

ASIAN DEVELOPMENT BANK

TAR: SRI 36168

TECHNICAL ASSISTANCE
(Financed by the Japan Special Fund)

TO THE

DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA

FOR PREPARING THE

PUBLIC SECTOR RESOURCE MANAGEMENT PROJECT

August 2002

CURRENCY EQUIVALENTS

(as of 15 August 2002)

Currency Unit	–	Sri Lanka Rupee/s (SLRe/SLRs)
SLRe1.00	=	\$0.0104
\$1.00	=	SLRs96.15

ABBREVIATIONS

ADB	–	Asian Development Bank
BOI	–	Board of Investment
CSPU	–	country strategy and program update
GDP	–	gross domestic product
IMF	–	International Monetary Fund
MOF	–	Ministry of Finance
PEMS	–	public expenditure management system
RMAC	–	Revenue Management Advisory Council
SMESDP	–	Small and Medium Enterprise Sector Development Program
TA	–	technical assistance
VAT	–	value-added tax

NOTE

In this report, "\$" refers to US dollars.

I. INTRODUCTION

1. During the 2002 Country Strategy and Program Update (CSPU) mission, the Government of the Democratic Socialist Republic of Sri Lanka (the Government) requested Asian Development Bank (ADB) technical assistance (TA) to implement tax administration reforms announced in its 2002 budget and to implement the recommendations of the ongoing ADB-funded TA to strengthen the public expenditure management system (PEMS).¹ The CSPU mission responded favorably to the Government's request and included an allocation for the Public Sector Resource Management TA in Sri Lanka's 2002 program.² During 28 May – 7 June 2002 ADB fielded a fact-finding mission,³ which met with key government agencies involved in the country's budgeting and revenue management as well as representatives of the International Monetary Fund (IMF) and the World Bank. The fact-finding mission reached agreement with the Government on the goals and scope of the assistance, implementation arrangements, cost estimates and financing arrangements, and the detailed terms of reference for the consultants.

2. The TA continues ADB's previous support for strengthening Sri Lanka's financial management controls, with the PEMS TA focusing on the expenditure side and the Small and Medium Enterprise Sector Development Program Loan (SMESDP)⁴ partly addressing the revenue side. The TA will help the Government to improve public sector efficiency and achieve its ambitious fiscal deficit targets, as outlined in the poverty reduction partnership agreement.⁵

II. ISSUES

3. Sri Lanka's fiscal deficits of roughly 10% of gross domestic product (GDP) in the last two years are unsustainable. The prevailing inefficiencies in both tax collection and expenditure management are affecting productive public investment and poverty reduction. Revenue mobilization has fallen far below the potential collection levels for the country's present stage of development. The ratio of tax to GDP has declined steadily, from 17.8% in 1995 to 14.6% in 2001. The falling tax ratio reflects both inadequacies in the tax structure and deficiencies in tax administration. Although Government expenditures are generally more than 25% of GDP, budgeting procedures are weak in terms of allocating resources to achieve medium-term policy objectives. Public investment, which plays a major role in alleviating poverty, has been declining as a proportion of GDP, from 6.9% in 1995 to 5.3% in 2001.

4. The large fiscal deficits have drained foreign reserves and swollen the national debt. Because of the fiscal imbalances, official reserves dropped from \$1.6 billion at the beginning of 2000 to \$918 million in January 2001—about 5 weeks of import coverage—at which point the Government was forced to float the currency. Without this important nominal anchor, continued budget deficits will have inflationary effects. The debt-to-GDP ratio has been increasing continuously since the mid 1990s and reached 104% of GDP in 2001. The effect of the budget deficits is most apparent on the level of domestic debt, which has risen to 54% of GDP. The

¹ ADB. 1999. *Technical Assistance to the Democratic Socialist Republic of Sri Lanka for Strengthening Public Expenditure Management Systems*. (TA 3301-SRI). Manila.

² The TA first appeared in *ADB Business Opportunities* (Internet edition) on 30 April 2002.

³ The mission consisted of Joseph Zveglic, Economist/Mission Leader, Sri Lanka Resident Mission; Shenuka Chanmugam, Economist, Sri Lanka Resident Mission; and Sanath Jayanetti, staff consultant.

⁴ ADB. 2001. *Report and Recommendation of the President to the Board of Directors on Proposed Loans, Partial Credit Guarantee, and Technical Assistance to the Democratic Socialist Republic of Sri Lanka for the Small and Medium Enterprise Sector Development Program*. (Loans 1894/1895/1896). Manila.

