Final Report to:

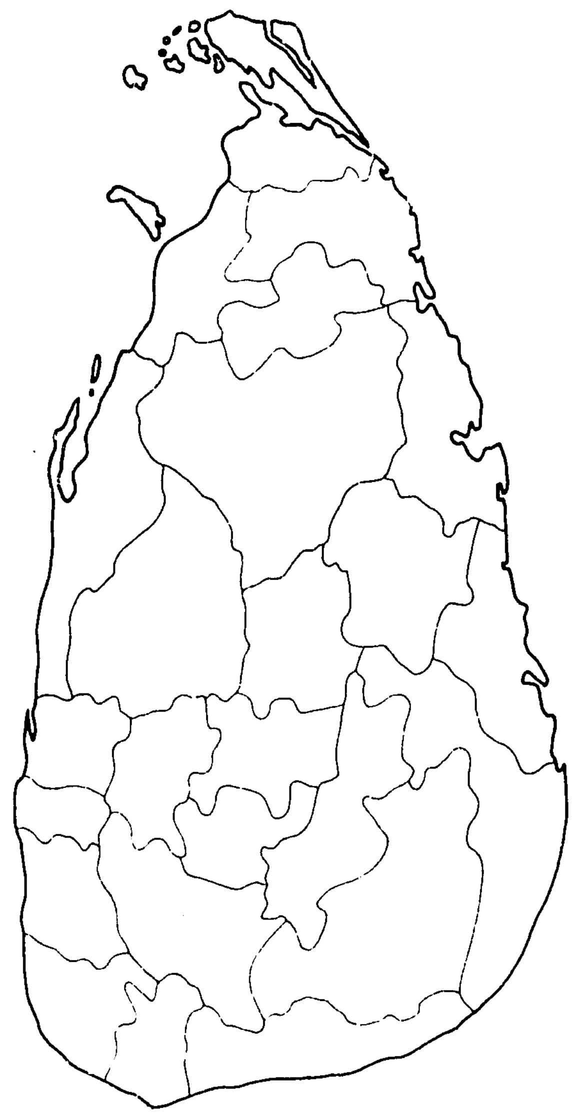
Ministry of Finance and Planning

Coordinating Committee for Private Sector Development

August 1983

Developing Sri Lanka's Private Sector and Its Investment Opportunities

Volume 2
The Private Sector and Its Environment



Arthur D. Little International, Inc.

Reference 88454

DEVELOPING SRI LANKA'S PRIVATE SECTOR AND ITS INVESTMENT OPPORTUNITIES

Volume 2

Definition of the Private Sector and the Environment for its Development

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

United States Agency for International Development

Contract No. AID/SOD/PDC-C-0390

August, 1983

Arthur D. Little International, Inc.

PREFACE

The present volume is the second of four volumes comprising a larger study entitled: Developing Sri Lanka's Private Sector and Its Investment Opportunities. Arthur D. Little International, Inc. was contracted in February 1983, by the United States Agency for International Development to undertake an analysis of means to strengthen and expand Sri Lanka's private sector and to identify a series of investment opportunities for private enterprises which would contribute to the growth of the sector as well as the national economy. The study which occurred over a four month period was conducted by a team of Arthur D. Little consultants and industry specialists in conjunction with a counterpart team of Sri Lankan professionals.

The study had two major objectives. The first focus was on the "environment" for private sector development, defined as the underlying conditions that affect the willingness and ability of private entrepreneurs (producers, manufacturers, and marketers) to invest their capital in new or expanded ventures. Such issues as government policies, regulation and programs were critical factors in this part of the analysis. Similarly, the resources needed by private entrepreneurs to launch and operate their ventures successfully were studied, namely, the availability of appropriate long-term capital and adequately trained managerial personnel.

The second objective of the study was to survey several economic sectors to identify investment opportunities for private enterprise. Sector opportunities were selected on the basis of several criteria:

- Commercial viability
- Comparative advantages either in domestic or foreign markets
- Employment generating potential
- Favorable foreign exchange impacts
- Strong linkages to other industries
- Positive impact on rural development

To test the conclusions and recommendations which emerged from the study, the Arthur D. Little - Sri Lankan study team formed several advisory groups composed of senior Sri Lankan public officials, bankers, and private entrepreneurs. Each of the seven advisory groups met periodically to review the results of the analysis and to offer their criticisms and suggestions.

The results of the study have been published in four separate volumes, as follows:

Volume 1 - Summary of the Study

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

Volume 3 - Opportunities for Agro-Industry Development

- Fruits and Vegetables
- Coconut Products
- Dairy Industry
- Fisheries
- Other Opportunities

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

- Rubber-based Products
- Light Engineering Industries Related to Agriculture
- Minerals Processing

TABLE OF CONTENTS

LIST OF TABLES

LIST OF TABLES
(Continued)

CHAPTER 1

DEFINITION OF SRI LANKA'S PRIVATE SECTOR

A. INTRODUCTION

This analysis brings together available data on the private sector as a whole, and particularly on the agricultural and industrial sectors which are the special focus of this study. Two difficulties have confronted this exercise. The first difficulty is the poor quality of such data in Sri Lanka. The quantitative information available is drawn largely from the Central Bank's statistics and is in highly aggregated form. For this study, the Central Bank's statistical services were requested to disaggregate some of these data to the extent possible to produce a clearer picture of the private sector's contribution and role in the economy. These data are contained in the tables of this chapter.

Second, with respect to private sector activity in agricultural and industrial sectors, quantitative data are also limited and unreliable. The situation is complicated by the fact that Sri Lanka's informal sector is no doubt very large and a major "employer" of the country's population. Since 75% of the island's population resides in rural villages, it is assumed that the informal sector is indeed sizable.

In the following sections particular attention has been paid to different segments of the agricultural sector because of their importance to development of the economy as a whole as well as private enterprise. The analysis purposely excludes the four major crop areas (tea, paddy, coconut, and rubber) for the following reasons. Both tea and paddy have been studied exhaustively in other reports and are presumed, for the purposes of this study, to offer few new opportunities for private sector expansion. Coconut and rubber are examined as specific sectoral opportunities in Volumes 3 and 4 respectively of this study.

B. GENERAL DIMENSIONS OF SRI LANKA'S PRIVATE ECONOMY

As a share of Gross National Product in 1981, the private sector accounted for 72% of the total. Of a total GNP of Rs 77,625 million in 1981 at current prices, the private sector accounted for Rs 56,173 million (see Table 1). The bulk of the private sector share was accounted for by the agricultural sector, followed by wholesale and retail trade and manufacturing. The public sector's weight is felt particularly in plantation agriculture, construction, and petroleum and chemical products.

1. Agriculture Production

The major role of the public sector in agriculture has been in the plantation sector (see Table 2). The State Plantation Corporation and the Janatha Estates Development Board together accounted for 79% of tea production and 40% of rubber production. However, a negligible 1.6% of coconut was in the public sector. While the public sector accounted for 12% of the agriculture sector as a whole, it nevertheless controlled 65% of the plantation sector. Other public sector activity in the agriculture sector has been in the provision of extension services and in planting and replanting. The public sector is also dominant in sugar production where it accounts for an estimated 90% of the total. In the dairy industry, the state accounts for an estimated 20% of milk production.

In other areas of agriculture, however, the private sector accounts for virtually all production, namely in paddy, tobacco, minor export crops, subsidiary food crops, fruits, vegetables, poultry, etc.

2. Industrial Production

In aggregate terms, the state corporations dominated total industrial production in 1981, accounting for 63% of total production

TABLE 1

GNP 1981 AT CURRENT FACTOR COST PRICES

(Rs millions)

	Private Sector	Public Sector	Total
1. Agriculture, Forestry and Fishing	19,380	2,597	21,977
Agriculture	15,880	2,424	18,310
Tea	451	1,697	2,148
Rubber	568	383	951
Coconut	2,903	47	2,950
Paddy	5,372	--	5,372
Other	6,592	297	6,889
Forestry	1,348	151	1,499
Fishing	2,146	22	2,168
2. Mining & Quarrying	1,231	283	1,514
3. Manufacturing	8,861	4,022	12,883
Export Processing	2,580	1,397	3,977
Factory Industry	4,644	2,625	7,269
Small Industry	639	--	639
Other	998	--	998
4. Construction	2,637	4,364	7,001
5. Electricity, Gas, Water & Sanitary Services	--	808	808
6. Transport, Storage and Communication	4,723	584	7,307
7. Wholesale & Retail Trade	11,310	2,887	14,197
Imports	3,727	--	3,727
Exports	1,697	1,130	2,827
Domestically produced goods	5,886	1,757	7,643
8. Banking, Insurance & Real Estate	1,447	1,016	2,463
9. Ownership of Dwellings	1,768	--	1,768
10. Public Administration and Defense	--	2,350	2,350
11. Services (n.e.s.)	5,004	2,065	7,069
12. G.D.P.	56,361	22,976	79,337
13. Net Factor Income from Abroad	188	1,524	1,712
14. G.N.P.	56,173	21,452	77,625

*Calculated on Basis of Central Bank Data

TABLE 2

GNP 1981 - SECTORAL SHARE
(Percent)

	Private	Public
1. Agriculture, Forestry and Fishing	88	12
Plantation Agriculture	35	65
Other Agriculture	97	03
2. Mining & Quarrying	81	19
3. Manufacturing	71	39
Export Processing	65	35
Factory & Other	71	29
4. Construction	38	62
5. Electricity, Gas, Water & Sanitary Services	---	100
6. Transport, Storage & Communication	65	35
7. Wholesale & Retail Trade	80	20
8. Banking, Insurance and Real Estate	59	41
9. Services (n.e.s.)	71	29
10. G.D.P.	71	29
11. Net Factor Income from Abroad	89	11
12. G.N.P.	72	28

*Calculated on Basis of Central Bank Data as shown in Table 3. This figure may be misleading because of the weight of petroleum refining which is undertaken exclusively by the state. If petroleum is removed from these calculations, industrial production by the private sector accounts for 65% of total production. The largest categories of production are in food, beverages, and tobacco (38% of total private industrial production in 1981) and textiles, garments and leather products (accounting for 27% of total private production in 1981) as shown in Table 3.

In Table 4, the Central Bank of Ceylon estimates for 1981 total value added to industrial production at approximately Rs 6 billion, of which Rs 3.4 billion (or 56%) is accounted for by the private sector. Value added to local production within the private sector occurs mainly in food, beverages, and tobacco as well as in chemical, rubber, and plastic products.

3. Exports

Sri Lanka's exports are dominated by tea, rubber, textiles and garments, and petroleum products. As shown in Table 5 for 1981, the private sector was the principal exporter in most categories with the exception of tea and petroleum products. Industrial exports of the private sector were overwhelmingly dominated by textiles and garments.

4. Fixed Capital Formation and Value of Stock of Assets

As shown in Table 6, there has been a dramatic increase in fixed capital formation since 1977 when the current government took office. Private sector fixed capital formation rose from Rs 2.7 billion in 1977 to Rs 8.7 billion. Public corporations (including the Mahaweli Authority) showed an increase from Rs 0.8 billion in 1977 to Rs 11 billion in 1981. Almost half this latter figure was accounted for by the Mahaweli Authority investments.

<u>TABLE 3</u>

VALUE OF INDUSTRIAL PRODUCTION[1]
(Rs Million)

		Private Sector		Public Corporations	
		1980	1981	80	1981
1.	Food, Beverages and Tobacco	2,712	3,167	187	1,329
2.	Textile Wearing Apparel and Leather Products	1,426	2,264	497	776
3.	Wood and Wood Products	3	15	286	300
4.	Paper and Paper Products	187	226	289	400
5.	Chemicals, Petroleum, Coal, Rubber and Plastic Products	737	1,669	8,679	10,346
6.	Non Metallic Mineral Products	233	264	923	986
7.	Basic Metal Products	--	--	478	428
8.	Fabricated Metal Products	573	738	47	44
9.	Other Manufactured Products	54	58	--	--
	TOTAL	5,925	8,401	12,386	14,609

[1]Disaggregated figures for industrial production include manufacturing, mining, construction, and utilities.

Source: Central Bank of Ceylon.

TABLE 4

VALUE ADDED IN INDUSTRY
1981

	Category	Rs Millions Private Sector	Public Sector	Total
1.	Food, Beverages and Tobacco	1,333	558	1,891
2.	Textile Wearing Apparel and Leather Products	381	132	513
3.	Wood and Wood Products	07	162	169
4.	Paper and Paper Products	96	168	264
5.	Chemicals, Petroleum, Coal, Rubber and Plastic Products	1,059	1,039	2,098
6.	Non-Metallic Mineral Products	130	463	593
7.	Basic Metal Products	--	80	80
8.	Fabricated Metal Products	383	23	406
9.	Manufactured Products n.o.s.	16	--	16
	TOTAL	3,405	2,625	6,030

Note: These estimates have been obtained by applying the value added ratio in each category, to total production value.

Source: Central Bank of Ceylon estimates.

TABLE 5

COMPOSITION OF EXPORTS IN 1981

	Private Sector	%	Public Sector	%	Total
1. Agricultural Exports	4,866	(40)	7,206	(60)	12,072
Tea	611		5,833		6,444
Rubber	1,797		1,092		2,889
Coconut	1,172		266		1,438
Other	1,286		15		1,301
2. Industrial Exports	3,483	(49)	3,576	(51)	7,059
Textiles & Garments	2,997		3		3,000
Petroleum Products	--		3,375		3,375
Other	486		198		684
3. Mineral Exports	632	(83)	134	(17)	766
Gems	632		--		632
Other (Graphite, Ilmenite,etc.)	--		134		134
4. Other Exports	688	(100)	--	--	688
TOTAL	9,669	(47)	10,916	(53)	20,585

Note: Based on Sectoral origin of exports

Source: Central Bank of Ceylon.

TABLE 6

FIXED CAPITAL FORMATION BY SECTOR
(Rs Millions)

	1973	1974	1975	1976	1977	1978	1979	1980	1981
Private Sector	1,414	1,777	2,138	2,471	2,721	3,796	5,781	9,095	8,653
	(57)	(60)	(58)	(54)	(54)	(43)	(43)	(42)	(37)
Public Corporations	489	384	466	493	772	2,002	4,002	7,681	10,951
	(29)	(13)	(13)	(11)	(15)	(23)	(29)	(36)	(46)
Central Government	590	811	1,095	1,631	1,542	3,077	3,809	4,709	4,126
	(24)	(27)	(30)	(35)	(31)	(35)	(28)	(22)	(17)

Note: Percentage share in brackets.
Public Corporations includes Mahaweli Authority

Source: Central Bank of Ceylon.

According to the Central Bank calculations based on the value of total fixed capital formation over the 1974-1981 period, the value of stock of assets for the private sector is estimated at approximately Rs 35 billion. Public corporations' assets are estimated at Rs 26.4 billion (of which the Mahaweli Authority is said to account for Rs 10.1 billion) and Central Government assets are estimated at Rs 21.4 billion.

Fixed capital formation in the private sector for 1979-1981 is shown in Table 7. Building and construction show a regular decline in the three year period while plant and machinery were rising steadily.

Capacity utilization, shown in Table 8, for 1981 reveals that those industries with the greatest export orientation (petroleum products and minerals) have had the largest degree of utilization of installed capacity.

C. DESCRIPTION OF THE PRIVATE AGRICULTURAL SECTOR

The agricultural or agri-based industry sector is, for purposes of this study, assumed to encompass all the participants involved in the production, primary processing, and marketing of farm products or commodities. It includes farm suppliers, farmers, storage operators, transporters, processors, wholesalers, and exporters involved in the process of producing farm commodities, transforming them, and moving them through the system to the domestic or foreign consumer. It also includes those institutions which affect and coordinate the successive stages of these product movements. Government, in the form of its various boards and departments for research, extension, regulation, etc., is typically the dominant actor in this latter activity.

Within the agro-industry or agricultural sector, the "private sector" is intended to imply those enterprises engaged in any of the above activities whose management decisions are made completely by a person or persons who:

TABLE 7

FIXED CAPITAL FORMATION IN THE PRIVATE SECTOR
(Rs Millions)

	1979	1980	1981
Planting and Replanting	313	571	342
Building and Construction	2,159	2,039	1,659
Plant and Machinery	1,422	2,355	2,575
Transport Equipment	821	3,056	2,402
Other Capital Goods	1,066	1,074	1,675
TOTAL	5,781	9,095	8,653

Source: Central Bank of Ceylon.

TABLE 8

CAPACITY UTILIZATION
1981

		Private Sector	Public Sector
1.	Food, Beverages & Tobacco	66	n.a.
2.	Textiles, Wearing Apparel and Leather Products	65	50
3.	Wood and Wood Products	--	68
4.	Paper and Paper Products	30	61
5.	Chemicals, Petroleum, etc.	76	65
6.	Non Metallic Mineral Products	65	86
7.	Base Metal Products	--	48
8.	Fabricated Metal Products	60	--
9.	Manufactured Products	60	--

Source: Central Bank of Ceylon.

