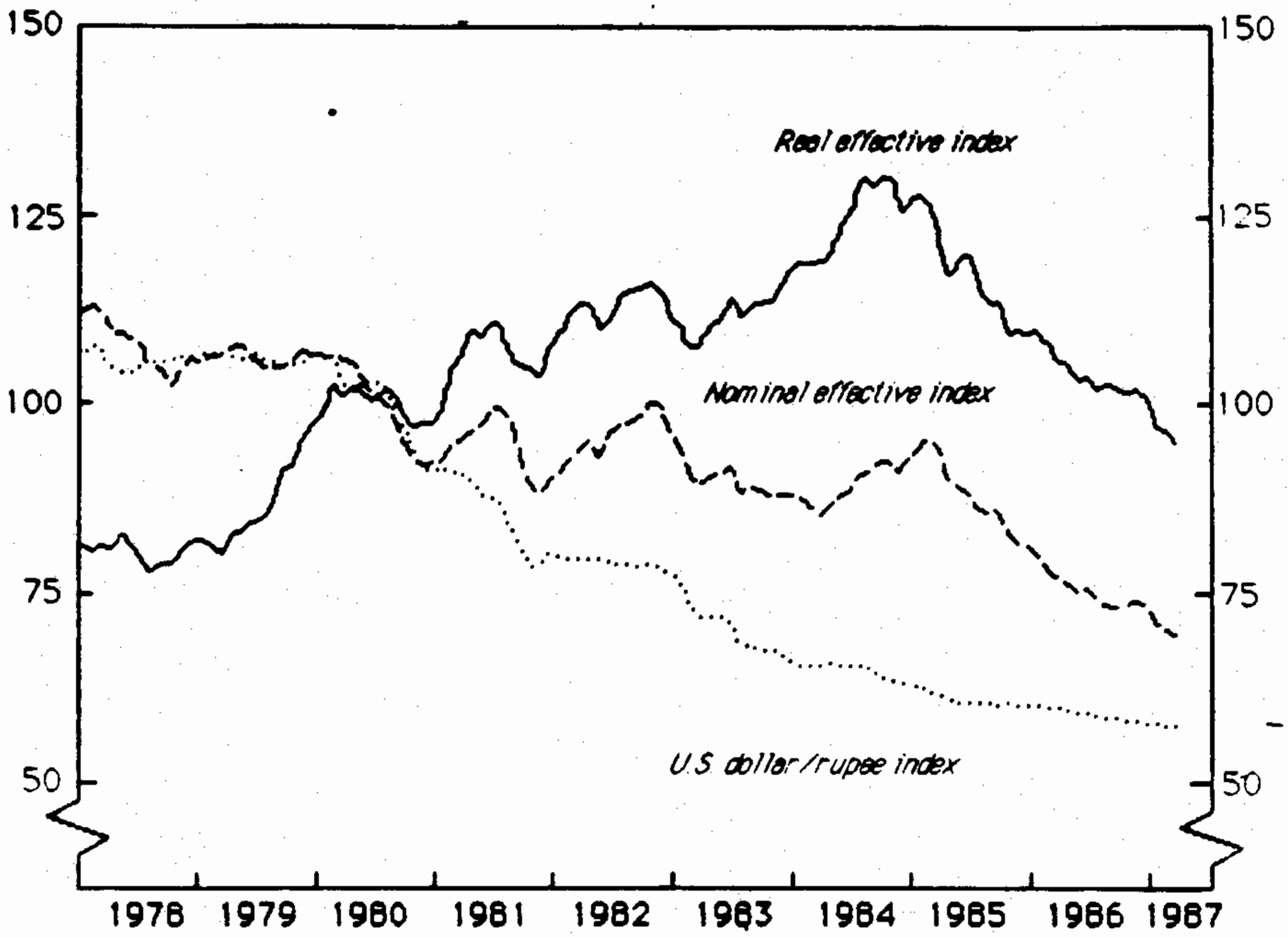
9 Another tax incentive currently mooted is the transferable tax credit (TTC) which offers some advantages (equal treatment for exporting and import-substitution activities), but also considerable drawbacks, such as possibly heavy revenue losses, the possible imposition of countervailing duties by importing countries, and the spectre of supporting inefficient export industries to match inefficient import-substitution activities.

Figure 2: Effective Exchange Rate Indices

(1980=100)



Source: IMF and Central Bank data

percent of total tax revenue. Figure 3 shows a comparison of Sri Lanka's revenue level and structure with that of other Asian countries. Of the six countries shown, Sri Lanka's (current) revenues as a percentage of GNP are higher than those of India, Pakistan or Thailand.[10] The overall composition of revenues is similar to that of the other two South Asian countries shown, and not that different from Thailand's. Although Sri Lanka's import tariffs are low, the level of imports combined with significant export duties, primarily on traditional treecrop exports, yield the highest percentage of revenue from duties on foreign trade among the six countries.

Sri Lanka resembles the other South Asian countries and Thailand in having a relatively low percentage of revenues coming from taxes on income, profit and capital gains. Tax expenditures (incentives) may have contributed to an income tax structure that appears to be inelastic with respect to GDP; over the period 1950-85, each 1 percent increase in GDP increased tax revenues by only 0.85 percent. In recent years, the share of non-tax revenues has increased, but is still lower than in other countries.

Between tax holidays and a relatively low top income tax rate -- the maximum personal income tax rate was reduced to 40 percent in the 1988 budget -- income taxes are unlikely to dampen private sector growth. In fact, current developments in Sri Lanka mirror those in other countries -- reductions in rates and elimination of special provisions and tax expenditures (such as exemptions or tax holidays).[11]

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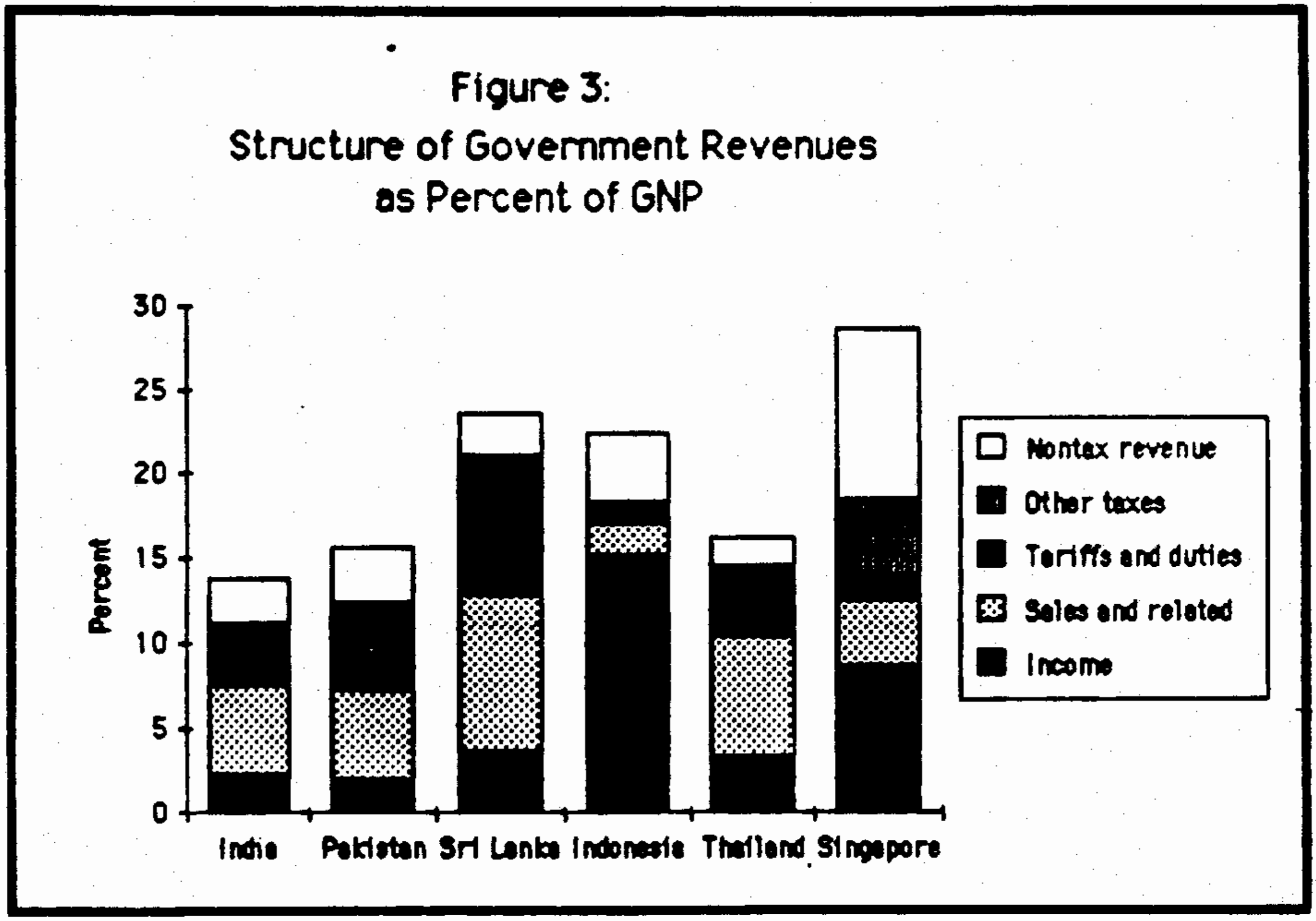
[10] Data from the World Development Report 1987 have been used to assure consistency. However, other data sources suggest a percentage of current revenues closer to 20 percent than the 23.8 percent shown in the World Development Report 1987.

[11] The Sri Lankan Government clearly is hoping for effects similar to those in other countries -- increased tax revenue as fewer loopholes and a less confiscatory rate encourage better compliance.



