

National Economic and Fiscal Commission

**REVIEW OF INTERGOVERNMENTAL FINANCING
ARRANGEMENTS**

***INTERIM REPORT
AND
PROPOSALS FOR A NEW FRAMEWORK***

May 2003

EXECUTIVE SUMMARY

Background

In late 2001, the National Economic and Fiscal Commission was asked to investigate the problems with the current system of intergovernmental financing, and recommend changes which would improve its operation. This Report presents the findings of the Commission's work so far, including broad framework proposals for a new system.

It is intended that the Report should serve as the background to a process of discussion about the proposals for a new system over the next nine months. The NEFC intends to report at the end of that period on a set of final proposals. It is crucial that there should be wide-ranging discussion so that the final proposals incorporate the views of provincial and local-level governments, Members of Parliament and those who know and understand the complexities of implementing a system of fiscal decentralisation.

Analysis of the current system and lessons learned

The NEFC's recommendations for a new system of intergovernmental financing are based on its observations about the existing system and why it has not worked as well as it was hoped. It is important that the lessons which this experience offers should be incorporated into the design of the new system. Nine key observations informed the decisions about components of the new system.

Service delivery is deteriorating

There is general agreement that services are deteriorating, but not much agreement about exactly why. Clearly the reasons are complex and do not only relate to financing systems. However, the NEFC believes that current financing arrangements are contributing to poor service delivery.

Most importantly, there is insufficient goods and services funding to meet the operational costs of service delivery. Without goods and services funding, services cannot be delivered. Although there are public servants to do the work, they do not have funding for program delivery. The current system of Organic Law grants places a high emphasis on infrastructure spending. This is reflected in provincial government budgets which show a high level of proposed spending on capital. If

there is already inadequate funding to operate existing services and undertake routine maintenance of the infrastructure which is already in place, then expanding new services and infrastructure is likely to make this situation worse.

The new system should ensure that recurrent costs of priority services are properly funded, and ensure an appropriate balance between new infrastructure and maintaining existing services.

National and provincial governments may have different priorities

The lack of goods and services funding affects rural health and basic education services particularly. These are both core priorities within the National Medium Term Development Strategy. It appears that some provinces do not share the National Government's emphasis on these priorities, and this is evidenced by the amount they allocate to operating these services. The resulting shortfall in operational funding leads to essential programs such as immunisation not being delivered in some provinces. This can have spillover effects in other provinces.

It is unlikely that national and provincial governments will ever have exactly the same priorities in a decentralised system, and it is precisely these differing perspectives that decentralisation is intended to accommodate. However, it is also important that these core national priorities should be adequately provided for, because they affect the wellbeing of our people and national economic growth. Since the national government no longer has a service delivery network in the provinces, these services will have to be delivered by provincial and district administration staff.

The new system should ensure that both nation-building priorities and local priorities are reflected in funding decisions.

Confusion over functions

It may be that some provinces are not adequately funding functions like health and education because they consider them to be national functions. Since the New Organic Law was implemented in 1996, there has remained considerable confusion about what provincial governments are supposed to fund, and what functions they are responsible for.

At the core of this confusion is the fact that the current arrangements have resulted in funding being de-linked from functions, because the grants

under the *Organic Law on Provincial Governments and Local-level Governments* were based on formulas, rather than the cost of services.

Further confusion was caused by the major budget changes which happened when the new Organic Law was implemented. Goods and services funding to provinces increased by almost K100 million between 1995 (the old system) and 1996 (the current system). This meant that some national programs were de-funded, and by default 'transferred' to the provincial governments.

At the same time, the Department of Provincial Affairs began a separate process of negotiated function transfer that was never properly finalised, even after two years of work. These two parallel processes resulted in substantial confusion about which level of government should be doing what. Perhaps the greatest confusion is in relation to local-level governments, which in many cases have significant capacity problems and limited staff.

Clear agreement on functional and funding responsibilities should be the starting point for the new system. The agreement needs to be developed through negotiation and should take into account which level of government is best placed and best able to carry out a function.

Differential capacity is not accommodated

The 'one-size-fits-all' model of decentralisation has not been appropriate for PNG, because provinces vary so greatly in their capacity. Local-level governments probably experience the greatest capacity constraints, but there is very little capacity at the National level to seriously address this. The system should incorporate a means to assess whether a province has the capacity to carry out transferred functions.

The new system should recognise and accommodate differential capacity among provinces and LLGs.

Inequitable distribution of resources

The current distribution of resources (especially non-salary funding) between provinces is very inequitable. Two provinces have over K400 per head in total revenue, while four provinces have less than K125 per head. Those provinces with the lowest development ranking also tend to have the lowest per capita revenue.

In addition, resource distribution does not take into account different development needs or the higher cost of service delivery in some parts of the country.

The new system should address the differential levels of development and access to services.

Internal revenue is not part of the system

The most significant reason for the inequitable distribution of resources is the highly variable distribution of internal revenue. The current system of intergovernmental financing does not take account of the internal revenues received by provincial governments.

In PNG these internal revenues are significant (a total of around K300 million per year), but even those which are transferred from the national government (VAT and mining and petroleum royalties) are not shown in the national budget. Internal revenue received by provinces represents around 40 percent of the total funding available for goods and services across all levels of government.

Internal revenue is important for generating ‘bottom-up’ accountability in decentralised systems. The system of intergovernmental financing should maximise the capacity of provinces to collect their own revenue. VAT sharing is likely to be a very important component of the new system, and the Review will have to consider a number of options for reform, but there are other opportunities for local revenue generation which can also be looked at.

Internal revenues should be an integral part of the new system, and all sources of revenue should be taken into account in determining each province’s level of funding. The system should seek to maximise effectiveness and efficiency in local revenue generation.

Unintended effects of different elements of the system

The interaction of different components of the current system produces unintended effects. One example is the operation of the grant indexation provisions. If these provisions had been properly applied, grants would have risen each year until 2001, when they would have been recalculated according to the formula for a new ‘base year’. This would have meant a sharp drop in grants in a single year, which can not have been what was intended by the system’s designers.

This demonstrates why it is so important to consider all the elements of intergovernmental financing arrangements as part of an integrated system.

Grants are not affordable

The effect of implementing the grant formulas in the Organic Law for the first time was to require a substantial transfer of resources from the national to the provincial and local levels of government. In the initial years, budgeted provincial grants were at almost the level mandated by the Law. Since 1999, however, the National Government has not been able to meet the full requirements and the gap between grants due and grants actually paid has become increasingly wider.

Two factors have contributed to the National Government's inability to pay the full amount of the grant. First, an increasing number of provincial level services are now paid out of the national budget instead of out of provincial budgets. Second, the amount of funding available for goods and services (including transfers to provincial and local governments) has been growing smaller because of rising salary and debt servicing costs.

The decreasing amount of funding for non-salary grants is compounded by the effect of the falling kina exchange rate. The same amount in non-salary grants now cannot buy as much as it did in 1995. In addition, the overall fiscal situation of the national government is also growing increasingly constrained.

The package of funding for provincial and local-level governments must be sensitive to the national fiscal context, but it should also provide provinces with some certainty as to their funding levels.

Implementation was not in accordance with design

The original concept of the new system was very ambitious. In practice, much of it has not been implemented as it was designed. There are many reasons for this, including lack of resources, lack of capacity, and unanticipated problems with some aspects of the reforms.

This highlights why it is so important to consider implementation issues carefully as an integrated part of the design process. Implementation needs to be carried out through a properly thought-out, costed and phased plan which is developed as part of an inclusive process.

Proposals for a new system

The proposals for the new system address four key questions which are central to the design of any system of decentralised financing:

- who does what? (*expenditure assignment*);
- who levies what taxes? (*revenue assignment*);
- how is the imbalance between revenues and expenditure responsibilities to be addressed? (*vertical equalisation*—that is, between national and lower levels of government);
- how should differences in capacities and needs among lower level governments be addressed? (*horizontal equalisation*—that is, between provinces).

There are seven grant types and three adjustment mechanisms that make up the framework of the proposed new system of intergovernmental financing, together with an appropriate range of revenue powers.

Function Grants (which implement policy on expenditure assignment)

Function Grants would cover the operational costs of delivering basic core services, for example primary health, basic education and transport infrastructure maintenance. Provinces would control the allocation of each grant within those limitations, and could apply to have further functions transferred to them if they demonstrate capacity. These additional functions would also be funded through Function Grants.

In order to formulate Function Grants, the distribution of functional and funding responsibilities will have to be clarified, and the cost of service delivery to a specified standard determined.

Mechanism for transfer of additional activities

This mechanism will set out what criteria a provincial government should meet in order to have additional functions transferred to them, and the process for negotiating additional funding to cover them.

Block Grants (which would implement vertical equalisation)

Block Grants would cover the cost of government administration and operating overheads, additional non-core functions, and funding to address local priorities and projects. The allocation of Block Grants would be at the complete discretion of the province. Eventually, when appropriate staff ceilings have been developed and costed, staffing costs

would be included in the Block Grant, to give provinces an incentive to reduce staff numbers and gain the benefit of savings.

Provinces which meet certain criteria in the management of resources would be able to apply for Function Grants to be converted to Block Grants, giving them more autonomy over spending decisions.

Mechanism for conversion of Function Grant into Block Grant

This mechanism would establish the criteria and process for conversion of Function Grants into Block Grants, and for monitoring continued maintenance of agreed service delivery standards.

Derivation Grant

If Derivation Grant is included in the new system, it would be calculated on the basis of primary production and secondary processing of primary products within a province. It will be for the purpose of promoting production of export commodities. Further investigation is needed to determine if it is feasible to continue to incorporate Derivation Grant into the new system.

Less Developed Province (District) Grant (horizontal equalisation)

This is a new grant type, intended to address the need for additional funding to address underdevelopment in some areas, and to provide a mechanism for horizontal equalisation between provinces.

The Grant will be calculated according to a development index based on a range of available development indicators.

Rural Local level Government Grant and Town Services Grant

Rural Local-level Government grants and Town Services Grants will be calculated according to the cost of the functions which are determined to be the responsibility of these local level governments. This a

District Support Grant

If District Support Grant is to continue, it should be integrated into the system of intergovernmental financing. Options for reform of District Support Grant should be considered, including converting a proportion of the grant for use exclusively for road maintenance.

Taxation powers and improved revenue generation

The Review will focus on improving provincial revenue-generating capacity, and examine the options for reform of VAT/GST. This will await the outcome of political negotiations on distribution of VAT/GST for 2004.

Mechanism for internal revenue off-setting

This mechanism will provide an appropriate means of off-setting high levels of internal revenue against national grants, but not so far as to remove any provincial incentive to collect revenue.

Mechanism for annual adjustment.

This mechanism will allow grants to be adjusted annually in response to the changing fiscal circumstances of the national government. It should also provide provincial and local-level governments with a reasonable measure of predictability in their funding.

Further work to be done

There is considerable further work to be done to properly develop each of these components, and understand how they would work as part of an integrated package. The process of defining a clear assignment of functions and costing Function Grants in particular requires a process involving both information gathering and policy development with key agencies. The Report sets out in detail the work that the NEFC considers needs to be undertaken in order to ensure that its final recommendations are informed by a comprehensive understanding of the current system, and a thorough evaluation of the impact of any changes.

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List of Acronyms

ADB	Asian Development Bank
CACC	Central Agencies Coordinating Committee
CPI	Consumer Price Index
DPM	Department of Personnel Management
DoF	Department of Finance
DPGLGA	Department of Provincial Government and Local Government Affairs
DPM	Department of Personnel Management
DSG	District Support Grant
EPD	Economic Policy Division (of Treasury)
FFR	Full Financial Responsibility
FMIP	Financial Management Improvement Project
GST	Goods and Services Tax
HDI	Human Development Index
HSIP	Health Sector Improvement Program
IMF	International Monetary Fund
IRC	Internal Revenue Commission
JDPBPC	Joint District Planning and Budget Priorities Committee
JPPBPC	Joint Provincial Planning and Budget Priorities Committee
LLG	Local-level Government
MP	Member of Parliament
MTDS	Medium Term Development Strategy
MTFF	Medium Term Fiscal Framework
MUG	Minimum Unconditional Grant
NCD	National Capital District
NEC	National Executive Council
NEFC	National Economic and Fiscal Commission
NMA	National Monitoring Authority
OLPGLLG	Organic Law on Provincial Governments and Local-level Governments
PEC	Provincial Executive Council
PERR	Public Expenditure Review and Rationalisation
PGAS	PNG Government Accounting System (formerly Provincial Government Accounting System)
PSRAG	Public Sector Reform Advisory Group
RAMS	Road Asset Maintenance System
SRC	Salaries and Remuneration Commission
SSG	Special Support Grant

TSC Teaching Services Commission
VAT Value-added tax

1. INTRODUCTION

1.1 Background to the Review of Intergovernmental Financing

In late 2001, the former Government requested that the National Economic and Fiscal Commission (NEFC) undertake a review of the intergovernmental financing arrangements set out in the 1995 *Organic Law on Provincial Governments and Local-level Governments*.

The Review commenced in 2002, when funds were made available through the Asian Development Bank (ADB) Public Sector Reform loan. In April 2002 a Scoping Paper was released outlining the intention to review all the fundamental elements of the intergovernmental financing arrangements, including the grant components, equity and derivation issues, and the arrangements for ensuring accountability.

1.2 Approach taken

The current system of fiscal decentralisation has not lived up to the hopes for improved service delivery which accompanied its enactment. One of the criticisms leveled at the current system is that it was not based on a sound understanding of the problems of the old system. Indeed, some provinces now argue the old system was preferable.

The NEFC considers that proposals for change should be developed on the basis of a sound understanding of why the current system has not worked. For this reason, the initial phase of the review has concentrated on a comprehensive situation analysis, which seeks to understand the underlying causes of symptomatic problems with both design and implementation of the new Organic Law.

Lack of data has been a major impediment to accurate diagnosis of what is wrong with the present system. For example, there is no comprehensive data on provincial expenditure between 1996 and 2002, nor is there reliable data about revenue flows. Therefore, a major thrust of the NEFC's work so far has been to address the lack of data through substantial data gathering and analysis.

The NEFC is also concerned that any new system should be developed in an inclusive and collaborative way both with national agencies and provincial governments. Substantial effort has been made during 2002 to undertake comprehensive consultations, including with provincial administrators; visits to provinces to talk with provincial administration

staff; and briefings for national agency staff, CACC, PSRAG members, Governors and members of the Government Caucus.

This collaborative approach will be fundamental to the sustainability of the outcomes of the Review. Changes to the existing arrangements cannot be effectively implemented unless the key stakeholders at all levels of government understand the detail of proposals and their purpose. It is proposed to continue this collaborative approach throughout the remainder of the Review.

1.3 Studies undertaken

To inform its understanding of why the current system is not working as desired, and what solutions might be proposed to help address these problems, the NEFC has undertaken a series of background studies and data collections. This work has included:

- analysis of the 2001 **'fiscal envelope' of government**, and how the resources were divided between different government services;
- calculation of the **grants due to provincial governments** in the period from 1996 to 2003 in accordance with the Organic Law and grant indexation mechanism;
- compilation of data on **actual provincial grants paid** between 1996 and 2001;
- collection of comprehensive data on **provincial internal revenue collection and off-budget transfers** to provincial governments for 2001;
- collection of data on **royalty payments to provincial governments** 1996-2002
- collection of data on **internal revenue reported in provincial financial statements** 1996-2001
- analysis of the **equitability of distribution of resources between provinces** for 2001;
- compilation and analysis of **provincial budget allocations** by function and economic classification for 2001;
- compilation of data on **resource transfers under the old system of provincial financing** (through both grants to provincial governments and national budget allocations to provincial departments) between 1991 and 1995;
- identification of **issues relating to planning, budgeting and accountability systems** at provincial and local level;

- options for **reform of VAT**;
- analysis of selected **local level government budgets**;
- **distribution of functions** between different levels of government.

As data is finalised and analysed, these studies are to be written up as a series of NEFC working papers.

1.4 Framework of a new financing package

On the basis of its analysis of the current situation and lessons learned, the NEFC has formulated the framework of a new proposed financing package. Considerable further work is required to develop the detailed specifications for the new system, ensure it is workable and design an appropriate means to implement it. However, it is appropriate at this stage to seek the views of Government and other stakeholders as to whether the broad framework is in line with the key policies of the Government and its intentions with respect to the system of decentralisation.

The purpose of this Interim Report is to present these framework proposals for the new system, seek the views of Government, Provincial Governors and other MPs, and other stakeholders. It is intended that this Interim Report should form the basis for consultations which will seek endorsement of the broad approach outlined here, and for the next stage involving full development of the proposals over the remainder of 2003.

Section Two of the report outlines the analytical foundations of the new system, and Section Three sets out the components of the new system, the major outstanding design issues, and the process which is proposed for resolving these issues. Section Five provides a greater level of detail on the information gathering and analytical work which the NEFC proposes should inform the detailed development of the new system.

