Chapter 4
Intergovernmental Fiscal Framework for Local Government and Centre-Local Revenue and Expenditure Sharing: A Comparative Analysis

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4.1 Introduction

The ideal State is usually characterized as both democratic and developmental in governance context, underpinned by equity, inclusiveness and broad based participation. Since the 1970s, the history of conflict in Sri Lanka suggests that the governance of development had created disparities in access to social and economic opportunities. Reflecting on the emergent gaps in social integration, conflict, social distance of the government machinery from the people whom it was expected to serve, creating a divergence of democracy and development in its practice. The form and substance of decentralization has become a major issue today in the design of an inclusive state structure, the structure of an effective public sector, and the scope and content of intergovernmental arrangements.[1] This chapter examines the aspect of intergovernmental structuring of public finance for local government in Sri Lanka that could provide a unified approach to democracy and development.

The issue is complex as the form and substance of decentralization itself, and could be approached from the perspective of the centre or that of the local government, formulating the issue in terms of broadest national welfare or widest local welfare. While these alternate approaches will produce different public sector expenditure patterns, it is pertinent to note that in a heterogeneous society interests of the constituencies are at the centre and the local government are bound to be different, leading to conflict as to what and how of development. The critical point

[1]Marga Institute, Powers and Functions of Local Government, Study undertaken for National Peace Council, 2012, Etul Kotte, Sri Lanka.

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at issue then is the form of decentralization, i.e., the nature and scope of local autonomy. While distributive policies constitute the central modality for managing conflict, it is generally recognized that the ability of local governments to effectuate distributional goals is largely limited. The primary rationale for local autonomy would, therefore be, to provide their constituents with what they want and are willing to pay for, in a responsive and accountable manner.

This raises issues regarding the assignment of taxing and spending powers at the local level in terms of the concomitant issues of fiscal balance, both vertical and horizontal, closing the gap between taxing and spending, and of revenue and expenditure sharing, such that the welfare considerations of public sector service delivery will be optimized. However, the effectiveness of public sector service delivery is not only providing public services efficiently, but also equitably across the national territory. Under conditions of decentralization and local autonomy, the question arises as to whether such structuring of public finances achieves equity across local jurisdictions, such that there is cohesion in terms of national unity and development. This takes into account the inherent dichotomy of subsidiarity and solidarity that arises with local autonomy in revenue and expenditure and national redistribution.[2] This is the twin challenge that confronts the design of decentralization and the role of local government in moving towards a vision of a shared future that is interdependent diverse, just and equitable.[3]

4.2 Local Autonomy and Sharing Revenue and Expenditure Responsibilities for Development: Review of Issues

Thus, decentralization has implications for the fiscal structure of the state, impinging upon who gets what services where and pays for them. It raises a whole set of issues relating to the nature of relationships between the centre and the local in terms of their fiscal relations within the framework of an effective public sector. The critical question is under what conditions the local autonomy responds positively to assignment of taxing and spending powers in enhancing performance and accountability of local jurisdictions characterized by asymmetries in context and capacity to exercise their powers and functions. It is important that the ensuing relationship between the local and the centre is sustained and not undermined by local autonomy.

[2]See Bird and Ebel (2002).

[3]See Lessons Learnt and Reconciliation Commission (LLRC) (November 2011), Recommendation 9.231.

4.2.1 Development and Local Autonomy: Issues of Expenditure and Revenue Responsibilities

The justification for local provision of goods and services rests on the premise that welfare is enhanced beyond what is possible under more uniform national provision. While the specific bundles of goods and services provided at different levels of government will differ in time and place, the efficiency presumption is that the allocation of resources for the provision of public services should be located at the lowest level of government that is able to take into consideration the relevant costs and benefits. Horizontal equity in development is to be achieved through redistribution, to be worked out from the centre. However, it is increasingly recognized that local governments can have distinct advantages in identifying the poor and understanding their multidimensional characteristics on account of their proximity to people.

The issue of local autonomy is then about the form of involvement of local government in the conduct of development programs, whether under delegation, de-concentration or devolution. Under devolution the responsibility to design and implement development programs is entirely the responsibility of local governments, at least in part funded by their own resources. Whereas delegation and de-concentration cannot be considered to be true models for local government in so far as they do not exercise discretion in expenditure, their accountability is to the central government. In the devolution model of local government, there is greater responsibility on the part of local government for design and implementation of development programs, as well as accountability to the citizens.

While noting the popular dictum that finance follows function, the general experience is that local governments do not get assignments of revenue that match expenditure responsibilities. There is also the question of what sources of revenue make good sense at the local level. However, while local governments under devolution require revenue discretion in order to fully benefit from fiscal decentralization, there seems to be a general reluctance on the part of central governments to provide significant levels of revenue autonomy. This leads to the situation of imbalance between revenue and expenditure in local governments.

4.2.2 Fiscal Arrangements for Local Autonomy: Issues of Efficiency and Equity

The decentralization of expenditure and tax responsibilities leaves different jurisdictions with different fiscal capacities in that they can provide given public services to their citizens only at different tax rates. This would mean that the potential benefits available to citizens would differ and it can result in the inefficiencies in the inter-jurisdictional allocation of resources, leading to iniquitous treatment of citizens across jurisdictions. At the same time, the exercise of fiscal responsibilities by local jurisdictions can lead to distortions in the free flow of goods and services, labour and capital between them. Similarly, expenditure responses to imbalances can lead to differences in program design resulting in distortions in the allocation of resources across jurisdictions. These situations arising from revenue inadequacy is addressed through equalizing transfers to equalize fiscal capacities across the jurisdictions.

Intergovernmental transfers thus constitute a distinctive and significant policy instrument in fiscal decentralization, the primary justification for which is on equity grounds. Transfers can be conditional (where restrictions are placed on their use by the recipient) or unconditional where lump-sum amounts are made available for use according to the discretion of the recipient. When conditional grants take the form of matching grants (financing a part of the recipient's expenditure), it is usually employed to provide local services that generate benefits for residents in other jurisdictions. Unconditional grants typically address equalization purposes, based on an equalization formula usually depends on need and capacity of the local jurisdiction, so that larger shares of such transfers would go to those with greatest fiscal need and least fiscal capacity.

4.2.3 Local Autonomy: Issues of Performance and Accountability

There are many reasons for adopting local autonomy. Literature suggests that the search for the right balance in the division of powers between different levels of government is not always the primary reason for decentralization.[4] The reasons are very much country specific. What is efficient from an economic point of view may not be politically sustainable. However there is no doubt that moving decision making closer to people must have in place adequate arrangements to allow such local jurisdictions to exercise control over fiscal, regulatory and administrative matters—fiscal and administrative decentralization. Local autonomy in respect of fiscal and administrative matters is necessary for effective decision making at local levels.

Thus, a balance is necessary between political and economic considerations, if local autonomy is to perform. As noted earlier the economic case for decentralization is based on economic efficiency, the provision of local goods and services that are differentiated according to local needs and circumstances resulting in higher levels of welfare than through centrally determined and more uniform service deliveries across all jurisdictions. However, the case for economic efficiency of local government rests on the presumed responsiveness of local governments to their respective constituencies.

[4]Shah and Theresa (2004).

As pointed out, the political basis for decentralization rests on participation of people and making for greater accountability in the performance of local governments. However, it is generally believed that such participation is confined to the local elite groups who are likely to pursue their own self-interest. Indeed the most important potential gain from decentralization arises from the participation of, especially the poor, in the political process and local decision making. While enabling to remove social and institutional barriers, such participation brings service providers closer to the poor, potentially enhancing people's control over services.[5]

There are certain conditions that must be fulfilled if local governments are to have the capacity to perform effectively. First, local authorities need their own independent sources of revenue, with the important issue of balance in the vertical structure of revenues. In this regard the role of intergovernmental transfers is important, without undermining local autonomy and vitality of local governments. Importantly, central financing does not make for responsible local decisions with no real economic costs to the local jurisdiction associated with these decisions. The second important condition is the nature of own revenues, that local taxes do not produce distortions in the flow of economic goods and activities and are tied to benefits to produce the right signals concerning costs to the local community arising out of local decisions. Thus, modalities of financing the local provision of goods and services are fundamental to ensuring the performance and accountability of local autonomy.

