Capacity Building for Fiscal Devolution in Sri Lanka

Ashok K. Lahiri

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National Institute of Public Finance and Policy
18/2 Satsang Vihar Marg
Special Institutional Area
New Delhi-110067, INDIA

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Sri Lanka: Basic Statistics

	1997	1998	1999 Estimates	2000 Projections
		(In million)		
Mid-year population	18.6	18.8	19.0	19.2
Labour force	6.2	6.6	6.7	6.8
Employed	5.6	6.1	6.1	6.2
Public sector	1.1	1.1	1.1	1.1
Private sector	4.5	5.0	5.0	5.1
		(In persons)		
Foreign employment (departures)	150,281	159,078	146,252	158,132
		(In US dollars)		
GDP per capita	814	837	843	898
		(In billions of Rupees)		
GDP at current market prices	890	1,015	1,131	1,276
GDP at constant 1996 market prices	740	775	806	850
Money supply (M2)	288.3	316.2	350.3	393.8
		(In per cent)		
Sectoral composition of GDP				
Agriculture, mining and primary activities	23.7	23.0	22.7	22.1
Manufacturing and processing	16.6	16.9	17.1	17.4
Construction	6.9	7.0	7.1	7.1
Services	52.8	53.1	53.2	53.4
GDP growth rate	6.3	4.7	4.0	5.5
Wholesale Price Index inflation	6.9	6.1	5.7	6.6
Money supply (M2) growth rate	13.8	9.7	10.8	12.4
		(In per cent of GDP)		
Domestic savings	17.3	18.9	19.2	19.7
National savings	21.5	23.2	23.6	24.2
Investment	24.4	25.4	27.2	28.8
Public	5.8	6.7	7.4	8.1
Private	18.6	18.7	19.8	20.7
		(In millions of US dollars)		
Exports	4,639	4,735	4,587	5,056
Of which: Tea	721	780	642	683
Textiles and garments	2,279	2,466	2,399	2,641
Ceramic products	183	214	232	266
Imports	5,864	5,891	6,247	6,853
Of which: Consumer goods	1,223	1,255	1,301	1,388
Intermediate and investment goods	4,420	4,455	4,796	5,350
Trade balance	-1,225	-1,156	-1,660	-1,797
Service balance	159	143	169	225
Factor income	-159	-178	-188	-217
Private transfers	787	848	872	830
Official transfers	44	55	28	30
Current account balance	-394	-288	-779	-929
Capital account balance	557	325	600	948
Of which: foreign direct investment	301	56	0	100
Overall balance	163	37	-179	19
		(Rupees per US dollar)		
Exchange rate	58.99	64.59	70.62	74.07

Source: Government of Democratic Socialist Republic of Sri Lanka (2000): Budget Estimates, Vol.1, pp. Iii-vi.

Executive summary

Background

Following ethnic conflicts in the 1980s, devolution came in Sri Lanka in 1987 with the 13^{th} Amendment to the Constitution. The Amendment ushered in eight Provincial Councils in Central, North Central, North Eastern, North Western, Sabaragamuwa, Southern, Uva and Western Provinces. Functions entrusted exclusively to the Provincial Councils were enumerated in the Provincial List of the Constitution. In addition, there was a Concurrent List. A Finance Commission, by Constitutional mandate, was set up to oversee the fiscal transfers from the Centre to the Provinces.

Ethnic, religious, linguistic and geographic diversity has been a major force behind moves towards federal arrangements in countries of South Asia. Political pressure drives most decentralisation efforts not only in South Asia, but all over the world. It is also widely recognised, however, that a federal fiscal framework can have significant welfare impact through its effects on resource mobilisation and allocation, quantity and quality of service delivery, and on equity. Thus, it is possible to argue in favour of devolution from a purely economic standpoint. Furthermore, even if economic policy makers may not have much control over the political genesis or the pace of decentralisation, the challenge lies in implementing it in a way that ensures the optimal combination of maximum efficiency, equity and stability of the economic system.

Unsatisfactory Progress

The performance of the federal framework in Sri Lanka since 1987 is yet to be considered satisfactory. This is partly reflected in the ongoing discussion on the successive drafts for Constitutional reforms for strengthening fiscal devolution. The Provinces have continued to be minor players in the overall fiscal arena in the country. Provincial Governments spend about only 10-11 per cent of the combined expenditure of the Centre and Provinces. Furthermore, the share of expenditure administered by Provincial Governments overstates the extent of devolution in the country because of Central regulation, and financing pattern of Provincial expenditure. Own revenues of Provincial Governments account for less than a fifth of their expenditures. With very limited own revenues, Provinces in Sri Lanka depend heavily on transfers from the Central Government for meeting their expenditure needs. For example, in 1997, with Provincial total expenditure at Rs. 27.8 billion, their own revenues of less than Rs. 5 billion could finance only 18 per cent of such expenditures. The proportion of expenditure financed by own revenues continued to be stable at around 18 per cent in the following two years. In 2000, with a large increase in Provincial capital expenditure financed by Provincial specific development grants, this proportion is expected to go down further to 16 per cent.

In a devolved system, lower level governments are expected to play a meaningful and substantial part in choosing policies, making allocations of public funds among competing claims for public goods and services, and monitoring performance in terms of delivery of such goods and services. In sharp contrast, in a deconcentrated system, while agencies exist even at lower levels, their role is limited to implementing decisions taken at the Central level, and at most providing some feedback to the principal about local demands and preferences. Despite the Constitutional devolution, the *de facto* system in Sri Lanka still resembles deconcentration rather than devolution.

Design-related Reasons for Unsatisfactory Progress

Several reasons can be adduced for the unsatisfactory progress of fiscal devolution in Sri Lanka. While some of the reasons are institutional, others relate to design issues and the lead-time needed for a new system to take root and start functioning smoothly. Barely thirteen years have passed since the process of devolution was initiated. Many of the teething troubles are only gradually sorted out as the functionaries 'learn on the job', and conventions are built. Models of governance have to be homegrown. While best practices can be emulated from other countries of the world, adaptation of the system to ground realities at home necessarily takes time. There are indications from higher turnouts in successive elections to the Provincial Councils that the devolution system is taking root in Sri Lanka.

At the design level, the pattern of expenditure assignments led to fragmentation of responsibilities over many ministries and overlapping departmental functions between Central and Provincial departments of administration in both the areas of concurrent and devolved subjects. Such fragmentation and overlap can be illustrated by the three major areas of education, health and roads. It can be argued that most devolution arrangements have a concurrent list of functions with simultaneous jurisdiction of both the Central and lower level governments. However, often, the two levels of government work out arrangements to minimise overlap and unnecessary duplications. In Sri Lanka, perhaps because of an institutional failure rather than a design deficiency per se, this has not yet happened.

A serious imbalance between decentralisation of expenditure and revenues to the Provincial level at the time of the switchover to a fiscally devolved system in 1987 had a role to play in the development of the dependency syndrome. A severe lack of correspondence between expenditure and own revenues at the margin erodes accountability and performance monitoring, and results in an incipient excess demand for funds from the financing agency. Substantial own revenues are critical for developing a sense of responsibility at lower levels of government. Some vertical imbalance is unavoidable in any devolved system, but in Sri Lanka because of too little own revenues of the Provinces the imbalance was severe. At the level of all Provinces in the aggregate, in 1997, Central Government grants amounting to Rs.22.8 million financed as much as 82.15 per cent of total expenditure of Rs. 27.8 million. Promoting self-sufficiency was not among the principles that the 1987 Constitution enjoined on the Finance Commission for distributing grants. The nature of the fiscal imbalance at the Provincial level has a horizontal dimension as well, particularly with reference to the Western Province containing the national capital region of Colombo.

In Sri Lanka, the Constitutional devolution design did not envisage any revenue sharing, which may have contributed to the 'dependency' of Provinces on the Centre. The central theoretical problem of fiscal devolution is the determination of the optimal structure of the public sector in terms of the assignment of decision making responsibilities. Dependency militates against the development of decision making responsibilities at appropriate levels.

With limited assigned revenues, and no sharing of Central revenues with the Provinces, the vertical fiscal imbalances between the Centre and the Provinces have been addressed solely by a system of intergovernmental grants. Routine projections of own revenues and recurring expenditures from the past to the future, without reference to the tax potential, or to the needs and delivery efficiency of public services in Provinces, contributed to a gap-filling nature of inter-governmental grants. Furthermore, the combination of the way block grants were administered and matching grants were designed resulted in a set of inadequate incentives for additional revenue mobilisation by Provinces. Block grants being calculated as recurrent expenditure *less* own revenues, any additional revenue mobilisation by Provinces automatically led to an equivalent reduction in block grants. The only additional resources left with the Provinces were the matching grants. The differentiated slabs for the Provinces implied that there was *no additional incentive* for the six Provinces of North-Central, North-Eastern, North-Western, Sabaragamuwa, Southern and Uva to mobilise additional revenues up to 25 per cent over the benchmark level. For every rupee of additional revenue mobilised they would lose a rupee in block grant and gain a rupee in matching grant, leaving them with exactly a rupee of additional revenue – no more and no less – at the end. By the same argument, there was no additional incentive for the Central Province to mobilise additional revenues up to 50 per cent over the benchmark level. For the Western Province, while there is no additional incentive ever for mobilising extra revenues, there was *taxation* involved until it doubled its revenues over the benchmark figure. In the event, insignificant allocations for matching grants, partly induced by fiscal stress, led to its having no effect on the Provincial revenue mobilisation effort.

There has been a singular lack of enthusiasm on the part of the Provinces to exploit their tax potential granted by the Constitution. Many Provinces have not even passed the statutes for levying the relevant devolved taxes. The lack of enthusiasm of the Provinces in mobilising additional devolved revenues reflects the inadequate incentive built in the design of devolution, as well as its operation.

INSTITUTIONAL FACTORS BEHIND UNSATISFACTORY PROGRESS

The design of any system strongly influences the outcome and can make a substantial difference with regard to its acceptability. Although ambiguities in design can be overcome by the development of strong conventions, such conventions require time to develop and also sustained consensus. The absence of political reconciliation under the new arrangements diluted the faith in the effectiveness of the new federal arrangements, and hence commitment to its successful implementation. Potential threat of secession and fragmentation of the country have muted political demands for decentralisation, which can be efficiency and welfare enhancing without fracturing the body polity. These general socio-political factors definitely played a role in affecting the functioning of the Central and Provincial Governments as well as the Finance Commission in advancing fiscal devolution in Sri Lanka.

Lack of restructuring of the Central Government

Among the institutional reasons for inadequate progress of fiscal devolution, the continuation of the system of centrally appointed divisional secretaries and line ministries at the Centre even on devolved subjects together with the Ministry of Provincial Councils and Local Governments have been the most important ones. Line ministries – such as the ministry of livestock, and the ministry of cooperatives – continue to exist even on devolved subjects. Furthermore, the Central government continues to build rural roads, and have new institutions such as the Southern Development Authority in Provinces. These have not only created unnecessary duplication and overlap between Central and Provincial functions but also led to ambiguities regarding responsibilities between the Centre and the Provinces. Elected local governments represented by Municipal Councils, Urban Councils and the Pradeshiya Sabhas have had uneasy existence parallel to divisional secretaries, representing the long arm of the deconcentrated Central government and its line ministries.

Similarly, the Ministry of Provincial Councils and local Governments has coexisted with a Finance Commission to mediate the intergovernmental transactions between the Centre and the Provinces. Considerable ambiguities regarding the exact role of the Ministry of Provincial Councils and Local Governments has undermined the development of a sense of responsibility and accountability of Provincial governments to their own citizens. In any fiscally devolved system, the Central government has a legitimate and useful role to play in monitoring and overseeing fiscal performance of lower level governments. But, in Sri Lanka, the system with divisional secretaries and the Ministry of Provincial Councils and Local Governments has led to a system of detailed central control over provincial use of funds, far beyond monitoring and overseeing of fiscal performance and retarded the progress of meaningful fiscal devolution.

Compliance with the recommendations of the Finance Commission and their full implementation are essential for the effective functioning of a devolved system. The experience during 1995-1999, however, shows that, on average, total grants released were a little less than 97 per cent of the recommended amount. The deviations of funds released from funds recommended could be high in particular years. In 1997, for example, total funds released to the Provinces at Rs.18,347 million was less than 94 per cent of Rs.19,590 million recommended by the Finance Commission. The variations of funds released from amounts recommended were particularly large for individual categories of grants in some Provinces. In 1999, for example, matching grants of Rs.65 million released to the Western Province was only 27.5 per cent of Rs.236.4 million recommended by the Finance Commission.

The Provincial Councils Act No. 42 of 1987 made by Parliament laying down the procedure for the transaction of business by a Provincial Council provides for the establishment of a Provincial Public Service. The Provincial Public Service was critical for providing the Provincial Councils their functional autonomy, and the quality of the service was meant to be protected by an independent Provincial Public Service Commission working under delegation from the Governor. In practice, however, much of the devolution of powers to the Provinces regarding staffing has not taken place. At the time of their establishment, with the aim of maintaining high staff-quality, the Provincial Councils reached an understanding with the Central Government that all upper and middle management level staff would be obtained on temporary release from the All Island Service (AIS) to the Provincial Public Service (PPS). The dominance of block grants in the receipts of Provinces, and the large share of wages and salaries in Provincial budgets contributed to the Central control of Provincial cadre. With a tight Central control over cadre at the Provincial level, devolution had little chance to succeed in Sri Lanka.

At the Provincial level

Apart from the tight control of cadre at the Provincial level, a system of parallel Central administration has undermined capacity building at the Provincial level. There are four aspects of this parallel administration. First, the District Secretary and her subordinate staff, all Central Government employees, continue to function in devolved areas such as provincial planning. Second, more than 230 Divisional Secretaries appointed by the Central Cabinet on the recommendation of the Ministry of Public Administration control over half of the government employees in the Provinces. Third, superior facilities such as easier access to loans (for purposes such as housing and school textbooks), faster career development opportunities, prospect of transfer to Colombo or other coveted places, and greater prestige and status makes Central employment more desirable than Provincial employment. Not only does this build bureaucratic support for 'nationalisation' of schools, hospitals and roads, but also saps the morale of Provincial administration by reducing Provincial service to second class service. Fourth, the Consequential Provisions Amendment Act of 1989, which was intended to allow the Provincial Councils to carry out devolved functions under existing legislation until they drafted the relevant statutes, has been used by the Central Government and the line ministries to maintain their presence and involvement in devolved subjects.

Information base of the Provinces is very weak. This not only poses considerable difficulties in management of the finances by the Provinces themselves as well as monitoring by the Central government and the Finance Commission, but also reflects a lack of capacity at the Provincial level. The inference about the lack of capacity at the Provincial level from the non-availability of reliable and timely information is confirmed by a lack of responsiveness and enthusiasm about collating such information. Inadequate capacity may have resulted from a combination of lack of skills, of incentives and of deterrent action.

The Provinces have had an unequal position vis-à-vis the Centre in terms of bargaining capacity. There were two important reasons behind this Provincial infirmity. First, the rule by the same political party at the Centre as well as most of the Provinces dampened the intensity of the Centre-Province dialogue. Provincial political leaders being relatively junior to national leaders of the same party had to play a muted role in their negotiations with the Centre. Second, the Provincial bureaucracy with relatively junior AIS officers could not negotiate with senior AIS officers of the Central bureaucracy.

At the Finance Commission level

The Finance Commission, apart from its five members, has 35 positions, including 4 unfilled ones. Of the 31 staff on the rolls, nine Assistant Research Officers are in Provincial headquarters preparing data for the Commission. Significantly, out of five technical positions -- two each of Senior Research Officer and Research Officer and that of an economist -- three have remained unfilled ever since the setting up of the Commission. Reportedly, the salary offered is not attractive for attracting a person of the requisite caliber. There is a lack of technical expertise at the Finance Commission to deal with the issues of fiscal devolution. The emphasis on community-based 'proportional representation' in the membership of the Commission in a small country denies the Commission of the chance to have the best possible talent to deal with the complex issues of fiscal devolution. The lack of technical expertise is manifested by the fact that the Commission has not revised the weights in the determination of the Criteria-based grants ever since the Salgado report in 1989.

There is very little documentation of the workings of the Finance Commission. The Commission, in its eleven years of existence has not come out with a single comprehensive report about the state of fiscal devolution or fiscal position of the Central or Provincial Governments. The Commission's reports could have been useful for initiating an informed public debate about fiscal devolution in Sri Lanka. The absence of a report may also be because of the lack of technical expertise in the Commission. The absence of a full-time Chairman and Secretary, until the present incumbents took up their positions, may also have contributed to the poorer documentation. Anyway, the inexplicable absence of a well-documented data base as well as a properly organised set of papers to support how the Commission arrived at its awards prevents a meaningful discussion about the merit of the awards.

The lack of commitment of the members to the Commission is clear from the attendance at its meetings during 1999-2000. Out of eleven meetings held in 1999, not a single one was attended by all the five members. Furthermore, as many as three of these meetings were attended by only two members, while at six others the attendance was only three. The Commission appears to display a lack of independent opinion at certain times. At times, it takes its cues from the Centre and endorses what the Centre has already decided.

One of the major reasons for the unsatisfactory functioning of the Finance Commission is the lack of scrutiny by the Provinces. While a lack of documentation prevents a careful analysis of the Finance Commission's decisions, the insufficient documentation itself reflects the lack of interest and, perhaps a lack of capacity, in the Provinces in scrutinising what the Finance Commission does.

Fiscal stress

One of the factors underlying the unsatisfactory progress of fiscal devolution is the fiscal stress at the Centre. Continuing fiscal distress at the Centre, mainly because of a debilitating and expensive insurgent war in Sri Lanka both in terms of lives and funds, has led to failures on the institutional front of providing financial incentives to the Provinces to mobilise additional resources.

Need for simultaneous action on two fronts

Commitment to devolution as well as an appropriate design – in terms of tax and expenditure assignment and of transfer schemes – are essential to the success of devolution. A lack of commitment leads to a marginalisation of institutions of devolution, and their authority, acceptance and capability of implementing decisions suffer. At the same time, an inappropriate design can handicap fiscal devolution even with the best of commitments. Experience with a devolved scheme for almost a decade and a half in the backdrop of a protracted troubled period with civil strife may have increased the acceptance of devolution at the political, administrative, and civil society level of the country. The increase in voter turnout to over 70 per cent in both the second and third elections to the Provincial Councils in 1993 and 1999 from less than 50 per cent in the first election to the Provincial Councils in 1988 may be construed as a sign of the devolution system taking root in Sri Lanka. Limitations on the design front are also attracting the attention of the people and policy-makers as manifested by the recent discussions on the draft for Constitutional reforms for strengthening fiscal devolution.

There is clearly a need for moving simultaneously on both fronts. Success will be dependent on having the right design with vigorous implementation of the decisions taken. While a certain level of commitment is necessary for devolution, demonstrated tangible benefits from devolution as well as a public awareness campaign will reinforce commitment. It is in this context that it is important not to exaggerate the chicken and egg type agnosticism about commitment and appropriate design, and move vigorously on both fronts. A Finance Commission Act to govern the functioning of the Finance Commission, as per this Act requiring the Finance Commission to submit an annual report describing its methodology, data used, and recommendations to the Parliament, and a review of the staffing pattern along with a revision of salaries, as recommended in this report, will help in creating the right environment for garnering popular support to devolution as well as implementing devolution in the country.

RECOMMENDATIONS

1. *Both the Constitutional assignment of functions as well as international practice suggest that the share of the Provincial Councils in general government expenditure in Sri Lanka should be at least doubled to around 25 per cent.* [V.3 c]

Doubling the Provincial share of expenditure in general government expenditure would bring the role of the Provinces more in line with the spirit of the assignment of functions in the Constitution. It will lead to a greater correspondence between local needs and the provision of public services, enhance accountability and people's participation. Furthermore, it would align Sri Lanka more closely with international practice in fiscal devolution.

[V.3 c]

2. *It is important to note that the derivation of the desirable size of Provincial expenditure can be obtained from the desirable relativity only when the total general government expenditure has been specified. The specification of total general government expenditure for a year has to equal the sum of the revenue projections for the year and the permissible fiscal deficit for maintenance of macroeconomic stability.*

[V.3 d]

3. *It is important to design the central transfers within a unified scheme such that the criteria of equity, efficiency and adequacy are fulfilled. The scheme should help develop the Provinces as competent spending authorities, responsive to the needs and preferences of the residents within their jurisdictions and encourage economy and the pursuit of most cost effective methods in the provision of public goods and services. It would also promote revenue – both tax and non-tax – mobilisation efforts in their territories.*

[V.4]

The four main elements of the proposed unified scheme are (i) total revenue sharing, (ii) need-based, performance-linked, normative expenditure assessment, (iii) normative revenue estimation, and (iv) equalisation grants. The first step in the proposed unified scheme involves distributing specific shares of total revenues of the Central Government to the Provinces. The second is Provincial expenditure assessment with due regard to the Provincial 'needs' as well as performance in terms of cost-effectiveness of production and provision of public goods and services. The third is normative revenue forecast. In the fourth and final step, the equalisation grants can be obtained as the difference between normatively assessed expenditure on the one hand and the sum of the share of total Central revenues and normative revenue estimates on the other.

[V.4]

The proposed approach would achieve fiscal equalisation both from the revenue and expenditure side, and provide incentives to the Provinces to mobilise revenues, and improve performance in the production and delivery of public goods and services up to a desired minimum standard. [V.4]

4. *Given the large vertical fiscal gap, to enhance the 'autonomy' of the Provinces, Sri Lanka needs to introduce a system of the Centre sharing its tax revenues with them.*

[V.5]

Complementing by revenue sharing a revamped system of grants would not only reduce the vertical fiscal imbalance and enhance Provincial autonomy, but also impart much-needed buoyancy, predictability, coordination and burden-sharing to the system.

[V.5]

Furthermore, the sharing of total gross tax revenues, rather than total net tax revenues is recommended to provide incentives to the Centre to minimise collection costs.

[V.5]

The normative gap between own revenues and expenditures shall be first estimated for all Provinces to identify the Province with the lowest gap per capita. The proportion of total gross tax revenue to be shared with the Provinces should be fixed such that, when the shared revenues are distributed to the Provinces in proportion to their population, it covers 75 per cent of the normative gap of the Province with the lowest normative gap per capita.

[V.5]

To let the Provinces share the benefit of buoyant Central revenues, and also the burden of depressed revenues, the tax share may be kept unchanged for a period of five years.

[V.5]

The system of estimating the total revenue share as well as its inter-se distribution among Provinces should be reviewed by the Finance Commission on a periodic basis.

[V.5]

5. *The extant approach to expenditure assessment should be replaced by a need-based, performance-linked normative approach.* [V.6]

The need-based approach to expenditure assessment will have to take into account the initial discrepancies in the availability of such services from the 'desired' or 'normative' levels in each Province. The normative levels should indicate the minimum level of services that are desirable through the length and breadth of the country. [V.6]

The objective is to ensure the provision of an equal and normatively acceptable standard of core governmental services to the citizens whatever province they may choose to reside in. This is subject to reasonableness and feasibility. Measuring standardised expenditure requires specification of (i) services with respect of each expenditure category and its average cost with respect to the standard level of provision, and (ii) permissible Province-specific cost differentials (compared to the average cost of providing the standard service). The assessment of expenditure needs should then proceed in two steps: (a) estimation of the extent to which the provision of a service in a State is less than the "standard"; and (b) estimation of permissible differences in unit costs due to factors like economies of scale, dispersion or concentration of population, distance from economic centres, hilly terrains, etc. [V.6]

In the calculation of need-based, performance-linked normative expenditure assessment, each Province should be allowed only those costs that are consistent with an average level of performance, adjusted for permissible differences in costs due to specific factors.

[V.6]

In the Sri Lankan case, an assessment of expenditure requirements across Provinces, using relative norms may be useful. [V.6]

Need-based, performance-linked, normative expenditure assessment is a continuing exercise, and it is important to revise the methodology of assessment every year in the light of the *most recent data. A few years into the process, regression analysis using panel data may be used to obtain the weights for determining the inter-Provincial differentials.*

[V.6 c]

6. *Exemptions on petroleum and pharmaceutical products under GST for additional revenues should be removed.* [V.7]

Exemptions on income taxes, including those on salaries of government employees should be withdrawn. [V.7]

For income tax purposes, the depreciation rates for plant, machinery and fixtures, computer software and motor coach for employee transport should be reduced from the current 50 per cent, 50 per cent and 100 per cent, respectively, to a uniform 25 per cent.

[V.7]

At the Provincial level, it would be necessary to introduce a reasonable threshold under the Provincial turnover tax, move away from 100 per cent assessment to a policy of selective assessment, and withdraw exemptions to cooperative societies. [V.7]

There should be a Provincial land and buildings tax at the rate of ½ per cent of the market value of land and buildings with a threshold of Rs. 1 million. The tax can be legislated at the Central level and collected and retained by the Provinces. Pre-defined rules for determining the market value of immovable property will facilitate self-assessment of the tax with subsequent verification by tax officials. Credit should be given for taxes paid on buildings and acreage tax on land to local bodies against Provincial tax on land and buildings for avoiding the problem of double taxation. [V.7]

The GST should be extended to the retail level with full coverage of wholesale and retail trade. The Provinces should be allowed to levy a retail level sales tax. The retail level sales tax should replace the Provincial turnover tax. Provinces may be allowed to choose a single rate of retail level sales tax in a band of rates of 5 to 7 per cent.

[V.7]

Excise duty under the Excise (ordinance) Duty Act charged on domestically produced hard and soft liquor and duty on domestic production of tobacco (other than cigarettes) under the Tobacco Tax Act should be assigned to the Provincial Councils.

