

## CONCEPT PAPER

### **1. Introduction to the country**

- 1.1 Population:** Sri Lanka is an island in the Indian Ocean lying 29 km off the coast of India. It is located 7 degrees North of the Equator. The country has a total land area of 25,332 square miles (65,610 square kilometers) and a population estimated at 19 million in 2002. Of this total, 4 million or 21% live in urban areas and about 15 million or 79% in rural areas. Annual population growth has now been reduced to 1.1%, and is regarded as one of the lowest among the developing countries. Owing to its success in regulating population growth, the population is expected to stabilize at around 25 million in the year 2040.

The breakdown of population by gender reveals that 51% are female and 49% are male. The overall sex ratio is marginally in favour of a higher female population. The population comprises a number of ethnic groups: Sinhalese 74%, Tamil 18%, and Muslims 7%. The remaining 1% consists of minor ethnic groups such as Burghers and Malays.

- 1.2 Administration:** The country is made up of 9 Provinces (two Provinces- the North and the East are temporarily merged), with each Province being administered by an elected Council. The Chief Minister is assisted by a Chief Secretary appointed by H. E. the President, and Deputy Secretaries with support staff.

Each Provincial Council is made up of two to three Districts, there being 25 Districts in all. The District has a District Secretariat headed by a District Secretary, who implements the projects and programmes assigned by the Provincial Council in addition to performing Central Government functions.

Districts are divided into Divisional Secretariat (DS) Divisions, headed by a Divisional Secretary. There are 308 such Divisional Secretary Divisions. Each DS Division contains a number of "Grama Niladari" (GN) or Village Officer Divisions. The GN Division is the primary administrative unit in the country and there are 14110 such units. Local Government functions are handled by Municipalities, Urban Councils and Pradeshiya Sabhas. These bodies are directly elected by the people at 5 year intervals.

- 1.3 Democracy:** The democratic tradition in the country is vibrant. In the 50 years since Independence, two major parties, the United National Party and the Sri Lanka Freedom Party either by itself or in alliance with smaller parties, governed the country. General and local government elections are scheduled to be held every five years. The April 2004 General Elections have been called free and fair by international observers.

## 2. Income and Millennium Development Goals:

Although the average per capita income being approximately, US \$ 1,000 is closer to that of other countries in South East Asia, achievements in the social and human development sectors are on par with many developed countries. These social indicators have already surpassed almost all of the Millennium Development Goals. For example:

- life expectancy at birth is 70 years for males and 75 years for females, equal to many developed countries;
- primary, secondary and even tertiary school enrollment rates are equal for boys and girls, the expected target for 2015;
- primary school enrollment is at 100%, also the envisaged target for 2015;
- adult literacy rate is 93% infant mortality rate is 13 per thousand [target is 7.4], and the maternal mortality rate is 0.2 per thousand births, equal to middle income countries.

The country ranking is 96 in the Human Development Report for 2004.

## 3. Poverty

Although Sri Lanka has a good record in demography and its social indicators, a significant segment of the population is still unable to afford a minimum set of consumption requirements. The Department of Census and Statistics, which is the official Government agency responsible for collecting and disseminating primary data on poverty, shows that about 23% of the total population live in absolute poverty (2002). In comparison with corresponding data for 1990 and 1996, this incidence of poverty is quite low but it continues to remain a major socio-economic problem. Sri Lanka has a long tradition of caring for its poor and giving high priority to reducing and alleviating poverty.

**3.1 Poverty over time:** The poor benefited very little from this higher rate of growth. Over more than 20 years, from 1980 to 2002, the average income of the poorest 10% was stagnant and that of the poorest 20% increased by less than 6%. The income of the richest 10% and of the richest 20% increased around 2.5 times. In the last 10 years, the problem has been just as serious: from 1990/91 to 2002 the consumption of the poorest 20% increased by 2% and that of the second poorest group by 6%, while that of the richest 20% increased by 50%. This sharply widening gap between the rich and the poor is giving rise to social and political discontent.

**3.2 Regional poverty:** Regional differences in poverty and growth pose yet another serious problem. The benefits of growth have mainly percolated to the poor in the areas around the commercial capital (Colombo) and in other main cities, like Kandy. These areas, which were already well endowed, have grown rapidly and presently have poverty rates as low as 6%, as in the Colombo District. On the other hand, the poorer districts with the highest percentage of poor have grown little and

their poverty rates have actually increased. Several of these have been adversely affected by the conflict that has ravaged Sri Lanka since 1983 thereby increasing the incidence of poverty.

**Table 1**  
**Population, Per Capita GDP, Maternal Death Rate, Electrification & Road Density**  
**by Province in Sri Lanka**

Category	Province	Popu- lation- Million (2002)	Per Capita GDP \$			Maternal death rate (1996)	% Electri- fication (2002)	Road density (km/sq km) (1998)
			1996	2002	% Change			
<b>High income &amp; growth</b>	Western	5.4	1,288	1,470	14.2	0.11	83	3.1
<b>Medium income &amp; growth</b>	North Western	2.2	726	769	5.8	0.06	50	2.0
	Southern	2.3	522	698	33.6	0.18	64	1.6
<b>Low income, slow Growth or decline</b>	Central	2.4	603	637	5.5	0.28	59	2.2
	Sabaragamuwa	1.8	706	633	-10.4	0.20	48	1.7
	Uva	1.2	622	599	-3.7	0.30	46	0.9
	North Central	1.1	570	578	1.4	0.21	45	1.4
<b>Conflict affected*</b>	North-East	2.6	367	483	31.5	0.62	37	1.0
	<b>National</b>	<b>19.0</b>	<b>759</b>	<b>870</b>	<b>14.6</b>	<b>0.20</b>	<b>63</b>	<b>1.5</b>

\* Data is approximations as surveys could not be conducted in some areas and had to be estimated.

Low growth in most of the Provinces and high growth in the Western Province and the Districts surrounding, has created great differences in income per capita among the Provinces and Districts, as well as great differences in poverty rates. The following two tables reflect these disparities.

It is clear from the above data that less than one-quarter of the population is in areas with high incomes, low poverty and good access to the market [Colombo and Gampaha Districts, both in the Western Province]. Even in the small area of the two high-income Districts, there are pockets of poverty and poor connection to the rest of the economy. Over half of the population is concentrated in Provinces where incomes are less than one-half [at most 43%] of that in the Western Province. In the North East and in the poorer Districts of most Provinces income is most probably less than one third of what it is in the Western Province. These areas account for almost half the population of the country. In the poorer District areas the incidence of poverty is around one-third of the population [probably more in the North-East], road density is low, with a substantial proportion of the population unable to grow high value crops due to lack of access to the market. Power is available to only 30-40% of households in the poorer Districts, compared to about 90% in the wealthiest Districts.

What is equally disturbing is that the wealthier regions have also been the faster-growing regions, so the differences have become even more stark. The exception is the North-East where the ceasefire brought about certain improvements from a previously war damaged situation. However, per capita income is still the lowest in the country in this region. While per capita income in the rich Western Province rose by over 2% a year, it actually dropped in two of the poorest Provinces and was essentially stagnant in the other two. As a result, per capita income in the Western Province was 1.8 times more than in the Sabaragamuwa Province in 1996, but the gap has widened 2.3 times in the 6 years since 1996.

**Table 2**  
**Poverty Headcount Ratio by District (%)**

Province	District	1990-91	1995-96	2002		
				%	Head-count Mn. by District	Head-count Mn. by Province
National	All	26	29	23	4.37	4.37
Western	<i>Colombo</i>	<i>16</i>	<i>12</i>	<i>6</i>	<i>0.14</i>	<i>0.58</i>
	<i>Gampaha</i>	<i>15</i>	<i>14</i>	<i>11</i>	<i>0.23</i>	
	<i>Kalutara</i>	<i>32</i>	<i>29</i>	<i>20</i>	<i>0.21</i>	
Central	<i>Kandy</i>	<i>36</i>	<i>37</i>	<i>25</i>	<i>0.32</i>	<i>0.62</i>
	Matale	29	42	30	0.13	
	N <sup>o</sup> Eliya	20	32	23	0.16	
Southern	Galle	30	32	26	0.26	0.64
	Matara	29	35	27	0.21	
	<b>Hambantota</b>	<b>32</b>	<b>31</b>	<b>32</b>	<b>0.17</b>	
North-western	Kurunegala	27	26	25	0.37	0.59
	<b>Puttalam</b>	<b>22</b>	<b>31</b>	<b>31</b>	<b>0.22</b>	
North-central	Anuradhapura	24	27	20	0.15	0.24
	Polonnaruwa	24	20	24	0.09	
Uva	<b>Baddulla</b>	<b>31</b>	<b>41</b>	<b>37</b>	<b>0.29</b>	<b>0.44</b>
	<b>Moneragala</b>	<b>34</b>	<b>56</b>	<b>37</b>	<b>0.15</b>	
Sabaragamuwa	<b>Ratnapura</b>	<b>31</b>	<b>46</b>	<b>34</b>	<b>0.35</b>	<b>0.60</b>
	<b>Kegalle</b>	<b>31</b>	<b>36</b>	<b>32</b>	<b>0.25</b>	

Source: Department of Census and Statistics

*Italics:* Poverty incidence declined by more than 25% from 1996 to 2002.

**Bold:** Poverty incidence increased by more than 10% from 1996 to 2002 or is above 30% in 2002.

In terms of the incidence of poverty the picture is equally clear. In 2002 poverty is concentrated in two Provinces and six Districts, with rates above 30%. The poverty level in the two Districts of Moneragala and Badulla is six times higher than that in the Colombo District, which recorded the lowest ratio. Several of them have been affected by the fighting in the neighboring North-East. Some of the poor comprise

the IDPs [Internally Displaced Persons] and many have seen their wages fall as the hard-pressed IDPs also compete for jobs. The increasing gap in poverty between the small areas that have primarily benefited from growth and the large areas that have got poorer, also contributes to social and political tensions. Poverty in Sri Lanka is above all a regional problem.

**3.3 Poverty in the North and East:** A special regional poverty problem exists in the North and East as a consequence of the armed conflict. Most of the statistics given above relate to the remaining 7 Provinces as data on the North-East is sparse or unavailable. Since the cease-fire, some data is available and, according to the data, poverty is a serious problem in these Provinces. Unemployment and infant mortality rates are twice as high than in the rest of the country; and maternal mortality is nearly four times the average. According to a rough estimate, the per capita income is only 60% of the average of the country. The 8 Districts in the North East region need to be added to the other poorest 6 Districts (Hambantota, Puttalam, Badulla, Monaragala, Ratnapura and Kegalle) as indicated table 2. The critical problem is, slow or declining growth and rising poverty in these Districts.

**3.4 Women and poverty:** In Sri Lanka, unlike in most other countries, there is no gap between the wages of women and men. Poverty among female-headed households is almost the same as among male-headed households. Gender balance is largely due to the preponderance of women in the garment industry and among foreign migrant workers especially in the Middle East. Therefore, women workers would be particularly vulnerable to the vicissitudes of the garment industry following the abolition of the MFA in December 2004. They are also very vulnerable to any downturn in the price of oil, which would reduce the demand for their labour in oil-rich countries. There are also a significant number of widows in the North-East alone, who face specific problems.

The problem of open female unemployment exists, despite the growth of employment in the major sectors that principally employ women: tea, garments and household workers abroad. Since employment abroad and in the garment industry may not increase in the future, female unemployment may well increase with some 100,000 women entering the labour force every year.

The problem for men is principally one of underemployment – workers with part-time work and part-time incomes or casual work with low returns. To provide full time employment for men require generating growth in less developed rural areas, in sectors such as agriculture, agricultural processing including supply of goods and services to consumers with increased incomes in these areas. The other major source of employment for men will be in infrastructure development programmes, which are important catalysts of growth leading to poverty reduction.

#### **4. Key problems**

The major obstacles to growth, and poverty reduction, are a number of interrelated problems that need to be addressed in an integrated manner.

**4.1 Inadequacy in the growth of the economy:** The economy of Sri Lanka grew at a rate of 4.4% per annum between 1980 and 1990, 5.3% per annum between 1990 and 2000, and 3.4% per annum from 2000 onwards. Although a growth of this magnitude was regarded as a moderate one, it was not sufficient to provide full employment and meaningful incomes for the people.

The GDP of Sri Lanka has a highly volatile pattern. For the period 1985 to 2003, the coefficient of annual variation of GDP was 3.6 times higher than that of Thailand and 2.8 times higher than that of Malaysia. This has resulted in a significant fluctuation in the availability of resources for consumption and investment.

Future growth target is a minimum of 6% with a desired growth of 8%. A doubling of the recent growth rate is considered essential to employ productively the annual additions to the labor force [around 300,000 or about 4%] and to reduce the high rate of open unemployment of 6% for men and a very high 13% for women [average 8.6% in 2003 with the Northern area excluded].

**4.1.1 Lack of job opportunities:** Unemployment is a chronic problem in the country. Since independence (1948) it has never been recorded at levels lower than 8%. As of the 4<sup>th</sup> quarter of 2003, unemployment has been estimated at over 8%. It is largely a problem of educated youth seeking jobs for the first time. About 80% of the unemployed are between the ages of 15 and 29 years. About 59% of the unemployed have passed GCE (O/L) and examinations above. About 72% of the unemployed wait for more than 12 months to obtain a job.

Unemployment among females is almost twice as high as that among males. In 2003, the rate of male unemployment was about 6% and the rate of female unemployment was over 13%.

An important implication of high unemployment is that resources which could otherwise be available for saving and investment, had to be spent on the maintenance of the unemployed by their parents or other family members as, 90% of the unemployed are supported by family transfers.

**4.1.2 The economic cost of the ethnic conflict:** According to government estimates, the size of the overall economy of the North and East shrank from US \$ 350m to US \$ 250m between 1990 and 1995, corresponding to a negative annual average GDP growth of 6.2% per annum. The Central Bank of Sri Lanka reports that the conflict is likely to have reduced the country's GDP by about 2 – 3 percentage points a year. The indirect costs of the armed conflict are also high. These costs represent the incomes lost as a result of forgone domestic investment, reduced tourism, the decline in foreign direct investment, out-migrations of a large number of skilled persons and human capital loss associated with death, injury, and displacement.