1.5 Proposals for 2004 Budget

The Government has asked the NEFC to formulate proposals which could be used as the basis for intergovernmental financing in the 2004 budget. This is difficult to achieve in the time frame, because of the long lead time for passing amendments to the *Organic Law on Provincial Governments and Local-level Governments*.

The NEFC has attempted to find a way forward which would allow most of the elements of the new system to be applied in 2004, but without fully developing the mechanisms for calculation and adjustment. In particular, it will not be possible to develop appropriate mechanisms for inter-year adjustment in time for the 2004 budget. Accordingly, it is proposed that this interim proposal should apply only for the 2004 budget year.

Section Four of the Report sets out the interim proposals for 2004. It should be emphasised that these have not been the subject of any consultation with Provinces because of the tight time frame within which they have been developed.

2. ANALYSIS OF CURRENT SITUATION AND LESSONS LEARNED

Nine key observations about the design and implementation of the current system are summarised below. These give rise to the “lessons learned” which form the basis for the design of the new package of proposals. They are each discussed in detail in this section of the report.

The nine key observations are:

1. *Service delivery is deteriorating.*
2. *National and Provincial Governments may have different priorities.*
3. *There is confusion over functions.*
4. *Differential capacity is not accommodated.*
5. *Resources are inequitably distributed between provinces.*
6. *Internal revenue is not taken into account.*
7. *There are unintended effects of different elements of the system upon each other.*
8. *Formula-based grants are not affordable given current funding arrangements.*
9. *Implementation of the current system was not in accordance with its design.*

Figure 1: Nine Key Issues with Provincial Financing Arrangements

2.1 *Service delivery is deteriorating*

Arguably the most important objective of decentralisation is to improve the quality of service delivery. Decentralisation contributes to improved service delivery by giving greater scope for decision-making at the lowest possible level of government at which programs can be efficiently and effectively delivered.

Anecdotally, it is apparent that both provincial governments and national government agree that service delivery is deteriorating.

However, the two levels of government disagree on what the cause of this deterioration is. Provincial Governments maintain it is because the National Government has not paid the full amount of the Organic Law grants. From a National Government perspective, it can be argued that

the failure of provincial governments to fund core activities such as school operations and church health services in the past has meant that the National Government had to find funding for these within its own budget. This in turn has reduced its capacity to pay the full amount of the grants to provinces.

Insufficient goods and services funding

Reviews of service delivery seem to indicate that where inadequate funding is contributing to deteriorating service delivery, it is **goods and services (recurrent)** funding that is lacking, not funding for new infrastructure.

This may be partly because of the way the current system of intergovernmental financing is structured. The current system (of Organic Law grants with specified purposes) provides for more than twice as much non-salary funding to be available for development as is available for the goods and services costs of administration. The Provincial Infrastructure Grant and the Local-level and Village Services Grants are both specified to be development grants. The District Support Grant has also been effectively used as a development grant.

In 1996, the first year of implementation of the current system, over K150 million was budgeted to provinces in development funding, while the Administration grant was K70 million. Although it is not clear what “development” means precisely, it is to be presumed that these grants were not intended to cover ordinary year-to-year running costs of health, education and routine road and building maintenance.

Emphasis on new infrastructure at the expense of service delivery

Much of this development funding appears to have been allocated to expenditure on new infrastructure projects. This has two significant impacts. First, it means there is less funding for the operation and maintenance of existing core services such as health centres and schools. A study by the NEFC of provincial budgets for 2001 has shown the relative priority provincial governments are giving to capital expenditure over goods and services. For example:

- K15 million was budgeted for the goods and services cost of running all the government rural health facilities in the country (not including transfers to church health services);
- K13.6 million was budgeted for the goods and services costs of the education system (not including K34.6 million transferred to education institutions);

- K72.3 million was budgeted for capital expenditure on roads, out of a total of K124 million budgeted for capital expenditure.¹

Second, if this capital expenditure is going to new infrastructure, it will generate an even greater demand for recurrent resources for operation and maintenance in future years. This imbalance between recurrent and new infrastructure is inherently unsustainable.

Inadequate expenditure on routine maintenance

The NEFC Study on Provincial Budgeting also revealed that around K22 million was budgeted for routine maintenance. However, K14.8 million of this was budgeted in only four provinces—NCD, Morobe, East New Britain and New Ireland. Four provinces budgeted less than K100,000 for routine maintenance. A further six budgeted less than K200,000.

It is clear that maintenance of transport infrastructure and buildings is a particular problem that affects not only service delivery but economic development. This has been a problem since early on in the history of decentralisation in PNG. The 1984 Specialist Committee on Intergovernmental Financing highlighted this issue almost 20 years ago, but successive changes to the system of fiscal decentralisation have failed to address it.

Lessons learned:

Funding should be linked to the delivery of core services in order to ensure that:

- **the recurrent costs of core services (in particular maintenance) are adequately provided for;**
- **core services are accorded an appropriate priority in the use of resources; and**
- **an appropriate balance is struck between providing for new infrastructure and maintaining and operating existing services.**

2.2 National and provincial governments may have different priorities

The lack of goods and services funding for programs like health and education may in part reflect the different funding priorities of national and provincial governments. This is quite legitimate and should not be

¹ Data taken from summary tables set out in NEFC Background Study on Provincial Budgeting 2001, 3December 2002

considered a criticism of provincial governments. Indeed, it is the accommodation of these differing local priorities that is the main objective of decentralised financing.

Core MTDS priorities not reflected in some provincial budgets

Health and education services are two of the core priorities emphasised in the Medium Term Development Strategy (MTDS). At present, the National government anticipates that rural health and basic education will be supported by allocations from provincial budgets, because these are considered provincial functions. However, not all provincial governments give these programs priority.

The results of the Provincial Budgeting Study for 2001 outlined in part above lead to the conclusion that some Provincial governments may give a lower priority to running health and education services than they do to funding infrastructure and other programs. For example, in 2001, one province budgeted only K14,200 for the non-salary operating costs of its health facilities, but K1.6 million in grants to community organisations to perform community services. A representative of that Provincial Government has declared that health is “a fourth or fifth priority”. Another province allocated K36,600 for operating health services, but more than K3 million as grants to other bodies for infrastructure projects.

Problems with Budget Coding

The Provincial Budgeting Study provides an analysis of provincial budget allocations based on data from the PNG Government Accounting System (PGAS). **This data is only reliable if the budget votes are accurately coded.**

It appears likely that the quality of budget and expenditure coding in some provinces is very poor. This means that it is very difficult to get a clear picture of how almost K500 million of the country’s public resources are spent.

Coding problems fall into two broad categories. First, **expenditure is not coded to particular functions**. For example, expenditure on district health services may be coded ‘1’ for ‘Administration’ instead of ‘2’ for ‘Health’. This means it is not possible to determine whether the Organic Law requirements for 50% of grants to be spent on social purposes is being complied with.

Secondly, **inaccurate economic classification of expenditure is used**. This coding indicates whether money is spent on goods and services, salaries, transfers or capital, and of what kind. For example, the general classification item 135 (‘other operational expenses’) can mean virtually anything. One province had more than 45% of its total non-salary budget coded against item 135 in 2001.

It is important that core national programs should be properly delivered, as these are essential to the wellbeing of the nation and the growth of the economy. Some programs like health and education have spillover effects—the failure to deliver services in one province may cause

problems in other provinces (such as the spread of disease—or may impact on the economy as a whole. Since the national government no longer has a service delivery network in the provinces, these programs will have to be delivered by provincial and district administration staff.

Lessons learned:

The new system of decentralised financing should be structured so as to ensure that overall nation-building goals are reflected in adequate funding for national priority programs, but it should also provide scope for local priorities to be realised in funding decisions.

2.3 *Confusion over functions*

Another reason for the non-funding of some core functions may be the ongoing confusion about which level of government is responsible for funding what activities. This confusion dates back to the time when the new Organic Law was implemented, and continues today.

De-linking of funding and function

The changes to the intergovernmental financing arrangements in 1995 effectively de-linked funding from function. Under the original system of provincial funding, provinces received funding either through the Minimum Unconditional Grant (MUG)—based on the cost of delivering transferred functions—or through allocations to Provincial Departments—which provided funding for specific programs such as health services, agricultural extension and information services.

From 1995, this was no longer the case. Instead, funding was based on formula related to population, land and sea area. Although the Organic Law provided a long list of *legislative* functions of provincial governments, it did not clearly specify the *administrative* responsibility for different programs. In particular, it was not clear which of the existing range of programs provincial governments were supposed to fund with their grants. It was intended that the transfer of functions to provincial governments would be negotiated on a case-by-case basis.

Financial implications of increased provincial funding

The good intentions with respect to a negotiated approach to function transfer were undermined by the financial realities of the 1996 budget, the first one in which the new funding arrangements were implemented.

The new Organic Law came at a time when PNG was experiencing its first major macroeconomic shock because of the closure of the Bougainville gold and copper mine.

The practical effect of the changes in provincial financing from 1995 to 1996 was to **increase the amount going to the provinces by K165 million in one year.** In

1995, the total funding to provincial governments and provincial departments was K315 million including all development funding. In 1996, the National Budget provided for provincial funding of K480 million not including development projects.

The only way in which the Department of Finance and Planning could find the additional money to pay to provinces was to cut funding for a number of national programs—effectively transferring these as a provincial funding responsibility but without any formal process of transfer or even notification to provinces of their new responsibilities.

Allocative efficiency in service delivery

The objective of decentralising responsibility for service delivery is to achieve *allocative efficiency*. This means that control of service delivery is devolved to that level of government most closely matched to the people who are most affected by the service in question, as long as that is consistent with the capacity and resources at that level of government. Economies of scale are also an important consideration.

For example, it would not be efficient for 300 local-level governments to each write their own school curriculum. On the other hand, rubbish collection would not be run most efficiently if all the rubbish collectors reported to the Department of Health in Port Moresby.

Two separate processes of function transfer

While the Organic Law provided for the phasing in of function transfer, it did not provide for the corresponding phasing in of funding—all the increased funding was required to be paid in the first year of operation.

Furthermore, it appears there was a disconnection between the way two key national agencies approached this issue. Between 1996 and 1998, the Department of Provincial Government and Local Government Affairs

spent considerable effort developing a process for identifying functions for transfer, and designing a process for progressive transfer. This process seems not to have acknowledged that a defacto transfer of some functions had already occurred in 1996 when the national government funding for these functions was cut.

Local-level Government functions

Further comprehensive work is needed to determine what functions and activities local-level governments have or should assume responsibility for. It is at this level of government that clarity and definition of roles are most problematic. In 1995 most local-level governments (if they existed) operated with modest budgets and were mainly responsible for carrying out local projects. A Village Services funding scheme operated by the Department of Provincial Affairs was one of the National programs cut in the 1996 budget. In 1996 around K20 million was budgeted to LLG grants. This grew to K43 million in 2001, including the grant for LLG staff.

The biggest confusion in local-level government funding seems to be whether local-level governments are responsible for funding some aspects of operational service delivery, even though the public servants who deliver these services are not responsible to them. Some LLG budgets include contributions to local health facilities and schools, others are mainly focused on capital expenditure such as new classrooms and teacher housing. Overwhelmingly, however, the NEFC's study of a selected range of LLG budgets for 2001 indicates the majority of LLG funding was allocated to the administrative overheads of the system itself, in particular the cost of allowances for LLG members.

An example of shared responsibility for program delivery

Immunisation is a national program, but inputs into program delivery are currently paid for by all levels of government and administration:

- *National government:* provides program design (e.g., what and how often immunisations are to be done), pays for vaccines, distributes to provincial health office, and collects monitoring data;
- *Provincial administration:* distributes vaccines to health centres, provides supervision of program delivery and training for health facility staff, collects monitoring data from district health staff and sends to national Department;
- *District administration:* pays for costs of patrols, including providing vehicles, fuel, TA and costs of cold chain (refrigerators, gas etc.), directs district health staff to undertake patrols, and collects monitoring data;
- *Local-level Governments:* pays for cost of maintenance of aid posts and provides other clinic points where vaccinations can be administered.

Distinguishing delivery responsibilities from funding responsibilities

The NEFC has embarked on a study of what national agencies and provincial administrations now understand to be the division of functions and responsibilities between the four levels of government and administration. It is clear from this study that there is still major confusion about funding and service delivery responsibilities. This confusion cannot be resolved by the National Government alone – a participative process involving provinces is needed.

The division of functions between the different levels of government is complicated by the fact that the National Government no longer has any significant service delivery network in the provinces. This means that even nationally-funded program in most cases must be delivered by provincial administration staff.

What this means is that not only does responsibility for carrying out particular activities need to be clarified, but also what inputs into those activities each level of government is responsible for funding.

Factors affecting distribution of functional responsibilities

At present, in some provinces, functions are not well matched to capacity, (as measured in its broadest sense including access to funding, staff, skills, support and basic infrastructure—such as banking facilities—without which governments cannot easily function). However, not all these capacity shortcomings can be remedied with more training or supervision. The National Government itself lacks the capacity to provide the support that provincial and local-level governments need to improve.

Lessons learned:

The starting point for any new system of decentralised funding should be a clear, appropriate and agreed division of functions and responsibilities across all levels of government.

The division of functions needs to be developed through a process of negotiation, and not unilaterally determined by one level of government. This process should take into account what functions each level is best able and best placed to carry out.

The NEFC proposes to facilitate an inter-agency and intergovernmental process to ensure that the new system is developed on the basis of a clear agreement as to the division of functional responsibilities.

2.4 Differential capacity is not accommodated

One solution to the problem of differential capacity among different provincial and local-level governments is to allow them to assume functional responsibilities at their own pace, as their capacity develops.

The Organic Law reforms of 1995 provided the scope for recognition of the graduated transfer of responsibilities in line with the differing capacities of provincial governments. However, in practice a ‘one-size-fits-all’ model has been implemented. This model has proved to be too restrictive for some provinces, which are seeking increased transfer of functions and increased autonomy over funding. On the other hand, provinces with lesser capacity have not been provided with enough guidance or support to ensure that they make the best use of their resources.

There is little information about how LLGs have performed, but there is anecdotal evidence to suggest that capacity at this level varies a great deal, and in many instances is inadequate. The difference between highly sophisticated urban LLGs and very basic rural LLGs in remote areas highlights this range. Even though LLGs now report directly to the National Government, it is likely that capacity at the LLG level is dependant on support from the provincial government, since the National Government’s capacity to support LLGs is quite limited.

Further work is needed to understand the precise capacity shortcomings which affect individual provincial governments, and to develop a simple set of criteria by which this could be measured. This is the major impediment to instituting a system of graduated transfer of responsibility—the system must provide a way of assessing which provincial governments have the capacity to carry out an increased range of functions.

Lessons learned:

<p>The new system should acknowledge and accommodate differential capacity between different provinces and LLGs, and encourage capacity improvement by concentrating scarce national resources on those governments which most need assistance.</p>
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2.5 *Inequitable distribution of resources*

PNG's Constitution requires that all Papua New Guineans should have an equal opportunity to participate in development (National Goal and Directive Principle 2). A major thrust of the Organic Law reforms was to attempt more equitable distribution of resources between provinces using a formula based on provincial population and land area. However, the objective of fairer distribution of resources has not been realised in practice.

Distribution of revenue resources

The main reason for inequitable resource distribution is the impact of non-grant revenue. The Organic Law Grants are not the only source of provincial funding. Some provincial governments also receive substantial revenue from both internal sources and off-budget transfers of revenue from the National Government. To better understand the impact of these other revenue flows, the NEFC undertook a study of how resources were distributed between provinces for 2001. This examined revenue from all sources, including VAT transfers, mining and oil revenues, and income from provincial tax collection and investments.

The results of this study show that some provinces have significantly more per capita revenue than other provinces. Table 1 below shows the figures of total revenue (including salaries) per capita for each province except Bougainville.

The disparity between different provinces is even more striking when just the non-salary revenue sources are considered. (Non-salary funding is important because it pays for the inputs into services such as drugs, power, fuel and travel costs.) At one end of the scale, funding available to the NCD for goods, services and infrastructure amounts to more than K400 per head,² and more than K300 per head in Western Province, while Simbu, Sandaun, East Sepik, Madang and Central receive less than K50 per head. This affects the capacity of the provinces with lower revenue levels to deliver services adequately.

² The NCD does not receive a staffing grant, because it does not employ national public servants. However, for the purposes of comparison, its salary bill was deducted from its overall revenue so that non-salary revenue could be compared fairly with other provinces.

Taking into account relative need and differences in development

Historically, PNG has developed unevenly. In some parts of the country there are aid posts only 15 minutes' drive apart. In other places some communities are more than a day's walk from the nearest health facility.