[V.7]

The normative revenues of the Provinces should be assessed at their own tax-to-GDP ratios for 1992 adjusted for the GDP of the relevant year. [V.7]

Further, if the suggested changes in the tax structure come about, then additional tax potential from the changeover to retail sales tax from the provincial turnover tax levied at present need to be added on along with those relating to the reassignment of excise duty under the Excise (Ordinance) Duty Act. [V.7]

A reasonable relationship between the revenue bases of both the Centre and the Provinces and their revenues on the one hand and projecting the revenue bases will have to be developed and updated every year to obtain the normative revenue estimates on an ongoing basis. [V.7]

7. *Equalisation grant for a Province should be calculated as the difference between the need-based performance-linked, normative recurrent expenditure and the sum of normatively assessed own revenues and shared revenues with the Centre.* [V.8]

8. *The system of Provincial Specific Development Grants (PSDG), which replaced the MTIP grants from 2000 and are in the ambit of the Finance Commission, should continue to be channeled through the Finance Commission.* [V.9]

In order to augment the transparency and autonomy of the system of fiscal devolution, the distributable funds under PSDG may be gradually increased to around 10 per cent of total general government expenditure. [V.9]

The distribution of PSDG among the Provinces to be recommended by the Finance Commission should be based on an index of available infrastructure in each of the relevant areas such as hospitals and roads in the Provinces. The Provinces, however, should be allowed the flexibility of utilising the PSD grants in any combination within the specified areas. Any part of PSDG not utilised within a year shall be carried over, subject to an adjustment in the fresh grants to an equal extent. [V.9]

In order to impart greater flexibility to the system, the index of available infrastructure should be constructed on the basis of an expert study commissioned by the Finance Commission and reflect the current infrastructural needs of Sri Lanka. Furthermore, the index should be revised every five years to respond to the changing needs of the country. [V.9]

9. *Specific purpose grants or matching grants for agency functions and for developing national minimum standards in specified services may continue outside the ambit of the Finance Commission. They should be programme-based and may be decided by the Central line ministries. To prevent the tail from wagging the dog, a cap of around 20 per cent relative to aggregate transfers by the Finance Commission may apply on such transfers.* [V.10]

10. *The line ministries at the Centre on devolved subjects, such as ministry of livestock and the ministry of cooperatives, should be abolished. Furthermore, the Centre should desist from creating institutions such as the Southern Development Agency that encroach upon devolved subjects. Line ministries should operate through their own employees and divisional secretaries should stop being responsible to the line ministries.* [VI.1 a]

11. *Given the enhanced role of the Finance Commission and the new role of the Department of National Planning in providing assistance to Provincial Councils in the preparation of Provincial plans, the Ministry of Provincial Councils and Local Governments should, without any attempt at*

micromanagement, adhere to its role of assisting Provincial Councils and Local Governments to operate within the framework of national policy, to liaise with the Centre, to obtain financial, legal and technical assistance, to develop human resources, and to improve their effectiveness. [VI.1 b]

12. *The Centre may set up a forum of all Provincial Chief Ministers to meet under the Chairmanship of the President to discuss issues of inter-Provincial interest or issues involving Centre-Provincial matters.* [VI.1 b]

13. *It is imperative to develop a healthy convention of accepting and implementing Finance Commission awards in full. Furthermore, the Central Government should present to Parliament a detailed explanatory memorandum when the recommendations are either not accepted or not implemented in full.* [VI.1 c]

14. *The control of the Centre of Provincial cadre requirements through a process of approval from the Ministry of Provincial Councils and Local Government should cease. It may be replaced by a system of caps on wages and salaries bill. The understanding reached between the Provincial and Central Governments that all upper and middle level staff would be obtained on temporary release from the All Island Service should be scrapped.* [VI.1 d]

15. *It is necessary to organise training and development of the Provincial staff through workshops and seminars, and also interaction with officials of other countries that have implemented successful fiscal devolution.* [VI.2 a]

16. *Responsibility of maintaining a reliable and timely data base relating to revenues and expenditures and other budget related items should be assigned at the level of the Chief Secretary. Data for a particular year should be posted on the electronic web and published annually with a maximum delay of six months.* [VI.2 b]

17. *There should be a Finance Commission Act to govern the functioning of the Commission* [VI.3 a]

18. *The Finance Commission should have a full time Chairperson and members. The Secretary to the Commission, who is not a member, should also be full time secretary* [VI.3 b]

19. *The Finance Commission should be required by the Finance Commission Act to submit an annual report describing its methodology, data used, and recommendations to the Parliament.* [VI.3 c]

20. *The salaries of technical staff at the Finance Commission should be fixed with reference to comparable salaries of technical staff elsewhere in the economy. Technical posts should be filled up through open recruitment and on a contract basis. For the Commission to function effectively in dealing with both the Provinces and the Centre, the post of the Secretary to the Commission should be upgraded to that of Chief Secretary at the Provincial level.*

[VI.3 d]

21. *The staffing pattern of the Finance Commission should be reviewed to reduce the number of non-technical and under-skilled personnel. With a much-reduced non-technical staff retinue, but improved electronic data processing facilities, the Commission may be expected to function much more effectively than now.* [VI.3 e]

22. *There is a need to draw up a critical time path for implementing the recommendations. A distinction can be made between those recommendations that require only administrative action and those that call for legal or Constitutional changes. But even within these two sets of recommendations, the sequencing of steps is of considerable importance requiring inputs from policy makers both at the bureaucratic and political levels. Once a decision is taken to go ahead with the recommendations, a high-powered committee may be set up with participation from bureaucracy as well as politicians with a deadline for implementing the new strengthened system of devolution in Sri Lanka.*

I. Introduction

I.1 Terms of Reference

Fiscal devolution started in Sri Lanka with the establishment of Provincial Councils in 1988. There have been recent initiatives towards further devolution of power to the Provinces. The Government of Sri Lanka has launched a programme for building capacity of the fiscal devolution framework and the institutions needed for its management. The objective of the programme is to set in place an effective system of fiscal devolution that will enable meaningful, devolved governance and development management. The strengthening of the fiscal framework and the institutions responsible for its management is conceived as the main instrument that will lead to efficient and effective public institutions, able to deliver public goods and services to the population, while being responsive to its needs.

Under the sponsorship of the United Nations Development Programme (UNDP), the National Institute of Public Finance and Policy (NIPFP) was engaged by the Sri Lankan Government to provide international expertise in:

(a) reviewing and redesigning the methods and procedures for analysis and estimation of financial needs of Provinces;
(b) reviewing and redesigning the system of grants to Provinces;
(c) reviewing the devolved tax regime and assessing the Provincial revenue potential; and
(d) conducting a preliminary review of financial management arrangements at the Provincial level.

The project contract for "Capacity Building for Fiscal Devolution" was signed on December 2, 1998, and the NIPFP, as the international consultant to the Sri Lanka Finance Commission, immediately started work in the first week of December 1998. The project's main focus is to reach out to the respective Provincial Councils, which are assigned devolved finances and receive intergovernmental transfers, in respect of capacity building, while advising the Finance Commission about: (i) the methods and procedures for analysis and estimation of Provincial financial needs; (ii) the system of grants to Provinces; (iii) devolved tax regime and assessment of Provincial revenue potential; and (iv) financial management arrangements at the Provincial level.

I.2 Missions and Consultations

The NIPFP consultants initiated the work with a mission to Sri Lanka during December 14-20,1998 itself and have followed it up with 38 subsequent visits. Up to end-November 2000, 319 man-days have been spent on mission to Sri Lanka. During the missions, apart from having extensive discussions with the relevant officials of the Finance Commission, Ministry of Finance and Planning, offices of the Solicitor General and the Auditor General, the consultants traveled to various Provinces to hold discussions with Governors, Chief Ministers, and other officials including Chief Secretaries, Secretaries of the Departments of Education, and Local Government, Revenue Commissioners, Deputy Chief Secretaries for Finance, and for Planning.

I.3 WORKSHOPS AND TRAINING

Three workshops were held in Sri Lanka and one training programme was organised at NIPFP, New Delhi to discuss the issues. An inception workshop, held during February 12-13, 1999 at Berjaya Mount Royal Beach Hotel, Mt. Lavinia. was attended by 51 participants, including all Chief Secretaries (but one) from the eight Provinces and representatives of the Government of Sri Lanka. The keynote address was given by Dr. Neville Kanakaratne, Governor, Southern Province, and Mr. K. Balapatabendi, P.C., Secretary to Her Excellency (H.E.) the President, gave the opening remarks. The Provincial participants prepared eight Status Papers, commented on each others' work, and also engaged in group discussions on the following five topics: (i) expenditure assessment issues, (ii) tax issues, (iii) inter-governmental grants and revenue forecasts, (iv) institutional development and (v) local government finance.

A second workshop for two days on "Taxation in Sri Lanka" was held on August 9-10 at Royal Oceanic Beach Hotel, Negombo. Thirteen Sri Lankan officials and consultants presented papers on various aspects of national and provincial taxes. The presentations were followed by lively discussions led by the NIPFP consultants. The workshop, attended by over 50 participants – including Chief Secretaries and their deputies, Revenue Commissioners and Commissioners of Local Government from seven provinces, Finance Commission officials, officials from Ministry of Provincial Council, Attorney General's Department, Fiscal Policy Department, Inland Revenue Department, Excise Department, Customs Department, Department of Motor Traffic, and National Budget – provided a valuable forum for exchange of views among local officials and the identification of several lacunae in the Sri Lankan tax system. Some of these include: a serious erosion in the tax-to-GDP ratio of as much as 2.5 per cent in three years until 1998, lack of adequate tax resources in the hands of the provinces, and the enormous scope for rationalisation of the tax structure and improvement in tax mobilisation.

A third one-day workshop on "Fiscal Devolution in Sri Lanka" was held on August 12, 1999 at Berjaya Mount Royal Beach Hotel, Mt. Lavinia. The NIPFP consultants presented three papers entitled " Fiscal Devolution in Sri Lanka – An Assessment of the Experience", "Fiscal Devolution in Sri Lanka – Directions for Change", and "Fiscal Devolution – Institutional Aspects, Some Issues". Professor C. Sriyakumaran, Professor Buddhadasa Hewavitarne, and Mr. Godfrey Gunatilleke chaired the three sessions. The tentative diagnosis of the problems as well as the probabale solutions were commented upon by the participants, which included again most of those who were present in the workshop on August 9-10, a number of Sri Lankans who specialise in this area and some others, such as from the Department of National Planning. In the plenary session, the chairman, Mr. K. Balapatabendi, Secretary to H.E. the President, was briefed about the day's deliberations. The plenary also witnessed some exchange of views.

A training workshop for about 20 Sri Lankan officials on "Expenditures of Subnational Governments: Assessment, Management and Control" was organised at NIPFP, New Delhi during September 13-24, 1999. The programme is attached at Appendix I.

A workshop to discuss the final draft report on Capacity Building for Fiscal Devolution in Sri Lanka along with the four constituent modules was held in Kalutara during December 4-5, 2000.

I.4 LOCAL CONSULTANTS

After extensive interviews of the applicants, five local consultants – two on expenditure assessment, two on institutional development and one on tax issues – were appointed in early-March 1999 for an initial period of three months. The local consultants were provided with detailed terms of reference and asked to produce reports in their respective areas. After evaluation of their reports, their contracts were extended for a further period of three months.

I.5 REPORTS

The project was conceptualised in terms of four modules – Expenditure Assessment, Fiscal Devolution, Tax Issues, and Institutional Development. The pre-final drafts of the reports on the first two modules were submitted in September, 2000. The final drafts of these two modules were submitted in December 2000. Preliminary drafts on Tax Issues and on Institutions in the context of fiscal devolution in Sri Lanka were submitted in May. 1999 and September/November, 1999, respectively. Final drafts of these two modules were submitted in September 2001. This report is a revised version of the final draft report in light of the comments received in the final draft report in May 2001. This constitutes the final report.

I.6 PLAN OF THIS FINAL REPORT

Chapter II provides a brief overview of the background of fiscal devolution in Sri Lanka and the manifestations of its unsatisfactory progress. Chapters III and IV provide the underlying reasons in terms of design issues and institutional factors. respectively. Chapter V describes a suggested redesign of fiscal transfers, while Chapter VI delineates a proposed revamping of institutions. Chapter VII consolidates the recommendations and concludes.

II. Fiscal devolution — unsatisfactory progress

II.1 Background

Federal systems give a way of combining, as De Tocqueville put it, 'the different advantages which result from the magnitude and the littleness of nations.'[1] Ethnic, religious, linguistic and geographic diversity has been a major force behind moves towards federal arrangements in countries of South Asia. Political pressure drives most decentralisation efforts not only in South Asia, but all over the world. Decentralisation and devolution are often in response to cultural, religious and linguistic issues that get converted into political problems, for example, in Catalonia in Spain, Bosnia in Bosnia and Herzegovina and Quebec in Canada. It is also widely recognised, however, that a federal fiscal framework can have significant welfare impact through its effects on resource mobilisation and allocation, quantity and quality of service delivery, and on equity. Thus, it is possible to argue in favour of federalism from a purely economic standpoint. Furthermore, even if economic policy makers may not have much control over the political genesis or the pace of decentralisation, the challenge lies in implementing it in a way that ensures the optimal combination of maximum efficiency, equity and stability of the economic system.

Deconcentration or administrative delegation of some fiscal authority existed in Sri Lanka almost since independence.[2] The British rulers had carved out nine provinces and, some of the Resident British Governor's powers were entrusted to the Government Agent in each of these provinces. The provinces had 20 districts altogether in the beginning, and this number increased to 25 in due course (a list of the Provinces and districts are attached at Appendix II). There was a District Government Agent in each district. District Coordinating Committee had the Government Agent as Chairperson and included Members of Parliament from the area, representatives of heads of local authorities, and district heads of government departments and agencies. These Committees played an important role in coordinating all Government functions at the district level.

Following ethnic conflicts in the 1980s, devolution came in 1987 with the 13th Amendment to the Constitution.[3] The Amendment ushered in eight Provincial Councils in Central, North Central, North Eastern, North Western, Sabaragamuwa, Southern, Uva and Western Provinces.[4] Functions entrusted exclusively to the Provincial Councils were enumerated in the Provincial List of the Constitution. In addition, there was a Concurrent List. A Finance Commission, by

[1] Alexis De Tocqueville in Democracy in America, as quoted in W.E. Oates (1972), Fiscal Federalism, Harcourt Brace Jovanovich, New York, p.3.

[2] The period under British rule is not considered because there is not much meaning to federalism without democracy.

[3] The legislative provisions are contained in Article 154R and the Ninth Schedule of the Constitution (Thirteenth Amendment to the Constitution, 14th November, 1987), Provincial Councils Act, No. 42 of 1987, and Provincial Councils (Consequential Provisions) Act, No. 12 of 1989.

[4] Following the Colebrooke-Cameron Reform of 1833, Sri Lanka was divided into nine Provinces, namely, Central, North Central, Northern, Eastern, North Western, Sabaragamuwa, Southern, Uva, and Western. The post Colebrooke-Cameron Reforms nine Provinces, which were administered by Government Agents, were later abolished, and the unit of administration shifted to Districts. The eight Provinces created after the 13th Amendment had identical names as after the 1833 reform, except that the Northern and Eastern Provinces after Colebrooke-Cameron Reform were merged into one Province of North Eastern.

Constitutional mandate, was set up to oversee the fiscal transfers from the Centre to the Provinces. After elections, the Provincial Council in the North Eastern Province functioned for a period of about one and a half years until June 22, 1990.[5] Civil strife and terrorist problems, particularly in the Tamil majority northern part around Jaffna, have not allowed elections to be held and the new arrangements to operate in the North Eastern Province.

The performance of the federal framework in Sri Lanka since 1987 indicates its immaturity and is yet to be considered satisfactory. The Provinces have continued to be minor players in the overall fiscal arena in the country. This is partly reflected in the ongoing discussion on the draft for Constitutional reforms for strengthening fiscal devolution.[6] The draft for Constitutional reforms visualizes Sri Lanka as "an indissoluble Union of Regions" rather than as a unitary state as at present, elimination of the Concurrent List and renaming Provincial Councils as Regional Councils, among others.

Among the manifestations of inadequate progress, three can be highlighted. These are limited role of Provincial Councils in the area of public expenditure, insignificant own revenues of Provinces, and 'resulting dependency' of the Provinces on the Centre.

II.2 Limited Role of Provincial Councils in Public Expenditure

In Sri Lanka, Provincial Governments spend about only 10-11 per cent of the combined expenditure of the Centre and Provinces (Table 1). For example, in 1998, the Provincial Governments spent Rs. 31.2 billion while the Central Government spent Rs. 268.2 billion.[7] The combined expenditure of the Centre and the Provinces was Rs. 299.4 billion on a gross basis and Rs. 278.0 billion on a consolidated basis, that is after netting out Centre-Provincial transfers that are double counted in the gross figure. Thus, in 1998, the Provinces' share in the combined expenditure of the Centre and the Provinces was 10.4 per cent on a gross basis and 11.2 per cent on a net basis. Moreover, this Provincial share has tended to decrease over the period 1997-1999. In 1997, the Provincial share of gross (net) combined expenditure of Centre and Provincial governments was 10.6 per cent (11.4 per cent), which came down to 10.4 per cent (11.2 per cent) in 1998, and in 1999, further to 10.0 per cent (10.8 per cent) according to the revised estimates. The budgets for 2000 has seen a reversal of this trend with the share of Provinces projected to increase to 11.1 per cent on a gross basis and to 12.1 per cent on a consolidated net basis. This projected increase in the Provincial share is primarily from a large increase in capital account transfers from the Centre to Provinces. Such transfers, which were a little less than Rs. 2 billion in 1999, are budgeted to increase to almost Rs. 10.5 billion in 2000.

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5 After the elections, Mr. Vardharajali Perumal was appointed as Chief Minister of the North Eastern Province on December 15, 1988. After declaration of independence by the Council, the President of Sri Lanka, through a Proclamation, dissolved the Council on June 22, 1990.

6 The status of the draft for Constitutional reforms, which was being discussed in the last Parliament prior to the elctions on October 10, 2000, is unclear.

7 The figure for the Provincial Governments does not include funds disbursed by line ministries at the Centre and administered by Provincial Governments.

At the heart of the economic impact of decentralisation is the *decentralisation theorem* popularised by Wallace E. Oates. It states that for a public good, it will always be more efficient for local governments to provide the Pareto-efficient levels of output for their respective jurisdictions than for the central government to provide any specified and uniform level of output across all jurisdictions.[8] For example, in the case of schools, vis-à-vis central government, local governments, with superior knowledge about local conditions and needs, can exercise superior judgement about their location, staffing pattern and even curriculum and extra-curricular activities. In Sri Lanka, within the general government, the minor role played by Provincial governments indicates that the potential benefits from decentralisation may not have been realised.

The relativity of Provincial Governments' expenditure vis-à-vis Central Government expenditure in the country indicates the slow progress of decentralisation in Sri Lanka. Furthermore, the share of expenditure administered by Provincial Governments overstates the extent of devolution in the country because of the two other facets of expenditure devolution, namely, regulation, and financing. A large part of the funds administered by Provincial Governments are mandated for specific purposes by the Central Government. The extent of regulation is illustrated by the fact that the number of employees and their emoluments at the Provincial levels are determined not by the Provincial Governments but at the national level. Moreover, expenditures at lower levels financed by own revenues have a qualitative difference in terms of associated responsibility regarding optimality of use and efficiency of outcome with such expenditures financed by resources transferred from the Central Government. Concerns about whether the Provincial governments have adequate administrative or technical capacity to carry out new functions traditionally discharged by the Centre may have had an important role to play in the pattern of expenditure assignment in 1987. But, the continuing lack of progress towards expenditure decentralisation in this context points to flaws in the institution-specific design of fiscal decentralisation in Sri Lanka.

II.3 INSIGNIFICANT OWN REVENUES

Own revenues of Provincial Governments account for less than a fifth of their expenditures (Table 2). In 1997, for example, revenues of less than Rs. 5 billion constituted only 17.9 per cent of expenditure of Rs. 27.8 billion. This proportion of expenditure financed by own revenues, after increasing to 18.3 per cent and 18.4 per cent in the two subsequent years, is budgeted to decrease to less than 16.5 per cent in 2000. With transfers from the Centre financing more than 80 per cent of their expenditures, the fiscal autonomy of the Provinces is severely compromised.

[8] A Pareto-efficient outcome is one under which no one can be made better off without making someone else worse-off.

.Table 1. Sri Lanka: Limited role of Provincial Governments in Public Expenditures

(In millions of Sri Lankan Rupees)

	1997			1998			1999[2]			2000[3]		
Expenditure category	Centre	Provinces	Total[1]	Centre	Provinces	Total	Centre	Provinces	Total	Centre	Provinces	Total
1 **Recurrent**	184,749	23,050	207,799	199,650	25,545	225,195	205,619	26,536	232,155	231,001	29,990	260,991
			(190,674)			(205,564)			(211,366)			(238,356)
a Emoluments	47,901	17,207	65,108	55,487	19,425	74,912	57,259	19,658	76,917	62,305	21,937	84,242
General public service	11,785	17,207		13,208	19,425		14,218	19,658		16,734	21,937	
Security and defence	17,324	-		23,004	-		23,720	-		25,093	-	
Pensions	18,792	...		19,275	...		19,321	...		20,478	...	
b Travelling expenses	-	998	...	-	393	...	-	455	...	-	508	...
c Supplies and services	37,596	1,588	39,184	41,925	1,683	43,608	33,758	2,253	36,011	41,891	2,605	44,496
General public service	9,948	...		13,967	...		14,130	...		18,868	...	
Security and defence	27,648	...		27,958	...		19,628	...		23,023	...	
Pensions	...	741		...	737		...	897			999	
Maintenance	...	411		...	387		...	501			710	
Contractual services	...	437		...	560		...	855			897	
d Current transfers	42,684	497	43,181	46,695	925	47,620	48,988	795	49,783	51,105	926	52,031
			(26,056)			(27,989)			(28,994)			(29,396)
Provincial councils	17,125	...		19,631	...		20,789	...		22,635	...	
Corporations	2,693	...		2,967	...		2,486	...		2,721	...	
Statutory agencies	2,657	...		4,320	...		6,033	...		6,622	...	
Local authorities	1,941	...		1,977	...		2,103	...		1,625	...	
Samrudhi	8,718	...		8,652	...		8,374	...		8,000	...	
Other welfare	9,550	...		9,148	...		9,203	...		9,502	...	
e Current grants	-	-	-	-	-	-	-	-	-	-	-	-
f Interest payments	55,246	-	55,246	54,898	-	54,898	63,285	-	63,285	71,048	-	71,048
g Others	1,322	2,761	4,083	645	3,119	3,764	2,329	3,375	5,704	4,652	3,325	7,977
h Payment of arrears of principals' salaries		-	-	-	-	-	-	-	-	-	689	689
2 **Capital**	50,151	4,730	54,881	68,532	5,632	74,164	83,236	5,694	88,930	102,455	11,471	113,926
			(53,370)			(72,400)			(86,955)			(103,449)
a Acquisition of assets	25,652	3,263	28,915	32,246	4,078	36,324	35,299	3,599	38,898	38,624	8,308	46,932
b Capital transfers	18,515	-	18,515	21,915	-	21,915	32,437	-	32,437	43,159	-	43,159
			(17,004)			(20,151)			(30,462)			(32,682)
Provincial councils	1,511			1,764			1,975			10,477		
Corporations	17,004			20,151			30,462			32,682		
c Rehabilitation and Improvement of assets	-	1,467	1,467	-	1,555	1,555	-	2,095	2,095	-	3,163	3,163
d Net lending	3,791	-	3,791	10,683	-	10,683	11,520	-	11,520	15,453	-	15,453
On lending	7,278			14,117			15,820			19,853		
Advance a/c net lending	1,226			2,784			1,500			1,500		
Repayments	(4,713)			(6,218)			(5,800)			(5,900)		
e Others	2,193	-	2,193	3,688	-	3,688	3,980	-	3,980	5,219		
3 **Total**	234,900	27,780	262,680	268,182	31,178	299,360	288,855	32,230	321,085	333,456	41,461	374,917
			(244,044)			(277,965)			(298,321)			(341,805)

Source: Budget Estimates 2000, Vols.I and II, Government of Democratic Socialist Republic of Sri Lanka. For Centre, Vol. I, p. xvii, for Provinces,Vol. II, p, 681.

[1] The figures in parentheses under recurrent and capital expenditures, and current and capital transfers are consolidated figures corrected for double counting. [2] Revised estimates

[3] Budget estimates.

Table 2. Sri Lanka: Limited own revenues of Provincial Governments
(In millions of Sri Lankan Rupees)

	1997			1998			1999[1]			2000[2]		
Revenue Item	Centre	Provinces	Total	Centre	Provinces	Total	Centre	Provinces	Total	Centre	Provinces	Total
Tax revenue	**142,429**	**3,454**	**145,883**	**147,369**	**3,996**	**151,365**	**169,777**	**4,091**	**173,868**	**198,941**	**4,660**	**203,601**
Income taxes	20,845	-	20,845	20,429	-	20,429	25,592	-	25,592	27,880	-	27,880
Goods and services tax	-	-	-	23,177	-	23,177	39,250	-	39,250	50,536	-	50,536
Turnover tax	43,259	2,581	45,840	16,166	2,880	19,046	2,150	2,924	5,074	2,759	3,314	6,073
National security levy	17,274	-	17,274	21,079	-	21,079	28,824	-	28,824	34,490	-	34,490
Excise levy	26,550	-	26,550	30,293	-	30,293	36,594	-	36,594	39,052	-	39,052
Stamp duties	6,392	873	7,265	7,079	1,116	8,195	8,150	1,166	9,316	9,200	1,347	10,547
Import duties	26,991	-	26,991	28,154	-	28,154	28,127	-	28,127	33,874	-	33,874
Motor vehicle levy and others	1,118	-	1,118	992	-	992	1,090	-	1,090	1,150	-	1,150
Non-tax revenue	**22,440**	**1,506**	**23,946**	**27,664**	**1,707**	**29,371**	**30,175**	**1,833**	**32,008**	**31,658**	**2,170**	**33,828**
Rent	859	-	859	1,410	-	1,410	1,500	-	1,500	1,700	-	1,700
Interest	7,753	-	7,753	7,786	-	7,786	6,850	-	6,850	7,100	-	7,100
Profit and dividend	4,189	-	4,189	6,200	-	6,200	8,810	-	8,810	8,760	-	8,760
Licence fees	-	917	917	-	1,062	1,062	-	1,111	1,111	-	1,251	1,251
Sales and charges	4,582	282	4,864	6,081	358	6,439	5,805	394	6,199	6,436	517	6,953
Social security contribution	1,870	-	1,870	2,837	-	2,837	3,445	-	3,445	3,652	-	3,652
Other	3,187	307	3,494	3,350	287	3,637	3,765	328	4,093	4,010	402	4,412
Total	**164,869**	**4,959**	**169,828**	**175,033**	**5,703**	**180,736**	**199,952**	**5,923**	**205,875**	**230,599**	**6,830**	**237,429**

Source: For Centre, Budget Estimates 2000, Vol.1, p. xv, Government of Democratic Socialist Republic of Sri Lanka.
For Provinces, Budget Estimates 2000, Vol.II, p. 681, Government of Democratic Socialist Republic of Sri Lanka.

1 Revised estimates.

2 Budget estimates.

In a comparison of own revenues rather than expenditures, the relativity of Provincial Councils vis-à-vis the Centre gets even more skewed against the Provinces. The own revenues of the Provinces at less than Rs. 5 billion in 1997 constituted only 2.9 per cent of the combined revenues of almost Rs. 170 billion. This proportion increased to 3.2 per cent in 1998, mainly as a result of the loss of revenues for the Central Government in that year from the switchover from turnover tax to a VAT-style Goods and Services Tax (GST).[9] Revenues of the Central Government bounced back in 1999, and the own revenues of Provinces fell back to 2.9 per cent of the combined revenues of the Centre and the Provinces in 1999. In 2000, this share is expected to continue at 2.9 per cent.

II.4 'DEPENDENCY' OF PROVINCES ON THE CENTRE

With very limited own revenues, Provinces in Sri Lanka depend heavily on transfers from the Central Government for meeting their expenditure needs (Table 3). The proportion of expenditure financed by own revenues after being stable at around 18 per cent during 1997-1999, is expected to go down to 16 per cent in 2000, with a large increase in Provincial capital expenditure financed by Provincial Specific Development Grants (PSDG).

In a devolved system, lower level governments are expected to play a meaningful and substantial part in choosing policies, making allocations of public funds among competing claims for public goods and services, and monitoring performance in terms of delivery of such goods and services. In sharp contrast, in a deconcentrated system, while agencies exist even at lower levels, their role is limited to implementing decisions taken at the Central level, and at most providing some feedback to the principal about local demands and preferences. In a decentralised system, agencies performing tasks of implementing policies transcend to 'autonomous bodies' or 'lower level governments', and they play a more important role in formulation of policies, allocation of funds, and monitoring of performances. But, such bodies or governments, because of the absence of constitutionally mandated powers and responsibilities, continue to function at the 'pleasure' (either an Act of the national legislature or an executive order) of the principal, namely, the Centre.[10]

Federalism is a term that evokes strong feelings among people in many countries. That, however, is because of the political connotations of the term federalism. To economists, the meaning of federalism differs in some fundamental way from its meaning to most political scientists. In political science, power is the most important variable, and hence federal structures

9 In 1998, Sri Lanka switched over from a system of turnover tax to a VAT-style GST. Turnover taxes on banking and financial services, however, continued.

10 Organisation of governments is more a spectrum of arrangements rather than watertight compartments of alternatives. Decentralised systems can function quite effectively (for example, in the United Kingdom) like Constitutionally devolved systems, if conventions have been established and are respected at all levels.