- are not acting on behalf of the government;
- are not hired by the government to manage the enterprise nor are subject to civil service personnel policies; and
- do not have access to government regulatory, financing, pricing, or other possible concessions or advantages not generally available to other firms operating in the sector.

In other words, an individual farmer, a sole private proprietership, a private partnership, and a public stock company (whose majority stockholders and operating by-laws were not government dominated) would all be considered "private sector enterprises." However, a state-owned corporation, although ostensibly operating independently of the government, would not be "private sector".

Evaluating the degree and nature of public/private involvement in the sector is important for several reasons. First, the information developed can provide insight into the likely responsiveness of the sector to various stimuli like shifting market conditions, increasing or decreasing profitability, competitive pressures, etc. Second, it provides a guide for tailoring agricultural policy for the maximum effect (i.e., policies designed to influence the private sector may be totally inappropriate to public enterprises, and vice versa). Finally, it provides a structural benchmark of the sector from which government may wish to evolve to meet various national objectives.

Table 9 summarizes the degree of public/private involvement at various levels of the agricultural sector. Except for tea and sugar production and processing, and to a much lesser degree, rubber production and processing, the private sector tends to dominate all stages of agricultural production, processing, and marketing.

Approximately 16-17 percent of the value of production at the farm level is controlled by the state. This is somewhat greater at the processing level (perhaps 20 percent) due to the purchase of small holder production by government tea, rubber, and coconut facilities and the involvement of the state in tobacco, fruit, wheat, milk, and animal feed processing or manufacture. However, in the marketing of

TABLE 9

PUBLIC/PRIVATE CONCENTRATION IN THE AGRICULTURAL SECTOR

(Percent of Volume)

Commodity	PRODUCTION		PROCESSING			MARKETING[1]			
						DOMESTIC		EXPORT	
	Private	Public	Percent of Production Processed	Private	Public	Private	Public	Private	Public
Tea	21.0	79.0	100.0 (Dried, etc.)	18.9	81.1	11.0	1.0	86.0	2.0
Rubber	60.0	40.0	100.0 (Smoked/Sheets, etc.)	63.2	36.8	11.0	0.0	86.0	3.0
Coconut	98.5	1.5	44.6	89.6	10.4	77.0	0.0	23.0	0.0
Paddy	100.0	0.0	93.4[2]	98.6	1.4	62.0	38.0[3]	0.0	0.0
Sugar: Sugar	10.0	90.0	100.0	0.0	100.0	76.2[4]	23.8[4]	0.0	0.0
Jaggery	91.7	9.3	100.0	91.7	9.3	91.7	9.3	0.0	0.0
Tobacco	100.0	0.0	85.4	71.4	28.6	88.2	5.9	5.9	0.0
Minor Export Crops	99.3	0.7	48.6	100.0	0.0	81.5	0.2	18.0	0.2
Subsidiary Food Crops	99.9	0.1	6.9	15.0	85.0	82.5	12.4	5.1	0.0
Fruits	100.0	0.0	3.9	62.5	37.5	89.6	2.9	7.5	0.0
Vegetables	100.0	0.0	Minimal	--	--	84.5	14.1	14.1	0.0
Poultry	100.0	0.0	50.0 (Broilers)	100.0	0.0	100.0	0.0	0.0	0.0
Dairy	80.0	20.0	60.0	30.0	70.0	80.0	20.0	0.0	0.0

[1] Domestic and export together add to 100 percent. Does not reflect quantities consumed on-farm.

[2] Balance is seed and post-harvest losses.

[3] Includes imported rice sold by the Food Commissioner.

[4] Includes imports.

Source: Arthur D. Little, Inc., estimates based on Sri Lankan Government data and interviews with individuals knowledgeable of the various subsectors.

agricultural products either domestically or abroad, state involvement is probably less than 10 percent. Only in rice and sugar marketing (38 and 24 percent respectively) does the government have any appreciable involvement. Of course, the source of nearly 45-50 percent of agricultural exports is government estates. However, most of this is actually marketed by private firms. In addition, approximately one-quarter of the agricultural labor force is employed on these government estates.

For many agricultural inputs, the State sector tends to be dominant. This is especially true in animal feeds (63 percent of production and 50 percent of capacity), seeds (perhaps 90 percent of nonplant-back seeds), hoes or mammoties (all imports and domestic production); and fertilizer (all domestic production, 85 percent of issues). However, the provision of day-old chicks for poultry operations is entirely in private hands as are most sales of farm tools and implements. Tractors are supplied by both the public and private sectors although most are imported by the Sri Lanka Trading Corporation.

Table 10 reflects those principal government groups currently involved in the commercial aspects of the agricultural sector. These commercial-type ventures fall under the administrative control of nine separate Ministries. In addition to these state corporations, the Government controls the major financial institutions providing credit to the agricultural/agribusiness sector as well as the Agricultural Insurance Board and the Sri Lanka Export Credit Insurance Corporation, which extends insurance services to the sector.

Numerous government bodies (e.g., the Mahaweli Development agencies and boards, the Department of Rural Development) undertake or oversee development projects in which a number of commercial-type activities are handled by the implementing state institution. These activities may include land clearing, credit extension, provision of inputs, storage facilities, and marketing services, and even product processing. Other government groups have been established to assist

TABLE 10

PUBLIC (STATE) BODIES INVOLVED IN COMMERCIAL AGRIBUSINESS

	Production	Processing	Marketing (Retail or Export)
1. Janatha Estate Development Board (Tea, Rubber, Coconuts)	X	X(Primary)	
2. Sri Lanka State Plantations Corporation (Tea, Rubber, Coconuts)		X(Primary)	
3. Sri Lanka State Trading (Tea) Corporations			X
4. State Rubber Manufacturing Corporation		X	X
5. Sri Lanka Cashew Corporation	X	X	X
6. Sri Lanka Sugar Corporation	X	X	
7. Ceylon Fertilizer Corporation			X
8. Paddy Marketing Board		X(Milling)	
9. Lanka Canneries (Fruit)		X	
10. Consolidated Commercial Agencies Ltd. (Tea Machinery)	X		X
11. Department of Food Commissioner			X
12. Sri Lanka Tobacco Industries Corporation		X	
13. Sri Lanka Jute Industries Corporation		X	X
14. Sri Lanka Tyre Corporation		X	
15. Sri Lanka State Flour Milling Corporation		X	
16. State Fertilizer Manufacturing Corporation	X	X(Blending)	
17. State Distilleries Corporation		X	
18. Sri Lanka State Trading (General) Corporation		X	
19. Sri Lanka State Trading (Consolidated Exports) Corporation			X
20. National Milk Board		X	
21. Ceylon Oils and Fats Corporation		X	X
22. British Ceylon Corporation (Coconuts)		X	X

in promoting and marketing products abroad. Finally, a number of agriculturally-related cooperatives were organized, are administered, and/or are regulated by the government. However, most government "cooperatives" in Sri Lanka are basically retail outlets handling primarily consumer goods without any real member base or governance.

In total there are approximately 75 state agencies, departments, boards, authorities, and corporations under 15 ministries which influence or participate in one facet or another of the agricultural/agribusiness sector. There appears to be no logical framework or comprehensive guiding principles for this state involvement in the sector at this time. While well articulated and logical objectives may have motivated initial government entry into an area, the evolutionary process over time of politics, personalities, economics, regulations, and market conditions have eroded any sound basis for much of this involvement. Thus, while most of the agricultural sector in percentage terms remains in private hands at all levels (production, processing, marketing), the patchwork and sometimes questionable rationale of government involvement at so many junctures within the sector and the fact that government need not act within the parameters which dictate rational private sector behavior, creates an often untenable or uncertain operating environment for many private sector firms or individuals.

General Trends and Implications

Since 1977 there has been a gradual move away from the more rigid and comprehensive involvement of government in the agribusiness sector. This has been manifested in a number of ways to include:

- Undertaking mixed private/state ownership of projects (as is currently planned for the three new sugar mills).
- Leasing of certain government estate lands to private firms (generally, or at least initially, these appear to be some of the less profitable operations of the government).

- Requiring certain state corporations to operate as companies rather than as public agencies (e.g., Lanka Canneries).
- Transfering state corporations or activities to private firms (e.g., flour milling to Prima, milk processing to Nestle's).
- Permitting private sector participation in the import and/or sale of such items as fertilizer and sugar which were previously entirely in government hands.
- Establishing floor prices rather than fixed prices for agricultural commodities which permits the private sector to bid products away from state corporations if it is profitable to do so.
- Having agencies such as the Paddy Marketing Board act primarily in a regulatory mode and buyer of last resort rather than as the principal purchaser, handler, and marketer of farm products.
- Distributing new lands (e.g., Mahaweli) to private farmers rather than retaining them under state ownership or state cooperatives.

Most of these actions on the part of government have had or are expected to have a positive influence on the future growth of the agribusiness sector. However, others, while on the surface appearing as positive moves by the government to open up or stimulate the agricultural economy, in fact have little influence at all. A key example would be the government floor price to farmers for milk. This is discussed in more detail in Volume 3. Finally, there are those government actions which, while intended to stimulate or contribute operational efficiency, may actually be detrimental to medium-to-long term sectoral growth in agribusiness. An example may be the virtual monopoly given to large foreign firms in the milling and dairy industries apparently without adequate guarantees or stipulations to protect local competing firms, to promote eventual transfer to local hands, to stimulate to local production, and/or to provide nutritionally high quality products (in the case of the 72 percent derivative flour to be produced and marketed). A danger may also exist with projects like the planned sugar mills less the guaranteed financial returns by government are coupled with appropriate performance criteria by the project operators.

While the government presently states its desire to further "privatize" and open up the agribusiness sector, for the immediate future, this will probably be limited primarily to new ventures and supporting policies, regulations, and financial access rather than to any major divestments of state properties or corporations. While the political mood in the country appears to be such that further public divestiture would be acceptable to the people, government may be unwilling to make such moves for three fundamental reasons: revenues, employment, and patronage.

With Mahaweli and other government initiatives making major demands on revenues, the government will feel pressed to retain any state corporation felt capable of generating a positive cash flow. Conversely using this rationale, any state corporation operating in a deficit situation would be a logical candidate for divestment. However, this is where the employment issue comes to the fore. Perhaps half of all public jobs (government and semi-government) and 20 percent of all jobs in Sri Lanka are within the state controlled agribusiness sector (farm production and related industries). Thus, this becomes a powerful mechanism for rewarding supporters and remaining in elective office. In addition, since employment in most state corporations is felt to exceed that needed to operate effectively and profitably, any transfer to the private sector of these firms could result not only in the loss of patronage options but also might cause a rise in unemployment in the short run which would generally be unacceptable politically. Nonetheless, whereas this situation may exist in the near term, provided the political climate does not change, government actions should continue the trend toward operational rationality which would include further transfers of management if not also ownership to the private sector.

D. DESCRIPTION OF THE INDUSTRIAL SECTOR

The industrial sector in Sri Lanka has remained a relatively small component of the economy with only modest growth over the years. Total industrial production (including manufacturing, mining, construction, and utilities) accounted for 29% of Gross Domestic Product in 1981 or a total of Rs 23 billion. Real growth in the sector in 1981 was 2%. Manufacturing industries alone, however, accounted for only 14% of GDP.

Total output value for the industrial sector of Rs 23 billion can be broken down as follows:

• Raw Materials	
Imported	Rs 10.7 billion (46%)
Domestic	Rs 4.6 billion (20%)
• Value Added to Production	Rs 6.0 billion (26%)
• Power and Fuel	Rs 1.7 billion (8%)

As shown in Table 11, the chemicals and petroleum group represents over half of industrial output. It must be noted, however, that the majority of this production consists of petroleum processing based on imported crude. Food, beverage, tobacco, textiles, apparel, and leather goods account for another 34% of production. Therefore non-textile, non-food processing, and non-petroleum production accounts for less than 20% of total industrial production (or less than Rs 4.6 billion).

Industry in Sri Lanka has traditionally been oriented toward the small domestic market, dominated by the food, beverages, and tobacco, and the textile and garment industries. Until recently, industrial policies have emphasized import substitution with only marginal support for exports. The result had been the development of many

TABLE 11

INDUSTRIAL PRODUCTION BY MAJOR SUB-SECTORS (1981)

	Industry Group	Industrial Output (M Rs)	Value Added (M Rs)	Raw Material Usage (M Rs)	Fuel & Power Usage (M Rs)	Public Sector (M Rs)	Private Sector (M Rs)	Number of Private Sector Registered Firms
01	Food/Beverage/Tobacco	4,496	1,891	2,487	118	1,578	2,918	481
02	Textile/Apparel/Leather	3,040	513	2,371	156	354	2,686	1,591
03	Wood and Wood Products	315	169	117	29	299	16	69
04	Paper and Paper Products	626	264	246	116	355	271	250
05	Chemicals, Petroleum, Coal, Rubber and Plastic Products	12,015	2,098	9,181	736	11,096	919	1,251
06	Non-Metallic Minerals	1,250	593	185	472	985	265	205
07	Basic Metal Products	428	80	299	49	424	4	31
08	Fabricated Metal Products, Machinery and Transport	782	406	342	34	317	465	968
09	Other Manufactured Products	58	16	38	4	0	58	69
		23,010	6,030	15,266	1,714	15,408	7,602	4,915

SOURCE: Central Bank of Ceylon

small domestic producers in consumer durables in such areas as fabricated metal products, chemicals and plastics, operating with considerable protection from international competition.

Exports and imports of all types of agricultural and industrial goods in 1981 are illustrated in Table 12. As indicated, Sri Lanka has no significant exports of manufactured goods but is heavily reliant on imported machinery and mechanical appliances, both electrical and non-electrical.

The private sector accounted for approximately 33% of total industrial production (Rs 7.6 billion). Table 13 details the exact contribution by the state corporations and other public entities to industrial production.

1. Structure and Characterization of the Private Industrial Sector

In terms of size and employment, industrial firms can generally be classified as follows:

	Number of Units[1]	Estimate of Employment[1]	Production (Million Rs)[1]
1. Public Sector	28	61,452	15,408
2. Private Sector			
• Registered--Large[2]	382	53,000[2]	
• Registered--Small	4,532[3]	100,000[2]	7,602
• Unregistered--Cottage	15,000 to 30,000	350,000[2]	

[1]Central Bank of Ceylon, 1981.

[2]Nathan Report, 1982, USAID.

[3]Estimates of the total number of small firms (registered and unregistered) range up to 8,300.

TABLE 12

MAJOR IMPORTS AND EXPORTS - ALL SECTORS (1981)

MAJOR EXPORTS

Customs Code	Description	Value (Rs)	Percent of Total
09	Coffee, Tea, Maté and Spices - Tea (6,443,548,000)	7,314,267,889	37.0
40	Rubber, Synthetics	2,962,776,856	15.0
61	Apparel	2,734,353,689	14.0
27	Mineral Fuels and Oils	1,028,647,703	5.0
08	Edible Fruit and Nuts - Coconut (775,114,000)	900,439,796	4.6
58	Carpets, Mats, Matting, Tapestry	374,616,567	1.9
03	Fish, Crustaceans and Mollusks	346,195,347	1.7
12	Oil, Seeds, Plants, Straw, Fodder	253,185,590	1.3
			80.5%

MAJOR IMPORTS

Customs Code	Description	Value (Rs)	Percent of Total
27	Mineral Fuels and Oils	8,644,281,936	25.0
84	Machinery and Mech. Appliances	3,144,084,358	9.1
10	Cereals	2,763,879,429	8.0
17	Sugar and Sugar Confectionary	2,681,665,744	7.8
87	Vehicles	2,216,305,019	6.4
85	Electrical Machinery and Equipment	1,961,524,060	5.7
73	Iron and Steel and Articles Thereof	1,589,209,574	4.6
31	Fertilizers	1,191,374,740	3.4
56	Man-Made Discontinuous Fibers	1,093,391,033	3.2
			73.2%

TABLE 13

INDUSTRIAL PRODUCTION - STATE SECTOR
(Rs. MILLION)

	1980	1981
Food, Beverages and Tobacco	1187	1329
National Milk Board	252	182
Ceylon Oils & Fats	198	148
Sri Lanka Sugar	173	261
State Flour Milline	315	391
National Salt	32	44
State Distilleries	166	244
Sri Lanka Tobacco Industries	46	54
Ayurvedic Drugs	5	5
Textiles Wearing Apparel Leather Products	497	776
National Textiles	96	138
Wellawatte Spinning & Weaving Mills (G.O.B.U.)	20	22
Ceylon Silks (G.O.B.U.)	32	30
Ceylon Leather Products		
Wood and Wood Products	286	300
Ceylon Plywoods	160	112
State Timber	126	188
Paper and Paper Products	289	400
National Paper	247	355
State Printing	42	45
Chemical Products	8,679	10,346
State Rubber Manufacturing	33	28
Sri Lanka Tyre	403	230
Paranthan Chemicals	27	39
B.C.C.	--	--
Ceylon Petroleum	8,216	10,049

TABLE 13
(Continued)

INDUSTRIAL PRODUCTION - STATE SECTOR
(Rs. MILLION)

Non Metallic Mineral Products	923	986
Ceylon Ceramics	120	130
Sri Lanka Cement	756	677
Ceylon Mineral Sands	12	23
State Mining and Mineral Development	35	136
Basic Metal Products	478	428
Ceylon Steel	478	428
Fabricated Metal Products	47	44
State Hardware	47	44
TOTAL	12,386	14,609

Source: Central Bank of Ceylon.