⁵ ADB. 2002. *Poverty Reduction Partnership Agreement between Democratic Socialist Republic of Sri Lanka and the Asian Development Bank*. Manila.

resulting increase in real interest rates has been crowding out private investment. The Government recognizes the burden that continued high budget deficits places on the macroeconomy, and has initiated measures to contain the problem. For 2002, the Government plans to reduce the deficit, excluding grants and privatization proceeds, to 8.5% of GDP from the 10.9% realized in 2001. This will be achieved mainly through revenue mobilization measures, but current and capital expenditure are also to be kept in check.

5. Over the years, ADB has been supporting the Government's efforts in public expenditure management through loan and TA. The most recent assistance is the TA to support a comprehensive modernization of the PEMS to improve fiscal discipline and expenditure control, including strategic allocation of resources consistent with policy priorities, and operational management. To improve resource allocation, the Government intends to develop a full set of estimates for all components of public outlays over a multiple year horizon. Current activities under the PEMS TA include the development of the macroeconomic model to enhance the forecasting and planning capabilities of the Government and the adoption of an output-based and multiyear planning and budgeting approach in the public sector. The Government is taking steps to integrate the public expenditure information systems across the Government, which will enable better monitoring of disbursement, physical implementation, and economic targets, which will feed into the rolling multiyear investment plan.

6. The main innovations in the 2002 budget are on the revenue side. Tax reforms are being introduced to simplify administration and widen the tax base. The 12.5% Goods and Services Tax and the 6.5% National Security Levy will be combined into a new value-added tax (VAT) that covers a broader range of goods and services on 1 August 2002. The VAT will have two tiers (10% and 20%) with fewer exemptions than the previous system. The move to a single tax is expected to reduce distortions and improve administration. There are also plans to expand the coverage of the VAT to include the retail sector in 2003. The Stamp Duty was abolished, but to partly offset the revenue loss, two new taxes were introduced in areas previously subject to Stamp Duty: (i) a temporary debit tax was added to some financial transactions (e.g., checks, credit cards, and traveler's checks) and (ii) a port and airport development levy was added to imports. The tax threshold for personal income taxes was raised and the number of tax brackets was reduced from four to three. Interest and dividends will not be included as personal income and will be taxed at a flat rate of 10% to simplify administration. The 20% surcharge on corporate income tax was removed, and the capital gains tax abolished to encourage private-sector investment. Corporate taxes will be simplified to two rates with a view to raise compliance and stimulate business activity. The top rate of corporate income tax will be reduced from 35% to 30% in 2003 and then to 20% in 2004. The surcharge on import duties was reduced from 40% to 20%, and protective taxes and import licenses for rice, chilies, onions, potatoes, and edible oil—the main agricultural staples—will be replaced by a 60% duty on the import of these goods.

7. To broaden the revenue base, exemptions, concessions, and tax holidays given to companies through the Board of Investment (BOI), which have distorted the tax system in the past, will be reduced. Actions have also been taken to strengthen the large taxpayers unit, the collection of arrears, and registration of new taxpayers to address the need for improved tax administration. According to the IMF, the impact of tax administration weaknesses especially related to not incorporating goods and services tax taxpayers into the large taxpayers unit accounted for a revenue slippage of 0.2% of GDP. Coordination within and among revenue collecting agencies, computerization, lack of skilled people, and the incentive structure are to be addressed in achieving a more efficient and effective tax administration. The Government will establish a new revenue authority that will include tax administration professionals and

representatives of the private sector. The revenue authority will combine the functions of the current inland revenue, excise, and customs departments, as well as taking over the tax incentive functions of the BOI.

8. Experience from other countries shows that the benefits from establishing a revenue authority depend on the country situation and the political commitment behind the change. Autonomous revenue authorities generally have more flexibility in their remuneration, hiring, and firing policies; have independent budgets; and are better protected from political interference. However, even though a country may need to upgrade the efficiency and effectiveness of its tax administration, there are risks to pursuing the revenue authority model in the reforms. Continued political interference and restructuring of salaries without flexibility in hiring and firing policies may only worsen the situation. Furthermore, establishing an autonomous revenue authority may contribute to fragmentation of the civil service. Tax policy and tax administration are interrelated. Ambitious tax policies can complicate tax administration, while ineffective tax administration can undermine tax policy. Since the sustainability of a tax reform agenda hinges on coordination of these activities, it is important to assess the Government's capacity for setting tax policy when establishing the revenue authority in Sri Lanka.

9. As announced in the 2002 budget speech, the Government appointed the Revenue Management Advisory Council (RMAC), which includes the former commissioner-general of inland revenue, the former director general of customs, and five members from the private sector. The RMAC has the mandate to develop the plans for establishing the revenue authority.

