National Economic and Fiscal Commission

2021 Budget Fiscal Report

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Foreword

I am pleased to present this 14th Annual Budget Fiscal Report as required under the Intergovernmental Relations (Functions and Funding) Act 2009 (Section 69). The Act passed in March 2009, defines the reforms to intergovernmental financing arrangements (RIGFA). This annual publication forms part of the budget documentation to the National Executive Council and is required to be tabled in Parliament by the Minister for Treasury.

I must say that 2020 was a difficult year and like all other organizations, the NEFC also experienced major disruptions due to the COVID-19 pandemic. It was unfortunate that the NEFC Regional Workshops, a major annual event on the NEFC calendar was cancelled due to safety restrictions imposed by the Government to control the spread of the epidemic. Despite this set back, I am pleased and happy to say that apart from other achievements, the NEFC has delivered the following major critical work and these are reported in detail in this 2021 Budget Fiscal Report.

Determination of the Equalization amount

This is the minimum level of funding for the assigned service delivery functions and responsibilities of provincial and local level governments and set by the *Intergovernmental Relations (Functions and Funding Act* (Section 4 Schedule 1). The equalization amount is set by a formula based on a percentage (6.57%) of the net national revenues (NNR). The NNR amount is the total tax revenue received by the National Government excluding mining and petroleum tax revenue. The level of equalization funding available each year depends on the performance of the national economy and the government's total revenue collection. The total equalization amount for the year 2021 is **K627.0 million** million which is an increase of K23.1 million from the previous year's equalization amount.

Provincial & Local Level Governments' share of the equalization amount.

Annually, the equalization amount is distributed among the two lower levels of government, the provincial and local level governments on a fiscal need basis. The fiscal needs of these two levels of government is calculated based on their estimated recurrent costs and assessed revenue. The difference between the costs and assessed revenue becomes the sub national governments' fiscal need or funding gap. For 2021, the breakup of the equalization amount between the provincial and local level governments was **K563.9 million** and **K63.0 million** respectively. Commencing in 2020, Morobe and New Ireland provinces have fallen out of the equalization system because their assessed revenue is higher than the estimated recurrent service delivery costs. However, the Local Level Governments in these two provinces continue to receive their function grants basing on the fact that their revenues cannot adequately meet the cost of service estimates.

Review on Intergovernmental Financing Arrangements

The National Government has placed high priority on giving more political, administrative and fiscal or financial autonomy to the provinces. In view of the Government's plans, the NEFC with financial support from the Australian Government (DFAT), has engaged two technical advisors (international and national) to review the fiscal implications of granting for administrative and fiscal autonomy to the provinces. The technical reports have been completed and these will form the basis for reviewing the current intergovernmental financing arrangement systems and making recommendations to the NEC/National Government for an appropriate sub national funding system. A condensed article giving key recommendations of the study is presented in this Fiscal Report and I encourage readers to read this.

Cost of Service Study

The NEFC has undertaken its 4th major Cost of Services Study. This major study which is undertaken every 5 years, involves field visits to all the provinces, engaging and consulting with provincial, district and local level government officials, to establish and confirm functions and activities, existing staff & facilities numbers, service delivery travel routes and collecting latest prices of essential service delivery goods and services. These data will be uploaded onto the cost of service model to update the cost of service for the provinces and will be used to calculate the function grants going to the provincial and local level governments and the provincial health authorities. The final cost estimate figures in this cost of service study will be used for the 2022 function grant calculations. I am pleased to say that this is the first time that such a major study was entirely coordinated, managed and executed by all national staff, unlike the previous studies which were driven by international technical advisors. The training, mentoring and skills received by young national policy officers under the international technical advisors from previous studies paid off well during the 2020 cost of service study. I also thank the PM & NEC, Treasury and DPLLGA departments' staff who have joined the NEFC staff to undertake this critical study.

Issues

There are some critical issues that I have mentioned in my earlier reports and in other forums and I will continue to emphasize because these are prevailing key impediments that affect service delivery in the provinces.

Late cash release of functions grants from the national level to the provinces has been an on-going issue that needs to be addressed. Despite funds eventually going to the provinces, our Facility Based Funding Diagnostic Expenditure Reviews have identified that on average less than 20% of funds budgeted for facilities is actually reaching the facilities. This is a critical issue affecting service delivery and hopefully the PFM reforms undertaken by Government will address these issues. On the reporting and monitoring aspect, the NEFC's yearly publication, the Provincial Expenditure Report (PER) has been delayed due to issues in extracting the required expenditure data from the IFMS system. The NEFC team is working closely with the provincial governments on how best we can get the required information and also working with Finance Department to address issues in extracting the required data from the IFMS system.

Going Forward

In terms of going forward, I am optimistic that the NEFC in working with key stakeholders will play a critical role in the review of the intergovernmental financing arrangement systems and coming up with an improved and better system to support gradtive decentralization for exclusive growth and improve service delivery outcomes in the provinces.

HOHORA SUVE
A/ Chairman & Chief Executive Officer

Executive Summary

Each year the National Economic & Fiscal Commission (NEFC) is required to produce to the Minister of Treasury, a report on the workings of the Commission and its annual provincial grant determination. This 2021 Annual Budget Fiscal Report is produced in accordance with Section 69 of the Intergovernmental Relations (Functions & Funding) Act 2009 and under Section 117 (9) of the Organic Law on Provincial & Local-Level Governments. It is required to be tabled in Parliament by the Minister- Treasury.

Since the inception of RIGFA, grants to Provinces and LLGs have increased from K140 million in 2009 to K627 million in 2021. A major concern for the government has to do with how well provicnes are utilizing these grants to carry out service delivery. It is anticipated that The NEFC's Provincial Expenditure Reviews (PER) will continue to reaffirm the government that provinces are expending according to their service delivery responsibilities. The underlying concern lies with how well provicnes are reporting using both the Papua New Guinea Accounting System, also known as PGAS and the Integrated Financial Management System (IFMS).

Whilst RIGFA has been successfully implemented and bedded down after nearly ten (10) years, it has faced many challenges with the growing macro reforms such as the Tuition Fee Free Policy (TFF) which was introduced by the government in 2013 and the introduction of District Development Authorities (DDA's). Along with these reforms came changes in the provincial govenrments accounting systems, thereby hampering NEFC's expenditure reviews as sub-nationals had to accustom themselves to a shift in both the budgeting and reporting system.

Despite the challenges faced in 2020, Service Delivery must continue to be a priority for the government. The government must ensure that this is delivered in an efficient and accountable manner in order to achieve broader objectives and outcomes. Timely release of cash is critical as this will ensure provinces to carry out programs directly linked to their Minimum Priority Areas (MPAs). This was cited as an issue for many provinces who attended the Quarterly Budget Review, which was chaired by the Department of Treasury and supported by other relevant agencies.

In recent years, the NEFC has made assessments on the impact of the reforms at the sub-national levels of government, especially at the facilities. The challenges identified were mainly to do with cash disbursements from the national level to the provinces and also the funding availability for the operation of rural facilities, which were assessed as being insufficient. This clearly shows the need for proper structutral adjustments and the strengthening of links between different the levels of government.

The NEFC has always been involved in providing advice on fiscal arrangements between different levels of government. The NEFC understands the national governments intended focus in giving more political, administrative and financial autonomy to provinces. This has prompted the Commission to review the fiscal implications of granting administrative and fiscal autonomy to the provinces. A detailed report has been completed which also highlights the impact of the imbalances that inhibit the implementation of service delivery within provinces.

The increased level of funding for the 2021 fiscal budget draws the need to emphasize the responsibilities that public servants at both national and sub-national levels bear to ensure that service delivery takes place. Proper and adequate level of monitoring and review over the implementation of government initiatives is also necessary. Provincial Administrations must guarantee proper planning, budgeting and spending of government grants to ensure that a villager at the end of the chain receives access to basic health services, education, transport and other vital services in the same regard.

It is NEFC's intention that it's various publications will enable even the most ordinary villager and the community at large to become an informed recipient of government services. For that matter, he or she can be in a position to demand from the relevant authorities, improvement in basic rural services.

In conclusion, the NEFC intends to continue working closely with all relevant stakeholders in progressing the reform and improving the system, such that the system can be fine-tuned for greater performance and providing confidence to the Government that funding provided to Provinces and LLG's is well spent.

Contents

CHAPTER ONE: FINANCING SERVICE DELIVERY IN PNG

Service Delivery in Papua New Guinea is and has always been a major concern for the national government. In order to finance service delivery in PNG, the national government has to make necessary adjustments to maintain the principle of equity for all Papua New Guineans taking into account the perception of social and economic differences amongst provinces. PNG's intergovernmental financial relations framework was purposely established to address these differences.

The different levels of payments between PNG's three tier government are subjected to legislations and guidelines of which outlines what particular level of government is responsible for certain services and activities. These legislations also outline how provinces and LLG's are able to raise revenues.

Having a highly centralized system, the national government raises approximately 95% of total tax revenues. Provincial governments in their own capacity raise own-source revenues, though certain revenue sources have been prohibited for provinces to collect mainly to avoid duplications. This can be seen from prohibitions imposed by the Internal Revenue Commission (IRC) on beer and cigarette taxes as this is already part of the Goods & Services Tax. In most cases, provinces do not have sufficient revenue raising powers thus, bearing the need for revenue collecting arms within the provinces to be fully capacitated.

The system recognizes the differences amongst the sub-national levels of government thereby, fixates the different imbalances that inhibit the implementation of service delivery within provinces. The two underlying imbalances that the system aims to address are:

1. The differing tax revenues and government spending requirements of which can be referred to as **horizontal fiscal imbalances** &
2. the inability of provinces to raise revenues and spend according to their responsibilities- **vertical fiscal imbalance.**

As opposed to the horizontal fiscal imbalances, the inability for provinces to raise greater revenue calls for centralized tax collections by the national government. Provinces in this context are better placed to only deliver services.

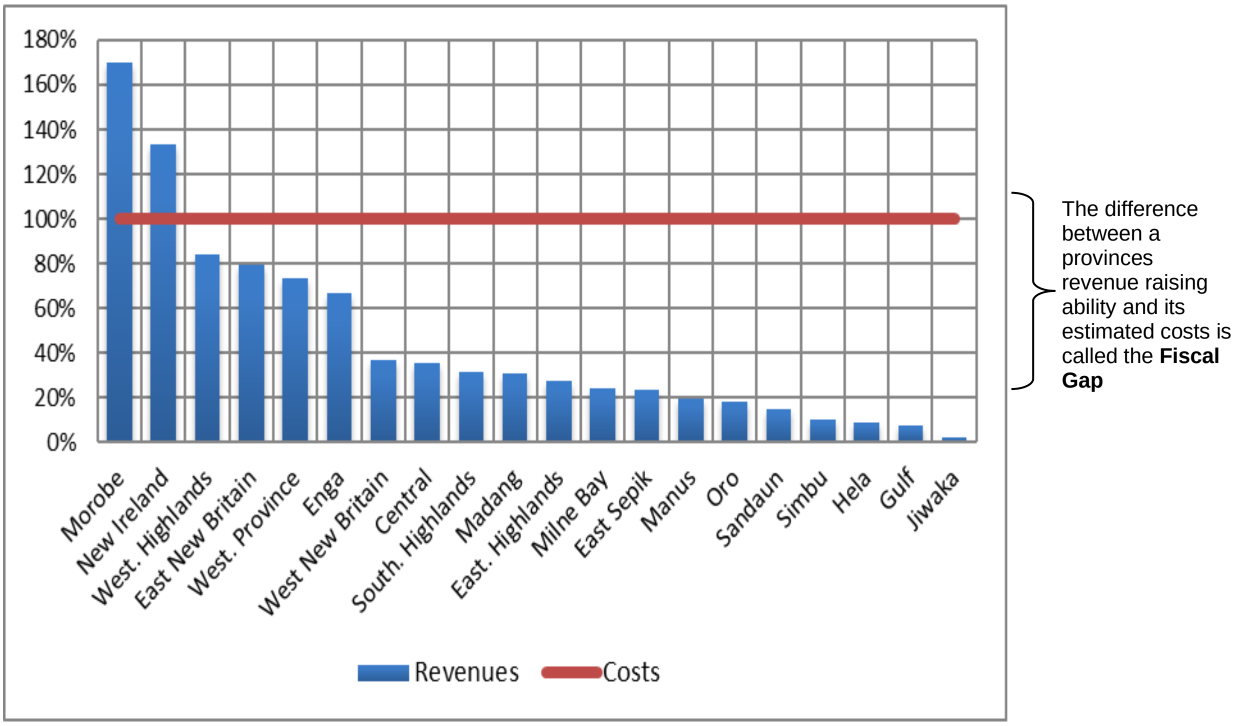
The intergovernmental financial relations framework addresses both types of fiscal imbalances as well as to serve other purposes, such as the national coordination of policies.

