

**Service Delivery and Decentralization in Sri Lanka
Assessment and Options**

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Foreword

Sri Lanka's 13th constitutional amendment (1987) called for substantial decentralization of the public sector and service delivery. This report assesses the challenges of decentralization and its implications for service delivery in Sri Lanka. The Report proposes a set of reform options aimed at improving delivery of services in selected social and infrastructure sectors while strengthening the intergovernmental fiscal framework.

Much of the data used to prepare the report was obtained through a series of missions fielded during 2004 and 2005 comprising Bank staff and international and local consultants. The mission interviewed extensively officials from the central, provincial and local governments, the Finance Commission and met with think-tanks, academics and leading thinkers on decentralization in Sri Lanka. We gratefully acknowledge their contribution. The Report draws on information and data from a number of national, provincial and local institutions and sources. All sources and specific material provided are acknowledged in footnotes wherever applicable.

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Service Delivery and Decentralization in Sri Lanka: Assessment and Options

Executive Summary

1. Sri Lanka's 13th constitutional amendment in 1987 called for substantial decentralization of the public sector and service delivery. While various reasons, including the ethnic conflict, motivated the original decentralization decision, it is important to give strong consideration to the implications for service delivery outcomes in assessing the decentralization framework in Sri Lanka today. Even though not always explicitly stated, improving service delivery is an implicit motivation behind most decentralization efforts.

2. This Report assesses Sri Lanka's experience with decentralization to date and discusses options for decentralization and implications for service delivery in three sectors—roads, solid waste and health. Indeed, to get a fuller picture, one should examine a broader set of services including education, water supply and sanitation; nonetheless, the selected sectors in the report illustrate quite well the considerations relevant to the decentralization decision and its future direction. The services selected cover a range of central, provincial and local responsibilities in delivery and illustrate quite well how the cause of success or failure of service delivery is rooted in the institutional framework, division of responsibility, funding mechanisms i.e. incentives and accountability. The effective provision of these services requires a clear understanding of the service delivery goals, technical capacity, adequate assets and recurrent inputs to deliver services. Each sector has its particular needs and to some extent can be considered independently, but the political realities effectively require that any constitutionally mandated and elected level of government have some corresponding responsibilities.

3. The options for improving service delivery outcomes analyzed here are all within the framework of the 13th amendment of the constitution of Sri Lanka. The report does not examine issues in the Northeast conflict region, since, at least in the short term, the solutions lie predominantly in the political arena.

Service-Delivery Diagnosis

4. Services are delivered by all three levels of government. Some services are centralized such as water supply and electricity. Others such as solid waste are primarily the responsibility of the local authorities. Health and education are delivered at the national, provincial and local authority level. Capacity and funding have a significant impact on the quality of services delivered. Any options on improving service delivery levels to citizens would need to be rooted in the incentive, accountability framework and are determined by the factors including the design of fiscal transfers, own revenue generation, structure of civil service administration and capacity to deliver. The quality and coverage of the selected three services offers a mixed picture, with varying levels of performance and universally high costs relative to benefits. While different in myriad ways, these core services remain a fundamental public responsibility. These services are delivered at both the provincial and the local level and demonstrate clearly the impact of unclear mandates, lack of resources/funding and lack of accountability on the quality of delivery of services to the citizens. Regional differences in the delivery of services are also noteworthy.

- Roads. Although road density in Sri Lanka is relatively high by regional standards, only 10 percent of the paved road network is in good condition due to lack of maintenance. Roads are substandard for almost all of the country—without a good national highway system, and with lack of maintenance and extreme regional disparities. Only 1 percent of paved roads have four lanes. Over 50 percent of national and provincial roads have poor or bad surface conditions—local roads are even worse—and all major roads suffer from congestion. Only 10-15 percent of

rural population has access to an all-season road as compared to 60 percent in India and 39 percent in Bangladesh. The Investment Climate Survey for Sri Lanka cited the lack of good roads as one of the most important constraints to growth. The Integrated Nationwide Road Sector Master Plan, completed in 2005, aims to address some of these issues.

- Municipal Solid Waste Services (MSW). MSW management in Sri Lanka is today largely comprised of collection and ad-hoc disposal of solid waste in environmentally sensitive “open dumps” in largely inappropriate locations. Only 40 percent of the waste generated is collected resulting in significant public health risks to all income groups, and particularly to the poor. Collection schedules for solid waste are normally not adhered to. There is high absenteeism in the work force and shortage of resources for investment and O&M for the existing vehicle fleets. Above all there is a lack of adequate disposal facilities which could have potentially adverse impacts on the environment.
- Health Services. Sri Lanka has achieved significant improvements in health outcomes in meeting the Millennium Development Goals (MDGs). This has been achieved through public health measures (including immunization and better water supply), and primary health clinics, especially infant and maternal care. These have been run by the Provincial Health authorities since decentralization in 1987. The curative care services which are provided through a range of hospitals are managed by both the provincial and central ministry of health. Teaching hospitals and specialized hospitals along with selected other hospitals are managed by the Central Ministry of Health which represent 1/10th of the facilities but serve approximately 45% of inpatients in the country. Moreover, service delivery outcomes in health vary significantly across regions. Colombo has the lowest Maternal and Infant Mortality Rate (15 maternal deaths per 1000 live births); while Nuwara Eliya in the Central Province, has almost 168 deaths per 1000 live births. Furthermore, provincially-managed hospitals have poorer quality and much lower bed occupancy (53 percent) than nationally-managed hospitals (86 percent).

Intergovernmental Allocation of Responsibility for Services

5. The intergovernmental allocation of responsibilities for the service delivery in roads, solid waste, and health varies across these three sectors. The road and health services are delivered by all three levels of government – the national, provincial and local authority. The solid waste is primarily the responsibility of the local authorities. The national government has taken main responsibility for urban land management leaving little room for local government. The allocation of responsibilities, capacity, and funding have a significant impact on the quality of services delivered. Any options for improving service delivery levels to citizens would need to be rooted in the incentive and accountability framework and are determined by the factors including the design of fiscal transfers, own revenue generation, structure of civil service administration and capacity to deliver services.

- Roads. Road investment and maintenance involve all three tiers of government. There is a clear division of responsibility in theory, but in practice Sri Lanka has not found a way to reach political agreement to build the various road links (each with local benefits), that would add up to a national network that the national economy urgently needs. Total revenue from the sector (vehicle import duties, licenses, gasoline tax, etc) greatly exceeds the total spending in the sector (investment and recurrent) but the revenues do not get ploughed back into the sector. Provincial and local government authorities lack funding, capacity and incentives to maintain local roads.
- Solid Waste. Local governments are responsible for solid waste collection and disposal. Although local government’s have nominal responsibility in this area, they do not effectively control the service providers (municipal workers), since the latter enjoy civil service protection

and thus are immune to sanctions for the prevailing high absenteeism and poor service. Furthermore, local councilpersons depend on national politicians (MPs) for their positions and therefore also do not respond to local constituents. It should be noted however that the recent local elections included SWM issues on the agenda. Environmental externalities and economies of scale indicate that leaving disposal of waste to individual local authorities is a sub-optimal solution.

- Health Services. The health services were delivered through the de-concentrated system prior to 1987. Decentralization has created a parallel delivery system, with the central government continuing to administer national health policy and manage national teaching and specialized hospitals, and with provinces managing provincial hospitals and all primary care. The role of local authorities is limited to sanitation, accounting for less than 3 percent of total health spending. The parallel delivery is not well linked with local interests and preferences. The financing of the parallel delivery is through two channels which are not coordinated and monitored. Provincially-managed hospitals largely rely on central block grant transfers based on the gap-filling approach. The civil servants managing provincial hospitals depend on the central government for transfer and promotion, which weakens their allegiance to provincial councils. Therefore, the public health system in Sri Lanka is characterized by inadequate financing of provisional facilities, lack of clear criteria for differentiating nationally and provincially delivered hospital services, inefficient allocation and high levels of recurrent expenditure mainly constituting staff and personnel financed through block grants.

Fiscal and Administrative Decentralization: Systemic Issues

6. The sector-specific issues in service delivery reflect some systemic problems in the decentralization/deconcentration arrangements, with contradictory incentives and weak institutions.

- *First*, while many sub-national officials are elected, namely the provincial and local councils and mayors, they have limited powers in practice. Provincial governors are appointed by the President. Moreover, the provincial and local council elections are contested as a referendum on national party issues, not the performance of the sub-national governments themselves.
- *Second*, the sub-national governments have little autonomy and authority in managing the personnel and spending programs nominally assigned to them, and what they have is not well defined. While formally there is a separate civil service at the provincial level, in practice management and executive level posts are generally filled by assignment from the central civil service, and the Chief Secretary in each province is appointed by the national cabinet and paid directly through the central government payroll. As a result, accountability flows to the central government rather than to the elected sub-national governments.
- *Third*, the current spending assignments have duplication, with both deconcentration (central spending through districts and divisions that report to the central administration) and devolution (spending through provinces and local authorities). This has led to unclear accountability and to excess employment without commensurate results in service delivery. Only a fraction of money which is due service providers actually reaches them due to the power of the central government vis- a-vis local governments through whom the money gets transferred.
- *Fourth*, combined provincial and local own tax revenues account for only 7 percent of total government tax revenue, much below international comparators. The transfer system (gap filling for staff costs and other aspects of the budget process), which is influenced by the budgetary system, discourage provincial and local governments from raising their own revenue (and provincial councils lack authority) and from being efficient in service delivery. For this reason and because of the central government's predominance in the capital budget, funding for sub national government investment comes only as a residual.

- *Fifth*, urban planning and land management is not keeping pace with urbanization, affecting delivery of core urban service. Financing for urban service delivery is constrained by inefficient land markets and lack of provision of serviced land leading to squatter settlements and poor housing conditions and suboptimal use of land as source of revenue for urban local authorities. Coordination among various central agencies responsible for urban infrastructure and land management is problematic. UDA consolidates the functions of policymaking, regulation and real estate development, which is not a good practice internationally. Inefficient urban land management not only affects urban services but also the competitiveness of urban centers and economic growth.

7. These problems lead to excess costs and suboptimal service delivery outcomes. The Government could consider various options to address these systemic and institutional constraints. The options for reform presented here follow the logic of a decision tree—first whether to decentralize or to deconcentrate - what the trade offs for each are, and second how to do it.

First Decision Point: To Emphasize Decentralization or Deconcentration

8. At present the Sri Lankan structure reflects a striking dualism, a de facto deconcentrated form of government with some decentralized features. To move forward, the government needs to clarify what the deconcentrated districts and divisions of the national government do (or if they should continue), and what, if anything, would be left to the provincial and local governments. This should be to a substantial extent decided sector-by-sector, based on what works best for the sector and reflecting core principles of efficiency, economies of scale, and subsidiarity¹. Table 1 summarizes the advantages and disadvantages.

Table 1: Balance of considerations for Decentralization or Deconcentration

	Advantages	Disadvantages
Decentralization	<ul style="list-style-type: none"> - Decision makers would be (potentially) closer to the voice of the people. - Consistent with constitutional Amendment 13. - Reduce duplication of functions 	<ul style="list-style-type: none"> - Local officials are often accountable to national politicians - Lack economies of scale (for some activities) - Lack of capacity
Deconcentration (governing through departments and divisions)	<ul style="list-style-type: none"> - Effective status quo in many sectors - Technical capacity now in the deconcentrated agencies - Reduce duplication of functions 	<ul style="list-style-type: none"> - Chain of accountability to clients too long - Budget allocation might not reflect local preference

Second Decision Point: Which Form of Decentralization or Deconcentration

The second stage in the decision tree—which would need to be understood before finally deciding on the first stage—is which form of decentralization or deconcentration to follow.

¹ The subsidiarity principle is that each function should be done at the lowest possible level, consistent with the distribution of capacity and economies of scale.

A. Decentralization

International experiences indicate four key lessons that are relevant for the allocation of service delivery responsibilities under the decentralization option:

- Sectors differ in the appropriate degree of decentralization, according to economies of scale, externalities, and proximity of providers to clients.
- Different levels of government can have responsibility for different aspects of a single sector, and this can work very well, given clear and logical allocation of mandates.
- Spending decisions for investment and maintenance need to be at the same level of government; otherwise each tends to avoid responsibility at the expense of the other.
- Decentralization may work better, either as a transition or as a permanent structure, if some local governments (like Colombo) with greater size and capacity take on correspondingly greater responsibilities.

9. With regard to the macro parameters of decentralized government, international experience suggests two additional guidelines:

- Give sub-national governments the authority and capacity to collect own-revenue in order to enhance the efficiency of financing and delivering services and make them more responsive to local clients. Transfer systems should move away from gap filling practices. International experience shows that urban land is an important source for financing urban infrastructure and services through leasing, sales, user charges, taxes and other means. Setting a hard budget constraint on resources from the center helps create the appropriate incentives.
- Set rules and incentives for staffing so that the wage bill does not overshadow the other spending priorities, and so that public employees can be paid adequate wages to retain qualified workers. The degree of control over staffing decisions (recruitment, dismissal, etc) assigned to the sub-national level should be consistent with the degree of control over the wage bill, or the design of the transfer payment regime.

