Fiscal Federalism: Financial Power Devolution Under the Sub National Government System in Sri Lanka

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Abstract

This study attempts to analyze strengths and weaknesses pertaining to fiscal decentralization in Sub National governments (SNGs) in Sri Lanka. Constitutionally the government of Sri Lanka has given self-ruling rights to the top layer of SNGs regional/ provincial governments in 1987 while local governments are operating under the Central Cabinet since 1947. With this decentralization of political power, the Central governments has been handling their functions and responsibilities in a sharing system with provincial and local governments for more than six decades. However, though a significant role has been assigned to the SNGs in Sri Lanka, the effectiveness of operation is questionable due to their inherent constraints, such as the lack of financial autonomy. This limited financial capacity of provincial governments and local governments has been a major weakness in Sri Lanka, vesting more strength of taxation power with the Central Government. This is further weakened by non-implementation of the existing tax power of Provincial governments and also, the devolved power to the Provincial governments has not been transferred fully by the Central Government. Creating limited and a shortage of funds, the annual transfers have not been made by the Central Government at the required level. As a result, the annual revenues of both regional governments and local governments in Sri Lanka have never met the annual expenditure requirements.

Key Words: *Fiscal Federalism, Decentralization, Regional Governments, Local Governments, Financial Autonomy, Public Administration*

JEL Codes: H77, H75, R50, H76, H71, H83

Introduction

Sri Lanka is a small developing country that follows the Westminster model of cabinet government with a French-style Executive President at the top and a system of regional governments in the middle and local governments being placed at the bottom. This system has been developing gradually from Independence basically where a regional government system was initiated in 1987 with modifications to the Local Governments system. The political system is highly adversarial, which is alternated in power since Independence. Specially, this power decentralization from top to down has adopted as a conflict management strategy in Sri Lanka. Such decentralized political systems are abundant in the world, adopted by many countries in their political administrative processes and have responded to the changing conditions and circumstances despite their strong centralized tendency. By present, many such countries function effectively in these power decentralized systems. The Central government of Sri Lanka has been handling their functions and responsibilities in a sharing system with sub national and local governments for over five decades.

The theory of fiscal federalism[1] assumes that a federal system of government can be efficient and effective at solving problems governments face today, such as distribution of income, efficient and effective allocation of resources, and economic stability. Federalism is the sharing of power between national and state/ local governments[2]. Fiscal federalism attempts to define division of governmental functions, and the financial relationship between, different levels of government (usually how federal or central governments fund state and local governments)[3]. The principles of fiscal federalism are concerned with design of fiscal constitutions, that is, how taxing, spending, and regulatory functions are allocated among governments and how intergovernmental transfers are structured (Agrawal et al., 2024). Both in the industrialized and developing world, nations are turning to such a devolution to improve performance of their public sectors. The hope of this federalism is that the state and local governments, being closer to the people, will be more responsive to preferences of their constituencies and will be able to find new and better ways to provide the services. Focusing on such a role, Sri Lanka has shared their functional and financial

[1] The term "fiscal federalism" was introduced by the German-born, American economist Richard Musgrave in 1959. Fiscal federalism refers to how central, state, and local governments share funding responsibilities.

[2] For an economist, nearly all public sectors are federal in the sense of having different levels of government that provide public services and have some scope for de facto decision-making authority (irrespective of the formal constitution) (Oates, 1999).

[3] There are different meaning of fiscal freedom, fiscal devolution, and fiscal federalism. Fiscal freedom is a broader suite of local taxes and restoration of certain grant funds, fiscal devolution is same local taxes but devolution of some central taxes and fiscal federalism is locally determined tax regimes (Local Government Association, 2020).

powers to Sub National Governments (SNGs)[4]. Under this devolution frameworks, a considerable number of functional responsibilities are assigned to the lower-level units/ governments. The consequence of this is inadequate financial capacity of SNGs as it is directly related to financial autonomy pertaining to revenue raising power.

Under federalism, functions are devolved from center to sub national governments (SNGs) providing opportunities to offer services and engage in development activities in their territories. The functional devolution mostly 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 and such functions are divided on a legitimate framework while there are some shared works in a concurrent list. Ministries or institutions are formed in each level to manage, implement, and monitor these functions. Matters regarding how these institutions are financed in order function effectively, efficiently, responsively, and accountably, should be addressed from the outset, because the operational success of public institutions depends on adequate financing. In a federal system, fiscal autonomy should have to be constitutionally defined and guaranteed and given a real meaning to the notion of self-rule, particularly. However, the most vital part of fiscal federalism is revenue raising power and how its power is delegated to lower-level governments. Fiscal and financial arrangements hence are pivotal in a federal system in that they determine the nature and meaning of shared rule and self-rule in practice. Especially, to carry out functions successfully, various levels of government require a specific fiscal autonomy and a revenue raising authority.