Thus, decentralization is in the nature of a contract though rarely spelled out in all its details and implications. The fundamental problem in developing countries is that the institutional supports necessary for decentralization to work are not in place.

4.3 The Intergovernmental Fiscal Framework for Local Government and the Nature and Scope of Centre-Local Sharing of Resources

Local authorities constitute the primary jurisdiction for the provision of public services in a multi-level system of government constituted at national, provincial and local levels. Sri Lanka moved on to a multilevel system with the establishment of Provincial Councils in 1988 as a regional tier of government reconstituting the extant centre-local governmental relationship as a multi-level one. The role and function of local finance was subsumed within the framework of the new multilevel intergovernmental system. While radically altering the form of decentralized government, ensuing intergovernmental arrangements was set within the framework of centralized practice severely restricting autonomy of local government.

[5]See Govinda Rao (1988).

4.3.1 The Multi-level System and the Nature and Scope of Local Autonomy

Local government had been established in Sri Lanka by law[6] with a mandate for "the regulation, control and administration of all matters relating to public health, public utility services and public thoroughfares and generally with the protection and promotion of the comfort convenience and welfare of the people". The 13th Amendment to the Constitution (1987) in establishing Provincial Councils with legislative, executive and fiscal powers, radically changed the status of local government. Local government was constitutionally recognized and became the third tier of government with a constitutional guarantee of existing powers and provision for enhancement of powers by the provincial council through a provincial statute.[7]

The introduction of Provincial Councils as an intermediate tier, constituted a hierarchy of governance roles at national, provincial and local levels. The ensuing multi-level governance structure has created a polycentric service delivery system at the local level. It includes an array of national, provincial and local organizations with complementary mandates providing public services through a hierarchy of development plans where national plans are implemented through de-concentrated local agents.[8]

The resulting system of governance has marginalized local government in the regulation, planning and financing of public services.

Thus, powers and functions of the national and provincial and by implication local, are defined constitutionally.[9] On paper local authorities are responsible for the provision of a range of local services. However, the de facto exercise of functions

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[6]Municipal Councils Ordinance (1947), Urban Councils Ordinance (1939), Pradeshiya Sabha Act (1987).

[7]Thus item 4 of the Provincial List on Local Government specifies the scope of the assignment as follows:

4.1 Local authorities for the purpose of local government and village administration, such as Municipal Councils, Urban Councils and Pradeshiya Sabhas except that constitution, form and structure of local authorities shall be determined by law;

4.2 Supervision of the administration of local authorities established by law, including power of dissolution (subject to such quasi-judicial inquiries into the grounds for dissolution, and legal remedies in respect thereof, as may be provided by law, and subject to provisions relating to audit as may be provided by law);

4.3 Local authorities will have powers vested in them under existing law. It will be open to a Provincial Council to confer additional powers on local authorities but not take away their powers;

[8]The delivery of public utility services such as electricity, water, gas, roads and housing formerly the responsibilities of (urban) local authorities have since been taken over by central agencies Health and education are the responsibility of the central and provincial agencies with limited participation of public health and sanitation. Roads are the responsibility of all three levels of government, national, provincial and local.

[9]The thirteenth amendment to the Constitution demarcated the competences of national and provincial through three lists, Reserved (subjects retained at the centre), Provincial (subjects assigned to the provinces) and Concurrent (an area of shared competences).

constitutes a complex adjustment between power sharing imperatives of centralization and de-centralization. De-concentrated central agents deliver services in areas assigned to provincial and local governments making for agency competition and overlap in development roles, responsibilities and activities.

Thus, the provision of local services has an inter-governmental fiscal context, in terms of national, provincial and local responsibilities. The roles, responsibilities and relationships of national, provincial and local have set the limits of devolved provision and determine the basis for allocation of resources and achieving local development outcomes. The ensuing situation of revenue and expenditure of national, provincial and local levels sets out the size of provincial and local levels in the structure of public service provision. The respective shares of revenue and expenditure of the three levels of government over the period 2009–2011 is shown in Table 4.1.

The role and responsibility of local government in the multilevel system is not only miniscule, but is also largely static.

4.3.2 Expenditure and Revenue Domain of Local Government

As noted above, the thirteenth amendment to the constitution, while assigning the supervision of the administration of local authorities to provincial councils, guaranteed their extant powers, entrenching the fiscal basis of local government. Local authorities derive their financial powers from the establishment of a "fund" under the respective laws, for managing the financial operations arising from the powers vested in local government to receive and expend funds.[10] Together, the taxing and spending powers provides for the competence and the autonomy of the primary tier to function as a provider of local public services.

The mandates of local authorities, as set out in their respective laws, comprise of specified duties and permissive powers. Specified duties of local authorities extend to those functions specified and required to be provided under the respective laws. These services that local authorities are required to provide comprise of the three core areas of public health, public thoroughfares and public utility services. Permissive powers are those functions in respect of which a local authority may take action by passing by-laws. Hence the scope of service delivery is defined by both specified duties and permissive powers and the extent to which local authorities have sought to demarcate their area of operation through by-laws,[11] as well as programmes and projects for the delivery of ensuing services. Within the

[10]Municipal Fund for Municipal Councils (Section 185), a "Local Fund" for Urban Councils (Section 158) and "Pradeshiya Sabha Fund" for Pradehsiya Sabhas (Section 129).

[11]Local authorities are empowered to make by-laws as may be necessary for the purpose of carrying out the principles and provisions of the respective laws.

Table 4.1 Intergovernmental shares of revenue and expenditure—2009–2011 (Rs. Millions)

Level of government	2009		2010		2011	
	Rev	Exp	Rev	Exp	Rev	Exp
National	699,644 (94.27%)	1,201,927 (88.60%)	817,219 (94.06%)	1,290,205 (88.04%)	949,917 (94.46%)	1,400,099 (88.25%)
Provincial	29,443 (3.96%)	130,260 (9.60)	36,829 (4.23%)	145,491 (10.01%)	40,990 (4.07%)	157,373 (9.92%)
Local	13,015 (1.75%)	24,429 (1.80%)	14,735 (1.69%)	28,405 (1.95%)	14,687 (1.47%)	29,009 (1.83%)

Source Central Bank and Ministry of Local Government

Table 4.2 Expenditures of LGIs—2011 (Rs. Millions)

Expenditures/LGIs	Recurrent expenditure			Capital expenditure	Total
	Personnel	Other	Total	Capital	
Municipal Councils	5,857,145	4,904,996	10,762,141	1,285,906	12,048,047
Urban Councils	1,856,923	1,061,105	2,918,028	972,024	3,890,052
Pradeshiya Sabhas	4,615,571	2,741,380	7,356,951	5,713,807	13,070,758
Total	12,329,639	8,707,481	21,037,120	7,971,737	29,008,857

Source Ministry of Local Government and Provincial Councils

framework of their respective mandates all local authorities follow a "programme framework" extending over a set of standard service provision "programmes" in health services; physical planning, public thoroughfares, land and buildings, water supply, public utility services, and civic amenities. Service delivery activities are undertaken according to the availability of resources.

Local Government Expenditure: The comparative recurrent and capital expenditure situation of local government bodies in 2011 is presented in Table 4.2.