While it is not possible to completely even out all the imbalances, the system of inter-governmental financing should not unintentionally lock in these disparities. This was the unintended effect of the Minimum

Unconditional Grant (MUG) under the old system of decentralisation. Because the MUG was calculated on the basis of service delivery costs in 1976, it was not able to be adapted to the increased need for funding in areas where service networks were growing faster, on account of the greater need to 'catch-up' to the rest of the country.

The current distribution of resources fails to take account of two additional factors which should be factored into the calculation of transfers to provinces.

<i>Province</i>	<i>HDI 1996</i>	<i>Revenue per capita 2001</i>	<i>Ranking of per capita revenue</i>
NCD	.758	K454	2
Western	.472	K464	1 (highest)
East New Britain	.432	K211	6
Manus	.421	K325	3
Milne Bay	.420	K172	10
Central	.408	K174	9
New Ireland	.396	K322	4
West New Britain	.394	K199	7
Morobe	.389	K150	12
Oro	.386	K164	11
Madang	.336	K115	19 (lowest)
Gulf	.331	K305	5
Eastern Highlands	.325	K121	17
Simbu	.320	K127	15
East Sepik	.304	K117	17
Enga	.283	K198	8
Western Highlands	.282	K126	16
Southern Highlands	.274	K139	13
Sandaun	.262	K136	14

Table 1: Provincial HDI Ranking contrasted with Per Capita Revenue Ranking

(Sources: Papua New Guinea Human Development Report (1998) and NEFC Analysis of 2001 Provincial Revenue)

First, services cost much more to deliver in some parts of the country than in others. Provinces with sparsely distributed populations (like Gulf), or a large number of islands (Manus, Milne Bay), or remote regions which can only be accessed by air (Sandaun, East Sepik), need more revenue to deliver services to the same standard.

In addition, distribution of resources should reflect the differential need of different provinces. Some provinces are significantly under-developed and therefore need a greater level of funding to “catch-up” to other provinces. Most significantly, the current distribution of resources results in some of the provinces which are most in need receiving the lowest level of resources.

One way to determine whether current distribution of resources is addressing or exacerbating differences in development is to compare current resource distribution with a ranking of provinces based on indicators of development. The Human Development Index (HDI) is a composite index of indicators developed in 1996. It provides individual rankings for all provinces in PNG except Bougainville.

The HDI ranking is based on 1996 data contained in the 1998 PNG Human Development Report, which found that PNG is low in Pacific region terms. In general, the report confirms the perception that PNG’s considerable economic development, especially resource extraction, has not contributed to the human development of the nation.

Table 1 contrasts the 1996 HDI ranking (with the most developed province having the highest ranking) against the ranking of total provincial revenue in 2001 expressed as a kina per head figure. However, it should be noted that since the NEFC only has complete data on revenue for 2001, some caution should be used in interpreting the results of this comparison. Development status (and therefore the relative ranking of provinces) may have changed between 1996 and 2001.

Five of the six provinces with the lowest HDI (lowest levels of development) are among the six poorest provinces (those with the lowest per capita revenue). Six out of the eight provinces with the highest HDI (most developed) are also among the eight richest provinces. Most significantly, the two richest provinces (NCD and Western) are those with the highest and second highest levels of development in PNG, according to the 1996 HDI.³ The province with the lowest HDI, Sandaun, ranks 15th in terms of overall per capita revenue.

Lessons learned:

³ It needs to be remembered that provincial HDI aggregates can mask the real development status at the district and LLG levels, as data could be skewed by urban centres (eg., Madang) and resource enclaves (eg., Western). There are also regional differences, with the New Guinea Islands region generally showing higher values.

Intergovernmental financing arrangements should address the differential levels of development and access to services, and the differential cost of service delivery in different parts of the country.

2.6 *Internal revenue is not part of the system*

A key reason for the inequitable distribution of resources may be that the value of internal revenue resources of provincial governments are not widely known. Since the amounts of internal revenue are not readily known at the national level, they are not taken into account in determining the level of transfers to particular provinces.

There is great variation between provinces in terms of how much internal revenue they receive. The distribution of VAT, mining and petroleum revenues is particularly uneven. For example, on the basis of the NEFC's assessment of provincial revenue for 2001, the 'province' with access to the highest level of resources is the NCD, which receives K428 per head in internal revenue. The next closes province is Western, with K190 per head, and the lowest is Simbu with K4 per head.

Figure 2 shows the percentage of funding for goods and services which came from national grants, district support grant, VAT, mining revenues and other internal revenue. It can be seen that National Grants account for less than half the funding available to the provinces for funding goods and services.

What is 'internal revenue'?

Internal revenue is also called 'own-source' revenue. In PNG it covers a range of different kinds of revenue. These fall into two broad categories:

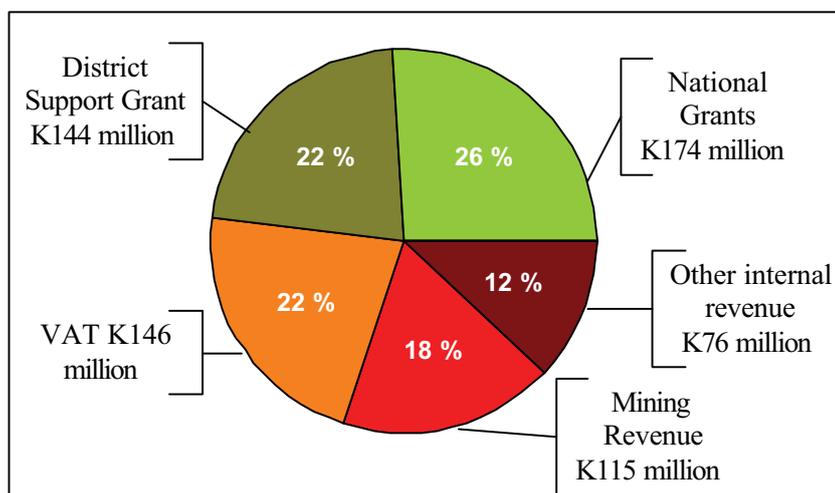
- *Off-budget transfers*: revenue that is not physically collected by the provincial administration—rather it is collected by the National Government and then transferred to provinces. The transfers of **VAT and mining and petroleum royalties** are examples. Together these two transfers were valued at **K189 million**.
- *Provincially collected revenue*: these revenues include local taxes, proceeds of investment including dividends from equity in mining and petroleum projects. In 2001 **other internal revenue** was valued at **K100 million**.

Figure 2: Funding for goods, services and capital expenditure in provinces, 2001

Source: NEFC 2001 Provincial Revenue Analysis (preliminary results)

Off-budget transfers of VAT and mining revenue are invisible

These two internal revenue sources (VAT and mining/petroleum revenue) are actually transfers of national taxation, but they are not shown in the



National budget.

Since there is no public reporting of provincial revenue or expenditure, these flows of revenue are relatively invisible. However, they have a major impact on the total resources available to different provinces.

The NEFC has estimated that in 2001 provincial governments received around K320 million in internal revenue, off-budget revenue transfers and 'in kind' transfers (tax credit projects). This was around twice the value of the non-salary Organic Law grants paid to the provinces in the same year.

It would be possible to make these off-budget transfers (which make up most of the internal revenue funding of provinces) more transparent by formally appropriating these amounts in the national budget.

High dependence on internal revenue in some provinces

In 2001, on average 64% of the funding available to provinces for goods and services, capital and casual wages came from internal revenue. However, there is substantial variation in the extent to which individual provinces are dependent on one source of funding over another.

Figure 3 shows the share of non-salary funding in each province that comes from internal revenue and national grants. In three provinces, more than 70% of the funding which is available for allocation by the provincial budget (excluding public service salaries) comes from internal revenue. In three provinces more than 80% comes from national grants. Figure 3 shows which provinces have the greatest dependence on internal revenue.

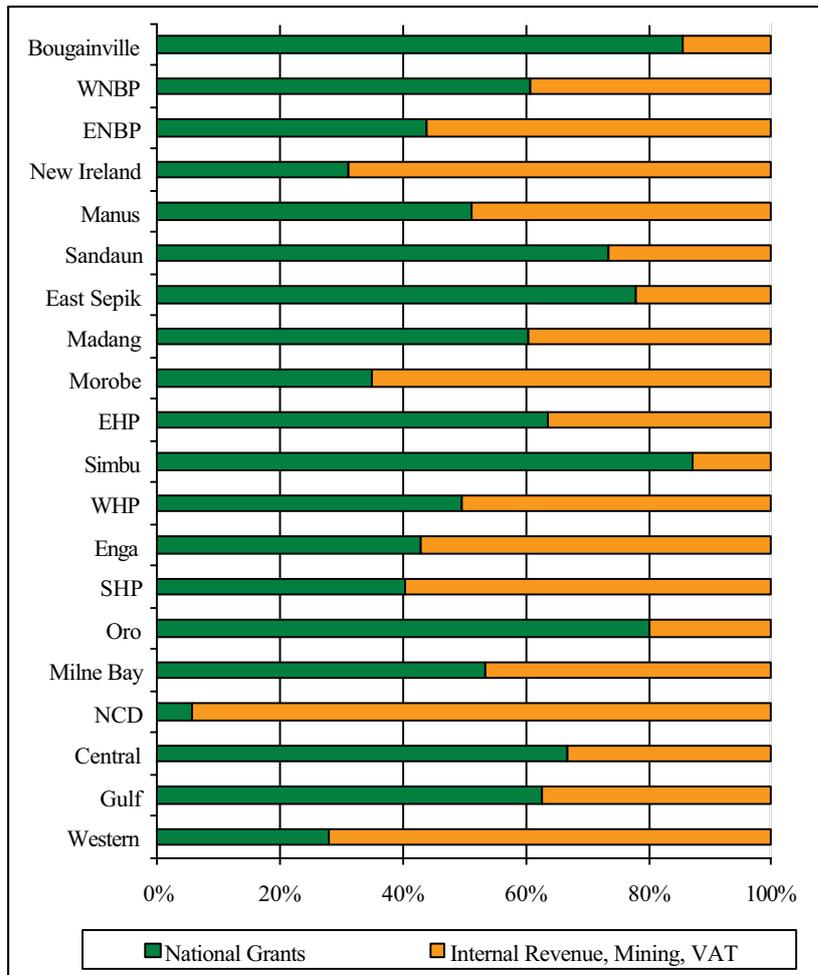


Figure 3: Provincial non-salary funding from grants and internal sources, 2001

Source: NEFC 2001 Provincial Revenue Analysis (preliminary results)

Since eight provinces get more than fifty percent of their non-salary funding from internal revenue sources, it is all the more important that these revenue streams should be factored into the intergovernmental financing arrangements.

Unsustainable dependence on mining and oil related revenues

Of the eight provinces that get more than fifty percent of their non-salary funding from internal revenue, four are mining provinces. New Ireland and Western both receive around 70% of their non-salary funding through internal revenue, principally mining and oil revenues. In the case of Enga and Southern Highlands the figure is around 60%.

In these ‘mining and oil’ provinces, a high dependence on non-grant funding has another important implication. Resource projects do not last forever. When these sources of funds dry up, these provinces are likely to experience severe economic shocks that will place great strain on their administrative and governance resources.

It is likely that much of these unsustainable revenue flows are being used mainly for recurrent or unproductive expenditure instead of being invested in ways which will provide a replacement revenue stream. This economic phenomenon is common in countries with a high dependence on mining and oil resource revenues (including Papua New Guinea) and is one dimension of the ‘resource curse’ observed by economists. It can be argued that the economic impact on a provincial government of the closure of a mining or oil project may well be more severe than the impact on the national government.

Significance of internal revenue in making decentralisation work

Internal revenue is an important component of any decentralised financing system, because it allows local expenditure priorities to be matched with local revenue raising. In this way the principles of ‘allocative efficiency’ (delivery of services at the lowest level of government where there is sufficient capacity) can be balanced by local accountability. Where citizens of a province pay taxes to a provincial or local-level government, they are more likely to demand that services be delivered in return. This is the ‘bottom-up’ accountability of decentralisation at work. There is evidence that local-level governments in some places have become less effective since they lost the capacity to collect their own revenue in 1995.

The literature on fiscal decentralisation suggests that **own-source revenues should ideally be sufficient for the richest subnational governments to finance all the local services which primarily benefit local residents from their own resources.**⁴ Local taxes⁵ should be the primary source of revenue for sub-national governments, with national grant transfers being used to top up the funding for those provincial governments which do not have enough revenue to meet their expenditure responsibilities.

Significance of internal revenue for goods and services

It is important to understand how much is available for goods and services, because this funding pays for the inputs into the delivery of services. These include the cost of school books, paper, telephone calls, power, fuel, and drugs for health centres. Without goods and services funding, even with the best infrastructure, there will be no services delivered.

In 2001, the National Government had a total of K572 million available for goods and services after payment of provincial grants, salaries, debt and support to statutory bodies.

Provincial governments received K184 million in non-salary grants, and a further K290 million in off-budget transfers and own source (other internal) revenue, giving them a **total of K474 million to spend on goods and services (including capital) at the provincial level.**

Source: NEFC Fiscal Envelope analysis for 2001

Assigning tax collecting powers to lower level governments

Not all taxes are suitable for collection at a local level, and in most cases the national government can collect a tax more efficiently than a provincial government. However, these efficiency objectives need to be balanced with the local accountability benefits highlighted above.

Provincial governments lost the capacity to collect their most important tax, retail sales taxes, when a uniform VAT was introduced in 1999. While a national VAT is a much more efficient tax than 19 individual retail sales taxes, this change diminished the autonomy of provincial governments over their own revenue. This has in turn weakened the effective accountability of provincial governments to their constituents.

Neither VAT nor mining and oil revenues fulfill the objective of linking local needs to locally-raised revenue because these are now another form of (unbudgeted) national transfer. VAT is also significantly different from retail sales tax, both in terms of its incidence (the transactions to which it is applied) and the revenue it returns to individual provinces.

⁴ Richard M. Bird and Francois Vaillancourt, *Fiscal Decentralization in Developing Countries*, Cambridge University Press, Trade and Development Series, Cambridge, 1998.

⁵ 'Local taxes' means any tax imposed below the national level.

There are several other forms of provincial and local tax collection set out in the Organic Law, but the lack of any enabling provisions in national legislation has limited the extent to which provincial and local-level governments have been able to exercise these powers.

Possible areas of reform

Provinces and local-level governments can easily be empowered to exercise their remaining tax collection powers through a simple amendment to the Organic Law. However, except in a few provinces, these powers are unlikely to generate any large amounts of revenue.

A more challenging task is to identify reforms which can contribute to provincial revenue without hindering economic growth or imposing a greater burden on the poor.

At the NEFC seminar in November 2002 it was suggested that VAT collection could be shared between the national and provincial governments. Provinces which demonstrate that they have the capacity could take over collection of VAT on retail sales within the province. It is in this area of collection of VAT from retailers that the IRC experiences the greatest problems with tax collection in provinces. This option merits further study.

Changes to VAT distribution in 2003

In late 2002, following a court case initiated by the Governor of Morobe, the Supreme Court declared that the National Government was not Constitutionally empowered to collect VAT. An agreement between the Governor and the Prime Minister resulted in a stay of that decision until

Differences between VAT and Retail Sales Tax

VAT differs from RST in two important respects. First, **VAT is levied on a much wider range of transactions than RST**. In particular, it replaces a number of import duties.

Secondly, the **tax is collected along the manufacturing and supply chain**. This makes it a more efficient tax than retail sales tax (where failure to collect at point of resale means the whole of the tax take is lost). However, it also affects the rate at which particular provinces collect tax. A retail sales tax of 10% imposed on the sale of a K1 can of drink in Enga would provide 10 toea to the Enga Provincial Government. A 10% VAT would be spread between the provinces where the drink is manufactured and wholesaled, as well as the province where it is retailed. Enga could only collect a 10% tax on the *value-added* proportion of the final price.

July 2003. This provided the National Government with time to enact retrospective validating amendments to the *Constitution* and *Organic Law on Provincial Governments and Local-level Governments*.

An additional aspect of the Agreement was the requirement that the National Government replace its current system of VAT with a GST (a very similar kind of tax). It also required that the distribution of GST between the National and Provincial governments would change.

The distribution formula agreed between the Prime Minister and the Governor of Morobe required the National Government to give provinces 80% of inland VAT (that is VAT other than that collected on imports). Inland VAT accounts for around 47% of total VAT collected.

At a meeting of Governors in March this year, the IRC revealed that this new formula would be likely to disadvantage a number of provinces, because 80% of inland VAT would be less than the amount they currently receive (see the Box above for an explanation of the current distribution formula). It was therefore unlikely that a new distribution formula would receive enough support in Parliament to allow it to be enacted.

At the time of preparation of this report, this issue had still to be resolved. An alternative proposal put forward is for provinces to receive 60% of inland VAT, but with no province receiving less than it did in 2002. The NEFC was also directed to review the distribution arrangements in its final report at the end of 2003.

