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<table>
<thead>
<tr>
<th>Abbreviation</th>
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<tbody>
<tr>
<td>GoPNG</td>
<td>National Government of Papua New Guinea</td>
</tr>
<tr>
<td>GST</td>
<td>Goods and Services Tax</td>
</tr>
<tr>
<td>IGRFF</td>
<td>Intergovernmental Relations (Functions &amp; Funding) Act 2009</td>
</tr>
<tr>
<td>IRC</td>
<td>Internal Revenue Commission</td>
</tr>
<tr>
<td>LLG</td>
<td>Local-level Government</td>
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<tr>
<td>NCD</td>
<td>National Capital District</td>
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<td>NEC</td>
<td>National Executive Council</td>
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<td>NEFC</td>
<td>National Economic and Fiscal Commission</td>
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<tr>
<td>NSMA</td>
<td>National Service Monitoring Authority (proposed)</td>
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<tr>
<td>OLPGLLG</td>
<td>Organic Law on Provincial Governments and Local-level Governments</td>
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There has been a shift towards decentralisation across the globe. This shift is motivated by a desire to strengthen local governments, improve service delivery, and raise economic growth. Papua New Guinea (PNG) has not been an exception in this regard, having pursued decentralisation of decision-making at the local level and of service delivery from the birth of the nation in 1975. Self-reliance predates colonisation as relatively independent clans and tribes coexisted with one another without an over-arching administration before first European contact.

This paper builds on the companion paper that provides detailed contextual information on Decentralisation governance arrangements in Papua New Guinea: A framework for a national conversation (CTN henceforth) (Saunders and Dziedzic, 2022). The purpose of this paper is to identify the guiding principles for fiscal decentralisation, and apply these principles to PNG. Fiscal decentralisation as used here entails the devolution of the powers from the national government to subnational governments for raising of revenues and delivery of services to the local public. Subnational governments in PNG include the provincial governments, the District Development Authorities (DDA), and local-level governments. Fiscal decentralisation is considered in terms of powers to tax economic activities and spend public funds for the delivery of assigned responsibilities including the rights to receive transfers from the national budget in the form of grants, and the responsibilities to acquit funds in accordance with national regulations. Given the breadth of issues covered and their complexity, the coverage is selective and meant to trigger a deeper conversation on issues of pertinence to the ongoing reform efforts towards decentralisation.

PNG, as described in the companion paper, has three levels of government; namely, national, provincial, and local. Provinces in turn are further subdivided into districts and local level governments (LLGs) that are granted specific responsibilities for the delivery of basic services. Districts were originally created for national elections but have since taken on some of the responsibilities for delivering public services that originally were the domain of the LLGs. Consequently, some of the LLGs overlap across districts but the districts are distinct to the province. Issues relating to the division of legislative and executive powers, administration, and intergovernmental relations across the three levels of governments within PNG are explained in considerable detail in the companion paper. This paper in contrast is focused narrowly on the issue of fiscal decentralisation.

The national government has progressively devolved some of the powers to raise revenues and the responsibilities to deliver basic services to subnational governments; namely, the provincial and local-level governments, and the DDAs. This devolution of powers and functions, however, has not been uniform. Some provinces were handed more extensive powers compared to others. Bougainville, in particular, was granted autonomy (with respect to all powers of government) as part of the Peace Agreement signed in 2001 while Enga, East New Britain, and New Ireland provinces were handed increased autonomy in 2019 (Chand, 2018; Pouru, 2021).

Fiscal decentralisation, the subject of this paper, gives subnational governments the autonomy to set taxes and decide on public expenditures. These powers are specified in legislation extending across the national Constitution, the organic laws (e.g. the Organic Law on Provincial Governments and Local-level Governments 1998 (OLPGLLG)), and acts of the National Parliament (e.g. Intergovernmental Relations (Functions & Funding) Act 2009). PNG has followed international best practice in granting increased powers to raise revenues and in handing over of the responsibilities for delivery of basic services to subnational governments — a trend that has gathered pace recently. However, the reforms of 1995 led to the recentralisation of some of the responsibilities by allocating the responsibilities for service delivery to members of the National Parliament. Furthermore, this recentralisation took place through allocation of grants from the national budget to individual members for service improvement in their electorates.

While the general trend has been towards increased spending (and raising of revenues) by subnational
governments in PNG, the prevailing levels are low. This is evidenced by the fact that the National Government raised some 90 percent of all revenues (and 95% of all tax revenues) for the period 2010 to 2018, and took direct responsibility for 70 percent of all government expenditure in that period. Furthermore, the balance of 28 percent of expenditures that subnational governments undertook was cordoned by a combination of legislation, through directives from the national government, and via incentive payments (i.e. conditional grants). On taxes specifically, the national government has jurisdiction over all income taxes, resource rents, Goods and Services Tax (GST), and border taxes meaning that there is a very large vertical fiscal imbalance between the national government and the subnational governments. Besides, the Internal Revenue Commission (IRC) is responsible for collecting all income taxes and GST.

How should the responsibilities for delivering public services be divided between levels of government? Subsidiarity, a principle that guides this division, states that functions should be allocated to the lowest level of government to maximise efficient delivery. ‘Grassroot government’ has the advantages of having access to information in real-time on the needs of the public, their tastes for services provided, and the ability to reward efficient delivery. However, not all services may be delivered locally at the lowest cost or most effectively. Some of the public services are best delivered at the national level; examples include national defence, immigration, currency, and aviation as these services benefit from scale economies and require coordination in real-time nationally. Other services are effectively delivered locally. Policing, land management and mediation, and road maintenance are best undertaken near those directly affected. Yet many more services demand close coordination between local and national provision; examples include transportation, healthcare, and education where access at the local level has to be integrated with that at the national level (e.g. primary schooling in the village to university education in the capital). In sum, intergovernmental coordination and cooperation is critical to effective service delivery.

How should the responsibilities for raising revenues be divided between levels of government? Revenues are necessary to fund the delivery of public services. Police, public servants, teachers, and so on, have to be paid. Furthermore, access to revenues between the national and subnational governments are uneven (i.e. the vertical fiscal imbalance noted above), and access to revenues between subnational governments may be just as large (referred to as horizontal fiscal imbalance). The National Government has access to a much larger pool of funds given its powers over all income taxes, most indirect taxes (e.g. GST, border taxes, resource rents, etc.) and the IRC. Similarly, some subnational governments have a larger capacity to raise revenues locally due to local endowments such as a large and highly profitable gold mine (e.g. New Ireland Province). On the flip side of the differing capacities across subnational governments in terms of their capacities to raise revenues are differences in the costs of providing services (of a given quality). Thus, fiscal imbalances arise from differences in the ability to raise revenues and the costs of delivering services between the national and subnational governments, and across subnational governments. If citizens residing across the nation are to receive similar levels of public services as is mandated by the national Constitution, then the fiscal imbalances have to be addressed. This is done through transfers in the form of ‘equalising grants’ from the national budget to subnational governments.

Determining the level of transfers from the national budget that is necessary to equalise fiscal capacity across subnational governments is often controversial. In the case of PNG, this task is left to an independent agency; namely, the National Economic and Fiscal Commission (NEFC). The NEFC advises the National Government on the levels of transfers based on its own assessment of fiscal capacity across subnational governments.

The challenge for PNG with regards to fiscal decentralisation are as follows:

i. Subnational governments have access to adequate revenues to deliver those public services they are handed responsibility for (and at deemed quality);

ii. The transfers from the national budget to subnational governments are equitable (i.e. fair) and sustainable (i.e. can be maintained over time without creating macroeconomic distress); and,

iii. Subnational governments have an incentive to raise local revenues that both supplements their own resources and that of the nation at large to deliver services that lifts the welfare of the locals and that of the citizenry as a whole.
The above-enumerated boil down to the task of ensuring that fiscal decentralisation strikes a balance between local autonomy and national oversight that promotes efficient (allocates resources to satisfy needs/preferences of citizens), effective (i.e. at least cost), and nationally cohering services. The responsibility for oversight over public expenditures also is that of the National Government that ultimately is accountable to the taxpayers of the nation as a whole.
There has been a broad shift towards decentralisation across the world (Martínez-Vázquez et al., 2017; Oates, 1999). Such a shift has been motivated by the desire to strengthen local governments, improve service delivery, and raise economic growth (Bahl, 1999). The evidence supports such a claim, for example, Kaufman and Dilla Alfonso (1997), provided case studies where local empowerment community has led to improvements in economic development while Wang and Yao (2007) showed that elections of officials enhanced accountability of the village committee. The success of decentralisation is assessed in terms of the efficiency with which services are delivered, the accountability of the public service to the public, and the levels of regional and local development.

Decentralisation is being demanded by the public. Demands for increased decentralisation has arisen from a ‘geography of discontent’ (OECD, 2019); that is, perceptions of citizens residing away from the major hubs as being left behind from access to government services and opportunities for economic development. Demands for decentralisation within developing countries is more recent, and are aimed at bringing the Government to the grassroots and, improving service delivery by assigning responsibility for functions to the lowest level of government for economic efficiency (as enunciated through the principle of subsidiarity) (Bjornestad, 2009, p. 5).

