Forward

It is with much pleasure that I introduce this consultation paper on the Review of the Intergovernmental Finance System.

In 2003 the Commission released an interim report that outlined the problems with the existing intergovernmental finance system. Since that time the Commission has undertaken extensive data gathering exercises and is now able to release this consultation paper which describes in detail the main features and principles of the proposed intergovernmental finance system.

This consultation paper provides an opportunity for everyone to make any comments or contributions to the work already undertaken by the Commission.

Shortly the Commission will have completed a comprehensive exercise detailing the actual cost of service delivery in each district. This will allow the Commission to identify the difference between the actual cost of delivering services in each district and the revenues Provinces have to fund those services. The Commission will then be in a position to release final worked examples for each province showing the grants needed to ensure that all provinces and districts can deliver a similar level of services.

The Commission hopes that this paper will stimulate discussion on these important issues and looks forward to receiving your comments.

Nao Badu
Chairman / CEO
National Economic and Fiscal Commission

Executive Summary

In the last two years, the NEFC has undertaken studies, data gathering and consultations. We have now amassed a great deal of information about the responsibilities of each level of government, the differing costs of delivering services in each district, the revenues and current taxation powers of Provinces and Local-level governments, and details on the exact funding distributed to each Province.

We can now use this information to propose a new comprehensive and integrated intergovernmental financing system. The NEFC is proposing to base this system on a number of principles, in particular:

- That funding for service delivery should be matched as closely as possible to the *actual cost* of the services that Provinces, districts and Local-level Governments provide.

- *Equalisation of services* in all parts of the country should be the main principle on which intergovernmental financing arrangements are based.

- All resources, recurrent and development, received by provinces are public funds. These resources should be taken into account in calculating what Provinces should receive from the National government.

- The *transfer pool* (of service delivery grants) should be increased by including some or all of the:
  - provincial inland GST revenue; and
  - mining and oil royalties.

- The size of the *transfer pool* should be kept affordable by making it a share of total National Government revenues, after debt servicing and other essential commitments have been met. It should not be a fixed kina per head amount.

- The new system should strike a balance between bringing all provinces up to the same level and encouraging those that are succeeding.

Part one of this paper outlines the reasons for the deterioration in service delivery. One of the main reasons is that funding for service delivery at all levels of government has been steadily declining in real terms. Secondly, the distribution of funds has no relationship to the actual costs of service delivery.

Ideally, funds for service delivery should be distributed on the basis of costs, not equal kina per head. This is the only way that each district will have sufficient funding to deliver a similar level of services.

Part two of the paper introduces the idea of the *fiscal gap* – the difference between the costs of delivering services and the revenues available to pay for these services. The grants from the National Government for service delivery should be applied towards narrowing this gap.

Part three discusses how large the Provincial (and NCD) "pig" is, what it is made up of and how it is cut up between provinces. Only one-third of the K1 billion "pig" is available for goods and services. GST and royalties make up nearly two-thirds of funding for goods and services. These funds are largely distributed to only a few provinces and the NCD, so the goods and services funding for most provinces is starved.

Part four proposes a solution to this problem: a *transfer pool* to meet the difference between each province's actual costs of delivering services and their revenues. This pool should be distributed on the basis of need and should have the explicit aim of narrowing the difference between costs and revenues.

Part five deals with some other related issues which will have to be taken into consideration in putting together an integrated and comprehensive intergovernmental finance system.

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Introduction: Why is intergovernmental financing important?

Intergovernmental financing is critical to PNG's development. Soon after Independence, PNG adopted a system of government based on decentralization. Under the current decentralization arrangements, provincial governments (including district administrations) are responsible for service delivery in the following areas:

- **maintenance of transport infrastructure** (trunk and feeder roads, rural airstrips, wharves and jetties);
- **basic education** (elementary and primary schools);
- **primary health** (rural health facilities and preventive health programs);
- **agricultural extension** and small scale fisheries extension;
- **village courts**;
- **rural electricity** infrastructure;
- **land mediation** and support for customary land management;
- **business development** and commerce activities;
- **interaction with landowners** over natural resource development (forestry, mining and petroleum projects);
- **HIV awareness**;
- local **environment and conservation;**
- **community services** programs.

A number of these services have been identified as critical to PNG's development in the recent *Medium Term Development Strategy 2005-2010*. It is clear from Diagram 1 that provincial and district administrations are critical to successfully implementing the MTDS priorities.

This is because Provincial governments decide how much to allocate to these programs through their planning and budgeting processes. To a lesser extent, they also control whether there are

public servants in place to deliver these programs, and what they are directed to do.
If Provinces are not adequately funded they will not be able to meet their responsibilities under the MTDS.

Diagram 1: Responsibility for MTDS priorities in PNG's system of government

MTDS PRIORITIES	WHO IS RESPONSIBLE?
REHABILITATION & MAINTENANCE OF TRANSPORT INFRASTRUCTURE	**National** - National Roads (40% of roads) **Provincial/District** - Trunk & feeder (60% of roads)
PROMOTION OF INCOME EARNING OPPORTUNITIES	**Provinces/Districts/Commodity Boards** Agricultural extension **National/Provincial** - Fisheries extension
BASIC EDUCATION	**Provinces/Districts/LLGs** Elementary/ Primary schools
DEVELOPMENT-ORIENTATED INFORMAL ADULT EDUCATION	**National/Provinces** - Distance education **Provinces** - Vocational centres
PRIMARY HEALTH CARE	**Provinces/Districts/LLGs** Rural health facilities & programs
HIV-AIDS PREVENTION	**National** - Policy **Provinces** - HIV-AIDS awareness
LAW AND JUSTICE	**National** - Courts/Police/ Corrections **Provincial** - Village Courts

Resourcing of Provinces, districts and Local-Level governments is critical to implementation of the MTDS

Part 1: Improving service delivery in PNG

Deteriorating service delivery

The bulk of PNG's population lives in rural areas. Over the last ten to fifteen years, basic services available to people in rural areas has been deteriorating. For example,

- **Health facilities are closing**, or they no longer have the drugs and equipment they need to treat basic causes of death and disease. In some hospitals, there are **no drugs and not enough beds** for all the patients.
- In some cases, **buildings have deteriorated** to the point where they have to be closed.
- There are **not enough books** for students, some of the more **remote classrooms have no teachers** for much of the year because of a lack of adequate housing. Teachers often have to travel a long way to cash cheques.
- Because of PNG's mountainous terrain and wet climate, **roads are expensive to build and deteriorate rapidly**. Regular routine maintenance has been neglected over many years. The state of roads has **decreased the accessibility of districts**.

There are several reasons why services are deteriorating:

- **misappropriation and misuse of resources** for service delivery;
- **lack of training and capacity** of public servants;
- **lack of supervision** and corresponding poor performance by public servants;
- **confusion** over who is meant to do what; and
- **poor management and coordination**.

However, even if all these problems could be solved, it would still not be possible to restore service delivery to the levels which PNG enjoyed 20 years ago. This is because many provinces simply do not have enough money to meet the costs involved in delivering basic services.

Funding for service delivery is low and has been declining…

The amount of funding available for spending on service delivery has been declining in real terms at all levels of government. One reason for this is that an increasing proportion of the budget is spent on servicing debt, and on salaries—leaving less for goods and services and also development. Debt servicing commitments will consume a large share of National Government spending well into the next decade.

At the same time, the economy is growing more slowly than the rate of population growth. This means that the government's tax revenues cannot keep up with the increasing demand for services. Therefore, it may not be possible to maintain the current level and standard of services.

The intergovernmental financing arrangements have also contributed to less money being spent on service delivery. Since the new *Organic Law* came into operation in 1996, Provincial governments have been able to decide how they spend most of the funds available to them. Many of them have chosen to spend their funding on things other than service delivery.

For example, the cost of paying and housing politicians is a heavy burden for lower levels of government. Almost 40% of the national grants to provincial governments are taken up by the allowances and entitlements for provincial and local politicians which are fixed by the Parliamentary Salaries and Remuneration Commission.[1]

Funding should follow function

That "funding follows function" is a fundamental principle of any intergovernmental financing system. Currently, functions can be assigned to Provincial and Local-Level Governments without the funding necessary to implement them. For example in 1999, the National Government asked Provinces to meet some operating costs for Village Courts, CIS and Police. At that time, no additional

[1] Most Provinces and Local-level Governments pay their politicians the maximum allowances and entitlements permitted under the determinations in the *Eighteenth Report of the Salaries and Remuneration Commission (January 2002).*

Service delivery is a long chain involving all parts of government. In health vaccination programs:

- the National Government purchases medicines and transports them to Provincial capitals;
- Provinces deliver these supplies to rural health centres;
- Districts pay for gas bottles for the fridge and organize immunization patrols; and
- Local-level government maintains aid posts where immunization clinics are conducted.

funds were provided to perform these new functions. Ideally, if either functions or funding moves, then the other one should move as well.