How distribution of VAT is currently determined

The *VAT Distribution Act* provides that provinces are entitled to receive the same amount they got in the previous year. Where that amount is less than 30% of estimated VAT collections for a year, the excess is to be distributed according to the amount of VAT collected in that province.

The VAT formula therefore contains two separate elements—the base component which is determined by past *distributions* and the excess which is distributed according to *collections*.

There has not been any excess to distribute since the system of VAT commenced, because provincial entitlements have always exceeded 30% of total net collections.

The past distributions of VAT were determined by negotiation with the IRC at the time the VAT legislation was enacted, and are not related to the proportion of VAT collected in a province.

Lessons learned:

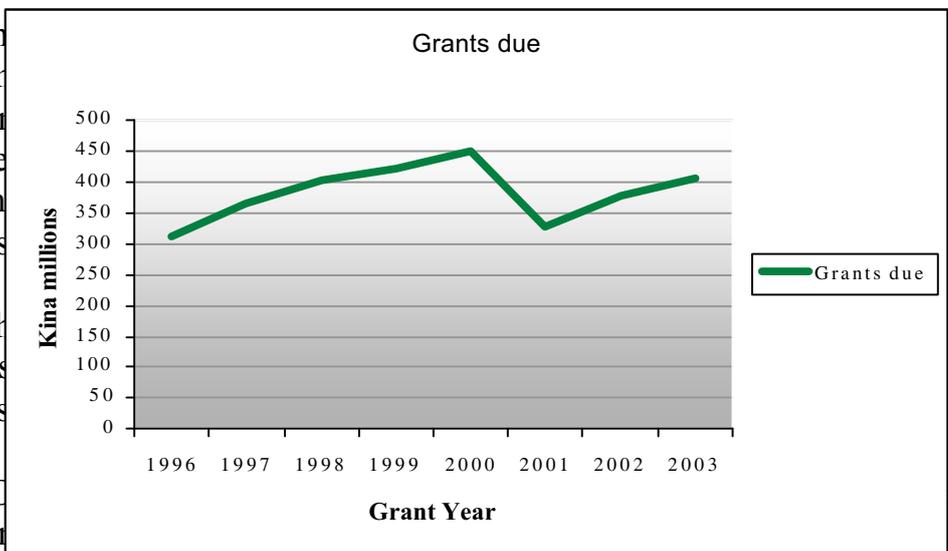
Internal revenue should be an integral component of the intergovernmental financing system. All sources of revenue (including district support grants and ‘in kind’ support) should be taken into account in determining the overall level of resources available to a province. The new system should also seek to maximise both efficiency and local accountability through revenue collection by provincial and local-level governments.

2.7 Unintended effect of different elements of the system upon each other

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applies to the ‘base year’, which is the first year after a census is conducted. Each year after that, the grant is to be adjusted by either the percentage increase or decrease in the consumer price index (CPI) two years previously, or the increase or decrease in payments into the consolidated revenue fund.⁶

The indexation mechanism only applies up to the year when the next census is held, and in the following year (which is the next ‘base year’), the grant is once again calculated in accordance with the the ‘un-indexed’ base formula. The effect of this is a sharp drop in grants payable between 2000 (the year of the last census) and 2001 (the next base year).

⁶ The Organic Law does not specify which of these two percentages is to be applied in any given year. Under the old *Organic Law on Provincial Government* it was the lesser of the two. Accordingly, in its calculations NEFC has adopted the most conservative approach of preferring the lesser of either changes in consolidated revenue, or change in CPI. In accordance with the Organic Law definition of “consolidated revenue” loan proceeds are not included.

Figure 4 shows the grants payable under these indexation formulae from 1996 to 2003. The top line is the grants that would have been payable if the Organic Law had been fully complied with.

It can be seen that full compliance would have meant a sharp drop in grants in 2001, when a new base year would have wiped out the previous gains made from indexation. It is unlikely that this is what the designers of the current system intended.

Figure 4: Indexed Grants Payable 1996-2003

Lessons learned:

Elements of the intergovernmental-financing system cannot be developed in isolation from the system as a whole. Each grant component and adjustment mechanism must be designed as part of an integrated whole, and the impact of the whole system operating together should be modelled in the light of reasonable economic projections to ensure that it will operate as it is intended to do.

2.8 Grants are not ‘affordable’

As highlighted above, a major point of difference between National and Provincial governments is the question of affordability of the Organic Law grants. Provincial Governments complain that they do not have enough funding to deliver services properly, and that additional functions have been transferred to them without any funding to pay for them. The National Government, on the other hand, argues that it cannot afford to pay the full amount of the grants from its existing resources.

Increases in provincial funding 1996

In reality, there is truth in both positions. Provincial Governments received an overall increase in non-salary funding under the reforms of around K165 million, not including development funding. Figure 5 shows the impact of the changes on levels of different kinds of provincial funding.

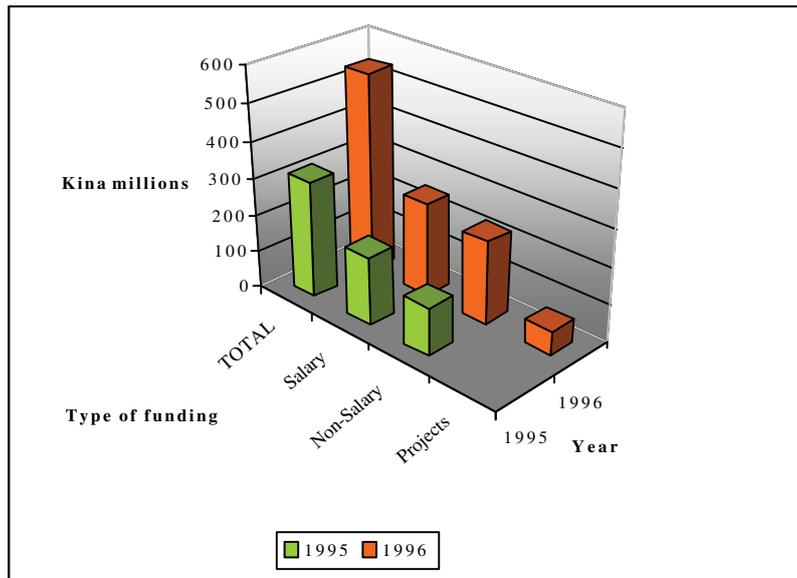


Figure 5: Budgeted funding to provincial governments, 1995-1996

The biggest increases in budgeted funding⁷ in 1996 were in the area of provincial salaries (including teacher salaries), which increased from K185 million in 1995 to K255 million in 1996. The explanation for this apparent increase is not yet clear. The most obvious explanation would be a transfer of some salary expenditure from national departments to provincial administrations. However, this is not apparent from budget documents. Volume 1 of the 1997 budget records that actual expenditure on national salaries in 1995 was K334.4 million, while the revised appropriation for 1996 was K352.3 million.

The second largest increases were in relation to non-salary funding. In 1996 the National Government had to find around K100 million in savings in its own budget in a single year in order to fund increased grants to provinces. It achieved this by ‘de-funding’ a number of national programs and effectively transferring the de-funded activities to provincial governments. As noted above, this contributed to considerable confusion about what functions the different levels of government are responsible for.

Shortfalls in funding the grants, 1996-2003

⁷

Comparison of actual funding for these two years would have been more appropriate, however budget documents do not record the detailed actual expenditure for either 1994 or 1995, because the format of the budget had changed in consequence of changed funding arrangements for provinces.

In 1996, provincial funding was almost at the level required by the Organic Law. Volume 1 of the 1996 budget indicates that the development grants (the Provincial Infrastructure, Town Services, Local Government and Mining grants) were funded at 75% of what was required. The Administration Grant was funded at 100% of what the Organic Law requirement (assuming indexation provisions were not applied).

Figure 6: Budgeted grants vs Grants due under Organic Law, 1996-2003

(Includes only population and land area formula-based grants. Additional goods and services funding paid through health and education grants, MUG payments to Bougainville, are included in actual budgeted figures. For the purposes of calculating grants payable under the Organic law, indexation is discounted.)

In 1997 and 1998 the total amount of budgeted grants came quite close to the level required by the Organic law, but in subsequent years actual grants increasingly fell further short of the mandated amounts. This gap became even wider in 2001 when the grants should have been recalculated according to new population figures from the 2000 census.

Figure 6 shows the increasing gulf between the grants payable (the top line) and the budgeted grants (the bottom line). In 2003 the budgeted grants are significantly less than what is fixed by the Organic Law.

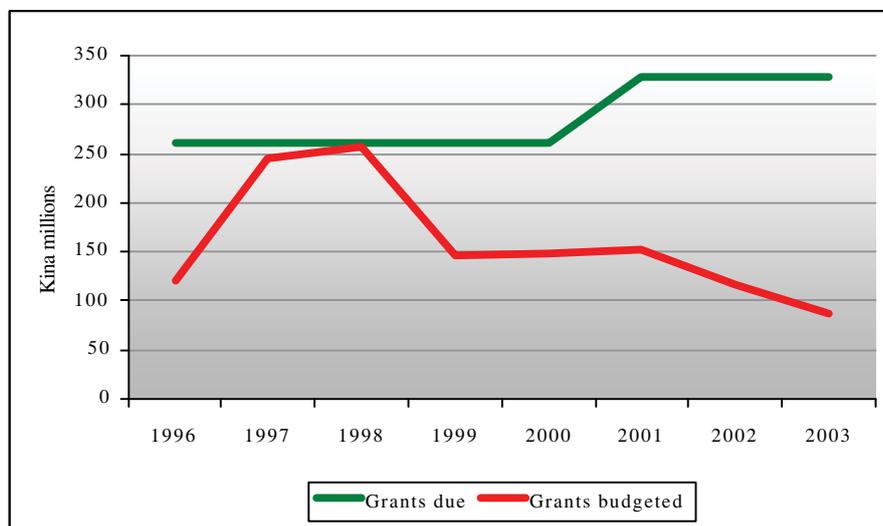


Figure 7 shows the shortfall in each of the different formula-based grants. Actual budgeted grants for 2003 are shown in red and contrasted against grants payable according to the Organic Law in 2003 (in green). The biggest gap is in relation to the local-level government funding.

Figure 7: Budgeted grants and Grants due under the Organic Law, 2003

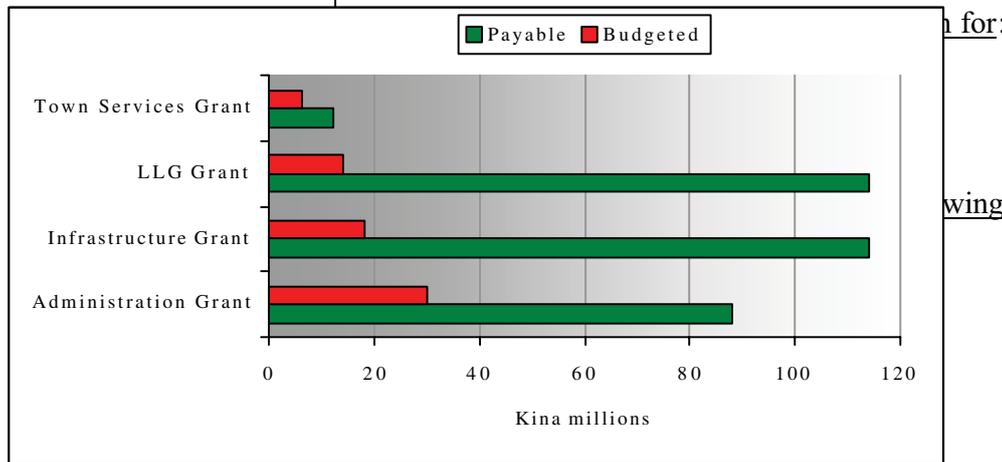
The total non-salary amount budgeted for provincial and local-level government grants in 2003 is K87 million,⁸ against an amount due under the Organic Law of K328 million. Clearly the gap between funding and the legal requirements is growing increasingly larger.

Provincial services funded from the National budget

One of the main reasons why the National Government has not been able to pay the grants is because a number of core

Payments from the National Budget to provincial services

Since 1996, the number of provincial services funded from the national budget has increased.



Provincial treasuries K237.5 million
 Total funding to provincial services in the 2002 national budget: **K237.5 million**

services at provincial level are now paid out of the National Budget instead of from

provincial budgets. These include church health operating and salary grants, provincial treasury operations, and subsidies for schools. In 1996 when the Organic Law first came into operation, it was presumed that these activities would be funded from provincial budgets, and no provision was made for them in the national budget.

However, over subsequent years it became apparent that these core services were not being funded in some provinces, and so the national government had to take over the funding of them. The requirement to find resources to fund these activities from the national budget reduced

⁸ Does not include Derivation Grant and Mining grants which are not included in the calculations of what would be due under the Organic Law.

the National Government's capacity to pay the full amount of the formula-based grants. The total amount of funding for these services in the 2003 national budget was around K150 million.

Impact of increasing salary payments

It is significant that the formula-based grants are non-salary grants and effectively come out of the goods and services budget envelope of the National Government. The resources available to fund these grants have also been reduced by the increasing cost of the staffing and teacher salary grants.

Figure 8 shows how salary grants to provinces increased between 1996 and 2003. The reduction in the non-salary formula grants can be seen as corresponding to the increase in the salary grants. The most significant increases have been in the cost of teacher salaries. These costs are projected to grow further because of the elementary education reforms.

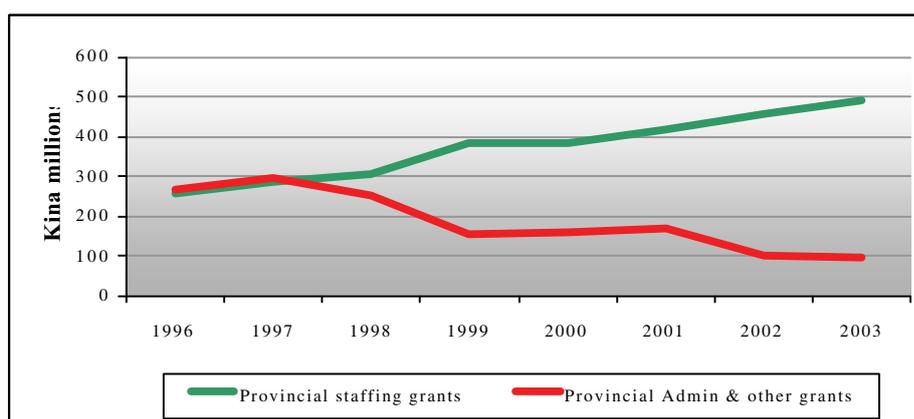


Figure 8: Changes in salary and non-salary provincial grants 1996-2003

Source: A Higgins, presentation to NEFC Seminar, Granville Motel, November 2002

Impact of kina devaluation

Finally, the real value of non-salary grants has also been reduced by the falling value of the kina. In mid-1995 when the new provincial funding arrangements began, the kina was worth around USD1.26, where as in mid-2002 its value was approximately one fifth of that—around USD0.25.

Since a significant proportion of goods and services funding is used to purchase inputs which are wholly or substantially imported, changes in

the exchange rate have a significant impact on what provincial governments have been able to do with that funding.

Overall resource envelope

An analysis of the national ‘fiscal envelope’ suggests that the medium term outlook is for government revenue to remain relatively static, or to grow only modestly. In the next decade, PNG faces the possibility that government revenue will decrease significantly as a number of mining projects come to the end of their life.

This means that the capacity for the National Government to increase the transfers to the sub-national levels of government is likely to be limited. For example, in 2001, there was around K550 million available for expenditure on recurrent goods and services (excluding salaries) in the national budget, and around K450 million in non-salary resources available for goods, services and infrastructure at the provincial level (including internal revenue). (See the Box on page 27 for more detailed information.)

The National Government could not free up the amount needed to increase the provincial grants up to the level required by law unless it stopped funding provincial level services such as schools, church health services and hospitals. This would leave provinces having to pick up these funding responsibilities.

Current trends in the growth of salary expenditure suggest this is an area where increases can continue to be expected. Under the present arrangements there is little incentive for provinces to minimise expenditure on staffing costs. Payroll expenditure is managed centrally at the national level, and because of this any over-runs against staffing grants are borne by the National Government.

In the long term staffing levels in provinces will not be reduced unless provinces are actively committed to doing so. Some of the better functioning provinces have already sought to reduce staffing levels, but they have done so because of their commitment to good governance, not because there are incentives for them to do this.

Lessons learnt:

The package of funding for provincial and local-level governments must be sensitive to the national fiscal context (both currently and in the medium term future) and the distribution of functional responsibilities between different levels of government.

However, the funding package should also provide a reasonable level of fiscal certainty for Provinces. There should

The National Resource Envelope

Do Provinces and Local Governments get the full amount of their grants?