1.1 The Fiscal Gap

Annually, the NEFC determines a funding base for provinces and local level governments known as Function Grants. These are based on the level of responsibility by the national government to provide a number of government services to their communities. The costing levels within different provinces also differ mainly because of the unique characteristics that provinces bear. Some have large populations who live in easily accessible areas whereas others have small populations that live in difficult to access remote areas. The NEFC conducts a costing exercise once every five years of the critical activities undertaken by the provinces; this goes in line with their levels of responsibilities, hence, taking into account their characteristics.

Once provincial costs have been established, the national government looks into funding arrangements. Though from a funding perspective, provinces are restricted in what local revenue bases they are allowed to tax. There are limitations on certain taxes mainly because of the issue of duplication and hence, the centralized role of the national government on tax imposed activities. The limitations imposed by the IRC on provinces in revenue raising results in a mismatch between the cost of delivering government services and the financial resources available to provinces to fund those services. This is known as the Fiscal Gap. The graph on the next page shows the fiscal gap for 2020.

Figure 1: Fiscal capacity of Provinces compared to their estimated costs



In order to ensure that the provinces have sufficient funding to undertake their service delivery responsibilities, the national government makes available a series of grants to each province to assist for staffing and recurrent goods and services.

1.2 Reforms on Intergovernmental Financial Arrangements (RIGFA)

The funding flow to the provinces has always been of paramount interest to the national government. Prior to 2009, provinces were receiving funds based on a “Kina per Head” system. In essence, this fiscal arrangement saw few provinces receiving the bulk of funds and others receiving less. The “Fiscal Gap” was not fully covered for a number of provinces. Hence, there were minor flaws that paved way for a non-equitable distribution of funds amongst provinces. Provinces who had larger revenue sources such as mines and other economic activities that could have been taxed were receiving larger revenues which were above what they needed to provide basic services.

Basing on the principle of equal distribution, an Act had to be passed in which the key features would involve a larger revenue sharing arrangement between the different levels of government. Eventually, the old system was reformed under the new inter-governmental financing arrangement approved by Parliament on 16 July 2008 and the *Ordinary Act* passed in 2009. The Reform brought astounding changes; one that focused on revenue sharing based on a percentage of the resources available to the government.

The new system also changed the way funds are being distributed between provinces. The formula used to determine each province's share of the funds is now based on the NEFC's cost estimates. The results, ten years later, is that more funding is going down to all provinces, particularly, those provinces with low fiscal capacity.

1.3 Types of Grants

Over the last decade, the national government has been providing provinces with three main types of grants, namely:

The staffing grant. Public servant salaries and allowances are funded by the national Government regardless of whether they are provincial or national staff. The single government payroll means that administratively the payments are made directly between the National Government's payroll system and the employee. To maintain budget integrity, each province is provided with a staffing grant that sets out the ceiling that is available for personnel emoluments and the staffing structure of each province is approved by the Department of Personnel Management (DPM). The management of the staffing grant is highly centralised and is managed by the DPM and Department of Treasury (DoT).

Development funding. Capital and human development funding is provided through a range of grants. These are project specific while others are devolved grants provided for a range of activities. The Provincial Services Improvement Program (PSIP) provides each province with K5 million per District. The District Services Improvement Program (DSIP) provided K10 million per District, and most recently the Ward Services Improvement Program (WSIP) will be provided K10, 000. Guidelines for the use of these funds direct that certain percentages must be allocated into particular sectors (health, education, infrastructure, etc.) but the specific projects are left to the discretion of decision making committees in the respective Provinces, Districts, LLGs and Wards.

Recurrent funding (function and administration grants). In order to provide basic services, each level of government requires funding for goods and services. These include items such as fuel in order to undertake patrols or materials for maintenance. The NEFC recognises that without sufficient recurrent funding, service delivery for rural communities is ineffective. The national government provides a set of *Function Grants* that provide extra recurrent funding to those provinces with the lowest fiscal capacities. It is expected that those provinces with high internal revenues are able to fund a larger portion of their own recurrent costs.

Recurrent funding was the focus of RIGFA, and is the main concern of the NEFC. Chapters 2 to 5 of this report outline the process for determining the Function Grants and the amounts for 2021.

1.4 Role of the NEFC

The NEFC provides advice to the government on intergovernmental financing matters in Papua New Guinea. Its role is to recommend how to distribute the function grants amongst the Provinces and LLGs. The Treasurer then makes a determination of how the function grants will be distributed based on the advice provided by the NEFC.

From a technical perspective, the NEFC works to understand the cost pressures each province faces and their respective own-sourced revenues available to them. Using a legislated formula, the NEFC calculates each province and LLG's share. The NEFC follows a number of principles in making its recommendations *(The process of how NEFC allocates the Function Grants is in Chapter (4)* :

- *Funding should follow function.* That is, the level of government that is undertaking an activity should be the level that receives the funding.

- *Own-source revenue should be used to fund service delivery.* The NEFC calculates the needs of each province taking into account the amount of own-source revenue available to the province. It is assumed that the province uses their own-source revenue on recurrent costs, and therefore those provinces that have high revenues receive less function grants.
- *Each province should have an equitable share of funding that is sufficient to run their basic services.*

CHAPTER TWO: EQUALIZATION AMOUNT

Provinces are expected to receive a minimum level of funding annually. The amount that is allocated to provinces is known as the “Equalization” amount. This basically forms the pool of funding for the Function & Administration Grants. The revenue sharing formula is embedded in Section 19 of the *Intergovernmental Relations (Functions and Funding) Act 2009.* Further, the equalization amount is then divided between individual provinces and LLG’s. For the 2021 Fiscal Budget, the Equalization amount is calculated to be **K627.0 million** (*Detailed calculations provided on page.11*).

Since the transitional period, the prescribed percentage has been fixed at 6.57% of the Net National Revenues (NNR). Accordingly, the funding available for provincial & Local Level Governments increases or decreases as a proportion of the NNR with respect to the prescribed percentage. The NNR amount is the total tax revenue received by the national government excluding mining and petroleum tax revenue. RIGFA emphasizes the revenue sharing arrangements between the national government and provincial & local level governments. Coherently, if NNR is high in one particular year, provincial governments and LLGs will receive more funding. If NNR in a particular year is low, they will receive less funding.

2.1. Calculation of the Equalization Amount- 2021

The *Intergovernmental Relations (Functions and Funding) Act 2009* sets out the formula for calculating the Equalization Amount. As specified above, this forms the funding pool to be distributed on an equitable basis between provincial and local level governments. The NNR is calculated using actual data from the second preceding fiscal year. Accordingly, the 2021 NNR was calculated using data published by the Treasury Department in the 2019 Final Budget Outcome which is usually on or before the 31st of March.

A written estimate of the equalization amount for the subsequent fiscal year is provided to the Secretary for Treasury on or before the 31st of March. The Secretary for Treasury has the power to increase the amount. The Act states the Secretary for Treasury will then notify the NEFC on the increased estimate on or before the 30th of April of the same year. This estimate of the ‘equalization amount’ is a minimum amount and so can only be increased rather than being decreased.

The following formula illustrates section 19 of the Act.

General tax revenue for 2019	**-**	**Mining and petroleum tax revenue for 2019**	**=**	**Net National Revenue**

Where:-

“General tax revenue” is the total amount of tax revenue received by the national government in the second preceding fiscal year; and

“Mining and petroleum tax revenue” is the total of the following amounts received by the National Government in the second preceding fiscal year:-

(a) Gas income tax within the meaning of the *Income Tax Act 1959;*
(b) Mining income tax within the meaning of that Act;
(c) Petroleum income tax within the meaning of that Act;

(d) Any other tax imposed in relation to any gas, mining or petroleum activity.

Being highly volatile in nature, the Mining and Petroleum Tax Revenue is usually excluded to maintain stability in the provinces pool of funding and also stabilizes the amount of funding to Provinces and Local-Level-Governments.

The following table shows how the NNR amount for 2021 was calculated:

Act Definition	Final Budget Outcome equivalents	2018	2019	Difference
General tax revenue	Tax revenue	9,966.9 million	10,304.3 million	*337.4 million*
MINUS (-)				
Mining and petroleum tax revenue	Mining and petroleum taxes	775.0 million	760.7 million	*-14.3 million*
EQUALS (=)				
		2020 Budget	2021 Budget	
Net National Revenue Amount		9,191.9 million	9,543.6 million	*351.7 million*
Multiplied by (*) 6.57%				
Equalization Amount		**603.9 million**	**627.0 million**	***23.1 million***

For the 2021 Budget, the minimum funding level for the equalization amount is calculated according to the following formula in Kina million:

Net national revenue for 2019	X	6.57%	=	NEFC estimate of 2021 equalization amount
K 9,191,900,000	x	6.57%	=	**K 627, 014, 520**

The total amount for 2021 (K627.0 million) has increased to about K23.1 million higher than the 2020 total funding amount (K603.9 million). Given the increase in the 2021 total funding, all provinces are expected to receive substantial amounts with only few exceptional cases where several provinces have either huge declines or increases in their revenues basing on individual fiscal capacities.

2.2. Apportioning the Equalization Amount between Provincial & Local-level Governments

Equalization Amount

The Ministerial Determination that was issued by the Treasurer splits the equalization amount of **K627.0 million** as follows;

Local Level Share

The Local-level share is the proportion of the equalization amount to be distributed amongst all rural and urban LLGs. As stated also in the Ministerial Determination, the share is about 10.05% of the 2021 Equalization Amount.

Overall, for the 2021 Budget, LLGs will receive a funding of **K63.0 million.**

Provincial Share

The provincial share is the amount remaining after deductions are made from the local level share on the Equalization Amount. The share will be distributed amongst all provinces through Function and Administration Grants.

Available funding for Provincial Governments from Ministerial Determination		
2021 Equalization Amount	**K627.0 million**	**100.00%**
(Less) LLG Share	*K63.0 million*	*10.05%*
Provincial Share	*K563.9 million*	*89.95%*

As shown in the table above, for 2021 Budget, provinces will receive a total funding of **K563.9 million**.

The two components are funded from the equalization amount (EA) and distributed on the basis of need.

CHAPTER THREE: RECOMMENDATIONS

Recommendations on the distribution of Function & Administration Grants to Provinces and LLG's are made to the Treasurer through the Ministerial Determination. For the provinces, this recommendation is disaggregated according to the different service delivery function grants such as health or infrastructure maintenance. Within the provinces overall sectoral ceiling, provinces are allowed to request for minor shifts among functions grants. The NEFC sets a maximum shift no more than 10%. Treasury and NEFC usually hold negotiations with provinces that request changes allowing an agreement to be reached as to the revised split among the function grants.

The Treasurer is then advised of this shift through a negotiated recommendation from both the NEFC and Treasury. If accepted, the Treasurer then makes a determination to formalize the splits amongst the provincial grants for the coming year's fiscal budget.

The results of the NEFC's formula are detailed in this chapter. The following chapters outline the steps of how the NEFC calculates the distribution and includes the data that was used. A more detailed description on the formula is in the NEFC's *Plain English guide to the new system of intergovernmental financing.*

3.1. Provincial distribution

The table below shows the final amounts (in K'000) for each service delivery function grant for each province for 2021.