The pattern of local government expenditures as between recurrent and capital demonstrates its nature and scope. Overall, recurrent costs account for 72.5% of total local government expenditure in 2011, out of which personal emoluments account for 58.6% of recurrent costs. The share of personal emoluments is highest at approximately 62.78% of recurrent costs in respect of Pradeshiya Sabhas. However, the situation changes in respect of capital costs of local service delivery. Overall capital costs account for approximately 27.5% of total local government expenditure, out of which Paradeshiya Sabhas account for a share of approximately 71.7%, while Municipal Councils and Urban Councils account for approximately 16.1 and 12.2% of total capital expenditure. In terms of each category, capital costs account for 43.7% in respect of Pradeshiya Sabha expenditure, 25.0% in respect of Urban Councils and 10.7% in respect of Municipal Councils. Thus there is greater engagement of local bodies in development expenditure on the part of Pradeshiya Sabhas than Municipal Councils and Urban Councils.

Table 4.3 Per Capita expenditures by type of local authority: 2011

LGI/expenditure category	Municipal councils	Urban councils	Pradeshiya Sabhas
Total recurrent expenditure	Rs. 4180	Rs. 1575	Rs. 464
Personnel costs	Rs. 2275	Rs. 1002	Rs. 291
Operational costs	Rs. 1905	Rs. 572	Rs. 291
Capital expenditure	Rs. 499	Rs. 524	Rs. 360

Source Based on Ministry of Local Government Data

The above expenditures work out on a per capita basis as follows (Table 4.3).

Thus, on a per capita basis, both recurrent and capital expenditures are highest in Municipal Councils, followed by Urban Councils and lowest in Pradeshiya Sabhas, thereby widely reflecting different capacities to operate and sustain local service delivery.

Local Government Revenue: The revenue assignment of local government comprises of tax and non-tax powers to raise incomes to meet expenditures.

a. Revenue collected from sources assigned to local authorities by way of rates, taxes and any user fees that may be charged for services provided.
    - The main tax revenues assigned to local authorities comprise of property rates and acreage taxes, trade licenses and entertainment taxes,
    - The main non-tax revenues available to local authorities include rentals, license fees, fees for services (fees for services include registration fees, statutory fees, fees for building applications, warrant costs and penalties),
b. Revenues assigned to local authorities but collected by the provincial council, comprised of stamp duties and court fines.
c. In addition, local authorities receive allocations of funds under national and provincial programmes for specific items of capital expenditure.

Further local authorities are empowered to borrow funds. (Section 191) A statutory body dedicated for providing loans to local authorities has been established for providing finances to local authorities. The main focus of the Local Loans and Development Fund (LLDF) was granting and administering loans for investment in infrastructure development and revenue generating projects (Table 4.4).

Overall own revenue, both collected by the local bodies (Self-Generated Revenue—SGR) and collected by provincial councils and transferred to local bodies (Assigned Revenue), account for 41.2% of all income received by local bodies. The share of own revenue is highest for Municipal Councils at 54.2%, with shares of 43.4% in respect of Urban Councils and 30.3% for Pradeshiya Sabhas. The share of directly self-generated revenue is significantly less at 45.3% for Municipal Councils, 37.6% for Urban Councils and 22.5% for Pradeshiya Sabhas.

Table 4.4 Financing of LGIs—2011 Rs. Millions

Sources/LGIs	Own revenue			Revenue grant	Other revenues[a]	Capital receipts	Total receipts
	Self-Generated Revenue	Assigned Revenue	Total				
Municipal Councils	5,387,314	1,050,288	6,442,522	4,299,614	603,660	540,646	11,886,448
Urban Councils	1,580,049	242,452	1,822,501	1,323,674	331,850	713,122	4,191,117
Pradeshiya Sabhas	3,379,865	1,160,315	4,540,180	3,335,213	944,326	6,149,007	14,968,726
Total	10,347,228	2,457,975	12,805,203	8,958,501	1,879,842	7,402,775	31,046,501

Source Ministry of Local Government and Provincial Councils

[a]Other revenue is classified as an assorted set of incomes generated by local authorities that includes interest, sales, refunds, advertising and VAT repayments. It is significant that overall other revenues account for approximately 6% of total local government income in 2011

Table 4.5 Per Capita revenues by type of local authority: 2011

LGI/Source of revenue	Municipal Councils	Urban Councils	Pradeshiya Sabhas
Total Own Revenue	Rs. 2502	Rs. 983	Rs. 286
Self-Generated Revenue	Rs. 2092	Rs. 852	Rs. 213
Assigned Revenue	Rs. 407	Rs. 130	Rs. 73
Other Revenue	Rs. 234	Rs. 179	Rs. 59
Revenue Grant	Rs. 1670	Rs. 714	Rs. 210
Capital Receipts	Rs. 210	Rs. 179	Rs. 388
Total Income Generated	Rs. 4616	Rs. 2055	Rs. 943

Source Based on Ministry of Local Government Data

The pattern of SGR income differs in respect of the Urban Local Authorities (ULAs), i.e., Municipal Councils and Urban Councils and Pradeshiya Sabhas.[12]

Local government revenues on a per capita basis are presented in Table 4.5.

Thus per capita revenues of local government present widely differing fiscal capacities to provide services between the different types of local government institutions. It is noteworthy that Pradeshiya Sabhas record higher per capita capital receipts than own revenue, demonstrating a dependence on ad hoc allocations especially from central programmes.

Revenue-Expenditure Gap: The overall operational status of income and expenditure of local government is presented in Table 4.6.

While local government records an overall operating surplus of 06.56%, approximately 93.14% of the surplus accrues to Pradeshiya Sabhas. The operating surplus for Urban Councils amounts to 7.18% of income and for Pradeshiya Sabhas 12.67% of income. It is noted that local authorities are required to prepare balanced budgets and estimated income meeting estimated expenditure. An operating surplus suggests poor readiness to disburse items of budgeted income (Table 4.7).

The overall revenue-expenditure gap is approximately 49.4%, and is highest for Pradeshiya Sabhas at approximately 60.1%, Urban Councils at 44.6% and lowest for Municipal Councils at approximately 41.5%. While the revenue potential is higher in the case of ULAs, it is pertinent to take note of the comparative levels of capital expenditure of local authorities with capital costs of Pradeshiya Sabhas at a high of 43.7%, when compared with Urban Councils at 25% and Municipal Councils at 10.7%. These levels of expenditure are largely explained by the amount of capital receipts received by each type of local authority. As far as Pradeshiya Sabhas are concerned the operational surplus requires to be reconciled with the high revenue-expenditure gap.

Horizontal Imbalances: There are significant imbalances in the fiscal situations of local authorities inter and intra provincial level, as well as inter and intra

[12]Tax revenues are the major sources of SGR for ULAs while non-tax revenues provide the larger share of SGR of Pradeshiya Sabhas. Tax sources offer greater potential for generating revenue in ULAs as the total jurisdiction is declared for purposes of levying property rates whereas in Pradeshiya Sabhas property rates are levied only from the “built-up areas”.

Table 4.6 Operational status of local government—2011 (Rs. Millions)

Financial Operation/LGI	Revenue	Expenditure	Surplus/Deficit
Municipal Councils	11,886,448	12,048,047	(161,599)
Urban Councils	4,191,117	3,890,052	301,066
Pradeshiya Sabhas	14,968,726	13,070,758	1,897,968
Total	31,046,501	29,008,857	2,037,644

Source Ministry of Local Government

Table 4.7 Revenue-Expenditure Gap—2011

Revenue-Expenditure/LGI	Revenue	Expenditure	Gap
Municipal Councils	7,046,182	12,048,047	(5,001,865)
Urban Councils	2,154,351	3,890,052	(1.735,701)
Pradeshiya Sabhas	5,484,506	13,070,758	(7,586,252)
Total	14,685,049	29,008,857	(14,323,808)

Note Revenue includes self-generated, assigned and other, excludes capital receipts and revenue grants that constitute transfers

categories. Table 4.8 presents the local authorities with the highest and lowest financial operational levels in Municipal Councils, Urban Councils and Pradeshiya Sabhas in each of the Provinces.

