

## ECONOMIC IMPLICATIONS OF THE INTENSITY OF FISCAL DECENTRALIZATION: EVIDENCE FROM SRI LANKA

Dulanii Liyanahetti

*Department of Social Studies, The Open University of Sri Lanka*

**Keywords:** *Fiscal Decentralization, Measuring Decentralization, Economic Growth, Provincial Growth*

### Introduction

Devolution of power is an accepted principle under good governance of which fiscal decentralization acquires a central 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, 2005). 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 on their revenue and spending patterns. Consequently, fiscal decentralization aims at a more equitable economic growth among provinces in a country rather than the center acquiring all benefits and thereby increases the well being of individuals. In a strict sense, therefore, fiscal decentralization forms the financial aspect of devolution of power to regional/provincial/local government levels (Davey, 2002).

Sri Lanka adopted fiscal decentralization actively with the enactment of the 13<sup>th</sup> amendment to the constitution and along with the Provincial Councils Act No. 42 of 1987. However, the history of local governments in the country dates back to 124-168AD<sup>4</sup> and currently there are nine (09) Provincial Councils and 336 local bodies functioning which includes 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 here the important phrases to be noted are *allocate adequate funds* and *ensure balanced regional growth*. This is sufficient evidence to prove as to what the Government intended through fiscal decentralization in Sri Lanka although its efficient implementation is subjected to rigorous criticisms at various junctures. The objective(s) of conducting this study can be summarized as follows:

- To construct a statistical/mathematical process to measure the degree of fiscal decentralization in Sri Lanka using sub-national governments' expenditure and revenue data; and
- Analyze the contribution so far made by the fiscal decentralization process to Provincial Gross Domestic Product (PGDP) and country's Gross Domestic Product (GDP).

As mentioned earlier almost more than two decades have lapsed since the activation of the fiscal decentralization process in Sri Lanka without a proper impact analysis being 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 *whiteelephant* and

---

<sup>4</sup>The powers of the local governments in Sri Lanka became a devolved subject under the Provincial Councils after the 13<sup>th</sup> amendment to the Constitution enjoying less importance.

causing wastage of resources<sup>5</sup>. There is also a doubt whether decentralization has taken place at all since the center still persists to possess a fair degree of discretion in revenue distribution and spending independence. 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). In short, has fiscal decentralization in Sri Lanka caused centralization of powers quite contrary to what is envisaged in the 13<sup>th</sup> amendment to the Constitution? This forms the primary research problem that the study seeks to answer.

### Methodology

Measuring fiscal decentralization is a complex process which has no single or universally accepted criteria. Numerous studies carried worldwide have introduced methods by which it could be done viz. Revenue Approach (RR), Expenditure Approach (ER) etc. The methodology adopted largely depends on the particular fiscal structure in existence and the availability of data. The present study has adopted the Decentralization Measurement Model applied in The Philippines to measure decentralization intensity (Uchimura and Suzuki, 2009) which is a culmination of the ER and RR approaches<sup>6</sup>. The rule of thumb is if the value calculated is closer to 1 then degree of decentralization is high and vice versa. Secondary data relating to the past decade obtained from Provincial Authorities has been employed for calculation purposes.

No.	Measurement Indicator	Formula
1.	Provincial share of total fiscal expenditure (PFE)	$PFE = \frac{\sum PE}{(\sum LE + CE)}$ Where PE is provincial expenditure, LE is local government expenditure and CE is central government expenditure.
2.	Provincial share of total fiscal revenue (PFR)	$PFR = \frac{\sum PR}{(\sum LR + CR)}$ Where PR is provincial revenue, LR is local government revenue and CR is central government revenue.
3.	Provincial dependency on fiscal transfers (PDFT)	$PDFT = \frac{\sum FT}{\sum PTR}$ Where FT is total fiscal transfers and PTR is total revenue of provincial governments.
4.	Provincial fiscal autonomy (PFA)	$PFA = \frac{\sum POR}{\sum PTR}$ Where POR is own revenue of provincial governments and PTR is total revenue of provincial governments.
5.	Provincial expenditure discretion (PED)	$PED = \frac{\sum GR}{\sum PTR}$ Where GR is general revenue of provincial governments and PTR is total revenue of provincial governments.
6.	Composite ratio (CR)	$CR = \frac{\sum PE}{\sum CE}$ – Grants received by sub-national governments – Grants given by the central government, Where PE is total provincial expenditure and CE is total expenditure of the central government

<sup>5</sup> The main issue to be discussed is whether the fiscal decentralization policies had been able to achieve its intended outcome as per the 13<sup>th</sup> amendment to the Constitution rather than being further centralized.

<sup>6</sup> This process has been modified accordingly to suit the Sri Lankan context. It should be mentioned that this process can be further developed in subsequent research.

The impact of fiscal decentralization on economic 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 ratio of fiscal expenditure to GDP. Although the country has recorded an annual growth rate of 8% in 2010 how has fiscal decentralization behaved in this high growth performance? Has devolution played a key role in achieving such a growth level? 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.

Therefore, the methodology adopted is primarily a deductive approach employing quantitative techniques including a comprehensive interpretation of secondary data to evaluate as to how fiscal decentralization has affected GDP and PGDP.

### **Discussion and Conclusion**

An effort is made in this study to analyze the degree of fiscal decentralization using different indicators namely, expenditure, revenue, fiscal transfers, fiscal autonomy, provincial expenditure discretion and composite ratio. 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 which shows the provincial fiscal autonomy fares a lesser fiscal decentralization similar to provincial share of fiscal revenue. On the other hand 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. The composite ratio stands as the indicator that shows the highest degree of fiscal decentralization.

During the period of operating the fiscal decentralization there cannot be seen a rapid turn of economic events to accelerate the provincial shares in 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 gone especially to 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.

As reiterated earlier there is a dearth of studies in Sri Lanka which have attempted to quantify fiscal decentralization in mathematical/statistical terms. This is because of the complexity and ambiguity of formulating a process by which fiscal decentralization can be measured. Thus, in that sense this study seeks to contribute to the available literature on fiscal decentralization by providing a basic framework through which decentralization can be measured in absolute terms.

### **Reference**

Amarasinghe, R. et al. (2010). *Twenty two years of devolution: An evaluation of the working of Provincial Councils in Sri Lanka*. Sri Lanka: Institute for Constitutional Studies.  
Central Bank of Sri Lanka Annual Report: various issues

- Davey, K. (2002). *Fiscal decentralization* [on line] Available from <http://unpan1.un.org/intradoc/groups/public/documents/untc/unpan017650.pdf> [Accessed 23rd November 2010]
- Smoke, P. (2001). *Fiscal decentralization in developing countries: A review of current concepts and practice* [on line] Available from <http://www.policycafe.rs/documents/economic/publications/fiscal-policy/decentralization-in-developing-m> [Accessed 10th April 2011]
- Uchimura, H. And Y. Suzuki (2009). *Measuring fiscal decentralization in The Philippines* [on line] Available from <http://202.244.105.129/English/publish/Download/DP/pdf/209.pdf> [Accessed 01st December 2011]