The mechanisms used for the decentralisation of the delivery of public services have taken a multitude of forms. It has ranged from the transfer of functions from the central bureaucracy to those in the periphery, the delegation of functions to quasi-public corporations, the devolution of the responsibility for delivery of services to local-level governments, and in specific circumstances, even the transfer of functions to non-government organisations (Bardhan & Mookherjee, 2006; Bjornestad, 2009; Rondinelli et al., 1983; Work, 2002). PNG has indeed experimented with each of the above. The National Government has delegated responsibility for delivery of specific public services to provincial and local-level governments, and DDAs have been established as quasi-public corporations headed by a CEO. The issues pertaining to decentralisation in PNG is presented in the companion paper (CTN, 2022).

This paper is about fiscal decentralisation. Fiscal decentralisation entails the devolution of powers from the National Government to raise revenues and spend public funds transferred from the national budget to the governments located lower down the hierarchy (Fritzen, 2006). Such devolution hands over the powers to impose taxes, determine the tax base, and collect the proceeds to local-level government authorities who then are assigned the responsibility to deliver public services. The autonomy that is granted over revenue raising and expenditure through fiscal decentralisation is accompanied with institutional reconfiguration of the relationships between the various levels of governments. The ensuing reconfiguration delineates both the powers to raise revenues and the responsibilities to deliver functions between the authorities.

Fiscal autonomy of a subnational government is determined by the extent to which the government can fund its services, and the discretion it has over both the raising of revenues and that on expenditure. Such autonomy may be constrained by higher-level governments through limits placed on taxation and expenditure through issue of edicts and incentives. The National Government, for example, may forbid subnational governments from imposing any income taxes and provide matching grants to local authorities for expenditure on national priorities. Autonomy of local-level governments may be curtailed through standards set by the National Government. These may be in the form of regulations relating to audits, rules for procurement, and minimum standards for specific services.

Revenue autonomy is measured by the share of locally generated revenues in total receipts, and the power the subnational government has over raising local revenues including the authority to borrow and engage in private-public partnerships. Full revenue autonomy is achieved when the subnational government funds all its
expenditures and has the freedom to borrow and engage in private-public partnerships. Similarly, expenditure autonomy is assessed by the share of total local expenditure that the subnational government engages in, including those relating to the hiring (and firing) of staff.

Decentralisation in Papua New Guinea has entailed the devolution of decision-making powers from the National Government to subnational governments. This devolution of power commenced after political independence in 1975 when the National Government handed legislative, fiscal, and administrative functions to the provinces. Political decentralisation involved the transfer of powers to legislate on specific issues. Administrative decentralisation entailed the devolution of decision-making authority over the deployment of resources and the responsibility for delivery of selected government services. Both of the powers to legislate at the local level and to administer the functions are contained in the OLPGLLG. Similarly, the powers to raise revenues and take responsibility for specific functions are included in the OLPGLLG and the Intergovernmental Relations (Functions & Funding) Act 2009 (IGRFF).

Fiscal decentralisation has its merits and risks. The merits are many, including the potential to “improve the allocation of public spending by making it more consistent with the wishes of the citizens, and [thus] provide the glue for countries with regional ethnic diversity (Tanzi, 1995, p. 295). A risk is that it can lead to capture of the bureaucracy by the local elite that, in turn, could lead to corruption, nepotism, and waste. Thus, democracy does not necessarily lead to improved accountability and better access to services from local governments (Bardhan & Mookherjee, 2006). These risks are particularly significant within contexts of clientelist politics where public handouts may be used to consolidate electoral support. Another risk is that of fragmentation. Fiscal decentralisation may reduce the willingness of wealthy subnational governments to share their fortunes with the rest of the nation. This in turn may lead to demands for separation. Consequently, fiscal decentralisation — and decentralisation more generally — entails ongoing rebalancing of the costs of the union with the ensuing benefits.

The discussion that follows extends across three areas:

i. the division of responsibilities for the delivery of specific services across the levels of governments;

ii. the distribution of powers to raise revenues through local taxes and levies by subnational governments; and,

iii. intergovernmental transfers, including to grants from the national budget and loans from both the public and private sectors.

The above-enumerated raise issues when applied to specific contexts in terms of the responsibilities that may be devolved from the national government, the division of the responsibilities to raise revenue and spend public funds at the local level, and the levels of transfers between the national and subnational governments. These questions are addressed from a theoretical perspective in section 2, the research methodology employed is explained in section 3, the practical challenges of implementation within the context of PNG are addressed in section 4, and the policy implications arising from the above and conclusions are in the final section.
Ch. 2 Methodology

The method used in this research has been a combination of comparative design, detailed case study, and the use of longitudinal analysis. Use of the above-mentioned for the subsequent analysis is explained briefly next.

Section 3 is devoted to the lessons for fiscal decentralisation from abroad. A detailed account of the international experience in relation to the theoretical motivations and the practice of fiscal decentralisation is used to provide lessons on future reforms to fiscal decentralisation in PNG. The lessons have been informed by comparative international experiences, drawn from market economies that have pursued fiscal decentralisation. Specific lessons have been drawn on the motivations for fiscal decentralisation, the assignment of responsibility for delivery of specific functions and the raising of revenues for the budget across the various levels of governments, and the challenges faced in imbedding the chosen design. A drawback of such an approach is that this literature largely draws on the experiences of rich western democracies of which PNG is not one. Thus, while the utility of the comparisons is constrained by the contrasting contextual details of PNG, this deficiency is addressed through use of a detailed case study approach.

The case study of PNG is presented in section 4 and is two-pronged. First, the data relating to the specific functions that are devolved, and the underlying motivations for doing so from the international comparative experience is distilled. Second, the relevance of these lessons is then tested against the context of PNG, noting that the comparator nations are much richer than PNG, and largely Anglo-Saxon thus having cultural differences too. PNG is not only a developing nation, but also one with enormous cultural diversity. The cultural differences in PNG are assumed to evolve slowly, thus a comparison of the structure of fiscal decentralisation pre- and post-independence is used to enrich the lessons drawn from the international comparisons. In other words, the unique cultural context of PNG is accounted for through a longitudinal analysis where comparisons are made pre- and post-independence with respect to the structure of decentralisation.

The longitudinal analysis is used to compare the proposed structure of fiscal decentralisation in PNG in the lead-up to independence in 1975 by the Constitutional Planning Committee and what transpired some 47 years later (i.e. by 2002). Comparisons between these two points in time is used to explore the underlying forces responsible for the change. Specifically, the underlying incentives that have been responsible for the evolution of fiscal decentralisation are investigated with a view to informing future reforms.

Both quantitative and qualitative data is used for the analysis. Quantitative data from past national budgets have been used to assess the quantum (and proportions) of funds allocated from the budget to individual subnational governments, and for specific functions. This quantitative information is complemented with information drawn from the underlying legislations on the assignment of responsibilities for delivery of specific public services and the powers to raise revenues to subnational governments.

Lastly, information from both the public and the policymakers has been used to test the veracity of the findings. Feedback from the NEFC that has the primary responsibility for advising the national government on the distribution of public funds to the subnational governments was sought. Furthermore, the preliminary version of this paper was presented at a national conference with the feedback from the participants incorporated in this version.

In summary, fiscal decentralisation in PNG has been informed through analysis of the experience of similar reforms abroad, and in PNG over the past half-century. The first of the above provides the international comparisons to reveal areas for reform in PNG while the second is used to accommodate the unique context of PNG with respect to proposed reforms to fiscal decentralisation.
Central governments have pursued decentralisation with the aim of spreading out access to public services across the nation (Rondinelli et al., 1983). The public sector created to facilitate nationwide access to services is made up of several layers with each such layer having distinct responsibilities in terms of enacting laws and regulations, administration, and delivering public services.

This section explains why countries pursue fiscal decentralisation, explains the rationale for the assignment of responsibilities for specific functions between levels of government, the division of responsibilities for raising of revenues between tiers of government, and then identifies some of the major challenges of implementation within the context of developing countries.

3.1 The motivations for, and some limitations of decentralisation

The literature on fiscal decentralisation is still evolving and has, to date, progressed in two distinct phases; namely, the analyses from the first and second generations. While this is not the place to provide the full details on this literature, what I will explain here are simply the motivations for decentralisation that emanate from both strands.

The first-generation theory assumed benevolent officials. The resulting structure of intergovernmental relations under the assumption of benevolent officials is static in which efficient levels of services are provided by each level of government within the (physical and legislative) limits of their jurisdiction. Subnational governments in the setup above was assumed to operate much like branches of a national corporation. The second-generation theory relaxes both the assumption of benevolence and static structures — in this case, public officials make choices to maximise their own interests that may include maximising votes, prospects for promotion, and their budgets. In this case, the intergovernmental relations are the product of strategic interactions between the stakeholders and therefore endogenous, and the ensuing structures would adapt to change of circumstance; that is, the structure is dynamic Oates, (2005). As an example, the discovery of rich mineral resources within the jurisdiction of one subnational government can create the incentives for the polity to cede should the prevailing system of taxes and transfers be viewed as being exploitative. Conversely, the National Government together with the remaining subnational governments may have an incentive to centralise control over the rich resources for the benefit of the nation.