However, this is a critical part and hence it may not have been successfully delegated or financial devolution is weak when it comes to lower level of governments. Indeed, there are questions relating to the allocation of expenditure responsibilities, the assignment of revenue raising powers, a system for fiscal equalization, and regional borrowing. In relation to this, a considerable number of cases in the world has recorded that the power of revenue generation in lower-level governments are not successful and or there are some inabilities to do that due to constitutional barriers. Nonetheless, the availability of revenue sources, particularly in imposing taxes, is limited in jurisdiction, and existing sources are not feasible or adequate. This is directly connected with the amount which they spend on service provision and development activities of lower-level governments. Though a significant role has been assigned to the SNGs in Sri Lanka, the effectiveness of operation can be questionable due to their inherent

[4] Sub-national governance can be defined in general, as a process of exercising administrative, legislative, economic, and political authority and powers by provincially elected bodies functioning within their respective legally recognized territorial jurisdictions (Sivakuma, 2013).

constraints, particularly, arising with limited financial autonomy. Despite the ability to work for local interests, if financial capacity is weak or inadequate, it is difficult to execute functional responsibilities. Therefore, each level of government needs financial resources that can broadly match its expenditure requirements. In other words, devolution should ensure adequate financial resources in relation to its expenditure responsibilities which can be usually done either by assigning adequate tax raising powers to each level. Many cases in the world have shown such a mismatch of revenue collection and excess expenditures compared to level of revenue. This would be a result of unsuccessful financial devolutions with power devolution, based on many reasons. As Waidyasekara (2005) stated 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 existing framework for the devolution of power under the 13th Amendment, even though largely meaningless in practice, provides an inescapable context to the debate about more meaningful power-sharing between the Centre, and regions. Meantime, there is an argument in relation to Provincial council system that they are not working efficiently and effectively (Lakshman et al., 1998). The main reason behind the weaknesses of financial base of the system and financial resource mobilization and revenue raising autonomy at the regional level is a contentious issue.

The decentralized administrative and financial mechanism has been in place for over four decades in Sri Lanka. This strategy is used to maximize regional attention and to provide a fair service and benefit at regional and local level and used as a political peace-making process of the country. Meantime, the devolution of administrative and financial power in regional and local level was introduced as a solution of ethnic crisis in Sri Lanka, particularly to shift the decision-making power in development into regionalized administrative structure. However, unsuccessful operation of this system has been a major hitch leading to a political issue. The main cause of this problem is financial limitations of regional governments disrupt the service provision and activities of the regions. Therefore, it is useful to examine the SNG system in Sri Lanka enabling policymakers to reorganize the systems and to find solutions for imperfect parts of power devolutions.

Literature Review

The literature on intergovernmental fiscal relations has been expanding rapidly in the last two decades, in line with a growing worldwide trend toward fiscal decentralization. Fiscal federalism[5] studies show how to share responsibilities (including finances) among federal, state, and local governments to improve economic efficiency and

[5] Federal systems are seen to provide safeguards against the threat of centralized exploitation as well as decentralized opportunistic behavior while bringing decision makers closer to the people.

achieve various public policy objectives. It is assumed in the theory of fiscal federalism that distribution of tax and expenditure powers between different vertical levels of government takes place informally in country even with the system of 'unitary' form of government. It has often been argued that a decentralized fiscal arrangement improves the allocation of resources because decentralization of fiscal decisions implies that the package of spending and taxing tends to better reflect the wishes of the local voters. Fiscal federalism helps governmental organization to realize cost efficiency by economies of scale in providing public services, which correspond most closely to the preference of the people.

Table 01: Broad Principles Associated with Fiscal Federalism

Fiscal equivalency	Decentralization theorem	Principle of subsidiarity
The principle of "fiscal equivalency" requires a separate jurisdiction for each public service. Wallace Oates proposes a related idea, the so-called "correspondence principle". According to this principle, the jurisdiction determining the order of provision of each public good should include the set of individuals that consume it. This generally requires a large number of overlapping jurisdictions.	According to the "decentralization theorem" advanced by Oates, "each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize the benefits and costs of such provision." Unlike the general prediction, a higher degree of spillovers may reduce the difference in the utility of centralization and decentralization.	The "subsidiarity principle" states that functions should be performed at the lowest level of government. The principle, if not explicitly but implicitly, implies hierarchy. The deeper questions that arise are who will decide, and for whom, coupled with which functions will be assigned to which level.

Source: Singh (2020)

For successful decentralization, national governments need to design and supervise clear fiscal arrangements that support local service delivery. At the same time, local authorities are challenged to strengthen their financial capacities and use their limited resources in an effective and efficient way. Oates (1972) argues that fiscal autonomy induces a better match between public services delivery and citizens' preferences and willingness to pay, incentivizing transparency and accountability, thus increasing efficiency. Baldwin and Krugman (2004) also argue that fiscal autonomy can act as a powerful instrument against agglomeration forces as it introduces mechanisms for peripheral jurisdictions to compete with the "center". Furthermore, the goal of modern fiscal federalism is not just to ensure the efficient allocation of resources, but also to protect liberty and restrain the power of government, to share legislative and fiscal competencies, to foster political participation and preserve markets.

The principles of fiscal federalism are concerned with the design of fiscal constitutions – that is, how taxing, spending, and regulatory functions are allocated among governments and how intergovernmental transfers are structured. These arrangements are of fundamental importance to the efficient and equitable provision of public services. As Singh (2020) stated, there are important Principles for a fiscal federalism (Table 01).

There are two types of lower-level governments or SNGs below the central government in Sri Lanka. Rationale for such federalizing in Sri Lanka is accommodation of multiple identities within one viable state. The lower-level governments are namely 'provincial governments (Provincial Councils (PCs)) and local governments including municipalities'[6]. Provincial governments constitute the intermediate level of government that was established within the existing governmental system which provided for a set of structures and positions with authority to exercise powers and functions at the provincial level. Local governments are elected councils for the local level and its main role is the delivering required services to the locals in which public service responsibilities are shared between deconcentrated line agencies at the district and divisional level and local governments at the rural/urban level.

