

Provincial and Local-level Revenue Assignment in Fiscal Decentralisation in Sri Lanka

Sri Lanka, in 1988 through a constitutional amendment, devolved responsibility for providing "public services" to Provincial Councils. While there existed a system of local government established by law providing public services at the local level, provincial councils constituted a radical departure in the provisioning of public services. They were hitherto, nationally defined, sectorally oriented, and delivered through local-level agents accountable to the centre. Creation of an intermediate tier of taxing and spending established a system of multi-level governance in Sri Lanka.

Assigning Revenues for Service Provision Responsibilities under Decentralisation

The case for devolution of power to sub-national levels rests on their ability to understand better and address more efficiently the differing needs of regions and communities on account of their proximity to them. This would thereby enable more responsive provision of public goods and services and foster greater efficiency in the allocation of resources. The matching of public functions with appropriate levels of decision-making power and responsibility for the provision of public services constitutes the framework for fiscal aspects of devolution. Then devolution provides the governance mechanism through which the delivery of public services can be designed to meet the needs of the people.

In a system of multi-level government, the assignment of subjects between the different tiers follows the simple principle¹ of which level is in a better position to carry them out in a more responsive and hence more efficient manner. Importantly, the principles of decentralisation also suggest that fiscal resources available to each level of sub-national government should be proportional to the share of the level in the public sector expenditure burden. The choice of the appropriate structure of fiscal resources (comprising a mix of taxes, user charges and transfers) should be open to choice depending upon the spending responsibilities of the tier of government.

Usually, the question of spending responsibilities precedes the question of how resources are to be generated to pay for spending. However, these decisions cannot be separated one from the other. It is generally argued that the financing of decentralisation should follow "benefit pricing" or benefit taxation.² The assignment of tax revenue in multi-level governments can follow three options, where local jurisdictions collect all taxes and transfer some revenue upwards for the national level to meet its spending responsibilities, national government collects all taxes and transfers revenues adequate to meet spending responsibilities at the local level, or assigning to the local level some taxing powers and complementing, if necessary, local revenue with grants transferred from the national government.

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Revenue Assignment at Provincial and Local Levels

The purpose of local taxes is to finance locally-provided public services to local residents. Then the assignment of revenue to sub-national entities should enable each level of government and each entity within each level to finance its own budget independently on its own criteria, in packaging the bundle of public services to meet the needs and preferences of the citizens living within the jurisdiction. The principles of decentralisation assert that the assignment of public expenditure powers to provincial and local levels must be matched by adequate finances to meet such needs.

The financing of decentralisation takes place within the framework of the 13th Amendment to the constitution. The following are the core constitutional provisions:

- i. Assignment of expenditure and revenue powers in terms of the Provincial List in the Ninth Schedule to the Constitution.
- ii. Guarantee of the allocation of funds from the annual budget to meet the needs of the provinces.
- iii. Apportionment of such funds between the Provinces on the basis of principles formulated by the Finance Commission in terms of

the following criteria set out in the constitution:

(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) Progressively reduction of the differences between the per capita income of each Province and the highest per capita income among the Provinces”.

Provincial Revenue Assignment

Provinces are assigned with a large number of tax and non-tax revenue sources shown in Box 1.

However, the provincial tax base is miniscule. It is noteworthy that the sources with any significant

Table 1: Provincial Revenue Collection (Rs millions) by Source in 2004 and 2008

Source	2004	%	2008	%
Business Turnover Tax	5,912	44.38	16,641	53.04
Motor Traffic Fees	1,668	12.53	2,812	8.96
Excise duty	259	1.95	467	1.53
Stamp Duty	3,761	28.23	6,023	19.19
Court Fines	579	4.35	1,054	3.35
Other	1,140	8.56	4,373	13.94
Total	13,319	100	31,370	100

Source: Finance Commission Annual Report, Ministry of Provincial Councils

potential, such as, turnover taxes on wholesale and retail sales, motor vehicle licence fees, and taxes on mineral rights, are within such limits and exemptions as may be prescribed by law made by the parliament. Further, taxes on land and buildings including the property of the State and any other taxes within the province to raise revenue for provincial purposes are only to the extent permitted by the

parliament. Thus, provinces can not act on the revenue powers assigned by the constitution without approval of the parliament. At the same time, provinces cannot introduce any new revenue measures. Thus, provinces are severely constrained in mobilising revenues.

Provincial revenue collections in 2004 and 2008 are shown in Table 1.

