Review of Intergovernmental Financial Arrangements

SCOPE OF THE REVIEW: DISCUSSION PAPER

April 2002

Introduction

In November 2001, the Government announced that it would undertake a Review of Intergovernmental Financial Arrangements. The Review has been prompted in part by the preparation of the 2002 Budget. In handing down the Budget, the Prime Minister observed that the current financial obligations under the Organic Law on Provincial and Local-level Government 'threaten the future fiscal stability of the country, because they are unrealistic and unsustainable.' The Budget policy papers indicated that the Review would seek to 'determine an appropriate mechanism for the calculation of provincial grants which addresses both discrepancies between development status and the fiscal capacities of provinces, while giving due regard to the constraints of overall public financial resources.'

The Review of Intergovernmental Financial Arrangements is being coordinated by the National Economic and Fiscal Commission. The NEFC is established under Section 187H of the Constitution and has a function to advise the NEC on intergovernmental financial arrangements.[1]

The purpose of this Discussion Paper is to outline the scope of the proposed Review, identify the issues to be taken up in the Review, and pose questions which the fact-finding phase of the Review will take up. It is hoped that the Discussion Paper will stimulate wide discussion among those with an interest in the Organic Law financial arrangements, to ensure that the Review covers all the relevant issues.

Submissions on the scope of the Review can be addressed to:

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Existing arrangements

The current system of decentralisation operates under the *Organic Law on Provincial Governments and Local level Governments.* The Organic Law established a two-tiered system of decentralised Government, comprising 19 Provincial Governments and 284 Local-level Governments.[2] It replaced the first system of decentralisation which had been in place since 1977.

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1 Section 17, *Organic Law on Provincial Governments and Local-level Governments*

2 260 rural local-level governments and 24 urban local-level governments.

National goals and directive principles

Papua New Guinea's Constitution sets out a series of national goals and directive principles which set an overall direction for all levels of government to follow:

1. Integral human development of every individual;
2. Equal opportunity to participate in development;
3. National sovereignty and self-reliance;
4. Natural resources to be used for the benefit of all;
5. Development through Papua New Guinean forms of social, political and economic organisation.

The Review needs to consider how the system of financial decentralisation currently contributes to the achievement of these aims, and whether it can be improved to do so more meaningfully.

Political and administrative structures

Under the new system, Provincial Governments are not an elected level of government. Instead, they are comprised of members elected to both National Parliament and Local-level Governments. This has important implications for principles of accountability, because there is no electorate to whom Provincial Governments are directly responsible. The Review needs to take account of how the political structures and administrative arrangements of the new system impact on intergovernmental financing arrangements.

Funding arrangements under the Organic Law

The Organic Law provides for Provincial Governments and Local-level Governments to be funded mainly by the National Parliament. The Law sets out a number of grants that should be paid each year to the sub-national governments. The grants are based on formulae set out in the Law itself. There are five broad groups of grants, each of which has quite a different basis:

(a) a **Staffing Grant**, which is based on the actual cost of salaries of some specified provincial staff;

(b) **Administration, Infrastructure and Local Government Grants**, each of which are based on either K15 or K20 per head of provincial population, plus a certain amount per hectare of provincial land area, and in some cases effective sea area as well;

(c) **Derivation and Special Support Grants** which are based on the value of certain types of provincial exports;

(d) **District Support Grant** which is fixed at a minimum of K500,000 per district;

(e) **Additional Conditional Grants** which are for horizontal equalisation purposes, to redress inequities between the provinces. There is also provision

to vary other grants in the case of provinces that are severely disadvantaged or excessively advantaged, but neither of these provisions has been used.[3]

Of these grants, only the Staffing and Additional Conditional Grants can legally be varied in amount, unless there is a serious down-turn in the national economy.[4] Because the Organic Law fixes the way the other grants are calculated, they cannot be changed without changing the Organic Law. This requires support by a two-thirds absolute majority of Parliament, in two votes taken at two separate sittings of Parliament.

Amount of the provincial grants

A major source of tension between the three levels of government has been the amount of funding transferred to Provincial Governments and Local-level Governments pursuant to these arrangements. The Organic Law mandates that amounts of K15 per head and K20 per square kilometre of land area for the Administration Grant, and amounts of K20 per head and K20 per square kilometre for the Provincial Infrastructure Grant, Town and Urban Services Grant and Local-level Government and Village Services Grant.

Since the commencement of the new arrangements in 1995, Provincial Governments and Local-level Governments have never been paid the full amount of the grants. The National Government has argued that it cannot afford these grants without compromising funding of national-level services, and Provincial Governments have argued that they cannot carry out their mandated functions without the level of funding provided for under the Organic Law. Legal action has been taken by at least one Province seeking to recover amounts under the Organic Law, but the National Government has relied upon provisions of the *Claims By and Against the State Act* and has not paid the amounts awarded by the National Court.

This is perhaps the most significant issue in the current arrangements and one which the Review should address comprehensively.

Financing in practice

In practice, the financing arrangements for Provincial and Local-level governments differ significantly from what is provided in the Organic Law. This was also the case with the old system of provincial government.[5]