**4.2 Deteriorated and Inadequate Infrastructure:** In Sri Lanka, there is a strong link between poverty and lack of irrigation. Areas deprived of irrigation become gradually impoverished due to the adverse impact of drought and floods, that compel the use of reserves to prevent famine. Although there are more than 30,000 small reservoirs and dams present in the country, they are largely unusable or less effective for want of serious renovation or rehabilitation. As a result, more than 200,000 acres of land have remained uncultivated or abandoned creating a severe shortage of rice and loss of significant amounts of income that would have accrued from commercial agriculture. People living in these areas do not have access to safe drinking water, particularly during the dry season. Therefore, the incidence of water borne diseases has increased.

Many of the same areas also lack a decent feeder road system and access to main roads. Substantially large areas remain isolated and physically cut off from the mainstream due to lack of roads and bridges. People in these areas are discouraged from cultivating fruits or vegetables due to lack of access to markets. Electricity supply needed for most off-farm processing and other small plants is not available. Communication links are very poor. Therefore, people have no access to market information that would encourage them to cultivate higher value crops or raise livestock [see Table 1 for data on infrastructure].

**4.3 The Budget Deficit:** The problem of the budget deficit needs to be addressed seriously if the government is to come up with resources to implement the pro-poor -pro-growth programmes to which it is committed. Infrastructure development and maintenance require substantial resources from the budget, as does provision of education and health services.

**4.4 Deteriorating Education and Health Services:** Expenditure on Social Services, particularly education and health, has declined from 4.5% of GDP in 1995 to 3.8% of GDP in 2003. A direct result is the declining quality of life, especially in the rural and less developed areas. The negative trend needs to be reversed if Sri Lanka is to compete in the world market by maintaining high levels of productivity.

**4.5 Limited Access to Vocational and Technical Education:** The present education system produces with specialized skills and with adequate technical training. This is a problem particularly affecting the rural areas and the less developed Districts. Vocational Training (VT) Centres are mainly located in the suburbs. The few VT centres accessible to rural youth are without resource persons and modern equipment. Course work offered in these centres, is obsolete and do not enhance the employability of trainees.

**4.6 Lack of Property Rights:** One of the key factors inhibiting rural income growth is lack of clear private property rights over land. Most of the poor farmers operate land parcels for which they do not have clear titles. The accompanying insecurity coupled with government restrictions on land use, destabilize the poor from making effective choices in land use and land allocation. Hence, they are unable to make optimal use of their land.

- 4.7 Environmental Degradation:** This has become an increasingly serious concern. In rural areas, the key problems include deforestation and soil erosion and, encroachment on reserved land for agricultural purposes. These result in biodiversity being adversely affected, water pollution and coastal erosion. Environmental stress also results from mining of riverbeds, and through use of firewood. The cost of such non-sustainable resource use is estimated to be 2.5% of GDP.
- 4.8 Lack of Capacity of Government Officials, especially Local Governments:** Historically, Sri Lanka has had a strong centralized government. As noted earlier, substantial responsibility has been decentralized to the Provinces, Districts, Divisions and even Village units. But these sub-national units lack the necessary financial and human resources to discharge their responsibilities. One of the most significant factors contributing to rural poverty is the limited capacity of public officers to utilize resources in an effective and systematic manner. Officers are hindered by a lack of knowledge of their roles and responsibilities. Decision-making remains very weak due to low management skills. They often do not have access to advanced training in the area of monitoring of projects and project implementation. Locally available training does not equip them to address the emerging challenges in a fast changing and complex world. One simple example: local tanks and dams were maintained by the Central Government, which had the administrative and technical wherewithal. In 1989, the responsibility was shifted to the respective Local Governments. In the absence of necessary funds and personnel, these vital irrigation works were largely neglected.

## **5. Objectives and Priorities**

The principal objective of the Government, and of the proposed Compact with the MCC, is to reduce poverty. In order to reach the Millennium Development Goal of reducing poverty in half by 2015, Sri Lanka plans to focus on areas where poverty is most acute - mostly those Districts and Divisions that have been bypassed by development efforts and/or those that have been badly ravaged by the conflict. The Poverty Reduction Strategy, which the Government will soon announce, is predicated upon pro-poor growth through a strong focus on the poor and the less developed, low-income regions.

## **6. Policies and Strategies**

### **6.1 Strategies**

**6.1.1 Higher Growth is a necessity:** An essential objective of the Poverty Reduction Strategy is to generate a higher rate of growth. A GDP growth rate of 6% is the minimum needed to achieve the envisaged poverty reduction objectives. It would be much easier to reach with a growth rate of 8%. The broad policy framework towards this has been announced in the government's Economic Policy Framework – *Creating Our Future; Building Our Nation*.

The strategy and priorities outlined below are designed to achieve a higher growth rate as well as, to substantially reduce poverty throughout the country and among all groups. More details will be provided in the Poverty Reduction Strategy currently under preparation.

### **6.1.2 Strategy for higher growth- policies and investment composition:**

Higher growth will be impossible to achieve without macro-economic stability and policies that encourage production, investment and productivity and the willingness to invest and to take some risks. In view of Sri Lanka's high rate of unemployment and the even higher rate of underemployment, growth also requires investment and promotion of sectors and activities that can efficiently and competitively put idle labour to productive work. Plans to do so are discussed below and will be given in greater detail in the National Poverty Alleviation and Growth Strategy (NPAGS).

### **6.1.3 Investment strategy**

Since, creating demand for unskilled labour is key to reducing poverty, unemployment and underemployment are a waste of Sri Lanka's potential. This programme will encourage productive investment in sectors and activities that create demand for unskilled workers. Sri Lanka cannot afford to waste resources. It needs to be recognized that 8-9% of the labour force are unemployed and the larger proportion that is underemployed, consume but do not produce. Putting them to work in productive employment, especially in the private sector, would be a net benefit to society. In addition to the increase in output, they will also contribute to stability when they become productive members of society.

The Strategy is based on the belief that for markets to work well, most areas and people need to have access to the market for the goods and services they produce and the goods and services they consume. It will therefore, give priority to investments in infrastructure, skills development, institutions and facilities which in turn will make it possible for investment and production to flourish. A key part of this is to give neglected areas better access to markets by way of better roads and communications, to increase labour productivity by appropriate training and to make services –such as credit and technology- available to MSMEs [Micro- and Small- & Medium-scale Enterprises]. The Provinces and Districts where poverty is most prevalent are primarily agricultural areas.

The pro-poor strategy will therefore emphasize the revival of agricultural sector growth. The centerpiece of the investment strategy is to greatly increase the availability of irrigation, mostly by emphasizing local, small irrigation schemes. These schemes involve rehabilitation of existing structures. Their principal requirement is for unskilled, local labour, much of which is already available in these areas. They have a very low cost per acre benefit, especially in terms of the materials required.

The specific investments to be financed are described in detail below. What is central to all of them is that they are:

- designed to support private farms and firms, principally by supplying services that the government has traditionally supplied in Sri Lanka: irrigated water, extension services and technical support, credit for the smallest units not served by commercial banks and so on;
- with an emphasis on local control and local labor contributions;
- concentrated in the areas that have been left out of the development process, that have the greatest poverty, that have deteriorated rather than developed;
- supporting the small firms and farms that produce most of the goods consumed in Sri Lanka and a substantial share of exports, but that have also been neglected in the past.

However, for cultivators to produce higher value crops in the newly irrigated areas, and for agricultural processing to develop in these areas, they need to have access to motorable roads, to power, as well as to water. They also need to be well informed of market conditions, which means availability of rapid communication facilities. The programme, therefore, also includes substantial investment in infrastructure development.

## 6.2 Policies

The above strategy will not work or at least will not give the expected results, if it does not operate under an appropriate set of policies. These are being enumerated in detail in the NPAGS, but will be briefly summarized here.

**6.2.1 Macro-economic stability:** Private Farms and Firms find it difficult to function unless they know that policies will not be subject to sudden change and that their economic environment is reasonably stable: inflation is unlikely to accelerate greatly, prices of services they buy will not greatly change overnight, the exchange rate is reasonably stable. Of course, some variables are completely outside Sri Lanka's control – the surge in oil prices most notably. But the government will avoid sharp, unexpected changes in its policies, and will avoid contributing to rapid inflation.

**6.2.2 Reduce the Budget Deficit:** The budget deficit is perhaps the most serious problem facing the Government. The Government is committed to reducing it, despite its determination to increase spending on neglected areas and groups. This strategy would require reduced spending in areas that benefit primarily those with access to better facilities. The 2005 budget, now under preparation, will make a start on the difficult process of reducing the deficit while increasing spending on priority projects to accelerate growth and help the poor through a Medium Term Macro Fiscal Framework in which the deficit is to be reduced to around 5% of GDP.

**6.2.3 Increase the efficiency and reduce the costs of Government services:** One of the problems facing the private sector is the high cost of delivery and unavailability of services such as power, water, communications and transport. The Government would be using privatization to a limited extent to cope with these problems. It is committed to a strong effort to increase the efficiency of the SOE

[State-Owned Enterprises] that are providing some of these services. This is no easy task, but it is being revisited in the budget under preparation. In the case of roads, what is needed is targeted investment and that is discussed below. Of course, often both are needed [see discussion on electric power]. A new Strategic Enterprise Management Agency (SEMA) has been set up to oversee and develop business for large State Owned Enterprises (SOEs).

**6.2.4. Participatory Approach:** The newly established National Council for Economic Development (NCED) has set up nearly 20 clusters comprising both private and public sector representatives to address and evolve specific sector strategies. This new public/private sector partnership arrangement in policy formulation and implementation is helping to promote a participatory approach in development. For instance, the apparel industry is working closely with the government in an NCED cluster to prepare for the post MFA 2005 period, especially focusing on small and medium factories located in rural areas which are bound to experience adjustment difficulties in the quota free era.

**6.2.5 Targeted Programmes:** In its poverty reduction programme, the Government is moving away from general subsidies and grants to large numbers with up to 40% of the benefits presently going to the non-poor, to two approaches that are more carefully targeted:

- labour intensive employment programmes that shift emphasis from subsidizing consumption to employing the poor in income producing activities. The irrigation rehabilitation and feeder road programmes are examples;
- a limited programme of welfare for the extremely poor who usually cannot benefit from employment programmes because the family has no one capable of full-time work: the old, widows with young children, the sick and disabled. The aim is to provide productive job opportunities for all willing and able to work and to limit welfare grants to those who cannot work.

## **7. Role of the Compact and MCA**

During the last 6 months, the Government has begun to reorient its development strategy from an almost exclusive preoccupation with growth to one emphasizing pro-poor growth, because of its commitment to poverty reduction, which is a top priority. This means focusing on neglected, low- or no-growth rural areas with a high incidence of poverty. Support from the MCC is sought to increase the overall growth rate of Sri Lanka, mainly by helping change the rate of growth in poorer areas from stagnation or decline to significant per capita growth in the next 4 years.

### **7.1 Justification**

The Government is approaching the MCC for assistance rather than other, well-established, donors, primarily because of the expected flexibility and speed of action under the MCA. Donors active in Sri Lanka for many years have ongoing programmes to which they are committed. These are focused on growth and poverty

reduction in the country as a whole. Whilst most donors pay special attention to the North and East, their regional concerns have otherwise been limited. But the new Government's highest priority is growth in the poorer Provinces and Districts, because that is the surest and most rapid way to increase growth and reduce poverty where it is most widespread. Ours is a geographically focused programme: it is no longer satisfactory to have growth occur primarily in the Western Province, which already has a low incidence of poverty. What is needed is far more rapid growth in the 5 Provinces with low growth and much poverty, and in the Districts with the same characteristics, while at the same time providing growth in urban areas.

The Government appreciates the MCC's emphasis that the programmes be "home-grown", Sri Lankan in design and execution. Of course, this approach requires careful monitoring and reporting, which the Government wants to undertake, in any case, as the basis for any needed mid-course correction in the larger effort it will undertake in neglected areas.

Sri Lanka notes the change from conditionality to a performance-based approach. Our desire is to cooperate with the MCC in demonstrating that this approach can produce good results in countries where there is a free press, a strong opposition and periodic open elections.

## **7.2 Relations to other programmes**

As described in the case of each project or programme we are proposing for the MCC, we intend to take full advantage of the strengths of existing projects and donors to advance the MCA programme, by:

- [i] Having the programme or project financed by other donors subsequently [Small Irrigation Programme];
- [ii] Requesting other donors to take on some tasks in which they have special experience [World Bank on medium-sized irrigation and roads];
- [iii] Requesting donors to provide Technical Assistance in areas where they have worked [USAID on Evaluation and Training];
- [iv] Where there are ongoing projects or programmes supported by other donors, integrate the MCA programme into a joint effort [European countries on governance, ADB, JBIC, and GTZ on SME support].

The aim is to take advantage of the flexibility of the MCC, and of its ability to act quickly to launch or support activities that have high priority and to marry it with the experience in Sri Lanka and strengths of other donors in particular fields to obtain the best results.

In addition, we are proposing MCA support for those activities, which have as their main goal, increasing the rate of growth and environmental protection. As discussed earlier, we are very much aware that growth and poverty reduction are closely related and can be consistent objectives. Indeed the Government's development programme calls for poverty alleviation and growth. At the same time, some targeted programmes have poverty reduction as their main objective, while some infrastructure projects have mainly a growth objective.

## **8. Opportunities and Risks**

With the signing of the CFA with the LTTE in 2001 and virtual cessation of violence since then, the country has a great opportunity to move forward. As seen in Table 1, growth in the conflict affected North and East has been high since the CFA. Tourism has boomed island wide and investor interest has increased. But the CFA remains to be consolidated and final peace settlement still needs to be negotiated.

The regional development programme proposed for MCA funding can help achieve a higher rate of growth, particularly in the North and East and in the poorer, stagnant areas of the rest of the country, thus providing concrete evidence to the people that cessation of hostilities has brought real benefits and that real peace will bring more dividends.

This government has just completed its first 6 months in office. The combined opportunity of a new government and the continuing ceasefire needs to be seized expeditiously. For the first time after 20 years, there is also recognition by all parties in Sri Lanka for the need for a peaceful resolution to the conflict.

The Government remains committed to the peace process and has made concerted efforts to uphold the ceasefire. The Government has set up a National Advisory Council on Peace and Reconciliation to bring all stakeholders together to help reach a negotiated settlement.