PRINCIPLES FOR A NEW INTERGOVERNMENTAL FINANCING SYSTEM

Principle 1: Funding for Provinces, districts and Local-Level governments should be based on the functions they are expected to carry out.

Level of funding should be determined by the actual cost of service delivery

Not only should the amount of money allocated reflect functions, but it also should be related to actual cost. At present, funding available for service delivery does not reflect costs.

Principle 2: Funding for service delivery should be matched as closely as possible to the actual cost of those services

What would it cost to deliver basic services?

The NEFC has undertaken a major study of service delivery at the provincial and district level. The main purpose of this study is to understand what costs are involved in basic service delivery by provincial, district and LLG administrations.

The Cost of Provincial and District Services Study has collected information on all the facilities (such as schools and health centres) and services in every rural district of PNG. The NEFC has mapped all of these facilities and the routes by which public servants travel to the facilities to deliver services. For example, we

Rural power is very expensive. A generator of this size in Kandep District, would cost at least K50 000 per year in fuel alone. In Goilala District it costs more then K500 per drum to get diesel to Woitape.

Box 1:

The main costs of service delivery in PNG for Provinces and Local-Level Governments:

- **Maintenance of PNG's extensive trunk and feeder road network.** There are at least 15-20,000 kilometres of roads.
- **Distribution of specialist materials and supplies to schools and health centres**. There are more than 4,000 schools and 1,500 health facilities and aid posts.
- **Transport costs and allowances for public servants to undertake patrols**. The include patrols by health staff, school inspectors, didimen and didimeris and local government staff.
- **Operating costs of schools, health faculties and office buildings –** these include the cost of pens, paper, computers, electricity, telephones, vehicles and fuel that public servants need to do their work

have tried to find out <u>where</u> the schools are located in each district and <u>how</u> school inspectors travel to visit them (by road or boat etc).

PNG's service delivery network is spread over a large area, much of which is quite inaccessible. There are many villages that can be accessed only by walking, and many islands accessible only by boat. In order to make services available to people where they live on their traditional lands, public servants must work in, or travel to, these remote areas.

The main factors affecting the differing cost of travel for public servants are:

- distance traveled;
- the means of transport—because travel on foot takes much longer, so more travel allowance is required, and more staff are needed to cover the same number of facilities; and
- how often each patrol needs to be undertaken.

To calculate the costs of service delivery, the NEFC has adopted the standards specified by national line agencies as to how often each patrol should occur. For example, the Department of Education specifies that Inspectors should travel to each school three times each year. Health centre staff are expected to make four patrols each year in order to immunize children.

Most provinces have great difficulty maintaining the trunk and feeder roads and bridges in their districts. It costs at least K400 000 to reseal just 1 km of road. In addition, Works unit equipment and facilities in rural areas must be maintained.

The cost of service delivery for each district is unique – each district has a different number of schools and health facilities, some districts have an extensive road network, while others rely on boat. The cost of traveling to these facilities and maintaining them to an acceptable standard is different for each district. The funding provided to provinces and districts should reflect these differences in the actual cost of delivering services.

Service delivery should be affordable for all provinces…

However, given the high cost structures for delivering public services, some service delivery expectations are unaffordable.

If the total cost is more than the amount of money PNG can reasonably afford to spend on service delivery, some hard decisions will have to be made. This may involve reducing the number of facilities at which services are offered, or reducing the standards of service that are offered to make them more affordable.

> *Principle 3: Funding for Provinces, districts and Local-Level Government should be based on an affordable level of services.*

Equal services, not equal Kina…

The Second National Goal of the Constitution calls for:

> "*equalization of services in all parts of the country, and for every citizen to have equal access to legal processes and all services, governmental and otherwise, that are required for the fulfillment of his or her real needs and aspirations*"

Rural schools need housing for teachers, maintenance, supplies and schoolbooks to operate. Getting books to schools is costly and hard to organize. A six hour boat ride from Alotau uses K80 of zoom.

What does **equalization of services** mean in practice? Equal Kina per head does not mean equal services.

Equalisation of services means that each district should be able to undertake a **similar** level of service delivery. For example, each provincial and district administration might be able to:

- do 4 (or 2) immunization patrols per year
- maintain half (or one-quarter) of its roads maintained
- give all farmers (or half of the farmers) extension services.

Inevitably, different funding levels will be needed for each district, because of the different costs.

This means that the amount required *per head* to deliver the *same level of services* will be different in different parts of the country, depending on their different costs.

The objective of the intergovernmental financing system should be to put each province and district in a similar financial position to meet their service delivery responsibilities.

> *Principle 4: Equalisation of services in all parts of the country, to a similar level, should be the main principle on which intergovernmental financing arrangements are based.*

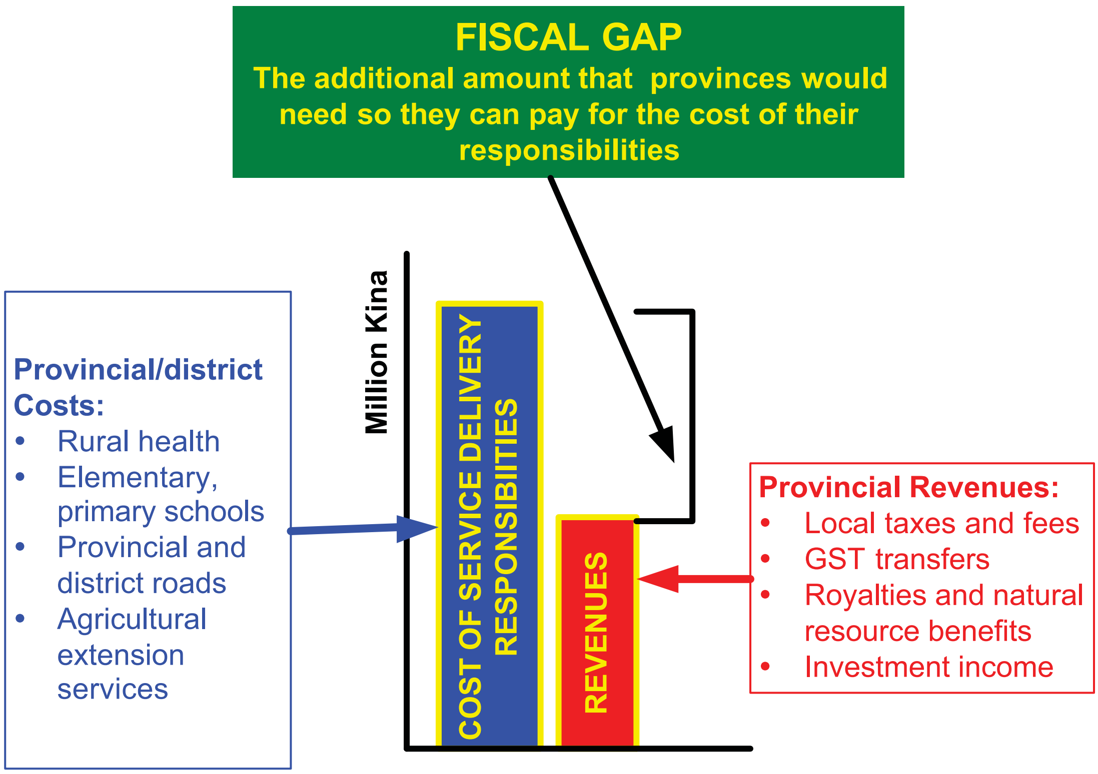
Part 2: What is the fiscal gap?

Understanding the fiscal gap

The next part of the paper will focus on the difference between the cost of delivering services and the revenues that Provinces have to pay for these services. This difference is also known as the "**fiscal gap**". Diagram 2 illustrates the concept of the fiscal gap.

Diagram 2 – The Fiscal Gap

FISCAL GAP = Costs of service delivery - revenue



This concept is central to intergovernmental financing, because the grants (transfers) from the national government should be designed to bridge that gap — so that all provinces and local-level governments can afford a similar level of services.

Principle 5: All transfers, including the National Government grants, should be designed to try to fill the fiscal gaps.

Part 3: How large is the "Provincial pig"?

Total funding available for Provincial and NCD service delivery and development 2005

This part of the paper looks at how all the funds available to Provinces and the NCD are shared. This can also be thought of as the "Provincial pig".