Source: World Bank, *World Development Report 1987*

Monetary and Financial Policy: Sri Lanka today has a financial system and a monetary policy that are geared toward the mobilization of resources and the provision of -- for a country at this stage of development -- more than satisfactory banking services for industrial expansion. Further reforms and improvements are needed, but can build on a sound basis.

The 1977 reforms in the financial and monetary arena addressed two weaknesses: inadequate savings mobilization and a poor performance of the banking system. The main response to the first problem was the shift to a high-interest rate policy, primarily intended to encourage domestic savings. In 1977, the Central Bank doubled the normal deposit rate on 12-months time deposit, from 7.5 to 15 percent, and raised it further to 20 percent in 1980. As illustrated in Figure 4, this policy resulted in positive real interest rates in all but one of the years since 1977. Figure 4 also suggests that real changes in total savings responded in part to changes in interest rates and in part to other factors, as indicated by the sharp increase in 1977 and the slowdown in 1983 and 1984.

A number of reforms strengthened the banking sector. One major factor was the liberalization of the foreign exchange regime which, along with other economic benefits, formed part of a concerted effort by the Government to expand the foreign banking sector in Sri Lanka. Foreign banks now account for some 20 percent of total financial transactions. The Government also engineered some (albeit limited) deregulation of the financial sector to allow for and encourage the formation of finance companies and merchant banks.[12]

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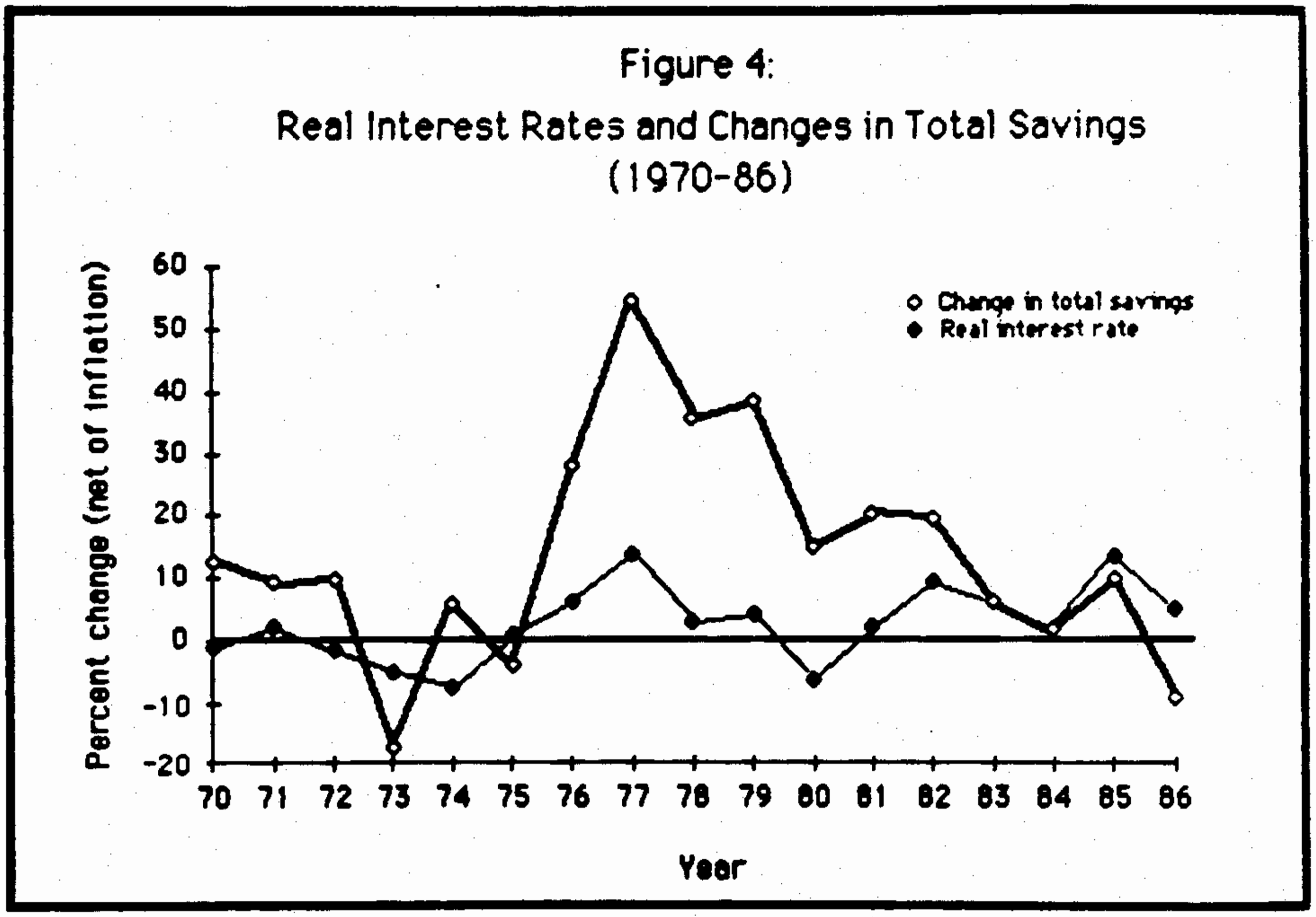
[12] As discussed further below, "deregulation" involved primarily the lifting of barriers to entry. Unfortunately, the required regulatory oversight of new financial institutions lacks both an adequate legislative base and sufficient administrative capacity and experience. Lack of effective controls has contributed to the widely reported difficulties of some of the finance companies.



Source: Central Bank data

In spite of the growing maturity of the banking system, the Central Bank continues to rely on both adjustment of reserve ratios, coupled with a high penal rate, and the imposition of credit ceilings to regulate the expansion of credit and advances to the private sector. The credit ceilings, though, have not been relevant lately, since effective demand for credit has fallen short of allowable levels.

With respect to equity markets, the Government has taken steps to support the formation of investment banks. It has recently launched an initiative to improve the regulation of the stock exchange to boost its viability through the Securities Council. Finally, capital gains taxes -- although still on the high side -- have been lowered to encourage secondary markets in equity instruments.

Pricing and Market Deregulation: Price controls in force before 1977 have been almost completely abolished. Price fixing by the Government is now virtually limited to areas in which the Government maintains a monopoly, for whatever reasons. The most important price distortions that do remain include subsidies to agricultural inputs and taxes on certain consumer products, notably petroleum products.

Reforms of pricing policies have played a key role in the restructuring of agricultural policies. Raising of the floor price for paddy and increasing fertilizer subsidies improved the profitability of paddy production and contributed to a substantial increase in national production. These changes in pricing policies were accompanied by the systematic dismantling of the Government monopoly in paddy procurement, distribution and marketing. Until 1978, the Food Department's cooperative stores handled all rice marketing, distributing free or subsidized rice to households with a monthly income of less than Rs.300. The (partial) replacement of this scheme with food stamps in 1979 brought consumers into the open market, creating more opportunities for the private sector. Since losing its monopoly, the Government's Paddy Marketing Board has begun to focus on the task of maintaining buffer stocks. Under a Title I self-help measure, the Government is now in the process of testing the feasibility of abolishing the public sector's de facto monopoly in paddy seed marketing.

Several other initiatives have been undertaken to relax existing public sector monopolies. One of the more successful ones has been the public transit system in the country, which was a Government monopoly until 1978. By now, privately operated buses account for some 50 percent of total passenger traffic. In another critical step, the Government has abolished the public sector monopoly in the insurance business; private insurance companies have since been launched. In other areas, however, initiatives to open Government operations to competition have often lacked the strong commitment and follow-through necessary for more than token progress.

Foreign Investment: On the legislative front, Sri Lanka has eliminated virtually all barriers to foreign investment. The country not only welcomes foreign investment, but pursues it actively and energetically. Until the deterioration of the security situation, the response had been good, especially in the two free trade (or export promotion) zones. The constitution itself guarantees protection of foreign investors.[13] These guarantees have been spelled out in a series of bilateral agreements. In a few instances, the Government itself has teamed up with foreign investors in joint ventures.

The Weak Points

Sri Lanka's accomplishments in abandoning *dirigiste* policies and moving to an open, market-oriented economy should not obscure several remaining weaknesses. The major weakness is the Government's continuing role as an highly active economic player, in particular through state-owned enterprises. Historically, the Sri Lankan polity has sought to pursue a host of economic and non-economic objectives through direct involvement in productive activities. The multiplicity of objectives of course jeopardized the financial performance of public enterprises.

Pressures to maintain at least some level of financial viability of the state-owned enterprises in turn served to justify various kinds of market distortions, mostly by maintaining high effective protection against both foreign and domestic competition. Although the failure of these policies has been largely accepted, serious concerns about the (often quite laudable) non-economic or social objectives have weakened the commitment to seek a lasting solution through full divestiture and privatization. Many of these concerns appear justified, because Sri Lanka has yet to develop adequate regulatory instruments to assure full operation of the market and to protect consumers as well as critical social goods.

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[13] Although the Constitution can be amended with a two-thirds majority, the major opposition party has expressed its support for the protection of foreign investment.

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Two recent examples illustrate the problem of inadequate regulatory controls. Liberalization of financial markets has encouraged the formation of finance companies. Many, if not most, of the companies are managed in a sound manner. However, some have been undercapitalized and have accepted unreasonable risks, leading to losses for depositors. Better regulatory oversight should have prevented some of these problems. In the area of public transit, the fast emergence of private sector operators to capture some 50 percent of the market is justly regarded as a success of liberalization. At the same time, inadequate regulatory oversight has allowed poor maintenance and poorly trained drivers -- making many of the privately operated buses something of a menace to their passengers and others in traffic.

The development of regulatory safeguards to provide adequate protection to various groups[14] is a critical condition for the successful completion of Sri Lanka's liberalization agenda, especially with respect to privatization and the full public commitment to private sector growth. The Government has taken some steps in this direction, for example, with the creation of the Securities Council to oversee the operations of the stock exchange, or the formation of the (so far apparently largely ceremonial) Fair Trading Commission focusing on restrictive business practices. However, further and more systematic efforts are needed.

