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Decentralization and Provincial Finance in Sri Lanka: 2004 - An Update

D D M Waidyasekera

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Abstract

Decentralization and fiscal devolution have assumed importance in Sri Lanka particularly in the context of the ongoing ethnic crisis, but the Provincial Council system which arose from the Thirteenth Amendment to the Constitution has several inherent weaknesses and deficiencies.

This paper analyses the fiscal and financial issues pertaining to the Provincial administrative system including the relative insignificance and inadequacy of the revenue sources devolved to the Provinces, provincial revenue buoyancy, the wide disparity between the different provincial administrations, the nature of provincial expenditure and the weaknesses of the prevailing grants system on which the Provincial Councils depend for their existence and functioning.

It also includes a list of the financial powers and functions devolved to the provinces, those in the list reserved to the centre and the functions relating to planning in the concurrent list as provided in the Thirteenth Amendment. The paper also includes a summary of the recommendations made to enhance the revenue performance of provincial administrations so as to reduce the vertical and horizontal imbalances presently prevalent.

Acknowledgement

This paper is based on a presentation made at a workshop organised by the Finance Commission in August 1999 and a seminar at the Institute of Policy Studies in January 2000. This was followed by a Study initiated by the UNDP and Finance Commission in 2002. The views expressed and the discussions by the participants both local and foreign proved extremely useful and so were the views and output provided by the other consultants in the Study. However the author alone is responsible for the views expressed and for any errors and omissions. The author is also beholden to the Ministry of Provincial Councils and Local Government, the Ministry of Finance and Planning and the Chairman, Secretary and staff of the Finance Commission who were most helpful, for assistance in gathering the relevant data and providing necessary facilities.

1. Introduction

This paper attempts to deal with some of the main issues pertaining to fiscal decentralization and provincial revenue in Sri Lanka in the context of the Thirteenth Amendment to the Constitution. Its objective is limited firstly, to fiscal and revenue issues and not to political, economic or social issues pertaining to decentralization or devolution. Second, its focus is on fiscal decentralization and not on devolution proper. Decentralization is essentially a means of implementing functions assigned at the discretion of the Centre and not embedded in the Constitution. Devolution is a broader concept and involves sharing, not mere control of functions or of finance. The issues discussed in this paper are therefore within these parameters and within the framework of the above limitations.

While a system of decentralized units in the form of Village Councils or "Gam Sabhas" existed in Sri Lanka from ancient times, prior to Independence the system of local government was essentially dependent on the central government and even after Independence what continued to prevail was administrative decentralization with the main authority being the central government and taxes being implemented by its departments and agencies with local bodies only enjoying limited revenue powers.

In 1973 and 1980 some attempts at decentralization were made but they were not major departures from the prevailing system. The Thirteenth Amendment to the Constitution certified on 14th November 1987, paved the way for the creation of Provincial Councils under Section 154A of the Constitution and enacted under the Provincial Councils Act No. 42 of 1987. This was an attempt made for the first time for the effective decentralization of administration by a process of devolution giving powers to the Provincial Councils to plan, execute and manage the totality of selected functions. However, the case of Sri Lanka as compared to other countries where multi-level systems of government prevail appears to be unique in that the sub-national units of government were introduced into a state explicitly unitary in character. Under Section 154 B(2) of the Thirteenth Amendment, Governors for the respective Provinces are appointed by the President and hold office during the pleasure of the President. Nevertheless, recent decisions by the Supreme Court have established that the Governors cannot act as mere agents of the President but must consult with the Chief Minister.

Under the Eighth Schedule of the Thirteenth Amendment the country was divided into nine provinces and under the Ninth Schedule the allocation of functions was categorized into three Lists – List I the Provincial Council List, List II the Reserved List and List III the Concurrent List. This followed the general trend of allocating matters of national importance to the Central Government and those of regional or local interest to regional or local governments. However, for the purpose of the Cenral Government having a strong influence on regional responsibility, the Concurrent List included certain subjects assigned to the periphery to be also of interest to the Centre. This interest is so even in federal states like Australia, the best example however being India where in its Seventh Schedule to the Constitution, there is a Concurrent List with overriding powers and also a proviso that the residual powers belong to the Centre. Table 1.1 provides the basic economic data of the provinces established.

Figure 1.1
Sri Lanka - Provincial and District Boundaries

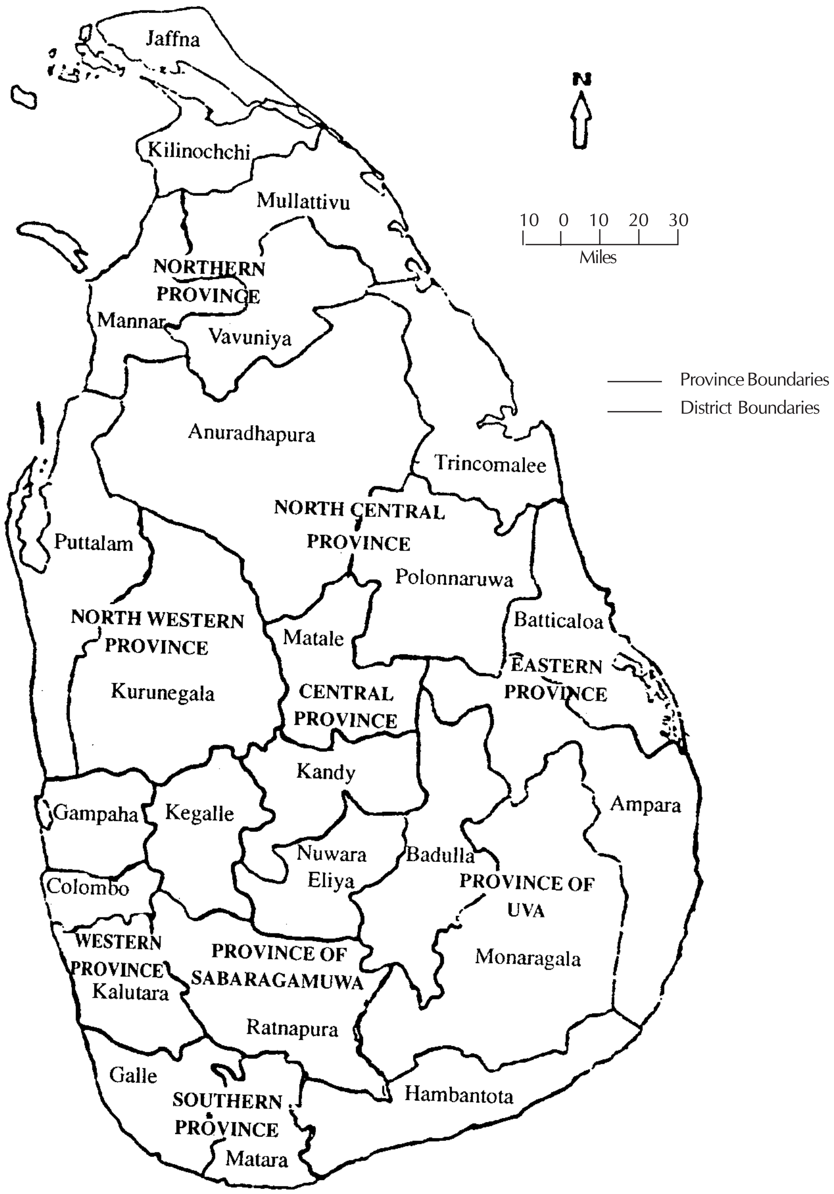


Table 1.1
Basic Economic Data of Provinces 2003

Province	Population 000	Land Area Sq. Km.	Density of Population
Western	5,471	3,593	1,523
Central	2,474	5,575	444
Southern	2,324	5,383	432
North Western	2,196	7,506	293
Sabaragamuwa	1,825	4,921	371
Northern	1,106	8,290	133
Eastern	1,518	9,361	162
Uva	1,206	8,335	145
North Central	1,132	9,741	116
National	19,252	62,705	307

Source: Central Bank of Sri Lanka, Economic & Social Statistics of Sri Lanka 2004.

Figure 1.1 illustrates in topographical form the demarcation of the provinces including the districts within each Province.

The rest of the paper is divided as follows: Section 2 deals with the revenue sources, volume and performance of the decentralized provincial units. Section 3 examines the revenue capacity and fiscal potential of the decentralized provinces. Section 4 describes the nature and extent of provincial expenditure. Section 5 analyses the prevalent system of fiscal transfers to the sub-national units and measures to bridge the inherent deficits of Provincial Councils. Section 6 summarises the weaknesses of the Provincial Council System and Section 7 concludes. The Appendix provides relevant annexures.

2. Revenue Sources and Revenue Performance

2.1 Main Sources of Provincial Revenue

The revenue sources devolved to the provinces are enumerated in Sections 36.1 to 36.20 of List 1 of the Ninth Schedule to the Thirteenth Amendment. Details of these sources are given in the Appendix. While at first glance these sources appear formidable, a closer scrutiny reveals that the main sources consist only of the turnover taxes and stamp duties while licence taxes, motor vehicle licence fees and court fines are the other substantial revenue sources. Enabling legislation in the form of Financial Statutes have been passed by the respective Provincial Councils with effect from January 1, 1991 to empower them to recover the relevant taxes and fees, e.g. Western Province Statute No.6 of 1990, Southern Province No.9 of 1990 and North Central Province No.13 of 1990 etc. In order to achieve uniformity of application, the substantive as well as the procedural law in all provinces is basically the same.

An analysis of provincial revenue and revenue performance may be looked at from three dimensions - macro wise, source wise and province wise.

2.2 Revenue Macro-wise

In Sri Lanka most of the government revenue is derived through taxation, non-tax revenue being only about 16 per cent. In 2003 for example, out of the total revenue of Rs.276 billion, Rs. 231 billion or 84 per cent was from tax revenue. However, the sources devolved on the Provincial Councils accounted for only less than 4 per cent of the Government's total revenue. The following table gives the comparative position of Provincial Council revenue in relation to the Government's total revenue and tax revenue respectively.

Table 2.1
Provincial Council Revenue in Relation to Government Revenue 1999-2004 (Rs. Million)

	1999	2000	2001	2002	2003	2004
Central Government Total Revenue	95,905 (17.7)	211,282 (16.7)	234,296 (16.6)	261,887 (16.5)	276,516 (15.7)	311,437 (15.3)
Provincial Total Revenue	6,993 (0.6)	7,534 (0.6)	8,674 (0.6)	9,366 (0.6)	11,625 (0.6)	13,522 (0.6)
% of Provincial Total/Government Total Revenue	3.5%	3.5%	3.7%	3.7%	4.2%	4.3%
Central Government Tax Revenue	169,029 (15.2)	182,392 (14.5)	205,840 (14.6)	221,837 (14.0)	231,648 (13.1)	281,552 (13.8)
Provincial Tax Revenue	5,965 (0.5)	6,478 (0.5)	7,539 (0.5)	7,952 (0.5)	9,968 (0.5)	11,544 (0.5)
% of Provincial Tax/Government Tax Revenue	3.5%	3.5%	3.6%	3.6%	4.3%	4.1%

Note: Figures in parenthesis denote percentage/GDP.

Source: Compiled from Central Bank of Sri Lanka Annual Reports, various years.

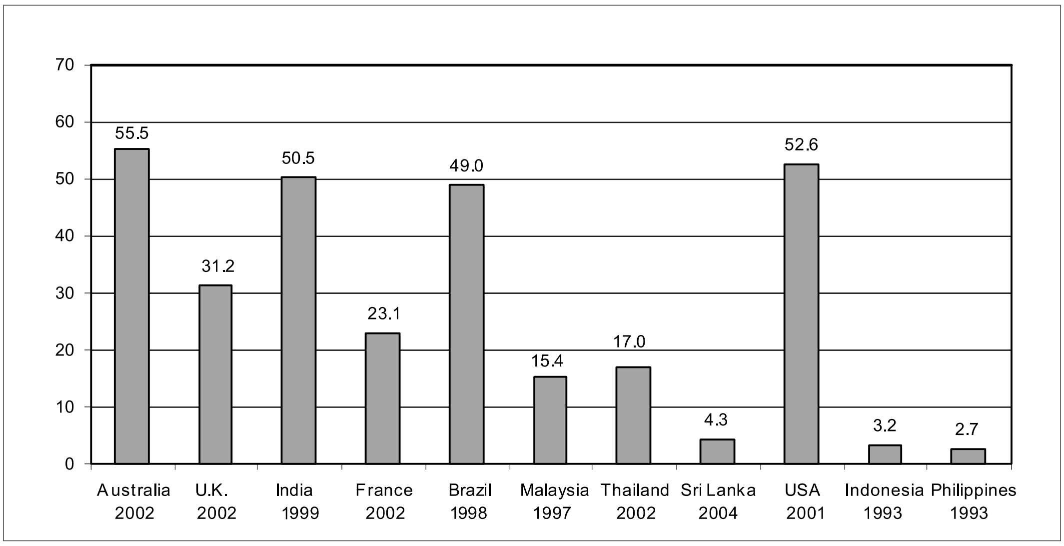
It will be seen that the sources devolved on the Provincial Councils account on an average for only 3.8 per cent of Central Government total revenue while provincial tax revenue averages about 3.7 per cent of Central Government tax revenue or 0.5 per cent of GDP. Thus, only a relatively insignificant proportion of the country's revenue has been devolved on the sub-national units.

This has led to a serious imbalance between provincial revenue collection in relation to provincial expenditure. Some vertical imbalance is unavoidable in any devolved revenue system but in Sri Lanka because of too little internal provincial revenue, the imbalance is severe.

2.3 Provincial Revenue in the International Context

Figure 2.1 illustrates Sri Lanka's provincial revenue in relation to Central Government total revenue in comparison with the sub-national revenue of certain selected countries, both developed and developing countries in Europe, Asia and Latin America. Developing countries with basically unitary characteristics show a relatively small percentage of devolved revenue as compared to the developed countries or large federated states where the proportion devolved is significant.

Figure 2.1
Sub- National Revenue as a Percentage of Central Government Total Revenue - Selected Countries



Note: Developed countries and large federated states as compared to developing countries which are basically unitary in status.

Source: Compiled from IMF Government Finance Statistics.