Table 3. Sri Lanka: Financial Dependency of Provincial Governments

(In millions of Sri Lankan Rupees)

Revenue/Expenditure/Financing	1997 Provinces	1998 Provinces	1999 [1] Provinces	2000 [2] Provinces
al own revenue	**4,959**	**5,703**	**5,923**	**6,830**
Tax revenue	**3,454**	**3,996**	**4,091**	**4,660**
Turnover tax	2,581	2,880	2,924	3,314
Stamp duties	873	1,116	1,166	1,347
Non-tax revenue	**1,506**	**1,707**	**1,833**	**2,170**
Licence fees	917	1,062	1,111	1,251
Sales and charges	282	358	394	517
Other	307	287	328	402
al expenditure	**27,780**	**31,178**	**32,230**	**41,461**
Recurrent expenditure	**23,050**	**25,545**	**26,536**	**29,990**
a Emoluments	17,207	19,425	19,658	21,937
b Travelling expenses	998	393	455	508
c Supplies and services				
Of which				
Supplies	741	737	897	999
Maintenance	411	387	501	710
Contractual services	437	560	855	897
d Current transfers	497	925	795	926
e Others	2,761	3,119	3,375	3,325
f Payment of arrears of principals' salaries	-	-	-	689
Capital expenditure	**4,730**	**5,632**	**5,694**	**11,471**
a Acquisition of assets	3,263	4,078	3,599	8,308
b Rehabilitation and Improvement of assets	1,467	1,555	2,095	3,163
erence	**(22,821)**	**(25,475)**	**(26,307)**	**(34,631)**
ntral Government's contribution	**22,821**	**25,475**	**26,307**	**34,631**
a Block grants	18,065	19,901	20,788	22,634
b Criteria based grants	1,168	1,163	1,320	2,000
c Matching grants	325	333	600	1,000
d Provincial specific development grants[3]	3,263	4,078	3,599	8,308
e Payment of arrears of principles' salaries	-	-	-	689

urce: Budget Estimates 2000, Vol.II, p. 681, Government of Democratic Socialist Republic of Sri Lanka.

[1] Revised estimates.

[2] Budget estimates.

[3] Until 2000, these grants were known as Medium-term Investment Plan (MTIP) grants.

require constitutional provisions to protect the autonomy of different levels of government. In economics, on the other hand, federalism requires both a central and decentralised levels of decision making regarding the provision of public services. The critical consideration is that provision of public services should reflect the demands for these services by the residents of the respective jurisdictions. Constitutional provisions protecting the powers of lower level governments are not essential for economic federalism. Such provisions can be substituted by healthy conventions. Legal provisions, however, often help in promoting economic federalism.

Decentralisation is not a purely economic decision. The nature of decentralisation in different countries shows that such decentralisation in every country has its own peculiarities and socioeconomic and ideological context. For example, the United Kingdom showed an increasingly centralist stance from 1945 until recent times. "The success of centralised wartime planning during 1939-45 and the subsequent growth of the welfare state resulted in increased control by national government over the expenditures, revenues and provision of services by local governments."[11] The recent devolution of powers to Scotland and Wales appear to have brought an end to the centralisation phase.

According to economists, federalism is a relative rather than an absolute concept.[12] There can be various types of economic federalism in a spectrum of such federalism, with the differences being one of degree rather than kind. Under this approach, in economic terms, while most if not all systems are federal, the critical issue is the appropriate degree of decentralisation. According to Oates, the central theoretical problem of the subject of fiscal federalism is "..the determination of the optimal structure of the public sector in terms of the decision making responsibility for specified functions to representatives of the interests of the proper geographical subsets of society."[13] While the debate about optimal degree of fiscal federalism continues, there appears to be a large degree of consensus as well. For example, the European Charter of Local Self-Government, formulated by the Council of Europe in 1985, has been ratified by almost all member states of the Council of Europe. Within the European Union, this decentralisation principle has been adopted under the name of subsidiarity, namely that powers of the government should be exercised at the lowest level of government possible.[14] Subnational governments are vested with powers to levy their own taxes and user-charges to finance provision of a self-determined mix and level of public sector outputs. Taking into account even the role of local governments, Sri Lanka appears to be very far off from practising the principle of subsidiarity, suitably modified to fit its own conditions.

Neither Constitutional provisions nor conventions have helped Provinces in Sri Lanka to develop as competent spending authorities mobilising and spending resources in accordance with the preferences of their constituents. In Sri Lanka, Provinces 'depend' on the Centre for approval of cadre and for funds to disburse the salaries. In 1999, for example, total emoluments at the Provincial level amounted to Rs. 19,658 million. Block grants of Rs. 20,788 million received from the Centre in 1999 were utilised to disburse these emoluments, leaving little else for other purposes.

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11 Stephen J. Bailey, "Local Government Economics", Macmillan, London, 1999, p. 37.

12 See, for example, Wallace E. Oates, "An Economic Approach to Federalism", in Samuel H. Baker and Catherine S. Elliott (edited) Readings in Public Sector Economics, D.C.Heath &Co., London, 1990, pp. 554-565.

13 See, Wallace E. Oates (1990), ibid, p. 564.

14 See, Stephen J. Bailey (1999), ibid, Ch.2.

III. Underlying reasons – design issues

III.1 A Combination of Factors

Several reasons can be adduced for the unsatisfactory progress of fiscal devolution in Sri Lanka. While some of the reasons are institutional, others relate to design issues and the lead-time needed for a new system to take root and start functioning smoothly. Institutions can be broadly defined as "the rules of the game in society or the incentives and constraints that influence human behavior, and the organizations and other means to enforce them."[15] Fiscal devolution consists of four important components, namely the assignment of expenditure, revenues, transfers and borrowing powers. The 'rules of the game' regarding all the four components, which have not changed much even after the 13th Amendment to the Constitution, can be interpreted as institutional factors in the strict sense of the term. However, in this report, these rules of the game are discussed under design issues, while institutional factors relate to the workings of organisations such as the Central and Provincial Governments, and the Finance Commission.

III.2 Devolution in Its Youth

The 13th Amendment of the Constitution, ushering in federal principles, was passed on November 14, 1987. The Finance Commission was appointed on April 25, 1988. Seven Provincial Councils were constituted in May and June 1988 after elections to Provincial Councils in respect of seven of the nine Provinces specified in the 8th Schedule to the 13th Amendment were held. The Provincial Council for the North-Eastern Province was constituted in December 15, 1988 after elections in respect of the North-Eastern Council were held with the Northern and Eastern Provinces merged as one unit. Thus, barely thirteen years have passed since the process of devolution was initiated. Any new system takes time to start functioning smoothly. Many of the teething troubles are only gradually sorted out as the functionaries 'learn on the job', and conventions are built. Models of governance have to be homegrown. While best practices can be emulated from other countries of the world, adaptation of the system to ground realities at home necessarily takes time.

There are indications that the devolution system is taking root in Sri Lanka. For example, apathy to the new system was demonstrated in a low voter turnout in the first election to the Provincial Councils in 1988. "The national turn-out for the Parliamentary elections (1977), and the Presidential elections (1982) had been 86.7% and 81.1%, respectively. However, at the PC *(Provincial Council)* polls, the turn-out in six of the provinces varied between 53.9% in the Western province and 64.4% in Uva; and in the Southern province, it was only 27.9%."[16] The national average for turnout was only 49.70 per cent. Compared to the first Provincial Council elections, there was widespread voter participation in the second elections to the Provincial Councils held on May 17, 1993.[17] "The elections showed a commendable high voter turnout of

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15 Jennie Litvack, Junaid Ahmad and Richard Bird (1998): "Rethinking Decentralisation in Developing Countries," Sector Studies Series, World Bank, Washington, D.C., 1998, p. 16.

16 G.R. Tressie Leitan, Shirani A. Bandarnayake, and V.N.Sivarajah: "Sri Lanka's System of Provincial Councils: The Second Phase", Centre for Regional Development Studies, Sri Lanka, August, 1994, p. 8.

17 In the Southern Province, after dissolution of the Provincial Council, elections were held again on March 24, 1994. Turnout at 73.97 per cent was slightly higher than the 73.78 per cent observed in the elections held a little more than nine months ago. See "General Elections to Provincial Councils 1988-1994, Final Results by Polling Divisions of Electoral Districts", Department of Elections, Election Secretariat, Saran Mawatha, Rajagiriya, Sri Jayawardenapura.

73.98%."[18,19] A sustained high turnout of 71.85 per cent in the third election to the Provincial Councils (Table 4), held in 1999, demonstrates the growing enthusiasm of the people in the affairs of Provincial Governments.[20]

III.3 DESIGN ISSUES

The design of any system strongly influences the outcome and can make a substantial difference with regard to its acceptability. Although ambiguities in design can be overcome by the development of strong conventions, such conventions require time to develop and also sustained consensus. When neither are guaranteed, it is safer to rely on appropriate design.

The design of fiscal devolution has to address four important components among others. These relate to assignment of functions or expenditures, assignment of revenues, the nature of intergovernmental transfers and that of borrowing powers. Some of the major issues in the context of Sri Lanka relating to these four aspects are discussed below.

a) Fragmented responsibilities and overlapping functions

At the design level, expenditure assignments led to fragmentation of responsibilities over many ministries and overlapping departmental functions between Central and Provincial departments of administration in both the areas of concurrent and devolved subjects. The Thirteenth Amendment to the Constitution in 1987 divided subjects into three categories: Lists I, II, and III (Tables 5 and 6). Provincial Councils were given the right to make statutes applicable to the Province for which it was established [Article 154G(1)], while they were debarred from making statutes on any matter set out in List II or the reserved list [Article 154G(7)]. Parliament and Provincial Councils were given concurrent jurisdictions over matters in List III, the concurrent list [Article 154(5) (a) and (b)]. However, in case of any inconsistency between a statute made by the Provincial Council and a law made by the Parliament, the provisions of the Parliamentary law were designed to supersede the Provincial Statute [Article 154G(6)].

18 Tressie Leitan, Bandarnayake, and Sivarajah (1994), op.cit., p. 31.

19 There were two major differences between the 1988 and the 1993 elections to the Provincial Councils. First, the 1993 elections were held on the same day, but the 1988 elections were staggered. Second, during 1993, elections could not be held in the Northern and Eastern Provinces because of the civil disruptions.

20 Elections in 1999 were staggered over three different dates between January and June. Voter turnout in the North-Western Province, which led the elections on January 25, was a high of 78.65 per cent. Western, Central, North-Central, Sabaragamuwa and Uva followed on April 6. The turnout in these five Provinces varied between 67.18 per cent in Western and 74.34 per cent in Uva. Voter turnout in the Southern Province, where elections were held last on June 10, was 73.78 per cent. No elections could be held in the North-Eastern Province.

Table 4. Sri Lanka: Growing Popular Enthusiasm in Provincial Councils
Turnout in 1999 Provincial Council Elections

Province	Date of Election	No. of electors	Votes polled	Turn-out in per cent
North-Western	25-Jan-99	1,359,295	1,069,019	78.65
Western	6-Apr-99	3,217,038	2,161,293	67.18
Central	6-Apr-99	1,452,906	1,068,887	73.57
North-Central	6-Apr-99	665,416	466,482	70.10
Uva	6-Apr-99	678,990	504,746	74.34
Sabaragamuwa	6-Apr-99	1,113,105	798,735	71.76
Southern	10-Jun-99	1,505,542	1,110,783	73.78
Total		9,992,292	7,179,945	71.85

Source: "General Elections to North Western Province Provincial Council 25.01.1999 & Southern Province Provincial Council 10.06.1999", and "General Elections to Provincial Councils of Western, Central, North Central, Uva & Sabaragamuwa Provinces – 06.04.1999", Final Results by Polling Divisions of Electoral Districts, Department of Elections, Election Secretariat, Saran Mawatha, Rajagiriya, Sri Jayawardenapura.

Table 5. Sri Lanka: Devolved and reserved powers according to Constitution, 13th Amendment

List I (subjects devolved to Provinces)	List II (subjects reserved for the Centre)
1. Police and public order	1. Defence and national security
2. Implementation of provincial planning	2. Foreign affairs
3. School education excluding national schools	3. Posts and telecommunications, broadcasting and television
4. Local government	4. Justice
5. Provincial housing and construction	5. Finance in relation to national revenue, monetary policy and external resources; customs
6. Roads and bridges, excluding national highways	6. Foreign trade; interprovincial trade and commerce
7. Social services and rehabilitation	7. Ports and harbours
8. Road transport services	8. Aviation and airports
9. Agriculture and agrarian services including minor irrigation	9. National transport including railways and national highways
10. Rural development	10. Rivers and waterways, shipping and navigation
11. Health and indigenous medicine	11. Minerals and mines
12. Pawnbrokers, markets and fairs	12. Immigration, emigration and citizenship
13. Food supply	13. Elections
14. Cooperatives	14. Census and statistics
15. Land rights, land settlement and improvement	15. Professional occupation and training
16. Irrigation except interprovincial schemes	16. Archaelogy and archives
17. Animal husbandry	17. Foreign pilgrimage
18. Provincial public enterprises	18. Incorporation and regulation of corporations, including financial institutions, but excluding cooperatives
19. Juvenile delinquency	19. Patents, inventions and design
20. Regulation of intoxicating liquors	20. Standards of weights and measures
21. Burial and burial grounds, cremation and cremation grounds, excluding national memorial cemeteries	21. Quality control of exports and interprovincial trade
22. Provincial cultural institutions and historical monuments other than those of national importance	22. Control of industries
23. Mines and mineral development to the extent permitted by law	23. Mine safety and regulation of labour
24. Regulation of non-financial and nontrading corporations, operating only within a province	24. Salt
25. Regulation of unincorporated societies and associations	25. Opium
26. Entertainment industry excluding television and broadcasting	26. Industrial disputes concerning employees of the Government of Sri Lanka
27. Sports, excluding national sports	27. Institutions of national importance
28. Betting and gambling, other than imposition of license fees and taxes	28. Geological, botanical, zoological and anthropological surveys of Sri Lanka; meteorological organisations
29. Provincial debt	29. National public service commission
30. Power, other than hydroelectric power and those feeding the national grid	30. Pensions
31. Devolved taxation powers[21]	31. Parliamentary affairs
32. Environmental protection to the extent permitted by law	32. Interprovincial migration and quarantine
	33. All unspecified matters

Source: Parliament of the Democratic Socialist Republic of Sri Lanka (1987): Thirteenth Amendment to the Constitution. Published as a supplement to Part II of the Gazette of Sri Lanka of November 20, 1987.

[21] See Box 1.

Table 6. Sri Lanka: Concurrent powers according to Constitution, 13th Amendment

List III

1	Planning, including formulation and appraisal of plan implementation strategies at the provincial level, monitoring progress of public and private investment, evaluation of performance of institutions engaged in economic activities, presentation of data regarding achievement of plan targets, publicity of implementation programmes, manpower and nutritional planning.
2	Education and education services except those in the devolved list.
3	Higher education, including establishment of universities.
4	National housing and construction.
5	Acquisition and requisitioning of property.
6	Social services and rehabilitation.
7	Agricultural and agrarian services.
8	Health.
9	Registration of births, marriages and deaths.
10	Renaming of towns and villages.
11	Private lotteries within the Province.
12	Festivals and exhibitions.
13	Rationing of food and maintenance of food stocks.
14	Cooperatives – cooperative banks.
15	Surveys for any of the matters enumerated in the provincial or concurrent list.
16	Irrigation.
17	Social forestry and protection of wild animals and birds.
18	Fisheries other than fishing beyond territorial waters.
19	Animal husbandry.
20	Employment.
21	Tourism.
22	Trade and commerce in foodstuffs and cattle fodder, and any other product declared by Parliament to be in national interest.
23	Newspapers, books and periodicals and printing presses.
24	Offences against statutes with respect to any matters specified in the concurrent list.
25	Fees with respect of any matters in the concurrent list except court fees.
26	Charities, and charitable and religious institutions and endowments.
27	Price control.
28	Inquiries and statistics for the purpose of any of the matters in the Provincial or concurrent lists.
29	Adulteration.
30	Drugs and poisons.
31	Electrification and regulation of the use of electricity.
32	Environmental protection.
33	Archaeological sites and remains, other than those declared to be of national importance.
34	Prevention of infectious or contagious diseases or pests across provinces.
35	Pilgrimages.

Source: Parliament of the Democratic Socialist Republic of Sri Lanka (1987): Thirteenth Amendment to the Constitution. Published as a supplement to Part II of the Gazette of Sri Lanka of November 20, 1987.

It can be argued that most devolution arrangements have a concurrent list of functions with simultaneous jurisdiction of both the Central and lower level governments. Often, the two levels of government work out arrangements to minimise overlap and unnecessary duplications. In Sri Lanka, perhaps because of an institutional failure rather than a design deficiency per se, this has not happened.

Fragmentation of responsibilities and the overlapping of functions can be illustrated by the three major areas of education, health and roads. 'Education and education services' is item 4 on List I, which is meant for Provincial Councils. List I stipulates that the jurisdiction of the Provinces extends to areas of education – mainly school and pre-school education – as set out in Appendix III. Appendix III, however, further clarifies that Provincial jurisdiction will not extend to 'specified schools', which are National Schools, Special Schools for Service personnel and schools for specified development schemes. Only 'institutions, such as Universities, declared by Parliament by law to be institutions of national importance', police training institutes, coordination and determination of standards in institutions for higher education or research and scientific and technical institutions are included under 'Professional occupations and training' in List II reserved for the Centre. However, specified schools (as explained above) and higher education – the establishment and maintenance of new Universities, and the establishment of degree awarding institutions under the Universities (Amendment) Act, No. 7 of 1985, and other institutions for tertiary, technical and post-school education and training – are included in List III under the concurrent jurisdiction of the Centre and the Provinces. It is reasonable to conclude that as per the scheme of the Thirteenth Amendment, the Centre was expected to play a minor role relative to Provinces in the area of education. But, the share of the Centre in total public expenditure on education in Sri Lanka was an average of over 97 per cent during 1997-2000 (Table 7), with a mild tendency for the Centre's share to increase over time. In the creeping acquisition mode, an increasing number of schools has been designated by the Centre as 'national' schools. "In one province, ...at the commencement of devolution (1987) there had been 4 national schools.... There are now 50 such national schools in the province."[22]

Table 7. Sri Lanka: Overlapping Roles in Education, Health and Roads Public Spending by Two Levels of Government

(In millions of rupees)

Year	Education		Health		Roads	
	Centre	Provinces	Centre	Provinces	Centre	Provinces
1997	22,349	731	12,135	820	7,087	732
1998	26,578	750	15,044	1,039	10,668	1,000
1999(RE)	28,032	800	17,795	1,579	11,511	1,000
2000(BE)	30,377	900	22,724	2,520	12,821	3,000

Source: Budget Estimates, 2000, Vol.I, p.xviii and Vol. II, p.681.

Like in education, the Thirteenth Amendment reserves dominant roles for the Provincial Governments in the areas of health and roads as well. Health is in List I as item 11, and includes the establishment and maintenance of public hospitals, rural hospitals, maternity homes, and dispensaries (other than teaching hospitals and hospitals established for special purposes); public health services, health education, nutrition, family health, maternity and child care, food and food sanitation, environmental health. Interestingly, item 11 in List I also states that the provision of

22 AACM International (2000): "Technical Assistance to the Democratic Socialist Republic of Sri Lanka: Institutional Strengthening of the Ministry of Provincial Councils and Local Governments", Interim Report, for the Asian Development Bank, TAR: SRI 32305, August, p. 22.

facilities for all within-province institutions mentioned is devolved to the Provinces, except 'the procurement of drugs.' Drugs and poisons are in the concurrent list (item 30, Table 6). Again, the spirit of the Thirteenth Amendment is clearly in favour of devolving health services to Provinces, but the Centre has continued to occupy a large place in the sector, particularly through procurement of drugs for provincial institutions. The share of the Centre in the total public expenditure on health was a high of over 92 per cent on the average during 1997-2000 (Table 7).

List I assigns 'Roads and bridges and ferries thereon within the Province, other than national highways, and bridges and ferries on national highways' to the Provinces. National highways – highways declared by or under law made by Parliament to be national highways – are on List II reserved for the Centre. In spite of the clear importance assigned to the Provinces in the area of roads, the share of the Centre in total public spending on roads was between 81 and 92 per cent in each of the four years of 1997-2000 (Table 7).

'Planning' is another area that has led to considerable overlap and ambiguities. Implementation of provincial economic plans, formulation and implementation of Health and Education Development Plans and Annual Health and Education Plans of the Province, planning of irrigation works other than irrigation schemes relating to rivers running through more than one Province, industrial development plans for the Province are devolved subjects. On the other hand, "national policy on all subjects and functions" is in the reserved list (List II) for the Centre, while formulation and appraisal of plan implementation strategies at the provincial level, manpower and employment planning, and nutritional planning are in the concurrent list.

Box 1. Devolved taxation powers

Devolved taxation powers include: turnover taxes on wholesale and retail trade; betting taxes; taxes on prize competition and lotteries other than national lotteries and lotteries organised by the Government of Sri Lanka; license taxes, arrack, toddy rent, tapping license fees, and liquor license fees; motor vehicle license fees as prescribed by Parliament; dealership license taxes on drugs and other chemicals; stamp duties on transfer of properties such as land and motor cars; toll collections; fines imposed by courts; fees charged under the medical ordinance; fees charged under the motor traffic act; departmental fees in respect of any matter specified in List I; fees under the flora and fauna protection ordinance; fees on land alienated under the land development ordinance and crown lands ordinance; court fees, including stamp fees on documents produced in court; regulatory charges under the weights and measures ordinance; land revenue; taxes on lands and buildings; taxes on mineral rights as prescribed by the Parliament; licensing fees on possession, transport, purchase and sale of intoxicating liquors; any other tax as permitted by Parliament.

b) Vertical imbalance

A serious imbalance between decentralisation of expenditure and revenues to the Provincial level at the time of the switchover to a fiscally devolved system in 1987 had a role to play in the development of the dependency syndrome. A severe lack of correspondence between expenditure and own revenues at the margin erodes accountability and performance monitoring, and results in an incipient excess demand for funds from the financing agency. Substantial own revenues are critical for developing a sense of responsibility at lower levels of government. Some vertical imbalance is unavoidable in any devolved system, but in Sri Lanka, because of too little own revenues of the Provinces, the imbalance was severe.

At the level of all Provinces in the aggregate, in 1997, Central Government grants amounting to Rs.22.8 million financed as much as 82.15 per cent of total expenditure of Rs. 27.8 million (Table 8). The imbalance was so pronounced that own revenues of less than Rs.5 million could have financed barely 21.5 per cent of the recurrent expenditures of the Provinces in the aggregate. Indeed, the imbalance partly reflects inadequate efforts on the part of the Provinces to mobilise additional own revenues. As discussed below, while the unwillingness on the part of the Provinces to mobilise additional revenues itself reflects a devolution design failure, the imbalance also reflects a lack of correspondence between expenditure and revenue assignments. Furthermore, it can be argued that the Centre continues to carry on spending activities that according to the Constitutional assignment of functions belong to the Provincial domain, and the 'true' magnitude of the imbalance is considerably larger than that reported in Table 8.

Table 8. Sri Lanka: Fiscal Imbalance at the Provincial Level, 1997

Province	Expenditure			Central Government Grants	Grants as a proportion of total Expenditure
	Recurrent	Capital	Total		
	(In thousands of rupees)				(In per cent)
Western	5,602,407	900,951	6,503,358	3,352,471	51.55
North-Western	2,790,887	486,522	3,277,409	2,853,838	87.08
Central	3,235,449	634,845	3,870,294	3,425,924	88.52
Southern	3,090,874	796,265	3,887,139	3,500,663	90.06
Sabaragamuwa	1,930,658	523,922	2,454,580	2,236,864	91.13
Uva	1,603,366	530,092	2,133,458	1,984,730	93.03
North-Central	1,733,140	428,980	2,162,120	2,014,136	93.16
North-Eastern	3,063,475	428,212	3,491,687	3,452,119	98.87
Total	23,050,256	4,729,789	27,780,045	22,820,745	82.15

Source: Budget Estimates, 2000, Vol. II, p.681-690.

Promoting self-sufficiency was not among the principles that the 1987 Constitution enjoined on the Finance Commission for distributing grants.[23] Article 154R(3) requires the Finance Commission to recommend allocations in the Annual Budget of the government of grants "adequate for the purpose of meeting the needs of the provinces." Article 154R(5) provides elaborate guidelines regarding the principles to be adopted in recommending grants to PCs "with the objective of achieving balanced regional development in the country." There was no mention of the need to encourage Provinces to meet a growing part of their needs from their own finances.

c) Horizontal imbalance

The nature of the fiscal imbalance at the Provincial level has a horizontal dimension as well. For example, the own revenues of the Western Province amounting to Rs. 3.1 million was more than 63.5 per cent of the aggregate own revenues of all Provinces of a little less than Rs.5 million. The Western Province, containing the capital territory of Colombo, has a large concentration of economic activities and a large tax base. Location in Colombo of many large manufacturers as well as wholesale dealers having country-wide dealings gives the Western Province its preeminent position in devolved revenues. In 1997, the individual share of the three Provinces of North-Western, Central and Southern in aggregate own revenues of the Provinces was between 8-9 per cent, with the corresponding share of Sabaragamuwa at around 4.5 per cent. The shares of Uva and North Central were at around 3 per cent, while that of the disturbed North-Eastern Province was less than one per cent.

Of course, the expenditure responsibilities of the Western Province are also far greater than in other provinces, if only because it contains almost quarter of the entire population of the island. But even after allowing for it, the Western Province still enjoys some advantage over all other provinces in terms of own revenues.

According to the Constitutional reform proposal that was pending before the last Parliament, the territory of the Republic would comprise of the capital territory, the regions (provinces would be renamed as regions), the territorial waters and the air space above. Thus, Colombo would cease to be a part of the Western Region (currently Western Province). While this proposal would have redressed a part of the horizontal imbalance, without the other measures proposed in the reform proposal – such as, revenue sharing with the Central Government – it would do so only by increasing the dependence of the Western Province without helping the others.

d) Absence of revenue sharing

In Sri Lanka, the Constitutional devolution design did not envisage any revenue sharing. Salgado (1989), in his pioneering report, noted "Neither Article 154R nor any Article of the Constitution of Sri Lanka makes reference to the possibility of revenue sources other than any included in the Concurrent List being shared between the Government and the Provinces or any revenues being assigned (as distinct from being devolved) by the Government to the Provinces."[24]

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[23] Promotion of efficiency at all levels of government through the system of intergovernmental transfers is another principle that the Constitution is silent about.

[24] Dr. M.Ranjit P.Salgado: "Report on Fiscal Aspects of the Public Sector Restructuring Project (Financial Devolution to the Provinces)" World Bank, September 6, 1989, p.3.

In a footnote, he also emphasised that "In this respect the Constitution of Sri Lanka differs sharply from that of India."

In a letter to the Attorney General, Sri Lanka, dated June 30, 1987, the Chairman of the Finance Commission had sought clarification regarding, among other things, "Whether revenue from general taxation could be i) "assigned" rather than "devolved"; ii) shared with the Provincial Council/s." In his reply of August 8, 1987, Attorney General P. Sunil C. de Silva stated "I am of the opinion that the 13th Amendment envisages only certain specified means by which the Provincial Councils obtain their revenues, viz. by recourse to such sources as are specified in List I or List III and such grants as the Government may make. The Indian Constitution specifically permits revenue 'sharing' and 'assignment' between the Central Government and the State Governments and the Finance Commission of that country is called upon to make recommendations regarding the distribution of tax revenues taking that into account. Our Constitution does not provide for such assignment or sharing." He went on to add "If the Government wishes to assign or share a portion of tax revenues collected under an Act of Parliament, to the Provincial Councils, an Amendment of the Constitution would be required."[25]

It may be argued that even grants to Provinces, in so far as they are financed by Central Government's revenues, are 'shared revenues' in an indirect way. While that is true, shared revenues have four major differences with grants. First, shared revenues are 'entitlements' of Provinces, and more like 'own revenues'; grants, on the other hand, have the flavour of hand-outs. Shared revenues help to promote responsibility more than grants do. Second, with shared revenues, Provinces develop a stake in the Centre's revenues performing well. There are benefits in tax administration and improvements in compliance. Third, shared revenues have more certainty associated with it. The sharing ratio is expected to remain unchanged for stretches of time. Fourth, shared revenues have a built-in adjustment mechanism associated with it. Shared revenues go up when the economy does well and taxes are buoyant. The absence of shared revenues contributed to the 'dependency' of Provinces on the Centre. The central theoretical problem of fiscal devolution is the determination of the optimal structure of the public sector in terms of the assignment of decision making responsibilities. Dependency militates against the development of decision making responsibilities.