Provincial governments (and particularly local governments) sometimes complain that they do not get the full amount of the grants they are allocated. The following table shows the amounts by which payment of each of the formula-based grants was under or over paid in each year, and by what percentage. There were significant underpayments in 1998, but generally provincial governments have fared much better than national Departments in terms of receiving their full allocations. Local-level Government and Town Grants are the grant types most likely to be underpaid. Further work is required to determine whether the timing of grant payments (in other words, warrant releases) causes problems for provincial governments.

	Admin Grant over/under payment (K millions)		Infrastructure Grant over/under payment (Km)		LLG Grant over/under payment (K millions)		Town Grant over/ under payment (K millions)		TOTAL BUDGETED GANTS (K millions)	TOTAL ACTUAL PAYMENTS (K millions)	TOTAL UNDER/OVER PAYMENT (K millions)	
	over/underpayment (% of budgeted grant)		over/underpayment (% of budgeted grant)		over/underpayment (% of budgeted grant)		over/underpayment (% of budgeted grant)				over/underpayment (% of all budgeted grants)	
1996	-2.5	-3.4%	-3	-14.9%	12.2	62.6%	-0.9	-14.8%	118.4	124.2	5.8	4.9%
1997	-3.2	-5.1%	-6.7	-8.1%	-6.2	-7.5%	-0.2	-1.8%	240.4	224.1	-16.3	-6.8%
1998	2.7	4.6%	-8.8	-12.3%	-27.3	-35.4%	-1.6	-15.5%	218	183	-35	-16.1%
1999	2.3	5.7%	-0.2	-0.7%	-0.4	-1.3%	-0.2	-4.0%	105	106.5	1.5	1.4%
2000	0	0.0%	0	0.0%	-0.2	-0.6%	0.1	2.0%	116.2	116.1	-0.1	-0.1%
2001	5.2	11.6%	-1.2	-3.6%	0.6	1.8%	-0.2	-3.3%	117.9	122.3	4.4	3.7%

Source: Budgeted and actual figures recorded in National Budget documents 1996-2003

Note that “quasi-Administration grant” items such as school subsidies and church health grants are not included. Supplementary budget revisions of 2000 not included

be incentives for efficient and effective use of resources.

2.9 Implementation not in accordance with design

Since the reforms were not implemented as they were designed in 1994, it is difficult to know whether they *would* have worked if they had been implemented properly. In some cases what has been implemented has been quite different from what was designed.

There is a general consensus that the implementation of the reforms has failed in part because of inconsistent and inadequate funding and staff resources being allocated to implementation. For example, although the law provides for inspectorates of the National Monitoring Authority (NMA), these have never been funded. The NMA itself was funded in 1996, but had its funding cut completely in 1997. Provincial offices of the Auditor-General, which were also established under the new Organic Law, were closed in 1999 because no funding was provided for them in the budget, and they have not been re-opened.

Inadequate resourcing continues to impact on the capacity of national agencies to provide necessary support and coordination for the change process. Capacity issues have also affected sub-national governments, some of whom are not able to effectively carry out the functions that were transferred to them.

The lack of adequate resourcing and poor coordination may have been inevitable, given the lack of a properly costed implementation plan agreed by all stakeholders. If a plan had been prepared, and its implementation overseen by an agency or Minister with authority to ensure it was carried out, the unrealistic nature of some of the implementation timing may have become apparent.

Overall there was a lack of continuity between the design phase and implementation phase. The bureaucrats in charge of implementation did not have the benefit of the thinking of those who had developed the new Organic Law. Nor did those who designed the law consult extensively with those who would have to implement it. The administrative implications of some of the changes appear not to have been fully thought through. Some of the changes were probably too complicated or difficult to implement, and as a result, in some cases, implementation differed substantially from what was envisaged.

Lessons learned:

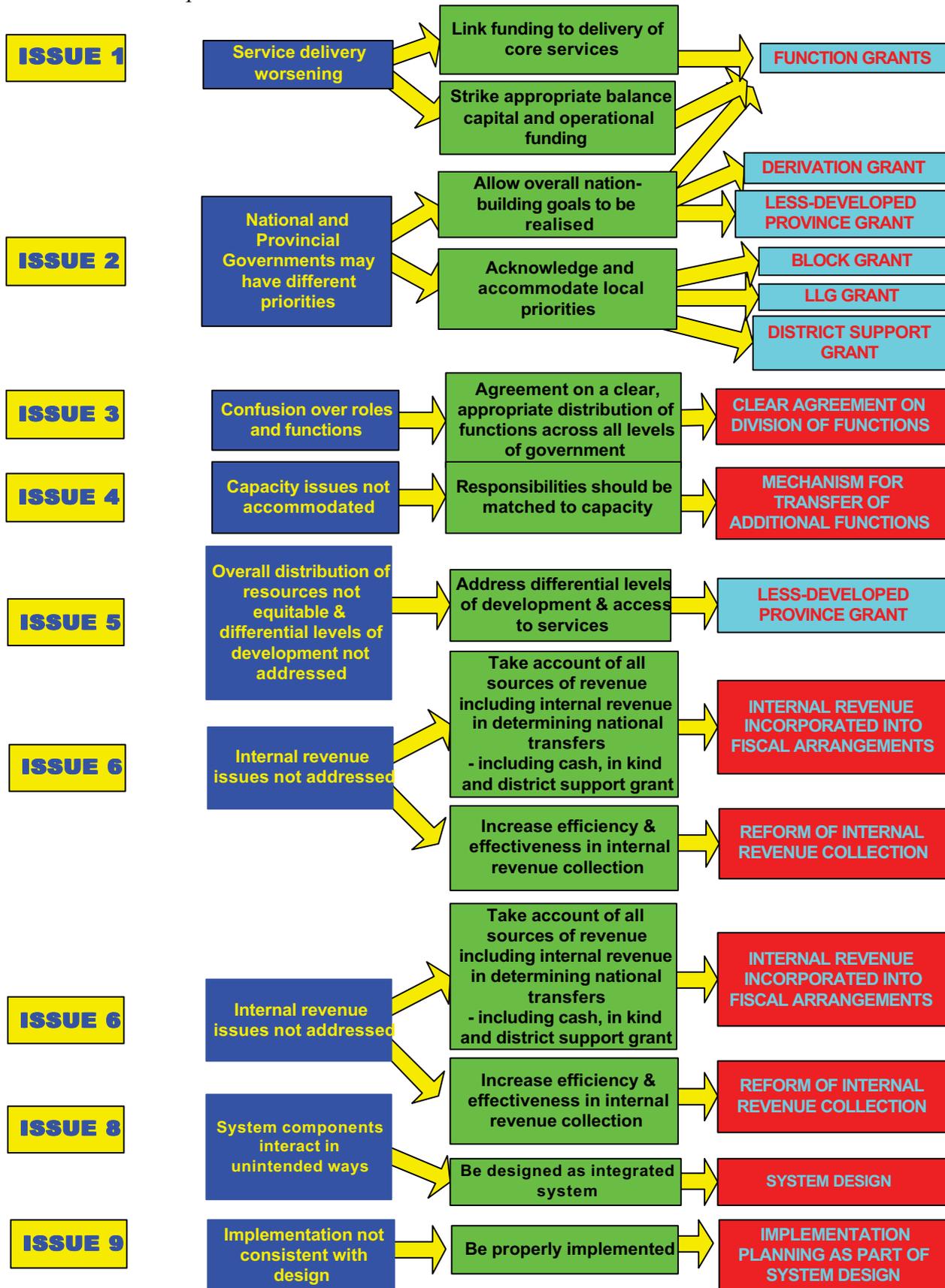
Consideration of implementation issues should be integral to design. In particular, implementation should be properly thought out, costed and planned and carried out through an inclusive process.

2.10 How design principles relate to the issues identified with the current system

Logically, the design principles which form the basis of the new system should be based on the issues which have been identified with the current system. In this way, it can be ensured that the new system does not feature the same flaws as the existing one.

Figure 9 shows how these issues identified with the current system give rise to the design principles for the new system. These design principles are reflected in the components of the new system, which are described individually in the next Section of the Report.

Figure 9: Link between issues with current system, design principles and components



3. SPECIFICATIONS FOR THE NEW SYSTEM

3.1 *Design principles and system components*

Based on this analysis of the current situation, the NEFC has developed proposals for a new package of intergovernmental financing components. Each component of the package addresses one or more of the problems and issues identified and discussed in the previous section.

Elements of a decentralised financing system

The design principles derived from this analysis have been reflected in the design of system components that address the four essential questions relating to decentralised financing:

(1) Who does what?—the question of **expenditure assignment**.

Financing should start with assignment of functions, and *funding should follow function*. Functions should be assigned to the level of government which is most appropriately placed to be responsible for them. Programs which have a national impact should be national functions.

(2) Who levies what taxes?—the question of **revenue assignment**.

As far as possible, sub-national functions should be funded with revenue collected at that level so that there is a direct relationship between the collection of taxes and the delivery of services. However, not all kinds of taxes are suitable for collection at the provincial or local level, nor is there necessarily the capacity at lower levels of government in PNG to collect them.

(3) How is the imbalance between revenues and expenditure of lower level governments to be addressed?—the question of **vertical equalization**.

The revenue-raising capacity of lower levels of government is usually not sufficient to raise all the taxes needed to cover the cost of services delivered at that level, so some form of vertical equalisation is needed, usually in the form of grants, to redistribute resources from national to lower levels of government.

(4) To what extent should the system adjust for the differences in needs and capacities among lower-level governments?—the question of **horizontal equalization**.

Different provinces and districts have different levels of development, and therefore need different levels of resources. Furthermore, services cost more to deliver in some more remote or inaccessible parts of the country (often these are the same ones as those which are underdeveloped).⁹

3.2 Components of the proposed system

Figure 10 shows the components of the proposed system of decentralised financing. These components are grouped into grant types; adjustment mechanisms; accountability systems; and the implementation approach.

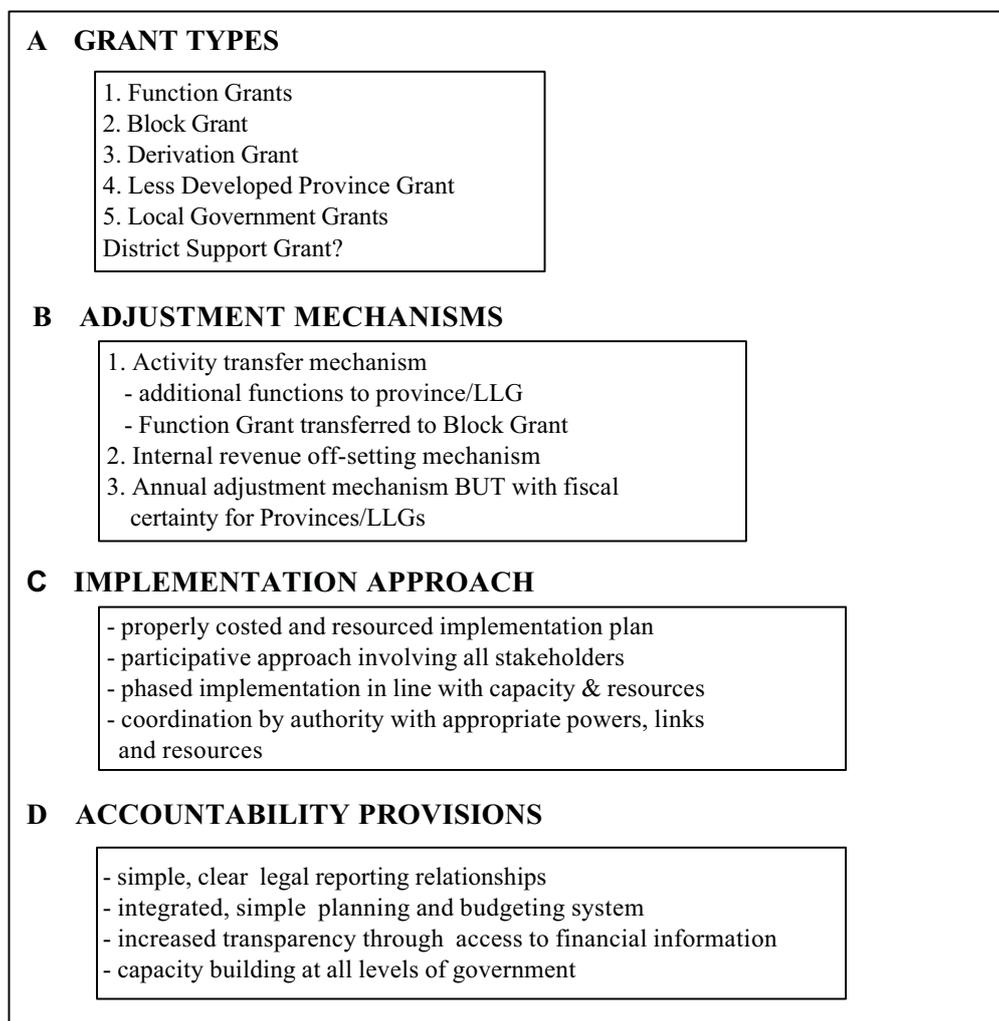


Figure 10: Components of the Proposed New System

⁹ This framework for analysis is based on Richard Bird and Francois Vaillancourt, *Fiscal Decentralisation in Developing Countries* (cited above) page 15.

Figure 11 shows how these components relate to each other and the purposes of each grant. Each of the components in the system is explained in detail below.

3.3 *Function grants*

The central theme of the new arrangements for financing sub-national governments is to link funding to function. Core functions of provincial governments, in particular those ‘national’ functions that have spillover impacts outside individual provinces, would be funded through Function Grants. These grants would ensure that provincial governments receive sufficient goods and services funding for proper service delivery.

The main purpose of Function Grants is to ensure that operating costs of core services are properly funded. Function grants also provide a better basis for considering the global resources available to a sector. This improves the scope for planning of sector resources across different activities and levels of service delivery. (For example, it may reveal that health resources need to be redirected away from the National level and toward the provincial and district level.)

Scope for increased fiscal autonomy

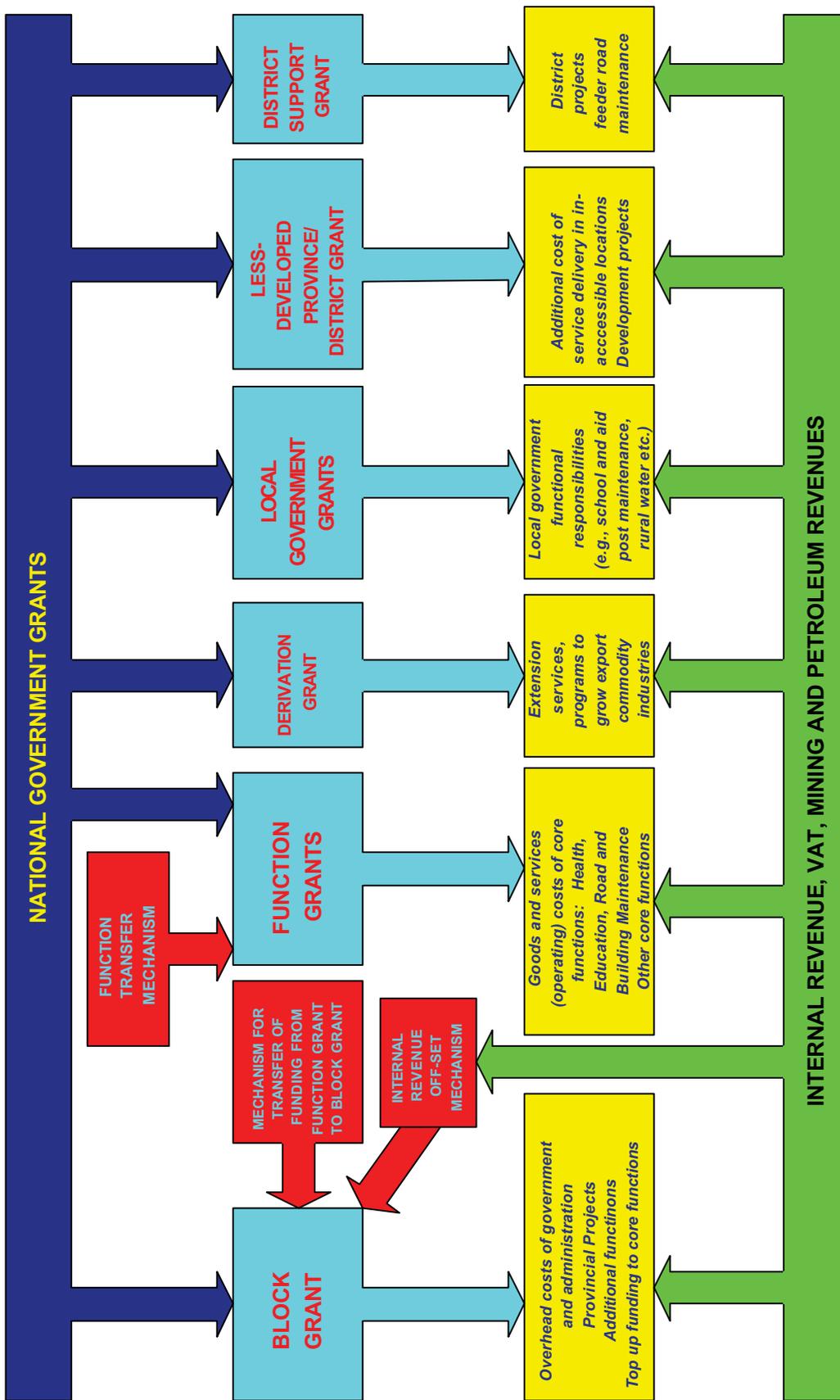
Allocation of resources within each Function Grant would be at the discretion of the provincial government. In addition, the new system would also incorporate scope for provinces to have greater control over resource allocation.