2.4 Revenue Source-wise

The revenue sources of Provincial Councils can be divided into three broad categories.

a) Taxes on Production and Expenditure;
b) Receipts from Property and Investment;
c) Sales and Charges.

a) Taxes on Production and Expenditure consist mainly of the turnover taxes on wholesale and retail sales, licence fees on liquor, betting taxes, taxes on lotteries and prize competitions, arrack and toddy tavern rents, stamp duties, motor vehicle licence fees and fines.

b) Receipts from Property and Investment consist largely of rents from land and buildings, interest and dividends.

c) Sales and Charges include profits from commercial activities, court fees and fines, fees under the Motor Traffic Act and the Omnibus Act and the Registrar of Companies. Such sales also consist of sales of capital goods.

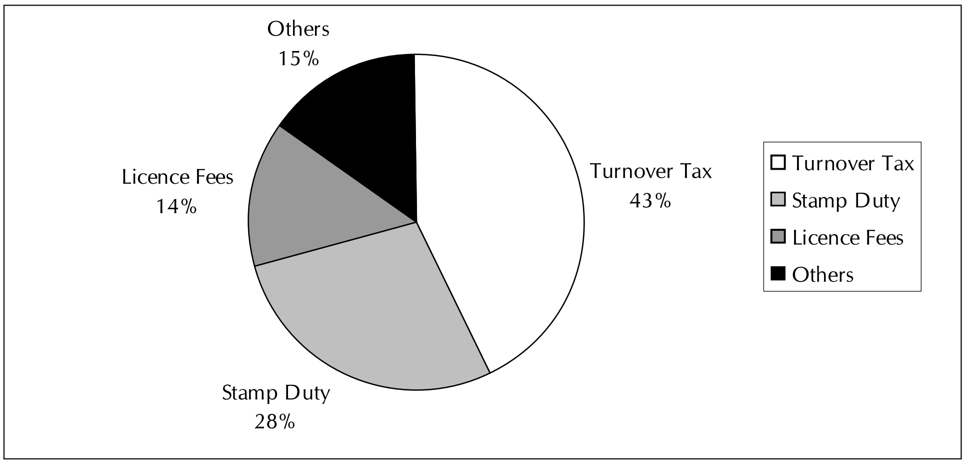
Provincial revenue could also be classified into two types:

i) those that are collected by the Provincial Council and credited to the Provincial Fund itself, and
ii) those that are collected by the Councils and not credited to the Fund but distributed to local bodies.

The majority of the sources consists of the former category while the latter category includes stamp duties on the transfer of immovable property and fines imposed and fees collected by courts.

Table 2.2 gives the details of the performance of the Provincial Councils source-wise for the year 2004. Figure 2.2 illustrates the composition of Provincial revenue for 2003.

Figure 2.2
Composition of Revenue 2003



Source: Compiled from Ministry of Provincial Councils data.

A number of salient features may be noted. The contribution of taxes on production and expenditure to total revenue of the Provincial Councils was about 60 per cent of their total receipts.

Turnover Tax

Of these the turnover tax was the most important bringing in about 43 per cent of total revenue, followed by stamp duty 28 per cent and motor licence fees 14 per cent. Turnover is defined as in the principal Turnover Tax Act No. 69 of 1981, as the total amount received or receivable from transactions entered into in respect of a business. Turnover does not include any amount received or receivable in respect of the sale of capital assets. In ascertaining the turnover of a business the bad debts incurred in a business are deducted. Unlike in the Turnover Tax levied by the Centre up to March 31, 1998 (when it was replaced by the GST on April 1, 1998 and subsequently by the VAT on August 1, 2002) and where an exemption limit of Rs 25,000/= a quarter prevailed, there is no statutory exemption limit for the levying of turnover tax under the provincial regulations. A branch of any business is also liable to pay the tax as a separate business.

The base of the tax is limited by three factors.

i) Exemption of certain commodities and items gazetted.

Table 2.2
Revenue Performance of Provincial Councils by Source 2004 (Prov.)(Rs. Million)

	Western	Central	Southern	North East	North Western	North Central	Uva	Sabara-gamuwa	Total
1. Turnover Tax	4,416 (0.4)	438 (0.2)	365 (0.2)	- -	283 (0.1)	132 (0.2)	130 (0.1)	182 (0.1)	5,946 (0.3)
2. Stamp Duty	2,733 (0.2)	259 (0.1)	277 (0.1)	-	322 (0.17)	13 (0.01)	34 (0.04)	118 (0.09)	3,756 (0.13)
3. Court Fines	229	29	83	-	92	53	30	59	575
4. Interest on Loans	364	46	23	39	25	20	13	-	530
5. Excise Duty & Licence Fees	112	59	21	-	18	12	11	16	249
6. Motor Traffic	1,043 (0.1)	114 (0.06)	160 (0.08)	-	200 (0.10)	73 (0.10)	45 (0.05)	110 (0.09)	1745 (0.10)
7. Others	182	128	99	102	37	53	54	138	793
Total	9079 (0.9)	1073 (0.6)	1028 (0.5)	141	977 (0.5)	356 (0.4)	317 (0.3)	623 (0.5)	13,594 (0.6)

Notes: Figures in parenthesis denote percentage of provincial GDP.

Source: Finance Commission data.

ii) It is limited to wholesale and retail sales and precludes other activities such as manufacturing and services. Hence the base is determined by the definition of "wholesale and retail sales" as well as of "manufacturing" and "services".

iii) It is subject to the limitations and exemptions prescribed by Parliament and legislated under the Provincial Councils' Turnover Tax (Limits and Exemptions) Act No. 25 of 1995.

Stamp Duty

Stamp duty is levied on instruments and documents relating to:

a) investments transferring immovable property situated in the province;

b) documents presented or filed in any proceedings in any court of law in the province;

c) transfer of motor vehicles effected in the province.

The transfer of immovable property and motor vehicles would include a sale, gift, inheritance or exchange but not a mortgage or lease. The stamp duty in respect of a mortgage or lease of immovable property by a person continued to be payable to the Stamp Duty Branch of the Inland Revenue Department in terms of the Stamp Duty Act No. 43 of 1982 till the latter Act was abolished on 30 April 2002. Certain instruments and documents are exempted from Stamp Duty including transfer of immovable property by the government or in favour of the government, documents relating to criminal proceedings and wills etc.

Stamp duties collected are transferred to the local authorities under the powers available to the local bodies like the Municipal Councils, Urban Councils and the Pradeshiya Sabhas under their respective Ordinances.

Licence Fees

Of the licence fees which account as the third highest revenue earner, the largest is from motor vehicles. The Provincial Councils act as licensing authorities of motor vehicles among the provinces and an equal licensing fee is levied throughout the provinces. However, the income received by the respective Councils depends on the number of registered motor vehicles in the province. For example, in 1998 the Western Provincial Council issued 479,172 licences as compared to 120,209 in the Southern Province, 124,526 in the North Western Province and 45,761 in the North Central Province (Provincial Council Data).

Another significant feature is that the majority of the sources listed in Section 36 of the Ninth Schedule yield little or no revenue. Some examples may be cited.

- Fees under the Medical Ordinance. These represent fees collected by the Medical Council for registration of medical practitioners, dentists, pharmacists and midwifes. Some Councils get no revenue from this source.
- Fees under the Fauna and Flora Protection Ordinance. These are fees charged for permits to enter the National Wildlife Parks and are enjoyed only by the Councils within whose boundaries such parks are located.

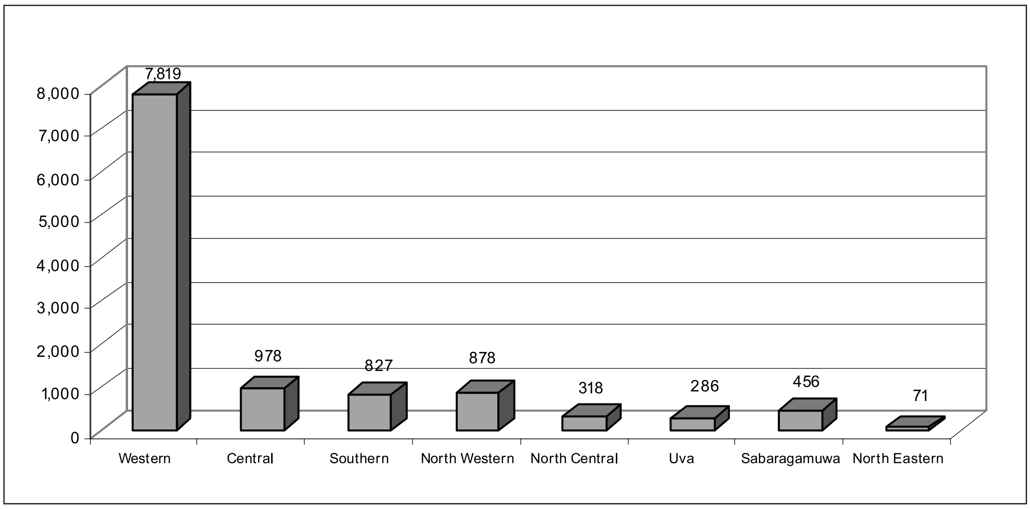
- Toll collections. These are generally on permits to operate ferries. Most provinces derive no revenue from this source.
- Tax on Prize Competitions and Lotteries. This excludes the National Lotteries and Lotteries organized by the Government or a Provincial Council. Such exclusion leaves only private lotteries and prize competitions organized and run by schools, welfare associations and sports clubs etc. liable to tax. The revenue from this source is relatively insignificant.
- Tax on mineral rights. This represents a charge for permits to mine, prospect for and remove any material from a land within the province. The base is limited by the definition of "mineral" in Section 70 of the Minerals and Mines Act No.33 of 1992 and the rate is limited to 0.5 per cent of the turnover under Section 67. No province other than Sabaragamuwa and Central derives revenue from this source.
- Fees on land alienation, land revenue, charges under the Weights and Measures Ordinance, licence fees on toddy, arrack rents and liquor licences. These fees are collected by the Divisional Secretariats. The total revenue is relatively insignificant.

2.5 Revenue Province-wise

Looking at the revenue performance province-wise, it is seen that the tax base varies considerably among the provinces. The most striking feature is the dominance of the Western Provincial Council in the collection of devolved revenue. Almost 70 per cent of the total devolved revenue is collected by the Western Provincial Council. Table 2.2 and Figure 2.3 below illustrate the revenue performance of the respective provinces for 2004 and 2003 respectively.

It will be seen that the Western Provincial Council has collected Rs.9,079 million or 67 per cent of the total revenue, the North Western Province Rs.977 million or 7 per cent, the Central Province Rs.1,073

Figure 2.3
Province-wise Revenue Collection 2003 (Rs. Million)



Source: Compiled from Finance Commission provisional data.

million or 8 per cent, and the Southern Province Rs.1,028 million or 7.5 per cent of total provincial revenue for 2004.

At the other end of the spectrum are the Sabaragamuwa Province with Rs.623 million or 4.5 per cent of total provincial revenue, Uva with Rs. 317 million or 2.3 per cent, and the North Central Province with Rs.356 million or 2.6 per cent of total provincial revenue.

A similar pattern is observed in the distribution of GDP on a provincial basis as shown in Table 2.3. The Western Province's share of GDP dominates at around 49 per cent of the total GDP, followed by the Central Province at 9 per cent, North Western Province 10 per cent and the Southern Province 9 per cent. The lowest shares are accounted for by the Sabaragamuwa Province at 6 per cent. North Eastern at around 7 per cent, North Central 4 per cent and Uva 4 per cent. Thus the nature of the fiscal imbalance in Sri Lanka has also a horizontal dimension.

The wide disparities in revenue collection of the different provincial units necessitates the recourse to equalization measures in the form of either inter provincial transfers or transfers from the Centre to the

Table 2.3
Provincial GDP 1999 to 2004 at Current Market Prices (Rs. Billion)

Province	1999	2000	2001	2002	2003	2004
Western	538.6 (48.7)	624.0 (49.6)	679.5 (48.3)	760.9 (48.1)	870.0 (49.4)	1002.3 (49.4)
Central	101.7 (9.2)	118.3 (9.4)	132.2 (9.4)	150.3 (9.5)	156.7 (8.9)	180.6 (8.9)
Southen	106.2 (9.6)	118.3 (9.4)	136.4 (9.7)	150.3 (9.5)	172.6 (9.8)	198.9 (9.8)
North Western	115.0 (10.4)	130.8 (10.4)	150.5 (10.7)	163.0 (10.3)	165.5 (9.4)	190.8 (9.4)
North Central	45.4 (4.1)	49.1 (3.9)	52.0 (3.7)	63.3 (4.0)	68.7 (3.9)	79.2 (3.9)
Eastern	55.3 (5.0)	56.6 (4.5)	69.2 (5.0)	77.5 (4.9)	96.8 (5.5)	111.5 (5.5)
Northern	27.7 (2.5)	27.5 (2.2)	32.5 (2.4)	42.7 (2.7)	47.5 (2.7)	54.7 (2.7)
Uva	45.3 (4.1)	49.1 (3.9)	64.7 (4.6)	66.4 (4.2)	77.5 (4.4)	89.3 (4.4)
Sabaragamuwa	70.8 (6.4)	84.3 (6.7)	90.0 (6.4)	107.6 (6.8)	105.6 (6.0)	121.7 (6.0)
Total	1106	1258	1407	1582	1761	2029

Notes: (I) Figures in parenthesis denote percentage share of each province.
(ii) National GDP at current market prices apportioned province-wise on ratios indicated in the Central Bank Annual Report 2004.
(iii) For 2004 same ratios taken as for 2003.

Source: Compiled from Central Bank of Sri Lanka Annual Report 2004.

provinces. These can take several forms such as grants, tax base sharing, revenue sharing etc. Tax base sharing would entail that the tax administration remain at the Centre but it would reduce its rates of tax thus creating tax room for the Provinces. The Provinces would levy these taxes at their own supplementary rates on the Central tax bases. The Centre would retain control in defining the tax bases but with consultation with the Provinces whenever changes are necessary.

Revenue sharing is based on the principle that the provinces have the right to a specified share of certain revenues raised by the Centre for their unconditional use. This is an effective means of affording provincial units access to more elastic revenue sources and thereby reduce their dependence on conditional transfers.