The second major risk factor is economic instability. The budget deficit has comedown from an unsustainable 16% of GDP in 1985 to approximately 8% in 2003. However, it is still far above the target and interest costs uses much of declining revenues. This is a key factor, which creates macro economic instability.

It should be noted that these problems have been in large part long standing or inherited. Government revenues have been declining since 1995 and the budget deficit has been increasing since then. This government is committed to reducing the budget deficit, not by cutting important programmes, but by addressing two fundamental problems: the declining tax revenues as a result of proliferating special exemptions, and the provision of subsidies to non-poor people.

Another significant challenge Sri Lanka would have to face is the elimination of textile and apparel quotas in 2005 with the lapse of the MFA. The apparel industry is of extreme importance to Sri Lanka in terms of export earnings and employment. The sector accounts for 53% of export earnings and over half a million direct and indirect employment opportunities. It is envisaged that some garment firms' particularly in the Small and Medium Enterprise sector located outside the Western Province will be adversely affected and their survival would depend on support being provided by the Government in the interim period.

## **9. Specific Goals**

It is the goal of the Government with the support of the MCA to raise the rate of growth to a minimum of 6%, from less than 3% achieved in the last 3 years and 5% since 1991. We have set the goal at a realistic 6% and aim to exceed it. In per capita terms the differences are greater: from less than 1.5% in the last 3 years to 4.5% in the next 5 years.

Equally or more important is that this growth rate be reached by turning around the Districts and Provinces whose per capita incomes have been stagnant or declining.

The specific goal is reduce the number of poor people from about 4.4 million to 3 million over the next 5 years, which implies that the poverty rate would decline from 23% to 15%. In view of the fact that in the last 12 years poverty was only reduced by 3% [from 26% to 23%, Table 2] this will be a major achievement.

## **10. Duration**

We propose that the MCA programme begin early in Fiscal and Calendar year [the same as in Sri Lanka] 2005 and be concluded 3 years later. The FY 2005 budget is being submitted in November 2004 and will therefore, not incorporate MCA programmes, except to the extent that start up is already funded from the Government budget. In any case, the MCA programme would not be in place until some months into 2005. However, a strong start needs to be made in 2005 if the programme is to show clear and measurable results in the short term. Moreover, there is a great deal of urgency with respect to many of the aspects of the Proposal. A speedy decision by the MCC is expected and a start on most of the programmes in the first half of 2005.

## **11. The MCA Proposal**

The MCA Proposal is determined by the government objective of achieving a high rate of growth, with growth focused on the regions and the sectors where poverty is concentrated: the rural areas and the identified districts with widespread poverty. In addition, there is need for attention to the industries that employ large groups entering the labour force, or currently unemployed or under-employed, for whom there are no productive jobs in agriculture or agriculture-dependent industries. That means largely Small- or Medium-sized firms [SME] and firms in the labour intensive garment industry.

The objectives of higher growth and poverty-reduction are not incompatible in Sri Lanka. Not only is higher growth a necessary condition to reduce poverty but the poor rural areas have some of the greatest potential for rapid growth at relatively low cost investment. This is the case particularly with respect to rehabilitation and expansion of infrastructure in the poorer, rural areas.

## 11.1 An integrated Programme

The proposed MCA grant will play a key and catalytic role in an integrated development programme, concentrating on the poorer rural regions.

- [i] The cornerstone is a substantial expansion of the irrigated area by rehabilitating small and medium, local [and two larger] irrigation works to expand agricultural production. This programme has already commenced and is considered a solution to the problem of recurring droughts. The cost is low and labour intensive and the benefits significant, including provision of water for livelihood and industries as well.
- [ii] Combined with the second element is a substantial programme for rehabilitating and improving the rural road network. The expanded irrigation system will make it possible to produce high value crops, particularly fruits, vegetables and flowers, that need to be brought to the market speedily. A new rural road rehabilitation programme has already commenced.
- [iii] Safe water supply and sanitation for the rural areas is a third important element to reduce the toll of disease and the hours now spent in fetching drinking water, both with a particularly great impact on the earning capacity of women and the education of children.
- [iv] Expansion of rural electrification is therefore another element in the program, particularly important for SMEs that can not afford their own power supply.
- [v] A massive road-building programme is the fourth important element to connect the less developed areas to the ports, airports, industry, jobs and other facilities of the developed areas and the international market. Some analysts believe the roads are the highest priority, the most important catalyst for the development of the less developed regions. National and Provincial roads are being rehabilitated and developed under other programmes.
- [vi] Electricity is presently at high cost and is available to less than 50% of the households in the less developed areas. Since availability of low cost electricity is also important for development of the country, for enhancing the competitiveness of existing exports and for more rapid development of the less developed areas, a low- cost coal-fired plant and rural electrification schemes are also part of the Proposal.
- [vii] Agriculture cannot create the additional productive employment that Sri Lanka needs. Industry will also need to expand. In the less developed, more rural areas that will mean primarily setting up SMEs. A special problem facing the SME garment firms is the ending of quotas, on which many have relied heavily. For the SMEs, improved infrastructure is also crucial and will be largely provided by the road and power elements of the integrated programme. In addition, they need access to capital, specially equity capital, and help with technology and marketing, which are included in the SME part

of the MCA program. Special attention is given to the garment industry and to tourism.

[viii] In the longer-term, the effectiveness of the Government as an implementing and governing agency is critical to the success of many programmes. Until recently, Sri Lanka's sub-national bodies were quite weak and essentially extensions of the national government. Several elements of the MCA programme rely heavily on new local bodies. However, even among them, local government officials need to play an important role. Therefore, a serious training programme for sub-national officials is envisaged in the MCA Proposal.

The targets of the proposed MCA programme, its costs and the requested MCA contribution to costs are outlined in Tables 3 and 4.

**Table 3**  
**Targets of Proposed Projects under MCA Programme**

<b>Area</b>	<b>Project</b>	<b>Targets</b>
Irrigation	Rehabilitate 10,000 minor tanks and anicuts [weirs].	Rehabilitate 10,000 minor tanks and anicuts [weirs] - 2004: 1000 2005: 2-3000 2006: 5-6000 2007: 1-2000
	Construct two medium sized irrigation projects.	Menik Ganga - Irrigate 4,000 ha of uncultivated land for both seasons and two crops. - Supply drinking water for one city and other consumers in two Divisions throughout the year. - Provide water all year for the animals in a national park.
		Deduru Oya - irrigate 9,500 ha of cultivated land to provide to permit double cropping. - irrigate 1,600 ha of uncultivated land to produce 2 crops - supply households and industries in the area with drinking water - Generate 8 GWh of electricity
Rural roads	Rehabilitation of rural roads with abandoned bus routes during 2005-2008	Rehabilitate 6,600 km of rural feeder roads and restore bus and lower-priced truck services.
	Minor extensions	Extend rural roads to areas now not connected to the road system.
Water supply & sanitation	Community water supply and sanitation project (CWSSP)	Provide drinking water & sanitation facilities to areas unserved by previous or current projects to a total of 1,000 of the roughly 14,000 GND in the country.
Rural electrification	Large, low cost coal-fired power station – stage 1	- Generate 300MW of electricity - Reducing electricity cost by more than 15%
	Rural electrification of poorer, less developed areas	Provide electricity to 50,000 rural households by 2009.
	Increase supply from minor local hydro and thermal power, from cogeneration, from renewable sources	Increase of 50% in energy supplied by these sources or 170 MW

Area	Project	Targets
SME	SME Bank, Trust Fund & Venture Capital Fund	By 2006, SME Bank, Trust Fund & Venture Capital Fund will be operating and making its first no-collateral based loans and equity financing.
	SME Development of Federation of Chambers & International Executive Services Corps	<ul style="list-style-type: none"> <li>- by early 2006 will have a total of at least 40 executives working with the 2 industries selected and,</li> <li>- by 2009 output and employment will have increased on average by 65%.</li> </ul>
	District level SME Development Centre	The Ministry of SME by early 2006 will have one District Office providing services to SME, and by 2007 at least 50% of the SME in the Division and 20% in the rest of the District will have visited the office and feel they have been helped.
Apparel Industry	Industrial Park (primarily for apparel)	<ul style="list-style-type: none"> <li>- An industrial park will be in operation by early 2006 and by early 2007 &amp; will have attracted firms employing 5000 people. By 2008 it will be breaking even and by 2009 showing a small return on capital.</li> <li>- The Textile Training and Service Centre and the Clothing Industry Training Institute will need to be developed with the assistance of North Carolina State University College of Textile.</li> </ul>
Capacity building	Capacity building in the public sector, especially sub-national governments	<ul style="list-style-type: none"> <li>- Conducting 24 training programmes in the country, 3 training programmes for each province.</li> <li>- Foreign training for 100 young professionals</li> </ul>

**Table 4**  
**Summary of Costs and Proposed MCA Contribution**

Area	Project	Total Cost	Sources of funds (US \$ mn)	
			Govt. & other	MCA
Irrigation	Rehabilitate 10,000 minor tanks and anicuts	50.0	25.0	25.0
	Construct two medium sized irrigation projects	83.2	24.2	59.0
Rural roads	Rehabilitation of rural roads with abandoned bus routs during 2005-2008	55.0	20.0	35.0
	Minor extensions	5.0	0.0	5.0
Water supply & sanitation	Community water supply and sanitation project (CWSSP)	35.0	10.0	25.0
Rural electrification	Large, low cost coal-fired power station – stage 1	450.0	430.0	20.0
	Rural electrification of poorer, less developed areas	20.0	6.3	13.7
	Increase supply from minor and local hydro and thermal power, cogeneration, from renewable sources	30.0	20.0	10.0
SME	SME Bank, Trust Fund & Venture Capital Fund	210.6	180.1	30.5
	SME Development of Federation of Chambers & International Executive Services Corps	5.0	2.5	2.5
	District level SME development centre	4.3	4.1	0.2
	Industrial park (apparel)	5.0	2.5	2.5
Capacity building	Capacity building of officers involved in the MCA programme in the public sector	24.6	5.0	19.6
<b>Total</b>		<b>977.7</b>	<b>729.7</b>	<b>248</b>

### 11.2 Complementary Programmes and Policies

Other steps are needed to reach the objectives of Growth and Poverty Reduction that the Government has set out to accomplish. But everything that needs to be done cannot be included in the MCA Proposal. Other important elements in the Poverty Reduction Strategy, to be funded by the Government or other donors, will be complementary to the MCA Proposal. They include:

- Improved communications in the rural areas,
- Major irrigation and multi-purpose projects,
- Assistance to large garment firms that face increased international competition
- Some major roads that the rural roads will feed into, and

- Major infrastructure projects needed to expand the tourist industry.
- Human resource development, other than the training of local government officials, is another important need outside the MCA Proposal. This is increasingly important in the integrated global economy in which Sri Lanka must compete.

A sustainable higher rate of economic growth and reduction of poverty will depend upon increased levels of domestic and foreign investment. The importance of appropriate macro-economic policies has been briefly discussed earlier. Some elements are given below.

Improving governance in connection with the elements of the MCA programme as well as the participation of private business and civil society in various aspects of the programme are also discussed below.

### **11.3 The Cornerstone: Rehabilitate Irrigation**

The cornerstone of the MCA Proposal is the rehabilitation of existing small and medium- sized irrigation works. These structures have existed for a long time, some for centuries, and were always maintained by the national government. As part of a general decentralization effort, the responsibility for maintenance has been shifted to the Provincial Councils, but no funds were allocated for the purpose. As a result these structures have been deteriorating for lack of resources and funding for maintenance. The proposed programme is designed to rehabilitate the deterioration and to ensure that the structures are maintained on a regular basis following such rehabilitation/renovation.

#### **11.3.1 Rehabilitate 10,000 Minor Tanks and *Anicuts* [Weirs]**

##### **11.3.1.1 Summary:**

Estimated cost:	\$ 50 million; Proposed MCA funding: \$ 25 million.
Executing agency:	Local tank committees of beneficiaries
Benefits:	New cultivation of 30-35,000 acres Doubling the intensity of cropping on 300,000 acres.
Status:	Project started in 2004; 1,000 tanks rehabilitated in 2004

##### **11.3.1.2 Description:**

The genesis for the rehabilitation of the 10,000 minor tank project, arose from the grass root level. It was the people of those areas who were aware of the location of these tanks and their potential contribution to the development of their villages and who were instrumental in highlighting the significance of the project.

A survey revealed that Sri Lanka has some 35,000 of these small irrigation works. However, some are incorporated in major tanks or irrigation and drainage projects and therefore, are not included in this programme. This programme includes the remaining 24,000, with a command of some 600,000 acres, or an average of 25 acres each. They are spread over the whole country, some, in each of the 25

Districts. About 3,000 have been abandoned because they have silted or their sluices no longer work or both. Another 11,000 are working but often substantially below capacity. Of these 24,000 abandoned or defective irrigation works, 10,000 are being included in the rehabilitation programme.

**11.3.1.3 Status:** The rehabilitation programme began in mid-2004 with 660 tanks and almost 360 weirs in 23 out of the 25 Districts, including 6 in the North and East [Work could not begin in 2 Districts, mainly because of landmines and other conflict related problems]. Despite the fact that work needs to be done during the dry season and that it only began in mid 2004, 990 estimates of cost were prepared by September, about 800 agreements were signed with existing farmers' organizations and it is expected that at least 1,000 rehabilitation projects would be completed around the end of the year. They were entirely financed by the Government budget.

**11.3.1.4 Executing responsibility:** New Tank Committees have been set up to execute irrigation works, under contract to the executing Ministry. The President, the Secretary of this Committee and the majority of members must be beneficiaries of the new or additional irrigation projects. The membership of the existing Tank Committees tends to be poorer and less educated than those who run the Farmers' Organizations. The Tank Committees will report to Divisional Committees which report, in turn, to District units, and they to each Provincial Committee. The Committees are intended to get the community closer to the project and to make it work.

**11.3.1.5 Targets and Costs:** The target is to at least double the number of works rehabilitated in 2005. The schedule is as follows:

2004:	1,000	2005:	2-3,000
2006:	5-6,000	2007:	1-2,000

In 2004, average costs per tank were approximately Rs. 500,000, (or \$ 5,000). It is estimated that the total cost for 10,000 tanks and weirs would be in the range of \$ 50 million. The costs of rehabilitation, of course, are lower than building new works. Half of the total costs are expected to be covered by MCA assistance. The Government budget has already funded the programme in 2004 and will continue to fund part of the remaining rehabilitation needs. It is also scheduled to increase expenditure on the support and extension of the agricultural advisory services [Agricultural Production and Research Assistants] to help farmers take full advantage of the potential offered by increased and more reliable irrigation. Some NGOs, banks and other Sri Lankan and foreign organizations are willing to support particular rehabilitation projects.