Province	Health Function Grant	Education Function Grant	Transport Infrastructure Maintenance Function Grant	Primary Production Function Grant	Village Courts Function Grant	Land Mediation Function Grant	Other Service Delivery Function Grant	Administration Grant	Total Provincial Government Grants
Western	4,599.0	3,408.0	5,360.1	1,474.5	117.1	61.6	720.8	323.8	16,064.8
Gulf	6,231.8	5,374.1	7,712.0	2,859.4	628.6	117.8	1,917.3	2,875.2	27,716.1
Central	7,384.6	7,594.9	12,489.9	3,202.6	627.4	100.0	2,941.0	2,335.1	36,675.5
Milne Bay	7,330.4	7,677.9	7,638.5	3,298.1	453.9	102.2	3,337.9	2,323.1	32,161.9
Oro	5,242.7	4,694.6	4,711.4	2,521.7	367.4	98.8	2,093.8	1,822.6	21,553.0
Southern Highlands	6,649.3	8,980.0	8,372.8	2,954.7	792.0	170.2	3,984.5	1,993.0	33,896.6
Hela	7,715.1	5,960.1	5,851.4	2,260.6	639.6	98.8	2,186.2	3,075.4	27,787.2
Enga	3,088.0	4,225.7	6,825.1	955.0	344.4	35.0	1,611.0	1,257.0	18,341.2
Western Highlands	2,589.1	1,424.8	1,949.1	858.1	328.2	37.6	337.0	725.7	8,249.6
Jiwaka	6,018.0	9,133.1	13,620.0	1,484.0	446.2	127.9	2,435.0	2,491.0	35,755.2
Simbu	8,995.7	11,751.6	12,023.0	3,016.1	821.9	139.4	3,279.7	4,477.8	44,505.0
Eastern Highlands	7,436.8	13,941.9	20,162.7	2,769.0	706.6	129.0	3,739.7	3,356.8	52,242.6
Morobe	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Madang	9,961.4	10,681.3	14,191.3	4,043.1	589.2	81.0	3,740.5	3,894.2	47,182.1
East Sepik	9,934.7	13,354.4	21,969.8	3,905.0	731.6	126.5	3,073.3	4,107.0	57,202.3
Sandaun	11,082.5	10,547.5	9,291.2	4,096.9	539.8	94.8	2,576.1	3,990.0	42,218.8
Manus	2,250.4	3,479.2	5,696.8	1,794.4	502.0	82.5	1,803.5	2,307.9	17,916.6
New Ireland	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
East New Britain	2,634.8	2,685.2	2,896.7	1,621.2	164.8	40.7	641.8	496.3	11,181.5
West New Britain	5,917.7	8,974.2	9,267.8	3,524.7	609.0	186.2	2,636.5	2,233.5	33,349.6
TOTAL	**115,062**	**133,889**	**170,029**	**46,639**	**9,410**	**1,830**	**43,055**	**44,085**	**564,000**

Figure 2: 2021 Function and Administration Grants Determination (K '000).

3.2. LLG Distribution

The table below shows the final amounts (in K'000) for the LLG grants by Province for 2021. The Urban and Rural LLGs are shown separately.

Figure 3: Local-level Government share by Province for 2021 (K'000)

Province	Urban LLG Grants	Rural LLG Grants	Total LLG Grants
Western	802.5	3,034	3,837
Gulf	154.8	1,429	1,584
Central	0.0	2,150	2,150
Milne Bay	311.8	2,524	2,836
Oro	774.5	1,801	2,576
Southern Highlands	737.6	2,620	3,358
Hela	1,032.9	1,594	2,627
Enga	257.1	2,799	3,056
Western Highlands	863.3	2,089	2,952
Jiwaka	0.0	1,411	1,411
Simbu	408.8	1,585	1,994
Eastern Highlands	803.7	2,900	3,703
Morobe	2,685.1	5,017	7,703
Madang	919.6	4,035	4,955
East Sepik	707.7	4,470	5,177
Sandaun	531.2	4,017	4,548
Manus	233.6	534	767
New Ireland	439.8	1,194	1,634
East New Britain	966.4	2,807	3,773
West New Britain	602.8	1,770	2,373
TOTAL	**13,233.1**	**49,782**	**63,015**

CHAPTER FOUR: CALCULATING THE FUNCTION GRANTS

In calculating provincial and LLG grants on a needs basis, the NEFC uses a formula that is legislated. This formula has two key steps:

Step 1: Determine the 'fiscal need' of each Province and LLG by comparing their estimated costs and assessed revenues;

Step 2: Using the different levels of fiscal need, calculate the share of the equalization pool going to each Province and LLG.

4.1. Summary of Legislative Provisions

Two key pieces of legislations provide the basis for the NEFC to determine how much each provincial and LLG receive as grants.

1. The *Organic Law on Provincial and Local-level Governments*

Part 4, Division 2, of the Organic Law explains the division and distribution of revenue among and between the levels of government and other financial arrangements.

These provisions are further supported by more detailed description in the *Intergovernmental Relations (Functions and Funding) Act 2009*.

2. Intergovernmental Relations (Functions and Funding) Act 2009

Part 2 of the Act explains the principles and the circumstances under which service delivery functions and responsibilities assignments will be determined.

Part 3 explains the equalisation system of the new intergovernmental financing arrangements, which also clearly highlights the fiscal need basis upon which provincial and LLG grants will be calculated.

4.2. The Framework for Determining Fiscal Needs of Provincial and Local-level Governments

Over the cause of the reforms, much clarification had to be put into understanding the fiscal needs of Provinces and LLG's. The underpinning definition of fiscal needs is essentially the difference between the cost of providing the assigned service delivery functions and responsibilities and the revenue available to the provincial and LLGs to pay for these services. Though, in a case where a province or LLG has a strong revenue base, this reflects a favourable fiscal capacity. For all intent, this shows strong assessed revenues against costs. The NEFC assesses this as having a fiscal need equal to zero. That is, it has fiscal capacity to fulfil service delivery functions without additional revenue from the national government.

The amount that a province and LLG needs is called the fiscal needs amount. This amount is calculated on the basis of the recurrent cost of providing the assigned service delivery functions and responsibilities, as well as the revenue already available to the Province and LLGs to pay for these services.

4.2.1 Fiscal Needs Amounts for Provincial governments

The fiscal needs amount for a provincial government is calculated using the formula:

Estimated recurrent cost of assigned service delivery functions & responsibilities	**-**	**Assessed revenue**	**=**	**Fiscal Needs amounts**

-where

"*Estimated recurrent cost of assigned service delivery functions and responsibilities*" are the estimated recurrent cost for the provincial government in performing its assigned service delivery functions and responsibilities for the fiscal year, including the necessary and incidental costs of administration for the provincial government;

"*Assessed revenue*" is the amount of revenue that the NEFC considers to be available to the provincial government for meeting the recurrent cost of its assigned service delivery functions and responsibilities for the fiscal year.

4.2.2 Fiscal Needs Amounts for Local-Level Governments

The fiscal needs amount of each LLG for each fiscal year is calculated using the formula –

Estimated recurrent cost of assigned service delivery functions & responsibilities	-	**Assessed revenue**	=	**Fiscal Needs amounts**

Where:

"Estimated recurrent cost of assigned service delivery functions and responsibilities" are the recurrent cost to the LLG for performing its assigned service delivery functions and responsibilities for the fiscal year, including the necessary and incidental costs of administration of the LLG;

"Assessed revenue" is the amount of revenue that the NEFC considers to be available to the LLG for meeting the recurrent cost of its assigned service delivery functions and responsibilities for the fiscal year.

Since the inception of the new system, the NEFC has predominantly been assessing LLG fiscal needs against the costs carried out at the District level in proportion to District population. This has been a proxy for the assessment of fiscal needs at the LLG level mainly because of the unavailability of revenue data. Coherently, the NEFC assesses LLG revenues annually as equal to zero.

Urban and Rural Local-Level Governments have different assigned service delivery functions and responsibilities. Though having different revenues available to them, the question lies with how best the NEFC can gather these revenue data and assess using the legislated formula. Eventually the NEFC expects to obtain better information on the revenues of urban and Rural Local-level Governments and would then assess these more accurately.

4.3. Estimating the cost of service delivery

Cost is one of the two key determinants which impacts on provinces' share of the function and administration grants. Each province has differing cost factors due to its unique circumstances.

4.3.1 Roles and responsibilities - The Function Assignment

The reforms to the intergovernmental financial arrangements envisaged a fairer system of distribution of resources. In order to achieve this vision of a fairer system, it was necessary to establish the roles and responsibilities of LLGs and Provinces. This, in turn, would allow for more accurately estimating the costs of the services they are supposed to provide.

In 2009, the introduction of the *Inter-governmental Relations (Functions and Funding) Act 2009* and the formal gazette of the Function Assignment Determination in June 2009 set out the roles and responsibilities of the Provinces and LLGs. The ultimate aim was to reduce the confusion and to provide certainty about the roles and responsibilities which contributes towards effective planning, budgeting, delivering and monitoring of the activities they are accountable for delivering. More details on the Function Assignment can be found in The Department of Provincial & Local Level Government Affairs publication: *The Handbook to The Determination of Service Delivery Functions and Responsibilities*.

The NEFC's cost estimates are based on how much it would cost to undertake these functions irrespective of whether the Province or LLG is actually undertaking them. This is because the intention is to give the Provinces and LLGs the fiscal ability to deliver on all their responsibilities.

4.3.2 Cost of Service Estimate

The NEFC undertakes a costing exercise of all the functions of provincial governments every five years. This costing provides a basis for determining fiscal needs. In 2015, the NEFC updated this cost estimate, and it is indexed every year between updates to adjust for changing costs as a result of inflation and population growth.

The determination for any year is based on the costs from the second preceding fiscal year. Therefore, for the 2021 determination, the 2019 cost estimate is used. This maintains consistency between revenues and costs.

The graph below outlines the estimated costs for each province in 2019.

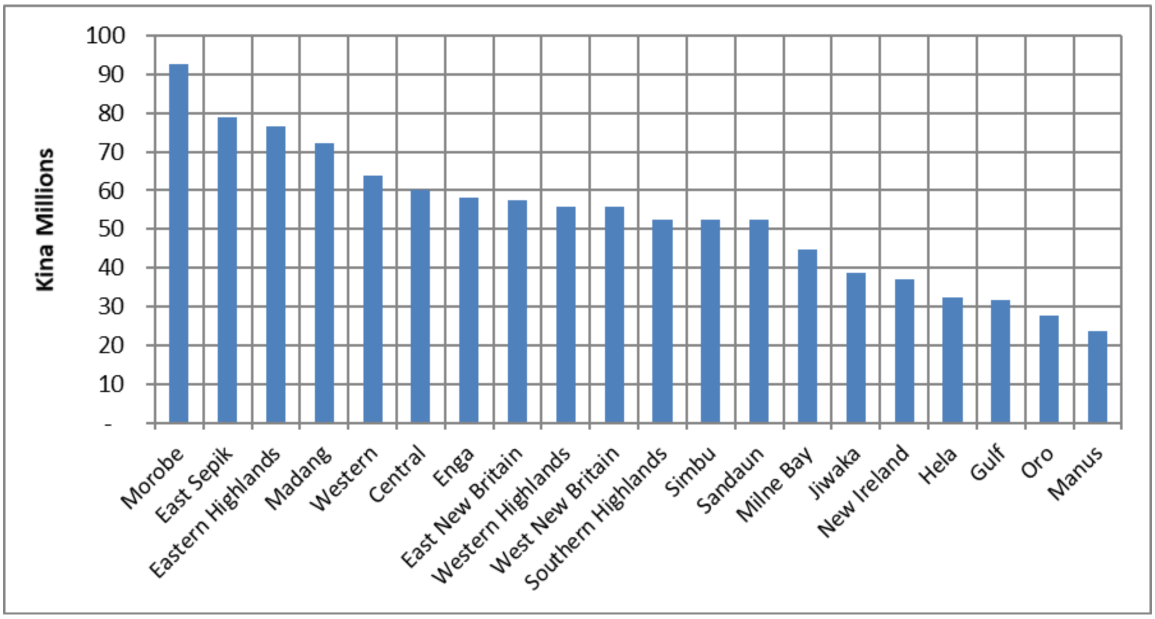


Figure 4: 2019 Cost of Service Estimate by Province

4.4. Assessed Revenues

The calculation of the available own-source revenues forms the second part of the formula to determine the fiscal needs for provinces. This need is quantified by calculating the difference between provincial revenues and their costs of assigned service delivery functions and responsibilities. By conforming to the formula, the NEFC is required to collect and assess revenue data for provinces. This process involves provinces extracting revenue data from their PGAS. However, with the introduction of the Integrated Financial Management System (IFMS), several provinces have transitioned into using this system. Like all other systems, flaws are inevitable. With this being the case, the collection of revenue data in 2019 from provinces were to some extent slow, as capacity issues were of concern.