The Provincial governments of Sri Lanka are autonomous regional governments to a particular region, but the executive power of the President is imposed by the Governor/ the Representative of the Executive President. Functions assigned to the Governor seek to ensure that devolved powers are exercised within the framework of the law. Governor's role responsibilities are the implementation of executive powers regarding matters on which the PC has power to make statutes, either, directly or through Ministers of the Board of Ministers, or through subordinate officers. Generally, with the advice of the Board of Ministers, except where he is required to act in his own discretion, which is usually under instructions from the President (Welikala, 2016). As well as, under the devolution subjects of the concurrent list, the PC can exercise power regarding the subjects in this list. However, before the PC could pass a statute on such subject, it should consult the Parliament of Central Government for its opinion on the provisions contained in such statute. Local governments are the lowest level of governments in Sri Lanka. The local government bodies are collectively known as local authorities. Local authorities do not derive their powers from an individual source but from numerous Acts and Ordinances. The Ministry of Local Government and PCs is

[6] With the introduction of universal franchise in 1931 that elected local authorities of four types - Municipal Councils, Urban Councils, Town Councils and Village Councils were established (Leitan, 2001) and the Provincial Councils were established under the Thirteenth Amendment to the Constitution, which came into effect on 14 November 1987 (Wickramaratne 2010).

responsible for policy and legislation at the national level, while the provincial ministers of local government are responsible for administration and supervision at the local level. The national-level minister has powers to create, reconstitute or upgrade a local authority based on the recommendations of a committee established for these purposes.

Method and Materials

The overall methodology of study was critically investigated, described, and analyzed the fiscal federalism/decentralization with a special reference of revenue raising power devolution in Sri Lanka under the sub- national government system. The research relied substantially on secondary data of the period of 2001-2022 and information from the Ministry of Local Government and Provincial Government of Sri Lanka, the Finance Commission of Sri Lanka and Ministry of Finance, Gazettes of government of Sri Lanka, Central Bank of Sri Lanka, Department of Census and Statistics and Ministry of Planning and Implementation. In addition, to review the coordination structure of financial, financial mobilization structure, allocation mechanism, financial capability descriptive information was collected from documents such as reports, acts and articles. In addition, this study was completed reviewing partly the literature collecting information of sub-national government system in Sri Lanka by conducting interviews with experts of local governments/ members of Provincial Councils, members of Municipal Councils and other relevant officials.

Results and Discussion

Fiscal/ Financial Devolution

Availability of sufficient financial resource is an important aspect of devolution of powers. Especially, the fiscal power of sub national governments is the most important part in power devolution packages. Because meaningful decentralization is a pre-requisite for effective and efficient exercise of authority and powers by sub-national government. Nonetheless, distribution of taxing and spending powers between central and sub national governments affects the implementation of economic policies and ultimately their outcome in terms of growth and regional inequality. As stated in SNGWOFI (2019), subnational governments are governed by political bodies (deliberative assemblies and executive bodies) and have their own assets and administrative staff. They can raise own-source revenues, such as taxes, fees and user charges and they manage their own budget. In other words, it is said that without fiscal decentralization[7], political and administrative decentralization are meaningless.

[7] Fiscal decentralization involves delegating taxing and spending responsibilities to subnational tiers of government. In this case, the degree of decentralization depends on both the number of resources delegated and the autonomy in managing such resources (SNGWOFI, 2019).

Nevertheless, when the practical situation is considered in Sri Lanka, each level of government needs financial resources that broadly match its expenditure responsibilities. Specially, with the increase of functions and role under the devolved responsibilities, the required annual funds must be increased. Furthermore, the money is required to run their own administrative setup of relevant regions and areas and o pay their salaries, provide day--today logistic requirements. It can be large with size of responsibilities, geographical area, service delivery, and with national policies and programs carried out by local governments. The existing expenditure has been recorded in different reports with regards to Sri Lanka. For example, since 1987 spending by sub-national governments in Sri Lanka has accounted for only 10% of total public sector expenditure; on average 8% for Provincial Councils and slightly more than 2% for local governments (Cartier et al., 2005). To meet these, expenditures funds should be available in SNGs and therefore ensuring that each level of government has adequate financial resources in relation to its expenditure responsibilities is usually done either by assigning adequate tax raising powers to each level, or by creating a system ideally with a framework in the Constitution through which the proceeds of taxation raised by one government (most commonly the central government) are allocated between all levels of government.

The Legal Framework of Fiscal/ Financial Devolution to the PCs in Sri Lanka

The Thirteen Amendment in 1987 and Act no 42 and its part III explains the financial matters of the Provincial Council system. The revenue sources devolved to the provinces are enumerated in Sections 33 and 36.1 to 36.20 of List 1 of the Ninth Schedule to the Thirteenth Amendment. There are twenty sources of revenue currently allocated to the provinces under Item 36 of the Provincial List. 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 license taxes, motor vehicle license fees and court fines are the other substantial revenue sources. However, implementation of Turnover taxes on wholesale and retail sales (paragraph 36.1), motor vehicle license fees (paragraph 36.4), and taxes on mineral rights (paragraph 36.18) are within some limits and subject to such exemptions as may be prescribed by law made by Central Parliament (Welikala, 2016).