The Provincial pig is made up of recurrent and development resources that provinces and the NCD receive to meet their costs[2]. In 2005, total funding available to provinces and NCD are estimated at about **K1,000 million** (all Budget estimates – excludes donor funding[3]):

- **Locally generated revenue** from Provincial and Local-Level government taxes, fees and fines – K58 million
- **Transfers of national taxation** —GST and royalties (which are shared on a derivation basis, meaning that these go back to the provinces where they were raised) – K230 million
- **Grants from the national government**: staffing grants, non-staffing goods and services grants and infrastructure development grants – K680 million

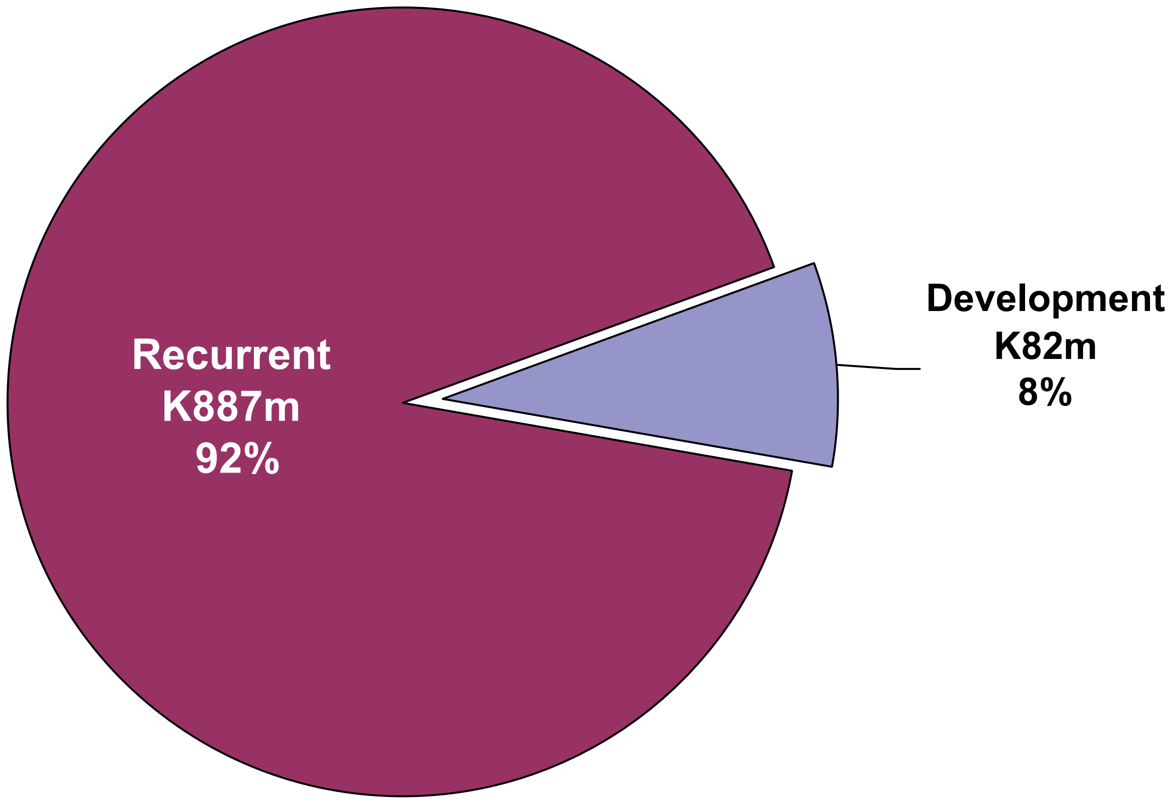
2 Note that these diagrams do not include local government revenues. The NEFC is currently gathering information about all urban and rural LLG revenue collections.

3 Volume 1, 2005 Budget, , Tables A.2.1 and A.2.2

How is the total resource "pig" shared between recurrent and development funding?

Not all of this K1,000 million "pig" is available for service delivery. Chart 1 show how this pig is split between resources available for **recurrent** funding (92%) and **development** funding (8%).

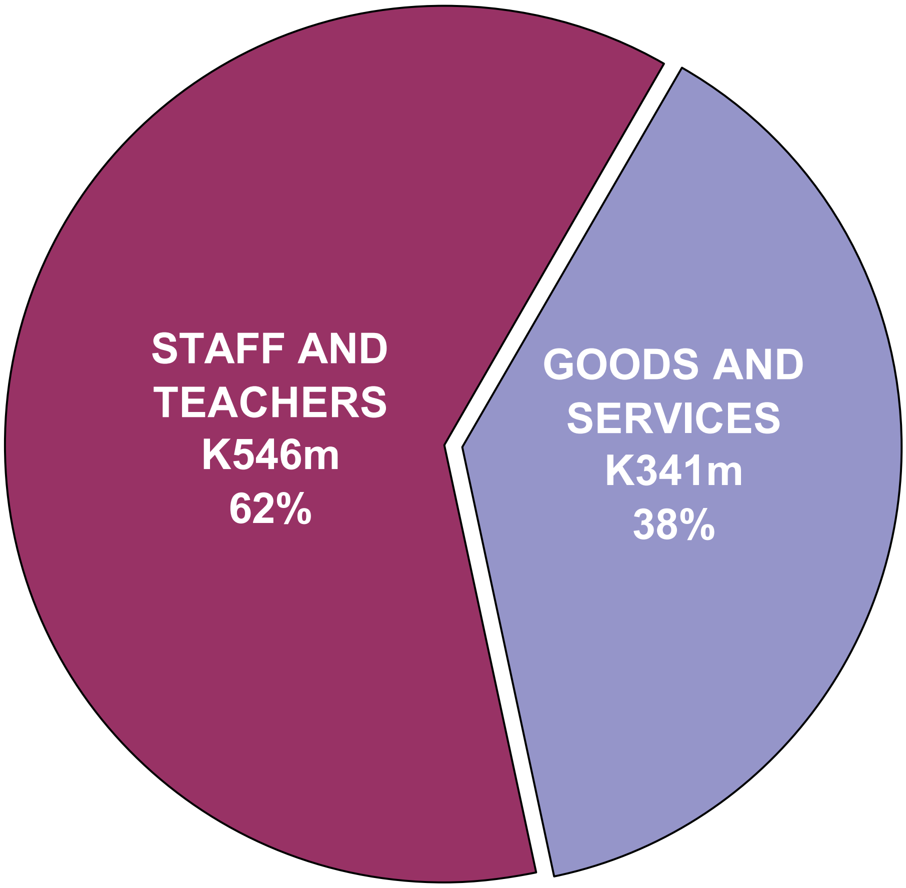
Chart 1 - Total funding for Provincial Governments and NCD 2005



How is recurrent funding spent?

Chart 2 shows that out of the total recurrent resources, 62% is spent on Provincial staff and teachers, leaving only 38% for goods and services. Staffing grants are paid directly to public servants and teachers by the National Government, so cannot be used for goods and services as they are not "cash".[4]

Chart 2 - Recurrent funding for Provincial Governments and NCD 2005



[4] NCD estimated staff expenditures (K30m) are included in the staff portion.

How is development funding distributed?

