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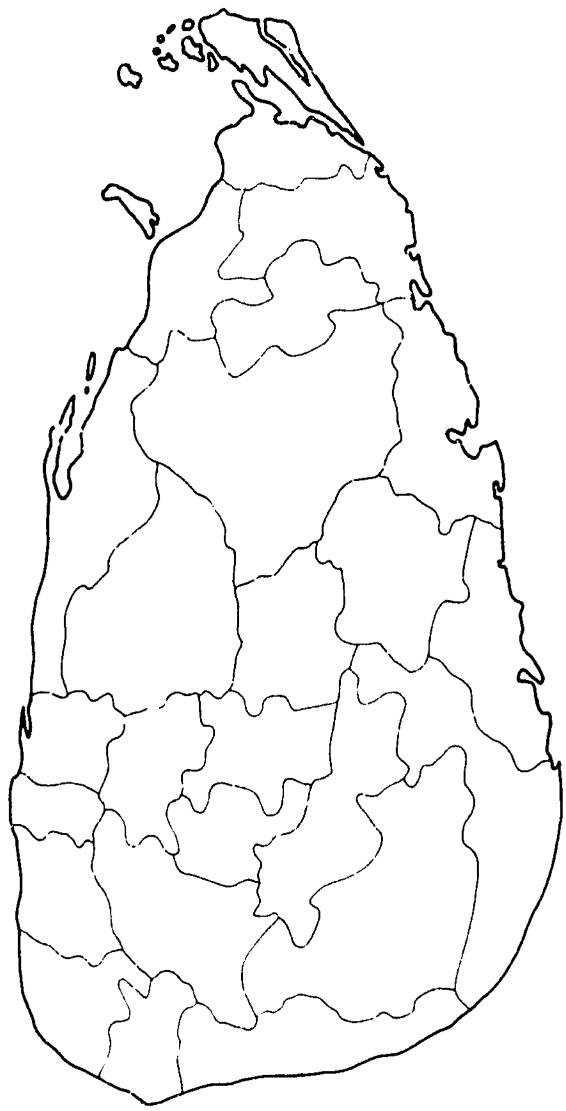
Ministry of Finance and Planning

Coordinating Committee for Private Sector Development

August 1983

Developing Sri Lanka's Private Sector and Its Investment Opportunities

Volume 1
Summary of the Report



Arthur D. Little International, Inc.

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DEVELOPING SRI LANKA'S PRIVATE SECTOR AND ITS INVESTMENT OPPORTUNITIES

Volume 1

Summary of the Study

A Report Prepared by

Arthur D. Little International, Inc.

For the

Sri Lankan Ministry of Finance and Planning

and the Coordinating Committee for Private Sector Development

Commissioned by the

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PREFACE

Background

In 1977 Sri Lanka's newly elected government was confronted with two critical tasks. The immediate problem it faced was to arrest the rapid deterioration of the nation's economy, rising unemployment, and declining living standards, resulting from years of a stagnating and closed economy.

The second challenge was of a more structural nature. The country's new leaders were confronted with the dilemma of how to place Sri Lanka's economy on a more self-sustaining growth path, one which would assure expanding capacity, output and employment. The required reforms meant a repudiation of the previous economic philosophy which had favored a dominant role for the state in an economy carefully shielded from the rigors of international competition.

The restrictive policies of the previous government and its nationalization of private property had led the country's private sector to retreat from investments in resource-based industries into safer, but economically less-productive, areas of trade and services. The new government recognized from the outset that long-term growth in Sri Lanka's productive capacity could be assured only by restoring an open economy in which the energies of private entrepreneurs, large and small, could be allowed to operate freely. It recognized that attainment of its economic objectives was inextricably linked to the successful development of the country's private sector.

This study, whose conclusions and recommendations follow, is intended to address this second challenge.

Origin, Purpose, and Process of the Study

Recognizing the important problems confronting Sri Lanka in its attempts to reorient its economic policies, the United States Agency for International Development (USAID) concluded that strengthening the indigenous private sector was one of the most critical factors facing the attainment of Sri Lanka's national goals. USAID, therefore, proposed to the Ministry of Finance and Planning a private sector development program focusing on a search for new opportunities for indigenous investment as well as means to improve the environment for growth of private enterprise. The Ministry of Finance and Planning and USAID both saw the need for a highly interactive program in which the public and private sectors could develop a consensus on the problems and possible solutions facing development of the private sector. As a result, a special Coordinating Committee for Private Sector Development was formed, composed of representatives from private enterprise and government alike.

In February 1983, USAID contracted with Arthur D. Little International, Inc. to undertake for the Coordinating Committee a four month study to examine means to promote private sector development and specifically to identify opportunity areas where private investment could have the most positive impact not only on the private sector but on the country's longer-term economic development.

The 12-member Arthur D. Little team worked closely with a group of 20 Sri Lankan professionals during the February to June 1983 period. To assure that the conclusions and recommendations were realistic and feasible in Sri Lanka's context, a series of Advisory Groups of senior representatives from the government, the private sector, the banking community and state corporations was formed for advice and criticism. Groups were established to advise the study team in the following areas:

- Financial Markets
- Managerial Training
- Agro-based Industries
- Fisheries Industries
- Manufacturing Industries
- Rubber-based Products
- Minerals Processing Industries

Nature of the Recommendations

The joint Arthur D. Little-Sri Lankan team concluded early in the study that analyzing means to promote the development of private enterprise in Sri Lanka could have relevance only if placed in the broader context of the nation's economic development process. In short, the private sector was seen as one of the principal forces for developing the island's natural resource base and employing its labor.

Based on these assumptions the following questions were asked:

- Are there clearly defined development objectives that serve to suggest and guide government policies and private sector activity?
- What mechanisms exist for coordinating policies and programs in a coherent and disciplined manner to meet these objectives?
- What are the minimum conditions and resources needed to motivate and enable private enterprise to move into priority development areas?
- What are the principal areas for investment opportunity in Sri Lanka that satisfy both the country's need for self-sustaining development of its resources and private enterprises' need for commercially viable ventures?

The conclusions and recommended actions that follow attempt to address those questions.

Organization of the Report

The Arthur D. Little report to the Ministry of Finance and Planning and the Coordinating Committee is organized around four volumes as follows:

Volume 1 - Summary of the Report

Volume 2 - Definition of the Private Sector and the Environment for its Development

Volume 3 - Opportunities for Agro-Based Industry Development

- Fruits and Vegetables
- Coconut Products
- Dairy Products
- Fisheries
- Other Agro-based Opportunities

Volume 4 - Opportunities for Development of Manufacturing and Minerals Processing Industries

- Rubber-Based Products
- Agricultural-based Light Engineering
- Minerals Processing

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CHAPTER 1

EXECUTIVE SUMMARY

A. BASIC PREMISES UNDERLYING THE STUDY OF SRI LANKA'S PRIVATE SECTOR

The study team conducting this analysis of Sri Lanka's private sector and its contribution to the country's economic development did so on the basis of the following basic assumptions, or premises, which guided the investigation and the conclusions and recommendations emerging from it.

1. Sri Lanka's long-term economic growth will depend heavily on the ability of its private sector to expand and develop the productive sectors of the economy.

The success of the nation in attaining its economic objectives will ultimately depend on the ability -- and willingness -- of the country's private sector to expand and diversify its productive base. Sri Lanka's low level of economic development today is burdened by a rapidly deteriorating unemployment situation. The number of unemployed and underemployed workers is already critically high. These circumstances worsen each year with the entry into the economy of thousands of new job-seekers. Rapid expansion of economic activity within the private sector is the only means available to the country to absorb these growing numbers of unemployed in rural and urban areas alike. Similarly, only through growth of the private sector can the country create the large middle class needed for long-term economic, social, and political stability.

2. Self-sustaining economic growth in Sri Lanka must occur in its natural resource-based sectors.

Real economic growth in Sri Lanka must occur in those sectors where maximum value can be added to local production and where the greatest positive impact can be felt on employment, national income, and foreign exchange earnings. Sri Lanka's comparative advantages lie in its rich natural resource base and its educated labor force. With 75% of the island's population living in rural areas where significant development potential exists in agriculture, agro-based industries, fisheries, forests, and minerals, a self-sustaining growth momentum can only be achieved on the basis of these factors of production.

3. The government's economic development strategy must therefore focus primarily on developing the country's private sector and directing that development into labor-intensive, resource-based activities.

Sri Lanka is caught in a difficult dilemma. On one hand, its private sector is weak, undynamic and unorganized, composed of thousands of small cottage industries and a few large urban businesses, the latter mostly involved in trade and services. On the other hand, the ultimate success of the government's economic program is heavily dependent on how effective it is in motivating and facilitating the development of private sector activity in priority growth areas. In short, the government cannot begin to attain its objectives without major transformation of the behavior and capacity of the private sector to invest, produce, and market.

B. PRINCIPAL CONCLUSIONS OF THE STUDY

1. Sri Lanka's current investment climate is not yet fully conducive to rapid growth of investment by the private sector in the country's natural resource, production-based sectors.

To encourage investment and production in high priority resource sectors (that are higher-risk, long-gestation investments by nature), investor confidence in the economy and its management must be strong. Within Sri Lanka's private sector today, there is a perceptible lack of such confidence in the government's development policies, its management of the economy, and its genuine support of the private sector. Investors remain generally reluctant to place major capital resources at risk, for fear of unpredictable shifts in government policies and orientation. The experience over the previous 20 years has created a deep-seated skepticism and defensive posture on the part of the private entrepreneur. The perception remains strong within the private sector that the rank and file of the government does not share the political leadership's pro-private sector convictions but retains the "anti-profit" bias of previous governments.

The issue of confidence is not limited to the private sector. Within the public sector, there is the perception that Sri Lanka's private sector is undynamic, risk-averse, non-innovative, often "profiteering", and dominated mainly by conservative family firms and tiny cottage industries. The public sector frequently views private entrepreneurs as having little sense of responsibility toward the nation's broader economic interests or its labor force.

Symptomatic of this impasse is the lack of constructive communication between the public and private sectors. There is little formal discussion between the two sides on economic objectives, the problems facing development, and possible solutions acceptable to all. As a result, the strong national consensus needed for rapid economic growth is yet to be achieved.

Given Sri Lanka's limited capital resources and low level of economic development, it needs maximum cohesion and coordination between the government and the private sector. A national economic "partnership" should be sought to integrate the private sector more fully into the country's economic development and raise its level of consciousness of its own responsibilities and potential. The product of this partnership should be an indicative development strategy that identifies priority areas of development, respective roles for public and private sectors, and policies and programs needed to reach those goals.

2. Sri Lanka's economic growth policies and objectives still lack a strong sense of direction.

Within the private sector, there is confusion concerning the direction of the country's economic growth. Government declarations, policies, and programs are seen either as conflicting or subject to frequent change. The "steady-hand" of a clear national development strategy needed to guide government economic management and private sector investment is missing. While the government's economic philosophy and orientation have been stated, the implementation and coordination of its policies have not been part of an effective management process.

The government's present effort at defining the course of the nation's economy is confined largely to the Public Investment Program. While the Program gives useful indication of government funding priorities, it gives little guidance to the private sector in terms of priority areas and supporting measures and programs. In the formulation of this program, the private sector is not formally consulted. Consequently, the program has little influence on private investment decisions. Similarly, the Public Investment Program contains no mechanism to coordinate or integrate the government's multiple policies and programs.

3. <u>There is lingering uncertainty within the private sector whether the government will give private investments basic minimum legal protection from future nationalization or fully guarantee the proper functioning of a free market economy.</u>

The "liberalization" process since 1977 has gone far in dismantling the regimented, state-controlled economy of the previous years. Similarly, the government's recent actions to place several state corporations on an equal competitive footing with private companies demonstrates major progress toward creating a competitive free market.

Despite this progress, private investors express hesitation on two issues. First, they question what protection or legal recourse is available to them to protect their investments from possible takeover by future governments. Second, they note the lack of mechanisms to prevent unfair trading practices from occurring, such as a formal appeals system through which trade disputes can be adjudicated in a fair and just manner.

Despite government declarations that it abides by a free market philosophy, private entrepreneurs tend to be skeptical, believing that these assurances will remain verbal but not enforced by concrete legal or administrative actions. Although more symbolic than real under the current government, the continued existence of the 1971 Business Acquisitions Act illustrates the precarious nature of long-term investments in resource-based sectors. In the investor's view, different leadership or future governments might resort to use of the Act again depending on the political interpretation of what is in the "national interest". Entrepreneurs interested in potential investment and production in politically sensitive resource areas such as agriculture and agro-based industries are especially uncertain about long-term investment security.

While the government has made a strong verbal commitment to a free, competitive market, private entrepreneurs are quick to note that existing agencies and regulations are designed to protect the consumer, not the producer, from unfair trade practices. No strong government action has yet been taken to institutionalize safeguards which prohibit unfair trade practices among producers, whether private, public or foreign.

Private entrepreneurs remain uncertain as to the future role of the state corporations in a free market economy. The government has already taken action to place several state corporations on an equal competitive footing with the private sector. Nevertheless, the fact that the public sector accounts for half of the nation's industrial output means that the actions of many state corporations have a controlling influence on individual sectors. New entries into the economy of existing production or expansion by private entrepreneurs in those sectors dominated by larger state corporations will depend on the entrepreneur's assessment of how the behavior of these corporations will affect his own fortunes. Entrepreneurs therefore need to know who their state-owned competitors will be and under what rules they will compete. In short, the government should define and declare the state's future role in the economy as a part of its overall development strategy.

4. <u>Serious resource constraints inhibit the ability of the private entrepreneur to undertake new investments in higher risk ventures.</u>

Most entrepreneurs are faced with three types of "resource" barriers apart from the problems of physical infrastructure, namely, finance, management personnel, and information.

The most immediate of these resource constraints is equity and working capital. The high cost of capital, due in large part to the government's deficit financing requirements, has excluded many investors from financing profitable ventures. Apart from its cost, the difficult access to capital, because of the banking system's unusually stringent requirements for collateral and documentation, also discourages borrowing except by the larger, wealthier, and better-known borrowers.

A development banking system and concessionary development financing are in place in Sri Lanka. In practice, however, the banks administering these programs tend to operate as conservative commercial banks rather than as institutions designed to actively promote and develop high priority ventures.

Appropriately trained managerial talent at all levels of private enterprise is severely lacking. Progress has been made by the government in creating institutions to help meet these needs, but more flexible, practical, problem-solving training is required to complement existing programs.

