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BUDGET CIRCULAR 1/2006

10 February 2006

CIRCULAR LETTER TO:

All Provincial Administrators

cc: All Departmental Heads and Heads of Statutory Authorities

2006 PROVINCIAL AND LOCAL LEVEL GOVERNMENT GRANTS AND TRANSFERS

This Circular letter is intended to inform and guide all levels of government about the Provincial and Local Level Government (LLG) Grants passed in the 2006 National Budget, particularly the recurrent non-staffing grants for goods and services. The Circular has been developed in consultation with the National Economic and Fiscal Commission (NEFC). The Circular has effect from 1 January 2006.

Provincial and LLGs should be aware that legislative amendments to the *Organic Law on Provincial and Local-Level Governments* have been drafted and were gazetted in mid 2005 to give effect to the Functional Grant arrangements. These Grants form an integral part of the National Government's policy on transfers to Provincial and LLGs.

1. Block and Function Grants

In the 2004 Budget, the National Government introduced changes to the recurrent grant arrangements for Provincial and Local Level Governments.

The Administration and Infrastructure Grants were replaced by an unconditional **Block Grant** and three conditional **Function Grants** tied to service delivery in the *Medium Term Development Strategy 2005 – 2010* (MTDS) core priority areas: basic education, primary health care and transport infrastructure maintenance. These arrangements were extended in the 2005 Budget and applied in the 2005 financial year and will continue to apply in the 2006 financial year.

The allocations for the Function and Block Grants have been calculated at approximately K12 per head and K5 per square kilometre of the Province.

Use of the Block and Function Grants

The **Block Grant** should be used to cover the costs of Provincial Government administrative overheads and the costs for other sectors not covered by the Function Grants. Provincial Governments will need to supplement this Grant, drawing on revenues or other benefits, to fund local priorities.

The main intention of the conditional **Function Grants** is to target the *MTDS* core priority areas and improve service delivery, by ensuring that these three sectors have a minimum level of conditional funding provided by the National Government. As with the Block Grant, it is expected that Provincial Governments will supplement these National Government Function Grants with funding from their own internal revenues.

Function Grants are to be used to pay only for operational ‘goods/services’ and maintenance costs incurred in the primary health, basic education and transport infrastructure maintenance sectors. They **cannot** be spent on salaries or capital development unless the budget allocation specifies that purpose.

Block/Function Grants maximum level

The NEFC has recommended that Block Grants be allocated up to a maximum of 25% of the total Block/Function grants ceiling. This is because the intention of the arrangements was for the Function Grants to be tied to the core priority sectors. During the course of 2004, several Provinces reduced their Function Grants and transferred funding to their Block Grants. The 25% cap is intended to prevent this. The NEFC will shortly be undertaking a review of the expenditure on 2005 function grants over the 2006 budget year.

To ensure that Parliament’s intention is met, any Provincial Government wishing to make an adjustment to its Block or Function Grants or to transfer funds between them is required to submit a formal proposal to the National Department of Treasury. Such proposals will normally be considered as part of the Quarterly Budget Review process, but may be considered outside that process in exceptional circumstances.

2. Conditions applying to the Function Grants in 2006

As noted, Function Grants should not be transferred to fund other sectors, except with the prior formal approval of Treasury.

The NEFC will be closely monitoring the transfer and expenditure of the **Function Grants**. This is because the Function Grants were intended as an interim measure to improve funding to core service delivery areas, while the NEFC completes the Review of Intergovernmental Financing Arrangements (RIGFA). The NEFC expects to complete this review later this year.

To assist the NEFC as it frames appropriate proposals for reform, Treasury has emphasized the importance of Provincial Governments providing expenditure reports for health, education and transport infrastructure maintenance spending from their '200 series' grants and '700 series' revenues, as part of the Quarterly Budget Review process.

Provincial Administrations will be asked to provide full and complete expenditure information for 2005 in the 2006 First Quarter Review.

Treasury will provide a revised, simplified format for providing that information in its Circular advising of the 2006 First Quarter Review. It is expected that this Circular will be issued in mid March 2006.

The NEFC emphasizes that the success or otherwise of the Function Grants in improving Provincial Government expenditures on the MTDS core priority sectors will be a central consideration for the Commission as it designs final reform proposals for the National Executive Council during 2006.

Provinces that do not provide an appropriate and timely level of expenditure reporting to the National Government may find that monies appropriated for the purposes of the Block Grant are held back. In addition, the Treasury may consider recommending a reduction in the level of the subsequent year's Block Grant where a Province is found to have used funds from its Function Grants or Derivation Grant for purposes other than those specified in this Circular.

'Rolling over' of Function Grants

Function Grants are appropriated by the Government for the purpose provided. It is therefore expected that Provincial Governments will expend the full amount of the Function Grant within the Budget year. There may be occasions, however, when it is not possible to expend all the available funds. This should only occur, however, in exceptional circumstances. In the normal course of business, provinces should actively work towards expending funding provided as Function Grants in line with this Circular.