The biggest contribution to the cost is not included in any of these numbers: that is provided by the Tank Committees. They are executing the projects by providing free labour as specified in the contract for funding from the national government. In addition, they are also committed to maintaining their tank.

**11.3.1.6 What is to be done:** Removing accumulated silt, which greatly reduces the storage capacity of tanks, is a major task. Capacity will also increase by raising spills and bunds that contain the water. Deteriorated gates need to be repaired or replaced and better works installed in some cases. The main purpose is to retain enough water in the tanks, or to raise the level of weirs sufficiently so water is available in the dry season.

**11.3.1.7 Benefits:** The most obvious benefit is additional crop production. The measurable benefits are large because cropping intensity can be increased by irrigation from the typical intensity of less than 1 to 1.8 an average. With irrigation, most of the areas will be able to grow 2 crops a year. Double cropping is a very cost-effective way of increasing output quickly. A study conducted by the World Conservation Union in 2004 states that this amounts to Rs. 60,000 per ha, or about Rs 25,000 per acre a year. Water for Livestock and fish production contributed more than crop production to the benefits, nearly Rs.70,000. Additional and reliable water for household consumption was valued at nearly Rs. 150,000. These benefits include not only the time saved in fetching water from greater distances, but also the gains from cleaner water. A tank that continues to hold water during the dry season raises the water table. That in turn means that wells with clean drinking water remain available during a season when they might otherwise be dry.

All benefits totaled nearly Rs 300,000 per ha a year. With an average of 10 ha irrigated by each tank, total benefits, according to this calculation are Rs. 3 million or \$ 30,000 per year. With the average tank rehabilitation costing \$ 5000 the benefits in the first 2 years exceed the cost. Since the Tank Committees are contractually obliged to maintain the tank, these benefits will continue to flow for years. The contract for maintenance is likely to be honoured because the process assures ownership by the community. In the past, the tank was “the government’s tank” – the national government had constructed it and had maintained it. Now, the tank will be the community’s. The Tank Committee had overseen the rehabilitation and the community had contributed labour. So the community is quite willing to maintain it.

There are additional benefits, which are difficult to quantify. The greatest benefit is the availability of water during the dry season, which is of particular significance to the poor. When the wells run dry, because the water table is not replenished from the tanks, water for human consumption needs to be purchased, at considerable expense to the poor. Water for livestock and other needs has to be brought from great distances, creating a special burden for women and children from poorer families who customarily carry the water. The risk of drought is especially hard for the poor because they have fewer reserves of food, less savings and less assets to help them tide over.

Finally, there are governance, social and health benefits, also not included. The Tank Committees are the first local government institutions dominated by the poor. They are providing a powerful voice for the poor with respect to making decisions

that are of importance. Moreover, the Tank Committees are increasingly being used to funnel information and technical assistance to rural groups that will increase their production and income. Technical /agricultural advice, for instance, will flow to and through them. The availability of water during the dry season will reduce the number of poor children being taken out of school to help in carrying water or to supplement the families' income during major droughts. The economic and other benefits of mitigating disease are not included in the benefit calculations. All these indirect effects might well equal the measure of benefits.

**11.3.2 Construct two medium-sized irrigation projects**The minor irrigation projects discussed above, can store only a very limited amount of water and irrigate only a small area. They are attractive and high priority because they can provide benefits in the short term across the whole country. But some of these tanks are dependent on upstream works that store or divert large amounts of water to keep the small tanks supplied. The two projects proposed below serve that purpose among other benefits.

While the Menik Ganga project is in the Southern Province, with the third highest income and rapid growth [Table 1], the project will benefit primarily Hambantota, one of the Districts deserving special emphasis because the incidence of poverty is high at 32%. It has not declined [see Table 2]. Moreover some of the benefits will be in the Uva Province, the second poorest with the highest incidence of poverty in the country [37%].

The Deduru Oya project in the Northwestern Province, which is medium-income, will benefit the dry northern areas of Puttalam, a District with a poverty incidence well above average [31%].

**11.3.2.1 Summary:**

***Menik Ganga project***

Estimated cost: \$ 18.2 million; Proposed MCA funding: \$ 14 million  
 Executing agency: Irrigation Department  
 Benefits: 4,000 ha double cropped land, hitherto uncultivated. Supply water for humans and animals in the dry seasons in towns and wildlife sanctuaries.  
 Status: Large reservoir completed, but lacks water for last 14 years to irrigate 40% of its 10,000 ha of command area. Detailed reports are available. Preliminary design completed.

***Deduru Oya project***

Estimated cost: \$ 65 million; Proposed MCA funding: \$ 45 million  
 Executing agency: Irrigation Department  
 Benefits: Irrigate 9,500 ha of cultivated land [double output] and 1,600 ha of uncultivated land [two crops]. Feed 200 existing tanks. Generate 8 GWh of electricity.  
 Status: Two large and 200 small tanks exist but have inadequate water. Project design to be completed.

**11.3.2.2 Description:** Both projects have a good cost-benefit ratio because they take advantage of existing irrigation works that are only partially used for lack of water during the dry season. Both involve constructing a medium-sized reservoir to store water and feed existing structures when they run dry or have low water tables. In a real sense, they are rehabilitation projects. Both also benefit wildlife parks as well as human beings. Both use water that hitherto not harnessed, to feed existing works in the dry season, by building a storage reservoir and a transfer canal to existing irrigation works.

**11.3.2.3 Status:** Both projects were designed some time ago and both are ready for implementation in 2005. They have been delayed due to lack of funds. For both projects, pre-feasibility studies were done some time ago. For the Menik Ganga, a Feasibility Study was completed in May 2004 that included an Environmental Impact Assessment.

**11.3.2.4 Executing responsibility:** The Irrigation Department will execute both projects since there is no organization below the national government level with the technical or managerial capacity to carry out a project of this size, complexity and geographical coverage.

**11.3.2.5 Targets and Costs:**

***Menik Ganga:***

Completion is scheduled for the end of 2008. By that time a reservoir will have been constructed with a storage capacity of 75 MCM (Metric Cubic Metres) and a canal to transfer that water to an existing reservoir and irrigation system. Five minor tanks to hold the water and an internal road system in the Yala National Park will also have been completed. The targets are to:

- irrigate 4,000 ha of uncultivated land for both seasons and two crops;
- supply drinking water for one city and other consumers in two Divisions throughout the year; and
- provide water all year for the animals in a National Park and small holder livestock industry.

***Deduru Oya:***

Completion scheduled by 2009. By that time a main dam would have been constructed as well as 2 canals to feed three large tanks/reservoirs, including the largest and second largest in the river basin, as well as more than 50 minor tanks along both canals. In addition, there will be a hydroelectric power-generating station and water for households and commercial use. Targets are to:

- irrigate 9,500 ha of new cultivated land to provide an assured water supply and permit double cropping;
- irrigate 1,600 ha of uncultivated land to produce 2 crops;
- generate 8 GWh of electricity
- supply households and industries in the area with drinking water.

### 11.3.2.6 What is to be done: projects already described.

**11.3.2.7 Benefits:** The *Menik Ganga* feasibility report includes a detailed discussion of costs and benefits. The principal benefit is in the form of increased crop production. Based on the current pattern of production this is forecast to include:

- 14,400 metric tons of paddy [unhusked rice]
- almost 27,000 tons of bananas and
- 525 tons of high value chillie peppers.

In addition there will be:

- increases in the fish catch and sugar-cane production,
- provision of 4 MCM of drinking water, and
- additional income from tourism as a result of the increase in wildlife consequent to the availability of water during the dry season.

Discounted at 10%, the Net Present Value of the benefits is estimated at \$ 7.4 million a year, resulting in a Cost-Benefit ratio of 1:49 and an Internal Rate of Return (IRR) of 15.6%. Sensitivity analysis still leaves the project as attractive even in a worst-case scenario (if construction takes one year longer, the estimated net benefits are reduced by 10% and forecast costs are increased by 10%). In this situation the IRR will still be 13.3% and the cost-benefit ratio still 1:26.

The more significant of these is the insurance provided against drought. When rains fail, the poor are particularly vulnerable. They may lose their crops. Unable to borrow they may have to sell whatever assets they possess in order to survive because they cannot borrow to tide over the disaster. Often they can never recover their former position. The benefits of avoiding that catastrophe are not captured in the cost-benefit analysis, which deals with the increase in average production.

A second uncounted benefit is the improvement in health as the result of a safer supply of drinking water. The production benefits will increase as the result of other elements of the integrated programme to develop the poorer regions.

The two projects are similar in that they will permit double cropping on land that is currently single cropped or not cultivated at all. Both are relatively low cost because they take substantial advantage of existing works. The returns may be slightly less for the Deduru Oya project because the cost is 3.6 times that of the Menik Ganga, while the irrigation benefits are approximately 1.6 times. However, the Deduru Oya will also produce hydro-power, particularly important at a time of high fuel prices in a country completely dependent on imports of fuel. In any case, the returns on Menik Ganga are so high that even if those for Deduru Oya are only one-half, the Cost-Benefit ratio would still be a high 1:25. The project will not go ahead until these assumptions are proved or disproved by a careful feasibility study.

## **11.4. A Second Crucial Element: Rehabilitate and Extend Rural Roads**

Without an improved and extended road system most other investments in the less developed rural areas will not produce the expected benefits. Much of the road system was essentially built in colonial times, more than 50 years ago. For close to 50 years very little was spent on new major roads. Expenditure on the existing road system was also inadequate to maintain them, outside of some heavily used roads in the Western Province. As a result, some less developed areas are unreachable by motorized vehicles. A large number of roads are not in a motorable condition. Transportation of produce has also become expensive as a result. Agricultural input prices are high because of transport costs. Even industrial goods are made uneconomical due to the same factor.

Rehabilitation of the rural road network is considered by some analysts to be the number one priority for the neglected rural areas.

### **11.4.1 Summary:**

Total cost for rehabilitation, and widening of deteriorated roads inclusive of some extensions:      Approximately \$ 260 million

For rural roads with abandoned bus routes:      \$ 78.2 million;

To be rehabilitated in 2005-08: \$ 55 million; Proposed MCA funding: \$ 35 million.

For minor additions/extensions: \$ 5 million; Proposed MCA funding: \$ 5 million.

Executing agency: Local Authorities

Benefits: Large savings in time and cost of transport

opening of new areas to commercial production;

expanding production of high value, perishable or time-sensitive products.

### **11.4.2 Description:**

Rural roads are 75% of the total road network. Over 90% of these are gravel and usually cannot be used during the rainy season. Of the 65,000 km of such roads over 9,000, or 15% have deteriorated to such an extent that buses no longer use them. Virtually all of the remainder of the rural road network has also deteriorated over the last 50 years resulting in time and involve a high cost as equipment constantly break down. Slow speeds, also greatly increases the cost, since buses and trucks take a long time to cover short distances. Further, state-owned bus services, the only ones serving rural areas, have not been able to keep all of their fleets operating because of high costs and the constant need for replacing tyres, tubes and spare parts. As a result, a distressingly large proportion of services have been discontinued: 30% of rural services and 35% of school bus services. The local authorities lack sources of revenue to pay for maintenance.

Moreover, there are significant areas that are not connected to motorable roads due to bridges and culverts being washed away. Since rural people on average need to travel nearly 6 km to hospitals and markets this is a serious problem.

National roads are in a somewhat better condition. ADB, Japan [JBIC], Korea and Kuwait have all helped to fund or are funding rehabilitation and improvement of these roads. However, even one of the most important roads in the country, from Colombo to Kandy, which was last rehabilitated in the 1980s with World Bank funding has deteriorated since. Like other major roads, traffic on it has greatly increased and increased travel time considerably between the two cities.

While there is a need to rehabilitate old roads and to widen many of them; to construct new ones of all sizes and categories; and to provide spare parts and new equipment for rural bus services, the proposed project will concentrate on rehabilitation and limited construction of new rural roads. The first priority will be given to roads where bus services have been abandoned and in those Districts with high poverty, including the North-East.

#### **11.4.3 Status:**

The Government allocates substantial funds for roads in each Budget for Class A and B roads [Rs. 8 billion = \$ 80 million]. But this is inadequate to prevent further deterioration of these roads and it does not help with rural roads. The ADB is now working on a Provincial road rehabilitation project in 4 out of the 9 Provinces and Japan's aid programme is working on another Province. However, neither deals with rural or feeder roads. The proposed project will concentrate on areas where the ADB is not working and on rural roads. The Provincial Councils have limited technical staff –just one person each - for roads, and the local governments have even less technical competence. Therefore, technical expertise will have to come largely from the National Government. But there is a well-established mechanism for roadwork. What is mostly lacking is money.

#### **11.4.4 Executing responsibility:**

Local Authorities will execute the project, with technical inputs and supervision from the National Government. In addition, a Steering Committee will be established, including the Road Development Authority, the Ministry of Provincial Councils and Local Government, the Ministry of Finance and the truckers and bus operators associations. It will set priorities on an yearly basis on the allocations to be made by Districts. It will also decide on the commitments that need to be made by Provincial Councils and local authorities with respect to the future maintenance of these roads.

#### **11.4.5 Targets and Costs:**

Main target is to rehabilitate 6,600 km of rural feeder roads and restore bus and lower-priced truck services on them. The average cost of the proposed rehabilitation is Rs. 830,000 or \$ 8,300 per km, but costs vary widely.

In addition, a \$ 5 million fund will be established to extend rural roads to areas now not connected to the road system. On average, rural people now have to walk 1.6 km to reach a road. Since some of them do not need to walk any distance this average includes a substantial number who need to walk 3 km or more to reach a road. The fund will make a start on reaching these areas, especially by funding

culverts and small bridges. The fund will be open to contribution from other donors, NGOs and other private groups and the National Government. It will pioneer the extension of the rural road network and provide, on a matching basis, other contributors.

