

# **CHAPTER 4. BUILDING THE ECONOMY THROUGH SUSTAINED REFORM**

## **4.1 OVERVIEW**

The strength of the economy over the past four years has been founded on sound macroeconomic management, sustained reform and supportive global economic conditions. Macroeconomic stability and clear policy direction have created a more stable economic environment and underpinned an improved performance from the private sector. The 2007 Budget continues to promote economic growth through prudent fiscal management and ongoing reform.

The 2007 Budget is set within a medium-term framework. It is guided by the Medium Term Fiscal Strategy (MTFS), which established budget-balance ceilings consistent with the Government's fiscal principles, and the Medium Term Development Strategy (MTDS), which sets out the Government's spending priorities. It also reflects the Medium Term Debt Strategy, introduced in the 2005 Budget, and other medium-term initiatives.

The 2007 Budget promotes the Government's reform strategy through:

- creating a stable investment climate;
- providing an efficient, effective and affordable public sector; and
- ensuring a competitive and dynamic private sector.

On the fiscal front, the target budget balance for 2007 is a small deficit, 0.2 per cent of GDP, consistent with the MTFS.

In the 2007 Budget a greater proportion of resources are allocated to the MTDS priority areas of: transport infrastructure rehabilitation and maintenance; promotion of income-earning opportunities; basic education; development-oriented informal adult education; primary health care; HIV/AIDS prevention; and law and justice. In addition, funding will be provided for logistics and security arrangements for the conduct of the 2007 National Elections.

Supporting these broad fiscal objectives is a range of improvements in public financial management systems. Budget systems and processes have been enhanced and financial management has been tightened. The Government will continue to improve the operation of its human resources and payroll systems in 2007. It will also continue its efforts to improve financial management in the public sector through the Financial Management Improvement Program (FMIP). Improved financial management systems will allow better policy making and better delivery and monitoring of government programs.

Consistent with the objective of improving public sector service delivery, the 2007 Budget emphasizes mechanisms for better service delivery to rural areas, through a range of initiatives at the district level. The District Service Improvement Program (DSIP) is a key Government initiative to bring basic services back to rural areas. Other programs, such as the District Transport Infrastructure Program (DTIP) continue to promote improved service

delivery in rural areas. These structured programs are more likely to deliver better services to rural communities than are programs like District Support Grants.

The 2007 Budget continues to support private sector growth. Prudent fiscal and monetary management has seen a continuation of a low inflation, low interest rate environment. Better-focused public expenditures and greater efficiency should improve public sector service delivery and reduce business transaction costs.

The Government will undertake further work to reduce the costs of doing business in Papua New Guinea. Substantial progress has been made in removing impediments to business, but challenges remain, particularly in areas such as telecommunications, transport and other infrastructure. The Government will continue to work closely with the private sector through the National Working Group on Removing Impediments to Business and Investments ("National Working Group") and the Consultative Implementation and Monitoring Council (CIMC) to address policy and structural issues affecting the private sector and civil society.

## **4.2 A STABLE INVESTMENT CLIMATE**

A stable investment climate is a necessary condition for economic growth. Political, policy or macroeconomic instability all make it difficult for businesses to plan and to make a well reasoned assessment of the likely returns on their investment. Under these conditions businesses will seek a very high return on investment or, in many cases, not invest at all.

Papua New Guinea has made considerable progress in building a stable investment climate. The current Government has now been in place for over four years and is close to completing its full term. Political initiatives such as the enactment of the *Political Parties and Integrity Act* and the progressive introduction of Limited Preferential Voting have increased the likelihood of a more stable political process.

Policy stability has improved with the Government introducing, and adhering to, a range of medium-term policy frameworks, particularly the MTFS and the MTDS.

Macroeconomic stability has been improved through disciplined fiscal and monetary policies. Prudent macroeconomic policy settings have led to lower inflation and interest rates, and a more stable exchange rate. Sensible wages policy has seen wage increases that are moderate and affordable. Prudent debt management has led to a more stable and less risky debt profile.

### **4.2.1 Prudent Fiscal Management**

A mid-term 2006 Budget review projected a surplus for 2006 of K682.5 million, instead of the small deficit budgeted. This projected outcome reflected discipline on expenditure and better-than-expected revenue, especially from mining and petroleum taxes. In August 2006, the Government announced a Supplementary Budget which allocated substantial funds to investments in public infrastructure in areas of the Government's priorities, and to meeting outstanding State obligations. The Supplementary Budget was set on a theme of "Repairing the Neglect of the Past".

The 2006 Supplementary Budget expenditure targeted MTDS priorities with 80 per cent of the projected surplus allocated to these areas. The expenditure items fell into three broad categories: MTDS priority projects; outstanding State obligations; and, non-MTDS spending. It also targeted the repayment of a range of outstanding contractual and legal obligations, including arrears, court orders, superannuation obligations and debts to some provinces.

These are effectively part of the Government's debt but, since they had not been 'brought to book' in the past, they will be paid through appropriations for spending.

It is important for the Government's fiscal strategy that additional windfall revenue in 2006 and 2007 is not allocated in such a way that it becomes embedded in ongoing expenditure. This would make it difficult to manage expenditures in the future when revenues return to more normal levels. Rather, through the maintenance of fiscal discipline over ongoing expenditure, windfall gains are available to ***invest in the future of our nation***.