In the specific context of Sri Lanka, some of the virtues of shared revenues can be incorporated into grants as well, mainly because the latter are determined annually unlike, for example, in India. The built-in adjustment that shared revenues have in relation to overall economic fluctuations can be easily provided for in a system of annual grants that is explicitly or implicitly based on revenues of the grantor government. Also, for Provinces to develop a stake in Central revenues, as presumed in the case of shared revenues, under a system of only grants, perfect knowledge of the direct link between grants and Central revenues should suffice.

How great, then, is the need for revenue sharing in the specific context of Sri Lanka? The balance of considerations suggests that it is needed, but not to the same extent as, for example, in India or Australia.

[25] Reproduced in Appendix I of Salgado (1989), op. cit.

e) Too little incentive through grants for revenue mobilisation

Without limited assigned revenues and no sharing of Central revenues with the Provinces, the vertical fiscal imbalances between the Centre and the Provinces have been addressed by a system of intergovernmental grants. The responsibility of designing these grants was assigned to the Finance Commission. Article 154R(3) requires the Finance Commission to recommend to the Government the allocation from the Annual Budget, of funds "adequate for the purpose of meeting the needs of the Provinces." According to Article 154R(4), the Commission is also required to recommend to the President the "principles on which such funds as are granted annually by the Government for the use of Provinces, should be apportioned between the various Provinces." Article 154R(5) enjoined the Commission to formulate its recommendations "with the objective of achieving balanced regional development in the country."

After a tentative beginning for the second half of 1988, when the Finance Commission recommended that the available funds allocated in the Central Budget for District Development Council be distributed pro rata to the Provincial Councils, grants in 1989 jumped up from Rs. 200 million for the second half of 1988 to Rs. 1,360 million in 1989. Apart from funds allocated for District Development Council, those allocated for the Decentralised Budget and Integrated Rural Development Project were also 'granted' to the Provincial Councils.

A pioneering 1989 report by Dr. M. Ranjit P. Salgado, which came to be known as the Salgado Report, provided the framework that the Finance Commission adopted for giving its recommendations to the Government. Details of the Salgado recommendations are given in Boxes 2, 3 and 4. The Salgado recommendations were adopted by the Finance Commission from 1990. There was no attempt to revise the formulae recommended by Salgado in the light of the evolving situation, and the combination of 'gap filling' by block grants and taxation of additional revenue mobilisation through a system of matching grants resulted in too little incentive for additional revenue mobilisation by the Provinces and perpetrated the 'dependency' of Provinces on the Centre.

i) 'Gap-filling' by block grants

Salgado, while recommending block grants equivalent to '80 per cent of the gap between estimated current expenditure and the estimated revenue collection of each Provincial Council', had pointed out that '80 percentage' was proposed for 1991, and the percentage may be changed, if necessary, in subsequent years. In the event, the percentage was closer to 100 in recent years. For example, block grants were equivalent to 99.89, 100.23, 100.66 and 98.25 per cent of recurrent expenditure less own revenues in 1997, 1998, 1999, and 2000, respectively. The way block grants were administered resulted in complete 'gap-filling' by the Centre. Routine projections of own revenues and recurrent expenditures from the past to the future, without reference to the tax potential, or to the needs and delivery efficiency of public services in the Provinces, contributed to the 'gap-filling' nature of the grants.

With continuing pressure of defense expenditure on the Centre because of the prolonged ethnic conflict in the Jaffna peninsula and declining revenues, criteria-based grants after increasing from Rs. 788 million in 1990 to Rs. 1,000 million in 1992, declined gradually to Rs.

800 million in 1996 before increasing to Rs. 1,168 million in 1997. Devolution became an exercise in filling the recurrent expenditure gaps of Provinces.

Box 2. Salgado recommendations

In the fall of 1989, Dr. M. Ranjit P. Salgado submitted his "Report on Fiscal Aspects of Public Sector Restructuring Project (Financial Devolution to the Provinces)." Salgado proposed five different types of grants: i) block grants, ii) matching grants, iii) criteria-based grants, iv) medium-term investment programme (MTIP) grants, and v) special reconstruction and rehabilitation grants.

Block grants were proposed to meet the major part of recurrent expenditures net of devolved revenues. They were 'needs-oriented rather than principles-based.' Salgado recommended that block grants equivalent to 'the gap between 80 per cent of the estimated current expenditure and the estimated revenue collection of each Provincial Council' be provided by the Centre.

Matching grants were designed to reward revenue efforts. The matching grants were linked to the increase in revenue collection in the lapsed year compared to the revenue collection of a specified base year or base year period average.

Criteria-based grants were meant to reflect 'differences in per capita income and social and economic disparities and their application should result in higher allocations, relative to population, to the more disadvantaged Provinces,' and aimed at reducing inter-Provincial disparities. The total amount of criteria-based grants – grants meant to address the issue of inter-Provincial disparities – was left by Salgado to be 'ascertained by the Finance Commission in consultation with the Ministry of Finance, the Ministry of Policy Planning and the Ministry of Provincial Councils'.

MTIP grants were designed to reconcile the ambiguities in the Thirteenth Amendment regarding the status of planning in the devolved schemes.

Specially tailored reconstruction and rehabilitation projects were needed for redressing the impact of civil disruptions. While the Centre implemented some of these special projects, others had to be done by the Provinces. *Special Reconstruction and Rehabilitation Grants* were designed to finance the special projects that were to be implemented by the Provinces themselves.

See, Dr. M.Ranjit P.Salgado: "Report on Fiscal Aspects of the Public Sector Restructuring Project (Financial Devolution to the Provinces)" World Bank, September 6, 1989.

ii) Taxation of additional revenue mobilisation by matching grants

Salgado's scheme of matching grants took into account the existing revenue base, revenue potential, tax incidence and tax administration capacity of Provinces. On the basis of 1987 data on collection of devolved taxes and their per capita incidence, a differentiated scheme was devised such that, with reference to the Western Province – the richest Province in terms of devolved revenues – equivalent effort in terms of percentage increase in own revenues would result in equal per-capita matching grant rewards. The scheme is given in Box 3. Matching grants were disbursed from 1995 onwards, and the benchmark year taken for calculating relevant slab for a Province was 1992. Thus, for the year 2000, the percentage increase in revenues – and hence the relevant slab – was determined by calculating the percentage increase in revenues in the previous year, i.e. 1999, over revenues in 1992.

The combination of the way block grants were administered and matching grants were designed, however, resulted in a set of inadequate incentives for additional revenue mobilisation by Provinces. Block grants being calculated as recurrent expenditure *less* own revenues, any additional revenue mobilisation by Provinces automatically led to an equivalent reduction in block grants. The only additional resources left with the Provinces were the matching grants. The differentiated slabs for the Provinces implied that there was *no additional incentive* for the six Provinces of North-Central, North-Eastern, North-Western, Sabaragamuwa, Southern and Uva to mobilise additional revenues up to 25 per cent over the benchmark level. For every rupee of additional revenue mobilised they would lose a rupee in block grant and gain a rupee in matching grant, leaving them with exactly a rupee of additional revenue – no more and no less – at the end. By the same argument, there was no additional incentive for the Central Province to mobilise additional revenues up to 50 per cent over the benchmark level. For the Western Province, while there is no additional incentive ever for mobilising extra revenues, there was *taxation* involved until it doubled its revenues over the benchmark figure. For example, up to 50 per cent of revenues over the benchmark, for an extra rupee mobilised, the Western Province would lose a rupee in block grants, and get a matching grant of only Rs. 0.50. Thus in effect, it would get additional spendable resources of only Rs. 0.50 for the extra Rs.1 mobilised, the other half of the additional rupee being in effect 'taxed away' by the Centre. Ostensibly for ameliorating the continuing fiscal stress at the Centre, the Finance Commission recommending less matching grants for the Provinces than what the Salgado report had prescribed compounded the built-in incentive problem.[26]

[26] See discussion below under section 2.c and section 4 in Chapter IV.

Box 3. Rates of Matching Grants

Category increase	Provinces	Slabs	Rates per rupee
A	North-Central North-Eastern North-Western Sabaragamuwa Southern Uva	0-25% above the benchmark	Rs.1.00
		25%-50% above the benchmark	Rs.2.00
		50%-75% above the benchmark	Rs.3.00
		75%-100% above the benchmark	Rs.4.00
		Over 100% above the benchmark	Rs.5.00
B	Central	0-50% above the benchmark	Rs.1.00
		50%-100% above the benchmark	Rs.1.50
		100%-125% above the benchmark	Rs.2.00
		125%-150% above the benchmark	Rs.3.00
		150%-175% above the benchmark	Rs.4.00
		Over 175% above the benchmark	Rs.5.00
C	Western	0-50% above the benchmark	Rs.0.50
		50%-100% above the benchmark	Rs.0.75
		Over 100% above the benchmark	Rs.1.00

M.Ranjit P.Salgado: "Report on Fiscal Aspects of the Public Sector Restructuring Project (Financial Devolution to the Provinces)" World Bank, September 6, 1989, pp. 65-66.

The Thirteenth Amendment to the Constitution provided scope to the Provinces for additional revenue mobilisation through several items, notably taxation on lands and buildings, including the property of the State, taxes on mineral rights and a 'residual' omnibus category (Box 1). These were, however, circumscribed by the clause 'to the extent permitted by or under any law made by Parliament'. According to the Attorney General, the clause 'to the extent permitted by or under any law' implies the need for enabling legislation by Parliament.[27] Nevertheless, there was a singular lack of enthusiasm on the part of the Provinces to exploit their tax potential granted by the Constitution. Many Provinces have not even passed the statutes for levying the relevant devolved taxes (Box 4). The lack of enthusiasm of the Provinces in mobilising additional devolved revenues reflects the inadequate incentive built in the design of devolution.

[27] See "Report on Fiscal Aspects of the Public Sector Restructuring Project (Financial Devolution to the Provinces)" by Dr. M.Ranjit P.Salgado, World Bank, September 6, 1989, p. 6.

Box 4. Lack of enthusiasm in tapping devolved revenue sources

Except for turnover tax, stamp duty on transfer of property, and tavern rent for sale of arrack, toddy and foreign liquor, for every other tax or levy, there are many Provinces[28] that have not even passed the enabling statutes to start the process of collecting the revenue. As of early-October 2000, the Provinces that had not passed the statutes with respect to some important devolved revenue sources are indicated below:

betting tax: North-Central, North-Western, Sabaragamuwa, and Southern Provinces
taxes on prize competition: all except Uva and Western
taxes on lotteries: all except Central, Uva and Western
taxes on land and buildings: all except Sabaragamuwa, Southern and Uva
taxes on mineral rights: all except Central, Southern and Uva
license taxes: North-Central and Uva
land revenue: North-Western

See Pawan K. Aggarwal: "Capacity Building on Fiscal Devolution in Sri Lanka: Some Tax Issues", July 2001, Table 6.

f) Absence of loans from the Centre

In Sri Lanka, the Provinces are free to raise loans on their own. But, they have not done so, and consequently Provinces have no debt liabilities. Furthermore, in some countries, part of the finances provided by the Centre to the Provinces is in the form of loans. For example, 70 per cent of the 'plan assistance' provided to the States by the Centre in India is in the form of loans.[29] In Sri Lanka, there are no loans from the Centre to the Provinces.

In Sri Lanka, even the capital grants from the Centre to the Provinces called Medium Term Investment Projects (MTIP) grants were in the form of grants. In a circular dated September 8, 1999, the Finance Commission informed the Provinces that "...the MTIP Grants have been renamed as Provincial Specific Development Grant (PSDG) from year 2000 and include more activities than that of MTIP. PSDG is a capital grant, which should be spent on the purposes indicated and according to the guidelines given. Funds under this will be released to Provinces directly by the Treasury on the recommendations of the Finance Commission." The main difference between MTIP and PSDG thus is that unlike MTIP, under which funds were channeled through line ministries at the Centre, PSDG funds are released directly to the Provincial Governments. But, the assistance, like under MTIP, continues to be in the nature of grants even under PSDG.

With a well-designed devolution system, the interest obligation on its debt liabilities can provide incentives to a government for additional resource mobilisation.[30] In Sri Lanka this incentive is absent as well. Furthermore, given the asymmetrics of the financial position of the

28 The discussion excludes the North-Eastern Province, where the Provincial Council does not exist since June 22, 1990.

29 There are two types of States in India: special category States and others. While only 10 per cent of the plan assistance to the special category States is in the form of loans, the loan component is 70 per cent for others.

30 It may be noted, however, that such incentives disappear with the Finance Commission following a 'gap filling' approach.

Provinces, it appears unlikely that, with the possible exception of the Western Province, others will command a satisfactory credit rating.

g) Role of local governments

The role of the 309 local government institutions – the municipal councils, the urban councils, and the Pradeshiya Sabhas – are a subject under List I in the Ninth Schedule added to the Constitution under the Thirteenth Amendment. The Thirteenth Amendment, by not permitting the Provincial Councils to reduce the functions and powers of the local authorities, has effectively created a three-tier system of fiscal devolution. Interestingly, according to the Thirteenth Amendment, where warranted, Provincial Councils can assign to local government institutions powers additional to those given by the Constitution.[31] Economies of scale available at different levels recommend a three-tier system. Furthermore, the extant two-tier system of only a Central Government and local bodies did not seem have worked well in Sri Lanka, perhaps because of an asymmetry of bargaining power between the two tiers of the system.

Like in the case of Provinces, there has been a lack of enthusiasm on the part of the local government institutions to fully play their roles in the new devolved system. While it is possible to surmise that the reasons for the lack of enthusiasm are analogous to those for Provinces, a more detailed analysis is needed to come to firmer conclusions. It appears that the question of relationship between local government institutions and provincial councils has not been addressed adequately. For example, the conditions under which local governments can approach the Provincial Councils in matters of say, staff, planning and development, and finances, need to be looked into. A three-tier system of devolution is a time-tested model, but a study of the whole gamut of issues relating to expenditure and tax assignment and the transfers from the second tier (namely, the Provincial Councils) to the third tier (namely, the local governments) is beyond the scope of this paper.

There are a host of 'core' public goods and services that governments at the three levels must take responsibility for making available to the citizens. But, at all levels of government, there must be a clear recognition of the distinction between the government as a facilitator and financier of the provision of public goods and services, or of private goods and services with large externalities, and the government as the direct provider of such goods and services. There are areas where the private sector as well as non-governmental organisations (NGOs) can produce and deliver public goods and services at a lower cost than the government. In an era of liberalisation and globalisation, the governments at all levels must focus on provision of public goods and services at the lowest possible cost by enlisting the services of the private sector and NGOs, both at home and abroad.

31 See Om Prakash Mathur: "Institutions for Fiscal Devolution: A Study", September 2001, p.35.

IV. Underlying reasons – institutional factors

IV.I Nature of Institutional Factors

The institutional limitations impinging on the inadequate progress on the devolution front have their roots in history, geography as well as political developments. Historically, Provincial Council administrations were deconcentrated line ministries of the Central government, with centrally appointed divisional secretaries (under centrally appointed district secretaries) discharging the function of service delivery.[32] Sri Lanka, a small country with an area of 66,000 square kilometers, had been a unitary country. While the ethnic conflict led to the adoption of a federal arrangement, the question of whether or not any departure from a unitary arrangement of the past was at all needed, sometimes distracted focus away from 'how to devolve' to 'why devolution'.

A World Bank report notes: "Sri Lanka has not realized the potential benefits of a decentralised system of economic management. In particular, the decentralization implemented in Sri Lanka has not permitted high quality demand-driven service delivery to local populations. This is not surprising given that the first round of devolution in 1987 was introduced to the country more as a potential solution to the conflict in the North-East, than from a firm commitment to improve mechanisms for better service delivery and public administration to the provinces."[33]

The political setting of Sri Lanka is described well in a recent AACM report: "The literature on the post-colonial state in Sri Lanka consistently describes the post-independence period as one of mounting centralisation of power. This movement had strong political and socio-cultural foundations. From a political standpoint, growing ethnic tensions made it necessary to reassert the supremacy of the notion of a unitary (Sinhala) state. The rallying cry against the threatened disintegration of the state created a laager mentality in the Sinhalese community that was strongly supportive of centralisation. Both popular and political support stemmed from the perceived necessity for the ethnic community to close ranks against the threats posed by the Tamil separatist movement. This strong centrifugal pull reinforced political and administrative traditions and inclinations established since independence that were in any case strongly centralist."[34]

"Moreover, this crisis of the state promoted widespread interest in finding deeper historical and cultural rationalisations for strengthening and maintenance of a 'single sovereignty.' The crescendo of political opposition that greeted the introduction in 1987 of the 13^{th} Amendment to the Constitution, which ushered in the idea of devolution and threatened to undermine the Sinhala position, was to be expected. But powerful community groups, such as the Buddhist

32 Sri Lanka has 8 provinces divided into 25 districts. The number of districts range from only 2 each in North-Central, Sabaragamuwa and Uva to as many as 8 in the North-Eastern province. Each district is divided into divisions, with the number of divisions in each province ranging from 25 in Uva to 69 in the North-Eastern province. The total number of divisions is 314.

33 World Bank Country Report: "Sri Lanka: Recapturing Missed Opportunities," 2000, p. 25.

34 AACM report, ibid, p. 9.

Theosophical society, were also moved to present rebuttals of decentralisation, demonstrating the depth and breadth of opposition to the idea in Sinhalese society. These rebuttals challenged decentralisation on historical and cultural grounds."[35]

The report goes on to say "...in 1987 Sinhalese politics and society was moving determinedly away from decentralisation. The passing of the 13th Amendment was therefore against the current of popular and political sentiment and could only have been accomplished under externally imposed duress. Uyagonda (1994) and others confirm this: "In a very significant way the devolution package of 1987 marked a somewhat abrupt break in the centralising tendency of the Sri Lankan state."(p. 84) Indeed, "the leading political forces in Sinhalese society were vehemently opposed to such a major rearrangement of the political order" (Uyagonda, 1994, p. 85)."[36]

"At the same time, however, in some quarters it was acknowledged that some form of devolution might help to solve the Tamil question without leading to the breakup of the state. But in the Sinhala community such views were expressed without conviction or political support, and remained *sote voce*."[37]

The question of the constitutionality of the new structure came up before the Supreme Court as well, and survived only by a narrow margin.[38] Furthermore, after the adoption of the new Constitution, the hope of a rapid establishment of peace in the war-torn northern areas was frustrated by political developments. The North-Eastern council had to be dissolved in June 1990 after declaration of independence by the Council. The absence of political reconciliation under the new arrangements diluted the faith in the effectiveness of the new federal arrangements, and hence commitment to its successful implementation. Potential threat of secession and fragmentation of the country have muted political demands for decentralisation, which can be efficiency and welfare enhancing without fracturing the body polity. These general socio-political factors definitely have played a role in affecting the functioning of the Central and Provincial Governments as well as the Finance Commission in advancing fiscal devolution in Sri Lanka. A brief discussion of the main institutional features that impeded the functioning of devolution in Sri Lanka follows.

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35 AACM report, ibid, p. 10.

36 AACM report, ibid, p. 10. The quotes from Uyagonda is from S. Bastian (edited): "Devolution and Development in Sri Lanka," International Centre for Ethnic Studies, Colombo, 1994.

37 AACM report, ibid, p. 10.

38 The question whether the 13th Amendment and the Provincial Councils Bill were 'consistent' with the Constitution, and required a referendum came up for judgement before the full bench of the Supreme Court. "The Supreme Court of nine judges was divided on the issue. The majority decision was that neither the Provincial Councils Bill nor any provision in the 13th amendment to the Constitution required approval by the people at a referendum, by virtue of the provisions of Article 83. According to this view, once the bill is passed in Parliament by a 2/3 majority, and the Constitution amended accordingly, the Provincial Council Bill would not be inconsistent with the so-amended Constitution. This majority view was taken by 4 judges, including the Chief Justice. One other judge agreed with this determination, but held that the provisions of clauses 154(2) (b) and (3) (b) of the bill to amend the Constitution required approval by the people at a referendum The minority judgement on the other hand held that both bills in their totality required approval of the people at a referendum." See Tressie Leitan, Bandarnayake, and Sivarajah (1994), op.cit., p. 5.

IV.2 INSUFFICIENT RESTRUCTURING OF THE CENTRAL GOVERNMENT

a) Divisional Secretaries and line ministries

Among the institutional reasons for inadequate progress of fiscal devolution, the continuation of the system of centrally appointed divisional secretaries and line ministries at the Centre even on devolved subjects together with the Ministry of Provincial Councils have been the most important ones. Line ministries – such as the ministry of livestock, and the ministry of cooperatives – continue to exist even on devolved subjects. Furthermore, the Central government continues to build rural roads, and have new institutions such as the Southern Development Authority in provinces. These have not only created unnecessary duplication and overlap between Central and Provincial functions but also led to ambiguities regarding responsibilities between the Centre and the Provinces. Elected local governments represented by Municipal Councils, Urban Councils and the Pradeshiya Sabhas have had uneasy existence parallel to divisional secretaries, representing the long arm of the deconcentrated Central government and its line ministries.

The World Bank (2000) notes that "There has also been a proliferation of government institutions over the last 20 years. The number of central ministries increased from 33 to 46 between 1980-85, reduced to 28 in 1990, and is now at 35. Further, there are a large number of para-statals like statutory boards and corporations whose jurisdictions overlap with those of the Provincial Councils.[39]

Writing about the failure of the decentralisation strategy in the pre-devolution phase, Gunawardena (1991) observed: "A decentralisation strategy failed to institutionalise 'district' coordination of programmes, which seemed to rest more on the personal initiative and leadership of the Government Agent. Line Departments continued to maintain their departmental orientation rather than develop a district orientation. The district had little or no role in decision making. Further, the decentralisation programmes remained essentially an administrative exercise with little or no political involvement."[40] Much of Gunawardena's commentary remains valid even today about implementation of fiscal devolution under the Thirteenth Amendment.

b) Micro-management through Ministry of Provincial Councils

Similarly, the Ministry of Provincial Councils has coexisted with a Finance Commission to mediate the intergovernmental transactions between the Centre and the Provinces. Considerable ambiguities regarding the exact role that the Ministry of Provincial Councils should play has undermined the development of a sense of responsibility and accountability of Provincial governments to their own citizens. In any fiscally devolved system, the Central government has a legitimate and useful role to play in monitoring and overseeing fiscal performance of lower level governments. But, in Sri Lanka, the system with divisional secretaries and the Ministry of

39 World Bank Country Report: "Sri Lanka: Recapturing Missed Opportunities," 2000, p. 21. In the new Central Government that came to power in October, 2000, the number of ministries has again gone up to 46.

40 Asoka S. Gunawardena: "Provincial Councils: Structures and Organisation", Centre for Regional Development Studies, Sri Lanka, October 1991, p. 3.

Provincial Councils has led to a system of detailed central control over provincial use of funds, far beyond monitoring and overseeing of fiscal performance and retarded the progress of meaningful fiscal devolution.

In the design of decentralisation, central monitoring and oversight of fiscal performance are important to ensure the attainment of objectives regarding nationally mandated services (such as basic education or family planning) that are important for the whole country. Such monitoring and oversight are also important to control the deficit behaviour of provincial governments, avoiding impairment of a national common market through taxes on inter-provincial trade, and intergovernmental coordination. But, detailed central control over provincial use of funds is highly undesirable. Such detailed control not only leads to provincial divergence in priorities not getting reflected in provincial tax and expenditure decisions, but more importantly to also a break-up of the accountability link between Provincial Governments and their local constituents. Provincial Governments have never been treated as competent spending authorities. Even Finance Commission statutory grants have been a part of the budget for the Ministry of Provincial Councils.[41] There have even been a presumption in some quarters that because it is 'central funds' that is transferred to the Provinces, detailed scrutiny of the use of such funds continued to be within the jurisdiction of the Parliament! Gunawardena (1991) had warned "Any tendency towards expansion in centralised micromanagement is likely to lead to a marginalisation of devolution in a dependent partnership"[42]; his warning does not appear to have been taken seriously.

c) Non-compliance with recommendations

Following rules and setting up conventions are critical for the functioning of a devolved system. In Sri Lanka, according to Article 154R(3), "The Government shall, on the recommendation of, and in consultation with, the Commission, allocate from the Annual Budget, such funds as are adequate for the purpose of meeting the needs of the Provinces." According to Article 154R(4), the Commission is also required to recommend to the President the "principles on which such funds as are granted annually by the Government for the use of Provinces, should be apportioned between the various Provinces." Article 154R(7) states "The President shall cause every recommendation made by the Finance Commission under this Article to be laid before Parliament, and shall notify Parliament as to the action taken thereon." Constitutional provisions and the implied force of the recommendations of the Finance Commission are important in facilitating fiscal devolution.[43]

Most important, however, is the development of a healthy convention in devolved systems to accept the recommendations of the Finance Commission and to implement it fully. In Sri

41 Other grants through line ministries, which were and are large, were included in the budget of the respective line ministries.

42 Asoka S. Gunawardena: "Provincial Councils: Structures and Organisation", Centre for Regional Development Studies, Sri Lanka, October 1991, p. 27.

43 Whether Article 154R(3) is as strong as in other Constitutions of the world can be a matter of debate. For example, according to Article 281 of the Indian Constitution, "The President shall cause every recommendation made by the Finance Commission under the provisions of the Constitution together with an explanatory memorandum as to the action taken thereon to be laid before each House of Parliament." This is somewhat stronger than Article 154R(7) of the Constitution of Sri Lanka. The words 'explanatory memorandum' is missing in Article 154R(7).

Lanka, by Article 154R(1), the Governor of the Central Bank of Sri Lanka and the Secretary to the Treasury are two of the five members of the Finance Commission. In spite of the presence of these two senior officials in the Commission providing the Government with adequate opportunities to reflect its views in the deliberations of the Commission, the recommendations of the Commission were not implemented in full.