Competition for windfall gains such as those arising from resource discoveries could lead to redefinition of the structures for fiscal decentralisation. At the extreme is the case of secession when the exploited jurisdiction finds out that the losses exceed the benefits from remaining within the union if the exploited jurisdiction has the capacity to leave. Consequently, a union-preserving structure would require adaptation to balance the interests of the exploited with those of the exploiters; that is, the subnational government contemplating secession with the others. These are not hypothetical scenarios but one familiar to policymakers in PNG who are currently in the process of negotiating new autonomy arrangements for subnational governments (see Ghai & Regan, 2006; Pouru, 2021).

In both strands of the literature, the economic arguments for decentralisation rest on the premise that the devolution of the powers to tax and spend public funds brings the government closer to the people at the grassroot. This in turn helps improve the flow of information between the government and the governed, allowing supply of services to be matched closely and quickly to the needs of the public. The ability to match demand with supply of public services is particularly important when citizens are spread across wide spaces, mobility across space to access services is limited (such as through customary land tenure arrangements), and especially when they have diverse demands — bringing services closer to the recipients in such a situation will raise citizen welfare (Oates, 1999).

\[1\text{This draws from Public Choice Theory.}\]
Preferences can differ enormously across space, and space is a significant factor in planning for the distribution of public services in any country (Tiebout, 1961). PNG is a case in point given the rough terrain of the mainland and the many dispersed islands that limit mobility across the nation. Consequently, proximity of policymakers to the people being served is paramount for delivery of basic services. Such proximity reduces the gap of information between those responsible for supply and the consumers of the service, and lowers transaction costs for delivering services that lack economies of scale. Furthermore, provision of public services locally lends the opportunity to tailor supply to the espoused need when preferences vary significantly across regions, thus raising citizen welfare (Oates, 1999).

The capacity of local authorities to respond to the needs of locals in a timely manner is a major motivation for decentralisation. Local governments, however, may not be in a position to meet all of the diverse needs of their residents. Mobility of people across the nation compensates for the absence of some local services. Mobile individuals are able ‘to vote with their feet’, and in doing so meet their own needs while forming communities with common preferences for specific services (Tiebout, 1956). Tertiary healthcare is a case in point where individuals needing the service and having the ability to move are able to access hospitals in the major urban centres of the country, or even abroad. These benefits are fully realised with perfect mobility, but this is an unrealistic assumption. The reality is that mobility is imperfect and no local government is able to meet every need of their people. Any level of mobility helps however. As an example, specialist health care is available only in large urban hospitals and these are accessed by those in need and the capacity to move to these facilities. That said, not all individuals are able to move to access the services that they may need — so some unmet need is likely to remain at each locality.

The implications of the above for policymaking are several. First, a benevolent local government will work towards satisfying the needs of the public regardless of local interests while public officials pursuing their own popularity will respond to local lobbying. The latter points to the fact that decentralisation can improve allocation of resources while minimising waste when officials are accountable to the local public (Weingast, 1995). Second, and even more importantly, benevolence assumes away strategic interactions between levels of governments; that is, subnational governments accept the status quo for efficient delivery of services. In the case where subnational governments engage with the central government to maximise their own interests, fiscal decentralisation provides the opportunities for the preservation of the union as well as the risks of disintegration. Considerable efforts have been placed under the second-generation reforms to align incentives of subnational governments to raise revenues locally and take responsibility for the delivery of services that support national priorities. Some of these issues are explained in the next two subsections, dealing with assignment of the responsibilities for expenditure and division of the tasks for revenue raising between levels of government.

Some public goods are efficiently provided by the central government. Amongst them are what economists call ‘pure public goods’ which contain two characteristics: those that are ‘non-excludable’ — meaning that consumers cannot be excluded once the good is provided; and ‘non-rival in consumption’ — meaning that the marginal cost of an additional consumer is zero. National defence is an example of a pure public good since no one can be excluded from enjoying the benefits of national defence once it is provided, and that additional cost of extending national defence to another citizen is zero. Pure public goods are provided cheaply at scale, thus, services such as national defence, macroeconomic management, foreign relations, currency, etc. are provided at the level of the nation as a whole. Similarly, policies relating to the exploitation of natural resources, redistribution of income, access to education and healthcare are designed at the national level but implemented locally. Doing so allows for the integration of local supply with that of the nation as a whole; the education provided at the local primary school, for example, has greater value if integrated within the education system of the nation as a whole. Centralised delivery of basic services and their integration across the nation, also helps consolidate a common national identity — often a priority for a newly independent nation. Indeed, many unitary states were created under a national constitution that underwrote access to the same public services following widespread publicity as a means to nation building.

Decentralisation has its limitations too. Four from the literature that are relevant for the subsequent discussion are
enumerated next. First, some services are best provided nationally while most other services, as explained above, require integration at the level of the nation as a whole. Clean air, immigration services, and national defence are examples of services that simply cannot be provided at the local level. Others such as education, healthcare, and transportation infrastructure can be provided locally but their efficacy increases when these services are integrated across the nation (and sometimes even internationally (e.g. aviation). Second, decentralisation brings the government closer to the people, and in doing so, it also offers the opportunity for elite capture and attendant risks of nepotism and corruption. These risks are significant within the contexts of clientelist politics. Third, subnational governments often lack the human, financial, and technical resources that national governments have and therefore, hamstrung from delivering services. Furthermore, skilled bureaucrats have the incentive to move from the outer rings of government to the centre for advancement, compounding the problems of retaining talented staff by subnational governments. Fourth, and building on from the second point is that decentralisation as a whole requires constant rebalancing so as to ensure that the benefits of ‘shared-rule’ (i.e. remaining part of the nation-state) exceed those from ‘self-rule’ (i.e. secession).

**Lesson 1:** Autonomy arrangements survive through constant rebalancing to maximise the net benefits arising from ‘shared-rule’, realising that a wobble in the direction of ‘self-rule’ can undermine national integration. Canada, Italy, and Spain have been successful in this rebalancing. Fiscal decentralisation is used as an instrument to bind the subnational governments into the nation state where the efforts of individual subnational governments to exploit national commons is kept in check.

### 3.2 Assignment of responsibilities for expenditure

The responsibilities for specific functions assigned to subnational governments is guided by the *principle of subsidiarity*. This principle asserts that

> Taxing, spending and regulatory authority for any service should be vested in the lowest order of government unless a convincing case can be made for higher order assignment (OECD, 2019; p. 137; emphasis added).

The economic justification for the subsidiarity principle including those relating to economic efficiency and effectiveness of service delivery has been explained above, thus the reasons for deviation from adherence to this principle is explained next. Note that a blind application of the subsidiarity principle would mean the ‘decentralisation of everything’; which is the same as complete centralisation since nation-states are exactly that. However, not all taxing, spending, and regulatory functions within a nation is handed over to lower levels of governments. Decentralisation entails a lot more nuanced application of the subsidiarity principle where the prevailing economic, political, administrative, social, and cultural factors are considered. We focus next on the economic motivations for vesting of the responsibility from the central government to subnational governments for public expenditure.

Some services are provided solely by the central government. As explained above, doing so minimises cost of supply and allows for integration of the services supplied across the nation. National governments all over the world have taken responsibility for the issue of a national currency, macroeconomic management, immigration, and national defence. Furthermore, nations cooperate on matters relating to the management of the environment, international trade and communications, natural disasters such as the ongoing Covid-19 pandemic, and so on. Conversely, matters relating to licencing of local businesses and municipal services are universally the responsibilities of local-level governments. Such responsibilities are delivered by local-level governments within the confines of the national framework for the named services. In-between the central and local-level governments, sits a plethora of public services such as education, healthcare, and transportation services that require coordination across levels of governments for effective delivery. Moreover, the peculiarities of the context may shift the balance between centralised verses decentralised delivery of a particular service — vaccination being a case in point where historically this has resided within the realm of responsibilities of local health workers but since the advent of Covid-19, has elevated to a national if not an international responsibility.
**Lesson 2:** Efficient delivery of most public services requires close coordination and cooperation between the central government and the subnational governments, and that between subnational governments.

Not all subnational governments have to be assigned the same functions; that is, functions assigned to individual subnational governments will depend on their individual contexts. This is encapsulated in the principle of *Asymmetric decentralisation* which states that

To make decentralisation work, it is desirable that functional responsibilities be tailored to the local preferences and needs, demographic and geographic character (area, population size, topography, urban vs. rural, small towns vs. metropolitan areas, plains vs. mountainous region, agricultural vs. industrial towns, etc.) and fiscal capacity of local jurisdiction (OECD, 2019, p. 137; emphasis added).