Of these main sources of revenue, the Turnover Tax had replaced with the Nation Building Tax in 2010 through a government circular. It was recommended that PCs be allowed to directly collect turnover taxes. It was further recommended that procedures and limitations be established in the constitution to limit the Central government's ability to control the taxation powers devolved to the provinces. Section 2 of the PCs Turnover Taxes (Limits and Exceptions) Act No. 25 of 1995 imposes restrictions on the turnover taxable by a provincial council in the following ways: the rate of tax imposed by a PC shall not exceed five percent of the turnover, and PCs must mandatorily exempt wholesale or retail sales by the manufacturer of goods, wholesale or retail sales by co-operative societies, or wholesale or retail sales to buyers outside Sri Lanka are permitted only to the extent permitted by law made by Parliament (Waidyasekera, 2005, Welikala, 2016). Furthermore, enabling legislation in the form of Financial Statutes have been passed by the respective PCs with effect from January 1, 1991, to empower them to recover the relevant taxes and fees.

With limited tax raising powers of PCs in Sri Lanka under the 13th Amendment, they are considerably dependent on transfers from the Central Government[8]. Sri Lanka has a Finance Commission established under Article 154R of the 13th Amendment, which is somewhat similar to the Finance Commission of India, although the latter's mandate appears to be far wider than its Sri Lankan counterpart's constitutional sphere of activity. The Finance Commission is charged with the duty of recommending to the President the principles to be employed in allocating funds to provinces and for the due apportionment of such funds between the provinces. The Constitution states that the commission must consider "the need, progressively, to reduce social and economic disparities" (154R (5) (c)). Thus, it was recommended that the constitution make provisions concerning the amount of funds to be transferred to the provinces by the Centre (Ganeshathasan & Mendis, 2015). Such transfer procedures from Central Government to local governments are common characteristic in a federal system which ensured adequate financial resources in relation to expenditure responsibilities to each level of governments. In addition, external resources are always channeled through central institutions, and a limited form of intergovernmental relations. This borrowing ability, however, has its limitations both legally and commercially. 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 must be channeled through the Central Government and would be project oriented (Waidyasekera, 2005).

Fiscal/ Financial Power of Local Governments in Sri Lanka

The powers and functions of the local authorities are mainly derived from the relevant legislations i.e., the Municipal Council Ordinance No. 29 of 1947, the Urban Council Ordinance No 61 of 1939 and the Pradeshiya Sabha Act No 15 of 1987. Financial arrangement for local governments has also noted in the Municipal Council Ordinance No. 29 of 1947, the Urban Council Ordinance No 61 of 1939 and the Pradeshiya Sabha Act No 15 of 1987. As the third tier, local authorities are responsible for collection of local taxes and user fees, as well as other sources of revenue such as property rates and

[8] Transfers come as Block Grants, Criteria Based Grants and Development Grants.

assessments, revenue grants for salary and rents. Locally raised taxes must be levied within limits prescribed by national government. In addition, national government provides grants/ financial transfers to cover salaries in whole or in part and to meet the monthly allowance payable to councilors and the Local Loan and Development Fund (LLDF) is, a statutory body established under the Local Loans and Development Ordinance No.22 of 1916, providing over LKR100m of loans per year to local government at below-market rates, with a focus on investment needs and infrastructure development.

Operational Status of Fiscal/ Financial Devolution

Most integral part of power devolution to sub national governments is the fiscal and financial devolution. Also, fiscal relations across different levels of government are a key determinant component of the institutional framework that can affect regional convergence and inequality across territories. If the financial devolution is not perfect, the power devolution process is weak and does not work properly. As Gulati (1994) stated "the functional decentralization will remain on paper is a corresponding financial devolution is not made will be generally accepted". Specially, if the fiscal federalism is not perfect, if there is no locally determined tax regime, SNGs cannot raise funds on their own. Therefore, allocation of functions and responsibilities to SNGs should match with financial powers and funds are put at their disposal without many constricting conditions. Ideally speaking, the SNGs should have adequate powers to raise matching resources of their own. It is important in this study that to explore the extent of fiscal devolution in relation to Sri Lanka.

Power and Limitations of Fiscal/ Financial Devolution: Sri Lanka

The devolution of powers and functions on provincial councils in Sri Lanka are largely based upon the powers and functions of the States in India (Welikala, 2016). The 13th Amendment to 1978 Constitution of Sri Lanka indicates the "devolved subjects" to the PCs under List I, while categorizing the "reserved subjects" for the central government under List II. This specifies the reserved subjects as "national policy on all subjects and functions." In addition, the List III specifies the "concurrent subjects" those concurrently managed by the Centre and the provinces. To execute the functions in the list I and concurrent list, Provincial governments need a considerable number of financial resources annually. Nonetheless, a significant amount of money has been paid out by the PCs annually to run the administrative mechanism of nine PCs in the country, particularly for salary payments and logistics items. This annual required money does not fulfil from revenue of the PCs earned, but largely come from the Central Government allocations. Following table shows the PCs tax earning and its size compared to the Central Government earning and the GDP percentage in Sri Lanka.