Table 9. Sri Lanka: Grants Recommended by Finance Commission

(In thousands of rupees)

Province	Grants	1995	1996	1997	1998	1999
Western	Block	1,838,682	1,815,671	2,251,359	2,758,311	2,717,361
	Criteria based	211,530	211,530	253,800	253,800	279,180
	Matching	175,028	175,028	117,650	185,915	236,400
Central	Block	2,474,624	2,312,771	2,722,961	3,060,934	3,113,485
	Criteria based	137,960	137,960	165,600	165,600	182,160
	Matching	53,914	53,914	33,962	41,715	69,000
Southern	Block	2,395,074	2,303,547	2,590,782	2,844,486	3,085,136
	Criteria based	147,740	147,740	177,240	177,240	194,964
	Matching	17,500	17,500	29,575	75,190	69,000
North-East	Block	2,841,276	2,745,000	3,179,932	3,225,568	3,226,284
	Criteria based	146,650	146,650	175,920	175,920	193,512
	Matching	0	0	0	0	0
North-West	Block	2,275,694	2,337,617	2,450,622	2,568,546	2,984,068
	Criteria based	118,160	118,160	141,840	141,840	156,024
	Matching	28,234	28,234	47,548	47,895	86,400
North-Central	Block	1,452,885	1,472,363	1,554,086	1,635,723	1,853,372
	Criteria based	62,770	62,770	75,360	75,360	82,896
	Matching	3,449	3,449	21,710	46,350	39,600
Uva	Block	1,307,680	1,305,702	1,429,764	1,521,281	1,643,615
	Criteria based	65,810	65,810	78,960	78,960	86,856
	Matching	23,453	23,453	45,435	68,495	58,200
Sabaragamuwa.	Block	1,880,448	1,840,431	1,885,509	1,986,297	2,224,684
	Criteria based	109,380	109,380	131,280	131,280	144,408
	Matching	23,422	23,422	29,120	49,440	41,400
Total	Block	16,466,363	16,133,102	18,065,015	19,601,146	20,848,005
	Criteria based	1,000,000	1,000,000	1,200,000	1,200,000	1,320,000
	Matching	325,000	325,000	325,000	515,000	600,000

Source: Data provided by Finance Commission, Sri Lanka.

The experience during 1995-1999 (Tables 9-11), shows that, on average, total grants released were a little less than 97 per cent of the recommended amount. The deviations of funds released from funds recommended could be high in particular years. In 1997, for example, total funds released to the Provinces at Rs.18,347 million was less than 94 per cent of Rs.19,590 million recommended by the Finance Commission. The variations of funds released from amounts recommended were particularly large for individual categories of grants in some Provinces.

Of the three different types of grants recommended by the Finance Commission, releases of matching grants showed the maximum departure from the recommended amounts.[44] Total matching grants released during 1995-1999 at Rs.1,557 million was only 75 per cent of the

44 The other two grants, namely Medium Term Investment Plan (MTIP) grants and Special (IRDP) grants, from the Centre to the Provinces are outside the purview of the Finance Commission. From 1999, IRDP grants are being handled directly by the Ministry of Plan Implementation. The MTIP grants, on the other hand, were replaced by Provincial Specific Development Grants in 2000 and are being decided by the Finance Commission.

recommended sum of Rs.2,090 million. The total releases of criteria-based grants at Rs. 5,264 million during 1995-1999 were 92 per cent of the recommended amount of Rs. 5,720 million. Even the releases of block grants at Rs. 89,075 million were 98 per cent of the recommended Rs. 91,113 million.

Table 10. Sri Lanka: Grants Released to Provinces

(In thousands of rupees)

Province	Grants	1995	1996	1997	1998	1999
Western	Block	1,763,628	1,835,537	1,849,521	2,570,745	2,634,735
	Criteria based	189,480	165,626	253,800	253,800	195,000
	Matching	175,028	125,647	117,650	54,150	65,000
Central	Block	2,408,477	2,348,594	2,610,819	3,036,336	3,103,549
	Criteria based	123,493	106,735	165,600	165,600	182,160
	Matching	53,914	41,486	33,962	12,150	69,000
Southern	Block	2,326,947	2,331,067	2,539,583	2,815,438	3,079,008
	Criteria based	132,966	119,818	177,240	177,240	194,964
	Matching	17,500	14,199	29,575	75,190	69,000
North-East	Block	2,775,667	2,905,524	2,947,549	3,122,203	3,143,164
	Criteria based	131,656	117,140	165,720	139,320	193,512
	Matching	0	0	0	0	0
North-West	Block	2,197,239	2,384,467	2,303,166	2,554,844	2,976,632
	Criteria based	106,342	106,344	138,340	141,840	156,024
	Matching	28,234	25,411	47,548	13,950	86,400
North-Central	Block	1,416,423	1,473,095	1,472,005	1,608,511	1,845,722
	Criteria based	55,758	48,964	75,360	75,360	82,896
	Matching	3,449	3,105	21,710	13,500	39,600
Uva	Block	1,274,060	1,303,140	1,388,938	1,511,577	1,638,410
	Criteria based	59,224	51,271	60,610	78,960	86,856
	Matching	23,453	15,464	45,435	53,150	58,200
Sabaragamuwa	Block	1,826,351	1,814,204	1,743,019	1,974,346	2,220,316
	Criteria based	98,213	84,113	131,280	131,280	144,408
	Matching	23,422	16,837	29,120	14,400	41,400
Total	Block	15,988,792	16,395,628	16,854,600	19,194,000	20,641,536
	Criteria based	897,132	800,011	1,167,950	1,163,400	1,235,820
	Matching	325,000	242,149	325,000	236,490	428,600

Source: Data provided by Finance Commission, Sri Lanka.

Table 11. Sri Lanka: Ratio of Grants Released to Grants Recommended to Provinces (In per cent)						
Province	Grants	1995	1996	1997	1998	1999
Western	Block	95.9	101.1	82.2	93.2	97.0
	Criteria based	89.6	78.3	100.0	100.0	69.8
	Matching	100.0	71.8	100.0	29.1	27.5
Central	Block	97.3	101.5	95.9	99.2	99.7
	Criteria based	89.5	77.4	100.0	100.0	100.0
	Matching	100.0	76.9	100.0	29.1	100.0
Southern	Block	97.2	101.2	98.0	99.0	99.8
	Criteria based	90.0	81.1	100.0	100.0	100.0
	Matching	100.0	81.1	100.0	100.0	100.0
North-East	Block	97.7	105.8	92.7	96.8	97.4
	Criteria based	89.8	79.9	94.2	79.2	100.0
	Matching	...	...	...	...	...
North-West	Block	96.6	102.0	94.0	99.5	99.8
	Criteria based	90.0	90.0	97.5	100.0	100.0
	Matching	100.0	90.0	100.0	29.1	100.0
North-Central	Block	97.5	100.0	94.7	98.3	99.6
	Criteria based	88.8	78.0	100.0	100.0	100.0
	Matching	100.0	90.0	100.0	29.1	100.0
Uva	Block	97.4	99.8	97.1	99.4	99.7
	Criteria based	90.0	77.9	76.8	100.0	100.0
	Matching	100.0	65.9	100.0	77.6	100.0
Sabaragamuwa	Block	97.1	98.6	92.4	99.4	99.8
	Criteria based	89.8	76.9	100.0	100.0	100.0
	Matching	100.0	71.9	100.0	29.1	100.0
Total	Block	97.1	101.6	93.3	97.9	99.0
	Criteria based	89.7	80.0	97.3	97.0	93.6
	Matching	100.0	74.5	100.0	45.9	71.4

Source: Tables 9 and 10.

Within 1995-1999, there were rather large departures of releases from recommended amounts in the case of a few Provinces. In 1999, for example, matching grants of Rs.65 million released to the Western Province was only 27.5 per cent of Rs.236.4 million recommended by the Finance Commission. In the same year, even the release of criteria-based grants of Rs.195 million was less than the recommended sum of Rs.279 million by over 30 per cent. The discrepancy of releases from recommended amounts was not restricted to the Western Province alone. In 1996, matching grants released to Uva was less than 66 per cent of the recommended amount, while in 1998, such grants released to Sabaragamuwa was only about 29 per cent of the recommended sum. Even block grants released varied considerably from the recommended amounts; in 1997, the shortfall of releases from the recommended amount for the North-West Province was 6 per cent.

A recent AACM report also records large funding delays and shortfalls in devolution. According to the report "The receipt by the PCs (Provincial Councils) of funds from Treasury via

MPCLG (Ministry of Provincial Council and Local Government) is subject to delays and shortfalls. In one case, in four out of the five preceding years, a province had experienced shortfalls in excess of Rupees 25 million from Treasury. In 1999, the province in question had therefore withheld payments to the centre (pension contributions) of Rupees 10 million in order to cushion the effects on cash flow of anticipated shortfalls in Treasury funding. It frequently becomes necessary for Chief Ministers to lobby personal contacts in the Treasury and other relevant central agencies to facilitate the release of funds."[45]

There does not appear to have been much discussion or recriminations about the institutional failure of implementing the Finance Commission recommendations. Even the calculations of the grants or their inter-se distribution have not been subjected to much scrutiny. In the absence of much interest on the part of the Parliament or the Provincial Councils either in the "principles on which such funds as are granted annually by the Government for the use of Provinces, should be apportioned between the various Provinces" or the slippages in implementation, devolution suffered.

Furthermore, while block-grants were in the nature of a gap-filling exercise, matching grants and criteria-based grants were aimed at rewarding revenue effort and reducing inter-Provincial disparities. The large departures of releases from the already small sums recommended for these two grants resulted in a perpetuation of the dependency of the Provinces on the Centre.

d) Cadre control by the Centre

Historically, Sri Lanka had a unified government service, controlled and directed from the Centre and transferable throughout the country. After the Thirteenth Amendment, the staffing of the Provincial Council Secretariat was determined through a cadre fixing exercise undertaken in 1990-91. The Provinces continued to require the approval of the Salaries and Cadres Committee at the Centre to change the number or position of its staff.

The Provincial Councils Act No. 42 of 1987 made by Parliament laying down the procedure for the transaction of business by a Provincial Council provides for the establishment of a Provincial Public Service. The Provincial Public Service was critical for providing the Provincial Councils their functional autonomy, and the quality of the service was meant to be protected by an independent Provincial Public Service Commission working under delegation from the Governor.[46] The Provincial Councils Act envisaged a lot of Provincial autonomy vis-à-vis its own cadre. Gunawardena, writing in 1991 reflected the expectations of those times: "The Provincial Public Service Commission is therefore made responsible for staffing of the Provincial Council's administration, i.e., providing the necessary staff and ensuring that they conform to prescribed codes of conduct and standards of behavior. Schemes, codes, principles and procedures

45 AACM report, ibid, p. 21.

46 "The Provincial Public Service Commission (PPSC) is appointed by the Governor, comprised of three members, one of whom is nominated as Chairman. The PPSC functions as an independent body. Any attempt to influence its decisions is made an offence punishable by the High Court, thereby seeking to eliminate interference in its actions." See Asoka S. Gunawardena: "Provincial Councils: Structures and Organisation", Centre for Regional Development Studies, Sri Lanka, October 1991, pp. 14-15.

in this regard will be laid down by the Governor who will as far as practicable follow practices adopted by the Public Service."[47]

In practice, however, much of the devolution of powers to the Provinces regarding staffing did not take place. At the time of their establishment, with the aim of maintaining high staff-quality, the Provincial Councils reached an understanding with the Central Government that all upper and middle management level staff would be obtained on temporary release from the All Island Service (AIS) to the Provincial Public Service (PPS).[48] The officers would not be directly recruited, instead their services would be obtained for a specified period (extendable by mutual agreement) with their reverting to their substantive posts in the National Public Service at the end of that period. "Very few staff grade officers who are not members of the AIS have been appointed to the PPS by the respective PPSCs."[49]

Appointment, transfer, disciplinary control and dismissal of AIS officers in the nine services are governed by the provisions of the respective Service Minutes as modified in terms of the Public Administrative Circular No. 56/89 of November 15, 1989, Public Service Commission Circular No. 62 of February 1993, and Public Administration circular 56/89(1) of April 23, 1993. Originally the circular of November 15, 1989 placed the AIS officers on temporary release to the Provinces under the disciplinary control of the PPSCs. This, however, changed in 1993, and the PPSCs were left with normal supervisory control. If a prima facie case arises for disciplinary action against any of the AIS officers in a Province, the facts have to be reported to the national PSC through the relevant appointing authority (for example, Ministry of Public Administration in case of a Sri Lanka Administrative Service officer) with a draft charge sheet.

The dominance of block grants in the receipts of Provinces, and the large share of wages and salaries in Provincial budgets contributed to the Central control of Provincial cadre. Recruitment or upgradation of posts by a Province leads to an increase in its recurrent expenditure, which in turn leads to a higher requirement of block grants. With salary costs constituting 95 per cent of Provincial budgets, and the Provinces having little revenues of their own, decisions regarding cadre size and promotions have serious financial implications for the Centre through the system of block grants and the Centre exercises strict control on such decisions.

The interaction between insignificant own revenues of the Provinces and preponderance of block grants in their budgets has led to a complete dependence of the Provinces on the Centre in staff matters. Thus, "After the PCs make an assessment of their cadre requirements, instead of allowing the Governor of the Province to review it and grant approval, the PCs are required to obtain the central Government approval. For this purpose the PC makes an application to the MPCLG which passes it onward to the Management Services Department (MSD) of the Ministry of Finance and Planning. MSD reviews the request and approves or approves with modifications

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47 Asoka S. Gunawardena: "Provincial Councils: Structures and Organisation", Centre for Regional Development Studies, Sri Lanka, October 1991, p. 14.

48 The AIS includes nine services: Sri Lanka Administrative Service, Sri Lanka Accountants Service, Sri Lanka Engineers Service, Sri Lanka Agricultural Officers Service, Sri Lanka Animal Production and Health Officers Service, Sri Lanka Scientific Officers Service, Sri Lanka Medical Officers Service, Sri Lanka Educational Administrative Service, and Sri Lanka Planning Service.

49 AACM report, ibid, Annex 13, p. 2.

or rejects the request for additional cadre."[50] Similarly, "When a position in a PC or a LA (Local Authority) falls vacant they are not allowed to fill it without obtaining the approval of the Cabinet. The PCs are required to make an application to the MPCLG for this purpose. The MPCLG prepares a Cabinet Memorandum under the signature of the Minister recommending the filling of the vacancy and sends it up to the Cabinet. The Cabinet reviews the request and grants it or rejects it."[51] With such a tight Central control over cadre at the Provincial level, devolution had little chance to succeed in Sri Lanka.

IV.3 Limited Capacity of Provincial Councils

a) Dual governance structure undermines Provincial capacity building

Apart from the tight control of cadre at the Provincial level, a system of parallel Central administration has undermined capacity building at the Provincial level. There are four aspects of this parallel administration.

First, the District Secretary and her subordinate staff, all Central Government employees, continue to function in devolved areas such as provincial planning. Second, more than 230 Divisional Secretaries appointed by the Central Cabinet on the recommendation of the Ministry of Public Administration control over half of the government employees in the Provinces.[52] These two factors together create a 'confused situation of roles, responsibilities and reporting relationships' that is 'not conducive to high levels of performance or morale, particularly for the PCs.' "Difficulties also arise because of the role confusion, ambiguity and overlap between Divisional Secretaries and Pradeshiya Sabhas in such areas as public health promotion, garbage collection, sanitation, water resources and roads."[53] The parallel Central administration has facilitated top down planning and 'serious rollbacks in the devolution process', such as 'nationalisation' of Provincial schools and hospitals, and created uncertainties about the future of devolution itself. The Central employees are not only 'autonomous' of Provincial and lower level governments, but cherish their independence. The experiment of making the Divisional Secretary the secretary to the Pradeshiya Sabhas and make her work under the Sabha and its Chairperson did not find favour with the Divisional Secretaries. Reportedly, many of them protested.[54]

Third, superior facilities such as easier access to loans (for purposes such as housing and school textbooks), faster career development opportunities, prospect of transfer to Colombo or other coveted places, and greater prestige and status makes Central employment more desirable than Provincial employment. Not only does this build bureaucratic support for 'nationalisation' of schools, hospitals and roads, but also sap the morale of Provincial administration by reducing Provincial service to second class service.

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50 AACM report,ibid, Annex 13, p. 4.

51 AACM report,ibid, Annex 13, p. 4.

52 The Divisional Secretaries were previously called Assistant Government Agents. According to the World Bank (2000): Sri Lanka: Fiscal Issues in Decentralisation and Their Impact on the Poor" (mimeo.), their control has shifted between the Centre and the Provinces at least three times.

53 AACM report,ibid, p. 23 Pradeshiya Sabhas are Divisional level local authorities.

54 AACM report,ibid, Annex 17, p. 2.

Fourth, the Consequential Provisions Amendment Act of 1989, which was intended to allow the Provincial Councils to carry out devolved functions under existing legislation until they drafted the relevant statutes, has been used by the Central Government and the line ministries to maintain their presence and involvement in devolved subjects. The Consequential Provisions Amendment Act does not prohibit continued Central involvement in devolved subjects. The failure on the part of Provincial Councils to pass the relevant statutes reflect the lack of enthusiasm of the bureaucracy to do so as well as the 'insufficient capability and capacity in the provinces to draft the necessary legislation.'[55]

b) Lack of reliable and timely information

Information base of the Provinces is very weak. This not only poses considerable difficulties in management of the finances by the Provinces themselves as well as monitoring by the Central government and the Finance Commission, but also reflects a lack of capacity at the Provincial level. According to a recent Asian Development Bank report: "The provision of financial information to monitoring agencies by different provinces is somewhat erratic and the quality of information when supplied is highly variable. For example, in one province, accounts have not been presented for audit for four years and there has been little pressure from relevant government agencies at the centre for them to be produced." [56]

The inference about the lack of capacity at the Provincial level from the non-availability of reliable and timely information is confirmed by a lack of responsiveness and enthusiasm about collating such information. Again, according to the recent ADB report, "In one province, we were informed by the Governor that more than 126 questions concerning the accounts and related matters that had been raised by the Office of the Auditor General had not been answered by the PC (Provincial Council). Follow-up on these matters had not materialised..."[57]

Inadequate capacity may have resulted from a combination of lack of skills, incentives and deterrent action. But, at the Provincial level, apart from the reports about a general disregard for timeliness and quality of data, including avoidance of gross inaccuracies, by other observers, such disregard was also observed during the course of the current project. Some of the papers commissioned from senior officials at the Provinces had obvious errors that even eyeballing the data could detect.

c) Unsatisfactory arrangement for budgeting and financial management

Most Provincial Councils have a Treasury Department headed by a Deputy Chief Secretary (Finance). The functions of the Treasury are defined as per Sections 24(1) and Section 24(3) of the Provincial Councils Act No. 42 of 1987. The Treasury is responsible for preparing the financial statement and supplementary estimates and securing the approval of the same, and ensuring the introduction of proper rules, methods and procedures, and proper interpretation of financial regulations, among other things. The Deputy Chief Secretary (Finance) is supported by two or three Directors, depending on the size of the Province, and other staff. The Directors of the Treasury Department belong to the Sri Lanka Accounts Service, while the junior staff are from the

55 AACM report,ibid, p. 26.
56 AACM report,ibid, p. 20.
57 AACM report, ibid, p. 20.

general clerical services. Most of the staff do not have the requisite training in budget preparation, which explains, in part, the routinisation of the budget process at Provincial levels.

The Finance Commission sends out an annual circular with instructions about how to prepare the budget. Expenditure needs prepared by Provincial ministries and departments go to the Deputy Chief Secretary (Finance), who heads the Treasury and is responsible for the preparation of the Provincial budget. The Provincial Treasury checks the information with the actual figures and projects the requirements for the year of estimation. The Provincial Treasury then forwards the previous year's actual figures and the current year's estimate to the Ministry/Department concerned. The Ministry/Department makes the request for the year of estimation with justification if there is a gap. The Provincial Treasury thereafter collates the estimates and forwards the same to the Finance Commission. It is an entirely Provincial treasury affair, with the Ministries and Departments being, at best, passive furnishers of information. Provincial budgeting is an activity in projecting expenditures for the subsequent year on the basis of past and current figures.

The routinisation of the budget process is largely the result of the set of formats that are prescribed by the Finance Commission. The formats currently in use for the formulation and presentation of budgets follow the programme budget framework. While the Finance Commission guidelines require performance measurement data, estimates of expenditure are nothing more than the expenditure disbursement figures. It is not possible to assess cost efficiencies of recurrent expenditures. They, therefore, become truly recurrent in a repetitive and routinised manner. The formats and the procedures do not allow recurrent expenditures to be assessed in terms of cost per unit of service delivery. Capital expenditure is presented separately, dichotomised into continual works and new works. Provincial Councils do not present an investment programme/plan, although the Finance Commission requires it.

A routine historical bias inherent in the regulatory framework of guidelines, formats and procedures for provincial expenditure assessment does not create any incentives for assessment of expenditures on the basis of strategic development priorities. Nor does the internal rules of the Provincial Councils for budget preparation require such an approach or methodology to be pursued. The absence of a mechanism for Provincial accountability for fiscal performance and of performance-oriented monitoring to generate and transmit information exacerbate the problems of budgeting and financial management.

d) Unequal bargaining position

The Provinces have had an unequal position vis-à-vis the Centre in terms of bargaining capacity. There were two important reasons behind this Provincial infirmity. First, the rule by the same political party at the Centre as well as most of the Provinces dampened the intensity of the Centre-Province dialogue.[58] Provincial political leaders being relatively junior to national leaders of the same party had to play a muted role in their negotiations with the Centre. Second, the Provincial bureaucracy with relatively junior AIS officers could not negotiate with senior AIS officers of the Central bureaucracy.

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58 The importance of the first factor can be seen from the heated exchanges that took place between the Southern Province and the Centre during 1993-94 after the second election to the Provincial Council.

There are instances when the Centre takes decisions on devolved subjects with financial implications for the Provinces and the Provinces fall in line without much of protest. "In one such case, the centre agreed to union demands for uniforms of health workers. PCs were obliged to pay these allowances immediately, but no commensurate additional allowance could be obtained from Treasury without considerable lobbying by the Chief Minister (using personal contacts). Even so, the additional amounts received covered only a period commencing with Cabinet approval and not from the date used by the unions, which was the date of approval by the central line minister concerned (the difference between these dates was about 6 months). The PCs were expected to make up the shortfall."[59]

IV.4 AN INADEQUATELY PERFORMING FINANCE COMMISSION

a) Lack of technical expertise

The Finance Commission, apart from its five members, has 35 positions, including 4 unfilled ones. Of the 31 staff on the rolls, nine Assistant Research Officers are in Provincial headquarters preparing data for the Commission. Significantly, out of five technical positions -- two each of Senior Research Officer and Research Officer and that of an economist -- three have remained unfilled ever since the setting up of the Commission. Reportedly, the salary offered is not attractive for attracting a person of the requisite caliber.[60]

Table 12. Sri Lanka: Staffing at the Finance Commission

Position	Number	Unfilled
Secretary	1	--
Economist	1	1
Senior Research Officer	2	1
Research Officer	2	1
Assistant Research Officers	14	--
Budget Assistant	2	--
Administrative Officer	1	--
Data Entry Operators	1	1
Clerks	3	--
Typists/stenographers	4	--
Drivers	4	--
Total	**35**	**4**

There is a lack of technical expertise at the Finance Commission to deal with the issues of fiscal devolution. According to Article 154R(1) of the Constitution, "There shall be a Finance Commission consisting of –

(a) the Governor of the Central Bank of Sri Lanka;
(b) the Secretary of the Treasury; and

59 AACM report, ibid, p.21.

60 By a Cabinet decision, the current Senior Research Officer is drawing a salary higher than that designated for the post.

(c) three other members to represent the three major communities each of whom shall be a person who has distinguished himself, or held high office, in the field of finance, law, administration, business or learning."

The emphasis on community-based 'proportional representation' in a small country denies the Commission of the chance to have the best possible talent to deal with the complex issues of fiscal devolution.

The lack of technical expertise is manifested by the fact that the Commission has not revised the weights in the determination of the Criteria-based grants ever since the Salgado report (Box 5). The weights recommended by Salgado in 1989 may have been appropriate for that period of time. Whether it continues to be appropriate for the current period requires scrutiny. There is no evidence that the Finance Commission has revisited the weights in the determination of the criteria-based grants in the last eleven years.

Box 5. Criteria-Based Grants: Weights

	Criteria/indicator	Weight in per cent
1.	Per capita income	10
2.	Difference between per capita income of each Province and the highest per capita income among Provinces	10
3.	Poverty index	10
4.	Rate of unemployment	15
5.	Inverse of the index of educational status[61]	15
6.	Health and nutrition	15
	Infant mortality per 1000 live births	7.5
	Inverse of expenditure on food per capita per month	7.5
7.	Economic and social infrastructure	25
	Number of persons per hospital bed	5
	Number of classrooms per 1000 in age group 5-17 years	5
	Households lacking toilet facilities	5
	Households without electricity	5
	Inverse of roads per square kilometer	5

M.Ranjit P.Salgado: "Report on Fiscal Aspects of the Public Sector Restructuring Project (Financial Devolution to the Provinces)" World Bank, September 6, 1989, pp. 57-60.

The staff of the Commission has not had much exposure to the nitty-gritty of fiscal devolution. A large proportion consists of non-technical hands who can contribute little to the functioning of the Commission.

61 An index of educational attainment constructed by weighting the number of persons in identified levels of education by the average number of years of schooling required to attaining that level.

b) Lack of documentation

There is very little documentation of the workings of the Finance Commission. The Commission, in its eleven years of existence has not come out with a single comprehensive report about the state of fiscal devolution or fiscal position of the Central or Provincial Governments. The Commission's reports could have been useful for initiating an informed public debate about fiscal devolution in Sri Lanka. The absence of a report may also be because of the lack of technical expertise in the Commission. The absence of a full-time Chairman and Secretary, until the present incumbents took up their positions, may also have contributed to the poorer documentation. Anyway, the inexplicable absence of a well-documented data base as well as a properly organised set of papers to support how the Commission arrived at its awards prevents a meaningful discussion about the merit of the awards.

The Commission follows a set annual cycle in seeking suggestions and formulating its recommendations. A flow chart showing the time pattern of the cycle is given in Chart 1. The Commission does not systematically document the draft estimates of recurrent and capital expenditures as well as those of criteria-based and matching grants provided by the Provincial Councils in May. Nor does it document the discussions of these estimates in June, or how it arrives at its recommendations in July/August in light of its consultations with the Treasury, Ministry of Planning and Ministry of Plan Implementation. Not only was no data readily available to compare the 'demands' of Provinces with the final awards, but the Commission did not even have readily available data on its own recommendations, the voted amounts and actual releases for the period since its inception.

The calculation of criteria-based grants and matching grants are far from transparent. Fiscal stress created considerable complications in the Centre providing "such funds as are adequate for the purpose of meeting the needs of the Provinces". But, the lack of documentation regarding how the Finance Commission systematically reconciles the varying needs of the Provinces within the available limited funds posed considerable difficulties in analysing the merits of the awards. No systematic records exist on the deliberations of the Commission at its various meetings. Lack of documentation has resulted in a near absence of institutional memory for the Finance Commission. Even the documentation regarding the decision to accept the Salgado report and implement it was not readily available.

c) Lack of commitment

The lack of commitment of the members to the Commission is clear from the attendance at its meetings during 1999-2000 given at Appendix III. Out of eleven meetings held in 1999, not a single one was attended by all the five members. Furthermore, as many as three of these meetings were attended by only two members, while at six others the attendance was only three. The attendance record of the two official members – the Governor of the Central Bank and the Secretary to the Treasury – because of their other official duties was particularly poor. Out of the eleven meetings during 1999, the Governor managed to attend only two meetings. Until November, 1999, the Secretary to the Treasury was the Chairman of the Commission and his attendance was obligatory, attendance of the Secretary deteriorated after the appointment of a new

Chairman. In 2000, the attendance improved considerably. Yet, not a single meeting had full attendance.

d) Lack of independent opinion

The Commission appears to display a lack of independent opinion at certain times. At times, it takes its cues from the Centre and endorses what the Centre has clearly decided. One such occasion was the allocations made from the Provincial Specific Development Grants (PSDG) in September 1999.[62]

On September 10,1999, the Finance Commission informed the Provinces that "On the recommendation of the Presidential Task Force on Health, H.E., the President has directed to improve one Hospital in each District commencing from the year 2000." The Provinces were informed of the hospitals identified in the whole of the country. Reportedly, the identification of the hospitals was done in consultation with the Provinces, but details were not available.

e) Lack of scrutiny

One of the major reasons for the unsatisfactory functioning of the Finance Commission is the lack of scrutiny by the Provinces. While a lack of documentation prevents a careful analysis of the Finance Commission's decisions, the insufficient documentation itself reflects the lack of interest and, perhaps a lack of capacity, in the Provinces in scrutinising what the Finance Commission does.