The principles of subsidiarity and asymmetric assignment provide guidance on assignment of functions to subnational governments. Note that the principle of asymmetric assignment states that functional responsibilities must be tailored to, amongst other things, the fiscal capacity of the local jurisdiction.

The provision of pure public goods, as noted above, are assigned to the National Government. In contrast, responsibility for provision of impure public goods such as schooling and roads that confer disproportionately larger benefits to those close to supply are best delivered at the local level. The importance of proximity to source of supply is an important consideration when assigning functions to local-level governments. That is, the local jurisdiction should be assigned responsibility for services whose access diminishes with the distance of the place of supply from the consumer. Consequently, ‘impure’ public goods are produced within the community to meet demand *in situ*. Not all services may be available at each location as the costs of supply will differ across the nation, and so would the preferences of the locals for specific services. In either case, individuals may be able to move across locations to meet their individual needs. Parents, for example, move to places with good schools while market vendors move to locations where the public congregates. Thus, a combination of decentralised production of impure public goods together with the option for consumers to move and/or commute to the place of production allows individuals to meet their needs$^2$.

What is the optimal size of a subnational government? The answer is this could differ depending on the service being considered. Consider the case of an uncongested local road that is freely accessible to all but where an additional user does not diminish access to another user. The local nature of the road means that access diminishes with the distance from the user’s place of residence. These considerations lead to an optimal size of local-level governments, and they lead to what are called ‘boundary problems’ in spatial economics. That is, public roads are built far enough from each other to economise costs and the boundary between them is determined by a user who at the margin is indifferent to using either of the two roads. Such endogenously determined boundaries are likely to diverge for the local primary school, secondary school, health post, police station, and so on. Boundaries for local-level governments are also affected by physical barriers such as the ocean, rivers, mountains, etc. and social considerations of history, language, and so on. In PNG, for example, provinces were formed from the colonial districts while the districts that exist today are delineated by electoral boundaries.

To sum up, the National Government is assigned the responsibility for access to pure public goods while local-level governments are assigned the responsibility for the remaining public functions. Assignment of responsibility for functions to the local authority has the advantages of matching local preferences with supply, allows for use of information to adapt supply to expressed need, and provides the opportunity to the recipients of the service to hold their government to account. The national government is responsible for integration of the services provided at the local level and often provides the funds from the national budget to allow local-level governments to exercise their responsibilities. This simple case illustrates an important fact regarding the assignments of functions between local and national governments — even when a public service may only be delivered locally, the National Government has a critical role to play in overseeing the delivery and appropriate use of the funds. The arguments for oversight of locally provided public services becomes stronger when benefits spill across

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$^2$ Such movements is referred to in the literature as ‘Tiebout sorting’ (Tiebout, 1956).
borders, or when there are additional benefits from integration of locally delivered services.

**Lesson 3:** The national/central government is critical to the functioning of a nation even with autonomous subnational governments.

### 3.3 Division of responsibilities for funding

Decentralisation requires subnational governments to have sufficient resources — human, financial, capital, consumables, etc. — to exercise all of their responsibilities. Fiscal decentralisation narrows down the focus to finances only, but the issue of resourcing is a lot broader than money alone. This subsection explains the conceptual arguments for the division of responsibilities for funding of public expenditure incurred by subnational governments. Explained next are the division of powers to tax local economic activity, the sharing of revenues collected nationally, and the role of transfers from the national budget for fiscal equalisation.

Grants are provided from the national budget to fill the gap between the costs of exercising the assigned functions by the subnational government and their capacity to raise revenues locally. Consequently, such grants are called ‘gap filling’ as they equalise fiscal capacity across subnational governments to deliver the assigned services. Note that costs of delivering services across the subnational governments are likely to depend on population density, terrain, and the nature of the service while the capacity to raise revenues will again depend on a multitude of factors including endowments (such as gold deposits) and the level of economic activity within the jurisdiction. We revert to some of the basic principles from the literature that provide guidance on the division of responsibilities between the central and subnational governments for funding of public services.

Recall from the earlier subsection that the principle of subsidiarity mandates that the powers to tax should be devolved to the lowest levels of government for economic efficiency. The three primary considerations in assigning taxes between national and subnational governments are as follows:

i. Benefit taxation (e.g. user-pays) should be used at the level where users are aligned to payments made;

ii. Taxes with mobile bases (e.g. income taxes) should be administered at the national level; and,

iii. Taxes whose bases are immobile across space (e.g. land taxes) should be assigned to subnational level governments (Bird, 2011).

Most local governments do indeed administer and collect local taxes such as road user charges, business license fees and municipal rates. Making users pay for the services consumed has been popular but not without its critics as explained in the next subsection. Income taxes, border tariffs, and most indirect taxes such as the GST, in contrast, are administered and collected centrally. The income generated in an economy may be spread across the nation, thus income taxes are collected centrally. Doing so minimises the costs of collecting revenues which often is undertaken by a single (national) agency, and the opportunities to shift economic activity within a nation to minimise income tax liability is eliminated when the tax is administered at the level of the nation as a whole.

### 3.4 Application of the ‘user-pays’ principle

The first generation of this literature argued for the use of the ‘benefit principle’, meaning that users should pay for the public services that they use. Making users pay for the services has the advantage of allocating limited supply to those willing to pay (i.e. achieve allocative efficiency) with prices reflecting the marginal costs of production. The main drawback of making users pay for public services is that this is unfair to the poor (i.e. is inequitable), and it may also encounter problems of free-riding; that is, beneficiaries not paying for the service consumed. The risks of free-riding are particularly high when consumers cannot be excluded from enjoying the service. Notwithstanding the above deficiency, application of ‘user- pays’ principle saves the need for use of distortionary taxes to fund the service and for transfers from the national budget to fill any gaps in funding.

Gap-filling grants can create disincentives for revenue raising by the recipients, thus impose a heavy dependence on the national budget. That is, grants provided from the national budget to subnational governments dampens the incentives for local revenue generation. Local-level governments who have guaranteed access to grants
from the national budget lose the motivation to raise their own revenues. Since tax revenues collected by local governments are dependent on the level of economic activity within their jurisdiction, grants from the national budget reduce the incentives for local-level authorities to support local economic enterprise. When other subnational governments follow suit, growth of GDP falters, budget deficits and public debt rise, and macroeconomic management suffers. Grants from the centre also reward efforts put into lobbying for a larger share of the national pool of funds, and risk politicising the instruments for fiscal equalisation (Brinkerhoff & Johnson, 2009; Martínez-Vázquez et al., 2017).

Grants, however, are necessary for fiscal equalisation. This is because costs of delivering services across the nation vary as does the ability to raise revenues locally. The cost of delivering services in densely populated regions with good infrastructure are lower than in sparsely populated regions that are difficult to reach. Similarly, resource rich areas of the nation have greater capacity to raise revenues than those lacking such endowments. The very notion of a nation often entails equal access to public services across the nation. National constitutions often mandate that citizens have uniform access to public services regardless of the place of their residence. In the case of unequal capacity to raise revenues locally, national governments include provisions for fiscal equalisation; that is, the levelling of financial capacity of local-level governments to allow them to provide uniform public services. The national Constitution of PNG, for example, mandates;

…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 fulfilment of his or her real needs and aspirations (s. 2(4)).

In summary, the principle of fiscal equivalence posits that local services must be financed locally where the local-level government has jurisdiction over both the raising of revenues and the spending of the proceeds to meet the expressed needs of the local population. Adherence to the principle of fiscal equivalence helps engender accountability of the local government, and minimises the risks of free-riding by individuals who consume the public service but evade paying costs for the provision. Putting the principle into practice is problematic because aligning the benefits of a public service to the administrative boundaries of a local-level government is difficult, however. Furthermore, benefits provided by one subnational government often spill across boundaries with neighbouring jurisdictions. Such spillovers may lead to under-provision of the service unless the central governments step in to coordinate delivery across jurisdictional boundaries. Lastly, jurisdictional boundaries are often set by history and/or geography that may not align with the principles of fiscal equivalence.

There are a live and ongoing debates on the rationale for and the levels of fiscal equalisation that we turn to next.

3.5 Fiscal equalisation through ‘gap-filling’ grants

As explained earlier, the capacity to raise revenues and the cost of providing specific services may vary enormously both between levels of government, and that amongst subnational governments. Fiscal equalisation addresses these disparities through transfers between the central government and those at the lower levels (i.e. through vertical transfers) and that between subnational governments for horizontal equalisation of fiscal capacity. Thus, transfers from the national budget fills the gap between revenues and expenditure across the different levels of government, and equalises the capacity of individual subnational governments to deliver the services devolved to them. These equalising transfers are normally based on formulas that take into account the costs of delivering the services for which subnational governments have responsibility, their capacity to raise revenues locally, and the effort put into minimising costs of delivering services, and in raising revenues locally.