From a fiscal capacity point of view, local government presents wide variations in the income-expenditure situations, both across the three types of local authorities, as well as within each type of local authority. The wide variation in fiscal capacities points to widely varying bundles of local services in terms of what services and at what levels of provision. This situation brings to the centre the scope of the intergovernmental fiscal framework in equalizing the financing local government services across jurisdictions with widely differing fiscal capacities and development needs.

4.3.3 Intergovernmental Fiscal Framework for Local Government

The intergovernmental financing of local government include both financial transfers to meet the imbalances arising from the fiscal capacities of local authorities to finance local services, as well as channelling of allocations for spending as agent on services provided by them. While the extant revenue for financing local government are guaranteed by the thirteenth amendment in the post provincial council decentralization situation, the extant schemes for transfers have been superseded by the intergovernmental fiscal arrangements introduced for financing provincial councils. The Thirteenth Amendment provided for the allocation of funds to

Table 4.8 Horizontal imbalances in fiscal operations of local authorities—2011 (Rs. Millions)

LGI/Province	Municipal Councils	Urban Councils	Pradeshiya Sabhas
Western	Colombo: Revenue 3,992,844 Expenditure 5,441,268	Maharagama: Revenue 170,234 Expenditure 192,284	Kelaniya: Revenue 115,207 Expenditure 201,158
	Kaduwala: Revenue 115,453 Expenditure 201,898	Minuwangoda: Revenue 20,418 Expenditure 42,002	Agalawatta: Revenue 12,979 Expenditure 22,994
Southern	Galle: Revenue 99,783 Expenditure 290,809	Tangalle: Revenue 13,297 Expenditure 96,365	Pasgoda: Revenue 10,375 Expenditure 103,396
	Matara: Revenue 98,421 Expenditure 190,098	Hambantota: Revenue 13,427 Expenditure 33,928	Lunugamwehera: Revenue 3,248 Expenditure 21,341
Central	Kandy: Revenue 122,240 Expenditure 707,143	Nawalapitiya: Revenue 355,287 Expenditure 916,193	Dambulla: Revenue 31,886 Expenditure 74,724
	Dambulla: Revenue 7039 Expenditure 33,292	Talwakele-Lindula: Revenue 7351 Expenditure 25,594	Ambagamuwa: Revenue 1644 Expenditure 14,012
Northern	Jaffna: Revenue 132,929 Expenditure 406,777	Vavuniya: Revenue 70,275 Expenditure 105,909	Nallur: Revenue 35,684 Expenditure 133,422
		Velvettiturai: Revenue 4030 Expenditure 21,290	Musali: Revenue 2285 Expenditure 9116
North Western	Kurunegala: Revenue 143,102 Expenditure 355,279	Kuliyapitiya: Revenue 44,540 Expenditure 81,204	Wariyapola: Revenue 60,967 Expenditure 228,030
		Puttlalam: Revenue 44,813 Expenditure 41,813	Mawatagama: Revenue 2763 Expenditure 16,109
North Central	Anuradhapura: Revenue 87,161 Expenditure 171,762	–	Tamankaduwa: Revenue 44,004 Expenditure 196,049
			Rambewa: Revenue 4.397 Expenditure 7624
Uva	Badulla: Revenue 69,479 Expenditure 147,797	Haputale: Revenue 10,378 Expenditure 27,871	Wellawaya: Revenue 16,421 Expenditure 33,396
	Bandarawela: Revenue 51,307 Expenditure 147,797		Uva Paranagama: Revenue 7005 Expenditure 13,358
Sabaragamuwa	Ratnapura: Revenue 86,841 Expenditure 288,213	Kegalle: Revenue 55,804 Expenditure 118,269	GalIgomuwa: Revenue 10,920 Expenditure 141,764

(continued)

Table 4.8 (continued)

LGI/Province	Municipal Councils	Urban Councils	Pradeshiya Sabhas
		Embilipitiya: Revenue 14,540 Expenditure 20,980	Bulathkohupitiya: Revenue 3258 Expenditure 14,756
Eastern	Batticoloa: Revenue 45,521 Expenditure 156,207	Trincomalee: Revenue 76,445 Expenditure 122,385	Korale Pattu: Revenue 14,838 Expenditure 48,863
	Akkaraipattu: Revenue 10,311 Expenditure 17,229	Eravur: Revenue 4627 Expenditure 21,583	Lahugala: Revenue 1540 Expenditure 5440

Note Based on information from Ministry of Local Government

Provinces as being "adequate to meet the needs" of the provinces from the annual budget. (Article 154 R3 of the Constitution).[13]

The Thirteenth Amendment does not provide for transfer of funds to local authorities and hence the scheme of fiscal transfers to Provinces does not explicitly provide for transfers to local authorities. Transfers to local authorities comprise of a single grant, referred to as "Revenue Grant", and are incorporated in the "Block Grant" to the Provinces. The grant is for the purpose of reimbursement of allowances paid to Chairman and Members, as well as salaries and wages paid to staff employed by local authorities. Therefore, financial transfers to local authorities are for meeting personnel costs of service provision; in fact the major part of recurrent expenditure. The design of the Revenue Grant is in the nature of a non-matching conditional grant (being for the specific purpose of meeting personnel costs). While most of the local authorities incur personnel costs out of their own revenue, the revenue grant takes note of only personnel holding positions that are approved by the central government and hence meets different proportions of total personnel costs of local authorities.

There are several problems with the revenue grant as a transfer system.

a. The fiscal transfer system does not address the expenditure needs of local authorities directly. On the one hand, the Revenue Grant is embedded into the Block Grant to provinces in meeting the recurrent costs of local government expenditure needs. Thus, local government is not recognized as a distinct sphere of service provision under the Constitution; hence the intergovernmental fiscal framework does not assess the imbalance, i.e., the need at the level of the primary tier of service provision.

[13]Transfers to Provinces comprise of four grants, Block Grant—an unconditional transfer to meet the gap between assessed recurrent expenditure needs of the Provinces and the estimated revenue collection target for each financial year; Criteria-based Grants—Formula-based block transfer for development expenditures of the Provinces; Province-specific Development Grant—Conditional transfer for provincial infrastructure; Transfer in lieu of Business Turnover Tax—A compensatory transfer in lieu of Business Turnover Tax taken administratively over the by the Central Government since 2011.

Table 4.9 Adequacy of revenue grant—2011

	Rs. Millions		
Costs/LGI	Personnel Costs	Revenue Grant	Surplus/Deficit
Municipal Councils	5,857,145	4,299,614	1,557,531
Urban Councils	1,856,923	1,323,674	533,,249
Pradeshiya Sabhas	4,615,871	3,335,213	1,280,658
Total	12,329,639	8,958,501	3,371,138

Source Ministry of Local Government

b. Further, the Revenue Grant is provided to meet the cost of personal emoluments paid to the chairman/mayor, members and the staff of local authorities. The grant is required to meet the costs of personal emoluments of staff whose positions have been approved by the central government, following a process of assessment of staffing needs of local bodies according to their current operational needs. Thus, local bodies find the need to hire additional staff, to meet personnel requirements not met by the central government approval of positions and numbers. The assessment of staffing needs is not designed to provide for personnel requirements for the provision of a standard package of minimum local services horizontally.[14] The assessment recognizes current operational levels, but does not allow planning for future needs. The transfer mechanism is therefore static and control oriented. The input-based conditionalities on which the grant is designed does not provide for enhancing accountability or performance.
c. As shown by Table 4.9, the revenue grant does not meet the total needs of personnel costs of local government with the ULAs recording the larger gaps. Additional personnel costs are required to meet personal emoluments of staff recruited by the local authorities, for positions that are not approved by the central government and the costs are met from own revenue. It reduces the funds available for undertaking new and expanded delivery of services. The grant does not meet the norm of adequacy.
d. Thus, there is an overall deficit in respect of personnel costs which is met by own revenue. As the single item of intergovernmental transfer for local government, the Revenue Grant accounts for only 78% of total personnel costs, making personnel costs spill over into the use of own revenue. In respect of Municipal Councils, the revenue grant met approximately 73% of personnel costs, 72% in the case of Urban Councils and 86% in the case of Pradeshiya Sabhas.

