NATIONAL ECONOMIC & FISCAL COMMISSION

INFORMATION PAPER:

2005 Derivation Grant

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National Economic and Fiscal Commission

Under the present set of intergovernmental financial arrangements, the Derivation Grant is a recurrent conditional grant that is transferred by the National Government to Provincial Governments. This paper provides some background on the data sources and methods for the Derivation Grants appropriated in the 2005 National Budget.

Derivation Grant – a history

The Derivation Grant (DG) is a conditional economic grant that the National Government has been legally bound to transfer to Provincial Governments, under the original Organic Law on Provincial Governments (OLPG – 1977 to 1995) and its successor, the Organic Law on Provincial and Local Level Governments (OLPLLG – 1996 to present). The DG has been paid as some ratio of the value of exports originating from a Province, under several formulas.

Derivation Grant – 1977 to 1995

In 1977, only Bougainville was directly deriving a share of the taxation and other revenue its copper exports generated for the National Government. This was through National Government transfers of royalties, which were levied at the rate of 1.25% of the value of the Pangua mine's exports. The DG was introduced in the 1977 Budget, to be paid only on exports not already attracting royalty payments. The rate was set at **1.25% of the free-on-board[1] value of eligible exports** from a province in the previous year. The main purpose of the DG was to offer an incentive for stronger export performance. This was achieved by paying the grant against the value of exports, and restricting its use to stimulating export generating activities.

Products that the National Government was already transferring royalties against, including exports of minerals, oil, natural gas, timber and marine resources, were excluded in calculating the DG payment. In addition, exports containing more than 70% imported inputs were also excluded from the DG calculations. For processed products, the export value-added from each province involved in the production process was to be apportioned to it.

Derivation Grant - 1996 to 2003

In 1996, the new Organic Law on Provincial Governments and Local Level Governments (OLPLLG) was implemented. The OLPLLG introduced a new method for calculating the DG payment. Under Schedule 6 of the OLPLLG, the rate paid on the free-on-board value of eligible exports **would not exceed 5 percent**. Exclusions continued on goods attracting royalty payments, development levies and any other National Government grants. However, royalty payments were no longer deducted from DG payments. The definition of eligible exports also excluded:

- Goods comprising or including imported components where the value attributable to those components **exceeded 70% of the export value**;
- Goods exported as passenger baggage or personal effects;
- Ships or aircraft stores for the use of the vessel or aircraft on which they were exported; and
- Imported goods not released from bond for re-export.

[1] The free-on-board export price is the port price, excluding insurance and freight costs.

In practice, the “would not exceed 5%” clause specified in the OLPLLG has caused great confusion. In many instances, this has been misinterpreted as meaning that 5% would always be paid. In reality, the National Government has only been able to afford an appropriation significantly less than 5%, at around ½% to 1% of eligible exports in recent years. For example, actual DG paid was K10.7 million in 2002, and K10.3 million in 2003.

The conditionality associated with the DG remained broadly unchanged under the OLPLLG. This means that provinces were required to expend the grant exclusively for promoting the exports of their primary and secondary industries.

Derivation Grant arrangements 2004 and 2005

In 2004 and 2005, DG has been calculated at a fixed rate, **0.75% of the free-on-board value of eligible exports**. This fixed rate is close to the actual rate that the National Government has been able to afford, in practice, between 1996 and 2003. The return to a fixed rate has two aims: firstly, to provide more certainty to Provincial Governments about the amount they will receive than the “not exceeding 5%” regime has provided; and secondly, to ensure that the DG is affordable for the National Government, since the grant has no direct funding source[2].

Logs have been included as eligible exports, as there are now insignificant royalty payments received by Provincial Governments on this commodity. In addition, the import content of processed products must now be **less than 40%**, down from the 70% used previously. These are the only changes to eligible export commodities for DG payments from 2004.

2005 Derivation Grant: Data sources and methods

For the 2005 Budget calculations, actual export data from 2003 is used, as this is the most recent full year of export data. Table 1 below provides a summary of the total eligible exports and resultant DG payments for each province. The commodities that have been used to calculate DG are a range of agricultural tree and other crops, logs, eligible marine resources and some processed products. The total value of eligible exports was about **K1.57 billion**. Applying the fixed 0.75% rate gives total DG payments of **K11.8 million**, which has been appropriated in the 2005 Budget. The value of exports in 2003 was slightly lower than 2002, since the Kina increased in value by about 7%. The volume of exports was broadly unchanged.