IV.5 FISCAL STRESS

One of the institutional factors underlying the unsatisfactory progress of fiscal devolution is the fiscal stress at the Centre. Continuing fiscal distress at the Centre because of a debilitating and expensive insurgent war in Sri Lanka both in terms of lives and funds and of unsatisfactory revenue performance have led to failures on the institutional front of providing financial incentives to the Provinces to mobilise additional resources. Defence expenditure in 1998 amounted to Rs. 51 billion (Table 1), which is over 25 per cent of the recurrent expenditure or 5.4 per cent of GDP. Tax revenues of the Central Government declined from 18.0 per cent in 1991 to 14.5 per cent in 1998. The fiscal deficit of the Centre has been fluctuating around 7.5 per cent of GDP. In 1998, for example, total expenditure of the Central Government at Rs. 289 billion exceeded revenues of Rs. 175 billion by Rs. 114 billion. Fiscal problems of the Central Government have prevented the scope for augmenting the resources of the Provinces through criteria-based and matching grants.

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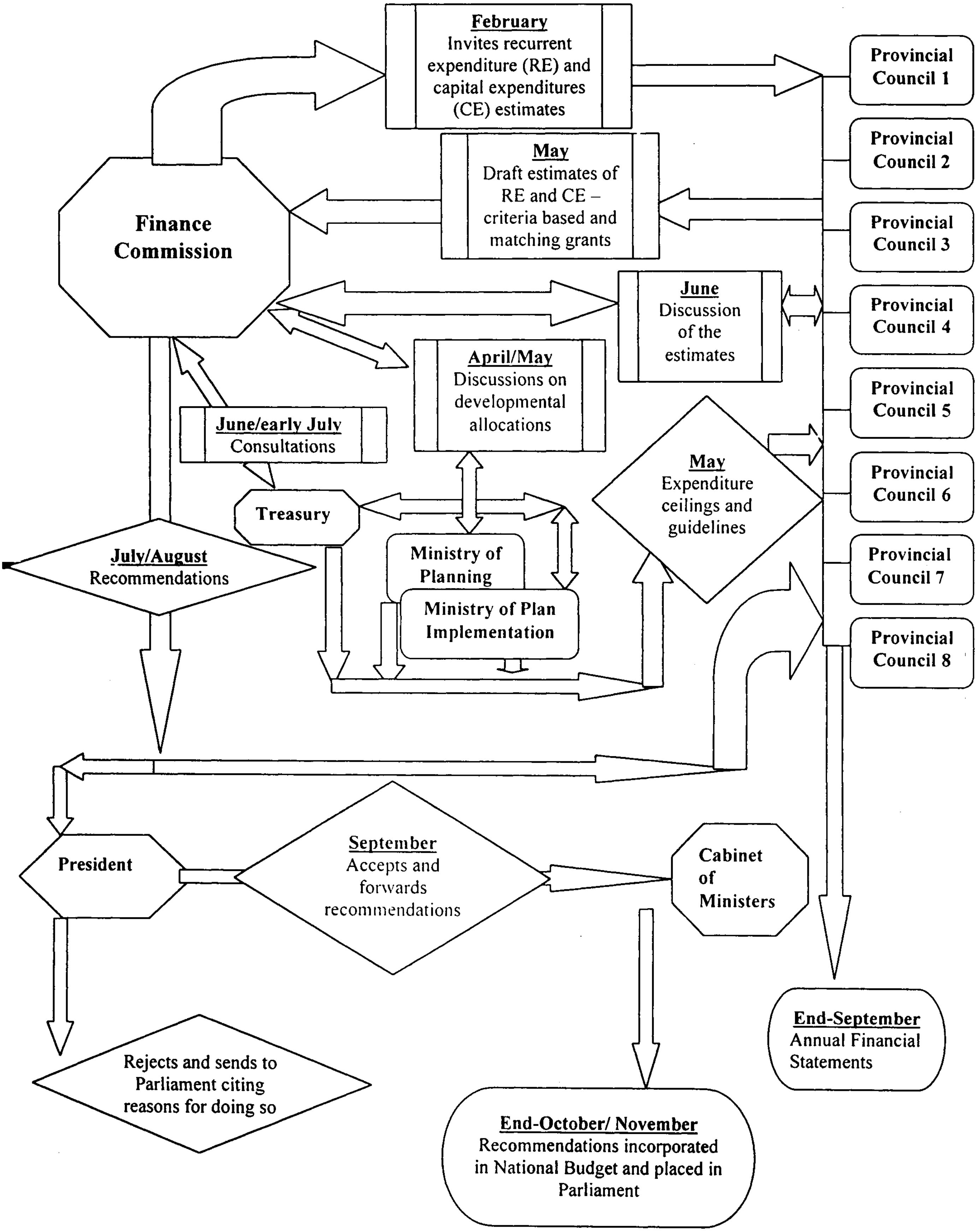
62 In a circular dated September 8, 1999, the Finance Commission informed the Provinces that "...the MTIP Grants have been renamed as Provincial Specific Development Grant (PSDG) from year 2000 and include more activities than that of MTIP. PSDG is a capital grant, which should be spent on the purposes indicated and according to the guidelines given. Funds under this will be released to Provinces directly by the Treasury on the recommendations of the Finance Commission." The main difference between MTIP and PSDG thus is that unlike MTIP, under which funds were channeled through line ministries at the Centre, PSDG funds are released directly to the Provincial Governments.

Chart 1

Sri Lanka: Finance Commission 1999Annual Cycle for Fiscal 2000



Criteria-based grants aimed at reducing inter-Provincial disparities, after increasing from Rs. 788 million in 1990 to Rs. 1,000 million in 1992, declined gradually to Rs. 800 million in 1996 before increasing to Rs. 1,168 million in 1997 (Table 10). After remaining more or less unchanged from 1997 in 1998, it increased only marginally to Rs. 1,236 million in 1999. Similarly, matching grants, which were designed to encourage Provinces to mobilise additional resources and were disbursed from 1995 onwards, have practically disappeared due to inadequate allocation. Such grants, after fluctuating between an insignificant allocation of Rs. 236 million and Rs. 325 million during 1995-98, increased only marginally to Rs. 429 million in 1999. The fiscal pressure at the Centre required the Finance Commission to take a very cautious approach to criteria-based and matching grants. In 1999, for example, while the Commission calculated a required allocation of Rs. 2.5 billion under matching grants, it recommended an allocation of only Rs. 600 million (Table 9).

It is universally recognised that the Central Government can best resolve the problem of stabilisation. Fiscal devolution in times of fiscal distress requires a fair system of burden sharing. The system followed by the Finance Commission to spread the burden of stabilisation, however, is difficult to analyse for the lack of documentation.

IV.6 Need for Simultaneous Action on Two Fronts

Commitment to devolution as well as an appropriate design – in terms of tax and expenditure assignment and of transfer schemes – are essential to the success of devolution. A lack of commitment leads to a marginalisation of institutions of devolution, and their authority, acceptance and capability of implementing decisions suffer. At the same time, an inappropriate design can handicap fiscal devolution even with the best of commitments. Experience with a devolved scheme for almost a decade and a half in the backdrop of a protracted troubled period with civil strife may have increased the acceptance of devolution at the political, administrative, and civil society level of the country. The increase in voter turnout to over 70 per cent in both the second and third elections to the Provincial Councils in 1993 and 1999 from less than 50 per cent in the first election to the Provincial Councils in 1988 may be construed as a sign of the devolution system taking root in Sri Lanka. Limitations on the design front are also attracting the attention of the people and policy-makers as manifested by the recent discussions on the draft for Constitutional reforms for strengthening fiscal devolution.

There is clearly a need for moving simultaneously on both fronts. Success will be dependent on having the right design with vigorous implementation of the decisions taken. While a certain level of commitment is necessary for devolution, demonstrated tangible benefits from devolution as well as a public awareness campaign will reinforce commitment. It is in this context that it is important not to exaggerate the chicken and egg type agnosticism about commitment and appropriate design, and move vigorously on both fronts. A Finance Commission Act to govern the functioning of the Finance Commission, as per this Act requiring the Finance Commission to submit an annual report describing its methodology, data used, and recommendations to the Parliament, and a review of the staffing pattern along with a revision of salaries, as recommended in this report, will help in creating the right environment for garnering popular support to devolution as well as implementing devolution in the country.

V. Redesigning fiscal transfers

V.I Basic Principles Underlying the Redesign

It is imperative to redesign the system of fiscal transfers in Sri Lanka to realise the full benefits of fiscal devolution and attain the fundamental objectives motivating the Thirteenth Amendment of the Constitution. The basic principles underlying such a redesign must be the criteria of autonomy, equity, efficiency, adequacy, transparency and timeliness.

Fiscal transfers should not infringe the autonomy of Provincial Councils in determining the relative priorities between different public goods and services. Such autonomy can be only limited by the requirement that they maintain some specified minimum standards in the provision of these public goods and services, or on the ground of countering underprovision of a public service caused by externalities. Too many restrictions on the autonomy of the Provinces would transform the Provincial Councils into extensions of the Central Government and deny the country the full benefits of decentralisation.

Taking into account the fiscal disabilities, such as cost disadvantages and relative backwardness, of Provinces in the calculation of transfers can satisfy the criterion of equity. In the design of equalisation transfers, it is simultaneously important, however, to guard against the practice of making the transfers a 'gap-filling' exercise. The gap between own revenues and expenditure do not reflect fiscal disabilities alone, but may contain inadequate revenue mobilisation effort, and inefficiencies in the delivery of public goods and services. It is critical to disentangle the elements of fiscal disability from those of insufficient effort in the calculation of equalisation grants and leave enough incentives for the Provinces to mobilise revenues and improve efficiency.

The criteria of efficiency and adequacy are interlinked with the whole issue of how much of the total general government expenditure should be carried out by the Centre and how much by the Provinces. In this context, there are two factors that should determine this division. The first relates to the intent of the existing Constitutional provisions regarding functional and tax assignments. The second is the international practice in this regard that provides valuable lessons with respect to the working of fiscal devolution.

The criterion of transparency demands that the transfers to the Provinces should be based on clearly stated principles and it should be possible to verify that the amounts recommended for transfers (and actually transferred) can be derived from reliable data on the basis of the stated principles. The criterion of timeliness, on the other hand, requires that the Provinces get the recommended funds smoothly over the year, and there are no liquidity problems as a result of mistimed transfers.

V.2 Transition to Redesigned System

The implementation of the redesigned fiscal transfers suggested in this report would require a management of change. Fast implementation will help Sri Lanka realise the benefits of the new system faster. Often, difficulties pointed out in effecting a change stem from exaggerated, if not misplaced, fears about a new system. It is important to emphasise that the experience of fiscal devolution over more than a decade will ease the implementation of the redesigned system.

Commitment at the policy making level and emphasising the economic benefits from a vibrant, fiscally devolved system to the people are critical for a successful management of change. This report describes a redesigned system, without delineating a transition path. While the transition may be phased out over more than one year, care must be taken to avoid unnecessary delays in implementing the new system.

V.3 SIZE OF PROVINCIAL GOVERNMENTS RELATIVE TO THE CENTRE

The relativity of Provincial Governments' expenditure vis-à-vis Central Government expenditure in the country appears to be small both in terms of Constitutional assignment of functions as well as international practice.

a) Constitutional assignment of functions

The minor role played by the Provinces in the fiscal arena in Sri Lanka does not appear to conform to the Constitutional assignment of functions according to the Thirteenth Amendment. Fragmented responsibilities and overlapping functions of the Central and Provincial Governments according to the Thirteenth Amendment have been adduced as a source of ambiguity that has resulted in the diminished role of the Provinces. What is important in this context is the spirit rather than the letter of the Constitution. Most devolution arrangements have a concurrent list of functions with simultaneous jurisdiction of both the Central and lower level governments, and the two levels of government work out arrangements to minimise overlap and unnecessary duplications according to the spirit of the Constitutional assignment of functions.

The interpretation of the spirit of the Constitution has to be guided by the basic insight of the *decentralisation theorem*, which states that for a public good, it will always be more efficient for lower level governments to provide the Pareto-efficient or optimal levels of output for their respective jurisdictions than for the Central Government to provide any specified and uniform level of output across all jurisdictions. Thus, unless there are truly compelling reasons for the Centre to intervene, the functions specified in the concurrent list also should ordinarily be carried out by subnational governments. It is important to interpret the Constitution and implement its provisions in this spirit to realise the potential benefits from decentralisation in full measure.

The discussion of the relative role of the Centre and the Provinces in the fields of education, health and roads illustrate that, at least in these three areas, the spirit of the Constitution wanted the Provinces to dominate the provision of public service.[63] During 1997-2000, the average share of the Centre in total public expenditure on education at over 97 per cent, and on health at over 92 per cent indicates a good deal of scope for reducing the Centre's share and correspondingly augment the Provinces' share in these two sectors. Similarly, in spite of the clear importance assigned to the Provinces in the area of roads, the share of the Centre in total public spending on roads was between 81 and 92 per cent during 1997-2000.

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63 See section III.3.a.

Taking the spirit of the Constitution into account, it appears that the share of the Centre in general government expenditure should be reduced from the current 88-89 per cent to around 75 per cent.

b) International practice

The international practice in terms of the relativity of subnational vis-à-vis national governments differs from country to country. Yet, from a sample of 39 countries (Table 13), it appears that the proportion of general government expenditure administered by the Central Government in Sri Lanka at around 88-89 per cent is considerably higher than the sample average of 72 per cent. Furthermore, compared to Sri Lanka, the share of the Centre in general government expenditure is lower in all the sample countries except the nine countries of Chile, Indonesia, Israel, Kenya, Malawi, Mexico, Paraguay, Thailand, and Tunisia.[64]

The share of the Centre in general government expenditure appears to be very high in Sri Lanka by international standards. The pattern of regulation and financing of Provincial Government expenditures by the Centre makes the dominance of the Centre in general governance even more pronounced than the simple figures suggest. A large part of the funds administered by Provincial Governments are mandated for specific purposes by the Central Government. Moreover, the financing of Provincial expenditures by 'grants' rather than own revenues or 'revenue shares' of Provinces may have developed a Provincial dependency syndrome that is not captured in the statistics on relative shares.

c) Desirable relativity

Both the Constitutional assignment of functions as well as international practice suggest that the share of the Provincial Councils in general government expenditure should be at least doubled to around 25 per cent.

Doubling the Provincial share of expenditure in general government expenditure can be easily achieved by simply transferring expenditure responsibilities in education, health and roads alone in line with the Constitutional provisions. For example, the total Provincial expenditure budgeted for 2000 is Rs. 41,461 million (Table 1). Central expenditure budgeted for education, health and roads in 2000 are Rs. 30,377 million, Rs. 22,724 million and Rs. 12,821 million, respectively. Transferring 63 per cent – or, less than two-thirds – of the Central allocation for education, health and roads to the Provincial Councils could double Provincial share in general government expenditure in 2000.

Doubling the Provincial share of expenditure in general government expenditure would bring the role of the Provinces more in line with the spirit of the assignment of functions in the Constitution. It will lead to a greater correspondence between local needs and the provision of public services, enhance accountability and people's participation. Furthermore, it would align Sri Lanka more closely with international practice in fiscal devolution.

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64 In Indonesia, a country that is besieged with ethnic conflict in East Timor, the share of the Central Government in general government expenditure is almost identical to that in Sri Lanka. Ominously enough, East Timor has now separated from Indonesia. Some of these nine countries, like Thailand and Paraguay during the reference period were not even democracies in the true sense of the term. In Kenya and Malawi, substantial decentralisation is in progress. In Tunisia, democracy has a very short history.

d) Desirable size

It is important to note that the derivation of the desirable size of Provincial expenditure can be obtained from the desirable relativity only when the total general government expenditure has been specified. The specification of total general government expenditure for a year has to take into account the revenue projections for the year and the permissible fiscal deficit for maintenance of macroeconomic stability.

Table 13. Magnitude of General Government Expenditures and Portion Administered by Each Level of Government[1]
(Average of latest three years available)

Country (ending year)	Total expenditure[3] in per cent of GDP	Percentage share of total expenditures		
		Central Government	State Government	Local Government
Argentina[2] (1987)	33.2	60.3	39.7	
Australia (1987)	39.1	52.9	40.4	6.8
Austria (1987)	51.8	70.4	13.7	16.9
Belgium (1987)	56.7	85.9		11.9
Bolivia (1986)	11.1	85.9	10.6	3.4
Brazil (1987)	34.1	65.8	24.5	9.6
Canada(1987)	46.0	41.3	40.3	18.4
Chile (1987)	32.3	93.8		6.2
Colombia (1984)	18.0	67.4	23.9	8.7
Denmark (1986)	57.6	44.9		52.9
Finland (1987)	43.0	54.7		45.3
France (1985)	49.3	82.2		16.5
Germany (1983)	50.2	58.7	21.5	17.9
Hungary(1988)	64.5	77.8		22.2
India[2] (1986)	22.6	47.5	52.5	
Indonesia[2] (1988)	22.8	88.7	11.3	
Ireland (1987)	35.8	72.5		27.5
Israel (1986)	62.9	90.8		9.2
Kenya(1984)	29.3	94.3		5.7
Luxembourg (1987)	39.1	81.3		15.9
Malawi (1984)	29.1	93.7		6.3
Mexico (1984)	30.2	90.1	7.6	2.3
Netherlands (1988)	59.2	70.1		29.9
New Zealand (1981)	43.2	86.9		13.1
Norway(1986)	47.2	66.4		33.6
Pakistan (1979)	26.1	68.2	28.3	3.5
Paraguay (1984)	11.3	95.1		4.9
Poland (1988)	48.1	71.1		28.9
Romania (1985)	32.3	77.0		23.0
South Africa (1986)	33.3	74.8	12.5	12.7
Spain (1986)	38.2	78.8	9.9	11.3
Sweden (1987)	61.6	59.8		40.2
Switzerland (1984)	37.4	47.5	28.3	24.2
Thailand (1982)	21.2	92.3		7.7
Tunisia (1982)	34.0	94.6		5.4
United Kingdom (1987)	44.8	70.9		27.2
United States (1987)	37.1	60.3	17.3	22.4
Yugoslavia (1987)	25.3	23.2	31.4	45.4
Zimbabwe (1986)	45.0	75.8	24.2	60.2

Source: Ahmad, Ehtisham, Daniel Hewitt, and Edgardo Ruggiero (1997). "Assigning Expenditure Responsibilities" in Ter-Minassian (ed.). Fiscal Federalism in Theory and Practice. International Monetary Fund. Washington. D.C., p. 38.

1 Excluding intergovernmental grants.

2 Data for general government do not include local government.

3 Includes supranational authorities' share of general government expenditures in Belgium (2.2 percent). Denmark (2.2 percent). France (1.4 percent). Germany (1.3 Percent). Luxembourg (2.7 percent), and the United Kingdom (1.9 percent).

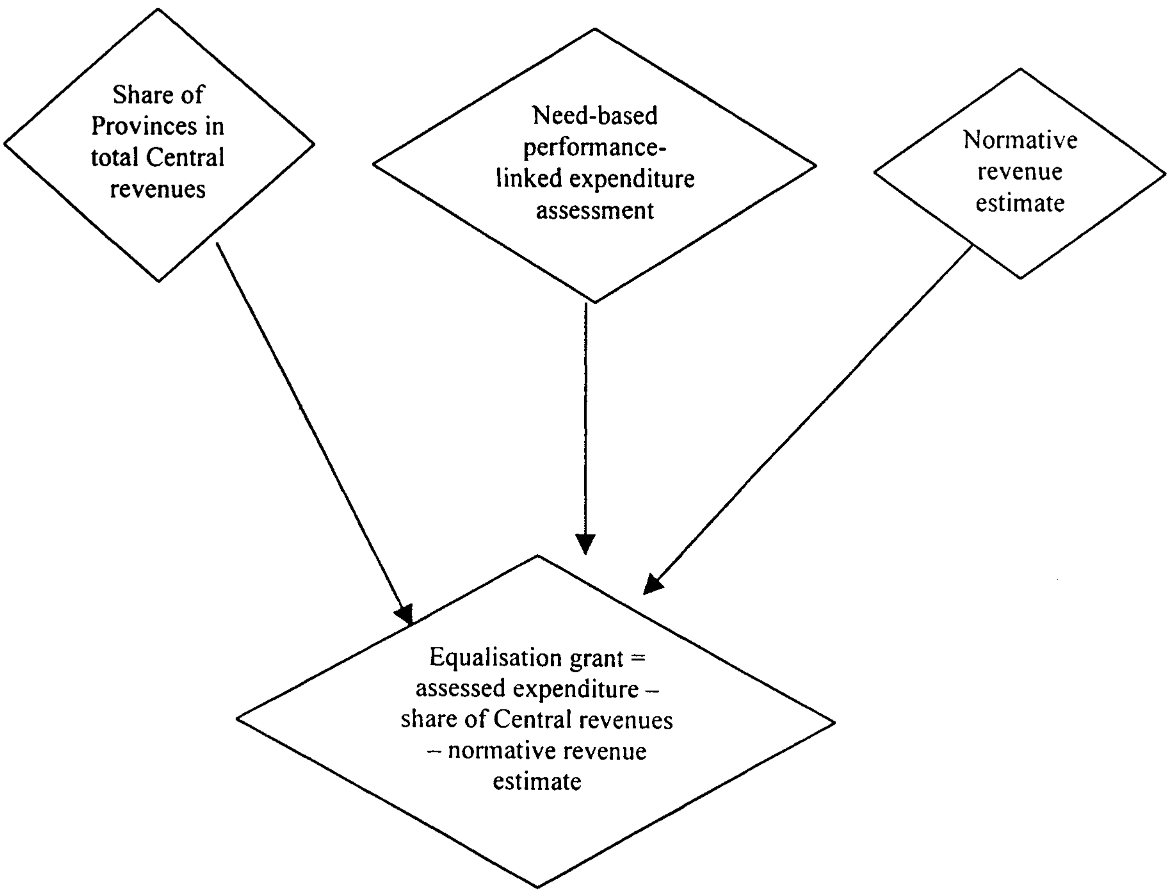
V.4 Unified Scheme to Address the Issues of Autonomy, Equity, Efficiency and Adequacy in Determining Transfers

It is important to design the central transfers within a unified scheme such that the criteria of autonomy, equity, efficiency and adequacy are fulfilled. The scheme should help develop the Provinces as competent spending authorities, responsive to the needs and preferences of the residents within their jurisdictions, encourage economy and the pursuit of most cost effective methods in the provision of public goods and services, and also promote revenue – both tax and non-tax – mobilisation in their territories.

The four main elements of the proposed unified scheme are total revenue sharing, need-based, performance-linked, normative expenditure assessment, normative revenue estimation, and equalisation grants (Chart 2). The first step in the proposed unified scheme involves distributing specific shares of total revenues of the Central Government to the Provinces. The second is Provincial expenditure assessment with due regard to the Provincial 'needs' as well as performance in terms of cost-effectiveness of production and provision of public goods and

Chart 2.

Sri Lanka: Proposed Unified Scheme for Determining Transfers



services. The third is normative revenue forecast. In the fourth and final step, the equalisation grants can be obtained as the difference between normatively assessed expenditure on the one *hand and the sum of the share of total Central revenues and normative revenue estimates on the other.*

The share of total Central revenues, as opposed to grants, accruing to the Provinces would enhance a sense of responsibility and autonomy among Provinces. A 'share' has a connotation of entitlement associated with it. Need-based, performance-linked, normative expenditure assessment, as opposed to the historical method of giving an incremental increase to the prior year's budget, would reduce the regional disparities in the availability of public goods and services, and improve fund utilisation and performance. Incorporation of assessed revenue potential, as opposed to an extrapolation of historic trends in revenue, in the equalisation grants would provide incentives to the Provincial governments to mobilise additional devolved revenues and not leave potential revenues untapped as under a gap-filling approach.

The proposed approach would achieve fiscal equalisation both from the revenue and expenditure side, and provide incentives to the Provinces to mobilise revenues, and improve performance in the production and delivery of public goods and services upto a desired minimum standard. The model proposed in this report is in line with similar approaches followed in Australia.[65]

V.5 Total Gross Tax Revenue Sharing

Given the large vertical fiscal gap, to enhance the 'autonomy' of the Provinces, Sri Lanka needs to introduce a system of the Centre sharing its gross tax revenues with them. Although an expanded volume of grants can augment the resources of the Provinces and thereby satisfy the criterion of adequacy, it cannot supplant a system of revenue sharing for two reasons. According to Sen: "First, historically, the grants from the Central Government to the Provincial Councils have been *de facto* tied to specific types of expenditures for the most part, thereby denying any substantial initiative and consequent fruits of decentralisation to the citizens. Second, beyond a point, grants-financed expenditures can cause fiscal irresponsibility, and lack of accountability. Therefore, the first task is to ensure higher revenues for the Provincial Councils through enabling changes and their own efforts."[66]

Complementing by gross tax revenue sharing a revamped system of grants would not only reduce the vertical fiscal imbalance and enhance Provincial autonomy, but also impart a much-needed buoyancy, predictability, coordination and burden-sharing to the system. Just as the Provinces would benefit in times of unanticipated revenue inflows, they would have to share the burden of fiscal adjustment with the Centre in times of unanticipated revenue shortfall. By increasing the stake of the Provinces in the centrally administered taxes, it would lead to better coordination of the Central and Provincial tax effort. This would be particularly relevant if a nation-wide value added tax, cutting into the tax base of Provincial turnover tax, were to be introduced.

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65 For details see D.K.Srivastava: "Provincial Expenditure Assessment", Capacity Building for Fiscal Devolution in Sri Lanka, Part I, specially Annexure 4, NIPFP, November 2000.

66 Tapas Sen: "Intergovernmental Grants in Sri Lanka", Capacity Building for Fiscal Devolution in Sri Lanka, NIPFP, October 2001, pp. 18-19.

Sharing total revenues has distinct advantages over sharing the revenue from the levies of particular taxes. Tax-wise sharing can give rise to allegations of the Centre focusing its revenue mobilisation efforts selectively on those taxes that it does not have to share, or have to share only a small portion, with the Provinces.[67] *Furthermore, the sharing of total gross tax revenues, rather than total net tax revenues, is recommended to provide incentives to the Centre to minimise collection costs.*[68]

Sen argues that some of the positive features of revenue sharing are particularly relevant for countries (such as India) where the Finance Commission gives its awards for more than one year at a time. They lose their force with annual awards, as in the case of the Australian or Sri Lankan Finance Commissions. For example, grants on annual basis can be adjusted for unanticipated fluctuations – both upwards as well as downwards -- in Central revenues in the previous year. But, even with annual award, without revenue sharing, no adjustment can be made for unanticipated revenue bonanza or shortfall within the year. Furthermore, the advantage of transparency and predictability remains; the link between grants and Central revenue collections can only be indirect, and not so visible as in the case of revenue sharing. Also, the perceived autonomy of the subnational units and their stake in national revenue collection is higher in the case of revenue sharing. Thus, on balance, some amount of revenue sharing would be desirable.[69]

Given the unconditional nature of both equalisation grants and shared revenues, it is possible to substitute one for the other in the elimination of vertical fiscal imbalance. However, grants can be targeted more accurately, and also allow building in appropriate incentives for greater fiscal efficiency of the subnational governments. Hence, it is suggested that *the normative gap between own revenues and expenditures be first estimated for all Provinces. The Province with the lowest gap per capita should be identified. The proportion of total gross tax revenue to be shared with the Provinces should be fixed such that, when the shared revenues are distributed to the Provinces in proportion to their population, it covers 75 per cent of the normative gap of the Province with the lowest normative gap per capita.* In mathematical terms, let P_j, E_j, and R_j denote the population, normatively assessed expenditure and normatively assessed revenues of the j-th Province. Let the k-th Province have the least gap between normatively assessed expenditure and revenue in per capita terms. In other words,

$$(E_k - R_k)/P_k \leq (E_j - R_j)/P_j \quad \text{for } j=1,2,\ldots\ldots,8.$$

Then, S_k, the revenue share of the k-th Province is determined as

$$S_k = 0.75\,(E_k - R_k).$$

Ensuring equality of revenue share in per capta terms gives the revenue share of the j-th Province as

$$S_j = (P_j/P_k)\,S_k,$$

67 In many countries in Latin America, such as Argentina, Brazil and Chile, the Centre shares revenues from the levy of only a specified tax or taxes with the subnational governments. However, allegations of shifting of Central tax effort from the shared to other taxes are also common. India, where the sharing was on the basis of particular taxes, recently shifted to total revenue sharing.