The NEFC recognizes the use of this revenue source when carrying out assessments. Assessed revenues are the total amounts likely to be received by the provincial government for that fiscal year to be used to carry out their assigned service delivery functions.

Generally, revenues for a fiscal year are assessed with reference to the second preceding year to that fiscal year as this will be the last available year of actual complete data. That is, for the 2021 distribution year, 2019 revenues were assessed by the NEFC.

The sources of revenue are outlined below:

4.4.1 National Goods and Services Grants

The National Government provides provincial governments with a range of goods and services grants each year to support a variety of core service delivery activities.

This information is sourced from data on actual grants paid, as reported in the National Budget Papers.

4.4.2 Goods and Services Tax

Provincial governments receive a Goods and Services Tax (GST) distributions paid through the IRC.

GST is collected and administered by the IRC. The IRC distributes a portion of the GST revenue to provincial governments and the NCD as set out in section 40 of the *Intergovernmental Relations (Functions and Funding) Act 2009*. Any remaining GST that is not distributed to provincial governments or the NCD under these sharing arrangements is paid into consolidated revenue (to the national government).

The amount of GST distributed under the Act is based on 60% of net inland GST collections for each province from the second preceding year.

Generally, revenues for a fiscal year are to be assessed with reference to the second preceding year to that fiscal year as this will be the last available year of data. So GST distribution for 2021 will be based on 60% of net inland GST collected from the second preceding year (i.e. 2019).

4.4.3 Bookmakers Tax

Bookmakers Tax is also administered by the IRC.

Bookmakers Tax received by provincial governments is 40% of the revenues collected in the province in the second preceding year.

4.4.4 Own-source revenue

These are local taxes, charges, and receipts collected by the provincial administrations, which is the primary revenue base for the provinces. These comprise of:

- licences for liquor outlets;
- licences for gambling establishments;
- motor vehicle registration and license fees;
- proceeds from business activities, rents, sale of assets;
- provincial road users tax;
- court fees & fines; and
- Other fees & charges.

The NEFC estimates that in 2019 (the second preceding year), provinces raised **K85.6** million[1] from this revenue source. This data is obtained from the PNG Government Accounting System (PGAS) internal revenue electronic summary files held by the Department of Finance. It is well understood that several provinces have also transitioned into the Integrated Financial management System (IFMS). The NEFC is aware that not all revenues received by the provincial governments are recorded accurately in PGAS & IFMS.

[1] This excludes Bookmakers Tax

4.4.5 Mining and Petroleum Royalties

Provincial governments with mining and petroleum activities within their provincial boundaries may be entitled to royalties as a result of Memorandum of Agreement (MOA) between the provincial government, customary landowners, the mining company and other stakeholders. In the case of petroleum projects negotiated after 1988, provincial government shares are provided under the provisions of the relevant mining and petroleum legislation.

For every new project since the late 1980s, the national government has not exercised claims over mining and petroleum royalties in the MOAs. Instead, the royalties have been split amongst landowners, and local and provincial governments in various ways depending on the project. In turn, provincial governments have also sometimes made various long-term commitments regarding their share of royalties (for specific projects, to local governments and/or non-government agents).

In 2019 (the second preceding year), the NEFC estimates that provinces received **K126.6 million** from royalty and dividend payments.

This data has been sourced directly from mining and petroleum companies and from government agencies (Mineral Resources Authority (MRA) for mining projects, and Department of Petroleum and Energy (DPE) for petroleum projects) and also directly from the companies themselves.

Figure 5: Actual revenues collected by province in 2019

Province	GST Distributions	Bookmakers Tax	Own Source Revenues & Others	Royalties	Dividends
Western	16,398,976	0	1,131,487	32,300,000	8,000,000
Gulf	1,294,584	0	1,424,126	0	590,000
Central	3,419,115	0	13,047,245	0	0
Milne Bay	9,642,666	0	2,255,763	0	0
Oro	4,564,917	47,974	741,674	0	0
Southern Highlands	15,246,792	4,302	2,528,813	0	0
Hela	2,966,268	0	0	0	0
Enga	4,594,858	0	11,125,396	30,872,220	8,000,000
Western Highlands	45,374,498	442,655	2,576,164	0	0
Jiwaka	756,803	0	0	0	0
Simbu	4,513,200	0	1,584,524	0	0
Eastern Highlands	17,987,531	443,597	4,616,862	716,145	0
Morobe	148,024,009	1,015,154	10,895,443	3,743,517	0
Madang	19,889,066	1,223,175	2,500,038	0	0
East Sepik	15,822,411	42,423	5,424,820	0	0
Sandaun	3,890,340	0	7,661,992	0	0
Manus	5,091,461	0	1,309,474	0	403,161
New Ireland	15,115,010	0	1,314,975	41,947,238	0
East New Britain	41,425,695	146,125	8,022,111	0	0
West New Britain	16,708,812	171,558	7,402,623	0	0
TOTAL	**392,727,012**	**3,536,963**	**85,563,530**	**109,579,120**	**16,993,161**

4.4.6 Assessing revenues

For the purpose of calculating the different funding levels of the different function grants, the following assessments have been made. All revenues are assessed based on the actual revenues collected for the second preceding year for each province.

i) Royalties and Dividends from Mining and Petroleum Projects

- 80% of *royalties and 50% of dividends from mining and petroleum projects.* This gives the recognition that some revenues are spent on development of mining infrastructure.

ii) Own-source Revenues

- The NEFC takes into account only 50% of *own source revenues* collected in order to encourage provinces to continue to collect and enhance their own revenue base[2].

iii) GST

- 100% of *GST* distributed under the *Intergovernmental Relations (Functions and Funding) Act 2009* (which is 60% of net inland collections).

iv) Bookmakers' Turnover Tax

- 100% of *Bookmakers Tax* distributed under the *Intergovernmental Relations (Functions and Funding) Act 2009.* (Which is 40% of net inland collections)

4.5. Calculating Fiscal Needs of the Provinces

Bringing together the estimated costs and assessed revenues of each province gives a calculation of fiscal needs. The calculation for 2021 is outlined in the below table.

[2] The practice by NEFC to use the above percentages of 80% of royalties and 50% of dividends is included in the Regulations of *Intergovernmental Relations (Functions and Funding) Act 2009*. The application of the percentage is subject to a periodic review by the NEFC and adjustments made if necessary.

Figure 6: Fiscal Needs of Provinces for 2021 (Kina '000)

Provinces	Estimated costs	Assessed revenues	Fiscal needs	% of total fiscal needs
Western	63,780.6	46,804.7	16,975.9	2.8%
Gulf	31,589.6	2,301.6	29,288.0	4.9%
Central	60,216.4	21,460.9	38,755.5	6.5%
Milne Bay	44,756.5	10,770.5	33,985.9	5.7%
Oro	27,759.1	4,983.7	22,775.3	3.8%
Southern Highlands	52,334.5	16,515.5	35,819.0	6.0%
Hela	32,330.5	2,967.4	29,363.1	4.9%
Enga	58,236.7	38,855.3	19,381.4	3.3%
Western Highlands	55,822.7	47,105.2	8,717.4	1.5%
Jiwaka	38,539.8	756.8	37,783.0	6.3%
Simbu	52,334.5	5,305.5	47,029.1	7.9%
Eastern Highlands	76,518.0	21,312.5	55,205.5	9.3%
Morobe	92,511.1	157,481.7	0.0	0.0%
Madang	72,220.2	22,362.3	49,858.0	8.4%
East Sepik	79,023.7	18,577.2	60,446.4	10.1%
Sandaun	52,334.5	7,721.3	44,613.2	7.5%
Manus	23,607.6	4,674.9	18,932.7	3.2%
New Ireland	36,953.2	49,330.3	0.0	0.0%
East New Britain	57,398.5	45,582.9	11,815.7	2.0%
West New Britain	55,822.7	20,581.7	35,241.0	5.9%
TOTAL	**1,064,090.3**	**545,452.0**	**595,986.0**	**100.0%**

4.6. Calculating Individual Province Shares

Once fiscal needs have been calculated, the next step is to apportion the shares of the equalization pool to determine the final amounts going to each provincial government. The calculation of fiscal needs recognises that each province is different, and as such, each province will receive a different share of the equalization amount.

Once the individual province share is calculated the next step is to divide up the total share into service delivery function grants and an administration grant.

For 2021, the individual province share is calculated using the formula:

$$\text{equalization amount for provinces} \times \frac{\text{fiscal needs amount of individual province}}{\text{total fiscal needs amount of provinces}} = \text{individual province share}$$

Where –

'equalization amount for provinces' means the amount equal to the province share specified in the determination made under Section 17 (1) *(a)* that is in force on 30 April of the immediately preceding fiscal year;

'Fiscal needs amount of individual province' means the fiscal needs amount of that provincial government for the relevant fiscal year;

'Total fiscal needs amount of provinces' means the total of the fiscal needs amounts of the provincial governments that have fiscal needs amounts greater than zero for the relevant fiscal year.

Figure 7: 2021 Individual Province Share (K'000)

Province	**Estimated Fiscal Needs** (Estimated costs minus assessed revenues)	**Percentage of total fiscal needs**	**Funding based on percentage of total fiscal needs** ***(b)***
Western	16,975.9	2.8%	16,064.8
Gulf	29,288.0	4.9%	27,716.1
Central	38,755.5	6.5%	36,675.5
Milne Bay	33,985.9	5.7%	32,161.9
Oro	22,775.3	3.8%	21,553.0
Southern Highlands	35,819.0	6.0%	33,896.6
Hela	29,363.1	4.9%	27,787.2
Enga	19,381.4	3.3%	18,341.2
Western Highlands	8,717.4	1.5%	8,249.6
Jiwaka	37,783.0	6.3%	35,755.2
Simbu	47,029.1	7.9%	44,505.0
Eastern Highlands	55,205.5	9.3%	52,242.6
Morobe	0.0	0.0%	0.0
Madang	49,858.0	8.4%	47,182.1
East Sepik	60,446.4	10.1%	57,202.3
Sandaun	44,613.2	7.5%	42,218.8
Manus	18,932.7	3.2%	17,916.6
New Ireland	0.0	0.0%	0.0
East New Britain	11,815.7	2.0%	11,181.5
West New Britain	35,241.0	5.9%	33,349.6
Total	**595,986.0**	**100.0%**	**563,999.6**

4.7. Individual Local-level Government Share

The individual rural local-level share is the amount an individual rural LLG receives from the equalisation system.

The LLG share is divided into two amounts: one for urban LLGs, and another for rural LLGs. These are called individual local-level shares.

The amounts for individual urban or rural LLG for the relevant fiscal year are calculated using the formula below:

$$\text{equalization amount for urban Local-level governments} \times \frac{\text{fiscal needs amount of individual urban Local-level Government}}{\text{total fiscal needs amount of urban Local-level Governments}} = \text{individual Local-level share}$$

Where -

'equalization amount for urban LLGs' means the amount estimated by the NEFC to be the urban LLGs' share of the local-level share specified in the determination made under Section 17 (1) *(b)* that is in force on 30 April of the immediately preceding fiscal year;

'Fiscal needs amount of individual urban LLG' means the fiscal needs amount of that urban LLG for the relevant fiscal year;

'Total fiscal needs amount of urban LLGs' means the total of the fiscal needs amounts of the urban LLGs that have fiscal needs amounts greater than zero for the relevant fiscal year.