[2] The National Government funds Derivation Grants out of general revenues, such as income and corporate taxes. It does not receive direct revenue from exports, but only the taxes that exporting companies and workers pay. Exporters themselves do not keep all export revenue, but only the profits and wages. There are no export taxes (except for logs) that directly fund the DG. In contrast, mining and oil exports have export taxes, that the National Government transfers to provinces under the the Memoranda of Agreements for mining/oil projects.

Appendix 1 contains more detailed data showing total eligible exports by commodity, value and Province of origin.

Table 1: Eligible exports and 2005 Derivation Grant appropriation

	Eligible export value (2003 actual exports, Kina)	Derivation Grants at 0.75% of export value (Kina)
Western	129,706,134	972,796
Gulf	73,868,434	554,013
Central	23,848,951	178,867
Milne Bay	75,553,113	566,648
Oro	96,194,218	721,457
Southern Highlands	4,607,000	34,553
Enga	11,056,000	82,920
Western Highlands	177,347,247	1,330,104
Simbu	15,048,000	112,860
Eastern Highlands	89,059,000	667,943
Morobe	36,727,081	275,453
Madang	56,011,634	420,087
East Sepik	23,316,844	174,876
Sandaun	40,228,099	301,711
Manus	9,750,020	73,125
New Ireland	68,407,438	513,056
East New Britain	222,214,184	1,666,606
West New Britain	335,208,139	2,514,061
Bougainville	81,379,059	610,343
TOTALS	**1,569,530,595**	**11,771,479**

Data sources

DG grant calculations require nationally consistent, comparable, accurate and reliable sources of data. The NEFC is generally unable to rely on data that has been produced by individual provinces, since these are typically assembled using different assumptions and methods and may not be comparable across all provinces. The OLPLLG requires NEFC to include export commodities only where it is satisfied that all provinces' exports of a particular commodity have been counted and the origin determined. The NEFC prefers to use the export data provided by a relevant industry body, that provides a consistent and comparable record of the exports of a particular commodity across Papua New Guinea.

For 2005, NEFC has used 2003 actual (as the most recent available year) export data from the following sources:

- **Coffee**: Exports by province as measured by the Coffee Industry Corporation and valued at the free-on-board price.

- **Cocoa**: Exports by province as measured by the Cocoa Board and valued at the free-on-board price.
- **Copra**: Exports by province as measured by Kokonas Indastri Koporesen and valued at the major port price.
- **Corpa Oil:** Exports by province as measured by the value of copra oil exports from each mill less the value of domestic use copra purchased. Exports are valued at free-on-board prices. Data are provided by each mill.
- **Palm Oil:** Exports by province as measured by palm oil exports from each mill and valued at the free-on-board price. Data are provided by each mill for the various types of palm oil (crude palm oil, palm kennel oil and palm kennel extract).
- **Rubber:** Exports by province measured by the Department of Agriculture and Livestock and valued at the free-on-board price.
- **Logs:** Exports by province as measured by SGS PNG (Societe Generale de Surveillance) and valued at the free-on-board price.
- **Tea:** Exports by province as measured by WR Carpenter's, the only tea growing estate, and valued at the free-on-board price.
- **Marine Products:** Exports by province as measured by the National Fisheries Authority and valued at free-on-board prices.

The key data sources for primary products are the major export commodity boards, which collate export data from the various registered processors/factories and exporters. The Department of Agriculture and Livestock (statistics section) also collects data for some export products, using the same methodology. The NEFC cross-checks the two sources for accuracy, however, it primarily relies on the data of commodity boards as this is typically more complete and timely. The Bank of PNG (BPNG) has aggregated data for the major export commodities, which the NEFC has cross checked, to ensure that DG calculations are capturing all, or nearly all, eligible exports. The NEFC is confident that the 2005 DG calculations have been made on the basis of complete and robust export data.

Data methods

Treatment of exports by smallholders and small export crops

There is limited information regarding the points of production and export for some DG commodities, making the allocation of export earnings to the right province difficult. For example, a significant portion of the agricultural export crops are accounted for by smallholder farmers with no official geographically matchable record of their transactions, nor are systems necessarily in place to record the origin of their production. So there is a risk that some smallholder production could be misallocated. A further complication is that provinces with smaller ports that do not ship exports directly overseas may not be credited with DG on an export basis. A similar problem arises in according coffee production to its origin, since many smallholders sell their produce directly to processors that travel the Highlands Highway. For these reasons, the NEFC apportions the major agricultural exports on the basis of production patterns, not export patterns. Production patterns are a very close approximation for export patterns, since around 98% of the value of agricultural tree crop production is exported.

