

CONSULTANT'S REPORT

TO

THE COMMITTEE TO REVIEW THE FINANCIAL PROVISIONS
OF THE ORGANIC LAW ON PROVINCIAL GOVERNMENT

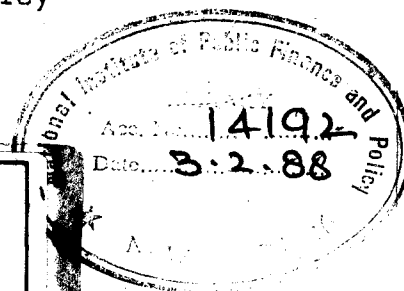


PART II: SOURCES OF PROVINCIAL REVENUE AND
MECHANISM OF FISCAL ADJUSTMENTS

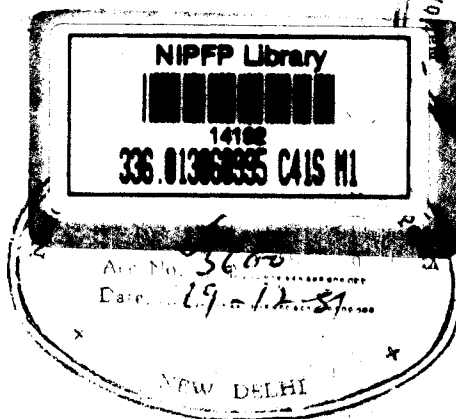


BY

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NEW DELHI

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I wish to acknowledge the help, assistance and support I received from several officials of the Department of Finance, who cannot all be named individually. I am in particular indebted to Mr. Len Crossfield, Executive Officer to the Committee and Assistant Secretary, National Fiscal Commission, Department of Finance, who besides looking after the practical aspects of my stay in Port Moresby in the most helpful way, was the main channel and source of information and clarification on the complex problems of provincial finances in Papua New Guinea. I am equally indebted to the other consultant, Dr. Ron J. May, who liberally shared his deep knowledge and sympathetic understanding of the culture, life and problems of the peoples of this country. Mr. Rarua Biga rendered efficient research assistance.

I would like to thank also the members of the Committee and other participants in the Symposium on Provincial Government Financing held in Waigani on August 26 to 28, with whom I had the opportunity to hold discussions on several aspects. Last, but not least, I wish to express my gratitude to the Chairman of the Committee, Mr. John Vulupindi who officially invited me to take up the consultancy and took personal interest in my work.

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I. TERMS OF REFERENCE

While Dr. Ron May and myself have been required to work as a consulting team and consider all matters relevant to the work of the Committee, we have also been given distinct terms of reference. My specific terms of reference are as follows:

"The consultant should analyse the existing system of provincial funding as defined in the Organic Law on Provincial Government and recommend such changes (if any) that he feels are appropriate.

In doing this, the consultant should keep in mind:

- i) the constraint imposed by limits of total funds available to the nation in relation to the development of the economy in general and the need to promote private sector economic growth in particular;
- ii) the spending aspirations of both the National and the Provincial Governments given their respective responsibilities under the Constitution and Organic Law;
- iii) the need to ensure an efficient and easy to administer system of public revenue collection;

- iv) the need to promote a more equal distribution of benefits between the provinces.

Among other tasks he considers relevant to the above, the Consultant should:

- a) review briefly the lesson to be learnt from "fiscal federation" in other countries with similar tiers of government.
- b) comment on the advantages and disadvantages for Papua New Guinea of the various systems available, e.g., conditional grants, unconditional grants, devolution of taxing powers, revenue sharing, etc;
- c) consider the effects on the allocation of resources of different tax rates between provinces (e.g., with a retail sales tax) and assess the efficiency of central revenue collection at uniform rates to be distributed to provincial governments on an unconditional basis;
- d) suggest any appropriate new tax measures for provinces, particularly where the present incidence of taxation at national or provincial level is low or non-existent, e.g., taxation of non-corporate agricultural incomes; and

- e) consider and evaluate appropriate criteria for the distribution of grants from the National Government to Provincial Governments, factors as need, origin of

II. THE PREMISES

2.1 The Constitution of Papua New Guinea (PNG) lays down the framework for what is essentially a unitary state with clearly marked federal features that call for a substantial degree of decentralisation of the exercise of power. Decentralisation of political and administrative authority calls for the decentralisation of financial powers and perhaps even a degree of financial autonomy, since, after all, an adequate command over resources is a sine qua non of the exercise of governmental authority. However, the question of the proper or desirable degree and manner of financial decentralisation can only be considered within the context of a given Constitution and its fundamental characteristics. Any financial scheme that is adopted must satisfy the logic of the Constitution that the founding fathers have fashioned.

2.2 Thus a basic premise for the discussion of inter-governmental financial relations in PNG is the fundamentally unitary nature of the state in which, although there is to be a considerable degree of decentralisation of power, the

provinces do not exercise co-ordinate authority with the National Government and in which the latter is the supreme custodian of national welfare and can override the will of the provinces on many important matters.

2.3 The position of the National Government vis a vis the provinces is brought out clearly in a number of provisions of the Constitution. Thus, Section 187E of the Constitution says:

"(1) Parliament may suspend a provincial government if

- a) there is wide-spread corruption in the administration of the province;
- b) there has been gross mis-management of the financial affairs of the province".

Division 4 of the Organic Law on Provincial Government (Organic Law henceforth) places a large number of subjects in the concurrent list. Section 4 of the Organic Law authorises the National Parliament to make Acts in the concurrent field (a) in relation to a matter that is of national interest; and (b) to the extent that the matter is of national interest. The question whether an Act of Parliament on a concurrent subject satisfies the above conditions, (a) or (b), is not justiciable (Section 29(2) of the Organic Law). Any provincial law inconsistent with a National Government law will be invalid.

2.4 Section 37 of the Organic Law states that "the National Parliament may, by a two-thirds absolute majority vote, by resolution disallow any provincial law if in its opinion the disallowance is in the public interest". (At least two months before the disallowing resolution is made, the Parliament must have, by a simple majority, resolved to consider the matter of the disallowance.)

2.5 Furthermore, while the provinces have been authorised to levy a limited number of taxes, the National Parliament has reserved for itself the power to set right or remove any tax imposed by a provincial law which, in its (Parliament's) opinion, creates discrimination between persons, or against persons resident in other provinces, or against products originating in other provinces; or is set at an unreasonably high level. These questions also are not justiciable.

2.6 The above-mentioned provisions of the Constitution and the Organic Law do not by any means negate the philosophy or the principle of decentralisation. Indeed, the intention is clearly to transfer to the provinces many functions and powers that closely affect the lives of the people; and, equally important, a reasonably adequate provision is to be made for granting to the provinces the financial resources that are required to perform the functions expected of them. In this connection, it may be noted that the provinces are expected to deal with several of the subjects falling in the concurrent list under Division 4, although the National Parliament may enact laws concerning those subjects in the national interest. There is in fact a large number of subjects in the concurrent list.

2.7 Four points become clear. First, substantive decentralisation is the desired goal of the creation of provincial governments. Second, such a large concurrent field calls for a great deal of co-operation and co-ordination between the two levels of government. Third, while the provinces have powers to act on their own initiative within their sphere of competence, the National Government is the custodian of national welfare and interest and has the power to act to thwart or remove any provincial action that may harm the nation. And fourth, it is incumbent on the National Government to make provisions for, and in respect of, grants to the provinces and the imposition and collection of taxes by provincial governments and to make other financial provisions for provincial governments "to an extent reasonably adequate for the performance of their functions"^{1/}.

2.8 These are the premises on the basis of which I shall attempt to critically evaluate the existing arrangements for the provision of financial resources to the provinces and then make recommendations which will be

^{1/} It can be argued that what the Constitution says in this regard implies that the National Government is not expected to, or should not, provide for more than what can be reasonably regarded as adequate. By the same token, the responsibility is cast on the National Government to provide resources to the provinces, in one way or another, which are necessary or adequate for the performance of the functions allotted to them.

consistent with the spirit of the Constitution and are at the same time necessitated by the objective conditions prevailing in the country.

2.9 The plan of the rest of the Report is as follows. In Chapter III, I briefly summarise the major provisions of the Organic Law relating to fiscal matters contained in Part X. The summary is intended to bring out the salient principles implicit in the provisions. Chapter IV gives a profile of National and provincial finances. Chapter V describes and comments on the existing arrangements for the devolution of financial resources to the provinces. Chapter VI is largely theoretical and discuss the economic and fiscal issues raised by the decision to have two or more tiers of government in a country. These issues, in the ultimate analysis, require political solutions, but the political decisions must be made after paying due regard to rational economic considerations. In Chapter VII, I shall consider the changes that are required in the financial provisions of the Organic Law and in the administrative procedures that have evolved over time. In doing so, I shall keep in mind the relevant lessons to be drawn from the experiences of other fiscal federations and also seek to apply the basic principles discussed in Chapter VI. The final Chapter contains a summary of conclusions and recommendations.

III. MAJOR LEGAL PROVISIONS RELATING TO PROVINCIAL FINANCES

Sources of Revenue

3.1 The financial resources of a province shall consist of

- a) receipts from taxation imposed by provincial laws or imposed under delegation from the National Government;
- b) grants, unconditional and conditional, from the National Government;
- c) shares of National taxes;
- d) the proceeds of court fees, fines and penalties and other fees and charges under provincial laws;
- e) returns on and proceeds of investments;
- f) income from commercial enterprises conducted by it;
- g) proceeds of short-term borrowings, loans from the National Government and long-or medium-term loans, if any, specifically approved by the National Minister for Finance; and

- h) "such other moneys as are lawfully available to it under an Act of Parliament or a provincial law."

3.2 It is seen that the Organic Law gives the provinces varied sources of revenue which in principle should enable them to build up in course of time a strong and diversified revenue structure. However, they are now predominantly dependent on grants and other transfer from the National Government. As can be seen from Table 1, in 1980, appropriations under Section 248 (largely consisting of transfers to finance the 7 transferred functions in respect of 15 provinces which have not yet been granted full provincial autonomy) and minimum unconditional grants together constituted more than 78 per cent of the provincial revenues. Own tax and non-tax revenues constituted about 1 per cent of the total.^{2/} Of the rest of the 21 per cent or so, conditional grants accounted for 10 per cent, National Fiscal Commission grants for 4.5 per cent, derivation grants for 1.5 per cent and the share of national taxes

2 As of 1980, the provinces themselves did not raise any significant amount of tax revenues. It is understood that the general retail sales tax is being put into operation in three provinces only this year (1981). A limited amount of non-tax revenues might have also been collected by some of the provinces but complete figures are not available. It could be surmised that if the probable collections by the provinces are all taken into account, they might amount to 1 per cent of the total receipts.

(royalties and motor vehicles registration fees, etc.) for 4.8 per cent. Assuming that derivation grants, in a sense, represent shares in the national tax on exports, it could be said that the revenues raised by the provinces on their own and shares of national taxes together brought in just above 7 per cent of the total provincial revenues (i.e., non-capital receipts).

TABLE 1

Sources of Provincial Revenue
(1980)

	Amount K'000	Per cent of total
1. Division 248 appropriations	67,446.5	43.7
2. Minimum unconditional grants	52,308.8	34.5
3. Conditional grants	15,594.9	10.1
4. National fiscal commission grants	7,000	4.5
5. Shares of national taxes	7,430	4.8
6. Derivation grants	2,250.6	1.5
7. Own tax and non-tax revenues	1,360.2	0.9
8. TOTAL	154,390.9	100.0

Provincial Tax Powers

3.3 Exclusively provincial taxes, referred to in Sections 56 and 57 of the Organic Law, consist of

- a) retail sales tax;
- b) taxes on public entertainments and places of public entertainments for which admission is charged;
- c) taxes on land;
- d) head tax;
- e) fee for licences for (a) mobile traders (other than mobile banks, (ii) places where intoxicating liquor is sold and (iii) operating or carrying on gambling, lotteries and games of chance; and
- f) any other tax that could have been imposed by the Local Government Councils before the commencement of the Organic Law.

3.4 The range of tax powers granted to the provinces is quite limited. Of the above list, only three sources can, strictly speaking, be regarded as modern forms of taxes that could be expected to be exploited; namely, the retail sales tax, the tax on entertainments and land taxes. The head tax could perhaps be used to some extent by village bodies; but it can hardly be used to raise significant amounts of revenue at the provincial level, having

regard to the fact that it seriously violates the canon of equity. Rates on land, which would come under (f) above, would be needed by the Local Government Councils and cannot be used to finance provincial expenditure. That leaves the provinces with three taxes. These may be considered to be suitable for provincial operation in that the impact of the taxes will, and can, be largely localised, whereas more broad-based taxes like the income tax would have nation - or economy - wide repercussions. The Constitution makers seem to have given much weight to this consideration just as the Consultants to the Constitutional Planning Committee (CPC), Professors Tordoff and Watts had done.^{1/} It is also possible that the CPC felt that it would take some time for the provinces in general to develop a set-up of tax administration and that it would not be wise to burden them with the task of administering more complicated, or a larger number of, taxes.