**11.4.5.1 Other contributors:** Current donors have funded National and Provincial roads, not local rural roads. But these are important for rural development, particularly in the less developed areas where deterioration has been particularly extensive. The MCA would play a pioneering role in helping to deal with this important development need. One contribution from the donor community is likely to come for rural roads in the North and East. Roads in that region have been identified, as a high priority need. \$ 15 million for rural roads has been proposed as part of an “Immediate” programme in the assessment of the needs of the region. That would cover much of the gap between the total cost of the programme in the next four years and the proposed MCA funding. But the expectation is that other donors can be persuaded to fund rural roads in the later years once the MCA grant has demonstrated the major impact of rural road rehabilitation.

**11.4.5.2 Future maintenance:** Maintenance of rural roads is a special problem, because the Local Authorities receive minimal funds from the National Government and Provincial Councils and have virtually no tax base in the rural areas. The Provincial Authorities are only slightly better off in both respects. Even maintenance of national roads is clearly inadequate. The Government intends to set up a fund for the maintenance of roads in the near future but the expected revenue from this endeavour will not be sufficient for the upkeep of even national roads. As such, there is no short-term solution to the maintenance of rural roads. This will require expanding the tax base of Local Authorities and/or the provision of matching funds from the National Government. That will come as part of a major tax overhaul of the Government plans.

**11.4.6 What is to be done:**

Earth-works, resurfacing, mostly with gravel, filling of holes, restoring culverts and a few bridges will all be needed. Minimal engineering and design work will be needed, in addition, on the new roads.

**11.4.7 Benefits:**

The ADB’s consultants estimated highly conservative Economic Rates of Return [ERR] for national [Class A & B] roads. They took account only of the saving in time and in the cost of operation of vehicles on the roads as a result of rehabilitation. For Category A roads, the ERR was a high 34-42%, while for the smaller category B roads it was a moderate 14-22%. The external benefits were not taken into account.

These benefits will be substantial for all roads both main and rural. The biggest benefits will come from re-establishing road connections to areas that never had them or in disrepair. As a result, production of high value crops, livestock products, handicrafts and connected rural economic activities will increase. These benefits are

expected to be significant, as they would open up rural areas and link them to production centers.

## **11.5 Community Water Supply & Sanitation**

One of the most cost-effective ways of improving rural health is to provide clean water and some sanitary facilities. At the same time, the provision of water, by freeing women and children from the onerous and often time consuming task of fetching water, helps keep children in school, which is important to help families move out of poverty. It also frees women's time for productive work. The projects for rural water supply and sanitation are suffering neglect instead of expansion, for lack of funding. A grant from MCA, together with funds from other sources, particularly the communities concerned, can make a significant contribution to the development of neglected rural regions.

### **11.5.1 Summary:**

Estimated cost: \$ 35 million; Proposed MCA funding: \$ 25 million.  
Executing agency: Community Based Organizations, assisted by NGOs & Private Sector, under supervision of CWSSP (Community Water Supply & Sanitation Project) Unit of the Ministry of Urban Development and Water Supply (MUDWS).  
Benefits: Community based water supply facilities in selected rural 1,000 GNDs [lowest level of government] in 10 neglected districts.  
Status: CWSSP I & II have been implemented successfully. This new project commenced with funds from Japan, GOSL and local communities. Funds have been completely utilised. Smaller efforts funded by World Bank in other Districts is under way.

**11.5.2 Description:** About 80% of Sri Lanka's 19 million people live in rural areas, and over 40% of the rural population, or over 6 million people, do not have access to safe drinking water and adequate sanitation. Moreover, those without basic necessities are generally the poorer sections of the community and hence investment in RWSS (Rural Water Supply & Sanitation) sector will substantially add to overall development and the poverty alleviation effort. At present 70% of the total population has access to safe drinking water, which includes water from pipe borne facilities, tube wells and protected dug wells. Only about 31% have access to pipe borne water.

Government is committed to provide access to safe drinking water and adequate sanitation facilities for the entire population by 2010. However, the estimated investment needed to achieve this goal, at Rs. 10-12 billion per year, or \$ 100-120 million, is in excess of available funding. The average value of investments by the government in recent years [from own and donors funds] has been around \$ 70 million.

**11.5.3 Status:** CWSSP I and CWSSP II have been implemented successfully and a small start has been made on the Reactivated CWSSP-II and the 2<sup>nd</sup> CWSSP in some Districts. The project cycle takes 22 months because of the locally based, decentralized implementing organization, which requires an institution-building effort, to assure ownership and maintenance. Additional funds are needed quickly to produce results in neglected Districts [including North-East].

**11.5.4 Executing Responsibility:** Community-based Organizations are the implementers at the local level, assisted by NGOs, and semi-governmental or private firms, with technical and managerial experience, which are designated as Partner Organizations. Overall responsibility for project implementation is vested with the CWSSP Unit of the Ministry of Urban Development and Water Supply. The CWSSP Unit is responsible for planning, management, coordination, monitoring and reporting of project activities, working through Regional Offices, in each project implementation District, and in all matters concerning project implementation. However, it is the Community-based Organizations that plan, implement and manage water supply and sanitation facilities on behalf of their members.

There are a number of other stakeholders who will be involved in project activities. Although these stakeholders are not directly involved in project implementation, their support and coordination are crucial to project success. They are: the Pradeshiya Sabhas [local government authorities with their own staff], the National Water Supply and Drainage Board, the Provincial Department of Health Services, the Provincial Department of Education, Environmental Authorities, the Divisional Secretary and the private sector.

The coordination will include Community-Based Organizations, Village Coordination Committee, Divisional Secretariat RWSS Coordination Committees, Regional RWSS Coordination Committees, and the National Steering Committee.

**11.5.5 Targets and Costs:** The target is to cover areas unserved by previous or current projects, providing services to a total of 1,000, GND units. The cost has been estimated based on past experience and at \$ 35,000 per GND.

**11.5.6 What is to be done:** Different technologies will be used in different areas, depending on what is lowest cost/most efficient: dug wells, dug wells with hand-pumps, pipe-borne systems – usually from tanks – either gravity-fed or pumped, and rainwater harvesting. The targeted districts are in the North-East, most of it left out because of the conflict [Jaffna, Trincomalee, Ampara, Vavuniya]; or have a high poverty rate [Badulla, Moneragala, Puttalam, and Hambantota], or have Divisions with substantial needs, affected badly by drought and not included in other programmes [Anuradapura, Polonnaruwa]. In addition to water, simple sanitation facilities will be provided to needy households in the communities in these Districts.

To take full advantage of the water supply and sanitation facilities the Community Based Organizations and the Partner Organizations are being used to provide health and hygiene awareness and practices to the rural communities. Household and community based environment protection programmes were also implemented to ensure continued and effective use of water supply and sanitation facilities. Systems and institutes were developed for community based planning, implementation, operation and maintenance of cost effective and sustainable water supply and sanitation facilities.

**11.5.7 Benefits:** The project will benefit roughly 200,000-250,000 households with about over 1 million beneficiaries with reliable clean water. In addition it will provide about 50,000 simple latrines.

The overall objective of the project is to improve the living conditions of the rural communities by increasing their effective access to safe water.

This project will improve the health of the rural community by reducing incidence of water related diseases, and improved hygiene education and will increase income due to better health and reduced medical expenses. Energy saving by reducing the need for boiling drinking water, particularly after floods, is a major benefit in Sri Lanka where many rural households boil their water, unlike other countries in South Asia. Other benefits include improved water quality, improved social conditions and economic performance including the value of community assets including land values, improved environment including clean home gardens, protected water sources, and well conserved water catchments.

The World Bank did a cost-benefit analysis in 2003 for a similar project in other areas. The results of the analysis depended very much on the cost of providing water to one household. Dug wells or deep wells, used by many households, were the cheapest, at about \$ 100 per household. Pumping water through pipe to a single house cost almost twice as much. The Expected Economic Rate of Return [ERR] was from 15% to 51%. Of the 6 methods for supplying water only one method had an ERR below 25%. Its ERR was also sensitive to assumptions while the others were called “robust”. The reason for the lower benefits of one technology was that it involved the cost of pumping water. But this method is needed mostly in dry, hilly areas, where benefits of reliable water are often greatest. However, the difference caused by a major benefit was not really taken into account: the calculation assumes 1-2 hours of additional time available regardless of location. If women and children need to go further and spend more time to get water in dry hilly areas, as seems likely, then the additional benefits may be bigger than the additional costs and the ERR for this technology would be higher.

Because the individual projects will be carried out by local organizations, with a substantial cost contribution by them [average 31%] there is little doubt that they will “own” these projects and will continue to maintain them.

## 11.6 Electricity for Consumers and Producers

Electricity is an important part of development. The Ceylon Electricity Board (CEB) is the sole state authority responsible for generation, transmission and distribution of electricity in Sri Lanka. Its capacity of generating power has been estimated at 2,141 MW by end 2003, of which 1240 MW was hydro, 560 MW public thermal and 338 MW by private thermal connected to the national grid. The total supply from the national grid is 63%.

There are three problems with the supply of electricity in Sri Lanka:

- [i] like other elements in the infrastructure its supply is especially inadequate in the neglected areas. In the 3 Provinces with the greatest incidence of poverty i.e., North East and Sabaragamuwa, the percentage of households with electricity ranges from 37-48%, compared with 63% nation-wide;
- [ii] the cost of power is high compared with the cost elsewhere in the region. This affects the poor directly, because it is a drain on their budget. This also decreases the competitiveness of job-creating industries such as tourism and trade;
- [iii] most of Sri Lanka's energy is produced from imported oil. This creates a burden on the balance of payments, particularly as the price of oil is high. Furthermore, it pollutes and also contributes to the high cost of electricity. Sustainable energy has been much talked about, but little has been done in a concerted manner.

This Proposal is designed to begin to address all 3 problems in a coordinated manner

### 11.6.1 Summary:

Estimated cost: \$ 450-470 million initially, \$ 970 million ultimately;

Proposed MCA funding: \$ 43.7 million

The three projects in the proposed MCA programme:

- [i] Large, low cost coal-fired power station:

Estimated cost: \$ 400 million for first phase, \$ 900 million when completed;  
Proposed MCA funding: \$ 20 million.

Executing agency: Private investors and/or Ceylon Electricity Board [CEB]

Benefits: 600 MW of power by 2009, reducing electricity costs by more than 15% and reducing blackouts that cost an estimated 1.5% of GDP;

Status: Ready for implementation; designed, foreign investors interested.

- [ii] Rural electrification of poorer, less developed areas:

Estimated cost: \$ 20 million plus initial subsidy of operating costs;  
Proposed MCA funding: \$ 13.7 million

Executing agency: Rural electrification unit of CEB.

Benefits:	130,000 rural households connected to electricity, increasing access in poorer, less developed areas by roughly 10%.
Status:	There is a current donor-supported programme to subsidize rural electrification; certain difficulties in extending this programme to poorer, less developed areas.
[iii] Increase supply from minor and local hydro- and thermal power, cogeneration, from renewable sources: biomass [ <i>bagasse</i> ], wind, solar, particularly from private investors.	
Estimated cost:	Approximately \$ 30-50 million; Proposed MCA funding: \$ 10 million.
Executing agency:	Investors, including local agencies, private firms, local and provincial governments.
Benefits:	Increase of 50% in energy supplied by these sources or 170 MW; electrify areas not connected to the grid; feeding lower cost energy into the grid; reduction of blackouts due to inadequate energy.
Status:	World Bank supported renewable energy project is currently in operation.

### 11.6.2 Description:

The country has no proven reserves of fossil fuels. Sri Lanka's only indigenous energy resources are hydro energy and biomass, mainly fuel wood. Fossil fuel is imported, primarily as crude oil and partly as refined petroleum products. The household sector is the largest consumer of energy followed by the transport and industrial sectors.

#### 11.6.2.1 Constraints:

Biomass/wood provides some 50% of primary energy requirements, largely used in households and small commercial establishments. *Bagasse* is used in the sugar factories for cogeneration systems. Private costs of wood for cooking is higher than electricity in some areas and there are large economic costs to society as cutting wood increases the problem of flooding drought and providing clean water.

The bulk of electricity production is by diesel fuel. It is expensive as it uses relatively small plants for producing electricity. The base load for an electric grid should be large plants, coal, or semi refined oil plants to reduce the cost of production.

Hydropower generation is diminishing since its potential, especially large hydro, has largely been tapped. Other renewable sources of energy are not significant. However their future potential is considered to be high, as envisaged by the recent World Bank/GEF (Global Environmental Facility) project for development of 85 MW (approximately 5% of total capacity) of renewable energy in Sri Lanka.

Distribution losses from the national grid are relatively high. As of 2003 losses were about 18.5%. The CEB has had a long-standing goal of bringing the

distribution losses down to 13%. Since 2000, total losses have been brought down from 21.6% to 18.5%. Since such losses were at 17.7% in 1997, this decline is neither steady nor assured. The CEB management will need to be given a target for distribution loss reduction as part of the investment programme to increase capacity and decrease costs that will result in an increase in capacity of 4-5%.

Although tariffs are relatively high, they are inadequate to cover the costs of delivering electricity to consumers. High cost electricity plants have a heavy debt-servicing cost. The cost of production is nearly as great as the average sale price [production cost about Rs. 6, distribution cost about Rs. 3.45, tariff Rs. 7.8; production costs could be brought down to Rs. 4]. As a result the CEB had losses of nearly 17% in 2002 [a loss of Rs. 7.4 billion, or \$ 74 million on an income of Rs. 44 billion].

The medium sized firms in the country, which produce garments, and agricultural raw materials pay 20-40% more than their competitors. The situation is even worse for commercial firms handling export commodities. Their competitors in other countries get electricity 40-50% cheaper. There is a shortage of power supply in some firms and such shortages are met by increasing the number of small, power generating units at a higher cost.

**Table 5**  
**Tariff for Electricity in Sri Lanka and Neighbouring Countries**  
**[in Sri Lankan Rupees]**

Country/State	Small household	Medium	
		Industry	Commercial
Sri Lanka	4.00	8.10	12.30
Pakistan, Kerala, TN	2.55		
Thai, Maharashtra	3.95		
Bade, Malaysia, Phil	5.50		
Philippines, Thailand		4.70	5.50
South Korea		5.60	7.40
Bangladesh, Malaysia		6.50	
Pakistan		7.60	
Mahar, Kera, Tamil Nadu		9.10	
Malaysia, South Korea		7.50	
Banglade, Kera, Maha, Pak		8.80	
Tamil Nadu			13.10

NOTES: The data in this and other tables in 12.7.2.1 are from a presentation made by Dr. Tilak Siyambalapitiya, and kindly made available by him. Three Indian States and several countries have been abbreviated; e.g.: TN=Tamil Nadu, Maha=Maharashtra, Kera=Kerala; Bade=Bangladesh.