The grants from the National Government can either be given without conditions (i.e. in the form of unconditional grants) or come earmarked for specific purposes (i.e. functional grants). In addition to the above, derivation grants provide for the redistribution of a fixed share of taxes collected within the jurisdiction of the subnational government; in PNG, as an example, provincial governments, are handed back 60 percent of GST revenues raised within the province. The main attraction of derivation grants is the incentive it provides subnational governments to expand economic activities within their jurisdiction. The share of the proceeds handed back to the subnational governments where the proceeds were raised may range from 0 to 100 percent.
The incentives for supporting local enterprise are correlated with the share of the revenues returned to the subnational government. Conditional grants, in contrast, are used by the central government to incentivise the provision of specific services; as an example, a national government may share in the costs of vaccination undertaken by the subnational government if this is seen as a national priority.

### 3.6 Assessing the level of fiscal decentralisation

The level of fiscal decentralisation across nations is quantified by the share of total revenues raised locally and the share of total expenditures devolved to the local-level government. That is, the Revenue Sharing Ratios is equal to the revenues of the subnational government as a share of total general government revenues while the Expenditure Sharing Ratios is equal to the level of total expenditure by the subnational government as a proportion of total general government expenditure (see Pouru, 2021, for PNG). While these ratios are easy to calculate, any assessment of the level of fiscal decentralisation is complicated by the absence of data, the details of the types of expenditures, and oftentimes, the overlapping responsibilities of the various levels of governments for individual services — health in PNG as an example.

### 3.7 Options for assignment of revenue raising powers to subnational governments

The central government may use one or a combination of the following interventions to assign responsibility for the raising of revenues by subnational governments — arranged from that with the least autonomy to the most.

1. The National Government sets the tax rate and defines the tax base for the nation as a whole (e.g. income taxes), and then distributes the collected revenues to subnational governments on an agreed formula;
2. The national governments set the tax base and lets subnational governments set the tax rate (e.g. municipal rates);
3. The national government sets the tax rate and lets subnational governments set the tax base; and,
4. The national government lets subnational governments set both the tax base and the tax rate.

The literature points to the fact that transfer system that includes incentives for subnational governments to raise their own revenues leads to better use of available funds (Bird & Smart, 2002; p. 899). In this context, derivation grants provide the incentives for the local government to encourage economic enterprise within its jurisdiction; matching grants reward expansion of the supply of public services by the local authorities; and, lump-sum unconditional transfers from the national budget reward free-riding. This leads us next to highlight some of the main challenges of implementation.

### 3.8 Challenges of implementing fiscal decentralisation

To conserve space, we will enumerate the five main challenges in implementing fiscal decentralisation.

1. **Risk of under-funding:** Central governments, as explained earlier, must have sufficient resources to exercise their responsibilities. This could entail transfers in the form of grants from the national budget and/or devolution of powers from the centre to raise taxes in order to match ‘finance to function’ (see subsection above). The ‘Finance follows function’ principle requires that the transfer of responsibilities from a higher-level government must be accompanied with the necessary resources to allow effective exercise of the devolved responsibility. A significant and common failure of fiscal decentralisation has been the under-funding of responsibilities handed to subnational governments. In the most extreme case, the National Government allocates responsibilities for delivery of public services to lower-level governments but without providing the necessary funding (Bahl, 2008; Constitutional Planning Committee (CPC), 1974).

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2This is also referred to as the Matching or Connection principle.
2. **Risk of over-spending:** When subnational governments are highly dependent on transfers from the central government, then this can create incentives for over-spending and waste. This problem is particularly acute when any over-spending by the subnational government is underwritten by the central government; that is, when subnational governments operate under a soft budget constraint (OECD, 2019).

3. **Risks to local revenue generation:** Highly generous transfer systems can discourage efforts at expanding the local economy that in turn dampens tax collections. Furthermore, when transfers from the national budget are made on a discretionary basis, then they can encourage rent-seeking (i.e. lobbying to increase share of receipts of grants from the centre) and waste.

4. **Failure to recognise economies of scale:** Many public services enjoy significant economies of scale. Delivery of such services by the subnational governments can lead to duplication of effort and raise costs of service delivery. The collection of taxes is a case in point where a national level agency may be able to collect a given amount of revenues at lower cost compared to the case when the collection is undertaken by independent subnational tax offices.

5. **Need for adaptation:** Fiscal decentralisation requires constant updating as circumstances change. A large resource project within the jurisdiction of one subnational government may require adjustment to the formula used for sharing of revenues, failure of which may exacerbate the pressure for increased autonomy and in the extreme case secession.

Fiscal equalisation, including the estimation of the levels of transfers from the national budget to individual subnational governments, is often outsourced to independent institutions. The mechanisms used to determine the level of transfers by independent institutions, as elaborated later for PNG, are through simple transparent formulas that tie the costs of delivering the services by the subnational governments to their capacity to raise revenues locally. The central government in a decentralised system takes direct responsibility for national functions including the oversight over public spending and the integration of the services delivered by subnational governments.

International evidence supports the proposition that decentralisation is beneficial to the public. A positive correlation has been observed between the extent of decentralisation with measures of economic activity, human development, public sector efficiency, democratisation, and political stability (OECD, 2019, p.19).

In summary, the lessons from international comparative research are that the benefits of decentralisation are maximised when

a. intergovernmental relations are designed as a comprehensive system;

b. finance follows function;

c. the National Government is able to oversee fiscal effort and public expenditures;

d. transfers from the national budget for fiscal equalisation are based on a simple and transparent formula; and

e. a hard budget constraint is in place (Bahl, 1999).

We apply the above-enumerated lessons to fiscal decentralisation in PNG next.
4.1 Demand for decentralisation

It is important for the subsequent discussion to note that the demands for political and administrative decentralisation were considered in considerable detail during the drafting of the national Constitution in the lead-up to independence in 1975. Demands for fiscal decentralisation was also made by the then North Solomons Province (now Bougainville) as the Bougainville Copper Limited had already commenced production in the province by then.

Equity in terms of access to services in PNG was prioritised at the birth of PNG. Section 2 on National Goals and Directive Principles of the national Constitution espouses ‘equality and participation’ where every citizen is to have “an equal opportunity to participate in, and benefit from, the development of our country” (PNG Constitution, p. 14). Self-reliance, in terms of access to community services such as personal security and communal land, however, predates colonisation of PNG.

Cultural diversity and self-reliance are intrinsic to PNG. PNG has always been an ethnically, culturally, linguistically, and spatially fragmented nation (Fearon, 2003). When first contact was made by western explorers, they noted that people lived in villages had organised to defend themselves from invasion, and that each community lived independently of others but for some limited exchanges including inter-tribal fighting. The German, then Australian colonial administrations that governed PNG prioritised the maintenance of law and order over democratic participation in government (CPC, 1974, ch. 10, para. 158). The unitary state that got established at independence in 1975 under a centralised administration is the product of the colonial past, and motivated by the desire of the leaders then to create a unified nation.

The people have been persistent in their demands for greater participation in government. This is evidenced by the observation of the CPC, which, after nationwide consultation and its own deliberations, reported that

> There is widespread discontent with the present distribution of power in our country, and a deep yearning among our people for a greater say in the conduct of their affairs. If the Committee's recommendation in Chapter 7, “The Executive”, that the Constitution should explicitly vest power in the people, is to be more than legal rhetoric, then opportunities must be provided for our people to participate meaningfully in those aspects of government that directly concern them (CPC, 1974, ch. 10, para. 1).

The people of PNG were demanding the application of the subsidiarity at the birth of the nation, and the CPC was supportive of this demand. The CPC acknowledged that the colonial administration had installed peace and delivered public services to the communities. In doing so, the CPC argued that the colonial administration had left the nation with a “highly centralised” and overly “bureaucratic” system of government with “all significant decisions affecting the lives of people in every part of the country [being] made in Konedobu” (CPC, 1974, ch. 10, p. 2). This in turn, the CPC argued, had deprived the people of self-government, recommending that;

> Power must be returned to the people. Government services should be accessible to them. Decisions should be made by the people to whom the issues at stake are meaningful, easily understood, and relevant. The existing system of government should therefore be re-structured, and power should be decentralised, so that the energies and aspirations of our people can play their full part in promoting our country’s development (CPC, 1974, ch. 10, para. 9).

Demands for the devolution of authority from the centre to allow for a flexible, participatory, and decentralised system of government within a unitary state is as old as the nation itself. The communities had “expressed overwhelming support for the establishment of representative bodies with the power to govern at the district level” (CPC, 1974; ch. 10, para. 257). The calls for ‘representative bodies with the power to govern at the district level’ are still alive even after the central, regional, local, and district-level administrations were installed
following independence. That is, the demand for decentralisation has been a permanent feature of realpolitik in PNG for close to half a century.