On the revenue side, the Government will commence the second round of tax cuts that were announced in the 2006 Budget. The mining levy will continue to be phased out as planned.

Consistent with the Government's commitments, the final stage of the phased tariff reduction program ended in January 2006. The Government is already planning for a comprehensive review, an independent consultant has been selected and consultations with the business community and other stakeholders will commence in early 2007 that will determine the future of tariff policy.

#### **4.2.2 Fiscal Responsibility Act**

To strengthen the medium term framework for fiscal policies, the *Fiscal Responsibility Act* was enacted in August 2006.

The Act contains a set of fiscal principles which are to be applied through each Government's term of office. These principles are about sound fiscal management and implementation of the Government's Budgets.

In implementing the principles for sound fiscal management, it is specified that:

- Government agencies have regard to the provisions of the *Public Finances (Management) Act 1995* and the Financial Instructions issued under Section 117 of that Act.
- The Treasurer be consulted on any submission to the National Executive Council that will have a financial implication for the State, prior to consideration of the submission by the NEC.
- Government agencies not be permitted to borrow funds without the prior approval of the Treasurer.

The Act also stipulates the release of three key fiscal reports each year.

- An annual Budget Strategy Paper
- A Mid Year Economic and Fiscal Outlook Report
- A Final Budget Outcome Report

These build on the existing Annual Budget Strategy Paper and the existing Quarterly Budget Review process.

Nothing in the Act creates rights or duties that are enforceable in judicial or other proceedings.

### **4.2.3 Public Debt Management Policies**

Prudent management of public debt is an important component of the fiscal strategy. The Government has developed and implemented a Medium Term Debt Strategy (Debt Strategy) since 2004. The objective of the debt strategy has been to minimise the cost of debt consistent with the Government's tolerance for financial risk, including a sustainable level of debt, and to develop an efficient market for government securities.

The Debt Strategy is described in Chapter 8 of this volume.

### **4.2.4 Affordable Wages Policy**

The Government continues to support affordable wages policies, with moderate increases in wages underpinned by performance and productivity increases.

The three-year Agreement (2004-2006) on salaries and allowances negotiated in late 2004 with the Public Employees' Association has continued to prove its success. The moderate increase in that agreement did not put undue pressure on prices, and this has been one factor in inflation remaining low. Therefore the agreement has continued to provide a real increase in purchasing power for public servants.

More broadly, the affordable and sustainable wage outcome for the public service in 2004 has underpinned macroeconomic stability, helping to keep business costs, inflation and interest rates low. This in turn has contributed to increases in investment and employment.

A new salary structure for police, based on increases in productivity, was successfully negotiated in mid-2006.

Negotiations with the Public Employees' Association for the next Wage Agreement (2007-2009) are an important priority for the Government and will link improvements in remuneration structure and pay increases to increases in productivity and performance.

## **4.3 AN EFFICIENT, EFFECTIVE AND AFFORDABLE PUBLIC SECTOR**

### **4.3.1 Improving Public Sector Resource Allocation**

The breadth of the distribution of limited public resources is an important determinant of the Government's capacity to deliver goods and services. The scope of the Government's activities in PNG is very broad, with the Government providing as broad a range of functions as in many developed countries. This means that many functions are not adequately resourced. The scope of the Government's operations needs to be reduced, so that it has more money to spend on its core priorities, and can improve its delivery of basic services. Better basic government services would make it easier for others in the community to deliver additional services.

In August 2006, the National Executive Council endorsed the principles and objectives of the Rightsizing Report. The Government deferred consideration of the Report's recommendations for abolishing or merging departments and functions until after the 2007 General Election. Meanwhile other recommendations of the Report are being pursued, notably those for rebalancing resources within each agency from administration to front-line service delivery, and from personnel remuneration to goods and services.

The 2007 Budget again follows the MTDS by concentrating recurrent resources in the priority areas of basic education, health, law and justice and infrastructure, and in core agencies. Government agencies in the MTDS priority sectors and core agencies will have responsibility for additional flows of funds from the allocation of windfall revenue to investments in rehabilitation of public infrastructure. But these agencies' recurrent funding is not being increased by any substantial amounts, because that would worsen the problem of public-sector resource allocation in future years. Instead, the additional investments will be managed through improved productivity, out-sourcing, and assistance from development partners.

#### **4.3.2 Provincial Resources Allocation**

In mid 2006 the National Executive Council agreed to a package of reforms to the Organic Law on Provincial Governments and Local-level Governments. These reforms were proposed by the National Economic and Fiscal Commission (NEFC) after three years of studies and consultations with stakeholders. They apply the principle in the NEFC's July 2005 Report on the Review of Intergovernmental Financing – that funding for service delivery in provinces should be matched as closely as possible to the actual cost of supplying those services, assessed for each province according to its circumstances.

The key features of the new system of funding will be:

- GST will be distributed to provinces, as now, according to where net inland GST is derived, but instead of using an inaccurate and unstable forecasting method of calculation, actual collections from the last complete year will be used. Provinces will also receive a transfer of 100 per cent of the bookmakers tax raised in the province.
- All income received by provinces and local-level governments, except for taxes they raise themselves, will be taken into account in calculating the transfers they receive from the National Government.
- Provincial Governments will continue to receive discretionary block grants and function grants for goods and services but the basis for determining the amount of these grants will be an equalisation system designed to give more funding to those provinces which have less revenue from other sources. These payments are designed to ensure, once the system is phased in, that each province will have a similar ability to meet its needs for service delivery.
- Funding for urban and rural Local-Level Governments will also be based on their assessed needs.
- After a transition year in 2007, the new system will be introduced in 2008, with additional funding for the equalising payments being phased in over the five years to 2012. During the transition period, no province will receive less in grants and GST than it did in 2007.