The utilization of revenue is shown in Table 4.10.

[14]Local authorities usually do not engage in planning, it is the budget that constitutes the annual plan of work. They lack a medium-term perspective.

Table 4.10 Utilization of local government revenues—2011

Rs. Millions

Cost Item/LGI	Recurrent Expenditure			Revenue			Surplus/ Deficit
	Personnel	Other	Total	Own	Other	Total	
Municipal Councils	1,557,531	4,904,996	6,462,527	6,442,522	603,660	7,046,182	583,655
Urban Councils	533,249	1,061,105	1,594,354	1,822,501	331,850	2,154,351	559,997
Pradeshiya Sabhas	1,280,658	2,741,380	4,022,038	4,540,180	946,326	5,486,506	1,464,468
Total	3,371,138	8,707,480	11,379,720	12,805,203	1,879,842	14,687,039	3,307,589

Source Ministry of Local Government

Overall 77.48% of the revenues of local government (including assigned revenues and other revenues) are spent on recurrent costs of services provided. The situation in respect of the different local government institutions in regard to the share of revenue spent on recurrent expenditure is 91.71% for Municipal Councils, Urban Councils at 73.96% and for Pradeshiya Sabhas at 73.30%. The revenue surplus on recurrent financial operations accounts for approximately 11.40% of total local government expenditure. However, the surplus available for Municipal Councils amounts to approximately 4.84% of total annual expenditure, while in the case of Urban Councils the surplus amounts to 14.39% in the case of Urban Councils and 11.20% in respect of Pradeshiya Sabhas.

e. The central government transfers do not provide for capital expenditure needs. The rationale for reimbursement of staff costs by way of central government transfers was to provide for a measure of horizontal equalization of recurrent expenditure needs of service delivery operations by meeting personnel costs. The rationale presumed that the funds made available through the revenue grant would complement self-generated revenue in enhancing fiscal capacity of local government to provide for a local development programme to improve and expand service delivery operations for local authorities. According to Table 4.10 the surpluses available to local authorities for development expenditures is overall 11.40%.
f. Thus, there is a question of the adequacy of the intergovernmental fiscal framework to create fiscal capacity of local government for development expenditures. The horizontal imbalances in the fiscal capacities of local authorities, across the types of local authorities and within each type, must also be taken into account in assessing adequacy.

Allocation of funds for capital expenditure is presented in Table 4.11.

The revenue surplus so created accounts for 41.47% of total capital expenditure of local government, working out to shares of 45.38 in respect of Municipal Councils, 57.59 in respect of Urban Councils and 25.63% in the case of Pradeshiya

Table 4.11 Allocation of funds for capital expenditure—2011

Rs. Millions

Fund Status/LGI	Funds for capital expenditure			Capital expenditure	Surplus/deficit
	Revenue Surplus	Capital Receipts	Total		
Municipal Councils	583,655	540,646	1,124,301	1,285,906	(161,605)
Urban Councils	559,997	713,122	1,273,119	972,024	301,095
Pradeshiya Sabhas	1,464,468	6,149,007	7,613,475	5,713,807	1,899,668
Total	3,307,589	7,402,775	10,010,895	7,971,737	2,039,158

Source Ministry of Local Government

Sabhas. In the absence of service delivery planning targets, it is not possible to make any assessment of the adequacy of the current levels of capital expenditure by local government. However, a comparison of the respective shares of capital expenditure and the per capita spending levels would seem to suggest low levels of local government capital spending. Thus, Pradeshiya Sabhas spend 43.7% on capital expenditure working out to a per capita capital expenditure of Rs. 360, Urban Councils spend 25.0% on capital expenditure for a per capita expenditure of Rs. 524, and Municipal Councils spending 10.7% on capital expenditure record a per capita expenditure of Rs. 499 on capital items.

4.3.4 Nature and Scope of Expenditure and Revenue Sharing

Thus, the current design of the intergovernmental fiscal framework raises the critical question of its relevance to provide for local autonomy in terms of the fiscal capacity of local government. The intergovernmental fiscal framework for local government finances have approved personnel costs of recurrent expenditure of service provision. However, such financing leaves only a margin of 11.40% for development expenditures of local government which works out to 4.84% for Municipal Councils, 14.39% for Urban Councils and 11.20% in the case of Pradeshiya Sabhas. This situation raises the question of the adequacy of centre-local revenue sharing through the revenue grant to meet development expenditure needs of local government.

Availability of adequate resources for capital expenditure needs has been a major gap in the scheme of financing available for local authorities. As already noted the intergovernmental fiscal framework for local government does not provide transfers for capital expenditure. For a predictable programme of capital expenditure, the local authorities must therefore rely on a surplus of income over recurrent expenditure. While this is implicitly intended in the scheme for revenue grants (meeting personnel costs so as to allow an adequate surplus of revenue for development expenditures), the reality is that the financial operations of local government institutions do not leave a significant balance of finances for capital expenditure. However, several programme sources, whether through transfer of allocations to local government or directly through alternate local agencies outside of local government, provide for capital spending in areas of local government services within respective local authority jurisdictions.

a. *Transfer of allocations to local government institutions*

The post-provincial council framework of inter-governmental service delivery relations has given rise to several programme arrangements for revenue and expenditure by way of capital receipts made out to local government institutions.

Indeed, capital receipts have turned out to be the main sources of funds for capital expenditure of local authorities. These are:

National:

i. Financial provisions from Decentralized Capital Budget (DCB) allocated by Members of Parliament.[15]
ii. Allocations from programmes under National Ministries, notably the Ministry of Economic Development (Maga Neguma for rural roads).[16]
iii. Allocations from foreign funded programmes targeting local government services.[17]

Provincial:

i. Allocations under the Province Specific Development Grant (PSDG)

While overall capital receipts account for 92.8% of actual capital expenditure, such funding accounts for approximately 42.0% of capital expenditure in respect of Municipal Councils, 73.3% in the case of Urban Councils, and approximately 107.6% for Pradeshiya Sabhas. In fact, the share of capital receipts received by Pradeshiya Sabhas amount to 83.0% of total received by all local government institutions. Such allocations are negligible for ULAs Municipal Councils receiving 7.3% and the share of Urban Councils being 9.7% of total capital receipts.

While all local authorities receive allocations for capital expenditure from central and provincial sources, these are entirely at the discretion of the relevant agency and do not constitute a regular financing programme. They are ad hoc and depend entirely upon the discretion of the granting authority. As demonstrated in practice there is no predictability of the amounts of such allocations or of the allocations themselves. Hence capital receipts as a mechanism for resource sharing do not create local autonomy for meeting local development needs on the part of local government institutions.

b. *Direct programme spending in local authority service areas*

There are several areas of programme spending in the area of local government services that are delivered directly by central providers outside of local government budgets, notably in infrastructure and public utilities (water, electricity and housing). These are local services where expenditures are incurred by central providers financed by cost recovery for operation and maintenance and central government

[15]Decentralized Capital Budget (DCB) is a programme for the provision of fixed amounts of financial allocations to Members of Parliament for capital works of a local nature. It was first introduced in 1974 as the fiscal mechanism to provide financial space for central parliamentarians to engage in local level development activities.