[14] Another example is the protection of lenders through better debt recovery legislation.

POLICY ISSUES

Private Sector Policy Agenda

Overview: Progress in the Mission's private sector policy agenda during the past year has been twofold. First, through its project portfolio and continuing policy dialogue, the Mission helped advance certain critical policy initiatives, especially in the areas of privatization and capital markets. Second, the Mission's analysis and coordination with the GSL as well as with the World Bank and the Asian Development Bank have helped us to focus our policy agenda much more effectively. In the targeted priority areas, we have been able to delineate our interventions more clearly for maximum impact. In addition, we have moved ahead on our rural enterprise development initiative to complement our private sector policy work.

Privatization: Privatization of state owned enterprises (SOEs) continues as a principal area of policy dialogue. Our new Private Sector Policy Support Project (PSPS), 383-0100, will provide direct support to the development of a GSL privatization strategy both on an economy wide basis and for specific enterprises to be identified under the project. The reduction of state participation in the economy is important not only to the establishment of a more competitive, open economy, but also to reduce the strain on annual budgets caused by largely unprofitable SOEs.

Capital Markets: We will also be looking for a dynamic capital market to provide the necessary long-term capital -- particularly equity -- required for growth in the productive sectors of the Sri Lankan economy. The new PSPS project will provide assistance to strengthen the Securities Council and the stock exchange to develop appropriate policies, mechanisms and regulatory safeguards which will facilitate the expansion of ownership in the industrial development of Sri Lanka. The policy dialogue will focus on the need to broaden the equity base and the institutional framework to ensure that the general public has an opportunity to participate in the private ownership of what are now SOEs. Our housing program also provides continuing opportunities for policy dialogue, in particular with respect to interest rate policies.

Rural Enterprise: Our policy dialogue with respect to rural enterprise development has concentrated on the need to support and take advantage of agricultural development to diversify the employment and income base in rural areas. This main concern also defines the geographic focus of our work, the Mahaweli Special Areas. Work over the past year has laid the foundations for an effective policy framework for the Mahaweli Enterprise Development (MED) project.

Agriculture Policy Agenda

Overview: The agricultural policy framework for Sri Lanka is generally very supportive to agricultural development, particularly in the food crop subsector that holds the greatest interest for USAID. Free market pricing for products and factors generally prevails. Strong participation of the private sector in food production, marketing and processing is widespread.

The GSL, with the active encouragement of USAID, is attempting to refocus its priorities from rice production to a more balanced agricultural production base. A successful transition will require a comprehensive review and coordination of agricultural policy. Much groundwork for agricultural diversification has already been accomplished with assistance from USAID. A broad National Agriculture, Food and Nutrition Strategy and a National Agricultural Diversification Plan that identifies policy issues has been completed. Several existing and planned USAID projects are addressing specific areas such as agricultural research (Diversified Agriculture Research Project [DARP]), 383-0058, institutional planning and coordination (Agricultural Planning and Analysis Project [APAP]), 383-0083, and agricultural marketing (Development of Agricultural Marketing Systems [DAMS]), 383-0093. These policy initiatives are also being incorporated in the recent project initiatives in the Mahaweli. The Mahaweli Agriculture and Rural Development (MARD), 383-0086, and Mahaweli Downstream Support (MDS), 383-0103, projects, for example, provide the mechanism and resources to implement policy initiatives in irrigation management and agricultural research. Through APAP, policy research will identify and refine policy issues. PL 480 Title I self-help measures are carefully selected to complement the policy initiatives addressed through projects. In specific cases (for example land tenure) self-help measures tackle issues that are not project specific, but more general in nature.

Agriculture Diversification USAID has been instrumental in fostering recognition within the GSL that a policy shift from a single minded pursuit of rice self-sufficiency to diversifying the small-holder agricultural base is desirable. The principle of diversification as a means to increase rural incomes and improve standards of living is now widely accepted, but certain adjustment of agricultural policy is needed to successfully implement a diversification program. A policy environment that supports agricultural diversification encompasses a broad range of issues that are inter-related, and as appropriate, we have incorporated them into our policy agenda.

A basic issue is developing sufficient scientific capacity to sustain the technological change needed to support a diversification program. Increased human and financial resources are required to meet this challenge. Very substantial progress has been made in building such an institutional capacity through the Diversified Agriculture Research Project. Title I self-help measures reinforced DARP objectives by increasing GSL financial support for diversified agricultural research. The Mission will continue to encourage a balanced allocation of resources between rice and other crops to expand the technological base, primarily through DARP. Close coordination will occur with the World Bank Agriculture Research Project which has similar objectives. Three changes will be sought to improve decision-making:

a) Research in production economics, marketing, and policy will be encouraged by DARP to set the stage for deciding on research priorities and general research policy.

b) DARP will assist the Department of Agriculture to install a program research budgeting process that will, for the first time, require deliberate and clear allocation of research resources to specific research programs. And

c) APAP and DARP will support the refinement of the national diversification policy as a basis for setting research priorities.

Crop diversification in Sri Lanka is constrained by uncoordinated government policies on trade, i.e., conflicting import and domestic pricing policies and related marketing policies. For example, importation of certain food commodities is monopolized by government parastatals that enjoy special tariff rates causing import prices to be lower than government producer support prices. It is clear that trade policies and their linkage with domestic pricing and marketing have an effect on domestic production. These policy inconsistencies are beginning to be raised in public fora, and USAID is in a good position to assist in their resolution. Detailed study and appropriate coordination and adjustment of these policies will reinforce and support the diversification program. USAID has begun to engage the GSL in a dialogue on these issues through two avenues; the agricultural economics component of DARP and the Agricultural Planning and Analysis Project. We have sponsored several studies that have identified the problem areas and begun to raise the awareness of the GSL on these issues. Carrying out an effective dialogue is difficult because the policies are made and administered by a broad range of GSL ministries and parastatals with very weak coordinating mechanisms. The Mission intends to continue to utilize our two projects as means to conduct analysis, provide a mechanism for coordination and demonstrate the advantages to rationalization of these policies.

We plan to take specific actions in this area. A comprehensive study on producer pricing policy will be undertaken by the Mission to evaluate the effects of GSL interventions in subsidiary food crop markets on technological adoption, income transfers and export competitiveness. As we develop the DAMS project, we will incorporate a policy component to address issues related to government market intervention if analysis identifies appropriate measures that can be undertaken.

Irrigation Policy Agenda

Overview: An additional policy area of interest to USAID is the efficient utilization of irrigation resources. The irrigation infrastructure has expanded rapidly with the implementation of the Accelerated Mahaweli Program. The challenge now is to extract the maximum economic payoff from the investment in the infrastructure. USAID believes that improved performance of existing irrigation systems is one of the most cost-effective avenues for expanding rural incomes. Significant progress in this policy area has been made through earlier USAID projects and dialogue with the GSL Irrigation Department. The concept of incorporating user groups in operations and maintenance decision-making is taking root as a means to improve water management and maintain the systems. The Mission is now carrying these concepts into the Mahaweli system through a new project (MARD) with a significant policy dimension that will follow up an excellent beginning by Mahaweli Basin Development II (MBD II), 383-0073. Selected self-help measures are being used to address broader policy goals including the concept that users' fees support identified operations and maintenance (O&M) costs. The Mission also will be utilizing self-help measures to assist the GSL develop a comprehensive irrigation policy implementation strategy beginning late in CY 1988.

Efficient Utilization of Irrigation Resources The Mission's irrigation program focuses primarily on the improved utilization of existing irrigation infrastructure, rather than the support of new construction. Ground breaking work in irrigation management was done in the Gal Oya scheme under the Water Management Project (383-0057). The experience gained there continues to shape Mission project and policy dialogue priorities in the irrigation sector. The follow-on Irrigation Systems Management Project (ISM), 383-0080, a Water Management Amendment to the Mahaweli Basin Development I Project, and the new Mahaweli Agriculture and Rural Development Project, 383-0086, all focus on establishing viable farmer organizations to improve water delivery and use of the overall scheme level and both on-farm and lower system levels. Upgrading the irrigation bureaucracy to more efficiently manage main systems and link operations to expressed farmer needs is a complementary goal of our efforts in water management policy. ISM continues to strengthen and work through the Irrigation Department and the Irrigation Management Division of the Ministry of Lands and LandDevelopment. The Irrigation Mahagement Division itself was largely the outcome of policy dialogue during the Water Management project.

The Mission's policy dialogue efforts in the irrigation sector focus primarily on two objectives:

(1) To move toward the full recovery of operation and maintenance costs from irrigation user fees; and

(2) To establish policies encouraging representative farmer organizations which can play a strong role in intermediate level scheme management, water distribution, and maintenance.

Both are long term objectives; they are important in our dialogue with both the Mahaweli Authority and the Ministry of Lands and Land Development (the Irrigation Department and the Irrigation Management Division). The primary instruments for the dialogue are the three current projects mentioned above, the new Mahaweli Downstream Support Project (MDS), 383-0103, donor coordination, and Title I self help measures.

The Mission's strategy concerning cost recovery has been (a) to encourage the clear identification of actual O&M costs to determine what fees would be required for full cost recovery, (b) to encourage the GSL to set and assess users fees that cover increasing portions of O&M costs, (c) to improve the financial management of operations and maintenance, and (d) to encourage the establishment of O&M fund accounts at the scheme level (rather than in the national treasury) in order that farmers' organizations can monitor and influence the expenditure decisions for their schemes.

