Government of the
Solomon Islands

Review of Intergovernmental Fiscal Transfers in Solomon Islands

Final Report by the Fiscal Decentralization Specialist

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Juan Luis Gomez Reino
Research Associate
Andrew Young School of Policy Studies
Georgia State University

jlgomez@gsu.edu

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Terms of Reference

The objective of the assignment is to review the current system of Provincial Services Grants, and to recommend changes to the system to make it more equitable and more effective. Develop practical guidelines and policy implementation frameworks that could address both vertical and horizontal fiscal imbalances in the current system by taking into account their fiscal needs and absorption capacities.

The expert will:

a. Analyze the current design and management of Provincial Services Grants, and Provincial Governments revenue raising powers.
b. Review the revenue sharing and intergovernmental fiscal transfer system outlined in the draft constitutional reform, which is proposing the transition from a unitary to a federal state system and will be discussed in the national Parliament at the end of 2009 or early 2010.
c. Design and finalize questionnaires and data collection templates for field research.
d. Field test data collection methodology in at least two provinces with the support of a national consultant specifically hired by PGSP. The national consultant will then independently continue and finalize work activities.
e. Assess the adequacy of accounting for, monitoring, and reporting on the current grant system and own revenues.
f. Analyze the intergovernmental transfer system and make recommendations for reform. The proposed new system shall be based on transparent, efficient and equitable criteria, and adequate to address current and future fiscal needs of Provincial Governments.
g. Develop a timetable for the implementation of the proposed systems.
h. Present findings and recommendations for reforms at a national workshop with relevant stakeholders to validate their relevance to local conditions, and facilitate a discussion on these issues.

The consultant will provide:

a. An inception report which describes the consultant’s response to the TOR and details the methodology and work plan of the consultancy. The inception report is not to be more than two pages long and is due within the first 5 days of the consultancy. ***Already submitted.***
b. An intermediate report after the first period spent in the country, briefly outlining preliminary findings and providing guidelines for work of the national PGSP consultant***. Already submitted.***
c. Final report recommending the re-design of the intergovernmental transfer system with detailed action plan that will guide the Ministry’s policy in proposing reforms to the SI Government. The final report will take into consideration all the comments made on the draft report by various stakeholders, including major outcomes of the national workshop.

I. Introduction

With a total population of around 500,000 people stretching over 28,000 square kilometers, the nation of Solomon Islands (SI) is organized administratively in 9 provinces and the town of Honiara. Since its independence in 1978, the role of sub-national governments in the delivery of services to the local population has been increasing steadily, fuelled by separatist demands and ethnic tensions that have in the recent past severely jeopardized the stability of the country. The first devolution order dates from 1983, although a more determined drive towards decentralization of expenditure and revenue powers to provincial governments was sanctioned in the 1997 Provincial Government Act (PGA). Currently, a draft Constitutional text is under discussion which would implement a Federal system of government in the country with arguably greater autonomy at the provincial level (or State level if the reform is eventually implemented). The implications of the provisions included in the draft Constitutional text on the structure of intergovernmental fiscal relations are widely discussed in the report.

In terms of the legislative framework currently in place, the PGA defines the legislative powers of Provincial Governments (including their revenue raising capacities), and lists a wide range of government functions that could potentially be decentralized to them. To date however, little progress is reported in the implementation of these provisions of the act, and some confusion remains as to the level of services that Provincial Governments are actually delivering to their constituencies. In part due to a vaguely defined statement of expenditure responsibilities, the system of provincial financing does not seem to address adequately sub-national needs for service delivery, even within the limited resources available.

Provincial Governments in SI also face significant constraints related to their lack of managerial capacity and a general shortage of staff. The work of Provincial Governments seem to be additionally vulnerable to political pressures which pose important constraints to efficient service delivery and to the implementation of transparent and accountable financial management systems. The challenges faced by SI are however common to many other countries with relatively immature decentralized systems of government, and SI stands to benefit from a wealth of accumulated international experience in the definition of intergovernmental fiscal systems.

Without adequate public financial management systems in place that ensure accountability and transparency in the budgeting process (from formulation to implementation and audit), the size and distribution of grant allocations may not matter much. If the limited available funds for grants are left at the direct discretion of political representatives (that is, by-passing the executive power), or if budgetary allocations can be capriciously modified by the bureaucracy without proper consultations with the sub-national levels of governments, then additional funds or a more equitable distribution of resources may not have an impact on overall living standards and service delivery levels. This report however does not aim to provide a comprehensive evaluation of the quality of the current public financial management system in the SI, although references are made to general aspects of it.

The report, moreover, does not make a case for additional decentralization. The latter is ultimately a political decision that needs to be taken in the context of the full knowledge of the current system of basic service delivery in the Solomon Islands. The lack of clarity perceived regarding the current distribution of functional responsibilities across levels of governments, added the significant weaknesses of the system of public financial management recommend a very cautious approach towards further decentralization of functions and responsibilities. In any case, the recommendations offered are amenable to the current or any future level of decentralization in the country.

Acknowledging the system of intergovernmental fiscal relations has multiple and inter-related components, this report is specifically concerned with the current design and implementation of the Provincial Services Grants, the largest source of Provincial Government financing in SI. The recommendations here contained offer potentially large improvements to the efficiency and equity of the provincial financing system, and their implementation is independent of the eventual constitution of the country as a Federal State.

In Section II, the report offers a “best practices” framework to provide the necessary technical background for the proposals of reform. In Section III, the report analyses the current design and allocation of the Provincial Services grants, while in Section IV and V proposals for its reform are suggested. Section VI evaluates the alignment of the reform proposals with the potential constitutional changes. Summary conclusions are offered in Section VII.

II. The design of an efficient and equitable system of intergovernmental transfers.

On the components of an intergovernmental fiscal system

A fiscally decentralized system has four main components or "pillars": the assignment of expenditure responsibilities, the assignment of revenue sources, a system of fiscal transfers, and the borrowing powers of sub-national levels of government. Each of these elements must be well integrated with the rest.

The design (or the eventual reform) of a system of intergovernmental fiscal relations must follow a certain sequence. First, in a multi-level vertical structure of government, as it is the case in the Solomon Islands, we need to determine which level of government is more efficient at delivering each of the public services provided (in basic terms, who should do what?). Local preferences on the level and characteristics of the public goods provided differ across areas due to a variety of reasons (cultural, geographical, historical, etc.). It is therefore efficient to assign responsibility for the delivery of certain services to the sub-national levels of government, since they are in a better position to match local preferences and public expenditure.

The assignment of expenditure responsibilities must be unambiguous, sanctioned by law, and should avoid situations where different levels of government share responsibilities over multiple functions. An efficient expenditure assignment is the first and most important step in the definition of a decentralized fiscal system, since only once we have determined the assignment of government functions across levels of governments we will be able to estimate their financing needs.

The second stage in the definition of an efficient intergovernmental fiscal system is the assignment of revenue powers to sub-national levels of government. For local governments to be able to respond to the specific needs of their citizens, they need some revenue autonomy. If all the funds came in the form of conditional or earmarked grants, local governments would be unable to adapt their expenditure to local needs. Such autonomy is partly granted with the assignment of own source revenues[1].

International experience on decentralized systems shows that it is more efficient to assign expenditure responsibilities than revenue powers to sub-national governments. Typical services delivered at the local level include, in many countries around the world, primary education, basic health care, road maintenance, police and fire protection services, parks and public space management, water provision, garbage collection, etc. On the other hand, the number of revenue sources traditionally assigned to sub-national levels of government is small: property taxes, licenses and fees, and other tax and non-tax revenues of more limited importance. This situation creates a ***vertical imbalance*** between the expenditure needs derived from an efficient assignment of expenditures and revenue powers across levels of government. An important share of public expenditure is implemented at the local level, but the most

[1] Greater autonomy is also granted with unconditional grants.

important sources of revenues are commonly (and reasonably) retained by the national government. In addition, the revenue collection capacity of sub-national governments varies greatly as the tax base is not distributed uniformly. This means that, even though they may have identical revenue powers, the fiscal capacity of local governments differs importantly, creating what we call ***horizontal imbalances***. The system of fiscal transfers, the third pillar of a fiscally decentralized structure, should address these horizontal and vertical imbalances, ensuring that comparable levels of service are delivered across sub-national governments.