Treatment of processed goods and secondary industries

Determining the value added to exports by processors requires apportionment between the province in which the input commodity was produced, and the province where processing occurred. This involves apportioning: the purchases of primary inputs deducted from the processing industry's export earning, to determine the value-added. Essentially, this prevents double counting the input commodity.

One example is copra produced in province A and shipped to Province B for processing into copra oil and then export. NEFC would deduct raw copra purchases from the copra oil exports for Province B (and only credit it with the value-added proportion of the export), and credit the purchases to Province A, to calculate the DG. In practice for 2005, NEFC has derived value added portions in three large downstream industries – tuna canning, copra oil and palm oil.

Treatment of migratory species

The Organic Law on Provincial Boundaries defines the land and sea boundaries of provinces. Under this law, all 14 coastal provinces have significant sea areas. Determining the province of origin of migratory marine species for DG transfers is very difficult, since they are known to travel throughout the waters of PNG. The OLPLLG stipulates that where the origin of a commodity "cannot be determined", no DG will be payable. Therefore, following advice from the National Fisheries Authority (NFA) about the migratory pattern of tuna, NEFC has excluded migratory species of undeterminable origin from the 2005 DG calculations.

For secondary industries where migratory species are an input, such as the RD tuna canning plant in Madang, NEFC has counted the intermediate processing component as an eligible export for DG payments, as outlined in the section above.

Treatment of marine resources exported from the NCD

Under the Organic Law on Provincial Boundaries, NCD does not have a sea area, being thoroughly surrounded by Central Province[3]. Additionally, NCD is not a province under the OLPLLG, therefore is not entitled to receive DG transfers. However, a significant proportion of marine resources are exported from Port Moresby, because it is the best equipped export processing facility in the Southern Region. NFA has advised NEFC on how to reallocate these exports to their respective origins in Western Province, Gulf Province and Central Province. The two exported species reallocated are non-migratory: prawn and crab.

Commodities not included in the 2005 DG

There are a range of export commodities on which the Commission is unable to recommend a DG distribution. These include vanilla, pyrethrum, chilli, crocodile skins,

[3] Fisherman's Island is part of NCD, however the surrounding sea area remains part of Central Province.

artifacts, fruit wine and others. Unfortunately, there are no nationally consistent or reliable data sources for these products to determine their province of origin. With the exception of vanilla, the Bank of Papua New Guinea data suggests that the value of these exports is low, meaning their inclusion would not make a large difference to the DG calculations and payments to any provinces.

Vanilla

The NEFC is aware that Vanilla is a significant crop. However, consistent data is not yet available that allows the province of origin to be determined. As all exporters and buyers have now been licensed, province-by-province vanilla export data can be collated. The PNG Spice Board has indicated that such data is likely to be available during 2005.

Appendices

There is a range of information regarding DG in the appendices:

- APPENDIX 1: 2005 DG export data by province and commodity
- APPENDIX 2: Contact details for commodity boards and other data sources.

For further information about 2005 Derivation Grant calculations, please contact the NEFC:

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Waigani NCD
Ph: 328 8411 or 328 8434
Fax: 328 8526
Email: jacob_ekinye@treasury.gov.pg
http://www.nefc.gov.pg

References

Axline, W.A, *Financial foundations of Provincial policy making in Papua New Guinea,* ANU Centre for Research on Federal Financial Relations Research Monograph No. 45, Canberra, 1986

Bonney, N, *The politics and finance of Provincial Government in Papua New Guinea,* ANU Centre for Research on Federal Financial Relations Research Monograph No. 43, Canberra, 1986

Ghai, Regan, *The Law, Politics and Administration of Decentralisation,* NRI, Port Moresby, 1990

Simonelli, A, *1986 Derivation Grant Payments,* Report to the Department of Finance, 1986

APPENDIX 1

2005 DERIVATION GRANT ELIGIBLE EXPORTS

(2003 actual export data used - Kina)