A similar formula is used to calculate the rural LLG share.

Most rural LLGs have minimal revenues available to them. However, they each have very different costs. Reasons include higher costs due to remoteness or having different populations to service. Even though most rural LLGs have little or no revenue, they have different fiscal need amounts because they all have different costs.

Urban and rural LLGs have different assigned service delivery functions and responsibilities as defined by the Function Assignment Determination approved by the NEC. They also have different revenues available to them. Urban LLGs can raise substantially more revenue to fund a more significant proportion of their service delivery costs. Rural LLGs tend to have minimal revenues and fewer service delivery functions and responsibilities.

Revenues of rural and urban LLGs have been assessed at zero. This is due to data on these revenues being incomplete and of poor quality. As stated in ***sub-section 4.2.2***, given the unavailability of revenue data, the NEFC has sought to use District

costs and population as proxies for determining LLG costs. This method of assessing LLG fiscal needs narrows in NEFC's assessment so as to be permissive with deriving a base cost for both Rural and Urban LLG's. However, eventually the NEFC expects to obtain better information on the revenues of urban LLGs and will then assess these more accurately. It may not be possible to accurately assess revenues for over 300 rural LLGs in the foreseeable future. Consequently, revenues for rural LLGs may continue to be estimated at zero.

The total LLG share is divided between rural and urban LLGs in the same proportion as provided in the 2009 budget i.e. 79% rural, 21% urban.

The rural LLG share is then further divided into the 300 plus individual LLG amounts, based on district costs and population in each LLG. Considerably, the NEFC understands the nature of the establishments of rural LLG's. Should new LLG's be gazetted in the foreseeable future, LLG shares will have to be shared accordingly.

For urban LLGs, their funding is determined as their share of funding based on their assessed fiscal needs[3].

4.8. A note on calculating the determination

Occasionally revenue data is not available to the NEFC at the time it undertakes its calculations early in the financial year (May). When data is not available, the NEFC makes a forecast of the revenues using historical data (normally based on a 3 year average).

Due to the uncertain nature of forecasting, the calculated estimates may sometimes differ to actual revenues eventually recorded later in the year. Similarly, on occasions, data collected by other government agencies is later revised after the NEFC makes its calculations. The NEFC has a long-standing practice of not changing its recommendations in these circumstances. The NEFC makes its calculations using its best efforts and the data available at the time. This ensures that the calculations are made early in the financial year which then means that Provinces receive their funding ceilings in a timely manner.

4.9. Resource-Rich Provinces & the Funding Arrangements.

Since the inception of RIGFA, the reform has witnessed astounding shifts in the funding arrangements. However, the NEFC has not shifted its attention in advocating for service delivery. The use of provinces own-source revenues has always been of paramount concern. With lessons learnt from the previous "Kina per Head" System, the reform plays a pivotal role in allocating funds for provinces in an "equitable" manner, more so, funding arrangements will have to be made on a needs basis. The NEFC takes into account provincial fiscal capacities when allocating funds. This process involves assessing provincial revenues to weigh out fiscal needs. Where a province fiscal need is equal to zero, subsequently this means the province has the fiscal capacity to accolade service delivery.

This is consistent with the principles of the Inter-governmental financing arrangements where provinces with higher fiscal capacity (*higher revenues to meet cost of services*) to provide for basic service delivery must utilize their internally generated resources to complement government funding.

The *Intergovernmental Relations (Functions and Funding) Act 2009* introduced a five-year transitional arrangement. This included a five-year transitional guarantee whereby provinces would not be worse off than the funding they received in 2008. This basically allowed resource-rich provinces like Morobe, New Ireland and Western to continue receiving grants. The Arrangement ceased in 2016 in which the transitional guarantee funding was last effected in the 2017 Budget. Accordingly, following the 2017 and 2018 Budget, Morobe & New Ireland province became ineligible to receive any function and administration grants. Though ceasing the provincial portion of the grants, Rural & Urban Local-level Governments still continue to receive LLG grants.

[3] Fiscal needs in the context of assessing District costs in proportion with District population.

Though being robust, the system allows for leniency. In the case of Western Province and most recently Manus, the system allows for grants to be re-allocated to provinces given a sudden decrease in fiscal capacities. As highlighted, function grants are given in proportion to fiscal needs.

CHAPTER FIVE: CONDITIONS ATTACHED TO THE USE OF THE FUNCTION AND ADMINISTRATION GRANTS

In 2020, the NEFC issued a letter to the Secretary for Treasury to remind provinces on the "Conditions of Funding", purposely on the use of function grants and roll-overs. The sub-sequent approach would involve the Secretary issuing a directive to provinces highlighting the conditions set-forth in the Budget Expenditure Instructions (BEI). This was a necessary approach as assessments on the Service Delivery Function Grants showed misapplication on the use of these grants.

5.1 Service Delivery Function Grants

Service Delivery Function Grants are provided to provincial governments to ensure that a minimum set of core services are adequately funded so as to benefit the majority of people across Papua New Guinea.

Section 65 of the *Intergovernmental Relations (Functions and Funding) Act 2009* serves as the basis on which the Secretary for the Department of Treasury may, in consultation with the NEFC, determine the conditions over the administration of the following grants; as follows:

- service delivery function grants;
- administration grants;
- rural LLG grants;
- urban LLG grants;
- staffing grants, and allowances for village court officials;
- Other development needs.

The conditions are subject to the provisions outlined under section 66 of the Act.

Service Delivery Function Grants are to be used exclusively for goods and services (operational costs) and not to fund salaries, capital or development costs unless specified in the Budget Expenditure Instructions.

The following service delivery function grants will be in operation in 2020;

- Education Service Delivery Function Grant;
- Health Service Delivery Function Grant;
- Transport Infrastructure Maintenance Grant;
- Village Courts Function Grant (Operations);
- Land Mediation Function Grant *(newly established)*
- Village Courts Allowances Grant;
- Agriculture Service Delivery Function Grant;
- Other service delivery Function Grant *(Grant composed of funding for other services sectors such as Community Development, Lands, Commerce, Environment, etc.).*

5.2 Administration Grants

This grant is to fund general overhead costs or meeting the day to day operational costs of the provincial administration.

The Administration Grant **cannot** be used to pay salaries or other personal emoluments, casual wages, or debt payment. This grant is intend to fund the

operation of the administration sectors such as the Legal Services; Human Resource Development; Policy, Planning & Research; Internal Audit; Assembly/Parliamentary Services; Office of the Administrator; and LLG Administration.

5.3 Minimum Priority Activities and Performance Indicators

In 2009, the Secretary for Treasury issued Budget and Expenditure Instructions calling for Provinces to adequately fund eleven (11) specific service delivery activities. These eleven activities were identified as a basic provincial responsibility across the nominated five key function grant categories of Agriculture, Education, Health, Transport Infrastructure and Village Courts (all MTDS priority areas) and are known as the Minimum Priority Activities (MPA's).

These MPA's were arrived at after extensive consultation with national agencies, Provinces and PLLSMA. MPAs should assist provincial governments to prioritise effective and targeted service delivery outcomes at the district and LLG level.

Provincial governments must create identifiable activity codes for each MPA in their respective budgets and request performance reporting from sector managers. The MPAs are:

Agriculture
- Extension activities for agriculture, fisheries and forestry

Education
- Distribution of school materials
- Supervision of schools by district and provincial officers
- Operation of district education offices

Health
- Operation of rural health facilities
- Integrated health outreach patrols
- Drug distribution

Transport Infrastructure Maintenance
- Road and bridges maintenance
- Airstrip maintenance
- For maritime provinces- wharves and jetties maintenance

Village Courts
- Operation of village courts
- Supply of uniforms / inspection of village courts

Additionally, there is a set of very specific indicators against which each of these MPAs could be measured.

The full set of MPA's and performance indicators are provided on the following pages.

Minimum Priority Activities and Performance Indicators

The Minimum Priority Activities that **must** be funded from service delivery function grants within each financial year. These form part of the conditions of the service delivery function grants.

These minimum activities are a **minimum priority activities which the NEFC monitors and encourages provincial administrations to adequately fund these from their total function grant allocations...** Function grants can still be used for funding other recurrent goods and services activities within that functional area.

Minimum Priority Activity	Performance Indicator
Health	
1. Operation of rural health facilities	i. Total number and names of health facilities ii. Number of Health Facilities open and staffed iii. Health facilities with access to running water in labour ward
2. Drug distribution*	i. Number of months health facilities stocked with essential supplies in the last quarter
3. Integrated health outreach patrols	i. Total number of health patrols conducted and then, a. Number of administrative supervision patrols to health facilities b. Number of patrols with specialist medical officers to health facilities c. Number of maternity child health patrols to health facilities.
Education	
4. Provision of school materials	i. Total no of schools by type ii. Percentage of schools that received basic school supplies before 30th April.
5. Supervision by provincial/district officers	i. Number of schools visited by district / provincial education officers
6. Operation of district education offices	i. Number of District Education Offices that provided quarterly performance reports.
Transport Maintenance	
7. Road and bridge maintenance	i. Names and approximate lengths of provincial roads maintained ii. Names of bridges maintained
8. Airstrip maintenance	i. Names of rural airstrips maintained
9. Wharves and jetties maintenance	i. Names of wharves, jetties and landing ramps maintained
Agriculture	
10. Extension activities for agriculture, fisheries and forestry	i. Number of extension patrols conducted by provincial government staff and ii. Number of people who attended extension sessions
Village Courts	
11. Operations of Village Courts	i. Number of village courts in active operation ii. Number of village courts supplied with operational materials iii. Number of inspection to village courts

*It is understood that the distribution of drug supplies is being managed through donor support. Whilst this activity was identified as a minimum priority activity, proper assessment and monitoring of this activity is being considered by the NEFC. In the meantime this should not deter the Province from reallocating the cost previously budgeted for the drug distribution to other areas of priority expenditure.

*It is also understood that the establishment of the TTF has induced provinces to use the Education Function Grants on other activities. The NEFC still maintains its objectivity by encouraging provinces to fund distribution of school supplies as TTF is only a policy and NEC decision and can be changed anytime.

The Land Mediation Function Grant as it was created in 2016 is yet to establish its minimum priority activities and its performance indicators through another consultation process with the key stakeholders such Department of Treasury, Department of Finance, Department of Justice & Attorney General and Provincial Administrations.

5.4 Improving Compliance of Conditions for Funding

Conditions for function grants (including the Minimum Priority Activities) and management of expenditure are provided for in the Function Grant and Administration Grant Determination and the ‘Budget and Expenditure Instructions’ issued by the Secretary for Treasury in August 2012. The Budget and Expenditure Instructions specify:

- which grants, receipts or other revenues are to be used for and the expected outputs from spending
- the management of grants, receipts or other revenues
- how the expenditure of grants, receipts or other revenue is reported; and
- The budget preparation process, including consultation with stakeholders.

The Department of Treasury, in conjunction with the Department of Provincial and Local Government Affairs and the NEFC continue to work with provinces to improve the compliance of these Budget and Expenditure Instructions. The NEFC has undertaken a series of budget workshops with all provinces to further improve budget compliance to the use chart of accounts coding and other budget scorecard criteria.

CHAPTER SIX: IMPLEMENTATION OF PROVINCIAL BUDGETS: ASSESSMENT AND ISSUES

Ensuring that the available funding for goods and services is spent wisely on intended purposes has always been the NEFC's focus. Exclusively, the NEFC plays a pivotal role in being the bridge between the national government and provinces. Though appropriate as it may seem, policies and administrative practices being implemented at the national level have adverse impacts on the sub-national level. The NEFC uses a number of opportunities throughout the year to highlight and assess the inevitable issues and bring together parties to find solutions.