10. ADB's involvement in the country's tax reform efforts began as part of the policy dialogue under the SMESDP. In response to a request from the Government in mid-2001 for support in tax and customs administration reform, ADB held several discussions with IMF and the Government to identify areas of ADB assistance to modernize the tax system. The Inland Revenue Department with assistance from IMF and ADB held a management workshop in June 2001. Participants identified key impediments to efficiency in the framework for tax policy and administration. IMF organized a workshop during 20–24 August 2001 to reach an understanding with the Government on a set of tax policy measures to be announced in the budget. The Government's recent efforts in simplifying the tax system and rationalizing archaic and inefficient taxes arise from these recommendations and were supported through the SMESDP.

11. Although some improvement has been made in tax policy reforms, the tax base is narrow because of avoidance, evasion, and leakage. Furthermore, different revenue regimes applied to enterprises under BOI aggravate the problem. Substantial strengthening of the administrative capacity is required to achieve optimal gains from tax policy reforms. The integration of the functions of inland revenue, customs, and excise departments will help the economy move toward a nondistortionary tax system with reduced revenue leakage, lower compliance costs for business, and lower administration costs for the Government.

III. THE TECHNICAL ASSISTANCE

A. Purpose and Output

12. The TA will help prepare a public sector resource management project, suitable for ADB financing, which will assist the Government to lower the fiscal deficit by establishing a more effective and efficient fiscal administration through strengthening institutional capacity for revenue mobilization and expenditure management. The project will assist the Government to (i) establish an autonomous revenue authority, combining the existing inland revenue, excise, and

customs departments; and (ii) implement streamlined budgeting procedures and expenditure control processes within the Ministry of Finance (MOF). The project will use ADB's sector development program modality, as the project scope is likely to cover (i) TA, such as long-term advisers and capacity building; (ii) direct investments, such as information technology systems; and (iii) budgetary support for adjustment costs, such as transitional tax shortfalls. As the PEMS TA can support components of the proposed project relating to public expenditure management, the consulting services under this TA will focus on the preparatory work needed to establish the revenue authority.

B. Methodology and Key Activities

13. The TA will support the preparation of a detailed implementation plan for establishing the revenue authority. The TA will adapt international experience in tax reforms to the Sri Lankan context, under the guidance of RMAC and in close collaboration with tax administrators in the inland revenue, customs, and excise departments. The scope of work will cover three broad areas: (i) revenue administration, (ii) human resource management, and (iii) information technology (IT). The TA will prepare the draft project documents, including incorporation of inputs prepared by the consultants engaged under the PEMS TA.

14. Under the revenue administration work area, the main activity under the TA will be supporting the work of RMAC by developing an appropriately-sequenced implementation action plan for establishing the revenue authority. The plan will include monitorable milestones. As part of the process of developing the plan, the TA will (i) recommend short- to medium-term improvements in tax administration procedures, (ii) develop the legal framework and organizational structure for the revenue authority, (iii) prepare a business plan for the revenue authority, and (iv) promote dialogue between RMAC and current tax administrators in the design of the reforms. In the human resource management work area, the TA will assess the staffing, remuneration, and training needs of the revenue authority. In the IT work area, the TA will assess the IT needs of the revenue authority, as well as recommending short-term measures to enhance revenue mobilization.

C. Cost and Financing

15. The total cost of the TA is estimated at \$625,000 equivalent, comprising \$362,000 in foreign exchange costs and \$263,000 equivalent in local currency costs. The Government requested ADB to finance \$500,000 equivalent, comprising the entire foreign exchange cost and \$138,000 equivalent of the local currency cost. The TA will be financed on a grant basis from the Japan Special Fund, funded by the Government of Japan. The Government will finance the balance of the local currency cost, equivalent to \$125,000, which will cover the remuneration costs of counterpart staff, office accommodation, and local transport. The cost estimates and financing plan are given in Appendix 1.

D. Implementation Arrangements

16. MOF will be the Executing Agency for the TA. A consulting firm will be recruited in accordance with ADB's *Guidelines on the Use of Consultants*, using quality-and-cost-based selection, and other arrangements satisfactory to ADB for engaging domestic consultants. Shortlisted firms will submit full technical proposals. The consultants will provide about 11 person-months of international and about 19 person-months of domestic consulting services. The international consultants will have expertise in tax administration, human resource management, and IT systems. The domestic consultants will have expertise in inland revenue

administration, customs administration, tax law, human resource management, and information technology systems. The outline terms of reference for consulting services are provided in Appendix 2. The consultants will work in close association with RMAC, which will act as the steering committee for the TA.