3.5 Taken together, these three taxes cannot be regarded as quite insignificant. But the development and administration of an equitable and economically efficient land tax would present a number of problems in the peculiar conditions of land tenure and land use in PNG. Also, it is a moot question if all the provinces are capable of administering a full-fledged retail sales tax. We shall return to these questions later.

^{1/} Cf. Chapter 7 of Report on Central Provincial Government Relations by Tordoff W. and Watts R.L., 1974 (Tordoff and Watts Report).

Transfer of Proceeds of Selected National Taxes

3.6 Section 67 of the Organic Law specifies that the net proceeds of (a) the royalties on petroleum, other minerals, natural gas, timber, fish and water used for hydro-electric projects and (b) the fees for the Registration and Licensing of Motor Vehicles and for licences and permits to drive motor vehicles, collected by the National Government, will be paid over to the respective provinces wherein they are collected or can be deemed to be collected. Thus the Organic Law, having given to the provinces three taxes with potential for exploitation, stipulates that the net proceeds (i.e., net of cost of collection) of two more taxes could be wholly transferred to the provinces. The proceeds of both these taxes are to be allocated among the provinces on the basis of origin. This has two implications.

- a) The National Government, apart from ensuring a nationally desirable level and uniformity of rates, acts as a collecting agency for the provinces; and
- b) Since the allocation is on the basis of origin, those provinces endowed with the concerned natural resources and enjoying a higher level of economic and commercial activity would benefit proportionately more.

Derivation Grants

3.7 In their Report cited earlier, Todroff and Watts had recommended that in addition to the payment of the net revenue from centrally imposed royalties to the provinces on the basis of derivation, the entire net proceeds of a moderate rate (say, 5 per cent) of an export tax levied by the National Government on agriculture produce "be distributed according to the proportion collected on produce originating from each province". While accepting the principle behind the recommendation of the two experts, the CPC softened its impact by making some significant modifications to the scheme. Thus the Organic Law specifies (Section 66) that a derivation grant will be paid to a province which will be equal to "1.25 per cent of the value derived from the province to goods exported from Papua New Guinea during the preceding fiscal year" minus the amount received by that province in the form of royalties during the preceding fiscal year. This means in effect that instead of being eligible to receive both the royalties and the derivation grant, the provinces producing exported goods on which royalties are collectible (minerals, timber, fish, etc.) can receive only the higher of the two. Also, the derivation grant was linked to the export value rather than to the amount of the export tax collected. so that even if export taxes are removed, the concerned provinces would continue to receive the derivation grant.

3.8 However, so long as the derivation grant is payable, the National Government will have an incentive to continue the export taxes. This in turn limits the scope for the levy of a tax on land or the produce of land by the provinces.

Unconditional Grants.

3.9 Unconditional grants provided for under Section 64 of the Organic Law consist of two components: There is first a minimum amount of grant in respect of each province tied to the cost of maintaining the services transferred to that province under the scheme of provincial devolution. As indicated in detail in Dr. May's Report, all provinces assumed responsibility for the provincial legislature and secretariat, capital works maintenance and Rural Improvement Programme (RIP), but seven other functions have been transferred effectively only in respect of four provinces which have assumed full financial autonomy. In respect of these latter four provinces, the minimum unconditional grants (MUG) cover all the transferred functions, whereas in respect of the rest of the 15 provinces, MUG for the first three functions are supplemented by expenditure by the National Government under Division 248 of the National Budget. As regards the latter, while the provincial government personnel are involved in the spending, the funds do not pass through the provincial budgets, and fairly close supervision is exercised by the National Government's Department of Finance over the expenditure. The MUG received by the four provinces that have assumed full responsibility should be compared with MUG and Division 248 expenditure in the case of the other provinces.

3.10 The MUG are calculated according to the formula laid down in Schedule 1 of the Organic Law. Essentially, the formula aims to guarantee to each province an amount equal to the cost of the functions that it has taken over adjusted by a cost of living index, at the same time

ensuring that the grants will not have to be increased faster than the major sources of revenue of the National Government. The actual formula is:

If A is the base figure of the amount spent on the transferred activity in 1976/77, B is the percentage increase in the cost of living index (prepared by the National Statistician) in the preceding year and C is the percentage change in the revenues accruing to the National Government from the income and corporate taxes, customs and excise duties and the Mineral Resources Stabilisation Fund in the year of grant over those in the preceding year, the guaranteed amount in 1977/78 would be the smaller of

$A + AB$, and

$A + AC$.

For any subsequent year, the adjusted base figure for 1977/78 is to be carried forward, year by year, in the same manner. Although 'B' is defined in the formula as "the percentage increase (if any) in the cost of living", the actual method of computation stipulated calls for the unweighted averaging of the "Consumer Price Index and the Statistician's Import Price Index". The underlying assumption seems to be that this average would fairly approximate to the index of the prices of the goods and services bought by the provincial governments.

3.11 The second component of the unconditional grants can be used for new services beyond the level represented by MUG or MUG and Division 248 expenditure, as the case may be. Section 64, Sub-section (1) of the Organic Law

stipulates that "for each fiscal year, the National Government shall, out of moneys lawfully available for the purpose, make unconditional grants to the provincial governments". (Italics added). From this, we can infer that (a) the National Government is under an obligation to make unconditional grants to the provinces every year, (b) the amount for the purpose must be appropriated by Parliament; and (c) the size of the grant is left entirely to the discretion of the National Government, though it must consider the recommendations of the National Fiscal Commission in regard to allocation.

Conditional Grants

3.12 The National Government is empowered to make conditional grants to provincial governments for any purpose agreed on between the National Government and the provincial governments concerned. The National Government may desist from making conditional grants in a year, if it is so chooses, but this is only a theoretical possibility. What is more important is that the grants would be subject to conditions agreed upon and should be spent only for the purposes for which the grants are made. Matching grants are not specifically mentioned, but, presumably, could be one of the conditions in suitable cases. Most of the conditional grants are now being made in respect of sectoral programmes and projects under NPEP.

Fees and Fines

3.13 The provincial governments may impose and collect court fees as well as fines and penalties, leviable or prescribed under provincial laws made for the purpose of Section 41. They may also impose fees and charges in respect of goods and services supplied under a provincial law. These are supplementary, but by no means significant, sources of revenue for the provincial governments.

National Fiscal Commission

3.14 As required by Section 187H(1) of the Constitution, the Organic Law establishes a National Fiscal Commission (NFC). The NFC consists of five members including the Chairman, who are to be appointed by the Head of State on the advice of the National Executive Council, given after consultations with provincial and local government leaders (as laid down in Section 76, Sub-section 2 of the Organic Law). The members will hold office for four years and will be eligible for re-appointment. As of now, the Chairman and the members are all part-time appointees.

3.15 The NFC has been given three specific functions to perform:

- a) to consider and report on any alleged discrimination or unreasonableness in provincial taxation and on any proposal by the National Government to remove or correct it;

- b) to consider and to make recommendations to the National Executive Council on the allocation of unconditional grants to provincial governments and as between provincial governments; and
- c) to consider and make recommendations to the National Government and provincial governments on other fiscal matters relating to provincial governments referred to it by the National Government or a provincial government.

3.16 The NFC has to be consulted before a decision is made by the National Government as to the allocation of unconditional grants under Section 64. The Commission is enjoined to recommend to the National Executive Council "a just and equitable allocation, within the limits of finance available, to each province". From Section 79, Sub-section (3), it would seem that no province can be left out of the allocation of unconditional grants. Furthermore, Sub-section (4) lays down that the NFC "shall, in principle, base its decision on equal grants per head of population", although it may depart from the above principle where some relevant factor, like the level of development, will make the strict application of the principle unjust or inequitable. This means that a partial departure from the principle of equal per capita grants is allowed on properly justified grounds.

3.17 It is interesting to note that the NFC has so far not allocated any part of the unconditional grants on a per capita basis, though such factors as the number of children of school going age not enrolled have been given weight.

IV. A PROFILE OF NATIONAL AND PROVINCIAL FINANCES

Introductory

4.1 PNG possesses several of the characteristic features of a developing country. Its per capita gross domestic product (GDP) in 1980 is estimated at K577.4, which at the current exchange rate is equivalent to US\$ 808. Although there is a net outflow of factor incomes, its level of per capita national product can be said to be high enough to place PNG in the top 20 per cent of the developing countries. Nevertheless, in some respects the economy of PNG is quite underdeveloped. Its relatively high income is mainly due to selected profitable exports, while the rest of the economy remains largely undeveloped with a sizeable subsistence and non-monetised sector. Two of the basic weaknesses are the backward state of general agricultural production and the lack of communication/transport facilities.

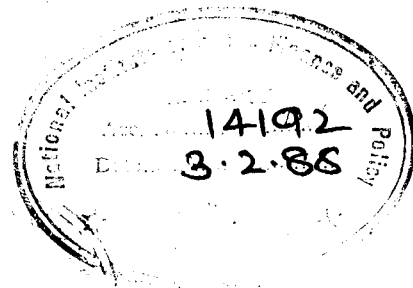
4.2 While manufacturing accounts for only about 8-9 per cent of GDP, mining and quarrying account for about 11 per cent and the tertiary industries excluding public and professional services account for about 17 per cent (Table 2). Together the above sectors account for about 41 per cent of GDP. In principle, production or income of these sectors, exports and public service salaries can be made the basis of deriving government revenues. However, the unorganized nature of much retail trade and small businesses, the undeveloped state of non-export agriculture and the dependence on export markets act as important limiting factors in diversifying the bases, and raising the level, of taxation.

TABLE 2

Gross Domestic Product By Industrial Origin - 1979

	(Percent of total)
1. Agriculture, hunting, forestry and fishing	33.7
2. Mining and quarrying	16.0
3. Manufacturing industries	8.5
4. Electricity, gas and water supply	1.2
5. Construction	4.0
6. Trade, restaurants and hotels	7.3
7. Transport, storage and communications	4.4
8. Other	24.9
9. Total	100

Source: UN, Statistical Abstract,
June 1981, p. Liv



4.3 This is not to say that the level of taxation is not already high in PNG, given its level of development and of its per capita income. The ratio of total tax revenues (national and provincial) to GDP was 17.5 per cent in 1980 and the total revenues (tax and non-tax excluding foreign grants) amounted to as much as 19.7 per cent of GDP. Of the 63 developing countries studied by the officials of the International Monetary Fund, for 1972-76, only 21 countries had a tax ratio higher than that of PNG and the average tax ratio for the 63 countries was 15.80 per cent^{1/}. Countries which had tax ratios of 18 per cent and above were mostly those exporting petroleum and other minerals. Their revenues and economies tended to depend largely on their mineral exports. The situation is not very different in PNG^{2/}.

4.4 Table 3 presents trends in and composition of National Government revenues from 1978 to 1981. In the three-year period, the total revenues including foreign grant assistance increased by 27 per cent. Between 1978 and 1979, the increase was only of the order of 1 per cent, but in the succeeding two years, the rate of increase was 13.1 per cent and 11.3 per cent, respectively. If foreign grant assistance is excluded, the rate of growth of revenues in 1980 and 1981 (over the respective previous years) was distinctively higher at 21.8 per cent and 14.3 per cent.

^{1/} Tait, A.A. Oratz N. and Eichengreen, B, "International Comparison of Taxation for selected Developing Countries, 1972-76" IMF, July 31, 1978 (Mimeo)

^{2/} It must be noted that the PNG government budget shows only the amount of money withdrawn from the Mineral Resources Stabilisation Fund; the actual receipts from Bougainville Copper could be higher. In 1980, they were K108.7 million. On that basis, the tax ratio would amount to 20.6 per cent.