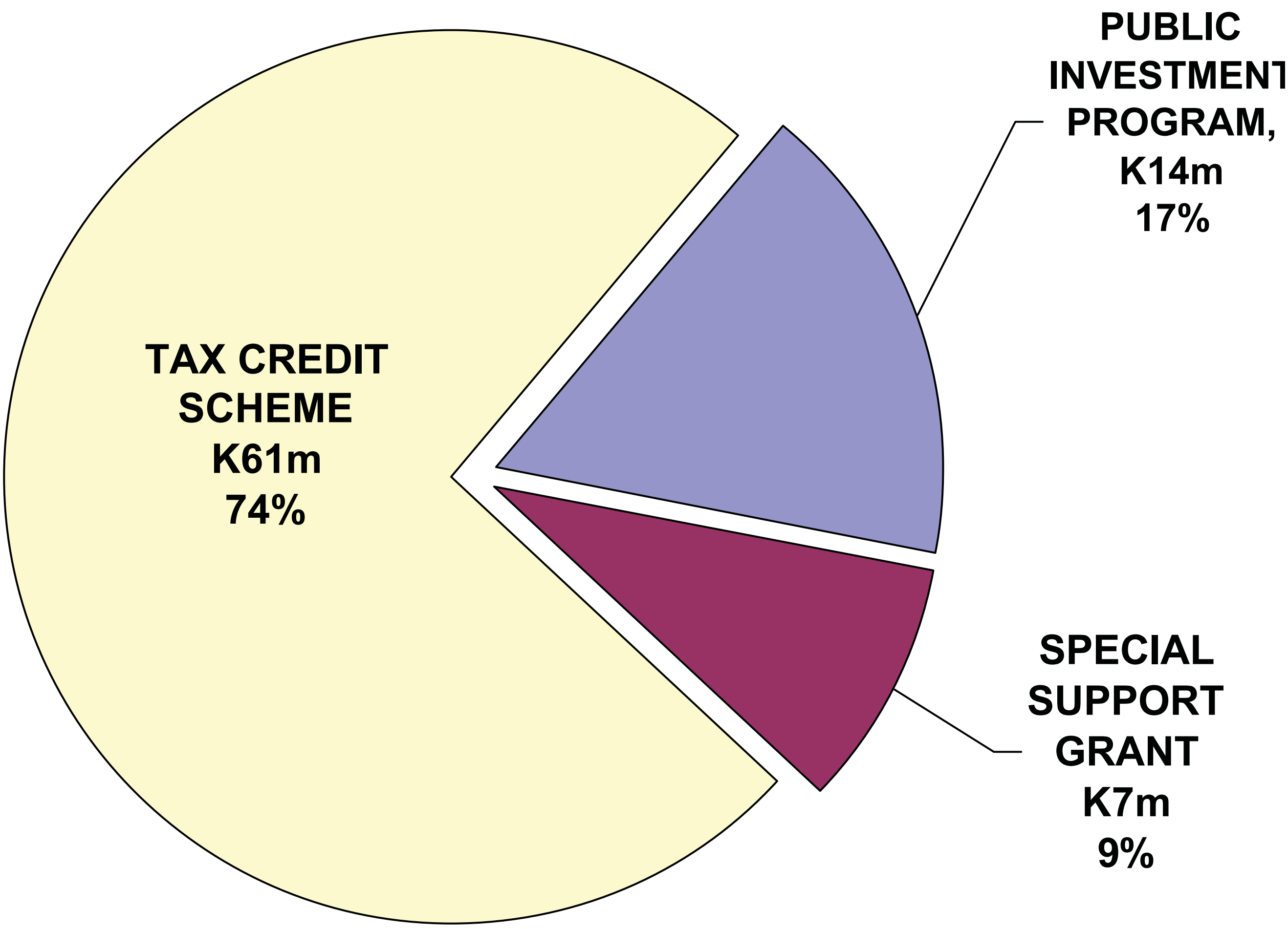
Chart 3 shows that development funding paid is generally not available for provinces to spend on service delivery as most are tied to particular projects. These are:

- Tax Credit Scheme (TCS) infrastructure
- Special Support Grants (SSG)
- Public Investment Program grants (PIPs)

The PIPs and SSG grants are paid as "cash"[5], whereas TCS projects are built by the resource companies using credits provided through the corporate tax system. The TCS are infrastructure transfers as the national government foregoes sizeable corporate tax revenues to pay for them. TCS spending accounts for 74% of total infrastructure grants, as can be seen in Chart 3.

[5] DPNRD has a role in monitoring and making payments against project progress.

Chart 3 - Development funding for Provincial Governments and NCD 2005



How is goods and services funding distributed?

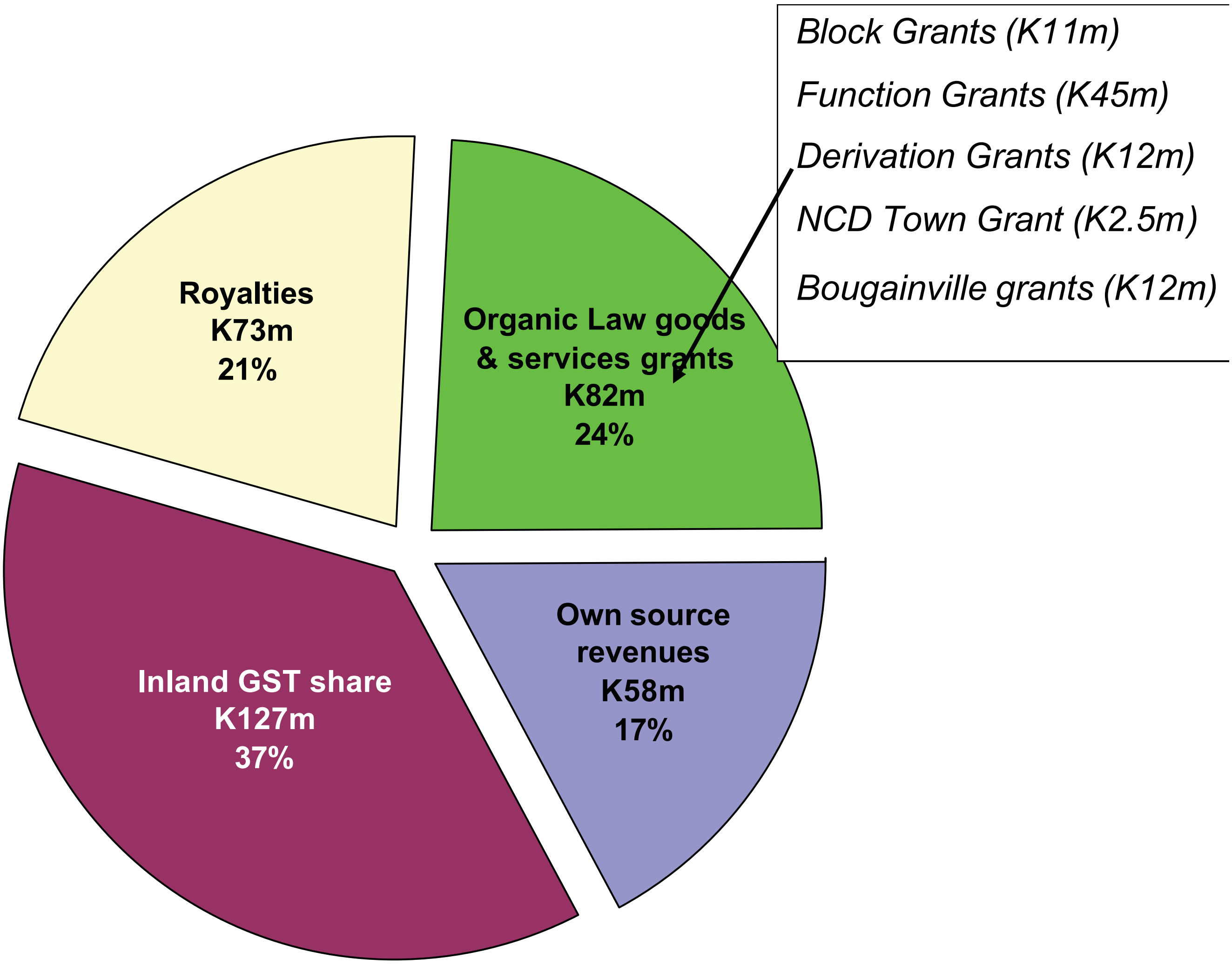
From Chart 2, we have seen that only K341m of the K1,000 million pig is available for goods and services.[6]

In Chart 4, it can be seen that nearly 60% of the goods and services funding available to provinces does not come from their

[6] It is actually less than this, as provinces also spend on staffing (casuals) and development activities from this pool.

own revenues or the *Organic Law* grants, but from GST and royalties.[7]

Chart 4 - Goods and services funding by source Provincial Governments and NCD 2005



[7] The inland GST portion excludes K30m of NCD's GST share, which it spends on its staff. This K30m appears in the staffing portion shown in Chart 2.

How is goods and services funding distributed between Provinces and the NCD?

Chart 5 shows the distribution of goods and services funding between provinces. It can be seen that the distribution of resources between provinces is grossly uneven.

This is because GST and royalties make up about two-thirds of the funding available to provinces. GST and royalties are distributed on a derivation basis, so most of these revenues go to only a few provinces. Most of the provinces receive no royalties (because they have no mining or oil projects) and/or have low GST per capita (because their urban centres are relatively small).

It can also be seen that grants from the National government are a relatively small proportion of the total resources available to most provinces.