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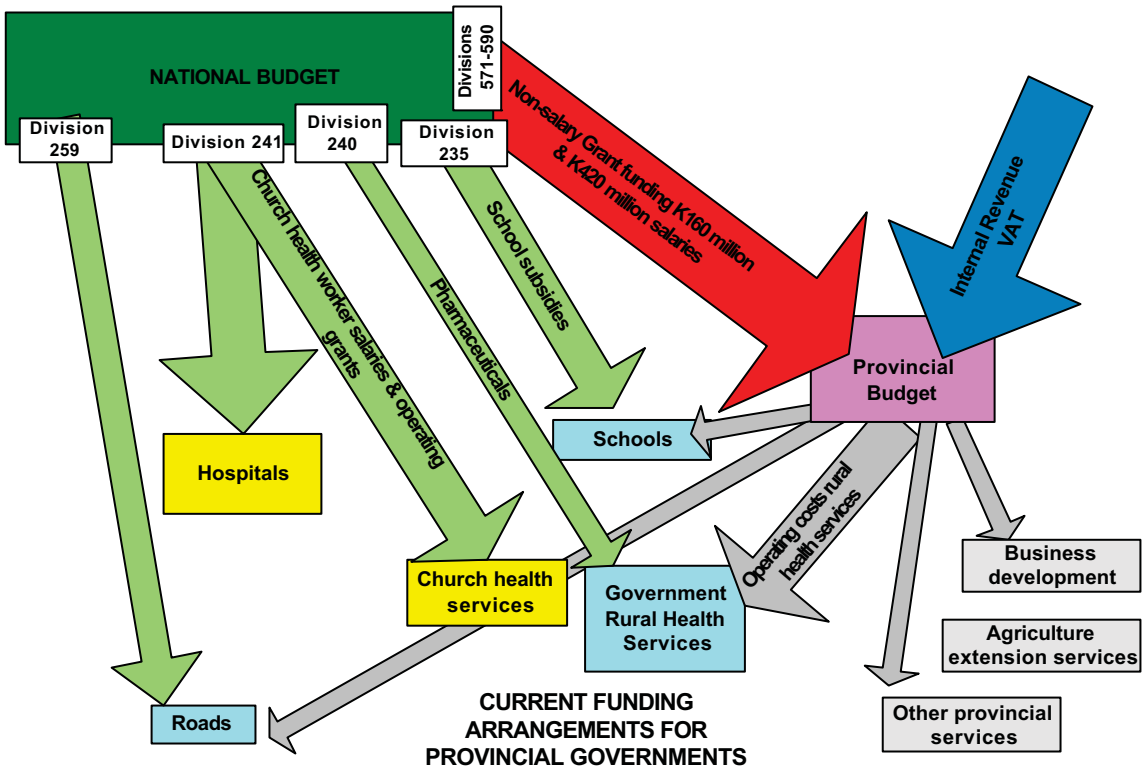
[3] Section 96 and Section 95(2).

[4] Schedule 1.2 provides that 'Where there is a serious down-turn in the national economy, the National Executive Council in consultation with the National Economic and Fiscal Commission shall determine the level of funding for the Provincial Governments and the Local-level Governments in accordance with the formula of the schedules.'

[5] Under that arrangement, much of the expenditure by provincial governments was effectively controlled by the National Government. This was done by allocating most of the provincial funding through 'Departments of the Province' in National budget votes 271-290. These votes specified in detail the purpose and type of expenditure in the same way as it is specified for other national departments. Only eight Provinces were 'fully financially responsible' and received a minimum unconditional grant (MUG) as set out in the old Organic Law on Provincial Government (less the cost of Public Service salaries). As a result, most provincial budgets dealt only with internal revenue spending and a very small amount of minimum unconditional grant.



The diagram above shows Organic Law grants in red (note it does not attempt to capture the contribution of local-level government financing, which varies significantly from province to province). Legally, all funding to Provincial Governments should be in the form of Organic Law grants, which are transferred as one line amounts and then re-appropriated by the Provincial Assembly through the provincial budget. However, a number of other funding arrangements not specified in the Organic Law are also used. These transfers from other parts of the National budget are shown in green. Provincial services that are jointly funded by National and provincial governments are shown in pale blue. The services in yellow are entirely funded by the National Government. Services funded entirely by Provincial Governments are in gray.

Bougainville funding

The funding arrangements for Bougainville are somewhat different. The Bougainville Provincial Government receives significant funding through the development budget. As part of the Bougainville Peace package, new financing arrangements have been agreed to, leading eventually to financial autonomy. Any redesign of the system of intergovernmental financing should take account of the long term implications of the Bougainville Peace agreement for the rest of the country. The National Executive

The allocation of money under Divisions 271-290 was done by negotiation between senior bureaucrats in the province and the Department of Finance. (These arrangements are discussed further below under 'Capacity').

Council indicated in its decision approving the Bougainville Agreement that it would consider claims by other Provinces for increased autonomy in line with the Bougainville arrangements, without committing itself to the full extent of the Bougainville autonomy provisions.

National Capital District arrangements

Arrangements for the National Capital District are different from those that apply to other provinces, for a number of reasons. NCD was to have been made a province under the new Organic Law, which provides for the NCD to become a province upon the gazetting of a notice by the Head of State, acting in accordance with the advice of the Minister for Provincial Affairs.[6] However, the NCD has remained governed by an ordinary Act of Parliament and has not become a province.

Despite this the NCD is treated in many respects as if it were a province. Local-level governments are established in each of the three electorates, and there is a Joint District Planning and Budget Priorities Committee in each. This gives the MPs for the NCD access to a 'District Support Grant' like other MPs.

Funding arrangements for NCD are also different to those of other provinces. Around half the VAT collected and remitted back to provinces in the country, goes to the NCD. This means first that the NCD is disproportionately wealthy in comparison with other provinces. However, for what may be historical reasons, some of the services provided in the NCD are paid for by National Government Departments. For example, the National Department of Health in 2002 has budgeted K1.8 million for NCD health services. In 2001 the NCD budgeted to spend only K710,000 on health, of which K300,000 was for capital expenditure.

The location of the NCD within Central Province also has an important impact on that province's financing too. Because Central Province does not have an urban centre of its own, the NCD captures VAT which would otherwise go to the Central Provincial Government. This has been the subject of intergovernmental resource-sharing agreements between the two governments, but these have not entirely resolved the problem. The Review should consider what an appropriate basis for sharing revenue between the NCD and Central Provincial Government should be.

Issues:

- *how have the two systems of decentralisation differed in practice from the way they were described in the laws that created them?*
- *what are the strengths and weaknesses of each system?*
- *what have been the impediments to fully implementing the current system of decentralisation?*

[6] In has been argued that it would not be possible to create the NCD as a province simply by gazetting it as such, because the NCD is established as a *district* rather than a *province.* The Organic Law on Provincial Boundaries (which provides that PNG is divided into 19 provinces, and describes their geographic boundaries) would need to be amended. It has also been argued that the Organic Law on the Boundaries of the National Capital District establishes the NCD as a *district*.