Finally, the weakness in the collection and interpretation of information, particularly market and investment data, continues to isolate much of Sri Lanka's private sector from commercial opportunities. The marketing tradition in Sri Lanka is weak and there are few institutions to collect, organize, and interpret information that can be used by all participants in the economy.

5. <u>Sri Lanka's agriculture-based economy affords a large number of private sector investment opportunities in agro-processing activities and related industrial production. However, many of these opportunities are constrained by current government policies or lack of basic infrastructure.</u>

Seven subsectors were surveyed to produce profiles of possible opportunities as well as to recommend product areas for prefeasibility studies. In several cases, however, expansion of production, processing, or marketing is severly limited by government policies, among which are the following examples:

- Agro-industries (dairy, coconut products, fruits and vegetables, and fisheries).
  - Producer prices too low to stimulate local production.
  - Land policy too restrictive to permit production economies of scale.
  - Import duties raising cost of essential inputs.
  - Imports sold in Sri Lanka at dumped prices.
  - Inadequate market information facilities.
  - Inadequate capital investment in collection, processing, or marketing systems.
  - Absence of sectoral development plans.
- Industrial production (rubber-based products, light engineering).
  - A protective tariff system which penalizes exports and often favors highly import-dependent industries.
  - No anti-dumping laws to protect local producers from artificially low pricing of imports.
  - Onerous import duties on inputs of essential raw materials and capital equipment.

6. In the seven resource-based sectors surveyed, several opportunities emerged which should be studied further by the government and the private sector.

The opportunities surveyed were selected on the basis of how well they satisfied the following criteria:

- Commercial viability
- Development of resource-based industries
- Foreign exchange earnings (or savings)
- Employment generation
- Linkage with other sectors or industries
- Rural and regional development.

a. Agro-Based Industries and Fisheries

Fruits and Vegetables

- Production of seed for fruits and vegetables and multiplication of seedlings for non traditional and exportable varieties.
- Processing of the Jaffna mango for domestic and export markets.
- Fruit processing and packing operations at community level.
- Joint ventures between producers, processors, and marketers.
- Joint ventures between fruit and vegetable exporters and an airline service for air transport to foreign markets.

Coconut Based Products

- Industrial processing of coconuts into coconut milk.
- Industrial processing of green coconut husks into white fiber or coconut yarn.
- Refining and packaging of coconut oil.

Dairy Products

- Milk collection systems.
- Commercial dairy herds.
- Small-scale regional multiproduct dairy processing plants.
- Ice cream production plants.
- Spray drying plants.

Fisheries

- Prawn (shrimp) mariculture for export.

b. Manufacturing and Minerals Processing

Rubber-Based Products

- Medical and health care related rubber products.
- Natural rubber composite products.
- Speciality rubbers and polymers.

Light Engineering Industries Related to Agriculture

- Small diesel engines.
- Small four-wheel tractors.
- Mold board plows/unibar ridger for animal draft and two wheel tractors.
- Hand pushed seed drill, granular spreader, or fertilizer applicators.
- Portable sprayers/applicators.
- Transportable winnowers, threshers/reapers.
- Bottling and packing.
- River and shallow water pumps

Minerals Processing

- Carbon Refractories - upgrading of graphite to flake.
- Titanium Dioxides from mineral sands.

C. RECOMMENDED PUBLIC AND PRIVATE SECTOR ACTIONS

1. The government should develop a broad policy dialogue with the private sector to help create a consensus on how best to develop Sri Lanka's resource-based economy.

To move the country along a strong growth path, a united and coordinated effort between the public and private sectors is essential, as demonstrated by other rapidly growing Asian countries. In order to set realistic and achievable goals, the government needs to consult the private sector in the formulation of development targets and the implementation of programs. A private sector Economic Development Advisory Council should be established, formally recognized by the President, and reporting periodically to him and the Development Ministers and Secretaries.

The Council should be composed of senior representatives of all segments of Sri Lanka's private sector, encompassing private sector activities, large and small, rural and urban, agricultural and industrial, and including all ethnic groups. The Advisory Council should become not only the nucleus organization for a national "economic partnership" with the government but be a source of cohesion within the private sector. The Council must be supported by a highly qualified secretariat to act as a professional policy analysis body on strategy and options for Sri Lanka's development. Specific task forces would be established by the Advisory Council to study sectoral policies, recommend adjustments, identify new opportunities, and propose private-public sector cooperation.

2. A medium- and long-term National Economic Development Strategy should be formulated to coordinate the government's economic development policies and programs and guide private sector development.

A National Economic Development Strategy should be formulated to define the following:

- Broad economic objectives of the country over the next 15-20 years.
- Priority sectors and subsectors on which Sri Lanka's long-term growth will be based.
- Government policies and programs that will be implemented to achieve these targets.
- Mechanisms for coordinating government programs and policies, defining responsibility and accountability of each institution.
- Benchmarks for measuring progress and mechanisms for taking corrective actions when performance falls short of goals.
- Role of the private sector and the state corporations in production, processing, manufacturing, and marketing.
- Guidelines where private investment is encouraged and supported.
- Guidelines for foreign investment in individual sectors.

3. Concrete actions should be taken to establish a favorable investment climate for encouraging the private sector to launch long-term ventures in priority sectors.

The government should consider measures giving appropriate legal protection to private investors from arbitrary administrative or political decisions affecting their investments or property. Serious consideration should be given to granting private investors constitutional or legal assurances that future governments must show substantial "just cause" for any takeover of private investments.

The functioning of a free market should be enforced through strong fair trade laws affecting pricing, restrictive practices, abuse of monopolistic positions, etc. Consideration should be given to establishing a Fair Trade Commission to defend the interests of producers. This Commission could act as a form of "ombudsman", providing for an independent appeals system and overseeing the proper functioning of the free market.

Finally, the government should rationalize and reorder the role of the state corporations so as to indicate to the private sector the relative positions private companies and state corporations will play in the economy. A strategy for transforming the state corporations should be openly discussed and declared. At a minimum the public should be informed of the status to be imposed on the corporations in the future, such as:

- State corporations or plantations whose assets should remain part of the national patrimony but whose management may be contracted out to private concerns, foreign or domestic.
- State corporations which will be put on equal footing with the private sector and forced to compete under the same conditions or else be liquidated.
- State corporations whose assets will be sold off, partly or totally, to private investors.
- State corporations which will remain under state management and be subject to special market conditions.

4. <u>The government should take direct action to channel development capital into private sector ventures in high priority resource-based sectors and to stimulate the development of private or cooperative banks in rural areas.</u>

Sri Lanka has the necessary institutions in place to direct long-term capital into high priority investments. Consideration should be given to altering the National Development Bank's mandate and its performance standards. Its portfolio should be invested in the high priority sectors identified in the National Economic Development Strategy and in enterprises primarily within the private sector. When necessary, the NDB's resources could be further enlarged by new funding from government-controlled institutions and state-owned banks.

In support of its project finance role, the NDB should offer services to private borrowers through assistance in defining appropriate projects, brokering individual ventures, and sometimes taking direct equity positions. The NDB should be an investment promotion body as well as a bank, supporting the priorities of the Development Strategy. The Bank should develop close working links with the private sector.

The government must address the urgent need for rural credit to support new and expanded agricultural production, collection, and processing. Support must be given to locally-based regional and/or producer cooperatives and small private banks serving the needs of small producers in the countryside. Consideration should be given to requiring the state-owned commercial banks to lend a percentage of their portfolios to these rural banks that are in a better position to administer and recover loans to small borrowers.

5. Sector policies in agriculture, fisheries, industry, and minerals must be aimed at providing greater returns to producers and improved infrastructure for processing and marketing.

Processing industries in the agro-based sectors have not advanced greatly despite their substantial potential for both the private entrepreneur and national development. In several product areas, e.g., dairy, coconut, etc., processing industries have been unable to develop because of low levels of production. This low output is due largely to price levels which do not cover the costs of production. In other areas (such as fruits and vegetables, prawn mariculture, etc.) land policies may prevent the proper minimum scale of production. Export taxes and import duties also tend to penalize the development of these transformation industries by seriously reducing the profit margins needed to induce new production and investment.

In industrial production, the structure of protection and incentives needs to be reformed. Anti-dumping laws are required to reduce unfair competition for local producers. Import duties on critical imported inputs must be reconsidered as well as quality standards which apply to local goods but not to imports.

In the context of the National Economic Development Strategy, the country must undertake a fundamental reexamination of its incentive systems offered to producers and processors. To induce growth in these sectors, policies must allow producer and processor to make satisfactory profits. Physical infrastructure development, as well as collection and marketing systems, must be promoted to remove current bottlenecks and the inefficiencies due to costly, unproductive middlemen.

6. <u>The private sector should undertake several important initiatives to advance its own interests as well as to support the objectives of a National Economic Development Strategy.</u>

The private sector should consider several initiatives of its own, with or without external support. Three areas of activity appear particularly necessary:

- The private sector must begin to develop a greater self-awareness as well as a sense of responsibility to the nation's economic development. It must seek to play a constructive partnership role with government. As a point of departure, it must be able to represent its views effectively to the public and the government. A new Economic Development Advisory Council should initiate this effort with the support of a strong technical secretariat. Specialized task forces should be appointed to study policy issues and discuss problems with the government in search of constructive solutions.

- The Advisory Council should also take the initiative of studying the needs of the private sector in the area of investment and marketing information. It should consider the creation of an Investment and Marketing Center. A professional staff with marketing and investment expertise is needed to collect and interpret domestic and international marketing data. General information services would be provided as well as specific advice on investment opportunities. The Center should operate as an investment catalyst in resource sectors and offer assistance in dealing with government agencies and financial institutions
- To meet the specific and growing managerial needs of private firms, the Advisory Council should take the initiative in establishing a Management Development Center, responsible for both training and management consulting services available to all members of the private sector. These programs should be designed to give diversified, problem-solving training to private companies. The organization created to administer these programs should have a degree of "marketing" responsibility to demonstrate to private sector firms the importance of training and management advisory services.

7. <u>Existing export promotion and foreign investment encouragement programs should be strengthened and focused more selectively on high priority sectors and product areas.</u>

The current programs of the Export Development Board (EDB) and the Foreign Investment Advisory Committee (FIAC) are moving in the right direction, but require more defined, concentrated focus.

The EDB should concentrate less on supplementing the profitability of exports, and more on opening up markets for Sri Lankan products. Export trading companies or other forms of marketing assistance, assisted by EDB, is an urgent requirement to break through the international marketing barrier which confronts the great majority of Sri Lankan firms. Emphasis throughout should be placed mainly on high value-added exports. The concept and approach to establishing a trading company should be studied.

The foreign investment program (outside the Investment Promotion Zone) should be handled by a one-stop Foreign Investment Authority (transformed from the present FIAC) which centralizes and simplifies the procedures required for setting up joint ventures between foreign investors and local Sri Lankan partners. Current regulations governing maximum foreign ownership should be liberalized to permit majority foreign ownership in approved sectors. The exact percentage of foreign ownership could be pegged to such factors as the nature of technology transferred, manpower training programs, percentage of production exported, use of local raw materials, and total capital imported.

SUMMARY OF PRINCIPAL RECOMMENDATIONS

I. Giving direction to the nation's economic development.

1. Formation of a private sector Economic Development Advisory Council to meet at regular intervals with the President and the Development Ministers and Secretaries.
2. Formulation of a National Economic Development Strategy.

II. Developing the proper environment for a free, competitive economy.

3. Legal protection to private investors from nationalization of property.
4. Establishment of a Fair Trade Commission to formulate and enforce free market rules.
5. Formulation of strategy for rationalizing the role of state corporations in the economy.

III. Strengthening sector development policies.

6. Review of producer prices in such areas as milk, coconuts, etc. to determine how best to increase local production.
7. Review of export taxes and import duties on priority sectors to determine their impacts on returns to producers.
8. Adaptation of tariff protection program to give favored protection to high priority and exporting industries.
9. Revision of fiscal incentives, when possible, to give strong but selective encouragement to high priority development sectors.

IV. Resolving major resource constraints.

10. Reorientation of National Development Bank to channel long-term credit into priority sectors.
11. Promotion of private and/or cooperative banks in rural areas.
12. Formation of a Management Development Center under private sector direction for specialized management training and technical assistance.
13. Formation of Investment and Marketing Center under private sector management to serve as an information center for investment and marketing opportunities.

V. Strengthening and focusing promotion and incentive programs.

14. Reinforcement of Export Development Board programs in the marketing area to break through the marketing barrier for Sri Lankan producers.
15. Formation of strong, centralized Foreign Investment Authority administering a more liberal and streamlined system to encourage foreign investment.

CHAPTER 2

ECONOMIC BACKGROUND

A. HISTORICAL LEGACIES

At the time of its independence from British colonial rule in 1948, Ceylon, as Sri Lanka was known until 1971, enjoyed a higher per capita income than any other Asian country after Japan, exceeding that of Malaysia, the Philippines, and Indonesia. By 1980, Sri Lanka ranked among the 20 poorest countries of the world by the same standard. Its 1982 per capita income was US$285 compared with approximately US$1,850 for Malaysia, whose population and natural resources bear ressemblance to those of Sri Lanka.

This poor performance is especially disappointing in view of the fact that Sri Lanka's natural resource base (with the exception of its lack of petroleum reserves) is comparable to that of several Southeast Asian countries that have achieved high growth rates in recent years. Furthermore, the level of public education of its population has been distinctly higher than these same nations.

Sri Lanka's political and economic history from 1947 to 1977 took a distinctly different course from that of the ASEAN countries. Since its independence, the nation has maintained a strong commmitment to a democratic, non-authoritarian, form of government and has experienced frequent and often dramatic alternations of power. Sri Lanka's success in maintaining a functioning democratic system has had its costs in terms of consistent, coherent economic management. Successive governments have sought to build the island's economy on the basis of strong economic and social protection of the consuming public. To assure the welfare of its constituents, the government introduced and expanded a variety of subsidies for basic commodities and brought in social programs of free, universal health care and education.

Ceylon's strong agricultural base in tree crops, namely tea, rubber, and coconut, on which the British had built a thriving plantation system, led the country's new leaders into the fallacy of believing that the productive plantation sector could subsidize indefinitely this welfare system designed for the good of the population as a whole. Neglected in the concern for the well-being of consumers was a strategy to assure the well-being of producers.

This original pattern of Sri Lanka's economic policies not only continued but intensified over the years. Governments became increasingly populist, culminating in the mid-1970s with massive nationalization of private agricultural and industrial holdings, ostensibly for social and economic purposes, but also for political reasons. The effect was not only to destroy the equity base of much of the private sector, but to sow a legacy of deep mistrust of the government's commitment to a free, private economy.