These changes will make the system of Provincial and Local-Level Government funding fairer, and focus on meeting the costs of basic service delivery.

The new system will also incorporate changes to make it easier for Provincial and Local-Level Governments to raise their own revenues, and a mechanism to clearly determine the service delivery functions and responsibilities of lower levels of Government.

**CURRENT SYSTEM****SHARED NATIONAL REVENUES****GST**60% of net inland collections PLUS  
'top-up' if less than 2004 distribution**ROYALTIES**

As per existing MOAs

**GOODS AND SERVICES  
GRANTS****BLOCK GRANT  
(untied)****HEALTH FUNCTION  
GRANT****EDUCATION  
FUNCTION GRANT****TRANSPORT  
FUNCTION GRANT**K10 per head  
K4 per sq km**DERIVATION GRANT**0.75% of  
export value**TOWN SERVICES  
GRANT**

K9 per head

**RURAL LLG GRANT**K3 per head  
K2 per sq km**STAFFING GRANTS****STAFFING GRANTS**

Based on cost

**2007****SHARED NATIONAL REVENUES****GST** 60% of net inland collections  
based on last complete year PLUS  
'top-up' if less than 2006 distribution**ROYALTIES**

As per existing MOAs

**GOODS AND SERVICES  
GRANTS****BLOCK GRANT  
(untied)****HEALTH FUNCTION  
GRANT****EDUCATION  
FUNCTION GRANT****TRANSPORT  
FUNCTION GRANT****VILLAGE COURTS  
FUNCTION GRANT****NEW!****DERIVATION GRANT**0.75% of  
export value**TOWN SERVICES  
GRANT**

K11 per head

**RURAL LLG GRANT**K7 per head  
K2 per sq km**STAFFING GRANTS****STAFFING GRANTS**

Based on cost

**NEW SYSTEM****SHARED NATIONAL REVENUES****GST** 60% of net inland collections  
based on last complete year**ROYALTIES**

As per existing MOAs

**BOOKMAKERS TAX**

100% to provincial governments

**GOODS AND SERVICES  
GRANTS****BLOCK GRANT  
(untied)****HEALTH FUNCTION  
GRANT****EDUCATION  
FUNCTION GRANT****TRANSPORT  
FUNCTION GRANT****AGRICULTURE  
FUNCTION GRANT****VILLAGE COURTS  
FUNCTION GRANT****NEW!****TOWN SERVICES  
GRANT****RURAL LLG GRANT****STAFFING GRANTS****STAFFING GRANTS**

Based on cost

**Amounts  
determined as  
equalisation  
payments,  
based on  
COSTS minus  
other  
REVENUES**

(for first five  
years,  
equalisation  
payments +  
GST will be  
not less than  
2007 grants +  
GST under old  
system)

**NEW!**

In the transition year of 2007, only three changes will be made to the system:

- the change to GST distribution described above will be made, with a provision to ensure that provinces do not receive less in GST than they did in 2006;
- funding for rural Local-Level Governments will be doubled; and
- there will be a new village court grant, covering both the cost of allowances and the operational costs of supervision and support of the village courts system.

The other sub-national financing arrangements introduced in the 2004 Budget will remain in place – namely Function Grants, Discretionary Block Grants, Derivation Grants, Staffing and Teachers' Grants, Rural Local Level Government Grants and Town Services Grants.

#### **4.3.3 District Services Improvement Program (DSIP)**

The primary objective of the DSIP is to ensure that people are empowered and provided with the opportunity to be engaged meaningfully and drive the development process themselves for their own benefit. Only then will they be able to improve their own quality of life and establish a sustainable standard of living for their children.

The DSIP is being implemented nationwide and is focused on the provision of funding towards maintenance and upgrading of existing facilities at the district level that will generate the greatest returns in the shortest possible time both socially and economically.

The DSIP involves all National Departments, Government agencies and statutory bodies which are responsible for the provision of basic services in the districts. Police officers will be stationed in the districts as part of the program, and there will be magistrates and rural lockups in some areas. Health facilities will be improved and education services will be enhanced through the location of inspectors in the districts. Statutory bodies and business arms of Government such as Post PNG, PNG Power, Telikom, the Water Board, various commodity boards, and Bank South Pacific will assist Government in providing these basic services as part of their social service responsibilities to the community.

The implementation strategy as currently adopted is three-fold: (i) executing through national line agencies, (ii) executing through provincial administrations and (iii) executing through district administrations.

The approach in the 2007 Budget will be to have all the funds appropriated under provincial administrations so that they coordinate implementation in the districts in the priority sectors.

The sectors currently receiving funding are transport infrastructure, health, education, law and justice and water supply.

The program was allocated K71.2 million in the 2006 Development Budget with a further K62.3 million allocated in the 2006 Supplementary Budget. A further K71.2 million will be appropriated in the 2007 Development Budget.