[16]There are several nationally implemented programmes providing local services. The "Maga Neguma" road development programme funds local roads that are the responsibility of local government.

[17]Foreign funded programmes are executed centrally. There are several programmes that target local services funded through local government institutions.

grants for capital investments. The responsibility for such services lies with the central providers and accountability for the quality and quantity of services delivered through local sub-offices is upwards to the heads of respective operations, usually a public enterprise. Accordingly, while taking responsibility for specific items of local services, direct provision does not coordinate vertically or horizontally with local government and hence does not promote local autonomy in the provision of such services. Furthermore, differing service delivery jurisdictions and information gaps between the central providers and local government does not allow coordination of service provision.

c. *Agency-based spending in local jurisdictions*

Units of territorial administration of the central government, the district and the division, have provided alternate administrative mechanisms for channelling local spending, virtually competing with local government in providing for local services.[18] While the division and the local authority areas correspond geographically, divisional coordination has sought to bring about greater complementarity and partnership between the division and local authority in the provision of local services. The mechanism for coordination seeks to provide for a measure of expenditure sharing in the provision of local services. However, the division as the central government's agent for most nationally budgeted development programmes has emerged in a competitive relationship with local government, rather than expenditure sharing partnership at the local level. It is noteworthy that the two structures are fundamentally different one from the other with different competences and accountabilities.

d. *Local government coordination for sharing expenditure*

Expenditure sharing between local government bodies is rare, or virtually non-existent. In this context, the recent initiative to establish a metro region authority for the greater Colombo urban local authorities is noteworthy.[19] While the Urban Councils Ordinance provides for joint action by mutual consent, it is noteworthy that such joint action and coordination has not occurred so far. Several factors account for absence of co-sharing between neighbouring local authorities in the provision of services.

- The practice so far has been to approach area coordination sectorally, whereby the coordinating authority must have a sector location in an appropriate Ministry adopting special purpose institutional arrangements.

[18]The division constitutes the unit of administrative operations for most central government as well as provincial development activities. The division performs a dual role, linking the dual system of sub-national government, the central and provincial systems. It is accordingly vested with statutory authority and agency functions of central government agencies hitherto performed at the district level The Divisional Secretary also functions under delegation from the Governor of the province in carrying out executive functions executive functions of the provincial council administration.

[19]The proposal to create a Metro Authority for five local bodies, Colombo MC, Sri jayawardenapura MC, Dehiwala-Mt. Lavinia MC, Kollonnawa UC and Kotikawatta-Mulleriyawa UC.

- Provincial councils responsible for the supervision of the administration of local authorities have so far not been innovative in promoting local government co-sharing of expenditures.
- The competitive context in which local authorities operate does not create conditions conducive for co-sharing partnerships between local authorities.
- The resource constraint in which local authorities find themselves operating would not leave adequate surpluses to be invested for joint activities.

Local government coordination for co-sharing expenditure, whether between local authorities or between local authorities and provincial or national level providers, is yet to be explored.

4.3.5 Performance of the Intergovernmental Fiscal Framework in Financing Local Government Service Provision

From the perspective of local autonomy for development what is at issue is the extent to which the intergovernmental fiscal framework creates capacity in local government to finance local services efficiently and equitably. This is about the availability of sufficient sources of revenue that would adequately take care of expenditure responsibilities. It is in this regard that the role of intergovernmental transfers and revenue and expenditure sharing become important, without undermining local autonomy and vitality of local governments. The general experience is that such central financing does not make for responsible local decisions with no real economic costs to the local jurisdiction associated with these decisions. Modalities of financing the local provision of goods and services are fundamental to ensuring the performance and accountability of local autonomy. The foregoing analysis of the functioning of the intergovernmental fiscal framework for local government suggests several shortcomings as a policy instrument for efficient and equitable service provision. These are examined in the next section.

4.4 Intergovernmental Context of Local Government Expenditure and Revenue Responsibilities in Sri Lanka: Issues

Thus, local government operates within an environment of inherited limitations of resources. Indeed, local government, as the devolved sphere, functioned within the framework of centralized planning, financing and implementation of development programmes prior to the establishment of provincial councils in 1987. Introduction of a regional tier of devolution was worked out within the framework of centralized practices.[20] It resulted in a dichotomy of functions and structures for regulation and planning of development, thereby creating two institutionalized sets of roles and responsibilities; one based on the exercise of devolved power (comprised of the provincial councils and the local government institutions) and the other based on the exercise of de-concentrated central authority (at the sub-national level whether directly through local offices of sector agencies or indirectly through central agents at district and the divisional levels). Dualistic financing of local services has severely constrained intergovernmental resource flows to local government, and undermined local autonomy and marginalized local service delivery roles and functions.

4.4.1 Defining Centralized Distribution and Local Allocation: Issues of Multi-level Responsibilities

Thus, the multilevel system has worked in a heavily centralized manner as demonstrated by the shares of national, provincial and local expenditure, without clear demarcation of roles and responsibilities in the provision and delivery of services. While the starting point for the demarcation of public finance roles and responsibilities between different levels of government is the recognition of the advantages of locating distribution at the centre and allocation at the local. The Sri Lankan situation is defined by the absence of clarity in how distribution and allocation functions are assigned and shared between national and local levels. Thus, existing intergovernmental arrangements for financing public sector service delivery raise many issues of demarcation of multilevel responsibilities in a manner that enhances capacity and autonomy of local government.

a. Subsidiarity and the functional responsibilities

The first logical step in a system of intergovernmental finance is the vertical demarcation of functional responsibilities for different levels of government. In Sri Lanka, the vertical demarcation of functional responsibilities has tended to follow historical adjustments in regard to subjects and functions at the national and local, leaving a residual set of service delivery responsibilities with local government. This is further exacerbated when the extant functional responsibilities of the provincial tier is brought into the scenario of the allocation of vertical functional responsibilities in government, presenting a de facto picture where local service delivery responsibilities are exercised out of all three levels. Thus, resources allocation responsibilities in respect of local services are undertaken at the national level in the form of sectoral or cross-sectoral redistribution programmes. The vertical allocation of functional responsibilities does not follow a subsidiarity principle within the framework of comparative advantages of national, provincial

[20]See Gunawardena and Laxman (2008).

and local levels in undertaking public finance responsibilities especially relating to the distribution and allocation of resources. This situation leads to several inefficiencies in the vertical dimension of intergovernmental finance.

b. Fiscal efficiency and resource allocation

The efficient provision of government services requires that government satisfy the needs and preferences of taxpayers as best as possible. This is best achieved by the "subsidiarity" principle in assignment of intergovernmental responsibilities. Responsibility for the provision of services should be at the lowest level of government compatible with the size of the "benefit area" associated with those services. The services assigned to local government meets with this criterion. Nor are local government assigned responsibility for services with wider benefit areas which would result in the inefficient under-provision of services. The issue of fiscal efficiency and resource allocation in the provision of local services is the fragmentation of responsibility for local services across the multilevel system that prevents a unified approach to addressing needs in a responsive manner. Additionally, these service deliveries are financed out of general taxes and are not linked to costs of provision via fees, service charges, or local taxes.

c. Gap between recurrent and capital expenditures

The concentration of recurrent and capital expenditure in respect of local services between local and national independently of the level of government responsible for the provision of the services is reflected in low levels of capital expenditure by local government. Efficiency criterion would require responsibilities for capital infrastructure that should be placed at the level of government responsible for the delivery of the specific services, including the operation and maintenance of those facilities. This will encourage a more efficient use of resources. Only the capital infrastructure facilities actually desired by subnational governments will be built and subnational governments will have an interest in maintaining and repairing the capital infrastructure.

d. Vertical fragmentation and programme co-sharing

It is important to note that the actual assignment of functional responsibilities is often quite different from what it appears to be in the "formal" assignment established by law or practice. Thus, in the case of education, local government has responsibility only for pre-schools. It is to be noted that policy and regulation in regard to preschools is located at the central and provincial level. There is no clear modality for financing pre-school buildings, staff and quality inputs, while staff appointments are at the level of local government. Similar issues arise in other sectors such as public health. While ideally all inputs for the delivery of a particular service should be simultaneously decided by one single authority, co-sharing of responsibilities for a single service is inescapable. Co-sharing of responsibilities may not be a problem when particular functions and tasks in a common area are clearly assigned to different levels of government.

e. Financing poverty alleviation/social protection.