Annually, series of workshops are held by the NEFC bringing together provincial administrators and relevant sector managers/ advisors. 2020 however, was a difficult year of which the Annual NEFC Regional Workshop was not undertaken due to the Covid-19 pandemic. The NEFC will continue to use the workshop in the coming years as an avenue for provinces to provide assessments of their own performances. The objective of conducting the workshop is also in line sub-national level issues that may arise as a result of policy inclusions at the national level. The NEFC then engages in higher level forums in an attempt to solve provincial issues. Such forums as PLLSMA and the Inter-Departmental Committee meetings pave way for airing out pertinent issues expressed during the workshops. Coherently, the NEFC has also sought to gain political support in the past by advocating for solutions during the Governor's Conferences.

Furthermore, the NEFC also assists the Department of Treasury and Department of National Planning & Monitoring in carrying out the Second Quarter Budget Expenditure Reviews. These Reviews are conducted as a medium for assessing how provinces effectively implement their budgets.

6.1 Implementation of Budgets and Analysis

Annually, Second Quarter Budget Reviews are conducted by the Department of Treasury to see how well sub-national levels are spending their funds from the National Government. This activity is conducted to track the provincial expenditures from the first two quarters. Although the intent of carrying out this review is to assess expenditure, the late release of funds has been an ongoing issue and one that still impedes the budget implementation process for provinces.

It was assessed from the Review that of the 20 Provincial Administrations, only 13 were able to comply with the Second Quarter Budget Circular and have submitted their reports. It was fairly evident from their reports that the dilemma relating to warrants and cash releases were still being faced by the majority. It was also expressed by Provincial Administrations that partial cash transfers on warrants from the Department of Finance has caused confusion as actual cash transferred do not show break ups. Function Grants are tied to Minimum Priority Areas and so this causes confusion as to which programs to fund using the partial cash transfers.

The Department of Treasury through the Review has highlighted key indicators. One of which that should be emphasized is the Financial Performances for the Sectors in the second quarter.

The table below highlights total provincial expenditure against warrants released to date.

Fund Type	2020		WA		Exp	Variance	
	Orig. Bud	Rev. Bud	Pro rata	Amount	Amount	%Wa Vs Exp	Amount
Operations							
PE	*1,804.83*	*1,804.83*	*902.417*	*9.464*	*1,067.88*	*-11,184.0*	*-1,058.42*
GS	*541.145*	*550.145*	*275.073*	*137.425*	*114*	*17*	*23.43*
Total Operations	**2,345.980**	**2,354.980**	**1,177.49**	**146.889**	**1,181.88**	***-705***	***-1,035.00***
Capital							
GoPNG-D	*1,256.0*	*1,506.200*	*753.100*	*753.100*	*753.100*	-	-
Donor Grants	*19.200*	*19.200*	*9.600*	-	-	-	-
Internal Revenue	**1,178.60**	**1,178.60**	**589.0**	**278.638**	**139.319**		
Grand Total	**4,799.780**	**5,058.980**	**2,529.190**	**1,178.627**	**2,074.299**	**(705.0)**	**(1,035.0)**

Source: Department of Treasury IFMS 2nd QTR Report

The total 2020, National Government budget allocation to the Provincial Administration is K2,459.4m. This comprises of K2,345.98m in Operational Budget and K1,275.2m in Capital Budget, inclusive of the Donor grants K19.20m. The total warrants released Ytd for the Provincial Administration Sector amounts to K899.9m. This comprises of K146.9m Operational and K753.1m in Capital Budget.

Total expenditure incurred Ytd by the Provincial Sector amounts to K1,935.0m, compared to K900.0m of total warrants issued. This is K1,035.0m or 115% above the total warrants released in the first half year of the 2020. Notably, the Personnel Emolument expenditure is higher than the total warrants released by 11,184%, as there were low warrant ceilings being approved and issued in the 1st half of the year.

As opposed to the Operational Budget, The Capital Budget expenditure incurred YTD is in line to the pro rata basis (50%), as the bulk of the warrants are SIPs and COVID 19 related expenditures. These critical expenditures were released upon political requests and directives.

The actual collection for the Provincial Internal Revenue is far below the projected amount for the period across all Provincial Administrations. This was due to the COVID-19 shut down effect which had badly impacted the sub national levels potential to generate revenues.

CHAPTER SEVEN: ASSISTING THE REFORM PROCESSES

Since the inception of RIGFA, NEFC has been proactively involved in assisting provinces through various interventions. 2020 was no different from prior years in which the national government yet again embarked on driven policies to adjust the current economic situation of the country. The sub-national level of government rides on these policies using developed strategies and goals. A major impediment in the implementation process is the late release of funds.

The NEFC, through the reform process, advocates to provinces through the regional workshops conducted for each region annually; in recent years, Budget Workshops; Unspent/Rollover Study; Facility Based Funding-Diagnostic Expenditure Review; Personal Emoluments Costs; and most recently, the Public Expenditure & Financial Accountability (PEFA) & the Gender Equity & Social Inclusion (GESI) Mainstreaming.

7.1 GESI Mainstreaming

The NEFC was nominated to undertake the Secretariat functions to the GESI Mainstreaming Committee, thus, working in collaboration with the Departments of Personnel Management, Community Development, National Departments of Health and Education and Central Provincial Administration, to form a committee aimed at mainstreaming GESI at the sub-national level. The primary focus of the External GESI mainstreaming Committee is to promote the public sector GESI policy, providing data and information to assist government in developing evidence –based policies in support of GESI mainstreaming.

The Department of Community Development & Religion has the overarching responsibility for progressing GESI policy to the broader community. Whilst GESI has been slowly taking shape within the Public Service, there appears to be no specific collection and analysis that would influence the progression of GESI policy through targeted funding including gender based budgeting.

The Government of PNG has been rolling out its GESI policy since 2013. DPM has been tasked to implement the policy by developing a framework which included the appointment of GESI officers across agencies within Government at all levels.

During the initial meeting between committee members, it was apparent there is data available through the various agencies particularly, the national Sectoral agencies which could be collated. The NEFC was considered by the Committee as an independent and objectivity body to be able to collate and to provide analysis on GESI indicators. The GESI interdepartmental committee would then be in a better position to be able to provide evidence based policy changes in support of future GESI reforms.

The NEFC will be responsible for obtaining data and information, providing analysis as considered relevant by the Committee. Further responsibilities include producing a periodic publication and/or chapter to be incorporated in the existing Provincial Expenditure Review (PER) publications.

7.2 2020 Cost of Services Study Update

The Cost of Service Study (CoSS) is one of the NEFC's key priority programs for this year, 2020 and forms the corner stone of all activities under its mandate which is to provide independent and objective advice and also make recommendations to the NEC and National Parliament on;

- Economic and Fiscal Policies of the National government
- Financial arrangements and the allocation of grants from the National government to Provincial governments and Local level governments

The CoSS is crucial in enabling the NEFC to fulfill its mandate and it is undertaken after every five (5) years. The first nation-wide Cost of service study was done in 2005. Since then, there have been two Cost of service studies (i.e. 2010 and 2015). The current is the 4th CoS Study which is also intended to provide the National Government with an update on the cost of providing basic services in each province and across the key service delivery sectors.

1. Importance of the Study

The Cost of Service Study is a crucial component that the NEFC uses to calculate the Provincial Function Grants, the Local-level Government Grants including the determination of other fiscal transfers to sub-national levels of government.

Apart from other aspects, the study includes field visits to sub-national levels which are vital to allow NEFC to update the information required for the NEFC Cost of Services Models (CoSM).

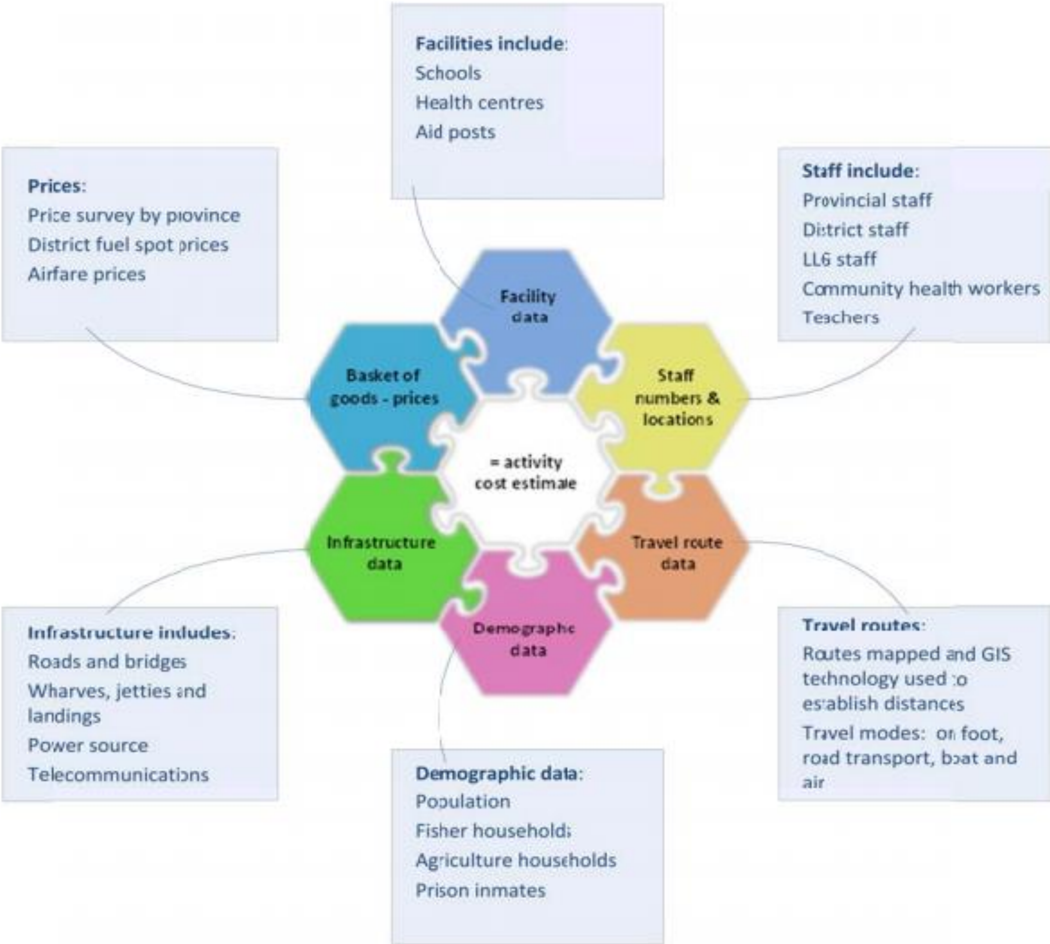
For the 2020 study, the NEFC for the first time has invited its stakeholders, particularly the Departments of Treasury [DoT], Provincial & Local Government Affairs [DPLGA] and Department of Prime Minister & NEC [PMNEC] to be involved in this exercise.

2. What does Cost of Services Study involve?

This study will be focused on collecting the following sets of data

1) Facility Data – number, location and status of operation of facility (Open/ Close/ relocated, etc.)
2) Staffing numbers and locations – staff on strength
3) Basket of Goods – Spot price survey
4) Infrastructure data – type and condition of infrastructure
5) Demographic data - Population
6) Travel routes data – type of travel route and mode of travel to facilities

The schematic diagram below summarizes various data required to update the Cost of Services Models.



3. The Next Steps

The field visits and the data collection phase of the study is expected to end by early November, 2020. The next steps include the compilation, validation and the updating of Cost of Services Models for individual provinces. The focus is to be able to use the updated Models for the 2022 National Budget Determination. A separate report on the survey will be published and made available to partners and stakeholders.

7.3 Implications on Greater Fiscal Autonomy for the Provinces

The National Government has placed high priority on giving more political, administrative and fiscal or financial autonomy to the provinces. Three provinces have been selected as a start to grant more political, administrative and financial autonomy and other provinces are mooted to follow. This means granting more increased access to revenue assignments and control over tax sharing and enhanced administration over a range of government functions and responsibilities. The quest for greater autonomy needs to be supported by relevant organic law on decentralization and a clear policy with clear institutionalized framework and implementation processes to achieve intended outcomes. Tax and revenue autonomy in fiscal devolution of subnational governments if not well researched, designed, coordinated and implemented, can weaken the relationship between the national tax base and subnational government revenue base.

