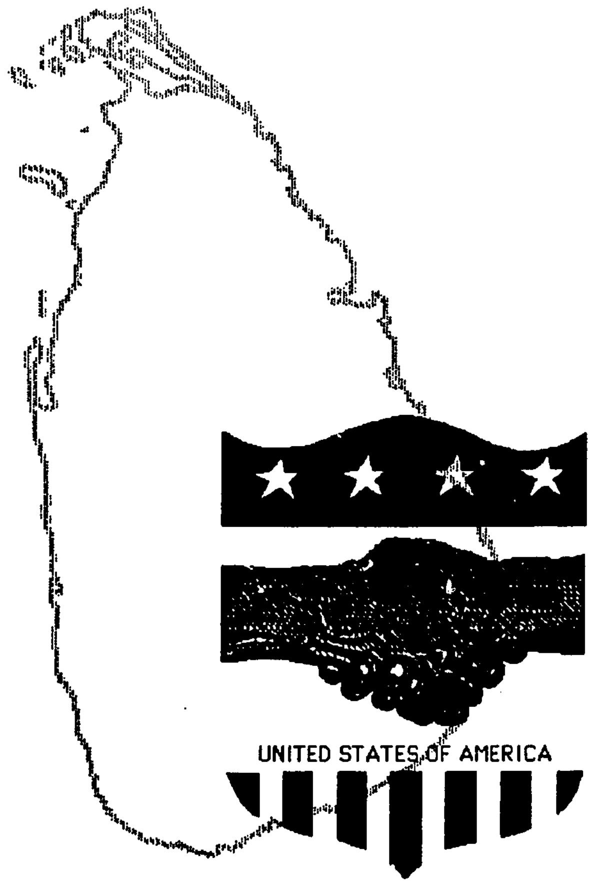

USAID/Sri Lanka

Development in Sri Lanka

A review

April 1991

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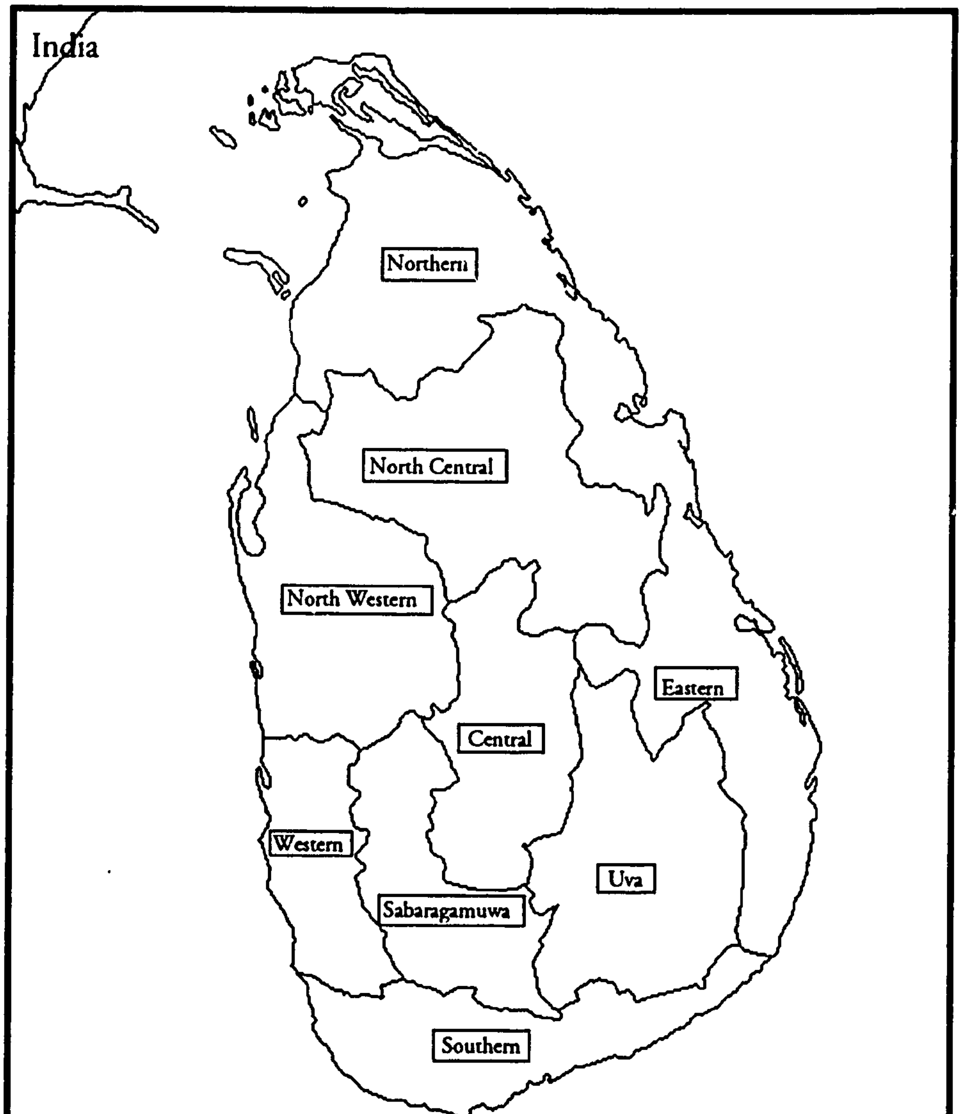


Sri Lanka's provinces
The Northern and Eastern Provinces have been merged.

Introduction

To provide a road map for development cooperation between Sri Lanka and the U.S. in the 1990s, the United States Agency for International Development Mission to Sri Lanka has conducted a comprehensive appraisal of the development context and its own assistance program. This paper summarizes our assessment of development prospects and constraints. It is intended as a companion document to USAID's *Strategic framework FY 1992-96.*

The length of this paper clearly precludes a comprehensive treatment of the development problem in Sri Lanka — an extraordinarily complex subject. Rather, it seeks to highlight specific aspects that we believe are key to stimulating and accelerating development in this country, and where USAID cooperation can be most productive.

Development challenges, opportunities and choices

The case for agricultural development-led industrialization in Sri Lanka

In 1989, the Sri Lanka Association of Economists decided on "industrialization" as the theme of its Annual Meetings and invited Irma Adelman to give the keynote address. She wasted little time in deflating expectations:

> What you have heard up to now is mostly bad news, You have heard that in Sri Lanka agricultural policy has been a failure. You have also heard that in Sri Lanka industrialisation has been a failure. What you will hear from me is that even if industrialisation had been a success it would not, in any acceptable time frame, achieve the objectives of poverty alleviation and employment creation. (p.17)

She then challenged the economists present, policy makers and advisers, to articulate an overall development strategy that would go beyond the fixation on aggregate income to look at impacts on poverty and employment:

> Now let me use my remaining minutes to suggest an alternative strategy which is likely to be superior to the export-oriented industrialization strategy that is currently being advocated for Sri Lanka. The strategy I would propose is that of agricultural-development-led industrialization. The beginning of the strategy, for which, it seems to me, you have amply laid the groundwork, is the improvement in total-factor-productivity in agriculture. Then, part (but only part) of the fruits of the improvement in total-factor-productivity should be invested in wage-goods industries. The industrial sectors which should receive priority should be the consumer-goods-producing sectors and agro-based industries. These industries are labour-intensive and the increase in demand generated by the higher incomes in the countryside will provide a natural market for their output. The expansion of these industrial sectors should be pushed not so much with a view to generating export markets or import substitution but with a view to satisfying the increases in domestic demand that are being generated by the new prosperity of the agricultural sector...
>
> It is worth pointing out that none of the currently developed countries achieved successful development unless they either started their industrialisation with a highly productive agricultural base or developed a highly productive agriculture during their industrialisation process. (p.19)

Recent research and accumulating evidence from actual experience in Sri Lanka are beginning to provide remarkably strong support for the validity of Adelman's principal assertion — that efforts to increase total factor productivity in agriculture will not only raise incomes, but may also expand employment more effectively than investments in other sectors. This evidence, together with information on the growth experience elsewhere, makes a persuasive case for agriculture as the lead sector in an industrialization strategy that emphasizes broad participation to address issues of employment and poverty. Unfortunately, though, few government officials or other donors appear to have been persuaded so far. Conventional wisdom views prospects in agriculture much more gloomily. Further research, experimentation, application and much convincing will be needed to promote the concept of agricultural-development-led industrialization in Sri Lanka.

In any case, Sri Lanka's economy and exports remain agriculture-based, although the structural transformation is underway. The performance of agriculture — still dominated by paddy cultivation and plantation tree crops — shapes GDP growth; production levels and world market prices for agricultural exports (tea, rubber, and coconut) largely determine export performance. Any strategy seeking the structural transformation of the economy therefore needs to take advantage of the potential inherent in the agricultural sector.

Development in an open economy

Agreeing with one critical point, though, does not mean wholesale acceptance of Prof. Adelman's policy prescription. An industrialization strategy for Sri Lanka that focuses on domestic demand overlooks the lack of competitiveness in consumer-goods industries. Locally produced goods are frequently more expensive or of lower quality than those available internationally. Competition will be essential to raising total factor productivity not only in agriculture, but also in industry. That means an open economy, with Sri Lanka's industry having to compete in both international and domestic markets. A blindered industrialization strategy that focuses exclusively on satisfying increasing domestic demand can easily slip into "temporary protection," in Sri Lanka as elsewhere somewhat of an oxymoron, in Prof. Michael Porter's words.

Open-economy policies designed to encourage and help Sri Lankan industry to compete are not only compatible with an agricultural-development-led industrialization strategy, but may well be essential to it. For some time, Sri Lanka's development will be based on factor advantages which tend to favor agriculture and agro-based industry. Exploiting these advantages fully will require access to up-to-date production and marketing technology, which in turn places a premium on (active) foreign investment and participation.

A new private-public partnership

At the beginning of the 1990s, Sri Lanka's best prospects appear to lie in an agricultural-development-led industrialization strategy that combines the following elements:

- it pursues industrialization through improvements in total factor productivity in agriculture, thereby creating both an investable surplus and an expanding market for local industry;
- it ensures an open economy that encourages competition and competitiveness in the local industry;
- it maintains an open investment regime and creates a supportive business climate that invites foreign investment and participation.