Lastly, the eventual assignment of borrowing powers to sub-national levels of government completes the definition of a comprehensive inter-governmental fiscal system. Arguably, adequate financial management mechanisms need to be in place in order to ensure that the borrowing powers granted to sub-national levels of government are used efficiently and do not jeopardize the overall country's fiscal stability. For countries in the initial stages of fiscal decentralization, the assignment of borrowing powers is arguably not a top priority.

On the objectives and structure of a fiscal transfer system

The basic structure of a system of inter-governmental fiscal transfers can be summarized along four fundamental dimensions:

1. the objectives of the system;
2. the sources of financing for the transfers;
3. the criteria for the distribution of available resources;
4. the conditions (if any) imposed on the expenditure powers granted through transfers.

As discussed, among other objectives, a system of inter-governmental fiscal transfers can address the vertical and horizontal imbalances caused by the uneven assignment of expenditure and revenue powers to sub-national governments. A well designed transfer system can assist in allocating sufficient resources to all levels of government to deliver the services under their responsibility; and to all governments within each level according to their needs and available resources (the so called equalization goal).

In addition to the objective of equalizing the needs and fiscal capacities of local governments, a system of fiscal transfers may have additional objectives, for instance:

- Encourage (discourage) sub-national public expenditure on services/expenditure programs with positive (negative) externalities.
- Support sub-national governments in the event of natural calamities or external shocks that may affect their stability.
- Promote economic development via capital investment projects and support o the local private sector.

The transfer system may have multiple objectives, but best international practices recommend the definition of a single objective for each grant *instrument*. Thus, we may have equalization grants, infrastructure development grants, etc. depending on the objective assigned to each instrument. In any case, assigning multiple objectives to a single grant is a sure recipe for goal dispersion and inefficient allocation of resources, and eventually makes difficult the evaluation of the grant's overall impact.

The amount of funds available for distribution in any grant can be determined in many different ways. It can be determined in a discretionary way, annually, by the central government authorities, or as a fixed share of one or several revenue sources (e.g. income tax, value added tax, etc.). The available pool of funds for distribution can equally be determined with a formula that estimates the financing needs of the recipient governments. Either alternative presents advantages and disadvantages. For instance, the central government would prefer to exercise discretional power over the determination of the overall amount distributed in the form of grants, since that would allow for greater flexibility in the country's macroeconomic management. This path reduces however the predictability of sub-national revenues and jeopardizes the efficiency of expenditure programs in the long term.

The determination of the pool of funds available for a particular grant as a fixed share over the central government revenues (or particular revenue sources) allows for greater revenue predictability at the sub-national level and more efficient expenditure planning, although it also limits flexibility on macro-economic management. If so determined, such a system requires however that future volatility on the yield of the revenue sources justifies adjustments to sub-national expenditure.

Ideally, one would try to estimate first the amount of financial resources necessary to meet the objectives of a particular expenditure program and then allocate such amount to the grant. However, the inherent difficulties in costing the provision of public services, and the financial constraints traditionally faced by the central government make the option of tying the size of the grant to a share of a certain (or several) revenue source the simplest decision. In any case, this arrangement needs to be monitored to ensure that the expected volatility in revenue collection does not jeopardize the achievement of the program goals.

The third dimension of a grant program is the determination of distribution criteria. Such criteria can be defined in a discretionary way (annually for example), as a fixed proportion of the available funds, or by formula. Best practices recommend the use of formulas that ensure a level of fairness, transparency and stability. Formulas also assist fiscal discipline and efficient behavior by the different government levels, diminishing as well the potential for political bargaining.

Of course, the distribution criteria must be closely aligned with the grant objectives. Similarly, any conditions imposed in the use of funds must also be linked adequately to the grant objectives, the fourth dimension of a grant program. Even though any conditions imposed in the use of a grant are limited by the fungibility of the funds assigned, it is possible to utilize conditional grants efficiently to establish minimum standards of expenditure in a particular sector at the national and sub-national level. If however the goal of the grant is to assist the capacity to finance public services at the election of the sub-national government, then the grant must be unconditional in nature and practice.

In summary, best practices in the definition of effective grant programs require that:

a. A single, clear objective is defined for the grant.
b. The government determines the sources of funds for the grant in a transparent, and as predictable a way as possible.
c. The government defines equally transparent distribution criteria, preferably in the form of a formula, well aligned with the objective of the grant.
d. Ensure any conditionality imposed on the use of the grant is supportive of the objective designed for the grant.

In the next sections of this report we use the above “best practices” framework to analyze the current system of Provincial Services Grants in SI and offer proposals for its reform.

III. The system of Provincial Grants in the Solomon Islands.

As currently designed, the Provincial Grants in the SI include:

1. Revenue Sharing Grant;
2. Productive Resources Grant;
3. Special Supplementary Grant;
4. Library Services Grant;
5. Fixed Services Grant;
6. Road Maintenance Grant;
7. Town and Country Planning Committee Allowance;
8. Provincial Shipping Grant.

In addition, the central government is responsible for the payment of salaries of selected members of the provincial civil service (Secretary, Treasurer and Deputy Treasurer) and provincial members' salaries, and travel grants. The eight so-called Provincial Services grants (PSG) are jointly transferred to Provincial Governments in monthly, block installments. Saving relatively recent adjustments to the Special Supplementary Grants (conducted to address the consequences of the 2007 tsunami), most grants are annually indexed across the board by a certain percentage for the preparation of the national budget estimates.

One would be tempted to assume that the name of the grants indicate their main purpose/objective. However, although perhaps at the moment of their implementation that was the case, by now the Provincial Services grants are disbursed and used as a single, largely unconditional[2] financing instrument at the discretion of Provincial Governments. The PSG are by far the most important revenue source of Provincial Governments. From the limited available data, they represent close to or over 90% of all revenues in Rennell and Bellona (98% of all revenues), Central Islands (87%) and Malaita (85%) as we can see in Table 1. Their importance decreases expectedly in those regions with richer economic fabric that leads to better revenue collection from own source revenues, such as Western Province and Guadalcanal.

[2] We were told that, depending on the province, the Shipping grant is sometimes transferred directly to the provincial shipping authority and thus it may be somewhat more conditional in nature.

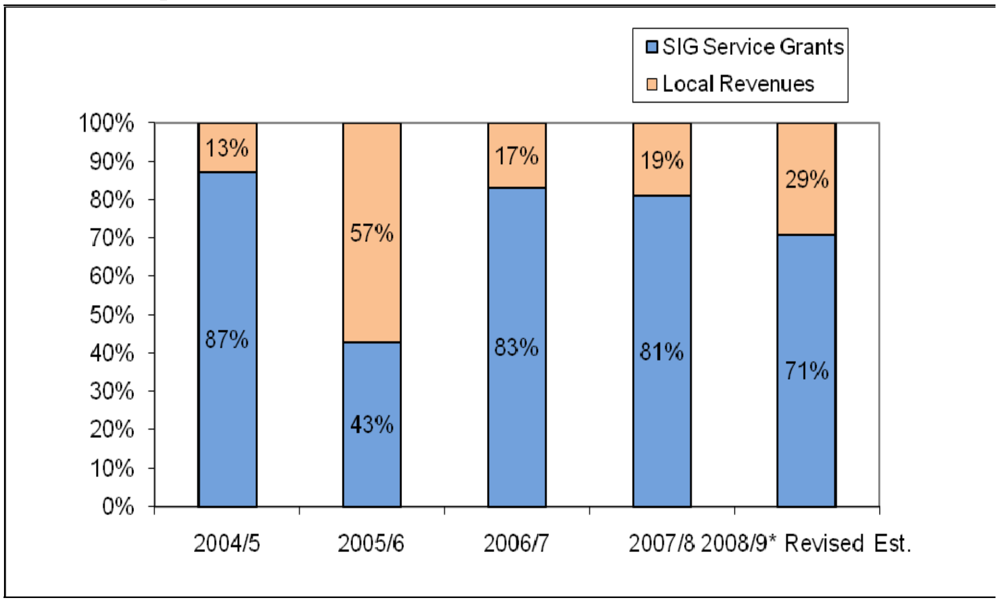
Table 1. Provincial Grants and Own Source Revenues as a percentage of total revenues (financial year of data)