The increasing numbers of state corporations in virtually all sectors of the economy further distorted efforts to achieve an efficient economic structure. The state corporations became safety valves for the nation's unemployment problems and, perhaps more importantly, a valuable source of political patronage for the government. The inefficient operation of the corporations complicated the worsening public deficit. Their monopolistic or quasi-monopolistic position in various sectors, operating outside the rules of a free market economy, discouraged new entries by private companies whose fortunes could be affected by the unpredictable nonmarket behavior of the corporations which enjoyed automatic funding from the public treasury, many duty free imports of foreign equipment, and exemption from corporate and personal income taxes.

The result was an increasingly inefficient and financially burdensome public sector and a private sector which had either retreated into safe investments such as trading and services or else remained at the small cottage industry level.

B. MAIN FEATURES OF SRI LANKA'S ECONOMIC GROWTH

Sri Lanka is a relatively rich agricultural area. In spite of its small size, its potential for food self-sufficiency and food and fiber exports is substantial. The plantation economy introduced by the British was evidence that the agricultural wealth of the country could be exploited if well organized. Those plantation commodities provide the backbone of Sri Lanka's economy even to the present day.

With the stagnation of Sri Lanka's economic growth, attention has been turned to areas other than the traditional tree crops and paddy as a means of expanding and developing the country's productive economic base. The Mahaweli project, which began in 1977, is the new factor intended to bring into production large land areas in the island's dry zone. The development opens up vast new opportunities and places even greater emphasis on the agricultural sector as the basis of Sri Lanka's economic future.

Sri Lanka's economic policies in the past had been largely oriented toward import substitution to the point that the nation had become a haven for the inefficient producer, in public and private sectors alike. Excessive protection through tariffs, licensing, and other barriers led to a serious misallocation of resources over time. When the barriers were reduced in 1977 and pent-up domestic demand for low cost, higher quality products was unleashed, Sri Lankan industry had no means to compete with the international market and many bankruptcies ensued primarily among inefficient industries which had been overprotected for many years. Demands for tariff protection were again made and some restoration of former protective barriers occurred.

However, the policy shift in 1977 signaled a long overdue retreat from the costly import substitution policies of the past and a reorientation toward export-led growth. The protective tariff system has been slow to implement this strategy and recent studies by the World Bank and the Presidential Tariff Commission confirm a distinctly anti-export bias in the effective rates of protection granted to Sri Lankan industry.

Apart from the government's emphasis on export-led growth, it has simultaneously opened up its borders to foreign investment and has sought to actively encourage it. Foreign investment is seen as the element of "new blood" needed by the country to push it onto a higher growth path with injections of foreign capital, technology, and management skills. Equally important is the access to foreign markets afforded by overseas investors.

The showpiece of the government's foreign investment push has been the Investment Promotion Zone (IPZ) administered by the Greater Colombo Economic Commission. The IPZ, or free zone, has been a forceful effort to attract foreign manufacturing operations with generous incentives and the right to 100% foreign ownership. The progress of the free zone has been impressive although investments have been mainly in the garment industry. The IPZ has, and should continue to have, a major and favorable impact on Sri Lanka's foreign exchange earnings and employment in the Greater Colombo region.

There are, however, clear limitations to the IPZ's impacts on the overall economic development of the country. First, with 100% foreign ownership permitted, spill-over and spin-off effects on the indigenous private sector are restricted. Second, the value added to local production is limited because of the high import content of most of the IPZ's production. Third, the backward linkages of IPZ operations into the rural areas of the island, where 75% of the population resides, are equally limited.

More strategic for the long-term development of the economy are foreign investments made on the basis of joint ventures with Sri Lankan partners outside the IPZ. While the incentives for the foreign investor are less generous than in the zone, the focus of these investments is on achieving maximum benefit for local companies and the maximum value added to local production.

C. ECONOMIC "PLANNING" IN SRI LANKA

Economic management and planning in Sri Lanka has had a difficult history, largely as a result of the substantial swings in the political pendulum. Efforts to devise "plans" in the past have been overturned by succeeding governments or political leaders. The experience with the so-called "planned" economy of the 1971-1977 period, however, discredited the idea of planning that to this day tends to be looked upon with decided skepticism.

Substituting for a plan is the government's medium-term "Public Investment Program", a five-year rolling program which makes annual projections of economic growth by sector and designates areas where public investment funding will flow. The Public Investment Program falls far short of being an integrated indicative planning mechanism by which all government policies and public sector programs are coordinated and from which private entrepreneurs, banks, and other non-government institutions can take cues as to where the economy is moving and what priority development areas are.

However, the Public Investment Program offers a point of departure in this direction. It is an effort to indicate where emphasis should be placed in future economic development. It projects sector growth rates, although on the basis of current trends rather than desired targets. The entity responsible for the Program, the National Planning Division in the Ministry of Finance and Planning, is making efforts to promote and work closely with planning offices in other ministries. Some ad hoc consultation with private sector groups take place at these levels although this interaction is not formalized.

Nevertheless, there appears to be a growing realization within the government that good economic management must be based on sound planning. The limitation of Sri Lanka's resources and the urgency of its problems of employment and economic growth have begun to impress upon many public officials the need for more rational, orderly, and efficient allocation of resources.

CHAPTER 3

THE ENVIRONMENT FOR DEVELOPING THE PRIVATE SECTOR IN SRI LANKA

A. BACKGROUND

Rapid growth in a free market economy results from a complex combination of factors. Some of these factors may relate to the economy's resource base, stemming from the existence of abundant natural resources, financial capital, and labor. Other factors may be related to skilled organization and management both at the public and private sector level. However, probably most critical of all to the growth process is the investment climate. The lexicon of free market economies refers repeatedly to investor 'confidence', rising or falling 'expectations', investor or consumer 'perceptions', 'security' of investment, 'risk' and 'stability'.

A buoyant free economy is built on the foundation of long-term investor confidence. Entrepreneurs, large and small, by nature search for opportunities to produce and create wealth. Acting out of self-interest, the skillful investor, whether in a cottage industry or a large company, carefully assesses opportunities, the risks confronting these investments, and their ultimate payout. Trying to maximize his profit, he naturally seeks to reduce his production costs, thereby evolving toward greater efficiency in his operations.

To create this favorable environment for sustained private sector initiative, there must exist certainty among investors that they are free to invest and make profits without arbitrary, unforeseen interference from public authorities. Confidence must exist that the rules of free market competition are respected, enforced, and applied to all participants, public, private, and foreign alike. Similarly, the investor needs to have the assurance of a stable regulatory environment in which he can plan his production, investment, and marketing programs over the long-run.

Since 1977 the government of Sri Lanka has declared its intention of creating such a free market economy in which the private sector can grow rapidly and become a source of creative energy in the nation's economic development. This objective does not spring from any dogmatic, ideological conviction of the country's current leaders but from the practical lessons learned from Sri Lanka's past experiments with a state-directed economy.

The legacies of the past, however, continue to weigh heavily on the present environment. Sri Lanka's market economy was badly shattered in the 1970s. Investor confidence in the government and the economy was destroyed. Private capital that was not seized in the wave of nationalization retreated into safer investments which has contributed little to the development of the country's resources and the employment of labor.

B. REBUILDING THE PRIVATE SECTOR ENVIRONMENT

To realize its design for an economy in which private initiative becomes the driving force, the government must rebuild public confidence in the economy and itself through steady, concrete steps. This confidence factor is more critical than whatever the government may offer in the form of financial and fiscal incentives.

The indispensable first step must be through developing dialogue and cooperation between the public and private sectors. It is common in rapidly growing economies such as those of Malaysia, Singapore, Taiwan, Korea, and Japan to see a strong concensus developed around economic objectives, reinforced by public-private sector cooperation at several levels. The situation in Sri Lanka stands in stark contrast with these other models.

Within much of the public sector (namely, government agencies and state corporations) the private sector is seen as dormant, non-innovative, risk-averse, not growth-oriented, and characterized by inward looking family-owned operations and interlocking directorates. Moreover, these public sector observers typically see private sector investment flowing mainly into short-term trading or service operations where handsome profits on invested capital can be quickly recovered.

Within the private sector, there is the perception that while the President and principal ministers may be genuinely favorable to developing the private sector, the rank and file of the bureaucracy and the state corporations remain hostile to a free market economy in which the private sector is a major force. Bureaucratic red tape, procedural barriers, and administrative delays are seen as indications that the civil service not only has little interest in supporting the government's stated policies to favor the private sector but also wishes to complicate the simplest procedures which the private company must follow.

Private sector observers see the state corporations as inefficient organizations that could never survive in a fully free market environment. Even despite their artificially low cost structures in the past, they still managed to incur heavy losses which had to be met by the Treasury. Despite the inefficiency of the state corporations, private entrepreneurs have nevertheless been unwilling to enter many of the sectors dominated by these corporations because of the latter's nonmarket behavior.

While the above perceptions may represent extreme poles of opinion surveyed in the study, the lesson that emerges is the lack of solidarity or understanding between Sri Lanka's private and public sectors. There appears to be no effective forum in which public and private sectors can discuss the issues confronting the economy and how the country can emerge from this impasse.

There are several issues in particular which partially explain the private sector's perceived 'conservatism' or 'lack of dynamism' with respect to its investment behavior:

- The security of long-term investments in natural resource-based sectors.

- The design and enforcement of a genuine free, competitive market.
- The dominance of the state corporations in individual sectors.

- <u>The Issue of Investment Security</u>.

To carry out its economic program in the 1970s, the former government passed the Business Undertakings (Acquisition) Act in 1971. The Act was used repeatedly to acquire existing private property either for state control or for land redistribution to landless farmers. Large private plantations as well as large and medium size industries were summarily nationalized under the Act. Provisions of the Act permit the government to acquire the property first, and then negotiate compensation with the former owners. Even today compensation for a large portion of the confiscated properties has still not been settled.

Although the Business Acquisitions Act symbolizes an economic philosophy that has been openly rejected by the current government, no action has been taken to rescind this legislation. Observers in the private sector are quick to point out (1) that the Act has actually been used on occasion by the current government for other purposes, and (2) there is nothing preventing the current or future governments from using the Act to acquire private property if the government interprets that such property is in the 'national interest'.

The apparent indifference or unwillingness of the government to annul this legislation transmits negative signals to a private sector still bearing the scars of past confiscations of equity. This sensitivity is particularly acute in resource-based industries where long-term, higher-risk investments would be required in land development or processing of natural resources. Past nationalizations occurred heavily in the sectors that were defined as part of the national patrimony. Investments in land or resource-related areas, therefore, tend to be politically sensitive and hence more precarious from the investors viewpoint.

In order to encourage foreign private investment in Sri Lanka, the government has provided constitutional protection to foreign investors covered by so-called Investment Protection Agreements. Article 157 of the Constitution provides protection against legislative, executive or administrative action which place such investments in jeopardy. The government correctly judged that to encourage foreign investors into Sri Lanka, firm legal guarantees had to be offered.

The same logic should be expected to apply to motivating domestic investors, particularly in view of recent history and the continued existence of the Business Acquisitions Act. Reasonable legal protection against arbitrary political and administrative seizure of private property without due process of law should lie at the base of a private sector development program.

- The Free Market Economy

For many years, Sri Lanka's economy was essentially state-controlled, regulated by bureaucratic fiat. In 1977, the new government based its policies on "liberalization" of the economy and the creation of a genuine competitive market. Exceptional progress has been made in dismantling the regulatory structure which had previously existed. One of the last major obstacles to be overcome is the favored status granted to the state corporations.

In recent months, the government has begun to take the first significant actions to place state corporations on the same competitive footing as private enterprises by denying them duty free entry of imported components and subjecting state corporations to corporate taxes. Furthermore, many corporations have been informed that they will have to compete for finance on the financial markets just as any private company would. This process has only recently begun but it signals the government's intention to move toward more genuinely competitive markets.

Apart from requiring state corporations to compete on exactly the same terms as private companies, the long-term issue is how to "institutionalize" the government's commitment to a free market. Private sector observers point out that consumer interests are well protected (through the Department of Internal Trade and the National Price Commission) but no similar organization exists to defend producer interests. There is no body of legislation which establishes the standards of the free market or provides for an appeals system by which producers can draw attention to and seek remedies for unfair trade practices such as price fixing, dumping, abuse of market dominance, etc.

- State Corporations and the Private Sector

Although politically there remains a large constituency for the state corporations both for ideological and employment reasons, the trend in the current government is gradually to rationalize the state corporate structure. There is growing recognition that a dominant state sector is incompatible in practice with a growing free economy. There are, furthermore, heavy economic and financial costs involved in maintaining this state corporate apparatus.

First, the inefficiency of the state corporations translates into substantial deficits for the corporations and the public treasury. Resources within the corporations are therefore not available for streamlining operations or seizing new opportunities.

Second, the lack of genuine market-oriented growth of the state corporations means that they are not naturally creating new employment opportunities. Their employees remain redundant, earning wages which are too low to stimulate higher productivity or personal motivation to perform better. Incentives are totally lacking to act in a market-oriented manner.

Third, at the level of top management, managers do not feel the same pressures on their performance. Consistent failure to yield a profit or meet a growth target is not met by dismissal or demotion. Bankruptcy is impossible. Top managers are frequently chosen on the basis of political patronage, not on the basis of technical or business management skills.

Properly, the government has begun to recognize the high costs of maintaining a large network of state corporations as well as to question the wisdom of playing the role of entrepreneur and producer in a free market economy. The implications of reform of this structure for the economy as a whole and for the private sector in particular are far reaching. Placing the corporations on a free market footing, either as continued state-owned corporations or as "privatized" companies, will alter the performance of these companies substantially. "Privatization" of assets of many of the present corporations or "management contracts" to private entrepreneurs will offer the private sector important opportunities for expansion into existing sectors.

Needed, however, is a strategy for this transformation. To this end, the government needs to establish criteria for designating those state corporations whose assets should be sold off to private entrepreneurs as well as those corporations whose management should be contracted out to private managers. Other corporations should be put in a "sink or swim" situation to allow their performance to determine their future status.