The problem is aggravated by inadequate investment in low cost power in the past, resulting in increased blackouts in the last decade. An estimate [by Dr. Tilak Siyambalapitiya] is that in 2022 some 9% of demand [forecast sales] could not be met and that this reduced GDP by Rs. 13.5 billion [\$ 135 million] or 1.5%. These problems will get worse if projects ready for implementation are delayed. The pressure to limit blackouts is likely to lead to further investment in quickly available diesel generation. This will increase the cost of electricity by another one third by 2016. The result would be huge CEB losses or further increases tariffs and reduction or stagnation in the growth of the economy.

#### **11.6.2.2 Remedial Action:**

**Setting up of large coal-fired plants and developing remaining hydro-power:** Implement plans for at least one large and low-cost coal-fired generating plant [900 MW ultimately, equal to about 40% of current capacity] and for one significant hydro-project [150 MW about 6% of capacity]. The result would be a nearly one-third decline in cost of electricity by 2016 [in constant prices].

There is potential for developing some smaller hydro-power projects by agencies other than the CEB, taking advantage of co-generation by private or public units that have cheap sources of fuel and by developing renewable sources of energy. This requires greater flexibility in funding, arrangements for connecting to the grid and in paying for the electricity.

**Rural electrification:** The CEB has a special unit for rural electrification. Its mandate is to extend lines to rural areas as long as the EIRR [the Economic Internal Rate of Return] exceeds 12%. Naturally that results in extensions occurring primarily in densely populated and more developed areas and near the existing grid. The less developed areas increasingly lag behind. It is important that consumers in neglected areas be served to keep them from falling further behind. That will require either open or hidden subsidies.

**Minor and sustainable sources of production:** The development of sustainable energy production [biomass, wind, solar] has long been considered promising and essential in Sri Lanka because of the cost of importing fuel. But little headway has been made, except in using bagasse [stalks of sugar cane] for fuel. The World Bank has a project for Renewable Energy in Rural areas, but more needs to be done to stimulate minor sources of low cost local production.

#### **11.6.3 Status:**

##### **Cost and capacity**

Two major projects to reduce costs and increased capacity were designed some time ago and were ready for implementation. The large coal-fired plant, which was proposed to be set up at Norochhole was delayed. The Government has just decided that this project and the Upper Kotmale Hydro-project will go ahead.

### **Rural electrification is ongoing**

The World Bank and the Chinese government are currently providing funding to bring electricity to an additional 50,000 families. Since there are now some 2 million households without electricity this only makes a start on dealing with the problem. Funding would break the bottleneck in extending electricity to the less developed areas [see Table 1 for coverage].

**Table 6**  
**Sector Wise Electrification Level as at Beginning of 2002**

<b>Sector</b>	<b>% Population</b>	<b>% Electrification</b>	<b>% Accessibility</b>
Urban	21	85	95
Rural	73	47	62
Estate	6	50	56

### **Renewable energy**

Renewable Energy is assumed to have great promise in Sri Lanka and pre-feasibility studies have been done on windmills. A project was considered for proposal to the MCA.

**11.6.4 Executing responsibility:** Until 1996, electricity demand was met by CEB owned hydro and thermal generating plants. Since 1996, the private sector has also participated in power generation. The existing generating system in the country is still predominantly owned by CEB, which is about 80% of the total existing capacity. The remainder is owned by Independent Power Producers (IPP).

Programmes proposed for MCA funding:

- (a) Coal-fired plant will be executed by either a private investor or the CEB.
- (b) Rural electrification will be by the rural electrification unit of CEB, but under priorities set by a Steering Committee of which the Department of National Planning will be the Chairman and on which the neglected Districts will be represented.
- (c) Small hydro- or thermal projects; co-generation; and renewable energy projects will be managed by the same Steering Committee, but with additional members from the private sector and local governments with an interest in developing these sources of energy. The actual implementation of the project, however, will be in the hands of private business, Provincial Councils and local governments, local bodies and locally set up generating companies.

**11.6.5 Targets and costs:** There are three distinct targets for electricity generation with a view to reducing cost and increasing supply.

- [i] To set up a large coal-fired base-load plant that will generate 300 MW of electricity in its first phase, but can be expanded. Its cost of producing electricity would be at least 50% below the cost of current thermal plants.

The investment costs of the plant are to be borne by private investors, donors, joint ventures or CEB. MCA is requested to fund part of the total cost of the plant intended to be located at Trincomalee harbour. Because of the urgency of getting power, a jetty will need to be constructed in the area currently selected, to accommodate the large, coal-carrying ships needed to make the plant cost effective. Preliminary estimates are that the jetty will cost \$ 100 mn. The total cost of the plant was estimated at \$ 900 million.

- [ii] To provide electricity to 50,000 rural households by 2009 in areas not now supplied with electricity. The majority of them are in 13 Districts in the lower income Provinces such as North Central, North East, Uva and Sabaragamuwa, where less than 50% of households have electricity.

The typical cost for electrifying a household is Rs. 30,000. The proposed beneficiaries are in areas where existing lines are not available and therefore supply of electricity is more costly. The average cost of providing electricity to this area is estimated at Rs. 40,000 or \$ 400. To electrify 50,000 households would cost \$ 20 million. The CEB will not be able to bear the cost of providing electricity to this area due to financial constraints.

MCA assistance is sought to cover 67% of the capital costs for extending electricity to these areas at a cost of \$ 13.4 million. The remaining capital costs will be borne by the Government.

- [iii] To review pricing policies:
  - End the practice of charging lifeline rates for the first 90 units, even for customers who buy far more; only lifeline customers, who use less than 90 units should get the special rate for poor consumers.
  - Charge richer households, who are much larger consumers of electricity because they have many appliances [e.g.: air conditioners] a higher rate on the additional electricity they use.
  - Use the additional income to subsidize the cost for lifeline customers.
- [iv] To move towards a reduction of system losses to 13% by 2009, that is to 16% of total system losses by giving greater autonomy to CEB; and strengthening the management and technical operations. Financial costs are small and none to MCA.
- [v] To generate a 50% increase in power by smaller units outside the CEB: co-generation; small hydro and thermal power; possibly solar and wind. It will require substantial investment from private investors, Provincial Councils, local governments, and NGOs. The total investment in these sources is estimated to be around \$ 30-50 million.

The MCA funds would be used for [i] technical work on how to make it easier for local producing units to connect to the grid; Sri Lanka to adopt experience of other countries in the field of on renewable energy; and other technical and

managerial issues; and [ii] for venture capital, loans and subsidies to increase investment in these power sources.

The Steering Committee will develop and publish the rules under which the financing is to be provided, assuring in all cases that the investors bear the bulk of the risk.

### **11.6.6 Benefits:**

#### **Large coal fired station**

There are three major benefits: a larger, more reliable and cheaper supply, with less load shedding or blackouts.

*Cost:* As shown in Table 5, Sri Lankan commercial and industrial enterprises now pay 20-40% more for their electricity than most of their competitors. The CEB has substantial losses every year despite high tariffs. Setting up a large, low cost coal-fired plant is a crucial element in bringing costs and tariffs down and increasing the competitiveness of Sri Lanka in the export market. The estimated cost reduction is expected to be around 25% by 2009 and 30% by 2016 [from Tilak Siyambalapitiya]. It is rather difficult to quantify the benefits that would accrue to electricity-using firms, however they will be significant only for firms where it is a major element in cost [frozen foods]. A reduction of Rs. 2.75 per kWh on the total system sales of 15,813 GWh in 2016 would save the economy Rs. 43.5 billion or \$ 435 million a year by 2016. Sri Lanka is increasingly hard-pressed in competing with China and India on garments and processed agricultural products. Therefore, even a small cost reduction can help marginal firms remain competitive. It will also eliminate the loss sustained by CEB and the drain on the budget it represents.

*Supply:* The same source estimates that about 9% of demand could not be satisfied in 2002 and was unserved as a result of blackouts. The resulting loss that year was estimated at Rs. 13.6 billion, or \$ 136 million. The loss was 1.5% of GDP. Since the cost of the first phase of the plant is \$ 400 million that benefit alone produces a good return on the investment.

*Reliability:* Much of the current power supply is hydro-produced. In drought years the available energy is reduced by 25% [1,000 to 1,200 MW out of 4,200 from hydro]. A coal-fired plant will provide much needed reliable base-load energy every year. Fluctuations in hydro-power can then be met by higher-cost standby diesel and gas-fired sources only when needed. This reliability is important for some industries and other activities and is equally important to keep average costs down.

On the whole, in the context of the reduction in cost and the ending of blackouts, the combined rate of return of the project is very high.

#### **Rural electrification**

Benefits calculated are based on 3 different studies, including a survey of 1,000 households in 33 locations in the country. The financial benefits are a reduction in

costs of 30-50% by using electricity instead of kerosene and candles for lighting and car batteries for TV sets. Since all kerosene is imported and heavily subsidized these private financial benefits translate into benefits for society as a whole, by reducing the budget deficit through savings on the subsidy. The balance of payments deficit is also reduced through lower imports of kerosene.

**To increase power co-generation and generation by local units and renewable energy.**

Currently studies are not available quantifying the benefits. However, the cost-benefit ratio of the proposed project will be large. For example the Deduru Oya project, discussed earlier. The costs of this project are entirely justified by the benefits from irrigation. The 8 GWh of electricity it produces are a bonus. Similarly, the bagasse used in many co-generation projects as fuel is a by-product of sugar mills. Therefore, fuel for these plants is virtually cost-free. These plants reduce dependence on expensive diesel power generation. Wind and solar energy are cost-competitive in Sri Lanka, in areas that are far from the national grid. As the private sector will be involved in the project, costs are likely to come down over time and increase benefits.

**11.7 Small and Medium-sized Enterprises [SME]; with special attention to Garments and Tourism**

SMEs have played an important role in production and employment in Sri Lanka in the past and are expected to play an even greater role in the future. However, at the same time they face many of the problems that SMEs elsewhere face; plus some special ones. For instance, the garment industry, the leading manufacturing sector, has many firms, especially SMEs, which are poorly equipped to face the end of quotas in a few months. Assisting SMEs to deal with their problems and increase output has a high priority. However, such assistance needs to be carefully designed. Firstly, because it has proved difficult in all countries to provide such assistance cost effectively. Secondly, because there are already a number of programmes and projects supported by several donors, active in this respect.

**11.7.1 Summary:**

Total estimated cost: \$ 224.9 million; Proposed to MCA: \$ 35.7 million.

This programme has 4 parts:

(1) *SME Bank, Trust Fund and Venture Capital Fund [with complementary Grant funding]*

Total cost: \$ 150-210 million; Proposed MCA funding: \$ 30.5 million  
of which:

- a. Trust Fund for Redundant Labour primarily in the Garment Industry:  
Total: \$ 20 million; MCA: \$ 10 million;
- b. Venture Capital Fund: \$ 25-50 million; MCA: \$ 10 million.
- c. Grant component [incl. TA to SMEs]: \$ 40 million; MCA: \$ 10 million

- d. Loans for on-lending: \$ 65-100 million; MCA: \$ 0
- e. Technical and economic survey and analysis of the garment industry:  
Total cost: \$ 0.6 million; MCA: \$0.5 million

Executing agency: Individual businesses and SMEs Bank, Trust and Venture Capital Fund

Benefits: restructuring the garment industry into a growing sector that may otherwise shrink: avoiding social and security problems of unemployed garment workers: laying the basis for providing capital, particularly equity capital to growing SMEs sectors, particularly those outside the Western Province.

Status: SME Bank to begin operating in 2005. Experienced private and restructured public banks, small venture capital funds and extensive TA (Technical Assistance) systems exists.

- (2) *SME Development of Federation of Chambers [FCCISL] and International Executive Services Corps [IESC]:* Total cost: \$ 5 million; proposed MCA funding, \$ 2.5 million

Executing agency: FCCISL & IESC

Benefits: 65% increase in output and employment by fourth year in selected industries and areas

Status: based on successful USAID project. IESC has experience elsewhere.

- (3) *Set up one District-level SME Development Centre* on an experimental basis.

Total cost: \$ 4.3 million for all Districts; \$ 0.2 million for one Centre

Proposed MCA funding: \$ 0.2 million

Executing agency: Ministry of Small and Medium Enterprises (SME) Development

Benefits: Improved service to the SMEs Sector

Status: New project

- (4) *Set up one Industrial Park, primarily for Apparel*

Total cost: Approximately \$ 5 million; Proposed MCA funding: \$ 2.5 million

Executing agency: Private investors or local organization of Apparel Association, local body and investors; Supervision: SMEs Bank

Benefits: Address serious infrastructure problem of up-country SMEs, particularly garments.

Status: New project similar to those set up by the BOI.

### **11.7.2 Description:**

Small and Medium Enterprises (SMEs) are estimated to contribute 50% of the country's GDP. For example:

- 95% of establishments in manufacturing are SMEs, producing 25% of output and providing 34% of employment.

- 50% of the nation's apparel and garment manufacturing is handled by individual entrepreneurs.
- More than 70% of the public bus transportation sector is dominated by individually owned bus and lorry operators.
- 80% of domestic trade activities are conducted by sole proprietorships and partnerships.
- 45% of tourism and recreation services are handled by family-owned businesses.
- 50% of the local construction industry is supported by small and medium enterprises.
- Small-holders in the plantation industry account for 65% of total tea production of the country.

The generally accepted definition in Sri Lanka of Small Enterprises is 5-29 workers and of Medium-sized ones is 30-149 workers. Other definitions are in use as well and different estimates of the role of SMEs exist. But it is clear that they play an important economic role and, since they are more labor intensive than large enterprises, they are especially important in providing employment. The Government has assigned a high priority to increasing their output, employment, exports and productivity.