Progress with decentralisation since independence has been limited however. This is not for a lack of effort. The national Constitution included provisions for decentralisation, leaders across generations have argued for greater devolution of powers from the nation’s capital, and two major reforms were instituted to deliver decentralised government to the public. Devolution of powers from the centre to the subnational governments has been slow, and has even regressed when assessed in terms of expenditure and revenue ratios. Specifically, the national government for the two decades to 2019 took direct responsibility to spend approximately 72 percent of total government budget, leaving the balance of 28 percent to subnational-level governments. But this ratio has not been steady over time. There were two short episodes when subnational governments increased their share — this being between 1994 and 1996, and then again from 2013 to 2016 (Pouru, 2021, p. 23). The levels of expenditure have also varied markedly between the individual provincial and local-level governments. Bougainville, that has been omitted from the analysis of Pouru (2021), in all likelihood has had greater autonomy over public expenditures than the other subnational governments.

Fiscal concentration when assessed in terms of revenue ratios is higher still. The National Government collected approximately 90 percent of total revenues (and 95% of total tax collections), meaning that subnational governments collected 10 percent at most (Pouru, 2021, p. 25). In sum, the National Government is responsible for collecting the bulk of the revenues and takes direct responsibility for the majority of government expenditures meaning that there has been little fiscal decentralisation since independence despite the persistent demands of the public.

4.2 Devolution of powers to subnational governments

This section is devoted to a discussion on the resurgence in demand for autonomy, the conversations that must be held at the level of the nation on revenue powers that may be devolved to provincial governments, and the reasons for functional grants from the national budget.

The structure of decentralisation has evolved over the past five decades. The initial demands for decentralisation were addressed through devolution of political and administrative powers to the provinces (i.e. the former districts of the colonial era). The first phase of decentralisation that extended from 1976 to 1995 involved the establishment of provincial governments with elected assemblies, following closely the recommendations from the CPC (CPC, 1974, para. 43). The second and third phases that commenced in 1995 and 2006 respectively, reconfigured provincial governments wherein local-level governments were given a greater role in service delivery and direct support from the national budget. The details of these reforms are provided in the companion paper (i.e. CTN, 2022), suffice here to note that the drivers for change towards greater centralisation that began with the reforms of 1995 included (i) evidence of inefficient administration, nepotism, corruption, and financial mismanagement from reviews of the performance of provincial governments; and, (ii) national politicians seeing their elected provincial counterparts as competitors.

Legislations were passed to assign responsibilities for public services to the provinces and local-level governments. The responsibility for delivery of specific services by subnational governments is contained in a handbook produced by the Department of Provincial and Local Government Affairs titled The determination assigning service delivery functions and responsibilities to provincial and local-level governments (GoPNG, 2010). The handbook assigns 15 service delivery functions and responsibilities to provincial and local-level governments; namely: Basic and Primary Education, Rural Health, HIV/AIDS, Agriculture, Fisheries, Forestry, Disaster Management, Environment, Community Development, Village Courts, Land Mediation, Commerce and Industry, Lands and Physical Planning, Non-renewable Resources, Infrastructure, and Local Administration. The assignment of these local services are consistent with the principle of subsidiarity.

Duncan and Banga (2018) argue that ‘It now seems clear that provincial politicians’ threat to national members of Parliament was the key reason for the enactment of the OLPLLG, and not poor performance on the part of provincial governments, as many claimed at the time” (p. 498).
Some regress was made in terms of fiscal decentralisation afterwards. This followed the initial adverse assessment of the efficacy of provincial governments in delivering basic services. The National Government (and the National Parliament in particular) set in train moves for recentralisation of fiscal powers of subnational governments, but the success of three subnational governments in both raising revenues and in providing public services led to renewed demand for fiscal decentralisation. East New Britain Province, Enga Province, and New Ireland Province were granted greater autonomy in 2019 on the back of their ability to raise substantial revenues within their jurisdiction. In the case of New Ireland Province, dividends and royalties from a major resource project contributed some 86 percent of total local revenues. In the case of East New Britain Province, GST revenues were the major source accounting for one third of total revenues for the province (Pouru, 2021). While data from Enga Province is not available, dividends and royalties from the gold mine in the province would likely have accounted for a substantial share of total revenues for the provincial government. Thus, a major driver for increased autonomy by provincial governments in PNG has been their ability to raise revenues for their budget locally.

Revenue autonomy of three provinces has led to a shift in fiscal decentralisation. Demands for a greater share of the revenues generated within their jurisdiction reversed the moves towards fiscal centralisation by the National Parliament. Additionally, provincial governments beginning that of Bougainville at independence that have succeeded in growing their economies — either because of the presence of rich natural resources (e.g. copper and gold) or otherwise — have consistently demanded the right to the proceeds from the exploitation of ‘their resources’. Derivation grants have rewarded provincial governments that have been successful in growing their economies.

Thus, the questions to consider in a national conversation in relation to the division of responsibilities for revenue raising between the National Government and the provincial governments are as follows:

1. How much of the GST collected should be returned to the source province?
2. What proportion of royalties and dividends should accrue to the source province? Specifically, why limit this share to 60 percent as is the case at present?
3. How much of the dividends, royalties, etc. should accrue to provincial governments from mining projects?
4. What additional revenue raising powers, if any, should be granted to the provinces? Pouru (2021) argues for additional revenue powers to be granted to provincial governments, but the macroeconomic implications of this proposal have not been analysed.
5. Should provinces be allowed to borrow to fund any shortfalls in revenues, and if so, then how much? If yes, then how can the macroeconomic effects of such borrowing be contained? Is a hard budget constraint on provincial governments credible?

These questions can only be answered through a conversation with all of the stakeholders.

4.3 Revenue autonomy by raising share of GST revenues returned to the provinces

Some preliminary analysis is presented next, to argue that more of GST revenues may be returned to the provinces without adversely affecting the national budget, the levels of the deficit, or the level of public debt.

Provincial governments can be incentivised to support local enterprise by allowing them to collect all the GST revenues. This can be done without adversely affecting the national budget. Table 1 provides data for the case where all GST revenues are returned to the provinces, but under the assumption that this is done in a revenue-neutral manner for the nation as a whole. Column 1 lists down the names of the 20 provinces plus the National Capital District (NCD); column 2 shows the value of GST collections currently returned to the source province; column 3 provides the total value of grants from the national budget; column 4 is the total revenues available to each province (i.e. sum of columns 2 & 3); column 5 shows value of GST receipts in total per province;
and column 6 shows values of equalisation grants should all of the GST be returned without affecting the national budget (i.e. where total revenues of K1.64 billion provided to the provinces and NCD under the current arrangement is the same as under the new arrangement).

Table 1: Fiscal equalisation under current regime and that with all GST returned to the provinces

<table>
<thead>
<tr>
<th>PROVINCE</th>
<th>GST (60%)</th>
<th>Total Grants</th>
<th>Total Revenues</th>
<th>Estimated GST (100%)</th>
<th>Estimated Grants (@ GST100%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>West. Province</td>
<td>13,902,000</td>
<td>34,399,918</td>
<td>48,301,918</td>
<td>23,170,000</td>
<td>25,131,918</td>
</tr>
<tr>
<td>Gulf</td>
<td>269,000</td>
<td>58,399,132</td>
<td>58,668,132</td>
<td>448,333</td>
<td>58,219,799</td>
</tr>
<tr>
<td>Central</td>
<td>5,098,000</td>
<td>65,353,995</td>
<td>70,451,995</td>
<td>8,496,667</td>
<td>61,955,329</td>
</tr>
<tr>
<td>NCD</td>
<td>240,981,000</td>
<td>240,981,000</td>
<td>401,635,000</td>
<td>-160,654,000</td>
<td></td>
</tr>
<tr>
<td>Milne Bay</td>
<td>8,210,000</td>
<td>70,065,687</td>
<td>78,275,687</td>
<td>13,683,333</td>
<td>64,592,354</td>
</tr>
<tr>
<td>Oro</td>
<td>2,088,000</td>
<td>45,816,659</td>
<td>47,904,659</td>
<td>3,480,000</td>
<td>44,424,659</td>
</tr>
<tr>
<td>South. Highlands</td>
<td>16,814,000</td>
<td>31,128,142</td>
<td>47,942,142</td>
<td>28,023,333</td>
<td>19,918,808</td>
</tr>
<tr>
<td>Hela</td>
<td>420,000</td>
<td>33,139,319</td>
<td>33,559,319</td>
<td>700,000</td>
<td>32,859,319</td>
</tr>
<tr>
<td>Enga</td>
<td>1,593,000</td>
<td>59,384,844</td>
<td>60,977,844</td>
<td>2,655,000</td>
<td>58,322,844</td>
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<tr>
<td>West. Highlands</td>
<td>17,797,000</td>
<td>52,320,845</td>
<td>70,117,845</td>
<td>29,661,667</td>
<td>40,456,178</td>
</tr>
<tr>
<td>Jiwaka</td>
<td>82,000</td>
<td>51,427,971</td>
<td>51,509,971</td>
<td>136,667</td>
<td>51,373,304</td>
</tr>
<tr>
<td>Simbu</td>
<td>2,655,000</td>
<td>76,508,523</td>
<td>79,163,523</td>
<td>4,425,000</td>
<td>74,738,523</td>
</tr>
<tr>
<td>East. Highlands</td>
<td>13,112,000</td>
<td>99,100,521</td>
<td>112,212,521</td>
<td>21,853,333</td>
<td>90,359,188</td>
</tr>
<tr>
<td>Morobe</td>
<td>89,570,000</td>
<td>29,563,236</td>
<td>119,133,236</td>
<td>149,283,333</td>
<td>-30,150,097</td>
</tr>
<tr>
<td>Madang</td>
<td>12,460,000</td>
<td>96,650,236</td>
<td>109,110,236</td>
<td>20,766,667</td>
<td>88,343,569</td>
</tr>
<tr>
<td>East Sepik</td>
<td>8,770,000</td>
<td>126,363,357</td>
<td>135,133,357</td>
<td>14,616,667</td>
<td>120,516,690</td>
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<tr>
<td>Sandaun</td>
<td>1,958,000</td>
<td>89,859,983</td>
<td>91,817,983</td>
<td>3,263,333</td>
<td>88,554,649</td>
</tr>
<tr>
<td>Manus</td>
<td>14,686,000</td>
<td>28,212,540</td>
<td>42,898,540</td>
<td>24,476,667</td>
<td>18,421,873</td>
</tr>
<tr>
<td>New Iredeland</td>
<td>4,981,000</td>
<td>10,825,551</td>
<td>15,806,551</td>
<td>8,301,667</td>
<td>7,504,885</td>
</tr>
<tr>
<td>East New Britain</td>
<td>17,890,000</td>
<td>52,785,013</td>
<td>70,675,013</td>
<td>29,816,667</td>
<td>40,858,346</td>
</tr>
<tr>
<td>West New Britain</td>
<td>10,198,000</td>
<td>45,277,328</td>
<td>55,475,328</td>
<td>16,996,667</td>
<td>38,478,661</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>483,534,000</td>
<td>1,156,582,800</td>
<td>1,640,116,800</td>
<td>805,890,000</td>
<td>834,226,800</td>
</tr>
</tbody>
</table>