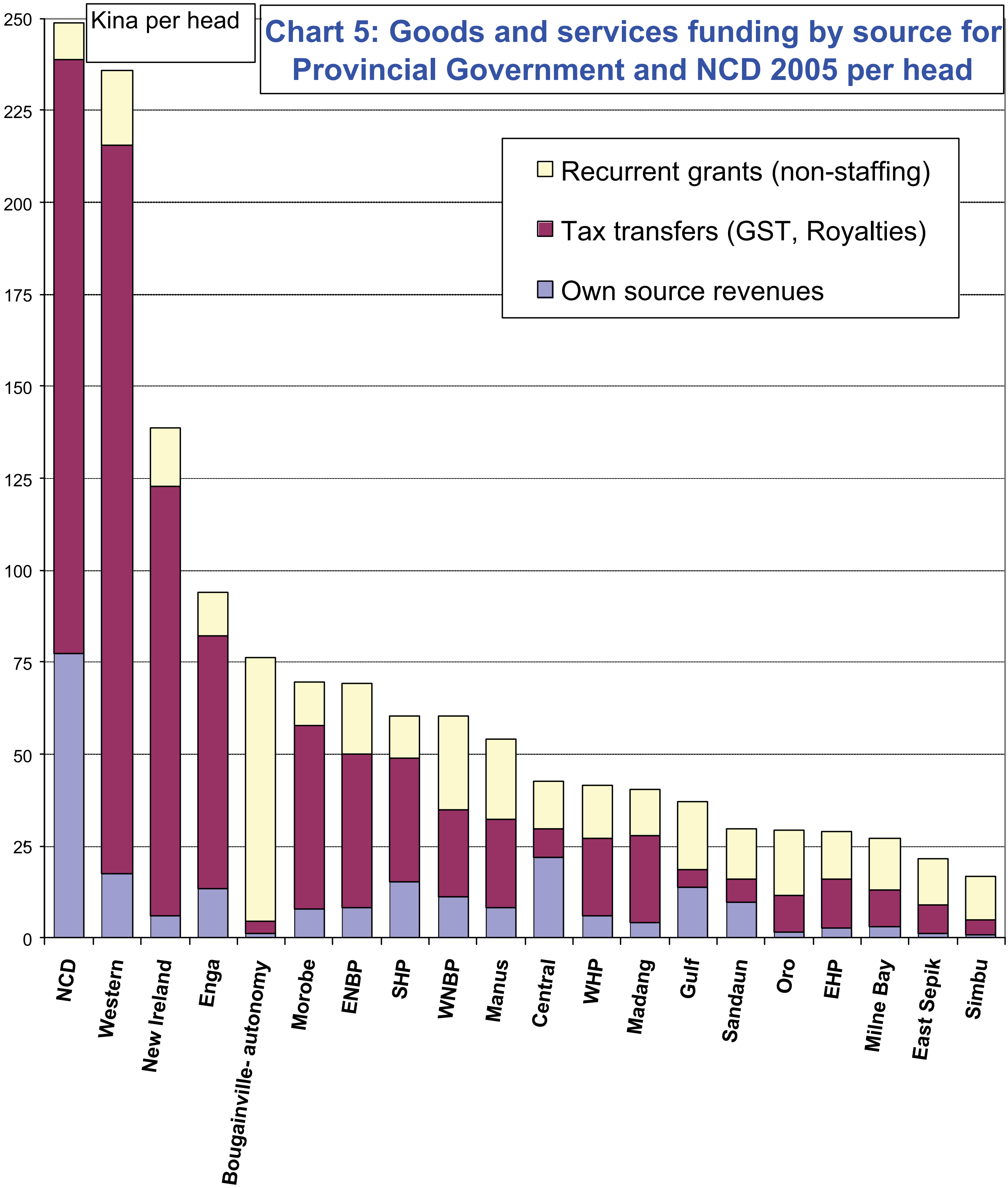

Kina per head
Chart 5: Goods and services funding by source for Provincial Government and NCD 2005 per head
Recurrent grants (non-staffing)
Tax transfers (GST, Royalties)
Own source revenues
250
225
200
175
150
125
100
75
50
25
0
NCD
Western
New Ireland
Enga
Bougainville- autonomy
Morobe
ENBP
SHP
WNBP
Manus
Central
WHP
Madang
Gulf
Sandaun
Oro
EHP
Milne Bay
East Sepik
Simbu

Chart 5 also indicates that the grants are distributed to all provinces, no matter what their particular circumstances or level of revenues are. This is because the grant formula distributes the majority of the grants on an equal kina per head basis [8] (see Box 2).

Box 2: Inequity in the current system

Current funding provisions	
Gulf	*New Ireland*
• Population 110,000	• Population 110,000
• Land area 51,000 square km	• Land area 9,000 square km
Current *Organic Law* grants:	Current *Organic Law* grants:
• Pop x K20 per head = K2.2 million	• Pop x K20 per head = K2.2 million
• Land x K20 per head = K1 million	• Land x K20 per head = K0.08 million
GST, royalties and internal revenue = K2 million	GST, royalties and internal revenue = K15 million
TOTAL = K5.2 million	TOTAL = K18 million

Factors affecting cost of service delivery	
Gulf	*New Ireland*
• Highly dispersed population • Swampy terrain • Many areas accessed only by river or walking • 90% of people live more than 4 hours from major service centre	• Small land area • Some island populations • Two roads along length of main island • 50% of people live more than 4 hours from major service centre

Source: *Rural Development Handbook*

It does not take into account all sources of provincial revenues or provincial costs of providing services. When other (non-grant) revenues are considered, the overall distribution of resources bears no relation at all to the actual cost of service delivery. In other words, the current formula does not target the fiscal gap (by considering revenues and costs), so fails at equalisation.

Chart 5 also demonstrates that the inequity between provinces is so great that many provinces have no hope of meeting service delivery standards with their existing revenues.

8 The formula does include land area, which tries to take account of the additional costs of delivering services across large regions. However, the land area weighting is less than 10%. In addition, land area is not the best approximation for cost variation in different districts.

The resources that provinces get through the GST transfers and royalties are public monies under the *Public Finances Management Act.* It is appropriate to take them into account in calculating the grants they should receive.

> *Principle 6: All resources, recurrent and development, received by Provinces and Local-Level Governments are public funds. They should therefore be taken into account in calculating what transfers they should receive from the National government.*

Why can't Provinces raise more revenue to fill the fiscal gap?

It is sometimes suggested that provinces should increase their own taxation, in order to make up the funding they lack to pay for services. The NEFC has undertaken a study of provincial revenue-raising, and it is clear that the tax base of most provinces is very narrow, and the potential to generate significant additional revenue is small. As Chart 5 shows, local revenues are the smallest striped sections. It can be seen that these are relatively insignificant in most provinces.

Some provinces have a much weaker capacity to raise their own revenue than others (there are many reasons for this). Therefore some provinces have a bigger gap between what they have, and what they need, than others. Local revenue collection on its own will not solve intergovernmental financing problems.

However, tax collection by sub-national governments is still very important because it generates accountability to constituents and helps enforce laws. Citizens are more likely to hold a provincial or local government accountable for service delivery (or non-delivery) if they have paid taxes.

> *Principle 7: Provinces should be assisted to maximize their locally-generated revenues.*

Part 4: The transfer pool

Filling the fiscal gaps…

If own source revenues are too low to meet all the fiscal gaps, how do you fill the gaps?

In most provinces, it is likely that the costs of service delivery (to our equal national standard) will be substantially more than the revenues that each province receives from its own taxes and from transfers of national taxation. This is where the national government comes in. In most systems of decentralization, the national or federal government helps lower governments to meet their expenditure responsibilities by giving them grants or transfers to top up their revenue.

The usual way to arrange this assistance is by having a **transfer pool** at the national level. Each province, district or LLG would receive a share of the pool based on a sharing formula that takes into account all revenues and costs. This involves four steps as can be seen in Diagram 3.

Diagram 3: Working out the size of the transfer pool

STEP 1

Determine expenditure responsibilities
OUTPUT: List of functions/ activities/ services/ that provinces and LLGs are responsible for

STEP 2

Work out how much those responsibilities cost
OUTPUT: Cost (Kina) for each province/ district/ sector

STEP 3

Find out how much revenue provinces have to pay for these costs
OUTPUT: Revenue forecasts for each province

The difference between these two is the FISCAL GAP - how much extra each province needs in transfers (grants)