Such a strategy in effect seeks to expand opportunities for private initiative, both as an end in itself in the political and social sphere and as a condition for the most productive use of the country's resources. More productive use of human, natural, financial and physical resources is critical to sustainable gains in employment and income. To succeed, this strategy calls for a *new partnership* between government and the private sector, one that concedes development leadership to private initiative, creates a supportive framework for entrepreneurs, small and large, and safeguards competition in the arena of values and ideas as well as that of human and economic performance. This new partnership is founded on the rule of market forces, strong economic and civic liberties, protected property rights and enforceable contracts, and full access to and control over resources, including technological knowhow. A commitment to these principles implies changes, ranging from major policy reversals that may go against long-standing traditions and deeply held beliefs to seemingly mundane reforms in day-to-day operations.

Development as productive resource management

The 1989 *World Development Report* offered a succinct statement of the central challenge of development policy: "The biggest difference between rich and poor is the efficiency with which they have used their resources." (p. 26) How efficiently resources are managed in turn depends on the institutional structures, procedures and mechanisms embodied in a country's economic and social system to provide access to and determine control over resources and to ensure that decision makers enjoy (or suffer) the consequences of their resource use decisions. Resource productivity also depends on the knowledge, skills and capabilities of the individuals and institutions using the resources.

Focusing on the determinants of resource productivity brings a solid body of knowledge in microeconomics and management to bear on the appraisal of institutional arrangements and policies. Such an appraisal can serve as a basis for formulating broad as well as targeted interventions to enhance the performance of the institutional framework governing resource management.

The diagnosis requires a survey of practices and problems across sectors, in the government as well as in business and non-governmental organizations. The range of critical resources can be divided into three major sets: human, financial, and natural (land, water, air, and biological resources). Man-made physical resources — economic infrastructure — also need to be included in this assessment.

Across all types of resources, the conclusion is similar: currently, despite liberalization, resource management in Sri Lanka relies too heavily on direct government control. This orientation provides few incentives or support for ensuring the most productive resource use. As a result, Sri Lanka's development performance to date has fallen short of its potential. New structures and mechanisms are required to reach that potential.

The background for development in the 1990s

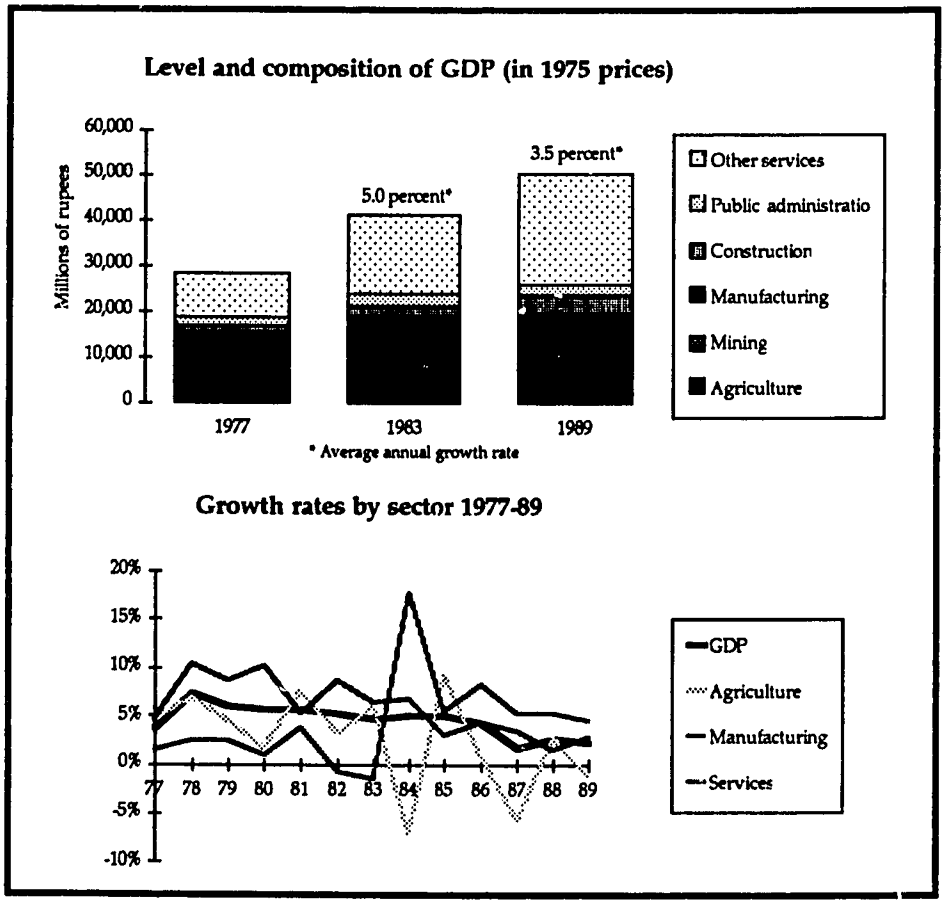
This paper presents some highlights of Sri Lanka's economic and political setting for development efforts in the 1990s. It is primarily intended as a background document for the discussion of the strategy for U.S. development assistance to Sri Lanka, designed to help the country reach its goal of joining the ranks of the newly industrializing countries, but preserving much of its natural resource base and relying on the full participation of all of its citizens. The paper first focuses on the political economy of development in Sri Lanka. It then reviews its experience in harnessing and preserving its natural resource base. The final section reviews the environment for trade and investment.

Growth in an equity-oriented democracy

Human development vs. growth

Sri Lanka's development record is unique — it combines solid achievements in human development with a lackluster economic growth performance. As a result of past investments in human capital, Sri Lankans are better educated, healthier, and enjoy many more social amenities than people in other South Asian countries.

The indicators used in constructing the Physical Quality of Life Index place Sri Lanka in the company of countries much better off economically. At a per capita income of $420 (1988), the country's illiteracy rate of 13 percent (1985, 17 percent for women) is *half* of that of the group of middle-income economies (as defined in the World Bank's *World Development Report*) with a per capita income of $1,930. Its life expectancy of 71 years is the same as that of Argentina or South Korea. Its child mortality rate of 21 per 1000 compares to 52 for the group of middle-income economies. Although expenditures on education and health services have been stagnant or declining in real terms, the country continues to make progress in terms of these indicators.

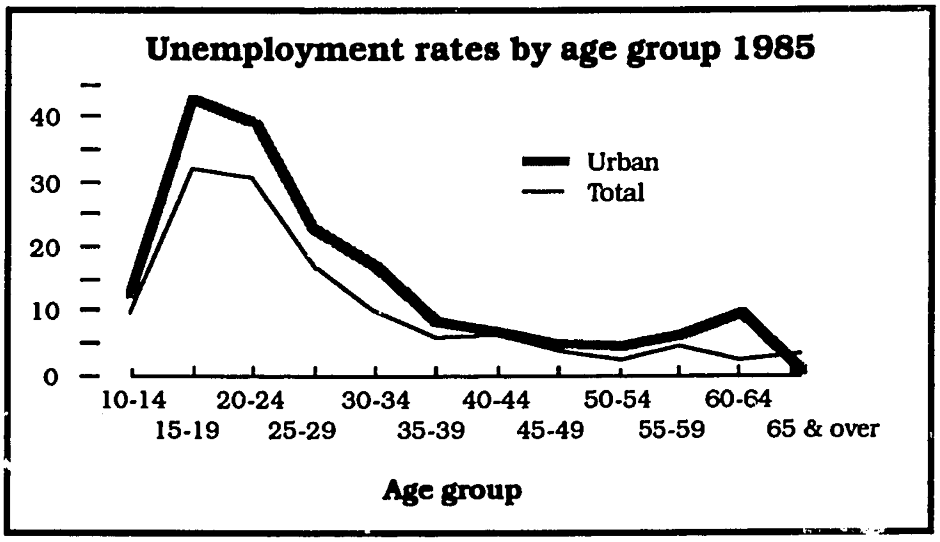


These accomplishments provide a striking contrast to a mediocre economic record. Over the period 1960-1989, Gross Domestic Product per capita has been growing at an average of about 2 percent; at that rate, per capita income would take 35 years to double. Since Sri Lanka has accomplished much in containing population growth — the natural rate of increase now stands at 1.6 percent — the modest gains in economic welfare reflect the failure to move the economy as a whole. Agriculture has stagnated over the last few years, and the dominance of state-owned enterprises in manufacturing has dragged down industrial growth.

Some have seen this contrast between human and economic development performance as evidence for the potential of an alternative path to development, one that stresses equity through redistribution over growth. Others have argued that Sri Lanka's outstanding human development record is largely a result of "initial conditions," a legacy of the decision to introduce free education and other social benefits in the early 1930s under the British colonial regime. In other words, the plethora of controls and interventions ostensibly aimed at promoting equity may not deserve the credit for the high levels of human development, although the resulting dominance of the state certainly deserves much of the blame for hobbling the economy and retarding growth.

Human resources: solid accomplishment, poor returns

The apparent paradox of a good human development record and mediocre growth means that the economy has been unable to take full advantage of the sizeable investment in human capital. The talents of Sri Lanka's people are largely underutilized because of haphazard human resource development policies that have failed to build on a strong base, barriers rooted in cultural attitudes and ethnic and social cleavages, and the lack of information and appropriate incentives. The national economy has proven unable to employ large numbers of literate and educated citizens productively. Private initiative in developing new knowledge and skills is not adequately mobilized or rewarded. Continuing social and separatist conflict is jeopardizing the success of national development programs.



Over 20 percent of Sri Lanka's labor force is unemployed. Unemployment is highest among the young, especially among young women. Overall, women are more than twice as likely to be unemployed as men. Many of the unemployed have completed secondary schooling, vocational programs, or some university courses, but face bleak prospects when they enter the job market. Even for those who are employed incomes are meager. Literacy (in the native language) and education do not translate into higher productivity. Low productivity impairs competitiveness and stifles expansion, even at low wages, In response to the lack of domestic opportunities, some five hundred thousand Sri Lankans are working outside the country in any one year. The most talented and best educated often leave for good.