Large, registered firms tend to have the following characteristics:

- Their ownership is generally in the form of a limited liability company or a joint venture with a foreign corporation.
- They are relatively capital intensive.
- They rely heavily on bank financing or off-shore equity participation.
- They are geographically concentrated in the Colombo area.
- They are concentrated in the electronic, electrical, glass, rubber, soap, pharmaceutical, paint, textiles and garments, steel rolling, metal forming and fabrication, castings, construction material, and wood and paper products.

Small registered firms tend to have the following characteristics:

- Generally family owned or a partnership.
- Relatively mechanized industries.
- Primarily private financing, with some bank financing.
- Geographically dispersed but with a greater concentration in Colombo and other metropolitan areas.
- Include light engineering, wood working, furniture, ceramics, leather finishing, leather products, jewelry, glass products, soap products, and construction material.

Unregistered firms tend to have the following characteristics:

- Owner-managed.
- Generally few (less than 5) if any employees; less than 10% would employ over 15 people.
- Low capital investment and very labor intensive.
- Non-bank financing.
- Geographically dispersed.
- Products are marketed locally.
- Heavy concentration in handicraft industries.

The key category of industrial products of interest to this study is Machinery and Fabricated Metal products because of its high growth potential, its ultimate employment impacts, and its linkages to other industries, particularly agriculture. Table 14 indicates the breakdown of this subsector in 1980-1981.

The private sector accounted for approximately 93% of total production in this sub-sector in 1981. Principal product categories were batteries, hardware, electrical appliances, and containers.

TABLE 14

DOMESTIC PRODUCTION
(08 - Machinery & Fabricated Metal Products)
(Rs Millions)

Subsector	# Firms	Production 1980	Production 1981	Employment 1981	Total Value (000)	Materials Power (000)	Value Added (000)
Galvinized Steel Sheets	1	41,776	37,144	50	768	46,596	9,431
High Fabricated Metals	-	-	-	-	-	-	-
Containers	1	39,404	65,503	313	1,691	24,343	41,160
Cables	2	33,388	18,618	485	3,340	23,430	9,660
Major Machinery[1]	2	21,289	24,506	763	4,742	6,482	7,899
Electrical Appliances[2]	2	72,135	61,688	498	6,670	47,330	14,350
Hardware	11	99,255	105,117	842	6,394	78,970	2,652
Spare Parts	1	9,229	9,503	100	1,330	7,259	2,244
Consumer Products[3]	1	18,254	26,190	313	3,446	8,150	18,032
Electric Bulbs	2	21,606	21,743	254	2,2023	11,575	10,167
Batteries	3	164,342	240,996	814	14,359	132,391	108,606
Radios	3	28,220	37,228	553	2,995	11,702	5,697
Printing	-	-	-	-	-	-	-
TOTAL	29	548,898	676,235	4,985			
Government Sector			53,000				
Grand Total			729,000				

[1] Tea, rubber processing.

[2] Fans, sewing machines.

[3] Rayons, hair clips, paper clips.

CHAPTER 2

AGRICULTURE AND INDUSTRY POLICY ENVIRONMENT

I. AGRICULTURE SECTOR DEVELOPMENT POLICIES

A. GENERAL POLICY CONSIDERATIONS

Sri Lanka's principal option for resource-based economic development is its agricultural potential. For years, Sri Lanka's agricultural sector has been the source of wealth which has funded government expenditures and economic development in other parts of the economy. While this dependence has declined somewhat in recent years, Sri Lanka must continue for the foreseeable future to rely heavily on agriculture as a major generator of national income, employment, foreign exchange, and government revenues.

Even as this dependence lessens, agriculture will probably always remain a mainstay of the economy. Consequently, at no time should support to the agricultural sector be permitted to evolve to the point where it becomes a drain on other sectors. The country cannot afford a "welfare" agricultural system where subsidies and the cost of sectoral programs exceed government revenues and/or are simply income transfers which do not stimulate production, productivity, employment, or exports.

Sri Lanka's underlying planning principle should be to develop a food and agricultural sector which is independent, self-sufficient, and increasingly adding value to production through processing. This independence implies the following:

- Financial viability so that the sector pays for itself: Gross farm income and government revenues from the sector must cover:
  - Production costs
  - Government services and programs, benefitting the sector
  - A proportional share of nonsector-specific government infrastructure and services, such as roads and ports
  - An appropriate share of social services flowing to employees of the sector and their families.

- Foreign exchange self-sufficiency, whereby exports of raw and processed products from the sector are at least equal to the import value of:
  - Food, beverage, tobacco, and fiber products consumed domestically
  - Production inputs of the sector, including inputs for processing and related public sector services and infrastructure (fertilizer, chemicals, fuel, machinery, vehicles, etc.)

Too often analyses of a sector's income and foreign exchange position take into consideration only enterprise profitability and food and agricultural commodity exports versus imports, not these other elements. This is misleading when setting national goals and targets if an economy does not have alternative sectors able to subsidize the sector being analyzed. Agriculture in Sri Lanka, as a sector, must carry its own weight.

B. CURRENT PRIORITIES FOR AGRICULTRAL DEVELOPMENT

According to the 1982-1986 Public Investment Program , the specific goals for the food and agricultural sector are:

- To maximize production of basic food items such as rice, milk, sugar, fish and pulses in order to achieve a high degree of self-reliance in the supply of food to the population;
- To expand earnings from agricultural exports to improve the balance of payments of the country; and
- To increase income and employment opportunities in the rural sector to help the poorer sections of the population attain better standards of living and food intake.

Although not explicitly stated, there appear to be several additional goals such as:

- To insure an adequate nutritional intake by the poorer sections of the population;

- To maintain, if not expand, Government revenues generated by the sector; and
- To increasingly shift the responsibility for future growth in the agricultural/agribusiness sector into private or public/private hands.

In order to attain these goals, the government delineates the following key program elements:

- Rehabilitation and expansion of irrigation facilities to broaden the agricultural production base and raise employment and productivity levels in the economy;
- Improvement in land and water management/utilization for promoting full and optimal use of agricultural resources in the country;
- Adequate producer incentives and improvement in the agricultural marketing support systems for inducing production increases and encouraging farmers' involvement in sustaining productivity improvements and growth in the leading agricultural activities;
- Rehabilitation of the major export crop sub-sectors through a combination of new planting/replanting programmes and modernization of facilities;
- Diversification of agricultural production and the export base in order to make the economy less susceptible to domestic and international market fluctuations;
- Expansion and improvements in the supply of agricultural inputs and supporting services; and
- Promotion of local and regional development.

As with the goals, these components do not include certain other elements reflective of recent government actions:

- transfer of various state commercial activities to the private sector and the "liberalization" of the environment within which the private sector operates; and

- continued use of the Food Stamp program, import programs, and various pricing mechanisms to insure that basic foods are available to the poor until such time as income levels rise.

Nonetheless, even with the inclusion of these additional two components, there is one striking observation: Almost without exception, government efforts focus on agricultural production and those inputs and services feeding into production. Processing and marketing have been neglected not only in the articulation of strategy and policy but in most actions undertaken by government. Generally, marketing efforts are continuations of past approaches, and processing activities remain of the primary-type in the traditional commodities (wheat, rice and sugarcane milling, primary processing of tea, rubber, and traditional coconut products). Little innovation, effort, or funding have been focused on the downstream elements of agricultural commodities.

Specific quantitative sectoral targets have not been summarized in any single government document or plan. Some individual subsector or project specific targets do exist, such as replanting rates for tea and rubber, and land development scheduled in the Mahaweli.

Also in no single document or easily referenced series of documents is there a compilation of all the government programs, policies, regulations, etc., affecting the agribusiness sector. Consequently, it is exceptionally difficult in this absence (both of policies and of statements of targets) for subsector officials and businessman to develop plans which complement rather than conflict with other subsectors.

On a countrywide level, it is difficult to develop realistic national plans without reasonable demand projections, resource assessments, and coordinated analysis of information and subsequent decision-making. It is difficult to implement any plan without a judicious use of resources, flexible and timely response to changing conditions, and cohesion of effort among implementing authorities. Common to both the planning and execution phases is the need for effectively coordinated decision-making, especially at the national level.

Such factors are not present in Sri Lanka today. Too many autonomous government bodies are responsible for designing and executing policy, programs, and projects affecting the agricultural sector. There are over 70 departments, boards, and agencies, in 15 ministries involved in some aspect of agriculture. As a result, government efforts are sometimes at crosspurposes, valuable resources (human and financial) are wasted, results are often discouraging, and time is lost. Sri Lanka is not sufficiently wealthy nor its populace sufficiently well off to be able to afford the luxury of inefficient resource utilization and the delay in benefits inherent in such inefficiencies.

C. PRIVATE SECTOR DEVELOPMENT POLICY

The government is involved to one degree or another in practically every agricultural commodity produced in the country and at all levels of the sector (inputs, production, processing, transport, marketing). Unfortunately, however, there is not a logical coherence to this involvement. Consequently, the issue of government policy with respect to private sector development in agriculture/agribusiness has two main components: the role of government in managing and owning enterprises, and actions intended to stimulate private sector growth and development.

Sri Lanka appears to be committed to a mixed economy approach to development. The question is not whether the public or private sector is to dominate the economy, but how the two can best complement one another so the country can reach its social and economic goals. Basically, in a mixed economy environment in a country such as Sri Lanka, the government or public sector should limit itself to involvement only if an activity meets one or more of the following:

- High risk enterprises which are key to initial upstream, or downstream development;
- Services or infrastructure which are "public" in nature, that is, areas in which the benefits cannot be tied to or the work easily undertaken by a single commercial enterprise (e.g. education, research, roads, ports);
- Enterprises in regions where demand for critical products or services is insufficient to permit financially viable private sector involvement;
- Enterprises for the international marketing or purchasing of products where volume control is critical to obtaining the best prices and the related domestic firms are too small and fragmented to wield sufficient market power; and
- Activities associated with national priorities, security requirements, etc., which are required immediately but which are of no or low priority interest to the private sector in the short-term (e.g., stockpiling critical materials, developing an isolated area).

State-controlled enterprises in the Sri Lankan agricultural/-agribusiness sector can basically be divided into the following categories:

- Estates/estate lands:
  - -- Major tree crops
  - -- Others
- Retail sales (fertilizer, machinery and equipment)
- Input manufacturing (fertilizer, seed, mammoties, feed)
- Processing (tea, rubber, fruits, oilseeds, coconuts, sugar, milk)
- Marketing/promotion (most export commodities, several domestic food crops)
- Regulatory/price control
- Water supply and management
- Services:
  - Marketing
  - Other

Except for non-marketable services (e.g., some extension and research), the regulatory and price control role, perhaps water supply and management at the early stages of water/irrigation projects, and limited special situation cases in the other categories, the Sri Lankan government could consider divesting itself of the management and ownership of many of its current activities. The major non-political problems associated with any rapid transfer of responsibilities to the private sector would be (1) possible short-term job losses, (2) limited absorptive capacity of the private sector, and (3) the private sector's unwillingness to indertake financially unattractive operations.

However the role of government with respect to encouraging increased private sector participation in the agricultural/agri-business sector should be reduced to a simple rule: Removing obstacles to investment without encouraging inefficiency among the investors. This should be done without the facilitator (i.e., the government) incurring unreasonable costs. Obstacles tend to fall into the following categories:

- Risk associated with:
  - Natural environment (weather, pests)
  - Government (unpredicability of regulations, input and output price controls, expropriation or divestiture)
  - Market (price volatility due to shortages, surpluses, etc.)
  - Inputs (availability, quality, price volatility, appropriateness)
- Financial attractiveness and "bankability" related to:
  - Long pay-off period with respect to tree crops with no short-term returns
  - Cost of local credit vs. world market cost
- Information shortcomings regarding:
  - Market opportunities and competition
  - Technologies available and their cost

- Growing requirements of new crops (new to the country or new to a region)
- Comparative returns and variability of returns between crops
- Joint venture partners and credit resources

- Market issues such as:
  - Effective export promotion (vs. "bureaucratic" promotion)
  - Major firm dominance (either government or private sector with the latter sometimes being a large multi-national)
- Infrastructure shortcomings
  - Services (extension, research, information)
  - Physical (roads, bridges, power, telecommunications) and Commercial (cold and dry storage, transport, etc.)

There are the obstacles which Sri Lankan agricultural development policy needs to address in order to induce a higher level of private sector investment in critical growth sectors. The following policy analysis refers to some of the agricultural sectors believed to offer important new opportunities for both private agricultural interests as well as the country's long-term economic goals. The important policy issues with respect to dairy, coconut, and fruits and vegetables are treated at length in Volume 3. Analysis has not been undertaken in this section of these three sectors or tea or paddy because of the numerous studies already completed on these latter subsectors.

Subsidiary Food Crops

Subsidiary food crops seem to offer the principal opportunity for diversifying out of paddy once paddy self-sufficiency is fully achieved and new lands are brought into production. However, significant domestic markets for at least the food and feed grains and oilseeds (to include cassava and soybeans) will primarily be a function of government policy and support for:

- Decreasing wheat imports
- Promoting the livestock, dairy, and poultry subsectors for rice and subsidiary food crops
- Providing floor prices reflective of product differences inherent in each commodity
- Some degree of import protection from international dumping during periods of abnormally low world prices

From a policy standpoint the government must focus on the wheat import issue. In 1982 wheat/flour imports approached Rs. 2 billion in value. As real world wheat prices rise, as they are expected to, and domestic demand continues to grow, the value of wheat imports is apt to increase significantly. In the absence of severe restrictions on wheat imports (which would not appear desirable unless the economy and foreign exchange situation were to deteriorate significantly), these options seem open to Government, neither being mutually exclusive of the other:

- Continue wheat research and (if the financial returns to farmers from wheat appear generally favorable compared to other crops) undertake aggressive extension, pricing, and temporary subsidy program to encourage wheat production.
- Require that all imported wheat be blended with a locally produced substitute flour, such as soy, coconut, or cassava, at levels of 5-15 percent (actual blend will depend on the substitute products selected).
- Promote the consumption of alternative flour/meal products (to include rice, maize, and cassava).

Through moderate success in these efforts, the volume of wheat imports can at least be kept constant and possibly even reduced. However, the key to any significant inroads will be whether Sri Lanka can grow wheat itself at a competitive price and provide competitive returns to farmers. That is still very much an unknown factor.

With respect to the use of subsidiary food crops as animal feed, expansion in demand will obviously be a function of the growth of the poultry and livestock industries themselves. Based on very preliminary estimates, feed demand is expected to grow from roughly 100,000 tons presently to nearly 150,000 tons in 1990, and 250,000 tons in 2000. Existing feed milling capacity exceeds 200,000 tons Planned expansions government and private (Ceylon Grain Elevators) are for another 240,000 tons capacity. If the government expansion occurs, it will likely phase out its generally antiquated equipment for nearly 90,000 tons capacity. Thus, with existing capacity and future adjustments, more than enough milling capability will exist to handle expected growth in feed demand. The expected constraint, then, is not capacity but domestic supply of feed ingredients, such as maize, sorghum, cassava (not presently used as a milled feed), poonac, and oilseed meals (e.g.,, sesame, groundnuts). To foster a steady growth in the supply of these crops to the feed industry, government policy should focus on:

- Insuring markets for output at a set price
- Supporting research and extension directed toward (1) increasing yields and reducing per unit production costs in both irrigated and rainfed production areas and (2) evaluating new crop possibilities (e.g., castor and winged-bean)
- Promoting their production under irrigated conditions in appropriate soils in various government projects like Mahaweli
- Freeing Ceylon Oils and Fats Corporation from its current cost-price operating constraint and providing adequate working capital for it to function effectively as a buyer of grains and oilseeds from farmers (or conversely divest the operation to the private sector in its entirety)

- Insuring that adequate oilseed milling capacity exists in the country to handle the volume of oilseeds (or related products) necessary to provide the needed volumes of high protein feed ingredients required by the feed milling industry.

Providing relatively stable marketing conditions exist (that, is buyers and prices) and returns are competitive, farmers can be expected to respond well to government encouragement and assistance for growing these crops.

Recently the government opened a soybean processing facility capable of generating four tons per day of dried soy milk. This product is intended for use as a substitute in cooking for coconut milk from nuts. This would free these nuts for further processing and eventual export in processed form. Its intent is to reduce the wastage of nuts associated with their use as sources of cooking milk.