10. Sri Lanka could consider three main options for decentralization (see Matrix Table X in the report).

- **Option 1:** Strengthen both Provincial Councils and Local Authorities, with a phase-out of districts and divisions and transfer of their resources (staff and funding) to provincially and locally elected governments.
- **Option 2:** Strengthen Provincial Councils, leaving Local Authorities with their current responsibilities and cutting back districts and divisions.
- **Option 3:** Strengthen Local Authorities, especially in the urban areas and cut back the resources for Provinces and divisions. The districts would be streamlined but would probably still have responsibility and resources for some tasks too large for Local Authorities. The elected Provincial Councils could still perform important functions of oversight and monitoring, particularly of the programs executed by the districts and divisions.

B. Deconcentration

11. **Option 4:** Strengthening the existing deconcentration is considered as Option 4. Given the constitutional amendment for decentralization, the deconcentration options—putting responsibilities more clearly in the hands of districts and divisions and reducing corresponding responsibilities of Provincial Councils and Local Authorities—would apply to selected sectors, while others would remain with the

constitutionally mandated Provincial Councils and Local Authorities. And even in the areas where Districts and Divisions take over responsibility for program execution, the elected Provincial Councils would remain as monitors and quality control agents. Local Authorities could probably remain in some limited functions, certainly solid waste collection, but there would be cutbacks of autonomy and resources even in places with strong capacity.

Options: Implications for Sectors

12. The various options have different implications in each sector. Within each option, governments that are the closest possible to the people are presumed to provide services the best. Key factors in determining the lowest level include the potential for economies of scale, the existence of interregional spillovers, variation in preferences, and the desire for equalization.

13. **Roads.** The central government would be responsible for national roads under all four options. The key issue is how responsibility and funding for capital investments and maintenance of provincial and local roads would be determined. Options 1 and 2 would enhance Provincial Councils' ability to plan and deliver intra-provincial roads. Under Option 3, local authorities would be responsible for planning local roads and intra-city transportation as part of their broader urban development plans. Local Authorities would also coordinate these plans with the appropriate provincial and national agencies. Local Authorities would maintain local roads using resources from their budget. Capital projects would be funded through competitive grants provided by the Ministry of Transportation or the Finance Commission. Under all three decentralization options, revenue mobilization (at least at the margin) for roads should emphasize property tax, improvement assessments, toll roads and gasoline tax. Capital project funding from the national block grant would come mainly as a grant to match locally raised revenues, with allowances for low-income inaccessible areas. Option 4 would enhance the planning, operations and maintenance capabilities of districts and divisions.

14. **Solid waste services.** Because of limited economies of scale and limited externalities, solid waste collection is universally best handled through local authorities. Treatment and disposal of solid wastes are subject to greater economies of scale (and therefore could be aggregated upwards), but still over a relatively narrow range, particularly if transportation of the wastes is costly (as it often is in Sri Lanka). These functions could be carried out (or contracted to the private sector) either by PCs (Options 1 and 2), by inter-governmental agreements between local authorities (Option 3) or by districts (Option 4). Financing for collection, disposal, and treatment should primarily be provided through local user fees and taxes. Higher level governments should provide grants or loans for capital costs to permit local authorities to purchase appropriate collection and treatment equipment. Finally, the level of government that has responsibility for this service should also have full authority to decide on staffing and other spending decisions.

15. **Health.** There are four main parts to health care responsibilities—primary care (clinics), secondary hospitals, tertiary hospitals (teaching, research, and sophisticated treatments), and regulation. For a country like Sri Lanka, the national government should handle tertiary hospitals and regulation. Also, except in the major urban areas, the local authorities would not be able to handle secondary hospitals. So the relevant questions are how to (i) demarcate responsibilities for managing non-tertiary hospitals and primary health care, (ii) match responsibilities to decision-making authority, (iii) linking financing with performance.

16. For hospitals, the international best practice is to give considerable autonomy to the administrations of each facility, with responsibility for quality and efficiency of service delivery and with authority to manage personnel and other inputs. This could happen under any of the scenario options. Options 1 and 2 would assign hospitals to the PCs. Options 3 and 4 would assign them to the national

government, except that with 3 a few large municipalities might manage hospitals. In other country experiences, the national governments have often been more willing than lower level governments to give appropriate autonomy to hospital facilities, but this would not necessarily be the case for Sri Lanka.

17. Primary care facilities would become responsibilities of Local Authorities in the third and probably the first option, although this might be differentiated among the Local Authorities, with only the larger ones taking this on. Under the second option the PCs would take over these health clinics. In option 4, the divisions representing the national government would have charge of the clinics. In any case the national government would continue to set the standards and regulations.

The Way Forward

18. Policy makers in Sri Lanka would need to debate and decide which option is more viable or feasible within the country's political, economic and social context. This requires consensus building concerning the type of accountability that is to be paramount and the degree of decentralization that accompanies it. Countries have chosen different ways to achieve this kind of consensus. In countries such as Australia, Denmark, Canada, India, and Thailand, National Commissions on Intergovernmental Finance have been created to develop and implement improvements on intergovernmental finance, as well as to improve monitoring, oversight, and evaluation. Of course, Sri Lanka has a similar institution in the Finance Commission, which has the potential to take on similarly strategic roles, beyond the current functions focused within the annual budget cycle. In other countries, governments table policy papers for discussion by all interested parties and stakeholders which is then used as a basis for examining and implementing policies.

19. The Core Report has eight sections. Volume 2 has detailed background papers on these topics.

20. **Section I** presents an overview of the challenges of decentralization and service delivery in Sri Lanka and provides a framework for analysis.

21. **Section II, III and IV** present three case studies of service delivery namely roads, municipal solid waste and health delivered at the local level and provide a robust example of how the inter-governmental fiscal relations and revenue mobilization and institutions impact incentives and accountability in service delivery.

22. **Section V** reviews the current government structure that has a striking feature of dualism. This dualism deeply affects the inter-governmental fiscal relations. The section discusses the expenditure assignments, sources of revenues and the intergovernmental transfer system that impact the incentives faced by the sub-national governments.

23. **Section VI** explores the issue of urban land as potential policy instrument for revenue mobilization and how it links with service delivery outcomes. It examines linkages between urban land management and infrastructure provision.

24. **Section VII** discusses administrative decentralization and its impact on budget, accountability and incentives for service delivery. It reviews broader issues of administrative challenges at the central government level which profoundly impact administrative decentralization and specific issues relating to sub-national level governments, with a focus on the degree of management autonomy in personnel management and how this interacts with the fiscal transfer systems.

25. **Section VIII** presents a menu of reform options.

SERVICE DELIVERY AND DECENTRALIZATION IN SRI LANKA: ASSESSMENT AND OPTIONS

1. **Sri Lanka's 13th constitutional amendment (1987) called for substantial decentralization of the public sector and service delivery.** This report assesses the challenges of decentralization and its implications for service delivery in Sri Lanka. The motivation for decentralization varies from country to country², but at its very core decentralization is an attempt by the state to transfer responsibilities of the state to lower tiers of government. Even when it is not explicit, improving service delivery is an implicit motivation behind most of the decentralization efforts. The experience with decentralization has mostly been quite mixed. Some of the reasons cited for this mixed success are, lack of capacity at the local government, lack of funding and misaligned responsibilities. The Report proposes a set of reform options aimed at improving delivery of services in selected social and infrastructure sectors. The analysis focuses on the incentives or disincentives faced by sub-national governments for making services work within the framework of the fiscal and administrative relationships among the central, provincial, and local governments.
2. **The report assumes asymmetrical decentralization.** This is because improvement in service delivery outcomes and improvements to the current fiscal and administrative arrangements in the non-conflict areas are politically feasible today while the political solution to the conflict areas would take its own course. This is in recognition of the fact that decentralization is a negotiated political process, and the first degree of priorities for the Northeast conflict area in Sri Lanka is to find a politically acceptable framework for resolving the conflict and reaching peace. Not surprisingly, the North East conflict areas represent the most underserved population in the whole range of services.
3. **Three specific services are selected for analyses-, roads, solid waste management, and health.** The analysis aims to arrive at a deeper understanding of the impact of intergovernmental relations in finance and administration on service delivery outcomes at the local level. The services cover a range of central, provincial and local responsibility in delivery. The effective provision of these services requires a clear understanding of the service delivery goal, technical capacity and adequate assets and recurrent inputs to meet the service delivery goal.
4. **The report assesses the following questions, analyzes challenges and constraints, and puts forward reform options to improve decentralized service delivery in Sri Lanka:** How have the administrative and fiscal relationships evolved among the three tiers of government? What role do sub-national governments play in delivering services and how effectively are these delivered. How are the provincial governments and local authorities financed and organized? How much autonomy and flexibility sub-national governments have in managing expenditures, raising revenues? What are the key sources of revenues for sub-national governments? What are key constraints and challenges in sub-national revenue mobilization? How predictable is the budgetary transfers for recurrent and capital items? And finally, how is the transfers system designed and how does it impact the incentive structure for sub-national governments in terms of mobilizing revenues and managing expenditure effectively.
5. **The report also analyzes urban land management and its implications for sub-national revenue mobilization and a broad range of service delivery.** Cross-country experience points to the importance of urban agglomeration to economic growth, hence the importance of core infrastructure and

² In Eastern Europe and the former Soviet Union, it was part of the political and economic transformation; in Latin America, it was to reinforce the transition to democracy; in South Africa, Sri Lanka and Indonesia, it was a response to ethnic or regional conflict; and in Chile, Uganda and Cote d'Ivoire, it was to improve the delivery of basic services (Shah and Thompson 2004).

social services delivery in order to strengthen the competitiveness of growth. Urban service delivery is closely tied to the capacity of local governments in mobilizing finances and linking finances to service outcomes. This in turn largely depends on how urban land is managed in its relationship with private financing and infrastructure planning and development.

I. Service Delivery Challenges

6. **Service Delivery Outcomes.** Sri Lanka performs far better than South Asian countries and other lower middle income countries in terms human development indicators, comparable in many cases to upper income countries like Malaysia and Chile (Table 1). Infrastructure service indicators, however, do not fair as well. Cross-country experiences demonstrate the importance of infrastructure to overall economic growth. Empirical evidence also underscores sustained economic growth is necessary for poverty reduction.

Table 1 : Sri Lanka Service Provision – International Comparisons

2001	Sri Lanka	Lower Middle Income Countries	South Asia Region	International Comparator
Primary School Enrollment (% gross)	112.	104	97	Chile: 100
Secondary School Enrollment (% gross)	86.	65	48	Chile: 89
Primary Completion Rate (% of relevant age group)	111	96	80	Indonesia: 105
Adult Literacy Rate (% of people 15 and above)	90.	89	57	Chile: 96
Infant Mortality Rate (per 1,000 live births)	13	33	66	Chile: 8
Under-5 Mortality Rate (per 1,000 live births)	15	42	92	Chile: 9
Improved Water Source (% of population with access)	78	81	84	Indonesia: 78
Improved Sanitation facilities (% of population with access)	91	78	64	Chile: 92

Source: World Development Indicators

Notes: Data are for the most recent year available up to 2003

7. Services are delivered by all three levels of government. Some services are centralized such as water supply and electricity. Others such as solid waste are primarily the responsibility of the local authorities. Health and education are delivered at the national, provincial and local authority level. Here question of capacity and funding have a significant impact on the quality of services delivered. Any options on improving service delivery levels to citizens would need to be rooted in the incentive, accountability framework and are determined by the factors including the design of fiscal transfers, own revenue generation, structure of civil service administration and capacity to deliver services.

8. The data for infrastructure provision does not take into account the quality of the service and out comes, and therefore portrays a much better situation that what is seen on the ground. For example, 90% of roads in Sri Lanka are in poor condition. While Sri Lanka has no access controlled, four- to six-lane expressway linking economic centers, major exporting provinces in China have substantially built up their capacity (e.g., 774 km for Zhejiang province and 1386 km for Jiangsu in 2001). Similarly solid waste collection and disposal are inadequate and pose large health and environmental problems. Only 40 percent of the solid waste generated is collected. Sri Lanka does not have a single solid waste treatment facility.

9. Service delivery outcomes vary significantly across regions. Take the example of maternal and Infant Mortality Rates, Colombo has the lowest MMR of under 15 maternal deaths per 1,000 live births, whilst Nuwara Eliya has almost 168 deaths. Infant Mortality Rates (IMR), although showing less

variation, still highlights significant regional inequality. Nuwara Eliya has also one of the highest IMR (20.7 infant deaths per 1,000 live births)³. Regional inequalities in terms of infrastructure provision are significant. Access to safe sanitation, for example varies from 46% of households in Trincomale to 95% in Colombo⁴ (the 95% coverage in Colombo may not measure quality of provisions). Overall, Sri Lankans living outside the Western Province do not enjoy access to roads and electricity that Westerners have. The situation in terms of road access is particularly bad in the conflict-affected areas in the North and East Provinces. Similarly, the percentage of households with electrification in the Western North province is 95 percent compared to 41% in the North Central province. North and the East being conflict areas have 9% and 36% access rates respectively.

10. **A Framework for Analysis.** Table 2 provides a simplified framework for assessing the incentives facing the sub-national governments to make service delivery work. The incentives are grouped under two broad headings: fiscal incentives and administrative incentives for sub-national governments.