The Indian Constitution for instance, permits such revenue sharing between the Centre and the State governments, and the Finance Commission of that country is called upon to make recommendations regarding distribution of tax revenues taking that into account. In Sri Lanka such sharing of tax revenues would require an amendment to the Constitution.

Fiscal equalization grants entail the transfer of funds from the Centre or from other regions, based on a designed transfer program. Such transfers are based on varying criteria and standards adopted. They are presently used in the form of block grants, matching grants and criteria based grants, Provincial Specific Development Grants and other Special Grants for equalization purposes. This issue is dealt with in greater detail in Section 5 of the paper.

2.6 Revenue Buoyancy

The buoyancy of a revenue system reflects the total response of revenue to changes in national/provincial income or GDP including the effects of discretionary changes in revenue policies over time. Elasticity reflects only the built-in responsiveness of revenue to movements in national/provincial income or GDP. Table 2.4 shows the comparative growth of Provincial Revenue and Provincial GDP for the period 2000-2004.

As can be seen from the table, the nominal growth of provincial revenue has been generally lower than the growth of provincial GDP at market prices. The growth in revenue has been slow and uneven implying low buoyancy in the provincial revenue system. However, the period 2000-2004 shows an improvement as compared to the 1993 to 1998 period.

There is little evidence of any significant discretionary changes in the form of broadening the provincial revenue base or increases in provincial tax rates during this period. Hence the buoyancy coefficients would show little variation if any, from the elasticity estimates. The provincial revenue system therefore cannot be characterised as being sufficiently elastic or buoyant. In this the provincial revenue system reflects the traits of the national tax system which itself is featured by insufficient elasticity and buoyancy (GOSL,Taxation Commission Report 1990).

Table 2.4
Comparative Growth of Provincial Revenue and Provincial GDP 2000-2004

Year	Western Province		Central Province		Southern Province		North Western Province		North Central Province		Uva Province		Sabaragamuwa Province	
	Revenue Growth %	GDP Growth %	Revenue Growth %	GDP Growth %	Revenue Growth %	GDP Growth %	Revenue Growth %	GDP Growth %	Revenue Growth %	GDP Growth %	Revenue Growth %	GDP Growth %	Revenue Growth %	GDP Growth %
2000	10.3	15.8	4.9	16.3	18.8	11.4	6.6	13.7	14.7	8.1	-0.5	8.3	7.0	19.0
2001	11.7	8.8	11.7	11.7	14.3	15.3	8.3	15.0	8.4	5.9	10.8	31.7	12.1	6.7
2002	14.5	11.4	8.4	13.7	12.0	10.2	8.1	8.3	4.9	21.7	9.4	2.6	12.7	19.5
2003	31.3	14.3	56.5	4.2	32.1	14.7	39.4	1.5	30.3	8.5	34.2	16.7	32.5	-1.9
2004	16.1	15.0	9.7	15.2	24.3	15.2	12.4	15.2	11.9	15.2	10.8	15.2	36.6	15.2
Overall Average	16.7	13.1	18.2	12.2	20.3	13.3	14.9	10.7	14.0	11.8	12.4	14.9	20.1	11.7
Overall Elasticity	1.2		1.4		1.5		1.3		1.1		0.8		1.7	

Notes: (I) GDP growth compiled from data indicated in Central Bank Annual Report 2004 (Table 2.3);
(ii) Revenue growth based on provincial revenue figures.

Source: (I) Compiled from Central Bank of Sri Lanka Annual Report 2004;
(ii) Finance Commission plus Provincial Council data.

3. Revenue Capacity and Fiscal Potential

The main fiscal weakness in the provincial council system is the paucity of revenue in relation to its expenditure, both in terms of volume and diversity. The tax base transfer has been minuscule compared to expenditure responsibilities. And even these revenue sources have not been utilized adequately or in many instance not utilized at all. The reasons for this under - utilization include:

1. The lack of statutory legislation or necessary gazetted regulations for some items.
2. The lack of effective administrative measures and procedures.
3. The lack of motivation to introduce imaginative or innovative revenue enhancing measures or schemes within the province.
4. The lack of adequate technical knowledge and training of personnel.

Hence their functioning indeed their very existence, is dependent largely on the grants from the Centre. Thus the search for adequate revenue and for new sources of revenue has assumed urgency and importance if the devolved system is to survive as a viable alternative to a centralized system of government.

The scope for additional revenue can be viewed from two angles - short-term measures to bolster existing revenues and medium and long term schemes to develop additional sources of finance.

Short term measures to secure additional revenue comprise two categories. Firstly, finding new sources of revenue within the existing framework of the Thirteenth Amendment; and secondly, improving the efficiency and effectiveness of the administrative mechanism involved in securing this revenue.

3.1 Improving the Administrative Mechanism

Improvements to the functioning of the administrative apparatus is an exercise by itself and has been the subject of a Study[1] to examine ways and means of strengthening the assessment and collection machinery of the provincial councils. Its areas include, (i) the methods of assessment, (ii) the procedures used for collection and enforcement, (iii) compliance ratios both in filing and payment, (iv) securing of information and economic intelligence, (v) exchange of information and coordination between provinces and between provinces and the revenue departments and agencies at the Centre, (vi) extent of tax delinquency and means of reducing it, (vii) staff and training.

3.2 Legal Constraints

In terms of the potential for additional revenue within the Thirteenth Amendment there appear to be two constraints in the existing legislation. One is that under item 36.20 of List 1 of the Ninth Schedule any additional taxation within the Province in order to raise revenue for provincial purposes should be "to the extent permitted by or under any law made by Parliament." The other is that in the Reserved List relating to national revenue, monetary policy, external resources and customs, "any other tax or fee not specified in List 1" (i.e. the provincial list) is the preserve of the Central Government. The second legal constraint does

[1] Provincial Revenue Performance Improvement Programme Report UNDP - Finance Commission 2002.

not appear to be a major problem as the Attorney-General has ruled that in terms of item 36.20 in List 1, Parliament could by enacting legislation with a simple majority, confer a Provincial Council the right to levy additional taxation, provided that such revenue sources do not conflict with those included in the Reserved List (Salgado, 1989).

3.3 Potential Revenue Sources

According to some studies, it is estimated that around half of the actual realizable revenue potential at Provincial or regional level may still be untapped (Wijesinghe, 1996).[2]

To realize at least a part of such potential within the constraints of the 13th Amendment, the most promising sources for additional revenue that may be considered appear to be the following:

1) Taxes on land and buildings including the property of the state to the extent permitted by Parliament. Presently, rates on immovable property and acreage taxes on land are being levied by local government authorities like the Municipal Councils, Urban Councils and the Pradeshiya Sabhas. Rates on land and buildings are calculated at a percentage of an Annual Value. These properties are expected to be revalued by the Government Valuer every five years but it is generally not done. Most local authorities impose rates at a percentage of the annual value as low as 3 per cent. Although this tax is included in the Provincial Councils Draft Supplementary Statute, it may be more effective if a separate statute with comprehensive provisions be adopted by the Provincial Councils since it would be a major source of income.

   A provincial tax on land is sometimes argued to be a feasible proposition. In fact a Land Tax was levied in Sri Lanka from 1959/60 to 1962/63 as part of the Kaldor scheme in order to induce land owners to cultivate bare and neglected land and thus develop the agricultural sector.

   Nevertheless, taxation of agricultural land has many problems as it is politically a sensitive issue, the rural vote base being an important element in the political structure. In India land revenue was an important source of revenue till 1964/65 but has ceased to be so since. In Sri Lanka the Land Tax was abandoned in 1963. There are also difficulties in taxing the farm sector. First, collection costs of land dues are high where the householders are dispersed and record keeping standards are low. Second, higher taxation could result in greater self-consumption by producers and reduce the marketable surplus. Third, there are valuation problems in taxing agricultural produce and assets.

   Fourth, agricultural incomes are often erratic and fluctuate from season to season thus not assuring a stable yield. Fifth, even if the tax is limited to the rich farmers, the ultimate incidence may be shifted downwards to the subsistence farmer and the landless rural peasantry.

[2] In the absence of reliable and accurate data as to provincial/regional resoruces or GDP, this is probably a speculative estimate. Province-wise GDP has been computed on a broad sector-wise basis by the Central Bank of Sri Lanka since 1999 (see Central Bank of Sri Lanka, Annual Report, 2004).

Despite these difficulties, theoretically there appears to be some rationale for taxing at least some part of the non-plantation agricultural sector at provincial level. The base of such a tax however, may, in the long run have to be shifted from land area to the value of produce though this may initially evoke considerable opposition.

2) Taxes on Mineral Rights. The provincial areas of Sri Lanka are rich in mineral deposits consisting of graphite or plumbago in the Southern and North Western Provinces, gems and precious stones in the Sabaragamuwa Province and at places like Elahara, Naula and Okkampitiya in the Uva and Central Provinces, ilmenite and monazite in the North East coast and the newly discovered phosphate deposits at Eppawela. This is a potential lucrative revenue source for the Provincial Councils but at present seems to be largely untapped. A sector-wise analysis of Provincial Council revenue does not indicate any significant revenue declared from this source. The levying of taxes on mineral nights is also dependent on the provisions of the Mineral and Mines Act No.33 of 1992.

3) Stamp Duty is collected purely on the basis of the valuation declared on the deeds relating to the transfer of immovable property in the respective provinces. Re- examination of the values declared in the deeds is not done except in a very few selected cases. The market value of immovable property is generally appreciating, but the market value declared is far below the existing market value. An acceptable method of regular and expeditious re-examination of deeds could result in considerable revenue improvement.

4) Other levies. There are other taxes among the listed provincial sources which still apparently seem to be collected by the Divisional Secretariats rather than by the duly authorized Provincial Councils. Little or no revenue is indicated as being collected as fees under the Medical Ordinance, Fauna and Flora Protection Act, Weights and Measures Ordinance (replaced by the Measurement Units, Standards and Services Act No.35 of 1995), licence fees on drugs and chemicals and betting which is common in provincial areas. It is understood that some of these items are still being levied by the Divisional Secretariats. No statutes have been passed by any of the Provincial Councils for collection of the specified Departmental Fees and collection of Tolls. Only one Provincial Council has adopted a statute to impose licensing fees on the possession, transport, purchase and sale of intoxicating liquors, but that too is not in operation.

Further, no Provincial Council has made use of the provisions of item 36.20 of the Ninth Schedule i.e. any other taxation within the province in order to raise revenue for provincial purposes to the extent permitted by or under any law made by Parliament.

5) Item 26 of the Concurrent List includes a revenue source entitled "Fees in respect of any of the matters in this List, excluding fees taken in any Court." Subject to the Government decisions as to "national policy" and any laws enacted by Parliament, the Provincial Councils may find it possible to levy fees under this item in such areas as tourism, trade and commerce that could, in time, develop a significant income yield. This is however a long term objective.

Apart from the above sources for additional revenue, there are two other sources which may be taken into consideration and which may be commented on.

One is the borrowing power available to Provincial Councils in terms of Item 35 in List I of the Ninth Schedule and further elaborated by Section 21 of the Provincial Councils Act No.42 of 1987 which empowers the Minister of Finance to guarantee loans raised by Provincial Councils.

This borrowing ability however, has its limitations both legal and commercial. The legal limitation is partly inherent in item 35 itself where the borrowing power is available only to the extent permitted by or under any law made by Parliament. Further, foreign borrowing is specifically precluded under List II and foreign aid through loans under Section 22 of the Provincial Councils Act No. 42 of 1987 have to be channelled through the Central Government and would be project oriented. The commercial and practical considerations would be the performance and credit-worthiness of the Provincial Council, as well as the viability of the projects concerned both for government guarantees and/or acceptance of collateral by banks. Up to now there is no evidence that Provincial Councils have made any significant use of these powers.

The other is the possible availability of surpluses generated by enterprises under the control of Provincial Councils though surpluses from commercially viable projects may not, in the short term, be a major source, particularly in view of the privatization and private sector oriented policies of the Government. There may however be enterprises that are, or may come within the control of Provincial Councils where user charges could be levied and could be promising sources if operated efficiently and on commercial lines. The expansion and development of such enterprises would come within the ambit of provincial economic plans in the Devolved List, the Concurrent List or a spin-off from the National Plan in the Reserved List.

3.4 Tax Rates

Harmonization in the application of rates is necessary to avoid disruptions in the market. Harmonization is also essential to prevent provinces from competing with each other by lowering taxes and increasing subsidies to attract investors. However, it may also be argued that a certain amount of healthy competition among provinces may be beneficial. The whole purpose of revenue devolution will be lost if all provinces are compelled to adopt the same tax rate determined by the Central Government. The Thirteenth Amendment has taken this into account by including the phrase "within such limits" which enables the Central government to determine the maximum rates. A partial harmonization has therefore been achieved by the Central Government fixing the maximum rate at 5 per cent in respect of turnover taxes (which is the major source of revenue) under the Provincial Councils Turnover Taxes (Limits and Exemptions) Act No. 25 of 1995.

The rates presently levied by Provincial Councils are:

i) 1 per cent on wholesale and retail sales

ii) 5 per cent on
- sale of furniture
- sale of timber and logs
- sale of gems, jewellery, precious and semi precious stones and ornamental jewellery.

Exemptions

The following are exempt:

- Wholesale and retail sales of a manufacturer, of any articles manufactured by him.
- Wholesale and retail sales of any articles to buyers outside Sri Lanka.
- Wholesale and retail sales by a Co-operative Society registered under the Co-operative Societies Law No. 5 of 1972.
- Exempted articles gazetted by Order of the different Provincial Councils. These include books, bread, green leaf, cardamoms, cinnamon, cloves, nutmeg, betel, rubber and gold among others.

With the existing revenue flow inadequate, increasing levels of expenditure, and the amount of matching grants depending on the increase in revenue collection, the Provincial Councils will in time be compelled to increase rates. With the high threshold of the VAT (Rs.500,000 per quarter or Rs.1.8 million per annum as compared to the turnover tax threshold previously of Rs.25,000 per quarter) leaving a large segment outside the indirect tax net, a modest increase in turnover tax rates may in course of time come into being.