68 This is in contrast to India, where net rather than gross tax revenues are shared by the Centre with the States.

69 See, Tapas Sen: : "Intergovernmental Grants in Sri Lanka", Capacity Building for Fiscal Devolution in Sri Lanka, NIPFP, October 2001, pp. 20-21.

and, λ, the share of total gross tax revenue of the Centre to be shared with the Provinces is given by

$$\lambda = \sum_{j=1}^{8} Sj / \mathrm{T},$$

where T is the total gross tax revenue of the Centre. It is possible to rewrite λ as

$$\lambda = \{\sum_{j=1}^{8} Pj\}\{\mathrm{S_k/P_k}\}/\mathrm{T},$$

or,

$$\lambda = \mathrm{P}\{\mathrm{S_k/P_k}\}/\mathrm{T},$$

where $\mathrm{P} = \sum_{j=1}^{8} Pj$ is population of the country.

It may be noticed that under the proposed method, given the normatively assessed expenditure (E_j) and revenue (R_j) of the Provinces, an annual determination of the tax share, namely λ, will result in an automatic downward (upward) adjustment of the share (λ) when Central tax revenues are projected to go up (down). *To let the Provinces share the benefit of buoyant Central revenues, and also the burden of depressed revenues, λ, the tax share may be kept unchanged for a period of five years.*

The simple revenue-sharing system proposed in this report has considerable scope for improvement. *The system of estimating the total revenue share as well as its inter-se distribution among Provinces should be revised by the Finance Commission on a periodic basis.*

V.6 Need-Based, Performance-Linked, Normative Expenditure Assessment

The extant approach to expenditure assessment should be replaced by a need-based, performance-linked normative approach. According to Srivastava: "The main deficiency of the arrangements concerning expenditure assessment and the consequent determination of block grants as a gap between assessed expenditures and devolved revenues is a lack of incentives for the Provincial Councils to economise on expenditures or improve the efficacy of expenditures. Since the Provincial Councils are effectively ensured of a gap-filling flow of funds, they have no incentive to improve the growth of revenue sources devolved to them, except for the limited role that the mechanism of matching grants can play in this context. On the other hand, any history of increasing expenditures (and/or falling devolved revenues) would be rewarded by correspondingly increasing fiscal transfers. At the same time, the Provincial Councils have no incentive to remove excess employment (such as that of teachers) or adopt strategies of redeployment, or restructure expenditure giving greater emphasis to maintenance rather than just maximising personal emoluments. It is clear that the strategy of expenditure assessment should change along with a change in the system of determining fiscal transfers."[70]

70 D.K.Srivastava: "Provincial Expenditure Assessment", Capacity Building for Fiscal Devolution in Sri Lanka, Part I, NIPFP, November 2000, p. 15.

The maintenance of certain minimum standards in the provision of essential public goods and services (such as primary education and primary health care) across regions in a country is a legitimate goal of any national polity. Considerable inequity exist across Provinces in the availability of public goods and services, and this is reflected in social and economic indicators such as infant mortality rate, poverty ratio, and access to safe drinking water. *The need-based approach to expenditure assessment will have to take into account the initial discrepancies in the availability of such services from the 'desired' or 'normative' levels in each Province. The normative levels should indicate the minimum level of services that are desirable through the length and breadth of the country.*

It may be noted that what need to be determined are the expenditure needs of the Provinces together with their share of Central revenues and transfers from the Centre. The expenditure needs of the Centre are not estimated as that would exhaust all degrees of freedom and make the deficit of the Centre go up or down as much as any change in the Centre's revenues (net of Provincial shares). The asymmetry of treatment between the Centre and the Provinces is underpinned by the implicit assumption that the Centre has more flexibility in adjusting its revenues as well as expenditures.

The goal of equity in the provision of services by the Provincial Councils, however, has to be pursued such that inefficiencies at the Provincial level do not get rewarded through the system of expenditure assessment, and hence fiscal transfers. According to Srivastava "*The objective is to ensure the provision of an equal and normatively acceptable standard of core governmental services to the citizens whatever Province they may choose to reside in. This is subject to reasonableness and feasibility. Measuring standardised expenditure requires specification of (i) services with respect of each expenditure category and its average cost with respect to the standard level of provision, and (ii) permissible Province-specific cost differentials (compared to the average cost of providing the standard service). The assessment of expenditure needs should then proceed in two steps: (a) estimation of the extent to which the provision of a service in a Province is less than the "standard"; and (b) estimation of permissible differences in unit costs due to factors like economies of scale, dispersion or concentration of population, distance form economic centres, hilly terrains, etc.* In estimating the level of service provision with respect to the standard (or desirable) level, they may be both quantitative and qualitative aspects. For example, if the goal of primary education is universal coverage, all children of the school going age in a province who are not attending school constitute the quantitative gap in the provision of the service. However, even when all children are attending school, the quality of education may be different across provinces, and there may be expenditure needs in some province to impart education up to an acceptable level of quality." [71]

Several aspects of the need-based, performance-linked, normative expenditure assessment need to be emphasised in this context. First, there is a difference between 'minimum' needs and 'equalised' needs. With fiscal stress, what should be attempted is the attainment of minimum needs across Provinces. Second, for the same level of public spending, the measurable results achieved in terms of provision of services are likely to differ among Provinces. The more efficient Provinces would indicate a higher than average achievement, and should not be punished for their efficiency. Similarly, less efficient Provinces with lower than average achievement

71 D.K.Srivastava: "Provincial Expenditure Assessment", Capacity Building for Fiscal Devolution in Sri Lanka, Part I, NIPFP, November 2000, p. 28.

should not be rewarded for their inefficiency. *In the calculation of need-based, performance-linked normative expenditure assessment, each Province should be allowed only those costs that are consistent with an average level of performance, adjusted for permissible differences in costs due to specific factors.*

There are two approaches to determining normative costs for providing a particular service, which are absolute and relative normative cost assessments. Under the absolute cost approach, the permissible expenditure E_j for the j-th Province is given by

$$E_j = U_j (e + \delta_j),$$

Where U_j is the number of units to be served (for example, number of school going children for school education), e is the norm based unit cost for average level of performance, and δ_j is the permissible deviation from average unit cost for the j-th Province. Under the need-based approach, U_j may be higher than the number of units being currently served to attain the desired level of coverage. The information requirement under the absolute cost approach is demanding, as it requires the detailed calculation of unit cost (e) from data on input costs (such as wages and salaries, material inputs, etc.). Furthermore, the absolute cost approach is likely to lead to very high expenditure requirement for a reasonable level of service.

Under the relative cost approach, relative norms – as opposed to absolute norms -- are calculated as weighted average per capita costs using past history of expenditures. As Srivastava observes: "*In the Sri Lankan case, ..., an assessment of expenditure requirements across Provinces, using relative norms may be useful.*"[72] Srivastava has produced some illustrative results for normative expenditure assessment for health and education.[73]

a) Illustrative case: health

"Sri Lanka's achievements in the health sector are exemplary for nations at comparable levels of income and development. Sri Lanka has been able to achieve a life expectancy which is already high (71 years in 1991) and projected to reach current U.S. levels by 2020. Fertility rate, measured at 2.3 for 1988-1993, is already below replacement level and continues to decline. Mortality rate (crude death rate) was 5.9 per 1000 population in 1998 and continues to decline. Through a network of hospitals run by the government and the provincial councils, health care has been made accessible to rural and urban population alike at relatively low cost."[74]

In health, Srivastava draws attention to the exemplary achievements of Sri Lanka in the health sector. But, he also points out the problems of a rapid increase in the number of aged people with a high incidence of chronic diseases, inter-Provincial as well as rural-urban differences in the quality of service available, growing shortage of trained health personnel in the public sector, and a shift in reliance from public to private health-care. Srivastava points out the recommendations of the Presidential Task Force on Health Policy appointed in January 1998 regarding rationalising resource allocations, basing them on needs, fund utilisation, and performance.

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72 D.K.Srivastava: "Provincial Expenditure Assessment", Capacity Building for Fiscal Devolution in Sri Lanka, Part I, NIPFP, November 2000, p. 34.

73 D.K.Srivastava: "Provincial Expenditure Assessment", Parts II and III, NIPFP, November 2000.

74 D.K.Srivastava: "Provincial Expenditure Assessment", Part II, NIPFP, November 2000, p. 1.

According to Srivastava, there are wide variations in per capita Provincial Council health expenditures. In 1999, recurrent health expenditures varied from Rs. 182.89 in the Western Province to Rs. 501.93 in the North-Central Province, while the all-island average was Rs. 253.38. This variation, however, conceals the wide variation in Central participation in the provision of health care services across Provinces.[75] The high variations are continuation of past trends, and he suggests a move to need-based, performance-linked normative expenditure assessment.

Srivastava suggests (i) the preparation of a standard budget using technical norms based on population, hospital beds per capita, supplies per capita, maintenance cost per capita, etc. and (ii) development of inter-provincial relativities reflecting differential needs, differential costs, and differential performance as compared to the standard budget.

The North-Western Province was selected as the median Province. In 1999, the North-Western Province had a per capita health expenditure of Rs. 295, which was significantly higher than the average of all Provinces, and Srivastava suggests a rigorous assessment of the expenditure of the Province using technical norms. For the time being, however, he recommends the per capita expenditure of all Provinces excluding the Western and Sabaragamuwa Provinces, where provincial hospitals are maintained and run by the Central Government.

Srivastava suggests some relative weights for calculating the inter-Provincial relativities with regard to normative expenditure assessment in health (Table 14).

Table 14. Sri Lanka: Relative Weights Illustratively Suggested for determining Inter-Provincial Relativities of Normative Expenditure on Health[76]

	Criteria/indicator	Weight in per cent
1.	Area per 1000 persons	20.0
2.	Per capita income for relative deprivation	15.0
3.	Share of rural population (1981 census)	15.0
4.	Population below 10 years of age	10.0
5.	Population above 60 years of age	10.0
6.	Improvement in performance	10.0
7.	Lack of availability of Central facilities	10.0
8.	Infant mortality rate	2.5
9.	Maternal mortality rate	2.5
10.	Neo-natal mortality rate	2.5
11.	Special diseases such as malaria and water-borne diseases	2.5

75 In the Western Province, with the lowest per capita Provincial Council expenditure on health, the Centre plays a major role in the provision of health services.

76 See, D.K.Srivastava: "Provincial Expenditure Assessment", Part III, NIPFP, November 2000, pp. 9-10, for details.

b) Illustrative case: education

"Sri Lanka's record in the education sector is impressive and worthy of emulating for any developing country with comparable level of resources. It has succeeded in near universalisation of elementary education for its children. It has attained a very high literacy rate for the overall population. All-island adult illiteracy is just about 8.9 per cent, although the inter-provincial profile differs widely. As per the official government policy, a primary school is provided within one kilometer of the home of any child in the six to ten year's age group. Gross primary enrolment in Sri Lanka is a hundred per cent in the relevant age group."[77]

In education, like in health, Srivastava, while praising the laudable and impressive successes achieved in Sri Lanka, points out some emerging problems. These problems relate to excessive provisioning of schooling in the public sector with the demographic pattern predicting a decline in primary enrollment, inadequate quality of teaching, inadequate availability of disciplines, rural-urban imbalance in quality, and inter-Provincial differences in educational attainments as reflected in differential transmission from lower to higher classes.

A straightforward comparison of per capita expenditure on education is not possible because many schools are run by the Central Government, and expenditures on these national schools are not reflected in the expenditures of the Provincial Councils. The pattern of Provincial Council expenditure on education reveals some minor differences across Provinces.

Choosing the median income North-Western Province with the second highest per capita recurrent expenditure on education (Rs. 865.15 in 1999) as the benchmark, Srivastava works out the inter-Provincial relativities with the help of (i) population in the age group of 5-19 years, and (ii) nine factors impinging on the higher needs, extra costs, or incentives for improvements in performance. The nine factors as well as their relative weights suggested by Srivastava for illustrative purposes are given in Table 15.

Table 15. Sri Lanka: Relative Weights Illustratively Suggested for determining Inter-Provincial Relativities of Normative Expenditure on Education[78]

	Criteria/indicator	Weight in per cent
12.	Per capita income for relative deprivation	15
13.	Area per 1000 persons	15
14.	Performance index	15
15.	Teacher-pupil ratio	15
16.	Share of rural population (1981 census)	10
17.	Relative distance from Colombo	10
18.	Improvement in performance	10
19.	Non-coverage of female students	5
20.	Non-coverage by national schools	5

77 D.K.Srivastava: "Provincial Expenditure Assessment" Part III, NIPFP, November 2000, p. 1.

78 See D.K.Srivastava: "Provincial Expenditure Assessment", Part III, NIPFP, November 2000, pp. 11-14 for details.

Srivastava suggests assessment of per student expenditure in the median North-Western Province by application of technical norms as well as the exogenous considerations like reducing or increasing total expenditures for maintaining macroeconomic balance. In the second step, he recommends determination of the per capita expenditure in all Provinces by applying the inter-Provincial relativities suggested in Table 15. Multiply the per capita expenditure in a particular Province by the total number of children in the school going age in that Province to obtain total expenditure on education in a Province. In the last step, arrive at the final estimate of Provincial expenditure by deducting Central expenditure on national schools in the Province from the total expenditure on education obtained in the last step.

Srivastava suggests that the indices suggested by him should be refined and further indices developed for determining inter-Provincial relativities in the future. Furthermore, every year, a fresh exercise should be undertaken and indices defining inter-Provincial relativities should be revised using the latest available data.

c) Other sectors

The estimation of need-based, performance-linked, normative recurrent expenditure of Provinces should be done separately for health and education from the first year itself as suggested by Srivastava. In the first year, the adoption of the methodology to other sectors may be difficult, and the other recurrent expenditure may be determined as a residual category on the basis of a projection of past trends.

From the second year onward, however, while refining and improving the methodology for health and education, the need-based, performance-linked, normative expenditure assessment should be extended separately to agriculture and agrarian services, roads and bridges, irrigation, and animal husbandry. The other recurrent expenditures may be determined as a residual category on the basis of a projection of past trends.

Need-based, performance-linked, normative expenditure assessment is a continuing exercise, and it is important to revise the methodology of assessment every year in the light of the most recent data. A few years into the process, regression analysis using panel data may be used to obtain the weights for determining the inter-Provincial differentials. In the initial period, as Srivastava observes, the use of past data, which do not incorporate the extra costs and other relevant factors in the determination of past health expenditures would not yield reliable results.

d) Move away from project-wise allocation

It is important to note that in the recommended approach of need-based, performance-linked expenditure assessment, there is a clear move away from project-wise allocation of expenditure being a concern of the Finance Commission. The desirability, or lack thereof, of any project will automatically be reflected in the expenditure assessment by the 'need-based' approach followed by the Finance Commission. Similarly, by linking the assessment of expenditure to performance, the new approach will stop rewarding Provinces for time and cost overruns for any project and punishing those that achieve economy in the implementation of projects.

The normative expenditure assessment of Provincial Council expenditures has been recommended with respect to broad sectors and services rather than for individual programmes and projects with a view to leaving sufficient autonomy with the Provincial Councils to select their desired combination of programmes and projects in the concerned sectors. Any project selected by a Provincial Council within the normative scheme of the Finance Commission, will automatically get examined in terms of unit cost norms regarding various inputs including salary and allowances, etc. for the next year.

V.7 NORMATIVE REVENUE ESTIMATION

Low and declining revenues – both of the Centre and the Provinces – as a proportion of GDP has been a major source of concern in Sri Lanka. As Aggarwal notes, "The resources available for effecting fiscal devolution in Sri Lanka are limited. The level of revenue exploitation in Sri Lanka is not only low by international standards, but is also declining. In 1999, the revenue raised by the Central Government and the Provincial Councils was only 18.1 per cent of GDP and that raised by the Central Government was 17.6 per cent of GDP. The tax revenue raised by both tiers of government was about 15.4 per cent of GDP and that raised by the Central government was about 15.0 per cent. The capacity for fiscal devolution followed a declining trend. Total revenue of both tiers of government as a proportion of GDP declined from 22.3 per cent in 1985 to 21.1 per cent in 1990 and 18.1 per cent in 1999."[79] Using a cross section of 29 countries, Aggarwal found that the actual tax revenue of the general government in Sri Lanka as a proportion of GDP was at least 3 percentage points less than the potential.[80]

Abolition of export duty on tea, rubber and coconut in 1992 and on all others in the following year, and of tax on treasury bills in 1998, which are beneficial in the medium- to long run, had an adverse impact on the Centre's tax revenue in the short run. Introduction of Goods and Services Tax (GST) in place of the turnover tax at a less than revenue neutral rate also contributed to the decline. Aggarwal notes that the initial teething problems relating to the introduction of GST is over, and Central tax revenue is expected to rise to over 17 per cent by 2005. He recommends *the removal of exemptions on petroleum and pharmaceutical products under GST for additional revenues of Rs.5.4 billion in 2001.* In income taxes, a Central tax, various exemptions and deductions, such as those on salary income of government employees and capital gains arising from the sale of shares of companies quoted at the stock exchange, have resulted in a substantial erosion of the potential tax base. He advocates *withdrawal of these exemptions on income taxes, including those on salaries of government employees.*[81] *For income tax purposes, the depreciation rates for plant, machinery and fixtures, computer software and motor coach for employee transport should also be reduced from the current 50 per cent, 50 per cent and 100 per cent, respectively, to a uniform 25 per cent. At the Provincial level, Aggarwal notes the scope for various improvements such as a reasonable threshold under the Provincial turnover tax, a move from 100 per cent assessment to a policy of selective assessment, and withdrawal of exemptions to cooperative societies.*

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79 Pawan K.Aggarwal "Capacity Building on Fiscal Devolution in Sri Lanka: Some Tax Issues", July 2001, pp. 2-3.

80 Pawan K.Aggarwal "Capacity Building on Fiscal Devolution in Sri Lanka: Some Tax Issues", July 2001, p. 96 and Table 10.

81 The withdrawal of the exemption can be effected on the same model as that for employees of the Central Bank of Sri Lanka and public sector undertakings. The revision of salaries to keep net pay constant would result in a simultaneous and equal increase in both revenues and expenditure, leaving the deficit unchanged. The main advantage of the reform will be in tax administration and transparency. The cost to the nation for public sector employment will be more realistically reflected in the budget documents.

Aggarwal also notes that the Provincial Councils are not fully exploiting the potential for taxes on land and buildings. Only three Provinces have passed statutes for collecting taxes land and buildings. Of the three, only two are collecting the tax, and that too in very small amounts. Taxes levied on the same base by local authorities complicate the levy of this tax by Provincial Councils. Aggarwal recommends *credit to be given for taxes paid on buildings and acreage tax on land to local bodies against Provincial tax on land and buildings for avoiding the problem of double taxation.* He also recommends *a rate of ½ per cent of the market value of land and buildings for the Provincial land and buildings tax with a threshold of Rs. 1 million. The tax can be legislated at the Central level and collected and retained by the Provinces. Pre-défined rules for determining the market value of immovable property will facilitate self-assessment of the tax with subsequent verification by tax officials.*

There exists considerable scope for improving tax compliance and the tax revenues of the general government through a reform of the GST and Provincial turnover tax. According to Aggarwal, *the GST should be extended to the retail level with full coverage of wholesale and retail trade. The Provinces should be allowed to levy a retail level sales tax. The retail level sales tax should replace the Provincial turnover tax. Provinces may be allowed to choose a single rate of retail level sales tax in a band of rates of 5 to 7 per cent. Furthermore, excise duty under the Excise (ordinance) Duty Act charged on domestically produced hard and soft liquor and duty on domestic production of tobacco (other than cigarettes) under the Tobacco Tax Act should be assigned to the Provincial Councils.*

At a more fundamental level, the Provincial Councils have not made enough effort to mobilise revenues because of a lack of adequate incentives in the fiscal transfer mechanism. Thus, many of them have not passed the necessary statutes to collect the devolved taxes. It is imperative to move to a system of assessing potential revenues in the calculation of fiscal transfers.

Aggarwal estimates the tax potential by assuming that the provinces reach their 1992 level of tax effort as signified by their own tax-GDP ratio for that year, given their present GDP. This is because tax-GDP ratios have fallen across the board, and the first task may be to push the provinces to their own peak levels of tax collection. *The normative revenues of the Provinces should be assessed at their own tax-to-GDP ratios for 1992 adjusted for the GDP of the relevant year. Further, if the suggested changes in the tax structure come about, then additional tax potential from the changeover to retail sales tax from the provincial turnover tax levied at present need to be added on along with those relating to the reassignment of excise duty under the Excise (Ordinance) Duty Act.* While the former can be based on the tax base for retail level GST, the latter would be based on actual collections by the Central Government at present. However, it needs to be emphasised that this suggested methodology can be used only for short period during the transition and ultimately a method for estimating relative taxable capacity will have to be adopted to get at normative estimates of tax and non-tax revenue.

Revenue potential in an absolute sense cannot be computed without some value judgements regarding the limits to taxation and other revenue collecting measures. In the analytical literature, therefore, only relative revenue potential is estimated. This essentially consists of finding an average or normative or postulated relationship between the revenue base (or a proxy thereof) and the revenue collections. Such estimation can be done at various levels of aggregation. Once the average relationship is established, given the revenue base for each of the units concerned, potential revenue is computed.

For example, let us assume that tax revenues (T_i) of each province is determined by provincial GDP (Y_i). Then the average tax ratio is given by $\Sigma\ T_i\ /\Sigma\ Y_i$. The simplest way of estimating potential tax revenue in this relative framework is to compute it for each province as $(\Sigma\ T_i\ /\Sigma\ Y_i)^*\ Y_i$. An increasing degree of complexity can be introduced into this simple methodology by disaggregating tax revenues, allowing for relationships other the proportional one that is implied by using the tax ratio, and introducing multiple determinants of tax revenue. Any combination of these complexities can also be introduced.

To take an example of norm-based revenue estimates, suppose that a norm of 10 per cent cost recovery in secondary education is imposed by the Finance Commission. Then, the potential revenue from secondary education would simply be given by 0.1C, where C denotes the cost of providing secondary education in a province. C would, of course, vary across provinces. *A reasonable relationship between the revenue bases of both the Centre and the Provinces and their revenues on the one hand and projecting the revenue bases will have to be developed and updated every year to obtain the normative revenue estimates on an ongoing basis.*

V.8 EQUALISATION GRANTS

Equalisation grant for a Province should be calculated as the difference between the need-based performance-linked, normative recurrent expenditure and the sum of normatively assessed own revenues and shared revenues with the Centre. This would allow the incentive for improving performance in the delivery of public services to work, and equity and the potential for meeting the minimum needs with regard to the services to be attained through the need-based, performance-linked normative expenditure assessment. Compared to the extant gap-filling approach, the suggested system, through the normative revenue assessment, would also provide incentives to both the Provinces and the Centre to mobilise revenues. The system of fixing the total expenditure of the general government on the basis of projected revenues and a level of deficit consistent with macroeconomic equilibrium, would allow the fiscal devolution mechanism to work without compromising the stabilisation objective. Sharing of revenues with the Central Government would enhance the autonomy of the Provincial Councils. In other words, the suggested system would meet the criteria of autonomy, equity, efficiency, and adequacy. The pursuit of this specific methodology would also enhance the transparency of the system.

V.9 CRITERIA-BASED PROVINCIAL SPECIFIC DEVELOPMENT GRANT

The system of Provincial Specific Development Grants (PSDG), which has replaced the MTIP grants from 2000 and are in the ambit of the Finance Commission, should continue to be channeled through the Finance Commission. They may cover the same area as they do now, with changes allowed in the coverage by the Finance Commission in consultation with the Provincial Councils and the Central Government.

In order to augment the transparency and autonomy of the system of fiscal devolution, the distributable funds under PSDG may be gradually increased to around 10 per cent of total *general government expenditure.*[82] *The distribution among the Provinces to be recommended by the Finance Commission should be based on an index of available infrastructure in each of the relevant areas such as hospitals and roads in the Provinces. The Provinces, however, should be allowed the flexibility of utilising the PSD grants in any combination within the specified areas.* This will allow for some amount of Provincial autonomy in deciding the weights they desire to attach to specific services. *Any part of PSDG not utilised within a year shall be carried over, subject to an adjustment in the fresh grants to an equal extent.*

The allocation of PSDG among provinces on the basis of an index of available infrastructure will be a clear move away from project-based allocation to a system that is underpinned by the need for augmenting infrastructure, and also enhancing the transparency and autonomy of the system of fiscal devolution. The basis, namely the index of available infrastructure, would imply choosing a prioritised set of sector activities. *In order to impart greater flexibility to the system, the index of available infrastructure should be constructed on the basis of an expert study commissioned by the Finance Commission and reflect the current infrastructural needs of Sri Lanka. Furthermore, the index should be revised every five years to respond to the changing needs of the country.*

V.10 Specific Purpose Grants

Specific purpose grants or matching grants for agency functions and for developing national minimum standards in specified services may continue outside the ambit of the Finance Commission. They should be programme-based and may be decided by the Central line ministries. To prevent the tail from wagging the dog, a cap of around 20 per cent relative to aggregate transfers by the Finance Commission may apply on such transfers.

V.11 A Step-wise Description of Suggested Derivation of the Transfers

i. *Project tax and non-tax revenues of the Centre and the Provinces on the basis of past revenues as well as optimal tax effort.*

ii. *Determine maximum permissible fiscal deficit of the general government consistent with maintenance of macroeconomic balance.*

iii. *Add revenues obtained in step (i) with maximum deficit in step (ii) to obtain general government expenditure in the given year.*

iv. *Fix 25 per cent of the general government expenditure as the total expenditure of Provincial Councils.*

v. *Fix 70 per cent of total expenditure of Provincial Councils obtained in Step (iv) as the total recurrent expenditure of Provincial Councils.*

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82 Given that capital expenditure is around 30 per cent of general government expenditure, the Provincial share has been kept at a third of this total.

vi. *Estimate need-based, performance-linked, normative recurrent expenditure of Provinces.*

This should be done separately for health and education from the first year itself In the first year, the other recurrent expenditure may be determined as a residual category on the basis of a projection of past trends.