Progress on the cost recovery objectives in the past year has been mixed. There have been significant positive policy developments, but several setbacks in implementation. Under a Title I self-help measure, O&M cost data on schemes under the Irrigation Department have been collected and tabulated, albeit behind schedule; but the analysis has not proceeded far, apparently because the results will now be superseded by a much more rigorous World Bank study to be completed by the end of CY 1988. In the dialogue related to fulfilling the conditions precedent for MARD and MDS and in the irrigation financial management work with the Mahaweli Authority under the CH2M Hill contract, the Mission has sought and received more explicit information than ever before on budgeting for O&M in Mahaweli irrigation schemes; however, the data are difficult to use to determine actual O&M costs. We now know we must work to help improve the financial data to be able to quanity costs to achieve this policy objective.

During the past year, the Mission has observed a stronger commitment than before to user fee collections in both the Mahaweli Authority and the Irrigation Management Division. Both agencies show willingness to work with the Mission on practical measures to achieve the goal of full collections. However, there have been setbacks in the field. Though the fees are not currently a "hot" political topic (as is sometimes the case), settlement officers responsible for fee collections in some schemes have recently received threats if they continue collection. Thus recent fee collections have dropped below last year, in an extreme case to 20% for one ISM scheme. The political situation in some areas makes it temporarily impossible for the government to sustain the push to improve fee collection and difficult for USAID to push for further strengthening the routine collection structures. In the schemes under the ISM project, the Irrigation Management Division is responding by trying to forge an alternate approach to the established fee collection system, by working directly with user organizations, showing the cost of needed repairs in a system and the funds available, then letting users determine how or whether to collect the balance of needed funds.

User organizations: Some progress has been made during the past year on the second irrigation policy objective, building user organizations. In the Mahaweli areas, where the government seemed to be resisting developing policies which would allow irrigation organizations to be strongly participatory and representative of farmers, the GSL agreed to incorporate strategies for building such organizations into the MARD project and agreed to allow organizations to select their own leaders, a seemingly small, but crucial development. USAID had pushed for establishing a system of independent Institutional Organizers (IOs), similar to those in Gal Oya; Mahaweli had previously insisted that the organizational work be done only by the Mahaweli Unit managers, who also have other types of authority over settlers. A compromise was reached for experimentation under the MARD and MDS projects, namely that half of the IOs would be independently contracted and half would be prior Mahaweli staff redeployed from other systems, but both would have organizational accountability independent of the Unit Managers.

Under the ISM project and the MLLD, the policy of building independent irrigation organizations was already accepted as a key element in improving water management. However, the issue was the approval (by the Finance Ministry) of positions for irrigation organizers in the ISM irrigation schemes. As 1987 was a year of unusual budgetary restriction and a freeze on government hiring, the issue was sensitive. However, all of the IO positions needed were approved and filled; only a few other related positions remain to be filled and trained in 1988.

Several major related initiatives are under consideration to enhance the Mission's position in policy dialogue, though final decisions have not been made. The first would be the conduct of an Irrigation Sector Assessment to review recent experience and to help define and get high level commitment in the GSL to future actions and needed policy revisions; this would be done by a short-term team. The second initiative would be obtaining a medium-term consultant (perhaps through the Joint Career Corps program) to help the Mission refine and carry out the policy dialogue in areas established in the Sector Assessment and provide any further required analysis. The consultant would also work with the GSL on the third initiative, helping the GSL to develop an Irrigation Policy Implementation Plan. By the end of CY 1988, action on one or more of these is expected to be underway.

IV. PRIVATE SECTOR STRATEGY UPDATE

Over the past year, the Mission has made considerable progress in its private sector strategy. In particular, we have been able to work with the GSL, as well as with other donors, notably the World Bank and the Asian Development Bank, in improving the focus of our interventions to target areas where the combination of program elements promises the greatest returns. This process of concentration is reflected in the design of the two private sector-development projects now in preparation, in the approach to the private enterprise component of the rehabilitation project, and in the overall thrust of our private sector policy dialogue with the Government. Specifically, we have identified three principal areas of concern:

Industrial Policy: i.e., support for the Government's efforts to complete the agenda of economic policy and liberalization. and to follow through on existing reforms;

Privatization: involving assistance to speed up the systematic withdrawal of the Government from directly productive activities through divestiture of holdings in variety of enterprises;

Capital Markets: where USAID support can be instrumental in assuring the badly needed reforms of equity markets through oversight of securities transactions, strengthening of relevant institutions, and the provision of venture-type capital;

Rural enterprise: providing direct assistance to small and medium-scale off-farm enterprises in the Mahaweli Special Areas to take advantage of the increased production from the completed irrigation schemes, and raise value added in the region.

In addition, a fifth area -- the promotion of science and technology for improving competitiveness of private-sector enterprises -- is emerging as a promising area for USAID intervention.

Each of these areas reflects priorities of the GSL as well as our own assessment of greatest comparative advantage and leverage of limited resources. To start with the most difficult area, the domain of industrial policy remains somewhat diffuse. After several years of work -- with some indirect support from USAID's Private Enterprise Promotion Project (PEPP), a commission composed of Development Secretaries (higher-level officials in ministries concerned with development policy), and others produced a programmatic document -- the Industrial Policy Statement (IPS). The IPS mapped out an impressive series of initiatives to move the country further along the path of market-oriented economic development. The Cabinet adopted the IPS as official Government policy in the spring of 1987. However, short-term political and economic pressures -- administrative reform, devolution of power to the provinces, continuing ethnic and ideological violence, the urgent problems of displaced persons and refugees, the rehabilitation of the North and East and other areas affected by the violence, and a worsening budget picture -- have led to some unevenness in the implementation of industrial policy with its medium-term orientation.

Specifically, progress has been quite remarkable in following through on the trade policy reforms, in particular the continuing reduction of protection. With the support of the World Bank, the Government (the Presidential Tariff Commission) has been reviewing the structure of tariffs and protection. Further tariff reforms are underway. Similarly, reforms of the financial sector have continued; USAID support (under the PSPS) will be critical in developing and strengthening securities and equity markets.

With the continuing reduction of protection, industrial policy concerns will increasingly focus on the impacts of structural adjustment on various subsectors. Successful adjustment may require further assistance through a variety of incentives, pricing structures, and simplification of bureaucratic procedures. But the overall setting appears to be fully conducive to successful business growth and adaptation.

Even so, progress on industrial policy remains a critical priority. Our approach has been to rely primarily on thoughtful analysis to identify and target specific areas for support. Such an assessment forms the core of the design of both the Mahaweli Enterprise Development (MED), 383-0090, and the Private Sector Policy Support (PSPS), 383-0100, projects. The contemplated initiative in science and technology is another result of our continuing systematic review of opportunities for supporting an effective industrial policy.

Similarly, we intend to support private-sector efforts to provide analytical inputs into the policy debate as a suitable means for contributing to the continuing process of industrial policy development and appraisal. Thus, assistance to an economic policy analysis unit in the Ceylon Chamber of Commerce, and possibly similar institutions, will enhance work already being done by the Sri Lanka Business Development Centre, established three years ago under the Private Enterprise Promotion Project (PEPP), 383-0082.

This approach to industrial policy implementation effectively complements the work of the World Bank which focuses on trade policy. Coordination with the IBRD and the Asian Development Bank has been effective.

In the area of privatization, USAID was directly involved in encouraging this process through work with a private sector advisory group. In July 1987, two regular members of this group were appointed to the new Presidential Commission on Privatization charged with mapping and carrying out the process of public enterprise divestiture. Technical support to this Commission is oneof the key components of the PSPS Project scheduled for a late FY 1988 start. To bridge the gap to the startup of the Project, we are providing interim technical assistance to the Commission on Sri Lanka's first two "real" privatization (State Distilleries Corporation and United Motors Limited) using funds under the Private Enterprise Promotion Project (PEPP), 383-0082.

In addition, we sponsored two studies on privatization policy, one on the feasibility of private sector involvement in Sri Lanka's seed industry, the other on the management and possible privatization of the GSL-owned Thrisposha (weaning food) factory.

We will continue to pursue other possibilities under the privatization agenda. Given the political controversy surrounding this policy, the upcoming elections might favor a go-slow policy. At the same time, one or two successful privatizations may well help to dispel some of the myths held by opponents of such schemes and establish privatization as an effective means of promoting growth and equity through private ownership of productive resources.

To strengthen capital markets, USAID has worked closely with the newly formed GSL Securities Council and the private Colombo Securities Exchange to develop support mechanisms in the framework of the PSPS Project. The Securities Council will be important not only to raise investor confidence through effective oversight of securities trading, but also as a highly visible prototype of new

Government institutions to replace direct intervention by regulatory control to assure proper functioning of markets. Assistance to the Securities exchange will center on improving its ability to handle efficiently a growing equities market.

USAID is simultaneously encouraging the formation of a private equity investment company (now known generically as the Investment Company of Sri Lanka) to help back promising new investment projects and broaden the demand for and supply of new equity issues. A final decision on the formation of this company will be made in early 1988, including the determination of appropriate financial or technical assistance by USAID.

Our PL 480 Section 108 program has also figured prominently in our capital markets initiatives. The private sector lending program was started in FY 1987 for rupee financing of innovative investments in the private sector tea industry. This was the first such program successfully negotiated in the ANE region. The Section 108 program is continuing under the FY 1988 PL 480 Agreement.

Accomplishments in the private sector policy arena include institutional support to the Sri Lanka Business Development Center (SLBDC) which has continued to provide leadership in the analysis and implementation of industrial development policies in Sri Lanka. We have negotiated a new Cooperative Agreement with the SLBDC. In addition, USAID continued its support to the Employment, Investment and Enterprise Development Division (EIED) of the Mahaweli Authority, using the bridge financing under MBD I. Over the last year, the EIED has improved its management capabilities significantly, and has become instrumental in promoting business development in the Mahaweli Special Areas, in particular through its Entrepreneur Development Training Programmes. It will also be the implementing agency for the MED project, now in design and scheduled for a late FY 1988 start.

V. DONOR COORDINATION

Other than the formal Paris Consultative Group Meetings, occasional seminars on major issues convened by the UNDP and ad hoc initiatives taken between bilateral donors, there exists no effective donor coordination mechanism here in Sri Lanka. The Department of External Resources of the Ministry of Finance and Planning handles donor coordination for the GSL but does not effectively keep the various donors informed of other donor activity. Each donor then, is responsible for any coordination that takes place.