Fiscal policy is moving in the directionof a multiple rate structure particularly in consumption taxes on order to avoid or minimize the regressive nature and effects of such taxes. The current VAT for instance has apart from the zero rate, 3 rates -- a Basic rate of 5 per cent, a Standard rate of 15 per cent and a Luxury rate of 18 per cent.[3] It has been recommended that the provincial turnover tax be modified to a multiple rate system subject to the provisions of the Turnover Taxes (Limits and Exemptions) Act No.25 of 1995.

It would also be pertinent to examine the validity of the existing exemptions and make modifications where necessary.

3.5 Medium and Long Term Potential

The financial viability of provincial administration in the medium and long term however rests on the sustainable economic development of the region as a whole. This relates on the one hand, to the development of the national economy with its trickle down effects to provincial and local levels and on the other, to the development of various regions relative to their specific resources and potential. To this end the Provincial Council List includes as its preserve the implementation of provincial economic plans. However, in order that such planning and implementation dovetails into the national planning strategies and secure assistance therefrom, plan formulation, progress control, monitoring, manpower planning and

[3] The single rate of 12.5 per cent under the GST was replaced under the VAT Act No. 14 of 2002 by two rates of 10 and 20 per cent. This was changed again to a single 15 per cent rate from January 1, 2004 to be replaced from January 1, 2005 by a multi-rate system under the VAT (Amendment) Act No. 6 of 2005.

evaluation etc. are included in the Concurrent List. The inclusion of these provisions aims at preventing the fragmentation and dilution of policy making or increasing the number of decision makers and points of decision making.

Regional economic development however assumes the existence of an effective planning and monitoring mechanism in the provincial administration. It also assumes that the Provincial administrations have comprehensive and updated data bases and regular flow of information to the Centre. Both these seem to be lacking in the provincial administrations and a lack of information flow from the Provincial Councils has led to various problems such as deficiencies in budget estimation, computing of the regional GDP for each Province, estimation of provincial development potential and effective regional planning and implementation.[4]

That there are sufficient untapped material resources as well as human resources at provincial level is well known. Each province or region has also its own specific resources which need harnessing and development. For example, the gem and lapidary industry in Sabaragamuwa, tourism in the Southern and Central Provinces and once hostilities are over, vast development potential in the North and East.

3.6 Other Factors

Apart from the weaknesses in the administrative mechanism and the legal and constitutional constraints affecting enhanced revenue as indicated in Sections 3.1 and 3.2, there also appears to be a lack of sufficient motivation for putting greater effort at enhancing revenue capacity. The Provinces have continued to be minor players in the overall fiscal arena. There has been a singular lack of enthusiasm on the part of the Provinces to exploit their potential granted by the Constitution. This lack of enthusiasm reflects the inadequate incentive built in the design of devolution as well as its operations.
Thus almost the entirety of the recurrent expenditure including administrative expenses and personal emoluments are met by the Block Grants given by the Central Government. Sections 4 and 5 of the paper deal with these aspects in greater detail. Once these grants are secured the provincial administrations appear to be satisfied and seem to have little motivation to exert any extra effort at revenue enhancement.

While the inverse relationship between revenue collection and quantum of the block grants dampens any incentive to increase revenue performance, another reason is that certain items allocated are purely for the purpose of transfer to local authorities. Item No. 4.3 of List I of the Thirteenth Amendment states "It will be open to a Provincial Council to confer additional powers on local authorities but not to take away their powers." Under the provisions of

- Section 185(2)(c) of the Municipals Ordinance No. 29 of 1947;
- Section 158(2)(6) of the Urban Councils Ordinance No. 61 of 1939; and
- Section 129(2) of the Pradeshiya Sabha Act No. 15 of 1987;

[4] It is understood that an officer from the National Planning Department has been now posted to each Provincial Council to work with the provincial administration and co-ordinate planning efforts.

Stamp duties collected have to be credited to the Funds of the respective local authorities. Hence all collections by the provincial administration of stamp duty is well as court fees and fines are transferred to these Funds.

There is also in place an incentive scheme aimed at motivating provincial revenue officials to enhance revenue collection. This scheme however appears to need revamping with better targeting and monitoring of performance as in practice it has turned into an automatic and very liberal salary increase rather than a well targeted and performance monitored scheme.

4. Provincial Expenditure

4.1 Provincial Expenditure in Relation to Total Expenditure

While the Provincial revenue in relation to Central Government revenue is only around 4 per cent or 0.6 per cent ofGDP, in contrast Provincial expenditure is around 11 per cent of total Central Government expenditure or 2.8 per cent ofGDP. Table 4.1 gives the percentage of Provincial expenditure to Central Government expenditure.

Table 4.1
Provincial and Central Government Expenditure 1999 to 2004 (Rs. Million)

	1999	2000	2001	2002	2003 (Prov.)	2004
Central Government Expenditure (Current + Capital + Net Lending)	279,159 (25.2)	335,823 (26.7)	386,518 (27.4)	402,989 (25.4)	417,671 (23.7)	476,905 (23.5)
Provincial Expenditure (Current + Capital)	28,717 (2.6)	37,328 (2.9)	40,094 (2.8)	44,314 (2.8)	49,224 (2.8)	56,964 (2.8)
% of Provincial to Central Government Expenditure	10.2	11.1	10.3	11.0	11.7	11.4

Note: Figures in parenthesis denote percentage/GDP.
Source: Compiled from Central Bank of Sri Lanka Annual Reports, various years.

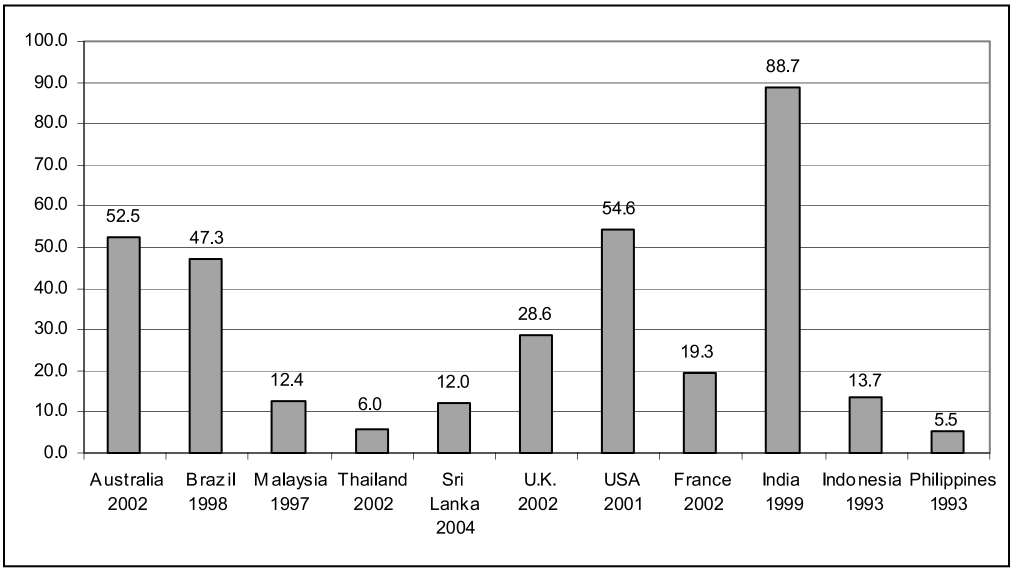
4.2 Provincial Expenditure in the International Context

The dominance of the Central Government in total expenditure is a common feature in most developing countries. Generally the share of sub-national expenditure to central government expenditure in developing countries is also on the average around 10 per cent except in the large federated states like India. This is in contrast to the developed countries where the share of sub-national expenditure ranges from about 20 per cent in France, 29 per cent in U.K., 54 per cent in U.S.A. and 52 per cent in Australia. Figure 4.1 illustrates the comparative position in selected countries.

4.3 Breakdown of Expenditure

The Expenditure of Provincial Councils are divided into two main categories - recurrent expenditure and capital expenditure. It is observed that of the total expenditure, on the average about 84 per cent is on

Figure 4.1
Sub-National Expenditure as Percentage of Central Government Expenditure - Selected Countries



Note: Developed countries and large federated states compared to developing countries basically unitary in status.

Source: Compiled from IMF Government Finance Statistics.

recurrent items leaving only about 16 per cent for capital development, expansion of services and facilities etc. Table 4.2 indicates the proportions of recurrent and capital expenditure of Provincial Councils for the years 1999 - 2004.

In terms of provincial GDP of an average expenditure of around 3 per cent, only around 0.2 per cent is utilized for capital expenditure (Vide Table 4.4).

There are however some funds spent by the Provincial Councils on behalf of the line Ministries under the Medium Term Investment Programme (MTIP) and also projects under the Integrated Rural Development Programme (IRDP). These have now been incorporated under the Provincial Specific Development Grant

Table 4.2
Provincial Council Expenditure 1999 to 2004 (Rs. Million)

	1999	2000	2001	2002	2003	2004 (Prov.)
Total Expenditure	28,717	37,328	40,094	44,314	49,224	56,964
Recurrent Expenditure	26,284	28,856	33,425	38,268	39,800	46,308
% of total expenditure	91.5%	77.30%	83.40%	86.40%	80.80%	81.30%
Capital Expenditure	2,433	8,472	6,669	6,046	9,423	10,656
% of total expenditure	8.50%	22.70%	16.60%	13.60%	19.20%	18.70%

Source: Compiled from Central Bank of Sri Lanka Annual Report 2004.

(PSDG) as well as Special Grants for projects. In 2004 the total expenditure under these grants amounted to Rs.8,842 million 80 per cent of which was utilized for education, health and highways.

Of the total recurrent expenditure the major portion on an economic basis, goes for personal emoluments and administration averaging between 70 - 80 per cent of such expenditure. On a functional basis, Provincial Council expenditure also shows a bias towards social infrastructure and social services. Only about 4 per cent of recurrent expenditure is utilized for economic services including economic infrastructure, agriculture and industries. Capital expenditure through funds made available by the line Ministries are also mainly used for the social sector such as education and health.

Table 4.3 gives as an illustration the Summary of Expenditure by Object Codes of the Western Provincial Council for 2002 and 2003.

Table 4.3
Summary of Expenditure by Object Codes 2002 and 2003
Western Provincial Council (Rs.'000)

	2002		2003	
	Amount	% of Total	Amount	% of Total
Personal Emoluments	5,837,369	62.3	5,959,771	57.8
Travelling Expenses	66,964	0.7	59,618	0.6
Supplies	226,949	2.4	215,218	2.0
Maintenance Expenditure	100,587	1.0	101,178	1.0
Contractual Services	191,577	2.0	205,204	2.0
Transfers	977,652	10.4	1,372,223	13.3
Grants	1,147,029	12.2	1,000,057	9.7
Subsidies	479	0.0	52	0.0
Interest Payment	1	0.0	-	-
Other Recurrent Expenses	93,110	0.9	89,330	0.9
Rehabilitation & Improvement of Capital Assets	112,731	1.2	25,747	0.3
Acquisition of Fixed Assets	582,367	6.2	1,158,760	11.2
Capital Transfers	-	-	126,242	1.2
Capital Grants	24,373	0.2	-	-
Total	9,361,188		10,313,400	

Source: Finance Commission data.

4.4 Expenditure Province-wise

Tables 4.4 and 4.5 indicate expenditure on a province-wise basis. The largest share of total expenditure by far is incurred by the Western Provincial Council followed by the Central and Southern Provinces while the lowest shares are indicated in the Uva, North Central and Sabaragamuwa Provinces. The same trend is observed in relation to capital expenditure.

Considering the size and density of the population in the relevant provinces and consequently the extent and scope of the services required, this may seem justifiable. Nevertheless the paucity of capital expenditure incurred in the Provinces where such expenditure on infrastructure is most required compromises the declared objective of balanced regional development.

Table 4.4
Expenditure Province-wise 1999-2002 (Rs. Million)

Provincial Council	1999 Recur-rent	% Prov. GDP	Capital	% Prov. GDP	Total	% Prov. GDP	2000 Recur-rent	% Prov. GDP	Capital	% Prov. GDP	Total	% Prov. GDP	2001 Recur-rent	% Prov. GDP	Capital	% Prov. GDP	Total	% Prov. GDP
Western	5870	1.1	737	0.1	6607	1.2	6543	1.0	483	0.1	7026	1.1	7923	1.2	392	0.05	8315	1.2
Central	1876	1.8	113	0.1	1989	1.9	4020	3.4	346	0.3	4366	3.7	4652	3.5	198	0.1	4850	3.6
Southern	3396	3.2	247	0.2	3643	3.4	3783	3.2	364	0.3	4147	3.5	4333	3.2	309	0.2	4642	3.4
North East	1982	2.4	509	0.6	2491	3.0	3882	4.6	157	0.2	4039	4.8	4259	4.2	83	0.1	4342	4.3
North West	3710	3.2	254	0.2	3964	3.4	3704	2.8	287	0.2	3991	3.0	4344	2.8	248	0.2	4592	3.0
North Central	3416	7.5	231	0.5	3647	8.0	2233	4.5	135	0.3	2368	4.8	2563	4.9	107	0.2	2670	5.1
Uva	3624	8.0	231	0.5	3855	8.5	2011	4.1	156	0.3	2167	4.4	2359	3.6	99	0.1	2458	3.7
Sabaraga-muwa	2400	3.4	160	0.2	2560	3.6	2680	3.2	211	0.2	2891	3.4	3048	3.4	105	0.1	3153	3.5
Total	26274	2.4	2482	0.2	28,756	2.6	28856	2.3	2139	0.2	30,995	2.5	33,481	2.4	1541	0.1	35022	2.5

Provincial Council	2002 Recur-rent	% Prov. GDP	Capital	% Prov. GDP	Total	% Prov. GDP
Western	8837	1.2	488	0.06	9325	1.2
Central	5127	3.4	161	0.1	5288	3.5
Southern	4848	3.2	209	0.1	5,057	3.3
North East	5318	4.4	146	0.1	5464	4.5
North West	5001	3.0	149	0.1	5150	3.1
North Central	2953	4.6	77	0.1	3030	4.7
Uva	2789	4.2	88	0.1	2877	4.3
Sabaraga-muwa	3395	3.1	110	1.0	3505	3.2
Total	38268	2.4	1428	0.1	39696	2.5

Note:
(I) Figures in parenthesis denote percentage share of expenditure;
(ii) Capital expenditure excludes amounts incurred by line Ministries;
(iii) Prov. GDP denotes GDP at current prices of each Province for the relevant year as per Table 2.3;

Source: Ministry of Provincil Councils.