#### **4.3.4 Improving Governance and Accountability**

Good governance and accountability are the cornerstones of a properly functioning public service. In 2007 the Government will continue with public sector reforms to strengthen leadership and management and to improve the oversight of the public sector. The reforms continue to be guided by the *Strategies for Supporting Public Sector Reform 2003-2007*.

A merit-based appointments system for departmental heads, provincial administrators and heads of statutory authorities has been put in place. This merit-based appointments system is intended to ensure more stable leadership across the public sector and improved accountability for the performance of Government departments and agencies.

Continued support is provided in the 2007 Budget for oversight agencies, including the Ombudsman Commission, the Office of the Auditor General and the Parliamentary Public Accounts Committee. These agencies provide external oversight of the public sector, supporting transparency in policies and processes, and strengthening accountability and compliance. The work of these agencies complements the reforms to internal controls in Government departments and agencies, described more fully below.

#### **4.3.5 Civil Service Size and Payroll Reform**

The Government has made major improvements in the size, structure and distribution of the public sector workforce. The size of the public sector payroll has stabilized, with controls on recruitment and restructuring now working well.

Public sector employment in PNG is larger than the country needs or can afford. Salaries and wages account for as much as 30 per cent of total public sector expenditure. For example, between 1999 and 2002, the number of personnel on the government payroll increased from 60,074 to 67,233, an increase of around 12 per cent. During this same period, expenditure by national departments on salaries and wages grew by 33 per cent.

The Government recognises that the rapid increase in payroll costs could easily lead to fiscal pressures that would impact negatively on the delivery of basic services. As part of the program of Public Expenditure Review and Rationalization (PERR), the Government has begun to undertake reforms in the civil service size and payroll system. The reforms in this area of the public sector are twofold: to secure the payroll and appointments process; and to reduce spending on salaries. The former has involved the incorporation of national agencies and provincial administrations into the Concept payroll system, data cleansing, training of personnel and the installation of new payroll processors.

Work is progressing on all these areas. The securing of the payroll and appointments process is critical to maintaining control over the size of the civil service. Other activities within the program are in support of this, and targeted towards reducing spending on the payroll. Once this objective is achieved, it will free budget resources for the provision of basic services such as health and education.

#### **4.3.6 Improving Financial Management**

The Government has made substantial progress in improving financial management over the past two years and reforms will continue in 2007. The Financial Management Improvement Program (FMIP) provides a broad financial management reform framework under which the Integrated Financial Management System (IFMS) is one of the core projects. The IFMS will transform the present planning and budgeting system and financial accounting and improve monitoring and reporting mechanisms for public sector financial management and accountability at all levels of Government.

Part of the Government's overall plan to improve the integrated approach is to interface the present Concept Payroll and the Commonwealth Secretariat Debt Recording Management System (CS-DRMS) into IFMS as well as to enable a single General Ledger to deliver whole of Government financial statistics. The present systems, including the Planning and Budgeting System (PBS), Treasury Management System (TMS) and PNG Government



Accounting System (PGAS), are standalone systems. They do not provide whole of Government financial statistics.

The development of communication infrastructure is a crucial component of the project, which to date is progressing well. This will enable improved communication links for data transmission across all national departments located in the National Capital District when IFMS is rolled out.

Under the improved financial management of the Government, there is a plan to implement a uniform budget classification and chart of accounts to improve planning and budgeting, linked to the MTDS and accounting, and managed through a single General Ledger which will have a Government Financial Statistics (GFS) reporting capability.

The challenge for the Government is to ensure there is capacity building and skills transfer with sufficient national staff trained to maintain and sustain the operation and management of the IFMS into the future. To address this need, training officers have been identified to design, prepare and deliver training modules to users for the pilot site and non-pilot sites.

#### **4.3.6.1 Improving Expenditure Control**

As part of the process of improved governance and accountability, the Government has continued with reforms to the procurement of services to ensure better control over public expenditure. Work will continue in 2007 to ensure compliance with the amendments to the *Public Finances (Management) Act 1995* (PFMA) enacted in 2005 to institute these reforms.

Expenditure control continues to be supported by the Authority to Pre-Commit (APC) and Integrated Local Purchase Order (ILPOC) requirements. The requirement to obtain an ILPOC is an external check on Government agencies when purchasing goods and services valued at less than K100,000. For goods and services over K100,000, the APC is used to ensure that the only contracts being entered into are those with confirmed funding available.

An additional initiative, introduced in 2006, is the reform of Settling of Deeds. A Finance Instruction was issued to inform parties involved in the Settling of Deeds for out of court settlements about the process involved in executing Deeds of Settlement or Releases. The Finance Instruction directs the Attorney General and the State Solicitor to write to the Minister for Finance and Planning for his approval under Section 61 of the PFMA if the proposed amount is in excess of K100,000.

Financial Controllers have been appointed to Defence, Police, Foreign Affairs, Health, Education and Correctional Services in another step to improve expenditure control and improve financial discipline at an agency level. These positions support the financial controls, ensuring that funds are applied to correct activities, that revenue management procedures are complied with, and that trust account transactions are properly accounted.

Internal audit and audit committees throughout Government departments and agencies were made mandatory when Section 9 of the PFMA was amended in 2004. The Act requires that Government bodies and instrumentalities establish internal audit units and audit committees to ensure good governance, compliance of laws and effectiveness of systems. Audit committees are now established in the following departments and agencies: Health, Correctional Institutional Services, Police, Education, Works, Defence, Mining, Transport, National Housing Corporation, Civil Aviation Authority and the National Capital District Commission.

