

## Chapter IX

### FISCAL AND FINANCIAL DIMENSIONS OF FEDERALISING SRI LANKA

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#### Introduction

The most important (but not the only) rationale for federalising Sri Lanka is the constitutional accommodation of multiple identities within one viable state. This entails regional autonomy over some spheres of government, whilst the centre retains responsibility over others. Thus there will be institutions of government that are regional, others central and still others which are shared for the delivery of public goods and services. The matters with regard to how these institutions are financed in order that they function effectively, efficiently, responsively and accountably should be addressed from the outset, because the operational success of public institutions depend on adequate financing. Therefore in order that the problems associated with the existing provisions for financing of regional government are not replicated in future institutional reformulations, it is vital that financial and fiscal issues are considered from the beginning. Moreover, it is important that the financial and fiscal aspects of a constitutional settlement are concretised before it comes into force, because errors will be harder to rectify later.

On the other hand, fiscal and financial arrangements are pivotal in a federal system in that they determine the nature and meaning of shared-rule and self-rule in practice. Institutions of the future Sri Lankan state should ideally be inclusively negotiated into a final political settlement and given expression in a new constitution. In federations, fiscal autonomy as constitutionally defined and guaranteed, gives real meaning to the notion of self-rule. At the same time, the equally important arrangements for the adjustment of imbalances underscore the interdependent and co-operative nature of federal government. These include provision for adjusting 'vertical'

imbalances between the centre and regions, i.e., to rationalise gaps in expenditure and revenue of regions, and for 'horizontal' equalisation of economic disparities between regions.

To this end, the existing framework for the devolution of power under the Thirteenth Amendment, even though largely meaningless in practice as a response to Tamil aspirations to autonomy, provides an inescapable context to the debate about more meaningful power-sharing between the centre, and particularly the North and East region. Noteworthy of the post-1987 attempts at constitutionally addressing the conflict is the dearth of interest in the financial and fiscal aspects of devolution and power-sharing. The idea seems to have been that it is more important to resolve the fundamental political and constitutional questions first, leaving the details of finance for later. In the case of some proposals moreover, for example the PA government's draft Constitution Bill of 2000, some of the regressive features of the Thirteenth Amendment framework for financing devolution were preserved. Yet, recently, the Majority Report (2006) of the Experts Panel of the All Party Representative Committee (APRC) endorsed the fiscal and financial provisions of the draft Constitution Bill as providing an appropriate framework of public finance for the quasi-federal constitutional scheme its authors proposed.

In a federal state, there are two or more tiers of government that are directly and separately accountable to the people. Each tier of government performs distinct functions incorporating the ideals of self-rule (i.e., by regional governments) and shared-rule (i.e., by the institutions of the centre and those that are shared). However, federal states are characterised by elaborate formal and informal channels of interdependence and co-operation between those tiers of government, especially regarding fiscal and financial arrangements. While the horizontal separation of powers is important to the federal idea for its inherent democratic value, the focus of this discussion is more on the division of subjects between the institutions of the centre and those of the regions. This vertical organisation of government is usually constitutionally recognised, because federal states are founded on the belief that the supreme constitution governing relations between

constituent units is in the nature of a negotiated political covenant that guarantees the autonomy of both the centre and the regions within the federal state.

It follows that where several tiers of directly answerable government exist with defined separate jurisdictions (although most federations have concurrent responsibilities) over certain functions of government, the financial capacity of the various tiers needs to be viewed from a perspective that is different to how one would consider the finances of a unitary state; even a unitary state that is de-centralised or devolved. This is because in a unitary state with devolutionary characteristics, regional administrations derive their authority and therefore their financial capacity from the express will of the centre, which is revocable by the centre at any time. Therefore, the ultimate focus of public accountability is concentrated on the centre, while regional administrations are treated as its agents. The Sri Lankan state following the Thirteenth Amendment to the Constitution is an example of this. In federal states, the opposite is the case, and even though widely varied arrangements exist for the imposition of taxes and their expenditure, the focus of accountability is the particular tier of government that is responsible for raising the revenue and / or spending the proceeds.

However, it is important to remember that there is no 'off the shelf' standard form of fiscal federalism that can be adopted by a country seeking federal-type reformulations. Every country has its peculiar needs to which its fiscal and financial arrangements should be specifically tailored. For this reason it is pertinent to remember that fiscal arrangements are the result, and once in existence, continue to be heavily influenced and shaped, by the political and social conditions within which they operate. If unity in diversity is the grand idea upon which the future Sri Lankan state is to be grounded, then the political dynamics which led to the failure and rejection of unitarism assume relevance as indicators of past mistakes and how not to repeat them.