Table 4.5
Province-wise Expenditure 2003 (Rs. Million)

Province	Recurrent	% of Prov. GDP	Capital	% of Prov. GDP	Total	% of Prov. GDP	Expenditure per head/ Population Rs.'000
Western	9,001	1.0	1021	0.1	10,022	1.1	1.85
Central	5,433	3.4	141	0.1	5,574	3.5	2.32
Southern	5,129	3.0	483	0.2	5,612	3.2	2.44
North-East	5,545	3.8	163	0.1	5,708	3.9	2.19
North Western	5,232	3.1	159	0.1	5,391	3.2	2.45
North Central	2,990	4.3	105	0.1	3,095	4.4	2.81
Uva	2,897	3.7	67	0.1	2,964	3.8	2.47
Sabaragamuwa	3,574	3.4	129	0.1	3,703	3.5	2.05
Total	39,801	2.3	2,268	0.1	42,069	2.4	2.2

Notes: (I) Figures in parenthesis indicate percentage share of expenditure.
(ii) Capital expenditure excludes amounts incurred by line Ministries.
(iii) Per Capita figures based on provincial population for 2003 as per Central Bank Economic & Social Statistics of Sri Lanka 2004.
(iv) Prov. GDP denotes GDP at current prices of each province as per Table 2.3.

Source: (I) Ministry of Provincial Councils.
(ii) Central Bank of Sri Lanka, Economic & Social Statistics 2004.

The position however appears to be more realistic when looked at on a population basis (Table 4.5). The highest per capita expenditure is incurred in the less developed provinces like Uva, North Central Province and North Western Province while the highly developed provinces like the Western, Central and Southern Provinces show a lower expenditure per head.

4.5 Monitoring of Expenditure

The Provincial Budgets are historically determined and are allocated by the relevant sector in the Central Government while the Provincial Councils have discretion in the usage of allocations. The Constitution allows the Provincial Councils that autonomy, hence there cannot be a mandatory request to disclose their expenditure. The Ministry of Finance and Planning and the Ministry of Provincial Councils and Local Government evidently do not have legislative authority to request periodic data of actual expenditure from Provincial Councils. Only the Finance Commission may request such data and the Finance Commission has up to now focussed its attention mainly on the grant of provincial allocations rather than on supervision or monitoring of expenditure.

Not only does this lead to wastage and corruption but to compromise of the objectives of the different grants and the funds provided under various programmes not being used for their proper allocated purpose. For example, it is speculated that funds under the MTIP which are exclusively meant for capital development have sometimes been used for recurrent expenditure apparently including items under personal emoluments.

The main conclusion that can be arrived at by an analysis of Provincial expenditure is that in Sri Lanka the sub-national units are almost entirely engaged in maintaining the existing services and paying for the personnel and administration engaged in the subject areas assigned to them. Any development work in these same subject areas is the responsibility of the Central Government. Thus the whole realm of regional development balanced or otherwise, appears to be out of their reach (Wijesinghe, 1996).

5. Revenue Transfers

5.1 Provincial Budget Deficits

Provinces are not equally developed in terms of infrastructure, resources and economic opportunities and they cannot therefore hope to overcome inter-regional disparities by their own efforts and resources. It is said that regions are born with budget deficits and left to themselves, the disparities will widen. This is a typical under-development phenomenon.

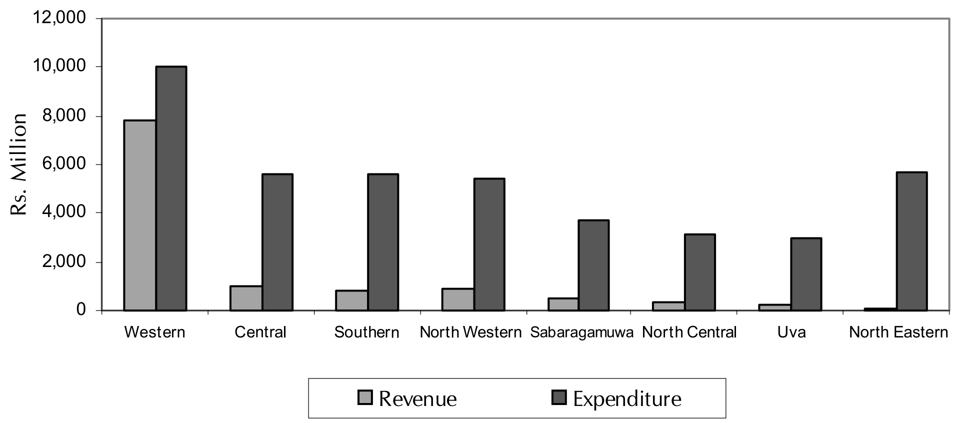
Table 5.1 shows the Budget out-turn of Provincial Councils from 1999 to 2004. Figure 5.1 illustrates the Budget Deficits of the respective Provincial Councils for 2003 indicating the gap between expenditure and own revenue.

Table 5.1
Budget Outturn of Provincial Councils 1999 to 2004 (Rs. Million)

	1999	2000	2001	2002	2003	2004 (Prov.)
Total Revenue	6,993	7,534	8,674	9,366	11,625	13,522
Total Expenditure	28,717	37,328	40,094	44,314	49,224	56,964
Deficit	21,724	29,794	31,420	34,948	37,599	43,442

Source: Compiled from Central Bank of Sri Lanka Annual Reports, various years.

Figure 5.1
Budget Deficits of Provincial Councils 2003



Source: Compiled from data in Figure 2.3 and Table 4.5.

5.2 Need for Fiscal Transfers

Even in countries where fiscal federalism is the norm, there is still the need for the Central Government to supplement the revenues of sub-national units. For example, fiscal transfers from Central government revenue to state or regional level in USA is about 15 per cent, Canada 17 per cent, Australia 27 per cent and India 39 per cent. (Vide Figure 5.2 below). This results from the fact that

i) in many instances. Central governments retain the major tax bases, leaving insufficient fiscal resources to the sub-national or provincial units to cover their local expenditure needs;

ii) there is need to ensure that regions maintain a minimum level of public utilities and services and regions without sufficient resources to reach this minimum level have to be subsidized;

iii) there is the need to offset the regional inequality exerted by the spill-over effects;

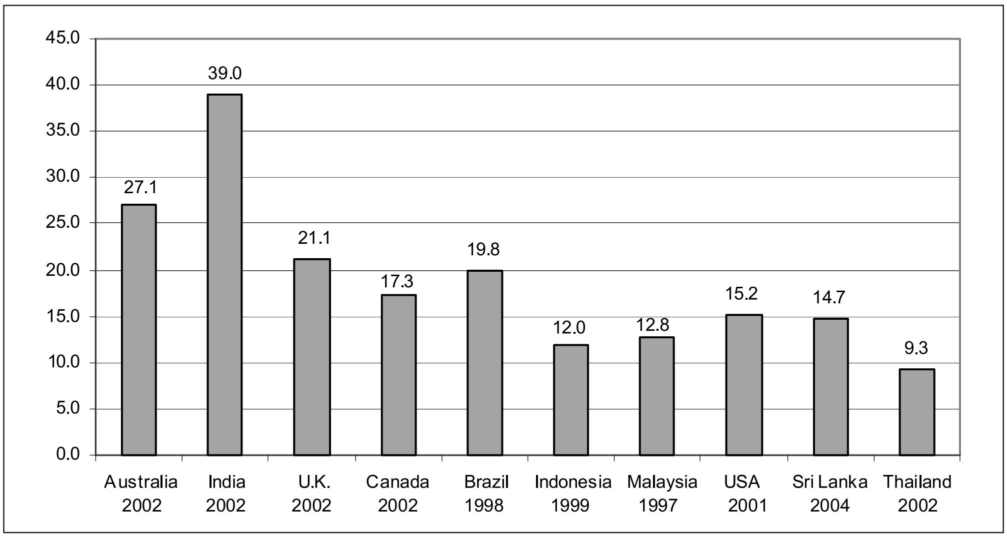
Given the prevailing structures of fiscal decentralization, fiscal transfers are therefore required to correct the inherent vertical and horizontal imbalances prevalent in decentralized regions.

In Sri Lanka with limited assigned revenues and no sharing of Central revenues with the Provinces, the vertical fiscal imbalances have been addressed solely by a system of inter governmental grants.

5.3 Fiscal Transfers in the International Context

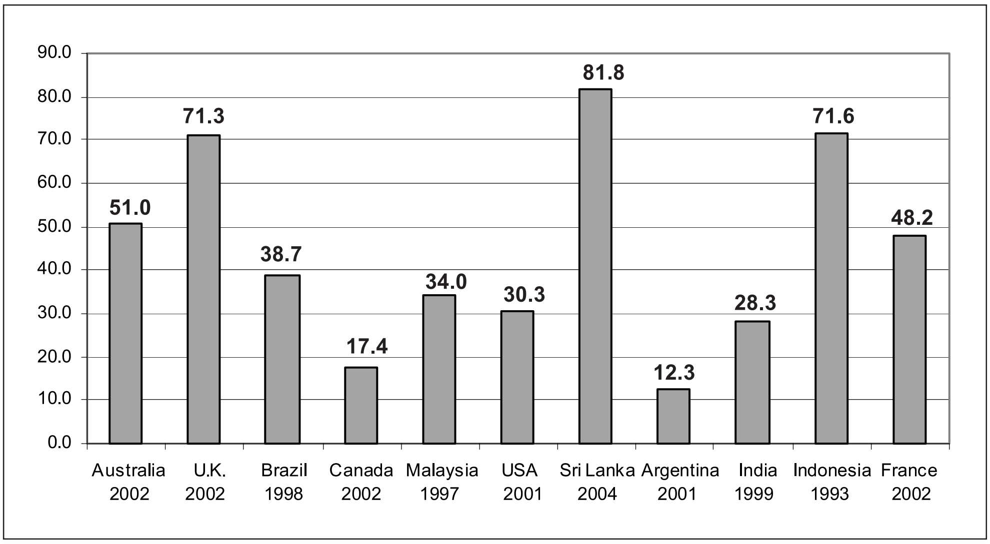
In developed countries though grants prevail, the grant element of the total sub-national expenditure is relatively not very large. In the USA it is around 30 per cent and Canada 17 per cent. In developing countries in contrast, a high percentage of such expenditure at the provincial level is financed by equalization measures from the Centre. For example, in Indonesia and The Philippines over 70 per cent of provincial level expenditure is financed by general purpose or specific purpose grants.

Figure 5.2
Fiscal Grants / Transfers to Sub-National Units as Percentage of Central Government Revenue - Selected Countries



Source: Compiled from IMF Government Finance Statistics.

Figure 5.3
Grants as Percentage of Sub-National Expenditure - Selected Countries



Source: Compiled from IMF Government Finance Statistics.

Table 5.2
Grants and Total Expenditure 1999-2004 (Rs. Mllion)

	1999	2000	2001	2002	2003	2004 (Prov.)
Total Provincial Expenditure	28,717	37,328	40,094	44,314	49,224	56,964
	(2.60)	(2.70)	(2.80)	(2.80)	(2.80)	(2.80)
Grants:						
Block Grants	21,122	23,220	24,699	30,574	30,462	35,892
	(1.90)	(1.80)	(1.70)	(1.90)	(1.70)	(1.70)
Criteria Based Grants	1,236	1,323	596	1,000	607	803
	(0.1)	(0.1)	(0.04)	(0.06)	(0.03)	(0.03)
Matching Grants	429	665	282	307	246	311
	(0.03)	(0.05)	(0.02)	0.02)	(0.01)	(0.01)
Provincial Specific						
Development Grant (PSDG)	-	5,523	4,208	3,405	3,332	3,854
		(0.4)	(0.3)	(0.2)	(0.2)	(0.2)
Other Special Grants	-	812	1,163	1,213	3,184	4,988
		(0.06)	(0.06)	(0.08)	(0.18)	(0.20)
Total Grants	22,787	31,543	30,948	36,499	37,831	45,848
	(2.0)	(2.5)	(2.2)	(2.5)	(2.1)	(2.2)
% to Expenditure	79.3%	84.5%	77.7%	82.3%	76.8%	80.5%

Note: Figures in parenthesis indicate percentage of GDP.

Source: Compiled from Central Bank of Sri Lanka Annual Reports, various years.

5.4 The Grants System

Figures 5.2 and 5.3 illustrate the comparative position in selected countries of grants to sub-national units in relation to Central Government revenue and as percentage of sub-national expenditure. In Sri Lanka over

80 per cent of the total expenditure of Provincial Councils is financed by Central Government grants, as shown in Table 5.2.

The grant system is based on two basic principles, (i) the principle of productivity and (ii) the avoidance of control of the periphery by the Centre. To adhere to these basic principles, two methodologies are generally followed and have been adopted in Sri Lanka in (a) the system of grants is based on a systematic formula; and (b) the establishment of an independent body to administer such a grant system.

5.5 The Finance Commission

Under Section 154R(3) of the Constitution, the Government is empowered to allocate grants to the Provinces. For this purpose Section 154R(1) establishes a Finance Commission which enunciates the principles under which these grants are allocated and administers them for apportionment between the various provinces. This is akin to the Finance Commission in India or the Commonwealth Grants Commission of Australia.

The Finance Commission which is an autonomous body consists of five members:

(a) the Governor of the Central Bank;

(b) the Secretary to the Treasury; and

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

Its main function is to make recommendations to the President as to

(a) the principles on which funds granted annually by the Government for the use of the Provinces, should be apportioned between the various Provinces; and

(b) any other matter referred to the Commission by the President relating to Provincial finance.

Such principles are to be formulated with the objective of achieving balanced regional development in the country. The Commission determines its own procedure and is conferred with powers for the performance of its functions. The Commission reports directly to the President and is granted immunity in its determinations and recommendations. The grant of immunity safeguards the independence of the Commission which also casts an obligation on it to discharge its responsibilities with care and impartiality.