- *how do the political institutions and administrative arrangements of the current system of decentralisation affect the way financial arrangements are designed?*
- *how will the financial arrangements agreed as part of the Bougainville Peace negotiations affect the broader system of intergovernmental financing in the future?*

The Constitutional Development Commission is currently undertaking a broader review of the Organic Law on Provincial Governments and Local-level Governments and the Review should seek to draw on its work.

Core principles

This Discussion Paper proposes that the reformed financial arrangements should be directed toward seven key principles:

(1) They should be **affordable,** but provide provincial governments with **reasonable certainty about funding** so that they can plan for the future development of the province.

(2) They should ensure that funds are directed toward core priorities for **improving the quality of life** of all Papua New Guineans.

(3) There should be **adequate accountability** to ensure money is spent properly.

(4) The system should attempt, as far as possible, to **address inequity in levels of development** between different provinces, taking into account the need to also foster the efforts of those provinces that are successfully achieving economic growth and so contributing to the wealth of the country as a whole.

(5) The **differences in capacity of provincial administrations** between different provinces should be taken into account.

(6) They should **maximise the involvement of people in their own development**.

(7) There should be **incentives for greater self-reliance** and to encourage citizens to work toward development.

These issues are discussed further below in the context of how the financing arrangements currently operate.

Affordability with certainty

The old Organic Law arrangements provided provincial governments with some level of certainty about the funding they would receive, because the Minimum Unconditional Grant was based on the cost of transferred services. However, this formula tended to 'lock in' large variations in levels of development. Those provinces with extensive service delivery networks in 1976 continued to receive higher levels of funding.

Under the new arrangements, there has been an attempt to make the basis of the funding fairer to all provinces, by basing the grant formulae on population, land and sea area, regardless of the cost of service delivery in the province.

As national revenue has declined in real terms, there is a perception by the National Government that the grants set out in the Organic Law have become unaffordable. Since 1995, the National Government has not paid the Organic Law grants to provincial and local-level governments at the full rate set out in the Organic Law. The rise in population figures revealed by the 2002 census has meant that this year the level of grant funding dictated by the Organic Law is even higher.

The issue of affordability begs the question about affordability of what. As indicated above, some provincial services are currently funded from other parts of the national budget. It may be possible for the National Government to pay the full amount of the grants if it discontinued direct funding for hospitals, church rural health services, schools and other services.

The level of grant funding to lower levels of government needs to be seen in the overall context of total sources of revenue, and as a component of all the resources flowing to the sub-national level. However, it is also important that Provincial Governments have some level of certainty about their funding so that they can plan to implement programs that will span several years.

Organic Law funding to provincial governments

The bulk of the funds transferred to sub-national government are in the form of grants to pay staff.[7] In 2002, provinces are budgeted to receive around K421 million in salary grants and K161 million in non-salary grants.[8] If the Organic Law were complied with, provinces should have received approximately K380 million in non-salary grants, bringing the total level of provincial and local-level grants or 2002 to around K800 million. In fact, as is discussed above, there is funding for the services delivered by provincial and local-level governments from several other sources apart from the Organic Law Grants.

In order to determine the proper levels of funding to provincial and local-level governments, the Review should seek to determine:

(a) **what is the total 'resource cake' available to all levels of government**,

(b) **how that resource cake is currently divided up through transfers of all kinds**—Organic Law grants, VAT distribution, assignment of other taxation powers, assignment of the right to receive other revenues (eg., royalties and licence fees) and 'in kind' transfers;

(c) **what is an appropriate basis for determining the distribution of resources between National, provincial and local-level governments.**

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[7] In fact, although Staffing Grants are appropriated through provincial budgets, they are actually administered centrally, through a national payroll system.

[8] K133 million through Divisions 271-290 of the recurrent budget, K38 million through the development budget. Project aid and aid to Bougainville are excluded from these figures.

National context of payments to sub-national government

Transfers to lower levels of government need to be seen in the context of all the funds available to government in PNG, and what they are currently used for. The National Budget for 2002 appropriates a total of K4.27 billion. Of this, K1.16 billion is appropriated under the Development Budget.

A substantial proportion of the Development budget is 'in kind' support from donors in the form of technical assistance and procurement of services, capital works and supplies. This is not revenue that can be converted into cash transfers. However, it is still important because it involves a transfer to provincial government of benefits which are due to the National Government under its arrangements with different donors. Around K165 million in the Development Budget does go directly to Provincial Governments. The main transfers are District Support Grant (non-discretionary)[9] (K27 million), Special Support Grant for mining and petroleum provinces (K11 million) and K122 million to Bougainville..

The Recurrent Budget for 2002 appropriates the remaining K3.11 billion. Of that, 38% goes in servicing public debt (K1.17 billion). Of the remaining K1.9 billion

- 29% goes in Provincial and Local-level Government grants (K.55 billion);
- 71% goes to recurrent services funded through the National budget (K1.38 billion).[10]

National spending on provincial services

In addition to what is transferred to Provincial Governments in the form of grants, some of the basic services delivered at provincial level are funded by the National Government. For example, out of the K1.4 billion recurrent budget allocated through National Departments, the following funding for provincial services is included:

- K92 million for operation of provincial hospitals and church health services[11];
- K28 million for purchase of pharmaceutical supplies distributed throughout the country[12];
- K135 million for education subsidies;
- K9.9 million for provincial Treasuries[13];

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9 Also referred to as Rural Development Fund. In the 2001 budget this amounted to K1.5 million per district, of which K500,000 per district was a 'non-discretionary' grant (that is, it is guaranteed by the Organic Law). This non-discretionary component is paid through the Development Budget in 2002.

10 In fact, there is some recurrent funding paid through the Development Budget, so this figure is not quite accurate.

11 Division 241 provides funding for all provincial hospitals and both the salaries of church health workers and the operating grants for church health centres. Port Moresby General Hospital and Laloki Psychiatric Hospital are not included in this figure.