**11.7.2.1 Problems of SMEs:** They suffer from many of the same problems as other SMEs around the world. The SMEs themselves give, as by far their highest priority, for better access to capital at lower cost, in the following categories: lower interest on loans [75%]; better access to credit [64%]; and availability of equity capital [51%]. The other major barrier to expansion and productivity is "market opportunity" [58%]. Experience elsewhere suggests that higher costs, lower quality than competitors, and lack of knowledge of markets impedes the capacity of SMEs to compete effectively. Outside analysts stress this aspect of limits on expansion: that they lack business or technical skills, or have marketing problems, and do not know how to obtain specialized services that can help them overcome these problems. Outside analysts and government officials therefore usually suggest special programmes to supply such BDS [Business Development Services]. But it has proved extraordinarily difficult to design programmes/ projects to provide subsidies for private BDS providers and equally difficult for governments to provide them.

**11.7.2.2 Programmes for SMEs and the Existing Gaps:** In Sri Lanka, a large number of donors have projects for assistance to SMEs and, the activities proposed to MCA are designed to fill important gaps and to pioneer in SME areas where neither donors nor commercial banks have taken the initiative. The ADB is providing a Line of Credit [\$60 million] to commercial banks for on lending to SMEs, and the IFC of the World Bank Group is mobilizing \$ 10 million to help banks lend to SMEs. Business Development Services [BDS] and related activities are being assisted by German [GTZ], U.S. Dutch, Norwegian and Swiss programmes, UNDP, ILO, IFC and ADB [estimated cost \$ 40-45 million]. Six BDS Centres were previously set up by the Ministry with ADB funds and their

functioning will be evaluated in 2005 to help develop an appropriate approach in this field.

All these activities leave some major gaps. First, with respect to a key problem facing the SMEs namely, availability of capital, existing programmes help facilitate loans but not equity investment. Part of the Proposal is for a new institution that can share in the greater risk involved in lending to SMEs, particularly those with no further assets to pledge, by providing equity capital. Second, it is not clear whether the ADB loan can provide grant funds to develop new forms of lending, not based on assets but on cash flow or business plans. Third, none can provide venture capital, essential for restructuring the garment industry. Fourth, none have grant funds to support the more rapid expansion of an industry like tourism, which requires investment in common assets [such as reef development] or the industrial estates/ industrial cities outside the developed Western Province, which may be needed for upcountry garment firms.

Indeed, it is generally recognized that the existing commercial banks have so far failed even to provide the loan needs of SMEs. As the IFC stated “Access to finance for SMEs is impeded by the limited capabilities of banks to lend to SMEs as well as the high costs of lending to this sector” and “Supply of equity financing for SMEs is very limited. At the end of 2002, there were only seven venture capital companies in Sri Lanka.” Finally the experience of the commercial banks with SME lending has not been good: the SME portfolio of one large bank shows that nearly one-third of its SME loans are non-performing. Moreover the commercial banks are, understandably, unwilling or reluctant to lend to SMEs in the garment sector or other industries whose future is uncertain at present. And the venture capital funds are too small to play much of a role in its restructuring.

**11.7.2.3 The Special Problems of the Garment Industry:** The special problems of the garment industry have already been referred to. It is the largest industry, accounting for roughly 40% of industrial production and two-thirds of industrial exports. Of the 540,000 employed in industries, 154,000 or almost one-third are in garments and another 75,000 in textiles, together accounting for more than 40%. Of these 175,000 are women, more than half the 272,000 women in industry. In addition, there are an estimated 100,000 Sri Lankans, again mostly women, employed in the garment industry abroad. Many are expected to lose their jobs and return home as factories in high wage countries close. They were profitable only because they had an assured market by virtue of quotas and by importing lower-cost labour from countries like Sri Lanka. The picture in Sri Lanka is complex. Sri Lankan labour costs are competing with countries such as China and India, which have lower labour costs. Electricity costs are relatively higher in Sri Lanka, as already noted, and internal transport and communications facilities are less effective. Much of the industry produces for the low end of the market where price is a major consideration. Since most fabric is imported, Sri Lanka has less flexibility in quickly responding to changing tastes in fabric and has to keep larger stocks on hand. This is reflected in costs.

Sri Lanka can boast of the best labour practices in Asia, as recognized by the EU. Another advantage is that a large proportion of the companies have developed ties with their purchasers, produces specialty products for a niche market [particularly in lingerie] and would therefore, continue to be competitive. A third advantage is that much of the industry has a good record with respect to on-time delivery. It is less affected than some competitors by political unrest, general strikes and frequent labour trouble. The problem is with the smaller firms, SMEs, who are less likely to have marketing tie-ups and established names. The biggest problem will be for the firms that were established with subsidies and quota allocations in the less developed areas under a “200 garment factory” programme to disperse units all over the country.

Informed observers say there are several categories of garment firms that will be differently affected by the new highly competitive environment;

- [i] The “phantom” firms, those that pocketed subsidies and/or sold quotas, without actually operating, will lose future ill-gotten gains without creating problems for others. The size of this group is unknown, because their income depends on concealing their true situation.
- [ii] There is another group that actually operates, has workers and exports, but is so high-cost, because of outdated machines, bad locations or poor management that they survive only because of quotas and cannot be competitive in the new environment. They need to shut down as soon as possible, pay their workers, sell their assets to the highest bidder and their debts to be written down or off. It is in virtually everyone’s interest that this be done as quickly so that further resources are not wasted while they increase their debts, failing to pay workers or creditors. Estimates of the size of this group seem to be in the range of 10-25%.
- [iii] Another operating group can survive, but only if their costs are brought down or their quality and marketing improved by improvements in infrastructure – under new programmes for less-developed areas- or new management, or possibly additional investment. Many of these firms will need to be merged with, or sold, to firms that have an assured market, good management and enough capital. But their debts need to be written down, or some of their labour paid off, or their capital written down before they can be sold off to new management. Another 20-40% of firms are in this category.
- [iv] and [v]The next group can survive and make adjustments to the new situation without any help or they are already fully competitive and need make no adjustments to be profitable without quotas [such as firms that sell in the non-quota markets]. An estimated 25-40% are in these 2 groups.

There are currently no institutions to deal with groups [ii] and [iii]. Sri Lankan domestic venture capital firms are too small to deal with more than a small part of the problem and they are not particularly interested in the garment industry. Also it seems to be too small an economy to be of interest to most foreign venture capitalists. If the number of firms in these groups that need some restructuring is small, then the banks and other existing institutions could take care of the problem.

Eventually the firms that cannot compete will go bankrupt; their workers may receive some compensation; their creditors will have to write off their debts; their owners will lose [most of] their investment; and their assets may eventually be bought up or disappear. But the garment industry is so important to the country, as it has so many women workers who cannot find other work given the unemployment situation [and the expected return of garment workers from other countries] that this process will be too slow and too painful to be feasible. It will be a severe strain on society and its resources if an estimated 100,000 or more workers become unemployed and are joined by another 100,000 returning workers. Together with their dependents there would be about one million people without income, or much reduced income over a period of a few months or a year.

**11.7.2.4 The SME Bank, Trust and Venture Capital Fund:** The Government plans to set up a SME Bank to be the key agency to help the SMEs to cope with capital needs not provided by the commercial banks. The Bank will also act as a Trust Fund and a Venture Capital fund, and will have a grant-making arm [most likely as a single institution, with different departments]. The Trust and Venture Capital funds will initially concentrate on the garment industry, because of its special problems.

The first task of the SME Bank, Trust Company and Venture Capital Fund will be to restructure the *garment* industry:

- Helping all firms that can become viable by lowering costs or improving quality to remain competitive;
- Restructuring firms and selling them off, preferably to existing firms, that can keep their assets and workers employed;
- Assuring that all workers who ultimately lose their jobs receive reasonable compensation [a major purpose of the Trust Fund].

More details are provided below. The aim of the restructuring is to build on the foundation of firms that are now at the forefront of their particular specialty to develop a garment industry that grows again. The restructuring is a necessary step to move the industry upstream, to use the assets of firms that are no longer competitive for firms producing higher quality or lower cost specialty products where Sri Lanka can continue to compete despite its distance from the market.

The first step in the restructuring process is a careful technical and economic survey of all the firms in the industry in order to get an understanding of the category into which each firm can be fitted. It will be quite easy to see how many phantom firms there are, but far more difficult to determine which firms need to be closed down and which have a chance of becoming competitive, if only with substantial change imposed from the outside. Equally difficult will be recommending a package of change for each firm to the management of the firm and to the SME Bank. A first class team will be needed. Separate funding has been suggested for this task to assure that a first class team is employed.

While the two industries are seen quite differently, the task with respect to another key industry the *tourist industry*, is quite similar in some respects, though less urgent: to help move it up-market and to grow more rapidly. Growth in the number of tourists has been slower than in comparable countries [Malaysia, Maldives]. More important, Sri Lanka is largely a mass-market tourist destination, with average spending per tourist being quite low. Much of what needs to be done must come from the private sector, but some important elements cannot be addressed by hotels or other tourism operators, particularly not by small ones: it needs to be done by the state, at least initially and/or in part. The improvement in roads, electricity supply and drinking water, discussed earlier will also help the tourist industry. But it is focused on the less-developed districts, not those where tourism is concentrated and flourishing.

The grant and lending arm of the SME Bank will offer regional tourist operators on a matching basis, both loans and grants to develop common tourist facilities: restoring reefs that have been largely destroyed, and with it the diving and snorkeling business [e.g. Hikkaduwa]; sound-and light shows [e.g.; Sigiriya]; and upgrading facilities at tourist destinations [e.g.; Galle Fort]. Income from tourism should be growing at a rate of 7-10%, as it has in other countries by a small increase in arrivals and a bigger increase in earnings per day.

There are other industries where SMEs are important that have substantial potential for growth. By combining lending that is not based on assets with venture capital and grants, the Bank can help solve a key problem in the SME sector. But it can do so quickly only if it acts as a funder, not a retail banker. It would take years for such an entity to build up staff throughout the country and at headquarters that can make loan and investment decisions at reasonable cost, that can avoid a large proportion of NPL [Non-Performing Loans], collect repayments and provide technical assistance to small- and medium-sized firms. This area has assumed a new urgency. It will therefore be structured to lend, to provide venture and equity capital and grants to existing institutions, normally on a joint venture basis. In general it will be a minority partner, so that the institution making the decision bears the larger part of the risk. But unlike other on-lending institutions it will be prepared to take part of the risk, and it will be ready to participate in venture capital funding that is inherently more risk –but potentially more profitable– than asset-based loans. It will also have a Trust Fund to assist in compensating workers in cases where reducing the labour force is essential to create a viable business. To be able to carry out these functions, however, it needs grant (seed) funds. That is the basis of the Proposal to the MCA.

There are three other, smaller, components to the SMEs Proposal.

#### **11.7.2.5 SMEs Development programme of the Chambers and the IESC**

The International Executive Service Corps (IESC)- which makes the services and expertise of retired executives and industry specialists available, could be deployed as only their everyday expenses need to be met. This organization can make available persons with a wide area of expertise to help firms improve management

and upgrade technology. Their joint proposal is for a very large undertaking, with some 1,000 IESC Executives working with the Chambers and the firms in all industries throughout the country and doing everything from suggesting overall economic policies to advising on the technical problems of the firm. Proposed to the MCC is a more modest approach for the next 4 years, limited to 1 or 2 industries and at first focusing on the less developed Districts where the proposed programme is centered. If this works well, expansion will be relatively easy. Because there are so many sources of technical and managerial advice to SMEs, but still many gaps to fill, there is further work to be done to make additional technical assistance most useful.

It is our view, that this effort should also concentrate on the SME firms in the garment and tourism industries. Both are important, both have management and marketing problems where experts could help and both are fields where US-based executives have experience. Of course, the ultimate selection will need to be done in consultation with the two sponsors i.e. the Chambers and IESC.

**11.7.2.6 SMEs programme of the Ministry of SMEs:** The newly set up Ministry of SME Development will be the major government agency in the SME field. Its programme addresses the problem of coordination in the SMEs sector, which hitherto required to seek permission from different government agencies for their activities. The Ministry proposes creating a “One-stop-shop” in every District. If this can be done effectively and cheaply the benefits can be considerable. The Proposal to the MCA is to fund one such District centre, to be set up in one of the less developed Districts. Once the concept is realized, it would need to be replicated.

**11.7.2.7 Industrial Parks for the Garment Industry:** A proposal by JAAF [Joint Apparel Association Forum] addresses another important problem of SMEs, particularly in the less developed Districts and areas: the lack of infrastructure, service providers, suppliers and purchasers in one place. There is also the problem of obtaining the land needed. This problem is particularly serious for the garment industry if it is to move upstream. It was less significant when it was producing simple products like t-shirts where timely delivery of high quality products mattered less. In the new competitive scenario, it becomes important for firms to be able to set up or expand quickly, to have reliable infrastructure available and a concentration of support facilities.

The proposal is for setting up industrial parks outside of the Western Province, focusing on SME, garments and supplying industries. They would be set up on land the Government controls, most probably land owned by the Railways. The parks would provide complete infrastructure facilities, including treatment of effluents, and some buildings on a rental basis, as well as such services as banking. These parks could make a considerable difference in helping the garment industry continue to be an important sector in Sri Lanka despite the problems it faces. The MCA Proposal therefore includes one such Industrial Park to be located outside the

developed Western Province, in a site to be selected in consultation with the JAAF and Provincial Council administration.

The JAAF would also need to find an investor who could supplement the funds provided by MCA. This could be a group of firms; an operator of industrial parks elsewhere; a private investor; or a semi-government entity in the region.

### **11.7.3 Status**

There are large ongoing efforts to provide credit and Technical Assistance to SMEs. The number of donors involved is large and so is the number of projects. The four programmes proposed to the MCA are new, designed to fill gaps, and are based on the experience in both Sri Lanka and other countries. They are;

- (a) The organization, functions and method of operation of the SME Bank is now being developed by the Government. It is to be functional in 2005.
- (b) Work on the joint project between the Chambers and the US- IESC has been ongoing for sometime and, is based on the extensive experience of IESC in other countries.
- (c) Government has had departments dealing with SMEs for some time, so the staff of the Ministry of SME has extensive experience. The design of the proposed programme shifts the emphasis from regulation and control to support and development, and joint partnerships with the private sector.
- (d) The garment industry is keenly aware of the increased challenge it will face in 2005 and has jointly tried to meet it. It has recently sent a mission to North Carolina to set up joint ventures with US fabric suppliers and with the textile institutions in that area. They are now proposing to address one of the serious problems the industry faces outside Colombo/Western Province. It is drawing on the experience of the Board of Investment in the Colombo area.