A further area of inefficiency is the marginalization of local government in regard to the marginal service delivery responsibilities for social protection and welfare. While it would be inappropriate to fund social protection and social welfare through local governments out of general budgets, they have a comparative advantage for the efficient delivery of these services. In fact, while poorer local governments would be unable to provide such services at an appropriate level, the preferred best practice would be for central funding of programmes that are locally delivered.

f. Provision of public utilities

As already noted public utilities fall within the service delivery mandate of local government. However, they are funded and delivered from the centre without any role and responsibility for local government. General practice is for these services to be provided by corporate entities dependent upon or regulated by local government with full-cost-recovery pricing.

g. Vertical fiscal gap and bridging revenue-expenditure gaps

Vertical fiscal imbalance arises because many of the taxes that are appropriately assigned to subnational governments from a conceptual point of view cannot easily be administered in a way that implements this assignment. It is especially difficult to find taxes that can be implemented in a way that provides subnational governments with marginal sources of own revenues. As noted earlier, neither revenue sharing nor tax sharing provides marginal sources of own revenues for subnational governments. The likelihood of vertical fiscal imbalance explains the earlier emphasis on subsidiarity in taxation: the view that subnational governments should generally be assigned any tax that they can administer (or that can be administered for it) that is not inappropriate for their use.

4.4.2 Horizontal Imbalances and Gaps in Development Linkages: Issues of Policy and Program Coordination

The second aspect of the intergovernmental context of local government expenditure and revenue is the wide horizontal asymmetries in fiscal capacities. The question is how far the intergovernmental fiscal framework has enhanced local government autonomy and accountability in ways that they are able to, while fulfilling own direct service responsibilities to use their spending power to fulfil national and local efficiency and equity objectives. The revenue grant neither enhances autonomy, nor creates accountability in regard to the ways in which resources are deployed to fulfil either national or local efficiency or equity objectives. The design of intergovernmental transfers should be guided by clarity in achieving objectives by such transfers and sharing of resources.

Reducing regional fiscal disparities: The local government in Sri Lanka demonstrates wide horizontal disparities. The approach of the revenue grant to reducing fiscal disparities across local government is one of funding salaries of personnel employed by local bodies. As already noted this does not lead proactively to enhancing fiscal capacity for service delivery. The development challenge in Sri Lanka is to bring within the service delivery system those that are currently excluded through regional imbalances in access to services, opportunities for economic participation and governance for equitable human development.[21] The revenue grant does not provide for equalization across local government jurisdictions for local service provision. An important part of the problem of resource transfers is the level of central funds flowing to local levels through national programmes implemented outside of local government. There is a need for a holistic approach to financing local services in a manner that equalizes fiscal capacities across local government jurisdictions.

Setting national minimum standards: Local government does not share a set of service delivery standards, nor has the central or provincial governments so far introduced policies that guarantee desired minimum levels of provision for certain services at the local level. National standards can be enforced in several ways such as enticing local governments with a matching grant program. But national standards may also be enforced by denying full receipt of block grant money unless certain minimum expenditures and provisions established by the central government are met. Programs in which national standards may be required include not only social welfare, but also education, health, sanitation, and the environment. But restrictions should be imposed sparingly to protect local autonomy which, in general, is very desirable.

Influencing local priorities: The intergovernmental transfer system comprised of the single grant for reimbursement of personal costs of service provision, neither enhances local autonomy nor enables the central control to deliver on national objectives. A more comprehensive system of intergovernmental transfers using a combination of general transfers (unconditional grants) and earmarked transfers (conditional grants) is required in order to enhance local autonomy (though requiring local capacity and accountability) and to give the central government more control to meet its objectives.

Fiscal equity, social justice and unity: A well designed intergovernmental fiscal regime should bind the various players in the intergovernmental system for an efficient and responsible provision of public services in an equitable and stable way. Such a system may also provide a combined sense of national-solidarity and "place equity" through a well-designed system of transfers. It would include conditional and unconditional grants that can address issues of both vertical and locational equity. An essential component of such a system would be an institutional structure to provide for periodic adjustments to meet changing circumstances, and serve as a

[21]See UNDP 2012.

forum for the resolution of the disputes that inevitably arise in any functioning intergovernmental system. This is not the case in Sri Lanka.

4.4.3 The Expenditure and Revenue Role of Local Government: Issues of Marginalization

Thus, the expenditure and revenue roles of local government are inadequate for any meaningful engagement in the provision of local public services. There are both questions of design and of practice. While creating capacity to match local services with local preferences is at the core of the design of local autonomy, it is important to position local government within the multi-level system as an equal partner in development. An enhanced role for local government is imperative in the post-war context of Sri Lanka[22] which requires bringing the local authorities out of their marginalization by enhancing their autonomy, as well as accountability. It is in this context that the intergovernmental fiscal regime requires to be reviewed.

Thus, the current intergovernmental fiscal regime for financing of local government is inadequate for any significant deepening of their role and functions. There are several policy issues that arise.

The first is about the conditions that would facilitate local government move out of resources dependency to a more efficient model of service delivery. The intergovernmental fiscal regime for local government has proved to be restrictive.

- The shares of recurrent and capital expenditure of local government confine service delivery responsibility to operation and maintenance with only a marginal engagement in development.
- Local authority financial operations take place within the framework of central controls, especially the central determination and approval of staffing. It undermines responsibility and accountability of local authorities for local government.
- Revenue share of local government has shown a downward trend suggesting weakness in revenue base, as well as revenue performance.
- Increasing demand for services calls for accessing finances from new and innovative sources. Local authorities seem reluctant to move on to such sources in financing local services.[23]

[22]Powers and Functions of Local Government: The Operational Context, Study undertaken by Marga Institute for the National Peace Council reviewing the role of local government in the post-war context, Mimeo, 2013.

[23]Overall borrowings have accounted for less than one and half percent of local government finances.

- The horizontal imbalances in fiscal capacities require central fiscal support to ensure maintenance of minimum standards of services. Local authorities with a weak fiscal base are becoming increasingly dependent upon central government transfers for meeting the salaries and wages of staff.
- The central transfers financing local authority expenditures by meeting costs of salaries and wages are creating perverse incentives that restrict choices for the delivery of services and in turn affecting efficiency of service delivery operations.

The second is about the increasing trend for central players to spend on local infrastructure often directly or through de-concentrated agents of the central government. Even where such spending is channelled through the local authority, there is no discretion in terms of decisions regarding the purposes for which such funds are used and usually takes place outside its budgeting process.

The third is about incentives to bring about a meaningful effort to improve revenue collection. Incentives in this regard could be created by moving on to performance-based modes of financing local government. Especially important would be the creation of incentives for local government; especially urban local authorities to use external sources for financing service deliveries.

The fourth is about incentives to change. The limitations in functions, finances and functionaries at the municipal level currently make for incentives that are of a short-term nature. A shift to a performance-based model of local government management can, therefore, be achieved only through system-wide reforms tailored to the different needs and capacity of Sri Lanka local authorities.