The National Economic & Fiscal Commission (NEFC), with financial support from the Australian Government (DFAT), has engaged two technical advisors (one international and one local) to conduct a study for the purpose of providing critical information on the implications of greater autonomy from the point of view of fiscal decentralization. Among other critical background information and issues highlighted in the report, the following are key recommendations presented in the study.

A complete review of functions and responsibilities across all levels of governments be undertaken and this to be considered as a first and fundamental step in determining what needs to be transferred to the sub nationals and what needs to be kept at the national level and vice versa.

Taxation Study is conducted to unbundle current taxing powers and arrangements both at the national and sub national levels to determine what taxiing powers need to be retained at the national level and what need to be transferred to the sub nationals under the autonomy arrangements.

Major taxes should remain under the control of the national government if the economy is to be efficiently managed and its vital interest are to be properly secured.

Goods & Services Tax remain a concurrent tax that is imposed, collected and managed by the National Government.

A review of all-natural resources benefits distribution arrangements be undertaken for the purposes of determining equitable distribution of wealth under autonomy arrangements.

Conduct a broader study to specifically determine key perspective (s) and conceptual framework linking the concepts of institutions, decentralization (political, administrative, and fiscal) and how these can facilitate rapid attainment of structural transformation towards achieving gradative decentralization.

To support greater autonomy arrangements, a holistic and integrated intergovernmental financing system be designed and implemented taking into account all funding going to the sub nationals to address; 1) administrative weaknesses and bureaucracy, 2) spill overs and externalities and, 3) vertical and horizontal imbalances in the decentralization financing system.

The NEFC with other key stakeholders will use the information and recommendations presented in this study for a major review of the current intergovernmental financing arrangement systems.

APPE NDICES:

APPENDIX A: REVISED BUDGET AND EXPENDITURE INSTRUCTIONS

DEPARTMENT OF TREASURY
Office of the Secretary

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Vulupindi Haus
PO Box 542, WAIGANI, NCD

REVISED BUDGET AND EXPENDITURE INSTRUCTIONS

9 August 2011

To: The following officers in all Provinces, *except* the National Capital District and the Autonomous Region of Bougainville:

- Provincial Administrators
- Provincial Budget Officers
- Provincial Planning Officers
- Provincial Treasurers

These instructions replace all previously issued Budget and Expenditure Instructions and come into effect on the date of issue.

CONDITIONS OF FUNDING, EXPENDITURE, ESTIMATION AND PROGRESS REPORTING FOR PROVINCIAL GOODS AND SERVICES GRANTS

1 Background

1.1 On Wednesday 16th July 2008, the National Parliament passed amendments to the *Organic Law on Provincial Governments and Local-level Governments* establishing a new system for funding goods and services in Provinces and Local Level Governments.

1.2 The new system covers goods and services grants for all Provinces, *except the National Capital District and the Autonomous Region of Bougainville* which are both subject to separate legislation.

1.3 Grants for personal emoluments continue to be determined through the normal Budget process.

National Government Funding

1.4 Under the new system, the amount of funding provided to Provincial and Local-Level Governments for goods and services is set at a specified percentage of actual revenue from two years proceeding the Budget year. The legislation specifies the proportion of this net national revenue that should be provided.

1.5 This "share of net national revenue" approach ensures that, as "normal" revenues rise, funding to Provincial and Local-Level Governments will increase. On current forecasts, these new arrangements will lead to substantial and ongoing increases in funding. However, medium to long term funding levels largely depend on the overall performance of the economy.

Focus on functions

1.6 The National Government has always provided funding to Provinces to perform particular functions. However, with the introduction of the revised system and substantially increased funding, the Government has more clearly defined the functions that Provinces are responsible for, and will establish reasonable conditions to link grant funding directly to those functions.

1.7 The intention is to ensure that funding is used as efficiently and effectively as possible to perform the vital basic services for which it is provided. To ensure that funds are used as intended, with a focus on improving service delivery to the people of Papua New Guinea, the new system allows the Treasury Secretary to issue Budget and Expenditure Instructions specifying what the funding has been provided for and how it is to be managed and used.

2 Purpose

2.1 The primary objective of these Budget and Expenditure Instructions is to advise Provincial Administrations/Governments (Provinces) of:

- the legal framework establishing these Budget and Expenditure Instructions;
- the functions for which the service delivery function grants, administration grants and local level government grants are provided;
- the minimum priority activities that Provinces are required to establish and report against;
- how Provinces are to budget for the receipt and expenditure of goods and services grants;
- how Provinces are to monitor and report on the expenditure of their goods and services grants;
- the strict conditions under which unspent service delivery function grant funding may be rolled over from one year to the next; and
- the penalties and sanctions that may be imposed if Provinces do not comply with the requirements set out in these Budget and Expenditure Instructions.

2.2 Provincial Administrators are responsible for ensuring that these Budget and Expenditure Instructions are complied with and must ensure that officers involved with preparing and executing Provincial Budgets are provided with copies of these Budget and Expenditure Instructions.

3 Legal Framework

3.1 These Budget and Expenditure Instructions are issued under Section 65 of the *Intergovernmental Relations (Functions and Funding) Act 2009*, which was passed by Parliament in March 2009. Section 65 allows the Treasury Secretary to issue Budget and Expenditure Instructions that specify:

- What grants, payments or other revenue are to be used for, and what Provinces are expected to achieve from spending these funds;
- The timing and nature of expenditure of grants, payments or other revenue;
- How grants, payments or other revenue are to be managed by Provinces;

- How the expenditure of grants, payments or other revenue is to be monitored and reported; and
- The budget preparation process, including consultation with stakeholders.

3.2 Section 67 of the *Intergovernmental Relations (Functions and Funding) Act 2009* empowers the National Government to take serious actions if these conditions are not complied with.

3.3 These Budget and Expenditure Instructions will stay in force until they are withdrawn, replaced or superseded.

4 Funding for Functions

4.1 Section 5 of the *Intergovernmental Relations (Functions and Funding) Act 2009* allows for service delivery functions and responsibilities to be formally assigned to Provinces and Local-Level Governments.

4.2 Furthermore, if a Province is determined to have a 'fiscal need', Section 28 of the *Intergovernmental Relations (Functions and Funding) Act 2009* requires the National Government to provide service delivery function grants and an administration grant to assist with meeting the recurrent costs of the *assigned* service delivery functions and responsibilities.

4.3 In June 2009, NEC approved a Function Assignment Determination which sets out the responsibilities of provincial and local-level governments. This clarifies the service delivery activities each tier of government is responsible for (assigned functions).

4.4 This means that National Government goods and services grants are **only** provided to contribute towards the costs of providing functions which are assigned to Provinces under the law. Provinces may choose to perform other functions, but will have to ensure that they have other sources of funding available.

Function Grant Funding only available for the stated purposes

4.5 Service delivery function grants are only to be used for the recurrent costs of goods and services related to the specific function grant.

4.6 Under no circumstances are service delivery function grants to be used for salaries and other personal emoluments, casual wages, debt payments, legal settlements or capital projects.

4.7 Provinces may spend a service delivery function grant on the administrative costs that are *directly* related to performing the relevant service delivery function. For example, the health function grant can be used to support health administration, but not other types of administration.

4.8 Service delivery function grants cannot be transferred between different grant and expenditure types without the express approval of the Treasury Secretary.

Service Delivery Function Grants and Administration Grant

Health Function Grant

4.9 Provinces are responsible for the administration and routine maintenance of all rural health facilities in the Province, other than provincial hospitals, including health centres, rural aid posts and urban day clinics.

Their responsibility includes the delivery of basic recurrent health services such as drug distribution, health patrols, immunisation, supporting women during childbirth, and HIV/AIDS awareness activities.

Education Function Grant

4.10 Provinces are responsible for the administration and routine maintenance of elementary, primary and secondary schools (including provincial high schools), and vocational centres, including the delivery of basic recurrent education goods and services such as the purchase and distribution of school materials to schools and vocational centres, distribution of curriculum materials and supporting supervision activities of teachers and schools.

4.11 More emphasis should be placed on expenditure on elementary schools and primary schools than vocational schools and provincial high/secondary schools. The Education Function Grant should not be used to subsidise university fees. While this is a worthwhile objective, it *is not* a Provincial Government function. If a Province wishes to subsidise, or otherwise fund university education, it must use provincial government own source revenues.

4.12 The Education Function Grant is not to be used for the construction of new teachers' houses or classrooms; however, it may be used for routine maintenance of these facilities.

Transport Infrastructure Maintenance Function Grant

4.13 The Transport Infrastructure Maintenance Function Grant can only be applied to the maintenance costs of existing transport infrastructure in the Province, such as provincial roads, jetties/wharves, airstrips/airfields etc.

4.14 This grant must not be used for the construction of new roads or maintenance of buildings, or for major reconstructions of unusable existing roads. Routine maintenance of buildings, including schools, health facilities and administrative buildings must be funded out of the relevant function or administration grant.

Village Court Function Grant

4.15 The Village Court Function Grant is provided to assist with the goods and services costs associated with the administration, supervision and support for the village court system in the Province. This includes operational materials needed for day to day operations of the courts.

4.16 The grant is not to be used for the staffing costs of Village Courts, which are funded separately through the Village Courts Allowance Grant under the Province's Personnel Emoluments Budget.

Primary Production Function Grant

4.17 The Primary Production Function Grant is provided to further the development of subsistence, domestic trade and export commodities in the Province. This was previously known as the Derivation Grant or Agriculture Function Grant.

4.18 The Primary Production Function Grant provides funding for the recurrent cost of goods and services associated with agriculture and other primary production, including fisheries, livestock and forestry.

The grant covers activities such as extension services to farmers, farmer training, and the distribution of seeds and other technologies to farmers and fishermen.

Other Service Delivery Function Grant

4.19 The Other Service Delivery Function Grant is to provide goods and services funding for functions other than those which have a specific service delivery function grant. This includes business development, community development, natural resource management, sports, environment, disaster management and lands administration.

Administration Grant

4.20 In addition to the service delivery function grants, Provinces will receive an Administration Grant to assist them to meet the day-to-day operational costs of the Provincial and District Administrations.

4.21 This grant is provided for the core costs of the administration such as utilities, stationary and anti-virus programs. The administrative costs of specific sectors, such as health and education, are provided for under the respective service delivery function grants.

4.22 Under no circumstances is the administration grant to be used for salaries and other personal emoluments, casual wages, debt payments, legal settlements or capital projects, without the express approval of the Treasury Secretary.

Local-level Government Grants

4.23 Local-level Government Grants are provided for *goods and services* directly related to the functions for which rural and urban LLGs are responsible.

4.24 Since 2007, there is no longer a separate LLG Secretariat Grant. Secretariat wages, salaries and allowances are to be met out of the Staffing Grant.

4.25 Provincial governments are required to specifically budget from their internal revenue for the allowance costs of LLG councillors.

Urban Local-level Government Grant

4.26 Urban Local-level Government Grants are provided to fund the functions for which an urban LLG is responsible, such as town maintenance, cleaning, upkeep and urban beautification.

5 Minimum Priority Activities

5.1 In addition to the general requirement that the service delivery function grants be used for goods and services for the assigned functions outlined above, from 2009 Provinces have been *required* to specifically fund a set of Minimum Priority Activities (MPAs).

5.2 The MPAs, which were determined in 2008 following consultation between Provinces, the National Economic and Fiscal Commission (NEFC) and the Department of Provincial and Local-level Government Affairs, are a minimum set of activities that *must* be funded out of each of the function grants.

5.3 The MPAs are not the only activities that can be funded, and in general Provinces would be expected to fund a broader range of activities out of each of their service delivery function grants. However, they are a core set of basic activities that most Provinces would be already expected to have in place.

5.4 In order to demonstrate that they are adequately funding these activities, Provinces will be required to establish programs/activities for each MPA within their Budget, and report regularly on performance against these activities throughout the year.