Table 2: Key Incentives in the Decentralized Structures

Fiscal Incentives	Spending responsibility and flexibility	Spending responsibilities and clear mandates
		Hard budget constraints
	Autonomy in preparing the budget	Autonomy in preparing the development budget
		Autonomy in preparing the non-salary recurrent budget
		Autonomy in preparing the salary budget
	Incentives for local revenue-raising	Buoyancy and potency of taxes assigned
Clarity of revenue assignments		
Additional incentives for revenue raising		
Administrative Incentives	Autonomy in personnel management	Autonomy in preparing the salary budget
		Local control over the establishment
		Locally determined recruitment
		Local determination of career paths
		Local management of performance
	SG authority over senior staff	Autonomy in pay policy
		SG's input into the performance evaluation for the local staff
	Adequate deployment of staff	Credible threat to transfer local staff
		Adequate numbers and skills
		Adequate technical sanction powers

11. The above framework is only a simplified and partial one, focusing on the relationship between politicians/policymakers and service providers. The most obvious channel that citizens can use to make their demands for better service delivery heard is that of democratic elections. However, voting may be based on criteria other than service delivery. Voters may also prefer short-term outcomes to long-term lumpy investments which in the near term only deliver geographically narrowly defined benefits and its impact on geographically dispersed population may be only in the long term (example, expressways). The political dimension of citizens/client power has not been examined in this Report.

12. **The report analyses service delivery in the areas of roads, solid waste, and health sectors.** While different in myriad ways, these core services remain a fundamental public responsibility.

³ World Health Organization and Ministry of Health, Nutrition & Welfare, Sri Lanka, Sri Lanka Health Atlas, December 2003. Pp. 54-57.

⁴ NWSB, Estimated Sanitation Coverage Percentage of Households (%) by Districts in Sri Lanka, 2003. Unpublished.

These services are delivered at both the provincial and the local level and demonstrate clearly the impact of unclear mandates, lack of resources/funding and lack of accountability on the quality of delivery of services to the citizens. They share three characteristics. First, they are core public services – these will remain a fundamental public responsibility, whether discharged directly or indirectly. Second, the provisions of these services require the interactions between service providers and citizens everyday and hence are transaction intensive. Third, these services are discretionary in that the service provider needs to take local and even individual specific conditions into account. What determines how well these core services are delivered? In each case for the service to be effective what is needed is that the frontline provider: (i) knows what the service delivery goal is; (ii) is technically capable; (iii) has at disposal adequate assets and recurrent inputs to carry out the task; and (iv) is motivated to use their capability and available assets and inputs to meet the service delivery goal.⁵ When one observes service provision failure it is easier to proximate the cause of failure to a lack of one of the above four factors. But why these four aspects are lacking may be grounded in institutional, and finally at the systemic level. What determines how well these core services are delivered?

II. Roads

Coverage and Quality

13. Although road density (1.5 Km/Km² of area) in Sri Lanka is relatively high by regional standards, only 10% of the paved road network is in good condition due to lack of maintenance. This situation results in increased road user costs, poor quality and frequency of transport services, low road safety. Moreover, the cost to the economy in terms of lost output due to poor road network linking rural and urban areas is substantial. Sri Lanka also has the highest road accident fatality rate in Asia with a cost to the economy of 0.4% of GDP⁶. Only 10-15 percent of rural population has access to an all-season road as compared to 60 percent in India and 39 percent in Bangladesh. The Investment Climate Survey for Sri Lanka cited lack of good roads as one of the most important constraints to growth. Despite a substantial increase in traffic demand over the past four decades, there has been very little investment in improving trunk roads, upgrading (e.g. widening) of roads and construction of new national highways.

Table 3: Roads Categorized by General Condition

Road Class	Good	Fair	Poor	Bad	
National Roads	18.4%	29.8%	35.4%	16.4%	100%
Provincial roads	8.0%	40.0%	36.0%	16.0%	100%
Local authority roads	5.0%	30.0%	40.0%	25.0%	100%
Total	7.2%	31.7%	38.7%	22.4%	100%

Source: Finnroad and RDC, Road Sector Master Plan. Draft Final Report, May 2005

Challenges in Service Delivery

14. Road infrastructure is currently delivered by all three tiers of government namely, national, provincial and local. Although decentralization was intended to be a means to empower local governments and communities, as well as redistribute resources, this has not been the case in Sri Lanka. The National Government still bears the vast majority of capital expenditure in the sector, and very little

⁵ Lant Pitchert, India DPR – Draft December 2005.

⁶ The National Transport Policy, 2000.

maintenance is carried out in practice. At the same time, it is known that road maintenance is only partially funded, and the allocation at the start of the fiscal year is not in practice fully disbursed. There has been a systematic under-expenditure at the sub-national level due to lack of capacity to implement the programs they plan. In this context, the main challenges in service delivery in the road sector are:

- **Lack of sustainable road sector policy financing.** The high road density has caused severe budget constraints in maintaining the roads. GoSL has made some recent progress by implementing an interim road maintenance trust fund so that continuous and adequate flow of funds is available and to avoid funds required for maintenance competing with the more popular spending on new roads. This, however, will only partially cover the maintenance needs of national and provincial roads.
- **Disincentives for revenue raising for road maintenance.** There are no appropriate fiscal incentives that encourage local authorities to raise revenues to maintain the roads in their care. Transfers are earmarked for capital expenditures and local authorities are expected to raise their own revenues to maintain the roads in their jurisdiction. This, coupled with the political pressure on road agencies to build new roads every year, results in minimal amounts spent on maintenance.
- **Vast majority of capital expenditure in the sector is undertaken at the national level.** There has been a systematic under-expenditure at the sub-national level due to lack of capacity to implement planned programs. Thus, road maintenance is not only partially funded, but the allocation at the start of the fiscal year is not in practice fully disbursed, and very little maintenance is carried out in practice.
- **Lack of local capacity to plan and implement investments.** This is so particularly at the Local Authority level and in many instances the Provincial Council road agencies manage the maintenance of Local Authority roads.

III. Municipal Solid Waste Services (MSW)

Service Delivery Outcomes

15. The State of Environment Report (2001) identified municipal solid waste management as one of the most serious environmental and public health problems in Sri Lanka. Municipal Solid Waste (MSW) services, in Sri Lanka as elsewhere, are provided by local authorities. Although the problem exists in semi-urban and rural areas as well, it is less severe than in urban centers. MSW management in Sri Lanka today largely comprises of collection and ad-hoc disposal of solid waste in environmentally sensitive “open dumps” in largely inappropriate locations. Only 40 percent of the waste generated in Sri Lanka is collected resulting in significant public health risks to all income groups, and particularly to the poor.

Table 4: Waste Generation, Collection and Disposal by Selected Secondary Cities (tons/day)

Secondary City	Waste Generation	Waste Collected	Waste Disposed	% of waste disposed
Badulla	41	21	21	51
Chilaw	22	12	11	50
Gampaha	54	11	9	17
Kandy	131	86	78	59
Matale	32	21	20	62
Negombo	136	56	54	40
Nuwara Eliya	29	18	17	59

Source: Delivering Natural Resource and Environment Management Services Sector Project, Draft Final Report, ANZDEC Limited, New Zealand, May 2005

16. Collection schedules for solid waste are normally not adhered to. There is high absenteeism in the work force and shortage of resources for investment and O&M for the existing vehicle fleets. Above all there is a lack of adequate disposal facilities which could have potentially adverse impact on the environment.

17. The main challenges in solid waste management are:

- **Lack of accountability in service delivery.** Most Local Authorities are unable to adhere to a collection schedule because of the lack of accountability with public sector employment regulations proving opportunities for high absenteeism, and local political interference in the work of officials.
- **Shortage of resources for Capital Investments and O&M.** Most Local Authorities are short of funding for capital investments and Operations and Maintenance. They have aging vehicle fleets that result in frequent breakdowns and high costs of repair. There is a general lack of funds for maintenance.
- **Disincentives for efficient operations in Local Authorities.** The central government, through the Provincial Councils, subsidizes wages of permanent employees of Local Authorities with funding based on the number of staff employed by the Local Authorities. This provides a disincentive for staff rationalization because a reduction in staff would automatically reduce the level of funding from the Treasury.
- **Financing MSW Management:** Studies on MSW management in Sri Lanka have concluded that solid waste management budgets in Local Authorities are poorly defined and not well reported, therefore, making it extremely difficult to define actual costs of MSW service provision.
- **Lack of Attainable Environmental Standards.** Since proper SWM is still in its infancy in Sri Lanka, attainable environmental standards are crucial to ensure compliance. The CEA needs to review its waste management legislation and adopt reasonable and achievable standards urgently.

IV. Delivering Health Services

18. While Sri Lanka has achieved significant improvements in health outcomes, achieving further gains is increasingly difficult. Compared with other countries, Sri Lanka has achieved impressive overall health indicators at a per capita income of approximately \$1,000 in 2004. Sri Lanka had managed to reduce infant mortality rate to 25 per 1,000 live births, maternal mortality ratio to 92 per 100,000 live births, total fertility rate to below replacement level at 2.0, and raise life expectancy to 75 and 68 at birth for women and men, respectively² (World health Report 2005). However, vast regional disparities are also observed and service delivery outcomes vary significantly across regions. Colombo has the lowest Maternal and Infant Mortality Rate (15 maternal deaths per 1000 live births) while Nuwara Eliya in the Central Province, has almost 168 deaths per 1000 live births.

19. The health services were delivered through the de-concentrated system prior to 1987. Decentralization has created a parallel delivery system, with the central government continuing to administer national health policy and national teaching and specialized hospitals, and the provinces managing provincial hospitals and all primary care. The role of local authorities is limited to sanitation. Despite the decentralization and the creation of three marked levels of health service delivery (central, provincial and local), the public health system remains centrally dominated. Ministry of Health plays a dominant part in the delivery of health services. The Central government accounts for 61% of the total public health expenditures while the eight Provincial Councils and the Local Authorities (LAs) account

for 39% and 1-3% respectively. The parallel delivery is not well linked with local interests and preferences. The financing of the parallel delivery is through two channels which are not coordinated and monitored. There are no clear criteria for differentiating among national and provincial council facilities yet this distinction creates disincentives for service delivery. Better-funded national hospitals have a larger demand as shown by their significantly higher bed occupancy rates of 86% versus 53% in provincially-managed hospitals.

Table 5: Poor/Rich Ratio of Selected Reproductive Health Indicators in Sri Lanka*

Indicator	Socio Economic quintile					Poor / Rich ratio
	Poorest	Second	Middle	Fourth	Richest	
Infant Mortality Rate /1000 LB	26.8	22.8	18.3	16.7	14.6	1.8
Prevalence of low birth weight %	19.4	21.2	16.2	14.6	11.3	1.7
Prevalence of stunting (Ht/Age) %	25.1	23.1	12.0	9.9	4.3	5.8
Prevalence of wasting (Wt/Age) %	19.6	19.3	14.6	11.7	10.4	1.9
Prevalence of under weight (Wt/ age) %	44.3	40.5	30.7	22.0	13.5	3.3
Immunisation coverage (Measles) %	85.8	88.9	89.6	90.6	89.5	0.96
Mother with BMI <18 %	37.8	30.2	22.0	18.3	13.5	2.8
Pregnant women who had domiciliary ante natal care %	80.2	83.7	87.9	90.1	81.6	0.98
Home delivery %	5.0	2.5	1.2	0.4	0.0	5/0
Women who received domiciliary post natal care %	75.4	77.9	75.6	80.2	76.7	0.98
Women who ever attended school %	83.5	92.9	96.6	98.7	99.2	0.84

*Based on an asset index computed using the DHS Sri Lanka 2002 data base by MEDISTAT Medical Research Consultancy, Sri Lanka as part of the work carried out for a AAA on 'Better Reproductive Health for Poor Women in South Asia'. MEDISTAT used the methodology published by Gwatkin et al (2000) to calculate the asset index for Sri Lanka.

20. Provincial Councils rely largely on central government block transfers allocated for salaries and wages to finance their health expenditures. The civil servants that manage Provincial Councils depend on the central government for transfers and promotions, which weakens their allegiance to the province and creates a lack of accountability. There is an imbalance in medical staffing (e.g. oversupply of doctors and undersupply of nurses and paramedics), negatively affecting service delivery, and in geographic inequalities in the distribution of trained staff.

21. Total health expenditures in Sri Lanka have been estimated at around 3.6 percent of GDP and \$36 in per capita terms. Public expenditure on the health sector make up about half of total expenditures on health, constitute about 7 percent of total public expenditures, amount to 1.8 percent of GDP (Rp. 36,000 million), \$18 in per capita terms, and employed over 100,000 staff in 2004.

22. If the Government wants to improve the alignment its expenditures in health with national policies and strengthen a decentralized system for service delivery, the management of national hospitals need to shift to either to autonomous hospital administration or to Provincial Councils along with relevant funding. The budget allocations to provincially-managed hospitals need to be raised to bring them on par with national hospital, and budget allocations to estate hospitals also need to improve. Clear criteria need to be developed to substantiate hospitals left under central government management. Incentives need to be developed to encourage provincial councils and local authorities to work together in preventing the spread of communicable diseases and in promoting maternal and child care.