Implementation is continuing of the following reforms reported in previous years' Budget documents:

- The Central Supply and Tenders Board (CSTB) has been strengthened through amendment of Section 39 of the PFMA to allow for new procedures to ensure appointment on merit and impartial behaviour of board members, the consolidation of all national boards under CSTB (except Bougainville, Gazelle Restoration Authority and Pharmaceuticals), and institutional and structural changes to improve transparency, equity, accountability and value for money. The CSTB is now operating under the amended Act, with all Provincial Supply and Tenders Boards reporting to CSTB. The procurement manual and corresponding financial instructions have been issued as part of the Government's procurement systems reforms.
- Penalty provisions have been incorporated in Section 63 of the PFMA to enforce compliance by public bodies with annual reporting requirements under the Act. Accompanying financial instructions, including penalty provisions, have also been approved.
- Amendments to Section 10 of the PFMA make it mandatory for Provincial and Local Level Governments to submit annual financial statements to the Minister for Finance and the Minister for Provincial and Local Level Government Affairs.

#### **4.3.6.2 Improving Financial Information and Communication Technology**

The FMIP (above, 4.3.6) involves a substantial improvement in infrastructure to support the IFMS and the Metropolitan Area Network, and further reform is in prospect for 2007.

Finance Instructions have been issued by the Department of Finance which mandate the use of Electronic Funds Transfer (EFT) for the disbursement of payments to all persons (payees) who are to be paid by the State. The EFT instruction means that payment will be by EFT straight to the payee's bank account rather than by raising a cheque for the payee. The EFT process will avoid the significant risk inherent in the current cheque process, with savings to the State in terms of losses from fraud and in secondary costs associated with audit reviews of fraud, prosecution and recovery costs. This move is in line with the National Government's policy objective for the implementation of the IFMS.

A Disaster Recovery centre has also been established and will soon support whole-of-government financial systems. Over time, the centre is also expected to serve the disaster recovery needs of other critical Government information databases.

#### **4.3.6.3 Rationalizing Trust Accounts**

The Government continues to rationalize the number of trust accounts and make improvements to the way they are managed. Over the last two years the number of trust accounts in the Public Accounts have been reduced significantly, from over 550 trust accounts in 2004 to around 150 accounts by September 2006. In addition, negative balances have been written off through accounting adjustments that were reflected in the 2003 and 2004 Public Accounts.

A review of provincial level trusts was also completed, and following this it was agreed by provincial administrators that an additional 150 Provincial Government trust accounts would close.

In addition, some 100 dormant Finance Operating Accounts have been closed.

The current focus of activity to rationalize trusts includes reduction in the number of non bank trust accounts, either to revoke them outright or to replace them with bank trust accounts. Replacement as bank trusts will improve controls and prevent any payments from trusts where insufficient balances exist.

To improve the management of trusts, instructions have been issued to departments and statutory authorities seeking compliance with the requirements of PFMA for the provision of annual budget estimates and for monthly reconciliations. Where non compliance persists, follow-up is being undertaken with each agency to provide appropriate assistance and training to ensure full compliance.

#### **4.3.6.4 District Finance Offices**

The District Finance Office Roll Out is an important initiative of the Government and is being undertaken in accordance with the Organic Law on Provincial and Local Level Government. Section 112 of this law makes mandatory the establishment of District Treasuries in the country. The aim of the roll out is to provide government financial services to the rural areas and to complement the provision of basic services to rural areas under the related DSIP.

The Government continues to recognise the importance and sustainability of the District Finance roll out program. It is desirable that the program continue in 2007, but as yet the administration of the program is inadequate. The Government, through the Department of Finance, will be formulating a strategy in 2007 to ensure the program is sufficiently administered.

To date, a total of forty-two District Finance Offices have been officially opened, in the following provinces: Central, Milne Bay, Morobe, Madang, Sandaun, EHP and Simbu. Plans are under way for District Finance Offices to be opened in SHP, ESP, NIP ENB, Enga, Oro, and Gulf provinces.

#### **4.3.6.5 Non-Tax Revenue Management**

Project 8 of Public Expenditure Review and Rationalization (PERR, 4.3.5) is directed at improving non-tax revenue collection. Under this Project, work is continuing to strengthen a number of key strategic areas and to improve the non-tax regulatory and legal framework. As a result, line departments are now more conscious of the regulatory controls applying to fees and charges and the importance of adhering to these controls. Two of the most important controls are the requirements that fees and charges on receipt are to be recorded and credited to the Consolidated Revenue Fund.

Work is also progressing to keep a more accurate account of non-tax revenue collections. The IFMS (4.3.6) will include a complete database of all non-tax fees and charges, which will greatly enhance the Department of Finance's ability to monitor revenue collections at all levels of Government. The Revenue Chart of Accounts will include a full and comprehensive break-up of all existing fees and charges for all line departments and agencies. Another major advantage is that it will make non-tax revenue cash flow forecasting easier and more reliable.

Some line departments are required to carry out field inspections to ensure that their rules and regulations are complied with. However, many line departments lack the capacity and funding to carry out this function. The Department of Finance will, therefore, assist them to ensure that businesses and other members of the public comply with the relevant rules and regulations. Non-compliance will result in the imposition of penalty fees and charges. In deciding whether to assist, the Department of Finance will give emphasis to those line departments which believe that their rules and regulations are being breached.