	Grants		Own Source Revenues
	Services Grants	**Other**	
Central Islands (07/08)	87%		13%
Choiseul (07/08)	72%		28%
Guadalcanal (06/07)	68%	3%	29%
Malaita (06/07)	85%		15%
Western (06/07)	51%		49%
Makira Ulawa (07/08)	81%		19%
Temotu (06/07)	87%		13%
Rennell and Bellona (07/08)	98%		2%
Isabel (07/08)	57%		43%

Source: UNCDF (2009)

We are unable to determine, on the basis of the available data, whether the relative importance of the PSG over total provincial revenues has been maintained over the years. One would in fact expect a decline of PSG as a share of total provincial revenues, due to the fact that overall grant allocations have diminished as a percentage of the national budget, but also due to the steady increase in own revenue collection. Analyzing for example a time series of fiscal data for Makira Ulawa Province, PSG have represented on average over 80% of total revenues, but are expected to decline to 71% in 2008/09. The data for the financial year 2005/06 must be taken with caution, since it shows a very significant increase in collection from own revenue sources that is not maintained the following years.

Chart 1. Composition of Makira Ulawa Revenues



Source: UNCDF (2009)

During the financial year 2009/10, Provincial Governments had initially witnessed substantial cuts to their PSG allocation (the so called reservations), to the amount of nearly a third of the total allocation, as provincial staff from the Guadalcanal government confirmed. The cuts were justified on the country's revenue shortfall and provincial governments are expected to adjust expenditures accordingly. In our conversations with provincial officials, we were informed that the Guadalcanal Provincial Government planned to cut expenditure on manpower but also service delivery, although we were not able to obtain further information as to which services would be affected. Eventually, the budget reservation was removed by the central government and Provincial Services Grants went back to original budget figures. Arrears due to the application of the reservation in past months will be transferred to provincial governments in the near future. The impact of these measures in the implementation of provincial budgets is hard to measure, even if the funds are eventually transferred, but the disruption caused to provincial government businesses is substantial.

Resources from all provincial revenue sources (including the PSGs) are highly vulnerable to political interference. Although we were only able to collect anecdotal evidence from a couple of provinces, it would seem that political representatives decide on the use of revenues even before those have been disbursed into the provincial coffers. In fact, it would seem that provincial political representatives in some provinces are able to negotiate tax and non-tax payments from the private sector directly (i.e. business licenses from logging companies for instance). Once the payment has been agreed, provincial government officials are informed by their political representatives on how those funds are to be allocated.

This is of course a highly inefficient practice that diminishes the authority and capacity of Provincial Governments for service delivery. In addition, provincial political representatives have a clear incentive to prioritize the allocation of available funds to their Ward Grants, payments of up to SI$60,000 per provincial member that are used at their full discretion presumably for development projects within their jurisdiction. No record exists of how the money is actually spent, although members do sign impress forms to account for the funds received. As a result, we are unable to analyze the impact of the Ward Grants, although experiences from neighboring countries should warn us against this kind of schemes, commonly used to assert political ties over personal jurisdictions.

PSG are not immune to this type of behavior. From the Office of the Auditor General we learned that the common practice of inflating provincial budgets on the basis of unrealistic revenue collection estimates is also prevalent in the SI. This allows inflating Ward Grants and, since political representatives seem able to determine expenditure priorities in a fully discretionary basis, those are paid first. When own source revenues are not sufficient, PSG are used to pay the Ward grants. In a context of very limited resources, this practice has the potential of turning Provincial Governments into irrelevant institutions.

In the absence of additional data, we can only conclude that the PSG remain the most important source of Provincial Government financing and it is reasonable to expect this situation will continue in the short term. Their relative importance on the provincial revenue bases may be diminishing as own revenue collection increases over time but this trend may differ widely by province. Thus, continued provincial dependency on PSG should be expected, as well as a certain level of volatility unless changes to the determination of the grant amounts are implemented.

Applying the "best practices" framework to the analysis of the PSG

How does the current system of PSG fare in terms of the "best practices" framework described in the earlier section of this report? For a start, the review of grant allocations and the conversations held with national and provincial government representatives during the mission revealed that the PSG do not have a clear policy objective currently defined. As discussed, the eight grants that compose the PSG package may have had at the moment of their implementation specific policy goals as their denomination may indicate. By now however, the grants are indistinguishable in practice and are discretionally applied to the overall running of Provincial Governments. In fact, collapsing them into a single budget line could simplify the budgetary process without a single policy implication. This recommendation has been taken on board by MPGIS and is reflected in the 2010 SIG Budget currently being discussed and approved in Parliament

It seems therefore that the conditionalities that may have been imposed in the use of the grants at the moment of their initial implementation have been relaxed in practice. This may not necessarily be an indication of mismanagement, but just the realization of the autonomy required by Provincial Governments in the use of their funds if they are to attend to particular provincial development priorities. If so, the main objective of the PSG *as they are currently implemented* seems to be, simply put, to allow Provincial Governments to deliver the services over which they have responsibility with a certain degree of autonomy.

It is hard to argue that the current allocation of PSG are however even vaguely based or aligned with national or provincial development priorities. PSG allocations are not determined on the basis of relative expenditure needs, and do not take into consideration the different fiscal capacities of the Provincial Governments. As a result, very important inequities in the distribution of funds are found as we can observe in Table 2.

Per capita allocations offer perhaps the best available indicator to analyze the distribution of the PSG. The reason is that population is the single most important determinant of expenditure needs. The more population, the higher the level of expenditure generally required to deliver a similar level of services, even when some economies of scale may operate in the production of services. As a result of this fact, most grant distribution formulas around the world rely heavily on population as the critical variable for efficient distribution[3]. In addition, although additional clarity is required in the assignment of expenditure responsibilities to Provincial Governments, such assignment seem to be symmetric. That is,

[3] In Spain, 94% of the Sufficiency Fund (an unconditional grant to the country's regions) is distributed by population criteria. In Peru, 80% of the FONCOMUN (a municipal unconditional grant to municipalities), has been distributed in the past according to population criteria. In an on-going reform, the Peruvian authorities are planning to increase that ratio to 95%.

all Provincial Governments have similar responsibilities for service delivery, which makes per capita allocations an even stronger indicator of efficient financing levels.

Table 2. PSG per capita Allocation (Approved 2009 Budget Figures)

Provincial Governments	Population Distribution	Services Grants Approved Budget 2009	Per capita Allocation
Malaita	140,569	4,605,407	**32.8**
Makira	50,026	2,677,328	53.5
Western	81,852	8,129,422	99.3
Isabel	23,638	2,982,201	126.2
Central	24,491	2,452,884	100.2
Guadalcanal	84,438	4,145,872	**49.1**
Temotu	23,800	2,831,784	119
Choiseul	31,259	4,264,583	136.4
Rennell & Bellona	4,409	2,276,460	**516.3**
Max	140,569	8,129,422	**516**
Min	4,409	2,276,460	**33**
Max/Min	31.9	3.6	**15.8**

Source: Ministry of Provincial Government and Institutional Strengthening

As it is well known, Malaita is the most populated province in SI, and they are the second largest recipient of PSG with $4.6 million in 2009. However, in per capita terms, Malaita was only assigned $32.8 per person in 2009, less than half the national average for 2009 of nearly $74 per person. Guadalcanal ($49) and Makira ($53.5) are the other two provinces that were allocated in 2009 per capita allocations below the national average. At the other extreme, Rennell and Bellona (R&B) received over $500 per capita in 2009 allocations, followed by Choiseul with a PSG allocation of $136 per capita[4].