Notes: Data is for 2016, figures for GST and Grants are from Erick Pouru (supplied); the Total Grants is the sum of Goods and Services Grant, Administrative Grant, Health Function Grant, Education Function Grant, Transport Infrastructure Function Maintenance Grant, Village Court Function Grant, Agriculture Function Grant, Other Services Function Grant, Land Management Function Grant, and Rural LLG Grant.

Two provinces raised more GST than the grants they received from the national budget. Imposing the requirement that the total allocation to the provinces from the national budget is left unchanged, NCD and Morobe need to return K160 million and K30 million, respectively, to the budget. Their contribution to the national budget is understandable. Both of these provinces host significant national assets that give them an advantage over their counterparts in terms of raising GST revenues. The NCD hosts the national capital Port Moresby, the main airport, and the second largest seaport — all credit to the significant investments made by the nation at large. Similarly, Lae city is the business hub of the nation as it funnels exports out of the highlands. Lae is home to the largest seaport and the second main airport of the nation — credit to investments made from the national budget. Thus, them paying a fee in terms of the sums noted above for these privileges may be defensible.

How can the support of Morobe and NCD be secured for the proposal to return all of the GST collections to the other provinces but for them? This, as explained next, can be done through two conditions so that
the incentives for each province to grow their own economies are retained. First, a ‘no harm’ provision could be incorporated so that the new scheme will not disadvantage any subnational government in terms of the revenues they currently receive. This would mean that NCD and Morobe will, in future, continue to pay the same fixed amount of their GST revenues to the national budget, and capture all the remaining. Such a mechanism preserves the incentives for any subnational government to recover all the GST generated from any additional economic activity. Second, and a major change from the existing arrangements would be that the subnational government would have the discretion over all expenditure funded from GST receipts but subject to public finance regulations and that of having to share data on the levels of access to assigned services to a national monitoring authority. Currently no subnational government has such powers. Granting these powers will mean loss of control over local expenditures by the national Government, but this is consistent with the principle of subsidiarity. Furthermore, the national Government will still be able to influence local expenditures through provision of matching grants. The change proposed above, while being revenue-neutral, would provide the incentives to provincial governments to support local enterprise as they will harvest the full benefits from increased receipts of GST revenues.

4.4 Assignment of functions to subnational governments

The Intergovernmental Relations (Funding and Functions) Act of 2009 spells out in considerable detail the responsibilities for service delivery that is assigned to provincial and local-level governments. It would be impossible to do justice in explaining all of the details surrounding the assignment of functions and the funding of the assigned responsibilities from the national government to provincial and local-level government. Thus the coverage in this section is brief and closely aligned to the preceding section.

Does funding follow function? The answer to this question is not clear as explained below. The NEFC is allocated the responsibility to estimate the recurrent costs of delivering the assigned services, assess the amount of revenue available to the subnational government, and use the above-mentioned to arrive at a figure for ‘fiscal need’ (IGRFF, ss. 21 & 24). The formulas used to reach the figures for fiscal equalisation for each subnational government is spelled out in detail in the legislation, but they are not accessible to an ordinary member of the public. Thus, updating of the formulas contained in the IGRFF after public discussion with the view to making them simpler is overdue.

Subsidiarity has been followed. Provincial and local-level governments are responsible for local services in relation to health, education, infrastructure maintenance, village court, land management, primary production, and so on. This assignment is consistent with the principle of subsidiarity, in that the responsibility for delivery of these services are vested in the lowest level of government, and there are no compelling reasons why such delivery should be otherwise.

Provincial and local-level governments are heavily reliant on the national budget for their expenditures. Grants provided from the national government to provincial governments include service delivery function grants, administration grants, rural local-level grants, urban local-level grants, staffing grants, and developmental grants. The NEFC has primary responsibility for oversight over all expenditure that is funded through these grants (IGRFF, s. 68), meaning that the national Government has close to complete control over expenditures at the local level.

Expenditure autonomy is limited. Recurrent funding attached to functions assigned to subnational governments is provided through an administrative and a functions grant. The administrative grant pays for incidental costs while the functional grants meet the costs of delivery. The IGRFF spells out in considerable detail the uses of both the administration and function grants. Provincial governments, moreover, have to secure approval from the national Treasurer for their budgets. These restrictions on the use of grants from the national Government limit autonomy of subnational governments in spending the funds on their own priorities. Consequently, the national Government has close to complete control over all recurrent expenditures in the provinces.

Coordination across levels of governments for integration of services could be challenging. This is because the role of DDAs is unclear, and their integration with local-level governments opaque. Sometimes the DDAs
operate in competition with local-level governments, making integration impossible.

4.5 Revenue autonomy

Provincial and local-level governments have limited autonomy with respect to setting the rate of tax, determining the tax base, and collecting the taxes. This autonomy, however, is limited to a narrow base and subject to revocation by the National Treasurer if deemed discriminatory or if the tax rate set is ‘unreasonably high’ (IGRFF; s. 70). The national Government sets and collects all income taxes, GST, and border tariffs. The reasons for the above are simple. Nationally determined taxes minimise the opportunities for tax competition between subnational governments within PNG. The IRC collects all tax revenues and operates at the national level. This is efficient as it minimises duplication of effort and allows for national coverage of the taxpayers.

About 90 percent of all taxes are collected at the national level. The revenues collected are then shared across 22 provincial governments (including the NCD), 89 districts, and 318 LLGs. Once again, the sharing of these revenues is set by legislation. The GST Revenue Distribution Act 2003 (GSTRA) and the Intergovernmental Relations (Functions & Funding) Act 2009, for example, stipulate that 60 percent of GST revenues collected in the preceding fiscal year in the jurisdiction of a provincial government or a LLG is returned to them (GSTRA, s. 7(2a); IGRFF, s. 40). Subnational governments are also entitled to receive a share of ‘bookmaker’ turnover tax and mining and petroleum royalties and dividends, but these accrue to only a few of the provinces. Provincial governments may impose their own local taxes, charge business license fees, and run their own commercial enterprises but these contribute to about 10 percent of their total expenditure.

The recent literature on fiscal decentralisation emphasises the importance of striking a balance between direct transfers from the national budget and the devolution of powers from the National Government to subnational governments to raise their own revenues. The evidence points to the fact that subnational governments spend their revenues more responsibly when these revenues are raised by themselves (Slack, 2017). But not all subnational governments have the same capacity to raise revenues locally, thus self-reliance has to be supported at the provincial level without exacerbating fiscal imbalance between them.

4.6 Access to information for effective grassroots government

Grassroot government provides the incentive for improved service delivery only when the local public holds the executive to account for the services provided\(^5\). A necessary condition for this to happen is access to timely and accurate data that allows the recipients of the service to judge the effectiveness of supply. The public, for example, will be able to assess the level of access to schooling if provided data on the proportion of school-aged children enrolled and residing in the jurisdiction of the school. Parents, similarly, would be in a position to judge the effectiveness of schooling only if they have access to results from the national examinations in realtime. Comparisons across jurisdictions of such objective information will create a climate for competition in the delivery of public services across provinces, districts, and LLGs.