Under Section 154R (7) the President is obliged to cause every recommendation made by the Finance Commission to be laid before Parliament and notify any action taken thereon. This procedure has the advantage of prior consultations before recommendations are made by the Finance Commission and almost total certainty that they will be implemented once made.

The Finance Commission in Sri Lanka[5] is a permanent body unlike in India, where it is appointed for a fixed period of five years. This while giving continuity has both strengths and weaknesses. Some question the advisability of having ex-officio members in the Commission and contend that it should be fully

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[5] The Finance Commission is empowered and presently functions under the provisions of Section 154R of the Thirteenth Amendment. A separate parliamentary statute has yet to be enacted. It is understood that steps are being taken in this direction.

independent (Suriyakumaran, 1991). The Commission's activities are confined mainly to the allocation of annual grants to the provinces and the securing of data for this purpose. It presently lacks the necessary staff or the expertise to supervise or monitor how such grants are utilized or the preparation of grant requests.

5.6 Types of Grants

The fiscal allocation scheme consists of three main grants:

a) Block Grants. These are needs oriented grants based on the difference between the estimated current expenditure and the estimated revenue collection of each Provincial Council. In 2004, the block grants represented 78 per cent of the total grants transferred from the Centre to the Provinces. Most of this grant is utilized for recurrent expenditure.

b) Matching Grants. These represent an incentive measure to enhance the efforts of the Provincial Councils to generate additional revenue by better enforcement or through new measures. These are however limited in scope and represent less than 1 per cent of the total grants.

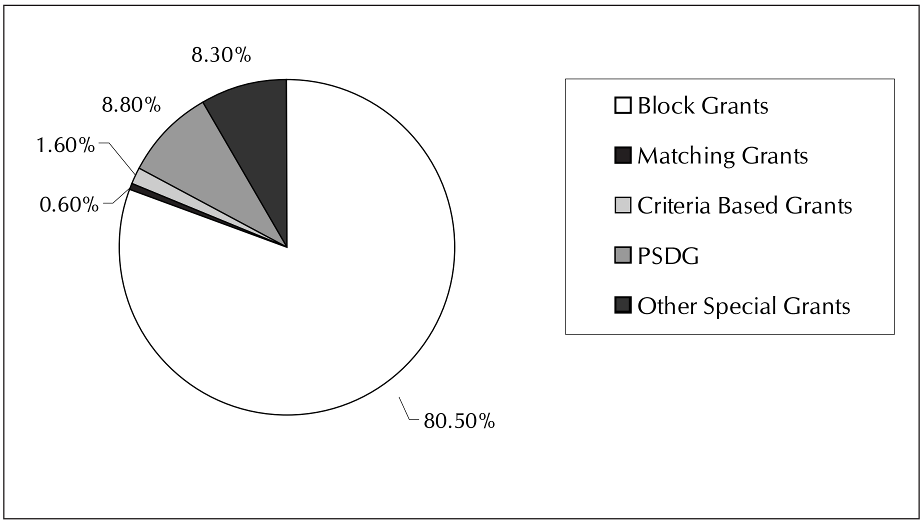
c) Criteria Based Grants. These allocations are based on a formula and constitute an instrument to achieve balanced regional development. They take into account the differences in per capita income and social and economic disparities of the various Provinces. Such grants represent about 2 per cent of the total grants.

Apart from the grants made through the Finance Commission, there were four other types of grants provided by the line ministries. These comprise the following:

- Medium Term Investment Program (MTIP),
- Integrated Rural Development Program (IRDP),
- Rehabilitation, and
- Reconstruction grants

From the year 2000 all these grants were incorporated into the Provincial Specific Development Grant (PSDG) and other Special Grants.

Figure 5.4
Percentage Allocation of Grants 2003



Reference may be made to Table 5.3 below for Province-wise details of the Grants. The main principles to be taken into account by the Finance Commission in allocating these grants as given in Section 154R (5) are:

- The population of each Province;
- The per capita income of each Province;
- The need, progressively, to reduce social and economic disparities; and
- The need, progressively, to reduce the differences between the per capita income of each Province and the highest per capita income among the Provinces.

The prevalence of "block grants" and "criteria based grants" in the allocation system ensures a degree of predictability in the Sri Lankan grant system and prevents control of the periphery by the Centre. The introduction of the "matching grants" in 1995 provides the Provincial Councils with the incentive to realize their actual revenue potential.

5.7 Grants to Provincial Councils - Breakdown

The grants released to the respective Provincial Councils for the years 2000 to 2004 are given in Table 5.3 below and illustrated in Figure 5.5.

5.8 Features and Weaknesses of the Existing Grants System

The above data illustrate a number of interesting features.

i) The bulk of the grants are provided to the Western, Central, Southern, North-Western and North-Eastern Provinces which account for between 11-16 per cent each of the total grants. The rest of the Provinces each receive between 8 - 10 per cent of the grants provided.

ii) About 80 per cent of the grants are the block grants with the criteria based and matching grants being relatively insignificant.

iii) The criteria based grants are also provided mainly to the Western, Central and Southern Provinces while the others, particularly the North Central, Uva and Sabaragamuwa receive relatively a paltry amount.

iv) The matching grants are also allocated mainly to the Western and Central Provinces. The North East Province is maintained almost solely by the block grants and does not operate in practice, hence matching grants being zero.

v) The Provincial Specific Development grants are relatively more evenly based and are intended to assist in promoting provincial development on a broader basis.

Apart from the cash flow uncertainty problem, this data reveals a number of weaknesses and deficiencies in the present system of grant allocation.

Fundamentally the principles underlying the grants system are based more on needs than efficiency promotion. These principles as embodied in Section 154R (3) which is a mandatory provision, stipulate that the funds allocated "are adequate for the purpose of meeting the needs of the Provinces". A Provincial Council is thus statutorily eligible to secure all its needs through government grants. This has however been

Table 5.3
Grants to Provincial Councils 2000-2004 (Rs. Million)

Province	Type of Grant	2000		2001		2002		2003		2004	
Western	Total	3557	12.5%	4509	12.5%	4853	13.5%	3934	10.7%	4236	11.0%
	Block	2,593		3,057		4240		3170		3280	
	Criteria										
	Based	193		193		193		211		211	
	Matching	166		323		144		103		115	
	P.S.D.G.	605		936		276		450		630	
Central	Total	4271	15.1%	5326	14.8%	5086	14.2%	5377	14.6%	5764	14.4%
	Block	3,556		4216		4473		4737		4874	
	Criteria										
	Based	202		134		193		138		138	
	Matching	88		100		144		22		82	
	P.S.D.G.	425		876		276		480		670	
Southern	Total	4270	15.1%	5011	13.9%	5045	14.1%	5370	14.6%	5286	13.7%
	Block	3,297		3781		4116		4689		4405	
	Criteria										
	Based	213		142		142		147		147	
	Matching	141		128		48		84		59	
	P.S.D.G.	619		960		739		450		675	
North East	Total	4646	16.4%	5463	15.2%	6027	16.8%	6092	16.6%	6403	16.6%
	Block	3914		4317		5240		5546		5857	
	Criteria										
	Based	218		151		150		146		146	
	Matching	-		-		-		-		-	
	P.S.D.G.	514		995		637		400		400	
North West	Total	3775	13.3%	4954	13.8%	4515	12.6%	5210	14.2%	5533	14.3%
	Block	2919		3892		4286		4599		4769	
	Criteria										
	Based	180		123		123		118		118	
	Matching	113		151		33		33		46	
	P.S.D.G.	563		788		73		460		600	
North Central	Total	2430	8.5%	3656	10.1%	3296	9.2%	3371	9.1%	3514	9.1%
	Block	1920		2453		2671		2824		2807	
	Criteria										
	Based	93		76		76		62		62	
	Matching	38		87		34		15		25	
	P.S.D.G.	379		1040		515		470		620	

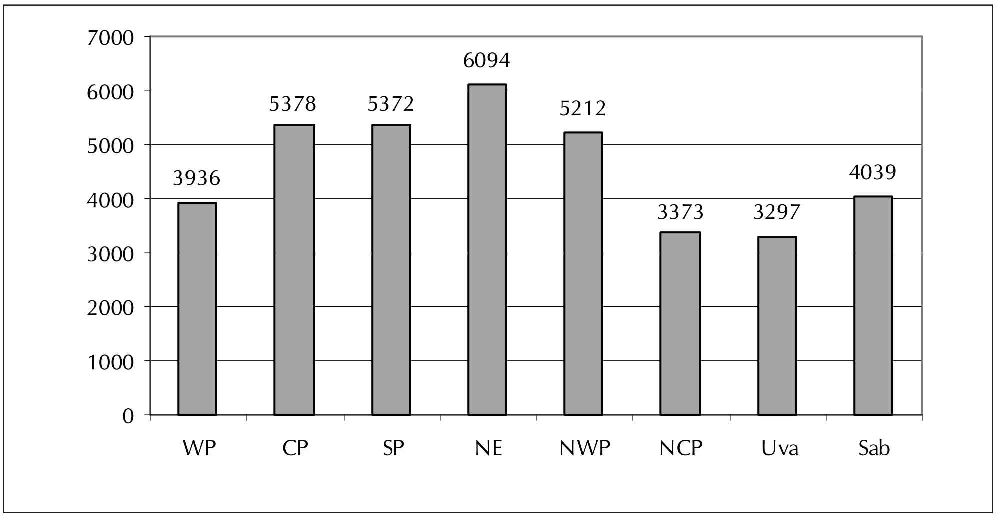
Contd....../-

Province	Type of Grant	2000		2001		2002		2003		2004	
Uva	Total	2338	8.2%	3283	9.1%	3083	8.6%	3295	8.7%	3596	9.3%
	Block	1803		2210		2498		2737		2896	
	Criteria Based	82		72		73		65		65	
	Matching	66		126		15		13		25	
	P.S.D.G.	387		875		497		480		610	
Sabara-gamuwa	Total	2978	10.5%	3646	10.1%	3843	10.1%	4038	11.0%	4140	10.7%
	Block	2288		2652		3016		3394		3360	
	Criteria Based	137		109		109		109		109	
	Matching	50		82		5		25		46	
	P.S.D.G.	503		803		713		510		625	
Total Block Grants		22,290		26,578		30,540		31,696		32,248	
	Criteria Based	1318		1000		1059		996		996	
	Matching Grants	652		997		423		295		398	
	P.S.D.G.	3995		7273		3726		3700		4830	
Total Grants		28265		35,848		35,748		36,687		38,472	

Note: P.S.D.G. indicates Provincial Specific Development Grant.

Source: Finance Commission data.

Figure 5.5
Grants to Provincial Councils 2003



Source: Compiled from Ministry of Provincial Councils.

interpreted to mean primarily the recurrent expenditure requirements of a Provincial Council to maintain the services entrusted under List I and to some extent List III of the Ninth Schedule (Wijesinghe,1996). The needs based principle is reinforced by the provisions of sub-section (5) which clearly implies a constitutional obligation to promote equalization.

The results in practice tend to promote a situation where the Provincial Councils on the one hand lack sufficient motivation to increase revenue while on the other, they tend to over- estimate their expenditure needs. This is reflected in the considerable disparity between the amounts requested by Provincial Councils, the amount recommended by the Finance Commission and the actual amounts released by the Treasury, as indicated in Table 5.4 below.

Another problematic area is the delivery mechanism of grants. Delays incurred in the disbursements of the grants recommended and released, due to liquidity problems of the Centre have led to cash flow problems at provincial level. Provincial administrations in such instances have to take recourse to bank borrowing/ overdrafts with resultant interest costs, in order to meet urgent recurrent expenditure.

Table 5.4
Amounts of Block Grants Requested, Recommended and Released
2000-2004 (Rs. Million)

	2000	2001	2002	2003	2004
Amounts Requested by Provincial Councils	28,378	34,041	33,260	43,566	48,632
Amounts Recommended by Finance Commission	23,162	26,672	31,684	31,700	36,917
Amounts Released by Treasury	22,519	24,698	30,574	30,463	35,891

Source: (a) Finance Commission;
(b) Ministry of Provincial Councils.

5.8.1 Block Grants

The preponderant portion of the grants being the block grants, merely fills the gap between the predetermined portion of the recurrent expenditure of a Province and the devolved revenue of that Province. They are therefore needs oriented than principles based. The bulk of the expenditure is recurrent rather than capital and of the recurrent expenditure, the grants are utilized largely for meeting administrative and personal emoluments expenditure. Block grants however are not unconditional and are subject to discretionary assessment by the Finance Commission.

5.8.2 Criteria-Based Grants

The allocation of criteria-based grants is based on a formula which takes into account the population of each province, selected indicators of the per capita income and social and economic regional disparities.

The indicators and weightage are based on the formula worked out in a Financial Devolution Report (Salgado, 1989) as follows:

Criteria/Indicator	Weight
Per capita income	10%
Per capita income difference	10%
Poverty	10%
Health and Nutrition	15%
Education	15%
Unemployment	15%
Social and Economic Infrastructure	25%

It will be observed from Table 5.3 that the criteria based grants have been allocated largely to the Western, Central and Southern Provinces while the less developed provinces like the North Central, Uva and Sabaragamuwa have received relatively paltry amounts, hence negating the professed principle of balanced regional development as advocated in Section 154R (5) of the Thirteenth Amendment.

The distortion however appears less marked when considered in terms of the population of the different provinces. Table 5.5 below gives the criteria based grants in terms of per head of provincial and in terms of provincial per capita/GDP for 2003.

It is observed that in terms of per head of population the highest amounts have been allocated to the Southern, Sabaragamuwa, and Central Provinces and the lowest to Western and Uva Provinces. Except for the Western Province, all the rest are above all island average. However, viewed in terms of provincial per

Table 5.5
Criteria Based Grants as Per Head/Provincial Population and Per Capita/Provincial GDP - 2003

Province	Criteria Based Grants Rs. Million	Per Head/ Provincial Population Rs.	Per Capita/ Provincial GDP Rs.'000
Western	211	38	159.0
Central	138	57	63.3
Southern	147	63	74.2
North Eastern	146	58	54.9
North Western	118	56	75.3
North Central	62	56	60.6
Uva	65	54	64.2
Sabaragamuwa	109	60	57.8
Total	996	51	91.4

Source: Compiled from data in Tables 1.1, 2.3, and 5.3.

capita GDP the Western Province with the highest per capita/GDP is allocated the highest grant which is more than double that of the lower per capita/provinces like North Western, Sabaragamuwa, and Uva and almost more than three times that of the North Eastern Province.