12 This is an estimated figure. K6.2 million is included in recurrent vote 240 and the remaining funds are under development vote 240 (HSSP), though not specified to be applied to pharmaceutical purchases. Under once-off arrangements with the Australian Government, donor funds will support the bulk of pharmaceutical purchase in 2002. Last year the National Government allocation to pharmaceutical procurement was K34 million.

13 Division 227

- K1.9 million for health services in the NCD.

Some of these allocations fund services which are decentralised, while others fund activities which have always been understood as national responsibilities.

The Development budget also includes some allocations to services at provincial level, including K138 million for provincial road construction and upgrading, and some specific allocations to particular provinces.

The Review needs to look carefully at these resource flows in order to understand the total picture of what is being funded and by whom.

Derivation grant

A derivation grant has been common to both the old system of intergovernmental financing and the new one. Derivation grant is payable on the export value of goods but excludes goods on which royalty is paid.[14] The new Organic Law provides for derivation grant to be paid at a rate 'not exceeding 5%', but does not specify how the rate should be determined.

Provincial Governments complain that they are receiving significantly less in Derivation Grant than they did under the old system, and that there is substantial underestimation of the value of their exports. In addition, there are long-standing issues about the apportionment of exports to the province of origin where they are actually exported from another province. For example, there is apparently no derivation grant paid to Gulf Province in respect of its substantial marine products production. There have been longstanding disputes between the National and Provincial Governments over the calculation of derivation grant since the early 1980s. The Review should examine why these problems are so difficult to resolve and what might be done about them.

Other sources of provincial revenue

National grant transfers should also be seen in the context of other revenue flows to provincial and local-level governments, which make up part of the total source of public sector funds. This includes non-grant revenue which provincial governments receive in the form of:

- VAT transferred from the National Government;
- other taxes collected;
- licence fees collected;
- proceeds from investments including equity in mining and petroleum projects;
- mining royalty transfers.

Some local-level governments also receive substantial locally-collected revenue, although it is far from clear what sources this comes from. None of these amounts appears in the National budget. Provincial and local-level governments also receive

[14] Section 97; Schedule 6 New Organic Law.

some 'in kind' transfers through the tax credit scheme, which also do not appear in either national or provincial budgets.

It is estimated that provincial governments collected around K270 million in internal revenue in 2001.[15] However, there is no readily available source of information about precisely how much is collected. Some provincial governments may not be collecting as much revenue as they could, because enabling legislation required under the Organic Law has not been passed. Accurate and comprehensive data is needed to assess the revenue-raising potential at sub-national level. The Review should seek to highlight any other available sources of revenue that might be available.

Value-added tax

Value-added tax is probably the second most contentious aspect of the current financing arrangements between the Provincial and National levels of government.

Under both the old system of decentralisation, and the *Organic Law on Provincial Governments and Local-level Governments*, provincial governments were assigned the power to collect tax on retail sales. This tax represented the largest single source of internal revenue to most provincial governments, but the existence of so many different tax systems with different rates was a major economic inefficiency. The new Organic Law was subsequently amended to give the National Government concurrent power to impose the same tax. It has also been argued by the IRC that Provincial Governments cannot lawfully collect taxes until the National Government passes an enabling law.[16]

In 1999, the National Government commenced collecting a value-added tax (VAT) under an arrangement with the provinces whereby they agreed not to collect retail sales tax. Under this arrangement, VAT is collected by the Internal Revenue Commission and around one-third of it is remitted back to provincial governments. Provinces are guaranteed to receive at least what they collected in 1999 as a minimum remittance.

Most provincial governments now complain that they do not earn as much from VAT as they might have done from retail sales tax, even though they are guaranteed to receive not less than they collected in retail sales tax in the year before VAT commenced. It is argued by the IRC that some provinces in fact receive more in remittances than is actually collected, because of the minimum guaranteed by the *VAT Distribution Act*.

It is also asserted by Provincial Governments that the NCD receives a disproportionate amount of VAT, since around half the VAT remitted back to provinces goes to the NCD. It is said that VAT record keeping arrangements are resulting in sales that actually take place in other provinces being recorded as taking

[15] No accurate figures are available for 2001, but this figure is arrived at by using the *lesser* of either the actual collection in 2000 as detailed in the provincial accounts, or the estimate set out in the 2001 provincial budget.

[16] Section 86(2)

place in Port Moresby. Cross-border issues were important in the old retail sales tax arrangements also, but may be even more significant under the VAT arrangements.

It will be important for the Review to examine the VAT arrangements closely, because they have such a significant impact on intergovernmental transfers and on horizontal equalisation issues.

Resource development revenue flows

There are significant revenue flows to provincial governments and local-level governments as a result of mining and petroleum projects. In the 2002 budget, Provincial Governments which host mining and oil projects are allocated K7.3 million in Special Support grant (SSG) and mining agreement payments, while local-level governments and development authorities will receive K3.9 million.

In addition, there are transfers of royalties for some projects, and some provincial governments hold equity in resource development projects that generate dividends. In all mining and petroleum provinces the Tax Credit Scheme provides for resource developers to construct infrastructure and offset the construction costs against company tax liabilities. This amounts to a net transfer of those costs from the National Government to the province, since the infrastructure is ultimately paid for by the National Government in tax foregone. The total amount of these 'off-budget' transfers needs to be fully ascertained.

Section 98 of the Organic Law provides for landowners to receive benefits from resource development projects. Section 98 appears to have been drafted without taking account of existing arrangements under the Memoranda of Agreement (MOA) for the mining and petroleum projects, which set out the division of resource benefits between National, Provincial, and Local-level Governments, and landowners. Its provisions fit more closely arrangements in the forestry sector, where provincial governments now no longer receive resource benefit transfers.[17] The Review needs to address the framework for distribution of resource development benefits, because this is an important source of revenue to some provincial governments.