A commonly used indicator to measure the relative dispersion between provincial financing levels is the ratio of the top provincial per capita allocation over the bottom one. For SI, and on the basis of the approved budget figures for 2009, the province that ranked first in per capita allocations (i.e. R&B) received nearly 16 times the per capita amount of the province with the lowest per capita allocation. Even Choiseul, the second ranked province in per capita terms, received more than 4 times the per capita

[4] Members of the National Assembly are granted annual grants for development projects in the National Budget to the extent of around SI$3 million per member. More populated provinces thus receive larger amount as they account for more representatives to the National Assembly. In principle, the assessment of overall provincial per capita financing levels should include all sources of revenue available and this source of funds should also be considered. However, the funds granted to members of the National Assembly seem to be fully discretionary “slush funds” for which there is little accountability. There is little evidence to support the argument that those funds are used to provide provincial government services for which responsibility has been decentralized. Thus, our criterion is not to include them in our calculations.

amount for PSG allocated to Malaita and over 3 times the amount allocated to Guadalcanal. It is hard to argue against the fact that such a per capita distribution seems to be excessively unbalanced.

The disparities in per capita allocations are even more striking when we compare the distribution of PSG with the distribution of other important service-oriented grants such as the Health or the School Grant, as outlined in Table 3 below.

Table 3. Per capita allocation of Health and School grants (2009 Budget Figures)

	Health grant	School grants*)	Population	Health Grant pc	School Grant pc
Malaita	6,269,000	10,133,000	140569	44.6	72.1
Makira	2,481,000	2,619,000	50026	49.6	52.4
Western	5,093,000	2,154,000	81852	62.2	**26.3**
Isabel	1,828,000	1,653,000	23638	77.3	69.9
Central	1,828,000	1,859,000	24491	74.6	**75.9**
Guadalcanal	3,526,000	4,691,000	84438	**41.8**	55.6
Temotu	1,959,000	1,607,000	23800	82.3	67.5
Choiseul	1,646,000	1,572,000	31259	52.7	50.3
Rennell & Bellona	522000	135000	4409	**118.4**	30.6
Totals	**25,154,000**	**27,732,000**	464482		
Average	2,794,667	2,935,889		54.2	59.7
Max	6,269,000	10,133,000		118.4	75.9
Min	522,000	135,000		41.8	26.3
Max/Min	12.0	75.1		2.8	2.9

Source: MoF (2009)

As it can be observed, the per capita disparities in the allocation of Education and School grants are far more modest as it is the case with the PSGs. The province receiving the largest Health grant allocation per capita (again Rennell and Bellona) receives however just three times as much as the provinces with the lowest per capita allocation (again Guadalcanal and Malaita). The distribution of School grants reveals similar disparities, but this time is Central the province with the largest per capita allocation with 76 dollars per capita, almost three times as much as Western province. As mentioned, although still large, these disparities are significantly smaller than those observed in the distribution of PSGs.

In principle, three main reasons could still justify such a huge disparity in per capita allocations for PSG. First, it could be the case that Choiseul and R&B delivered a much wider range of services in comparison to other provinces and, as such, required higher levels of per capita financing. The consultant's impression was however that the assignment of expenditure responsibilities did not differ so greatly across the country's provinces so this may not justify the disparities observed. Second, it could be the case that, in relation to other provinces, Choiseul and R&B had a much more limited revenue generation capacity and, as a result, in order to provide similar levels and qualities of public goods, they would require additional revenues that other provinces are able to generate from own sources. However, it is clear from the assignment of PSG that the distribution of the funds to the provinces is aligned with neither expenditure needs nor fiscal capacity. Yet a third possibility that could explain a deliberate disparity in provincial allocations of the size observed would be that the relative cost of service provision were 16 times higher in R&B (and 4 times higher in Choiseul) than in Malaita. Arguably, Choiseul and R&B may be further from the country's capital than many other provinces, but in itself that would not explain such a large discrepancy since accessibility is not only related to distance but to other geographical features that may affect service unit delivery costs.

Absent other technical explanations, we need to conclude that the disparities in PSG per capita allocations between Choiseul, R&B (perhaps even Isabel) and the rest of the country cannot be justified on fiscal arguments. They seem to be instead the result of years of "indexing" provincial budgetary allocations and perhaps even of political bargaining. It is a common occurrence in countries around the world that regional financing "deals" need to be reached in order to obtain support for national policies. It is unrealistic to expect that such practice will disappear in the near future. However, if such is the political reality, our recommendation is to use instruments other than the PSG for the implementation of such provincial deals. That would allow for greater budgetary transparency and would allow respecting the goals defined for the PSG as a system.

It is to be hoped that the current distribution of the PSG or even of the Health and School grants is not affected by the allocation of "development funds" to members of the National Assembly. These funds are fully discretionary in nature (thus by-pass largely the executive branch of power and provincial planning and budgeting systems) and devoted "in principle" to infrastructure projects. The grants analyzed here however are eminently devoted to meeting current expenditure responsibilities and as such not fully comparable as the target different policy objectives. The infrastructure development grants currently being managed under the UNCDF program do provide an interesting benchmark for the analysis of the use of development funds by members of the National Assembly.

To summarize the discussion until now, we would conclude that the main goal of the PSG, *as currently implemented*, seems to be to provide unconditional funding for the delivery of functions assigned to Provincial Governments. This is a fair and necessary policy goal. However, the grants design does not seem to be well aligned with such policy goal.

For a start, the SIG determines the amount of funds available for distribution under the PSG system in a fully discretionary fashion. As discussed, this limits the predictability of Provincial Government financing. Thus the SIG should consider the determination of the PSG as a fixed share of national revenues (a percentage of the income tax for instance) ensuring that potential volatility in revenue collection does not threaten the delivery of basic services at the provincial level. Secondly, there is no formula for distribution of funds to the provinces. In general terms, provincial amounts from the previous year are indexed by a certain percentage and larger changes in a particular province's allocation may be responding more to political than to development or fiscal objectives. It would advisable to increase the transparency and the efficiency of the distribution with the implementation of a formula that includes the most important determinants of expenditure needs, and in particular, population as the most critical variable. Lastly, it would not seem that any conditionalities exist in the use of funds from PSG, and therefore nothing seems to limit the exercise of provincial fiscal autonomy. This lack of conditionality should be retained in the consideration of future reforms for the PSG.

IV. Stages for the definition of a system of Provincial Financing.

We should expect that the demands for additional funding at the provincial level will continue to exceed the availability of funds for PSG in SI. This is a problem still faced by countries with 30 or more years of experience in the implementation of fiscally decentralized systems of government. There is no blueprint for decentralization, and no immutable assignment of expenditure and revenue responsibilities would prove efficient indefinitely. The system of intergovernmental fiscal relations is always “work in progress”, and the institutional framework of the country should reflect that reality.

It is possible however to reform the current system of provincial financing in SI so that the limited funds available are better aligned with national development goals and distributed in more efficient and equitable ways to the Provincial Governments. In this section we outline the possible stages of the definition of such a system of provincial financing prior to presenting a concrete proposal for the reform of the PSG.

1. *Clarify expenditure responsibilities and agree on an estimation of expenditure needs.*

It will not be possible to estimate the relative expenditure needs of the Provincial Governments if there is no clear assignment of responsibilities. Therefore, the first stage in the definition of an efficient system of provincial financing is to determine, as clearly as possible, what are the service delivery responsibilities of the Provincial Governments. Despite an initial drive towards decentralization of expenditure functions to the provinces in the Provincial Government Act of 1997, the mission confirmed that implementation has been lacking and few formal assignments have been made. A full report on functional assignments is being prepared by the UNCDF team, but it may be worth mentioning some general principles regarding this process.