#### **4.3.7 Enhanced Cooperation Program (ECP)**

Under the joint initiative of the PNG and Australian Governments, the Enhanced Cooperation Program (ECP) continued throughout 2006, despite the withdrawal of the policing contingent in 2005, with its focus on efforts to promote and enhance law and order, good governance, sound financial administration and capacity building within the PNG public sector.

ECP officials continued to work within the economic and public administration, legal, and border protection and transport security sectors in the PNG public sector. These officials continue to work with PNG officials, providing policy advice and building capacity.

Discussions between the PNG and Australian Governments on further improvements to the program continue, in particular looking at a way forward for the policing component of the ECP.

#### **4.3.8 Equity Injections in State Enterprises**

The allocation of 2006-2007 windfall revenue in the 2007 Budget includes additional equity funding to support the capital expansion plans of Telikom, PNG Power and Air Niugini. These equity injections will help to upgrade and expand the services these State-owned enterprises provide for PNG businesses and consumers.

Since many rural districts still do not have ready access to telecommunications or electricity services, funding will be provided as special purpose grants to Telikom for extending telecommunications services to rural districts, and to PNG Power for extending electricity services to rural districts.

The allocation to Air Niugini is to help its re-fleeting program.

#### **4.3.9 Statutory Authorities**

The Government sets aside significant budgetary resources for the operations of statutory authorities. In 2004, for example, well over K236 million was budgeted for about fifty of these statutory authorities. In 2006, a little over K402 million was appropriated for the statutory authorities, with a significant part of the increases allocated through the Development Budget.

The Government is concerned that financial management and governance within many of the statutory authorities is weak. Poor financial management and governance is at odds with the higher aim of government policy pertaining to fiscal sustainability and expenditure adjustment. While the PFMA provides for statutory authorities to submit financial statements to the Government annually, it appears that this is not often done.

The Government therefore intends to remedy this situation, and the process has begun with a review undertaken by the World Bank in September 2005. In summary, the review concluded that the main accountability systems exist but in practice their application is weak. The main causes of these problems are to do with the large number, and small size, of statutory authorities which make it difficult for the Auditor General and the Public Accounts Committee to effectively monitor their operations. In addition, assessments of these entities are inadequate even though current regulations allow for this under the PFMA. Accountability frameworks and models also differ widely among statutory authorities.

A component of PERR (above, 4.3.5) activity aims to improve expenditure control and realize savings by providing an improved framework and governance of statutory authorities. Within the overall aim of this project activity, the PERR Implementation Committee in

consultation with development-partner stakeholders has undertaken to review the relevant provisions of the PFMA to ensure statutory authorities are held accountable for their operations. It will be necessary to review the individual Acts of statutory authorities to ensure consistency with the PFMA in relation to financial management and good governance, and to ensure proper fiscal oversight and budgetary controls are in place. Technical assistance has been sought from the Asian Development Bank to help undertake this review.

#### **4.4 A COMPETITIVE AND DYNAMIC PRIVATE SECTOR**

A strong private sector is the key to creating growth in employment and incomes. A competitive private sector will seek out opportunities and produce goods and services that meet consumer demands. A supportive incentive structure which rewards hard work and innovation will see improved resource allocation, increased productivity and higher incomes. Strong institutions, appropriate regulation and efficient provision of public services are required to support private sector development.

The Government has worked closely with the private sector through the National Working Group on Removing Impediments to Business and Investment ("National Working Group") to address impediments to economic growth and some good progress has been made, particularly in the areas of visas, work permits and taxation reform.

More generally, however, many of the main impediments to investment have yet to be tackled. The private sector consistently points to law and order issues, corruption, poor service delivery from the public sector, poor road maintenance, inefficient telecommunications, poor service delivery from utility providers (particularly power and water), high transport costs, and a range of issues around land tenure, access and utilization, as factors impeding business investment. Until these factors are properly addressed, the private sector will continue to struggle.

##### **4.4.1 Improving the Openness of the Economy**

Papua New Guinea has a narrow resource base and a small domestic market, so a sustained pickup in the economy requires flows of capital, technology, labor and goods and services into and out of the country.

Substantial progress has been made in freeing up capital flows. In 2005 the Bank of Papua New Guinea introduced wide-ranging liberalization of foreign exchange controls. Capital account liberalization was achieved through a general exemption from regulations, subject to the usual compliance and reporting obligations. The exemptions cover inflows and outflows of loan and equity funds, and other capital. This complements the liberalized current flows regime for payments and receipts related to exports and imports and inward and outward transfers. The liberalization is supported by prudential measures, including foreign currency exposure limits and credit exposure limits, and prudent monetary policy.

The increased openness of financial flows also complements ongoing progress in reducing restrictions on trade flows. The Tariff Reform Program has seen tariffs fall in recent years with the final phase completed in January 2006.

There has also been considerable progress in opening up the market to direct investment flows. These flows bring much needed funds and skills. One example of this is the replacement of the Reserved Activities List by the narrower Cottage Industries List. This change balances the need for foreign inflows with the need to encourage local involvement in particular industries.