TABLE 3

National Government Current Receipts

Revenue sources	1978		1979		1980		1981	
	Amount	%	Amount	%	Amount	%	Amount	%
	K1000		K1000		K1000		K1000	
<u>Tax revenue</u>								
Mineral resources stabilisation fund	31,200	7.0	38,500	8.5	56,600	11.1	81,400	14.3
Income tax (Indv)	67,133	15.0	61,599	13.6	75,861	14.9	91,000	16.0
Income tax (comp)	49,183	11.0	40,784	9.0	47,460	9.3	50,000	8.0
Dividend withholding tax	3,504	.7	3,838	.8	5,083	.9	4,000	-
Succession duty	1,500	.3	302	.1	139	.02	100	-
Bookmakers turnover tax	168	.03	297	.06	252		300	
Bookmakers licences	14	.003	16	-	26		20	
Stamp duties	1	-	1,703	.3	1,853	.3	3,700	.6
Sundry receipts	78	.01	175	-	-		100	
Royalty taxes	-		-		53		50	
Import duties	46,000	10.3	48,034	10.6	54,532	10.7	64,600	11.4
Excises	38,300	8.6	40,995	9.1	44,737	8.7	51,100	9.0
Export tax	7,700	1.7	8,347	1.8	9,552	1.8	11,900	2.1
Sundry receipts	10	.002	135	-	129		150	
SUB TOTAL	244,791	59.9	244,726	54.4	296,277	58.2	358,420	63.3
<u>Non tax revenue</u>								
Investments revenue	2,644	.5	7,455	1.6	15,369	3.0	4,600	.8
Registration fees (documents)	99	.2	275	.1	1,225	.2	800	.1
Liquor licences	81	.01	97	-	263	.05	250	

Table 3 continued

Revenue sources	1978		1979		1980		1981	
	Amount	%	Amount	%	Amount	%	Amount	%
Land lease rentals	1,618	.3	1,034	.2	1,638	.3	2,500	.4
Timber leases	2,290	.5	2,039	.4	1,173	.2	1,600	.2
Administrative & other receipts	22,201	4.9	19,260	4.3	18,185	3.5	13,733	2.7
SUB TOTAL	28,933	6.5	30,160	6.7	37,749	7.4	23,489	7.4
<u>Grant assistance</u>								
Australian aid	171,360	38.4	174,142		19	34.1	182,500	32.2
Other assistance	103	.02	693	.1	860	.1	1,600	.2
SUB TOTAL	171,463	38.5	174,835	38.8	174,659	34.3	184,100	32.5
GRAND TOTAL	445,187		449,721		508,685		566,010	

Sources: Department of Finance, Public Accounts for 1979 and 1980 and Estimates of Revenue and Expenditure for 1981

4.6 It is seen that over the period 1978-81, the proportion of revenue from foreign grant assistance declined from 38.5 per cent to 32.5 per cent. The relative importance of other non-tax revenues also declined (from 6.5 to 4.1 per cent), while the proportionate contribution of taxation increased significantly - from 54.9 per cent in 1978 to 63.3 per cent in 1981. This trend is likely to continue as the importance of Australian assistance is expected to decline. The increment in resources that would become available to the National Government and the provinces would then largely depend on the growth of tax revenues in the future.

4.7 For some reason, there was a fall in the yield of pf the major taxes such as the individual income tax, the company tax and import duties between 1978 and 1979. Hence total tax revenues remained almost stagnant in 1979. However, in the next two years tax revenues grew by 21 per cent each year. Such a high rate of growth is primarily due to the growth of the total receipts from the copper company and secondarily due to the buoyancy of individual income tax revenue.

4.8 One could compare the rate of growth of National Government revenues with that of provincial revenues inclusive of Division 248 expenditures, in order to gain an idea of whether the resources allocated to and available for the provinces have been rising at least in step with National revenues. In order to be meaningful, the comparison must be made only for the years in which the provinces were performing more or less the same set of transferred functions. I have, therefore, chosen the three years 1979 - 81. The annual percentage increases in National revenues and provincial revenues inclusive of allocations were as follows:

	1980/1979	1981/1980
National revenues before transfers	13.1	11.3
Provincial revenues	16.1	9.7

4.9 Thus, while in 1980, the growth of revenues accruing to the provinces was faster than that of National revenues, in 1981, according to estimates, the reverse would be the case.

V. ARRANGEMENTS FOR PROVINCIAL FUNDING

Pattern of Financing

5.1 The broad pattern of provincial funding was indicated in Chapter III. The overwhelming importance of MUG and Division 248 expenditure was brought out in Table 1. It may be useful now to compare the patterns of financing in the several provinces. Appendix Table C gives the percentage contribution of the different types of transfers and taxes to the budgets of the 19 provinces. The information contained therein is summarised in Table 4. For purposes of meaningful comparison, the provinces are divided into three groups, *viz.*, the less developed, the advanced, and the less advanced or the intermediate; and the sources of revenue are classified into four categories, *viz.*, (a) MUG and Division 248, (b) conditional grants, (c) NFC grants and (d) tax related receipts including derivation grants.

TABLE 4

Composition of Provincial Revenue - 1980

Provinces	(Percent of total)			
	MUG & DIV 248	Conditional grants, NPEP etc.	NFC grants	Tax related receipts
<u>Less developed</u>				
1. Western	69.8	24.6	5.1	0.4
2. Gulf	73.8	18.4	5.9	1.9
3. West Sepik	73.7	21.0	3.7	1.5
4. Oro	81.6	11.2	4.4	2.8
5. Simbu	82.2	8.9	5.1	3.8
6. Enga	80.7	13.2	5.3	0.8
Average	76.97	16.22	4.92	1.87
<u>Less advanced or intermediate</u>				
1. Central	83.7	6.1	3.6	6.6
2. Milne Bay	76.6	18.1	3.6	1.7
3. Southern Highlands	86.8	7.6	5.0	0.4
4. Western Highlands	79.7	7.1	5.6	7.6
5. Morobe	80.8	8.6	4.8	5.8
6. Madang	81.3	5.8	5.8	4.6
7. East Sepik	85.0	7.6	5.6	1.8
8. West New Britain	77.5	11.3	4.8	6.4
9. Manus	79.4	12.1	6.0	2.5
Average	81.20	9.64	4.98	4.16
<u>Advanced</u>				
1. North Solomons	55.8	2.4	1.5	39.3
2. East New Britain	81.5	5.2	2.2	11.1
3. New Ireland	85.6	5.2	2.7	6.5
4. Eastern Highlands	75.6	10.8	7.1	6.5
Average	74.63	5.90	3.38	15.85

Table 4 continued

Provinces	MUG & Div. 248	Conditional grants NPEP etc.	NFC grants	Tax Related Receipts
IV. All Provinces	78.2	10.1	4.5	7.2

- a) Includes staff grants
- b) Includes derivation grants

Source: Appendix Table A1

5.2 It is seen that all the provinces except North Solomons depended on MUG to the extent of not less than 70 per cent. As many as 10 provinces depended on MUG and/or Division 248 for more than 80 per cent of their total revenues. Again, only North Solomons derived a substantial proportion of revenues from tax related receipts, i.e., receipts that will grow automatically with the rise in income and economic activity. If MUG take care of even the approximate cost of carrying out the transferred functions, that province has great manoeuvrability in budgeting and expanding activities. Next comes East New Britain which derives 11 per cent of its revenues from taxes and derivation grants.

5.3 Although there do not seem to be systematic variations in the percentage contributions from conditional (mainly NPEP) grants, the less developed provinces are generally seen to draw a larger proportion of their resources from them than the others. Similarly, the advanced provinces generally get a smaller proportion of their revenues from NFC grants.

If we consider average percentage contributions for the groups, there does not seem to be much variation as regards the contribution from MUG+Division 248; a point of interest is that the second group derives relatively more from these unconditional grants than the others. This is probably because in their case Division 248 expenditure

expenditure

has grown faster. In respect of conditional grants, there are clear and systematic variations in the averages for the groups. The share of conditional grants in total revenues is the highest for the 1st group (less developed) at 16.2 per cent, the next highest for the intermediate group (9.6 per cent) and the lowest for the advanced group (5.9 per cent). There is a similar systematic variation - in the reverse direction - in the average share of tax related receipts the lowest for the less developed group (1.9 per cent) and the highest for the advanced group (15.9 per cent), the average share in the case of the intermediate group being 4.2 per cent.

5.5 The broad conclusions that can be drawn are: a) the provinces as a whole are largely dependent on grants from the National Government which are tied to "the cost" of the transferred functions; b) tax revenues and tax shares constitute a small proportion of revenues for the provinces in general; and c) these statements apply with greater force to the more backward or less developed provinces.

Minimum unconditional Grants

5.6 It is generally agreed that upto a point unconditional grants constitute a proper, or more desired, form of transfers to lower-tier governments because they impinge less on the feeling of autonomy and allow those governments to allocate expenditure among different functions according to their respective scales of preferences. It is also usual, when provincial governments are created (or federations are formed), or a revenue source is taken away, to stipulate that a certain minimum amount should be guaranteed to all the provinces or to the concerned provinces, as the case may be. On the face of it, the system of transfers in operation in PNG satisfies both these criteria and hence one might argue that it is in conformity with the accepted principles of federal finance. But a closer analysis will show that there is a departure from the general principle of unconditional grants and that in fact the MUG are not truly unconditional.

5.7 Generally the guaranteed volume of grants is stipulated in terms of an absolute amount, or of a percentage of revenue from a source, or of a minimum per capita amount. The method of specifying the minimum, generally, is not the whole formula for making a grant, but merely a proviso to the formula which spells out the method of calculating the grant; or two or three options are given with one of them implicitly becoming the minimum. Thus, the 1947 tax rental agreement between the Dominion Government and the provinces in Canada in relation to income taxes contained the following options in regard to minimum payments

Option 1:

- a) \$ 12.75 per capita on 1942 population +
- b) 50% of provincial income and corporate tax revenue for year ended December 1940 +
- c) Statutory subsidies payable in 1947.

Option 2:

- a) \$ 15.00 per capita on 1942 population +
- b) Statutory subsidies payable in 1947.

Option 3:

- a) \$ 2 million guaranteed minimum with a special minimum of \$ 2.1 million for Prince Edward Island.

5.8 In addition, the minimum base of 150 per cent of wartime payments was continued with adjustments, but these details are not relevant for the present analysis. But it must be noted that all the three options ^{contained} a guaranteed minimum but the actual receipts could be larger, because all base payments, including the \$ 2.1 million guaranteed for Prince Edward Island, were adjustable with growth factors of population and provincial domestic products. Thus, under option 1, the minimum per capita was related to 1947 population, but the actual entitlement would be based on the population of the year of grant, if that was higher.

5.9 By contrast, the formula for MUG laid down in the Organic Law does not allow for the growth in income or population, but for changes in the general price level. Assuming that the mode of price level adjustment properly reflects the change in the cost of financing the transferred functions, the grants would be just sufficient to take care of those functions in basically the same manner as was done in the year of transfer. (A change or improvement would change the cost). Hence, even though, in principle, the provinces are free to spend the money from MUG as they like, in effect they cannot spare resources from MUG for any other purpose, unless the method of price adjustment should err on the side of generosity. Thus this large component of unconditional grants becomes in effect a conditional grant. Since the formula for MUG does not contain an adjustment factor with reference to population, income, etc., it does not provide for growth in receipts in real terms, part of which could be applied to other purposes, or for improving or extending the services within the sphere of the transferred functions.

5.10 A formula for a guaranteed minimum grant is usually intended to protect the recipient governments; the MUG formula in the Organic Law is designed more to protect the National Government than the provincial governments. The formula does not guarantee an unambiguous minimum to the provinces; what it specifies is the maximum that the National Government is obliged to pay.

5.11 If the formula were to state that the provinces would be entitled to a percentage of specified Central revenues or the base-year cost of carrying out the transferred functions adjusted by the factor of growth in specified revenues, subject to a minimum of the base-year cost adjusted by an appropriate price index or the growth of population in the provinces, the grant would become a truly unconditional grant with a guaranteed minimum. Such a formula would remove the "protection" given to the National Government, but its interests could be safeguarded by leaving one or two important sources of revenue out of the calculations.

5.12 As it is, since the MUG are "tied to certain functions in the manner explained earlier the truly unconditional grant is to be found in the 2nd component under Section 64, administered by the NFC. But the amount of money passing through the NFC forms less than 5 per cent of the total provincial revenues. Since it is also not growing, the kind of elasticity generally provided for in the formula for unconditional grants does not exist in the system of unconditional grants provided for in the Organic Law.

5.13 As pointed out in Chapter III, the percentage increase in the cost of living, for the purpose of adjusting the base year expenditure figure, is to be measured in terms of the average percentage change in the Consumer Price Index and the Import Price Index. Simple averaging gives equal (50%) weight to both components. Thus the formula for adjustment implies that 50 per cent of the provincial expenditure on transferred functions is on goods (which would increase in step with the Import Price Index) and 50% on wages (which would increase only in step with the cost of living index). I wonder if such an assumption is valid. Moreover, in course of time, would there not be, or should we not allow for, increase in real wages? Besides, the cost of different activities might, rather would, increase at different rates, some faster and some slower than the index. One cannot assume that these would balance out and result in an average rate of increase equal to $(CPI + Import I) \cdot / \cdot 2$ ^{1/}. In course of time the pattern of expenditure would change, and it would indeed be impossible to predict the rate at which the index of prices of the basket of goods and services the provincial governments would be buying_{1/}. The indexing procedure followed now could only be considered satisfactory as a short-term measure.

1/ would grow

1/ This is hereafter referred to as CP-IM average index.