Low levels of infant and maternal mortality in combination with improved medical services have increased life expectancy in Sri Lanka to 71 years. Efforts to lower the birth rate have been successful, more than offsetting the effects of longer life expectancies; fertility is approaching replacement levels, and an estimated 62 percent of Sri Lankan couples use some form of birth control. Although population growth is slowing, Sri Lanka is still experiencing rapid increases in the number of people between the ages of 15 and 20. As many as 200,000 young people are entering the labor force each year.

The statistics on infant mortality and life expectancy conceal a serious problem of malnutrition among young children. Based on anthropometric data, a 1987 national survey (omitting the North and East) classified over 30 percent of children between 1 and 3 years of age as "stunted" (based on height for age), and over 15 percent as "wasted" (based on weight for height). One frequently finds the assertion that malnutrition has worsened in the post-1977 liberalization, but the evidence does not allow for much confidence in any assessment of trends. If anything, the incidence of malnutrition may have declined somewhat. In the 1977 reforms, universal food subsidies were replaced by a supposedly more targeted foodstamp program. Budgetary allocations to this program have remained constant in nominal terms (that is, they have declined in real terms), but other programs targeting malnutrition directly (mid-day

Human development and initial conditions

As part of a major review of the "Evolution of living standards in Sri Lanka" in the early 1980's, a program sponsored by the World Bank and the Central Bank of (then) Ceylon, Paul Glewwe and Surjit Bhalla examined the apparent anomaly of Sri Lanka's human and economic development performance. Their findings, published in the World Bank Economic Review (Bhalla and Glewwe [1986]), stimulated a lively debate.

Basically, Bhalla and Glewwe argued that Sri Lanka's exceptional performance in human development was not so much a result of policies *since* independence, in particular of any higher allocation of resources to health and education, but rather a consequence of higher educational and health standards *at* independence (a result of efforts under the British colonial administration). Thus, they considered Sri Lanka's performance in the social field from 1960 to 1978 "nonexceptional." In their view, social indicators are affected by growth, in Sri Lanka as elsewhere.

Such a conclusion implies that development efforts should seek to improve living standards by focusing on growth (the *indirect* approach), rather than through *direct* intervention. Several development economists, including Pyatt [1987] and Isenman [1987] took issue with that implication as well as with the analysis itself. Arguing, in part, that the relevant question was why Sri Lanka kept its position of relative leadership in human development well into the 1970's (and beyond), they maintained that direct intervention can be an important element in promoting improved living standards. We now know that Sri Lanka's good performance on social indicators has continued throughout the 1980's — in spite of stagnant or declining expenditures on social services. Thus, the real question may be whether we understand the dynamics and causalities of social indicators sufficiently to use them to judge the performance of development policies.

Bhalla, Surjit S. and Paul Glewwe, "Growth and equity in developing countries: A reinterpretation of the Sri Lankan experience," *World Bank Economic Review*, Vol. 1, No. 1, September 1986; Pyatt, Graham, "A comment on 'Growth and equity in developing countries: A reinterpretation of the Sri Lankan experience,' by Bhalla and Glewwe," *World Bank Economic Review*, Vol. 1, No. 3, May 1987; Isenman, Paul, "A comment on 'Growth and equity in developing countries: A reinterpretation of the Sri Lankan experience,' by Bhalla and Glewwe," *World Bank Economic Review*, Vol. 1, No. 3, May 1987.

meal program for children) or indirectly (the Janasaviya poverty alleviation program) have maintained total welfare expenditures at over 3 percent of GDP.

Women have played a central role in human resource accomplishments. Although literacy among women is lower than that among men (83 vs. 91 percent), it is still high by developing country standards, making it easier to pass on information on family planning, health care, and nutrition — areas where the mother's education has been consistently found to be the most important factor. Women also play a visible role in politics, administration and business. Even so, the unemployment problem is most acute among women. Their potential to contribute to the adoption of new technology in small-scale farming and off-farm enterprise has yet to be fully utilized

Conflict, communal, social, and separatist, is the most significant impediment to effectively utilizing Sri Lanka's human resources. These conflicts are squandering opportunities, disrupting lives, destroying social and economic infrastructure, and fostering splits among communities that will hinder the cooperation required to achieve the country's development potential. Both the GSL and the private voluntary organizations have been searching for institutional structures to deliver relief and rehabilitation services and seeking to devolve greater authorities to local governments and local organizations. USAID has encouraged this search largely through its support to PVOs concerned with reducing tensions and strengthening democratic institutions. In addition, USAID has also sought to maintain a careful balance among different groups throughout its portfolio.

Almost continuous conflict has also affected the development of specialized technical knowledge and managerial skills. Researchers and higher education teaching staff have had to be extremely dedicated to continue through the turmoil that has affected the academic community in recent years, particularly when the universities were closed for two years. The turmoil has magnified the problems inherent in the institutional structure that provides few incentives for excellence in the development of new knowledge, skills and processes, especially in the technical fields. With a prevailing complacency that technical and managerial skills are, if not fully competitive, at least adequate for modern industry, Sri Lanka's "knowledge industry" is contributing little to development. Some of these problems are coming under closer scrutiny in the framework of the Government's industrialization initiative.

Ethnic and social tensions

Sri Lanka entered the 1980s poised for rapid economic growth. It was attracting foreign investment as well as tourists; innovation and massive infrastructure investments stimulated growth in the agricultural sector; exports surged. Actual performance in the 1980s, though, fell far short of optimistic expectations. Adverse weather, including a lingering drought in the second half of the decade and intermittent floods, accounts for part of the disappointing performance. Remaining weaknesses in the policy framework also bear part of the blame. But all of these factors are overshadowed by the precarious security situation created by the flare-up of ethnic and social tensions.

Three major ethnic groups make up Sri Lanka's population: Sinhalese (74 percent), Tamils (Sri Lankan Tamils: 13 percent; Indian Tamils: 6 percent), and Muslims (7 percent). While the Muslim population has been able to live generally in relative peace with the other ethnic groups, tensions and conflict between Sinhalese and Tamils continue. The presence of some 55 million Tamils across the Palk Strait in Tamil Nadu in southern India makes it possible for both groups to perceive themselves as an endangered minority — the Sri Lankan Tamils in this country, the Sinhalese in the region.

The roots of Tamil-Sinhalese tensions reach far back, as migration and conquests pitted the rulers of Sinhalese and Tamil empires on Sri Lankan soil against each other. The onset of colonialism in 1505, first by the Portuguese, then the Dutch and finally the British (who were the first to bring the entire island under their control by defeating the Kandyan kings in the central hills), changed the nature of the Sinhalese-Tamil relations, but did not settle differences. The British colonial administration pursued a deliberate policy of favoring the generally better educated Tamils in the civil service. After independence, the privileged position of Tamils became an issue. In 1956, an SLFP government sought to redress the perceived inequity by promulgating a "Sinhala-only" policy, making Sinhala the official language, especially for education, and introducing a quota system for both higher education and public administration.

The failure of the economy to keep step with population growth exacerbated Tamil resentment of the discrimination inherent in the "Sinhala-only" policies. Economic prospects for the rapidly growing number of young people in the North (virtually all Tamil) and the East (roughly a third Tamil, a third Muslim, and — in part a result of government resettlement programs — a third Sinhalese) were dismal, although perhaps no worse than in the rest of the country. Perceived discrimination and the lack of economic opportunity combined to fuel the drive for an independent homeland, *Tamil Eelam*, giving rise to several more or less violent separatist movements. The most ruthless of these groups, the Liberation Tigers of Tamil Eelam (LTTE), has established its dominance by neutralizing virtually all of its rival organizations, primarily through violent means, and by fighting effectively against government security forces as well as against an Indian Peace-Keeping Force.

An LTTE ambush of government troops in 1983 triggered a retaliatory pogrom against Tamils living in the southern part of the island, severely tarnishing Sri Lanka's emerging image as a country of opportunity. The separatist groups responded with a campaign of terror, culminating in the 1987 explosion of a powerful bomb in a crowded bus station in Colombo that left some 115 people dead and 200 injured.

An attempt by the Government to settle the conflict by defeating the LTTE militarily foundered in part because of Indian opposition to any settlement by force. The Sri Lankan Government yielded and agreed to some major concessions in the Indo-Sri Lanka Peace Accord of 1987, in particular greater autonomy for regional bodies, the Provinces, under elected councils. It also accepted a merger, subject to a later referendum, of the Northern and Eastern Provinces, a key demand of the separatists as the first step to a Tamil homeland. In exchange for these concessions, India agreed to help maintain the unity of the country by disarming the militant separatists, and stationing a Peace Keeping Force (the IPKF) in the North and East. Despite India's long-standing support for the Tamil cause, the IPKF was soon embroiled in open warfare with the LTTE. It left Sri Lanka in early 1990.

The Indian presence provided a Sinhalese nationalist rallying cry for a Marxist insurgency in the southern part of the country. This movement, the *Janatha Vimukthi Peramuna* (JVP) had attempted to launch a major uprising in 1971, which was bloodily suppressed by the Bandaranaike Government. Seeking legitimacy for a time (its leader ran officially for President in 1982), it was later proscribed by the Government and drifted back into subversion, finding a fertile ground for their slogans and recruiting drives in the frustrations and hopelessness of unemployed Sinhalese youth.

Starting in late 1988, the JVP imposed a reign of terror that came close to destroying the social and political fabric and stifling economic activity. Through an carefully orchestrated campaign of verbal and physical intimidation, including assassination of leaders or key personnel, the JVP disrupted the functioning of government and private enterprise. When it turned to the killing and intimidation of families of members of the security forces, the Government mounted a countercampaign whose brutality often rivaled that of the JVP's actions. Capturing or killing many of the JVP's top leadership, the Government succeeded in reestablishing control in the southern and central parts of the country in late 1989.

The good economic performance in the first part of 1990 once again confirmed the resiliency of the economy, and suggested the potential for growth in a stable, reasonably secure environment. Prospects looked bright — until the LTTE broke off negotiations in June and resorted once again to open warfare against government forces in the North and East. The Gulf crisis added to that shock, forcing nearly 100,000 workers to return to Sri Lanka and thereby sharply lowering the country's foreign exchange earnings from workers' remittances (although tea exports suffered less than originally expected with the loss of Iraq as a major importer). In general, the impact of the Gulf crisis on the Sri Lankan economy was less than originally feared.