Table 2: Revenues of PCS in Relation to Government Revenue 1999 – 2022 (Rs. Million)

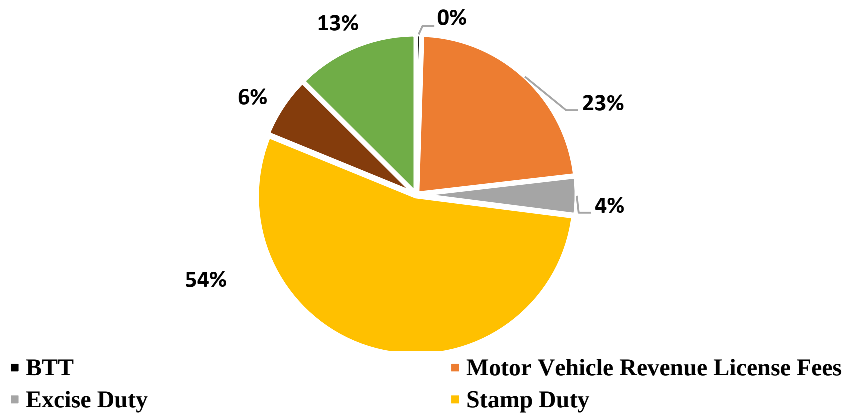
ITEM	2001	2004	2007	2012	2015	2018	2020	2022
Central Government total Revenue	234,29 6 (16.6)	311,43 7 (15.3)	565,05 1 (15.8)	1051,46 0 (13.9)	1454,87 8 (13.3)	1919,97 3 (13.4)	1367,96 0 (9.1)	1979, 184 (8.2)
Provincial Total Revenue	8,674 (0.6)	13,522 (0.6)	25,868 (0.7)	49,235 (0.6)	67,972 (0.6)	88,689 (0.6)	52,245 (0.3)	73,79 3 (0.3)
% Of Provincial Total/Governme nt Total Revenue	3.7%	4.3%	4.6%	4.7%	4.7%	4.6%	3.8%	3.7%
Central Government Tax Revenue	205,84 0 (14.6)	281,55 2 (13.8)	508,94 7 (14.2)	908,913 (12.0)	1355,77 9 (12.4)	1712,31 8 (11.9)	1216,54 2 (8.1)	1751, 132 (7.3)
Provincial Tax Revenue	7,539 (0.5)	11,544 (0.5)	21,473 (0.6)	41,657 (0.5)	61,476 (0.6)	82,228 (0.6)	43,096 (0.3)	59,89 4 (0.3)
% Of Provincial Tax/Government Tax Revenue	3.6%	4.1%	4.2%	4.6%	4.5%	4.8%	3.5%	3.4%

Note: Figures in parenthesis denote percentage/GDP.

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

Above Table No 02 shows the amount of revenues that the Provincial Councils of Sri Lanka collected from their own domains. It is demonstrated that the total revenue of all PCs as a percentage to Central Government total revenue is less than 5% and 0.6% as a percentage of GDP. The rates of tax revenues are reflected same pattern and more than 95% tax revenues collected of the country belong to the Central Government. Another salient feature of this revenue collection is that the PC of Western Province collected about 45-50% from total revenue collections of nine PCs. In other words, the size of revenue collection of Provincial Governments is relatively small except the Western Province. Further, there is an unequal revenue base in provinces. As mentioned in the Ninth Schedule to the Thirteenth Amendment and its devolution part of taxes, tax income comes from the turnover taxes and stamp duties while license taxes and motor vehicle license fees and court fines are the other substantial revenue sources. From Provincial revenues, main contributors are Stamp duties and Motor vehicles license fees, which recodes about 80%. However, the power of Turnover Tax collection on wholesale and retail had been given to the PCs since 1991 and it was a largest percentage in the early years of 1990s. In 1998, introduced the Goods and Services Tax in place of Turnover Tax (abolished Goods and Services Tax in 2002 and introduced Value Added Taxes). Converting remaining amount of provincial turnover taxes into Nation Building Tax (NBT) since 2009, collection of NBT removed from the PCs and now all sales taxes are collected by the Central government and the collection of NBT goes back to the PCs as transfers[9]. However, the collection of stamp duties in some limits are remaining and part of stamp duties are also collected from the Central Government and Transfers to the PCs. Particularly, showing an interesting characteristic in federal framework in Sri Lanka, almost all revenue is collected by the Central government whereas expenditures are highly decentralized and regional finance most of their obligations to deliver public services via transfer from the central government (a mix of conditional and unconditional transfers). Following Figure 01 shows that revenues receiving of the PCs in different sources by present.

Figure 01: Revenue Collected from Devolved Sources of the PCs - 2018



Source: Finance Commission, Annual Report 2018

Note: Others include rents, interests, examination fees, sale of capital assets, Betting tax etc.

Furthermore, the transfers of NBT revenues and stamp duty from the Central Government to the PCs accounted about 40-45 per cent and 40 per cent of total tax revenue of PCs, respectively. Revenue collection from fees and charges, which accounts for around 75 per cent of total non-tax revenue of PCs. Altogether, the revenue collection of PCs is covered only about 15% of PCs' total expenditure. The largest percentage of expenditures of PCs is recurrent expenditure, which indicates more than 90%. This happens mainly due to higher expenditure on personal emoluments and the maintenance cost of roads and irrigation, the personal emoluments are recorded about 70% from total expenditures and continued to be the single largest item in the recurrent expenditure. The capital expenditures of PCs are only about 5-10%, being a considerable issue of PCs in the country in relation to development role. Indeed, this

[9] National authorities such as the Commissioner General of Inland Revenue, the Director General of Customs, and the Commissioner General of Motor Traffic, has to be transferred to the provinces on the following basis: NTB 33%, Stamp Duties 100% and Vehicle Registration fees 70% (Finance Commission, 2018).

can no longer be justified. Huge amount of money is spent for survival, which is in fact wasteful. Further, regular delays in disbursements of funds by the Treasury has led to greater liabilities and provincial council's inability to meet their commitments, which in turn impact their credibility and image. In certain instances, a lack of proper financial control by some of provincial councils has led to mismanagement of funds.