5.14 Indeed, even in the short-run it has proved inadequate. It has been found that the cost of maintaining capital works - roads, bridges, buildings - has increased faster than CP- IMF average index. "Maintenance Subsidy" had therefore to be introduced in the form of a "conditional grant", which in 1980 amounted to K 1.97 million. For 1981 the maintenance subsidy is estimated at K 1.6 million. Presumably this was considered insufficient and hence the NFC made its own calculations of the escalation in the costs of maintaining capital works and provided for K 2.1 million for 1981 as part of the distribution of "unconditional grants". It cannot be maintained that a satisfactory solution has been found when additional unconditional grants through the NFC have to be diverted for the maintenance of existing assets so that the scope for equalisation grants is reduced.

5.15 Above all, since the MUG formula does not contain an element of income or growth elasticity, even if the price adjustment were satisfactory, the provincial governments would not be able to extend the scale of services within the same functions, let alone undertake new functions, unless they are given additional grants and/or they have access to other expanding resources. The more advanced provinces are in an advantageous position as far as their own resources or shares in national taxes (including derivation grants) are concerned. The poorer provinces are totally dependent on grants. Conditional grants under NPEP do benefit them substantially, but the assets created under the scheme of NPEP projects have to be maintained. The poorer provinces cannot find the resources for that purpose under the existing system and conditions.

5.16 On the basis of the several considerations set out above, I am inclined to conclude that the method of adjustment in the MUG formula is unsatisfactory from the longer-term point of view and that as it contains no growth factor in real terms, the case for additional grants at least in respect of the poorer provinces is very strong. Whether these should take the form of unconditional (through NFO) or conditional grants or of a share in an elastic source of tax or whether the present MUG formula should itself be modified to provide an element of growth are questions we shall consider later.

Conditional Grants

5.17 Conditional grants account for about 10 per cent of the total revenues of the provinces. The greater part of conditional grants is channelled through NPEP schemes. Of these, the Sectoral Programmes are the more important. Conditional grants outside NPEP Schemes are minimal. It is understood that NPEP grants are given both for the creation of capital and for recurring or current expenditure. If NPEP grants are made available for a limited period of time in respect of particular programmes the question will arise as to how the assets will be maintained, or the expenses of using them, e.g. of running the schools will be met, particularly in the poor provinces.

5.18 As far as I can understand, matching grants are not being given presumably because the provinces in general have no resources to match. Conditional grants tend to favour the poorer provinces: Per capita conditional grants are higher in such provinces as Western, Gulf and West Sepik. The impact of these grants is in general equalizing.

5.19 In their submission to the Committee, several Premiers have complained about the manner in which the funds under the Sectoral Programmes are being allocated. They feel that projects are started without the concurrence of the provinces, which are however expected to take care of the concerned projects. A clear demarcation of national and provincial responsibilities in respect of these projects is desirable.

National Fiscal Commission

5.20 The functions and composition of the NFC have already been described in Chapter III. I shall here deal with only the Commission's function relating to the allocation of grants. The other two functions mentioned in Section 78, subsections 1.(a) and (c) will be dealt with in Dr. May's Report.

5.21 A reading of the Organic Law would lead one to suppose that an important role was envisaged for the NFC. It would not only evolve into a respected, impartial referee, but would also constitute an important instrument for effecting equalising transfers to the provinces. If these indeed were the expectations, they have been belied. The NFC played a minimal role in the matter of transfer of resources to the provinces.

5.22 Section 78, Subsection 1.(b) stipulates one of the duties of the NFC "to make recommendations to the National Executive Council on the allocation of unconditional grants under Section 64 to provincial governments and as between provincial governments". At first sight it would appear that the jurisdiction of the NFC extends to all unconditional grants, because the reference is to "unconditional grants under Section 64". Even though the formula for MUG is laid down in Schedule 1, the NFC could still undertake the computation and ensure that each province gets its due. (This is not to say that the Department of Finance has not carried out the computations correctly). But the introduction of the condition, "in accordance with Section 29" has virtually confined the NFC to the amounts of unconditional grants in excess of the guaranteed minimum.

5.23 The MUG are presumably intended to enable the provincial governments to carry on the basic functions transferred to them in the face of inflation. Conditions change and circumstances might arise which would make the guaranteed amounts insufficient.

I have indicated earlier some of the reasons why the MUG might prove inadequate. The question arises as to who would decide that MUG have become inadequate and what should be done about it. One answer is that if the provinces find the MUG to be inadequate, they should use some of their own resources derived from provincial taxes or shares of National taxes. In a country where all the provinces are fairly well developed and their incomes and revenues are growing, this might be a proper answer, provided some substantial revenue sources have been allotted to the provinces. This answer is unsatisfactory in the context of PNG in which there are a number of poor provinces who have to depend, for some years to come at any rate, on grants and shares of national taxes allocated on the basis of need. Again, if the formula for the basic unconditional grants, besides specifying a minimum, had contained a growth factor, such a review about adequacy might not become necessary. As the present arrangements stand, there can be no doubt that one needs to enquire if the MUG are proving adequate for the purpose for which they were intended. The NFC could have made impartial studies of this question in respect of various provinces, but the Commission has not been asked to look into this question. The intention is perhaps to confine its activities strictly to the "excess" unconditional grants. In the event, the Department of Finance itself seems to have persuaded the NEC that MUG were insufficient and a capital maintenance subsidy was called for.

5.24 Since the growth in total resources had slowed down, NEC decided that increases in recurrent expenditure such as an establishment should be kept down, and the maximum possible resources should be diverted to development purposes. Hence the decision to make available substantial additional grants under NPEP. This inevitably meant that only a limited amount was available to be distributed as unconditional grants. This partly explains the limited role that the NFC has played so far.

5.25 In 1980, K 7 million were made available to the NFC for distribution as unconditional grants. This amount was reduced to K 5 million in 1981. The amount for 1982 is also likely to be kept at the same level, even though a request for K 11.5 million was put forward to the BPC by the concerned division of the Department of Finance.

5.26 It would be useful to discuss the manner in which the NFC decides upon the allocation among the provinces of the sum made available to it. We shall take the exercise relating to 1981 as the basis for discussion.

5.27 The Commission seems to have decided that the distribution of any part of the amount at its disposal on an equal per capita basis, as suggested in Section 79, Subsection 4, would not be equitable, although equalisation was its objective. The Commission decided that it would be more fruitful and beneficial if the provinces were helped in relation to their needs in certain vital areas. Two such areas were first considered, ^{namely,} the running of the provincial government and capital works maintenance.

5.28 The Commission felt that some of the poorer provinces were unable to raise resources on their own and the amounts which they received by way of unconditional grants (minimum) from the National Government was not sufficient to fully meet the cost of running the provincial government. This handicap was chosen as one of the criteria for making grants. The methodology adopted was as follows:

5.29 First, the cost of running the government in 1979 - the provincial Parliament's maintenance, salaries of provincial ministers and of support staff, travel costs, etc. - was estimated for all the provinces. Second, on the basis of those figures, the most "essential" cost of running a provincial government was computed. For 1979, this figure came to K14,000; for 1981/1982, it would be

about K175,000. Third, the total revenue receipts of each province (Division 248 expenditure excluded) were subtracted from this computed essential cost of running a provincial government. If the difference was negative, i.e., if the revenues were higher than the cost, that particular province was considered ineligible for aid under this head. In other cases, the province was given the difference to bridge the gap. In 1981, the total amount of grant to be given for the support of running the provincial government came to K400,000. This amount of grant can be looked upon as one for equalising the standards of general administrative services. In 1981, only 7 provinces were given this grant. (see Table 5).

5.30 For purposes of estimating the amounts of maintenance subsidy to be given, the cost of maintaining the capital assets in each province was estimated mainly on the basis of information supplied by ^{the} Departments concerned. The information covered roads, bridges, buildings, airstrips and water supply plants. It was found that in many provinces the assets were not being properly maintained. The more important among the causes for poor maintenance were lack of money, lack of skilled people and bad budgetary planning. The Commission could address itself only to the first cause.

5.31 In order to arrive at the amount of eligible grant, the actual amount spent on maintenance in the previous year was subtracted from the estimated cost in the case of each province. The difference was to be given as subsidy. Implicitly, actual expenditure was taken to represent 'revenue capacity' and the estimated cost 'the need'. It was felt that some of the provincial governments did not have the administrative capacity to spend. So some adjustments were made to the figures derived as above before determining the actual amounts of maintenance subsidy to be paid. The total amount to be paid came to K 2.1 million, and every province was given some amount of subsidy under this head.

This grant, therefore, cannot really be called an equalising grant. Though it is a specific purpose grant, since the provinces were free to spend the money on any activity they chose, it cannot be called a conditional grant. It can only be described as a general grant-in-aid of the provinces. This amount of grant for maintenance will be repeated for 1982.

5.32 After the two types of the grants mentioned above were provided for, the Commission was left with K2.5 million. These were used for making equalisation grants. It may be noted that under the procedure followed by the Commission, the amount available for making equalisation grants was derived as a residual.

5.33 The methodology of deriving the entitlement to the equalisation grant may be briefly described. Indicators of relative development or underdevelopment were developed in relation to five different areas: education, health, transport, cash income opportunity and public finance. The total amount available was distributed among the five areas on the basis of best judgement. For example, it was felt that transport development was probably the most important requirement; hence the largest weight was assigned to that area. In 1981, the amount of K2.5m available was distributed among the five areas as follows:

	<u>K'000</u>
Transport	600
Education	500
Health	500
Cash income	500
Public finance	400
Total	<u>2,500</u>

5.34 Next, the amount allocated to each area was distributed among the provinces in direct or inverse proportion (as the case may be) to the indicators (s) for each province in the concerned area.

5.35 In the area of education, the number of children in the age group 7-12 not attending community schools and the number of children in the age group 13-16 not attending vocational or high schools were estimated for each province. Besides, for 1981, the pupil to teacher ratio in the schools was also estimated. Each of the figures so calculated was taken as an indicator of deficiency. The total amount available for education was apportioned among the indicators and the amount so apportioned was distributed among the provinces in proportion to the indicators.

5.36 In the area of health, the indicators used for 1981 were attendance of children aged 0-1 at hospitals, clinics and aid posts, the number of cases of immunization of children aged 0-5, incidence of diseases (number of people reported falling ill) and hospital beds. The rest of the procedure was the same as in the case of education.

5.37 In respect of transport, road mileage per square mile/person was taken into account and the amount available was distributed in inverse proportion to the indicator.

5.38 Cash income opportunity was calculated by taking into account per capita rural small income, other government services and the number of posts in the private sector. Here again, the amount available was distributed in inverse proportion to the indicator.

5.39 In respect of public finances, per capita revenues of each province were first calculated. One of the highest per capita revenue figures was chosen as the standard and the deviation of the per capita revenue of each province from the standard was obtained (i.e. the standard per capita revenue minus the actual per capita revenue). This was multiplied by the population of the province. The products gave the population weighted deviation for each province. Ignoring the negative deviations, the others were added to give the sum of deviations. The available amount of K400,000 was allocated in the proportion of the ratio of the population weighted deviation for each province to the sum of deviations.

5.40 The grants given on the basis of the criteria of backwardness in relation to education, health, transport, cash income opportunity and public finances may be termed equalisation grants as they were intended, may be in a small way, to enable the less developed provinces to catch up with the more developed ones.

5.41 The amounts of grants allocated to the different provinces (under the three different categories and the total) in 1981 are presented in Table 5. The last column gives grants per capita. Per capita grants vary from K.13 for East Sepik to K3.90 to Gulf and K4.14 to Manus. The average comes to K1.78. While two of the poorer provinces, Western and Gulf, get the highest per capita grants (other than Manus) Simbu gets less than the average. The fairly sizeable variations in per capita grants have arisen because direct weight was given to population only in relation to calculating one indicator, the deficiency in public revenues. In developing indicators for health and education, population was indirectly given weight in so far as the number of children were taken into account.

5.42 Given the paucity of data, the methodology evolved by the Commission may be said to be fairly sophisticated. The question could of course be raised whether a substantial part of the money at its disposal should not have been distributed on an equal per capita basis. Would not the language of Section 79, Subsection (4) of the Organic Law call for a greater weightage to be given to population unless justification can be offered for a departure from the principle? A broader question is whether the discretion of the NFC should be circumscribed at all? If the total amount of grant is given and the principle of distribution pre-determined, then there would be no need for a grant-distributing agency! This matter needs to be sorted out. Suffice here to point out that while a departure from the principle of equal per capita distribution can certainly be justified, the departure must not hurt the poorer provinces. For example, the objective of equalization is not furthered by a province such as Simbu being given a lower than average per capita grant.