Box 1: Tax and non-tax Revenue Sources of Provincial Governments

1. Tax	36.1 Turnover taxes on wholesale and retail sales 36.2 Betting taxes 36.5 Dealership licence taxes on drugs and other chemicals 36.17 Taxes on lands and buildings including property of the State to the extent permitted by Law 36.18 Taxes on mineral rights within limits and exemptions as prescribed by Law 36.20 Other taxation within the province in order to raise revenue for provincial purposes to the extent permitted by Law
2. Duties	36.6 Stamp duties
3. Fees and Charges	36.3 Toddy 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 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 List I 36.12 Fees under the Fauna and Flora Protection Ordinance 36.13 Fees on lands alienated under 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 revenues, and survey and maintenance of land records for revenue purposes 36.19 Licence fees on possession, transport, purchase and sale of intoxicating liquors
Non-Tax	
1. Rents	36.3 Arrack and toddy rents

Source: The 13th Amendment to the Constitution:

While there are twenty items of revenue assigned to provinces, only three sources account for as much as ninety percent of total revenue. These are Business Turnover Tax on wholesale and retail sales, Motor Traffic Fees and Stamp Duty and Court Fines that are collected and transferred to local government authorities. While provincial revenue collections have improved significantly (by 30%) during the last five years, the respective shares of the provinces have remained relatively unchanged. Business Turnover Tax remains the main source of own revenue accounting for as much as half of all revenue collected. Therefore, despite the large number of sources assigned, the tax assignment to provinces under the Thirteenth Amendment is weak and ensuing revenues are low by any standards.

The provincial revenue structure has remained unchanged over the past two decades of fiscal devolution continuing to mobilise less than a fifth of expenditure needs at current levels of service delivery. Provinces collect less than 0.5% of GDP (gross domestic product) suggesting that the overall tax effort is inadequate. Provinces have been constrained in their tax operations by the limits of revenue assignment and inability to make any policy changes within those limits due to the failure on the part of the centre to have engaged the provinces in tax harmonisation.

Local revenue assignment

Local government bodies have a range of tax powers. The respective legislation establishing local government bodies; Municipal Councils, Urban Councils and *Pradeshhiya Sabhas* empowers them to take necessary action to ensure that adequate revenue generation takes place to provide the services that they are required to provide. The revenues of local authorities are usually classified into own revenue and contributions and

Box 2: Revenues Source of Local Government Authorities

1. Tax	Assessment Rates, Vehicles and animal tax, Entertainment tax
2. Duties	Stamp duties
3. Fees and Charges	Licence fees, Court fines, Public performance fees, Service charges, Warrant costs
Non-tax	
1. Rents	Rents
2. Miscellaneous	Tolls, Building application forms etc.

Source: Local Government Acts and Ordinances

Table 2: Receipts (in Rs million) of Local Government Authorities in 2003 and 2008

Source	2003	%	2008	%
Rates	2,726	22.16	3,514	13.41
Other Revenue	3,351	27.25	6,650	25.40
Stamp Duty	1,261	10.26	3,842	14.67
Government Transfers	3,311	26.92	6,241	23.83
LLDF Borrowings	330	2.69	362	1.39
Other Receipts	1,319	10.72	5,578	21.30
Total	12,301	100	25,804	100

Source: Finance Commission Annual Report, 2004 and Provincial Councils.

allocations of funds by government. Box 2 shows the sources of own revenue assigned to local authorities.

The significance of the above sources of local revenues is different according to the type of local government body. Thus, for Municipal Councils and Urban Councils, the main source of revenue is the assessment rates or the property tax. For *Pradeshhiya Sabhas*, the main source of revenues will be the rents on commercial stalls and *polas*. Local government authorities have greater control over their revenue in terms of the revision of rates. In fact, local government authorities must revise assessments and rates of levy on a regular basis to follow the appreciation of property values resulting from urbanisation through enhanced service provided. Further, *Pradeshhiya Sabhas* are required to declare built-up areas to be able to levy property rates in order to generate revenues for further investment. The major complaint is that they do not do so.

Other sources of revenue include financial allocations received from central and provincial sources, especially the Decentralised Budget allocations of the Members of Parliament. The overall position in regard to the shares of the different sources of revenue of Local Authorities for 2003 and 2008 are set out in Table 2.

(Data on revenue and expenditure for LAs are not available in a complete data set. Data for two years is presented for comparative purposes and 2003 and 2008 are years for which data is available)

Transfer of resources to meet imbalances

The design of the fiscal framework for devolution to provinces results in a significant shortfall in revenue over expenditure. The revenue-expenditure gaps at central, provincial and local levels are given in Table 3.

Thus, overall provincial revenue accounts for 22.7% of total expenditure. The revenue-expenditure gap varies from approximately 40% in Western Province to as much as 95% in North Central Province. This makes provinces heavily dependent on central government financial grants to meet their expenditure needs.

As already noted, the constitution guarantees the allocation of funds from the annual budget to meet the needs of the Provinces. The deficit is financed through transfer of resources from the centre through allocation of funds annually from the central government's budget (Box 3).