17. The TA will be implemented over an 8 month period, beginning in November 2002 and to be completed by July 2003. MOF will be responsible for coordinating with other Government agencies to provide the necessary support to the TA consultants, including access to information, facilities, and relevant staff. RMAC, in its role as the TA steering committee, will make decisions on the recommendations and alternatives prepared by the consultants. The major reports are as follows:

- (i) An inception report giving the detailed work plan and initial findings will be submitted three weeks from the start of the TA. The report will be discussed at a tripartite review meeting with the participation of the Government, ADB, and the consultants.
- (ii) Status reports will be submitted monthly.
- (iii) A draft final report will be provided in the final month of the TA implementation period. The report will include the draft project documents, as indicated in the terms of reference. The report will be discussed at a tripartite review meeting with the participation of the Government, ADB, and the consultants.
- (iv) A final report that incorporates comments received on the draft final report will be submitted within two weeks of receipt of comments from the Government and ADB.

18. In support of the TA activities, MOF will provide (i) furnished office space for the consultants, preferably near the offices of RMAC, and access to a conference room; (ii) secretarial support; (iii) local communication facilities for the consultants in Colombo; and (iv) local transport for the consultants. The Government will release two full-time counterpart staff, one from Inland Revenue and one from Customs, to work as part of the revenue administration team. These full-time counterparts will provide an invaluable link between the work under the TA and the work under the subsequent loan. Additional staff will be available on a part-time basis, as necessary. The consultants will provide 15 printed copies of all reports to be distributed to the following: 5 copies to MOF, 7 copies to RMAC (one for each member), and 3 copies to ADB. In addition, the consultants will provide 3 electronic copies of all reports on CD-ROM at the completion of the engagement to be distributed to MOF, RMAC, and ADB.

IV. THE PRESIDENT'S DECISION

19. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$500,000 on a grant basis to the Government of Sri Lanka for preparing the Public Sector Resource Management Project, and hereby reports this action to the Board.

COST ESTIMATES AND FINANCING PLAN
(\$'000)

Item	Foreign Exchange	Local Currency	Total Cost
A. Asian Development Bank Financing^a			
1. Consultants			
a. Remuneration and Per Diem			
i. International Consultants	260.0	0.0	260.0
ii. Domestic Consultants	0.0	95.0	95.0
b. International and Local Travel	35.0	5.0	40.0
c. Reports and Communications	0.0	5.0	5.0
2. Equipment ^b	8.0	0.0	8.0
3. Consultation Workshops	0.0	12.0	12.0
4. Representative for Contract Negotiations	5.0	0.0	5.0
5. Contingencies	54.0	21.0	75.0
Subtotal (A)	362.0	138.0	500.0
B. Government Financing			
1. Remuneration of Counterpart Staff	0.0	85.0	85.0
2. Office Accommodation and Transport	0.0	25.0	25.0
3. Others	0.0	15.0	15.0
Subtotal (B)	0.0	125.0	125.0
Total	362.0	263.0	625.0

^a Financed by the Japan Special Fund.

^b Two desktop computers, one printer, one copy machine, and one fax machine.
Source: Asian Development Bank estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

1. A consulting firm will be recruited to provide about 11 person-months of international consulting services and about 19 person-months of domestic consulting services. The scope of work will cover three broad areas: (i) revenue administration, (ii) human resource management, and (iii) information technology (IT). The team leader will coordinate the tasks under these three work areas.

A. Revenue Administration Advisory Team

2. In the revenue administration work area, the consultants will assist the Government-appointed Revenue Management Advisory Council to develop an implementation plan to establish the revenue authority. The consultants will consist of an international tax administration adviser (5 person-months), a domestic inland revenue specialist (5 person-months), a domestic customs and excise tax specialist (5 person-months), and a domestic tax lawyer (3 person-months). The international tax administration adviser will be the team leader for the entire consultancy. The international tax administration adviser will have experience in establishing an autonomous revenue authority, as well as policy and implementation experience in value-added tax, income tax, and/or customs.

3. To support the work of the Revenue Management Advisory Council, the revenue administration advisory team will do the following:

- (i) Prepare an analysis of the trends and sources of tax and nontax revenue.
- (ii) Review the current organizational structures and institutional capacities of inland revenue, customs, and excise departments, as well as relevant areas of the Board of Investment (BOI), and recent recommendations for their reform. Recommend changes to tax administration procedures to make the system more effective, efficient, fair, and transparent, with all tax incentives administered by the revenue authority.
- (iii) Review the legal framework, including legislation under preparation, and make recommendations on legal changes for the establishment of a modern, integrated, autonomous revenue authority.
- (iv) Organize workshops to support the consultations with the management and staff of inland revenue, customs, and excise departments, and BOI.
- (v) Prepare a framework for the revenue authority covering the organizational structure, flow of information, and tax administration systems and procedures. Make recommendations on the appropriate role of the Government vis-à-vis the autonomous revenue authority in setting tax policy and managing tax administration, as well as the interaction between the two institutions.
- (vi) Prepare a business plan for the revenue authority. Prepare a financing plan that covers the set-up costs of the revenue authority and sustainable financing for operations.