Regardless of the government plans towards further expenditure decentralization, it is still necessary to take stock of the functions being performed at each level of government as a first step in clarifying the (in practice) assignment of expenditure responsibilities. Although the process is a time-consuming one, it needs to be accorded adequate priority, as most of the potential efficiency gains from fiscal decentralization are derived from an efficient assignment of expenditure responsibilities.

There is no such as thing as a perfect assignment of functions. It is to be expected that the functional assignment across levels of government will vary as sub-national governments improve their managerial and financial capacities. But there is an “efficient process” for functional assignment, where international experiences and theoretical principles can guide this exercise in the Solomon Islands. From a legal point of view, the assignment of expenditure responsibilities needs to be “formal”, that is, sanctioned in an official document. However, its eventual legal form must allow for flexibility in the reform of the assignments, which is expected to be fluid. A cabinet decision or the implementing instructions of a law are better suited as legal framework for a functional assignment than an organic law, since they are easier to modify.

Another point worth mentioning here is the need to acknowledge the multi-dimensional nature of public functions. Education as a service involves normative, delivery and execution, financing and planning, and audit and monitoring responsibilities as well. The decentralization of Education services may not require (it usually does not) the decentralization of all these functions. It is therefore required that the functional assignment disaggregates (unbundles) all these sub-functions for further clarity. Eventually, functions need to be disaggregated to a level in which each sub-function can be allocated exclusively to a single level of government, avoiding excessive co-responsibility.

Lastly, the institutional requirements for the definition of an efficient functional assignment include the coordination of all central and line ministries by a central government office or a joint committee. It is unlikely that a single government agency will have complete knowledge on the current service delivery practices or on the preferences of such agencies regarding further decentralization, so good coordination would be essential.

2. *Define in clear terms the main goals of the system of provincial financing.*

On the basis of the current practice and the observed needs of the provinces, it seems that the Provincial Services Grants should try to ensure that provincial government have sufficient funds to deliver the services assigned to them. That should be done taking into account the different expenditure needs and fiscal capacities of the provinces.

We were also made aware that the SIG is interested in implementing adequate incentives for local economic development that leads to increased revenue collection. This is a fair a reasonable goal for the system of provincial financing. It is however necessary that the different policy objectives are articulated via different fiscal programs and coordinated adequately. As we discussed, it is not efficient to assign several policy objectives to the same grant instrument as it is the case now.

3. *Define the fiscal instruments required to implement the agreed goals.*

If one of the objectives of the SIG is to ensure that provincial grants are related to both the expenditure needs and the fiscal capacities of Provincial Governments, thus reducing the vertical and horizontal imbalances of the current system, then the PSG should evolve into a properly designed equalization grant. This is a fiscal instrument that is widely used in countries around the world and that could increase very importantly the efficiency of the overall system of provincial financing. The next section will discuss the main stages for the definition of such a grant.

For the objective of encouraging revenue collection via the development of the local economic fabric, the main two instruments recommended by the international experience are the assignment of own revenue sources and the implementation of revenue sharing mechanisms. With the assignment of own revenue sources, provincial governments will have an incentive to facilitate economic development in their areas since that would lead to higher revenue collection and more resources available for provincial services and projects. Eventually, certain autonomy over the definition of tax rates or tax bases should be allocated

A revenue sharing mechanism also poses good incentives for the development of local economic sectors since, as provincial governments would participate from a share of central government revenues from a certain tax, the larger revenue collection, the larger their share will be. At least in name, the Provincial Governments of the SI are receiving funds labeled as “Revenue Sharing”. It seems clear however that such budget line is determined in a relatively discretionary way and annually indexed by a percentage determined by the Ministry of Finance. That is really not a proper revenue sharing mechanism, and the proposal below will discuss the role “Revenue Sharing” could play in a decentralized system.

4. Develop an institutional framework for monitoring and reform.

Fiscal decentralization is a process that needs to be reviewed regularly. As provinces gain management capacity for instance, they may be able to take on additional expenditure responsibilities. As a result, their financing needs will vary and the system will have to adjust accordingly.

It is essential that the institutional framework that can monitor policy implementation and seek agreement on eventual reform is in place. Several models exist that could be considered for the SI, but they will necessarily include representation from the Provinces and the Ministries of Finance and Provincial Governments and Institutional Strengthening at a minimum.

Another important element of the institutional framework of an efficient system of inter-governmental fiscal relations is the design of a conflict resolution mechanism that allows solving the probable discrepancies that may exist among governments of the same level or between different levels of government (e.g. responsibility over a particular service delivery for instance). Again several alternatives exist for consideration, but best practices recommend the implementation of several steps to conflict resolution (e.g. from technical experts discussion to political negotiation to judiciary intervention for instance) that filter cases and facilitate the work of the judiciary system.

V. Turning the Provincial Services Grants into an Equalization Grant in SI.

The reform of the current PSG into a true equalization grant that has as main objective to reduce horizontal and vertical imbalances caused by the uneven distribution of the tax base and the differing expenditure needs of the Provincial Governments of SI.

The equalization grant here proposed would assign resources to provinces not as a result of the indexing of previous budgeted amounts, but taking into consideration both the expenditure needs of the provinces (derived from the assignment of responsibilities) and their internal fiscal capacity. The grant would therefore assign more funds to those with greater needs (for example due to larger population size) and to those with less potential fiscal capacity (due to a weak economic base).

The design proposed for the grant would allow for the dynamic adjustment of the provincial allocations. For instance, if a particular province increases its capacity for own revenue collection due to the development of the local economic base, that will result on a lower share of the grant all other things remaining equal. In addition, the grant would not need to be reformed should the national government decide to transfer new functions to the process. The expenditure needs derived from the new functions will be incorporated to the formula and therefore the grant would adjust automatically.

a. Objectives of an equalization transfer

Intergovernmental equalization transfers aim to ensure that all local governments have the means to provide a comparable level of local public services provided similar levels of tax effort. As it is currently the case with the PSGs, the equalization transfers should consist in unconditional lump-sum payments to provincial governments, so that the provincial administrations can decide how to use the additional revenues with independence and considering the particular preferences of their constituencies.

Equalization transfers do not attempt to reduce differences in income across provincial governments, and it is usually recommended to develop those policies with redistributive purposes with independence of the equalization transfer program. Equalization transfers can serve as a mechanism to neutralize fiscal disparities created by revenue sharing mechanisms and could also be used as a way of ensuring a minimum standard of local public services in all jurisdictions.

What do we propose to equalize? The main purpose of equalization transfers is to equalize the differences between the expenditure needs and the fiscal capacity of provinces across the country, that is, reduce the relative fiscal gap.

Per capita Fiscal Gap Province A = Per capita Expenditure Needs (A) – Per capita Fiscal Capacity (A)

An important implication of this approach is that, for those provinces for which their fiscal capacity exceeds their expenditure needs, no equalization grants should be granted. This is sound from both a technical and a financial management point of view. Since the available funds are generally scarce, maximizing the equalization power of the transfer program will require the exclusion of those provincial governments with larger fiscal capacity than expenditure needs from grant. Given the estimated per capita fiscal disparities for each provincial government, the natural criterion is to concentrate the benefits of the grants exclusively in those jurisdictions with a positive fiscal disparities (the “needy” jurisdictions), and further to distribute the transfer fund to each of them at least in proportion to the size of its disparity.

b. Stages for the calculation of the Provincial Fiscal Gaps

It is important to understand that the proposal contained in this section is comprehensive and involves several stages and the development of a variety of new instruments. The proposal is therefore outlined in a sequential approach, so as to offer a roadmap for the implementation of the system proposed.

Stage 1. Agree on a methodology to estimate expenditure needs of provincial governments.