While the concept is commendable, there are potential problems. Perhaps foremost, the coconut industry is considering production of dried coconut milk for use in the same manner. Given current consumer familiarity with the taste of coconut milk in cooking but not soy, the former would likely have a marketing edge. Second, while soy products are exceptionally nutritious and governments in other countries have attempted to encourage their consumption, the incidences of success have been relatively low. Traditional diets are exceedingly difficult to change. Thus, while government should continue to explore ways to encourage soy consumption (such as blending with wheat flour) enthusiasm over nutrition potential should be tempered by past experience in situations where consumption is a function of consumer preference not government edict (e.g., forced blending, school feeding programs).

One issue associated with major expansions in the production of high protein foodstuffs is the marketing of the vegetable oil "by-product." For example, producing 65,000 hectares of soybeans (required for 1990 soybean demand or its equivalent in high protein feedstuffs) would generate nearly 13,000 tons of vegetable oil. The logical use would be in the domestic market. However, in Sri Lanka, soy oil must compete with coconut oil which is familiar to the consumer. While it is generally felt that soy oil would be used if it were cheaper, in Sri Lanka retail prices for coconut oil are less than those for which soy oil could be sold at this time. Thus, soy oil could be exported to India (provided volumes become sufficient to warrant shipload movements). Unfortunately, from a national standpoint, since 1977/78, coconut oil has sold at prices 6-60 percent greater than for soy oil. Thus, it would make more sense to use the cheaper (on a world price basis) soy oil at home, and export the higher value coconut oil should this world price differential persist.

Thus, two problems confront government and the industry: restructuring prices so it makes more financial sense in Sri Lanka to export coconut rather than soy oil, if this can be done, and if not, addressing the need for large scale shipments in order to be an attractive supplier. This may not be a problem in later years once production has expanded. However, it may create short-term problems for oilseed processors who find they have insufficient volumes to permit export but cannot sell domestically due to price spreads between soybeans, feed, and soy oil.

Sugar

While not a basic food of the country like rice, sugar is still exceptionally important in Sri Lanka, to the populace's "psychological" if not also its nutritional well-being. Given Sri Lanka's climate and terrain, it is surprising that the country has not developed a larger, more efficient cane sugar industry through the years. Given its level of sugar imports, expected increases in per capita consumption with rising real incomes, the political nature of sugar availability, and the concomittant implications for foreign exchange, Sri Lanka needs to address a "national sugar policy." To date the result has been a commitment to upgrading existing mills and promoting public/private development of three additional ones. However, these efforts will only meet approximately 85 percent of "nutritional" and 45 percent of "market" demand by the end of the century. Consequently, further attention must be focused on this subsector.

In developing a sugar policy, the government must make decisions regarding the following:

- The overall level of national consumption permitted
- The overall level of national consumption/production encouraged
- The degree of sugar availability to all income groups
- The source of supply (imports versus domestic production)
- The composition of sugar (cane versus jaggery versus others)
- Price intervention (for stability, incentive, or disincentive reasons)
- Production/milling ownership and organization (public versus private, large versus small)

In recent decades, government has controlled consumption by controlling imports. Presently there appears to be a generally laissez-faire approach with no import controls (beyond sugar duties) influencing consumption. Demand is a market function. As stated earlier, unless there is a severe deterioration in the economy or foreign exchange situation, market determination of demand is felt to be a logical policy for government.

The degree to which production is encouraged by the government to meet this demand is another matter. If Sri Lanka had no foreign exchange concerns, there would be little cause for government to specifically promote or assist increased production in the subsector beyond nutritional or politically necessary levels. However, given the apparent desire of the Government to let the marketplace determine demand (not just for sugar but for most products), yet faced with the need to reduce foreign exchange pressures and find alternative crops to paddy and tea, support by the government of this subsector should induce production to expand to anticipated domestic demand levels.

Such a policy of sugar self-sufficiency may appear hard to justify in light of 1982-1983 world sugar prices (U.S.$0.06-.07 per pound). However, average world costs of production are currently US$0.175 per pound; low prices cannot persist indefinitely. Windfalls of US$.06-.07 sugar do exist but are often shortlived; therefore US$.20-.30 sugar is an equal possibility. In fact, world prices for raw sugar rose over 50 percent in the first part of 1983. Some authorities estimate prices may triple by 1985-86. Thus, to rely on the world market for sugar implies possible wide variations in foreign exchange, domestic prices, and domestic consumption, none of which are conducive to economic or political stability. Consequently, if Sri Lanka can produce sugar at or near the average world cost of production, it does not appear logical for the country to continue to rely on imports in light of its foreign exchange, national income, and employment requirements.

Previously the government had not concerned itself with the composition of sugar, that is, cane sugar versus jaggery versus others. In the past, this was logical. However, with growing domestic beverage, baking, and confectionery industries, the ability to use alternative sweeteners, such as those derived from corn, may make other types of "sugar" projects viable. Consequently, it may not be in the best interest of the country to expand cane production to meet all national sweetener needs. In fact, the possibility of a corn sweetener facility should be looked at seriously to supply perhaps 5-10 percent of the country's "sugar" demand.

II. MAJOR INDUSTRIAL POLICY ISSUES

A. INTRODUCTION

The problems confronting Sri Lanka's industrial development are not dissimilar from the obstacles facing most of the world's smaller and poorer countries. A small internal market, lack of basic raw materials, a weak technological base, and poor access to external markets typify the predicament of countries like Sri Lanka. The response to these circumstances of many countries has been to isolate their economies from these realities by creating a protected enclave based on import substitution industries and artificial cost and price structures.

This pattern characterized Sri Lanka's industrial policy prior to 1977. Recognizing the failure of import substitution and a state controlled economy as a means to achieve real economic growth with steady expansion of employment, the current government effected a radical shift in economic policy. The new thrust was toward development of the private sector and export-led growth.

These two long-term goals are closely interrelated. Exports can only be significantly expanded on the basis of a strong, growing private sector, regularly increasing the volume and quality of products which are able to satisfy the demands of external markets. Similarly, many private sector industries over the long-run cannot grow and substantially increase their efficiency unless they can produce for export markets. Sri Lanka's small internal market and low level of disposable income restricts the growth potential of local industry. Sufficient economies of scale in many industries cannot be achieved on the basis of local consumption alone.

In many industry areas, Sri Lanka is unable to add significant value to its production because of the heavy imported content required. The lack of many essential (non-agricultural) raw materials such inputs as basic metals, chemicals, capital equipment, etc. have forced Sri Lankan industry to import a major part of the content of its final production.

Complicating these natural constraints, Sri Lanka faces other problems related to its low level of economic development, namely very limited capital resources, low technological development, and undeveloped marketing channels, particularly for exports.

As a reflection of these limitations and Sri Lanka's dependence on the agricultural sector as its economic mainstay, the country's manufacturing sector accounted for only 14% of its GDP in 1981. Of this total industrial production (which also includes construction, mining and utilities), 60% was accounted for by state corporations. The emergence of the state corporations in the past was seen as necessary to compensate for the lack of local production. Furthermore, the economic philosophy of the time favored placing a large part of the nation's productive capacity in the hands of the state.

To offset the low productivity of both public and private industries, import barriers were established to protect local producers from more efficient world competition. The effects of this isolated market and the artificial cost structures caused by government subsidies and other measures served to encourage capital intensive industries dependent on imported inputs.

Liberalization in 1977 came from the recognition that genuine industrial growth with expanding employment opportunities could not be achieved in Sri Lanka's isolated environment. The opportunity costs to the country's economy and the financial costs to both the country and the consumer were excessive. Long-term growth of productive output, employment, and national income could come only through entering the world economy and promoting production for markets beyond Sri Lanka's shores.

The government undertook two major initiatives to stimulate industrial growth. First, it recognized that Sri Lanka's producers would have to look beyond their internal markets in order to develop an efficient scale of production as well as to earn the foreign exchange necessary to offset the costs of imported equipment and raw materials. Second, foreign investment in Sri Lanka was seen as a much needed injection of new capital, management, technology, and ideas as well as an access to foreign markets otherwise out of the reach of domestic producers.

Finally, in addition to export and foreign investment promotion, the government sought to readjust its external tariff regime so as to take the necessary steps toward placing the economy on an international competitive footing. The proper level of these protective measures is still an issue to be resolved by the government.

B. EXPORT PROMOTION POLICIES

The objective of achieving "export-led" economic growth automatically led the government to place considerable emphasis and resources behind its export promotion effort. The creation of the Export Development Board and formulation of a series of incentives have been the result of this emphasis. The EDB for its part has been one of the forward-looking institutions within the government apparatus, taking a broad view of the requirements of export-led growth in Sri Lanka. The EDB's National Export Development Plan constitutes a realistic appraisal of the country's long-term development requirements. The Plan's recommended strategy and policies reflect this hard realism and move in the right direction.

The EDB's "realism" is well founded. Sri Lanka's export performance is not encouraging. As shown in Table 1, the country's traditional tree crop exports have been declining in real value. The average growth rate of tea, rubber, and coconut over the 1978-81 period actually declined by almost 2%. The EDB has recognized correctly that the failure of exports to grow more rapidly cannot be explained away simply by the world recession or declining commodity prices. At the heart of the problem are important "structural" issues in Sri Lanka's economy. These structural issues pertain not only to government policies in the general sense but also to resource and organizational constraints.

TABLE 1

GROWTH OF SRI LANKA EXPORTS: 1978-1981
(Value in Constant SDR Millions)

Sector	1978	1979	Growth Rate (%)	1980	Growth Rate (%)	1981	Growth Rate (%)	Average Growth Rate (%)	Percentage of Total Exports 1979	1980	1981
Traditional											
Tea	327	275.48	-16	261.17	-5	245.50	-6	-9	37.5	35.1	30.0
Rubber	103	120.28	7	109.20	-9	110.07	1	3	16.3	14.7	14.1
Coconut	65	81.48	25	51.87	-36	54.78	6	-1.67	11.1	7.0	7.0
Total	495	477.24	-4	422.24	-12	410.35	-3	-6.33	64.9	56.8	52.4
Non-Traditional											
Minor Agricultural Crops	37	39.77	7	35.49	-11	49.57	38	11.33	5.4	4.8	6.3
Textiles & Garments	25	53.35	113	76.44	43	114.29	49	68.33	7.3	10.3	14.5
Petroleum Products	48	93.12	94	131.95	42	128.58	-3	44.33	12.6	17.7	16.4
Other Industrial Exports[1]	26	27.16	4	23.66	-13	25.91	9	0	3.7	3.2	3.3
Gems	-	24.25	-10	28.21	16	24.08	-15	-3	3.2	3.8	3.1
Other Exports[2]	16	21.34	33	26.39	24	31.48	17	24.67	2.9	3.4	4.0
Total	179	258.99	45	322.14	24	373.91	15	28	35.1	43.2	47.6
TOTAL EXPORTS	674	736.23	9	744.38	1	784.26	5	5			

[1]Food (including marine products), Beverages and Tobacco; Chemical Products; Leather Products; Rubber Products, Wood Products and Ceramics.

[2]Mining, Quarrying, Vegetables, Fruits, Cut-flowers and Foliage Plants & Handicrafts.

Source: Central Bank of Ceylon.

Recognizing the many problems facing potential exports, the EDB has sought to remove these obstacles. Since its inception in 1979, the EDB has operated on the assumption that exporting is less "profitable" financially than non-exporting and commercial activities, in short, that production for the domestic market was financially more rewarding than exporting to foreign markets. To help overcome the "profitability barrier", the EDB has advocated and/or administered several financial incentives for exporters such as the duty drawback scheme, a soft-loan facility, and a system of export expansion grants designed to defray part of the costs of product adaptation and export market development. In addition, a variety of tax incentives for exports have been maintained, including tax holidays on export profits, exemptions from income tax on dividends from exporting operations, investment relief for share purchases in export-oriented ventures, etc.

A recent study undertaken by the EDB at the request of the Arthur D. Little team has shed, however, some new light on this assumption.[1] To quantify the difference in profitability between export-oriented ventures and those serving only the domestic market, a survey of 50 firms was undertaken. The methodology of the analysis was to draw profiles of costs and returns from agricultural processing, manufacturing, and service operations. Firms were selected from the following categories:

<u>Non-Exporting Sectors</u>

- Hoteliering
- Construction
- Trading
- Transportation
- Production for local markets (namely, passion fruit, meat products, coconut products, sugar and molasses, cut flowers, auto spare parts).

---

[1] The study entitled "Profitability of Export Oriented Projects vis-a-vis Non Export Oriented Projects" was prepared in May, 1983 by Messrs. L.F. Yapa, L.S.G. Tillakeratne, and B.C. de Silva of the Export Development Board.

Exporting Sector

- Fruit and vegetable cultivation and processing
- Rubber-based products (TSR products and rubberized coir)
- Coconut products
- Processed seafoods
- Garments, footwear, and jewelry.

Profitability of production was tested on three bases. First, the return on investment was measured to determine profitability on the basis of fixed and working capital. Second, the return on equity was used as an indication of the profit generated by the funds contributed by the owners. Third, the return on sales turnover was used to estimated the profitability of the working capital used in production.

As illustrated in Table 2, the study showed that on the basis of all three measures, the more profitable enterprises were almost uniformly concentrated in export-related operations. This finding conflicts with the widely-held view that exports are not as profitable as other commercial activities. This result, however, should not automatically lead to the conclusion that all exporting is more profitable than non-exporting. It may mean that investors do not take to export-oriented projects unless they are highly profitable since they must offset the relatively higher risks of such ventures when compared to non-exporting ventures.

The conclusion drawn from the foregoing analysis is that several factors other than financial viability alone are responsible for the reluctance or inability of entrepreneurs to enter export markets. While there may be a wide range of problems confronting the new exporter (e.g., lack of finance, deficient infrastructure, procedures and documentation problems, quality standards, etc.), none appears more formidable than the issue of marketing and market penetration. Sri Lankan producers are generally small. Their experience has been confined to known, local markets whose quality and technical standards are below most international standards. Information on overseas

TABLE 2

RETURN ON INVESTMENT

Profit Range	Number of Projects: Export Markets	Local Markets	Hotel	Construction	Trade	Transport & Other
Over 200%	2	-	-	-	-	-
100-200%	3	-	1	-	-	-
50-100%	9	1	1	-	-	-
40-50%	3	1	-	-	1	-
30-40%	2	2	2	-	-	-
20-30%	1	2	1	-	-	-
10-20%	3	3	2	2	2	1
Less than 10%	-	2	1	1	-	1

RETURN ON EQUITY

Profit Range	Number of Projects: Export Markets	Local Markets	Hotel	Construction	Trade	Transport & Other
Over 200%	11	-	-	1	2	-
100-200%	5	1	2	-	-	-
50-100%	5	3	1	1	1	-
40-50%	-	-	-	-	-	-
30-40%	-	3	-	-	-	-
20-30%	1	1	2	-	1	2
10-20%	1	1	1	-	-	-
Less than 10%	-	2	1	1	-	-

RETURN ON TURNOVER

Profit Range	Number of Projects: Export Markets	Local Markets	Hotel	Construction	Trade	Transport & Other
Over 200%	-	-	-	-	-	-
100-200%	-	-	-	-	-	-
50-100%	2	-	-	-	-	-
40-50%	1	-	-	-	-	-
30-40%	3	1	-	-	-	-
20-30%	4	-	2	1	-	-
10-20%	9	3	4	1	-	1
Less than 10%	4	7	2	1	3	1

markets and their requirements is lacking. Local producers have neither the size of production, nor financial resources, nor marketing experience to undertake their own marketing effort.

The EDB has properly recognized this need but it has yet to put significant resources or a major effort behind a marketing program. More emphasis has been placed on supplementing the profitability of exporting rather than facilitating the marketing of exported products.

There is a limit to the extent which any government institution can assist individual exporters. Such institutions cannot substitute for actual marketing. At best, they are able to assist in information collection and exchange and give indications of possible market opportunities. Far greater attention needs to be paid to the creation of trading companies which will permit a single organization to achieve a "critical mass" of export volume. A trading company itself, drawn by profit incentives, would establish its own network of offices, agents, and information resources. Being assured of a profit margin on its sales, the trading company itself must take an interest in communicating back to the producer the quality and technical requirements of a product.

The EDB could and should be expected to work closely with these trading houses. To concentrate only on helping small, individual exporters will likely have only limited pay-off for the country. The EDB and the government need to make bolder efforts to create the proper intermediary institutions capable of representing a number of exporters and achieving a momentum behind the export process. Incentives need to be devised to induce the private sector to set up export trading houses similar to those in other countries. One suggested incentive is the extension of the tax holiday to such trading organizations provided they supply technical, material, and marketing inputs to Sri Lankan exporters. Similarly, private firms themselves should be offered a sizable deduction (e.g., 150%) for promotional expenses incurred abroad.

The government cannot expect that an institution such as the EDB or embassy officials abroad can conduct business for Sri Lanka's private companies. Successful commercial transactions seldom occur through intermediation by civil servants, but must be done on a bilateral private sector basis. The public sector can only give supporting assistance to facilitate these contacts.