- (vii) Prepare an implementation action plan for establishing the revenue authority—including appropriately sequenced steps and monitorable milestones—covering organizational changes such as autonomy, integration, systems modernization, degree of decentralization, etc.

4. To help Asian Development Bank (ADB) staff prepare the project, the revenue administration advisory team, with inputs from the human resource management and IT teams as necessary, will

- (i) Help prepare the draft project documents, including incorporation of inputs prepared by the consultants engaged under the public expenditure management system technical assistance (PEMS TA);
- (ii) prepare the logical framework for the proposed project, including a summary of the goals, objectives, outputs, activities, verifiable indicators, and assumptions;
- (iii) prepare cost estimates for the various elements of the project and a financing plan;
- (iv) prepare terms of reference for the consulting services required;
- (v) prepare a policy and institutional reform matrix with specific recommendations and milestones consistent with the implementation action plan;
- (vi) prepare a summary poverty reduction and social strategy following ADB's *Handbook on Poverty and Social Analysis*;
- (vii) prepare a benefit monitoring and evaluation program involving the concerned agencies, including benchmark and performance indicators, and establish procedures and responsible agencies for benefit monitoring and evaluation following ADB's *Benefit Monitoring and Evaluation Handbook*; and
- (viii) prepare a risk analysis for the project and recommend measures to minimize those risks.

B. Human Resource Management Team

5. In the human resource management work area, the consultants will assess the staffing, remuneration, and training needs of the revenue authority. The consultants will consist of an international human resource specialist (3 person-months) and a domestic human resource specialist (3 person-months), and will report to the team leader. The international human resource specialist will have experience working with the human resource department of a government agency undergoing a major restructuring, preferably a tax agency.

6. The human resource management team will do the following:

- (i) Review current inland revenue, customs, and excise departments' employment in terms of staff numbers (permanent and temporary), staff rank, skills distribution, and remuneration.

- (ii) Organize consultation workshops with the management and staff of inland revenue, customs, and excise departments, and BOI on the human resource needs for the revenue authority and during the transition.
- (iii) Prepare for the revenue authority a staff needs assessment that is consistent with the proposed organizational structure. The staff needs assessment will include a breakdown by department, skill, and rank as well as recommendations on the incentive structure (remuneration and nonmonetary benefits).
- (iv) Develop human resource policies for the revenue authority, in line with the Government's human resource policies. The policies will cover employment, separation, remuneration, and promotion. Provide options for managing staff resources in the transition to a revenue authority, with a detailed cost breakdown for each option.
- (v) Develop a staff training plan for the revenue authority.
- (vi) Support the revenue administration advisory team in preparing the draft project documents.

C. Information Technology Team

7. In the IT work area, the consultants will provide an IT needs assessment for the revenue authority. The consultants will consist of an international IT specialist (3 person-months) and a domestic IT specialist (3 person-months), and will report to the team leader. The international IT specialist will have previous experience setting up an IT system for an integrated tax administration agency.

8. The IT team will do the following:

- (i) Review the present IT systems in inland revenue, customs, and excise departments, and BOI; and any planned or ongoing system enhancements—such as the proposed electronic data interchange for customs.
- (ii) In consultation with the computer services departments of inland revenue, customs, and excise departments, and BOI, prepare an IT needs assessment that includes short-term measures to enhance revenue mobilization as well as the specific needs of an integrated revenue authority (retaining existing IT systems where practical), especially the electronic exchange of tax information among tax departments. The recommendations must be consistent with the framework for the revenue authority and the implementation action plan.
- (iii) In consultation with relevant Ministry of Finance officials, make recommendations for linking the revenue authority's system with the ministry's budget preparation and monitoring systems. Liaise with the PEMS TA consultants to ensure consistency.
- (iv) Prepare system specifications for the identified short-term measures and system enhancements needed for the revenue authority, including hardware, software, product support, and maintenance. Provide cost estimates for the IT systems.

- (v) Coordinate with the human resource management team on staffing levels, skill requirements, and training needs to implement and maintain the revenue authority's IT systems.
- (vi) Support the revenue administration advisory team in the preparation of the draft project documents.