Similarly, the *political* nature of federal inter-governmental relations with its culture, framed by co-operative constitutional values, of



centre-region bargaining as an integral part of democratic government must be kept in mind. This is because successful federations are dependent not only on the constitutional expression of shared rule and self rule but, equally, on the sentient political culture which underpins the constitution and other subordinate institutions and procedures.

### **Designing a Federal Fiscal and Financial Framework**

Bearing in mind the salience of the political dimension of federal fiscal and financial arrangements, it is possible to delineate the four broad sets of issues that are pivotal to designing any federal-type fiscal and financial system. They are the questions relating to (a) the allocation of expenditure responsibilities, (b) the assignment of revenue raising powers, (c) a system for fiscal equalisation, and (d) the framework for the management of the national economy, particularly in the context of regional borrowing. Considering the possible options fiscal and financial arrangements this way helps outline the parameters for further deliberation on fiscal federalism in Sri Lanka.

### **Allocating Expenditure Responsibilities**

In a federation, each level of government needs financial resources that broadly match its expenditure responsibilities. The latter depend on the particular division of subjects between the centre and the regions. In Sri Lanka under the Thirteenth Amendment, the devolved subjects of exclusive jurisdiction are provided in the Provincial Councils' List, the Reserved List contains those of exclusive central competence and the Concurrent List is an area of shared competence. The experience of federations shows similarities as well as wide divergences in the allocation of responsibilities. Matters like foreign policy, national defence and financial regulation are invariably handled by the centre, whereas responsibilities with regard to local infrastructure and services are usually regional matters.

Divergences between federal states are inevitable in this regard, because the distribution of powers in each federation is always the



result of particular political and historical experiences unique to each state. For example in Canada, where Quebecois secessionism based primarily on the French language, culture and history as distinguished from Anglophone Canada, influenced the federal organisation of the state with an emphasis on regional autonomy, one finds a wide variance in education and language policies between provinces. Generally, however, federations will have regard to principles based on efficiency of delivery, non-replication, regional needs and preferences, equity and rights of national citizenship in making decisions about allocating subjects and corresponding expenditure responsibilities.

### **Allocating Revenue Raising Powers**

Ensuring that each level of government has adequate financial resources in relation to its expenditure responsibilities is usually done either by assigning adequate tax and other revenue raising powers to each level, or by creating a system, ideally with a framework in the constitution, through which the proceeds of taxation (or other sources of income) raised by one government (most commonly the central government) are allocated between all levels of government. Sometimes, the egalitarian federalist principle that each constituent unit should have broadly the same resources available to it as the others, so as to enable it to provide broadly the same standard of services across the country, requires a system for fiscal equalisation.

Generally tax resources should be spent at the discretion of the level of government to which they are allocated, and that level of government should be accountable for its expenditure. In this respect, Germany is similar to South Africa in that the central government collects most of the tax revenue, but the regional governments are responsible for the delivery of programmes. In Canada, regions deliver most programmes and also raise over fifty percent of the total revenue.

The variance in possible arrangements for the imposition of taxation and expenditure of revenue is demonstrated also by the distinction

made in the PA government's draft Constitution Bill of 2000. For particular taxes, the draft envisaged a scheme whereby the centre levies the tax, but the region collects the proceeds. This would seem to have the advantage of promoting co-operative government as in South Africa, whereby the centre and the regions must co-ordinate fiscal needs, instruments and policy, having regard to the broader macroeconomic considerations of the regions as well as the country as a whole.

While principles such as transparency, low tax administration costs, needs of redistribution, regional ownership of natural resources etc guide federations in addressing this issue, the general principle is that the level of government that imposes a tax should be free to decide the conditions under which the proceeds are spent. However, the political questions of how to resource what responsibilities and by whom, should be constantly informed by the norm of accountability.

### **Equalisation**

Most federations contain elements of both methods of resource mobilisation outlined above, as well as of mechanisms for equalisation. Equalisation regimes are conspicuous by their absence in countries such as the USA, but regional imbalances are addressed by large federally financed programmes which are administered by the beneficiary state. Fiscal equalisation has the oldest history in Australia where the federation is based on the notion of a 'commonwealth' of states. The centre divides among and transfers to regions a fixed amount of revenue (currently all the proceeds of the Goods and Services Tax) to which the equalisation process is additional, and requires calculations based on revenue raising disabilities and expenditure needs. In Canada, the central transfers are determined by the scale of the annual imbalances.