The ethnic and social tensions will continue to shadow the Government's pursuit of faster economic growth. Without faster growth, frustration and mistrust is likely to fester and can erupt again and again, in turn blocking economic progress. A recent report by a Presidential Commission on Youth suggests a broad range of measures to provide better economic and educational opportunity to young people. Greater opportunity offers a chance, but the Government may have little time to show results. In fact, time may have run out in the North and East, where a tangle of political, ethnic and economic problems is proving virtually intractable.

The picture has been complicated by a deteriorating human rights situation. In responding to the insurgents' terrorism in the north and east as well as in the south, the security forces and vigilante groups with links to them have been showing a disregard for human rights incompatible with a democratic system

Four decades of democracy in search of a development policy

Sri Lanka's pride in its democratic tradition is well-founded. Over the first 30 years after independence in 1948, the electorate almost regularly replaced governments (and ideologies) in power. The country's first-past-the-post electoral system guaranteed that even relatively small shifts in voter preferences resulted in significant changes in parliamentary majorities, from the moderate United National Party (UNP) to the leftist Sri Lanka Freedom Party (SLFP) and its allies. Economic regimes changed with the party

An overview of Sri Lanka's political history

DATES	PARTY	COMPOSITION	LEADERS	MAJOR POLICIES/EVENTS
1948-56:	United National Party (UNP)	Center-right	D.S.Senanayake D. Senanayake J. Kotelawala	Open economy and an annual growth of 4.5%: Committed to plantation economy, encouraged minimal promotion of local industry development; financed expensive free education, health programs and consumer subsidies from revenues from Korean War boom; initiated land reform and peasant colonization of the dry zones.
1956-60:	Mahajana Eksath Peramuna (MEP)	Center-left Sinhalese	S.W.R.D. Bandaranaike	1955-57 - Growth averaged 3.5%: Established 'Sinhala Only' Language Act linking Sinhalese language and Sri Lankan nationalism provoking ethnic riots; passed Paddy Lands Act to regulate tenant rights.
1960-65	Sri Lanka Freedom Party (SLFP)		S. Bandaranaike	Nationalized key industries and local and foreign-owned enterprises—banks, life insurance, petroleum, transport, schools — and secularized education; restricted imports of essential items to state corporations; introduced electoral reform regulations to boost allegiance to party; expanded social welfare programs.
1965-70	United National Party (UNP)	Coalition	D. Senanayake	Established steel, tire and hardware state corporations; saw rise in educated unemployed as result of baby boom.
1970-77	United Front (UF)	Leftist	S. Bandaranaike	Set ceiling on private ownership of agricultural property; nationalized foreign-owned plantations; forced to trim welfare programs and cut food subsidies because of budget crisis; took over management and ownership of firms under Business Acquisitions Act; established a rigid tariff quota system; plagued by increased unemployment, rising prices and scarcities of food items.
1977-'88	United National Party (UNP)		J.R. Jayewardene	Average annual growth rate 1977 - 83: 5.0% Introduced a range of reforms to open the economy; liberalized trade by abolishing quantitative import restrictions, reduced most price controls and unified exchange rate and devalued rupee; launched massive public investment program—Accelerated Mahaweli Program (irrigation and settlement scheme); established two free trade zones ; curtailed consumer subsidy programs.
1988	United National Party (UNP)		R. Premadasa	Continued open-economy policies; initiated the 'Janasaviya' poverty alleviation program.

in power, with policies changing from *dirigisme* to relatively open-economy strategies and back.

Over time, until 1977, the country was drifting away from a market economy to increasing state control and intervention. Initiatives by successive governments greatly weakened the principle of private ownership. Land owned by the British colonial regime (crown land) remained in government ownership; today, the Government owns some 80 percent of the land in the country. Governments also nationalized key industries as well as foreign-owned plantations, reserved certain sectors for public enterprises, controlled imports and foreign exchange, and stayed with redistributive policies in the face of weak economic performance.

A leftist United Front government during the period 1970-77 administered a strong dose of *dirigisme.* In pursuit of growth through import substitution, the Government piled controls upon controls: import controls, foreign exchange controls, price controls, investment controls. An egalitarian ideal served as the basis for the nationalization of productive assets and extensive redistribution. The economy reacted predictably. Its poor response in turn triggered further intervention — bringing the economy to the brink of collapse. As unemployment climbed, shortages spread. People had to stand in line for hours even for basic foodstuffs.

In that environment, the economic program of the more market-oriented United National Party proved attractive. Elected in a landslide, with a four-fifths majority in Parliament, the new government moved swiftly to dismantle many of the controls and open the economy, abolishing import controls, lowering tariffs, devaluing the rupee, and liberalizing some segments of the financial system to allow foreign banks and some foreign currency banking. The Government also established two free trade zones in the Greater Colombo area.

All of these measures created new opportunities for both domestic and foreign investors. At the same time, however, the Government — with strong financial support from the donor community — launched a massive public investment program, the Accelerated Mahaweli Program (AMP). The AMP was designed to harness the Mahaweli river through a series of dams for irrigation and power generation to provide the basis for large-scale settlements in the dry zone in the north-central and eastern parts of the country. While the AMP has undoubtedly generated many benefits, particularly by doubling electric power generating capacity and reducing dependence on oil imports, appraisals have found a disappointing return on investment.

The massive investment program, combined with the unprecedented influx of concessional foreign exchange, produced side effects that undermined the efficacy of the economic reforms in spurring outward-oriented development. The demand for construction services offered good domestic opportunities for investors. It also fueled inflation, together with the failure of monetary authorities to sterilize the influx of foreign exchange. As a result, the rupee began to appreciate in real terms, further biasing profitability in favor of domestic investments. Assessing the full impact of these effects is difficult, though, since the general investment climate deteriorated rapidly after the outbreak of widespread violence in the country in 1983.

Although a single measure is always suspect as a descriptor of overall performance, the time pattern of the real GDP growth rate on a per capita basis provides a telling illustration of the consequences of shifting policy regimes and of the deteriorating economic climate over the last few years.

The policy apparatus and administrative devolution

As in any democracy, Sri Lanka's policy apparatus is complex. The Presidential system introduced in 1982 puts overall policy direction in the hands of the President, elected separately from the Parliament. In terms of economic policy, four institutions are playing key roles. Through its management of the budget and other fiscal matters, the *Ministry of Finance* sets the overall macroeconomic framework. Its counterpart on the monetary side is the *Central Bank*, which also operates a range of refinancing schemes and supervises the financial system. The *National Planning Department*, since 1989 in the Ministry of Policy Planning and Implementation (formerly in the Ministry of Finance), prepares medium-term public investment plans as a basis for the annual budgets and provides expert advice on a wide range on economic policy issues. The *Ministry of Industries, Science and Technology*, traditionally concerned with the management of a group of state-owned enterprises and regulation of industrial activities, has emerged as spearhead of the country's new industrialization initiative. Finally, a number of other Ministries also contribute to shaping the context for development, especially in the agricultural sector, where policy fragmentation has been the norm.

Sri Lanka's small size (66,000 sq km, about the size of West Virginia) facilitates a centralized administration. The country is organized into 25 Districts, each overseen by a Government Agent; each District covers an average of 11 divisions, with Assistant Government Agents. The Districts have virtually no autonomy, although one institution, the (now-defunct) District Development Council, had been set up to help in the formulation of a development strategy at the District level. Basically, the GA's and AGA's were there to execute the policies and programs of the central government.

Limited autonomy at the local level did little to assuage tensions growing out of social, ethnic or economic peculiarities. The demand for increased autonomy was strongest in the North and East, even among people who did not favor the separatist cause. In the 1987 Indo-Sri Lanka Peace Accord, the Government acceded to these demands and agreed to the establishment of eight Provinces (which had in fact existed in some form under British colonial rule), each with an elected Provincial Council at the helm and a Provincial Governor as representative of the central government. The 13th Amendment to the Constitution transfers many of the non-military/security activities to the Provinces. The Provinces have some revenue-raising powers, but are currently mostly dependent on financial transfers from the central government. The 1990 budget includes Rs.13.4 billion for devolved functions, compared to Rs.842 million in 1989. The Provinces have also been given some revenue-raising powers that are being phased in, but the legislation provides limited guidance on appropriate procedures and on arrangements between the central government and the Provinces.

Thus, while the devolution of power to the Provinces is underway, many of its modalities have yet to be worked out. Their genesis as part of the 1987 Indo-Sri Lanka Peace Accord ties their fate in effect to the conflict between the Sinhalese majority and the Tamil minority. At this point, the Provincial Councils lack the administrative capacity to handle many of the functions assigned to them, although that does not seem to stop them from pursuing their own policies and program initiatives with great vigor and often sovereign disdain for fiscal prudence. Over the next few years, Provincial Councils will conceivably become increasingly important in the design and implementation of USAID's program and project activities, although uncertainty about the magnitude and nature of their role lingers. Any mechanisms for working with such local institutions therefore will have to be flexible to respond to any changes.

For the most part, today's local authorities are ill-equipped to develop and implement programs to improve the provision of social or infrastructure services within their domain of responsibility. These weaknesses are likely to loom increasingly large, as the center relinquishes its decision making monopoly in the context of devolution.

Human settlements

Housing has been a high priority for the present government, both as a social service and a national investment program focusing on the formation of assets for the poor: the Million Houses Program (supported since 1981 with $60 million in A.I.D. Housing Guaranty resources), was responsible for increasing the supply of housing affordable to low income households by providing near-universal access to small, heavily subsidized, unsecured home construction and improvement loans. The Government showed considerable flexibility in encouraging individual initiative (by avoiding the temptation to introduce minimum standards that would put supported housing out of reach for the target population) and bringing in informal financial institutions to expand the coverage of the program. Recovery rates were low, however, and plummeted in 1988 because of an announced "forgiveness" of a major portion of these loans. (USAID was forced to suspend further disbursements under the HG program.) At the same time, budget funds became scarcer for housing, so the current GSL housing program, the One Point Five Million Houses Program, has yet to show substantial progress.