STEP 4

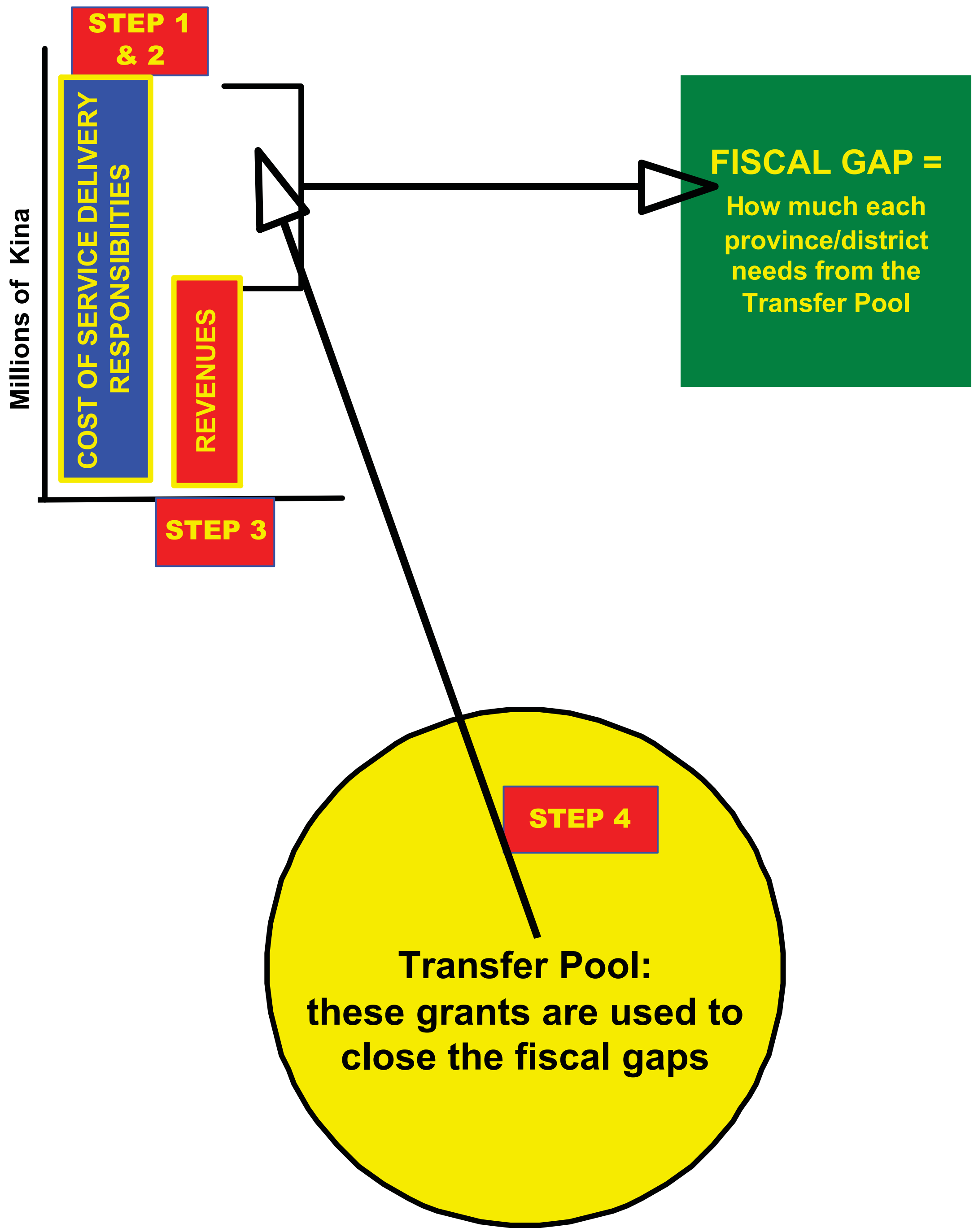
Create a service delivery transfer pool to close the fiscal gap
OUTPUT: Recommended grant(s) for each province

A transfer pool is a sum of money set aside in the budget to be used for transfers (grants) to lower levels of government. PNG already has an existing transfer pool that the National Government uses to fund the non-salary recurrent *Organic Law* grants to provinces and NCD. The current value of this is K82 million in 2005 (Chart 5).

At present, these grants are distributed on the basis of population and land area. They do not take into account a province's revenues or differing costs of service delivery.

The NEFC is proposing that these grants should be instead distributed on a formula that takes into account revenues and costs of service delivery. The aim of the distribution of this pool is to fill the fiscal gaps. Diagram 7 explains how the new distribution from the transfer pool would work.

Diagram 4: Explaining the distribution from the transfer pool



As we saw earlier, the difference between the costs and the revenues is called the fiscal gap. Ideally, the transfer pool should be large enough to close the fiscal gap in all provinces, so that all provinces can meet the costs of service delivery.

The existing transfer pool may not be big enough to fund adequate service delivery by all provinces. However, even if we distributed the existing transfer pool according to the actual cost of delivering services, this would be a major improvement on the current system.

However, this approach will fall short of addressing the problems of deteriorating service delivery. Fundamentally, if only a few provinces continue to take most of the pig, then service delivery will continue to get worse.

Principle 8: Ideally, the transfer pool should be large enough to meet this need (the gap between revenues and costs) in all provinces.

Is the transfer pool big enough?

At this stage, the NEFC considers it unlikely that the existing pool is large enough to meet all provinces' needs (i.e. the fiscal gaps).

The NEFC is undertaking a large study to determine the cost of Provincial and District service delivery. When this is completed in August 2005, we will know exactly how much each province needs, and how big the fiscal gap is for each province. Based on the NEFC's work so far, it is estimated that the total need may be around K300 million. The existing pool is around K80m.

If the transfer pool is not enough to meet the fiscal gap in all provinces, what should happen?

What to do if the transfer pool is not big enough?

This is likely to be the main topic of debate around the design of the new system. Indeed, the main purpose of this consultation paper is to raise these issues for discussion.

There are two broad approaches to deal with this problem:

1. Reduce provincial costs of service delivery by:

(a) shifting responsibility for some functions to the national government
(b) reducing the overall standard or range of services that provinces are expected to provide.

2. Increase the amount of revenue in the Transfer Pool to fund these costs by:

(a) moving some or all of the Provincial Inland GST share
(b) moving some or all of the mining and oil royalties[9]
(c) moving staffing grants for public servants and teachers
(d) moving **some** of the infrastructure and development resources (Tax Credits, Public Investment Program grants, Special Support Grants)
(e) the National Government increasing its contribution to the Transfer Pool.

These measures are not mutually exclusive. Combinations of one or all of them could be used. These approaches would sensibly be phased in over time.

The paper now discusses each of these approaches.

[9] Of the shares being transferred to Provinces, not landowners' shares.

Reducing provincial costs of service delivery

One way to *reduce* the cost burden of provincial service delivery would be to shift costs to the national government. Some aspects of provincial service delivery cost (for example, education subsidies, drug distribution, school book distribution or provincial road maintenance) would be made a national responsibility.

That would lower the costs that provincial governments are expected to meet, but grants would also have to be decreased to allow the National Government to fund these additional responsibilities.

Another way to reduce costs is to lower service delivery standards. For example, if the standard for health services assumes that there will be four immunization patrols per year, this could be reduced to two. A variation on this approach would be to close some facilities – for example, aid posts and elementary schools. This would reduce the overall costs of supervision and operating costs.

We are not suggesting that service delivery is currently extravagant, but these kinds of cuts are already occurring—but in the worse possible way. Instead of closing some facilities, we are giving each facility so little that none of them can operate properly. There would be a more open, transparent, and planned approach to achieving cost reductions.

Increasing the size of the transfer pool

Earlier we identified five possible ways to increase the transfer pool.

a) Some or all of the Provincial inland GST share into the pool

The pool could be more than doubled if all of inland GST presently transferred to provinces on a derivation basis were included.

However, securing a consensus to pool revenues that provinces currently regard as theirs will not be easy.

(b) Moving some or all of the mining and oil royalties

If K73 million in royalties were put in the pool, it would be nearly twice the size as the existing grant pool available for goods and services.

There is a long history of provincial entitlement to royalties – it will be politically very difficult to achieve consensus on pooling these to use for equalisation purposes. Derivation based sharing arrangements are deeply rooted in PNG.

However, the *Constitution* says "*natural resources should be used for the benefit of us all*". Virtually all of the royalties retained by the state are transferred to only four Provincial Governments.

At present, Provincial Governments do not meet much of the cost of hosting large resource projects – nearly all of the infrastructure and other costs are paid for by the National Government.

Despite relatively high levels of funding, the natural resource-rich provinces show low levels of development, rank poorly on social indicators and have suffered governance problems.

(c) Moving staffing grants for public servants and teachers

The National Government will spend about K520m on staffing grants to pay provincial public servants, teachers and village court officials – this is about one and a half times the amount available for goods and services.

Ideally, it is appropriate that staffing grants are calculated as part of the transfer pool. Provinces would be funded through a single recurrent grant to cover staffing, and goods and services. The advantage of this is that provinces would have a clear incentive to control and manage staff costs, since any savings could be pocketed as goods and services grants.