The very first and unavoidable step in the definition of an efficient system of provincial financing is to have an estimation of the relative expenditure needs of provincial governments. For such an estimation to be accurate, the SIG will need to clarify the assignment of expenditure responsibilities at all levels of government. It is important to re-emphasize that, without a clear understanding of the functions under the responsibility of Provincial Governments, the SIG will not be able to determine whether the level of financing provided through the PSG or any other instrument is adequate. Once the methodology is agreed, it would be also easier to negotiate with the provincial governments future adjustments to the provincial financing derived from changes to the assignment of expenditure responsibilities. Several methodologies are available for this estimation. The methodologies outlined below start with the approaches that require the least amount of data and move on into more data-intensive methods. It must be understood that no single approach is perfect and we will underline the advantages and disadvantages offered by each methodology. A last point worth mentioning is that the list is not comprehensive. There exist additional methodologies available for consideration, but their sophistication and data needs make them hardly applicable to SI’s current situation.

1. Lagged expenditure values

An uncomplicated way to define the expenditure needs of a locality is relying on historical expenditure patterns. The information on expenditure data of the last year(s) –adjusted by inflation– could be assumed to represent the expenditure needs for each jurisdiction. If provincial governments had a great deal of discretion in deciding the amount spent during the budgetary year, this method would offer a reasonably realistic estimation of expenditure needs, with important advantages like simplicity and minimum information requirements.

An important problem with this methodology is that if local governments have access to the financial markets, the use of historical data could also provide perverse incentives to the local authorities, because they will eventually “learn” that increasing expenditures in the present will result in higher equalization transfers in the future.

On the other hand, in the absence of discretion, the level of actual expenditures of past periods could be determined by historically “indexed” budgetary allocations (as it is the case with PSG) or particular financial constraints of the provinces (for example their inability to raise revenues locally). In such rather common cases, the historical expenditure patterns would reflect undesired differences in revenue-raising ability instead of expenditure needs, and thus they should not be used to estimate the expenditure needs.

In general, to rely directly on lagged expenditure patterns is not a recommendable way to estimate expenditure needs under equalization transfer purposes, but if it is the only available alternative, it should be used. The experience of Papua New Guinea in the implementation of their equalization grant system is a good example of how lagged expenditures are used as approximations of expenditure needs.

2. Equal per capita expenditure norm

The simplest way to estimate the per capita expenditure needs is by taking the average of historical expenditures per capita at a national level. In order to compute this average, we would first determine the aggregate level of sub-national expenditures needs, which can be based on adjusted historical data or on the budget forecast, and then to divide this amount by the national population. This simple procedure can serve as an approximation to expenditure needs when there is no other detailed information about the differences in the per capita needs or cost of provision of local public services across jurisdictions or when there are reasons to believe that those differences are negligible.

The per capita expenditure need will constitute a national norm in this case, and in order to compute the expenditure needs for each locality it will only be necessary to multiply this norm by the local population.

3. Weighted Indexes

The local population is likely the most important variable determining the total expenditure needs and the cost of public service provision for a local government, because it directly provides an order of magnitude for the total amount of expenditures that must be incurred. Of course, economies of scale, economies of agglomeration, demographic characteristics of the population, geographical differences of jurisdictions and other factors can substantially modify the applicability of the national average for each and every jurisdiction. In that case, the national norm could eventually be adjusted by one or more indexes containing information about differences in relative needs or costs of provision.

This is perhaps the most commonly used approach for estimating expenditure needs. It roughly consists in creating a composite index of expenditure needs, which captures and weights the factors determining the cost differences in delivering a standard package of local government services across jurisdictions. Such factors include demographic or geographic variables, and variables reflecting differences in the price levels or cost of living. The list of criteria entering the index and the weight used need to be carefully assessed and also thoroughly discussed with all stakeholders to ensure that the main causes for substantial differences in the costs of public service delivery across jurisdictions are captured in the index. If the index is a good approximation to the relative needs and costs of local governments this would clearly be an improvement. In any case, it is always necessary to take into account the higher complexity that comes with the gain in accuracy.

4. Per client (top-down) financial expenditure norms

This methodology follows a similar structure than the "equal per capita expenditure norm" methodology, but improves the estimation of the expenditures needs by using more detailed information about the expenditure functions assigned to the local governments, and devising a provincial government functional allocation in a "top-down" manner. The methodology would estimate the average amount of money spent per client (that is, per recipient of government services) by function (i.e. so much per pupil in primary education, so much per capita in basic health services, etc.). Once those "per capita norms" are calculated, they would be multiplied by the amount of clients in each province for each function. The addition of all functional amounts would provide the estimation of expenditure needs.

5. Traditional (bottom-up) physical expenditure norms

Expenditure needs can also be measured in a bottom-up manner, by exhaustively costing a standardized basket of local government services. In addition to the determination of standard levels of public services (national averages or minimum requirements), this approach requires a detailed quantification of the inputs, information about their cost or prices, a description of the production process for all local public goods and services, and very explicit procedures for how to cost all aspects of the expenditure responsibilities of sub-national governments. The expenditure needs for each local government are obtained by simply adding up all the costs of delivering the targeted standards associated with the sub-national services within the jurisdiction.

Although intuitively appealing, the traditional approach is usually unrealistic due to the impossibility of gathering all the information it requires. Collecting and managing all the information could be very demanding in terms of effort and extremely expensive. Finally, this approach may also be impractical because it can lead to unaffordable estimations of expenditure needs, forcing to adjust downwards the computed expenditure needs.

It is important to distinguish between the significant shortcomings of this methodology for the estimation of expenditure needs and the objectives and value of a costing exercise. The latter is aimed at exploring the relative differences in the cost of service provision across a country that can be due to geographical, demographic or economic reasons. A costing exercise would involve the assessment of the cost of delivery of a standard service or package of services in several locations of the country. The main goal would be to establish in which proportion the cost of delivery of the same service may differ from one jurisdiction to another on the basis of certain characteristics.

This cost factor can then be used in the estimation of expenditure needs by jurisdiction. Accordingly, if it would be established that the cost of delivery of standard primary education for instance is 50% higher in jurisdiction A than in jurisdiction B due to any of the factors mentioned (distance to capital, cost of shipping materials, education provided in regional languages, etc.) then, provided that they have an identical number of students, the expenditure needs for primary education of jurisdiction A would be 50% higher than those of jurisdiction B.

If the nature of a country lead policy makers to believe that substantial differences in cost of service delivery are present across jurisdictions, such as in Solomon Islands, it would be advisable to run such a costing exercise. Again, we need to emphasize that the goal of such exercise is not to come up with a figure of expenditure needs, but to estimate the differences in relative service delivery costs across jurisdictions so that they can be taken into account in the calculation of expenditure needs.

Stage 2. Agree on a methodology to estimate fiscal capacity of provinces.

Fiscal capacity of a sub-national government may be defined as the potential revenues that can be obtained from the tax bases assigned to the sub-national government if an average level of effort (by national standards) is applied to those tax bases. Thus, ideally, the measure of fiscal capacity should consider either the size of the tax bases available to sub-national governments or the revenue that these tax bases would yield under standard tax rates.

A variety of methods are used around the world to measure local government’s fiscal capacity, four of which are outlined below.

1. *Lagged own revenue collections*

The lagged or historical level of revenue collections constitutes a very simple way to define the fiscal capacity of the jurisdictions. Unfortunately, it may also introduce negative incentives, because sub-national governments can easily “learn” that higher collections translate into lower transfers and consequently reduce their tax effort in order to take advantage of the transfer system.

Another important problem with this approach is the existence of a difference between actual and potential collections in any jurisdiction. This may be due to differences on the tax structure or in the definition of the tax base across jurisdictions. For instance, they could compute the taxable income in a different way or have dissimilar criteria for tax exemptions. In both cases, the tax collection will likely differ between similar jurisdictions, even in the case where their fiscal capacity is identical. Similarly, tax avoidance and tax evasion might affect some local governments more than others, and the ability to overcome these problems, including the costs that must be assumed in order to improve the compliance rates, may also vary across jurisdictions.