Our working relationship with the World Bank, IMF, UNDP and Canadian CIDA continues to be good. We meet often and have effectively been keeping each other up to date on program planning and policy developments. The IMF is concerned with the macro-economic picture and issues in which we are interested but, as a rule, less directly involved. The UNDP program focuses on human resource development and institution-building in direct support of the GSL's Public Investment Program. The technical assistance and training of the UNDP and related agencies overlap with USAID projects in many areas, and we continue working to assure complementarity rather than duplication. Coordination is much more active with the World Bank which has projects and objectives similar to our own. We are both concerned with diversifying agricultural production, stimulating private sector industrial development, and expanding exports. We are both interested in stemming the drain on the treasury caused by state-owned enterprises although the Bank continues to be less enthusiastic about outright divestiture. The Bank and CIDA's involvement in the right bank of Mahaweli System B is expected to gain from our experiences on the left bank. Our coordination with the Bank has been very effective regarding the Reconstruction and Rehabilitation Program for which the Bank is the lead agency.

Planning for the Rehabilitation Program has also allowed us to improve our coordination with both the Asian Development Bank (ADB) and the British Overseas Development Administration (ODA). Visiting teams developing ADB and ODA projects have worked closely with USAID and we have shared information and plans. We believe that this effective communication now established will continue beyond the rehabilitation planning effort.

Further on the bilateral front, we have opened a dialogue with the Italians who have recently become more active in Sri Lanka. Again the opening has been our mutual concerns for the rehabilitation work, but discussions have gone beyond those concerns to broader development issues. We continue to work with the Dutch on the seed industry privatization objective we both share, and we have had limited program discussions with SIDA (Sweden), NORAD (Norway) and the Swiss Embassy. We plan to improve on these contacts over the coming year.

We also want to improve our coordination with the Japanese which has begun but has not developed as quickly as we had hoped. As Japan is now the largest bilateral donor here, their involvement in the policy dialogue will be considerably important. It is, however, something they have appeared reluctant to do. We, together with other major donors, hope to get them more actively involved over the next year.

VI. NEW PROGRAM THRUSTS.

The major development effort over the next several years will be the rehabilitation of the North and the East after years of internecine violence. While it is a new project -- the Rehabilitation Assistance Project (RAP), 383-0107 -- it does not represent a new program thrust. It has been structured as an extension of the current program and strategy into new areas of the country. Nevertheless, it will represent a considerable investment of USAID time and resources.

At the same time, we will begin two new and major private sector development projects, one designed to improve the environment for private sector development and the other an attempt to stimulate small to medium sized enterprises in rural resettlement areas. Both of these projects will help Sri Lanka address specific shortcomings which inhibit growth of the private sector. A new project -- Science and Technology Initiative for Private Sector (STIPS) 383-0112 -- proposed for FY 1990 initiation will address other areas of concern. This new initiative will promote technological innovation, strengthen scientific and technical competence and improve Sri Lankan abilities to meet competitive international standards.As a small island nation, Sri Lanka's future will depend on its ability to export. It must now begin to establish the institutional base for creating and adapting technology appropriate to its needs. This project then represents not so much a new program thrust, but rather a continuing attempt to create the appropriate setting for a dynamic and growing private sector.

Closely associated with the need to create a strong technological foundation for future development is the awareness that future development must be built on a sound and sustainable natural resource base. Sri Lankan leaders have recognized the importance of rational environmental planning and have created institutions to begin that work. In support of that effort, the Mission proposes to start a new project -- Sri Lanka Environmental Resources Protection (SLERP), 383-0111 -- intended to strengthen these institutions and their role in policy development. While the Mission previously indicated it would not continue to work in environmental/natural resource projects, the fundamental importance of natural resource management cuts across the entire portfolio and affects each of out strategic objectives. We believe it prudent, therefore, to again consider projects addressing this issue.

Agriculture remains the mainstay of the economy and a principal focus of out strategy. Crop diversification has been a major objective of that strategy. It has, however, been geographically focussed -- appropriately at the time -- on the dry zones of central and eastern Sri Lanka. In FY 1990 we are proposing to address crop diversification needs in the wet zone of southwestern Sri Lanka. The Wet Zone Intercropping and Diversification Project Project (SCIP), 383-0104, will increase the incomes of small-holder farmers by introducing inter-cropping techniques, new crops and livestock. SCIP will be complementary to our agricultural research efforts and the diversification program in the Mahaweli.

The Mission's development strategy remains valid, and the three new proposed projects support it while, at the same time, further defining the scope of the strategic objectives. Given the resources available to the Mission, we believe these are appropriate projects to undertake in this time frame. Each of the three proposed projects is presented in more detail below:

A. Project Title and No: Wet Zone Intercropping and Diversification Project (383-0104)

LOP AID Funding ($'000):

	FY 90	LOP	Appr. Account
Grant	574	5,074	ARDN
Loan		5,000	
Total	574	10,074	

Project Purpose:

The purpose of the project is to increase agricultural income of wet and intermediate zone small farmers by introducing intercropping, mixed cropping, and livestock enterprises on lands which are now primarily in coconut monoculture.

Problems to be Addressed:

In the wet and intermediate zones of Sri Lanka about 100,000 growers cultivate coconut, with 75% of cultivation accounted for by holdings less than 10 ha., and much of that on holdings under 4 ha. Poor productivity in monocrop coconut production and volatile coconut prices have caused very low and unstable farm income among coconut smallholders. Land use is rarely intensive.

Coconut is cultivated in the wet zone and under varying agroclimatic conditions in Sri Lanka which offer the potential for a variety of intercropping systems involving export crops (e.g., cocoa, coffee, and pepper), horticultural crops (banana, papaya, and pineapple) annual crops (colocasia, alocasia, and vegetables), agro-industrial crops (ramie and vinca rosea), and pasture for livestock production. These intercropping possibilities are rarely exploited.

Government responsibility for research and extension related to crops suitable for intercropping is divided among several different agencies. Thus there is now no locus for developing the complete farming system which is involved with coconut intercropping. In hill areas, soil degredation and erosion must be addressed concurrently with intercropping. Existing credit systems are tied more to monoculture, rather than diversified cropping.

Project Description:

The project will introduce diversified and intensified farming systems to coconut smallholdings including the development of new intercrop/multicrop farming packages, livestock production systems and necessary farm support services. The project will develop appropriate crop/stock mixes through adaptive research, demonstration and extension support. Recently developed advances in coconut intercropping made in Sri Lanka, as well as older technologies from other regional countries will provide the basis for technology introduced. As the project introduces new farming systems to coconut producers, it will work to strengthen marketing links to private sector input suppliers and organize marketing systems for the new products.

Relationship to A.I.D. Country Strategy:

The focus of the project is directly on one of the major Mission strategic objectives: increasing agricultural productivity and rural incomes. It is sensitive to agency equity concerns. Because of the land pressure in this part of the island, the main option of increasing small farmer incomes is through more intensive cultivation. Available intercropping technologies tend to be highly labor intensive, and thus adaptable by very small farmers, rather than large coconut estates.

Target Groups:

Small holder coconut farmers and under employed rural workers.

PID Approval:

In Washington in April 1989.

Special Concerns:

Diversified agriculture, increased food production, and employment generation.

B. Project Title and No: Sri Lanka Environmental Resources Protection (383-0109)

LOP AID Funding ($'000):

	FY 90	LOP	Appr. Account
Grant	500	5,000	ARDN
Loan	-	-	
Total	500	5,000	

Project Purpose:

To improve planning, policy and implementation of natural resources management in the public and private sectors of Sri Lanka.

Project Description:

The Natural Resources and Environmental Policy Project will focus on developing a policy framework and strengthening the institutional capacity for building effective programs to conserve and manage renewable natural resources that support economic growth. The project will seek to heighten public awareness and understanding about the role of natural resources management and environmental protection for continued development. It will work with the environmental institutions to support research, training and action programs dealing with land and water degradation, sustainable utilization of marginal lands, and maintenance of biological species diversity. It will encourage private investment in resource conservation, management and environmental protection.

The project anticipates working with the key environmental agencies in Sri Lanka. These include the Central Environmental Authority, the Coast Conservation Authority and the Department of Wildlife and Conservation. The project will attempt to:

a) strengthen the management and policy analysis skills of key agencies responsible for natural resources management and environmental protection;

b) strengthen the administration and coordination of resource planning, analysis, and evaluation;

c) share the management experience and technical knowledge of the American private and public sectors, both with selected Sri Lankan environmental PVOs and businesses as well as with GSL agencies;

d) improve the data base on and analysis of resource information; and
e) formulate solutions to specific resource and environment issues and demonstrate the efficacy of these solutions through pilot programs.

Relationship to A.I.D. Country Strategy:

Efficient resource management and and environmental enhancement now receive AID attention under the Mahaweli Environment Project, the Reforestation and Watershed Management Project, and the centrally-funded Coast Conservation and National Conservation Strategy projects. The maintenance of a sound and sustainable natural resource base cuts across the entire [illegible]

Host Country and Other Donors:

The topic of natural resources and environment commands senior level attention in the Government of Sri Lanka. Other donors involvement in environmental and natural resource management has been largely capital intensive with little assistance provided for policy analysis and institutional development.

PID Approval:

In Washington in May 1989.

Special Concerns:

Natural resource management, environmental policy, and institutional development.

C) Project Title and No: Science and Technology Initiative for Private Sector, 383-0108

AID Funding:

Appropriation	FY 1990 Funding	FY 1991 Funding	LOP Funding

Project Purpose:

To strengthen Sri Lanka's institutional capabilities to promote technology transfer and improvement of quality standards in key export sectors.