As shows in Table No 03, transfers of Central Government to the PCs are come in different forms. They are Block Grants, Province Specific Development Grants (PSDGs) and Criteria Based Grants (CBGs). The amount of these grants is decided by the Finance Commission of Sri Lanka under the given criteria. The Block grants are the major form of central government transfers to PCs, and it provides for recurrent expenditures of the PCs. As show in the above Table No 03, a largest percentage of transfers come from the Block Grants which is currently more than 90%. The transfers under PSDGs, grants for special projects and CBGs are about 4% and 1% respectively which basically come under the capital expenditures category.

Table 03: Financing the Expenditure of the PCs (Rs. Millions)

Item		2000	2005	2010	2015	2020	2022
TOTAL EXPENDITURE		37,328	73,009	145,491	269,586	337,006	392,512
TOTAL REVENUE		7,534	16,132	36,829	67,972	52,245	73,793
	FINANCING THE DEFICIT						
CENTRAL GOVERNMENT TRANSFERS		31,543	59,696	107,032	201,614	284,761	318,719
1. Block grants out of Central Government transfers		76%	79%	80%	83%	93%	93%
2. Criteria based grants out of Central Government transfers		4%	2%	2%	2%	1%	0.2%
3. Specific development grants out of Central Government transfers		18%	9%	11%	7%	4%	1.6%
4. Foreign grants for specific out of Central Government transfers		2%	10%	7%	8%	2%	4.4%

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

Note: In some years, the deficit is not equal to Central Government transfers due to differences of matching grants and specific development grants.

During the period after 2000, a share of 85 per cent of the total expenditure of PCs was financed through the Central government transfers reflecting the need to enhance the revenue collection of PCs, thereby to ease the burden on the Central government budget. Depending largely on transfers in financing the budget of PCs has in one side been lessening the taxing power of PCs further and creating of new revenue sources. Nonetheless, there is an inefficient impact on allocation financial resources, expenditure management and accountability. Regarding that, Bartolini et al. (2016) explain that subnational governments that rely on own resources, rather than transfers from the central government, tend to allocate more spending to economic rather than social areas (i.e., local policies related to investment and the business environment). Similarly, Kappeler et al. (2013) show that higher tax decentralization is associated with a shift of local spending towards investment in infrastructure and education.

Revenue Capacity and Fiscal Potential

The main fiscal weakness in the provincial council system in Sri Lanka 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. Meantime, inadequate financial capacity, duplication of work and lack of clarity in devolved functions hinder effective service delivery. Further, lack of effective authority over finances and human resources and lack of skills in enactment of statutes by provincial staff have contributed to weakened provincial administration and there is a lack of motivation to introduce imaginative or innovative revenue enhancing measures or schemes within the province. Despite the limited devolved powers in enactments of statutes for new avenues for taxes, it has been again controlled by the Centre under some limitations, prescribed by law made by Parliament and the dominance of central bureaucratic institutions, and non-implementation of the 13th Amendment to the 1978 Constitution fully. A limitation on revenue raising has been observed for almost all the taxes imposed by the PCs. For example, Turnover taxes on wholesale and retail sales, motor vehicle license fees, and taxes on mineral rights are within such limits and subject to such exemptions as may be prescribed by law made by Parliament. Enumerated Taxes on lands and buildings including the property of the state also, and other taxes within the province to raise revenue for provincial purposes are permitted only to the extent permitted by law made by Parliament. In brief, the 13th Amendment shows that it does not allow provincial councils any serious autonomous revenue raising power, instead opting for direct grants from the Centre and a limited form of revenue sharing.

Limitations of the Central Government Transfers

The annual gap between the revenues expenditures of PCs is financed by the Central government transfers which comes on the recommendation of the Finance Commission. The amounts of transfers given to the PCs are decided by the finance Commission to the stipulated criteria[10]. Decision over the transfers is not one and only role of the

[10] According to the horizontal equalization, the Commission is to formulate the principles necessary to achieve balanced regional development across the country. In doing so, the Commission considers (a) the population of each Province, (b) the per capita income of each Province, (c) the need, progressively, to reduce social and economic disparities, and (d) the need, progressively, to reduce the difference between the per capita income of each Province and the highest per capita income among the provinces.

Finance Commission in relation to the PCs. It has a somewhat broader role in fiscal and financial management. In fact, the function of the Finance Commission is to maintain 'vertical fiscal imbalance', i.e., setting of revenue raising powers of PCs and the equalization of horizontal fiscal imbalances among the PCs. The horizontal equalization is allocation of finance to regional disparities in economic development and wealth, arising from natural or geographical, economic, or political factors. Specially, the duty in financial allocation of the Finance Commission in the adjustment of the vertical fiscal imbalance is to make recommendations to the President as to the principles on which funds allocated annually by the central government budget to the provincial level should be apportioned between the various Provinces. In this situation, there is not an autonomous decision-making process to the PCs in relation to the financial transfers. It has been controlled by the Central Government allocation procedures and authorities. Nonetheless, there is neither direct provincial representation nor provincial involvement in this process which has been a major weakness in the process of financial allocation of PCs.

In addition, the Governor as the President's representative makes the rules governing all aspects of provincial finance, including the Provincial Fund and the Emergency Fund of the Province. Financial oversight of the provincial administration is to be carried out by the PC, and further oversight by the Governor and Parliament was deemed an unnecessary intrusion into provincial autonomy by the Centre. Meanwhile, the Governor's discretionary powers regarding provincial financial statutes are significant: all statutes involving revenue or expenditure can only be introduced, moved, or passed by the PC on the prior recommendation of such a statute by the Governor; all demands for central grants to the Provincial Council require the Governor's recommendation; the annual budget of the provincial administration is presented to the PC by the Governor[11]. All these reflect an interference of the Executive authority and the Central Parliament of the country in financial and fiscal matters of the PCs.