- <u>Investment Incentives to Stimulate Private Sector Activity</u>

Sri Lanka is currently working its way through a severe fiscal crisis characterized by high budgetary deficits, a critical balance of payments situation, and a declining real value of the rupee. As a result, the government's "crisis management" has had little choice but to grant top priority to the problem of revenue generation. The heavy capital and operating expenditures associated with the Mahaweli Development Program, the Urban Housing Project, and until recently the Investment Promotion Zone, in addition to Sri Lanka's heavy social overhead expenses, have forced the country to temporarily divert its attention from other long-term development priorities. Until those deficits are brought into greater control over the next two or three years, major shifts away from this revenue orientation cannot realistically be expected.

Fiscal policy is clearly one of any government's leading tools for stimulating development and channeling resources into desired areas. Sri Lanka has made substantial and successful use of tax incentives since 1977. In fact, until the Budget Speech in March 1983, when the government saw itself forced by circumstances to rescind many of these incentives, the tax regime was favorable for many investment areas. These incentives have traditionally taken the form of tax holidays in Sri Lanka, but also included exemption of taxes on dividends and capital gains, exemption from turnover taxes, and various forms of relief for investments.

Until March 31, 1983, tax holidays were granted in such areas as hotels, housing, and urban development, agriculture, animal husbandry, fishing, export industries, and small scale and "pioneering" industries. These holidays varied from five to ten years. With the exception of export profits which are permitted a five-year holiday, these holidays have been eliminated. The greatest benefit of these incentives was to the hotel and construction industries which were able to make profitable use of these fiscal advantages.

The nondiscriminatory, across-the-board treatment of industries as widely different as hotels on one hand and agriculture, fishing, and small scale manufacture on the other reflects a pattern which appears typical of many policies, namely the lack of sectoral priorities in formulating incentives. Investments in hotel industries, for example, have been low risk investments for which substantial public and private capital has been available. While these industries may have an immediate foreign exchange impact, their longer-term contribution to the island's development is far more limited. With little natural resource development and a modest employment impact, their priority in the nation's growth strategy should be low.

In contrast, attracting capital into resource-based investments (in agriculture, livestock, fishing, minerals processing, light engineering, etc.) is harder because of the higher risk, longer gestation, and therefore longer pay-out periods. If these industries are deemed to be priority areas for private sector investment, then differentiation must be made in the provision of fiscal and other incentives.

Other aspects of current tax policy show a similar lack of coherence. The prime example is the application of the business turnover tax (BTT). The BTT is levied on the sale of most products and services and is one of the government's leading revenue instruments. Curiously, in Sri Lanka the BTT is also applied to imports at the point of entry and to financial transactions. In the case of imports, for example, the BTT is applied to imported inputs which are also subject to import duties. For inputs used in the production of goods to be reexported, there is an import duty rebate. However, the effects of this rebate are virtually nullified by the BTT, thereby defeating the purpose of the rebate scheme for exporters.

CHAPTER 4

THE FINANCIAL ENVIRONMENT FOR THE PRIVATE SECTOR

A. INTRODUCTION

An ample supply of capital is required to develop the productive sectors of Sri Lanka's economy. This capital must be available in the forms of debt and equity and be usable by the private sector for periods of time greater than five years.

Many projects which should be of high priority for the country's development will have little or no trouble attracting capital. However, in Sri Lanka's developmental context, it is likely that many sectors and projects of importance to the long-term development of the country will have commercial characteristics or capital requirements which make them unable to attract capital from private sector suppliers, such as commercial banks or share markets.

Projects in this category are not necessarily "bad projects"; the fact that they are not desired for a commercial banker's portfolio is not evidence of a lack of viability. On the contrary, they may merely require a special consideration, such as (a) more time to repay a loan than conventional sources usually allow, or (b) greater leverage than is typically allowed. The structure of Sri Lanka's financial intermediation system and the methods by which its biggest members operate may make granting such concessions difficult. As a result, the distribution of capital to projects vital to the country's development may suffer.

Sri Lanka's principal financial intermediaries have evolved into institutions which are either government-owned (Bank of Ceylon, Peoples Bank, the insurance corporations, Employees' Provident and Trust Fund, National Savings Bank, National Development Bank) or government-controlled, e.g., the Development Finance Corporation of Ceylon. With the possible exceptions of the NDB and DFCC, these institutions appear to be largely unsympathetic to the long-term capital needs for development of private sector enterprise. For example, the portfolios of the commercial banks, which control 75% of Gross Domestic Credit, are dominated by short-term, secured lending. At June 30, 1982, fully 90.8% of all commercial bank assets had original final maturities of less than three years. Nor do the National Savings Bank, employees' pension funds, and the insurance companies fill this gap. Since the funds of these institutions are almost entirely (90% and above) invested in government securities, private sector entrepreneurs cannot look to these specialized institutions for the development capital they need.

B. THE SUPPLY OF DEVELOPMENT FINANCE

To address the need for longer-term development capital, the government has adopted a two-pronged policy. First, it has sought to induce the commercial and development banks' cooperation through the provision of refinance at rates below the market level for certain types of transactions. The government has also expanded the supply of long-term debt finance through the import of development capital from offshore sources, e.g., the World Bank and Asian Development Bank, through refinancing facilities and direct loans. Today, a very large percentage of the total supply of development finance in Sri Lanka is raised through these refinance facilities. Second, the government has contributed a substantial amount of equity to found the National Development Bank and aid the Export Development Board.

The primary channels for distributing refinance are the branch systems of the commercial banks. When designing the refinance programs, this seemed a good way to get development finance to the people who need it and to cause the banks to become involved in development finance. In practice, it has proven ineffective. The poor rate of usage of the refinance facilities, the poor rates of recovery, especially in rural areas, and the bankers' continued and sometimes unreasonable requests for collateral or documentation provide evidence of their failure.

If this means of distribution is to be used effectively in the future, major changes in the way the commercial banks handle development-oriented financial operations would appear necessary. Furthermore, as the provisions and supervision of development credit have proved to be far afield from the bankers' usual range of activity, the policy of trying to induce commercial bankers to act as development promoters has proven difficult.

Implementing the other part of its strategy, the government established the National Development Bank endowing it with Rs 600 million in equity free of dividend requirements. Though only a few years old, this bank has already played an important role. It is the central refinancing agent for the World Bank's SMI (Small and Medium Industry) program and had made Rs 254 million in loans using its own funding by 1981. Nevertheless, it has not met the needs for development of the private productive sector as effectively as it might.

A substantial portion of the NDB portfolio (25%) has gone to government-owned enterprises which likely could have obtained commercial bank funding rather than pre-empt funds from the private sector. Furthermore, much of its lending (25%) has been to the hotel sector and to the larger and more established companies in Sri Lanka which presumably could raise money at normal commercial rates. Its actual "development" activities, especially for private firms in the productive sectors of the economy, have been relatively few.

The government has recognized that something must be done to improve the amount of available development finance but it has failed to ensure the proper delivery and allocation of the credit it has supplied. One reason for this failure appears to be a lack of strategic management of development and its financing. No long-range development strategy, with identifiable sectoral goals, targets, action plans, and timetables exists to guide the managers of development finance portfolios. Therefore, the managers of the financial institutions themselves do not have responsibilities linked to the execution of a strategy. As in a business enterprise, the financing function exists only to serve the needs of the enterprise's operating plan. Without such linkage, projects that require government assistance to get going are ignored by the financing system. The incentives and accountability which are necessary to correct this lack of coordination are absent.

C. SATISFYING PRIVATE SECTOR NEEDS FOR DEVELOPMENT FINANCE

In analyzing the sectoral distribution of development finance in Sri Lanka, it appears that funds have been allocated with little reference to social and economic development targets. This is particularly noteworthy since many of the projects which have attracted government-provided development financing apparently do not need it. For example, hotels occupy a predominant position in the portfolios of both the DFCC and NDB, as well as of the commercial banks. Industries related to hotel construction, which presumably have guaranteed markets for their outputs, also occupy significant positions in their portfolios. This is partly a result of the financial institutions' responding to the government's policy of increasing invisible exports through tourism. However, it also reflects the institutions' apparent preference to invest in deals which are easily found and which are clearly "bankable".

In these instances, the development finance institutions have behaved more like private, profit-seeking merchant or commercial banks than vehicles through which development of productive enterprise is encouraged. Given the original purpose of the refinance schemes, these government funds should have been reserved primarily for projects that could not have found private or commercial bank funding. If the distributors of development finance are to follow the country's development priorities by offering preferential financing to projects in key sectors as identified by a development strategy, a different attitude will be required of development and commercial bankers.

Finally, the deteriorating situation in Sri Lanka with respect to rural credit must be addressed by the government. In an economic strategy based on the stimulation of resource-based industries a steady, adequate flow of capital to small rural producers is essential. It is the small agricultural producer in Sri Lanka who will ultimately determine the ability of the private entrepreneur to build agricultural-based processing and marketing industries. Hence, rural credit to the producer and development finance to the entrepreneur who wishes to launch a new venture must be seen in tandem.

The state-owned commercial banks, which have been pushed to provide rural credit, have increasingly retreated from this area. (The total amount of credit extended to the rural sector in 1982 declined 2%.) The rates of recovery of loans made in rural Sri Lanka are much less, on average, than those made in the Colombo area, with repayment of agricultural loans (processing and cultivation) particularly unsatisfactory. The principal reason for these problems is the politicization of rural credit. It has resulted in a great reluctance on the part of bankers to make new loans in these areas.

The Ministry of Rural Industrial Development and the Central Bank have both announced plans for the establishment of rural development banks. Rural development finance may well have to be treated by special lending institutions. However, because of the politicization of this area it is doubtful that any government-owned institution, or bank relying on government-provided refinance or equity, can successfully operate in the rural milieu. The establishment of cooperative or producer banks, owned and operated by rural citizens themselves, might be more appropriate. It has been shown that debtors are more responsive when their liability is to an institution to which they somehow feel attached. Furthermore, credit is better distributed and loans supervised more actively by such institutions. Local private or cooperative banks also relieve the larger commercial banks of the high administrative cost of distributing and recovering small loans.

D. RECOMMENDED ACTION

Development finance must be handled very differently than commercial or merchant banking finance. First, to be most effective, it must be distributed in a way compatible with the nation's development strategy. Thus, it should distinguish between projects which can be funded from the commercial and merchant banking sector and those which cannot. It also must differentiate between projects which further the strategy's goals and those which have a lesser priority.

Second, sectors within the strategy require differentiated financial treatment. Some acceptable projects will be highly capital-intensive and have low working capital requirements, while others will be quite the opposite. Some will add value to production and earn high margins, allowing them to pay commercial rates of interest. Others will be well capitalized, but low margin commodity-like products. These may require rate concessions. The development finance institutions must, therefore, be dissuaded from having "standard formulae" for doing credit analysis and "standard pricing". They must adopt a "project-cost-of-capital" approach to pricing and be insightful when studying unusual requests for funding or unusual projects.

To correct these problems, several changes are required, including:

- The methods of distributing development finance must be improved (refinance and otherwise).
- The activities of the NDB and other financial institutions involved in development finance, e.g., DFCC and the banks using refinance, need to be synchronized with the country's strategy for development.
- The terms and conditions under which development finance are made available must reflect development priorities, as well as the economic nature of the projects themselves.

Several recommendations flow from those criteria and from the analysis of the financial intermediation system:

1. Reinforcement and Reorientation of the National Development Bank

As the NDB is the government's leading development finance institution, it should logically become the central institution for supporting economic development objectives of the government in the development finance area. Such a designation should in no way reduce the role or importance of the DFCC or other development financing intermediaries. It would, however, set the standards by which the government allocates long-term development credit which could be followed by the DFCC and institutions with refinance facilities.

Based on priority development sectors established by the government in a National Economic Development Strategy, the Board of the NDB should establish lending criteria which channel funds selectively to those sectors. The performance standards of the NDB should be clearly differentiated from those of a commercial bank. "Successful" performance should depend on the composition of the bank's development portfolio rather than its profitability.

To achieve the desired orientation, the NDB must assume the role of a promotional, service-oriented development bank which actively promotes development lending. It cannot passively await applications for funding. To undertake this role, the bank will require improved quantity and quality of professional staff.

The staff would have the responsibility of identifying projects, assisting in project analysis, and in some cases brokering ventures between firms for the purpose of exploiting investment opportunities. Profits from the Bank's operations should be poured back into its service and project analysis and identification programs.

The NDB should promote its services, increasing customer awareness and lessening the confusion that arises from the present system. The NDB would benefit from having a clear, well-defined charter and goals, and should not compete in a destructive fashion with other suppliers of the same refinance funds, as happens today . The government would also benefit from having more centralized responsibility and control of development financing. It could easily tell if the NDB is doing its part in supporting the country's development priorities, and could make adjustments as necessary.

To supplement the equity base of the Bank and enlarge its lending capacity, government-controlled financial institutions should be required to participate in the equity of the Bank. The Central Bank and the government's captive rupee sources (the NSB, EPF, ETF) could be equity holders. Similarly, the state-owned commercial banks could also be required to contribute to the NDB's equity if greater capitalization is needed in the future.

2. Rationalization of the Refinancing Schemes

The administration of the refinancing schemes handled through the NDB, the commercial banks and the DFCC should be substantially rationalized, required to meet specific criteria, and centrally coordinated. Such coordination should either be handled directly by the Central Bank or by the NDB itself.

Currently, a variety of refinance is provided by indigenous and foreign sources. These programs vary in their efficacy and sometimes are redundant, i.e., they sometimes compete with each other. This is due partly to the way in which refinance is negotiated. Many private and public banks negotiate with offshore and Sri Lankan suppliers without the guidance of a development strategy or coordinating institution. It also is partly because the distribution channel used is the branch system of the indigenous and foreign banks. A more effective refinance program could be obtained if sourcing, refinance, and distribution were better coordinated.

3. Government Promotion of Private, Cooperative, or Producer Banks in Rural Areas

The gradual drying-up of rural credit must be reversed. The commercial banking system has steadily retreated from rural lending because of the high risk of nonpayment and the expense of administering and monitoring small loans.

A network of private or cooperative banks based on regions or producer groups offers an alternative over time to this problem. Local ownership of the banks facilitates higher recovery rates and local management ensures greater administrative oversight of the lending and repayment process. Producer banks in particular tend to unite their owners around sectoral development and the staff of these banks can develop specific expertise on producer problems.

The larger commercial banks, through the refinance schemes, can lend funds directly to these regional banks, which can in turn relend on small margin to local borrowers. To implement this concept and prohibit unnecessary duplication in the various ministries, that are currently trying to attack this problem, the Central Bank or Ministry of Finance should appoint a commission to study the issue of rural development banking and how the government can promote a system appropriate to the needs of rural development.