TABLE 6

National Fiscal Commission
Allocation of Additional Unconditional Grants - 1981

Province	Maintenance	Equalisation	Cost of provincial governments	Total acc-ording formula	Total as given	Per capita grants (Kinas)
Western	78.000	183.000	130.000	391.000	500.000	3.80
Gulf	25.000	119.000	45.000	189.000	250.000	3.90
Central	134.000	64.000		198.000	230.000	1.96
Milne Bay	52.000	143.000		195.000	260.000	2.03
Oro	42.000	102.000	10.000	154.000	180.000	2.33
Southern Highland	133.000	228.000	75.000	436.000	350.000	1.49
Enga	106,000	189.000	55.000	305.000	350.000	2.13
Western Highland	165.000	167.000		332.000	350.000	1.33
Simbu	105.000	161.000		266.000	250.000	1.40
Eastern Highland	207.000	270.000		477.000	420.000	1.52
Morobe	185.000	417.000		602.000	420.000	1.35
Madang	97.000	101.000		198.000	300.000	1.42
East Sepik	108.000	128.000		237.000	250.000	1.13
West Sepik	47.000	114.000	25.000	186.000	260.000	2.28
Manus	28.000	31.000	60.000	119.000	120.000	4.64
West New Britain	54.000	37.000		91.000	200.000	2.24
East New Britain	137.000	16.000		153.000	160.000	1.20
New Ireland	131.000	9.000		140.000	160.000	2.44
North Solomons	237.000	23.000		260.000	160.000	1.24
TOTAL	2,100.000	2,500.000	400.000	5,000.000	500.000	

Note: 1980 Population figures have been used.

Source : Executive Officer, NFC and
1980 Population Census,
op. cit.

The future role of the NFC would depend upon whether an automatic growth factor would be introduced in the formula for what is now called MUG or an additional amount could be made separately available through a share in a National tax or otherwise to be distributed by the NFC. As it is, since MUG have proved to be insufficient even for carrying on an unchanged scale of operations, including Capital Works Maintenance, the amounts available to the NFC have had to be used partly for purposes that ought to have been taken care of by MUG. Thus Capital Maintenance has had to be financed through three sources.

5.44 An Assistant Secretary in the Department of Finance acts as Executive Officer to the NFC. He and his staff act as its Secretariat. There are, obviously, some advantages in being ~~sergiced~~ ^{sergiced} by the Department of Finance whose officials have detailed knowledge of, and ready access to, information. But the demonstrability of the Commission's independent status is to some extent compromised by this close association. If the Commission is to play an enlarged role in the distribution of grants and a more active role in relation to other fiscal matters, it would become necessary to give it a proper office and an independent secretariat.

Revenues Based on Origin

5.45 These consist of three components: taxes within the provincial sphere, shares of national taxes and derivation grants. Together they account for 7.2 per cent of the revenues available to the provinces (inclusive of Division 248 expenditure). But they are quite unequally distributed among the provinces.

5.46 As far as own taxes are concerned, only two or three provinces have attempted to levy their own general or turnover retail sales tax. The others have legislated a sales tax on cigarettes and tobacco, may be some of them on beer also,

1 As of now, the Commission has not been allotted an office where the Chairman and members can sit and work and where a library of books and documents can be maintained.

but the taxes are collected by National Government's Excise Department and the net proceeds distributed to the Provinces wherein the tax is collected. Similarly, the Bookmaker's tax is collected by the National Tax Office. It is clear that several of the provinces do not have the administrative ability to effectively collect even a limited form of sales tax. Moreover, the provinces do not seem to have assumed the power to levy the entertainments tax, which some of the District Councils were already levying. The provinces would have to negotiate with those Councils which levy the tax. Here again not much by way of revenue can be expected in the near future.

5.47 The two National taxes, motor vehicle registration and mineral, timber and fishing royalties, whose net proceeds are given to the provinces on the basis of origin, bring in 5 per cent of the total revenues of all the provinces, but they accrue only to a few provinces. Only Central, Western Highlands, East New Britain and North Solomons get one or more than one per cent of their revenues from the motors vehicles tax. As for royalties, they contribute significantly to North Solomon's revenues thereby making it perhaps the only province to enjoy a degree of financial autonomy. Five other provinces derive between 2.0 and 5.5 per cent of their revenues from royalties, others only 1 per cent or less. If the two sources are taken together, only 7 provinces, namely, North Solomons, East New Britain, West New Britain, Morobe, Central, New Ireland and Madang are found to be deriving the bulk of the yield (between 3 and 36 per cent of their revenues). For the rest of the 12 provinces, these two sources bring in one or less than one per cent of their revenues.

5.48 The conclusions that emerge are that, firstly, since the derivation grants and the snares of the national taxes are distributed on the basis of origin, the less developed and less

endowed provinces can get little from them; and secondly, as far as provinces' own tax sources are concerned, the taxable capacity and the administrative ability are greater in the more developed provinces and hence here again the less developed provinces are left in the lurch.

Transfers to Provinces and Equalisation

5.49 It had been envisaged that the provisions of the Organic Law would result in a balanced system of transfers to the provinces, which would basically satisfy the criteria of adequacy, autonomy and equalisation, and at the same time leave scope for the National Government to promote nationally desirable activities through conditional grants. It may be recalled that Tordoff and Watts in their Report had recommended, in addition to taxes to be levied and collected by the provinces, a system of devolution or transfers consisting of a) a needs component - an unconditional grant to be distributed 90 per cent on the basis of population and 10 per cent on the basis of area; b) a derivation component consisting of shares of royalties on minerals, timber, etc., and the net proceeds of a 5 per cent tax on exports; c) a compensation component to be given to any province upon which an extra burden is imposed as a result of national policy; d) "a substantial equalisation component consisting of a sum arrived at on the basis of a province's deficiencies according to a set of socio-economic indicators" (emphasis added); and e) a stabilising component to be paid to any province if the first four components proved to be insufficient to cover the recurring costs of maintaining the functions transferred to the provinces (pp.7/32-33). While further recommending that the National Government should retain the power to make conditional grants in addition to the above transfers, the experts suggested that the allocation of unconditional transfers be made by the National Parliament acting on the recommendations of an expert commission to be appointed every four years. Whereas Professors Tordoff and Watts

showed provinces can get little from them; and secondly, as far as provinces' own tax sources are concerned, the taxable capacity and the administrative ability are greater in the more developed provinces and hence here again the less developed provinces are left in the lurch.

Transfers to Provinces and Equalisation

5.49 It had been envisaged that the provisions of the Organic Law would result in a balanced system of transfers to the provinces, which would basically satisfy the criteria of adequacy, autonomy and equalisation, and at the same time leave scope for the National Government to promote nationally desirable activities through conditional grants. It may be recalled that Tordoff and Watts in their Report had recommended, in addition to taxes to be levied and collected by the provinces, a system of devolution or transfers consisting of a) a needs component - an unconditional grant to be distributed 90 per cent on the basis of population and 10 per cent on the basis of area; b) a derivation component consisting of shares of royalties on minerals, timber, etc., and the net proceeds of a 5 per cent tax on exports; c) a compensation component to be given to any province upon which an extra burden is imposed as a result of national policy; d) "a substantial equalisation component consisting of a sum arrived at on the basis of a province's deficiencies according to a set of socio-economic indicators" (emphasis added); and e) a stabilising component to be paid to any province if the first four components proved to be insufficient to cover the recurring costs of maintaining the functions transferred to the provinces (pp.7/32-33) While further recommending that the National Government should retain the power to make conditional grants in addition to the above transfers, the experts suggested that the allocation of unconditional transfers be made by the National Parliament acting on the recommendations of an expert commission to be appointed every four years. Whereas Professors Tordoff and Watts

had quantified the derivation component by suggesting a specific formula, and the stabilising component could be derived as a residual, the relative proportions in which the other grants had to be given were left open. Components (a) and (b) were undoubtedly meant to be relatively large and important and were to be in the nature of unconditional grants. Since the expert Commission was to make recommendations in regard to unconditional grants, the magnitudes of "the needs" and "equalisation" components and the methods of allocating them among the provinces were left to be determined by it. The expert Commission was to be constitutionally enjoined "to seek a balanced set of recommendations taking account of the criteria of need, derivation, compensation, equalisation and National Welfare" (p.7/33). It would not be an incorrect inference to say that the experts had recommended that only one of the national taxes be shared and that too on the basis of derivation, because they had envisaged that the unconditional grants based on needs and equalisation would be substantial, both absolutely and relatively. In the event, when the Organic Law came to be written, much the greater part of the unconditional grants came to be linked with the level of services being performed at the time of transfer; and the role of the expert commission, which in the view of Professors Tordoff and Watts, was to review the financial situation every four years and to recommend the magnitude and allocation of the bulk of unconditional transfers, was reduced to that of allocating a relatively small amount of unconditional grants made available by the National Government from year to year. We **are** not here concerned so much with the importance of the Commission as with the fact the actual provisions of the Organic Law have reduced the effectiveness of the principle of equalisation in the scheme of transfers in general and reduced it to insignificance in the scheme of unconditional transfers in particular.

5.50 Table 6 presents the per capita revenues of the provinces from different sources as well as their per capita total revenues (as of 1980) Manus, because of the extremely smallness of its population is shown to have the highest per capita revenue. We shall leave Manus out of the comparison.

5.51 Barring Manus, per capita revenues range from K34.5 for Eastern Highlands to K99.9 for New Ireland, the average for the provinces working out to K53.5. Eastern Highlands, Western Highlands, East Sepik, Southern Highlands, Madang and Simbu get lower than average per capita revenues. While some of the backward provinces such as Western, Gulf and Oro are not doing badly, the top four ranks belong to New Ireland, North Solomons, West New Britain and East New Britain. It will be noted that the provinces receiving lower than average per capita revenues have relatively large populations. It can be said that the wide variations in the levels of per capita revenues largely reflect the fact that population is given little weight in the distribution of transfers. But part of the cause is also to be attributed to the fact that derivation rather than equalisation is the principle underlying the distribution of the revenues.

5.52. Summing up, it may be stated that since the minimum unconditional grants, which form the bulk of the transfers, are linked to the levels of services attained on the date of transfers, the shares of taxes and the derivation grants are distributed on the basis of origin, and the additional unconditional grants which could have been distributed on the principle of equalisation are nominal in magnitude, the entire scheme of financing taken together tends to have no significant equalising impact. Conditional grants and NFC grants which tend to be equalising account for about 15 per cent of the total transfers. Of these, the conditional grants are mainly related to new projects and do not immediately affect the inequalities in the permissible or feasible levels of

TABLE 5

Per Capita Revenue of Provinces - 1981

	All Prov- inces	West- ern	Gulf	Cent- ral	Milne Bay	Oro	Sout- hern High- lands	Simbu	West- ern High- lands	Enga	East- ern High- lands	Mor- obe	Mad- nag	East Sep- ik	West Sep- ik	West New Bri- tain	East New Bri- tain	New Ire- land	North Solo- mons	Manu
1. Uncondi- tional																				
a. Mug & sta- ff grants	18.48	12.09	18.9	12.66	9.6	10.36	12.5	14.2	10.8	15.1	26.1	7.5	8.9	7.6	12.1	11.6	64.5	95.5	53.0	46.1
b. Division																				
248	23.38	39.6	39.8	47.6	37.3	48.5	23.5	23.8	20.8	24.4		28.5	25.5	26.1	35.4	56.6				56.1
c. NFC	2.42	3.8	4.6	2.5	2.1	2.7	2.1	2.3	2.2	2.3	2.45	2.1	2.4	2.2	2.3	3.1	1.4	2.7	1.3	7.7
2. Condi- tional																				
a. NPEP	.29	.12	4.4	.51	1.0	.21	-	.06	.02	.51	.11	-	-	-	.43	1.46	.31	.82	-	-
b. Sectoral	4.15	17.2	8.2	3.48	4.25	7.17	2.45	3.6	2.27	3.6	3.1	3.0	3.1	2.67	12.8	5.3	1.95	4.3	1.1	14.9
c. Maintenan- ce subsidy	.68	-	.49	-	5.3	1.0	.59	.19	.43	.75	.19	.72	-	-	.07	.78	1.10	-	2.06	.3
d. Others	.29	.91	1.42	.40	.33	.63	.14	.25	.07	.30	.31	.11	.37	.34	.23	.21	.28	.12	.03	.2
3. Derivation	.78	.06	.8	.11	.14	.28	.08	1.08	2.16	.26	1.4	-	.45	.30	.15	-	1.36	2.8	2.63	.9
4. Share of na- tional tax																				
a. Motor vehi- cle regist- ration	.46	.02	.02	2.3	.04	.22	.05	.26	.41	.11	.31	.91	.30	.26	.04	.25	1.02	.28	1.23	.2
b. Book make- rs turnover	.07	-	-	.39	-	-	-	-	.04	-	.03	.09	.09	-	-	.02	.61	-	.05	-
c. Royalties	2.11	NEG	.48	.74	.43	.48	.05	-	NEG	-	NEG	1.24	.84	-	.82	3.5	1.98	2.66	32.9	-
5. Tobacco & cigarettes	.40	.22	.18	1.14	.53	.69	.08	.41	.39	.07	.47	.36	.27	.11	.07	.60	1.22	.70	.53	.6
TOTAL	53.5	74.02	79.29	71.83	61.02	70.24	41.54	46.15	39.23	47.7	34.47	44.63	42.22	39.58	64.41	83.42	75.7	99.88	94.83	127.54

Sources : Revenues - Department of Finance.