In fact the Salgado Report itself was conscious of the limitations of the methodology adopted in determining the criteria based grants. First, much of the data suitable for use as social and economic indicators had not been collected on a Provincial basis. Second, the different indicators often did not yield reasonably consistent measures of inter-provincial disparities, indicating that at least some of the available data was of doubtful reliability. Third, the choice of weights and indicators was conditioned by the existing data situation. In the absence of a provincial breakdown of national income estimates, proxies were used based on the Central Bank's Consumer Finances Survey of 1981-82 (Salgado, 1989).

It was envisaged therefore that the indicators and weightage given should be modified at appropriate times which however has not been done. More recent and reliable data are now available such as the Central Bank's Consumer Finances and Socio-Economic Survey of 2003/04 and estimates of provincial GDP and per capita income computed by the Central Bank. It would therefore be seen that the basis on which the criteria based grants are allocated need updating and change in line with the changing socio-economic conditions of the Provinces. This would enable the criteria based grants to be allocated on a more realistic basis than at present and more capable of achieving the desired objective of balanced regional development.

5.8.3 Matching Grants

The same trend is visible in relation to the matching grants. Matching grants were introduced in 1995 for the purpose of providing an incentive for Provincial Councils to enhance their effort and capacity either by discovering new sources of revenue, new tax measures and /or more effective collection and enforcement. Apart from the fact that the matching grants seem insufficient and relatively insignificant in the total grant allocation, their disbursement seems to be uneven. The bulk of the matching grants have been allocated again to the Western and Central Provinces. The rest of the Provinces particularly the Uva, North Central, Sabaragamuwa, North Western and even the Southern Provinces have suffered by comparison. The main reason seems to be that the rates of the matching grants are computed with the benchmark or the revenue collection for the year 1990. No account has been taken for inflation or revenue performance in real terms. Nor is it computed on a roll over basis on the previous year's performance. On the other hand, credit is given for revenue collected where no real effort is involved, for example motor vehicle licence fees collected by other agencies, or stamp duty collected. It is apparent that the methodology in computing matching grants, particularly the benchmarks and the formulae needs revision and change.

5.8.4 Other Grants and Funds

Grants outside the Finance Commission jurisdiction consisting of the Medium Term Investment Program (MTIP),[6] and the Integrated Rural Development Program (IRDP) and the Reconstruction and Rehabilitation grants were also subject to criticism. Their deficiencies related to the following:

i) their quantum was not determined objectively;

ii) the projects were unilaterally determined by the line Ministries;

iii) the inadequacy of the Provincial Council budget allocation;

iv) Government intervention in the implementation; and

v) the non-uniform procedural requirements of different line Ministries.

5.9 Transfers in the Overall Fiscal Context

Fiscal transfers to the provinces have also to be considered in the context of the overall fiscal problem of the country. There are limits to the extent to which resources could be transferred from the private sector of the economy to the public sector to be used by the Centre or the Provincial Councils.

The budgetary constraints in the context of increasing expenditure particularly war related expenditure, declining revenue/GDP ratio trends and persistent deficits illustrated in Table 5.6 below make it imperative that Provincial administrations reduce their preponderant dependence on Central Government financing.

Table 5.6
Revenue, Expenditure and Deficits of the Central Government
1999-2004 (Rs. Million)

	1999	2000	2001	2002	2003	2004 (Prov.)
Total Revenue	195,905 17.7%	211,282 16.7%	234,296 16.6%	261,887 16.5%	276,516 15.7%	311,437 15.3%
Tax Revenue % of GDP	169,029 15.2%	182,392 14.5%	205,840 14.6%	221,837 14.0%	231,648 13.1%	281,582 13.8%
Total Expenditure % of GDP	279,159 25.2%	335,823 26.7%	386,518 27.4%	402,989 25.4%	417,671 23.7%	476,905 23.5%
Budget Deficits (after grants and privatization)	6.9%	9.4%	9.8%	8.1%	7.0%	7.6%

Source: Compiled from Central Bank of Sri Lanka Annual Reports, various years.

[6] As from the year 2000 the MTIP and IRDP have been changed into a Provincial Specific Development Grant (PSDG) and other Special Grants. The provinces have been given greater powers of identifying, planning and implementing specific projects the expenditures for which are to be evaluated and requested by the Provincial Councils through the Finance Commission to the Treasury and granted directly to the Provinces. This process, to some extent rectified the deficiencies and anomalies prevalent in the MTIP system operated through the line Ministries.

The long term objective of Provincial Councils should therefore be that grants should be progressively reduced over time and that the provinces should be more self sufficient in their resources.

5.10 Overall Assessment of the System of Fiscal Transfers

The entire scheme of grants allocation needs revision and reconsideration because it is evident that effectively, the object of devolved fiscal management has not been achieved. Influence with the Central authority, political considerations, particularly the political complexion of the Provincial Council relative to that of the Centre and other factors seem to have weighed more than objective factors in the receipt of grants.

The weaknesses of the grants system may be summarized as follows:

- The block grants are of a gap filling nature and create incentive problems;
- The criteria based grants are based on outdated indicators and weightage and need revision and updating;
- The matching grants are not based on sound criteria;
- There are procedural issues like:
  - delays in the receipt of grants
  - downsizing by the Treasury of the amounts requested or recommended sometimes it is alleged arbitrarily, or due to budgetary or liquidity constraints;
- lack of accountability and transparency;
- vertical and horizontal imbalances;
- equity problems.

It may also be time to reconsider the entire concept of revenue grants as a means of fiscal transfer to bridge the inherent deficit of regional organizations and consider alternative measures. Such measures should be based on principles such as

- revenue adequacy;
- equity and reduction of imbalances;
- predictability and efficiency;
- simplicity, transparency and stability;
- promotion of revenue effort and economy in expenditure;
- accommodation of agency functions and special national concerns;
- tax revenue sharing.

6. Weaknesses of the Provincial Council System - Summary

The discussions of the preceding sections of this paper have brought forth the fact that the present decentralized Provincial Council system has, both in concept and practice, serious inherent weaknesses and contradictions. Beset with institutional and financial constraints, it is neither fish nor fowl being neither a purely administratively decentralized system nor a fully devolved system of government.

The Thirteenth Amendment has been a hastily drawn up document with the objective of solving a political and ethnic problem rather than a well thought out and well conceived scheme of decentralized governance within the Sri Lankan context. Further, little attention has been paid to the fiscal and financial aspects, monitoring and supervising mechanisms or inter governmental relations that underpin a multi level system of government. To quote Richard Bird "The process currently under way appears to assume that the extent, nature and timing of devolution is essentially a political question that will be resolved on political grounds. Any economic and fiscal questions relating to devolution seems to be viewed as simply details to be cleared up later, once a political solution is reached. The premise of this argument is sound. Devolution is essentially a political matter. The conclusion is mistaken. Careful attention must be paid to the economic and fiscal aspects of devolution from the beginning" (Bird, 1996).

Some of the weaknesses relate to the following:

1) The Centre has in practice used the Concurrent List to take back some of the powers devolved to the Provinces. The Concurrent List provided the Centre with the power of reservation of any matter thereby giving a policy prerogative to the Centre. No effective autonomous development work could, in practice, be carried out by any Provincial Council wit hout the free availability of the powers and functions as provided in the Concurrent List and the positive participation by the Centre in making available its powers under its own list, in certain categories at least, to the Provincial Councils in their development work.
2) Article 76(1) of the Constitution was not amended along with the enactment of the Thirteenth Amendment, with the result that Parliament had to make laws empowering provincial governments to make subordinate laws in the form of Financial Statutes. Some of the subjects in the Provincial List have so far not been devolved to the Provincial Councils.
3) State land being a reserved subject had made provincial governments face difficulties in implementing their projects.
4) The Governor as the agent of the President has had powers which sometimes have been used to interfere with the working of the provincial administration.
5) The inadequate fiscal decentralization made provincial governments heavily dependent on the Central Government.
6) The Provincial Councils lack adequate control, accountability and transparency in their fiscal operations.

This inherent Centre bias in the Thirteenth Amendment, which is sometimes considered as its strong point, has in reality made the system to run very much in the old central planning fashion. The current arrangement of grants has no devolutionary character being merely a system of decentralized grants. In quantity they do not reflect the opportunities of Provincial Councils for economic development and investment promotion, both local and foreign. In character, the present system lacks a strong base of its own resources or being provided with substantial shared resources. The failure of regional development in its full meaning was therefore an assured consequence (Suriyakumaran, 1991). These weaknesses were aggravated by the unresolved Centre-Provincial relationships of the fiscal system and the lack of real mechanisms for development planning and development undertakings. As Richard Bird concludes,

> "From a practical point of view .... in most ways the 1987 attempt to introduce (financial) decentralization in Sri Lanka failed" (Bird, 1996).

The dissatisfaction with the existing system of provincial councils has led to rethinking in two contrary directions. One school is an advocate of greater centralization in the interests of efficiency, economy, meaningful authority and more effective development. The other view is in the opposite direction of greater devolution at provincial or regional level.

7. Concluding Remarks

The system of administrative decentralization which had prevailed in Sri Lanka for decades was changed by the Thirteenth Amendment to a form of fiscal devolution but the Provincial Council system it produced was Centre biased and was a hybrid system. The main fiscal sources that were devolved were relatively insignificant, producing revenue totally inadequate to meet the demands of even a considerable portion of its expenditure.

Provincial expenditure itself consisted preponderantly of recurrent rather than capital expenditure, the major portion of which was incurred on personal emoluments and administration. Thus, born with budget deficits, in the form of large gaps between expenditure and own revenue, the Provincial Administrations depended largely on grants from the Centre for their functioning and existence. Of the Provincial Councils the preponderant position is held by the Western Provincial Council which accounted for over two thirds of total provincial revenue and one fourth of its expenditure. Their fiscal capacity is very unequal and there is a wide disparity between the different provincial administrations, both in terms of revenue performance, expenditure levels and even in the allocation of grants.

The grants system itself established to finance the provincial deficits in the form of needs oriented block grants also consisted of matching grants to motivate provincial revenue performance and criteria based grants to achieve balanced regional development. These were computed and allocated by the Finance Commission on certain stipulated principles but in practice the allocation system is characterized by several weaknesses. They have been insufficient, uncertain in amount and unpredictable in timing. The whole question of grant administration and the derivation of grant formulas needs updating and revision.

There is considerable scope for developing the financial resources of the Provincial Councils further by ensuring a more effective administrative machinery and finding new sources of revenue. The medium term and long term financial viability of the Provincial administrations however is related to the development of their untapped resources through a process of balanced and sustainable regional development to reduce the vertical and horizontal imbalances prevalent.

The deficiencies of the prevalent Provincial Council system has led to consideration of its revision which has evoked considerable controversy. The government's proposals for Constitutional Reform published as a document in October 1997 envisaged greater devolution and was the basis of a Constitutional Reform Bill presented in Parliament on 3 August 2000. However, in spite of prior assurances that it would secure broad support, the Bill met with unexpected opposition in Parliament and was not proceeded with. There has been no movement in constitutional reform since then. Any further attempts at devolution or decentralized governance have become tied to the cease-fire agreement and the peace process initiated in 2002.

Appendices

1. Thirteenth Amendment Ninth Schedule List I (Provincial Council List) Items 30 - 36:20

2. Thirteenth Amendment Ninth Schedule List II (Reserved List) Finance (a) to (o)

3. Thirteenth Amendment Ninth Schedule List III (Concurrent List) Items 1 and 26

4. Government's Proposals for Constitutional Reform List I (Reserved List)

5. Government's Proposals for Constitutional Reform List II (Regional List)

6. Summary of Main Recommendations for Improving Provincial Revenue Performance.

Appendix

Thirteenth Amendment
Ninth Schedule List I - Provincial Council List
Items 30 - 36:20

30 Betting and gambling, other than imposition of licence fees and taxes;

31 Provincial debt;

32 Offences against statutes with respect to any of the matters specified in this List;

33 Fees in respect of any of the matters in this List, excluding fees taken in any court;

34 Development, conservation and management of sites and facilities in the Province for the generation and promotion of electrical energy (other than hydro-electric power and power generated to feed the national grid);

35 The borrowing of money to the extent permitted by or under any law made by Parliament;

36:1 Turnover taxes on wholesale and retail sales within such limits and subject to such exemptions as may be prescribed by law made by Parliament;

36:2 Betting taxes, and taxes on prize competitions and lotteries, other than National Lotteries and lotteries organized by the Government of Sri Lanka;

36:3 Licence taxes, arrack, toddy rents, tapping licence fees, and liquor licence fees;

36:4 Motor vehicle licence fees within such limits and subject to such exemptions as may be prescribed by law made by Parliament;

36.5 Dealership licence taxes on drugs and other chemicals;

36.6 Stamp duties on transfer of properties, such as lands and motor cars;

36.7 Toll collections;

36.8 Fines imposed by courts;

36.9 Fees charged under the Medical Ordinance;

36.10 Fees charged under the Motor Traffic Act;

36.11 Departmental fees in respect of any of the matters specified in this List;

36.12 Fees under the Fauna and Flora Protection Ordinance;

36.13 Fees on lands alienated under the Land Development Ordinance and Crown Lands Ordinance;

36.14 Court fees, including stamp fees on documents produced in court;

36.15 Regulatory charges under the Weights and Measures Ordinance;

36.16 Land revenue, including the assessment and collection of revenue, and survey and maintenance of land records for revenue purposes;

36.17 Taxes on lands and buildings, including the property of the State to the extent permitted by law made by Parliament;

36.18 Taxes on mineral rights within such limits and subject to such exemptions as may be prescribed by law made by Parliament;

36.19 Licensing fees on the possession, transport, purchase and sale of intoxicating liquor;

36.20 Other taxation within the Province in order to raise revenue for provincial purposes to the extent permitted by or under any law made by Parliament.