Where provinces demonstrate a capacity to administer their Function Grants properly (according to a standard set of criteria), a Function Grant could be converted into Block Grant funding, giving provinces greater autonomy over decisions about the allocation of the funding for these functions. Continued autonomy over funding would be subject to monitoring according to agreed benchmarks.

Activities to be included in Function Grants

Further investigation of provincial functions and activities is needed to determine what activities should be covered by Function Grants. A starting point would be to take those service delivery functions which were funded through the (non-FFR) Department of the Provinces votes in 1995 (those with the maximum detail specified in budgets), together with any core functions and activities transferred since 1995.

Figure 11: How the components of the system relate to each other



A preliminary list of function grants might include:

- rural health services;
- education services;
- road and architectural building maintenance;
- possibly, village courts
- town services.

Costing of Function Grants

Provinces currently receive about 25% of total national revenue including all VAT (but not including mining royalty revenues).¹⁰ The question therefore needs to be asked whether this amount is too little (or too much) to fund the functions that are most appropriately delivered and paid for at the provincial level.

The amount of each Function Grant would be based on an estimate of the goods and services cost of operating and maintaining a particular service. Considerable further work is needed to determine what an appropriate level of funding would be. Since current funding levels may not necessarily be a guide to what is an appropriate level of funding for an activity, a broader investigation will be needed.

It is a major task to determine what the funding for delivery of a basic service in a province would be. However, it may be possible to build on work already undertaken including:

- In the health sector, the Department of Health has developed minimum standards for district health and has costed those using a standard unit costing approach, incorporating the cost of delivering all the ten basic health programs.
- AusAID has undertaken an education affordability study which is modelling the cost of delivering education at various levels of the education system.
- Development of the Road Asset Maintenance (RAMS) database by the Department of Works, which is preparing a database of routine maintenance costs as well as rehabilitation costs for all provincial and national roads.

Current and historical funding levels may also provide a guide to the levels of funding which will be required.

¹⁰ Tim Curtin, *Value-Added Tax Collection and Provincial Distribution*, 6 December 2002. Report to the NEFC.

Expenditure prioritisation

It is likely that some expenditure prioritisation will need to occur as the costs of particular functions are determined with greater accuracy. In order to determine the level of funding appropriate for Function Grants, it will be necessary to consider available resources, and decide between competing priorities. It is possible that the envelope of resources is not adequate to properly fund all the range of functions some provincial governments have assumed.

Ideally, these judgements should be made across a whole of government perspective, rather than just within the envelope of a perceived provincial “share” of resources. The decisions involved in splitting available resources between the funding responsibilities of national government, provincial governments and local-level governments will necessarily involve political considerations. An iterative process involving both national and provincial governments is needed. These decisions should be made by the Government in consultation with all stakeholders, rather than by the NEFC which is a technical advisory body.

Current activities related to expenditure prioritisation

Several activities currently underway are likely to generate or inform proposals on expenditure prioritisation. These include:

- Medium Term Development Strategy;
- Medium Term Expenditure Framework; and
- Public Expenditure Review and Rationalisation.

The NEFC will seek to engage with these processes, both in considering the distribution of funding responsibilities and resources between the levels of government, and in considering the allocation of resources between different activities at each level of government.

Further work required

Considerable work is needed to finalise the design of Function Grants, including:

- a clear agreement on which functions should be the subject of Function Grants and as to what activities provincial governments should be responsible for funding;
- costing of service delivery costs to an agreed standard;
- a province-by-province assessment of an appropriate pacing of movement toward defined minimum standards, especially if this

involves a significant increase in resourcing (to ensure absorptive capacity issues are addressed); and

- a review of staff allocations to ensure the functions are appropriately (but not over-) staffed.

NEFC has been working with the Department of Personnel Management (DPM) and Department of Provincial Government and Local Government Affairs (DPGLGA) to progress the development of a clear definition of functions of different levels of Government.

The data-gathering and policy development activities which will feed into the detailed definition of Function Grants are described in more detail in Section 5.1 below.

3.4 Transfer mechanisms

Mechanism for transfer of additional activities

The concept of graduated transfer of responsibility to provinces in line with capacity was part of the original concept of decentralisation developed for PNG by the Constitutional Planning Committee. However, the consulting firm hired to develop plans for implementation in 1977 recommended a uniform transfer of identical functions to all provinces at the same time. Graduated transfer of functions was also a component of the *Organic Law on Provincial Governments and Local-level Governments*, but as there has never been a formal process of function transfer, it too has not been implemented.

In the new system, the variable capacity of different provinces will be accommodated by providing that provinces can assume responsibility for additional functions by negotiation with the National Government. A formal mechanism for the transfer of additional functions (including the criteria used to determine whether such a transfer is appropriate), and the negotiation of the funding to go with those functions, will need to be developed.

Mechanism for transfer of Function Grants into Block Grants

In addition to the transfer of additional activities to provinces, provinces should be able to exercise greater control over the allocation of resources between functions. However, this must be conditional on Provinces demonstrating capacity to administer and budget for functions properly and continuing to meet agreed performance benchmarks.

Under the pre-1995 arrangements for decentralised financing, a similar mechanism for graduated autonomy over allocation of grants was provided through the Full Financial Responsibility (FFR) provisions. It is proposed to develop this concept further to include performance criteria as well as accountability criteria as the basis for the transfer of increased functions and the transfer of funding from Function Grants to the Block Grant.

Further work needed

Considerable work is required to develop the proposal for the transfer mechanism. Elements of this mechanism which will need both design input and negotiation with provincial governments are:

- definition of what functions are available for transfer (this is unlikely to include foreign affairs and defence, for example);
- the criteria which provinces will need to meet in order to have further functions transferred to them;
- the process for negotiating transfer of additional functions;
- the basis for calculating how much funding should be transferred along with a transferred function (the mechanism for costing of function grants); and
- the criteria for determining when Function Grants should be converted into the Block Grant.

The detailed development of these two transfer mechanisms needs to be undertaken jointly with the agencies that will be responsible for overseeing their implementation. DPGLGA, DPM, Department of Finance (DoF) and Treasury's Budgets Division need to be involved. This may be an appropriate extension of the work done by the group of Department representatives which is working on the clarification of functional responsibilities.

3.5 Block Grant

Block Grants are the second major component of the proposed system. Each province should receive a Block Grant that is intended to cover:

- other functions of provincial governments not covered by the Function Grants;
- overhead costs of government administration and political institutions that cannot be attributed to a particular function;

- locally-determined priorities, including topping up of Function Grants for activities that are considered a priority by the province, and infrastructure projects; and
- functions which have been transferred from a Function Grant funding mechanism to funding through the Block Grant.

Salaries incorporated into Block Grant

It is proposed that eventually salaries should be included in a global Block Grant as well. This will allow provinces to free up additional resources for goods and services or capital by rationalising expenditure on salaries. This provides a greater incentive for provinces to control salary expenditure, because they will bear the cost of over-runs out of the non-salary proportion of the Block Grant.

It will not be possible to include salaries in the Block Grant until a mechanism for determining a realistic and equitable estimate of an appropriate staffing and salary level is developed. In the meantime, salaries should remain a separate grant. At present, staffing resources are not equitably distributed between provinces, and it would be inappropriate to lock in inequitable levels of funding. Provinces also complain that although they provide reasonable estimates of actual salary cost, these are reduced in the formulation of the budget—resulting in apparent over-runs in provincial salaries. Before salaries are included in the Block Grant an agreed basis for calculating the Grant will have to be determined.

Once salaries are included in the grant, a mechanism will also be needed to adjust the grant in line with any increases flowing from negotiation of industrial awards, since provinces have no control over these rises. This was a problem with the old Minimum Unconditional Grant (MUG), which over time was increasingly absorbed by salaries as national public service salary levels increased. In 1978 an average of 47% of MUG was spent on salaries, and this increased to an average of 72% in 1988.¹¹

Adjustment of Block Grants

A mechanism for adjustment of Block Grants will also be needed. It is also important to ensure that the transfer of funding from Function Grants to Block Grants should not disadvantage the more fiscally responsible provinces. This was a further problem of the MUG, which was adjusted annually on a different basis from the funding for delegated functions,

¹¹ Ron May, *Equity Aspects of the System of Intergovernmental Transfers in Papua New Guinea*, mimeo, 2002.

inadvertently disadvantaging provinces which received funding through MUG instead of the Department of the Province votes. These issues relating to adjustment mechanisms are discussed in more detail in Section 3.11 below.

Further work required:

It is tentatively proposed to retain the ‘kina per head’ basis for the non-salary component of the block grant calculation, but this needs to be modeled in the context of the whole fiscal envelope, and the likely costs of the elements to be covered by the grant. In particular, the NEFC needs to estimate:

- a realistic but reasonable cost of government administration overheads;
- cost of other functions to be covered by the Block Grant; and
- a reasonable pool of discretionary funds to allow local priorities to be realised.

The salary component of the grant will need to be determined on a basis that is a fair estimate of the actual cost of salaries in provinces, and adjusted to take account of any flow-on rises as a result of national wage negotiations.

The work which will be needed to develop the Block Grant is described in detail in Section 5.2 below.

3.6 Internal revenue provisions and adjustment mechanism

Taxing powers

Sub-national taxation will be a key issue to be canvassed in the Final Report of the Review. The NEFC will need to consider whether the current mix of revenue-raising powers should be changed to allow provinces greater capacity to collect their own revenues, and on what basis nationally-collected taxes should be transferred back to provinces.

In 2002 the NEFC commissioned a report on VAT issues from an economist with PNG experience, Tim Curtin. His report raises a number of issues that probably need to be addressed by the IRC and Treasury, rather than the NEFC, since they involve questions of overall economic and fiscal policy. In particular, there are several observations about ways in which VAT take could be increased, both so as to increase the National

Government's capacity to transfer to the Provinces, but also so as to achieve a more balanced budget. These include:

- removing input credits (in effect, turning the VAT into a cascading sales tax, which it was argued would more accurately attribute the tax collection to the province where the value has been added);
- removing zero-rating for exporters (exporters pay VAT on all inputs into their export products);
- increasing the rate of VAT to 20% (raising an additional K241 million);
- increasing corporate taxation;
- introducing dividend imputation; and
- reducing personal income tax (only for genuine residents).

The report also raises some questions about VAT and provincial revenue-raising generally which should be addressed in the Review recommendations. These include:

- changing the method of allocating refunds to provinces, to reflect a more accurate attribution of refunds to the collections which actually attract them;
- addressing the equalisation question: either by pooling all VAT funds and allocating them according to a mix of derivation or equalisation principles as under the Australian fiscal federalism arrangements;
- the impact of the new VAT distribution arrangements will be to reduce the National Government's share of VAT and consequently reduce the potential to make other (more equalising) transfers to provinces;
- exploring the potential for the introduction of a provincial payroll tax (which would yield K185 million on 1999 employment figures);
- exploring the potential for increased collection of land taxes by provincial governments.

If these proposals are to be properly discussed and debated, and are to result in robust recommendations which are realistic and implementable, then detailed discussion with IRC and Treasury, as well as consultation with Provincial Governments, will be essential.

As noted above, not all forms of taxation are suitable for implementation at a sub-national level, and the overall social and economic impacts of increased taxation need to be assessed.

VAT/GST collection and distribution

The main focus of recommendations concerning taxing powers is likely to relate to VAT/GST, which is the most important form of tax-transfer currently available to provincial governments. The NEFC has been requested to advise on the impact of, and possible amendments to, the distribution arrangements agreed to following the VAT Supreme Court Case. It has also been asked to advise on the administrative and economic implications of possible exemptions of basic essential items.

Internal revenue should be taken into account

Internal revenue resources should be quantified and factored into the fiscal arrangements for provincial governments. This will ensure that the package of funding measures is not inadvertently distorted by internal revenue, as is currently the case.

The most straightforward way to do this would be by including transfers of VAT and mining and petroleum royalties as transfers in the National Budget. The budget should appropriate and plan for the expenditure of these amounts, because they are national revenue which is transferred to provinces by virtue of intergovernmental agreements or revenue-sharing legislation. This would have the added advantage of improving PNG's revenue outlook and giving a more accurate picture of national resources and how they are used. For 2001, this would have meant an increase of almost 10% in revenue shown in the budget (around K200 million).

Off-setting internal revenue against grants

The NEFC proposes that there should be some off-setting of internal revenue against the grants, to avoid the excessive inequity which is present in the current system. This issue raises questions about balancing the principles of **derivation** (giving provinces back the revenue which is raised within the province) and **equalisation** (sharing revenue raised in 'richer' provinces with 'poorer' provinces so as to provide a more equal resource base for funding services).

At least the Block grants and the Less Developed Provinces (or Districts) Grant should be adjusted to take account of internal revenue, (but without removing the incentive for a province to maximise its own revenue). The development of this mechanism for internal revenue adjustment needs

considerable work. One way to achieve this might be through the discounting of revenue flowing from non-renewable resources, but not revenue generated from renewable resources which rely much more heavily on provincial support. This may also lessen the tendency inherent in the present system for provinces to become dependant on relatively short-term flows of revenue.

Given the level of inequity between different provinces at present, it is likely that any process of adjustment will need to be phased in over several years.

Further work required:

An understanding of the full flows of revenue to provincial and local level governments is essential for a full picture of how provinces are funded, and in order to ensure that internal revenue off-setting is accurate. The NEFC is currently assembling a comprehensive picture of internal revenue. This information is not currently produced in any publicly (or even readily) accessible form from the PNG financial management system.

The NEFC also proposes to undertake analysis of options for changing the distribution and administration of VAT, in particular looking at the capacity of provinces to collect VAT. This study will also look at the options in relation to exemption of basic essential items. A further study to examine the options for increasing efficiency and effectiveness in provincial revenue generation is also proposed.

The NEFC has consulted with the IRC and Department of Treasury in formulating the terms of reference for these studies, and it is proposed to engage in close consultation with Provinces over the findings and the development of recommendations for the Final Report.

This work is discussed in more detail in Section 5.3 below.

3.7 Derivation Grant

The NEFC proposes to consider the question of whether Derivation Grant should be retained in the new system, or whether it would be more appropriate to provide a Function Grant to fund programs to support export commodity development.

There are three broad groups of issues in relation to the Derivation Grant which need to be considered:

- **Calculation and apportionment:** There are several sources of data on commodity exports and they are rarely consistent. There is limited information on the province where the commodities are produced, as opposed to those where they are exported. Smaller provinces without export ports complain that larger provinces are credited with Derivation Grant to which they are entitled. This has been an issue since the Derivation Grant was first introduced in 1977.
- **Source of funding:** Derivation Grant was introduced originally to balance out the transfer of mining royalties to provincial governments under the original *Organic Law on Provincial Government*. At that time, Bougainville was the only province receiving mining royalties. It can be argued that in 1977 Derivation Grant, like royalties, represented the transfer of a share of national taxation to provinces. In the case of Derivation Grant, it was a means to share with provinces the revenue from export duties on commodities. Many of those export duties have now been removed. This means there is no longer a source of national revenue from which the Grant is being funded.
- **Application:** The rationale behind a Derivation Grant is to provide resources back to those parts of the country that are generating economic wealth for the country, on the basis that they will use those resources to generate more wealth. However, there is evidence that some provinces have not used the grant as the current Organic Law requires. Furthermore, it appears that the activities which go into supporting the production of some commodities (for example coffee extension services) are no longer paid for by provincial governments but are funded through commodity boards.

It is tentatively proposed that a Derivation Grant should be included in the new system. However, there should be some adjustments designed to bring it back to the original concept as set out in the original *Organic Law on Provincial Government*. This conclusion is subject to further work to determine if the grant can be effectively administered.

If the Derivation Grant is retained, it would be calculated on the basis of a percentage of the value of primary products which are produced or processed in a province, that result in export earnings for PNG. In this sense, the Grant fits well with the Government's export-led growth strategy.

Derivation Grant would be payable to the province where the exported goods are produced, or apportioned where secondary processing occurs in a different province. Consideration should be given to whether it is feasible to incorporate migratory species such as tuna in the calculations.

