

## THE EXTENT OF FISCAL DECENTRALIZATION AND ITS CONTRIBUTION TO REGIONAL GROWTH: A CASE STUDY OF SRI LANKA

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### INTRODUCTION

Devolution of power is an accepted principle under good governance of which fiscal decentralization acquires a crucial role. Fiscal decentralization became a global trend mainly by the 1990s where many countries in the world (both developing and developed) began to devolve power from the center to the periphery (Smoke, 2001). This has few primary objectives which include the division of spending responsibilities and revenue sources between different levels of government (national/provincial/local) and giving more discretionary powers to sub-national/provincial/local governments to determine their revenue and spending patterns. Consequently, fiscal decentralization aims at a more balanced economic growth among provinces in a country rather than the center acquiring all benefits, and thereby, improving the well being of individuals.

Sri Lanka adopted fiscal decentralization with the enactment of the 13<sup>th</sup> amendment to the Constitution, and the Provincial Councils Act No. 42 of 1987. Currently there are 09 Provincial Councils and 336 local bodies functioning. These include Municipal Councils, Urban Councils and *Pradeshiya Sabhas*. Article 154R of the 13<sup>th</sup> amendment to the Constitution very clearly states the fact that the Government shall allocate adequate funds from the annual budget to meet the needs of the provinces and ensure that a balanced regional growth takes place. So, the important phrases to be noted here are *allocate adequate funds* and *ensure balanced regional growth*. This is sufficient evidence to prove what the Government intended to accomplish through fiscal decentralization in Sri Lanka, although its efficient implementation is subjected to rigorous criticisms at various junctures.

Despite the existence of the Provincial Councils in Sri Lanka for more than two decades, an Impact Analysis is yet to be performed on the existing mechanism. Needless to say that there are many criticisms leveled against the Provincial Council System citing the entire structure as a *white elephant* and causing wastage of resources<sup>2</sup>. Some even doubt whether decentralization has taken place at all, since the center still persists in possessing a fair degree of discretion in revenue distribution and spending independence. In short, has fiscal decentralization in Sri Lanka caused centralization of powers quite contrary to the doctrine of fiscal federalism? This has, in fact, curtailed the very existence of sub-national governments and made them mere entities than efficient public bodies (Amarasinghe *et al.*, 2010). Therefore, this study aims to provide a sound base to either appreciate or criticize the fiscal out decentralization process carried out so far using the accepted formulae in measuring the degree of decentralization in the economy. In this context, the present study entails two main objectives: firstly, to develop a statistical/mathematical mechanism to measure the extent of fiscal decentralization in Sri Lanka by using sub-national governments' expenditure and revenue data and secondly, to analyze the contribution made by the fiscal decentralization process to regional growth by using the Gross Domestic Product (GDP) and Provincial Gross Domestic Product (PGDP) data.

### METHODOLOGY

Measuring fiscal decentralization is a complex process which has no single or universally

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<sup>2</sup> The main issue to be discussed is whether the fiscal decentralization policies were able to achieve its intended outcome as per the 13<sup>th</sup> amendment to the Constitution rather than being further centralized.

accepted criteria. The present study has adopted the five-step process applied in The Philippines to measure decentralization intensity (Uchimura and Suzuki, 2009), which is a culmination of the expenditure and revenue approaches<sup>3</sup> in measuring decentralization. If the value calculated is closer to 1, then the degree of decentralization is high and vice versa.

The impact of fiscal decentralization on regional growth is analyzed using aggregate data on GDP for the time period under consideration. Here specific attention is on the ratio of fiscal revenue to GDP and the Provincial budget out-turn. This should necessarily be a foremost consideration when one looks back at the performance of GDP and provincial growth with the present degree of decentralization.

**RESULTS AND DISCUSSION**

**Table 1 – Results of the Fiscal Decentralization Indicators Measured for Sri Lanka**

| No.  | Indicator                                    | 2002  | 2004  | 2006  | 2008  | 2009  |
|------|--|-------|-------|-------|-------|-------|
| i.   | Prov. Share of Total Fiscal Exp. (ratio)     | 0.101 | 0.119 | 0.132 | 0.120 | 0.10  |
| ii.  | Prov. Share of Total Fiscal Rev. (ratio)     | 0.036 | 0.043 | 0.041 | 0.048 | 0.042 |
| iii. | Prov. Dependency of Fiscal Transfers (ratio) | 0.947 | 0.799 | 0.826 | 0.774 | 0.790 |
| iv.  | Prov. Fiscal Autonomy (ratio)                | 0.037 | 0.034 | 0.030 | 0.047 | 0.038 |
| v.   | Prov. Expenditure Discretion (ratio)         | 0.121 | 0.087 | 0.087 | 0.083 | 0.111 |

**Table 2 – Provincial Revenue Share in GDP (%), 2002-2009**

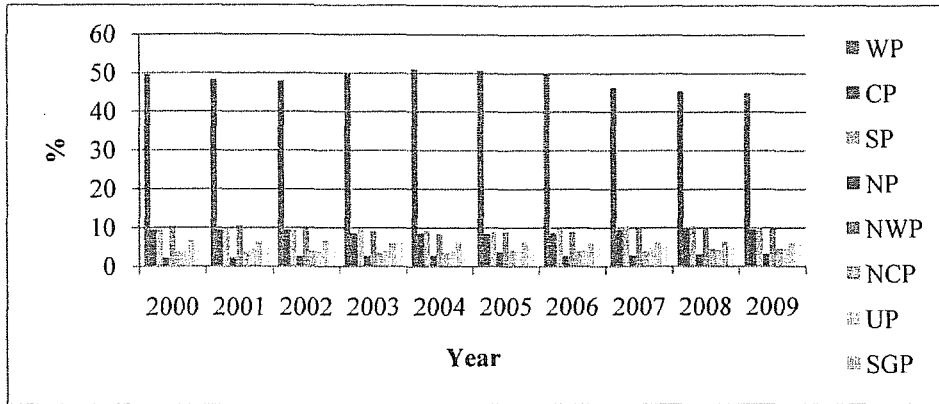
| Item/Year                | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|--------------------------|------|------|------|------|------|------|------|------|
| Prov. Rev. as a % of GDP | 16.5 | 15.7 | 15.4 | 16.1 | 16.3 | 15.8 | 14.9 | 14.5 |