Beyond the marketing issue, the EDB's recommendations to stimulate exports are broadly consistent with measures to stimulate private sector development in general, as proposed throughout this report . For example, the EDB draws attention to the major bottleneck of Sri Lanka's highly conservative banking system. The lack of credit available for export ventures is a problem which is generalized throughout the productive private sector in Sri Lanka. It has been identified in this report as a major obstacle facing much of the production based sectors of the economy and hence Sri Lanka's entire industrial policy.

Similarly, the EDB points to the inconsistent application of fiscal incentives to high priority areas. For example, existing tax holidays on profits from exports are available only to manufacturing companies. Adequate incentives are not available to two areas which offer the greatest opportunities to Sri Lanka, namely agro-based industries and private trading houses. Furthermore, the tax holidays on export profits apply only to companies and not to proprietorships and partnerships which constitute the great majority of enterprises in Sri Lanka.

The EDB also proposes, as has the Arthur D. Little team, that ownership provisions in the foreign investment encouragement program administered by the Foreign Investment Advisory Committee should be liberalized. Since foreign investment offers one of the most effective means not only to develop various sectors of the economy but to promote Sri Lanka's exports, maximum efforts are needed to attract these companies. At the present time, foreign companies investing outside the Investment Promotion Zone are limited to 49% ownership.

This serves to discourage major investments in higher risk productive sectors since the foreign company has limited ability to control his investment.

If Sri Lanka is to benefit not only from the investment of foreign capital, technology, and management in its productive sectors, but also from the access to foreign markets which foreign companies have, a more liberal regime is required. The government could peg the percentage of foreign ownership permitted to the amount of capital invested, technologies imported, production exported, employees trained, etc.

Whatever formula is employed, the government must realize that to encourage foreign investment into the higher risk production sectors, its incentives must be generous and permit the foreign company adequate operational control over its venture in Sri Lanka.

C. TARIFFS AND EFFECTIVE RATES OF PROTECTION

Prior to 1977, Sri Lankan manufacturers were able to operate behind high tariff walls in a virtually captive market with the predictable consequences in most industries 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 Lankan consumers. Another objective was to provide local industry with easier and cheaper access to foreign capital equipment and the basic raw materials needed for production.

The sudden removal of barriers unleashed strong pent-up demand for lower cost, higher quality goods. Many inefficient local industries, unprepared for competition, were driven into bankruptcy. Realizing that the sudden across-the-board action may have been too abrupt, the government gradually restored many tariffs on a case-by-case basis.

Unfortunately, throughout this process, the government has never had a defined tariff policy, primarily because of the lack of a broader industrial development policy. Tariffs have been set on a piecemeal basis without reference to objective criteria. Predictably, the demands for protection have come from those industries seeking to limit foreign competition in the domestic market. The pattern which has developed therefore, has shown a distinct bias favoring import substituting industries.

Effective rates of protection (ERP) have been the subject of special analyses by the World Bank in 1981 and 1983. Based in large part on these studies, the Presidential Tariff Commission has been instructed to recommend a revision of nominal tariff rates so as 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 on the average have been to expose these industries to excessive international competition and overprotect import substituting production. In the latter case, many of the import substituting industries being protected include those which add little value to production and are heavily import dependent for raw materials and intermediate goods.

To document the World Bank thesis, the Arthur D. Little team commissioned a study to determine the structure of protection of the current tariff regime according to product sector.[1] The purpose of the effort was to determine in general terms which sectors received the greatest degree of effective protection and, more importantly, within each sector, how protected were export versus import substitution firms. Table 3 shows the aggregate results of this effort.

---

[1] This study was prepared for the Arthur D. Little team by Mr. Ravindra Ratnayake of the Ministry of Finance and Planning.

TABLE 3

STRUCTURE OF PROTECTION FOR MANUFACTURING INDUSTRIES IN SRI LANKA

Industries Sector	Assistance to Industries in Terms of EPR (%)		
	Import Substituting	Exporting	Both
Meat, Fish & Dairy Products	55	-48	-24
Fruit & Vegetable Products	126	-5	54
Confectionary Bakery & Cereal Products	170	N.A.	170
Spirits, Alcoholic Beverages Aerated Water	25	N.A.	25
Other Food Products & Tobacco	36	-64	-64
Spinning, Weaving & Finishing of Textiles	95	9	77
Made-up Garments	347	6	43
Petroleum Products & Chemicals	45	46	46
Salt & Salt Based Chemicals	93	-6	-2
Other Chemicals	-12	N.A.	-12
Pharmaceuticals & Cosmetics	90	N.A.	90
Soap, Oil & Fats	188	12	12
Leather & Rubber	214	-48	186
Wood, Paper & Pulp	-188	-43	-167
Clay, Sand & Cement Products	147	-6	32
Basic Metal Industry & Machinery	70	N.A.	70
Ferrous & Non-Ferrous Metal Prod.	385	-2	384
Transport Equipment & Spares	-152	N.A.	-152
Electrical Goods	205	N.A.	205
Optical & Photographical Prod.	50	-24	50
All Sectors	94	6	-

Average Protection for Manufacturing Industries in Sri Lanka = 69%.

The research confirmed the argument that import substituting sectors are substantially more highly protected through tariffs, taxes, and various incentives than exporting sectors. The exposure of the exporting sector is especially high for resource-based industries where substantial value could be added to production, such as in agro-based industries. Those industries most highly protected tend to be those with the highest imported content and the least value added, for example, ferrous and non-ferrous metal products, electrical goods, and garments.

While such aggregation may hide many exceptions, a message nevertheless emerges. The sectors most favored by the system of protection and incentives are those which add the least value of Sri Lanka's local production. A strong argument of this study has been that it is the resource-based sectors of the country which offer real long-term growth potential. These sectors are largely penalized by the current protection system. As shown in the sector profiles of this study, it is also these sectors which offer Sri Lankan exports some long-term comparative advantages in world markets.

It appears clear that Sri Lanka currently needs not simply tariff adjustments but a wide range of tariff reform based on a phased strategy of protection. A point of departure should be the designation of key development sectors which will be afforded particular protection over a limited period of time. Once 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 broad guidelines which should govern tariff policy, there appear to be three specific needs to assist private sector firms operating in long-gestation, resource-based industries:

(a) Duty free access to imported raw materials and intermediate capital goods, unavailable locally, needed for the production of goods.

(b) A strong anti-dumping law which identifies and imposes appropriate levies on foreign goods sold in Sri Lanka below their true cost of production, transportation and insurance.

(c) A degree of protection for production-based industries with high local value added. Tariff levels should be moderate and temporary so as to require local producers to reach an efficient level of production as quickly as possible.

With respect to (a), existing duties on raw materials, plant and machinery force up unnecessarily the costs of production, raising final prices for the consumer (whether domestic or foreign) and requiring the entrepreneur to achieve a correspondingly greater return on his investment.

Sri Lanka's case-by-case approach to tariff fixing has invited all manner of vested interests in the country to influence the system to their advantage. The result is an incoherent tariff structure under which relatively similar products or inputs may have vastly different levels of protection.

It appears that many protective tariffs are excessively high (in the 100% range) encouraging not only inefficient production among local producers but serious evasion of these duties by under-invoicing. To a general duty rate of 25% can be added an additional 10-15% for transport and handling costs to bring up normal protective tariffs at the 40% rate for foreign goods. Beyond such rates, either inefficient local production is usually encouraged or evasive practices by importers to avoid high duties.

In short, three levels of action appear needed:

- Minimizing the cost of critical inputs of raw materials, plant, and machinery (when not available locally in quantity and quality) needed for local production.
- Moderate protective (25-50%) tariffs against imports of foreign finished goods competing with those local industries whose value added to production is substantial. Conversely, industries whose production is heavily import-dependent should be accorded substantially less protection since local value added is less.

- Eliminatic · of differential rates of protection which favor import substituting industries over export oriented sectors.

In terms of the appropriate institution to undertake the far reaching tariff reform for the country, it is doubtful that the current Presidential Tariff Commission's mode of operation can produce the most favorable long-term results. The Commission currently operates on the basis of an appeals system. What is needed is a mandate to a special technical body to analyze the current tariff structures in terms of their policy implications for Sri Lanka's development. This assignment should be completely divorced from an appeals system which ultimately tends tc reflect the perceived needs of industries which find themselves in difficulties. While an appeals system will be required under any system of tariff management, tariff reform should be effected by an institution which can operate above the pressures of specific industrial interests.

CHAPTER 3

THE FINANCIAL ENVIRONMENT FOR PRIVATE SECTOR DEVELOPMENT

A. INTRODUCTION

As Sri Lanka intensifies its efforts to develop the private productive sectors of its economy, the availability of appropriate long-term financing becomes increasingly critical. Three aspects of development financing will require careful management in Sri Lanka if the nation's development goals are to be met:

- The sufficiency of the supply of development capital (debt and equity);
- The means by which it is distributed;
- The support offered to investors by these distribution systems.

The research program undertaken had several components. Interviews with institutions involved in supplying credit were undertaken to determine the terms and conditions under which capital is typically made available to private enterprise. Included in this program were representatives of the Ministry of Finance, the Central Bank, the commercial banks (indigenous and foreign), development financial institutions (NDB, DFCC, EDB), finance companies, sharebrokers, merchant banks and the NSB, EPF and the state insurance corporations.

A program of interviews with private sector users of credit was also conducted. The goal of this exercise was to determine the degree to which the existing system of financial intermediation assists these firms' growth and development. The interviewees were selected from representative sectors of Sri Lanka's economy. Included in the sample were established and newly-started firms, large as well as small. Among the sectors represented were agriculture, light manufacturing, chemical processing, trading, and export.

Throughout the research, "development finance" has been understood to indicate capital, whether in the form of debt or equity, used by a venture to undertake long-term investments in the development of particular resources or economic activities. Often long-term and high risk projects such as large-scale agricultural or industrial projects require substantial equity capital and long gestation periods (between 5 to 15 years) before returns to that investment can be fully realized. Some such projects may not be acceptable to commercial financial intermediaries for the following reasons:

- The length of time needed for the project to yield an adequate return exceeds five years; the nature of Sri Lankan commercial bank lending is basically short-term, mostly one year or less.
- The collateral or guarantees which the commercial banking system perceives as necessary to cover the long-term risks incurred are often difficult or impossible for a borrower to satisfy.

Official funding agencies may be required to fill this gap in order to assist those ventures which can bring long-term economic benefits to the country. Given Sri Lanka's level of economic development, it is unrealistic to expect private, profit-seeking banks to be "developmental" in orientation particularly in higher risk sectors.

B. MAJOR FINDINGS

1. The Supply of Development Finance in Sri Lanka

The Central Bank of Ceylon's Monetary Survey (Table 1) indicates that the total amount of credit available in Sri Lanka has increased at an average annual rate of 36% during 1977-1982. In that period, Total Domestic Credit increased from Rs 8,796.1 million to Rs 42,412.0 million at year end 1982. These figures indicate that significantly more credit was available each year within Sri Lanka.

In 1982, the government's share of Total Domestic Credit was 40%, significantly higher than the 34% recorded in 1977. The rise in

TABLE 1

MONETARY SURVEY

Year	Total Domestic Credit	Government (Net)	Percent Total	State Corporations	Percent Total
1977	8,796.1	2,989.3	34.0	1,669.9	19.0
1978	10,575.2	1,863.0	17.6	2,363.1	22.3
1979	15,113.8	2,920.4	19.3	3,346.9	22.1
1980	25,635.9	8,972.0	35.0	4,122.8	16.1
1981	33,824.2	12,789.1	37.8	4,487.7	13.3
1982	42,412.0	17.150.2	40.4	4,677.4	11.0
Average Rate of Growth:	36.3%	41.8%		22.9%	

Source: Central Bank of Ceylon

the government share, from Rs 2,989.3 million in 1977 to Rs 17,150.2 million in 1982, represents a 42% per annum rate of growth. At the same time the share of domestic credit taken by state corporations declined, from 19% at year-end 1977 to 11% at year-end 1982. State corporation credit grew more slowly than either Total Credit or Government Credit. Although there has been a drop in the share of credit taken by the state corporations, the private sector as such does not appear to have been a major net beneficiary of this decline. These figures are summarized in Table 2.

Table 3 shows that the funding pattern of the government is one which relies heavily on the Central Bank the National Savings Bank deposits, insurance corporations, all of which are government-owned financial institutions. In 1981 fully 96% of all the government's outstanding debt was held by the Central Bank (38%) and the other financial institutions mentioned above (58%). Commercial banks held only 2% of all government debt. The large increase in the government's debt occurred without the direct help of commercial banks due to substantial funds being made available by its captive rupee sources, such as the NSB and other institutions. This pattern is substantially different from those of the ASEAN countries described in Table 3. In the Philippines, Malaysia, and Thailand the commercial banks play a larger role in funding their governments.

In Sri Lanka there is no market for publically listed and/or traded long-term debt instruments. The primary indigenous sources of long-term funds, which are critical to the viability of start-up and established business ventures alike, are institutions such as the NSB, EPF and the insurance corporations as well as the National Development Bank and the Development Finance Corporation of Ceylon. The latter two institutions, however, are relatively small compared to the NSB, EPF and insurance corporations. The total loanable funds of the NDB and DFCC at year-end 1982 were Rs 842 million, an amount equal to only 11% of the NSB alone. (see Table 4.)

TABLE 2

DOMESTIC CREDIT SURVEY

End of Year	Government (Net)	Corporations	Co-ops	Private Sector
1977	2,989.3	1,669.9	1,231.4	2,884.2
1978	1,863.0	2,363.1	1,674.6	4,774.2
1979	2,920.4	3,346.9	1,907.9	6,796.6
1980	8,972.0	4,122.8	1,368.2	11,340.7
1981	12,789.1	4,487.7	1,293.9	15,395.8
1982	17,150.2	4,677.4	1,187.7	19,382.3

Source: Central Bank of Ceylon.

TABLE 3

GOVERNMENT DOMESTIC DEBT OUTSTANDING BY HOLDER
(Percentage of Total as at end of June)

Country	Central Bank		Commercial Banks		Other Financial Institutions		Others	
	1980	1981	1980	1981	1980	1981	1980	1981
Burma	100.0	N.A.	--	N.A.	--	N.A.	--	N.A.
Indonesia	--	--	--	--	--	--	--	--
Malaysia	4.0	7.3	22.6	19.4	68.6	63.2	4.7	10.1
Nepal	58.0	58.3	28.1	25.6	6.9	8.8	7.0	7.3
Philippines	18.7	19.3	30.2	33.1	28.8	28.6	22.3	19.0
Singapore	--	--	--	--	--	--	--	--
Sri Lanka[1]	22.5	37.7	2.7	2.0	71.1	58.0	3.7	2.3
Thailand	37.0	39.2	31.4	28.9	26.5	26.2	5.2	5.7

[1] Other financial institutions include National Savings Bank, Insurance Corporation, Employees' Provident Fund, Insurance companies, Sinking Funds and Trust and other provident funds.

Source: Central Bank of Ceylon.

TABLE 4

(Amount of Rupees - Millions)

	Total Resources			Loanable Funds			Total Gross Credit		
	1980	1981	1982	1980	1981	1982	1980	1981	1982
Commercial Banks	25,728	31,652	38,811	16,604	20,455	24,287	17,479	21,557	25,969
Finance Companies	567	1,008	922	4	58	84	73	196	258
Subtotal	26,295	32,660	39,733	16,608	20,513	24,371	17,552	21,753	26,227
National Development Bank	754	957	977	115	395	361	115	395	605
Development Finance C.C.	297	389	534	274	360	481	274	360	481
Subtotal	1,051	1,346	1,511	389	755	842	389	755	1,086
SMIB	155	218		128	164		128	164	
NSB	5,329	5,876	8,299	4,948	5,390	7,634	4,948	5,390	7,634
Insurance Corporation	2,047	2,446		670	850		670	850	
Subtotal	7,531	8,540	8,299	5,746	6,404	7,634	5,746	6,404	7,634
GRAND TOTAL	34,877	42,546	49,543	22,743	27,672	32,847	23,687	28,912	34,947

Source: Balance sheets of these institutions.

This concern would be mitigated if the private sector had alternative sources or if the small percentage left to it were a large enough supply of rupees. Unfortunately neither is the case. The only alternatives which remain for businesses are the commercial banks, which do not accept the role of a supplier of long-term credit, and the two development finance institutions, i.e., the NDB and the DFCC. Furthermore, the nation's rate of capital formation is low. The ratio of Sri Lanka's Gross National Savings to its Gross National Product was only 12% by the end of 1982. Most ASEAN countries have capital formation in the high 20%'s and low 30%'s. This would indicate that the flow of capital available to the private sector is low and must increase if the country's growth aspirations are to be met.