Where it is not possible to expend all the available funds at the end of the Budget year, Provincial Administrations should 'roll over' the unspent

National Government funds into the following year's internal ('700 series') revenue budget.

To ensure these rolled over funds remain in that core priority sector, Provincial Governments should carry over the unused Function Grant funds into three specific revenue votes in their following year's internal revenue budget, as follows:

- Health Function Grant Former Year's Appropriation
- Education Function Grant Former Year's Appropriation
- Transport Function Grant Former Year's Appropriation

The NEFC will be requesting that Provinces provide evidence that, where applicable, this has been done.

Note: Any unused funds from the **Derivation Grant**, a conditional economic grant, should also be carried over into a specific revenue vote in the following year's internal revenue budget, as follows:

- Derivation Grant Former Year's Appropriation

Provinces should then appropriate the Function Grants and Derivation Grant into the same sectors in the following year. Other revenue and grants can be rolled over into a general 'former years' vote.

Guidance on the Health Function Grant

The programs and activities that should be funded under the *Health Function Grant* are:

- Immunization
- Malaria
- Safe Motherhood
- Water Supply and Sanitation
- Outreach services
- Supervision
- Health service monitoring, review and performance agreements, and
- Distribution of medical supplies.

To aid reporting to and monitoring by National Government agencies, Provinces should report expenditure outcomes by these programs and activities.

To receive access to **HSIP funding**, Provinces are required to meet the minimum costs of providing health services, by appropriating **at least 6%** of their discretionary goods and services resources to rural health services.

The National Department of Health has advised that discretionary goods and services are defined as all internal revenues (GST, royalties and other local revenues) and non-salary National Government recurrent grants (Block Grants and Function Grants).

Guidance on the Education Function Grant

The *Education Function Grant* should be used to fund operational costs for:

- Elementary Schools
- Community/Primary Schools
- Technical & Vocational Schools
- Provincial High/Secondary Schools

Note: Permitted and Private schools operate independently from the National Department of Education. They finance their own programs and do not receive direct funding, although the National Government provides them with grants from time to time.

There are also several other key activities that need to be managed and funded effectively to ensure continuous service delivery to staff and students, including:

- Processing and release of operational funds for school inspectors
- Paying freight charges and distribution costs for curriculum materials
- Processing and distribution of teachers' pay to the right location, and
- Funding support for training and staff development programs.

To aid reporting to and monitoring of outcomes by National Government agencies, Provinces should report expenditure outcomes by the category and location of school.

The **National Government's Education Subsidies**, which are additional to the Education Function Grant, cover all national and provincial institutions. Expenditures will be based on guidelines determined by the

Minister and Secretary for Education. In past years, subsidies were used to offset some of the costs charged to school boards.

For 2006, the breakup of the subsidy grants will be as follows:

- **School Infrastructure and Maintenance Grant:** These funds are to assist schools to maintain infrastructure, such as classrooms, dormitories, teachers' houses, library and furniture.
- **Quality Control Programs:** This component is to support the administration of national examinations, school inspections, student support and scholarships, teacher training and staff development, and to assist various education agencies.

Guidance on the Transport Infrastructure Maintenance Function Grant

The *Transport Infrastructure Maintenance Function Grant* can only be applied to the **maintenance costs** of provincial roads, jetties/wharves, airstrips/airfields etc. This grant should not be used for the construction of new roads or for major reconstructions of unusable existing roads.

Note: The *Transport Infrastructure Maintenance Function Grant* can be used to meet counterpart funding requirements for roads projects.

3. Local Level Government Grants

The **Rural Local-level Government Grant** is based on the rural population and divided between rural LLGs on an equitable Kina per head basis, at around K4 per head and K2 per square kilometre. **Town & Urban Services Grants** are provided only to fund the functions for which an urban LLG is responsible, at about K11 per head.

The National Budget has made a separate appropriation for each LLG. The Rural and Urban LLG Grants cannot be spent on salaries, fees and allowances, unless specifically provided for in the Budget.

4. Other grants

A short paper on how the National Government Grants were calculated for 2006 is provided in Attachment A.

Derivation Grants

The **Derivation Grant** has been calculated at the fixed rate of 0.75% of eligible exports. The NEFC has collected data on actual exports by Province for 2004, the most recent full year available.

The total value of Derivation Grants, based on 0.75% of total eligible export value in 2004, was K12.35 million, which has been appropriated in the 2006 Budget.

The Derivation Grant is a conditional economic grant that the National Government has been legally bound to transfer to Provincial Governments, under Organic Law on Provincial and Local Level Governments. The Derivation Grant is paid as a ratio, currently 0.75%, of the value of exports originating from a Province.

Simon Tosali

Secretary

Treasury

Attachment A: Provincial and LLG Grants in 2006