Financial transfers to provinces constitutes an annual cycle. The grants structure does not provide for equalisation of fiscal capacity between provinces making the Provinces dependent upon centre, thereby giving the Centre financial control over the Provinces. Nor is it designed to take account of provincial relativities either of norms or costs. The Criteria-based Grant alone incorporates socio-economic indicators that allow provincial disparities in development to be taken into account.

Table 3: Revenue-expenditure Gap in Rs millions in 2008

	Revenue	Expenditure	Gap	%
Central	699,388	945,247	245,859	26.1%
Provincial	23,915	101,173	77,258	77.3%
Local	14,020	23,894	9,874	41.4%
Total	736,603	1070,314	333,711	31.2%

Source: Government Budget Estimates and Ministry of Provincial Councils.

While the constitution guarantees allocation of funds to meet the needs of provinces, consultation and recommendation of the Finance Commission, as is constitutionally required, is not mandatory and the final decision rests with the Government, i.e., the Ministry of Finance. The decisions by the government regarding the allocation of funds from the annual budget have not been based on a sharing of service provision responsibilities and have followed imperatives of central requirements that are increasingly incorporating service delivery programmes in devolved subjects and functions.

The financial transfers to local government authorities are as follows (Box 4).

For most local government authorities, central government

transfers (referred to as revenue grants) reimburse the costs of salaries and wages of staff, which is, on average, about 25% of their total income. For small local government authorities with limited revenue capacity, the share of central transfers can increase up to half of their total income. The other external sources of income, such as, allocations from Decentralised Budget (DCB) are also significant, especially for *Pradeshiya Sabhas*. They account for about 10 per cent of income of local government authorities.

External sources of finance thus become a significant factor in financing of local government authorities. Amounts vary from around 45% for Municipal Councils, 60% for Urban Councils and as much as 77% for *Pradeshiya Sabhas*. Borrowings do not figure

Box 3: Financial Transfers to Provinces

1. Block Grant	An un-conditional block transfer to meet assessed recurrent expenditure needs of Provinces. The need is estimated on the basis of the gap between the assessed recurrent expenditure for the Financial Year and revenue collection target set for the year.
2. Criteria-based Grant	A formula based block grant for development expenditures of Provinces. Provincial index is calculated on the basis of a set of indicators reflecting per capita income and socio-economic disparities and the population of each Province.
3. Matching Grant	A formula based block grant to reward revenue collection effort of Provinces. The grant is computed on the basis of the excess of actual collection of revenues in a given year against a "benchmark revenue" being revenue collected in a base year. (This grant has since been discontinued)
4. Province Specific Development Grant	A conditional grant to finance an infrastructure development programme in specified areas of provincial services.

Box 4: Financial Transfers to Local Government Authorities

1. Revenue Grant	Reimbursement of allowances of members and salaries and wages of all officials holding positions approved by the Department of Management Services.
2. Other receipts	Allocations to local authorities from programmes funded by the centre (especially the Decentralized Capital Budget) and province.

Source: Author's tabulation.

prominently in the finances of local government authorities. Thus, it is to be noted that local government authorities with a weak fiscal base are becoming increasingly dependent upon central government transfers for meeting the salaries and wages of staff and have little fiscal space to provide services in a meaningful scope and extent.

Borrowing Powers

Both, provincial councils and local government authorities are vested with borrowing powers. In the case of provincial councils, borrowing is subject to approval of the parliament and enabling legislation has not been passed. Local government authorities are vested with borrowing powers and borrow from the Local Loans and Development Fund (LLDF). As indicated in Table 2, borrowings constitute an insignificant source of local government authority financing.

Issues of Provincial and Local Tax Systems

Devolution of power under the 13th Amendment gives only limited autonomy to provinces in terms of setting rates, adopting comprehensive tax bases and establishing an efficient and credible revenue administration. On the other hand, the 13th Amendment guarantees the existing powers of local government authorities and thereby the powers in regard to taxation under the respective laws establishing them. There are several issues in regard to the provincial and local tax systems.

Issues of Design

In an efficient provincial and local tax system, the vertical transfers from the central government should

be to supplement own resources for financing provincial and local public services. However, as indicated in Table 3, the revenue-expenditure gap of the provinces in 2008 stood at 77.3%. In 2003, the vertical gap stood at 82.5%. While the reduced gap reflects improvement in tax effort, it would seem that revenues are supplementing grants rather than the other way about. In the case of local government authorities, the revenue-expenditure gap has increased marginally from 40.4% in 2003 to 41.4% in 2008. (Finance Commission) The revenue situation in respect of local government institutions is better than that of the provincial councils.