Issues:

- *what have been the trends in resource transfers between national and provincial and local levels since 1995?*
- *did the new system of decentralisation result in significant changes to the resource flows from national sub-national levels?*
- *how are services at provincial and local levels currently being financed?*
- *what basic principles should apply to the division of fiscal resources between national and lower levels of government?*

[17] Under the old Organic Law on Provincial Government, provincial governments were entitled to transfers of the equivalent of timber royalties collected in the province, less the costs of collection and payments to landowners (usually 25% of royalties collected).

- *how can an adequate level of funding to provincial and local-level governments be guaranteed, without unduly constraining the National Government's management of macro economic policy?*
- *how should year to year levels of funding to provincial governments be determined?*
- *how should internal revenue and benefits from resource development projects be addressed in the system of inter-governmental financing?*
- *is the framework for distribution of benefits from resource development in Section 98 appropriate?*
- *what is the impact of the current VAT arrangements on intergovernmental transfers, and on the ability of the National Government to fund transfers to provincial governments? Should there be any changes to VAT administration arrangements?*
- *how effective is internal revenue collection by provincial governments? How can administration of internal revenue by be improved?*

Matching funding to priorities

Provincial governments now have much more discretion over how they spend the funds transferred to them than they did before 1995. Most of the money spent by provincial administrations is allocated through the provincial budget, rather than the National budget as was the case before. The only conditions attaching to the National Government grants relate to equal spending in the social and economic sectors. However, it appears to be difficult to monitor whether these conditions are complied with.

A major issue is that it is far from clear what was intended by the new Organic Law. At the national level, it is argued that lower levels of government are intended to carry out national development policies at the provincial and local level. However, the practical effect of the Organic Law is to make Provincial and Local-level Governments more autonomous than they previously were. This would suggest that the intention was to give them the freedom to formulate their own policies. This has major implications, because the National Government is attempting to set a national policy framework through the Medium Term Development Strategy. This strategy focuses particularly on exactly the kinds of services that are currently functions of Provincial and Local-level Governments: health, education, agriculture and roads.

The Review will need to consider how these confusions and contradictions in the current arrangements should be resolved.

Linking funding to service delivery

During the period immediately following the enactment of the new Organic Law, there was confusion about which level of government was responsible for funding which services. For example, Church health worker salaries and education subsidies for schools were no longer funded by the National government but provincial governments either did not accept responsibility for them either, or gave them a low priority in the issue of funds from the provincial accounts. As a consequence, from 1998 onwards special purpose grants were created to 'quarantine' the funding for these purposes. When this money is released to the provincial government, it carries a coding 'tag' which means that it should not be spent on another purpose. Some of this funding has now been recentralised altogether. In the 2002 budget all funding for church health services (both salaries and operating grants) and education subsidies are paid directly by National departments and do not pass through provincial governments at all.

Much of this confusion can be attributed to the de-linking of funding from functions. Provincial Governments complain that they have received transferred functions with no funding to deliver them. The National Government, on the other hand, complains that Provincial Governments do not carry out their mandated functions. Provincial Governments in turn also look to Local-level Governments for a contribution to service delivery, and both Provincial and Local-level Governments complain that they can not be expected to deliver mandated functions if they do not receive the mandated level of funding under the Organic Law. All of these problems can be resolved if the formula for funding is related b

Distribution of functions

The main reason for the confusion about which level of government should be paying for what is that there is confusion about the roles and functions of each. The Organic Law gives Provincial Assemblies power to make laws in certain areas, but these do not necessarily equate to administrative functions. The *Provincial Governments Administration Act* and the *Local-level Governments Administration Act* also provide lists of functions, but again they do not provide complete guidance about which of the portfolio of basic services provincial governments are responsible for. In addition, most essential services have always been jointly delivered. For delivery of education services, for example, curriculum materials and school inspectors are paid for by the National Department of Education, although education is primarily a decentralised function.

An attempt was made to delineate functions in 1996-1997 but it was never completed. Distributing functions was all the more difficult because at that point local-level governments had not been properly established and it was not clear what they would do.[18] Furthermore, the exercise did not involve matching the funding levels under the new Organic Law with the cost of delivering the functions that were determined to be a provincial responsibility.

[18] Handbook on Roles and Responsibilities of Different Levels of Government under the Reforms, March 1998. Note that for several agencies there is no clear description of the roles of provincial and local-level governments.

As noted above, there was an initial transfer of functions to provincial governments in 1996, in an attempt to match increased provincial funding with increased functions. In 1998 a number of national functions were also transferred to Provincial Governments without any corresponding transfer of additional funding. Some of these functions were funded by the respective provincial governments and some were not. In some cases, some national funding of these functions has been reinstituted.

Financial resources are not the only resources which are important for service delivery. Human resources are also critical. In 1996 a number of positions in National Departments were transferred to provincial administrations to accommodate the transfer of functions with which those staff were associated. The period from 1996 to 2001 has coincided with a series of down-sizing exercises which have reduced the numbers of staff at national and provincial levels. Provincial Governments have their staff ceilings set at the National level, so they are required to cut staff to fit within those budgetary and numerical ceilings. In some cases, this has reduced provincial capacity to carry out the transferred functions. The Review needs to determine clearly what functions were being performed by Provincial Governments in 1995, what further functions and staffing were transferred after 1995, and what financial and human resources are now associated with those functions.

Role of Local-level Government

The role of local-level government adds another dimension to the question of how to allocate functions according to service delivery responsibilities. Under the new system, Local-level governments are funded and supervised directly by the National Government, rather than by Provincial Governments as was the case before.

Local-level government is clearly intended to have a major role in service delivery under the new Organic Law, because such significant levels of funding are directed to them (around K35 million per year). However, they are permitted to have only six staff under the *Public Services (Management) Act*, and in fact only two staff positions are funded.

It is not clear what local governments are intended to do (or could actually manage to do) with only two staff. Although districts are the focus of service delivery, and the majority of public servants may now be at district level, they are part of the provincial administration and report ultimately to the provincial capital. Since local-level governments have their own bank accounts, there is no clear mechanism for local-level governments to fund the activities of these provincial staff working at district level. If it is intended that the majority of local-level government funds should be directed toward funding capital works constructed by private firms or local communities, then the question of their capacity to contract and supervise the execution of this work needs to be examined.