CHAPTER 5

THE MANAGERIAL ENVIRONMENT FOR THE PRIVATE SECTOR

A. INTRODUCTION

The study of the private sector focused on several specific "resource constraints" which inhibit the ability of private entrepreneurs to launch new ventures or expand existing ones. A critical constraint mentioned throughout Sri Lanka's private sector is the lack of appropriately trained management personnel at all levels of business and production management.

To analyze details of this problem, a survey of both supply (institutional training programs) and demand (nature of management training needs) factors was undertaken. Approximately 75 interviews were conducted with businessmen, government officials, and training institutions. In addition, a mail survey to 125 industrialists and graduates of local management programs was undertaken. Finally, use was made of a recently completed survey by the University of Sri Jayawardenapura of 800 private and public sector managers. The analysis sought to identify the gaps existing between training programs offered and actual needs of the private sector.

B. MAJOR CONCLUSIONS

- Private sector companies broadly concur that the existing management training programs are not geared to meet the practical needs of local enterprise development.

  The majority of senior level managers interviewed believes that present management programs are not responsive to problems they face in building a strong, domestic business environment. They question the quality of the faculty, the course selection, and the overall effectiveness of their output. They perceive a need for a quality management production, and marketing problems of private sector businesses.

- <u>The most critical training need identified by private sector managers is marketing analysis and management.</u>

  Almost without exception, middle and senior level managers stated that there is a critical need for improved marketing skills. More specifically, expertise is needed in identifying export opportunities and understanding the intricacies of trade transactions.

- <u>Private sector managers perceive the faculty members in existing management programs as too academic and lacking practical experience in business management.</u>

  The universities and the leading management training institute, the National Institute for Business Management (NIBM), have faculties that are well educated in their specific area of expertise. In terms of practical exposure to business problems, however, they are generally inexperienced. With few exceptions, the present and past participants in local management development programs believe that the lack of hands-on experience is the major weakness of faculty members in these institutions. This view is shared by most senior level executives interviewed in the private sector.

- <u>The preparation of business management curricula is not based on an analysis of what local businesses need or desire.</u>

  The curricula of existing institutes are planned largely on the basis of what the faculty can supply or wishes to teach.

Curricula selection does not appear to be determined by the demand from the ultimate user of these skills. Management institutions appear to be relatively resistant to adapting curricula in an innovative manner to reflect changing business and environmental conditions.

- <u>The Sri Lankan government recognizes the importance of management education and training but provides insufficient support for its development.</u>

  Historically, university programs in Sri Lanka have not included business or management-related courses. The major emphasis within the national education system has traditionally been on law, engineering, and the physical sciences. Business education was a markedly lower priority. There has been increased attention paid to business oriented programs over the past couple of years, but very little of this new enthusiasm has been translated into financial support or incentives.

C. RECOMMENDED ACTIONS

Actions to improve the quality and reach of management education can be taken on several levels. The following recommended actions focus on initiatives which could be taken on the part of the private sector, the universities and institutes, and the government.

Private Sector Initiatives

- <u>A Management Development Center should be established under private administration responsible for a series of flexible, practically-oriented training programs and consulting activities.</u>

  Consideration should be given within the private sector to means for establishing a privately administered management training center adapted to the needs of local private companies. The Coordinating Committee should appoint a special task force to explore private sector support for such an institution. The Center would be designed to supplement the more formal systems of management training offered by the National Institute of Business Management and the universities by an innovative system of short and medium term training programs. The staff of the Center would also contract its services out to companies for specific problem-solving tasks.

In its beginning phase, the MDC would have to receive start-up financing from the private sector and possibly the government or international institutions. Over time, however, the Center should be largely self-supporting through its training fees and management counseling services.

The Center would be a low overhead operation with its principal costs being the salaries of its staff. These salaries should be competitive with those offered by private enterprise so as to attract the most capable personnel available.

<u>University/Management Institute Initiative</u>

- <u>Formal training institutions should integrate private business managers into their curriculum planning process.</u>

  Training curricula should reflect the needs of management. There is some private sector participation in the present academic committees, aimed at incorporating private sector suggestions into program planning. Most management programs, however, have been designed totally within academic confines. There is limited support of these programs from the business community.

- <u>Training methods should be revised to emphasize problem-solving and decision-making.</u>

  Teaching methods in business management are highly traditional with heavy reliance on the lecture method and little interaction among participants. The objective of teaching should be development of the participants' decision-making abilities. Consideration should be given to use of the "case method", which has proved to be highly effective in developing a manager's competence in problem analysis and decision making.

  Other innovative, nonlecture oriented teaching methods should be employed such as independent study of actual management issues, field trip assignments, work-study projects, and group work programs.

<u>Government Initiatives</u>

- <u>A comprehensive management development training strategy should be formulated in coordination with the private sector and existing training institutions.</u>

  Skilled managers are a major resource gap facing the country. This gap should be addressed in a comprehensive way by the suppliers of management training and the users of their services. More efficient and focused allocation of training funds can be achieved if programs are properly targeted. Innovative and cost-efficient techniques are more likely if cooperation between providers and consumers of management training is achieved in program planning.

- <u>Bonding periods for university faculty members should be reduced.</u>

Sri Lanka's bonding system for faculty members who receive training abroad is stringent and ultimately counterproductive in terms of benefits to both management institutes and the private sector.

Bonding requirements prohibit the faculty member from working outside the university for a specified period. It would be in the interest of both the universities and the private sector to permit a more flexible formula, permitting faculty members to work part-time in the private sector while retaining their teaching responsibilities in the university system.

CHAPTER 6

SECTOR DEVELOPMENT POLICIES AND PRIVATE INVESTMENT OPPORTUNITIES

A. OVERVIEW

The focus of this private sector development study has been on Sri Lanka's resource-based sectors, namely those processing and transformation activities that add value to basic resources and generate maximum employment. In sectoral terms, the areas of concentration have been on agro-based industries and manufacturing operations related to agriculture.

The emphasis on agro-based investments results from a strong conviction on the part of the team undertaking the study that Sri Lanka's long-term development must occur in these resource-based sectors if self-sustaining economic growth is to be attained. The initial phase of this study was therefore devoted to screening the sub-sectors of the nation's resource-based economy to determine those categories of investment and production activities which would contribute most to developing the private sector and to the country's long-term growth objectives.

This initial screening employed several criteria in selecting industrial product areas for more detailed investigation. The sub-sectors had to satisfy several key conditions:

- Commercially viable investment opportunities
- Comparative advantage either in domestic or foreign markets
- Employment generating potential
- Favorable export potential
- Strong linkages to agricultural production or other industries
- Positive impact on rural development

The seven sub-sectors were identified and brief industry and product profiles were conducted. Several of these product areas are suggested as candidates for future prefeasibility studies.

Fundamental to encouraging private sector development are the basic sectoral development policies that determine the growth of production and supporting infrastructure. Throughout the industry profiles, reference is made to the constraints confronting the development of these sectors and on the attractiveness of the sector to private capital. In many cases, these constraints are so severe that, unless they are removed, prospects for long-term development are doubtful. The following summary is an overview of the principal constraints identified in the agricultural and industrial sectors specific to these industries (apart from the more general problems discussed previously such as environmental factors, finance, and management).

B. AGRICULTURAL POLICY

In the course of the screening process and the sector and product profiles undertaken in the study, the following principal constraints were identified with respect to agricultural sector policy:

- Inadequate producer prices to encourage production or permit reinvestment.
- Export taxes fixed without reference to costs of production or international prices.
- Lack of adequate market information or marketing support institutions.
- Import duties on critical processing inputs driving up costs of production.
- Lack of flexible land policy to permit commercially viable production in certain crop, livestock, and fishery areas.
- Continued dumping of certain commodities in oversupply in international markets.
- Quasi-monopolies by government boards, state corporations, or even foreign investors in certain sub-sectors.
- Excessive number of government organisms regulating agriculture, leading to highly inconsistent treatment.

The Arthur D. Little analysis supports the point of view already presented by the World Bank in previous studies that producer price incentives constitute the most significant barrier to developing the agricultural sector generally. The successful example of price liberalization in the paddy sector is evidence of the impact adequate producer margins can have on local production. The same liberalized regime does not yet exist, however, for many other tree and field crops. The lack of adequate production has direct impact on the development of processing industries, which could add value to production of the sector as well as increase employment and foreign exchange potential.

In the sectors studied, development of processed coconut and dairy products in particular are severely restricted by the lack of adequate producer margins to stimulate production and encourage reinvestment. Lacking in these sectors and others is a centrally coordinated review of producer incentives, costs of production,and international prices.

Coconut and rubber production, among others, are often subject to inconsistent treatment through the imposition of export taxes. The effects have been to discourage new production and processing because of low returns to the producer. Until recently, the tax scales have not taken into account the rising costs of production or declining international prices.

In the government's sector development plans, heavy emphasis is placed on production and its related support services. Little attention is given to the vital areas of marketing, either market information or marketing organization. Investigations within specific sectors have demonstrated the need to assist the small producer to identify growing markets, channels for selling his production, and quality requirements. Especially in view of the Mahaweli development, small holders need assistance in the selection of crops to be grown. Marketing institutions are equally necessary to facilitate the commercialization of products.

In the processing of agricultural products, the constraints are both organizational and technological. The broad dispersion of production units among thousands of small holders requires efficient collection systems that can avoid the traditional middleman barrier, which creates higher-cost commodities for processors and consumers and lower margins for the producers. Government and private sector organizations alike are needed to rationalize these collection systems.

Processing industries, particularly those with potential for exporting, require more advanced technology in terms of capital equipment and other inputs, which usually must be obtained from abroad. Existing import duties on these critical factors of production discourage the establishment or modernization of processing industries. The duties significantly increase the costs of production, reducing profit margins for processors. Sector development policies must take into account the necessity of importing capital equipment for the processing of agricultural products.

Inadequate scale of production limits the formation of many agricultural processing industries in Sri Lanka. Past land reform policies, while achieving important social objectives, have had the effect of making many agricultural operations uneconomic. The fragmentation of farm production must be overcome either through skillful organization of community-wide production, collection, and quality control systems, or through greater flexibility in the government's land use policy. In the sectors studied in this report, the dairy, fruit and vegetable, and fishery industries are particularly affected by economies of scale issues. Many operations need to be a minimum size to permit the industry to operate profitably and efficiently. This factor is all the more important if production for export is contemplated or foreign investment in the sector is being sought.

Although dumping practices generally affect only manufactured products, they sometimes tend to thwart the development of local agriculture. In the sectors studied, this impact is felt in the dairy industry due to lack of protection from imported milk powder, which is in surplus in international markets. Powder is imported at rates at best equal to the cost of production of local milk. The effect has been to discourage the development of a local dairy industry and maintain a dependence on imported milk powder.

In some cases, the structure of government or foreign company activities in the economy may shut out healthy competition from the private sector. For example, commercial dairy operations cannot operate in milk shed areas where the National Milk Board has collection centers. In the animal feed area, foreign investors are given a dominant market position, which in practice excludes competition from local processors. In the minerals sector, where some processing opportunities are possible, government control of resources serves to discourage private sector interests from participating.

Finally, apart from substantive inconsistencies in government policies toward the agricultural sector, it must be pointed out that both effective policy formulation and implementation are exceedingly difficult because of the large number of conflicting and overlapping government organizations responsible for agricultural development. More than 15 government ministries have varying degrees of responsibility for the sectors. Within these larger units are affiliated boards, authorities, and agencies that also act on matters of importance to sector development. Serious consideration must be given to possible consolidation of these many organisms or their coordination and control by a central body responsible for agricultural development.

C. INDUSTRIAL POLICY

While Sri Lanka has placed high hopes on developing the industrial sector, serious constraints inhibit this growth, some natural, others policy-related. A small domestic market is one of the chief natural barriers; another is a low material base for many basic industrial operations, e.g., iron ore, petroleum, coal, etc. The industrial sector in 1982 still accounts for only 14% of the country's GDP.

Major problems faced by Sri Lanka industry have been an inconsistent system of priorities and incentives given to the industrial sector and a tendency to encourage capital-intensive, import-dependent and import-substituting industries to the detriment of the higher value-added resource-based industries. Over the years the industrial structure has been dominated by uneconomic state corporations and the tariff structure has tended to protect the less efficient import-substituting industries.

The liberalization that began in 1977 has gone a long way toward eliminating many of the former distortions. Official policy is now oriented toward export-led growth and industry rationalization. There is recognition also that many industries promoted in the past (garments, petroleum products, etc.) are so heavily dependent on imports that overall value added to the country is minimal. Emphasis now appears to be turning toward agro-based industries with their higher local content and employment potential.

The current study therefore screened three subsectors that are consistent with this new emphasis: rubber-based products, agricultural-related light engineering industries, and minerals processing. In the course of the survey, four categories of constraints were present in these and other subsectors:

- Export marketing
- Effective rates of protection
- Structure of tax incentives to investors
- Weight and activities of state corporations.

The priority of export marketing has been acknowledged by the government since coming into power. The centerpiece of the government's economic philosophy has been a shift from import-substitution to export-led growth. The Export Development Board was established in 1979 as the implementing agent of this policy and remains one of the government's vanguard agencies. Despite the revenue crisis currently faced by the government, which has forced it to phase out many fiscal incentive schemes, the incentives for exports and the funding for the EDB have been maintained, reflecting the high priority attached to its activities.

The EDB and the government have operated for several years on the assumption that export-led growth has not advanced rapidly because exports are less profitable than production for the local market and the local service sector. As a result, the EDB has become the chief advocate and administrator of a series of financial grants, duty rebates, and incentives to make exporting patently more profitable. Of secondary importance in terms of effort and financial support have been the actual marketing services provided to exporters by the EDB.

During the course of this survey, this profitability thesis was tested to determine whether lack of profitability was indeed the principal barrier. A special study of representative exporting and nonexporting firms (detailed in Volume 2 of this report) showed that according to several measures, e.g., return on investment, return on equity, and return on turnover, exporting industries were by and large more profitable than locally oriented industries. The latter category included local production, hotels, construction, trade, and transport industries.

The conclusion drawn from the study was that a variety of barriers discourage producers from entering export markets. Probably the most important barriers are a lack of marketing channels and marketing information. It would appear that this marketing barrier must be broken through by a combination of efforts, including an expanded EDB role in market facilitation and the formation of trading companies specifically equipped to negotiate trade transactions.

The question of reasonable and appropriate protection for manufactured goods is currently being addressed by the Presidential Tariff Commission. Prior to 1977, Sri Lankan manufacturers were able to operate behind high tariff walls in a virtually captive market with the predictable consequences of inefficient, high cost production and low quality products.