There are several design issues in the system of fiscal decentralisation that account for the weaknesses in the revenue position of provinces and local authorities.

i. The meagre sources assigned, as far as provincial councils are concerned, provide a narrow tax base. As noted above, only four of the sources assigned to provincial councils yield substantial revenue. All the "other" sources accounted for approximately 14% of total provincial revenue, up from 8.5% in 2004.

ii. Absence of incentives for exploiting full potential. In the case of provincial councils the tax revenues are deducted from the Block Grant. The Matching Grant that was introduced incentivise revenue collection was never honoured fully by the government in the allocation of transfers to make any sense as an incentive to enhanced tax effort. In the case of local authorities grant for the reimbursement of allowances of members and salaries and wages of staff removes any incentive to enhanced tax effort. Indeed it can have perverse incentives.

iii. The exclusion of Business Turnover Tax (BTT)³ did not make for good design of consumption tax implemented through Value Added

Tax (VAT), making for discontinuity in the tax system. It made for a separation of manufacturing from wholesale and retail trade making for tax on tax as well as evasion. The exclusion of the wholesale and retail trade from VAT along with the long list of exemptions of many unconventional items results in substantial tax evasion and erosion of tax base. Thus, in addition to the list of items excluded from BTT, the exemption of a range of local goods and services, such as, tea, rubber, gems and tobacco, have prevented provinces from exploiting potential tax bases.

iv. Some of the revenue sources assigned to provinces do not accrue to them. Stamp duties and Court fines must be collected and passed on to local government authorities. It is important to note that stamp duty and Court fines constituted 20% of total collection in 2008.

v. There is considerable variation across provinces in the tax collection performance both in terms of per capita collections and as a percentage of GDP.⁴ However there is no provision for equalisation in fiscal capacity.

Issues of Practice

i. *Low level of voluntary compliance:* At the provincial and local levels, there is a low credibility in the revenue departments due to low levels of voluntary tax compliance on the one hand and fewer cases being taken to the Courts system. There seem to be a system of agreed assessment wherein taxpayers generally escape payment of heavy penalties on detection of defaults. The system would tend to bring about collusion between the tax payers and tax officials.

ii. *Less efficient tax administration:* Yet, much of tax functions in the provinces are undertaken manually. Provinces are yet to introduce a meaningful threshold limits for registration and

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assessment of turnover tax. Adequate staff is not available in many provinces for introducing functional specialisation in tax administration. Hence, provinces do not practice the in-depth assessment of selected high-risk taxpayers than a casual assessment of all taxpayers. The practice does not serve to enhance the credibility of the provincial tax department.

iii. Poor information base and absence of sharing information between the province and the centre. Inadequate adoption of information technology prevents provinces from establishing proper information bases. Further, there is no mechanism for sharing of information between central government tax agencies and provincial tax departments.

Issues of Capacity

Lack of adequate capacity at the provincial level: There is no proper system of improving technical skills for developing tax systems and enforcement strategies at the provincial level. There is no proper arrangement for training of provincial tax officials.

Assessing the Provincial and Local Tax Systems

The assessment of the performance of the provincial and local tax systems should be made in the

context of the performance of fiscal decentralisation. Fiscal devolution has not brought about a meaningful allocation of resources to provincial and local levels. It has created a mis-match between public functions assigned to provincial/local bodies and fiscal capacity required by them for those functions. Though the fiscal devolution is precisely to enhance potential to better address the varying needs of different regions and therefore of communities, significant fiscal imbalances in provincial finance has imposed limitations on its capacity to provide services.

Thus, the fundamental issue of fiscal devolution in Sri Lanka is as to how provinces could be established in fact as efficient and accountable providers of public services instead of being merely enjoying constitutional status. An appropriate design by itself is not sufficient to ensure the success of fiscal devolution, a commitment to devolution is necessary to bring about the potential welfare gains of fiscal devolution. The operational experience of fiscal devolution in Sri Lanka raises fundamental questions about the ability of the system of intergovernmental transfers to lead to efficiency enhancing equalisation of fiscal capacity of the Provinces.

Conclusion

The foregoing analysis of the revenue assignment shows that the

revenue raised from the sources assigned to provincial councils and local government authorities are not large enough to create significant fiscal autonomy and flexibility in service provision. The aggregate revenue raised by the provinces from own sources financed only a negligible proportion of their total revenues. There is no provision for equalisation of fiscal capacities to enable all provincial and local councils to provide services at a minimum level and standard. There is a need for a fundamental reform of the decentralised tax systems to enable the decentralisation to meaningfully perform service provision roles and responsibilities.

Footnotes:

¹ Referred to as the "principle of subsidiarity", it argues for a bottom-up arrangement in the location of responsibility for the provision of public services in terms of the relative efficiency of the different levels in their performance.

² The benefit rationale for local taxation argues that each (local) jurisdiction pay for its own benefits. For example public services enhance the value of local properties and therefore the owners of properties must pay for those benefits.

³ BTT has been taken over by the Central government under the Budget Proposals for 2011.

⁴ Making Decentralization Work for the Benefit of the People of Sri Lanka, NIPFP, Delhi, 2007. ■