How is basic service delivery being funded

The most fundamental test of the new system of intergovernmental financing is whether it is facilitating the delivery of basic services—education, health care, roads

and basic maintenance—in rural areas. A critical issue for the Review will be to determine how basic service delivery is being funded at present and how the Organic Law arrangements impact on that. Since there are almost no nationally-controlled staff at provincial level engaged in delivery of basic services, service delivery outcomes depend largely on how provincial governments and local-level governments deploy their human and financial resources toward achieving them.

In order to understand what contribution provincial governments make to service delivery from their slice of the national resource cake, the Review needs to examine provincial budgets and expenditure and analyse them on a sectoral basis.

Recent work analysing provincial budgeting and expenditure on health services suggests that some provincial governments do not necessarily accord priority in the allocation of funds to the basic services which National planning processes like the Medium Term Development Strategy and the National Charter for Reconstruction and Development have identified as important. Other provincial governments are supporting these activities comparatively well, and have achieved improvements in outcomes as a result. It will be important for the Review to understand why that is the case. As alluded to above, the question of whether provincial governments should be required to conform to nationally-set policy priorities sets the context for this analysis.

Recurrent vs project expenditure

There appears to be a high level of spending on projects in provincial budgets, compared with spending on recurrent goods and services. One reason for this may be the conditions attaching to Organic Law grants. In the 2002 Budget, more than 80% of the non-salary grants (that is, the money that is not for salaries) is earmarked for 'development' spending.[19] This leaves little money available for the day-to-day running costs of provincial and district services, unless provincial governments use their non-grant revenue for this purpose.

While there is clearly a need for essential infrastructure to be replaced in some areas, basic service delivery relies most of all on recurrent funding for operational materials, public servants' travel, training and so on. It is also important to understand how new infrastructure creates demands for even greater levels of recurrent funding. Each new school, for example, generates a demand for ongoing recurrent funding of teacher salaries, leave fares, school books, utilities and maintenance. The Functional Review of the rural health sector found that that the cost of delivering minimum standard services[20] amounts to around K53 million, but allocations from provincial budgets amount to less than one quarter of this.

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[19] These figures take into account the following: Administration Grant, Town and Urban Services Grant, Derivation Grant, Local-level and Village Services Grant, Infrastructure Grant, Non-discretionary District Support Grant, Special Support Grant. All but the first three have development purposes specified in the Organic Law. It is not clear whether 'development' is used in its local context in the Organic Law—meaning capital or project spending rather than recurrent, or whether it is used in its broad development economic sense—meaning activities which contribute to national development and so includes the recurrent cost of activities like health and education services.

[20] Clinical services, disease control, family health, health education and facility operation.

In addition to the mandate in the Organic Law to focus on development expenditure, Provincial Governments face other hurdles in allocating funding to operational costs. The arrangements for budgeting through committees of political leaders (Joint District Planning and Budget Priorities Committees and Joint Provincial Planning and Budget Priorities Committees) create huge pressures for project spending to be favoured over recurrent public service operational costs. The Review should consider how provincial funding arrangements can be structured so as to mitigate these pressures if this is appropriate. It should consider whether any emphasis on project funding at provincial and district level is adequately supported through existing planning systems, and whether there is the capacity to implement projects at all levels of government and in all provinces.

Cost of the new system

Some analytical work done so far on provincial budgets suggests that the new system has high political and administrative overheads, as a result of increased numbers of elected representatives in the system, and the need for public service resources to be devoted to administration in a system which has more tiers than it previously did. The high cost of the earlier system was one of the stated reasons for replacing it, but analysis at the time suggested that less than 5% of the funds going to provincial governments under the old system was spent on the cost of the system itself. Analytical work should be undertaken by the Review to determine whether the new system is more or less costly than the old one.

Issues:

- *what services are currently being funded at each level of government, and are these funding levels realistic?*
- *how should functions be distributed between different levels of government, and how should adequate funding for those functions be assured?*
- *what should local-level governments be expected to do with the funding they receive, or should the basis for funding local-level government be changed?*
- *is the flow of funding to provincial and district level supporting the delivery of basic services?*
- *how have changes in the pattern of flows to sub-national level impacted on service delivery by provincial governments and other bodies responsible for delivering public services (for example, churches)?*
- *what information is available to suggest what level of funding is required to meet the costs of basic services?*
- *should functions be rationalised to refocus on priority services?*

- *what is the cost of the administrative and political aspects of the new system of decentralisation? How does this compare with the old system of decentralisation?*
- *should expenditure planning at either provincial or local levels of government be subject to any constraints or conditions? If so, how should they be framed, and how should compliance with them be monitored?*
- *what priorities—national or provincial, or what mix of each—should determine the way funds should be allocated?*
- *are the current conditions attaching to grants useful, and are they capable of being monitored?*
- *what economic criteria should determine the assignment of expenditure and revenues to each level of government?*

Service delivery by provincial governments is the focus of the Service Improvement Program, being implemented from 2002 onwards. Any examination of service delivery patterns and responsibilities undertaken for the purpose of the Review should link with this program.

Some analysis of provincial budgets for 2001 was done as part of the Health Functional and Expenditure Review in 2001. The Review proposes to build on that work for the other sectors.

Analysis of Provincial spending on health has been carried out under the Health Sector Development Program each year since 1996. This work is particularly useful because it provides the only national level aggregation of data on both spending of national grants and internal revenue. It could be expanded to cover all the other sectors in 2002, when 2001 expenditure data will be aggregated.

In addition, an expenditure tracking exercise in the education sector will be undertaken in 2002 by the National Research Institute. This work proposes to track a sample of allocations to schools to determine whether the full allocation at the centre actually reaches the schools for which it was intended. A broader cross-sectoral study of all spending by provincial governments needs to be undertaken in order to establish what proportion of funding actually reaches the basic services for which it is intended.

Accountability and intergovernmental relations

Under the Organic Law, Provincial Governments no longer have their own finance management laws and provisions for accountability to the Provincial Assembly. Instead, they are accountable to the National Government through the Minister for Provincial Government and Local-level Government Affairs and the Minister for Finance.