Problems to be Addressed:

Sri Lankan industry is most competitive in world markets where one of two sets of conditions applies. First, it has traditionally been competitive in sectors where the country has a natural comparative advantage, such as tea and tea processing machinery. Second, it has proved highly competitive in sectors where foreign technology and management knowhow have combined with the skills and diligence of a relatively well-educated labor force such as in several of the Free Trade Zone enterprises.

These advantages have not been fully realized in the transition of industry toward an outward-oriented pattern. Many private sector operations have found it difficult to become fully competitive in export markets largely because of two factors:

* obsolete or inappropriate production technology;

* inadequate quality standards and quality control procedures.

Problems with production technology affect both product quality and cost. These problems can be traced partly to management lacunae, and partly to limited access to sources of new technology and relevant support services. Quality standards and quality control procedures in turn are also partly attributable to management weaknesses on one side, and to insufficient access to relevant information on standards regarding quality, design and functionality in international markets on the other. Thus, even as management capabilities improve, limited access to relevant information and assistance will hamper private sector efforts to take advantage of Sri Lanka's strengths.

This problem has been recognized as a priority issue in the Industrial Policy Statement (IPS), adopted in early 1987 as the Government's economic policy manifesto. The IPS recommended specific steps to facilitate the transfer of foreign technology to Sri Lankan manufacturing, in particular through the development of an effective "information base at the disposal of local investors" focused on technology negotiations. The IPS also suggests a stronger role of the Sri Lanka Standards Institute (SLSI) in quality standards and control.

Project Description

Through the proposed project the Mission wishes to address the twin problems of improving the competitiveness of selected sectors with good export potential by strengthening institutional capabilities in (a) technology monitoring (identifying and tracking technological developments of interest to Sri Lankan industry), technology adaptation and development, and technology dissemination, and (b) in setting and certifying quality standards, as well as assisting in the adaptation and installation of suitable quality control procedures in industry.

The target institution for the first component of the proposed project has been tentatively identified as the Ceylon Institute for Scientific and Industrial Research (CISIR). However, USAID will explore additional options to focus its support on private-sector initiatives in this area. The SLSI may be an appropriate lead institution for quality standards and quality control development, as identified in the IPS. Again, though, USAID will explore opportunities for relying fully or partly on private sector institutions for these functions.

The five-year project will combine some resident and more extensive short-term technical assistance to the selected institutions, training (primarily short-term training and internships) for their staff, and the provision of necessary equipment as determined during the design phase. Special emphasis will be placed on the option of developing lasting relationships with counterpart U.S. institutions such as the National Bureau of Standards or Underwriters' Laboratory. A rough estimate puts the total cost at $10 million broken down into a $6 million grant for technical assistance and training and a $4 million loan for equipment.

Target Group: The Sri Lankan Private Sector.

PID Approval: The Mission will submit the PID for AID/W approval in March 1989.

Research Activities: Research and analysis would be conducted to determine priority areas for technology monitoring and adaptation and for the development of quality standards and quality control procedures.

Special Concerns: Private Sector.

VII. EVALUATION STRATEGY

Overview

The evaluation strategy here details USAID/Sri Lanka's overall objectives for the monitoring and evaluation program for the coming years. The "Evaluation Plan" presenting the schedule of planned evaluations will be submitted with the Annual Budget Submission (ABS) in May. Discussion of performance indicators has also been deferred until the ABS.

The first section will summarize the evaluations of the past year and their use. The second section will present some of the strategic management, program, and project issues which the Mission plans to address through evaluations or special studies during the coming year.

Review of the Past Year

The past year has been a fairly intensive year for evaluation in the Mission. It included two final project evaluations, three mid-project evaluations, one assessment of GSL performance in a sector, and two program (or multi-project) evaluations. The Mission also experimented with and received useful results from locally contracted micro-level case studies which fed into a larger evaluation.

The purposes of these formal evaluations varied. Several were planned to contribute to basic management decisions which were imminent. One provided a basis for discussing and reaching agreement with the GSL on a wide spectrum of project issues. The two final evaluations were aimed to provide documentation of some project issues, to help articulate lessons learned, and identify loose ends which still needed to be tied up. One was intended to provide design guidance for a new phase of the same activity. And one grew out of a management decision need of AID/W, rather than the Mission's.

The two final project evaluations were for the Agricultural Education Development (AED), 383-0049, project and the National Institutes of Health Sciences (NIHS) project, 383-0062. The final AED evaluation was related to two factors. First, the project had a significant non-returnee problem, and the Mission wanted guidance on how the problem could be dealt with in other projects. Second, as it was an institution building project, it was considered important to examine the institution in detail, document changes which had occurred, and identify current issues facing the institution. For NIHS, an overall evaluation dealing with purpose level issues was not necessary, as the Mission already had adequate understanding and documentation of these from training program consultancies during the final project year; so a final evaluation done by a Sri Lankan engineer focused narrowly on the construction inputs and outputs.

The three mid-project evaluations included the Private Enterprise Promotion Project (PEPP), 383-0082, the Mahaweli Environment Project (MEP), 383-0075, and the Diversified Agricultural Research Project (DARP), 383-0058. The PEPP evaluation was primarily oriented to management concerns at two levels. On the one hand, it was the Mission's first project in the private sector; understanding as much as possible about interventions which did and did not work was considered important for forthcoming program and design decisions. On the other hand, the project itself was reaching a crucial point where a major contract was about to end, and management would soon have to decide whether to recast and extend the project and, if so, how to reform some awkward project administrative arrangements that had been a persistent problem. Many of the evaluation recommendations were accepted and provided the guidance for redesigning the project.

Early implementation of the MEP had been very slow. The first mid-project evaluation (late 1985) had recommended a strict implementation schedule for the following year which, if not adhered to, would be followed by a Mission decision to terminate the project. Though the evaluation in early 1987 was planned to review the 1986 implementation (which strikingly improved), it had to deal with a major new problem which resulted in Mission suspension of project activity just before the evaluation, namely the setting up of a training camp by the army in one of the project wildlife preserves. The evaluation team helped resolve the problem, suggesting minor changes in the project, but also arriving at a solution that all parties were able to accept.

The mid-project evaluation of DARP was planned as a more routine review of accomplishments, impact, design assumptions, and implementation issues. The evaluations recommendations provided the grounds for agreement between USAID and the Ministry on a long list of implementation steps.

The sectoral assessment of GSL performance was the Mahaweli Environmental Update; it was designed to determine the extent to which the GSL had made progress in implementing the wide-ranging recommendations of the earlier Environmental Assessment. Though the update was suggested by AID/Washington rather than the Mission, the Mission saw it as a useful exercise for the GSL and a way to inform Washington of extensive GSL environmental activity, of which USAID's Mahaweli Environment Project was only one part. The report essentially confirmed that the GSL continued to be guided by the earlier study and had made substantial progress.

Program evaluations were made of Centrally Funded Population Activities and of the Mission Housing Guarantee Program. The population evaluation was a consequence of the Mission decision, in light of declining budgets and USDH staff, to drop health as one of the Mission's strategic focuses. The evaluation was aimed to inform management's need to decide how to consolidate and focus the portfolio of small and disparate population activities, particularly in light of decreased ability to supervise them. The recommendations of the evaluation team were adopted in whole.

The Housing evaluation was intended to contribute to the design of Phase IV of the Housing Guarantee Program. It did not actually contribute as much toward that purpose as hoped, perhaps in part because of the political events and subsequent curfew during the evaluation which prevented sufficient discussion of the draft evaluation report with the consultant. However, as a prelude to the housing program evaluation, several micro-studies were contracted with a local PVO to examine the beneficiaries and the local level functioning of the thrift societies making housing loans. These studies were well executed and provided considerable new information to the Mission.

Evaluation Strategy for 1988

In contrast to 1987, this year will be a lighter year for formal project evaluations. A couple of previously planned evaluations for 1988 will probably be either deferred until 1989 or dropped entirely. The Mission was planning two sector assessments as well as several special studies intended to address program planning and monitoring needs. The combination of the need to direct Mission efforts (staff and funds) to rehabilitation project design and the shortage and delay in FY 1988 PD&S funding may crowd out some of these activities.

(1) Project Evaluations: Of the previously planned project evaluations, only Water Supply and Sanitation (383-0088) is a mid-project evaluation. It is expected to proceed on schedule in February. One critical management decision to be addressed will be whether to extend the contract for an institutional development team. This evaluation will also examine the ongoing internal project monitoring and evaluation system.

Several final project evaluations are also planned for this year. The Reforestation and Watershed Management (383-0055) evaluation is to document project accomplishments and the state of institutional development of the Forestry Department. Though the Mission is not planning further projects in this sector, and thus there is no strict requirement of an evaluation, it will be useful for other donors planning to work in the sector and for USAID's coordination with them.

The Mahaweli Basin Development (Phase I & II) final evaluation will be delayed until mid-year, when it will be possible to combine it with a final evaluation of the CH2M Hill water management activities under the project amendment to Phase II. Though under current evaluation guidelines, a final evaluation of the main MDB I & II project may not be required, the Mission believes that the magnitude of project expenditures for the construction justify a final evaluation. The amendment to MDB I which helped set up the Mahaweli Enterprise, Income, and Employment Division (EIED), in effect, has acted as a short "pre-project" for the planned Mahaweli Enterprise Development Project (383-0090). Though a separate evaluation of this activity was planned, a decision may be made to drop it; since fairly detailed analysis of EIED will be done during the final design of the MED project, a separate final evaluation may serve no useful purpose.

The remaining final project evaluation, that of the Private Enterprise Promotion Project, will be deferred until 1989 because of the extension of the PACD.

(2) Program or Sector Assessments: The Mission continues to look toward sectoral or cross-project evaluations in areas where the Mission has long standing project activity, where advice on sectoral policy issues is needed, and where substantial donor coordination is involved. Though the Mission has identified the following needs of this type, the actual implementation during 1988 is uncertain for the reasons mentioned earlier.