These observations concerning the supply of credit in Sri Lanka have not focused specifically on development finance, in particular the amount of refinance available for development purposes or the resources available through the NDB and DFCC. Table 5 indicates that the total amount of refinance made available by the Central Bank of Ceylon at June 30, 1982 was Rs 1,291.8 million. The Central Bank refinance scheme of agriculture and marketing is unlimited. The short-term export refinance scheme was limited to Rs 575 million while medium- and long-term refinance was limited to Rs 775 million at the end of June, 1982.

TABLE 5

CENTRAL BANK REFINANCE
OUTSTANDING JUNE 30, 1982

	Rs Million
Agricultural Cultivation	136.3
Agricultural Marketing	274.6
Export	371.5
Total Short-Term	782.4
Total Medium- and Long-Term	509.4
Total Refinance Outstanding	1,291.8

Source: Central Bank of Ceylon.

Central Bank of Ceylon refinance programs are intended for a variety of purposes. A short-term facility for exports by which commercial paper is discounted was introduced in March, 1983. A medium- and long-term project-oriented facility is available to both the development finance institutions as well as the commercial banks. Most Central Bank refinance programs are actively utilized and are distributed by all banks in Sri Lanka. A sectoral distribution of these funds was not available.

Another refinance facility is the World Bank's Small and Medium Industries Program which is administered by the NDB. The SMI scheme came into effect in September 1979 handling refinancing for loans granted by commercial banks under an International Development Association (IDA) program for assisting small and medium scale industries. Under this scheme a total amount of US$ 12 million (Rs 216 million) was granted to be lent to small industrialists through five participating credit institutions, namely the Bank of Ceylon, Commercial Bank of Ceylon, Hatton National Bank, the People's Bank and the Development Finance Corporation of Ceylon. Any privately or cooperatively-owned enterprise engaged in manufacturing, mining, construction, agro-industry, fish processing, handicraft production or industrial service was eligible for financing under this scheme. The maximum loan granted was Rs 1 million and the maximum repayment period was 10 years including a grace period of up to two years.

During 1980 refinance amounting to Rs 118 million was approved while the actual disbursement amounted to Rs 43 million. The interest rate of 15% charged to sub-borrowers under the scheme was maintained throughout the year. The prominent sectors that received most refinance under the SMI scheme included construction materials, food processing, metal products, agro-industries and wood products. Categories of industries involved in SMI I funding are shown in Table 6. The scheme also provided assistance both for setting up of

TABLE 6

SMALL- MEDIUM-INDUSTRY (SMI) I REFINANCE FACILITIES

	Rs Millions
Paddy Milling	43.0
Fiber Milling	4.0
Metal Products	9.6
Tiles	20.9
Metal Crushing	18.0
Furniture and Saw Milling	13.2
Bricks	2.0
Garments	5.3
Ice Making	4.7
Printing	8.9
Others	86.4
Total	216.0

new industries and for the expansion of existing ones. Of the total number of projects, 49 percent were new enterprises and 51 percent were expansions of existing enterprises.

In the early stages of the scheme no financing took place in some of the districts. However, by the end of 1980 lending had been extended to almost all districts. There were still a heavy concentration in districts such as Colombo, Gampaha, Kurunegala, Kandy and Puttalam. Colombo and Gampaha districts together accounted for 37 percent of the number of projects and 55 percent of the refinanced amount.

The leading participant in the scheme during 1980 was the People's Bank with refinance loans totalling Rs 54 million. The Bank of Ceylon accounted for Rs 40 million while the Commercial Bank and the Hatton National Bank accounted for Rs 13 million and Rs 10 million respectively. The DFCC operated at Rs 2 million.

The SMI operations were enhanced during 1981 with a line of credit of US$ 16 million provided by the IDA of which US$ 12 million was completely utilized. In order to maintain a continuing assistance under the SMI scheme, the NDB negotiated further loans of US$ 28 million from IDA in October, 1981 under the SMI II loan program. This became effective during April/May 1982. The interest rate charge to sub-borrowers under the scheme was maintained throughout the year at 15 percent. The financing was extended to the same sectors as under SMI I but the demand for loans was highest in the food processing, metal products, construction materials and wood products. Table 7 illustrates the industries that figured prominently in this scheme.

One will note that while the first program was completely subscribed, only Rs 23.3 million of the Rs 616 million total of SMI II

TABLE 7

REFINANCE APPROVALS UNDER THE SECOND SMI PROJECT
(Cumulative as at end of December, 1982)

Sector	Amount (Rs Thousands)
Food Processing	7,090
Other Agro Industries	183
Rubber Products	480
Metal Products	2,404
Construction Materials	614
Construction Contracting	--
Wood Products	3,500
Garments	877
Textiles	424
Repair Workshops	848
Miscellaneous	6,920
Total	23,340

Source: National Development Bank.

had been committed as of the end of 1982. Among other factors, an increase in the interest rate charged on these loans has been blamed for this poor utilization.

Other refinance facilities are also available. The DFCC has negotiated facilities extended by the ADB and its sponsors[1] that also provide Eurocurrency facilities. The exact amounts of these facilities are not known.

Another important source of development finance which is not refinance in nature is the government's large investment in the National Development Bank. This institution was founded in 1979 "to promote the industrial, agricultural, commercial and other development of the economy of Sri Lanka".[2] The government committed substantial resources to it; its paid-up capitalization, all of which is held by the government, is Rs 600 million. This capitalization is approximately equal to the amount available under the SMI II program. More importantly, it is rupee-dominated and its terms and conditions are flexibly set. There is no intrusion by an offshore refinance source to dictate the terms and conditions under which loans will be granted.

As shown in Table 4, of the total resources of Rs 977 million available to the NDB, by the end of 1982, only Rs 361 million was made available as loanable funds. The balance was kept in the form of fixed and liquid assets, a good part in the form of interest bearing deposits with the commercial banks. Table 8 presents a sectoral distribution of NDB commitments, which are shown to total Rs 898 million. Included in this total are refinance approvals under the SMI I and SMI II programs as well as direct financings, i.e., those in which the Bank's own funds were used. The most recent source of direct financing approvals is the Bank's 1981 annual report, which is summarized in Table 7.

---

[1] DFCC shares are held by the IFC, the DEG (German Development Association) and the FMO (Netherlands Fund for Developing Countries).

[2] National Development Bank of Sri Lanka Act, No. 2, of 1979.

TABLE 8

NATIONAL DEVELOPMENT BANK OF SRI LANKA - SECTORAL APPROVALS
1980,1981, 1982
(Cumulative)

Sector	Projects Approved		Amount (Loan + Equity)	
	No.	%	Amount (Rs M)	%
Food, Beverages & Tobacco	3	5	20.300	2
Agriculture, Agro-business & Fishery	3	5	45.200	5
Textiles & Weaving Apparel	9	13	117.698	13
Wood/Paper Products	1	2	8.000	1
Rubber & Leather Products	9	13	95.850	11
Metals & Chemicals (including Petroleum Products & Engineering)	17	25	276.200	31
Hotels	16	24	229.200	25
Service Industries	7	10	96.900	11
Miscellaneous	2	3	9.000	1
Total	67	100	898.348	100

Source: National Development Bank.

2. The Distribution of Development Finance

Many of the Central Bank's refinance programs, which serve development purposes, are distributed by the country's commercial banks. The same is true of the SMI programs, which are very important contributors to the nation's total supply of development funding. Unfortunately, since the commercial banks in Sri Lanka do not have a strong development orientation, those resources are not always used in the manner they were intended. Orientation is one which is largely short-term in its focus and risk averse in its practice.

As of June 30, 1982, 69% of all foreign and commercial bank assets had original maturities classified as short-term (1-12 months), 21% of all assets had medium-term maturities (13-36 months) and 9% were long-term (greater than 3 years). This distribution compares unfavorably with that of 1970 when 12% of all assets had original maturities greater than three years. According to Central Bank data, the commercial banks have become even more focused on short- and medium-term lending. It should be noted, however, that a portion of these short-term credits are continually rolled over, so that some have the effect of longer-term lending.

The collateral requirements of the commercial banks have become increasingly burdensome, particularly for small entrepreneurs. In 1970, fully 23% of all loans were either unsecured (4%) or secured by personal guarantees (19%). By 1982, this total had fallen to 14%, though the percentage of unsecured loans had increased to 6%. This suggests a more conservative attitude by the bankers, though it also suggests a change in the nature of the banks' portfolios. In 1982, 27% of all advances were secured by cash (9%) or trust receipts (17%) compared to a total of 11% in 1970. These types of collateral are often used in trade finance and their size suggests an increase involvement in trading by the banks. The increased short-term orientation of their portfolios would indicate that their involvement in long-term financing and lending based on the value of a project or its owner's reputation has declined.

Although the banks' lending policies have become more conservative, they have not caused the borrower to save anything on the interest rate he pays. By June 30, 1982 the median rate of interest on bank loans was 20% and 21% of all loans paid interest rates higher than 25%. A percentile distribution of interest rates is summarized below in Table 9. These appear to be very expensive loans, given that the official Central Bank estimated rate of inflation for 1982 was less than 6%. The high rates must be seen as a predictable consequence of the country's recent monetary policy.

TABLE 9

DISTRIBUTION OF BANK LOANS
BY INTEREST RATE

	1982
25 percentile	16%
50 percentile	20%
75 percentile	23%
Inflation rate	less than 6%[1]

[1] Colombo consumer price index.

It must also be noted that the banks' effectiveness as distribution channels for refinance has been poor. Because they earn less on Central Bank schemes than by lending their own funds, they are reluctant to market them, particularly when they have excess liquidity as is the case today. Also, their supervisory skills on loans once granted was faulted in many interviews, some with bankers themselves. As a result, the effectiveness of the refinance programs has been questioned by all involved.

While the banks have been the only alternative for many entrepreneurs seeking credit (given the government's preemption of the funds from the other financial institutions), many entrepreneurs were forced to look elsewhere since the banks' attitudes made it difficult for private investors to deal with them. The DFCC first, and the NDB later, have proved to be more amenable to doing business with the private sector under terms and conditions which businessmen could accept. Both institutions, however, lacking well-defined developing lending priorities in their charters, have tended to lend heavily to projects which probably could have been financed by the commercial banking system. Tables 10 and 11 indicate that considerable funding has gone into hotels, chemicals, and garments. These are all industries whose investors are typically the larger Sri Lankan companies often backed up by strong foreign collaboration. Similarly, the industries tend to be short gestation, lower risk investments.

The activities of the two development institutions, therefore, would appear to need redirection so their actual use of development equity (NDB) and refinance (DFCC) is more appropriate to the intended uses of those funds.

3. The Service and Development Orientation of Existing Development Finance Programs

Refinance programs are cumbersome to administer. There is substantial paperwork involved in a refinance loan application which is not necessary for a direct loan. Using the SMI II as an example, all imports exceeding $10,000 must be substantiated with three independent price quotations. In addition, to have an Rs 2 million loan approved under the SMI program requires approximately six to nine independent signatures -- one or two at the originating branch of the commercial bank, one or two at its regional headquarters, one or two at its headquarters, its Board of Directors, or at the NDB, and then the World Bank itself. Several interviewees said that approvals in less than nine months were remarkable and that the average was 12 to 18 months.

TABLE 10

DIRECT FINANCING APPROVALS
YEAR END 1981
NATIONAL DEVELOPMENT BANK

	# of Projects	Rs Millions
Food, Beverage & Tobacco	--	--
Agriculture, Agro-business & Fishery	1	5.8
Textile, Weaving & Leather	6	104.2
Wood/Paper	--	--
Metals, Chemicals	4	41.8
Hotels and Real Estate	6	81.2
Others	2	9.0
Total	19	242.0

Source: National Development Bank.

TABLE 11

SECTORAL DISTRIBUTION OF LOANS AND INVESTMENTS
DFCC 1982

	Rs Millions
Tourism (Hotels)	140.6
Chemical Products	69.8
Garments	48.9
Textiles	48.8
Rubber Products	42.1
Miscellaneous	29.1
Printing & Packaging	22.5
Engineering	20.2
Electrical Products	19.8
Building Materials	18.2
Food	16.3
Beverages	14.1
Metal Products	7.1
Agriculture	0.8
Total	498.3

Source: DFCC.

At each level of review of a refinance application, the "paperwork" is reviewed. Because the loan is in effect being sold when it is refinanced, it is critical that the forms be properly completed. Many times interviewees said that completing the applications consumed substantially more time than the review of the ventures' economic viability.

Furthermore, refinance conditions and terms are determined by the source of the funding and vary only according to the size of the loan. There is no flexibility left to either the banker or borrower to negotiate terms specific to the type of venture at hand. Perhaps this is one reason for the relatively high default rates on refinance loans which bankers cited in the interviews. It is only possible to negotiate specific terms and conditions when the project goes bad.

Surprisingly, there appears to be a widespread lack of awareness of the existing sources of development finance (i.e., refinance programs and the NDB). Several entrepreneurs who borrowed from banks or who cancelled projects which might have gone ahead had proper financing been available were unaware of the existence of alternatives. Neither the NDB nor DFCC have branches outside Colombo and there is no active marketing of their services.

Entrepreneurs also complained that the NDB too often requires a seat on a venture's Board as a matter of course. This is an understandable objection which should be answered by revised procedures. Another complaint cited frequently in the interviews concerned the cost of financing, developmental or otherwise. Partly because the country's high levels of real interest rates on both commercial loans as well as refinance and direct NDB loans, and partly because refinance sources determine the rates which shall apply, the entrepreneurs are not able to negotiate loans which reflect the unique natures of their ventures. This has caused many to abandon business ideas which appeared viable with lower rates.

4. Rural Credit

In examining repayment analyses done on a bank which focused on rural credit, there was immediate evidence that rates of recovery on loans made outside greater Colombo tend to be significantly lower than those made to urban borrowers. This was true of agricultural loans as well as commercial or industrial credits. Most bankers say that this phenomenon is due in large part to the politicization of rural credit in the 1970's.

At that time, encouraged by local politicians, borrowers came to view loans made by governmental institutions or with governmental funds (i.e., refinance) as grants rather than debts. Repayments dropped to the low 60% range for some banks on agricultural cultivation loans. Since then, the average for such loans has only been in the 75-85% range. Loans under the SMI programs in rural areas have been similarly treated.

Other reasons also explain these low rates of recovery. Bankers themselves admit to difficulties in supervising the repayment of rural credits once they have been made. Furthermore, government-owned banks tend to have greater problems in this regard, perhaps due to the managerial problems alluded to before. In addition, the rural economy is less robust than that of Greater Colombo and is frequently subject to crop failures or inclement weather. Another reason for the decline in rural credit over the last four years has been the withdrawal of the Central Bank guarantee on cultivation loans granted to commercial banks. This has discouraged the banks from extending further credit.

Since 1963, the credit requirements of the cooperative sector has been met by the People's Bank although over the years the People's Bank has grown and developed into a fully fledged commercial bank. In the commercial operations of cooperative societies much of the institutional credit has been provided by the People's Bank in the form of loans and overdrafts. In addition, the Food Commissioner and the Cooperative Wholesale Establishment (C.W.E.) provide customer credit to cooperative institutions. From time to time the Government has also arranged special credit lines for cooperative societies for specific purposes.

An important feature of the reorganization of the Multi-purpose Cooperative Societies in 1971 was the setting up of cooperative rural banks as a departmental activity of the Multi-purpose Cooperative Societies. Accordingly, the number of rural banks increased gradually from 90 in 1970 to a peak of 347 by end June 1977, but dropped to 285 by September, 1982. Similarly, the savings deposits of the rural banks rose from Rs 16 million at end 1970 to Rs 145 million at end June 1977 and further to Rs 433 million at end September 1982. Meanwhile, the time deposits of rural banks rose substantially from Rs 1 million at end 1970 to Rs 2 million at end 1982. The high interest rates on time deposits explain the higher mobilization of such deposits during 1977 to 1982. On the whole, the total deposits of rural banks rose significantly during the period under review. On the other hand, advances granted by rural banks, in particular, short-term loans, which stood at Rs 7 million at end 1970 rose to Rs 56 million at end June 1977 and further to Rs 115 million at end September 1982.

One of the striking features observed in the growth pattern of deposits and advances of rural banks during this period is that with the passage of time the amount of advances granted by the rural banks has declined in relation to the growth in deposits. The ratio of deposits/advances which stood at 42 percent dropped to 38 percent at mid 1977 and further to 21 percent by end September 1982. This partly explained the accrual of deposits in the rural areas to these banks and the lower utilization of such deposits by these banks.

5. Recommended Actions

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 plan 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 much value to the inputs and earn high margins, making them able 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:

a. 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 these sectors and primarily to private enterprises. The Board of the NDB should clearly differentiate the performance standards of the NDB from those of a commercial bank. "Successful" performance should depend on the nature of the Bank's development portfolio and the success of projects funded, rather than the Bank's overall 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 analysisand preparation, 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, project analysis, and identification programs so that these can grow in size and quality. The Bank should consider some form of bonus system for its staff so as to maintain high quality pesonnel.