Constraints on the provision of housing finance, particularly for low and moderate income households, include a general scarcity of long term loan funds on the capital market, a tradition of very low interest rates and weak credit discipline among low income borrowers, and a segmentation of the market into public and private, with the public sector being looked to to take care of the housing needs of the poor and the private sector providing market rate housing finance for upper income groups. Not surprisingly, given resource limitations and administrative overhead requirements, public housing finance institutions reach only a small segment of the target population. The informal sector accounts for about 80 percent of the financing of housing, with a consequent loss to the formal financial market of savings mobilized by housing investments.

Although a densely populated country (with the third-highest population density among developing countries), Sri Lanka has not experienced the rapid and uncontrolled urbanization that has taken place elsewhere. Even so, official statistics understate the percentage of the population living in urban areas, thereby disguising the need for a determined effort to address the problems of urban settlements before they become overwhelming.

The overall standard of existing urban infrastructure is generally better than that found in other countries in the region, according to multilateral donor studies. This may be because of Sri Lanka's relatively slow rates of urbanization. There are, however, clear signs that urban infrastructure is deteriorating and, especially in Colombo, overburdened. Researchers cite several infrastructure problems having adverse effects on business activities: traffic congestion in Colombo and transport difficulties outside the city caused by narrow, damaged, and inadequately maintained roads; poor telecommunications connections, both local and foreign, complicating market transactions; electricity interruptions; and water supply and sanitation problems, both for residential and commercial development purposes. Inadequacies in sanitation and waste treatment contribute to environmental degradation.

Shifting grounds in social services

Sri Lanka's human development record bears witness to the performance of its social service system, characterized by wide coverage and a high degree of professionalism. But signs are increasing that the high standards can no longer be maintained, partly because of the relative decline in budgetary allocations, partly because of increasing politicization and the effects of civil strife, partly because it has become tougher to attract and retain skilled and motivated people in these services. Reforms are necessary in particular in education and in the health care system.

The principal challenge to these reforms is to find ways of mobilizing individual initiative to improve the performance of the system to reach and surpass traditional standards. A key area for reform is the country's system of redistribution. Poverty alleviation through direct subsidies has a long history in Sri Lanka. A broad scheme of free rice was abolished in 1977 in favor of a foodstamp program that would allow for better targeting. Unfortunately, the coverage of the program expanded (now including over half of all of the country's households), while budgetary allocations were held constant. As a result, the truly needy did not obtain adequate support, while total program costs exceeded needs. In 1989, the new government declared poverty alleviation its major concern. It introduced a sweeping poverty alleviation program, the Janasaviya Program, and a mid-day meals program in schools to combat malnutrition. The effectiveness of the latter has been questioned, since the effects of malnutrition that occur early in the child's development are not reversible. Improving the nutrition of school age children is of course laudable, but it comes too late. The budget cannot accommodate all of these programs — foodstamps, Janasaviya, and mid-day meals — forcing the Government to delay its original schedule.

Any reform of this system and reforms of social services aimed at mobilizing individual initiative are likely to involve a greater role for Sri Lanka's private voluntary organizations. These PVOs, typically working at the grassroots level, have historically been the leaders in mobilizing human resources, investing in human capital, and creating economic opportunity. An estimated 3,000 PVOs represent a tremendous reservoir of energy that can contribute effectively to a national effort to raise the productivity of human resources, and thereby the incomes and living standards of the country's citizens. Past approaches have succeeded in establishing a solid base, but have failed to exploit the opportunities created by this accomplishment. This failure, combined with the fact that growing claims on the GSL budget will curtail public sector human resource programs. Private sector resources and private initiative, in partnership with the government, will be needed both to expand the scope and improve the direction of human resource development.

Natural resource based activities

The natural environment: an endowment in jeopardy

From ancient times, Sri Lanka has been renowned for its natural beauty — the coral reefs, the beaches, the palm groves, the plains, the streams, the jungles, the fauna and flora. A relatively small land area offers an astounding biological and climatological diversity. Rainforests and semi-desert, cold uplands and humid estuaries, and over 4,500 species of plants coexist in an area the size of West Virginia. In 1988, Sri Lanka experienced a drought in the north and flooding in the south during the same period. Such disparity gave rise to Sri Lanka's ancient "hydraulic civilization" and a heritage of resources management. This physical and biological diversity represents a unique natural endowment of considerable interest to science, but also a great attraction to tourism.

The growing concern to protect this natural endowment is rooted in historical, cultural and economic factors. Despite the intense population and economic pressures on the natural resources base, a relatively large land area is under some form of reserve protection (at 12 percent of the total land area, the second highest in Asia). Similarly, Sri Lanka has put in place a model package of laws and regulations designed to protect the environment.

Even so, environmental degradation is approaching crisis proportions in many parts of the country. The inexorable pressures of the growing population and its sustenance needs are taking their roll by encroachment into reserves and intensive annual cropping of marginal lands with resulting deforestation, land degradation and detrimental downstream impacts. Coastal areas and their coral reefs and estuaries are suffering from indiscriminate waste disposal (industrial and municipal effluents), coral mining and overfishing. While no epidemiological studies have been carried out to date, evidence of serious public health effects of environmental degradation, in particular of air and water, is growing.

The danger signs are increasingly ominous. But the wholesale destruction of the natural endowment so far has been limited to relatively small pockets. In most instances, the degradation so far has not reached the critical threshold, offering the opportunity to stop abuse before it is too late.

Sri Lanka's land, water and biological resources provide the foundation of its economy. How they are used determines the speed, nature and sustainability of development. Natural forests and paddy, spices, and plantation tree crops have historically been major sources of wealth for the country. The importance of productive natural resource management will increase as the pace of industrialization picks up, especially with the emergence of a stronger industrial sector out of an agricultural base. So far, the management of natural resources in Sri Lanka often shuns market forces, relying instead on administrative structures and procedures. Even if administrative decisions could somehow achieve efficiency and wisdom, actual implementation would be unlikely to reach these lofty standards, since the Government lacks the wherewithal to enforce adherence to decisions.

Land: unclear property rights

Land is perhaps the country's most precious resource. Counting all the land yields an average of one acre per person; but only one-quarter of that has been classified as agriculturally usable. With an average household size of five persons, each family could therefore claim no more than half a hectare on average. One hectare, the minimum size of land allotments in the Mahaweli resettlement schemes, may well be uneconomic for many traditional crops, since it precludes the use of scale-based technology. These ratios suggest a need for focusing increasingly on higher-density settlement (and economic activity) patterns, in agriculture as well as in other sectors, but also for institutional mechanisms to assure the most productive use of each piece of available land, including options to aggregate parcels of land, through voluntary cooperation or transfer of property rights, to allow for the deployment of scale-based technology. These policies and institutional mechanisms are not in place.

Most (some 80 percent) of the land remains in government hands. Issues of land titling and ownership generate much debate, but resolutions remain hazy. Private ownership prevails in some parts of the country; but even there, the legality of claims is often murky, providing much business for lawyers, a very active lobby against any changes in land tenure policies. In other areas, the state claims ownership of vast tracts of land, but cannot (or will not) prevent squatters from settling on state lands. The Government tends to legitimize the squatters' action by giving them some form legal claim to the land they have occupied for some time. These policies create serious obstacles to efforts to develop agribusiness ventures on state-owned land. No company leasing land from the Government — outright purchase remains impossible — can be sure that it might not have to accommodate (or somehow compensate) an unknown number of squatters.

The lack of clear title in many parts of the country, including government land that has been turned over to settlers, limits an active land market and keeps many small farmers and entrepreneurs from leveraging their principal asset to obtain access to other productive resources, notably credit. Without clear title, financial institutions cannot accept land as a collateral. Uncertainties about ownership also affect the choice of agricultural and other technology, providing little incentive to shift to sustainable land uses.

Effective land use planning is lacking. As a result, land use patterns are typically driven by *ad hoc* decisions, often with negative environmental consequences, in particular for watershed management. The largely uncontrolled expansion of squatter-cultivators is jeopardizing watershed management by cutting down the vegetative cover in critical areas. Similarly, poor management practices on the tea plantations also are major contributors to soil erosion.

Deficiencies in land use planning and enforcement combine with the absence of a land market to ensure that neither agricultural nor off-farm economic activity will seek the (socially) most productive uses of land.

While the Government tries to compensate through directives about and especially restrictions on the use of land, these efforts typically experience the same fate as other attempts to substitute administrative fiat for economic incentive — they rarely work as intended, and often create new problems.

Water: towards pricing and decentralized management

Water is equally critical to Sri Lanka's development. The country's prosperous ancient kingdoms were founded on success in harnessing water for irrigation, with both impressive feats of engineering and productive water management. The development and maintenance of the irrigation infrastructure and the management of irrigation water today remain two key elements of agricultural development policies. The current system still involves a high degree of centralization. An extensive administrative structure has been created to supervise the development, rehabilitation and maintenance of the physical infrastructure, and to manage the distribution of irrigation water. Water user charges as one means of encouraging more efficient use have often been treated as political anathema. Some encouraging changes are taking place to decentralize the management of irrigation resources, notably by turning the operation and maintenance of downstream parts of systems over to farmer organizations.

Pollution of inland and coastal waters is worsening. Waterborne diseases present public health problems. The Government has put in place a fairly comprehensive system of pollution regulations, but lacks the administrative means to enforce these regulations. New mechanisms are needed to achieve a significant reduction of water pollution. Such mechanisms need to involve the private sector in a much more active role. As long as incentives for more productive management of water resources are not internalized, the limited capacity of the public sector to monitor and ration the use of these resources will form a constraint on their contribution to economic development and allow for the continuing degradation of the aquatic environment.

With respect to water supply and sanitation, the first tentative steps have been taken to put the management of the system on a sounder economic footing. Recent revisions of water pricing policies, for example, establish economic incentives for more efficient water use. The management of water-supply is also being devolved to regional bodies.

Other natural resources

Sri Lanka's marine and coastal resources currently are not fully exploited for economic gain, nor are they being managed to ensure maximum sustainable yield. Sri Lanka's coastal resources are major contributors to development — for tourism, fisheries and mariculture, shipping and transportation, industry, and energy. While the Government is devoting a good deal of attention to these issues, its forces are stretched too thin to ensure adherence to plans by administrative means. Economic incentives and private-public partnerships to encourage the most productive uses of coastal resources may offer more promising alternatives.