Under its free market orientation, the current government dismantled these barriers in order to expose local industry to international competitive forces and benefit Sri Lanka consumers through lower cost, higher quality goods. Another objective was to provide local industry with easier and cheaper access to imported capital equipment and the basic raw materials needed for production.

Effective rates of protection (ERP) were the subject of special analyses by the World Bank in 1981 and 1983. Largely as a result of these studies, the Presidential Tariff Commission has been instructed to recommend a revision of nominal tariff rates to equalize the protection afforded import-substitution industries and export-oriented industries.

The initial World Bank study concluded that the structure of protection did not reflect a consistent set of policy objectives. While the government, on one hand, has been seeking to promote exports, the effects of the protective system have generally been to expose these industries to excessive international competition and to overprotect import-substituting production. In the latter case, many of the industries being protected contribute very little added value to production and are heavily import-dependent for raw materials and intermediate goods.

It appears that Sri Lanka's need is not for simple tariff adjustments, but structural reform of its tariff system based on a phased strategy of protection. A point of departure should be the designation of key development sectors to be given special protection over a limited period of time. Once these sectors are designated, the body responsible for tariff reform should assess the impacts of all existing interventions, including duties on imports, turnover and excise taxes, duty rebates, etc.

Beyond the broad guidelines that should govern tariff policy, there appear to be three specific needs of private sector firms operating in long-gestation, resource-based industries:

- Duty free access to imported raw materials and the intermediate capital goods, unavailable locally, needed for the production of goods.
- A strong anti-dumping law that imposes appropriate levies on foreign goods sold in Sri Lanka below their true cost of production, transportation, and insurance.
- Reasonable rates of protection for production-based industries with high local value added. This protection should be moderate and temporary, to induce local producers to reach an efficient level of production as quickly as possible.

Another key element in industrial policy is the structure of tax incentives. The government is now passing through a severe fiscal crisis caused by unsustainable budgetary deficits and a declining value of the rupee. With the exception of incentives for export-oriented industries, most fiscal incentives aimed at attracting investment into key sectors have been suspended. On the assumption that the fiscal crisis will pass within the next two years, the government must direct its attention to selective incentives for high-priority areas of development.

Finally, the rationalization of the state corporate structure will ultimately have significant implications for industrial development. The government's current efforts to place many of those corporations on competitive footing with the private sector and to contract management of some companies to private firms establish an important precedent. The nonmarket behavior of the state corporations in the past has severely distorted the markets and discouraged new entries by private firms. A strategy of rationalization of the companies will not only assure better functioning of the free market but offer opportunities for private entrepreneurs to manage or buy into existing state corporations with the prospect of greater efficiency of production.

D. SUMMARY PROFILES OF AGRICULTURE AND INDUSTRY SUB-SECTORS

The following pages summarize briefly the findings that emerged from the sector surveys conducted by the joint Arthur D. Little-Sri Lankan team. Detailed analyses of these opportunities are contained in Volume 3 (Agro-Based Industries) and Volume 4 (Manufacturing and Minerals Processing).

SUMMARY PROFILE OF THE FRUIT AND VEGETABLE INDUSTRY

A. OVERVIEW

Fruit and vegetable production in Sri Lanka is carried out almost exclusively by small-scale farmers in home gardens, on a total acreage roughly estimated at 500,000. Because of the favorable climatic and agronomic conditions, a wide variety of fruits and vegetables are grown, including carrots, leeks, chillies, cabbage, tomatoes, okra, mangoes, passion fruit, and mangosteen, totaling approximately 800,000 MT annually. The Sri Lankan farmer is generally relatively well-educated, familiar with vegetable and fruit cultivation and with modern farming practices such as irrigation, fertilizer, pesticides, and terracing, and is market-oriented in his attitude. The large areas of irrigated land coming into production as part of the Mahaweli Development Project offer significant potential for expansion of the fruit and vegetable industry, particularly for export.

B. CONSTRAINTS

The lack of linkages between production, processing, and marketing is the primary factor constraining the development of the industry; this constraint has a large impact on farmers. Because the flow of market information to farmers is negligible or nonexistent, the Sri Lankan farmer generally has no reliable markets for his goods. Market demand is generally not "pulling" production, leading to inefficiencies, loss of production and profitability, higher costs, and lack of growth for the industry. Linkages between production and processing, and production and marketing need to be further developed through the establishment and strengthening of supply arrangements (contracts) with farmers Another major constraint to farmers is the lack of seed material of appropriate quality and varieties in adequate amounts.

There are estimated 15 to 20 fruit processing firms in Sri Lanka basically processing only acid foods, canning them with pasteurization as the method of preservation. Industry products include passion fruit and mango cordials and juice, canned tropical fruit salad, and canned mango, jakfruit, and papaya. Processing by pasteurization followed by hot-pack filling is not acceptable or technologically adequate for general vegetable canning. As a result, no vegetable processing industry exists in Sri Lanka.

The technology and practices of the fruit processing industry are rudimentary, and the technological base of the industry is weak. With possibly one or two exceptions, the fruit processing industry does not produce goods that can be either exported or substituted for imported products.

The main problem the industry faces is an insufficient market. Poor understanding of the market on the part of producers and processors alike has resulted in few linkages of processors to the market, and has constrained the industry's growth and its flow of products. Other major constraints processors face are the unavailability of trained food technologists, the high cost of the imported packaging materials because of import duties, inadequate knowledge of products available internationally, and a lack of government support.

C. OPPORTUNITIES

Sri Lanka's fruit and vegetable exports have quadrupled over the past five years, primarily through sales to the Middle East markets. Its proximity to the Middle East is a comparative advantage in this large, relatively new market for fruits and vegetables. More than 100 private exporters of fruits and vegetables are now operating in Sri Lanka, and it appears that farmer, processor, and exporter are beginning to understand more about the quality, variety, and packaging requirements of export markets.

As this development continues, and through increased communication between producer, processor, exporter, and export market buyer, the fruit and vegetable industry should be able to increase its market share in the Middle East and further develop other markets. Marketing of fruits and vegetables is constrained by Sri Lanka's inconsistency in maintaining a market and lack of a market strategy. The high air freight rates are another major constraint to fresh fruit and vegetable exporting.

The objective of this study is to identify entry and expansion opportunities for private enterprise, building on Sri Lanka's comparative advantages, and recognizing its constraints, some of which were briefly mentioned above. These private enterprise opportunities are summarized below:

- Production of seed for fruits and vegetables and multiplication of seedlings for nontraditional and exportable varieties. This opportunity arises out of the domestic demand, which exceeds supply by nine times, and which is particularly keen for exportable varieties, i.e., okra, striped watermelon, bitter gourd, strawberries.
- Expanded processing of the Jaffna mango for the domestic market and possibly export markets. Arising out of a unique raw material supply situation, and what appears to be a unique product, this opportunity would require a low capital investment and would be labor-intensive.
- Small processing and packing operations at the community level in the Mahaweli area, utilizing production from home garden plots in a concentrated area. This opportunity would entail a joint venture between community ownership (producer association) and a private sector processor who presently markets.These could be a series of small basic, labor-intensive operations throughout Mahaweli, which would preserve surplus home-garden production, producing processed

products for the community's own consumption and for the domestic market.

- <u>Increased linkages between producers, processors, and marketers, through joint ventures or contract arrangements between farmers, wholesalers, processors, and exporters.</u> This opportunity has particular potential for a large-scale venture in the Mahaweli area, where the large dry land areas under irrigation, totaling close to 350,000 acres, present opportunities for such crops as tomato, okra, etc., for processing and export.
- <u>Joint venture between existing groups of fresh fruit and vegetable exporters and Air Lanka or other air service for the purchase of aircraft to provide air freight service for fresh produce exports, primarily to Middle East markets.</u> This opportunity would help to eliminate the major constraint on exporters cause by high air freight rates and limited availability. Such a venture would also build on the increasing export volume by forward integrating and gaining more control over the marketing channel.
- <u>Joint venture of private sector consulting firm with C.I.S.I.R. to provide technical assistance to the food processing industry in Sri Lanka.</u> There is no public or private sector entity currently providing technical assistance to the industry, and there is a lack of trained, experienced technical resources available to the industry from any source. This weak technological base affects product quality, food safety, plant productivity, and profitability of the industry. There appears to be a demand in industry for assistance in product development/formulations, process development, packaging, plant design/layout, quality control, and training of plant staff.

SUMMARY PROFILE OF THE COCONUT PRODUCTS INDUSTRY

A. OVERVIEW

Coconut processing activities are organized into six major product areas: copra, oil, desiccated coconut, charcoal, brown fiber, and white fiber. Just under half of all nuts produced go into processing; 70% go into copra and oil production and the remainder into the production of desiccated coconut. Most (75%) of the husks from the seasoned or brown nuts that are processed are used for mattress and bristle fiber; a small amount (4%) of green husks from nuts going to the fresh market are used for white fiber. In terms of tonnage, copra is the largest product area (140,000 tons per average year) followed by oil, fiber, desiccated coconut, and charcoal. In terms of value of production, oil (about Ea 2 billion per average year) is the largest product group, followed by copra, desiccated coconut, fiber and charcoal. Desiccated coconut has the greatest value added of all coconut products and provides the greatest monetary return per coconut processed.

The processing segment of Sri Lanka's coconut industry can be evaluated internationally in terms of the size of copra activities. Over the period 1971-80, average annual production of copra in Sri Lanka (187,000 MT) ranked fourth after the Philippines, Indonesia, and India. Sri Lanka's processing segment is half the size of India's but less than one-tenth the size of the Philippines'. Overall, coconut processing in Sri Lanka has been slowly contracting since 1964, because of the decreasing availability of raw materials. The technology used in processing is generally labor-intensive, with few changes made in equipment or facilities in the last 15 to 20 years.

Industry experts in Sri Lanka believe that the processing efficiency of most firms is low, partly because there is no incentive to improve it (margins allowed by the government are low) and partly because of the low world price of coconuts. The quality of copra and oil produced is highly variable, because there is no effective premium on quality. Investment in updated, more efficient, and even integrated coconut processing technology that maintains the existing high labor-to-capital ratios would increase yields, add more value, and open new domestic and foreign markets to the industry.

While the industry's operations are largely in the hands of private enterprise, the government has traditionally exercised heavy control and regulation of its activities through the Ministry of Coconut Industries. The main policy toward the industry has been to control exports of coconuts and coconut products through the use of export duties to: (1) ensure their availability for the domestic market at low consumer prices; and (2) maximize foreign exchange revenue for the national budget. This government policy has had the effect of absorbing most surplus revenue resulting from Sri Lanka's comparative advantage as a low-cost producer. As a consequence, the industry's operators have been deprived of profits that could be reinvested in expansion and in improvement of productivity. The Ministry of Coconut Industries has sought to offset this factor through various subsidy schemes to stimulate investment by growers. Such subsidies have focused on fertilizer use, the replanting of old low-yielding palms, and the planting of palms on new lands. Some subsidies have gone to processors in the form of rebates to cover wages when export restrictions stopped processing temporarily.

The present duty scheme adopted in November 1981 was intended to overcome many of the shortcomings of previous schemes. Nevertheless, the present scheme does not permit a downward adjustment to compensate for declining world prices, thereby intensifying the downward pressure on grower prices. In addition, as the market regains its strength with rising prices and the scheme goes into operation (as has happened since June 1983), the scheme will effectively siphon away the increased revenue which could be passed on to growers, thereby helping them to recover from the previous years of low prices. If the industry's position internationally is to be preserved in the future, the full impact of the present scheme needs to be evaluated in light of the more competitive world market which has evolved in recent years.

B. CONSTRAINTS

The major constraint facing the industry has been and continues to be the government's policy. Over the years the numerous duty schemes, export restrictions, and subsidies that have come and gone have increasingly brought the industry to at best a standstill or continued slow decline, threatening the significant contribution it has made to employment, foreign exchange, and value added.

To overcome this constraint, a major revision of the present duty scheme is required. In 1980, the World Bank observed that if adequate incentives were to be restored to coconut growers (and processors), a substantial readjustment of the relative prices of nuts was required. The wholesale price of nuts on the domestic market has typically been kept, by means of export duties, at 2 to 2.5 times below export market prices. Higher returns to growers and processors will allow for greater investment to increase production and processing yields. Lower duties on exports may initially mean lower revenues to the government, but as the industry gains strength and expands so will the tax base. A small duty on a large base can generate more revenue than a large duty on a small and slowly contracting base.

A second major constraint facing the industry is in the area of product and processing technology. Since there has been little incentive to invest in the industry, the adoption of new technology has been blocked. Thus, while industry experts in Sri Lanka are aware of technology developed and adopted in other countries of the world, the technological and economic feasibility of adopting those technologies in Sri Lanka has not been examined. The new products and markets made possible by this technology are not well known to the Sri Lankan industry and thus the opportunities they offer have not been assessed.

C. OPPORTUNITIES

Assuming the above constraints can be overcome, entry and expansion opportunities exist within the industry. Coconuts, coconut kernel products, and white fiber all have strong markets domestically and internationally, suggesting that if the industry's production and productivity were to increase, revenue would increase as well, providing an increase in employment opportunities and foreign exchange generation and a growing tax base for government revenue.

- Coconut oil refining and packaging in consumer-size containers for the domestic and export markets. Refined and packaged oil on the domestic market commands at least twice the price of the raw oil presently produced and sold. The Middle East presents an attractive export market. A small plant with a capacity to refine 15 tons/day would require an estimated Rs. 15 million investment. One plant of this size could process about 3,000 MT of oil per year, equal to about 8% of average annual exports over the period 1971-81.
- Integrated coconut processing facilities, capable of producing coconut milk, and all sub-products such as oil, pulp, and water. Coconut milk is a staple of the domestic in Sri Lanka. About 1,000 million nuts are used by households for this product. It is estimated that household processing wastes at least 30% of the oil available in the coconut kernel, or some 300 million nut equivalents of oil (37,500 MT) per year. To meet 25% of the domestic demand for coconut milk through industrial processing, would require an investment of some Rs. 500 million. Concurrently, domestic nut consumption for milk preparation could be reduced by an estimated 75 million nuts/year. This quantity of nuts is equivalent to 9,375 MT of oil, reflecting a 47% increase in average annual exports, or to 11,029 MT of desiccated coconut, reflecting a 31% increase

in average annual exports. Before industry operators can invest in this type of integrated technology (milk processing) as well as the technology to improve processing efficiency (oil and desiccated coconut), the technologies need to be tested and adapted to Sri Lanka's conditions. Investment in new processing technology with high labor-to-capital ratios will require domestic technological support if processors are to adapt it readily support which could be developed at the Coconut Research Institute.