Further work required:

Three issues require further work in relation to Derivation Grant:

- determining more clearly the definition and purpose of Derivation Grant;
- working out the basis for calculation and attribution of the Grant;
- determining whether or not the Grant is sustainable given that the national taxes of which it was once a share are no longer imposed.

The broad terms of reference for this proposed study are described below in Section 5.4 below.

3.8 *Less-developed Provinces (Districts) Grant*

A failing of both the old system and the current one is that neither incorporated any specific provision to address under-development in some parts of PNG (at least insofar as they were implemented in practice). As it currently operates, there is no mechanism for equalisation of resources between provinces.

The Constitution requires that all the people of Papua New Guinea should have equal access to development. At Independence, service delivery networks were very unevenly distributed throughout the country. The provisions of the old *Organic Law* tended to lock in these disparities in development through the formula for the MUG, which was based on the cost of actual program delivery in 1976, indexed in line with CPI or changes in national revenue.

The Less Developed Provinces (or Districts) Grant would address this under-development in provinces which lack the capacity to fund development projects from their own resources. Therefore, the calculation of the grant would be based on some measure of development status and access to services, adjusted to take account of internal revenue resources (again, without destroying the incentive for provincial revenue generation).

It is often the case that less-developed provinces are those least able to manage the large amounts of resources needed to address their under-development. It will be important to define the purposes to which the grant should be applied, and ensure that its expenditure is properly linked to development priorities and plans.

An additional issue to be addressed is how one-off events (such as natural disasters) can be factored into the grant. It may be appropriate for these situations to be provided for through the national development budget (as has been the case in East New Britain and Bougainville) rather than through the inter-governmental financing system.

Further work required:

Considerable work will be required to develop an appropriate commonly agreed measure of development as a basis for calculating or apportioning the grant. Ideally, this would be based on district-level information, as there is considerable evidence of significant differences between individual districts within a province.

The approach to determining an appropriate basis for the grant is described in more detail in Section 5.5 below.

It will also be necessary to review the development rankings that form the basis for the grant regularly. It is tentatively proposed that the NEFC could undertake a five-yearly review of relative levels of development and adjust the formula or apportionment of the grant accordingly.

3.9 Local-level Government Grant

Calculation of LLG Grant

LLG grants are currently calculated according to the number of people in each province, but within each province they are usually divided equally between each LLG regardless of the number of people that LLG serves. This means that the actual distribution of the grant is in fact quite inequitable.

Under the new system, it is proposed that the Local-level Government Grant should be calculated according to the cost of functions assigned to LLGs. As indicated above, until a comprehensive assessment of the performance of local-level government has been undertaken, it will be difficult to determine what those functions should be, and how the

variation in capacity between different LLGs should be taken into account.

Payment of grants

Problems with the receipt of LLG Grants under the current system suggest that LLG Grants should be paid directly to the LLG concerned by the National Government. This is consistent with the National Government having supervisory responsibility over LLGs, rather than provincial governments.

However, if it is considered appropriate for LLGs to be supervised by provincial governments instead of the National Government, it would also be appropriate for provincial governments to be funding LLGs. Accountability and supervisory responsibility without the capacity to withhold funds is unlikely to work.

Accountability and supervision

The question of an appropriate level of Government at which LLGs should be supervised needs to be considered carefully. On one hand, it is now clear that there will be sufficient capacity (and resources) at the national level in the foreseeable future to adequately supervise around 300 individual LLGs. In this sense, the call by Provincial Governors to have supervision of LLGs decentralised to the provincial level makes sense.

There are other issues to be considered. LLGs are directly elected, whereas Provincial Assemblies are constituent bodies comprised mainly of LLG representatives who are chosen by the LLGs rather than by the people of the electorate. In this sense it may not be appropriate for them to supervise LLGs which are arguably a more directly accountable level of government.

Urban LLGs/Town Authorities

A further question to be addressed is whether the larger urban LLGs (which were formerly town councils) should continue to be included as a form of LLG or should be funded quite separately. Literature on fiscal decentralisation suggests that urban areas should not be treated in the same way as rural areas because they have very different needs. The operation of the Lae Urban LLG, for example, is probably more complex than the running of a small province.

Differences between urban and rural LLGs are also important. At the moment, an identical framework is applied to both. Two current issues emerging from the differences between them are:

- **Jursidiction:** Disputes concerning jurisdiction over markets in provincial towns (for example, Mt Hagen Buai Market, Goroka market) have resulted in poor control of public health and other issues arising in market places.
- **Financial management practices:** Several large urban LLGs adopted separate accounting systems which use the accrual method of accounting when they were independent statutory authorities. Under the Public Finances Management Act they are required to use the PNGG Government Accounting System (PGAS), but this system does not cater for the special needs of large urban LLGs including debtor systems, multiple de-commitment (needed for managing public works projects) and proper management of assets and liabilities.

Cost of members allowances and fees

The NEFC's overview study of LLG budgets bears out the anecdotal evidence that LLGs are spending most of their resources on the administrative overhead costs of the system of local government, rather than on service delivery. One reason for this is that the total cost of meeting the Salaries and Remuneration Commission's (SRC) determination in relation to LLG members is more than K16 million per year. Total LLG funding for 2003 is less than this amount.

Under the old system of local-level government implemented from the 1960s and, in some provinces, up until 1995, the legislation governing the local governments prohibited councils from paying fees to members out of their national government grant funding. Councillors were limited to paying fees only from their internally generated revenue (which provided an incentive to collect head taxes) and then only up to a certain proportion of that revenue. If local government is to make a contribution to improving rural communities, it may be necessary to find some way to limit the amounts that can be absorbed in overhead costs.

Further work required:

The NEFC has commenced gathering data on local-level government performance beginning with an analysis of 40 rural and 8 urban LLG budgets for 2001. This provides some indication of the kinds of functions that LLGs themselves are assuming.

It is proposed to undertake a more comprehensive study including a number of case studies to provide a better information base for determining LLG functions and capacity. This is described in more detail in Section 5.6 below.

3.10 Other components

District Support Grant

District Support Grant (DSG) currently amounts to around K55 million and as such is a major source of non-salary funding for district level activities. However, it appears that in some provinces this funding is not well targeted at priority activities, and may be contributing to the increasing recurrent expenditure burden generated by continual spending on new infrastructure.

It will be a political decision as to whether DSG is continued under the new system. If it is, the amount to be allocated this way should be factored into the calculations of the package of funding measures. In particular, it should be considered as part of an assessment of their fiscal sustainability.

Options for reform of District Support Grant include:

- calculating the grant according to population;
- removing the discretionary part of the grant;
- better targeting of the funds through transferring the discretionary part of the grant to LLGs and Provincial Governments for maintenance.

Special Support Grant

Special Support Grants (SSG) are payable under the mining and petroleum forum agreements which the National Government enters into with Provincial Governments. Initially SSG was intended to be a 'start-up' grant to cover the initial costs of infrastructure that were required for a project. However, provincial governments increasingly no longer provide this infrastructure themselves, and provinces have come to expect that the grant will be paid throughout the life of the mine, so the rationale for the grant is no longer clear.

Changes to the fiscal regime for petroleum were inserted into the *Oil and Gas Act*, which now apply to new projects (Moran and the Gas Project). They involve the payment of development levies instead of SSG.

Changes are also proposed in relation to mining projects. The Department of Mining has recently overseen the development of a draft sustainable mining policy which recommended the abolition of SSG. This seems to be in line with government policy—in late 2002 as part of the budget, the NEC directed a review of all current mining agreement financial provisions.

If SSG (or development levies) are going to continue in respect of some projects, then they will need to be subject to a mechanism for adjusting other grants accordingly (as discussed above in relation to Internal Revenue).

3.11 Annual adjustment mechanism and fiscal certainty mechanism

In order to be fiscally sustainable, the overall grants payable to provinces need to be subject to some sort of adjustment mechanism which is sensitive to both inflation (and the resulting increases in the cost of inputs into services) but also sensitive to changes in the fiscal position of the National Government.

A mechanism that incorporates both CPI and changes in revenue would be appropriate. However it should also take into account that loan receipts artificially inflate revenue and must later be repaid. The mechanism also needs to be sensitive to the real fiscal capacity of government to transfer *non-salary* funding to provinces, given that salaries and debt are an increasing burden on the national budget, and there is less available for goods and services.

The annual adjustment mechanism should also provide provinces with some level of fiscal certainty—for example, through a guaranteed minimum payment or share of national revenue. This fiscal certainty was provided through the old system of decentralisation by the guarantee that the MUG would not be less than the cost of the transferred functions in 1976. Under the current Organic law, it is provided through the grant formulae.

The problems with full payment of the grants show how difficult it is to work out a way of giving provinces a minimum guarantee which is both fiscally responsible and sustainable. The development of these two mechanisms will need to be done in close consultation with Treasury.

3.12 *Bougainville and NCD*

Bougainville and NCD are special cases which do not fit completely within the current or proposed decentralisation systems. The provisions that apply to them (and the impact which a new system might have) need to be carefully looked at to see whether there are any unintended effects.

The potential for Bougainville to be seen as a model for other provinces also needs to be considered, and accommodated to the extent that the Government considers it appropriate to do so.

3.13 *Implementation principles*

Implementation planning and costing should form an integral part of the work of developing the new system, both to ensure that it is workable, realistic and achievable, but also to develop consensus among stakeholders about what is required to make the new system work.

Attention should be focused on ensuring that the following will be in place when implementation occurs:

- A properly costed implementation plan should be developed through a participative process involving all stakeholders.
- Adequate resources should be committed to implementation.
- Stakeholders should be fully involved in preparation for implementation, should agree on the approach, and should continue to be involved throughout implementation.
- Carrying out of the plan should be coordinated by an authority with a clear mandate and powers, appropriate links with other authorities and agencies, and adequate resources.
- Implementation of the new system should be phased in line with availability of resources and capacity.
- Designers should be engaged in the implementation process so that there is continuity between the design stage and implementation stage.
- Shortcomings in the capacity of agencies and authorities should be identified, factored into planning, and addressed where needed.

Further work required:

The NEFC should facilitate an interagency and intergovernmental process to develop a plan which addresses these issues.

3.14 Accountability and monitoring systems

Financial management

Accountability systems form a core component of an intergovernmental financing system. The NEFC has undertaken a study of provincial financial management and budgeting systems which revealed some substantial areas of weakness both in design and implementation.

Most alarmingly, until very recently there has been virtually no public reporting of expenditure by provincial governments. The information which is available (in the form of audited financial statements) is not useful in assessing the performance of provinces in appropriately prioritising their resources, because it does not provide any readily accessible data for determining how much has been allocated to the different functions of government.

Around K450 million, or more than 10% of national revenue, is spent by provincial governments each year through their own budget and expenditure management systems, so this is significant element of government spending. It is particularly important because this funding is of the kind most under pressure in the PNG budgetary system—resources for goods, services and capital.

Monitoring function transfer and service standards

In order to ensure that provincial governments are using Function Grants in the way which has been intended, and maintaining service standards where Function Grants are transferred into Block Grants, monitoring systems will be needed.

At the most basic level, these systems should be capable of providing information about what amounts are spent on the different functions, and for what broad economic purposes (capital, salaries, goods and services, and transfers). At present, the poor use of budget coding at provincial level means that the purpose for which funds have been used cannot be clearly established. Provinces need both incentives and support to use clear budget coding practices which produce good reliable information.

Where the transfer of additional functions to provincial governments is concerned, or functions are to be transferred from Function Grants to Block Grants, a more sophisticated level of monitoring is needed.

As part of the transfer process, performance benchmarks will need to be agreed between the National and Provincial Government. These will measure whether adequate maintenance of service delivery standards is being maintained. Continued exercise of the transferred function, or the continuation of greater autonomy over funding, will depend on continuing to meet performance standards.

Further work required

A cooperative approach with the Departments of Treasury, Finance and Provincial Affairs is needed to work out realistic reforms to accountability arrangements. These should be aimed at the following broad areas:

- planning and budget management systems;
- financial and performance reporting;
- improving transparency of financial information; and
- the legal regime for oversight by the National Government.

The criteria for measuring compliance with service standards, and the systems for monitoring compliance, should be developed by the working group determining a clear division of functions between the different levels of government.

The role of the body or bodies which will undertake ongoing performance monitoring of provincial governments is crucial. At present, responsibility for monitoring provincial (and local-level) government performance rests with the National Monitoring Authority (NMA). The NMA has not been very effective in this role. Before adding to its functions (or replacing it), the question of why it has not been successful should be considered.

4. IMPLICATIONS FOR THE 2004 BUDGET

The Government has asked the NEFC to advise on what it is feasible to achieve in terms of changes to the current system, in time for implementation through the 2004 Budget to be passed in November.

4.1 *Time constraints*

Because the detailed provisions of the current system are locked in through an Organic Law, amendments to that law are required in order to bring about any changes. Organic Laws require support of a two-thirds absolute majority of the members of Parliament, voting at two separate sittings, two months apart. One month's notice of the amendments must be given before the first vote. This means that the following timetable would need to be followed in order to ensure that amendments are passed in time to be enacted before the 2004 Budget is passed:

<i>Critical event</i>	<i>Last day under current Parliamentary schedule</i>
First NEC decision on proposals	28 May 2003
Second NEC decision to approve draft legislation	11 June 2003
<i>Means draft legislation completed by</i>	<i>9 June 2003</i>
Gazettal of proposed amendments to Organic Law	11 June 2003
Introduction into Parliament	11 July 2003
First Parliamentary vote on amendments	11 July 2003
Second Parliamentary vote on amendments	11 August 2003

These time constraints affect what it is possible to achieve for 2004, because they mean that there is very little time available to undertake complex technical work on the detailed components of the new system.

In particular, it will also not be possible to undertake the level of consultation with provincial and local governments which should be an integral part of the development of any new system.

4.2 *Proposal for interim package*

It is possible to develop an interim package which moves part of the way toward the system described above, but without attempting to put in place the full level of detailed changes proposed. The table annexed to this report describes in detail how it is proposed that the 2004 package would be put together.

However, it is important to recognise that two fundamental principles apply to any consideration of amendments for 2004.

First, the package must be fiscally responsible. The most important element of fiscal responsibility is that the package of funding must be adjusted on a yearly basis to ensure it continues to remain both fair to provinces, and affordable for the national government. It is not possible to develop such a mechanism in the time available. Accordingly, it is proposed that the 2004 proposals should only apply for one year. This can be achieved through the use of a sunset provision in the legislation which would provide for the alternative system of grants to lapse after one year.

Secondly, the package needs to be considered as an integrated whole. The package has been designed as a whole system and will not operate properly if elements of it are changed without reference to their impact on the overall levels of funding or the amounts of other grants. Accordingly, it is proposed that NEC should consider the proposals as a package, and not as a group of stand-alone elements.

5. FURTHER WORK NEEDED

This Section of the Report describes in detail the work that is needed to progress the full development of each of the components of the new system. It is intended by this to inform stakeholders about what work the NEFC will be doing in the lead-up to its Final Report.

5.1 *Function Grants*

The following policy development and data-gathering activities will be needed to fully develop the concept and definition of Function Grants:

(a) *Assignment of expenditure responsibilities*

The starting point for a function-based approach to decentralised funding is a clear, agreed basis for the assignment of expenditure responsibilities to provincial governments. The NEFC is in the process of completing a study of functional distribution between different levels of government that should be completed in June 2004.

The allocation of functions cannot be decided on unilaterally by one level of Government. It is proposed that a working group incorporating representation from the Departments of National Planning and Monitoring, Treasury, Personnel Management and Provincial and Local Government Affairs, together with Provincial Administrations, should be established to develop an agreed basis and mechanism for negotiating which functions should be provincial responsibilities.

As part of this work, it will be important to distinguish responsibility for carrying out an activity, from responsibility for funding different inputs. For example, a national immunisation program is likely to be...

- carried out at facilities maintained by local-level government...
- delivered by staff employed by provincial government...
- using operational funding provided through a conditional national grant to the provincial government to fund that activity...
- but involving the distribution of vaccines that are purchased by the national government.

(b) *Costing of Function Grants*

Function Grants need to be fixed by reference to the actual, reasonable costs of service delivery to a pre-determined standard. However, since it is believed that some of these functions are not being adequately funded

now, current funding levels do not necessarily provide a sound basis for determining future grants.

In order to develop a basis for calculating Function Grants, the NEFC proposes to examine:

- funding for these functions under the old system of decentralisation (1995 budgets);
- current funding levels as provided for in provincial budgets;
- unit costing work undertaken by various national agencies (health, education and road maintenance);
- information on the location-specific differences in the cost of service delivery; and
- appropriate and reasonable standards of service delivery.

(c) Provincial Expenditure Study 1996-2002

Estimates of resources currently provided to functions will rely on comprehensive data on provincial expenditure broken down by function. At present this data is not readily available, because provincial budgets and financial statements are presented on a district-by-district basis, rather than showing expenditure grouped according to function. This means that data needs to be re-keyed into a more useable format for analysis.