There are six mechanisms that allow the National Government to supervise provincial and local-level governments and which make them accountable to the National Government. First, **provincial and local-level governments can be suspended** if

they 'undermine the National Parliament or national unity'. A provisional suspension may be imposed by NEC and then confirmed by Parliament.[21]

Second, Section 51 of the Organic Law provides for a process of investigation and reporting where there is corruption, maladministration, poor financial management or a failure to meet the standards set by the National Government, which may be followed by **withdrawal of powers and funding by the NEC**. (This provision was ruled to be unconstitutional by the Supreme Court in October 2001.[22])

Third, some of the **grants to lower levels of government are subject to conditions**. The Infrastructure, Town and Urban Service and Local-level Government Grants are subject to grant conditions requiring them to be spent equally on social and economic development.[23] The Derivation Grant is required to be spent on promoting industry.[24] The Administration Grant is not permitted to be used for salaries.[25]

Legally, the only way this supervisory mechanism could be enforced is through the fourth mechanism, requiring **approval of draft provincial and local-level government budgets by the Minister for Finance**.[26] In practice, it seems that compliance with grant conditions is not monitored, and provincial budgets are not rejected if they do not comply.

Fifth, provincial governments and local level governments must **manage their finances and report in accordance with the *Public Finances (Management) Act***. Finally, there are **Organic Law reporting requirements**. Provincial and local-level governments must submit audited financial statements to the Ministers for Finance and Provincial Affairs. Half the funds due to the provincial government can be withheld if the statements are not submitted.

Supervision of local-level government

An important change which came about with the new system of decentralisation is that local-level governments are responsible directly to the National Government, instead of to Provincial Governments as was previously the case. The capacity of the National Government to undertake this supervision, particularly from Port Moresby, is questionable. Provincial Governors have lobbied at several meetings over the last six years to change these provisions so that local-level governments answer to Provincial Governments again.

The direct accountability of local-level government to the National Government has particular ramifications where the approval of budgets are concerned, and represents a major obstacle in the flow of funds. Local-level government budgets are required to

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21 Section 187E, Constitution.

22 In re Section 18 of the Constitution, Application by Anderson Agiru. SC 4 of 2000, SC 67, 8 October 2001

23 *Organic Law on Provincial Governments and Local-level Governments* Schedules 3.2, 4.2 and 5.2.

24 Schedule 6.6.

25 Schedule 2.2.

26 Section 141 *Organic Law on Provincial Governments and Local-level Governments*

be submitted to the National Minister for Finance for approval.[27] It is a large job for the Budgets Division in Department of Finance to scrutinise over 280 budgets. In some cases, the budgets are not approved until four or five months into the year, which means that the local-level government is starved of funds until that time. The Review should consider whether a more efficient form of accountability for local-level governments can be devised.

Transparency

Transparency is an important characteristic of accountable systems. There is now significantly less transparency concerning provincial finances than there was prior to 1995. Previously, provincial governments accounted for their internal revenue and grants according to their own provincial financial management legislation, and for funds received through Divisions 271-290 of the national budget in the same way as other Departments. This provided quite a detailed breakdown of spending by function and line item. Provincial financial statements provided a similar level of detail in relation to internal revenue. Now, the PNG Public Account reports expenditure of the provincial and local-level government grants as one-line amounts, and because of lack of agreement on format, provincial governments have only just begun to file their financial statements for the years since 1995.

Neither provincial budgets nor provincial financial reports are released publicly, unlike the National Budget and the Public Account. This means that there is little information available by which the performance of provincial governments might be assessed by voters in the province.

Government planning, budgeting and accounting system

The main reasons why there are not readily available reports on provincial expenditure relate to the government computerised accounting system, PGAS. The limitations of PGAS have been a major obstacle in implementing the Organic Law reforms. Because the national grant and internal revenue components of the provincial budget are accounted for in separate PGAS databases, it is difficult to get any clear picture of how provincial governments use the resources at their disposal.

There are also problems with provincial budgeting. Provincial budgets are presented in different formats which makes aggregation at the national level difficult. The primary division is by district, rather than sector, so it is difficult to get an accurate picture of spending on particular services. In addition, the number of steps involved in the budget cycle now that provincial and national budget processes are integrated rather than parallel, means that provincial government funding is usually not released until well into the financial year.

The Health Functional and Expenditure Review identified the difficulties in getting cash into districts as a major impediment to service delivery at the district level. Although service delivery functions are decentralised to the district level under the

[27] Section 141(4) provides that no provincial or local-level law relating to fiscal matters can take effect until it is approved by the Minister for finance matters.

Organic Law, the Government financial management system cannot easily deliver resources for service delivery to that level of government. Again the complexities of decentralising PGAS are a major obstacle.

In developing alternative arrangements for intergovernmental financing, the Review needs to take into account the limitations of existing financial management systems where those are not easily changed, or identify the implications of any changes that may be required.

Role of the NEFC and NMA

The National Economic and Fiscal Commission is established under the Constitution. It is independent of Government and has a role to provide policy advice to the Government on inter-governmental financing arrangements, and on the amount of grants. It also considers applications by sub-national governments for loans, and has powers to recommend on how to achieve equity in provincial funding, review public accounting practices, and carry out 'cost-benefit analyses' of natural resource developments. It has formal links to the NMA through its role to provide advice on planning and implementation systems of provincial governments, and it has a specific function to establish a gradation system for the purpose of ranking provinces according to their level of development. The Review should consider what the role of the NEFC under reformed arrangements should be.

Issues:

- *how can the system of public expenditure management be made more transparent?*
- *how can the difficulty of monitoring almost 300 local-level governments from the centre be addressed?*
- *what are the administrative obstacles to the decentralisation of financial management and how might they be overcome?*
- *what should be the role of the NEFC and how should it be formally linked to the NMA?*

The financial management and budgeting systems are being reformed under the Financial Management Improvement Program (FMIP). This program (which involves technical assistance provided by the ADB, UN and AusAID) will address some of the issues identified above.