Population - National Statistical Office, 1990
National Population Census, Preliminary Bulletin
No. 1.

recurring expenditure. Finally, it must be remembered that the formula for MUG does not contain a growth factor and therefore grants under the formula have tended to be inelastic.

VI. PRINCIPLES AND PROBLEMS OF INTER-GOVERNMENTAL FINANCIAL RELATIONS

The Economic Case for Decentralisation

6.1 It is not necessary for me to deal with the principles of inter-governmental financial relations in a comprehensive manner as the basic issues were adequately covered in the Tordoff-watts Report. I shall only deal with the subject briefly, concentrating on those aspects which were overlooked or insufficiently stressed in that Report.

6.2 A federal or a decentralised governmental structure is advocated and desired in different countries on political, administrative, cultural and economic grounds. The political and administrative arguments for a decentralised political structure are well-known and need not be repeated here. Cultural differences among the peoples inhabiting a country reinforce the desire for political devolution and often act as the prime motive for the creation of a decentralised governmental structure which, it is hoped, would enable the different groups to preserve their identities, at least to a limited extent, and make it possible for each group to run its own local affairs without interference from the other groups.

6.3 The economic argument for having more than one tier of government rests on the grounds of economic efficiency i.e., it is possible to achieve greater efficiency in the allocation of resources with decentralised decision making.

This will be so for two reasons. First, the scales of preferences of the members of small communities are likely to be more homogeneous than those of the people in the country as whole. Hence if the power to provide public services, particularly those with predominantly local impact, were to be given to local or smaller communities, the quality and scale of services provided could be more in accordance with the scales of preferences of the consumers and thus greater efficiency in resource allocation would be achieved. Second, the benefits flowing from different types of services extend to larger or smaller areas, i.e., the services have differing areas of incidence of benefit, or the benefit incidence can be restricted in several cases to particular areas. In every case where the incidence of benefit can be limited or is limited to some area, it would obviously be desirable for a governmental authority having jurisdiction over that area to provide the service in accordance with the scale of preferences of the people living in that area and charge them for it. The people who benefit from the service and the people who are charged for it would be the same and hence there would be matching of costs and benefits, ensuring efficiency in the use of resources. There are of course some public services whose impact and benefit extend to the whole nation, e.g., defence and foreign affairs. Such services have therefore to be provided by the national government and the cost defrayed through national taxes. By the same token, services which have a predominantly local or regional impact may best be provided by local or regional governments.

6.4 Ideally, one could think of several layers of government with differing jurisdictions, each performing one or more services whose benefit extends only to its jurisdiction, and taxing the people within that jurisdiction to pay for those services. In practice, a multiplicity of authorities will lead to conflict, confusion and excessive administrative cost. Hence not more than 3 or 4 tiers of government are envisaged under constitutions providing for a federal or decentralised structure of government. Such a structure would secure a reasonable degree of decentralisation.

6.5 In practice, there would be spill over of benefits and costs from one area to another. These can be dealt with by appropriate means in a federal system. We shall ignore this complication here and shall concentrate on the characteristics of a federal financial system that would ensure a high degree of economic efficiency and at the same time satisfy the political aspiration for autonomy of different regions, groups and localities.

Basic Problems of Federal Finance

6.6 But for economic efficiency to be secured and for the aspiration for autonomy to be fulfilled in the true sense, it would be necessary to provide each layer of government with independent means of raising resources. However, the means or taxes assigned to each level should enable it to raise resources in an equitable manner and on a scale sufficient to fulfil its expenditure responsibilities and at the same time the impact and incidence of taxes levied by it should largely be confined to its own jurisdiction.

The basic problems of multi-level or federal finance ^{1/} arise from the fact that taxes with localised effects and incidence tend to be neither productive nor elastic nor even very equitable. The most productive, modern forms of taxation, which can also be made progressive, like the personal income tax, the net worth tax and the corporation income tax have bases often extending beyond single localities or provinces and have nation-wide impact. Even the effective collection of the personal and corporate income taxes by a provincial or regional government is beset with difficulties because the assessee, personal or corporate, may derive income from many sources outside the province of residence. The problem would arise whether the provincial income tax should be based on origin or residence. This is a potential source of inter-provincial conflict. Even if a common definition of the income tax base is accepted by all the sub-national governments, tax competition

1 The term "federal finance" is used in this Report as a shorthand expression for "inter-governmental financial relations". No reference to a classic federal structure is intended.

among those governments would effectively prevent each government from raising the rate of its tax beyond a certain level, as otherwise taxpayers might move to other jurisdictions. Whatever has been said above regarding the personal income tax applies with even greater force to the corporation income tax. In any case, the personal and the corporate income taxes have to be harmonised and therefore need to be levied in the main only by one government authority. However, it is possible under certain conditions for the provincial governments to be permitted to impose a supplement on the national personal income tax, to be collected by the central government.

6.7 In the sphere of commodity taxation too, the scope for provincial levies does not cover the major taxes. Import taxes, for one thing, must be with the central government. Similarly, taxes on domestic production, or excises, cannot be left to be levied by the provincial governments as the incidence of those taxes will fall on consumers living in different provinces and on exports. Furthermore, a tax on all manufactures including inputs and intermediate products would lead to cascading, uncontrolled final incidence and other harmful economic consequences. Hence in the interests of economic efficiency and inter-provincial justice, a province can be allowed to levy only a commodity tax or commodity taxes that fall directly on the consumption of its residents. Indeed one of the important considerations in fashioning the tax structure in a federal system is to ensure that the taxing powers of the provincial governments would not

lead to harmful effects on the efficient allocation of resources or to the parcelling or break-up of the unified market within the whole country, or to one province taxing to any significant extent the residents of other provinces. Hence provincial taxation on the basis of production and the taxation of inter-provincial trade will have to be ruled out.

6.8 A retail sales tax, however, would be an eminent candidate for provincial use. But high rates would lead to diversion of trade (unless there is inter-provincial agreement on the general level of rates) and a pronounced reliance on retail sales taxation (on consumption) would tend to make the tax structure regressive.

6.9 Finally, as Professors Tordoff and Watts had pointed out, taxes are no longer used merely as a means of raising revenue, but also as important instruments of economic and social policy. Hence the power to levy the major taxes will have to be vested in the central government.

6.10 The conclusion is inescapable that the provinces or any sub-National levels of government cannot be endowed with tax powers which would make them even as a group-- let alone each individual government in the group-- self-sufficient or even nearly self-sufficient in resources. A substantial part of the resources needed by them would have to come in the form of transfers from the central government which would have to be given the power to levy the major taxes. To some extent, therefore, the nexus between the decisions to tax and to spend would be broken, but then the aim must be to enable the provinces, in the

long-run at any rate, to balance costs and benefits at the margin. Hence it would be necessary, to the extent possible, to let, or even make, the provinces raise part of the resources they need from their respective citizens.

6.11 Since, generally speaking, the provinces will be able to raise only a part of the resources needed by them while the central government will be raising the bulk of the resources, there arises the familiar problem of vertical fiscal imbalance in any federal or decentralised governmental structure. This imbalance needs to be remedied or redressed through a system of transfers from the central government to the provinces.

6.12 The transfers can take the form of shares in central taxes or of grants to be made at the discretion of the central government. The grants in turn could take the form of either conditional or unconditional grants. The determination of the scale of transfers, of the forms that the transfers should take and of the bases on which they should be distributed to the provinces are among the basic problems to be solved, once the assignment of tax powers has been decided upon.

Mechanism of Transfers

6.13 Since only considerations of economic efficiency, equity and administrative convenience lead to the centralisation of the levy and collection of the major taxes, it has been argued that it would be proper to return part or whole of the proceeds of specified central taxes to the

provinces from which they are collected. The argument really is that some of the taxes which the provinces should have been allowed to collect on the ground of their own requirements are given over to the central government only in the interests of efficiency and minimum cost, and that therefore it is only just that a good part of such tax money should be returned to the provinces on the basis of origin or derivation. This argument is specially applicable where the revenue source used by a region or a province at the time of forming the federation or a revenue source given to the province under the constitution, is centralised on grounds of economic efficiency. In some federal constitutions such as those of West Germany and India, tax sharing arrangements have been introduced as part of the total fiscal adjustment mechanism embodied in the constitution, but the distribution of the proceeds is not necessarily to be on the basis of derivation. A variant of the tax sharing arrangement is for the provinces to be allowed to levy supplements on selected central taxes which would be collected by the central government. The supplement will fall on the residents of the concerned province and the yield will be made over to it. Another variant is for the central government to lay down the broad law relating to a tax, the provinces to fix the rates of the tax with complete or limited freedom, and then the central government to collect it and distribute the proceeds on the basis of origin.

6.14 In all of these cases, the distribution of the proceeds of the tax(es) among the provinces is on the basis of derivation. If the provinces in a country are equal in essential respects (in per capita terms), and

if the central government has no desire either to encourage the provinces to undertake, or to prevent them from undertaking, particular services, then an arrangement by which some taxes (e.g., the retail sales tax) will be levied and collected by the provinces and the proceeds of certain other taxes will be distributed by the central government on the basis of derivation alone would represent a satisfactory solution of the federal finance problem. In fact, however, there are usually inequalities between the provinces. This is particularly so in developing countries. Besides, the central government would wish to retain the power to promote nationally beneficial activities. Because of these important reasons, all the transfers, or even a major part of the transfers, cannot take the form of shares of central taxes distributed on the basis of origin or, what comes to the same thing, of unconditional derivation grants. When provincial governments are formed in what was previously a wholly unitary state or when some regions or small units come together to form a federation, it is natural for the people in the better-off regions to seek to retain some of the economic advantages that flow from the higher level of development they have attained. Indeed, they would require a higher level of revenue than the poorer provinces, to begin with at any rate, because of the need to finance the higher level of, or more extended, services being performed by the governments of those areas. Nevertheless, the requirements of the poorer provinces cannot be ignored. While they can raise resources on their own only on a limited scale, as compared to the more advanced provinces, they face the uphill task of catching up with the latter in the matter of essential public services, and hence,

over time, proportionately more resources will have to be allocated to them. On the other hand, it is clear that the greater the decentralisation of the taxing powers or the more the transfers from the central government take the form of shares of taxes distributed on the basis of origin, the more the poorer provinces will stand to lose and the more the richer provinces will gain. Just as it is necessary to recognise the need to let the advanced provinces retain some of the advantages of their development, so also it is essential to remember that the poorer provinces should not be put to such disadvantage that the residents of those provinces would be distinctively worse off as a result of decentralisation (under a wholly unitary form of government, the level of public expenditure in an area will not be linked to the amount of revenue it contributes to the national exchequer). Since the less developed or the poorer provinces cannot themselves raise resources, or claim resources on the basis of origin, to the extent they need them and since the inequalities between the provinces have to be redressed over time, under a decentralised political structure it is necessary to provide for a substantial porportion of the grants and shares of taxes to be distributed on the basis of need and equalisation. The principle of equalisation is of special significance in the context of a developing country such as Papua New Guinea.

Unconditional vs Conditional Grants

6.15 The provinces would like to enjoy the maximum degree of autonomy within the spheres allotted to them. The feeling and fact of autonomy occur when the provinces are able to raise resources on their own or receive them in the form of clearly specified shares of national taxes or of unconditional grants. As between shares of taxes and unconditional grants, the provinces would tend to favour the former because an element of discretion remains with the central government in the case of grants, which can be increased from year to year on the basis of a deliberate decision, whereas the share of a tax is already specified and has a growth element built into it.

6.16 In any case, both are received without any conditions being attached and the recipient government is free to spend the money as it thinks best.

6.17 Fiscal theorists generally prefer the bulk of the transfers to be made in the form of unconditional transfers for the reason that the very intention of setting up provincial or lower-tier governments is to enable the communities concerned to provide public services unto themselves according to their own preferences. Of course, the presupposition here is that provincial governments will act responsibly and that the people of each province will be able to ensure that the government would allocate the resources fairly efficiently. To the extent that provinces are dependent on unconditional grants, it is true that the decisions to raise resources get divorced from the decisions

to spend. But if the provinces have been assigned some tax powers the balancing of the cost or burden of taxation and the benefit of public expenditure will still take place at the margin.