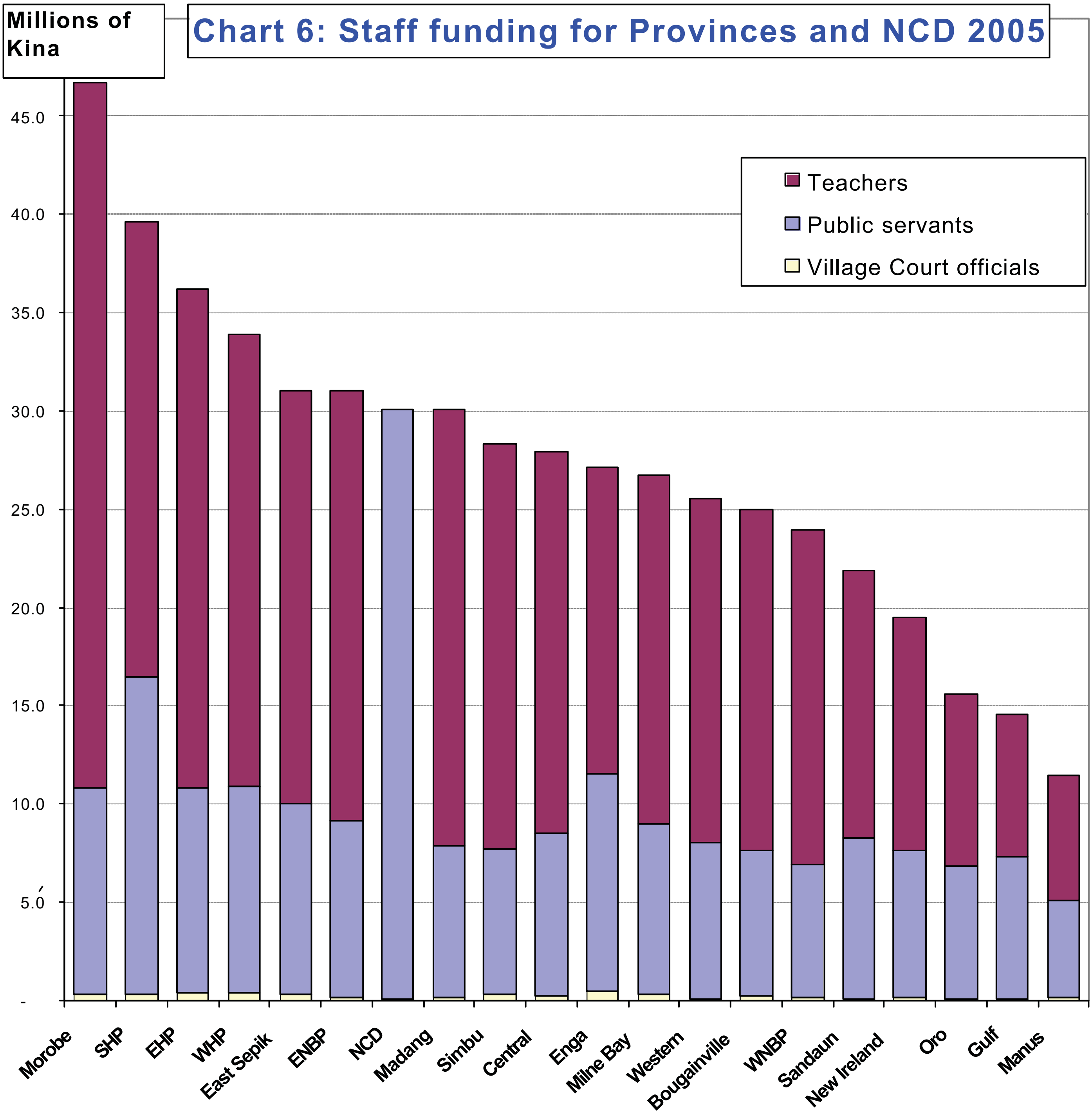
However, it is the National Government that ultimately determines the level of staffing in each province:

- the Department of Personnel Management, approves or disapproves changes to the organizational structures for each Provincial and District Administration; and
- the Department of Education who approves any new government schools.

Once a given staffing structure or new schools are approved, provinces are not able to reduce staffing levels and convert this into funds for goods and services.

Chart 6 below shows the spending on public servants and teachers in each province and the NCD[10].

[10] NCD does not pay for teachers, but spends about K30 million on its public servants.



There are observable disparities in the allocation of staff between provinces. It is true that provinces with bigger populations, more districts and bigger land areas tend to spend more in total on staff. Indeed the highest staff spending is in the four most populated provinces – Morobe, Southern Highlands, Eastern Highlands and Western Highlands.

However, with simple analysis that separates public servants and teachers, large disparities appear. For example, Southern Highlands and Morobe have almost identical populations (about 540,000) and similar number of districts yet:

- Southern Highlands' public servants cost 53% more than Morobe's
- Morobe's teachers cost 55% more than Southern Highlands'

Ideally, there should be a benchmark for an appropriate staff structure (number and grades) for each function of provincial governments that the staffing grants would fund. At present, the disparities present suggest that staffing levels, and therefore levels of service delivery possible, vary between provinces.

There has been some useful work done on public sector reform. For example, the *Rightsizing exercise* is undertaking a review that aims to restructure the public sector to ensure the efficient and effective delivery of services by returning agencies to their core functions.

This, and other, work could usefully inform the setting of an appropriate benchmark level of grants for public servants and teachers, more closely related to needs. Then if a province chose to have an above average level of public servants, then their goods and services grants could be reduced.

For the time being, staffing grants should be dealt with separately from the goods and services grants and not included in the transfer pool. There is also a practical reason for this - it is hard to shift funding from staffing to goods and services quickly. Retrenching staff can be costly and take a long time to implement.

(d) Moving some of the infrastructure and development resources (Tax Credits, Public Investment Program grants, Special Support Grants)

Infrastructure grants are usually for large capital projects that are carried on over a long time. For example, building new roads, schools and health centres. Recurrent grants are used to fund ongoing operational costs, such as school text books, teachers and fuel for vehicles. Since recurrent and infrastructure funding is very different they should be calculated separately.

At the moment there are three main grants for infrastructure and development received by provinces:

- tax credit scheme
- public investment program grants
- special support grants

Since these grants are used for large capital projects that are carried on over a long time they should remain separate and should not be put into the transfer pool.

e) The National Government increasing its contribution to the Transfer Pool

The National Government could increase the size of the pool by adding in additional revenues (eg, the rest of inland GST). However, it would then have to reduce its own expenditures. This reduction will most likely impact national agencies good and services spending, such as police and national health programs.

Alternatively, the National Government could increase the size of the pool by raising tax rates. For example, GST could be raised to 12½%. However, raising taxes is usually not very popular and have a negative impact on the economy.

Principle 9: The transfer pool should be increased by including some or all of the:

- provincial and NCD inland GST revenue; and
- mining and oil royalties.

If neither of these sources are available for the pool, other ways should be found to make it larger.

The transfer pool should not include:
- staffing grants; and
- infrastructure and development grants.

Keeping the transfer pool affordable

Since 1996, the Organic Law grants have become increasingly unaffordable. If these grants were paid according to the *Organic Law*, the National Government would have to shut down half of Waigani. This is because the grants were set in Kina terms, with no relationship to the National Government's revenue growth and debt servicing commitments. For example, the National Government was required to pay the same amount in grants to provinces despite weak revenue growth and a heavy debt servicing burden during the 2000-02 recession.

The NEFC proposes that the size of the transfer pool should be set as some proportion of National Government revenues (after debt servicing and other essentials). This will ensure that the pool remains affordable for the National Government. In addition, it will provide better certainty for Provinces regarding the size of the pool.

> *Principle 10: The size of the transfer pool should be based on a share of the total National revenues, after its debt servicing and other essential commitments. It should not be a fixed Kina per head amount.*