5.5 The minimum priority activities are:

Primary Production
Agriculture Extension
Fisheries Extension
Forestry Extension

Education
Distribution of school materials
Supervision of schools by district and provincial officers
Operation of district education offices

Health
Rural Health Facilities
Outreach Health Patrols & clinics
Drug distribution

Transport Infrastructure Maintenance
Road and bridges maintenance
Airstrip maintenance
For Mmaritime provinces – wharves and jetties maintenance

Village Courts Operations
Provision of operational materials

5.6 The inter-departmental committee overseeing implementation of the reforms to intergovernmental financing arrangements has agreed and endorsed Indicators for MPAs which will serve as the standard performance assessment guide for Provincial Administrations. These indicators are included with this Instruction as *"Attachment A"*. Explanatory notes including definitions from NEFC are also attached for information and reference.

5.7 Provinces will be required to report on their performance against these indicators through the regular quarterly reporting process. This requirement will start with the second quarter review in 2010.

6 Provincial Budgets

6.1 Provinces are required to correctly budget for the receipt of National Government Grants for goods and services from the Recurrent Appropriation as well as the Development Budgets. The expenditures of these grants must be aligned to purposes/functions intended and identified programs.

6.2 The Provincial Budgets should be endorsed and enacted through an "Appropriation Act" by the Provincial Assembly and submitted in two parts; Part One reflecting expenditure estimates for the approved National Grants for both Recurrent & Developments Grants and; Part Two showing the expenditure estimates under Internal.

6.3 This means that Provinces will have to use the correct PGAS codes for both revenue and expenditure, clearly identify each grant in the Budget documents they submit to Treasury, and identify all of the programs/activities, including the MPAs, that the grants will be spent on.

6.4 Provinces should submit their draft budget for vetting to ensure that they comply with this Instruction soon after the circulation of the preliminary ceiling, given the level of certainty over the final figures that would be approved in the National Budget. Treasury officers within the Provincial Budget Branch will assist in the vetting process of the Provincial Budgets.

Revenue - Correct PGAS Grant Codes

6.5 With regard to revenue, the following Grant Types (codes) and function codes (FC) are to be used to identify each of the goods and services grants:

Grant Type (Code)	Function Code	Grant Description (Name)
1	1	Administration Grant
1	9	Other Service Delivery Grant
2	1	Staffing Grant
2	4	TSC Teachers' Salaries Grant
2	1	Public Servants Leave Fares Grant
2	4	Teachers' Leave Fares Grant
2	5	Village Court Allowances Grant
3	2	Primary Health Services Function Grant
3	3	Primary Production Function Grant
3	4	Basic Education Function Grant
3	5	Village Court Function Grant
3	6	Transport Infrastructure Maintenance Function Grant
4	7	Rural Local Level Government Grant
5	7	Urban Local Level Government Grant

Projections for Internal Revenue should be realistic and there should be a high degree of certainty for the realisation of those projections. It is advisable to exclude political commitments as well as sector programs that involve financing from uncertain Internal Revenue projections.

Expenditure - Correct PGAS Activity Codes

6.6 Provinces must also ensure that programs/activities are established to expend the goods and services grants. As a minimum, this will mean that all Provinces will have to establish, and account for expenditure against, each of the MPAs.

6.7 Provinces must ensure that each activity, including each MPA, has its own activity code in their future Budgets submitted to the Department of Treasury, and that these activity codes are consistent with the standard chart of accounts guide, *"Attachment B"* of this instruction.

6.8 Before submitting the Budgets for ministerial approval, Provinces should consult with Budget Division in the Department of Treasury to ensure consistency with the correct chart of accounts for the programs and activities they will fund, including the MPAs.

6.9 Before submitting the Budgets for ministerial approval, Provinces should consult with Budget Division in the Department of Treasury to ensure consistency with the correct chart of accounts for the programs and activities they will fund, including the MPAs.

6.10 If a Province submits a Budget that does not comply with the requirements regarding activity codes, it will be returned to the Province for correction before it will be considered for approval by the Treasurer.

6.11 It is now compulsory that a standardized chart of accounts must be used from 2012 budget onwards both under the 200 and 700 series,

6.12 The expenditure Code structure to treat the former years grants will be as follows:

Grant Type	Indicator Code	Vote Code
Recurrent Grant	1	27111013101
Development Grant	2	27121013101
Local Level Government	3	27131013101
Former Years	4	27141013101
Former Years	5	27151013101

6.13 The details Revenue Code structure are shown as "Attachment C".

7 Monitoring and Reporting on Performance

7.1 At this stage, all additional reporting requirements, such as reporting on performance in the MPAs and reporting on expenditure of rolled over funds, will be met by the regular quarterly reporting process.

7.2 Section 5 of the *Public Finances (Management) Act* 1995 requires Provinces to report each quarter on their financial performance. However, despite this, Treasury is concerned that Provinces regularly fail to submit their reports on time or fail to report at all.

7.3 Provincial governments must report on service delivery, so that the Government is satisfied that the funding provided is being spent for the benefit of the people. Under the revised funding system, Provinces that fail to report as required may be subject to a range of sanctions, as outlined in Section 9, below.

7.4 In 2009, the Department of Treasury, with NEFC and the Department of Provincial and Local Level Government Affairs, consulted with Provinces about introducing a range of relevant performance indicators for the MPAs and has introduced the MPA Indicators endorsed by the Inter Departmental Committee as highlighted in section 5.5 above and outlined in Attachment A.

7.5 Provinces will be required to report against these indicators from second quarter of 2011.

8 Restrictions on Rollovers

General restrictive approach to Function Grants Rollovers

8.1 As outlined in section 4 above, service delivery function grants are provided by the National Government for specific purposes, with the intention that they be spent on the function for which they are provided within the year they are provided.

8.2 In the normal course of business, Provinces should actively work towards spending their service delivery function grants throughout the Budget year. In the event that Provinces do not fully spend their Function Grants, they should 'roll-over' the unspent National Government funds to remain in the Provincial Government Grants Account (PGGA) and create specific Revenue Heads in the following year ('200 Series') estimates.

8.3 It is a *strict* condition that these funds remain in the core priority sectors for which these were provided. For example, rolled over Health Function Grants must *only* be used on recurrent goods and services relevant to primary health care.

8.4 To ensure they are used as intended, unused funds from previous year must be rolled over into one of the following specific revenue votes for current/(budget) year:

- AdministrationHealth Function Grant Former Year's Appropriation;
- Other Service Delivery Grant Former Year's Appropriation;
- Health Function Grant Former Year's Appropriation;
- Education Function Grant Former Year's Appropriation;
- Transport Infrastructure Maintenance Function Grant Former Year's Appropriation;
- Primary Production Function Grant Former Year's Appropriation; and
- Village Court Operations Function Grant Former Year's Appropriation.

8.5 Where a Province intends to roll over one or more service delivery function grants, it must include accurate estimates of the rollover in its Provincial Budget, with the rolled over funds shown against the relevant revenue vote from paragraph.

The Department of Treasury will not approve Budgets that fail to clearly roll over unspent function grants into the correct revenue votes.

8.6 If a Province continually fails to fully spend its service delivery function grants, Treasury will consider re-allocating the funds to a Province with a better track record.

9 Penalties for Non-Compliance with Budget and Expenditure Instructions

9.1 Provinces must ensure that they comply with these Budget and Expenditure Instructions when developing, presenting and executing their Budgets.

9.2 Where a Province submits, for approval, a Budget that does not comply with the conditions in these Budget and Expenditure Instructions, it will be returned to the Province for correction before it is considered for approval by the Treasurer.

9.3 Furthermore, there are a range of possible sanctions set out in Section 67 of the *Intergovernmental Relations (Functions and Funding) Act 2009*. These include:

- The Treasury Secretary may issue a non-compliance notice under the legislation outlining:
    - the circumstances of the non-compliance;
    - the action required to be taken to rectify the non-compliance;
    - the date by which the action must be undertaken; and
    - any additional reporting requirements;
- The Treasurer may make a written determination to the Province for all or any of the following purposes:
    - specifying how the expenditure of the grant is to be managed;
    - requiring expenditure to be supervised or authorised by a person or body specified in the determination;
    - delaying the making of any further grants or payments to the Provincial Government, until such time as is specified in the determination; or
    - requiring the Provincial Government to repay an amount specified in the determination.
    - redirecting funding to Functions with the capacity to effectively spend the funds for service delivery.

10. Contact Officers

Should you require any further clarification, do not hesitate to contact the following officers;

Lazarus Enker	312 8739
Dessie Kuburam	312 8786
Graham Ararua	312 8784
Robyne Joshua	312 8785
Richard Lucas	312 8787

11. Conclusion

I urge all Provinces to comply with this Budget & Expenditure Instructions for effective and timely approval and implementation of all future Budgets.

SIMON TOSALI
Secretary

Attachment A: Quarterly Performance Reporting - Minimum Priority Activity Indicators
Attachment B: Chart of Accounts Guide for Minimum Priority Areas

"Attachment A"

Quarterly Minimum Priority Activity Indicators

Minimum Priority Activities (MPAs)	Agreed Indicators
Health	
1. Operation of Rural Health Facilities	i. Total Number and Names of all Health Facilities (HFs) ii. No. of Health Facilities (HFs) open & staffed iii. Number of HFs with access to running water in labour ward
2. Outreach Health Clinics and Patrols	i. Total number of health clinics and patrols conducted ii Number of administrative supervision patrols to HFs iii Number of patrols with specialist medical officers to HFs iv Number of maternity child health patrols to HFs
3. Drug Distribution	i Number of months HFs stocked with essential supplies in last quarter
Education	
1. Provision of School Materials	i. Total number of schools by type ii % of schools that received basic school supplies before 30 April
2. Supervision by Provincial/ District Officers	i. Number of schools visited by district/provincial education officers
3. Operation of District Education Offices	i. Number of District Education Offices that provided quarterly performance reports to Provincial Education Officers
Transport Maintenance	
1. Road and Bridge Maintenance	i. Names and length of provincial roads maintained ii. Names of bridges maintained
2. Airstrip Maintenance	i. Names of rural airstrips maintained
3. Wharves and Jetties Maintenance	i. Names of wharves, jetties and landing ramps maintained
Primary Production	
1. Extension Activities for Agriculture, Fisheries and Forestry	i. Number of extension patrols and training sessions conducted ii. Number of people who attended extension and training sessions
Village Courts	
1. Operation of Village Courts	i. Number of village courts in active operation ii. Number of village courts supplied with operational materials

"Attachment B"

Chart of Accounts Guide for MPAs

The Provincial Chart of Accounts has 14 digit Coding, i.e.

Sample Chart of Accounts

	A			B	C				D	E	F			G		
1	**2**	**3**	**-**	**4**	**5**	**6**	**7**	**-**	**8**	**9**	**10**	**11**	**-**	**12**	**13**	**14**

Part A – Digits – 1,2,3	= Division Identification e.g: 271 – Western Province
Part B – Digit – 4	= Activity or Project Code i.e: '1' = Activity (Recurrent Expenditure) '2' = Project (Development/Capital Expenditure)
Part C – Digits – 5,6,7	= Cost Centre (Location of Expenditure) i.e: PHQ, District & Local Level Government
Part D – Digit – 8	= Grant Code (refer to Section 6.5 of Revised BEI 09, pg 7) e.g: '1' for Administration Grant '3' for Function Grants '4' for Rural LLG Grant
Part E – Digit – 9	= Function Code (refer to Section 6.5 of Revised BEI 09/10, pg 7) e.g: '1' for Administration '2' for Health Function '3' for Primary Production Function '4' for Education Function
Part F – Digits – 10, 11	= Activity/Project/Programme Numbers – 01 to 99
Part G – Digits – 12,13,14	= Expenditure Item Code

Eg:

Activity Description: **Operations of Kerowagi District Education Office**

Correct Vote: 280 – 1050 – 3210 – 123

i.e. 280 for Simbu Province
'1' for Recurrent Activity
'050' for Kerowagi District
'3' for Function Grant
'2' for Education Function
'10' District Education Office Operations &
'123' Office Materials & Supplies