An Irrigation Sector Assessment was originally scheduled for 1988. The assessment would serve several Mission purposes. Given the fairly extensive work of the Mission in irrigation management and the prominence among donors of USAID's efforts in the sector, the time seems ripe to examine accomplishments and lessons learned and make strategic decisions about how to best target future project and policy dialogue efforts. Because of the importance of irrigation in Sri Lanka's economy, a broad look at accomplishments and continuing problems in the sector (i.e., including those areas beyond USAID project activity) may help the GSL to establish overall sectoral priorities.

A second sectoral assessment under discussion for 1988 is another in the series of evaluations of Mahaweli Settlements Policy by anthropologist, Ted Scudder. The six previous reviews have helped the Mission identify progress and problem areas in Mahaweli settlements. The needs addressed in the new Mahaweli Agriculture and Rural Development (MARD) project and the planned Mahaweli Enterprise Development (MED) project were first articulated in Scudder's policy review series. Because of the change in the focus of AID's projects and the considerable progress in settlements sinceScudder's last report (late 1985), the Mission would find another evaluation useful.

For the longer term, the Mission is also planning a major sectoral assessment of diversified agriculture in 1989. The Mission and the GSL have put considerable resources into projects which assume considerable potential in the diversification of agricultural production and the development of agro-processing. By 1989 there should be sufficient experience with that strategy to evaluate whether the assumptions are still valid and whether pay-offs can be realized.

(3) Special Studies for Program Planning and Monitoring: The Mission is looking toward several studies during the next two years which have several program purposes. First, there is uncertainty about several broad socio-economic trends (such as whether there has been a serious deterioration in the nutritional status and income of the lower economic strata) which should be understood in any revision of Mission strategy. Second, the Mission needs to examine several fundamental changes in government organization which are being planned (i.e., the devolution of some government powers to provincial councils as a part of the ethnic settlement package) which may have considerable impact on the way USAID works in Sri Lanka in the future. Third, the Mission needs to continue developing measures of program performance. And fourth, there are some focused studies which are planned to help the Mission get a handle on some basic issues in a new area of Mission project development, agricultural marketing.

Assuming that PD&S funds become available or other funds can be identified, the Mission plans to carry out or at least begin the following studies during 1988:

** Development of a methodolgy of measuring real rural incomes;
** An analysis of trends in the location and characteristics of poverty;
** Exploration of regional development strategies;
** An analysis of the GSL floor price subsidy scheme; and
** A regional agricultural marketing study.

III. RESOURCE REQUIREMENTS PLAN

The Rehabilitation Assistance Project (RAP), 383-0107, will be a primary concern in terms of resource requirements for the Mission. At this writing sufficient financing to meet our pledge of $75 million in assistance has not been identified. The accompanying tables indicate the up-front funding requirement. In order to be responsive to the immediate nature of a rehabilitation program, we will need to provide for a majority part of such financing in the early stages of the program. We have asked for not less than $30 million in the first year with the balance split almost evenly over the remaining two years. Likewise, the Housing Guarantee and PL 480 Title I programs should be provided in the First year -- FY 1988 -- of the program.

Additional staffing will almost certainly be required to manage a program of this size. We currently expect the need for two project funded PSC project managers to oversee the various and widely scattered elements of RAP. The specific personnel requirements to manage RAP will be determined during the final project design work and may well vary from that presented above.

The ongoing Development Assistance program has not changed from the levels which determined the current Mission staffing ceilings. While we believe higher approved assistance planning levels would afford us somewhat greater influence in policy dialogue and allow for wider development impact on our basic objectives, we have not attempted to plea for increased levels other than our pledged response to the rehabilitation needs in the North and East. Our current program has been planned to reach key constraints to economic growth, and we are adequately staffed to carry out the program.

ASSISTANCE PLANNING LEVELS
(Millions of U.S. Dollars)

FUNDING SOURCE	FY 88	FY 89	FY 90	FY 91	FY 92
BASIC PROGRAM LEVEL					
Development Assistance (DA)	16.8	16.8	16.8	16.8	16.8
Economic Support Funds (ESF)					
PL 480 Title I/III	16.0	16.0	16.0	16.0	16.0
PL 480 Title II	0.6	0.6	0.1	0.1	-
Housing Guarantees (HG)	-	20.0	-	20.0	-
TOTALS	33.4	53.4	32.9	52.9	32.8
PROGRAM LEVEL WITH REHAB.					
DA	46.8	26.8	26.8	16.8	16.8
ESF	-	-	-	-	-
PL 480 Title I/III	26.0	16.0	16.0	16.0	16.0
PL 480 Title II	0.6	0.6	0.1	0.1	-
HG	15.0	20.0	-	20.0	-
TOTALS	88.4	63.4	42.9	52.9	32.8

FY 88 OBLIGATION SCHEDULE ($ 000's)

PROJECT TITLE	PROJECT NUMBER	FUNCT ACCT	LOAN	GRANT	TOTAL	ACTUAL/PLND MONTH OF OBLIGATION
ONGOING PROJECTS						
DEV. STUDIES AND TRAINING	3830085	FN	-	$1,250		
		SD	-	$750	$2,000	FEBRUARY
MAHAWELI AG & RURAL DEV.	3830086	FN	-	$2,200	$2,200	FEBRUARY
PVO CO-FINANCING II	3830101	FN	-	$500	$500	FEBRUARY
MAHAWELI DOWNSTREAM SUPPORT	3830103	FN	$4,290	$1,300	$5,590	FEBRUARY
SUB TOTAL			$4,290	$6,000	$10,290	
NEW PROJECTS						
MAHAWELI ENTERPRISE DEV.	3830090	FN	$1,500	$1,750	$3,250	JULY
PRIVATE SECTOR POLICY SUPPORT	3830100	SD	-	$3,250	$3,250	JULY
REHABILITATION ASSISTANCE PROGRAM	3830107	FN	-	$10,010	$10,010	JUNE
SUB TOTAL			$1,500	$15,010	$16,510	
COUNTRY TOTAL			$5,790	$21,010	$26,800 *	

FUNDING LEVELS

	FUNCT ACCT	LOAN	GRANT	TOTAL
DA without RAP:	FN	$5,790	$7,000	
	SD	$0	$4,000	$16,790
RAP:	FN	-	$10,010	$10,010
DA with RAP:		$5,790	$21,010	$26,800 *

*Note: Totals represent planning levels given by AID/W, and include only $10 million of the $30 million needed for the rehabilitation project.

PRM: 88OBSCHWK1
February 1, 1988

USAID/SRI LANKA
FIVE YEAR OBLIGATION PLANNING WORKSHEET (1988-92)
($ 000)

Proj No.	Project Title	L/G	LOP FUNDING	OBLIG THRU FY87	FY 88 OBLIG	FY 89 OBLIG	FY 90 OBLIG	FY 91 OBLIG	FY 92 OBLIG	CUMUL OBLIG	EXPECTED MORTGAGE 9/30/92
AGRICULTURE, RURAL DEVELOPMENT, AND NUTRITION											
3830085	Development Studies & Trng	G	3,500	1,684	1,250	566				3,500	0
3830086	Mahaweli Ag & Rural Dev.	G	10,200	2,295	2,200	1,635	1,500	1,500	1,070	10,200	0
		L	3,800	3,191		609				3,800	0
3830090	Mahaweli Enterprise Dev.	G	9,600		1,750	1,850	2,000	2,500	1,500	9,600	0
		L	5,400		1,500	1,934	1,966			5,400	0
3830093	Devel of Ag Marketing Systems	G	5,500			1,500	2,000	1,000	1,000	5,500	0
		L	6,500			2,400	2,500	1,600		6,500	0
3830101	PVO Co-Financing II	G	3,996	3,496	500					3,996	0
3830103	Mahaweli Downstream Support	G	2,000	700	1,300					2,000	0
		L	13,000	5,734	4,290	2,296	680			13,000	0
3830104	Wet Zone Intercrop & Diversif	G	5,074				574	1,000	1,700	3,274	1,800
		L	5,000					1,700	2,190	3,890	1,110
3830107	Rehabilitation Assistance Prg	G	50,000		30,010	10,010	9,980			50,000	0
3830109	Sri Lanka Environmental Resources Protection	G	5,000				500	1,000	1,500	3,000	2,000
3830110	PVO Co-Financing III	G	5,000						540	540	4,460
3830111	Strengthening Irrigation Mgt	G	6,000						500	500	5,500
		L	12,000							0	12,000
	APPROPRIATION TOTALS		151,570	17,100	42,800	22,800	21,700	10,300	10,000	124,700	26,870
	GRANTS		105,870	8,175	37,010	15,561	16,554	7,000	7,810	92,110	13,760
	LOANS		45,700	8,925	5,790	7,239	5,146	3,300	2,190	32,590	13,110

USAID/SRI LANKA
FIVE YEAR OBLIGATION PLANNING WORKSHEET (1988-92)
($ 000)

Proj No.	Project Title	L/G	LOP FUNDING	OBLIG THRU FY87	FY 88 OBLIG	FY 89 OBLIG	FY 90 OBLIG	FY 91 OBLIG	FY 92 OBLIG	CUMUL OBLIG	EXPECTED MORTGAGE 9/30/92
HEALTH											
3830101	PVO Co-Financing II	G	250	250						250	0
	APPROPRIATION TOTALS		250	250	0	0	0	0	0	250	0
	GRANT		250	250	0	0	0	0	0	250	0
	LOAN										
SELECTED DEVELOPMENT ACTIVITIES											
3830085	Development Studies & Trng	G	2,500	1,000	750	300	450			2,500	0
3830100	Private Sector Policy Support	G	15,000		3,250	3,150	2,800	3,000	2,800	15,000	0
3830101	PVO Co-Financing II	G	1,800	400		550	850			1,800	0
3830108	Science & Technol Initiative	G	6,000				1,000	1,500	1,500	4,000	2,000
	for Private Sector	L	4,000					2,000	2,000	4,000	0
3830112	Development Issues	G	6,000						500	500	5,500
	APPROPRIATION TOTALS		35,300	1,400	4,000	4,000	5,100	6,500	6,800	27,800	7,500
	GRANTS		31,300	1,400	4,000	4,000	5,100	4,500	4,800	23,800	7,500
	LOANS		4,000					2,000	2,000	4,000	0
	TOTAL FOR COUNTRY		187,120	18,750	46,800	26,800	26,800	16,800	16,800	152,750	34,370
	GRANTS		137,420	9,825	41,010	19,561	21,654	11,500	12,610	116,160	21,260
	LOANS		49,700	8,925	5,790	7,239	5,146	5,300	4,190	36,590	13,110

IX. MAJOR IMPLEMENTATION ISSUES

Mission attention to implementation during the forthcoming year will be focussed on the following:

Project Portfolio Management: During FY 1988, four projects will be closed, reducing the portfolio to 11 projects. Three new projects are planned for FY 1988 -- Mahaweli Enterprise Development, 383-0090; Private Sector Policy Support, 383-0100; and the Rehabilitation Assistance Project (RAP), 383-0107. By the end of FY 1988, therefore, the project portfolio will include 14 projects. This level compares to 19 at the beginning of FY 1983 and represents a tighter focus of our portfolio on the broader issues identified in the updated CDSS.