[11] It is regarding the procedure for fiscal and financial statutes in the Provincial Councils that the Governor's powers are most visible, and least compatible with democratic and devolution principles. The Governor makes the rules governing all aspects of provincial finance, including the Provincial Fund and the Emergency Fund of the Province. The Governor presents the annual budget of the provincial administration to the Provincial Council showing the estimates of receipts and expenditure, and he must recommend all demands for grants made to the Provincial Council. While the Provincial Council has the authority to approve the annual budget, the consequent Appropriations Statute is subject to the assent of the Governor (Walikala, 2016).

The PCs Autonomy on Borrowings

Borrowing authority in Sri Lanka remains centralized. Under the 13th Amendment PCs may only borrow from the central government to the extent allowed by Parliament (*vide* s. 19 (1) (c) of the PCs Act No. 42 of 1987 and paragraphs 35 and 31 of the Provincial List). Regarding this Herath (2009) has stated that the PCs are allowed to maintain a provincial fund and raise loans, which somewhat offset limits on revenue generation via taxation. As well as, external resources are always channeled through central institutions, and a limited form of intergovernmental relations. Foreign funding, hence, obtained by the central government for projects falling within provincial subject matter should be directed to the provinces and international borrowings by regional administrations shall be subject to criteria and limitations specified by Parliament which requires the concurrence of the central Minister of Finance.

Fiscal/ Financial Power of the Local Governments of Sri Lanka:

The fiscal and financial powers of the local authorities are mainly derived from relevant legislations. The legislative clauses are clearly clarified the scope and responsibility of local authorities in provision of assigned services to the public and types of local taxes and user fees that can be collected from their domain. Basically, the local government revenues are mainly come from assessment rates, rent, license fees, charges for services and capital receipts respectively. However, the local governments do not have an autonomous authority in operation of service delivery and collection of charges, which are often regulated under the rules and scrutiny of the Central government. This control has been existing for many decades, particularly from prior to the independence and after 1948, the local governments have been operating under the line ministry of the Central Government. This has been further broadened with commencement of PC system since 1987 and hence the supervision of local governments has become a devolved subject of the provincial governments under the Sri Lankan Constitution.

By present, the Sri Lankan local government system does not have a strong fiscal and financial capacity as it is not an autonomous governing structure. The local governments have limited own sources of revenue with procedural constrains for enhancement of own sources especially regarding property taxes; limited use of powers conferred to it regarding taxation. Therefore, the local governments have a high dependence on fiscal transfers of the Central Government. As Smoke (2015) statedfrom a fiscal perspective, local governments in Sri Lanka are heavily dependent on central and provincial government transfers and loans. Own source revenues, which include property taxes, user fees and licensing charges, account for less than one percent in total public sector revenue. Of these existing revenue sources, the stamp duty on the transfer of property and court fees are largest respectively. Altogether, it is very clear with its receipts that the revenue grants including stamp duties (35%), capital receipts (14%), assessment rates (14%), license fees (11%) of the total revenues. When the revenue receipts are compared, from this total collection 40-50% is collected by the Municipal councils and 40-45% is collected by the Pradeshiya Sabhas and less than 10% is collected by the urban councils (Ministry of Local governments, 2021). Furthermore, it is to be noted that the local government own source revenues, which include property taxes, user fees and licensing charges, account for less than 1% in total public sector revenue. As a result, from the fiscal perspective, local governments in Sri Lanka are heavily dependent on central and provincial government transfers and loans. Meanwhile, the local governments have taken funds from external sources such as funds through private sector partnerships; community level interventions; loans /local loan development fund/over drafts from banks for short term financing.

Trends of Expenditures of the PCs and Local Governments in Sri Lanka

The revenue receipts of PCs are utilized to finance different expenditures annually. These expenditures as a percentage of GDP are annually laid between 2-4%. The largest percentage of these expenditures is utilized for recurrent expenditures and the recurrent expenditure for all provinces significantly outweighs capital expenditure annually. Personal emoluments account for more than 60% of this total recurrent expenditure (Table No 04) and the total amount of recurrent expenditures has been increasing continuously for the last couple of decades mainly due to the increase in personal emoluments, which continued to be the single largest item in recurrent expenditure of PCs. The education and health sectors absorbed a major portion of the personal emoluments of PCs accounting for nearly 90 per cent of the total expenditure on personal emoluments. The capital expenditures of the Local Governments are mostly used for building of capital assets and the rest spends largely for repair capital assets & supply of Equipment etc.