Due to these complications, the direct application of historical data in estimating the fiscal disparities should in general be avoided. If no other alternative exist, the perverse incentives outlined can be somewhat tempered as can be seen in the next methodology.

2. Average of past collection ratios

In order to reduce the problems related with the use of lagged own revenue collections in estimating fiscal capacity, some slight manipulations of historical collection can provide effective and straightforward solutions. The simplest way to do it is to compute the ratio between provincial per capita revenues and the per capita revenues at the national level for several years, and then to obtain an average of these ratios for each jurisdiction, which indicates the relative size of local per capita collections with respect to the national standard in a period of several years. Thus, a single estimator of relative fiscal capacity is obtained for each jurisdiction and considering only historical collection data.

This approach helps moderate the perverse incentives associated with the benefits of reducing tax collections, because now, if a local government wants to increase the amount of future transfers, it must modify a multi-year average instead of a single-year result. Indeed, the expected benefits of reducing the local tax collections are decreased in proportion to the number of periods used in the computation of the average, and so the perverse incentives are directly reduced as well. Additionally, if the local government officials are not sure whether they will remain in their positions during the following years or not, then the idea of beneficiating competing political parties in the future can also discourage that behavior. If present, this “democratic factor” could eventually increase the effectiveness of this methodology.

3. Basic proxies for the local ability to tax

A different approach to estimating the fiscal capacity of sub-national governments is by considering *proxies*, or variables that in theory should be highly correlated with their ability to collect revenues. A widely used variable is the per capita level of personal income, which tends to be a good proxy and is usually available. Another commonly used variable is the gross regional product (GRP), which is the sub-national equivalent of Gross Domestic Product (GDP) and can also serve as a proxy of fiscal capacity. GRP is actually a more comprehensive measure of fiscal capacity than per capita income because it includes all the income generated within a region, personal and corporate, irrespective of the location of residence of the worker or producer.

It is unlikely that this information is available at the provincial level in the Solomon Islands, but the methodology represents a significant improvement over the preceding two approaches.

Stage 3. Computation and Distribution of the Fiscal Gap

Once we have an indication of provincial per capita expenditure needs and fiscal capacity, it is straight forward to estimate the provincial fiscal gap:

Fiscal Gap = Expenditure Needs – Fiscal Capacity

As mentioned, the fiscal gap will be negative for provinces (if any) that have greater fiscal capacity than expenditure needs. Those provinces do not need equalization transfers, as they are capable to meet their need with own revenues and other transfers. Limiting the allocation of the grant to the "need" provinces will allow maximizing the equalization impact of the funds. The funds should be allocated at least in terms proportional to the size of each provincial fiscal gap. Alternatively, there are options to increase the equalization impact of the distribution, closing more the fiscal gaps of provinces with larger gaps.

Stage 4. Ensure proper coordination of the different elements of the system

All the elements defined in this proposal of reform must be properly coordinated. If the SIG has among its policy objectives to incorporate incentives to revenue collection to the system of Provincial financing, then it should consider the definition of a proper revenue sharing mechanism with the provinces. In the design of an efficient revenue sharing mechanism the SIG would need to:

1. Determine which source of revenue will be shared, as not all sources of revenue provide equal incentives, or are equally efficient for revenue sharing. For instance, it is more efficient to share revenues from the Personal Income Tax than from the Corporate Income Tax or the Value Added tax generally.
2. Define a sharing rate. This is a relatively discretionary decision but a generally good criteria is to define a sharing rate that will allow the richest province of the country to meet its expenditure needs with the use of own revenues plus revenue sharing.

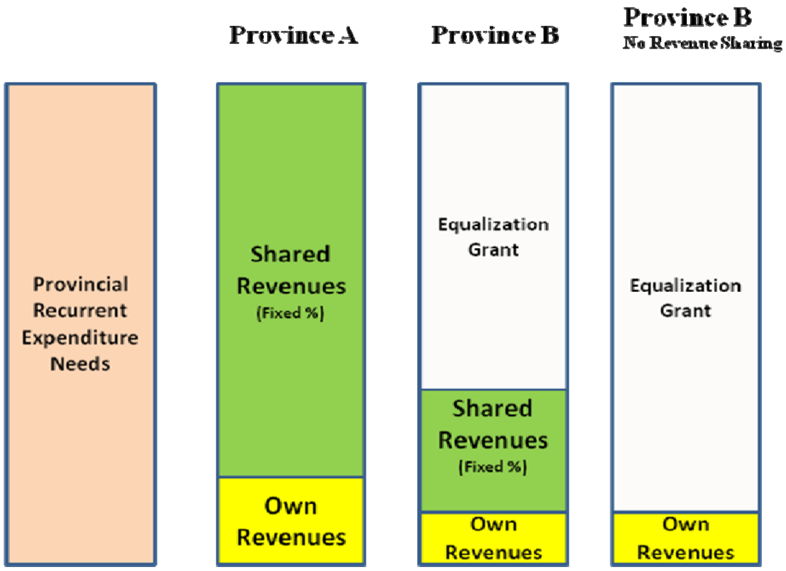
We should add that the definition of a revenue sharing mechanism proposed here is not an indispensable part of the future system of provincial financing. Our proposal here is justified by the expressed preferences of the national authorities interviewed, who insisted that any future reform should provide incentives for economic development and fiscal effort.

As shown in Figure 1, the SIG may decide to implement both a revenue sharing system such as the one described above *and* the equalization grant proposed *or* just the equalization grant.

Should the government opt for the definition of a proper revenue sharing system, then the amount of revenue shared from the selected taxes could allow the richest province in the country to meet provincial recurrent expenditure needs (left column of Figure one) with just own revenues and shared revenues, as with Province A in Figure 1 below.

The sharing rate determined (for example, 10% of revenues from the income tax collected in the province) would apply to all provinces equally. As it is to be expected, whereas in Province A below, that 10%, added to own revenue collection suffices to meet expenditure needs, in Province B (third column in Figure 1) is not enough. Thus, Province B will require the allocation of funds from the equalization grant (or services grants as described in Figure 1).

Figure 1. Structure of the Provincial Financing System



What this implies is that, if the criteria proposed for revenue sharing is implemented, Province A would not receive (as it would not require) equalization grants. If the government however decided not to opt for a proper revenue sharing system, then the structure of financing of Province A and B would only include own revenue collection and the equalization grant. As the system is regularly reviewed, it may require adjusting the revenue sharing rate and perhaps the formula for the distribution of the equalization grant.

Many countries around the world have implemented or are in the process of implementing equalization funds. Although it is acknowledged that every country presents specific challenges, the proposal here contained is applicable to a wide range of fiscal, economic and geographical environments. In fact, Papua New Guinea (PNG), arguably a country with similar characteristics and development challenges than SI has recently implementing an equalization grant formula with identical objectives to those stated here. The Papua New Guinea experience is summarized in Box 1 below.

Box 1. The Experience with Equalization Grants in Papua New Guinea

The government of PNG determined to undertake in 2002 a review of the system of provincial grants mindful of the fact that the old grant system distributed resources unfairly as it did not take into account the other sources of revenue available to provincial governments. As a result, an equalization fund has been designed with the main goal of ensuring equal access to basic services to all citizens of PNG.