23. In terms of recruitment and pay policies, regional and category imbalances in staffing can only be addressed by enhancing incentives to attract staff to relocate to remote areas, decentralizing the

recruitment of most categories of staff to the Provincial Councils, and removing job guarantees to doctors in the public sector. The Provincial Councils can also be strengthened by vesting the management of promotions and careers of senior staff with the province instead of the central Ministry of Public Administration. To improve the management of provincial expenditures and services the Government may want to consider enhancing the cadre of technical experts in provincial councils to bring them at par with the central ministry of health.

24. Finally, if the Government wants to improve service delivery in health in the context of a decentralized model, an attempt should be made to improve the technical capacity of the Provincial Health Management System by creating higher level technical positions in the province to oversee at least the overall areas of preventive health, medical services, and laboratory services.

25. To enable Sri Lanka to successfully implement the government's *Strategic Framework for Health Development 2004-2015* objectives, the country needs to address shortcomings in fiscal and administrative decentralization, rigidities in human resource management, inefficiencies, and weaknesses in the budget allocation in the health sector

26. **The main challenges in health service delivery are:**

- **The two parallel (central and provincial) delivery systems for health services are not well-linked with local interests and preferences.** The financing of service delivery is through two channels which are not coordinated and monitored. There are no clear criteria for differentiating nationally and provincially delivered hospital services, resulting in duplication and inefficient use of public resources.
- **Provincial Councils rely largely on central government transfers to finance health expenditures.** The financial allocations to the provinces are not based on an objective and transparent measure of population needs – only around 6 percent of funding is via “criteria based grants.” Neither is financing linked to performance and outcome. The gap-filling transfer system discourages efficient staff management and encourages overstaffing.
- **The central government exercises the most control over recruitment and staffing in the health sector resulting in limited accountability of health officials to the local citizens.** Top officials responsible for delivering provincial health services have allegiance to the center. Officials are dependent on the center for transfers and career matters. Standards and norms are set centrally with little flexibility and authority for managers at peripheral levels to make decisions.
- **The number of health care workers in most categories has increased over time.** At present there are about 62,000 staff employed by provincial councils and 43,000 by the central line ministries in the sector with large shares employed in the lower categories. Given the limited fiscal space, the growth in staff numbers squeezes essential spending in operation and maintenance and capital investment.

V. Fiscal Decentralization: Systemic Issues

27. The above sector-specific issues in service delivery reflect some systemic problems in the decentralization/deconcentration arrangements, with contradictory incentives and weak institutions. These problems lead to excess costs and suboptimal service delivery outcomes.

Political Economy

Many of the systemic issues in the areas of fiscal and administrative decentralization need to be put in the broader context of political economy.

28. First, while many sub-national officials are elected, namely the provincial and local councils and mayors, they have limited powers in practice. Provincial governors are appointed by the President. More importantly the provincial and local council elections are contested as referenda on national party issues, not the performance of the sub-national governments themselves. Decentralization has put the local government under the provincial councils. When the center and the provinces are governed by opposing political parties, the local governments invariably get caught in the resulting political tensions.

29. Second, the sub-national governments have limited autonomy and accountability in managing their personnel and spending programs nominally assigned to them, and what they have is not always clearly defined. The constitution sets out provincial service-delivery responsibilities, but most of these are set in a list of shared responsibilities with the central government. Furthermore, the list of exclusive central government responsibilities includes a clause for making policies in all areas of national interest—thus allowing interventions. In practice, the provinces have limited autonomy over the services that they deliver, such as basic education and health, and local authorities' responsibilities are limited even further.

30. Third, although successive central governments have put in place some important building blocks for developing a more professional and modern civil service, steps have also been taken that run counter to these reforms – specifically the use of civil service to create employment for new graduates and youth; approval of salary increases that further compress pay scales; and continued political interventions in the recruitment and transfer of civil servants. In addition, the central governments have retained de facto administrative authority over sub-national governments by controlling most personnel decisions from the centre; as a consequence, provincial councils and local authorities have limited ability to influence service delivery outcomes.

31. Fourth, the central government carries out some monitoring of provincial finances through the Finance Commission, and the Auditor General audits local governments and has some degree of information on nearly every sub-national government. Nevertheless, no one effectively monitors service performance or efficiency at the provincial or local levels.

32. On the positive side, the sub-national governments do generally confront hard budget constraints, as they should; the large public-sector deficits come mostly from central spending.

33. Finally, three characteristics about Sri Lanka's economy and polity are critical to understanding the intergovernmental fiscal and administrative relations: 1) the wide economic disparity between Colombo/Western Province and the rest of the country. Table 6 provides a basic profile of provinces. Overall Sri Lankans living outside the Western Province do not enjoy the same level of connectivity and access to services; 2) the ethnic divide between the Sinhalese majority and the Tamil; and 3) the political fragmentation within the Sinhalese majority. The latter is reflected in the extent that the outcomes in provincial and local elections depend largely on national-level party issues and not on how well or badly a local government performs and delivers services. This may result from the small degree of autonomy actually given to the local governments—with the two phenomena reinforcing each other—the lack of local autonomy and the dominance of national party politics.

Table 6: Basic Profile of Provinces

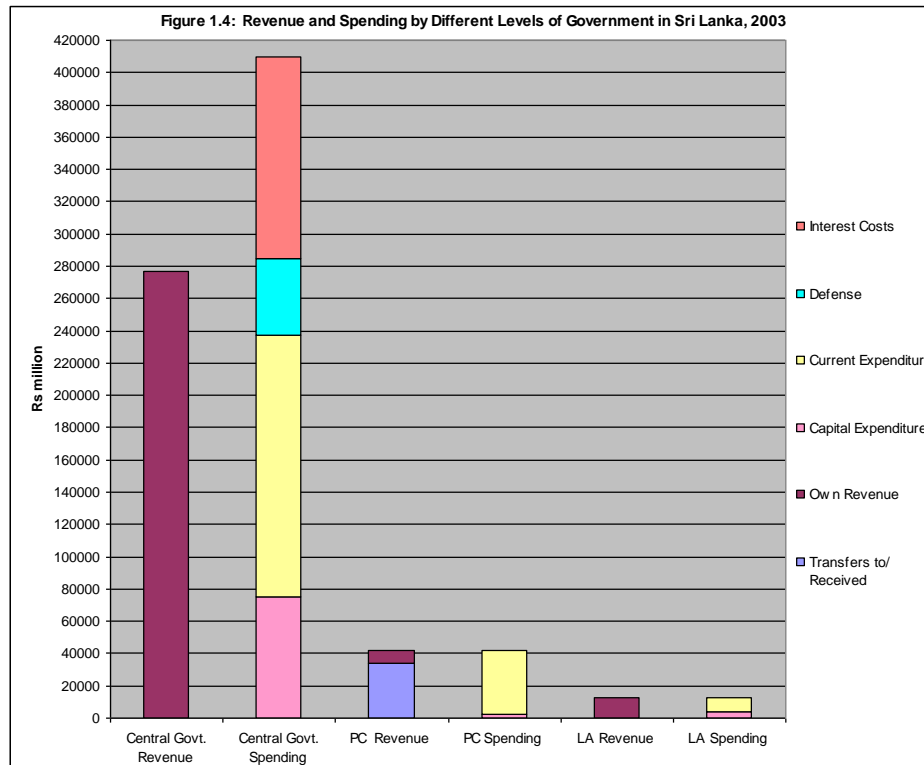
Province	Population ('000)	% Share of Total Population	% Share of Land Area	Density of Population	% share of GDP
Western	5,471	28	6	1,523	49
Central	2,474	13	9	444	9
Southern	2,324	12	9	432	10
North Western	2,196	11	12	293	9
Sabaragamuwa	1,825	9	8	371	6
Northern	1,106	6	13	133	3
Eastern	1,518	8	15	163	5
Uva	1,206	6	13	145	4
North Central	1,132	6	16	116	4
National	19,252	100	100	307	100

Source: Central Bank of Sri Lanka, Socio-Economic Data 2003.

Fiscal Overview

34. Before the decentralization in 1987, Sri Lanka had a deconcentrated government structure with four layers: central government, districts, divisions and Grama Niladhari. Services were delivered mainly through this structure. Sri Lanka also has had a long history of local government system, but it is yet to emerge as a viable level of governance. The 13th constitutional amendment created the provinces. However, together provinces and local governments have a limited fiscal role, as reflected by their small share in government spending and revenues.

Figure 1: Revenue and Spending by Different Level of Governments in Sri Lanka (2003)



Source: Ministry of Provincial Council and Local Governments, Central Bank Survey Data on Local Authorities 2003. Note: Revenue for Local Government includes transfers

35. Provinces account for only 9 percent of government expenditure, or the combined expenditures by provinces and local governments account for only 12 percent. Even if after adjusting military and interest spending, provinces and local governments combined still account for a small share of government spending. This is very low compared to international standards. On the revenue side, the combined provincial and local own tax revenues are about 1.1 percent of GDP (2003), or seven percent of total government tax revenue. This is also very low on international standards.

36. The national budgetary planning process is de-linked from the decentralization process. The budget is centrally set without substantive inputs from the sub-national governments. Central ministries take the priority claim to the capital budget and allocation to provinces is small and unpredictable. Capital funding to local governments is an even lower number. The Treasury budget is prepared prior to the Finance Commission's work so the budget initially approved by Parliament does not include direct inputs from either the Finance Commission or the Sub-national authorities.

Spending Assignment

37. **Dualism.** The current spending assignments have striking dualism in the form of deconcentration (central spending through districts and divisions) and devolution (spending through provinces and local authorities). Along the de-concentrated structure, there are 44 ministries, 25 districts, and 324 divisions. A somewhat reduced district secretariat and divisional secretariat structure continues to operate as a deconcentrated arm of the central government in each of the 25 districts. The district secretariats are attached to the Ministry of Public Administration and Home Affairs. But while there are no formal reporting relationship to the Provincial Councils, they do act as agents for the Provincial Councils in implementing development and other projects. Along the devolved structure, there are eight Provincial Councils, 18 Municipal Councils, 34 Urban Councils, and 257 Pradeshiya Sabhas.

38. This dualism (Figure 2) has led to functional proliferation, fragmentation and duplications, which have contributed to an expansion of public sector employment at all levels of the government. The expansion of public sector employment is further exacerbated by the way grants are transferred from the center to sub-national governments.

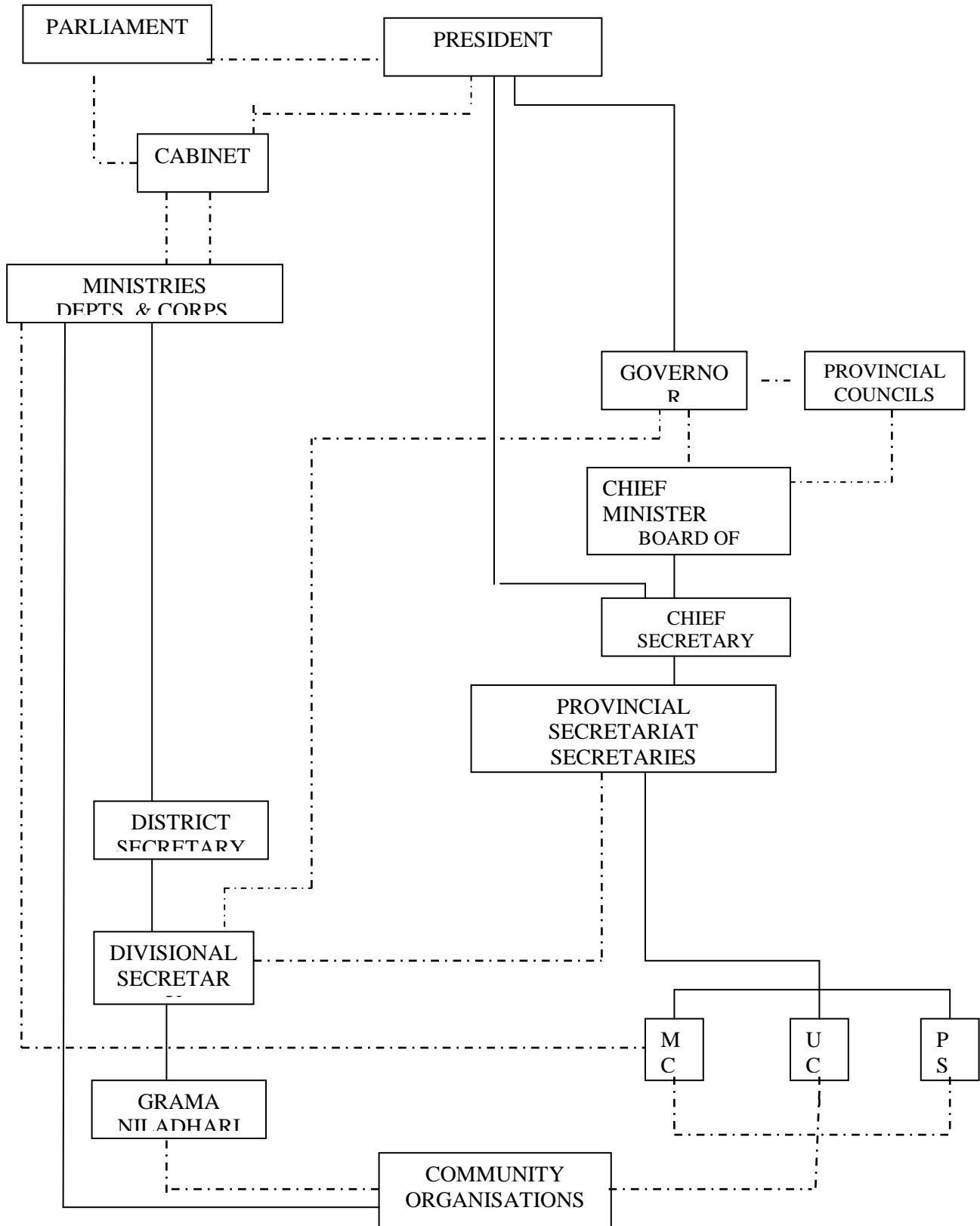
39. Despite decentralizing broad responsibilities to provinces, the central government continues to dominate the delivery of many services. The commonly held perception is that the Provincial Councils merely resulted in creating another layer of bureaucracy that does not represent the interests of local citizens. Another commonly held view is that the outcome has been a reduction in the degree of devolution because the local authorities have been emasculated and becoming increasingly dependent on and controlled by provinces.