The Government has also made changes to improve the flow of labour into PNG, responding to concerns in the private sector about the cumbersome processes and procedures involved in obtaining approvals for various permits and work visas. As reported in previous years' Budget documents:

- The *Employment of Non Citizens Act* has been amended to free up work permit processes, including lengthening the period of work permits, freeing up conditions of re-employment of people who leave their jobs, and allowing people to enter PNG for 6 months for resource industries without a work permit.
- The three-year training and localization plan has been separated from the Work Permit System, so as no longer to be a condition for issuance of a Work Permit. The responsibility for 'skills training' now rests directly with the private sector.
- The new visa category of Permanent Residency Status has been introduced to facilitate and encourage long-term business investors and residents.

Other initiatives, such as the APEC Business Travel Visa, are underway to facilitate the movement of business people into and out of PNG.

#### **4.4.2 Improving Public Infrastructure**

The poor state of public infrastructure continues to be an impediment to business. In particular, the poor state of roads is impeding market activity, particularly in rural areas, and there are ongoing deficiencies in air and maritime infrastructure.

The 2007 Budget will continue to address the national priority of maintaining roads with a further large infusion of funds for rehabilitation of priority national roads and district feeder roads. The rehabilitation of the Highlands Highway continues to be the Government's high priority and funds are again allocated in the 2007 Budget. This follows the K70 million allocated in the 2006 Budget and K70 million in the 2006 Supplementary Budget. Funds will be also made available through the District Transport Infrastructure Program. Rural communities will benefit from this large program through increased access to market for their produce. Reforms are ongoing at the Civil Aviation Authority (CAA), which should see improvements in air transport infrastructure and allow the CAA to become more business focused.

The other major area where infrastructure is a problem is in public utilities. Telecommunications, power and water utilities have all failed to invest sufficiently in capital equipment in recent years and this is showing up in reduced capacity to deliver basic services.

To address these issues, a number of Government-owned utilities have announced major investment programs to improve their service. Telikom has announced a program to upgrade its network, and Air Niugini has commenced an aircraft re-fleeting program.

PNG Power Limited (PNGPL) has also announced a major investment program and a range of supporting initiatives to improve the reliability of electricity supply.

More generally, opportunities for greater private sector involvement in the supply of electricity continue to be examined, including through consideration by the Independent Consumer and Competition Commission (ICCC) of new licences for other electricity service providers outside the area designated for PNGPL.

Eda Ranu and the PNG Water Board will implement capital investments provided for under pricing agreements with the ICCC. The 2004 pricing review provided for K56.4 million and K20.1 million respectively to fund new capital works projects in 2006 that are designed to deliver improved water and sewerage services.

Post PNG will continue its expansion of services through the District Services Improvement Program.

#### **4.4.3 Improving Competition**

Initial steps have been taken to improve competition in infrastructure industries. However, while progress is being made, it has not been as fast as desirable.

Important reviews were conducted by the ICCC in telecommunications, shipping, stevedoring, and aviation. Apart from referring matters to that body for inquiry, Treasury also made submissions and made staff available to appear before public hearings.

##### **4.4.3.1 Telecommunications**

Following the unsuccessful attempt at privatizing Telikom PNG Limited, steps to introduce competition in the mobile phone sector were taken. The ICCC was given the task of selecting two additional licensees to provide mobile services. That process is now complete and the successful bidders have been announced. Mobile phone competition is scheduled to commence in March 2007.

To ensure there will then be fair competition in the mobile phone sector, reviews were conducted by the ICCC on ways to prevent Telikom from misusing its market power arising from incumbency and control of the fixed line network. These include examination of access rules with a view to implementing a code of conduct; accounting separation between Telikom's fixed and mobile services; and reworking of the regulatory contract.

##### **4.4.3.2 Aviation**

Despite the "open skies" policy, the international aviation market in PNG has not seen new entrants for some time, aside from the limited competition on the Port Moresby/Cairns and Port Moresby/Brisbane routes. A code-sharing agreement has been in place between Air Niugini and Qantas since 1987. A number of public benefit claims have been made in support of this agreement but it has not been subjected to scrutiny under the authorisation provisions of competition legislation in either PNG or Australia.

In its review of the industry, the ICCC has indicated it proposes to examine the matter before any replacement agreement is concluded.

Reforms to improve the performance and financial capacity of the CAA are continuing, including the transfer of assets and liabilities from the State to the CAA to place it on a stand alone financial basis. Further reforms are being planned to improve the operating structure of the CAA that will allow a more independent and business-focused approach to the delivery of its services.

##### **4.4.3.3 Ports and Shipping**

The ICCC was tasked with reviewing the coastal shipping and stevedoring sectors. It was also requested to report on tourism (which is affected by the efficiency of ports, shipping, aviation and airports) in conjunction with the PNG Tourism Promotion Authority.

Reports on all these reviews have been made and practical steps to improve the efficiency of relevant sectors are being implemented.

#### **4.4.3.4 New Reviews**

The ICCC has been requested to review the wholesale and retail trading sectors, with particular reference to levels of competition and profit margins. The ICCC inquiry will make recommendations that will encourage efficiency of those elements of the vertical supply chain affecting the supply of goods generally.

Another inquiry has been initiated into fire and general insurance. Similar issues of competition and premium levels are of concern in this market. The review will also assess the appropriateness of the current regulatory arrangements in this sector.