The fifth is about the implications for local government budgeting in moving from a routine and historical budgeting to one of financing service provision. This would involve promoting the more efficient and sustainable models of financing service delivery and infrastructure with the introduction of user fees and private sector participation.

4.5 Redefining the Nature and Scope of Expenditure and Revenue Sharing for Local Government

The fundamental purpose of revenue and expenditure sharing is to correct fiscal imbalances that occur in the fiscal arrangements for managing the economy through the tendency to assign revenue to the central government and expenditure to local levels. The tax assignment has been such that growth of revenue at the central level is far quicker than at local levels. While the resulting fiscal imbalances can result in less than adequate capacity for local government service delivery, it is important to note that fiscal imbalances are also related to the assignment of expenditure responsibilities which can be subject to change. In the absence of specific expenditure assignment, it is revenue availability that dictates the responsibilities of local government. The correction of such imbalances should be carried out in manner that is least restrictive of local autonomy in responding to local needs and demand for services.[24]

4.5.1 *Rationalizing Distribution and Allocation: Achieving Clarity*

In this regard the assignment of expenditure responsibilities across different levels of government is critical to ensuring autonomy of local government. The subsidiary principle based on the responsibility for public finance functions, especially distribution and allocation, largely prescribes the assignment of expenditure responsibilities to different levels of government. However, the ensuing rules do not always yield an unequivocal answer.[25] What is considered the best assignment can change over time due to changes in costs, technology and preferences? While the role and responsibilities of local government must take note of the dynamism in service delivery situation, especially arising from policy considerations in regard to distribution, it is necessary at any given point of time to have a concrete assignment of expenditure responsibilities that could be considered optimal. Revenue and expenditure sharing arrangements should be able to address need for change over the medium term.

A specific issue in the local service delivery scenario is the concurrent operation of many operators outside the local authorities, undermining the role, responsibility and relevance of the elected local government sphere in meeting the needs of the respective jurisdiction. There is a need for mechanisms for greater horizontal expenditure sharing which requires a unified approach to local development. It would involve inter-agency coordination of expenditure at the local level, defining not only financing responsibilities for specific areas of service provisioning, but also defining the nature and scope of the decision-making responsibilities of the different agencies in regard to provisioning and delivery of services.

Such an arrangement goes beyond the popular notion of coordination as a clearinghouse for agency actions on to inter-agency expenditure sharing for specific outcomes. This would involve establishing a local government financial pool funding available for financing service deliveries in defined local jurisdictions. It would be demand driven and minimize duplication and overlap in funding on the one hand, and enhance responsiveness of service deliveries to meet local development needs on the other hand. Such an arrangement would enable decentralizing

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[24]The operation of the fiscal regime for local government restricts autonomy, especially the scheme of intergovernmental fiscal transfers.

[25]Some public services, e.g., primary education and primary health services, may be of a local nature by the size of their benefit area, but because of their relevance in welfare and income redistribution they may also be considered a responsibility of the central government.

capital expenditure responsibilities to support service delivery outcomes. This may be the only effective way to allow small local governments to fulfil their capital investment responsibilities.

4.5.2 Decentralizing Expenditures: Output-Based Transfers

Decentralizing expenditures requires addressing horizontal fiscal imbalances in financing local service delivery. As a first step towards enhancing accountability, transfers for correcting fiscal imbalances could be designed around performance target oriented to set national minimum standards. Output based transfer offer an alternative to fiscal need compensation, which as international experience suggests, is complex and complicated. Output based transfers enhance results based on accountability. Such fiscal transfer arrangements require continuous review and periodic revision.

4.5.3 Enhancing Fiscal Capacity: Equalization Transfers

There is a clear need for equalization of fiscal imbalances across local authority types and jurisdictions. On the one hand the revenue grant was found to be both inefficient and perverse.

Transfers to local governments require special considerations as local jurisdictions vary in population, size, area served and the services provided i.e., urban versus rural. There is a need to classify local governments by population size, municipality type, and urban/rural distinction and have separate transfer formula for each class of municipalities. Some common elements of such transfer schemes are amounts per municipality, per capita, service area and fiscal capacity. Fiscal capacity should take into account revenue bases and expenditure needs. The grant funds would then vary directly with service area, but inversely with fiscal capacity. The scheme could be worked out for each type of local authority using national average standards for each type. Introduction of such a scheme of equalization transfers involves the creation of a financial pool should ensure that local authorities do not receive less than current entitlements.

4.5.4 Intergovernmental Partnerships: Minimum Standards and Policy Coordination

The intergovernmental transfers should guarantee desired minimum levels of provision at least for specific services such as environment, health, sanitation and social welfare at the local level. National standards can be enforced through matching grant arrangements, as well as establishing minimum expenditures and provisions. The delivery of minimum standards would usually involve well defined sectoral policies. This will require comprehensive functional reviews of the priority local service sectors.

4.5.5 Embedding Autonomy for Local Government: Intergovernmental Fiscal Regime

Responsive local government requires control over its fiscal operations, allowing choice in the level of public spending. An important aspect of such autonomy is the tax assignment. Local governments must have enough "own" revenues to finance the services they provide. Even if such a government must rely on grants from a higher-level government, it may reasonably be considered to have own revenues, provided the grants are determined in an objective way and are guaranteed by the constitution or legislation of longstanding. By comparison, own revenues may not exist in any real sense, if grants are made at the sole discretion of the higher government, perhaps on an ad hoc, arbitrary, and unpredictable basis, and even well into the fiscal year and subject to renegotiation.

4.6 Conclusion: Challenges of Intergovernmental Fiscal Arrangements for Local Autonomy and Development

Decentralization, whatever its form, changes the fiscal structure of the state and hence would impact on the nature and scope of state activities. Therefore, decentralization makes for political and economic challenges. Some degree of local autonomy is necessary to meet the challenges, political accountability and economic efficiency. Since transfers account for a large part of subnational finances everywhere, their design is a critical factor in the success of decentralization.

Transfers perform three key functions in correcting fiscal imbalances. First, they fund the services local governments provide on behalf of the central government. Second, they ensure that equity is taken care of especially where programs administered by local government to redistribute income or when there are large income differences across jurisdictions. Third, the transfers determine the sectoral composition of local expenditure when earmarked or disbursed in the form of matching grants. The design of a transfer scheme must take into account three variables. The amount to be distributed, criteria for distribution among jurisdictions, and conditionalities imposed on the use of transfers.

Some basic governance principles are fundamental to an effective system of transfers. Transfers should be determined as openly, transparently, and objectively as possible. They should be kept reasonably stable from year to year so that local governments can plan their budgets. And they should be distributed on the basis of predetermined rules, which need to be kept as simple as possible. Simplicity, transparency, and predictability would help eliminate uncertainty and bargaining that can undermine intergovernmental fiscal relations.

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Ashoka Gunawardane is formerly of the Sri Lanka Administrative Service, held amongst others, positions of Additional Secretary to the Ministry of Public Administration, Provincial Councils and Home Affairs, Director of the Sri Lanka Institute of Development Administration (SLIDA) and Chairman of the Finance Commission. He is presently Chairman and Executive Governor of Marga Institute and a member of the Board of Governors of the Centre for Poverty Analysis (CEPA). He has worked for the UNDP as Chief Technical Adviser, Management Development Programme in Myanmar and as Training Specialist in Law and Judicial Process for project on "Building Capacity for Local Governance", Bangladesh. Holds a Bachelor of Arts (Hons), University of Ceylon, Post-graduate Diploma in Development Administration, University of Leeds, UK, and a Master in Social Science from the University of New England, Armidale, Australia. Has an abiding interest in public policy, governance and decentralization with a specific focus on issues of human development and has several publications to his credit in these areas.