Part 5: Other issues

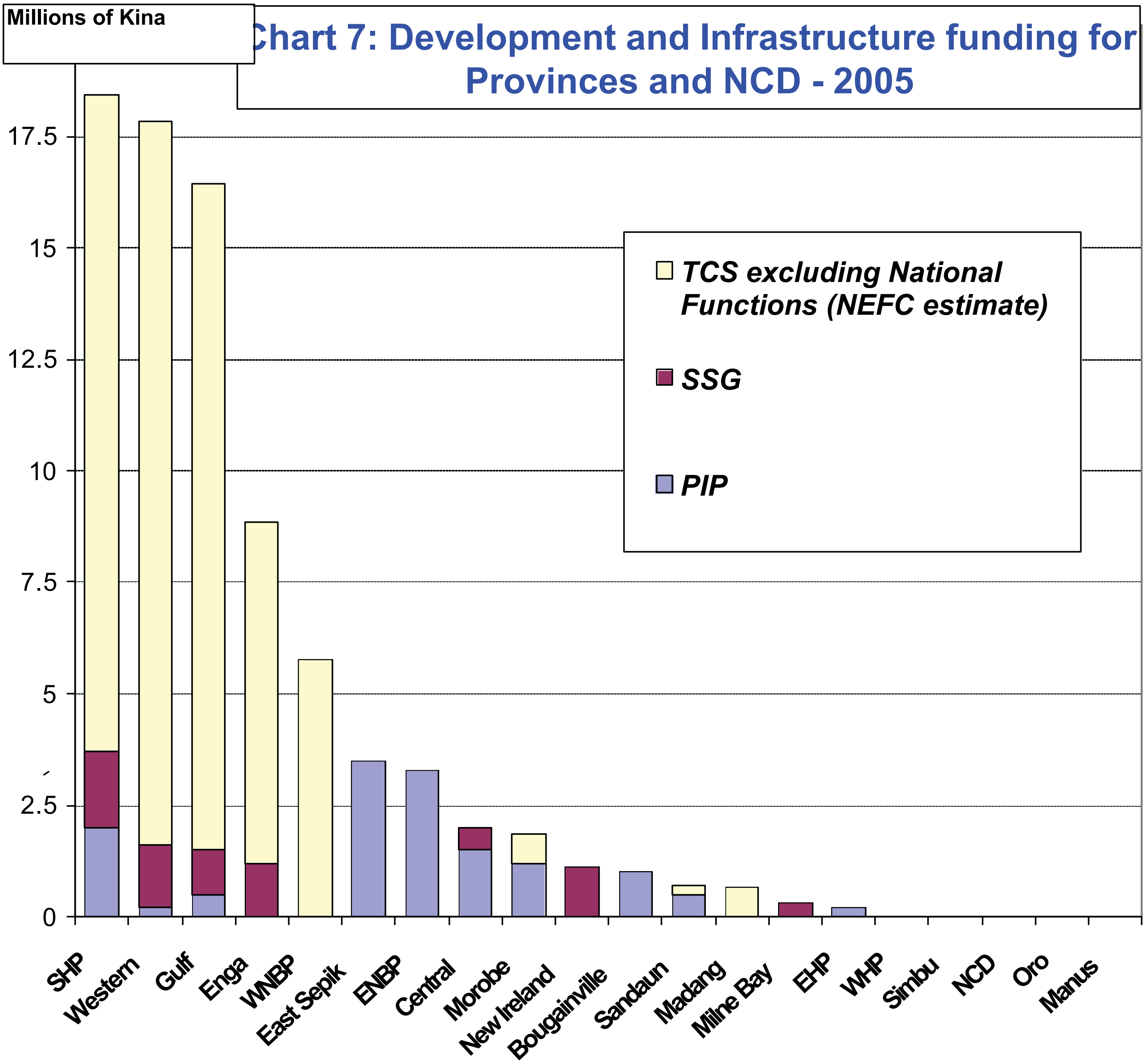
Infrastructure and development funding

Infrastructure grants are usually for large capital projects that are carried on over a long time. For example, building new roads, schools and health centres. Whilst recurrent grants are used to fund on going operational costs, such as school text books, teachers and fuel for vehicles. Since recurrent and infrastructure funding is very different they should be calculated separately.

At the moment infrastructure and development grants are concentrated in only a small number of Provinces and districts. Chart 7 shows the distribution in 2005 of:

- tax credit scheme not on national functions [11](TCS);
- special support grants (SSG); and
- public investment program grants (PIP).

[11] This mainly excludes Highlands Highway expenditures, since this is a national government function (NEFC estimates).



Three-quarters of the total funding is spent in only four Provinces. This is because TCS and SSG are spent only in Provinces hosting a mining or oil project. PIP grants are only a small proportion of funding, leaving some Provinces without any infrastructure grants.

Without adequate infrastructure it is difficult for a Province to develop. The most developed districts in PNG have more infrastructure in working order than the undeveloped regions.

Infrastructure grants can play an important role in reducing these differences between the most and least developed districts over time, if they are distributed on the basis of needs. The size of the grant should ideally be linked to the cost of the new infrastructure facility or project. In addition, to encourage local ownership and especially maintenance of the new facility, it is sensible to ask lower governments for a matching contribution, even if this is small.

Tax Credits and SSG account for over 80% of these grants. They are not targeted on needs, but rather are focused on resource rich regions. There is no link between these grants and the actual costs of infrastructure, since they are determined by the profits of the resource development.

That said, it must be recognized that hosting a resource project does place strains on existing infrastructure. Those Provinces facing additional costs associated with the project should be entitled to infrastructure grants to offset any additional costs.

Principle 11: A better way to distribute infrastructure and development funding is on the basis of need. The size of infrastructure grants should be related to the cost of the facility.

Local-level Governments

Local-Level government is responsible for providing a number of services, for example maintaining elementary schools and aid posts, ward supervision and village court co ordination.

However, most Local-Level governments do not have adequate capacity or funding to carry out these activities. Local-Level governments have few staff. They often operate in remote areas without access to telephones or computers.

*Principle 12: Local level governments should be adequately funded to perform the activities they are **capable** of performing.*

Bougainville and scope for increased autonomy in some provinces

The National Parliament has enacted an *Organic Law* covering the establishment, operation and funding of a new Autonomous Bougainville Government. This takes Bougainville completely outside the framework which governs all the other provinces in relation to funding.

Principle 13: Bougainville will continue to be covered by separate financing arrangements from the other provinces.

However, the new Bougainville arrangements (which came into operation in June 2005) are likely to have a profound impact on the other provinces. Already, East New Britain has submitted comprehensive proposals for increased taxing powers and increased functional responsibilities, as well as a different political structure.

While issues of political structure are outside the scope of this Review, it is important that the new system should be sufficiently flexible to accommodate political changes. The new system should be able to accommodate any changes in the responsibilities of Provinces. This is because distributions from the transfer pool will be based on the Provinces revenues and the cost of its responsibilities.

Principle 14: The distributions from the transfer pool should be flexible enough to allow increased functions (and funding) to be transferred to and from provinces.

The National Capital District

The operation of the nation's capital involves very different activities compared to Provinces and urban Local-level Governments. People from all across PNG use the services of the NCD. It is the largest urban center in the country.

However, the NCD provides very few of the same services, like agricultural extension, aid posts and schools. In the NCD, health and education services are funded through the relevant national Departments. The NCD maintains a large road network, storm water drains, rubbish collection and provides other community services.

It is not possible to work out its funding in the same way as Provinces and districts as their responsibilities are unique.

Principle 15: The NCDC should be funded on a unique basis suited to its unique functions.

District and Provincial Development Grants

The District and Provincial Development grants will remain unchanged. The District and Provincial grant shall continue to be allocated as follows:

- half of the amount for projects selected by the Joint District/Provincial Planning and Budget Priorities Committee from projects in the approved District/Provincial Plan; and
- half the amount paid to the applicable Member to be used in accordance with the District/Provincial Development Grant Guidelines.

Finding ways to reward success

Provinces in PNG are at very different stages of development. One of the reasons why provincial governments argue that they should be able to keep their GST and royalty revenues, is as a reward for generating revenue for the nation as a whole.

Where provincial governments have genuinely contributed to increasing economic growth with their policies and expenditure programs, it is fair that they should be rewarded for this. The new system should try to accommodate this objective, as well as the objective of sharing resources among all provinces equally according to their needs.

Principle 16: The new system should strike a balance between bringing all provinces up to the same level (on the one hand) and encouraging those that are succeeding (on the other).

Conclusion

The current intergovernmental financing arrangements have contributed to declining services, poor maintenance of infrastructure and worsening education, health and economic participation indicators. It is not an option to leave the system as it is. The only solution is to put in place an alternative system that aims to address these problems.

At the very least, it is essential that the distribution criteria for the grants changes to take account of actual costs and revenues. The current distribution method has resulted in gross disparities between provinces. However, as the grants are relatively small, it is likely that there will only be marginal improvement in service delivery in the majority of districts.

To achieve a significant improvement in service delivery, it will be necessary to include all, or a substantial portion of the Provincial inland GST and royalties into the *Transfer Pool*, or find other ways to make it larger.

The NEFC welcomes any comments on the proposed system and its principles. Please address your comments to

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LIST OF TERMS

Derivation: money is returned to the province that it came from.

Development funding: funding to pay for new infrastructure or capital items for example, new roads and new schools.

Equalization: money is shared on the basis of service delivery *needs*.

Equalization of services: means that each district should be able to undertake a similar level of service delivery.

For example, if there was equalisation of services, each provincial administration would be able to deliver the same level service:

- 4 (or 2) immunization patrols per year
- half (or one-quarter) of its roads maintained
- all farmers (or half of the farmers) would receive extension services.

Fiscal gap: the difference between the cost of delivering services and the revenues that Provinces have to pay for these services.

Intergovernmental financing: is the way money is shared between the three levels of government.

Transfers/grants: An amount of money that the National government gives to the Provincial government.

Transfer pool: A sum of money set aside in the budget to be used for transfers (grants) to lower levels of government.

Recurrent funding: funding to pay for ongoing or operational costs for example, school text books, teachers, and maintaining roads.