SOUTHERN REGION

Western Province	
	Export value
Marine Resources	18,733,354
Rubber	1,100,000
Logs	109,872,779
TOTAL	**129,706,133**
Gulf	
	Export value
Copra	22,772
Marine Resources	10,424,471
Rubber	100,000
Logs	63,321,191
TOTAL	**73,868,434**
Central	
	Export value
Copra	61,787
Marine Resources	344,628
Rubber	10,700,000
Logs	12,742,536
TOTAL	**23,848,951**
Milne Bay	
	Export value
Cocoa	32,020
Copra	460,698
Palm Oil	59,754,110
Marine Resources	12,086,704
Logs	3,219,581
TOTAL	**75,553,113**
Oro	
	Export value
Cocoa	6,525,676
Copra	28,335
Palm Oil	88,601,766
Marine Resources	538,486
Logs	499,955
TOTAL	**96,194,218**

2005 DERIVATION GRANT ELIGIBLE EXPORTS

(2003 actual export data used - Kina)

HIGHLANDS	
Eastern Highlands	
	Export value
Coffee	89,059,000
TOTAL	**89,059,000**
Western Highlands	
	Export value
Coffee	160,306,000
Tea	17,041,247
TOTAL	**177,347,247**
Simbu	
	Export value
Coffee	15,048,000
TOTAL	**15,048,000**
Enga	
	Export value
Coffee	11,056,000
TOTAL	**11,056,000**
Southern Highlands	
	Export value
Coffee	4,607,000
TOTAL	**4,607,000**

2005 DERIVATION GRANT ELIGIBLE EXPORTS

(2003 actual export data used - Kina)

MOMASE		
Morobe		
	Export value	
Coffee	24,875,000	
Cocoa	7,409,428	
Copra	249,671	
Marine Resources	1,404,109	
Logs	2,788,873	
TOTAL	**36,727,081**	
Madang		
	Export value	
Coffee	307,000	
Cocoa	28,452,972	
Copra	259,611	
Copra Oil	6,937,241	
Marine Resources	17,260,084	
Logs	2,794,726	
TOTAL	**56,011,634**	
East Sepik		
	Export value	
Coffee	1,536,000	
Cocoa	21,075,564	
Copra	297,959	
Marine Resources	7,321	
Rubber	400,000	
TOTAL	**23,316,844**	
Sandaun		
	Export value	
Cocoa	3,835,996	
Copra	97,614	
Logs	36,294,489	
TOTAL	**40,228,099**	

2005 DERIVATION GRANT ELIGIBLE EXPORTS

(2003 actual export data used - Kina)

ISLANDS	
Manus	
	Export value
Cocoa	64,040
Copra	127,877
Marine Resources	1,477,491
Logs	8,080,612
TOTAL	**9,750,020**
New Ireland	
	Export value
Cocoa	7,627,164
Copra	6,527,243
Palm Oil	45,797,494
Marine Resources	4,038,651
Logs	4,416,886
TOTAL	**68,407,438**
East New Britain	
	Export value
Cocoa	108,355,680
Copra	27,467,165
Marine Resources	1,702,870
Copra Oil	31,661,529
Logs	53,026,940
TOTAL	**222,214,184**
West New Britain	
	Export value
Cocoa	5,014,332
Copra	1,482,580
Palm Oil	255,504,413
Marine Resources	708,603
Logs	72,498,211
TOTAL	**335,208,139**
Bougainville	
	Export value
Cocoa	73,806,100
Copra	6,296,837
Marine Resources	1,276,122
TOTAL	**81,379,059**

APPENDIX 2

Contact details for export data sources

Cocoa Board of PNG
Post Office Box 532
RABAUL
East New Britain Province

Coffee Industry Corporation Ltd
Post Office Box 137
GOROKA
Eastern Highlands

W. R. Carpenter & Co Estates (Tea)
Post Office Box 94
MT HAGEN
Western Highlands

National Fisheries Authority
Post Office Box 2016
PORT MORESBY
National Capital District

Coconut Products
Post Office Box 94
RABAUL
East New Britain Province

Kokonas Industri Koporesen
Post Office Box 81
PORT MORESBY
National Capital District

Copra Marketing Board
Post Office Box 81
PORT MORESBY
National Capital District

PNG Rubber Industry
Department of Agriculture & Livestock
Post Office Box 417
KONEDOBU
NCD

SGS PNG Ltd (Logs)
Post Office Box 1260
PORT MORESBY
NCD

Oil Palm Industry Corporation
Post Office Box 3216
BOROKO
National Capital District