Thirteenth Amendment

Ninth Schedule List II
(Reserved List)

Finance in relation to national revenue, monetary policy and external resources; customs

This would include -

(a) Public debt of the Government of Sri Lanka;

(b) Currency, coinage and legal tender; foreign exchange;

(c) Foreign loans;

(d) Central Bank;

(e) National Savings Bank;

(f) Lotteries organised by the Government of Sri Lanka or a Provincial Council;

(g) Banking;

(h) Bills of exchange, cheques, promissory notes and other like instruments;

(i) Insurance;

(j) Stock exchanges and futures markets;

(k) Audit of the accounts of the Government of Sri Lanka and of the Provinces;

(1) Taxes on income, capital and wealth of individuals, companies and corporations;

(m) Customs duties, including import and export duties and excise duties;

(n) Turnover taxes and stamp duties, except to the extent specified in List I;

(o) Any other tax or fee not specified in List I.

Foreign Trade, Inter-Province Trade and Commerce

This would include -

(a) Trade and commerce with foreign countries; import and export across customs frontiers; definition of customs frontiers; and

(b) Inter-province trade and commerce.

Thirteenth Amendment

Ninth Schedule List III
(Concurrent List)

1. Planning -

    1:1 Formulation and appraisal of plan implementation strategies at the provincial level;

    1:2 Progress control;

    1.3 Monitoring progress of public and private sector investment programmes;

    1.4 The evaluation of the performance of institutions and enterprises engaged in economic activities;

    1.5 The presentation of relevant data in the achievement of plan targets;

    1.6 The dissemination of information concerning achievement of plan targets;

    1.7 Publicity of implementation programmes;

    1.8 Manpower planning and employment Data Bank;

    1.9 Nutritional planning and programmes.

Government Proposals for Constitutional Reform[7]

Second Schedule

List I

(Reserved List)

This list contains those subjects and functions that shall be exercised by the Central Government

1. Defence, national security, national police and the security forces.
2. Firearms, ammunition, explosives and other armaments.
3. Immigration, emigration and citizenship.
4. Foreign affairs, including all matters which bring the Government of Sri Lanka in-relations with other States and the undertaking of international obligations.
5. Entering into treaties, conventions and agreements with other States and international organizations and implementing such treaties, conventions and agreements.
6. Elections excluding elections to Local Authorities.
7. National Planning.
8. National census and statistics.
9. Currency and foreign exchange; international economic relations; formulation of monetary policy and external resources.
10. Public Debt of the Government of Sri Lanka.
11. Foreign loans of the Government of Sri Lanka.
12. Regulation of banking, banking institutions and other national financial institutions.
13. National policy on insurance and national institutions providing insurance services.
14. Regulation of securities, stock exchanges and futures markets.
15. Audit of the Government of Sri Lanka, State institutions and public corporations.
16. Taxes on income, capital and wealth of individuals, companies and corporations as provided in Chapter XXI.
17. Custom duties, including import and export duties, and excise duties (excluding such excise duties as may be specified by law) as provided in Chapter XXI.
18. Turnover taxes and stamp duties, goods and services taxes as provided in Chapter XXI.
19. Any other taxes, duties or levies not mentioned in the Regional List.
20. National Lotteries.
21. Pensions payable by the Government of Sri Lanka or out of the Consolidated Fund of Sri Lanka.
22. Atomic energy.
23. National grid for the supply of electricity, maintenance and management of the national grid.

[7] These schedules formed part of the document "The Government Proposals for Constitutional Reform" published in October 1997 by the Ministry of Justice, Constitutional Affairs and National Integration.

24. Minerals and mines including the regulation and development of oil fields and mineral resources, petroleum and petroleum products and the collection of royalties thereon.
25. Inter-regional rivers.
26. Airports, harbours, ports with international transportation, provision of facilities, in consultation with the relevant Regional Administrations, in fishery harbours used mainly by vessels engaged in fishing beyond territorial waters.
27. Inter-regional transport.
28. Railways.
29. Civil aviation.
30. Inter-regional highways linking the Capital Territory with regional capitals, regional capitals with each other and District capitals with each other in so far as the highway linking District capitals traverse regional boundaries, toll roads and expressways constructed by or under authority of the Central Government.
31. Shipping and navigation, Maritime Zones including historical waters and territorial waters, Exclusive Economic Zone and Continental Shelf.
32. Posts and telecommunications.
33. National mass media including Central Government broadcasting and television institutions in conformity with national standards, establishment of regulatory authorities for the determination of national standards relating to communication and media.
34. National Public Service, National Public Service Commission.
35. National Health Administration (inclusive of existing special purpose hospitals and teaching hospitals affiliated to National universities, co-ordination of health services, training and co-ordination of education and research relating to health, determination of national health standards, administration of all special programmes).
36. Policy and enforcement procedure relating to drugs, poisons and narcotics.
37. Administration of Justice (except administration of Justice in the Regions as specified) and court procedure.
38. Prisons established by the Central Government.
39. Adoption of children.
40. Inter-regional irrigation schemes.
41. Fishing beyond the territorial waters, registration of vessels engaged in fishing beyond territorial waters; rights relating to traditional migratory fishing within territorial waters, reference of inter-regional fishing disputes and disputes relating to traditional migratory fishing for settlement in accordance with Article 141.
42. Protection of marine and aquatic resources in keeping with international obligations and measures to enforce such obligations.
43. Management of national policy and national institutions in the field of education such as the National Institute of Education, management and supervision of national schools, determination of minimum standards for national public certification examinations, the conduct of national public certifications examinations, determination of minimum standards for curriculum and teachers qualifications and educational training, educational publications provided by the Central Government.
44. University Grants Commission and National Universities.
45. National standards with regard to professions, occupations and training.
46. National standards relating to research, development and training in the areas of agriculture, fisheries and aquatic resources, science and industries.

47. Foreign trade, inter-regional trade and commerce including settlement of disputes related thereto.
48. Establishment of national standards of quality for goods to be exported out of the Republic or transported from one Region to another.
49. Patents, inventions, designs, copyright, trademarks and merchandise marks.
50. Monopolies and mergers.
51. Inter-regional food distribution.
52. Buddhism - the formulation and implementation of national policy relating to the Buddha Sasana in accordance with the Tripitaka, Pirivena education.
53. National Archives and Museums.
54. National Libraries and the National Library Services Board.
55. Archaeology, policy formulation, excavation, conservation, including access for such purpose, maintenance and administration of ancient and historical monuments and archaeological sites and records declared, after consulting the relevant Regional Administration, by law, to be of national importance.
56. Promotion and advancement of diverse cultural activity so as to preserve the national heritage.
57. National Standards relating to public performances.
58. National policy on tourism and promotion of tourism.
59. National plans on environment and conservation including conservation of flora and fauna in keeping with international obligations.
60. Policy and national programmes relating to coast conservation.
61. Specialized housing programmes.
62. Formulation and co-ordination of national poverty alleviation programmes.
63. National Policy on youth and women's affairs.
64. Development of national sports administration and infrastructure.
65. Intervention in instances of national (natural and environmental) disasters and epidemics.
66. Labour regulation and standards.
67. Promotion of and Policy on industrial development.
68. Institutions for the promotion of, and determination of policy relating to, investment.
69. National programmes for public utility infrastructure development.
70. Surveys for the purpose of any matters enumerated in the Reserved List.
71. Offences against Laws with respect to any of the matters in the Reserved List.
72. Fees in respect of any of the matters in the Reserved List, but not including fees taken in any Court.
73. Acquisition of private land required for the purposes of any matter in the Reserved List.
74. Requisition of private land required for the purposes of any matter in the Reserved List.
75. Any other matter not enumerated in the Regional List.

List II
(Regional List)

This list contains those subjects and functions devolved to the Regional Councils.

1. Regional Planning including employment planning at the Regional level and plan implementation including employment programmes.
2. Public debt of a Region.
3. Domestic and international borrowing to the extent specified in Chapter XXI.
4. The management and promotion of foreign direct investment, international grants and development assistance to the Region to the extent specified in Chapter XXI.
5. Regional programmes for public utility infrastructure development.
6. Regional financial and credit institutions including regional institutions providing insurance services.
7. Excise duties to be specified by law.
8. Betting and gaming taxes, taxes on prize competitions and on lotteries to be specified.
9. Motor vehicle licence fees.
10. Stamp duties on transfer of immovable properties and motor vehicles.
11. Fines imposed by courts within the Region.
12. Court fees, including Stamp fees on documents produced in courts.
13. Land revenue, including the assessment and collection of revenues, and maintenance of land records for revenue purposes.
14. Taxes on mineral rights.
15. Pensions payable by a Regional Administration or out of the Consolidated Fund of a Region.
16. Regional Lotteries.
17. Regional Public Service, Regional Public Service Commission.
18. Regional Commissioner for Administration (Regional Ombudsman).
19. Health and indigenous medicine including Regional Health Services and Regional Health Administration.
20. Regional Policy and research on education, education, and educational services and higher education (excluding national schools and national universities, determmation of minimum standards for national public certification examinations, the conduct of national public certification examinations, and determination of minimum standards for curriculum and teacher qualifications), educational publications provided by the Regional Administration.
21. Agriculture and agrarian services inclusive of agricultural research, extension, promotion and education within the Region and promotion of agro-based industries within the Region.
22. Animal husbandry.
23. State land and its alienation or disposal as specified in Chapter XVI.
24. Irrigation within the Region.
25. Fisheries, marine and aquatic resources within territorial waters excluding rights relating to traditional migratory fishing in territorial waters, as provided in the Reserved List.
26. Forestry and protection of the environment within a Region, in conformity with national plans on forestry, environment and conservation.

27. Regional programmes for coast conservation in conformity with national plans.
28. Industries and regional industrial development inclusive of industrial research and training within the Region.
29. Energy excluding the national grid.
30. Trade and commerce within the Region.
31. Co-operatives and Co-operative Banks.
32. Supply and distribution of food.
33. Markets and fairs.
34. Manufacture and supply of salt, distribution of salt within the Region of manufacture.
35. Roads excluding those specified in the Reserved List, toll roads and expressways constructed by or under authority of the Regional Administration, waterways.
36. Transport excluding railways but including ferry services.
37. Minor ports and harbours.
38. Housing and construction.
39. Urban planning and implementation, public utilities.
40. Rural development.
41. Local Government consisting of regularly elected local authorities for the entirety of the Region.
42. Elections to local authorities, such elections to be administered by independent Local Authority Election Commissions established by Statute in each Region, election laws shall ensure that - Not less than twenty five per cent of the members elected thereunder to local authorities shall be women; and not less than twenty five per cent of the members elected shall be persons less than thirty five years of age.
43. Regional libraries and museums.
44. Promotion of religious and cultural activity within the Region including the preservation of religious and cultural diversity.
45. Maintenance and administration of ancient and historical monuments, archaeological sites and records other than those specified in the Reserved List.
46. Public performances.
47. Broadcasting and media, including television in conformity with national standards.
48. Promotion of tourism in the Region.
49. Relief, rehabilitation and reconstruction and the granting of compensation.
50. Social security and social insurance.
51. Social services.
52. Regulation of unincorporated associations and societies within the Region, charities and charitable institutions.
53. Regional Police, Regional Police Commission and law and order to the extent provided in Chapter XXII.
54. Administration of justice within a region to the extent provided in chapters XVII, XVIII and XIX, mediation and conciliation, provision and setting up of court buildings in consultation with the Regional Judicial Service Commission of the Region, maintenance of court buildings.
55. Prisons established by the Regional Administration, Borstal and reformatory institutions.
56. Implementation of programmes for the advancement of youth and women.

57. Sports.
58. Surveys for the purpose of any matters enumerated in the Regional List.
59. Offences against laws and Statutes with respect to any of the matters in the Regional List.
60. Fees in respect of any of the matters in the Regional List.
61. Acquisition of private land required for the purposes of any matter in the Regional List.
62. Requisition of private land required for the purposes of any matter in the Regional List.
63. Fines in respect of the matters in the Regional List.
64. Any other tax that may be devolved by law on the Region.

Summary of Main Recommendations for Improving Provincial Revenue Performance[8]

1. A consolidated Statute incorporating the principal Finance Statute, all supplementary statutes and amendments to be made and codified on a uniform basis into a single Consolidated Statute for each Province.

2. The turnover tax base to be broadened by revising the definition of "manufacture" to be as that prevailing in the VAT Act No. 14 of 2002 and the Provincial Councils (Limits and Exemptions) Act No.25 of 1995 to be amended accordingly.

3. The current list of exemptions to turnover tax to be reviewed.

4. The turnover tax rate system to be revised by adopting a multiple rate structure with essential items at a low standard rate and non-essentials at higher rates.

5. Items like liquor, cigarettes, motor cars and similar items considered to be of a luxury or semi-luxury character to be taxed at the maximum rate of 5 per cent.

6. Toll collections under item 36.7 should be imposed on heavy commercial vehicles using provincial roads, bridges and by-ways.

7. Steps to be taken to utilize the devolved sources in items 36.5 to 36.20 more fully.

8. A Provincial Development Levy to be imposed on all persons within the province not registered either for VAT or turnover tax on the basis of 5 per cent of turnover. Necessary Parliamentary approval to be secured in terms of item 36.20 of List I of the Ninth Schedule.

9. The problem of under-valuation of deeds resulting in loss of stamp duty should be tackled by a more effective system.

10. The upper rate of stamp duty on transfer of immovable property to be increased from 4 per cent to 5 per cent.

11. Periodic surveys should be carried out to gather information leading to additional tax liability and new businesses.

12. All active files should be grouped into Groups I, II, or III according to the grouping criteria adopted by each provincial revenue department.

13. All Groups II and III files should be examined and audited on a planned basis, securing accounts and relevant records. All businesses in these Groups should be subject to inspection after selection for tax potential.

14. There should be greater coordination between the Provincial Revenue Commissioner and other revenue collecting departments and agencies.

15. All grades of officers should undergo regular refresher training courses periodcally and a special inter-Provincial Training Unit should be set up for this purpose.

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[8] From Summary of Recommendations in "Provincial Revenue Performance Improvement Programme", UNDP - Finance Commission Consultancy Report, December 2002.

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