6.18 Conditional grants enable the central government to influence the public expenditure decisions of the provincial governments. Conditional grants may be used for the following desirable purposes:

- a) to promote expenditure on projects that are considered nationally important or that rank high in the scheme of national priorities (falling in the concurrent or provincial sphere);
- b) to bring certain essential services upto nationally accepted minimum standards in all provinces; e.g., primary education, health and transport; and
- c) to induce provinces to increase the scale of those services whose benefits tend to spill over across provincial borders, because a province would normally tend to underspend on those services whose benefits spill over to other provinces.

6.19 Conditional grants do not always fully succeed in their purposes. Supposing a province would have spent K50,000 on service 'A' in the absence of a conditional grant. Assume that a conditional grant of K25,000 is given to induce that government to raise its expenditure on 'A' to K75,000. That government may raise expenditure on 'A' to K60,000 only and direct K15,000 of its own resources to services 'B' and 'C'; or it could reduce its own taxes by some amount. Conditional grants are more successful in the case of services the demand for which are fairly income elastic (i.e. demand increases more than proportionately with government income).

6.20 Conditional grants may be given for capital formation expenditure, current but non-recurring expenditure, or current, recurring expenditure.^{1/} If conditional grants are given for the last category, monitoring of expenditure, to see that the grants are being spent for the purposes for which they are meant, would have to continue indefinitely unless the grants are just promotional and would cease after some time it is easiest to monitor grants given in respect of specific projects.

6.21 Conditional grants must be made selectively. If there is a plethora of objectives, monitoring would become difficult and, by and large, ineffective. Further, grants tied to a multiplicity of purposes would make the task of budget making unnecessarily complicated. This category of grants may best be given for specific projects and for expenditure under a few broad heads.

^{1/} By current expenditure is meant expenditure not leading to the acquisition of capital assets.

6.22 The major part of the transfers should take the form of shares of taxes and of unconditional grants, their local magnitude being determined on the basis of the range of functions to be performed by the provinces and in the light of their own resources

Impact of Transfers

6.23 Conditional grants are intended to influence the actions of the provincial governments in the desired directions. But all grants, besides fulfilling their objectives, may have some impact (intended or unintended) on the behaviour of the provincial governments. The possible effects will depend upon the nature of the grants and the principles on which they are distributed. In designing a scheme of grants, these possible consequences must be allowed for. And it is important to remember that unconditional grants too could have deleterious consequences.

6.24 Thus, for example, if a part of the grants is made in inverse proportion to the amount of tax revenues that a province is raising (with a view to helping backward provinces), the provinces would be induced to reduce their own tax effort. Or again, if unconditional grants are determined on the basis of underwriting provincial deficits, the provinces would be given an inducement to incur additional expenditures, which they would not have undertaken if they had to pay for them, and pass on the burden to the central government. On the other hand, if the

tax effort of a government is taken into account in determining its grants entitlement, provinces would be induced to raise more resources on their own. Similarly, if the distribution is partly on the basis of origin, there would be an implicit reward for good economic performance. In general, the effects to be avoided are expenditure exaggeration and tax effort reduction. In particular, provinces should not be given the impression that their budget deficits would be underwritten except in some abnormal circumstances.

6.25 For this reason, I should strongly recommend that a stabilising or topping up element should not form a part of the system of grants.

6.26 In the light of the foregoing principles and of the objective conditions obtaining in PNG, and keeping also in mind the historical developments since 1975, I shall attempt to discuss in the next chapter, the modifications to be brought about in the existing system of provincial financing.

VII. MODIFICATIONS IN THE EXISTING SYSTEM OF PROVINCIAL FUNDING

The Major Questions

7.1 In considering the need for modifications in the existing system of provincial funding, the following major questions may be asked:

- a) Is the magnitude of transfers adequate, or should it be increased?
- b) Should the pattern of transfers be changed: If so, in what directions?
- c) Is the distribution of the transfers as between the provinces equitable? How can the equity of the system be increased?
- d) How can the own tax revenues of the provinces be increased? and
- e) What should be the role of the NFC?

7.2 It is my considered opinion, formed after a careful evaluation of the system of funding prevailing, that the pattern of transfers and the mode of determining the components should be changed and that the distribution of the transfers as between the provinces should undergo a shift in favour of the less developed provinces. If the absolute

amounts going to the more advanced provinces are not to be reduced, increasing the share going to the less developed provinces would mean some increase in the total magnitude of the transfers. In 1980, 30 per cent of the total revenues (excluding capital receipts) of the National Government was transferred to the provinces; in 1981, nearly the same percentage (29.7) is expected to prevail. Whether this ratio can be increased will depend on the rate of growth of National Government revenues and its commitments. However that may be, it may be hoped that the same ratio of transfers to total revenues at least could be maintained. If so, with the growth of revenues, the total amounts of transfers to the provinces would increase. The shift in favour of the less developed provinces can then be brought about through giving them a larger share of the increment in transfers, i.e., by making the transfers to them increase faster than the transfers to the more advanced provinces.

The Magnitude of Transfers

7.3 If the burden of National Government taxation is not to increase significantly, it is clear that the diversion of a larger share of resources to the less developed provinces will have to be "at the expense of" the National Government and/or the more advanced provinces. ^{1/}

^{1/} This does not necessarily mean that the absolute amounts going to the more advanced provinces would fall.

7.4 I shall discuss the manner of the diversion later. But I would like to make two points in relation to the transfer of a larger volume of resources to the provinces in the immediate future.

7.5 First, it may be asked whether the level of National Government taxation could not be raised. It was seen earlier that the total taxation in PNG has already reached the level of 18-20 per cent of GDP. In my view, it would be undesirable to raise this ratio by the introduction of additional taxes at the National level. However, through better enforcement of the existing taxes, particularly the income tax, it should be possible to raise the ratio by one percentage point or so. This would give an additional revenue of about K20 million over and above the normal increase.

7.6 Second, any sizeable increase in the volume of transfers to the provinces can only be contemplated after the setting up of proper accounting systems in several of them which do not have such systems today and in the context of the establishment of the conditions of accountability. These matters are dealt with in detail in Dr. May's Report.

Provincial Taxation

7.7 The main reasons why there has to be a change in the pattern of resource transfers to the provinces are that in the present system too little weight is given to the principles of 'need' and 'equalisation' and that the mode of determining the bulk of the unconditional grants under the MUG formula has proved to be unsatisfactory. The detailed arguments have been presented in Chapter V.

Suffice it to point out here that the MUG formula is basically deficient because it effectively freezes the levels of services attained in the less developed provinces. These provinces get very little by way of shares of National taxes or derivation grants. And since the additional unconditional grants are of small magnitude, the question arises: from where will the poorer provinces find the resources to meet the recurring cost of providing the extended scale of services (more education, health services, etc.) even though the capital cost of additional facilities could be met out of conditional grants under NPEP?

7.8 One possible source is provincial taxation. Although assigning more tax powers to the provinces will benefit the more economically developed ones somewhat more, the scope for additional taxation by the provinces must certainly be explored. But the taxes must be such as will not place the poorer provinces to great disadvantage and will not harm national economic welfare on the lines indicated in the previous Chapter.

7.9 One suggestion that has been made is that the provinces be allowed to levy a supplement on the personal income tax. The supplement will be collected by the National Tax Office and will be distributed to the provinces on the basis of origin. The practice of the central government collecting the provincial levies has been in existence in Canada. But this device will not work in PNG under the present conditions and will also not provide resources to the poorer provinces. The points of collection of the personal income tax in PNG are only a few centres, Port

Moresby, Lae and Rabaul being the most prominent among them. The taxes on the salaries of even those working in the interior of different provinces are paid by their employers at the bigger towns where the headquarters of companies are situated. Thus it would not be possible to distribute the yield of the supplement on the basis of collection. Even if it were possible to do so, the poorer provinces will get hardly anything out of it. We will have to reject this solution.

7.10 . . . Another suggestion is that the provinces should develop a productive and equitable tax on land or the produce of land. If the tax is to be a substitute for an income tax on non-corporate agricultural income, it must, in some manner, be related to the productivity of the different holdings. I understand that, traditionally, the ownership of land is vested in the clans in most parts of the country and it is difficult to identify or select an individual on whom the responsibility to pay the tax can be fixed. This problem can in principle be solved; indeed it must have been tackled in some manner in relation to the making of loans for agricultural development. But the ascertainment of the normal productivity of land, based on past output and prices, would require a comprehensive cadastral survey of all cultivable land, as used to be carried out in the Indian sub-continent. It would be costly and time-consuming. Also, it would be difficult to levy this kind of tax in respect of land on which subsistence agriculture is being carried on. One could, however, think of an acreage tax in respect of lands on which cash crops are grown. The tax rates would be fixed in terms of different amounts of Kina per acre for lands growing

different types of crops. The rates would be low, but would bear some relation to the income per acre likely to be earned. They would be kept fixed for seven years or so, so that the increase in productivity during that period would wholly go to the owners.

7.11 Unless the acreage tax in respect of lands growing cash crops is kept at a very low level, it would lead to double taxation of the agricultural products being exported. Since, in the case of agricultural exports, PNG is a price-taker in the international market, an export tax can be said to fall on the local producers. Thus the levy of the export tax restricts the scope for the levy of a produce tax by the provinces.

7.12. The provinces cannot be permitted to levy a tax on the basis of production i.e., excises, because while the province where production takes place would levy the tax, the consumers of the product who ultimately will pay it will be spread over all the provinces. Similarly taxation of sales to producers and to dealers in other provinces will lead to multiple taxation (tax cascading) and the export of taxes to other provinces. For the time being, the National Government is levying the excise tax only on alcoholic liquor (mainly beer) tobacco and cigarettes and soft drinks. So long as the National Government excises are limited in coverage (as now), there is scope for the levy of a full-fledged retail sales tax by the provincial governments. They are empowered to levy this tax under Section 57 of the Organic Law.

7.13 Three provinces have already introduced legislation for the levy of "turnover type" or general retail sales tax. Other provinces, by and large, have only a cigarette and tobacco tax. (May be one or two of them a beer tax.) The cigarette and tobacco tax brings in only K 1.2 million. A general retail sales tax on the other hand can bring in a significant amount of revenue.

7.14 A number of aspects has to be considered in this connection. Unlike the excise duty which can be conveniently collected at the few points of production, the retail sales tax has to be collected at a much larger number of points of sale at the retail stage. The retail stage has been defined in the law, and where convenient, the sale to some one who buys for retail sale is permitted to be subjected to tax. This means that a system of registration of dealers having a turnover above a certain minimum can be introduced. Also, all dealers who largely sell direct to the public and are having a specified minimum turnover will have to be required to register themselves. Then sales by registered dealers to non-registered dealers and to consumers will be subjected to tax. The system can be made to work, but the administration of a retail sales tax is not an easy matter, as is well known to tax administrators. Most of the provincial governments would not have the capacity, as things stand now, to enforce such a tax effectively. Besides, if each province is to have its own sales tax system, there would be a multiplicity of systems, laws and rates of tax. Small differences in rates would not be a matter for concern, but

a multiplicity of laws and administrations would cause hardship and confusion to trade and business. Besides, it is an avoidable waste of resources in a small country to establish 19 provincial sales tax administrations with all the paraphernalia of tax collectors, head offices, tribunals, etc.

7.15 For reasons of minimising costs of collection, avoiding a multiplicity of laws and procedures and for securing effective enforcement of the tax, it would be desirable to have one National Sales Tax administration. In fact, for the present at any rate, I would think that this is the only option available if a general retail sales tax is to be developed. The plan I would recommend is as follows: In consultation with the provincial governments, the National Government should formulate a model sales tax law that will be adopted by all the provincial assemblies. The National Government would also specify the articles and services that would be beyond the purview of the sales tax. Petroleum products (whose prices must be regulated as a matter of national policy) and air services are instances in point. All other commodities will be divided into 3 or 4 rate categories and for each category, the National Government, after consulting the provincial governments, will prescribe a rate band within which a provincial government can fix the rates to be applied to different commodities on sales within that province. If a province wishes to apply, for some special reason, a rate of tax on a commodity which falls outside the band prescribed for the commodity, the permission of the National Government would have to be obtained for that. The rate bands will have lower or higher

rates depending on the nature and use of the commodities, i.e., whether they are necessities, articles of common use, non-essentials, or luxuries. Having determined the rates to be applied in their respective territories, the provincial governments will then pass resolutions delegating to the National Government the power to levy the retail sales tax, initially for a period of 5 years.

7.16 It would be ideal and in the interests not only of the orderly development of trade and industry but also of the provinces themselves, if all the provinces could be persuaded to join the scheme. If, unfortunately, this is not possible, two alternatives are open. The first is to inaugurate the scheme in respect of those provinces which wish to join it. The second alternative is to amend the Organic Law and transfer the power to levy the sales tax to the National Government. I would recommend the first alternative.