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 would not compete, in 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 when necessary, government-controlled financial institutions should be required to participate in the equity of the Bank if its is determined that the Bank's lending base needs to be enlarged. In particular, the Central Bank and the government's captive rupee resources (the NSB, EPF, ETF, insurance corporations, etc.) should be equity holders. Similarly, the state-owned commercial banks could also be required to contribute to the NDB's equity.

b. Rationalization of the Refinancing Schemes

The administration of the refinancing schemes handled through 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.

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

The growing shortage of rural credit must be reversed. The commercial banking system has progressively retreated from rural lending because of the high risk of nonpayment and the expense of administering and recovering small loans.

A network of small private or cooperative banks based on regions or producer groups offers an alternative to this problem. Local ownership of the banks ensures higher recovery rates. 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 which 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.

The potential for mobilizing deposits by rural banks may provide sufficient grounds for establishing cooperative banks. The network of cooperative banks include cooperative societies, credit and thrift societies, credit cooperative societies and welfare societies which could contribute substantially in the deposit mobilization drive.

The capital for the proposed cooperative bank could be provided by 50 percent of the share capital owned by cooperative societies of the People's Bank. Since the People's Bank has now become a state bank, the cooperative societies could be allowed to transfer their shares amounting to nearly Rs 3 million to the proposed cooperative banks. Capital requirements will depend on the nature of activites of the cooperative bank. The capital base can be further augmented by an initial capital contribution of the People's Bank and the cesses collected from the Food Department, the Paddy Marketing Board and the National Milk Board for the services rendered by the cooperative societies on their behalf.

CHAPTER 4

MANAGERIAL ENVIRONMENT OF THE PRIVATE SECTOR

A. SUMMARY CONCLUSIONS AND RECOMMENDATIONS

Based on extensive interviews and research of Sri Lanka's private sector, the study produced the following observations related to the training needs of private companies:

- Executives in most private sector companies believe that the existing management training programs do not meet their needs or the needs of their management staff.
- The most critical training need identified by private sector managers is marketing research and analysis.
- The demand for management training appears to be substantially greater than that supplied by current programs.
- Private sector managers perceive faculty members in existing management programs as too academic with little practical experience.
- The teaching methods used in current programs are traditional in nature and need to be supplemented with more innovative techniques.
- There is a lack of exchange of information and experience between the private sector and the academic community.
- The management institutes and universities prepare only a basic budget plan, ignoring other strategic issues that will influence their performance in the future.
- The Sri Lankan government has only recently recognized the importance of management education and training, and the flow of support funds is still considerably less than that given to other disciplines.

Based on the conclusions of the study listed above, the following recommendations are made:

a. Private Sector Initiative

- Establishment of a new management development center controlled and run by a private sector entity.

b. University/Management Institution Initiatives

- Creation of a formal academic/private sector management development committee for each institution.
- Introduction of new teaching methods appropriate for Sri Lanka's management environment.
- Use of program evaluations on a regular basis.
- Development of a formal strategic plan to guide programming and administration.

c. Government Initiatives

- Reduction of the bonding period that faculty members must serve in the university system.
- Interaction between the private sector and educational institutions involved in management training to develop a long term training plan for the government to use in resource allocation.

B. MANAGEMENT DEVELOPMENT CONTEXT OF SRI LANKA

Historically, Sri Lanka has had little experience in developing and using modern management skills. Apart from the plantation managers and trading houses, there has developed only a small cadre of experienced professional managers in the economy. In the production-based sector, which has been the focus of this study, the management cadre in Sri Lanka is especially inexperienced in management techniques.

As the country moves to develop its agricultural and industrial base and add increasing value to production, a new management class must be trained and developed. Professional skills have to go far beyond those of the traditional Sri Lankan management cadre to include such disciplines as cost accounting, production management, quality control, market analysis, and skilled labor training.

Another aspect of Sri Lanka's lack of management development tradition relates to professional and social attitudes towards business education. Traditionally the study of law, liberal arts, and the physical sciences have been viewed as the most prestigious disciplines, with business education lagging far behind. Partially as result of these professional and social biases only a small core group of professionals in business management has developed. With few exceptions, the majority of these managers received their education on the job, building up their businesses instinctively through trial and error. The traditional educational system offered little to prepare future managers of businesses. It is only recently that the government has decided that university campuses and training institutes should be the main components of a delivery system designed to produce skilled business managers.

C. ASSESSMENT OF MANAGEMENT NEEDS

1. Approach to the Assessment

The types and the quality of Sri Lanka's management development programs were studied through the following research methods:

- Interviews were conducted with administrators and faculty members at the local institutions with management programs, and with government officials responsible for these programs. Many of the visiting professors who have worked in Sri Lanka over the past five years were also interviewed.

- Mail surveys were sent to 125 graduates of university business and commerce programs to determine the school's ability to prepare its students for entry-level business or management positions.

- Data research of management programs in the country was conducted through a review of public and private documents.

The other key element of the analysis was an examination of the skills needs of private sector managers. This was accomplished through the following methods:

- Interviews were conducted with over 50 local businessmen, government officials, international donor agencies, and management training experts outside of Sri Lanka.

- Mail surveys were sent to a random sample of local industrialists regarding their company's management structure and training needs.

Based on the above information, gaps between the training being provided and the stated training needs of the Sri Lankan private sector managers were identified. This analysis led to a list of recommended actions to improve management training.

2. Findings of the Analysis

The analysis revealed a variety of "market segments" within the local management cadre. Distinct differences exist in the training needs of upper, middle and lower-level managers. There are also variations between the managers of small and large-scale businesses, although these differences appeared to be less defined than those relating to the management levels.

Management training needs are divided into the following three categories:

a. Senior Executive Level

At the senior level, the most apparent need is for a combination of organization development and human resource management skills. Many companies are first generation firms, still owned and managed by the founder. While their businesses have built up over the years, the management structure has remained virtually the same. In many of these companies there is a vacuum at the middle-level with direction being given from senior management down to floor-level supervisors. Even in many companies with middle-level managers there is no clear delegation of responsibility and authority. The owner/senior manager retains complete control in the organization. Training in organizational development/human resource management is needed to build an internal structure flexible enough to accommodate sustained growth.

The second highest priority training need at the senior level is market research and analysis, especially for external markets. Most key decision-makers in businesses have no experience in assessing market opportunities. Local industrialists, generally speaking, have technological backgrounds. According to the Nannayakara Report[1], 75% of all middle and top level managers included in the survey received engineering or science-oriented training at the university level. (See Table 1.)

Other training needs that were frequently mentioned by local senior managers are:

- strategic planning
- investment/project analysis
- decision analysis

b. Middle Level

At the middle-level, the training needs becomes more functionally focused. Responsibilities of middle level managers are usually confined to a division or department. These managers may be responsible, for example, for the quality and cost of an output, or they may be specialized in computer programming, stores management, or accounting.

[1] Dr. Gunapala Nannayakara, Dean of Graduate Studies at the University of Sri Jayawardenapura, recently completed an extensive study of management structures and training needs. His study included interviews with over 800 private and public sector managers.

TABLE 1

PRIVATE SECTOR MANAGERIAL PROFILE

Business Management Structure

Level	%	Age
Senior	13	44
Middle	17	36
Lower	70	33
	100	

Level of Education (%)
Sample Size = 239

	Senior	Middle	Lower
Post-Graduate	-	1	-
University Undergraduate	46	43	6
Non-University Professional/Tech	42	44	52
Secondary	12	12	42
	100%	100%	100%

Type of University Education (%)
Sample Size = 86

	Senior	Middle	Lower
Business	3	6	33.3
Technical	67	82	33.3
Other	30	12	33.3
	100%	100%	100%

The most frequently mentioned training need of middle management is market research and analysis. In their opinion, marketing is an area where they can contribute the most to company performance. The owner is also perceived to be ill equipped in terms of marketing management, thereby opening the door for a middle manager to fill the void and create future opportunities for himself and the company. The second important skill area is in operations management, especially for those managers with product responsibility. Another key skill is technical development, which in this context refers to increased knowledge/skills in specific business areas (i.e., rubber processing, soapmaking, tanning).

The mail survey and interviews revealed several other skill needs:

- financial management
- management information systems
- quantitative methods

c. Lower Level

The lower-level managers generally require job-specific training. Their management focus is usually directed at supervising a part of the production process. These supervisors are generally less educated (according to the interview results and the Nannayakara Report, almost half have had only a secondary education), and usually are given merit promotions into supervisory responsibilities from the production labor pool. Their primary objective is achieving maximum productivity. The two predominant training needs relate to production management and labor supervision. Other training needs of supervisors are:

- technical development
- stores management
- quantitative methods
- budget control techniques

It is important to emphasize the critical need for supervisory training. The management programs in Sri Lanka today are oriented towards senior level managers. These programs add a certain amount of prestige to the training organization, and are indeed beneficial and necessary. But the analysis has shown that the supervisory level training needs are much more critical at this juncture of Sri Lanka's private sector development scheme than those of the upper levels. Their ability to motivate the work force, and maintain high productivity and quality often has more of an impact on a company's financial position than any other management input.

D. ASSESSMENT OF EXISTING MANAGEMENT DEVELOPMENT PROGRAMS

There has been a significant increase in interest in management development over the past few years. The major universities in the Colombo area have introduced new executive diploma or Masters in Business Administration (MBA) programs. These programs vary a great deal in structure, quality and sponsorship.

In order to understand the range and quality of the management training programs in Sri Lanka, a brief profile of the various courses is presented below.

1. MBA Programs

a. University of Sri Jayawardenapura

The University of Sri Jayawardenapura has the only established MBA program in the country. The degree program is two and one half years in length. Hence, as yet there are no graduates from the program, which began in 1981. The program fees are Rs. 5,000 per year. It is estimated that the actual cost per student exceeds Rs. 7,500, with the shortfall being covered by government funds.

Almost all of the participants in this program were middle or senior-level managers. A preliminary survey indicated that the large majority was self-sponsored. The 1981 MBA class was composed of 43 participants, of which only 3 were from private sector firms. In 1982, 47 participants entered the program and 25 were working with private sector firms.

The curriculum is a standard combination of business administration subjects. The school received substantial assistance in its curriculum development efforts from senior administrators at U.S. universities. The total number of subjects that a participant must successfully complete is 20, with 8 of the 20 being electives. As is true with the other MBA and executive management programs, the classes are held in the evenings and on weekends.

There are 26 faculty members, 18 of whom are part-time. Most of the faculty members received their postgraduate degrees from institutions in Great Britian.

b. University of Colombo

The Univeristy of Colombo will soon inaugurate its MBA program with a class of 40 candidates. The administration is very encouraged by the initial demand for the program. Over 300 applications were received, and the Admissions Committee identified 100 candidates for oral interviews, leading to a final selection of 40 participants.

Tuition fees are Rs. 5,000 annually. It is expected that at least half of the participants will be sponsored by their employers. The program is two years long, with all classes being conducted in the evening. The Curriculum Committee is comprised of academicians from the University of Colombo as well as other neighboring educational institutions.

The focus of this program is on mid-level management. All subjects were designed for managers in roles that are considered to be functional in nature.

c. Institute of Chartered Accountants

The Institute of Chartered Accountants will offer an MBA degree program before the end of 1983. Still in the planning stage, the Institute is confident that it can serve a local market that is looking for a high quality business education program. It intends to provide such a quality product by seconding several staff members from a leading British university. By establishing an official relationship with an overseas institution, the Institute believes that its degree will have immediate recognition and credibility. The visiting professors will also be expected to bring in consultancy assignments to the university. The Institute seeks to show a reasonable profit on its operations. In order to do this, it will require a tuition fee that is substantially higher than the other MBA programs. The administration believes there is an adequate number of individuals and companies willing to pay the higher cost of this program in order to receive the appropriate training so desperately needed by their business.

2. Executive Management Diploma Programs

a. National Institute of Business Management (NIBM)

In August, 1968, the Management Development and Productivity Center (MDPC) was established by the United Nations Development Program and the International Labor Organization. The major thrust of the MDPC at that time was in training. By 1977, the MDPC had expanded its scope of activities to include consulting and research, and subsequently changed its name to the National Institute of Business Management (NIBM). Although it still receives substantial financial support and technical assistance from the UNDP, it is officially supported by the Sri Lankan government, through the Ministry of Industries and Scientific Affairs.

NIBM offers a year long executive management program. In addition to its executive program, it also offers a so-called diploma program. The programs offered by NIBM and a brief statistical profile of them is shown in Table 2.

The fees for the diploma program are Rs. 5,000. It has been

TABLE 2

NATIONAL INSTITUTE OF BUSINESS MANAGEMENT

TRAINING BREAKDOWN BY TYPE - 1981

	Diploma	Executive	Supervisory	Worker
Number of courses	8	43	49	26
Participants	212	927	1 596	892
Training days	538	233	255	110
Participant days	15 676	4 877	8 249	4 030
Average course length	67.3	5.4	5.2	4.2
Average class size	26.5	21.6	32.6	34.3

an ongoing program at NIBM since 1975. In the past three years, a total of 79 participants entered the diploma program in business management. The class has decreased from 34 in 1981, to 24 in 1982, to 21 in this year's class. The number of participants from private sector organizations over the three-year period is approximatley 60%. For the diploma program, there are 12 required courses and no electives. The faculty is comprised of 17 full-time members and 18 part-time teachers.

In total, NIBM offered 126 courses in its programs in 1981. This was almost a 50% increase over 1980 when it ran 85 courses.

b. University of Colombo

The Executive Management Diploma Program is in its third year of operation. In 1982, it graduated a total of 83 participants. There are 78 students in the 1983 program, with most of them representing public sector organizations.

The tuition fee is the same as other management programs in the Colombo area at Rs. 5,000. It is only one year in length, with 6 compulsory courses. The medium of instruction is English.

The administration hopes to expand the program. Interest in the program has been strong, in part due to the University's central location. The most pressing concern expressed by the administration was the attrition of qualified professors which has adversely affected both the MBA and Executive Diploma programs.

c. Open University

The Open University offers two long-term management education programs. They fall in between an MBA program and shorter, seminar-style courses. Open University will shortly offer a three-year Bachelor of Science in Management degree (B.S.M.) beginning in 1984. The tuition fees will be Rs. 1,500, and the course materials will be available in all three local languages - English, Sinhala, and Tamil. All of the programs are conducted through correspondence.

The second management program offered by the Open University is the Entrepreneurship Program which lasts one year with a four course requirement. There are no electives offered to the correspondents. The tuition fees are Rs. 600, with estimated cost per student totalling less than Rs. 250. The program is in its inaugural year, with an estimated 1,150 enrolled participants. Interestingly, only 50 of the participants requested the English version of the course.

3. Management Seminars and Short Programs

All of the universities and institutes mentioned above have incorporated workshops and seminars into their management curriculum. Listed below are a few of the smaller institutes involved in management training that focus on only one type of business discipline.

a. Institute of Marketing

A small-scale operation, the Institute has been in existence since 1970. It has between 300-350 members, of which over 150 are considered to be active. Typically, there are about 20 seminars sponsored every year by the organization, with a modest admission charge for both guests and members. An average of 70 participants attend each seminar. The longest seminars sponsored by the Institute are three days. Seminar topics are chosen by polling the Institute's membership. Based on the resources, available and the topics requested, the administration either invites local marketing managers or outside experts to speak.

b. Institute of Productivity

The Institute of Productivity is under the direction of the Ministry of Industries. It is recognized in some private sector circles as being the only source of quality training for production management. The courses are generally aimed at the supervisory and middle-management levels.

c. Institute of Personnel Management

This institute is also funded by the government. Although it aims primarily at public sector managers, it appears to be drawing increasing interest from private sector companies.

E. ASSESSMENT OF NON-INSTITUTIONAL MANAGEMENT DEVELOPMENT PROGRAMS

Formal management training at academic institutions can be a less relevant approach to developing necessary skills than more closely tailored programs that fit the trainee's needs. Some of the arguments against the classroom method are that it can be expensive, too academic in nature, and sometimes irrelevant to specific problems and goals of a company.

One type of training conducted outside of the Sri Lankan management institutions is on-site training. These programs are frequently highly effective. They can either be designed by the existing senior management staff or by outside consultants. Using the corporate staff to design and conduct training is less expensive, and the product meets the needs perceived by the executives. Through the other approach, having outside management training experts conduct a assessment audit, the cost per trainee will probably be greater with less corporate control on the output. The benefit of using outside consultants is the potential infusion of new ideas presented through more effective and innovative training techniques, coupled with the indirect savings gained by not pulling the company staff members and instructors away from their present assignments.

A second training method employed by private sector companies is offshore training. Many senior level interviewees believe this is the most effective form of management training in spite of the substantial costs that are incurred. The survey results indicated that the firms most willing to support overseas training were generally family-owned businesses.

F. CONCLUSIONS AND RECOMMENDATIONS

The recommendations emerging from the analysis fall into three categories -- the government, the education and training institutions, and the private sector business community. Each of these groups has distinctly different roles and responsibilities in the management development process. The conclusions upon which these recommendations have been made are also delineated below.