- White fiber or coir yarn processing plants where productivity can be increased and the processing period decreased. White fiber processing is presently a time-consuming and labor-intensive cottage industry. Of the coconut fiber products, it commands the highest price and represents the only growing market. Raw material (green husks) for the production of while fiber is abundantly available, with only 4% of present supply now being used. Investment in this product group will require development and testing of technology with a high labor-to-capital ratio.

SUMMARY PROFILE OF THE DAIRY PRODUCTS INDUSTRY

A. OVERVIEW

The dairy sector is an integral part of the overall livestock industry and contributes about 2% to Gross Domestic Product (GDP) of the Sri Lankan economy . This sector has been highly controlled by the government during the past two decades and has therefore been subjected to shifts in government priorities. Presently, the government is interested in removing itself from direct management of activities that are more appropriately managed by private sector initiative.

Dairying is an important activity for many small land holders and landless tea estate laborers. For this reason, effective development of the sector would have significant impact on the lower income groups in the economy. Because of these impacts, the sector has been chosen as an area of further investigation in an effort to identify opportunities where private sector initiatives can be utilized to promote development of the sector and ultimately benefit the small farmer.

B. OPPORTUNITIES FOR SRI LANKAN PRIVATE SECTOR INVESTMENT IN THE DAIRY INDUSTRY

The dairy industry offers several opportunities for private sector involvement in both production and processing:

- Establishment of milk collection systems.

There is a large market for locally produced milk. Establishment of milk collection systems could help small farmers receive a greater share of the price paid to producers by eliminating the middlemen who collect milk at very high cost to the farmer.

Establishing 16 or 17 milk collection centers domestically could increase farm income by approximately Rs 214 million per year and rural employment an estimated 1,400 jobs. Foreign exchange savings of Rs 248 million a year would be possible. Finally, regional economic development objectives would be substantially advanced.

- <u>Establishment of commercial dairy herds.</u>

There are entrepreneurs with land resources that can be used effectively to support dairy development. Increased support for establishing about 300 commercial dairy farms can increase incomes to rural commercial farmers by an estimated Rs 188 million per year. Employment could be expanded by 1,200 to 1,500 rural jobs. More than Rs 219 million a year could be saved in foreign exchange expenditures.

- <u>Establishment of small-scale regional multi-product dairy processing plants.</u>

This project would provide a means for integrating production and processing activities in a local area, thereby creating stable businesses. This venture has the potential of yielding a 15-20% return on sales and attractive returns to investment.

Establishment of five regional multi-product dairy processing plants can increase farm incomes by an estimated Rs 62.5 million/year and 400 rural jobs could be created. Foreign exchange savings of Rs 73 million/year are possible.

- <u>Establishment of new ice cream production capacity.</u>

The market for ice cream is growing and is not effectively served in many cities outside Colombo. The value added when converting milk to ice cream (Rs 35.3 per gallon) seems to be sufficiently high to make it an attractive investment opportunity. One ice cream plant, if domestically produced milk is used, can increase farm income by Rs 6 million a year, create 75 jobs, and save Rs 7 million a year in foreign exchange.

- Development of spray drying plant.

The market for spray dried dairy products is the largest in Sri Lanka and most of the product is presently imported because of a lack of local supply. Nestle is building a new spray dry plant at Ambewela that is expected to be profitable. Another plant at Ambewela should be profitable under proper management with an estimated 20% return on sales. Bringing such a plant to full operation at two shifts per day can increase farm income by Rs 178 million a year, employ 1,200 persons in rural areas, and save Rs 205 million a year in foreign exchange.

C. CONSTRAINTS CONFRONTING REALIZATION OF THESE OPPORTUNITIES

The key constraints that restrain development of the dairy sector include:

Production Constraints

- Milk prices are not based on production cost realities. They are not high enough to attract investment capital into commercial-scale dairy farms. At present prices, commercial-scale dairies do not receive an adequate return on capital.
- Producer associations at the small-farmer level lack management and financial backing to set up collection systems on their own.
- New entrepreneurs cannot operate in milk sheds where there are National Milk Board (NMB) collecting centers unless they joint venture with NMB or develop their own market.

- Government policy restricts land ownership; therefore, unless some mechanism can be developed to make sufficient land available to support commercial dairy farm development, the expansion of such farms will be slow.
- There are insufficient cows with potential for high yield to build herds rapidly.
- There is no clearly stated government policy supporting dairy herd development.
- Feed concentrates are in short supply and often too high priced to be attractive to dairy farmers; therefore, solutions to feed supply problems are essential.
- Prices of imported milk are currently subsidized as they are products in surplus in the international markets. Such dumping practices cause unfair competition for local producers and are a deterrent to development of dairy farms.

Processing Constraints

- Present supplies of milk are insufficient for existing process facilities; an adequate milk supply must be assured before constructing a new facility.
- Lack of a clearly stated government policy with respect to how milk prices will be determined at both farm and consumer levels may deter investors.
- Funding on terms acceptable to the entrepreneur is frequently not available.

Market Constraints

From a market viewpoint, there is no limitation the size of the market. However, unless a clear pricing policy is established at producer, wholesaler, and retailer levels many entrepreneurs may be discouraged. In selected local markets, the product mix of a facility may be sufficiently diversified to provide an attractive return on investment, but the private entrepreneur tends to be discouraged from mainstream markets.

SUMMARY PROFILE OF THE FISHERIES SECTOR

A. OVERVIEW

The fisheries sector in Sri Lanka is comprised of several subsectors. One subsector, shrimp (prawn) mariculture production for export, appears to have particularly high potential for growing private sector investment with favorable implications for export sales, resource utilization and employment.

Other subsectors would appear to have medium to low potential for new private sector investment, including the following:

- Speciality products for export (Beche de Mer, shark fins, jellyfish, seaweed);
- Value-added processing of inland finfish;
- Aquarium exotics for export;
- Marine finfish production; and
- Manufacture of fishing equipment (boats, gear, etc.).

These subsectors are affected by some or all of the major constraints on private investment in Sri Lanka including:

- lack of sufficient proven export market demand; and
- high risks and costs leading to low profit margins.

Two other subsectors--culture of bivalves (oysters, mussels, etc.) and harvest of squid (cuttlefish for export)--might have medium or higher potential for new private sector investment. However, there are inadequate basic data on potential markets and sustained resource availability for these subsectors to evaluate these opportunities.

B. OPPORTUNITIES FOR SRI LANKAN PRIVATE SECTOR INVESTMENT IN PRAWN MARICULTURE FOR EXPORT

The factors which make prawn mariculture a potentially attractive private sector investment opportunity in Sri Lanka are as follows:

- Established, large, growing export markets. Sri Lankan exports of prawns have been valued at about Rs 300-400 million per year in the recent past. Most of these exports have been to Japan, with the U.S. a secondary market. Export demand has consistently outstripped the available supply, which is still based almost entirely on maximum sustained harvests of naturally-occuring prawn populations in coastal waters. Prawn consumption in the established markets remains at least two orders of magnitude greater than the present Sri Lankan supply capability, and market growth in these and other areas (e.g., Western Europe and the Middle East) may be anticipated.
- Linkages to existing processing capacity and other industries. There are about a dozen "packers" exporting frozen prawn from Sri Lanka on a regular basis. Their combined processing capacity is reportedly significantly underutilized because of shortfalls in the resource supply available from harvests of natural populations. Prawn mariculture could be linked to another possible growth sector, the production of animal feeds, because of anticipated requirements for feeds comprised in part of such local products as fish meal and rice bran.
- Competitive advantages versus other potential producing countries. Sri Lanka is within 10 degrees latitude of the equator and has coastal waters and sites of the quality required for prawn mariculture yields comparable to the highest achieved anywhere else in the world. At least four highly valued prawn species occur in Sri Lankan coastal and brackish waters and appear amenable to existing state-of-the-art mariculture techniques. Labor cost advantages would also be expected to prevail over some other potentially competitive locations.

- Commercial prospects. The commercial prospects for prawn mariculture ventures in Sri Lanka appear attractive. The analysis performed for this study tends to confirm the optimism reported in earlier studies performed by prospective investors and international organizations. It is estimated that a relatively large commercial prawn farm of the size currently under active consideration by several Sri Lankan private sector investors (i.e., about 200 hectares) would realize sales revenue in the neighborhood of roughly Rs 100 million annually, with an estimated profit margin of no less than about 30% under normal operating conditions. The analysis also suggested that larger operations would be more profitable, but that self-supporting ventures on as little as 50 hectares could be profitable. Subsidized, small-holder production on plots as small as one hectare could also be economically attractive.
- Impacts. Prawn mariculture would have highly favorable impacts on the balance of trade and would provide for increased utilization of Sri Lanka's natural resources. Presently envisioned projects could increase export sales by Rs 300-400 million by 1985 and would help eliminate the present supply shortfall that constrains development of new export markets. Employment impacts would be positive, but not of great absolute magnitude. It is estimated that about two new local jobs would be created for each hectare committed to prawn mariculture. This would translate to perhaps one to two thousand new jobs by 1985.

C. CONSTRAINTS ON INCREASED PRIVATE SECTOR INVESTMENT IN PRAWN MARICULTURE

The factors which would be expected to constrain the development of new private sector opportunities in prawn mariculture in Sri Lanka are as follows:

- Site availability and selection. Estimates of the areas potentially suitable for prawn mariculture in Sri Lanka range from about 1,000 to 5,000 hectares. This is enough land to at least double present levels of export production (if developed), but raises a question about the ultimate extent of the development opportunity. In addition, proper site selection can be critical to the success of any venture, especially those of larger scale.
- Capital requirements. Prawn mariculture has significant capital requirements. A prototypical 200 hectare base-case shrimp "farm" evaluated in this study has construction costs estimated on the order of Rs 100 million and annual operating costs of about Rs 60 million. These types of costs suggest that such ventures, even if financed with special export-related loans with interest rates in the neighborhood of 12-15%, would be beyond the means of most Sri Lankan private sector investors without some foreign joint-venture (or other) capital support.
- Risk. As with fisheries ventures in general and mariculture ventures in particular, risks are relatively high due to the number of events that can lead to harvest or crop failure. State-of-the-art technology in site selection and facility engineering can minimize but not eliminate such potential risks.
- Technology Transfer. Prawn mariculture is an emerging technology, and one in which significant advances have been made in commercialization in the last 5-10 years. The technical know-how required for successful commercial-scale production must be imported to Sri Lanka via joint ventures or the purchase of consulting services. Some efforts in this direction have begun, but the technology transfer is still in a relatively early stage.

- Government Policies. If, as is generally believed, there is only a relatively small area of the Sri Lankan coastal zone that is well-suited to the development of prawn mariculture sites, the issue of government policy becomes especially important to the prospective private sector investor. In the one extreme, the government could allow a few, relatively self-sufficient private entrepreneurs to develop as much acreage as they could each afford and collect, process and export the products. On the other extreme, the government could subsidize small-holder production by supplying post-larval shrimp to many small grow-out ponds, constructed and operated with government financial assistance. The government or private sector could then process and market the product at a cost-effective scale.

During the course of this study, there appeared to be a strong emerging sentiment in both the private and government sectors in favor of the development of a comprehensive sector development plan for inventory of and assignment of allocation priorities to potentially suitable prawn mariculture sites and hatchery facilities. The present situation is sufficiently uncertain as to make the private sector uneasy about the risk of large-scale investment in the absence of clear government planning priorities.

SUMMARY PROFILE OF THE RUBBER PRODUCTS INDUSTRY

A. OVERVIEW

Natural rubber production in Sri Lanka is of vital importance to the country's economy, particularly as a source of of foreign exchange earnings and employment. At present, Sri Lanka is the world's fifth largest producer of natural rubber, producing about 125,000 tons per year. However, over the years rubber production in Sri Lanka has been steadily declining due to decreases in the area under tapping because of the poor replanting as well as delines in average yields. It is projected that Sri Lanka's rubber production will continue its decline for the next several years, but reverse this trend by 1985 as current replanting programs begin to show results.

To strengthen the rubber based economy, the government is considering a shift of emphasis from being a commodity exporter of raw natural rubber to that of a manufacturer and an exporter of intermediates and finished rubber products. To manufacture a broad range of fabricated and dipped rubber products, however, the industry must confront several constraints which currently weigh upon it, namely, a weak technological base, limited knowledge of markets and relatively poor management.

B. CONSTRAINTS

Over the years, the rubber products industry in Sri Lanka has been based on relatively rudimentary technology and production skills. Out of 145 rubber goods producers, including one major tire producer, only three to four companies have competitive technology, marketing and management strengths all of which have been acquired through joint ventures with foreign participants. Most rubber goods producers in the country manufacture consumer and industrial rubber products for local markets based on antiquated and obsolete technologies.

Although domestic consumption of natural rubber has increased over the years the total size of the domestic market for rubber products is still relatively small and likely to remain so. Therefore, the major development of the rubber products industry in Sri Lanka will have to be geared primarily towards export markets. Entering the international rubber products market in the 1980's will require careful strategic planning since Sri Lanka will be playing a "catch-up" game with its major competitors including India, Malaysia, Thailand, Indonesia, Taiwan and South Korea, all of whom are well entrenched in international markets. Sri Lanka will have to address its weaknesses and identify its specific competitive strengths. To this end, it is important to select specific product/business areas and identify market niches which provide long-term growth opportunities.

C. OPPORTUNITIES

Based on an assessment of Sri Lanka's natural rubber based industries as well as international markets, for natural rubber products, several opportunities emerge as possibly having long-term growth potential for Sri Lanka:

- Medical and Health-Care Related Rubber Products

  This opportunity stems from Sri Lanka's superior quality latex and latex crepe rubber which is used in producing a variety of dipped and fabricated rubber products for the growing world-wide health-care markets. Specific products include: surgical tubings, catheters, teats, adhesive plasters and tapes, sheeting, bottle closures, diaphragms, pacifiers, and other similar products.

  Sri Lanka will require foreign participation in developing these products. Specifically, the will need assistance in technology and production systems.

- Natural Rubber Based Composites

  Due to the unique physical and mechanical properties of natural rubber -- such as low hysteresis, high resiliency and good abrasion characteristics -- natural rubber in the form of composites, as with coconut coir fiber, presents an excellent opportunity. Although natural rubber/coconut coir fiber composites are currently produced in Sri Lanka of such products as cushions and mattresses, there are further opportunities in insulation, vibration isolation, sound deadening and similar engineering applications for the automotive, building, construction and industrial markets. The industry will require foreign participation primarily in the marketing area to identify specific end-use applications and market segments.