Better information is essential for a well-functioning intergovernmental fiscal relations (Bird & Smart, 2002). The task of monitoring the use of grants by provincial, district, and local-level governments is currently assigned to the NEFC operating in consultation with the chairman of the Provincial and Local-level Service Monitoring Authority and the departmental head of Treasury (IGRFF, s. 68). This is an excellent foundation that may be built on towards an independent National Service Monitoring Authority (NSMA) operating at arms-length from both the national and subnational governments but in close collaboration with the National Statistical Office. While the details of what the proposed NSMA would look like are still to be fleshed out, it would, at a minimum, be required by legislation to publish timely data on levels of access to public services in all of the provincial, district, and local-level governments jurisdictions. The NSMA could also be required to report to the National Parliament and the media annually. The reports from the NSMA will be credible only if the indicators of the effectiveness of service delivery are objectively assessed and easily understood, and these are communicated

\(^5\)Kaufman and Dilla Alfonso (1997) provide case studies where empowerment of the local community has delivered economic development, and Wang and Yao (2007) show that elections of officials enhanced accountability of the village committee.
to the public on a regular and timely basis. The details of the role and remit of the proposed NSMA can be part of a national conversation on structuring of incentives for improved service delivery.

Objective information on its own unfortunately is not enough for improved accountability of subnational governments. In the case where politics prevails so that parents prioritise their connections (via clan, language, ethnicity, etc.) over the quality of services received in local elections then grassroots government may not deliver improved accountability. Such accountability may be eroded further when grants for service improvement are allocated to members of the national parliament directly from the national budget. Discretion in the use of such grants for ‘service improvements’ in the electorate provides the incentive for, and the opportunity to, engage in clientelist politics. Reports to the National Parliament and the media will abate such a risk.
This paper has two aims: first, to describe the central features of the mechanisms used for fiscal decentralisation in jurisdictions similar to PNG; and, second, to compare them to the practice in PNG. While researching for this paper, it was also discovered that considerable thinking had been put in place in the lead-up to independence of PNG in designing intergovernmental relations pertaining to the devolution of legislative, administrative, and financial powers from the capital to the provinces. The paper draws many of the lessons from this earlier thinking, noting that the demand for increased autonomy by the provinces and local-level governments runs deep within the veins of the nation. We have also tracked the reforms that have been instituted with regards to decentralisation. While these reforms were intended to bring governments closer to the people, the changes introduced in 1995 through the OLPGLLG had the opposite effect. That is, the OLPGLLG centralised the authority to legislate, administer, and spend funds for the delivery of services within the provinces, districts, and local-level governments into the hands of members of the National Parliament.

Decentralisation in PNG began with the work of the CPC that deliberated in 1974, with many of the recommendations put to effect in the initial design of provincial and local-level governments. The CPC had noted that its “deliberations on the distribution of powers and functions between the National Government and provincial governments have been among the most difficult and time consuming of all” (CPC, para. 79). Not much has changed in the 48 years since — a poignant reminder that the current deliberations on autonomy and the design of intergovernmental relations will neither be easy nor quick. Reassuringly though, the population of PNG that is dispersed across the nation has survived for centuries as autarchic and independent communities. Their demand for greater self-reliance is to be both celebrated and respected.

The focus of this paper has been on fiscal decentralisation, meaning the transfer of the powers to raise revenues and the responsibility to spend the proceeds for delivery of public services from the National Government to subnational governments (i.e. within PNG the subnational governments are the provincial governments, district authorities, and local-level governments). The responsibilities assigned to subnational governments and the accompanying funding that is provided to enable them to exercise their obligations are spelled out in detail in legislations; namely, the Organic Law on Provincial Governments and Local-level Governments (OLPGLLP), Intergovernmental Relations (Functions & Funding) Act 2009 (IGRFF) and Goods and Services Tax Revenue Distribution Act 2003 (GSTRDA).

PNG has taken a strong legislative route to implementing decentralisation. The National Constitution accords the mandate to an independent National Economic and Fiscal Commission to advise the National Treasurer on the magnitude of transfers for equalisation of fiscal capacity, and to monitor and report on the use of the disbursed funds. The levels of transfers from the national budget are determined through the application of formulas included in legislation, and the use of the grants provided are also spelled out in legislation. Finally, the budgets of provincial governments are approved by the National Treasurer and all public expenditure is subject to audit by the National Office of the Auditor General.

The challenge taken up in this paper is to first assess the practice of fiscal decentralisation in PNG to established principles, and then use the information to propose mechanisms for fiscal decentralisation that will improve service delivery at the grassroot level. In addressing this challenge, lessons are drawn from the international experience. An important area for consideration in relation to existing fiscal arrangements is the mechanisms that exist for fiscal accountability and means to improving this.

The literature lays down five specific principles that guide the design of mechanism for fiscal decentralisation. The first is that of subsidiarity, meaning that the responsibility for the delivery of services should be devolved to the lowest level of government unless proven otherwise. Support for subsidiarity rests on the simple premise that a government serving in close proximity to the people has the information and the incentives to serve the interests of the public. In other words, grassroot democracy facilitates accountability of the public service. The second guiding principle is that of asymmetric decentralisation, which posits that functional responsibilities of
the local-level government must be tailored to the preferences and needs of locals. These two principles bring
to fore the concept of ‘grass-root government’. The third proposition is that services provided to the public, to
the extent possible, should be paid for by the beneficiaries; that is, with the use of ‘benefit taxation’. Fourth,
‘finance must follow function’; that is, the functions assigned to subnational governments must be funded.
And last, grants must be provided from the national budget to enable each subnational government to exercise
their responsibilities; this principle is that of fiscal equalisation. Fiscal equalisation recognises the reality of the
inequities that exist both between the national government and subnational governments as much as across
subnational governments in terms of their capacity to raise revenues and the costs of delivering services. But
grants for fiscal equalisation from the national budget can weaken the incentives for the recipients to raise their
own revenues while encouraging lobbying and corruption to maximise the values of the transfers. Thus, fiscal
equalisation through grants from the national budget has to be balanced against benefit taxation. On this, the
literature points to the use of simple transparent rules administered by an independent authority to strike this
balance.

How does the mechanisms for fiscal equalisation in PNG measure against the principles enumerated above?
On all counts, the assignment of functions to provincial governments, district authorities, and local-level
governments are consistent with the principle of subsidiarity. Similarly, most local authorities have a say through
their elected representatives in the services provided to them. These together, however, does not imply that
‘grassroot governments’ are delivering — missing from the above is timely and accurate information that is
necessary to close the feedback loop between the governed and their local government. Provincial governments,
tellingly, report to the National Government for their expenditures, and therefore, are immune from local
scrutiny.

Access to timely, accurate, and digestible information is necessary for the public to hold its government to
account. We have proposed an independent National Service Monitoring Authority with the remit to monitor
and the mandate to report on measures of the levels of access to services across all provinces, districts, and LLGs.
This information is to be provided to the National Parliament, broadcast through a dedicated website, and via
the media. A public that is in a position to compare the performance of its own local government with that of
their neighbours will be equipped to demand accountability. Clientelist politics may erode the value of such
information, but the National Parliament and the media will mitigate some of these risks.

An important lesson from PNG’s history is the perception that ‘finance has not followed function’. Lower-
level governments have consistently complained of being starved of funding, and used this as the reason for
their failures. Transfers from the national budget for equalisation are made on the advice of an independent
National Economic and Fiscal Commission. The value of grants provided to provinces are calculated using
legislated formulas, thus the mechanisms are transparent but the formulas are far from simple to comprehend.
Furthermore, the limited discretion that subnational governments have in spending their budgets hampers
service delivery. Lastly, grants can dampen the incentives for local governments to raise their own revenues;
a consideration that has led to discussion on the transfer of revenue-raising powers to the provinces (Pouru,
2021). An idea worthy of national conversation is allowing provinces to receive all of the GST revenues collected
in their jurisdiction. This then would provide a stronger incentive than the current arrangement where the
National Government collects 40 percent of the GST generated in the provinces. Similarly, allowing provinces
the discretion to spend revenues generated locally but subject to audit by the Auditor General and the scrutiny
by the public through information provided by the NSMA has the potential to increase local autonomy.

Finally, there are at least three issues deserving indepth national conversations. First is the question of the desired
levels of decentralisation, and specifically the functions to be devolved to the provinces, districts, and local-level
governments. Part of this conversation would be on the role of the National Government that is likely to lose
some of the direct control it currently has over expenditures at the local level. How much power should members
of the National Parliament have over service delivery in their electorates? Second, a conversation on how best
to improve access to information by the public to give ‘grassroot government’ a chance is overdue. A proposal
for an independent agency given the mandate to monitor, report, and publish information on access to basic
services across governments in PNG deserves discussion and fleshing out. And last, decentralisation is likely to
remain a live issue as it has for the life of PNG. Being cognisant of this fact will tamper expectation from the
current attempt at reform.
References


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