Another way of adjusting imbalances is the pro-active model that is found in India and South Africa. Freedom in both countries and socialism in the case of India gave those state-making processes potent ideological impetus. While cohesiveness of the national polity was a crucial consideration, democratic equality was an elusive

reality to both states at their inception, and reducing severe economic disparities was a natural first step in this direction.

In South Africa, the national government (centre) raises most of the revenue in support of national and provincial programmes, and some of the revenue for local government. However, while the provinces deliver most of the services included in the list of concurrent legislative competence, they raise less than five percent of their own revenue and therefore the provision of these services depends on the equitable sharing of national revenue. National revenue is divided into equitable shares for each of the three spheres of government – national, provincial and local, on the basis of recommendations of the Financial and Fiscal Commission. This Commission has independent constitutional standing and creates the norms of financial distribution and fiscal equalisation between centre and regions and among regions. However, the Commission's standing has been somewhat diluted by the attitude taken by the centre that its recommendations are merely advisory, especially in a context where there is constitutional ambiguity in favour of more regional fiscal autonomy. In India and Australia by contrast, there is a relatively crystallised convention that the central government accepts the recommendations of the National Finance Commission and of the Commonwealth Grants Commission respectively.

In Sri Lanka under the Thirteenth Amendment, Provincial Councils have only limited tax-raising powers, and they are dependent on transfers from the central government. Sri Lanka too has a Finance Commission established under Article 154R of the Constitution, which is somewhat similar to the Finance Commission of India, although the latter's mandate appears to be far wider than its Sri Lankan counterpart's constitutional sphere of activity. The Sri Lankan Finance Commission is charged with the duty of recommending to the President the principles to be employed in allocating funds to provinces and for the due apportionment of such funds between the provinces. The Constitution states that the commission must take into account "the need, progressively, to reduce social and economic disparities" (*vide* Art. 154R (5) (c)).



## **Managing the National Economy**

The last important issue is as to how federal countries manage their national economies in the context of institutional pluralism, and what structural arrangements they have in place for cohesion and effectiveness in this regard. In terms of *managing* the economy, as opposed to other governmental economic activities such as the provision of public goods and services, social security and regulatory functions, reductionist modern governments intervene in only one of two ways. That is either through monetary policy (i.e., control of currency, interest rates and exchange rates) or through fiscal policy (i.e., government spending, taxation and public debt management). Free flow of goods, services and capital between regions in a federation in the overall context of a global economy means that the centre is best placed to control monetary policy. However, most federations have vested this function in a Central Bank that is politically independent of the central government. Needless to say, fiscal policy is a shared responsibility in federal countries, but the procedures of fiscal policy-making may be designed in various ways according to economic considerations of growth and development.

## **Designing Fiscal Federalism in Sri Lanka: Some Caveats**

A significant cause of the failure of devolution under the Thirteenth Amendment is the unsatisfactory framework for the financing of Provincial Councils. The ability of a government to respond to economic fluctuations using the instruments of fiscal policy is dependent on the canons of sound economic management, or perhaps even ideology. In countries like Sri Lanka, moreover, there is an added political dimension to this issue, in that entrenched unitarism has been pathologically hostile to giving even a measure of financial autonomy to regions. Indeed, this is the pervasive character of the recommendations in respect of financial arrangements of the Minority Report (2006) of the Experts Panel of the All Party Representative Committee (APRC).

In federalising Sri Lanka, however, the assignment of extensive revenue raising powers to regional administrations as an answer to

the problem of financial over-centralisation is an appealing option. If asymmetric autonomy for the North and East is contemplated, a high degree of revenue raising power would need to be assigned to that region. This is a key feature of the LTTE's ISGA proposals of 2003, and it is unlikely that the political and constitutional aspirations of that region would not in the future include a desire for a large measure of financial and fiscal autonomy.

However, this would not by itself be sufficient to meet the spending responsibilities of a future North and East regional administration(s) for several other reasons. Extraordinarily large amounts would have to be spent for reconstruction of infrastructure and the resettlement of people, for which resources cannot be expected from the severely depleted tax base of the North and East. At another level, the capacity of a future administration to run an efficient, accountable, and transparent revenue regime in all its complexity is different from (and much more difficult than) its ability to effectively enforce such a regime, for example, in the manner that the LTTE has become accustomed to raising revenue in the areas under its control.