Table 04: Expenditure Classification of the Pcs in Sri Lanka 2000 -2022

Expenditure Item	2000 %	2005 %	2010 %	2015 %	2020 %	2022 %
1. Recurrent Expenditure	77	81	83	81	86	97
O/W Personal Emoluments	*59*	*64*	*65*	*63*	*67*	*78*
2. Capital Expenditure	23	19	17	19	14	2.4
Total	100	100	100	100	100	100

Source: Central Bank of Sri Lanka

SWOT Analysis on Improvement of Revenue Capacity

Sub national government system in Sri Lanka has been operating for last couple of decades. The role which has been done by these governments for peoples is more or less successful. Main obstacle of this unsuccessful operation of Provincial Governments in Sri Lanka is inadequate financial resources. Reason for inadequate financial resources is not just the limited tax incomes; the Provincial Councils do not use their maximum ability in tapping financial resources within the given constitutional power. In addition, some administrative and legal procedures have also been hampering this process. As a result, SNGs in Sri Lanka are largely dependent on outside sources and special grants etc. If these considered all together, it is clear that there is an imperfection in current devolution packages in Sri Lanka, particularly in the fiscal/ financial devolution. It is generally assumed that inter-governmental transfers should be minimized and strengthening, and broadening own financial bases requires the creation of an adequate tax-base. With this, revenue base of local governments becomes a long term uninterrupted revenue base which certainly enables an effective operation in service delivering.

Table 05: SWOT Matrix 0n Fiscal Devolution in Sri Lanka

Strengths	**Weaknesses**	**Opportunities**	**Threats**
1. Political will of Central Govt. 2. Devolution of Financial statutory power 3. Establishment of Finance Commission 4. Financial support from Central Govt. 5. Ensure management of resources & skill transferred 6. Effective involvement of locally elected members 7. Strengthening the collaboration of decentralized institutions 8. Existence of local budgets/ development plans 9. Enhanced local partnership for financial resources mobilization	1. Weak financial Capacity of Centre 2. Weak implementation of decentralization laws and policies 3. Inconsistency in financial resources transfer 4. Resistance from central government 5. Limited financial resources to local governments 6. Weak coordination & communication between local governments 7. Weak coordination with central departments 8. Partiality in financial resources transfer by the central Govt. 9. High politicization of financial resource transfer process 10. Ad hoc limitation and measures on financial transfer	1. International/ Global trend 2. Existing legal provisions 3. Financial resources availability 4. Best practices of other countries 5. Availability of untap revenue sources 6. Collaboration with decentralized departments	1. Risk of politicization 2. Misuse of resources 3. Social and political crisis 4. Misuse of financial resources 5. Financial corruption 6. Lack of cooperation between some decentralized departments 7. Regional poverty 8. Loopholes of laxation laws

This SWOT analysis examines the existing avenues and stimulations for improvement of financial capacities of local government systems in Sri Lanka (Table No 05). As stated in above Table No 05, there is a massive strength and an opportunity in improvement of local government capacity, especially financial capacity which is most cited strength. Basically, political willingness is indeed available in both countries for this. Similarly, required legislative provisions have set up and improvement should be done where necessary, both countries have built the required legitimate foundation. The weaknesses imply that the areas should be concerned for reformation and the opportunities are endorsing their possibilities.

Conclusion

Power decentralization to sub national governments is a universal practice which brings government closer to citizens, creating conditions for the democratization of governance and for increasing its effectiveness. Political decentralization aims to give citizens or their elected representatives more power in public decision-making and balanced development in a country with shifting responsibilities and resources to subnational units of government. Constitutionally the national government in Sri Lanka has given somewhat self-ruling rights to Provincial/regional governments while local governments are operating under the both the Central Cabinet and the regional governments. However, the financial capacity of regional governments/ local governments is a major weakness in Sri Lanka. There are many reasons for this. One reason is that the Central Government of Sri Lanka has not devolved their full power on fiscal and financial management to regional and local governments and hence there is a significant controlling mechanism on revenue collection and expenditure with various regulations, limitations, and directions. Specially, a more strength of taxation power has been held by the Central Governments in both counties from the beginning. However, deficit gaps of revenues that need to finance annual expenditures of regional/ local governments are filled out by financial transfers of Central Government alternatively.

Under these fiscal and financial arrangements, the regional/ local governments in Sri Lanka is facing an unsatisfactory financial capacity every year. Reason for such a situation is inadequate power on revenue generation and the limit of tax earning sources. This is further weakened by non-implementation of existing tax power of regional governments. The existing power is utilized in two ways-- the regional governments do not utilize their granted statutory power in detecting new tax sources and the devolved power to the regional governments has not been transferred fully by the Central Government in implementation of relevant legal procedures. Indeed, not implementing of given taxing power is a practical problem which leads to reduce the annual revenues of the regional government in Sri Lanka. Nonetheless, the Central government does not provide annual transfers in required level due to existing limitations and shortage of funds. As a result, annual revenues of both regional governments and local governments in Sri Lanka never meet the anticipated annual expenditure. Furthermore, according to these devolved fiscal and Financial Power to Provincial and local governments in Sri Lanka, there is limited power for borrowing from outside sources and to get direct grants from foreign sources. Specially, borrowing authority in Sri Lanka has remained centralized and the PCs are allowed to raise loans, which somewhat offset limits on revenue generation via taxation. Also external resources are always channeled through central institutions, and a limited form of intergovernmental relations. Regarding local governments, there is a highly controlled and reliant power that the local governments can take funds from external sources such as private sector partnerships, local loan development fund from banks for short term financing. The regional/ local governments in Sri Lanka have been operating for last many decades under the above mentioned fiscal and financial power with some required reforms and modifications time to time, considering adverse consequences and demands of local authorities. However, as usual in power decentralization processes in the World Sri Lanka has also not devolved a complete financial authority to the local governments similar to devolving functional responsibilities. As a result of significant financial paucity of local governments there is a huge demand for a more financial power in both countries. Nonetheless, Sri Lanka is reflecting a significant avenue for further reformations of the existing legitimate framework and demanding extra power in potential boundaries of power decentralization.

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