Source – Central Bank of Sri Lanka, Annual Reports

An effort is made in this study to analyze the degree of fiscal decentralization using different indicators namely, expenditure, revenue, fiscal transfers, fiscal autonomy and provincial expenditure discretion. The most important or decisive sector i.e. expenditure and revenue, do not show a sufficient degree of fiscal decentralization. However, the ratio on expenditure shows a better decentralization compared to revenue.

The rest of the indicators worked out to measure fiscal decentralization of the provincial government sector, the ratio of the fiscal transfers to provincial total revenue takes a positive relationship and the dependency of provincial governments’ on fiscal transfers is high, closer to 1 depicting a high degree of fiscal decentralization.

Ratio of provincial own revenue to provincial total revenue shows the provincial fiscal autonomy fares a lesser fiscal decentralization similar to the provincial share of fiscal revenue. On the other hand, the ratio of general revenue to provincial total revenue which is expected to show provincial expenditure discretion performs better than fiscal autonomy, but closer to expenditure in the degree of fiscal decentralization.



Source – Central Bank of Sri Lanka, Annual Reports

The PGDP figures were calculated at current market prices. The national GDP growth has grown by 33.3% in 2009 reaching Rs. 4,835 billion with a per capita income of Rs. 236,444. The Western Province dropped from 49.6% to 45.1% during the past 10 year period. The Southern Province and North Western Province are managing to hold second and third places achieving a share of around 10%. The Central Province comes next with an average of about 9.6%. *Sabaragamuwa* Province achieved 6.3% while the North Central Province and *Uva* Province achieved 4.8% and 4.6% respectively. The Eastern Province is catching up fast with a share of about 5.8%. The Northern Province is still behind the other provinces, 3.3%, but should contribute with a higher share as normalcy is fully restored.

Table 3 – Provincial Budget Out-turn (Rs. M), 2000-2009

| Item/Year                            | 2000  | 2001  | 2002  | 2003  | 2004  | 2005  | 2006  | 2007   | 2008   | 2009   |
|--------------------------------------|-------|-------|-------|-------|-------|-------|-------|--------|--------|--------|
| 1) Total rev.                        | 7534  | 8674  | 9366  | 11625 | 13522 | 16132 | 19481 | 25868  | 31368  | 29433  |
| 2) Total exp.                        | 37327 | 40094 | 44314 | 49224 | 56964 | 73009 | 94470 | 113067 | 120011 | 130260 |
| 3) Central govt.'s transfers         | 31543 | 30948 | 36499 | 37832 | 45848 | 59696 | 79029 | 88317  | 88942  | 93999  |
| 4) 1+3-2 (income over expenditure)   | 1749  | -472  | 1551  | 233   | 2405  | 2819  | 4040  | 1118   | 299    | 6828   |
| 5) Total exp. as a % of total income | 95.5  | 101.1 | 96.6  | 99.5  | 95.9  | 96.3  | 95.9  | 99.0   | 99.7   | 105.5  |
| 6) 3 as a % of 2                     | 84.5  | 77.2  | 82.4  | 76.9  | 80.5  | 81.8  | 83.6  | 78.1   | 74.1   | 72.2   |
| 7) 1 as a % of 2                     | 20.1  | 21.6  | 21.1  | 23.6  | 23.7  | 22.1  | 20.6  | 22.9   | 26.1   | 22.6   |

Source – Central Bank of Sri Lanka, Annual Reports

When total provincial revenue increases by Rs. 13,301 million from 2005 to 2009, total expenditure has increased by Rs. 57,251 million i.e. a 4.3 fold increase in expenditure compared to revenue. Meanwhile, the total fiscal transfers have increased by Rs. 34,303 million. Generally the central government had to meet over 80% of the expenditure of Provincial Councils but during the last 3 years there is a slight improvement in Provincial Governments' revenue bringing some measure of relief to the Central Government. However, the over-all position of budget out-turn of provinces does not show a turning point or a new trend setting process, rather it continues on the same lines with little ups and downs.

During the period of fiscal decentralization there is no observable rapid turn of economic events to accelerate the provincial shares in the country's GDP. The only noticeable change is that the share of PGDP of the Western Province has come down from 49.6% to 45.1% during the last 10 years and that difference may have shifted especially to the Southern Province. A change in the composition of growth to a balanced growth is a favourable sign. However, when analyzing the provincial shares of growth during the past decade that trend is not visible and the concept of "balanced regional development" is yet to be realized.

## CONCLUSIONS

Fiscal decentralization has been termed as a controversial issue in Sri Lanka by various interest groups and some even refrain from commenting on it. Yet, it is a mechanism that has been taken up with a specific purpose and a close examination of its existence and continuation ought to be carried out.

The analysis above shows that fiscal decentralization has not been quite successful so far and there should be serious policies to re-structure the process. Therefore, this study intends to contribute to the existing pool of literature on fiscal decentralization, both in Sri Lanka and elsewhere on the aforementioned path, by providing an economic perspective on the subject while making efforts to determine in measurable terms how far decentralization has occurred.

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