Pipeline Management: A number of factors account for the Mission's pipeline of approximately $81 million. Among these are the intensive institutional nature of the portfolio. Our 27 October 1987 report extensively analyzed our pipeline. That analysis remains current.

In general, however, disbursement performance and the size of the pipeline are acceptable. In FY 1987, the Mission disbursed $16.4 million or approximately 70 percent of the OYB, acceptable performance by any standard. During the course of the year, the Mission plans to focus more attention on the core issues restraining disbursement. Expenditure levels are expected to reach approximately $20 million in FY 1988 which, with the elimination of the special rehabilitation obligation, would represent 119 percent of our OYB.

Deobligation Actions: No deobligations are planned for FY 1988 due to our extensive exercise last year which cleaned up projects with excess funds or troubled projects. While some funding will become available for deobligation as older projects come to completion, the exact amount is not year known. They, therefore, will be deobligated in FY 1989 within the Terminal Date for Disbursement period.

Loan/Grant Restructing: During FY 1988, the Mission plans to begin utilizing more grant funds in our projects. The percentage of grant financing for the FY 1988 OYB, exclusive of RAP, will increase to 66 percent as the three new projects come on stream, up from 46 percent in FY 1987.

This shift is in response to serious macroeconomic (budgetary and balance of payments) constraints. Sri Lanka is among the group of countries with per capita GNP below $805 making it eligible for grant funding. AID guidelines for grant funding are compatible with the projects planned or under design. The planned projects all will yield broadly diffused social benefits for which full cost recovery is not practical, and each will involve innovative concepts characterizing them as pilot or demonstration projects.

The rehabilitation project is already planned for full grant funding. For FY 1988, the Private Sector Policy Support Project is set at $15 million grant; MED at $5.4 million loan and $9.6 million grant. For FY 1989, DAMS is set at $6.5 million loan and $5.5 million grant. All represent a varying combination of high innovation, high level of risk for the host country or demonstration effort. Furthermore, the Mission believes that new projects in natural resources/environment and science and technology will warrant grant funding as well. We, therefore, expect to maintain a high percentage of grant financing each year of this planning period.

X. MAJOR MANAGEMENT ISSUES

1. Overview of Mission Staffing FY 88-89

A. USDH - The Mission workforce FTE level for FY 1988 and FY 1989 is 19 USDH employees and that level will be reached by the final elimination of one additional position, the Regional Legal Advisor, by the end of FY 1988. The Mission will continue to require the services of a Regional Legal Advisor from a nearby Mission to accomplish our legal work requirement for 3-4 weeks per quarter. Plans for changes in personnel and organization contemplated during the past year and a half have now been implemented, and the Mission has been formally reorganized. However, the reorganization package ratified by AID/W varies from the Mission request, and we will pursue resolution of the anomolies this year.

The Mission still considers the level of 19 positions to be critical to the accomplishment of the objectives laid out in the action plan and CDSS update of the past year. We currently plan to implement the Rehabilitation Assistance Project in the North and East using program-funded PSCs to assist in the monitoring process.If final design indicates that an additional USDH position is needed, we will submit a request near the end of FY 1988.

The Mission is planning two IDIs, one each in the Office of Agriculture for 1988 and the Office of Projects in 1989. Positions for them to fill upon completion of their one year training programs have been identified and our request transmitted to AID/W.

The Mission is still dependent upon service of regional officers for commodity procurement and contracting assistance, and will definitely require legal services after the transfer of the RLA.

B. OE-FUNDED U.S. PSCs - The locally recruited U.S. PSC administrative assistant in the Executive Office is being continued. The Mission is currently hiring a U.S. PSC to replace our temporary part-time project development officer, Office of Projects, who is departing the Mission in March. Status of the newly-contracted employee will be converted to a Temporary Resident Staff (PIT) position upon the receipt of clearance from the Office of Personnel, AID/Washington.

C. FSN PSCs - USAID is currently recruiting a program assistant and an additional secretary for the Program Office. We have added a training assistant to the Office of Projects, in addition to transferring the Program Specialist (Health and Population) and a secretary to that office upon the disestablishment of the Office of Health, Population and Human Resources. Efforts are currently underway to recruit an administrative officer, a construction supervisor and a short-term editor/writer for the Executive Office. Other personnel recruitment activities have been dedicated to replacing personnel who have departed Mission employment for one reason or another.

D. PROGRAM FUNDED STAFF - The Mission has not utilized any program-funded staff in its office in the past. However, implementing the new $75 million Relief and Reconstruction program for the North and East may require some project-funded PSCs to assist the Mission in administering and monitoring that vital project.

E. FSN Ceiling - The ceiling for USAID FSNs has been established at 22 positions for FY 1988. FY 1989 figures have not yet been received. The Mission currently has 19 FSN employees on board and is recruiting a replacement Economist for the Office of Program. We have two vacancies available for the recruitment of professional employees, when needed. USAID will not exceed this established ceiling.

F. PASA - The Mission currently employs one PASA employee from the National Parks Service, Office of International Affairs, Department of the Interior under the Mahaweli Environment Project (383-0075).

G. JCC - A key area of our portfolio which cannot be adequately addressed within current staffing levels is the resolution of several issues on irrigation policy. In order to take a leadership role in this critical area, staff are needed to devote full time effort to precisely defining the issues, undertaking the analysis and formulating appropriate interventions. We have begun preliminary steps exploring the availability of a Joint Career Corps (JCC) person to assume this role. If a properly qualified person is found, we will then request action to establish the position.

H. TCN - There are no TCNs employed by USAID Sri Lanka.

2. Other Management Issues

A. Reorganization: The mission reorganization package was approved by AID/Washington and has been put into effect. However, as stated earlier, we will work this year to correct some anomolies.

B. Coordination with other USG Agencies: The USAID Mission is an active participant in the overall USG program under the guidance of the Ambassador, coordinating closely with: the Economics Section on PL-480 and economic analysis; the Political Section on refugees and reconstruction; and the Administrative Section for shared services. The Mission is continuing its cooperative efforts with the Peace Corps under a Small Projects Agreement. We will be working with USIS this year to produce a brochure on US Assistance to Sri Lanka.

C. Procedures: The Mission is continuing its efforts to completely revise all mission orders and will soon complete the USAID Colombo Project Officer's Handbook. As a result of internal mission assessment efforts, we have strengthened our funds control procedures and have also carefully reviewed and assessed the value and effectiveness of all other internal management procedures and practices.

D. Buildings: USAID continues to reside in the former U.S. Embassy compound located at 44 Galle Road, Colombo 3. Significant amounts of repair and maintenance work required to bring safety conditions to a satisfactory level were deferred during FY 1987 and it is hoped that they will be resolved at an early date during FY 1988. The work required entails rewiring the rear USAID building and replacing its roof, removing asbestos ceilings in both buildings, and repairing termite damage and replacing the air-conditioning system in the front building. Much of this work is prerequisite to the security work discussed below.

E. Security: The first phase (front perimeter) and the fourth phase (rear perimeter) have been completed. This effort has brought effective minimal perimeter security to our compound which had heretofore been lacking. The second phase (front public access control) and the third phase (rear public access control) are still in the planning stage and require additional pressures on the planning, contracting and construction requirements of the enhancement project to bring about their completion. There is first the requirement that the security work be fully coordinated with the rehabilitation work envisaged for this compound, then disagreement on specification standards between Sri Lankan contractors and FBO needs to be resolved and, finally, adequate funding and appropriate supervision must be made available for the construction work.

F. Budget Availabilities: USAID budget reductions have largely been offset by significant reductions in USDH staff levels. The Embassy has been far less fortunate and Gramm-Rudman-Hollings curtailments have severely affected their financial posture, leading them to reduce administrative services, including FAAS services which, in turn, has adversely affected USAID'S support services.

G. Automation: The MACS system is fully operational. Gymnastic funding manuevers during FY 1987 allowed the Mission to upgrade our computer system to the WANG VS 100, with component WANG VS-45 equipment serving us as a backup system. Space for a fully appropriate computer center has been allocated by the Embassy to house the system and installation planning has begun. An uninterrupted power source (UPS) and an additional six terminals and two printers were also procured with the VS-100 and will be installed concurrently. Sufficient funds have been set aside during FY 1988 to allow USAID to obtain additional terminals, PCs, and printers. The purchase of computer software is being reviewed by the USAID automation committee, and additional and appropriate software will be purchased. The WANG VS-100 and related equipment will allow movement of our automation assets into a single integrated Mission system and brings us closer to the day when direct data exchange with AID/Washington will be possible.