### **11.7.4 Executing Responsibility:**

- [i] The SME Bank is a new institution, which will play a key role, not only in providing capital, but also in channeling other assistance to SMEs. It will be responsible for the most important aspects of the SME programme.
- [ii] The IESC always works closely with a local institution and its partner in Sri Lanka is the Federation of Chambers. They will execute the project, working with the Federation for the industries chosen. It will therefore be an entirely private sector effort.
- [iii] The District Level SME Development Centre will be set up and operated by the Ministry of Small and Medium Enterprise Development until there is an SME Authority.
- [iv] The Industrial Park can either be set up and operated by a private firm or a group of private firms or by the Apparel Association [JAAF] or by a local government entity, depending on who is prepared to make some investment in the Park and to operate it.

**11.7.5 Targets and Costs:** In this programme only intermediate targets and rough estimates of costs can be given until the programme is developed further in the next

few weeks, in consultation with the relevant institutions. More detailed and accurate estimates will be available by the time the Compact with the MCC is ready to be negotiated.

[i] By 2005, the SME Bank, Trust and Venture Capital Fund will be operating and making its first no collateral based loans and equity funding. They will most probably be done through existing institutions. The SME Bank's target is to develop instruments not based on asset lending. By 2009, it is to have disbursed to SMEs at least the equivalent of \$ 10 million with an NPL [Non-Performing Loan] ratio of less than 15% and declining.

Loan funds spent under the Bank and Trust will come primarily from the existing banks and the on-lending programmes of the ADB and other donors. MCA funds will be used for the grant element, crucial to make the Bank and Trust work and from the TA projects of other donors. The biggest expenditure will be for the buy-out of excess labour in the garment industry. This will be a one-time expenditure without which the needed drastic restructuring of the garment industry is untenable. The cost cannot accurately be estimated at this time, but the assumption is that the greater part of the cost will be for firms which are going through bankruptcy. Operating firms are legally required to provide greater compensation to workers.

[ii] The Chambers-IESC effort:

- by early 2006 there will be a total of at least 40 executives working with the 2 industries selected and,
- by 2009 output and employment will have increased on average by 65%.

Total cost and needed MCA funding are estimated on the assumption that 90% of the people involved will not be paid for their services. Their free labour is shown in the total cost as their contribution to the effort.

[iii] The Ministry of SME by early 2006 will have one District Office set up under the MCA providing services to SMEs in that district.

[iv] The industrial park will be in operation by early 2006 and by early 2007 will have attracted firms employing about 5000 people. By 2008 it will be breaking even and by 2009 showing a substantial return on capital.

The assumption is that the National government will contribute the land, that some of the infrastructure will be built under other programmes proposed and that private or other sponsors will invest as well.

**11.7.6 Benefits:** Until further discussions are held with the sponsors and other stakeholders' details on the steps to be taken and calculation of benefits would be mere speculation.

## 11.8 Capacity building

Sri Lanka had the reputation of an efficient civil service with strength and integrity. Over the years standards have declined for a variety of reasons. Difficulties now exist in adequately staffing regional administration at Provincial, District and Divisional levels. With ongoing decentralization, the work of these regional or sub-regional local officers is more important, but they lack skills to effectively perform their tasks. However, even senior officers also lack advanced professional knowledge and requisite training. As a result, Government is less effective in carrying out its work, and particularly its development programmes.

The proposed programme is to strengthen administration at both national and regional levels. It will provide training mostly in Sri Lanka but also in the US.

### 11.8.1 Summary:

Estimated cost: US \$ 24.6 million: Proposed MCA funding: \$ 19.6 million.

Executing agency: Ministry of Provincial Council and Local Government

Benefits: Better utilization of resources allocated for projects and government functioning in general.

Status: New project

### 11.8.2 Description:

The number of government officers has been estimated at 1.2 million. Of this total, about 10% is in the professional and managerial category. About 60% of them are in regional level and the remaining 40% at the national level. There is no dearth of personnel in the government service.

However, it has been found that the implementation of projects remains significantly weak in the country and other government functions are also often not performed well. As a consequence, a large sum of resources allocated by donors and government for development projects are not utilized. Utilization of donor assistance has been around 13% on average during the last decade. In some projects more than 40% of funds have not been utilized. At the regional level, administrators are also weak in performing other functions.

Many reasons have been attributed for this situation, of which the inefficiency of professionals in the public sector is a major one. They are not trained in IT related techniques. Skills in accountancy, tender procedures, service delivery, and public relations are weak. No in-service training in management is provided. Many professionals do not have access to advanced academic degrees in relation to their responsibilities. Many officers have not been exposed enough to the international experiences in developed countries.

Under these circumstances, there is a strong need to implement a skills development programme for building of capacity of professionals, both at the national and regional levels. We expect to utilize MCA assistance for this purpose in the following manner:

### 11.8.3 Status: New project

#### 11.8.4 Executing Responsibility:

The Ministry of Provincial Councils and Local Government is the implementing agency of the project. At the sub national level, provincial councils and local government agencies also participate in the implementation of the project.

#### 11.8.5 Targets and Costs:

- (a) Conducting 24 training programmes in the country: three (3) training programmes for each province. The areas of training are as follows-
- Project Evaluation and Project Management
  - Information Communication Technology- computer skills
  - Office management, good governance and productivity improvement

The average cost will be \$ 1.2 million per province over 3 years and the average will be \$ 2.4 million spent a year according to the schedule given in table 7.

**Table 7**  
**Cost for Local Training from 2005-2008**

Year	2005	2006	2007	2008	Total
Cost in US \$	1,200,000	2,600,000	2,600,000	2,600,000	9,600,000

The total number to be trained is 3000 of the approximately 6000 Professionals in provincial and district administration.

- (b) Cost of foreign training of 100 young professionals - US \$ 15 million

#### 11.8.6 What Needs to be Done:

US experts are required to organize in-service training in the country in the area of productivity improvement, information communication technology (ICT), accountancy, e-governance, procurement procedures, service delivery, office management, project management (identification, implementation, evaluation, and monitoring), environmental impact assessment (EIA) and gender issues.

About 100 young professionals need to be trained in the USA. Most would take postgraduate studies and some would participate in shorter courses, and a very small group would be supported to obtain their PhDs. Those thus trained are expected to become the teachers for future in-service training or to occupy key posts in government policy analysis and decision making processes.

#### 11.8.7 Benefits:

- Maximum utilization of resources allocated for projects
- Sustainability of MCA and other projects
- Ensure enhanced institutional capacity at the local authority level.
- Better planning and monitoring of development activities at the regional level
- Improved quality and productivity of the public service

## **12. Consultation Process**

Discussions were held with NGOs, National and District Chambers of Commerce and Industry, including the principal national organizations of private enterprise, Government officials and community based organizations. Radio talks and TV discussions were also held to obtain views on the causes of poverty and what needs to be done to reduce it and to increase growth. This consultation process was undertaken by the Ministry of Provincial Councils and Local Government and the Department of Development Finance. The list of organizations consulted is in Appendix 1. Several government ministries, semi-government and private organizations submitted specific written proposals. The Department of Development Finance in turn discussed these proposals with the authors and others during the writing of this Concept Paper. The outcome of these discussions is detailed in the Proposal.

The essence of the consultation process was that it was being done in stages. The first stage was undertaken before any writing was done. The second round of consultations took place after specific programme proposals had been submitted by ministries and private sector organizations and took place while this Concept Paper was being written. The Proposal that has emerged from these wide-ranging discussions is now being submitted to the MCC. Further consultations are planned while MCC reviews this paper and after comments have been received on this Concept Paper. These consultations will be designed to make sure that the general approach is widely supported in society.

In addition, private organizations will be widely involved in the actual execution. For instance, a cornerstone of the programme - the rehabilitation of 10,000 small tanks and anicuts- will be executed by the beneficiaries themselves. On a parallel track, the Poverty Reduction Strategy is being prepared and will also receive a lot of consultation before it is finalized. Both documents are based on a common strategy.

## **13. Implementation**

Even the best-designed programmes will not give much benefit unless they are well executed. More important is to assure that the programmes are responsive to local needs, to truly help the poor and the marginalised. To achieve these objectives, the execution has been decentralized to the maximum extent possible. For decentralization to work, there needs to be careful after-execution monitoring and before execution transparency. This has been provided for.

Decentralization is also important for ownership, which in turn is crucial to assure maintenance. This is addressed below.

Finally the Government and other national organizations need to make their contribution. They are generally the ones with technical and managerial competence and experience. The individual programmes often rely on them to provide this competence to the implementing bodies. In addition they have an important role to

play in deciding on policies and principles for implementation and to monitor the success or failure of Provincial bodies.

### **13.1 Executing Institutions**

The programmes will be executed on a decentralized basis by Government agencies, private firms or trade associations [Chambers and IESC for SME] or by both private and local public sector groups [e.g. smaller electricity projects]. Some efforts will be carried out by semi-autonomous corporations [e.g. Ceylon Electricity Board].

A Cabinet sub Committee co-chaired by the Ministers of Foreign Affairs and Finance and Planning has also been set up for overall coordination and monitoring of the MCA programme.

At the National level, a Steering Committee has been set up, under the coordination of the Ministry of Finance and Planning. This Committee will be strengthened with all relevant line ministries and Provincial Chief Secretaries. It will be chaired by the Secretary, Ministry of Finance and Planning. Provincial and District-level committees will be set up for implementation of programmes at Provincial and district level. These steering committees will be responsible for monitoring the execution of the MCA programme and its targets and the timely submission of monitoring reports.

The Focal Point of the MCA project will be the Project Coordinating Unit of the Department of Development Finance of the Ministry of Finance and Planning, which will be assisted by the Economic Affairs Division of the Ministry of Foreign Affairs.

## **14. Monitoring**

District level Steering Committees will consist of representatives from NGOs, regional chambers, local authorities, and government officials of the relevant ministries and the Divisional Secretaries. Committees are expected to meet once a month and prepare reports indicating issues and identifying remedial action. Such reports will be sent to the Project Coordinating Unit of the Department of Development Finance in the Ministry of Finance and Planning, which will prepare a detailed report for the two Committees (Ministerial level and Secretary level) with regard to progress in implementation.

## **15. Commitment**

The Government of Sri Lanka appreciates the inclusion of Sri Lanka in the MCA programme. This Concept Paper prepared by the focal point, the Department of Development Finance of the Ministry of Finance and Planning, has been formulated in line with guidelines indicated by the MCC. In preparation of these proposals rural development has been emphasized as a means for overall economic growth. It

has also taken into account the importance of consultations with all stakeholders of society in developing project ideas. Government is committed for successful implementation of the project together with all stakeholders who are considered as co-owners of the project.

**Consulted Government and Semi -Government Institutions**

1. Ministry of Finance and Planning
2. Ministry of Foreign Affairs
3. Ministry of Small & Medium Enterprises
4. Ministry of Agriculture, Land, Irrigation & Livestock
5. Ministry of Urban Development and Water Supply
6. Ministry of Provincial Councils and Local Government
7. Ministry of Industrial Development and Investment Promotion
8. Ministry of Tourism
9. Department of Development Finance
10. Department of National Planning
11. Department of National Budget
12. National Council for Economic Development (NCED)
13. Institute of Policy Studies
14. Central Bank of Sri Lanka
15. People's Bank

**Consulted District Chamber of Commerce & Industry; Private Firms & Associations**

1. National Council for Economic Development,  
Colombo 01
2. Chamber of Small Industries,  
Colombo 01
3. National Prawn Farmer Association,  
Colombo 01
4. Ceylon Chamber of Commerce,  
Colombo 02
5. Construction Association of Sri Lanka,  
Colombo 01
6. Joint Apparel Association Forum,  
Colombo 02
7. Ampara District Chamber of Commerce & Industries,  
Ampara
8. Vijay Construction & Co.,  
Batticaloa
9. Auto Traders (Kandy) (Pvt) Ltd.,  
Kandy
10. Star Industrial Services (Pvt) Ltd.,  
Nayanmar Kadu, Jafna
11. CHASP Hayley & Co. Ltd.,  
Galle
12. M.R. Thassim & Co.,  
Hambantota
13. Asoka Jewellery Mart,  
Jaffna
14. Fabnal Industry,  
Paragastota

15. Lucky Lanka Dairies,  
Kamburupitiya
16. Monaragala District Chamber of Commerce and Industry,  
Buttala
17. Ran Lanka,  
Ratnapura
18. RMA Energy Consultant,  
Colombo 01
19. R. R. Group (Pvt) Ltd.,  
Trincomalee
20. Engineering Contracts,  
Vavuniya
21. Euroville Investment,  
Jaffna

**Consulted Civil Society Organizations**

1. Lanka Mahila Samithi,  
Colombo-02.
2. Center for Women’s Research,  
Colombo-05.
3. Sarvodaya Shramadana Sangamaya,  
Moratuwa.
4. Population Service Lanka,  
Colombo-05.
5. Center of Human Development,  
Thalangamuwa.
6. Dairy Development Association,  
Colombo-08
7. Fruit & Vegetable Association,  
Eastern Allied, Narahenpita.
8. Central Province Women’s Chamber of Small Industries & Commerce,  
Kandy.
9. Galle District Chambers of Commerce,  
Oroppawatta Galle.
10. Kegalle district Chamber of Commerce & Industry,  
83/3, Colombo Rd, Kegalle.
11. Matara District Chamber of Commerce & Industry,  
Matara.
12. North Central Province Chamber of Commerce & Industry,  
3011, Stage 3. Anuradapura.
13. Southern Province Chamber of Commerce,  
Matara.
14. Hambanthota District Chamber of Commerce,  
Hambanthota.

15. Wayamba Chamber of Commerce & Industry,  
Kurunegala.
16. Chamber of Commerce & Industries of Uva Province,  
Badulla.
17. Chamber of Commerce & Industries of Central Province,  
Kandy.
18. Uva Govijana Kendraya,  
Bandarawela.
19. Uva Praja Sahana Sanwardana Padanama,  
Uva Praja Sahana Sanwardana Project, Badulla.
20. Janatha Sanwardana Padanama,  
Kavuduwawa, Atakalanpanna.
21. Environment Conservation Foundation,  
Mirigama, Gampaha.
22. Environmental Protection & Scientific Exploration Society,  
Kandy
23. Environmental Protection Youth Front,  
Galle.

**Consulted International Institutions**

1. World Bank
2. International Monetary Fund
3. USAID
4. Asian Development Bank
5. The Competitiveness Initiative