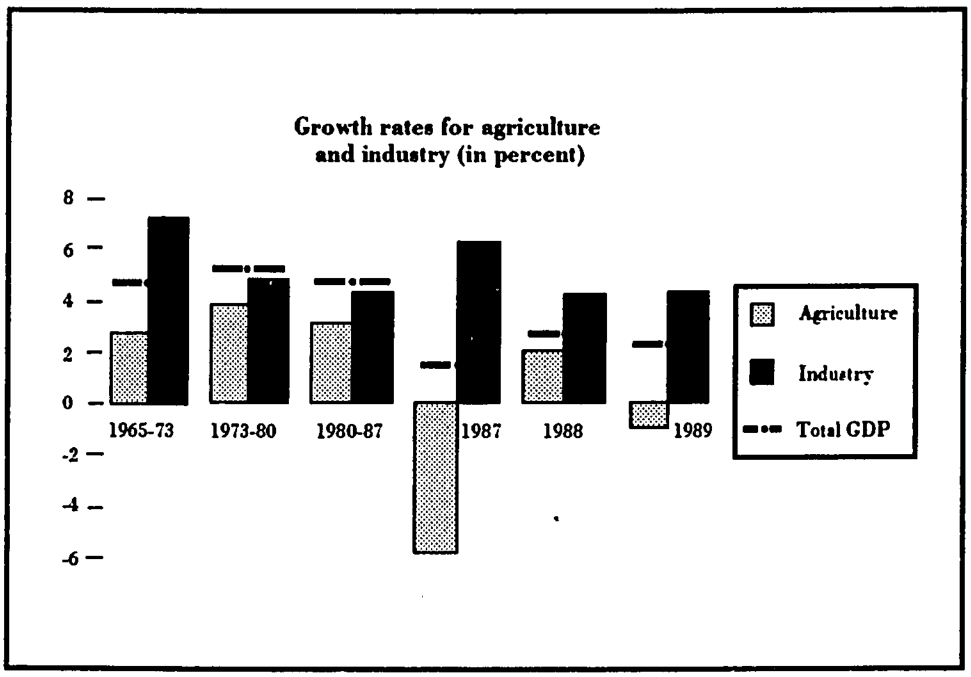
Sri Lanka's mineral resources are likely to play an increasing role in its drive toward industrialization. Two key industries, gems/jewelry and ceramics, build on the country's deposits of gemstones, clay and other minerals. As in other instances, management of many of these resources is based on Government ownership, with attendant controls and prevalence of quasi-legal or illegal means of exploiting these assets. Although much of gemstone mining is in private hands, the Government controls it to some extent by requiring licenses. Partly as a result of such regulation, smuggling Sri Lankan gemstones abroad is apparently a major industry, although no plausible estimates of its economic dimensions exist.

Finally, air pollution has not yet become a major issue, although it is by no means negligible in the urban-industrial concentration around Colombo, with transportation a major contributor. But so far, no attempts have been made to internalize these externalities — to make the polluter pay.

The agriculture sector: a faltering transformation

Agriculture remains the dominant economic activity in Sri Lanka. It accounts for 26 percent of GDP, 46 percent of employment and 60 percent of exports. Sri Lanka's overall economic growth continues to be largely determined by the health of its agricultural sector.

Following encouraging gains in the late 1970s and early 1980s (largely a result of the lifting of food price controls, improved irrigation and the introduction of high-yielding varieties), agriculture has stagnated. It remains dominated by highly traditional cultivation patterns and structures, retaining elements of a dualistic system. It consists primarily of smallholder subsistence farming and large cash crop plantations, pursuing rice self-sufficiency through the first and export revenue through the second. This traditional system has in the past been capable of stable if slow growth, a



Growth rates for agriculture and industry (in percent) result of productivity gains in paddy cultivation and generally profitable commodity markets. As the limits of rice technologies and of arable land are being reached, and as commodity markets are becoming increasingly competitive, sectoral productivity appears to be stalled at a low-income plateau.

Although annual growth of agricultural GDP averaged a respectable 3 percent since 1965, performance across subsectors has been mixed.

Weather and civil unrest account for some of the sharp year-to-year fluctuations. But heavy export taxation, lack of investment, and poor market responsiveness have brought about near-stagnation in tea, rubber and coconut plantation crops that has offset the early productivity gains in paddy. The solid performance of private smallholder tea production is the telling exception. For other crops, the typically small scale of production because of the fragmentation of holdings (73 percent of holdings are less than 2 acres in size), the limited size of the domestic market, and relatively high costs of production largely due to inadequate technologies have throttled growth.

Glimmers of potential brighten this generally gloomy agricultural picture. In 1985, the Government (with USAID assistance) formulated and promulgated a strategy of agricultural diversification which has engendered significant, albeit gradual, shifts in investment priorities. At the macro-level, the realignment of exchange rates and the progressive reduction of taxation on tree crops have begun to rectify the long-standing discrimination against higher-income export crops. The recent removal of fertilizer subsidies represents a major step toward bringing factor prices in line with market prices. The share of paddy and plantation crops in the total agricultural product is starting to decline, and other crops, livestock and fisheries have roughly doubled (to approximately 8 percent) their contribution to GDP growth in recent years. The number of agro-enterprises has also risen in the last years. Moreover, there appears a growing realization of the vital role of commercial forces in spurring agricultural growth.

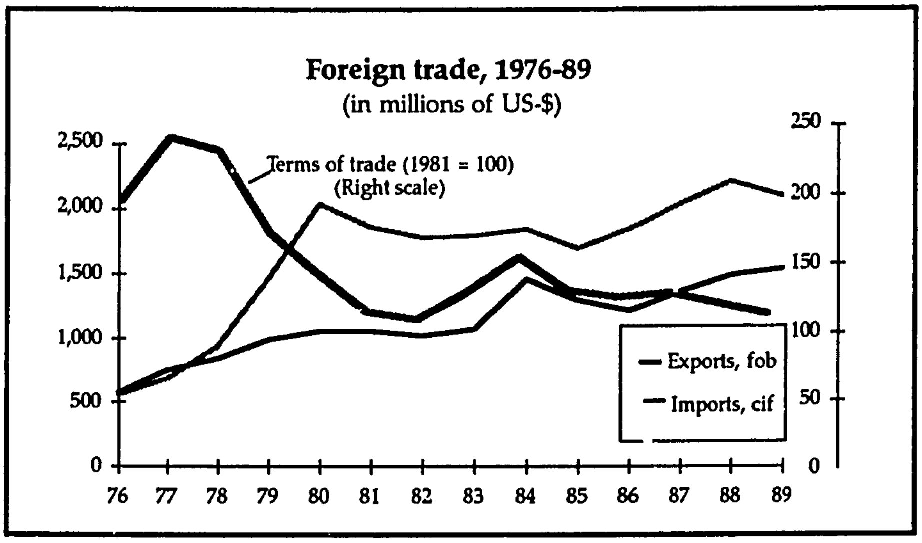
With most of the easy gains in expanded production from land and water development and "Green Revolution" technologies exploited, future growth in agricultural productivity will depend not only upon new scale-based and biological technologies, but also upon a new higher-income "line of products" for an expanded market through exports. A vertical intensification of agriculture with commercial technology and market-tailored crops will provide the growth in value-added and hence, in incomes and employment to transform this sector from its low-income traditional structure into a source of more rapid economic growth.

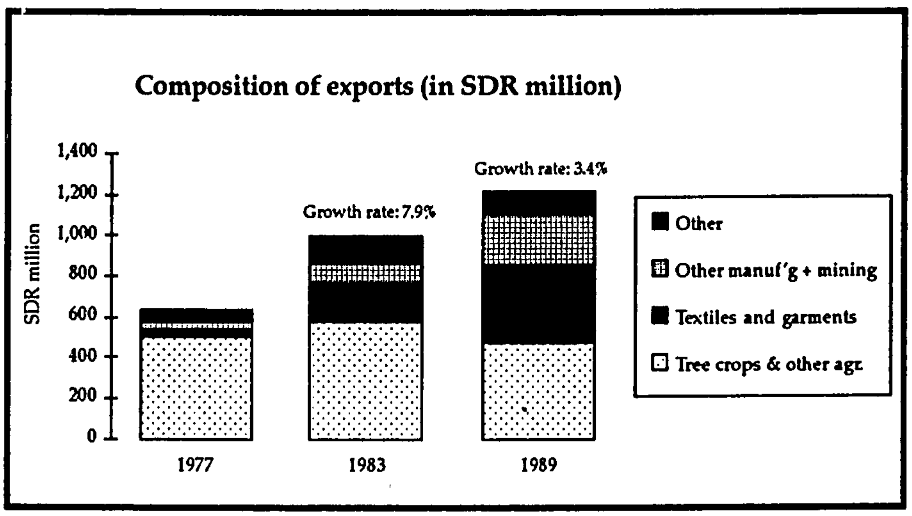
Although solid initial steps have been taken, this transformation will require not only further liberalization of government ownership and control of production assets, particularly land, water and biological technologies, but also new institutional relationships and mechanisms to facilitate the interaction of market forces with agricultural production systems.