40. The list of concurrent responsibilities includes higher education, health, irrigation, tourism, and trade and commerce. In principle, governments should be able to negotiate and arrange the relative roles that each level is to play in ensuring delivery of shared services. However, the concurrent list includes several functions that are also on the exclusive provincial list. This greatly increases the potential for confused and overlapping service delivery.

41. **International experience.** At the heart of any system of assigning responsibilities and accountability for service delivery is the clear assignment of responsibilities to different levels of government and the effectiveness with which these responsibilities are carried out. International experiences may provide useful references which suggest a number of principals for effective expenditure assignment (Box 1). It is possible for different levels of government to exercise different functions in a given sector. *The key lies on matching responsibilities to decision-making authority.* For example, one

level of government may be responsible for setting policy standards and oversight, and another level (province or local) may be responsible for the provisions or administrative of such activities. However,

Figure 2: Structure of Government Administration



there are a few activities that are strictly assigned to the national government including defense, foreign trade and affairs, and policing free flow of goods and factors within the national border.

Box 1: Some principle for Expenditure Assignment

There is no one best way for deciding which level of government should be responsible for the provision of particular government services. The adequacy of any assignment has to be judged in how well it achieves the goals or objectives set up by the central government in its decentralization strategy. Commonly accepted objectives of fiscal decentralization include an efficient allocation of resources via a responsive and accountable government, an equitable provision of services to citizens in different jurisdictions, and macroeconomic stability and growth. These objectives are also incorporated in the European Charter of Self-Government.

An efficient provision of government services requires that government satisfy the needs and preferences of taxpayers as closely as possible. This is best achieved by keeping the provision of services at the lowest level of government compatible with the size of the “benefit area” associated with those services. For example, the benefit area for sanitation services is clearly the local community, but for air traffic control the benefit is the entire national territory. Assigning public services with wider benefit areas to smaller units of government is likely to result in the inefficient provision of services; e.g. a tertiary hospital providing regional services is financed only by a single municipality, with other municipalities free-riding. Efficiency in the provision of public services is enhanced if consumption benefits are linked to costs of provision via fees, service charges, or local taxes.

Expenditures undertaken by government for equity or income equalization reasons, such as social welfare of low-income housing, are generally thought to be the domain of central government. The general belief is that local or regional government would not be able to sustain independent programs of this nature, because they would attract the needy from other areas while requiring that they tax their (potentially mobile) residents more heavily. While funding for these expenditures should be a central government responsibility, implementation can be left to local government, which may have informational and other comparative advantages.

Expenditures taken for stabilization and growth of the economy, such as public investment projects or unemployment compensation, are by their scale naturally assigned to the central government. The application of these rules largely facilitates the assignment of expenditure responsibilities to different levels of government. However, the rules are unlikely to yield a unique answer in every situation. Some public services, e.g., primary education and primary health services, may be of a local nature because of the size of their benefit area. But because of their relevance to welfare and income redistribution, they may also be considered the responsibility of the central government.

The objectives are not all attainable at the same time. The pursuit of greater efficiency and autonomy may be achieved at the cost of a sacrifice in the quality of service levels. It is for this reason that we cannot speak of a “best expenditure assignment”. The government’s strategy and priorities would assign different weights to the objectives of efficiency, equity, and stability. In addition, what is considered the best assignment by is likely to change over times with changes in costs and technological constraints, as well as changes in preferences. However, there is a need at all times to have a concrete and clear assignment of expenditure responsibilities that could be considered preferable among the alternative assignments. Failure to have a concrete assignment may lead to instability in intergovernmental relations and to the inefficient provision of public services. Without an explicit assignment of expenditure responsibilities it will be much harder to reach consensus and stability in the assignment of tax revenues and to arrive at a workable system of equalization revenues.

Source: Jorge Martinez-Vazquez, 1997. The Assignment of Expenditure Responsibilities. Intergovernmental Fiscal Relations and Local Financial Management course. World Bank Institute.

42. A key issue on spending assignment concerns infrastructure. The nature of certain infrastructure services such as water and sanitation entail high upfront fixed cost while the benefits can only be spread over generations. The economies of scale also require efficient provisions beyond

administrative boundaries of many small local governments. In some countries, such infrastructure is provided through special purpose districts often encompassing several local government jurisdictions. These special purpose districts have their own budget, operate on a commercial basis, and mainly rely on project revenue streams (i.e. user fees) for sustainable finance. In order for such institutions to have their desired effect in improving service delivery, eliminating duplication and avoiding excess public employment, international experience shows that the special districts need to have management autonomy, commercial principles, and clear spending mandates.

Revenue Assignment

43. **Revenue structure.** The major national taxes levied by the central government are VAT, excise, income and international trade tax. Provincial revenue sources are assigned in the 13th constitutional amendment and include the business turnover tax, stamp duties, court fines, excise duties, motor vehicle license and fines, etc. Local authorities collect property taxes, business license fees, and entertainment taxes and revenues from rentals and sales of services.

44. Provinces are highly dependent on transfers from the central government as own-source revenues account for only 17.5 percent of total provincial revenues. Combined provincial and local own tax revenues account for only 7 percent of total government tax revenue, much below international comparisons. The business turnover tax and stamp duty account for about 52 percent and 33 percent of provincial tax revenues respectively.⁷ Own-source revenues provide approximately 54.6 percent of total revenues for the 199 local governments. Property tax is the single largest revenue source for local governments, accounting for about 20% of total own revenues.

45. **Specific issues for sub-national individual revenue sources.** On *business turnover tax*, significant exemptions have made tax administration and compliance more difficult, with compliance rates in the 70-75 percent range. Moreover, the combined VAT (national tax) and BTT structures create cascading and pyramiding, discourage vertical integration from the manufacturing to the retail and wholesale levels, and potentially allow evasion. On *stamp duty*, high duties on the transfer of real property increase the transaction cost, create barriers to labor mobility, and encourage tax avoidance and evasion. On *property tax*, a key issue is the disconnection between the pricing of property and provision of public goods and the property tax has not become a viable financing source for local governments in Sri Lanka.

46. **Disincentive for mobilizing sub national revenues.** The autonomy and the ability of sub-national governments in raising own revenues is important to service delivery since it links service delivery to finances and provides more local control on the level and mix of local services. In Sri Lanka, there are disincentives for mobilizing sub-national revenues. At the margin, sub national governments have very limited capacity or incentive to increase their revenues, owing to extremely limited responsibility and autonomy in managing spending responsibilities, and the intergovernmental transfers system of the gap-filling approach that penalizes revenue efforts. Furthermore, the provincial and local council elections are contested as referenda on national party issues, not the performance of the subnational governments themselves.

47. Though provinces have the authority to raise tax rates according to Article 13, and the local governments have the legal right to impose property taxes, these authorities are seldom exercised, though there are exceptions. Provinces report that a combination of political pressure and implicit threats that national transfers will be lowered, precluding any net revenue increase, are used to discourage provinces

⁷ The business turnover tax is levied on retailers and wholesalers but not on service producers or manufacturers. The stamp duty is a tax by provinces on the transaction of immovable properties but the revenue is transferred to local authorities.

from raising rates. There are also few attempts by local governments to generate local resources from sale and leasing of public lands, fees for development permits and fees and charges for infrastructure service provision. The exception is the Colombo Municipal Council, which has expressed an interest in the leasing of public land and property and the Urban Development Authority, which develops, and leases land and properties.

48. **International experience.** For local governments, property taxes should function not only as a means of raising funds, but also as a price for local services. Property taxation is a powerful tool for financing infrastructure and urban service delivery and managing urban land development. An ad valorem property tax system, where taxes are levied on the basis of the market value of urban land can be an effective tool for financing a wide range of urban services—drainage, flood control, roads, street lighting, and parks and recreation. The provision of network and non-network infrastructure confers significant economic benefits on the private owners of real estate—both land and buildings. For example, better infrastructure provision has increased value of land in Addis Ababa, Bangkok, Jakarta, and Riyadh by 50 to 150 percent. If these increases in land values can be partially captured, they can be used to finance service provision. Absolute increases in land values can generate significant property tax increases through well administered ad valorem property systems. In Toronto, Canada, tax assessments near city center subway stations increased by 45 percent and in suburban locations by over 100 percent.

49. However, if a tax is to function as a price, it must be a benefit tax whose incidence corresponds to the distribution of the benefits of the services it finances. But local governments in Sri Lanka do not have responsibility and autonomy in many important local services, for which the property tax is to finance. Therefore there is disconnection between the right to price and the right to provide the consumption bundles.

50. Many transition economies in Asia (China, Vietnam) and Central and Eastern Europe (Poland, Russia, Ukraine) have initiated processes to transfer land use rights to private sector developers and users. These transfers are often in the form of long-term leaseholds (China for example), and in other cases land is sold on a freehold basis (Poland). In either case, these transfers have been successful in promoting urban development and revitalization and they have generated considerable resources for both local and central governments.

51. In addition, public-private-partnerships between developers and local governments helps transfer technical know-how about real estate development as well as encouraging developers to finance critical infrastructure. The most powerful examples are in the area of transportation infrastructure, where many public transportation agencies have been able to finance system development through private real estate partnerships around transit stations and along rights-of-way (good examples are Bangkok, Hong Kong, Singapore, and Japan). Given the proportion of publicly held land in Sri Lanka, this policy tool warrants further consideration.

52. **Devolution of Tax Bases.** To generate additional revenues at both the provincial and local levels, it is important to remember that sub-national governments can be expected to raise more revenues only if the basic system of intergovernmental revenues and service delivery creates appropriate incentives. Neither the Sri Lankan provinces nor local authorities are likely to make substantial efforts to raise additional revenue unless the underlying financial structure is changed. The structure must also permit sub-national governments to affect service delivery at the margin if they can be expected to seek additional revenues.

53. Provincial sales tax. Provincial revenue could be expanded with greater reliance on the sales tax or a surtax on the value added tax. Necessary prior steps, however, include rationalizing the national VAT system and clarifying sub-national spending responsibilities. The combined structure of national VAT and provincial BTT has several drawbacks. The reform of the combined structure should aim at

broadening tax base, eliminating cascading, encourage vertical integration, minimizing evasion. Once the combined structure is reformed, and spending authority clarified, either a sales tax (or surtax) on VAT or a shared VAT revenue between the center and the sub-national government can help expand sub-national revenues.

54. Local property tax. For local government, property taxes should function not only as a means of raising funds, but also as a price for local services. An ad valorem property tax system, where taxes are levied on the basis of the market value of urban land can be an effective tool for financing a wide range of urban/local services. The provision of network and non-network infrastructure confers significant economic benefits on the private owners of real estate—both land and buildings. For example, better infrastructure provision has increased value of land in Addis Ababa, Bangkok, Jakarta, and Riyadh by 50 to 150 percent. If these increases in land values can be partially captured, they can be used to finance service provision. Absolute increases in land values can generate significant property tax increases through well administered ad valorem property systems. In Toronto Canada, tax assessments near city center subway stations increased by 45 percent and by over 100 percent in suburban locations.

55. However, if a tax is to function as a price, it must be a benefit tax whose incidence corresponds to the distribution of the benefits of the services it finances. As already stated, local governments in Sri Lanka do not have autonomy in many important local services, which the property tax is supposed to help finance. Therefore there is a disconnection between the right to price and the right to provide the consumption bundles. Only Colombo appears to make significant use of the property tax. In general, the property tax generates very little revenue, indicating that substantial capacity remains for expanding use of the property tax. Assuming that sub-national governments would be given more autonomy in managing spending responsibilities, property tax reform could be pursued from procedural reforms to address base coverage, valuation accuracy, and collection efficiency, as well as from policy and institutional reforms to address the systems for rate setting, revaluation and indexation, and the incentives confronting the administrators of the tax.