In line with the stages recommended in this report, the PNG National Economic and Fiscal Commission first undertook a functional review to determine the roles and responsibilities of provincial governments. An estimation of expenditure needs on the basis of such assignments followed. In its third stage, the process involved an estimation of the fiscal capacity of provincial governments from all other sources of revenue. The fiscal needs amounts (the equivalent of our fiscal gap) were therefore calculated subtracting fiscal capacity from the estimated cost of delivering services:

Fiscal Needs: Cost of Service Delivery (Expenditure Needs) – Revenues (Fiscal Capacity)

The equalization grant distributes 6.57% of the National Net Revenues, thus allowing the estimation of the overall pool of available resources in a transparent and predictable way. The Cost of Service delivery was estimated on the basis of 2005 expenditure levels (thus using the lagged expenditure methodology described in this report) and later on *adjusted by inflation and population growth*. Similarly, Revenues (or fiscal capacity) are estimated on the basis of historical data, although not all sources are treated equally.

In true application of the equalization principles, those provinces with assessed revenues greater than their estimated expenditure needs are not allocated equalization grants, which allows concentrating those among the provinces with greater needs.

The PNG experience shows that a system of fiscal equalization that adjusts expenditure needs by population can be of great value to the Solomon Islands, and should dispel doubts regarding its general applicability to very different environments.

Source: Plain English Guide to the New System of Intergovernmental Financing. National Economic and Fiscal Commission of PNG (2009),

VI. Alignment of the proposals with the draft Constitutional text.

The draft Constitutional text being currently debated in SI contains critical proposals for the reform of the fiscal architecture of the country. Importantly, most of the proposals detailed under Chapter 15 of the draft text, on Financial Sharing provisions, are reasonable proposals whose eventual implementation would be beneficial for SI regardless of whether the country decides to opt for a Federal structure of government or not.

On the revenue sharing system

The proposals for reform contained in this final report are aligned with the financial sharing provisions contained in the draft Constitution currently being discussed by the GoSI. In particular, Articles 163 to 166 of the last draft reviewed make reference to the implementation of a system of revenue sharing between the central and provincial governments (referred to as Federal and State Governments in the draft Constitution). There are however important differences between the Constitutional text and our proposal worth underlining here.

The draft Constitution instructs, in its article 165, that 50% of central/federal tax revenues would be shared with the Provinces/States immediately upon approval of the Constitution. Schedule 6 of the Constitution stipulates that 20% of such revenues will be distributed in equal shares across provinces, 50% by population criteria and the remaining 30% of the total would be distributed by land area.

The stipulations included in Schedule 6 raise important issues. The determination of a revenue sharing rate on central/government taxes must be somewhat related to the amount and cost of the government functions that are to be decentralized to the provinces. There is no available estimation of the expenditure needs of provinces in a scenario of full decentralization of the functions included in the Provincial Government Act. From that point of view, it is difficult to assess whether a sharing rate of 50% over central government revenues is an adequate level, too high, or too low. It needs to be said however that sharing rates of this magnitude are only implemented in very decentralized countries where the burden of public service delivery is borne out by sub-national governments. This would not seem to be the case yet in Solomon Islands.

In this report we propose a principle for the determination of the sharing rate over central government revenues should the GoSI decide to implement such a fiscal mechanism. In summary, it is recommended that the sharing rate defined be that which allowed the richest province in the country to meet its expenditure needs with the sole use of own revenues and shared revenues from central government taxes. The application of such principle would align the revenue sharing system to an agreed estimation of provincial expenditure needs and also to their fiscal capacity.

From a technical point of view, the provisions for revenue sharing included in Schedule 6 are not truly a revenue sharing mechanism but a grant. A true revenue sharing mechanism would allow provinces to retain 50% of the revenues from central government taxes that are collected “within the province”. As it is clear that provincial revenue collection for central government taxes varies widely by province, the amounts collected will vary accordingly, thus the need for an equalization grant. The instrument being proposed in Schedule 6 resembles more another grant with several criteria for its allocation. In principle, the criteria listed (fixed share, population and surface) and sensible criteria, although the relative weights assigned to them (20%, 50% and 30% respectively) should be further discussed.

On the implementation of an equalization grant

Article 168 of the draft Constitution proposes that the Central/Federal Government make unconditional equalization transfers to the Provinces/States to ensure that:

a) "all States regardless of ability to raise revenue provide comparable levels of services at comparable levels of taxation"; and that
b) "State disparities in development and living standards are minimized."
c) "Minimum standards of State Services are maintained".

In the previous section of this report we have emphasized the need to turn the system of PSG (except perhaps the Revenue sharing grant if the government decides to opt for a properly design one) into an equalization grant that addresses the vertical and horizontal imbalances identified in Provincial financing. The proposed allocation of equalization grants, which would take into account both the relative expenditure needs of Provinces and their fiscal capacity (on the basis of comparable levels of taxation) would meet the objectives defined for this grant instrument in the draft Constitution.

On the institutional framework for an inter-governmental fiscal system

The draft Constitution proposes the establishment of a National Finance Council with a membership composed of three national Ministers and Provincial/State representatives. The National Finance Council would have among its responsibilities monitoring the implementation of the financial arrangements between the Provinces and the Central government and serve as a forum of discussion for eventual reforms of the system. On the basis of the current structure of government in the SI, it seems clear that the Ministry of Provincial Government and Institutional Strengthening would need to be one of the central government representatives in that Council. The third central government representative could be left open and decided on the basis of the topic being discussed by the Council at any given meeting (e.g. education, health, agriculture, etc.). In any case, the Council would require the definition of clear Statutes where its roles and responsibilities are clearly outlined, as well as the binding nature of its decisions in the country's general policy framework.

Article 171 additionally allocates the National Finance Council the task of facilitating "the settlement of intergovernmental disputes relating to financial or fiscal matters". We would agree in principle with a certain role of the institution in the resolution of conflicts between governments or among levels of government. However, it may be necessary to design a process for conflict resolution with different stages that filters the cases so as to ensure that those that can be solved at the technical level are not submitted to the council or the courts eventually.

In addition, should the GoSI proceed along the lines of the reforms proposed, it is clear that a fiscal unit would need to be created at the Ministry of Provincial Governments and Institutional Strengthening to monitor the implementation of the systems discussed in this report. Ministerial staff allocated to such a unit would be instrumental in feeding the National Finance Council with substantive analytical work to assist their deliberations on eventual reforms of the system.

VII. Conclusions and Way Forward

In this final report we argue that the future reform of the PSG needs to be anchored in a comprehensive vision of the system of intergovernmental fiscal relations in the Solomon Islands. In line of the current implementation of the PSG and the objectives that it seems it tries to serve, turning the PSG into a true equalization grant would improve the efficiency and equity of Provincial financing and also be well aligned with the draft Constitutional reforms currently under consideration.

We have also emphasized the need to coordinate the main elements of the system of inter-governmental fiscal relations for this reform to be efficient. The implementation of an equalization grant depends on a clear assignment of expenditure responsibilities and on an agreed estimation of expenditure needs and fiscal capacities. In addition, all other elements of the provincial financing system must be coordinated with the implementation of the equalization grant, like the possible implementation of a proper revenue sharing mechanism with the provinces.

The potential benefits of the proposals for reform outlined in this report are independent of the eventual constitution of the Solomon Islands into a Federal system of government. The efficiency gains from the system proposed are perfectly attainable with the current structure of government and can be approached sequentially over a number of years. The grant instrument proposed allows additionally for dynamic adjustments of the provincial allocations, such that changes to the assignments of expenditure or revenue powers would be easily reflected in the grant allocations.

In summary, the necessary technical steps for the implementation of the proposals contained in this report would include:

1. Functional Expenditure Review and definition of the expenditure assignments across levels of government in a cabinet decision or implementing instructions to the Provincial Government Act.
2. Costing exercise of standard services across the provinces of SI to identify relative cost differences in service delivery.
3. Policy decision turning the PSGs into a full equalization fund, outlining the principles, objectives and mechanisms to assign resources to the fund.
4. Design of a methodology for the estimation of the fiscal gap on the basis of the options outlined in this report.
5. Preparation of simulations on the impact of such reform on provincial financing and definition of a sequential approach to its implementation.
6. Consultation with Provincial Governments across all stages of the process in the framework of a National Fiscal Council or similar committee entrusted with this function in a regular fashion.

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