Equity and disadvantage

Under the old Organic Law, minimum unconditional grant funding for provinces was calculated on the basis of the cost of delivering transferred functions in those provinces in 1976, indexed annually. This formula tended to favour provinces which were well developed at independence, and so it locked less-developed provinces into a low level of funding. This is one of the reasons why provinces did not complain about receiving funding in other (more tightly controlled) ways, through the National

budget divisions 271-290, because it allowed funding levels to increase at a greater rate than the MUG formula.

Although they are fairer than the MUG formula, the new Organic Law formulae produce unintended results in two other ways:

(1) The formula for Town and Urban Service grants for each province is based on the 2000 urban population, however, the formula for the rural LLG funding (the Village Services and Local-level Government grant) is based on the *whole* provincial population, including the urban population, but is distributed among LLGs representing only the rural population. In effect, the kina per head funding is higher for rural LLGs than for urban LLGs, which have much more significant services to maintain.

(2) Provinces with substantial coastal or island populations are intended to receive an additional 'weighting' in the grant formula by the inclusion of maritime area in the calculations. However, only provinces with populations of less than 100,000 are included in the definition of 'maritime provinces'. Since the 2000 census, Gulf Province has a population of 105,000, and so it no longer qualifies as a maritime province.

The new Organic Law grant formulae provide a more equitable basis for distribution of funding than the old system, because they are based on population and land area, rather than on past levels of funding. However, two other major sources of revenue distort these per capita distributions between provinces.

First, VAT accounts for K150 million in transfers to provinces, of which around half goes to the NCD. The distribution of VAT reflects the level of economic activity in the province, and so it favours the better-developed provinces. (There are other problems with VAT distribution, as noted above.) Second, the provinces in which there are mining and oil projects receive benefits that other provinces do not. The benefits from mining and petroleum are fairly substantial and so they provide a windfall source of funding for new activities which is not present in other provinces. This effectively creates two classes of provinces. It will be important for the Review to understand how provincial and local-level governments have used this additional revenue to further development in their provinces.

These observations highlight the issues about the extent to which the intergovernmental financing arrangements should reflect the different objectives of horizontal equalisation, on the one hand, and creating incentives for growth through funding based on derivation principles, on the other.

Issues:

- *what has been the overall impact of differential resource transfers to some provinces? Has it resulted in improved service delivery in those provinces? Are those provincial governments addressing new priorities?*
- *to what extent should achievement of horizontal equity be a goal of the intergovernmental financing arrangements?*

- *how can levels of disadvantage in some provinces be addressed in intergovernmental transfer arrangements?*
- *what does past experience with horizontal equalisation mechanisms suggest about the design of mechanisms in future?*

Some work undertaken on agriculture and health status in districts of PNG has recently been released (Papua New Guinea Rural Development Handbook, November 2001). It ranks the districts from most to least disadvantaged on an index that includes criteria relating to land potential, agricultural pressure, access to services, income from agriculture, and child malnutrition. The Department of National Planning and Monitoring is also undertaking a poverty assessment which will generate additional information about the development status of people living in different parts of PNG. The Review should seek to build on this work in developing a basis for horizontal equalisation, if that is an appropriate approach.

Capacity

As noted above, the old Organic Law arrangements involved a high degree of centralised control over the allocation of funding to the majority of provincial governments. Despite the legal requirement to pay provincial governments a Minimum Unconditional Grant, in fact most provinces received allocations under function and activity classifications set out in the National budget divisions 271-290. This mechanism allowed the Department of Finance to control the allocation of funds to different activities, the pace of release of funds to provincial governments, and to demand accountability for its expenditure, in the same way that it controls spending by national agencies.

These arrangements had originally been established early in the implementation of the first system of decentralisation, in the late 1970s. At that time few provincial governments had their own public finance and accounting laws, and so the National Government determined that until they did, they would be treated as entities within the National system of financial management. Only once provinces could establish that they had the machinery for local financial management and accountable, would they be declared 'fully financially responsible'.

The concept of full financial responsibility (FFR) became firmly entrenched in the old system of decentralisation. It was considered among bureaucrats and commentators at the time to reflect the reality of highly varying levels of capacity to be financiallly self-managing between different provinces. In 1991 the provinces collectively proposed a set of amendments to the old Organic Law which would have formalised and 'legalised' the FFR arrangements, and provided a system of gradually lessening the controls over provincial budgeting and accounting as they developed capacity.

By the time the old system of decentralisation was abolished in 1995, only eight provinces had achieved full financial responsibility. Ironically, the effect of the new Organic Law was to grant all of them full financial responsibility, irrespective of their

capacity. Subsequent allegations and investigations of financial management in some provinces suggest that there are still major variations in capacity and that it might be appropriate to apply a greater level of oversight and support to some provinces than others.

As presently drafted, the Organic Law financial arrangements use a 'one-size-fits-all' approach. Nevertheless, the Constitution envisaged the possibility of a graduated system of decentralisation.[28] If there is to be a system of graduated decentralisation, it is important that objective measures of capacity are used to distinguish between different rankings.

The issue of capacity raises a further question, how to balance the competing principles of equity on the one hand and capacity, on the other. It is likely that those provinces which should receive the greatest share of the 'development wedge' to help them overcome their disadvantage, will also be the least likely to have the capacity to manage large amounts of funding. A mechanism for channeling funds to those provinces which does not overtax their capacity needs to be devised.

Issues:

- *how should the variation in capacity between different levels of government be addressed?*
- *do the full financial responsibility arrangements have any use in a future system?*
- *what should be the criteria for measuring capacity in a graduated system of decentralisation?*
- *how should the lack of capacity in provinces which are likely to receive additional funding for horizontal equalisaiton be addressed?*

[28] Section 187G of the Constitution provides: Nothing in any law is inconsistent with this Part so far as it provides for the full status, powers or functions of Provincial Governments and Local-level Governments to be acquired by a Provincial Government and a Local-level Government in stages, or provides for a gradation of Provincial Governments and Local-level Governments or provides for Interim Provincial Governments.