56. Stamp duty. Currently, provinces collect stamp duty and transfer it to local authorities. Local authorities complain about delays and withholding in transfers. The assignment of stamp duty to an appropriate level of the sub-national government will need to be linked with which level of the sub-national governments provides infrastructure services. Although provinces collect stamp duty, they do not provide infrastructure services. And local governments manage solid waste, an important infrastructure service. Another reform issue to take into consideration is to reduce the stamp duty rates so as to discourage tax evasion and encourage a more efficient market for property transactions. However, reducing stamp duty would need to go hand in hand with improving administration in order to increase revenues.

Transfers

57. **Challenges of the current system.** The grant system accomplishes vertical and horizontal balance to some degree and allows for some predictability, but is generally ineffective and does not provide the right incentives. The system seeks to establish a strong degree of horizontal equity. The inverse relationship between horizontal transfer of grants and per capita collection of own-source revenues is so strong that provinces with low own-source revenues end up with more total revenue per capita.

58. The transfer system is influenced by the budgetary system. The block grant (84 percent of total grant transfers) fills the gap between sub-national recurrent expenditures and available revenues. Gap-filling grants of this type create wrong incentives and discourage efficient budget behavior. First, sub-national governments have the incentive to increase recurrent expenditures since marginal expenditures are funded by the center. To partially counter this incentive, the central government controls

the total number of permanent employees and their wages for each province. The provinces can be expected to lobby for employment increases and to raise other recurrent expenditures. Service delivery can generally be improved if grants are moved away from a gap-filling structure that seeks to pay for specific costs and towards broader categorical grants that allow local governments more flexibility in how using resources.

59. Second, provinces have the incentive to decrease (or at least not increase) own-source revenue since raising more revenues results in lower transfers. Sub-national governments neither levy the maximum tax rates available (e.g., the national law permits 5 percent business turnover tax, but the provinces all have chosen 1 percent rate) nor use all taxes at their disposal. The lack of control over use of resources, combined with gap-filling grants, is an important reason for this behavior. Even if Sri Lanka wants to keep a transfer system that is strongly redistributive overall, the policies need to give sub-national governments incentives at the margin to raise more revenue and control their spending.

60. The overall grant system is generally predictable for recurrent purposes, but is much less so for capital purposes. The propensity to approve capital expenditures but not to provide full financing, often results in inefficient use of the resources.

61. **International experience.** Experience in other countries offers some models that, with modifications, could be useful in Sri Lanka. Canada, Australia, Mexico and other Latin American countries have a combination of sector block grants and revenue sharing, with increases tied to population and poverty. Applying this in Sri Lanka would simplify the transfers into two main programs. One would give provinces and local authorities earmarked grants for particular programs, like education and health, with allocations based on need—the number of students attending schools, potential health patients, and geographic dispersion. For the sake of transparency, the formulas should be kept simple. To motivate efficiency, they should not specify how the money is to be spent (wages, etc.), but rather would have regular inspection (to verify attendance, etc.), and testing for results. The other type of transfer would be unconditional (not earmarked to sectors) and based on shares of total national revenues, say 10 to 15 percent, allocated according to a formula. In Canada, as the provinces developed the capacity and clear responsibility to clients for service delivery, the earmarking was relaxed, and the federal government now just gives the provinces a certain allocation per capita and monitors the quality of service. Australia has an even more thoroughly progressive system of equalization transfer than Canada. Analogous to Sri Lanka's Finance Commission, Australia's Intergovernmental Grants Commission makes annual recommendations that are generally accepted fully by parliament. An important point about the Canadian and Australian systems is that their equalization formulas, while filling a gap in some sense, do not increase transfers if a province/state actually spends more or raises less in revenue. The gap to be filled is based on what a province should be able to collect (based on the national average, not its own actual performance) and what it should cost to deliver standard services. Thus the incentives reward fiscal effort and penalize excess spending.

62. Changing calculation of block grant would help improve the incentives for sub-national revenue mobilization and efficient levels of employment and spending on non-wage items.

- Salary reimbursement for provinces and local authorities. Since the provinces and local authorities have no control over the numbers or pay of senior administrative personnel, the requirement that local revenues pay part of their salaries acts as a tax (disincentive) on local revenue effort. Thus, to improve local incentives, it would make sense to restore the 100% reimbursement of those salaries. The employment of laborers for tasks like garbage collection and road maintenance, on the other hand, is under the control of local authorities (they request the extra positions), and produces tangible benefits for the local population. Thus, increasing the share of the laborer's salaries to be covered by local revenues would enhance the incentives for

both revenue collection and more efficient local service delivery. To calculate the grant on the number of posts rather than the number of employees would help eliminate the incentive to hire more staff and encourage sub-national governments to be more efficient with their resources.

- Calculation of local tax capacity. This other side of the revenue gap to be filled is done on the basis of actual revenues collected, which discourages collection. Moving to a calculation of the revenue gap based on estimates of the potential revenue, by contrast, would remove the disincentive. Such estimates could be based on population, province (district) GDP per capita, urbanization, and access to national roads. Canada and Australia do such estimates of potential revenue, and their experience offers valuable lessons. Since there is discussion of allowing increased staffing to sub-national governments, it would be good to amend and clarify the rules of the game before the staffing increases take place.

VI. Urban Land, Revenue Mobilization and Service Delivery

63. **Agglomeration, urban land, and service delivery.** Urban land markets are critical to service delivery. They provide the physical space for industrial, commercial and residential development as well as provide rights of ways for infrastructure systems such as roads, transit, water, sanitation, and power networks. As economies make the transition from primary to secondary and tertiary activities, cities and urban regions expand and require higher quality and more reliable services. Fostering this rural-to-urban transition is essential, because it works to absorb surplus agricultural labor and it creates agglomeration economies that drive a country's economic competitiveness and growth. To a firm, benefits from urbanization include access to specialized and diverse financial and professional services, inter-industry information transfers, input-output linkages, innovative technologies, and availability of infrastructure such as telecommunications and transportation hubs. Small cities are specialized in a few manufacturing activities or are either administrative centers or agricultural market centers providing services to farmers.

64. Sri Lanka's export economy is no longer dominated by agriculture—textiles, services and other non-agricultural businesses are now the principal components of international trade. These trends mirror those of other South Asia and middle income countries. As agglomeration economies and urbanization go hand in hand with increases in national-level GDP, Sri Lanka needs an urban land management policy framework that fosters urban agglomeration economies by providing an efficient spatial structure for infrastructure service provision and the siting of private sector investments.

65. **Challenges in Sri Lanka.** Field assessments in Colombo, Galle, Kandy, Monaragala and Central and Uva Provinces indicate that urban land management, revenue generation and service delivery is not optimal. Urban planning and land management is not keeping pace with urbanization. Most cities and towns lack up-to-date urban plans and capital investment programs. Table 7 provides district-wise data indicating severe disparities in levels of and access to infrastructure services. Where services are available they are frequently of poor quality.

66. High levels of public land ownership, complex property rights and titling and transfer systems make urban development particularly difficult. In Colombo, publicly-owned land is underutilized while at the same time private developers find it difficult to assemble land for residential, commercial and industrial development. Despite these problems, the Urban Development Authority (UDA) has been very slow in disposing of public lands in Colombo and in fulfilling its statutory obligations to prepare urban plans for all Municipal and Urban Councils. International experiences have shown the importance of urban agglomeration for economic growth. The sub-optimal in urban land management not only affects urban services but also the competitiveness of urban centers in Sri Lanka and the country's economic growth.

Table 7: Residential Infrastructure Service Coverage in Selected Districts, 2001

	Safe Drinking Water Coverage	Safe Wastewater Sanitation Coverage	Excusive Use of Toilet	Electrical Lighting	Biomass Cooking Fuel	Permanent Dwelling Construction
District	%	%	%	%	%	%
Badulla	65.5	75.9	80.4	57.9	92.3	63.6
Colombo	94.9	94.6	74.9	86.9	32.1	86.8
Galle	79.1	87	82.8	74.2	85.6	72.3
Gampaha	85.5	91.3	78.9	83.4	65.8	80.0
Kalutara	81.7	91.1	82.1	72.5	81.5	78.5
Kandy	74.2	83.5	81.7	71.9	85.1	73.2
Monaragala	57.7	53.1	84.1	32.2	na	48.1

Source: Results from Sample Tabulations, 2001 Census of Population and Housing, March, 2003.

67. Sri Lanka’s urban land management policy framework is extremely complex with overlapping authorities, contradictions and lack of a strategic focus. Urban planning and land management is largely controlled by key central government agencies—Ministry of Urban Development and Water Supply, the Urban Development Authority (UDA), Ministry of Lands, Board of Investment (BOI), National Land Use Physical Planning Agency, National Land Use Regulatory Department, and the Ministry of Housing and Construction Industries. In addition, local authorities such as municipal councils, urban councils and Pradeshya Sabas control land resources. Coordination among various central agencies has been problematic. It is worth quoting the Commission of Inquiry on Local Government Reforms: “The absence of finalized physical plans giving expression to economic development plans has caused deterioration in the development of urban Local Authority areas. Municipal Councils and Urban Councils have been deprived of the right to undertake physical planning in their areas due to delays observed in the formulation of plans...Provincial Councils have not been given devolved powers to deal with physical planning although it is a concurrent subject in the 13th Amendment to the Constitution.”⁸

68. The UDA is a multi-disciplinary organization responsible for the planning and development of urban areas throughout the country. Despite its sweeping powers the UDA has been very slow in achieving its mandates. The Auditors report of the UDA 2001 Annual Report pointed out the slow progress it was making regarding the preparation of master plans to guide development. UDA’s all encompassing scope of authority makes it impossible to separate policy making, regulation, and operation of real estate business.

69. In Sri Lanka, although local governments have the legal right to impose property taxes they do not make full use of this power. Instead they over-rely on stamp duties on real estate transactions. Stamp duties are high on the international standards, which encourages tax evasion. There are few attempts by sub-national governments to generate local resources from sale and leasing of public lands, fees for development permits and fees and charges for infrastructure services. The exception is the Colombo Municipal Council, which has expressed an interest in the leasing of public land and property. Again, sub-national governments can be expected to raise more revenues only if the basic system of intergovernmental revenues and service delivery creates appropriate incentives. The structure must also permit sub-national governments to affect service delivery at the margin if they can be expected to seek additional revenues.

⁸ Report of the Commission of Inquiry on Local Government Reforms, 1999. page 153.

70. **International experience.** On the management of urban planning and infrastructure development, Sri Lanka could consider decentralizing the responsibilities for urban and infrastructure planning to sub-national governments. This is the practice in many countries, and the experiences of Brazil, Canada, Mexico, Poland, and South Africa can be useful to look at.⁹

71. The practice of concentrating the three functions - regulatory, policy making and real estate development – in one agency (UDA) does not conform to good international practice. Sri Lanka could benefit from the experience of the National Housing Authority of Thailand on how to separate the three functions.

72. International experiences in Cape Town, Sydney, Singapore and Shanghai indicate that aggressive privatization of public real estate assets foster economic development and the attraction of foreign direct investment the supports the formation of agglomeration economies.¹⁰

73. In many middle-income countries, local governments effectively tap land and property markets to generate own source revenues to finance urban services. They also mobilize private financing of infrastructure. User fees are an important source of financing infrastructure assets that last many years, which should be financed by users who benefit from the services from the infrastructure. While the section on revenues have already explained property tax, paragraphs below discusses additional sources of revenues.

74. Land leasing or transfers. Many transition economies in Asia (e.g., China, Vietnam) and Central and Eastern Europe (Poland, Russia, Ukraine) have initiated processes to transfer land use rights to private sector developers and users. These transfers are often in the form of long-term leaseholds (e.g., China), and in other cases land is sold on a freehold basis (e.g., Poland). In either case, these transfers have been successful in promoting urban development and revitalization and they have generated considerable resources for both local and central governments.

75. Private financing of infrastructure. Given the limited fiscal space in Sri Lanka, owing to high expenditures on wages, military, and debt services, capital expenditure as share of GDP has been low. Infrastructure spending as a share of GDP averages around 8-10 percent in Southeast Asia and East Asia. Private financing of infrastructure therefore becomes an important source. Public-private-partnerships between developers and local governments helps transfer technical know-how about real estate development as well as encouraging developers to finance critical infrastructure. The most persuasive examples are in the area of transportation infrastructure, where many public transportation agencies have been able to finance system development through private real estate partnerships around transit stations and along rights-of-way (for example, Bangkok, Hong Kong, Singapore, and Japan). Given the proportion of publicly held land in Sri Lanka, this policy tool warrants consideration.

76. User fees. Sub-national governments should consider user fees that are directly linked to service consumption as an important option for financing service delivery. User fees are the best financing option for many services because fees are equitable (the beneficiary pays for the service), consumption of the service provides the means to finance service provision, the user decides how much to consume and the outcome can be economically efficient if there are no spillovers. User fees are particularly appropriate for utility services (water, solid waste collection, electricity, etc.), parking,

⁹ David Dowall and Giles Clarke A framework for reforming urban land policies in developing countries; Washington and Nairobi, Urban management Programme, 1996.

¹⁰ See Burgess, Rod, Marisa Carmona and Theo Kolstee, *The challenge of sustainable cities : neoliberalism and urban strategies in developing countries*. Atlantic Highlands, N.J. : Zed Books, 1997.

transportation services, access to parks and many additional services. Some services cannot be financed efficiently with user fees because the services are simultaneously consumed by all services or because consumers cannot be excluded from consuming the service. Shanghai government has developed a three-pronged strategy for user fees: conducting public hearings on levying or increasing user charges; providing direct lump-sum support to the low-income groups to ensure a minimum standard of living while taking into account the cost of consumption bundle; and (iii) containing costs by regulating service providers, enforcing competitive bidding, setting performance standards, and establishing incentives for meeting performance standards.