The trade and investment regime

Sri Lanka as an open economy

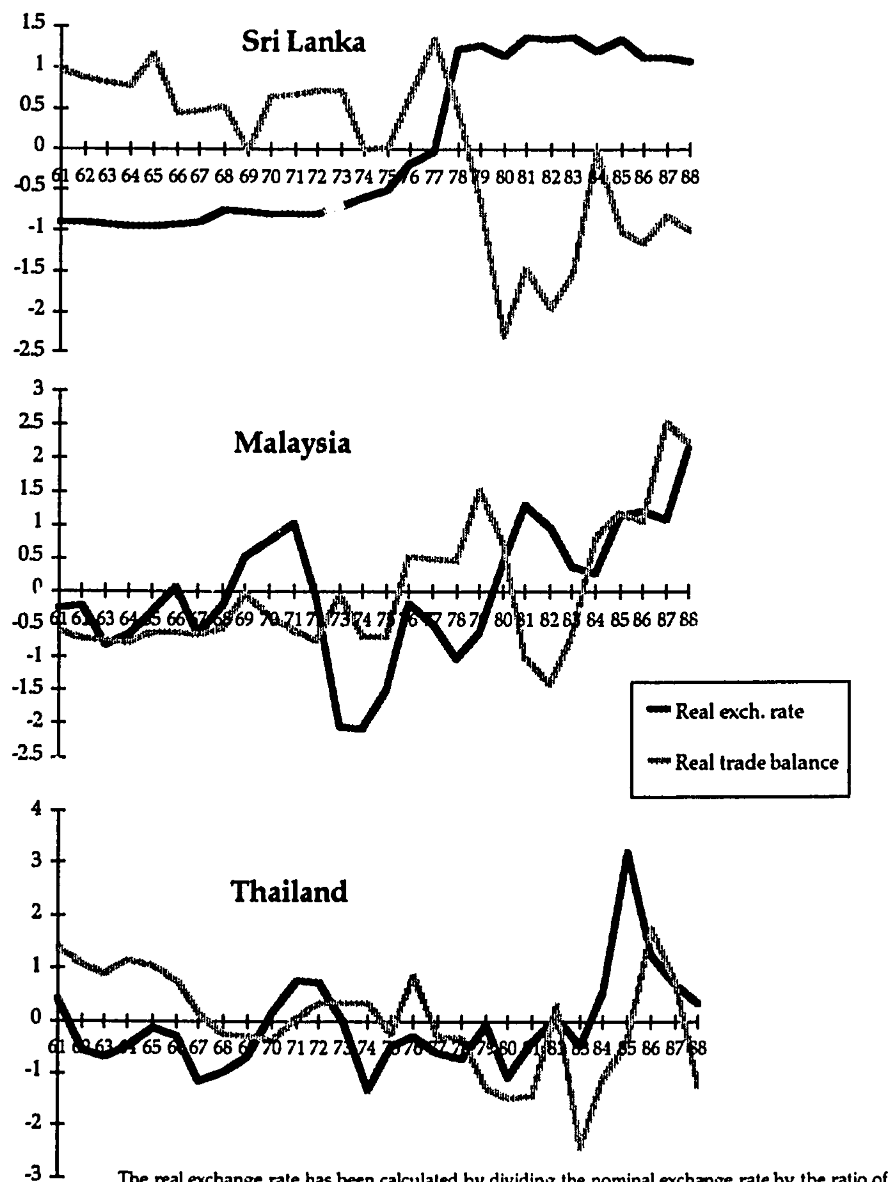
The 1977 reforms opened the economy to competition from outside. Sri Lanka's import substitution regime prior to 1977 sought to create domestic employment at the cost of pervasive inefficiencies. The 1977 reforms brought down the tariff walls as well as eliminating many direct import restrictions. Average nominal tariffs, among the lowest in Asia, amount to about 20 and 24 percent for intermediate and capital goods, respectively, and 33 percent for manufactured goods. A relatively high rate, 56 percent, for consumer goods provides higher protection to agriculture. These rates compare favorably with nominal tariff rates for other Asian countries. They are quite similar to those of Thailand, for example, and substantially below those for India or Pakistan. Even so, until well into the late 1980s, the average level of *effective protection* was close to 100 percent. Moreover, significant pockets of high nominal protection remain, especially in subsectors dominated by public enterprises. The liberalization of the trade regime continues; the country is moving to a four-tier tariff structure, with nominal rates of 10, 20, 25, and 40 percent (although exemptions will maintain higher effective protection in a number of subsectors).





Liberalization of imports has been accompanied by a series of measures to encourage exports. The overall goal has been to put exporters on an equal footing with competitors in other countries, for example, through duty-free access to imported inputs, and to compensate them for any disadvantages vis-a-vis import competing industries. The incentives provided include two (perhaps soon three) free trade zones, customs duty rebates, exemption from custom duties and BTT (business turnover tax), easier access to credit and credit insurance, tax holidays of up to ten years, investment credits and related fiscal inducements, and sometimes direct equity participation by government entities. Some gaps remain — availability of short-term credit for working capital needs has been a problem, export marketing support remains weak — but exporters can currently draw on a wide spectrum of assistance, both services and incentives.

Real exchange rates and real trade balances



The real exchange rate has been calculated by dividing the nominal exchange rate by the ratio of the domestic consumer price index to the U.S. wholesale price index; the real trade balance is the current trade balance in U.S. dollars divided by the U.S. wholesale price index. Cf. Helmers (1988). The measures have been standardized for a mean of 0 and a standard deviation of 1.

Perhaps the most dramatic shift in economic policies manifested itself in changes in the exchange rate regime. Since 1977, Sri Lanka has moved from a dual exchange rate structure and a heavily overvalued rupee to an open and reasonably flexible foreign exchange regime. Current process innovations have increased this flexibility further.

Even so, actual exchange rate management may not have been entirely in tune with the drive to an outward-oriented economy. Following the depreciation in 1978, the real effective exchange rate was allowed to drift upward. The massive influx of resources from aid donors and private lenders contributed to the appreciation of the real effective exchange rate. In 1986, the authorities took action to depreciate the rupee gradually to restore the country's competitiveness in export markets. Even so, the real exchange rate vis-à-vis the dollar showed little responsiveness to variations in the real trade balance, compared to other countries. Following a 20-percent devaluation in late 1989, the rupee has remained virtually constant vis-à-vis the dollar in nominal terms. Even so, observers have concluded that any overvaluation is moderate, in the 3-5 percent range.

With respect to foreign investment, Sri Lanka has tended to send mixed signals. It has eliminated many legislative barriers, and has not only welcomed foreign investment in the free trade zones, but has pursued it actively and energetically. At the same time, a plethora of restrictions remained that discouraged foreign investors (although actual effects may have been negligible, since the security situation has overshadowed all investment decisions.) Under the banner of the new industrialization initiative, Sri Lanka is now making a determined effort to remove obstacles to foreign investment outside of the free trade zones. The results of these efforts are likely to change the investment climate significantly.

Trade and balance of payments performance

The composition of exports still reflects the key role of agricultural exports. While garments have replaced tea as most important export category, their high import content leave tea as the principal net foreign exchange earner.

Virtually all of the growth in exports since 1977 has come from manufacturing. Textiles and garments account for the lion's share of that growth; starting from a small base, exports in this category surged between 1977 and 1983, registering an average annual growth rate of *55 percent* in SDR terms before slowing to less 13 percent between 1983 and 1989. A word of caution, though: textiles and garments have a high import content (75-80 percent or more). Therefore, the contribution of this sector to exports in value added terms, or net earnings, has been less spectacular. If the re-export of imported inputs is discounted, overall export growth in SDR terms between 1977 and 1989 falls from 5.6 percent to 3.3 percent per year — not the kind of success that liberalization is expected to produce. Fortunately, other industrial exports have continued to grow at a reasonable pace of around 33 percent a year, much of it due to a resurgence of gem exports.

Overall, growth in textiles and garments accounted for close to 70 percent of the total increase in exports since 1977; other industrial exports contributed another 25 percent. Net contributions of textiles and garments and exports of "other manufacturing and mining," that have maintained a healthy growth of about 15 percent a year since 1977, have been unable to offset the decline in the still-dominant segment of tree crops (tea, coconut and rubber) and other agricultural products.

Trade with the U.S.: Sri Lanka is running a trade surplus with the U.S. In exports, the importance of the North American market has grown rapidly; it is now as important as Europe, Sri Lanka's traditional market, each currently absorbing about 30 percent of Sri Lanka's exports. The growing importance of the U.S. is almost entirely due to garments exports; the U.S. accounts for some 60-70 percent of total garment exports. With 70 percent of the growth accounted for by garments, these figures suggest that *some 50 percent of the total export growth since 1977 can be attributed to access to the U.S. market under the MFA garment quotas.*

On the import side, the U.S. plays a minor role. The most important imports from the U.S. are related to the foreign assistance program — primarily wheat. From the U.S. point of view, increasing exports to Sri Lanka would appear feasible, although both distance and market size have limited awareness and interest on the part of U.S. business.

Industry: islands of modernization

A recent multicountry study placed Sri Lanka at the lower end of the technological development spectrum — characterized by "islands of modernization." A few industrial establishments in the country can compete effectively with up-to-date technology in international markets. But most produce with outdated technology for a still-protected domestic market, or survive because of their transport cost advantage in bringing goods to an unsophisticated local market, or in obtaining the raw materials (mostly agricultural produce) that they are processing for further use downstream. Still, manufacturing has performed well in one area: exports.

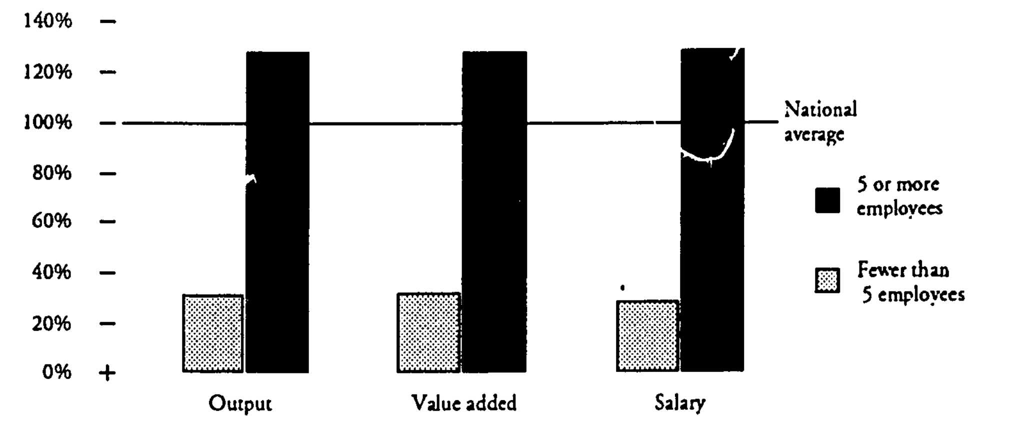
Statistical descriptors of Sri Lanka's industry are out of date. The picture emerging from a 1982 census is a familiar one for a developing country: small-scale enterprises (employing fewer than 5 workers) account for 86 percent of the (then) 100,000 manufacturing establishments, 30 percent of all manufacturing workers (then 600,000), and less than 8 percent of total value added in manufacturing (then Rs. 18 billion or 20 percent of GDP). Establishments employing 10-49 persons also account for about 30 percent of total employment in manufacturing, as do the larger establishments with 50 or more workers. The intermediate size, though, employing 5-9 workers, accounts for only 8 percent of total manufacturing employment — possibly an indication of the limited growth prospects of small-scale enterprises.