1. Conclusions

The general conclusions of the study are as follows:

- The overall demand for quality management training programs appears substantially higher than what is currently available.

  All institutions that provide management training have been able to be highly selective in choosing program participants. This has been especially true for the MBA programs. They have screened out 80-90% of the total applicant base in identifying the best candidates. The seminars given by the smaller management institutes also appear to have been well attended.

  In addition to the strong demand for training, there is also a potential demand which has not yet surfaced due to negative perceptions of the existing programs by the private sector. Numerous managers interviewed are supportive of management training, but are looking for higher quality instruction, offering more relevant information and skills. Employers who send their staff members abroad for training often do so due to an apparent lack of effective training within the country. Senior managers are generally sensitive to the long-term benefits of training, even in the face of substantial attrition through better job offers overseas.

- There is little "cross-fertilization" taking place between the academic and business communities.

There is little communication, information, and skills exchange between the business and academic communities. Members of the faculties at local management institutions have little opportunity to work on consulting assignments with private sector companies. On the corporate side, the low teaching salaries also serve to deter businessmen from entering academia in their middle or later professional life, either on a part-time or full-time basis. It appeared that few experienced managers would be interestd in making the transition to become an instructor under the present pay scale conditions.

It must be emphasized that the interchange of ideas and techniques between the two communities is integral to their mutual well being. This interdependence that has evolved naturally in many other countries must be facilitied and carefully nurtured in Sri Lanka.

- The Sri Lankan government has only recently recognized the need for effective management training programs.

The range of academic disciplines that have traditionally received strong governmental support did not include business or commerce. The traditional educational system emphasized the importance and social acceptability of law, medical, engineering and science-based studies. Business studies for industry and agriculture were not considered to be at the same level of professionalism. The result has been that financial support for business and commerce programs at the universities is a small percentage of the funding allocations for other programs. Since these are typically the backbone of private sector management, there is an urgent need for increased funds for materials and support services.

- Private sector managers perceive the training staff of existing management programs as too academic with little practical experience in business management.

Few senior level managers believe that mem s of local faculties have the requiste experience or abilities to train their staff members. This, of course, is a general observation with numerous exceptions. Overall, however, there appears to be a gap between what the management training institutions claim as their areas of expertise and what the private sector believes these institutions can deliver.

There are several factors that were frequently cited as major constraints to forming a quality management training staff:

Low salary levels - The salary level constraints placed on the universities and other management institutions under the jurisdiction of the government have had a critical negative impact upon faculty quality. It is estimated that a full professor, with the necessary academic credentials and teaching experience, receives a salary in the U.S. $1,500 range. This compares unfavorably with more lucrative financial benefits in the industrial and commercial sectors. As private sector activity continues to expand, the opportunities will also increase for qualified businessmen, which in effect will exacerbate the situation.

This attitude was also shared within the management institutions. There appeared to be a serious morale problem among many of the instructors that were interviewed, and program administrators concurred that retaining highly qualified staff members was their single most critical problem.

The bonding system - A faculty member who has studied overseas in a graduate or postgraduate business program must repay his sponsor typically with five to ten years of service. While it is understandable that the sponsor, usually a university or the NIBM, wishes to recoup its investment through a long-term teaching commitment from the individual returning from overseas training, there is a decided negative impact of such a bond. By the time the instructor completes his service, he is perceived as being steeped in academic theory with no balancing practical experience and is, thus, no longer attractive to a private sector business. The business firm usually concludes that it would be substantially more beneficial to promote young, capable individuals from within to management positions instead of hiring older academicians.

- The teaching methods in the management programs need to be updated.

The predominant method of teaching in the programs is by lectures. This technique follows the concept that the instructor understands the issues and answers, and imparts his knowledge through lectures.

Sri Lankar institutes have not properly utilized the "case study" approach which is based on a greater interchange between teacher and student aiming at solutions to specific problems. Administrators at two of the schools conceded that their staff members are reticent to using case studies in class. One reason for this is that there are few case studies that have contextual setting relevant to Sri Lanka, since most cases have been developed by and used in Western countries.

Other methods such as independent studies, role-playing, and group workshops are also rarely employed. By excluding these techniques, students are partially deprived of interactive training in which leadership techniques and decision-making analysis methods are practiced.

- Program planning at the local institutes and universities is confined to budget preparation, ignoring other issues that will influence program performance in the future.

The universities and management institutes do not view themselves as organizations that need to be "market responsive." They operate within the confines of a budget established by the government, and shape their program formats in accordance with the annual allocations.

There are key issues that any competitive enterprise should assess to operate successfully in the long-term. There must be an awareness that a training program participant is in fact a consumer. In planning a training program, therefore, the institutes need to be sensitive to the needs of its "market." They must be able to meet the professional needs of those who seek the training.

2. Recommendations

a. Private Sector Initiative

- Establish a new, privately-administered and controlled Management Development Center (MDC).

After a careful analysis of the training opportunities provided by existing management development institutions and the private sector demand for training, there is evidence of need for a new training center. Such a program should not be a direct competitor of the universities, NIBM, and the other smaller institutes, but complementary to them, focusing on market segments that are not being fully served now.

The new Management Development Center (MDC) is not envisioned to be strictly a formal academic institution. Sri Lankans who wish to obtain an MBA degree would still choose from the two university programs and the projected Institute of Chartered Accountants Program. The MDC would have a special niche in the training marketplace, seeking new ways of developing innovative, practical training programs that other institutions are not able to offer, or in areas where the supply of training cannot keep up with the demand. There could be faculty exchange and joint research projects among all of the organizations involved in management development.

The MDC should focus on three activity areas:

- <u>Training</u>

  More than half of the MDC's budget and efforts should be applied to training programs. While classes would be offered to both public and private-sector managers, design of the courses would be oriented towards management issues in a competitive marketplace. They would cover a wide range of topics, varying from one day to six months in length.

  All levels of management should be served, but the MDC should pay special attention to supervisory skills training, which is too often passed over in favor of the higher status executive group. All courses should be taught in English.

The Administration and the faculty members should be chosen primarily from the private sector. There are managers in companies that would be interested in part-time involvement with such an organization. The key is to attract as much relevant hands-on experience into the classroom as possible. Also, by tapping these professionals on a part-time basis, it would serve to keep the MDC's costs down.

Another important aspect of the training is that it should be conducted in a Sri Lankan context. Case materials, textbooks, and other inputs should stress the adaptation of generally-accepted management concepts to the local environment.

- Consulting

It will be highly critical to the success of the MDC that faculty members become extensively involved in consulting services throughout the private sector. The faculty must be viewed as being comprised of competent managers capable of solving local operational and strategic problems. The consulting work would be the intellectual linkage that ensures meaningful exchanges between the faculty and the local managers.

In order to earn a high level of respect, the MDC has to guarantee quality service. There is often an acceptance barrier that a consultant has to break through. In each case, the MDC would need to provide a reasonable, professional "product" to the client.

Another component of the consulting service that MDC could offer is access to overseas market data. There is no repository at present for export market data. The MDC may be an effective vehicle for obtaining and disseminating these data.

- Research

The third component of the MDC would entail research. The research projects may be funded by clients (for example, the government might be interested in a study of management emigration patterns of Sri Lankans going to the Middle East) or internally chosen with an eye to future business development. There could be research conducted in support of the training programs - i.e., case study development. Whatever form the research will take depends upon the information needs of the MDC at any given time.

There are a number of general guidelines for the MDC. It is worth re-emphasizing that the most important operational principle is that the MDC must be a self-supporting entity. Its operating revenues should cover its costs and still yield a reasonable net profit. There are several existing management institute models around the world that the MDC could follow. Moreover, there has been a trend in the U.S. of a large number of private firms entering into the training industry and turning a profit on this investment. Although most of them provide skills training for the high technology industry, they have proven that a well run institute offering a quality product can be run as a profitable business.

There are several categories of institutional improvements in which the MDC would need external financing. Overseas faculty training, capital equipment and facilities purchases are expensive items that the MDC's revenue stream could not expect to cover, at least in the short run. Although these would unquestionably enhance the MDC's institutional reputation and capabilities, they are not necessry to accomplish its objectives of offering quality management training on a profit-making basis.

The second guideline is that the major budget costs must be for the Director and the faculty. The rest of the MDC should be considered as "no frills" expenses. Overhead charges should be minimized.

As an indication of the MDC's ability to be self-supporting, broad estimates of its annual cost and revenue streams have been calculated. (See Tables 3 and 4.) These are based on the assessment of the overall demand for training and the experiences of several other institutes similar to the MDC around the world.

Table 4 illustrates a model that has been proven to be successful in other management institutes, such as the LPPM in Indonesia, the Management Education Institute at Arthur D. Little, Inc., and to a certain extent, at the Asian Institute for Management in the Philippines. The MDC should not wait for external financial or technical assistance to begin operations. It can start on a very low budget and offer courses which are most likely to receive a strong positive response from local managers. It should be very entrepreneurial in spirit and design, building its program base slowly. If and when technical assistance or other forms of major support emerge from outside resources, the MDC will have already tested its market and understood how to use these resources. The underlying premise of creating a self-supporting management development center is that it serves primarily private sector business.

b. Government Initiatives

- Reduce the bonding regulations

The bond requirements affecting academic staff appears to be one of the major bottlenecks to greater interaction between the private companies and the management institutions. A modification of this regulation is needed that would allow faculty members to serve their bond in one of two ways:

- Allow them to be a part-time faculty member, teaching while holding down a position with a private sector company; or
- Permit the faculty member to complete his teaching obligations at different intervals over a longer period of time so that he can operate within the private business environment.

- Demand a sound program strategy for each management institute.

The government should assist the management institutions in developing a more comprehensive plan for serving both private and public sector management. The net effect for the government is that it would then be in a position to channel its scarce resources into the most productive and focused programs.

c. University/Management Institution Initiatives

- Improve the teaching methods of the faculty.

The traditional lecture method should not remain as the only means of instruction. Its importance as a teaching technique should be reduced. Techniques such as role playing, group work, field trip assignments and case studies should be experimented with.
The case study method is important as a training tool

in a country such as Sri Lanka. The underlying objective of any case study is to put the student in a situation where he has to conduct an independent analysis of the problem and make a decision based on the information available to him. This type of skill cannot be taught through lectures, but from practical analysis.

The management survey indicated that Sri Lankan middle and lower managers are rarely given real decision-making authority. A significant number of senior managers believe that the lower-level staff are not experienced enough to make decisions, and are therefore reluctant to delegate such authority until the management staff proves its capability in using mature judgement and reasoning to resolve a problem.

Given this lack of delegation, then, the middle management cadre can best develop its decision-making abilities through the case method.

A teacher training program on the use of the case method should be given. The first part of the program would be spent by the consultant in explaining and demonstrating the case method. During the second part, the participants would spend more time peer teaching among themselves. A third component would be case development. At the end of the course, the participants - faculty members themselves - would be responsible for writing a case. The development of Sri Lankan cases would address one of the major impediments to effective utilization of case studies in the local training institutions today.

- <u>Conduct program evaluations on a regular basis.</u>

  There is very little program-related evaluation by the management institutions. For the most part, the administrators were not aware of participant satisfaction during the program or, more importantly, the impact of the training upon the professional performance of participants after completion of the program.

  A sound evaluation is also an indicator of market changes. The program must relate to the participants' needs. An evaluation would put the existing program to the test, and presumably provide the input for rational programmatic change. By assessing the management programs, administrators can build an information foundation for short and long-term planning.

- <u>Develop a formal strategic plan for operation</u>

  The local universities and management institutes do not appear to have any sense of short or long-term planning beyond budget allocation. There is little attempt at systematic program planning. It is vital to the long term development of an institution that it understand its own strengths and weaknesses, its students, and its role in the community. An organization must then be able to translate this information into a definition of its mission as well as its short and long-term goals.

  The professional staff executing the management programs must understand the market dynamics of its own program, including:

  - the external environment
    - political impact

  - cultural influences
  - regulatory issues
- the internal environment
  - administrative structure
  - faculty, structure/quality
  - institutional mandate
  - external image
  - operating costs
  - facilities and materials
- the competitive environment
  - number of competitors
  - competitive profile
  - market niche analysis
  - pricing (tuition)

- <u>Create a joint academic/private sector committee.</u>

There was a common concern among private sector managers that they do not have enough input into the policy and program formulation process of the management institutions. Consequently, there is no sense of affiliation with the programs.

If the institutions are to enhance their appeal to the private sector, they must adopt a partnership role with it. The participation of the business community should not be concentrated in a few individuals. Since training needs vary, different business segments in the private sector should be represented since training needs vary.

A Policy Steering Committee, composed of representatives from the business community should be formed. The committee should be balanced between managers of small and large-sized companies. There should also be a mixture - possibly integrated through subcommittees - of businessmen from different management levels. The supervisors will likely focus on a set of training needs different from those needed to executive management. The committee should have a significant number of rotating membership seats, giving wider exposure of the programs to the private sector.

TABLE 3

PRIVATE SECTOR

MANAGEMENT DEVELOPMENT CENTER

ESTIMATED REVENUES

CATEGORY	COSTS (Rs)	
A. ANNUAL OPERATING REVENUES		
TRAINING		
(5 programs) x (30 participants/program) x (Rs 5,000/participant)	750,000[1]	
(10 week-end programs) (25 participants/ program) (Rs 1000 program)	250,000	
	Minimum	Maximum
SUB-TOTAL[2]	750,000	1,250,000
CONSULTING[3]		
(4 studies) (220,000/consulting assignment)	880,000	
(8 studies) (220,000/consulting assignment)		1,760,000
RESEARCH		
(1 study) (220,000)	220,000	
(3 studies) (220,000/study)		660,000
TOTAL	1,850,000	3,670,000
B. CAPITAL BASE[4]		
(100 shares) (5,000 Rs/share)		500,000
(100 shares) (2,500 Rs/share)	250,000	
TOTAL	250,000	500,000

ESTIMATED REVENUES

FOOTNOTES

1. The programs would be at least 50 and no more than 80 training days long. They would have a specific focus (i.e., project analysis, personnel management, marketing management) with 3 to 7 different courses in each. These program lengths were chosen primarily to allow for a revenue projection. The actual course length can vary between two days and 6 months. Programs longer than 6 months are not advisable.

2. The subtotal is a range of 25% plus and minus the actual calculated training revenues.

3. At least half of the consulting assignments are expected to be provided by local private sector companies. The other half will be generated through sales to government ministries, international donor agencies, and potential foreign investors.

4. The capital base is a suggested mechanism for generating revenues to cover the start-up costs. If the private sector supports the concept of MDC, it must be willing to show its commitment financially. The MDC might sell shares to private firms in Sri Lanka at a price of at least Rs. 2,500/share. The actual mechanism will depend upon its legal structure.

TABLE 4

PRIVATE SECTOR

MANAGEMENT DEVELOPMENT INSTITUTE

ESTIMATED COSTS

CATEGORY	COSTS (Rs)	
	MINIMUM	MAXIMUM
OPERATING COSTS		
Direct		
• Faculty fees[5]	1,235,000	1,750,000
Indirect		
• Office/classroom Space rental	30,000	60,000
• Utilities and Communications	25,000	40,000
• Administration[6]	804,000	900,000
• Marketing and Sales	150,000	200,000
TOTAL OPERATING COSTS	2,243,000	2,950,000
CAPITAL EQUIPMENT COSTS		
Classroom materials	125,000	200,000
Administrative materials	371,000	677,000
TOTAL CAPITAL EQUIPMENT COSTS	496,000	877,000

ESTIMATED COSTS
FOOTNOTES

5. The faculty fees include provisions for five full-time staff members at a salary of Rs. 176,000 per instructor, all indirect costs included. The rest of the cost is charged against part-time teachers paid on an hourly basis to teach specific courses. Most should come from private-sector companies.

6. The driving force behind MDC will be the Managing Director. He must be highly qualified, dynamic, a good administrator, educator and businessman with a good sense of marketing. The administration costs include a projected salary of Rs. 550,000 for this position.

TABLE 5

STRATEGY FOR IMPLEMENTING A NEW MANAGEMENT DEVELOPMENT CENTER

A. Diagnostic Phase

- Identify interested private sector parties
- Create Steering Committee
  - Private sector leaders
  - University representatives
  - Appropriate Government officials
- Elect a Chairman for the Steering Committee
- Determine legal structure
- Collect initial start-up capital from MDC founders

B. Preliminary Formulation Phase

- Appoint/hire an interim director
- Identify office space and basic support materials for the interim director
- Determine capital structure
- Develop overall strategic plan
  - Market profile
  - Resource requirements
  - Competitive Analysis
  - Pro forma financial statements
- Contact other management institutes overseas regarding a partnership arrangement.

C. Strategy Implementation Phase

- Details to be determined by MDC Steering Committee, with outside technical assistance, if necessary.

D. Project Start-Up Phase

- Details to be determined by MDC Steering Committee, with outside technical assistance, if necessary.

PROJECT DEVELOPMENT DURATION: 9 - 15 MONTHS