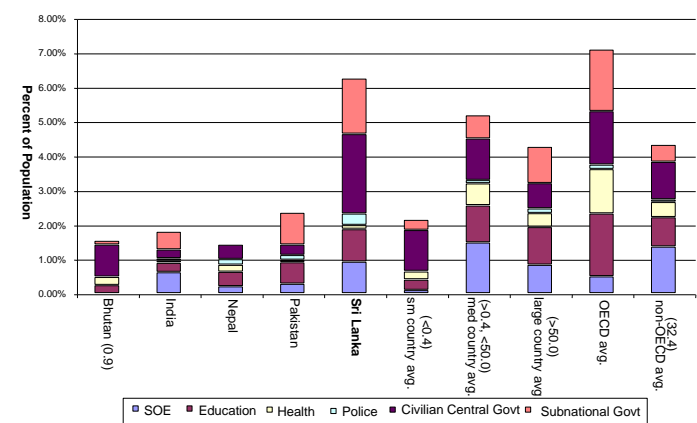
VII. Administrative Decentralization: Systemic Issues

77. In assessing Sri Lanka's civil service reform issues, including those arising from the decentralization process, it is clear that successive governments have put in place some important building blocks for developing a more professional and modern civil service. With the adoption of the 17th amendment to the Constitution, the country has reestablished a more independent Public Service Commission, which oversees the management of most staff officer and all non-staff officer posts. It has introduced a government-wide performance appraisal system. It is strengthening the promotion rules and procedures to place more weight on achievement and merit. And it has placed some controls on creation of new posts and filling of vacancies. A permanent body, National Council on Administration has been established to develop policies on wages and cadre management. An Administrative Reform Committee mandated to carry out functional review across the system has also been established.

78. **Challenges.** However, the government has also been taking actions that run counter to these reforms: specifically, the civil service continues to be used to create employment opportunities for new graduates and youth; the salary scale remains compressed, and unattractive for senior levels; the recruitment and transfer system are used for political patronage. The center continues to retain de facto administrative authority over sub-national government and as a consequence, provincial councils and local authorities have limited ability to control service delivery.

79. The size of government bureaucracy appears to be overly expanded, particularly compared to other countries in the region. The number of central government civil servants grew by 49 percent between 1994 and 2002, despite the fact that many functions have been devolved to Provinces. The total number of staff at the sub-national level reached a significant level of 308,429 in 2002. Although the constitutional amendment only allows five ministries for the Provincial Councils, a broad range of government activities have been lumped under the five ministries at the Provincial Councils whereas these activities at the central government level would be classified under more than five ministries. There seems to be significant room for streamlining functions. However, the incentive system associated with the grants transfer system fully reimbursing salaries discourages staff reduction from streamlining or from outsourcing those

Figure 3: Total Public Sector Employment Per Capita (1995-2002)



Source: Asian Development Bank, WHO, and the World Bank (from Manning, Nick, 'Sri Lanka Non-Lending Technical Assistance (Public Sector Reform) P090735', Annex to Concept Note, World Bank, September 3, 2004) Populations shown in parentheses (in millions).

functions that can be more efficiently performed by the private sector.

80. Managerial control over staff resources effectively lies with the central government. Provincial staff are paid the same salary scales, have the same pension rights, and have the same rights to transfers and promotions as their counterparts working in the central government within the same cadre. In addition, the central control over personnel management, such as recruitment, staffing numbers, promotions, and performance appraisals is extensive, and is strongest for the senior, managerial posts. The Chief Secretary for each province is appointed by Cabinet and paid directly from the central government payroll.

81. At the local level, every local authority has an elected council. The leading political party in the local council appoints the mayor. But staffing functions and responsibilities are very much controlled from the provincial council level. The employer-employee relationship follows a more extreme pattern. The local authority can hire contract laborers with permission of the Commissioner of Local Government (CLG-a Provincial employee). But all permanent staff must be recruited and appointed through the Provincial Council. For the more junior staff, the posts are filled by CLG. The Secretary of local authority effectively reports to the CLG, who reviews their performance appraisal, and sanctions all personnel related issues. The CLG also has an inspection team that regularly visits all local authorities to review activities and assess performance. The local authorities and the District Offices of the central government both claim to be the point where local people come with their problems, but only the latter have the resources to do much.

International Experience

82. It is possible to position the effective degree of managerial control exercised the Provincial Councils and local authorities within an international context, by employing an analytical framework¹¹ that examines the various dimensions of managerial control in terms of: the ability of sub-national government to hold staff accountable; the ability to allocate staff where the need is greatest; the ability to manage its financial resources and particularly the wage bill; and the ability of sub-national government to attract and retain qualified staff.

83. When this framework is applied to Sri Lanka, the analysis leads to the conclusion that neither Provincial Councils nor local authorities have much effective administrative control over delivering their functional responsibilities. If Sri Lanka is compared with other countries where the same analysis has been done, it squarely falls into the category of a weak decentralizer, as shown in Table 8.

Table 8: Assessing Managerial Control in Sri Lanka and Selected Countries

Dimensions of Managerial Control	Enabling Mechanisms	Weak Decentralizers			Intermediate			Strong Decentralizers		
		Sri Lanka	Benin	India	Pakistan	Mexico	Uganda	Philippines	Poland	Indonesia
Budget Transparency	• Processing the payroll	P	P	P	P	Y	P	Y	Y	Y
Budget & Establishment Control	• Controlling overall staff numbers • Controlling disposition of posts	N N	n/a n/a	N N	N N	P P	N N	Y P	Y P	Y P

¹¹ This framework is described in detail in Evans, Anne with Nick Manning. 2004. 'Administrative Decentralization: A Review of Staffing Practices during Decentralization in Eight Countries.' A draft paper prepared for the World Bank.

Dimensions of Managerial Control	Enabling Mechanisms	Weak Decentralizers			Intermediate			Strong Decentralizers		
		Sri Lanka	Benin	India	Pakistan	Mexico	Uganda	Philippines	Poland	Indonesia
	• Authority to dismiss surplus staff	N	N	N	N	P	P	Y	P	Y
Recruitment	• Formal employer	P	P	N	P	Y	Y	Y	Y	Y
	• Authority to hire	P	N	N	Y	N	Y	N	N	P
	• Independent oversight of merit (PSC)	P	Y	N	N	P	P	Y	Y	Y
Career Management	• Promotion	P	N	N	Y	P	P	Y	Y	Y
	• Transfers within local government	Y	P	N	Y	P	P	Y	Y	Y
	• Horizontal mobility	P	N	N	N	N	N	N	N	N
Performance Management	• Direct and supervise tasks	Y	P	N	Y	P	Y	Y	Y	Y
	• Conduct evaluations	P	N	P	Y	P	Y	Y	Y	Y
	• Ability to discipline/fire	N	N	N	Y	P	Y	P	P	Y
Pay Policy	• Set local hardship/remoteness allowances	N	N	N	N	N	N	Y	Y	P
	• Set overall wage rates	N	N	N	N	N	N	N	N	N

Key: Y=yes, P=partial, N=no

Source: Evans, Anne with Nick Manning, 2004. 'Administrative Decentralization: A Review of Staffing Practices during Decentralization in Eight Countries.' A draft paper prepared for the World Bank. Sri Lanka data added based on mission assessment.

VIII. Options for Reform

84. Both the system-wide and the sector-specific shortcomings have led to excessive costs and suboptimal service delivery. The reforms considered here start with the systemic institutional options and then lay out the sectoral implications.

85. There is a broad consensus in Sri Lanka in favor of clarifying the roles of sub-national governments. At present the Sri Lankan public sector is contradictory in that the constitutional forms are substantially decentralized, but most actually authority is with the central government or its deconcentrated branches—departments and divisions. This causes duplication and inefficient use of public resources and leaves the populace unsure of whom to hold accountable for proper service delivery. To move forward, the government needs to clarify what the deconcentrated districts and divisions of the national government do, if anything, and what would be left to the provincial and local governments. This should be to a substantial extent decided sector-by-sector, based on what works best for the sector and reflecting core principles of efficiency, economies of scale, and subsidiarity¹².

Decentralization or Deconcentration

86. Table 9 summarizes the general advantages and disadvantages of decentralization or deconcentration.

Table 9: Balance of considerations for Decentralization or Deconcentration

	Advantages	Disadvantages
Decentralization	- Decision makers would be (potentially) closer to the voice of the people.	- Local officials are often accountable to national politicians

¹² The subsidiarity principle is that each function should be done at the lowest possible level of government, consistent with the distribution of capacity and economies of scale.

	Advantages	Disadvantages
	<ul style="list-style-type: none"> - Consistent with constitutional Amendment 13. - Reduce duplication of functions 	<ul style="list-style-type: none"> - Lack economies of scale (for some activities) - Lack of capacity
Deconcentration (governing through departments and divisions)	<ul style="list-style-type: none"> - Effective status quo in many sectors - Technical capacity now in the deconcentrated agencies - Reduce duplication of functions 	<ul style="list-style-type: none"> - Chain of accountability to clients too long - Budget allocation might not reflect local preference

87. International experience indicates four key lessons that are relevant for the allocation of service delivery responsibilities under the decentralization option in Sri Lanka:

- Sectors differ in the appropriate degree of decentralization, according to economies of scale, externalities, and proximity of providers to clients. For example, delivery of higher education is appropriate for more central levels of government, and services like street lighting and trash collection for more local levels.
- Different levels of government can have responsibility for different aspects of a single sector, and this can work very well, given clear and logical allocation of mandates.
- Spending decisions for investment and maintenance need to be at the same level of government; otherwise maintenance will be skimped since the cost of that will be borne by a different government that has to do new investment to make-up for totally depleted infrastructure.
- Decentralization may work better, either as a transition or as a permanent structure, if some local governments (like Colombo) with greater size and capacity can take on correspondingly greater responsibilities. In a number of countries, large cities/capitals have been given a special status (e.g., Mexico City, Shanghai, Delhi, and Bogotá) which have considerable autonomy in managing their economic development. This is sometimes done as a conscious effort at asymmetry, and other times it is accepted as a pragmatic pilot-based strategy.

88. Concerning the macro parameters of the decentralized government, international experience suggests two additional guidelines:

- Give sub-national governments the authority and capacity to collect own-revenue in order to enhance the efficiency of financing and delivering services and to make them more responsive to local clients. Setting a hard budget constraint on resource transfers from the center helps create the appropriate incentives. If the Provincial Councils and Local Authorities raise more of their resources from local tax payers, international experience suggests that the local elections will be more oriented to local issues, rather than just referenda on national politics.
- Set rules and incentives for staffing so that the wage bill does not overshadow the other spending priorities, and so that public employees can be paid a salary adequate to attract and retain qualified workers. The degree of control over staffing decisions (recruitment, dismissal, etc) assigned to the sub national level should be consistent with the degree of control over the wage bill, or the design of the transfer payment regime.

Options for Moving Forward

89. Sri Lanka could consider four main options for rationalizing decentralization/deconcentration (see Matrix in Table 10 for details).

- **Option 1:** Strengthen both Provinces and Local Authorities, along with a phase-out or phase-down of districts and divisions and with the transfer of their resources (staff and funding) to provincially and locally elected governments.
- **Option 2:** Strengthen Provincial Councils, and leaving Local Authorities with their current responsibilities and cutting back districts and divisions. This seems to have been the original intent of the 13th amendment (which reduced the scope of Local Authorities relative to their pre 1987 position), but after two decades of not actually implementing this, it is appropriate to revisit the interpretation of the amendment.
- **Option 3:** Strengthen Local Authorities, especially in the urban areas and cut back the resources for Provincial Councils and divisions. The districts would be streamlined but would probably still have responsibility and resources for some tasks too large for the Local Authorities. The elected Provincial Councils could still perform important functions of oversight and monitoring, particularly of the programs executed by the districts and divisions, in order to provide accountability to the local populations.
- **Option 4:** Strengthening and giving more explicit recognitions to the existing deconcentration to districts and divisions. Given the constitutional amendment for decentralization, the deconcentration options—putting responsibilities more clearly in the hands of districts and divisions and reducing corresponding responsibilities of Provinces and Local Authorities—would apply to selected sectors, while others would remain with the constitutionally mandated Provinces and Local Authorities. And even in the areas where Districts and Divisions take over responsibility for program execution, the elected Provincial Councils would remain as monitors and quality control agents. Local Authorities could probably remain in some limited functions, certainly solid waste collection, but there would be cutbacks of autonomy and resources even in places with strong capacity.

90. Sri Lankans would need to debate and decide which option is more viable or feasible within the country's political, economic and social context. This requires consensus building concerning the type of accountability that is to be paramount and the degree of decentralization that accompanies it. Countries have chosen different ways to achieve this kind of consensus. In countries such as Australia, Denmark, Canada, India, and Thailand, National Commissions on Intergovernmental Finance have been created to develop and implement improvements on intergovernmental finance, as well as to improve monitoring, oversight, and evaluation. Of course, Sri Lanka has a similar institution in the Finance Commission, which has the potential to take on similarly strategic roles, beyond the current functions focused within the annual budget cycle. In other countries, governments table policy papers for discussion by all interested parties and stakeholders which is then used as a basis for examining and implementing policies.