7.17 If a tax is to be applied to the sale of a number of commodities in all the provinces, it would become necessary to levy this tax in the National Capital District. A portion of the yield may be given to the Municipal Government and the rest passed over to the NFC for distribution among the provinces who have joined the national scheme of sales tax.

7.18 Finally, there has to be co-ordination between sales tax policy on the one hand and the policy of import tax^{1/} and excise policy on the other. Since at present most consumer goods are imported, a retail sales tax would act in the main as an addition to import duty, but it would be different from a surcharge on import duty in that it covers value added at the wholesale and retail stages. In course of time, as local manufactures develop, it would begin to fall on domestically produced goods. If the sales tax gets well developed, then the scope for extending excise taxation would be limited. It is important to realize that by handing over the power to levy a general retail sales tax to the provinces, the National Parliament has implicitly placed a restraint on the extension of excises, because any such extension will lead to double taxation and uncontrolled incidence. By the same token, the combined incidence of the import tax and the sales tax would have to be kept under review and controlled.

7.19 One tax which the provinces themselves will be able to levy and collect is a "tax on professions, trade and calling" which is usually called a profession tax. This is a tax on services which the provinces can levy as a supplement to the sales tax on goods. But as the present provisions of the Organic Law do not permit the provinces to levy this tax, the necessary amendments may be made.

7.20 A profession tax is simply a tax on everyone who has a profession, trade or calling. It is not to be construed as a tax on income, though those with low incomes may be exempted from it. The maximum profession tax that can be collected

1 Revenue component of the import tax.

from a person may be limited to K100 by National law...
A full set-off for profession tax paid should be granted
against income tax liability. An illustrative rate schedule
is given below.

1. Lawyers, doctors, engineers, accountants, etc.

a. with less than five year's standing	Nil
b. with 5-10 years' standing	K50
c. with more than 10 years' standing	K100 with the provision that those who have retired, or are more than 60 years of age will be exempted.

2. Traders, restaurant owners, contractors, etc.

a. with gross turnover less than K10,000	Nil
b. with gross turnover between K10,000 and 50,000	K50
c. with gross turnover between K50,000 and K100,000	K75
d. with gross turnover above K100,000	K100

3. Salaried employees

a. with total emoluments below K7,500	Nil
b. with total emoluments between K7,500 and K15,000	K24-K60
c. with total emoluments above K15,000	K100

4. Artists, actors and writers

Same as in 3.

7.21 The provincial sales tax and the profession tax together may bring in between K7 and 10 million. The sales tax can now be applied only to selected commodities it will take a considerable amount of time and experience before it can be turned into an effective general tax.

Unconditional Grants

7.22 I recommend that the present formula for minimum unconditional grants be abandoned. In the present system the growth of the unconditional grant is by a percentage of the base grant. This places the less developed provinces at a disadvantage. A good part of the growth in the unconditional grants must be independent of the base grant. For this purpose, the total unconditional grants that a province will be given should consist of two parts: The first part will be the base grant or the minimum grant. This base grant may be specified in two alternative ways:

- a) per capita grant at the base year level, i.e., the same amount of per capita grant as the province was getting in the year previous to the year in which the new scheme is adopted. In the case of provinces which subsequently assume full financial autonomy, the minimum assured will be the per capita MUG + Division 248 expenditure; or

- b) the actual absolute level of MUG or MUG + Division 248 expenditure, as the case may be, in the year previous to the changeover. The first alternative allows for the growth of population. The grant which a province will be getting will be rising at the same rate as its population. The second alternative would not allow for that.

7.23 The minimum grants will be supplemented by additional unconditional grants. If the minimum grants are given according to the second formula, the amount of additional unconditional grants to be given would obviously have to be much larger. Hence the second formula for minimum grants is the less attractive of the two alternatives. The additional unconditional grants may be given in two forms:

- 1) a specified share in a productive National tax and
- 2) equalisation grants.

As regards (1), what can be considered is the sharing of 10 per cent, or at least 7.5 per cent, of the net proceeds of the personal income tax and a reduction in the level of the derivation grant from 1.25 per cent of export value to 0.625 per cent. At 1981 yield, this would mean a net outflow from the National Budget by about K7 million (at 10% share). If necessary, to this extent, or to partly cover this, the money given at present under the sectoral programmes may be reduced.

As regards (2), every two years an exercise will be carried out to see if, in addition to (a) the base or minimum grant and (b) the share of income tax, the provinces or any

of the provinces need further assistance and if so to what extent the National Government has the resources to meet the need. Assuming an extra amount is considered necessary, this may be fixed at a suitable level which will hold good for two years.

7.24 Another approach can be to leave the entire additional grant to be determined on the basis of an overall assessment and not to have the sharing of the income tax.

7.25 Let me sketch out one particular scenario, combining some of the alternatives mentioned above.

1. The minimum grant will be the per capita MUG in the year previous to the year of changeover. The total commitment of the National Government on this account will grow at the same rate as the combined population of the provinces (leaving out the National Capital Territory). The population figures for non-census years will have to be estimated on the basis of projections or otherwise.
2. 10 per cent (or at least 7.5 per cent) of the net yield of the personal income tax will be transferred to the provinces and the present derivation grant will be reduced by half (subject, however, to the condition that a province now getting derivation grants will not get less by way of the combination of the share of income tax and the reduced derivation grant).

Every two years an exercise should be carried out on a broad assessment of needs, keeping in mind the criterion of equalisation, to determine the additional assistance some or all of the provinces would require and to see to what extent this requirement can be met given the resource position of the National Government. Any additional grant that is decided upon will remain fixed for two years.

7.26 This is the combination I would like to recommend. It has several advantages. First, the minimum unconditional grant which increases according to the growth of population, while taking care of the growth of the needs of the province in one sense will in fact be less than the growth according to CPI or according to the growth of National Government revenues. This means that less will accrue under this formula to all the provinces including the richer provinces and there will be a distribution in favour of the provinces whose populations grow faster. The amount saved here, by having a lower growth of MUG than at present, can be used for giving increased additional grants to be distributed on different criteria. Third, one part of the additional grant, namely, the share of the income tax will be automatically determined. This provision will mean an increased net burden of around K 7 million. With a cut in sectoral programmes by K 2 or 3 million the net additional burden could be reduced to K 5 or 4 million. Part of this will be absorbed by the lower growth of the minimum grant between the year of change and the previous year. After the first year, in any case, the growth in the share going to the provinces will

depend on the growth of income tax revenue and will come out of it; hence it will not cause any problem to the National Government. On the other hand, many provinces will welcome this provision, because they will automatically gain from the growth of the economy. Fourth, any additional unconditional grant will be given only on the basis of need and equalisation and only to the extent that the National Government resources permit. Finally, the exercise will be done for a two-year period giving some stability to provincial budgeting.

7.27 The question arises as to how the amount of unconditional grants over and above the share of the income tax will be determined and who will determine it. Once this is decided, we must decide about the criteria of distribution of the total i.e., the share of the income tax and the additional grants.

7.28 It is a salutary principle that the amount of the additional unconditional grants should be left finally to be decided by the National Government. The interests of the provinces are taken care of by the guarantee of the per capita grant and the entitlement to the share of the income tax. However, it is desirable for the NFC to be associated with this exercise. The NFC should keep under continuous review the finances of the provinces and the way in which they spend the funds at their disposal. After the recommended scheme goes into operation, six months before the end of the two-year period, the provincial governments may be required by the NFC to make submissions on the state of their finances and their performance, stating also their needs for additional resources, if any.

The NFC will hold discussions with the representatives of provincial governments and question them on their claims, lapses and failures. At the conclusion of its study of provincial submissions and its deliberations with the provincial representatives, the NFC will submit a confidential report to the Minister for Financial Affairs on the state of provincial finances indicating broadly the total amount the several provinces will get from revenues from all sources other than the additional unconditional grants and any conditional grants that the National Government may decide to give (for the next two years). The Commission will also comment on the financial performance of the different provinces. The NFC will not be required to study the National Government Finances and will not be authorised to make any recommendations on the amounts of the two residual grants (additional unconditional and conditional grants) to be given. The National Government will be, however, required to take into account the report of the NFC before deciding upon the amount of additional unconditional grants to be given if any.

7.29 There remains now the question of the distribution among the provinces of the share of the income tax and of the additional unconditional grants which the National Government might decide to make. It may be laid down that 50 per cent of the share of the income tax be distributed on the basis of population. The rest of the 50 per cent of the share of the income tax and the additional unconditional grants, if any, may be left to be distributed by the NFC on criteria, such as the ones it has already developed, suitably modified in the light of the changes in the system of transfers now introduced.

The Role of the Fiscal Commission

7.30 Since the total volume of the share of the income tax and of the additional unconditional grants left to be distributed by the NFC will grow, the Commission will play an increasingly important role in the distribution of Funds among the provinces. If my suggestion that the NFC be required to receive submissions from the provinces and make a report to the Finance Minister every two years is accepted, the Commission will begin to play a truly educative and mediatory role. If these weighty functions are to be performed satisfactorily, the Commission itself should be strengthened and given an identity separate from that of the Department of Finance, I recommend that there be appointed one full-time member who will be designated the member-secretary. Under the present law, no member of the public services can be made a member of the Commission. This law could be amended, or an outstanding non-official with experience of public affairs could be appointed. The same person should not be appointed member-secretary for more than two terms. The second recommendation concerning the Commission is that the Commission should be given an office in a place other than the Department of Finance. Sufficient funds should be allocated to it so that a small library could be built up and the necessary staff may be recruited and trained. One middle level officer from the Department of Finance may also be seconded to the NFC.

Review

7.31 I recommend that 10 years after the new scheme is put into operation, the whole matter must be reviewed to consider in what ways it has successfully met the developing needs of the provinces and whether it has caused any serious difficulties to the National Government and if modifications are necessary. If possible, at the time of every 10-year review, the per capita minimum unconditional grant may be increased to the average of the per capita total unconditional grant (minimum grant plus the additional unconditional grant exclusive of the share of the income tax) for the previous 10 years. This would mean that a portion of the relative gains made by the poorer provinces will become part of the minimum grants for the next 10-year period. Also, the amount of the additional unconditional grants to be given at the discretion of the National Government would become correspondingly smaller.

Surcharge on Income Tax

7.32 The National Government should be authorised to levy a surcharge for its own purposes on the personal income tax under extra-ordinary circumstances or under a national emergency. The yield of the surcharge will not be shareable with the provinces. It may be laid down, however, that a resolution to impose such a surcharge should be passed by a two-thirds majority.

Concluding Observations.

7.33 The package of modifications in the system of transfers from the National Government to the provinces as well as the measures proposed to develop provincial sources of revenue should prove adequate to meet the growing needs of the provinces without jeopardising the fundamental and overriding interests of the National Government. I have sought to maintain a balance on the one hand between the needs of the National Government and those of the provinces, and on the other, between the interests of the more developed and the poorer provinces. By recommending that a moderate share of the income tax be handed over to the provinces, I have tried to introduce an element of automaticity in the transfers flowing to the provinces. The change in the system suggested would not mean any disruption of National finances at the time of changeover. Only a small reduction in the amount of expenditure under the sectoral programmes may be called for in the initial year. I fully recognise the importance of direct development expenditure by the National Government as well as of conditional grants (including sectoral programmes) which the National Government would wish to give to promote development in priority areas as well as to help the poorer provinces. The scope for such action by the National Government would by no means be significantly curtailed if the scheme I have recommended is adopted. Lastly, I have tried to enhance the importance and prestige of the NFC which could play a really important educative and mediatory role. Only a properly staffed NFC could make

a continuous study of the problems of inter-governmental financial relations so that policy decisions could be taken on the basis of correct information and analysis. While recommending steps to increase the importance of the NFC, I have taken care to ensure that the final word on the amounts of additional unconditional grants and conditional grants to be given to the provinces would rest with the National Government. The scheme of transfers I have recommended has enough flexibility inasmuch as it contains a share in a national tax, minimum unconditional grants, additional unconditional grants which could be used for the purpose of equalisation, and conditional grants which could be used both for equalisation and for promoting development in nationally desired areas.

7.34 One of my terms of reference requires that I should indicate "appropriate criteria for the distribution of grants from the National Government to Provincial Governments, including such factors as need, origin of revenue, etc." I have indicated the difficulty of apportioning the share of income tax on the basis of origin; however, the yield of the sales tax should be distributed on the basis of collection from each province. Insofar as the minimum unconditional grants will increase in accordance with the growth of population, the growth of needs would be taken care of to a large extent. Other than that, the criterion of need is best left to be enshrined in the transfers that would be made on the recommendations of the NFC. In this connection, I have described the present set of criteria used by the NFC and have suggested that they may continue to be applied by the NFC with suitable modifications in line with emerging developments.