It is also conceivable that an asymmetrically autonomous administration(s) in the North and East would want the power to borrow, and to negotiate foreign direct investment and international development assistance. While borrowing is a legitimate tool of fiscal policy, it is important that clear rules are established regarding the role of centre and region in this type of activity, including the competing economic principle that the centre must not guarantee regional borrowing. Prudently employed fiscal policy may be firstly, a catalyst for growth and development, and secondly, a short or medium term solution to temporary economic fluctuations. But for any form of fiscal federalism to work, fiscal autonomy must not be a cause of irresponsible or unaccountable economic management.

To conclude these brief remarks in a nutshell: sharing the power to tax is an important feature of the federal idea that gives real meaning to the notion of regional autonomy. On the other hand, sharing revenue raised by one order of government with others, as well as the feature of equalisation transfers, represent the element of unity and

interdependence. In this way, the symbiosis of unity and diversity inherent to the federal idea is reproduced in the fiscal relationship between centre and regions in federations.

### **The APRC Process and Prospects for Constitutional Reform**

The All Party Representative Committee (APRC) was appointed by President Mahinda Rajapakse in 2006 with the avowed purpose of formulating a Southern consensus on constitutional reform. The entire process is bedevilled by a not inconsiderable legitimacy crisis, and on present indications is not likely to contribute to a settlement of the conflict. The APRC was initially assisted by a Panel of Experts, who were divided on not only the technical substance, but also ideologically in their approach to constitutional reform. Both the majority (Sub Committee A) and minority groups (Sub Committee B) of the Experts Panel produced their recommendations in late 2006 in two separate reports, which were informally published in the media.

In respect of fiscal and financial arrangements, the majority report (in section 9) acknowledged that the Thirteenth Amendment is deficient mainly on the ground that it does not "...contribute towards 'balanced regional development'", and recommended that "A total redesign may be necessary taking into account the formulation set out in the Constitution Bill of 2000." (paragraph 9.1) In much of what follows, the majority report therefore refers back to the draft Constitution Bill of 2000, and endorses its provisions. The basic principles on which the redesign of the fiscal and financial framework should proceed are identified as (a) Provincial Autonomy, (b) Revenue Adequacy, (c) Equity, (d) Efficiency, and (d) Predictability. Based on these principles, the majority report reiterates the framework expressed in the draft Constitution Bill of 2000 in which, there has been an attempt to provide greater clarity in the assignment of competences between the centre and the regions; better finance the fiscal gap between expenditure responsibilities and revenue raising powers of regions; and provide a scheme of equalisation to address diverging fiscal capacities of various regions. The majority report also endorses the a draft Constitution Bill of



2000 in respect of institutional arrangements (in particular the powers, functions, and duties of a reformulated Finance Commission) and dispute resolution mechanisms.

The minority report is hostile to federalism and not over-enthusiastic about devolution. To the extent that it proposes a system of devolution, the minority report is replete with a strongly unitarian bias that seeks to maintain a pervasive role for the central government in both devolved competences and institutions. In the two paragraph section on 'Finance' under Chapter VI ('Other Recommendations') in the seventy nine page report, the constant motivation seems to be to maintain if not strengthen the centre's dominance in relation to public finance and to subordinate the devolved bodies to the centre. Indeed, the propositions of the minority report in this regard appear to be guided more by an ideological commitment to unitarism than either a technical understanding of the constitutional design elements of a fiscal and financial framework, or even the necessary financial implications of the framework of devolution the minority report more broadly recommends.

The publication of the majority and minority reports were a source of major controversy and the APRC process has since been conducted on the basis of a consensus document produced by its chairman, Minister Tissa Vitharana. Although the APRC continues to function, largely due to the perseverance of its chairman, there is little likelihood given the regressive attitude of the present government to power-sharing and a negotiated peace (evinced by the SLFP proposals to the APRC of 1<sup>st</sup> April 2007, and the political fiasco surrounding the production of the APRC's so-called interim report on 23<sup>rd</sup> January 2008, which recommended, at the instigation of the President, a scheme of devolution arguably *less* extensive than that contemplated by the Thirteenth Amendment) that it would contribute significantly to a breakthrough, even in the limited sense of forging a Southern consensus on constitutional reform.