91. Any of the four options would require a substantial realignment of government employment patterns, as functions and expenditure assignment get redefined. For example, if the deconcentration is to be continued, a functional review of each department would need to be carried out as part of the public expenditure review. There are duplications even within the single channel of the center-district-divisional service delivery. This will require making difficult choices and decisions.

92. All of these options are asymmetrical in that the Northeast area would need differential treatment for political reasons, and the Colombo area (with its unusually strong economy and fiscal capacity) may also warrant special treatment, at least as a pilot for greater autonomy and responsibility, which other areas could join as their economies and local capacity strengthen.

Sector Implications of Options

93. The various options have different implications in each sector. Within each option, governments that are the closest possible to the people are presumed to provide services the best. Key factors in determining the lowest level include the potential for economies of scale, the existence of interregional spillovers, variation in preferences, and the desire for equalization.

94. **Roads.** The central government would be responsible for national roads under all four options. The key issue is how responsibility and funding for capital investments and maintenance of provincial and local roads would be determined. Options 1 and 2 would enhance Provincial Councils' ability to plan and deliver intra-provincial roads. Capital project funding would continue to come primarily from a national block grant from which the Provincial Councils could select the specific projects based on provincial priorities for roads under its purview. Provincial Councils would plan and execute the operations and maintenance activities of provincial and local roads using the Provincial Council budget, which is derived from intergovernmental transfers and own source revenues. Provinces will likely subcontract operations and maintenance of some roads to local authorities and will subcontract much of the construction to private sector firms. Provincial Councils would be expected to have an O&M plan for all new capital projects.

95. Under Option 3, local authorities would be responsible for planning local roads and intra-city transportation as part of their broader urban development plans. Local authorities would also coordinate these plans with the appropriate provincial and national agencies. Local authorities would maintain local roads using resources from their budget. Capital projects would be funded through competitive grants provided by the Ministry of Transportation or the Finance Commission. Under all three decentralization options, revenue mobilization at least at the margin for roads should emphasize property tax, improvement assessments, toll roads and gasoline tax. Capital project funding from the national block grant would come mainly as a grant to match locally raised revenues, with allowances for low-income inaccessible areas.

96. Option 4 would enhance the planning, operations and maintenance capabilities of districts and divisions. Districts and divisions would need to have ongoing planning processes for the overall transportation needs of their area, including for the road system. The district and division plans for new capital investments would always be linked to comprehensive plans for operating and maintaining the new roads and other infrastructure. Districts and divisions would be responsible for building, operating and maintaining provincial and local roads. The Ministry of Transportation would finance the districts and divisions.

97. **Solid Waste Services.** Because of limited economies of scale and limited externalities, solid waste collection is generally best handled through local authorities. Treatment and disposal of solid wastes are subject to greater economies of scale (and therefore could be aggregated upwards), but still over a relatively narrow range, particularly if transportation of the waste is costly (as it often is in Sri Lanka). These functions could be carried out (or contracted to the private sector) either by Provincial Councils (Options 1 and 2), by inter-governmental agreements between local authorities (Option 3) or by districts (Option 4). With options 1 and 2, the Provincial Councils could facilitate agreements between local authorities, set service standards, and provide technical assistance as appropriate. Inter-governmental agreements between local authorities are frequently appropriate to take advantage of these economies, so with options 1 and 3 these responsibilities should also be devolved to the local authorities, which could then reach agreements with other local authorities as appropriate to achieve the best scale for treatment (which likely will vary across areas based on population density, topography, and other factors).

98. Financing for collection, disposal, and treatment should primarily be provided through local user fees and taxes. Higher level governments should provide grants or loans for capital costs to permit local authorities to purchase appropriate collection and treatment equipment. Finally, the level of government that has responsibility for this service should also have full authority to decide on staffing and other current spending decisions.

99. **Health.** There are four main parts to health care responsibilities—primary care (clinics), secondary hospitals, tertiary hospitals (teaching, research, and sophisticated treatments), and regulation. For a country like Sri Lanka, the national government should handle tertiary hospitals and regulation. Also, except in the major urban areas, the local authorities would not be able to handle secondary hospitals. So the relevant question is how to demarcate responsibilities for managing non-tertiary hospitals and primary health care. Internationally, there is no one model for demarcating responsibilities among different tiers of government for health service delivery. The key is to match responsibilities to decision-making authority and to link financing with performance.

100. It should be noted that reliance on central government finance for health services is in itself not an issue. In fact, centralized financing of health care can pool risks, allow for portability of benefits, and ensure the smooth working of the referral hierarchy. The key issue is the terms on which such financing is provided. In Central and Eastern European countries, there has been push to move from input-based financing (e.g., allocating central government funding to hospitals on the basis of individual allocations for staff, drugs, equipment and supplies, etc.) toward performance-based financing. Input-based financing is reported to fail to reward performance and prevents hospital directors finding more cost-effective means of providing services.

101. For hospitals, the international best practice is to give considerable autonomy to the administrations of each facility, with responsibility for quality and efficiency of service delivery and with authority to manage personnel and other inputs. This could happen under any of the scenario options. Options 1 and 2 would assign hospitals to the PCs. Options 3 and 4 would assign them to the national government, except that with 3 a few large municipalities might manage hospitals. In other country experiences, the national governments have often been more willing than lower level governments to give appropriate autonomy to hospital facilities, but this would not necessarily be the case for Sri Lanka.

102. Primary care facilities would become responsibilities of LAs in the third and probably the first option, although this might be differentiated among the LAs, with only the larger ones taking this on. Under the second option the PCs would take over these health clinics. In option 4, the divisions representing the national government would have charge of the clinics. In any case the national government would continue to set the standards and regulations.

103. Option 1 requires the greatest change from current delivery provisions. The basic model would have the central government responsible for setting health care policy and standards and potentially operating the highest-level hospitals. Provincial Councils would have control over other hospitals, including ability to make staffing decisions and flexibility over their budgets. They would also plan and set priorities for meeting health care needs in their province in accordance with the national health care plan. Local authorities would have authority over budgets and to some extent staffing for clinics, primary health care services, basic preventive medicine and maternity care. Technical capacity would need to be developed at both the Provincial Council and local authority levels to ensure quality service delivery. Local authorities would only be responsible for local health care services where they have the capacity to deliver services at acceptable quality and costs.

104. Since quality service delivery is essential for healthcare, an asymmetric arrangement may be necessary, at least during a transition period, to ensure that service quality can be maintained and

enhanced. Lack of sufficient scale in some local authorities can raise service delivery costs or poor delivery capacity can hamper quality such that Provincial Councils may best undertake production of local health care services in some areas.

105. The funding mechanism needs to ensure reasonably equal access to health care. Under options 1 through 3, this can be achieved by developing a categorical grant for health care that provides sufficient revenue for governments to finance their service responsibilities. The grant amount should be based on the health care needs in the relevant government and the grant should require that the providing government meet appropriately set output standards. With option 4, districts and divisions would receive budget allocations from the Ministry of Health according to needs in their respective areas.

Strategies for Implementation

106. International experience shows the importance of collective institutions that steer the decentralization process and serve as forums for negotiations and preemptive conflict resolution. Developing such institutions is particularly challenging for Sri Lanka, because of the highly political nature of decentralization issues and because such a large part of public services depend on the decisions about decentralization/deconcentration. Now it is necessary to create a consensus-building mechanism that is trusted by all parties and that takes care of the following critical tasks:

- Propose a long-term view of decentralization, intermediate goals, and ongoing adjustments
- Promote forums for discussing and negotiating intergovernmental fiscal arrangements and preventing inter-jurisdictional conflict.
- Produce an annual report on progress and current issues in decentralization, keeping federal agencies and sub-national governments alerted to their responsibilities within the process of decentralization.
- Provide competent information for the public discussion of federal, state, and local fiscal and financial policy and evaluate the design and exchange of information
- Design, collect, and disseminate key indicators for the implementation of decentralization, monitor the changes of revenue and expenditure responsibilities, and evaluate the capacity of sub-national governments to assume new responsibilities.

107. A Decentralization Committee of cabinet could include the Ministries of Finance, Ministry of Provincial and Local Government; Ministry of Plan Implementation could take the executive decisions. The Finance Commission could be its Technical Secretariat, with a mandate to gather the necessary information, to analyze it from the national perspective, and to disseminate the results.

Table 10: Matrix of Options for Fiscal and Administrative Decentralization

Areas of Reform	Decentralization			Deconcentration
	Option 1	Option 2	Option 3	Option 4
	Strengthen both PCs and LAs	Strengthen PCs	Strengthen LAs	Strengthen Central/District Divisions
Basic Structure	<ul style="list-style-type: none"> - Strengthen both PCs and LAs. - A clear delineation of functions and authority between PCs and LAs. - LAs become a viable form of government structure. - Fix transfers and revenue system to match responsibility for service delivery. - Reduce staff and funding of districts and divisions (partially transferred to PCs and LAs) 	<ul style="list-style-type: none"> - Full Federalism or give PCs well defined authority and autonomy. - Fix transfers and revenue system to match responsibility for service delivery. - Grant Colombo a PC, status following international experience - Reduce staff and funding of districts and divisions (partially transferred to PCs) 	<ul style="list-style-type: none"> - Gradual Asymmetrical. - Grant Colombo LA more autonomy and authority. - As capacity develops, more MCs can take on increasing authority. - Fix transfers and revenue system to match responsibility for service delivery. - Reduce staff and funding of districts and PCs (partially transferred to LAs) 	<ul style="list-style-type: none"> - Further strengthen the existing public functions and authority. - Reduce funding and staff in PCs and LAs - PCs monitor quality of service and advocate local preferences. - LAs are delegated some functions, like solid waste collection.
Expenditure	<ul style="list-style-type: none"> - Undertake a sector by sector review - Define role and functions of each level of government based on economies of scale, spillover costs and benefits, and proximity of service providers to clients. <p>For certain services across boundaries of smaller LAs, amalgamate small communities for certain functions through associations or special purpose districts.</p>			<ul style="list-style-type: none"> - Undertake a sector by sector review of functions of the center, district, & divisions. - Streamline functions, eliminate duplications. - Define the monitoring role of PCs. - Define the role of LAs (e.g. solid waste collection).

Areas of Reform	Decentralization			Deconcentration
	Option 1	Option 2	Option 3	Option 4
	Strengthen both PCs and Las	Strengthen PCs	Strengthen LAs	Strengthen Central/District Divisions
Revenue	<ul style="list-style-type: none"> - Assign tax base to PCs, or LAs or both, depending on expenditure assignment (e.g., stamp duty to a level of government responsible for local infrastructure) - Devolve tax base: PC or LA have sales tax surcharge, which needs to be coordinated with national VAT reform. - Reform property tax, stamp duty, and user fees; strengthen local capacity for assessment (property tax), collection, and enforcement. - Facilitate leasing or sale of public land in order to raise local revenue - Private financing of infrastructure 			<ul style="list-style-type: none"> - Sub-national revenue mobilization not relevant. - Focus on national tax reform (outside the scope of work). - Private financing of infrastructure - User fees
Inter-governmental transfers	<ul style="list-style-type: none"> - Simplify block grants into two main programs: earmarked grants to enforce national policy and standards and unconditional grants based on revenue sharing formula. - Change calculation of block grants to improve incentives for revenue raising. - Calculate of revenue gaps based on estimates of the potential revenues to remove disincentive. 			
Civil Service Reforms For all options: <ul style="list-style-type: none"> - Control the size of public sector employment. - Strengthen accountability for quality of service - Address salary compression. - Improve transparency in recruitment and assignment. Create senior management service.	<ul style="list-style-type: none"> - Strengthen accountability of staff to PCs and LAs, respectively. - Delegate appointment of Chief Secretaries (Commissioners/Secretaries) to the PCs (Local Councils), and place them on the PC (Local Council) payroll, and delegate appointment of to the respective PCs (local council). - Introduce performance contracts between the Chief Secretary & each of the provincial ministry secretaries. Introduce performance contracts between the local councils and the Commissioners/Secretaries. 	<ul style="list-style-type: none"> - Strengthen accountability of staff to LAs. - Delegate appointment of Commissioners and Secretaries to the respective local council - Introduce performance contracts between the local councils and the Commissioners/Secretaries - LAs should be involved in the recruitment of all staff - Amend the block grant formula to allow LAs to keep savings from eliminating posts. Give LAs some flexibility to award salary top-ups for hard-to-fill posts.	<ul style="list-style-type: none"> - Strengthen accountability of staff to PCs. - Delegate appointment of Chief Secretaries to the PCs, and place them on the PC payroll - Introduce performance contracts between the Chief Secretary & each of the provincial ministry secretaries - Board of Senior Officers in each PC manage all local staff recruitment - Amend the block grant formula to allow PCs to keep savings from eliminating posts. - Give PCs some flexibility to award salary top-ups for hard-to-fill posts. 	<ul style="list-style-type: none"> - Downsize PC and LA staff where functions overlap with divisions and districts