Each worker in a small-scale enterprise (that is, with fewer than 5 workers) produced about one-fourth of the value added by a worker in a medium to large enterprise, and earned about one-fourth as much. The difference in productivity reflects in part differences in capital use: new investment (gross fixed capital formation) for a worker in a larger enterprise was about four times that for small-scale enterprises. On the average, each worker in manufacturing produced a value added of slightly over Rs. 30,000 — roughly Rs. 75,000 in today's prices (total 1990 GDP per employed worker across all sectors came to Rs. 58,000, or about three-fourths of the industry figure).

In terms of the sectoral composition of manufacturing, agriculture-related industries, food processing and processing of tree crops except rubber, clearly dominate. Overall, textiles and chemicals come second. The share of chemicals, which includes rubber, is boosted by the country's single petroleum refinery. For the small-scale segment, the "primary market sectors" are leading — food, garments, and furniture, followed by chemicals (rubber) and non-metallic minerals (gems, pottery).

Although some structural change has taken place since 1982, industry today remains geared toward domestic markets. Respectable performance against competitors abroad is the exception, hinting at, rather than realizing, Sri Lanka's potential. Many factors combine to block the shift to an outward-oriented economy. Large state-owned corporations continue to dominate the industrial sector, created expressly to serve the domestic market under past import substitution strategies. Typically, they still enjoy levels of protection at odds with an open economy. An educational system favoring a liberal-arts curriculum has failed to produce the technical manpower needed for rapid modernization. Entrepreneurs and investors have generally been satisfied with licensing technology from abroad rather than seeking to adapt and develop their own. Inconsistent macroeconomic policies and an ambivalent approach toward foreign investors have stifled efforts to attract investment from abroad and thereby improve access to markets and technology. Finally, the precarious security situation has sapped investor confidence, directing investments into quick-payoff ventures (of which there are few in manufacturing), and has also stripped the country of much of its managerial talent that has sought better opportunities abroad.

Differences between small and medium/large enterprises



Output, value added and salaries as percent of national total

Source: 1983 Survey of Manufacturing

With all that, prospects for accelerating industrial growth are growing brighter. Faster growth in agriculture will mean an expanding domestic market for many industrial sectors, especially for the small-scale segments. A more commercially oriented agricultural sector will also create new upstream and downstream opportunities — the production of inputs and the processing of outputs. Moreover, the Government seems determined to dismantle some of the obstacles: it has taken the first real steps to restructuring and privatizing the state-owned manufacturing enterprises whose poor performance has retarded growth. It has lifted many of the restrictions that have kept foreign investors away, and is pursuing foreign investment much more aggressively. Finally, we may see some changes in the educational system that reduce the bias against science and engineering.

These initiatives form part of the Government's industrialization strategy officially launched in December 1989. USAID is providing advice and assistance to the agencies taking the lead in implementing that strategy, notably in the area of privatization, and is playing a lead role in supporting private initiative directly and indirectly.

Economic infrastructure: a constraint on development?

Weaknesses in economic infrastructure undermine the country's position in competing for investment. Since the late 1970s, the Government has been investing heavily in infrastructure, primarily the irrigation and hydropower facilities of the Accelerated Mahaweli Program. Although the economic soundness of those investments is in doubt, the AMP has contributed to better water availability, potentially a key factor in the commercialization of agriculture, and has also eased the country's energy situation, although leaving it dependent on the vagaries of precipitation.

Investments in the Colombo area have succeeded in establishing good linkages to international markets. Colombo Port has developed into one of South Asia's most important transshipment facilities; it is a major foreign exchange earner. Colombo also boasts of a modern airport and two well-equipped free trade zones.

In spite of these accomplishments, the country's economic infrastructure and often its management remain inadequate to boost growth, in particular outside of the Greater Colombo area. The provinces often lack reliable power; weaknesses in power supply and distribution have been exacerbated in the last few years by sabotage. Telecommunications facilities often do not meet minimum standards. Although the transportation network is extensive, limited road and rail capacity curb opportunities for industrial development in the outlying areas.

Poor management accounts for many of the weaknesses. Infrastructure services are rarely provided in an economically efficient way to ensure maximum productivity and ensure proper maintenance and upgrading. Some progress is being made toward more rational pricing structures in telecommunications and energy. But these efforts are often swamped by other factors. For example, the pricing structure for petroleum products is reasonable. Since the state accounts for some 40 percent of total consumption of petroleum products, however, the market signals of proper price structures are diluted by administrative decisions.

To compete effectively for foreign investment, and to keep up with competitors abroad, Sri Lanka will need rapid improvements in its telecommunications capabilities. The Government has spun off Sri Lanka Telecom as a separate entity (with support from the Asian Development Bank) to oversee an expansion program and improve management.

Energy is another concern. The Government has formulated a master plan for the development of the power generation and distribution system. Implementation of that plan faces some hurdles, though. With the country's large hydropower potential virtually fully exploited, expansion of generation capacity will require new thermal power facilities. A planned coal-fired power plant has been put on hold indefinitely because of environmental and related political concerns. While the authorities are bravely talking of deploying new, "soft" energy technologies as solutions for the energy dilemma, one finds it difficult to see a feasible alternative to a major new thermal power plant to provide adequate capacity into the 21st century.

The principal message from any appraisal of the country's economic infrastructure is gloomy: the infrastructure is inadequate, the shortcomings are getting worse, and the Government lacks the means to bring services up to the needed standard. New approaches, public-private sector partnerships are needed to mobilize the (financial) resources for expansion, improvement and maintenance. USAID's involvement in infrastructure development, primarily in irrigation, has focused on strengthening the management of facilities through such private-public sector partnerships. Similarly, USAID — along with other donors — has assisted efforts to define the roles of different levels of government, and provide guidance for planners at the local level. That assistance, together with that in the housing sector, provides a solid basis for promoting and supporting the development and implementation of new partnerships elsewhere. Direct support to capital projects may complement our assistance to the new forms of private-public coöperation.

Financial resources: lingering controls

Effective financial markets are essential to development. They are needed to channel financial resources (which represent claims on real resources) from low-productivity activities to investments with the highest returns. At this point, much remains to be done to improve the performance of financial markets to boost their contribution to growth and to raise the productivity of financial resources. The problems are familiar:

- extensive government intervention in the mobilization and allocation of financial resources, partially to cope with a chronic budget deficit, partially to direct credit to priority sectors, partially to deliver socially motivated transfer payments to poor population groups in the form of subsidized loans (which are subsequently often forgiven);
- fragmentation of the financial system, especially the dichotomy between formal and informal markets, that restricts the free flow of financial resources to high-productivity ends; and
- a lackluster performance of many financial institutions because of inadequate procedures, limited information, and limitations in staff skills and experience.

The open-economy policies introduced in 1977 did extend to financial markets reform. The Government raised deposit rates to encourage financial savings; interest rates on deposits have been positive in real terms for most of the years since 1977, although they have not kept pace with the acceleration of the inflation rate in recent years. Even so, these policies have been successful in building financial assets; Sri Lanka boasts of one of the highest ratios of financial assets to GDP among developing countries. The reforms also opened some segments of Sri Lanka's financial markets to foreign banks. Appraisals of the country's financial sector by institutions like the IMF and the Asian Development Bank therefore concluded that Sri Lanka has created an effective financial system for a country at its stage of development.

What these changes have done to the efficiency of the allocation of financial resources is yet to be determined. Evidence suggests that (1) pricing of financial resources (lending rates) is still largely governed by non-market criteria — nominal lending rates respond very little to inflation, resulting in considerable fluctuation of real lending rates; and (2) consumer lending has greatly expanded, more than tripling between 1981 and 1986 in constant rupees, bringing with it a lowering of average lending rates. The average interest rate on all household loans dropped from 33 percent in 1981/82 to 23 percent in 1986/87, or from 45 to 34 percent, if convenience loans at zero percent interest are excluded from the calculation. These trends suggest that the performance of the financial system has in fact improved perceptibly since the early 1980s.

Even so, persistent weaknesses of financial markets limit their contribution to accelerated economic growth:

(1) weaknesses of equity markets and poor enforcement of debt recovery continue to favor debt over equity financing;

(2) policy makers consistently turn to the financial system as an instrument of social policy through subsidized interest rates and directed credit programs, policies that result in financial repression;

(3) financial market segmentation restricts the efficiency of the system as a whole;

(4) two state-owned commercial banks dominate the financial sector, accounting for some 70 percent of total financial transactions; this dominance restricts competition and undermines the credibility of the Government in structuring and implementing prudential regulation;

(5) legislation designed to protect borrowers is stifling financial intermediation by making possession of collateral in case of a default on a loan a cumbersome and time-consuming process, although recent legislative action has brought some improvement; and

(6) taxation of transactions among financial institutions that hampers full integration.

In addition, the effective performance of Sri Lanka's financial institutions is also impaired by the dominant role of two state-owned commercial banks (which account for some 70 percent of all lending activities), and by internal management weaknesses, in particular in the area of project and risk appraisal, and in the development of institutional arrangements and innovative financial instruments to improve risk management.

Further financial markets reform will depend to a large extent on the success of efforts to rein in the chronic high budget deficit. Such efforts form the centerpiece of the medium-term structural adjustment program outlined in the *Policy Framework Paper* negotiated with the IMF and the World Bank. They will also require a rethinking of the various programs that seek to channel subsidies through directed credit and controlled interest rates — to make grants grants and let loans be loans at commercial terms. Under its new Housing Guaranty program, USAID is supporting the separation of grants from loans in the area of housing finance, largely to lay the foundations for a viable low-income housing finance system, but also to test new concepts in financial intermediation.

Generally, improvements in the performance of financial systems are critical to the development of a sound investment climate and the mobilization and productive use of financial resources.

In lieu of a summary

This brief review of key elements of development in Sri Lanka has highlighted some obstacles, but — more importantly — it has also underlined the basic strength and resilience of the Sri Lankan economy. The open-market policies pursued by the Government have begun to bear fruit. As more opportunities open to private initiative, development will accelerate. With the right policies, Sri Lanka has the potential to reach the ranks of the newly industrializing countries by the beginning of the new millennium.