- Specialty Rubbers and Polymers

  Specialty rubbers and polymers is probably the fastest growing segment of the polymer industry to date. Like many synthetic rubber and plastic resins, natural rubber provides an excellent potential for conversion into intermediates such as granulated natural rubber, thermoplastic natural rubber and custom tailored natural rubber alloys and blends. Such intermediates are currently finding increased usage in many consumer and industrial rubber and plastic product applications, in replacing conventional rubber and plastic materials, and providing favorable cost/performance benefits.

  Sri Lanka can exploit such intermediates through its domestic market base and gradually expanding into international markets. However, due to the intricacy and proprietary nature of the technology involved in the production of such intermediates, local producers will clearly require foreign participation specifically in the areas of technology and market research.

SUMMARY PROFILE OF THE LIGHT ENGINEERING INDUSTRY

A. OVERVIEW

Sri Lanka consumes Rs 3-4 billion worth of Light Engineering products per year. Eighty-one percent of this demand is filled by imported products covering approximately 250 product areas. Domestically, there are an estimated 1000 registered metalworking companies and another 2,000 unregistered companies.

Significant opportunities exist for the development of Light Engineering products for agricultural uses. Agriculture has been targeted for a variety of reasons, including:

- Imports of farm equipment and implements are growing rapidly, while imports of other Light Engineering products show only slight growth or are declining.
- The country's agricultural land base is growing and farming employs a large portion of Sri Lanka's population.
- Agricultural yields could be improved through greater use of small scale mechanical products.
- Farm income will increase with increasing farm productivity, thus improving living standards in rural areas. This, in turn, will encourage the development of markets for other Light Engineering products.
- Such Light Engineering products generally require relatively small amounts of capital for development, permit use of available technology, and can be produced on a small scale in urban or rural areas.

B. OPPORTUNITIES

Manufacturing capabilities in Sri Lanka appear adequate for producing many Light Engineering products at appropriate quality and price levels. There appears to be substantial excess capacity in much of the country's Light Engineering manufacturing, including casting, forging, sheetwork, welding, plating, machining, and press work. Manpower skills are generally adequate. Similarly, design engineering skills are suitable for tailoring current designs of products appropriate to Sri Lankan needs.

Domestically, agriculture represents an Rs 0.6 billion market for Light Engineering products. In addition, there appears to be a significant export potential for farm-related Light Engineering products at technology levels appropriate for Sri Lanka. Nearby developing countries import more than $4 billion worth of such equipment annually.

A number of Light Engineering products could improve the country's ability to capitalize on its agricultural base by encouraging further exploitation of available land. Such improvements could be made in various areas including planting, harvesting, processing, and storage.

Several specific product opportunities have been identified in this survey and can be classified according to three major product groupings:

- Currently available technology for widely-used products.
- New products for specific applications.
- Advanced products for wide use.

Development costs for each of these opportunities are estimated in the following paragraphs. Given the uncertainty of such factors as the status of available technologies, equipment requirements, design modifications, the amount of market testing required, such cost estimates are highly approximate, and must be tested through more thorough prefeasibility analyses.

1. Currently available technology for widely-used products.

- Moldboard plow/Unibar Ridger for animal draft and two-wheel tractors. Only a prototype is imported at the present time.

The market potential is high for a product of this nature which would cost approximately Rs 500. Its use would aid cultivation of a wide variety of crops, including rice. This plow could be developed for approximately Rs 1.0-2 million, and could be completely fabricated on the island.

- Hand-pushed seed drill, granule spreader, or fertilizer applicators. These products are not widely available on the island, being imported primarily for experimental purposes. The market potential is high, as this type of product has application regardless of the crop or the size of the holding. Development costs are estimated at Rs 1-2 million. Depending on the design, such a product could be sold for Rs 100 to 1000.
- Portable sprayers/applicators. Such products are imported now for broad use in agriculture, household, and industrial environments. The country's foreign exchange position would improve through domestic manufacture. Complete manufacture would be possible on the island. Depending on features, these products could be sold for Rs 100-2000 and developed for Rs 0.5-1 million.
- Mammoty and related products. This group includes the mammoty, axe, garden fork, rake, shovel, sickle, crowbar, and large knife. While these products are manufactured locally to some degree, a large number are imported. At present, approximately Rs 8 million worth of mammoties alone are imported yearly. A larger share of these products could be made locally and sold at Rs 100-150. Development costs should total Rs 500 thousand.

2. Products for Particular Applications

- Transportable winnowers, threshers/reapers. These products are mostly imported, with limited domestic manufacture. All are useful in improving rice yields. Product development could be completed for about Rs 1 million. Products could be sold in the Rs 2,000-10,000 range.

- Bottling and packing. Such equipment is essential for the commercialization of fruits, and vegetable oils. Development efforts would be directed at tailoring existing system designs to the needs of Sri Lankan farm products and would cost about Rs 1 million. It is anticipated that bottling and packing systems could be sold for Rs 500-5,000.
- Screw-type river and shallow water pumps. Prototypes are being imported. In the future, the motor could be imported with the pump being made locally. Such engineered products would support further irrigation, and could be developed for Rs 0.5 million to sell for Rs 1500-2000.

3. Advanced Products for Wide Use

- Small diesel engines. This product has high market potential. Diesel engines are used with sprayers, crushers, and extractors, winnower/threshing/reapers, water pumps of all types, and generators and tractors. At present, there are approximately 50,000 internal combustion-driven water pumps alone, with annual sales in the 7,000-9,000 unit range. Life span of the engine-pump system has been estimated at 4 - 6 years, so there is an attractive market for replacements in addition to new equipment. The engines are now imported mainly from India and Japan. While no new product research would be required, manufacturing techniques on the island would have to be upgraded. Thus, this product could act as a vehicle for improving the country's overall manufacturing capabilities. Development costs could range from Rs 5-10 million; products could be sold for Rs 1,000-10,000.

- Small 4-wheel tractor (20 hp). Present two-wheel tractors are frequently overloaded, which shortens the tractor's limited life span. Unfortunately, available four-wheel tractors are too large and expensive for general use. Thus there appears to be a medium to high market for a small 4-wheel tractor. These could be manufactured completely in Sri Lanka, or with the engine imported, and sold for Rs 50,000-80,000. Development costs of Rs 5-10 million should be expected.

SUMMARY PROFILE OF MINERALS PROCESSING INDUSTRY

A. OVERVIEW

The mineral industry in Sri Lanka is heavily controlled by the government through ownership of the major mining corporations. These corporations are also chartered to process minerals and manufacture end-products. While it would appear that the industry is relatively closed to the private investor, there are nevertheless a limited number of private sector opportunities. In practice, these opportunities would in all probability have to involve joint ventures between foreign firms and the state corporations or possibly small local firms.

The principal minerals in Sri Lanka include graphite, heavy metal minerals sands, silica sands, cement, clays, dolomite and phosphate. Graphite, mineral sands, and phosphate industries appear to offer the greatest opportunity for further development based on Sri Lanka's reserve quality and international market growth.

Annual sales by the minerals industry are approximately Rs 1.4 to Rs 1.6 billion. Approximately Rs 1.3 billion is sold domestically while approximately Rs 230 million is exported. The export is primarily graphite and mineral sands.

B. CONSTRAINTS TO THE INDUSTRY

There are several constraints confronting development of Sri Lanka's minerals industry, namely the following:

- Technology: Sri Lanka does not possess the necessary technology needed to process minerals. The number of trained technical personnel required for plant operation is also limited. Foreign interests appear necessary to bridge the technology gap.

- Marketing: Current marketing efforts are limited and passive. Sri Lanka is in need of marketing channels which foreign interests could provide.
- Management: Under government ownership, the pay scales for management are not competitive with private industry. The industry is faced with the problem of retaining well trained managers.
- Finance: Projects within the industry are capital intensive. The financing of processing plants will have to come from foreign sources.
- Cost Control: The industry is hampered by inflation, productivity declines, and large inventory carrying costs. Production costs have been rising, making it difficult for Sri Lanka to price competitively.
- Exploration: There is a Geological Survey Department, but its activity is limited. To develop the industry, a stronger exploration program is needed.

C. RECOMMENDED STRATEGIES

The Sri Lankan industry should follow two strategies for further development. The first would be to achieve greater market penetration with existing products, thereby obtaining higher economies of scale. The second effort should be to integrate forward into processing and the manufacturing of end-products. This strategy would be best implemented through joint ventures with foreign firms. Turnkey purchases of plants and technology are not appropriate since Sri Lankan personnel currently have limited training to operate these facilities once construction is completed.

D. PRIVATE SECTOR OPPORTUNITIES

While project opportunities are limited in number, there are several which would appear to be viable for joint ventures.

Graphite

- **Upgrading of Graphite to Flake**

  Cuska Graphite Ltd. is currently trying to create a subsidiary to process graphite into a flake product. A foreign joint venture could possibly qualify for tax holidays related to exports thereby increasing overall returns on investment. The investment would require Rs 70-90 million generating Rs 46 million in annual sales with after-tax margins of 15-20% and a payback in four to five years.

- **Joint Venture to Produce Carbon Brushes and Electrodes**

  Ceylon Pencil Co., Ltd. is seeking a foreign partner to incorporate a new company to produce carbon brushes and electrodes. The capital required is around Rs 80 million. Yearly revenues are estimated at Rs 44-50 million with a pre-tax margin in excess of 50% and a return on investment after tax of 18%.

- **Refractories**

  Another opportunity lies in carbon brick refractories. There are several joint venture opportunities. There already exists a company in refractories which could be one candidate, as well as the State Mining Corp. and other local investors. Capital requirements are estimated at Rs 230 million with yearly revenues of Rs 345 million. Operating profit is estimated at 23% with a return on investment of 34%.

Mineral Sands

The one opportunity reviewed was the construction of a synthetic rutile and titanium dioxide pigment plant. This would be a major joint venture requiring a large foreign partner. Capital requirements are Rs 3 billion. Yearly revenue is estimated at Rs 1.4 billion with a pre-tax margin of 47% and a return on investment of 23%.

CHAPTER 7

ACTION PLAN FOR SRI LANKA'S PRIVATE SECTOR

The private sector has not been able to organize itself in an effective manner to articulate its views and influence the government policies and programs which bear directly on its well-being. The result has been predictable, namely, an uncoordinated effort by a few concerned private entrepreneurs to represent the viewpoints of a large, heterogeneous sector. The lack of organization and back-up support for these spokesmen has meant that the private sector has not been able to engage in a "dialogue of equals" with the government.

Despite the lack of precedent, there appears to be no reason why the private sector in Sri Lanka should not be capable of rising to this challenge. A significant impetus for change could be achieved if the private sector could develop a nucleus organization representative of the country's diverse economy, not only to enter into a dialogue with the government but also to launch independent initiatives in its own interest. Several levels of action would be desirable.

A. CREATION OF A PRIVATE SECTOR ECONOMIC DEVELOPMENT ADVISORY COUNCIL

ith formal recognition by the President and the government, the private sector should create an Economic Development Advisory Council representative of the nation's diverse private economy. An appropriate point of departure should be the existing Coordinating Committee for Private Sector Development which should undertake three tasks:

- Obtain formal recognition from the President and the government of the importance of a dialogue between the government and a new private sector Advisory Council.
- Select a representative cross-section of members from Sri Lanka's private sector, including different regions, ethnic groups, agricultural, industrial and service operations, and large and small firms.
- Develop a long-term agenda for the Advisory Council to act as a strategy for its operations.

B. FORMATION OF A TECHNICAL SECRETARIAT AND TASK FORCES TO SUPPORT THE WORK OF THE ADVISORY COUNCIL

Indispensable to the success of the Advisory Council and its dialogue with the government will be a high quality technical Secretariat to undertake the necessary research and analysis needed to articulate private sector viewpoints. The Secretariat would be composed of several highly qualified, well-paid professionals, at least three of which should be full time. The Secretariat could draw upon resources from other Sri Lankan institutions as well as independent consultants to assist it in its work.

To study specific policy or program areas, the Advisory Council should appoint special private sector task forces to oversee this work. Possible areas for task forces might be agricultural policy, industrial policy, tax and tariff policy, financial and banking reform, and marketing and investment information needs.

The Secretariat would provide the research support for these task forces. To do so effectively, it is essential that the Secretariat be well funded so as to attract to its staff the best talent in Sri Lanka. The positions on the Secretariat should be highly prized and rewarded.

C. FORMATION OF AN INVESTMENT AND MARKETING CENTER

Lacking in Sri Lanka's private sector is a catalyzing agent to make things happen. While opportunities and resources are available throughout Sri Lanka's economy, those entrepreneurs who could capitalize on them are frequently either unaware of these opportunities or unable to link up with the appropriate partners or institutions. Lack of information is often the source of this problem. There is no central source or clearinghouse of information or assistance to investors designed to meet investor needs. Similarly, inadequate market knowledge plagues most of Sri Lanka's producers, regardless of sector.

The private sector could on its own initiative establish an important precedent by promoting a catalyst organization designed to stimulate both domestic and foreign investment in high priority sectors. An Investment and Marketing Center would be a promotion and information agency, focussing on agro-business and manufacturing opportunities. The staff of the Center would play a brokerage role by bringing potential investors face to face with market and investment opportunities. Similarly, the Center should work closely with government agencies and the banking system, particularly the National Development Bank and the Development Finance Corporation of Ceylon, to help identify opportunities and potential investors.

As in the case of the Advisory Council Secretariat, the success of the Investment and Marketing Center will depend heavily on the quality of the personnel who work in it. Hence, the Center must be adequately funded and professional compensation must be high in order to attract the best talent available.

D. CREATION OF A MANAGEMENT DEVELOPMENT CENTER

The Advisory Council should take action to initiate a privately administered Management Development Center composed of a staff of qualified professionals responsible for short- and medium-term training programs specifically tailored to local managerial needs as well as management counseling services. The Center's activities would be designed to complement and supplement existing programs run by the government. After an initial start-up period during which the Center would be supported by outside funding, the operation could be expected to be a self-supporting economic activity.

Financing of a small, highly competent staff of management training specialists and consultants would constitute the principal operating cost of the program. Fees from its training programs and management counseling services would after an initial start up period cover these costs and allow the Center to expand its services and professional staff.

STRUCTURE OF A PRIVATE SECTOR ACTION PROGRAM