#### **4.4.4 Improving the Regulatory Environment**

Appropriate, but not overly burdensome, regulation is an important complement to market development. In 2007, the Government will continue to implement the recommendations of the Foreign Investment Advisory Service review of PNG's investment regime, with a view to streamlining investment regulations and processes, and removing unnecessary impediments to investment.

The Government is determined to enhance private sector led economic growth by addressing regulatory impediments to doing business. As mentioned in the introduction to this chapter, the Government set up the National Working Group on Removing Impediments to Business and Investment ("National Working Group") several years ago to look at ways to lower the cost of doing business. This has had valuable results, such as efforts to reduce the number of days it takes to start a business. Similarly, the Investment Promotion Authority's foreign investment certification process, which deals with applications from foreign enterprises wishing to do business in PNG, after being initiated in 2006, will be strengthened in 2007.

The Government, through the National Working Group, will continue to address impediments to business and investment in PNG with a view to strengthening competition and where necessary improving regulation. The Government has taken note of recent concerns about counterfeit products, which the import/export sub-committee of the National Working Group will consider in 2007.

Regulatory supervision in the financial sector continues to be fine-tuned, especially in the superannuation industry. In late 2006, the Government decided on implementation of the recommendations of the Joint Superannuation Task Force, to improve and strengthen the effectiveness of the prudential regulation and administration of the superannuation industry. Some of the recommendations adopted are directed at improving prudential supervision. Others, with wider community implications, are about enforcement of employers' obligations, withdrawals of members' contributions to finance housing, mandatory coverage for non-citizens, and requirements for superannuation funds to make annual reports and disclosures to members.

The Government has directed the Department of Treasury and the Bank of Papua New Guinea to further review several related issues, including extension of superannuation coverage to the self employed and the informal sector, group-cover life insurance, and the three-month waiting period for mandatory contributions.



As noted above, another potential regulatory reform to be undertaken in 2007 is in fire and general insurance.

#### **4.4.5 Supporting Rural Activities**

The Government is committed to providing effective assistance to agriculture to maximise the contribution this sector can make to the PNG economy.

The 2007 Budget maintains the high level support for the rural sector established in the 2005 and 2006 Budgets through a range of mechanisms, including improved provision of basic services at the district level. This includes improved infrastructure facilities, health services, financing for rural projects and various tax concessions.

The provision of rural services including banking, postal and telecommunications will be facilitated under the DSIP (above, 4.3.3). This program will facilitate increased basic commercial transactions to support agriculture. Part of the program includes increased district police resources, which should also provide increased support for rural activities.

Road maintenance in rural areas will be improved by a continuation of the District Transport Infrastructure Program and a large injection of funds into rehabilitation and maintenance of the five Highlands Provinces feeder roads into the Highlands Highway.

To ensure safety at sea for sea farers, navigational aids will continue to be rehabilitated and maintained and major ports, wharves and jetties will be upgraded and maintained. A water transport trust fund has been established to subsidise the cost of sea transport to the rural population of the coastal provinces.

There will be a sectoral approach taken to address the issue of HIV/AIDS at the rural level that has been neglected in the past. This will involve public-private partnerships, including Development Partners, NGOs, Community Based Organisations and Faith Based Organisations.

The significant tax incentives for the agricultural sector outlined in the recent Budgets under the Green Revolution initiative are described above in Chapter 3.

The Government will continue to take a pro-active approach to ensure these incentives are as effective as possible.

Financing for the rural sector has been supported by the rehabilitation of the Rural Development Bank and continued progress with micro-financing programs.

The Government will continue to explore and support micro-financing programs, which provide microfinance services and facilities to viable, small and medium-sized enterprises as well as community organised enterprises.

The Microfinance Competence Centre will continue to develop institutional capacity of microfinance institutions (MFIs), including savings and loan societies, and micro-credit schemes.

New savings and loan products will be developed with a view to linking the informal sector of the economy, such as rural community saving groups or co-operative societies, with financial institutions. The pilot micro-banking scheme in Wau, established to undertake this exercise, will become the hub of a network of MFIs in several parts of PNG, continuing to provide financial services to the rural population.

A Revolving Finance Facility which had been established to provide loan funding for MFIs to expand their loan portfolios was found to have less demand among the MFIs than expected and has been cancelled. The funds allocated for this facility will instead be used to grow the microfinance industry and to support the work of the Microfinance Competence Centre.

Rural finance is also being supported under the DSIP (above, 4.3.3). For example, one of the major commercial banks, Bank South Pacific, has established branches in some of the recently-established District Finance offices.

The Government recognizes the importance of fisheries to the local markets and the subsistence economy. Through the National Fisheries Authority (NFA) specific programs are in place to promote and facilitate development of provincial and community fisheries. The NFA has taken steps to improve the effectiveness of joint fisheries management and development efforts with provincial governments, encouraging the development of community-based fisheries, and facilitating the Coastal Fisheries Development Program and the Rural Fisheries Development Program.

Forestry continues to be supported through tax concessions, including a reduction and simplification of the log export tax in the 2007 Budget. Three policy initiatives – downstream processing of forest products, national reforestation and eco-forestry – should provide an improved balance between harvest and replacement for sustainable forest use.

The Government has also increased funding in the 2007 Budget for protecting the environment in rural and marine areas. This funding will be directed to administering PNG's environmental laws, to ensure that resources are developed and managed in a sustainable way.