This Study will examine the expenditure of both national grants and internally-raised revenue.

(d) Review of staff resources allocated to functions

Funding is not the only resource needed to carry out a function. The distribution of staff resources to different functions at the provincial level should also be considered, to ensure that adequate staff are available to perform any activities for which Function Grants are provided. At present, there is no dataset at the national level which allocates provincial staffing resources by function. It may be necessary to undertake analysis of establishment registers to find this information.

(e) Review of monitoring capacity

The capacity of the National Government to adequately monitor the performance of provincial governments has not proved adequate to the considerable task of supervising provincial governments and supporting them where needed. Clearly an understanding of why this aspect of the New Organic Law's design has failed so comprehensively, needs to be examined. Issues which are likely to be canvassed include:

- lack of resources for the National Monitoring Authority (NMA) and the DPGLGA;
- failure of the NMA to meet regularly;
- lack of capacity (broader than just resources) in key monitoring agencies;
- poor information systems, and lack of data;
- legal impediments (the invalidation of Section 51 of the Organic Law).

5.2 Block Grants

(a) Cost of government study

There have been complaints from several quarters that the new system of decentralisation is more expensive than the one it replaced. However, since these costs are met by the provincial and local governments themselves, and there is little data available on provincial expenditure, the real costs are not clear.

Provincial governments need to be provided with a reasonable basis for meeting the administrative and political overheads, but this cost also needs to be kept within reasonable limits. The NEFC proposes to examine the cost of government in detail with a view to recommending a reasonable level of grant funding to cover these expenses.

It has been suggested that the Salaries and Remuneration Commission determination on the allowances for local-government members has meant that out of K34 million allocated to local-government in 2001, around K16 million would have gone to pay allowances and sitting fees of members. This can be contrasted with a cost of K40 million to run the National Parliament.

In addition to the costs associated with the political institutions of government, there are also costs associated with maintaining a decentralised service delivery network of district offices.

In some provinces where a further layer of local-level government management has been established below the district level, these costs are quite substantial. The requirement to identify additional administrative (as opposed to service delivery) positions at three layers in the system (provincial, district and local) at a time when overall public service numbers were being reduced may have effectively reduced the overall staff resources available for service delivery to unrealistic levels.

(b) Cost of salaries

As discussed above, salaries cannot be included in the Block Grant until a reasonable and agreed staffing level is agreed between each province and the National Government. A starting point will be to ascertain a reasonable estimate of current costs and the cost of maintaining a reasonable staff establishment.

It is likely that implementing this aspect of a new system will take some time because of the lack of data and the complexity of the issues. For example, some provinces have more extensive service delivery networks than others, and therefore higher numbers of staff—however, districts with poor services should not be disadvantaged in the allocation of staff resources.

Many provinces have substantial numbers of casual staff, who are not necessarily identified as an ‘item 112’ cost in their budget (in some provinces some casuals are paid from item 135).

(c) Payment and timing of grants

The amount of the Organic Law grants is not the only issue which provinces have complained about. They have also complained that grants are sometimes underpaid, and are not paid regularly and that this compromises their ability to manage service delivery. It should be possible to ascertain from Department of Finance data whether actual transfers were less than budgeted transfers, either overall or in any particular year.

This study will also examine how late-paid grants, which cannot be spent before the end of the financial year, are dealt with.

(d) Formula for calculating Block Grants

The NEFC needs to determine whether the Block Grant should be calculated according to a formula, and if so how the formula should be designed, given the range of different activities that the Block Grant will be directed to. The fiscal sustainability of the formula will be a key issue.

National agencies that should be involved in development of the Block Grant calculation provisions are:

- Treasury, Budgets Division;
- Treasury, Economic Policy Division;
- Planning.

5.3 *Internal Revenue*

(a) *VAT Administration and Exemption Study*

It is proposed to follow up the study undertaken last year with a further piece of work to address issues arising out of the VAT Supreme Court decision and the subsequent agreement between the Prime Minister and the Governor of Morobe on the redistribution of VAT including:

- exemption of basic essential items;
- administrative and logistic issues connected with this;
- likely economic impact;
- shared collection arrangements between two levels of Government; and
- whether provinces have the administrative capacity to collect VAT (and what the criteria for assessing that might be).

(b) *Provincial revenue-raising capacity*

A more broad-ranging examination of the full range of existing revenue-raising measures, possible options, with recommendations for change, will be required. In particular, this work should examine the feasibility of provinces collecting other forms of tax, what criteria should be used to determine whether capacity is present, and what level of national government oversight of the exercise of these powers would be appropriate.

(c) *Quantifying provincial internal revenue*

Work is currently underway to assemble the best available data on provincial internal revenue from 1996-2002. Although provincial revenues are public money under the *Public Finances (Management) Act*, there is no formal reporting of provincial internal revenue at the national level. Therefore, a variety of sources are being used to gather the data. Where discrepancies between data are revealed, these will need to be presented to provinces before the figures are finalised.

(d) *Internal revenue off-setting mechanism*

The mechanism for discounting internal revenue against other grants is likely to be a contentious issue, and should therefore be developed through a participative process involving provinces. At the National level, Treasury Economic Policy Division (EPD), and the IRC should be involved.

5.4 *Derivation Grant*

A Derivation Grant study is proposed to examine the three aspects of Derivation Grant described in Section 3.7 above.

(a) Purpose and definition of Derivation Grant

The purpose of the grant and the range of commodities to be included should be clarified. Derivation Grant under the current system is directed to be used for furthering export production.

This then raises the question of to whom the Derivation Grant (or its equivalent) should be paid, since extension programs for some commodities are supported through commodity boards, not provincial governments. The conditions of the Grant should ensure the purpose is addressed.

(b) Calculation

Initially, to determine whether it would be feasible to include a Derivation Grant in the model, global figures for all primary export commodities except marine products (which are not shown in the Budget tables on value of exported commodities) were assembled. However, considerable further work is required to determine the sources of data through which the origin of a commodity could be attributed to a particular province. Value-adding in the case of secondary processing poses further problems.

The basis for calculation and apportionment of the grant needs to be transparent to provinces. The following aspects of calculation need to be documented in a publicly available way:

- source of data;
- attribution of origin;
- value-adding (apportionment).

The rate of Derivation Grant is likely to be determined largely by the global pool of resources available to fund it, but consideration should be given to a clear rationale for arriving at a particular rate. In particular, the sources of national revenue which are available to fund the grant should be documented.

(c) Sustainability

Finally, the issue of fiscal sustainability should be addressed, given that in most cases there is no specific revenue source (in the form of export taxes) which will grow as Derivation Grant grows.

5.5 *Less-developed Province (or District) Grant*

The formula for calculating the LDP Grant, and if it is based on a development index, the methodology for arriving at, and updating that index, needs considerable work. Consideration will also need to be given to the purpose of the grant, and how the achievement of that purpose can best be assured. This work is central to the core functions of the Department of National Planning and Monitoring, which should be closely involved.

(a) *Equity in current distributions*

An important component of the work in gathering data on internal revenue is to provide the information base for an examination of equity in the current distribution of resources. A basis for determining how to measure relative equity in distributions also needs to be determined. At present, per capita allocations are used, but it may be more appropriate to consider a measure (such as the development index) which also reflects need.

(b) *Constructing a development index*

One way to calculate the LDP Grant would be on the basis of a development index. Several different country-wide surveys of development status have been conducted over the twenty years since independence which could be used to inform this.

The NEFC proposes to undertake a study to examine existing data sources, identify the sorts of indicators which would be included in a composite development index which would be used for calculating the Grant. The study will also examine how the comparative ranking of provinces or districts should be reviewed over time to ensure they remain an accurate reflection of relative disadvantage.

(c) *Assessing the economic impact of equalisation*

Horizontal equalisation is one of the most important objectives of a system of intergovernmental financing. Given the level of inequity in the current distribution of resources, equalisation in PNG is likely to have

profound economic and political consequences. It will be important for the NEFC to properly advise the Government on these issues and recommend a realistic approach to phased movement toward a fairer distribution of resources.

The advice as to the economic impacts of equalisation should ideally come from an economist with a background in fiscal decentralisation.

5.6 *Local-level Government Grant*

(a) *Local-level Government budget study*

NEFC staff have commenced a study of Local-level Government. Initially, budget analysis of 40 rural and 8 urban LLGs has been undertaken to identify the broad categories of expenditure by each of the LLGs planned for the year 2001. This will be contrasted with actual expenditure as set out in financial statements.

(b) *Local-level Government performance study*

Some issues surrounding LLGs that need to be considered include:

- What are the functions and responsibilities of LLGs?
- What human resource, financial and support capacity is there for LLGs to implement these functions? To what extent have these expectations been realised?
- Are funds for LLGs getting through from provincial governments?
- What is the cost of running the LLG system?
- What are the formal and informal links between district administrations and LLGs? How do they relate to one another?
- What are the formal and informal links between LLGs and provincial administrations? Are they effective?

5.7 *Annual adjustment mechanism and fiscal certainty mechanism*

Advice will be sought by the NEFC on previous precedents and possible approaches to developing the annual adjustment mechanism for grants, which ensure that the system is both certain (so that provinces can plan ahead) but sensitive to the fiscal capacity of the national government.

National agencies that should be involved in development are:

- Treasury EPD;

- Treasury, Budgets Division;
- Planning.

**OPTIONS FOR
INTERIM IMPLEMENTATION OF
PROPOSED REFORMED FISCAL FINANCING PACKAGE**

	FINAL PROPOSAL	2004 POSSIBILITIES	PRINCIPLES OF NEW SYSTEM REFLECTED IN 2004 PACKAGE
FISCAL RESPONSIBILITY	<p>The system needs to be designed to reflect fiscal realities, making best use of available resources, and to the greatest extent possible ensuring all levels of Government have the resources necessary to carry out their assigned functions adequately.</p> <p>To ensure that the system continues to be appropriate to the fiscal context, needs and responsibilities, there should be adjustment mechanisms that allow the system to respond flexibly to changing circumstances over time.</p>	<p>This principle must be maintained even for 2004.</p> <p>However it will not be possible to design adjustment mechanisms that are needed for a system that operates over more than one year, within the timeframe.</p> <p>Therefore, it is imperative that the interim package should apply for one year only. This should be achieved by the use of a sunset clause in the amendments to the Organic Law.</p>	Principle 1: Fiscal reality and responsibility
INTEGRATED PACKAGE	PACKAGE HAS TO BE CONSIDERED AS A WHOLE—IT IS NOT POSSIBLE TO IMPLEMENT ONLY SOME COMPONENTS	A refined package could be implemented for 2004, provided the refined package is implemented <u>as a whole</u> .	Principle 2: Integrated system

FUNDAMENTAL PRINCIPLES

RECURRENT BUDGET GRANTS

<p>FUNCTION GRANTS</p>	<p>Costed grant determined by actual reasonable cost of delivering defined core services to specified standard</p>	<p>Quarantine some level of funding for certain functions:</p> <ul style="list-style-type: none"> • health • education • road and building maintenance • <i>village courts</i>?? <p>Provinces to have input into proposed amounts of function grants.</p> <p>Process of determining Function Grants should ensure there is clarification of provinces' funding responsibilities.</p>	<p>Principle 3: Address worsening service delivery</p> <p>Principle 4: Balance recurrent and capital spending</p> <p>Principle 5: Nation-building priorities promoted</p> <p>Principle 7: Function distribution & funding responsibilities clarified</p>
<p>LOCK GRANTS</p>	<p>Formula-based grant to cover other functions (not in function grants) plus cost of government plus some scope for local priority-setting</p> <p>Likely to be off-set by internal revenue</p>	<p>Residual amount?</p>	<p>Principle 6: Local-priorities addressed</p> <p>Principle 1: Fiscal reality and responsibility</p>
<p>STAFFING GRANTS</p>	<p>Eventually to be incorporated into block grant once reasonable staffing levels determined and excess staff retrenchment funded</p>	<p>As per realistic estimates (in MTF?)</p>	<p>Principle 1: Fiscal reality and responsibility</p>
<p>DERIVATION GRANTS</p>	<p>Based on primary commodities only, paid to province of production or where processed in a different province, apportioned between two provinces or more.</p> <p>Rate to be determined.</p>	<p>Need to determine rate based on fiscal envelope.</p> <p>Ensure adequate data for apportionment (2002).</p> <p>Transparent process for demonstrating basis for calculation (including agreement on source of data).</p>	<p>Principle 5: Nation-building priorities promoted</p>

<p>LOCAL GOVERNMENT GRANT</p>	<p>Amount appropriate to LLG functions (to be determined)</p>	<p>As per budget projection (K14.3 million) (Not sufficient even to cover allowances of LLG members) Add DSG discretionary proportion of K27 million to LLG grants Quarantine for maintenance in areas of responsibility (aidposts, primary & elementary schools, feeder roads) Grants not to be used to pay LLG member fees & allowances.</p>	<p>Principle 6: Local-priorities addressed (and if DSG transferred to LLGs as suggested); Principle 3: Address worsening service delivery Principle 4: Balance recurrent and capital spending (and if Grants not to be used for allowances); Principle 11: Increase efficiency and effectiveness in internal revenue collection & use</p>
<p>TOWN AND URBAN SERVICE GRANT</p>	<p>Amount appropriate to Town Authority functions (to be determined)</p>	<p>As per budget projection for 2004 (K6.3 million) Grants not to be used to pay LLG member fees & allowances.</p>	<p>Principle 6: Local-priorities addressed (and if Grants not to be used for allowances); Principle 11: Increase efficiency and effectiveness in internal revenue collection & use</p>

DEVELOPMENT GRANTS

LESS-DEVELOPED PROVINCE GRANT	Payable to under-developed provinces without sufficient internal resources to address underdevelopment. Based on development index. Likely to be off-set by internal revenue. (Relative wealth considered together with relative development status)	Can't address easily, but it is important to lock in the idea of equalisation in funding and consideration of internal revenue. Determine whether it would be possible to pay to three or four worst off provinces, where total revenue is lowest per capita, if justifiable on basis of other assessments of under-developed districts.	Principle 9: Address differential levels of development Principle 10: Internal revenue is taken into account
SG	Factored into discounting of internal revenue against other grants.	Factor into internal revenue calculations.	Principle 10: Internal revenue is taken into account
DISTRICT / PROVINCIAL SUPPORT GRANT	Factor into total revenues if paid (political decision)	Options: (1) Potentially reduce to K250,000 (2) Redirect K250,000 to LLGs and Provincial Governments for maintenance	Principle 3: Address worsening service delivery (by transferring to LLGs & PGs for maintenance) Principle 4: Balance recurrent and capital spending Principle 6: Local-priorities addressed

INTERNAL REVENUE

STATE TRANSFERS	To be revisited after further work on economic and administrative impact of proposed redistribution, and consideration of options for shared collection	Options: (1) As per Somare-Wenge agreement (straight 80/20)? (2) Reduce to 60/40 with top up for provinces which would lose out? Should be factored into total fiscal envelope.	Principle 10: Internal revenue is taken into account (if top up proposal is adopted): Principle 9: Address differential levels of development (and resource distribution)
INTERNAL REVENUE ADJUSTMENT	Mechanism for off-setting internal revenue against other grants Remove any legal impediments to provincial and LLG internal revenue laws	Remove any legal impediments to provincial and LLG internal revenue laws (not limited to 12 month sunset period – would have to amend Sections 85-87 OLPGLLG)	Principle 10: Internal revenue is taken into account Principle 11: Increase efficiency and effectiveness in internal revenue collection & use

<i>ADJUSTMENT MECHANISMS</i>			
ACTIVITY TRANSFER MECHANISMS	Principle is recognition of differential capacity. Reflected in: (a) Mechanism for transfer of additional function responsibilities to provinces, and (b) Transfer of function grant into block grant.	Not possible to develop activity transfer mechanism to address differential capacity within 2004 timeframe.	
ANNUAL ADJUSTMENT & FISCAL CERTAINTY MECHANISMS	(a) Mechanism for annual adjustment in line with changing national economic circumstances; and (b) Mechanism to ensure minimum payment to provinces to provide fiscal certainty.	Part of calculation process for 2004 package. Not possible to develop adjustment mechanism which is sensitive to changing economic circumstances within 2004 timeframe. Therefore essential that interim package should apply only for 2004.	Principle 1: Fiscal reality and responsibility
APPLICABILITY			
BOUGAINVILLE & NCD	Applies to all provinces except Bougainville and NCD which are affected by special circumstances. Funding arrangements for NCD and Bougainville to be determined after better consideration of issues. Ensure equitable distribution of resources.	Interim package should not apply to Bougainville or NCD. OLPGLLG amendments should make provision for special arrangements for these two. (For example, NCD should not receive Town & Urban Services Grant, in light of high internal revenue.)	