From the second year onward, the need-based, performance-linked, normative expenditure assessment should be extended separately to agriculture and agrarian services, roads and bridges, irrigation, and animal husbandry. The other recurrent expenditures may be determined as a residual category on the basis of a projection of past trends.

vii. *Adjust the need-based, performance-linked, normative recurrent expenditure estimates of Provinces obtained in Step (vi) pro-rata so that the total for all Provincial Councils add up to total recurrent expenditure of the general government obtained in Step v.*

viii. *Calculate the differences between recurrent expenditure [from Step(vii)] and own revenues [from Step(i)] of every Province. Identify the Province with the least gap.*

ix. *Fix the proportion of total revenues of the Central Government to be shared with the Provinces on the basis of their population such that the per capita share in the Province with the least gap between recurrent expenditure and own revenues [identified in Step (viii)] bridges the gap in that Province to the extent of 75 per cent.*

x. *Fix the equalisation grant for each Province such that the need-based, performance-linked, normative recurrent expenditure equals the sum of normatively assessed own revenues and shared revenues with the Centre together with the equalisation grant.*

xi. *Continue to channel Provincial Specific Development Grants (PSDG) through the Finance Commission. Increase PSDG gradually to around 10 per cent of total general government expenditure. Base the Finance Commission recommendations regarding distribution of PSDG among the Provinces on an index of available infrastructure in each of the relevant areas such as hospitals and roads in the Provinces*

xii. *Continue with specific purpose grants from line ministries at the Centre. But. limit the total of such transfers to less than 20 per cent of the aggregate transfers through the Finance Commission.*

VI. Revamping institutions

VI.1 Need to Restructure the Central Government

According to Mathur: "Considerable amount of work has been done, globally and in the developing countries, on the role of institutions in economic planning, development and management. It is argued that institutions can significantly enhance the effectiveness of decentralisation and devolution efforts. Design of institutions is said to be vital for the success of decentralisation and devolution policies. In the context of Sri Lanka, the Administrative Reforms Committee has underlined the crucial importance of institutions stating that the path of democratic decentralisation which the country has taken, *unless adequately supported by carefully planned political and administrative institutions whose authority and responsibility as well as functions are clearly spelt out,* could result in instability."[83]

Taking the institutional factors as relating to the workings of organisations such as the Central and Provincial Governments, and the Finance Commission, there is an urgent need to revamp the institutions starting with the Central Government itself. For strengthening the fiscal devolution system, it is necessary to recognise the crucial role of the Government in fiscal devolution. Government alone can create conditions for Provincial Councils and other institutions to work efficiently. The Government alone is in a position to set in appropriate systems and procedures (rules of the game) for harnessing the energies of the institutions.

a) Reducing the number of line ministries

The line ministries at the Centre on devolved subjects such as ministry of livestock and the ministry of cooperatives should be abolished. Furthermore, the Centre should desist from creating institutions such as the Southern Development Agency that encroach upon devolved subjects. Line ministries should operate through their own employees and divisional secretaries should stop being responsible to the line ministries.

b) Stopping micro-management through the Ministry of Provincial Councils

The detailed Central control over Provincial use of funds through the Ministry of Provincial Councils and Local Government has been a major hindrance to the development of Provincial Councils as competent spending authorities and progress of fiscal devolution. *Given the enhanced role of the Finance Commission, and the new role of the Department of National Planning in providing assistance to Provincial Councils in the preparation of Provincial plans, the Ministry of Provincial Councils and Local Government, without any attempt at micromanagement, should adhere to its role of assisting Provincial Councils and Local Governments to operate within the framework of national policy, to liaise with the Centre, to obtain financial, legal and technical assistance, to develop human resources, and to improve their effectiveness.*

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83 Om Prakash Mathur: "Institutions for Fiscal Devolution: A Study", Capacity Building for Fiscal Devolution in Sri Lanka, NIPFP, September 2001, p. 19.

The Centre may set up a forum of all Provincial Chief Ministers to meet under the Chairmanship of the President to discuss issues of inter-Provincial interest or issues involving Centre-Provincial matters.

c) Implementing Finance Commission recommendations

Implementation is as important as design in any system. Tardy implementation can turn even a well designed system quite infructuous. *It is imperative to develop a healthy convention of accepting and implementing Finance Commission awards in full. Furthermore, the Central Government should present to Parliament a detailed explanatory memorandum when the recommendations are either not accepted or not implemented in full.*

d) Removing cadre control

Provincial Councils cannot become competent spending authorities, mobilising revenues and delivering public services according to the needs and preferences of the citizens within their jurisdictions, without an efficient bureaucracy that has strong ties with the Provinces and identifies with their welfare. *The control of the Centre of Provincial cadre requirements through process of approval from the Ministry of Provincial Councils and Local Government should cease. It may be replaced by a system of caps on wages and salaries bill. The understanding reached between the Provincial and Central Governments that all upper and middle level staff would be obtained on temporary release from the All Island Service should be scrapped.*

VI.2 IMPROVING CAPACITY AT THE PROVINCIAL LEVEL

a) Training

Many of the problems leading to insufficient capacity at the Provincial level are likely to disappear or diminish with the restructuring of the Central Government, particularly the reorientation of the Ministry of Provincial Council and Local Government and abolition of cadre control by the Centre. Nevertheless, *it is necessary to organise training and development of the Provincial staff through workshops, seminars and interaction with officials of other countries that have implemented successful fiscal devolution.*

b) Developing a data base and monitoring arrangement

There is an urgent need to improve the information base at the Provincial level. *Responsibility should be assigned at the level of the Chief Secretary to maintain a reliable and timely data base relating to revenues and expenditures and other budget related items. Data for a particular year should be posted on the electronic web and published annually with a maximum delay of six months.*

VI.3 IMPROVING CAPACITY AT THE FINANCE COMMISSION

a) Need for a Finance Commission Act

There should be a Finance Commission Act to govern the functioning of the Commission. The Act may contain provisions relating to: (i) objects and mission of the Commission, (ii) composition, qualifications, privileges and obligations of the members, (iii) tenure of the members with subprovisions for reappointment, termination and disqualification, (iv) functions and responsibilities, and subprovisions with respect to the failure to discharge, (v) budget, and its financial powers, and (vi) procedures, property and seal.

b) Full-time chairperson, members, and secretary

The work of the Finance Commission has suffered in the past because of the absence of full time Chairman and Secretary. Even members would need to devote considerable time and most of their attention to the work of the Commission to discharge their responsibilities satisfactorily. *The Finance Commission should have a full time Chairperson and members. The Secretary to the Commission, who is not a member, should also be full time secretary.*

c) Annual report

The lack of documentation about the workings of the Finance Commission can be redressed by establishing a system of publishing an Annual Report of the Commission. This Annual Report can also serve as a background paper for generating an informed public debate about the progress of fiscal devolution in Sri Lanka. The Finance Commission should be required by the Finance Commission Act to submit an annual report describing its methodology, data used, and recommendations to the Parliament.

d) Salary revision

A salary structure too much out of line with market trends denies organisations of qualified new recruits, leads to high staff turnover, and a progressive deterioration in staff quality. The salaries of technical staff at the Finance Commission should be fixed with reference to comparable salaries of technical staff elsewhere in the economy. Technical posts should be filled up through open recruitment and on a contract basis. The post of the secretary to the Commission should be upgraded to that of Chief Secretary at the Provincial level, for the Commission to function effectively in dealing with both the Provinces and the Centre.

e) Restructuring to improve technical competence

The staffing pattern of the Finance Commission should be reviewed to reduce the number of non-technical and under-skilled personnel. Improvement in the electronic data processing facilities would allow the Commission to function much more effectively than currently with a much-reduced non-technical staff retinue.

VII. Recommendations

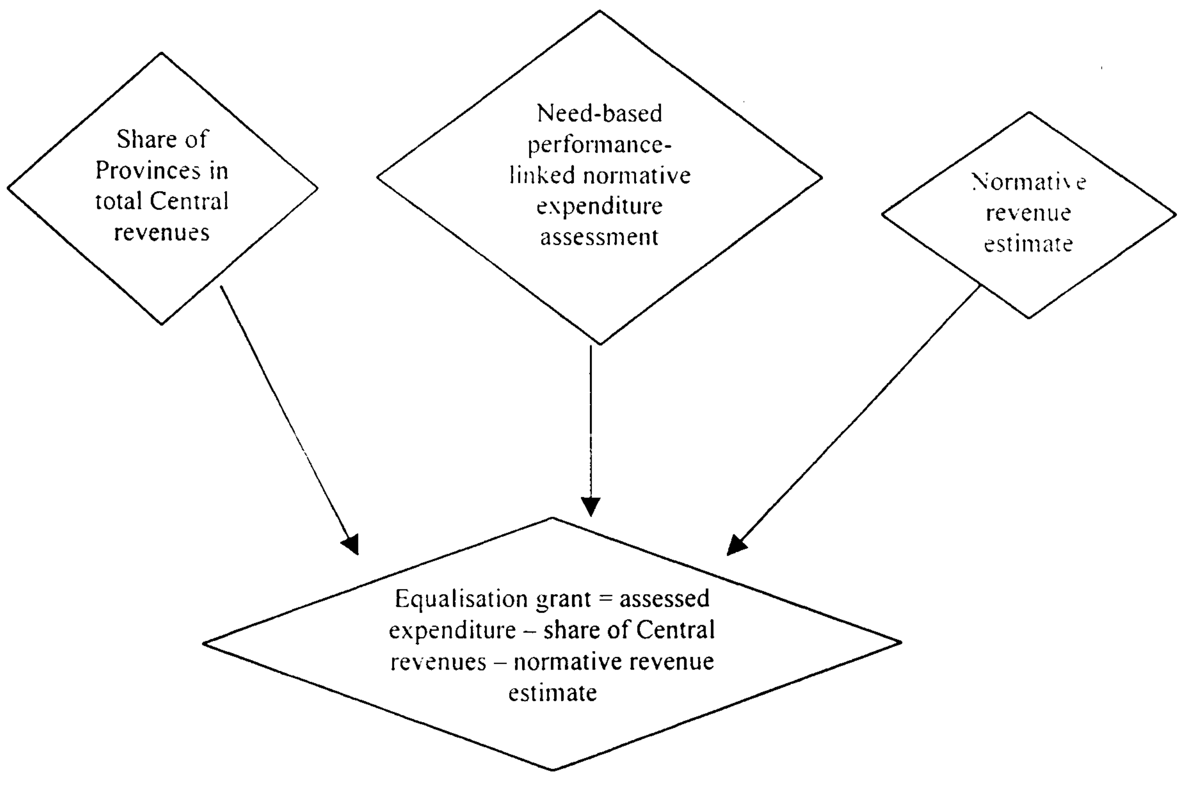
1. Both the Constitutional assignment of functions as well as international practice suggest that the share of the Provincial Councils in general government expenditure in Sri Lanka should be at least doubled to around 25 per cent. [V.3 c]

Doubling the Provincial share of expenditure in general government expenditure would bring the role of the Provinces more in line with the spirit of the assignment of functions in the Constitution. It will lead to a greater correspondence between local needs and the provision of public services, enhance accountability and people's participation. Furthermore, it would align Sri Lanka more closely with international practice in fiscal devolution. [V.3 c]

2. It is important to note that the derivation of the desirable size of Provincial expenditure can be obtained from the desirable relativity only when the total general government expenditure has been specified. The specification of total general government expenditure for a year has to take into account the revenue projections for the year and the permissible fiscal deficit for maintenance of macroeconomic stability. [V.3 d]

3. It is important to design the central transfers within a unified scheme such that the criteria of equity, efficiency and adequacy are fulfilled. The scheme should help develop the Provinces as competent spending authorities, responsive to the needs and preferences of the residents within their jurisdictions, encourage economy and the pursuit of most cost effective methods in the provision of public goods and services, and also promote revenue – both tax and non-tax – mobilisation in their territories. [V.4]

Sri Lanka: Proposed Unified Scheme for Determining Transfers



The proposed approach would achieve fiscal equalisation both from the revenue and expenditure side, and provide incentives to the Provinces to mobilise revenues, and improve performance in the production and delivery of public goods and services upto a desired minimum standard. [V.4]

4. Given the large vertical fiscal gap, to enhance the 'autonomy' of the Provinces, Sri Lanka needs to introduce a system of the Centre sharing its tax revenues with them. [V.5]

Complementing by gross tax revenue sharing a revamped system of grants would not only reduce the vertical fiscal imbalance and enhance Provincial autonomy, but also impart a much-needed buoyancy, predictability, coordination and burden-sharing to the system. [V.5]

The sharing of total gross tax revenues, rather than total net tax revenues is recommended to provide incentives to the Centre to minimise collection costs. [V.5]

It is suggested that the normative gap between own revenues and expenditures be first estimated for all Provinces. The Province with the lowest gap per capita should be identified. The proportion of total gross tax revenue to be shared with the Provinces should be fixed such that, when the shared revenues are distributed to the Provinces in proportion to their population, it covers 75 per cent of the normative gap of the Province with the lowest normative gap per capita. [V.5]

To let the Provinces share the benefit of buoyant Central revenues, and also the burden of depressed revenues, the tax share may be kept unchanged for a period of five years. [V.5]

The system of estimating the total revenue share as well as its *inter-se* distribution among Provinces should be reviewed by the Finance Commission on a periodic basis.

5. The extant approach to expenditure assessment should be replaced by a need-based, performance-linked normative approach. [V.6]

The need-based approach to expenditure assessment will have to take into account the initial discrepancies in the availability of such services from the 'desired' or 'normative' levels in each Province. The normative levels should indicate the minimum level of services that are desirable through the length and breadth of the country. [V.6]

The objective is to ensure the provision of an equal and normatively acceptable standard of core governmental services to the citizens whatever Province they may choose to reside in. This is subject to reasonableness and feasibility. Measuring standardised expenditure requires specification of (i) services with respect of each expenditure category and its average cost with respect to the standard level of provision, and (ii) permissible Province-specific cost differentials (compared to the average cost of providing the standard service). The assessment of expenditure needs should then proceed in two steps: (a) estimation of the extent to which the provision of a service in a Province is less than the "standard"; and (b) estimation of permissible differences in unit costs due to factors like economies of scale, dispersion or concentration of population, distance form economic centres, hilly terrains, etc. [V.6]

In the calculation of need-based, performance-linked normative expenditure assessment, each Province should be allowed only those costs that are consistent with an average level of performance, adjusted for permissible differences in costs due to specific factors. [V.6]

In the Sri Lankan case, an assessment of expenditure requirements across Provinces, using relative norms may be useful. [V.6]

Need-based, performance-linked, normative expenditure assessment is a continuing exercise, and it is important to revise the methodology of assessment every year in light of the most recent data. A few years into the process, regression analysis using panel data may be used to obtain the weights for determining the inter-Provincial differentials. [V.6 c]

6. Exemptions on petroleum and pharmaceutical products under GST should be removed. [V.7]

Exemptions on income taxes, including those on salaries of government employees, should be withdrawn. [V.7]

For income tax purposes, the depreciation rates for plant, machinery and fixtures, computer software and motor coach for employee transport should be reduced from the current 50 per cent, 50 per cent and 100 per cent, respectively, to a uniform 25 per cent. [V.7]

At the Provincial level, it would be necessary to introduce a reasonable threshold under the Provincial turnover tax, move away from 100 per cent assessment to a policy of selective assessment, and withdraw exemptions to cooperative societies. [V.7]

There should be a Provincial land and buildings tax at the rate of ½ per cent of the market value of land and buildings with a threshold of Rs. 1 million. The tax can be legislated at the Central level and collected and retained by the Provinces. Pre-defined rules for determining the market value of immovable property will facilitate self-assessment of the tax with subsequent verification by tax officials. Credit should be given for taxes paid on buildings and acreage tax on land to local bodies against Provincial tax on land and buildings for avoiding the problem of double taxation. [V.7]

The GST should be extended to the retail level with full coverage of wholesale and retail trade. The Provinces should be allowed to levy a retail level sales tax. The retail level sales tax should replace the Provincial turnover tax. Provinces may be allowed to choose a single rate of retail level sales tax in a band of rates of 5 to 7 per cent. [V.7]

Excise duty under the Excise (ordinance) Duty Act charged on domestically produced hard and soft liquor and duty on domestic production of tobacco (other than cigarettes) under the Tobacco Tax Act should be assigned to the Provincial Councils. [V.7]

The normative revenues of the Provinces should be assessed at their own tax-to-GDP ratios for 1992 adjusted for the GDP of the relevant year. [V.7]

Further, if the suggested changes in the tax structure come about, then additional tax potential from the changeover to retail sales tax from the provincial turnover tax levied at present need to be added on along with those relating to the reassignment of excise duty under the Excise (Ordinance) Duty Act. [V.7]

A reasonable relationship between the revenue bases of both the Centre and the Provinces and their revenues on the one hand and projecting the revenue bases on the other will have to be developed and updated every year to obtain the normative revenue estimates on an ongoing basis. [V.7]

7. Equalisation grant for a Province should be calculated as the difference between need-based performance-linked, normative recurrent expenditure and the sum of normatively assessed own revenues and shared revenues with the Centre. [V.8]

8. The system of Provincial Specific Development Grants (PSDG), which has replaced the MTIP grants from 2000 and are in the ambit of the Finance Commission, should continue to be channeled through the Finance Commission. [V.9]

In order to augment the transparency and autonomy of the system of fiscal devolution, the distributable funds under PSDG may be gradually increased to around 10 per cent of total general government expenditure. [V.9]

The distribution among the Provinces to be recommended by the Finance Commission should be based on an index of available infrastructure in each of the relevant areas such as hospitals and roads in the Provinces. The Provinces, however, should be allowed the flexibility of utilising the PSD grants in any combination within the specified areas. Any part of PSDG not utilised within a year will be carried over, subject to an adjustment in the fresh grants to an equal extent. [V.9]

9. Specific purpose grants or matching grants for agency functions and for developing national minimum standards in specified services may continue outside the ambit of the Finance Commission. They should be programme-based and may be decided by the Central line ministries. To prevent the tail from wagging the dog, a cap of around 20 per cent relative to aggregate transfers by the Finance Commission may apply on such transfers. [V.10]

10. A Step-wise Description of Suggested Derivation of the Transfers

i. Project tax and non-tax revenues of the Centre and the Provinces on the basis of past revenues as well as optimal tax effort.

ii. Determine maximum permissible fiscal deficit of the general government consistent with maintenance of macroeconomic balance.

iii. Add revenues obtained in step (i) with maximum deficit in step (ii) to obtain general government expenditure in the given year.

iv. Fix 25 per cent of the general government expenditure as the total expenditure of Provincial Councils.

v. Fix 70 per cent of total expenditure of Provincial Councils obtained in Step (iv) as the total recurrent expenditure of Provincial Councils.

vi. Estimate need-based, performance-linked, normative recurrent expenditure of Provinces.

This should be done separately for health and education from the first year itself. In the first year, the other recurrent expenditure may be determined as a residual category on the basis of a projection of past trends.

From the second year onward, the need-based, performance-linked, normative expenditure assessment should be extended separately to agriculture and agrarian services, roads and bridges, irrigation, and animal husbandry. The other recurrent expenditures may be determined as a residual category on the basis of a projection of past trends.

vii. Adjust the need-based, performance-linked, normative recurrent expenditure estimates of Provinces obtained in Step (vi) pro-rata so that the total for all Provincial Councils add up to total recurrent expenditure of the general government obtained in Step v.

viii. Calculate the differences between recurrent expenditure [from Step (vii)] and own revenues [from Step (i)] of every Province. Identify the Province with the least gap.

ix. Fix the proportion of total revenues of the Central Government to be shared with the Provinces on the basis of their population such that the per capita share in the Province with the least gap between recurrent expenditure and own revenues [identified in Step (viii)] bridges the gap in that Province to the extent of 75 per cent.

x. Fix the equalisation grant for each Province such that the need-based, performance-linked, normative recurrent expenditure equals the sum of normatively assessed own revenues and shared revenues with the Centre together with the equalisation grant.

xi. Continue to channel Provincial Specific Development Grants (PSDG) through the Finance Commission. Increase PSDG gradually to around 10 per cent of total general government expenditure. Base the Finance Commission recommendations regarding distribution of PSDG among the Provinces on an index of available infrastructure in each of the relevant areas such as hospitals and roads in the Provinces.

xii. Continue with specific purpose grants from line ministries at the Centre. But, limit the total of such transfers to less than 20 per cent of the aggregate transfers through the Finance Commission.

11. The line ministries at the Centre on devolved subjects such as ministry of livestock and the ministry of cooperatives should be abolished. Furthermore, the Centre should desist from creating

institutions such as the Southern Development Agency that encroach upon devolved subjects. Line ministries should operate through their own employees and divisional secretaries should stop being responsible to the line ministries. [VI.1 a]

12. Given the enhanced role of the Finance Commission, and the new role of the Department of National Planning in providing assistance to Provincial Councils in the preparation of Provincial plans, the Ministry of Provincial Councils and Local Government, without any attempt at micromanagement, should adhere to its role of assisting Provincial Councils and Local Governments to operate within the framework of national policy, to liaise with the Centre, to obtain financial, legal and technical assistance, to develop human resources, and to improve their effectiveness. [VI.1 b]

13. The Centre may set up a forum of all Provincial Chief Ministers to meet under the Chairmanship of the President to discuss issues of inter-Provincial interest or issues involving Centre-Provincial matters. [VI.1 b]

14. It is imperative to develop a healthy convention of accepting and implementing Finance Commission awards in full. Furthermore, the Central Government should present to Parliament a detailed explanatory memorandum when the recommendations are either not accepted or not implemented in full. [VI.1 c]

15. The control of the Centre of Provincial cadre requirements through process of approval from the Ministry of Provincial Councils and Local Government should cease. It may be replaced by a system of caps on wages and salaries bill. The understanding reached between the Provincial and Central Governments that all upper and middle level staff would be obtained on temporary release from the All Island Service should be scrapped. [VI.1d]

16. It is necessary to organise training and development of the Provincial staff through workshops, seminars and interaction with officials of other countries that have implemented successful fiscal devolution. [VI.2 a]

17. Responsibility should be assigned at the level of the Chief Secretary to maintain a reliable and timely data base relating to revenues and expenditures and other budget related items. Data for a particular year should be posted on the electronic web and published annually with a maximum delay of six months. [VI.2 b]

18. There should be a Finance Commission Act to govern the functioning of the Commission. [VI.3 a]

19. The Finance Commission should have a full time Chairperson and members. The Secretary to the Commission, who is not a member, should also be a full time Secretary. [VI.3 b]

21. The Finance Commission should be required by the Finance Commission Act to submit an annual report describing its methodology, data used, and recommendations to the Parliament. [VI.3 c]

21. The salaries of technical staff at the Finance Commission should be fixed with reference to comparable salaries of technical staff elsewhere in the economy. Technical posts should be filled up through open recruitment and on a contract basis. For the Commission to function effectively

in dealing with both the Provinces and the Centre, the post of the Secretary to the Commission should be upgraded to that of Chief Secretary at the Provincial level. [VI.3 d]

22. The staffing pattern of the Finance Commission should be reviewed to reduce the number of non-technical and under-skilled personnel. Improvement in the electronic data processing facilities would allow the Commission to function much more effectively than currently with a much-reduced non-technical staff retinue. [VI.3 e]

Fiscal devolution is an ongoing process. Design as well as implementation of fiscal devolution need to flexibly respond to developments within and outside the country. The dynamic challenge to modify what has been proposed in this report for redesigning the system and revamping institutions to suit the country's requirements through time will remain. Hopefully, the recommendations contained in this report will not only revitalise fiscal devolution in Sri Lanka in line with the spirit of the Thirteenth Amendment, but also equip the Central and Provincial Governments and the Finance Commission to cope with the dynamic challenge.

There is a need to draw up a critical time path for implementing the recommendations. A distinction can be made between those recommendations that require only administrative action and those that call for legal or Constitutional changes. But even within these two sets of recommendations, the sequencing of steps is of considerable importance requiring inputs from policy makers both at the bureaucratic and political levels. Once a decision is taken to go ahead with the recommendations, a high-powered committee may be set up with participation from bureaucracy as well as politicians with a deadline for implementing the new strengthened system of devolution in Sri Lanka.

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Appendix I

Training Programme

Expenditures of Subnational Governments: Assessment, Management and Control

National Institute of Public Finance and Policy

September 13-24, 1999

Monday, September 13, 1999

9:30 a.m.—10:30 a.m.	Inaugural lecture

Module 1: Functioning of a Federal System: Role of Local Governments

Lectures 1-2.	Determining Expenditure Responsibilities in a Federal System: Principles and Theoretical Issues
Lecture 3.	Expenditure Responsibilities of Provincial Level Governments: An International Perspective
Lecture 4.	Trends in Subnational Government Expenditure: A Survey
Lecture 5.	Local Governments as an Expenditure Responsibility of Provincial Governments

Module 2: Expenditure Estimation and Assessment

Lectures 6-7.	Expenditure Assessment: Methods and Issues (a) Recurrent Expenditure (b) Capital Expenditure, including multi-year expenditure programming.
Lecture 8.	Methodology for Unit Cost Estimation
Lectures 9-10.	Unit Cost Estimation: Education
Lecture 11.	Unit Cost Estimation: Health
Lecture 12.	Unit Cost Estimation: Roads

Module 3: Expenditure Management

Lecture 13	Expenditure Management in a Multi-level Government Framework
Lecture 14.	Budgetary Processes at Provincial Levels

Lectures 15-17.	Expenditure Management and Control (a) Concepts of management and control (b) Techniques of expenditure management (c) Mechanism and instruments for expenditure control (d) Expenditure management and control at local level.
Lecture 18.	Performance-based Financial Management
Lectures 19-20.	Accrual Accounting: Reporting, and Asset and Liability Management
Lecture 21.	Cashflow Management at Subnational levels
Lecture 22	Debt Management at Subnational Levels
Lecture 23	Expenditure Management of Externally-Aided Projects
Lectures 24-25.	Internal Management, Evaluation and Audit
Lecture 26.	Payment Systems

<u>Module 4: Supporting Infrastructure</u>

Lectures 27-28.	Application of EDP System to Local Finance Management
Lecture 29.	Process of Contracting: Implications for Expenditure Management
Concluding Session:	Panel Discussion

Appendix II

Sri Lanka: Provinces and Districts

Provinces	Districts	Total number of divisions
Central	Kandy (20) Matale (11) Nuwara-Eliya (5)	**36**
North Central	Anuradhapura (22) Polonnaruwa (6)	**28**
North Eastern	Ampara (17) Batticaloa (12) Jaffna (14) Kilinochchi (4) Mannar (5) Mullaitivu (2) Trincomalee (11) Vavuniya (4)	**69**
North Western	Kurunnegala (29) Puttalam (16)	**45**
Sabaragamuwa	Ratnapura (17) Kegalle (11)	**28**
Southern	Galle (19) Matara (16) Hambantota (11)	**46**
Uva	Badulla (14) Monaragala (11)	**25**
Western	Colombo (12) Gampaha (13) Kalutara (13)	**38**

Notes: Numbers in parentheses indicate number of divisions in the district.

Appendix III

(Information for 2000 valid upto September 2000)

Sri Lanka: Finance Commission Meetings and Attendance

1999-2000

Year/quarter	Number of meetings	Attendance
1999:		
Quarter I	4	1st 4, 2nd 3, 3rd 4, and 4th 2
Quarter II	2	1st 3, and 2nd 2
Qaurter III	2	1st 3, and 2nd 2
Qaurter IV	3	1st 3, 2nd 3, and 3rd 3
2000		
Quarter I	2	1st 4, and 2nd 4
Quarter II	3	1st 3, and 2nd 4

Attendance by individual members:

Out of 11 meetings in 1999

Chairman	11
Mr. A.S.Jayawardane, Governor, Central Bank	2
Dr. P.B.Jayasundara*, Secretary to the Treasury	1
Prof. M.T.A. Furkhan	7
Mr. T.Suntheralingam**	5
Mr. K. Neelakandan**	3

*Appointed in November 1999. Until November 1999, Mr. Dixon Neelaweera, Mr. Jayasundara's predecessor at the Treasury, was the Chairman of the Commission.

**The term of Mr. Suntheralingam, representative of the minority Tamil community, expired in August 1999, when Mr. Neelakandan was appointed in his place..

Out of 5 meetings so far in 2000

Chairman	5
Mr. A.S.Jayawardane, Governor, Central Bank	3
Dr. P.B.Jayasundara, Secretary to the Treasury	3
Prof. M.T.A. Furkhan	4
Mr. K. Neelakandan	4