Building a Dynamic Pacific Economy
Strengthening the Private Sector in Papua New Guinea

This report critically analyzes the complex environment for private sector development in Papua New Guinea, showing the country’s potential to capitalize on its vast wealth well into the coming decades. However, to ensure sustainable and inclusive growth, Papua New Guinea needs ongoing reform so that the benefits of future resource exports benefit the entire economy.

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BUILDING A DYNAMIC PACIFIC ECONOMY

STRENGTHENING THE PRIVATE SECTOR IN PAPUA NEW GUINEA


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ABBREVIATIONS

ADB  Asian Development Bank
ANZ  Australia and New Zealand Banking Group
ARB  Autonomous Region of Bougainville
BPNG Bank of Papua New Guinea
BSP  Bank South Pacific
CSO  community service obligation
GDP  gross domestic product
ENB  East New Britain
ha   hectare
ICCC Independent Consumer and Competition Commission
ILG  incorporated land group
IMF  International Monetary Fund
IPA  Investment Promotion Authority
IPBC Independent Public Business Corporation of Papua New Guinea
ICT  information and communication technology
IT   information technology
kg   kilogram
LGIAA Land Groups Incorporation (Amendment) Act
LNG  liquefied natural gas
MTFS Medium Term Fiscal Strategy 2013–2017
NMB  Nationwide Microbank
NPL  nonperforming loan
NTN  National Transmission Network
PNG  Papua New Guinea
PPP  public–private partnership
PSA  private sector assessment
SME  small and medium-sized enterprise
SOE  state-owned enterprise
This report critically analyzes the complex environment for private sector development in Papua New Guinea (PNG). It focuses on the policy and institutional requirements to achieve sustained, broad-based private sector growth. The Asian Development Bank (ADB) prepared a private sector assessment for PNG in 2008, through the Pacific Private Sector Development Initiative (PSDI). This report reviews PNG’s private sector environment against issues identified in the 2008 assessment, and expands the review to the wider economy.

PNG has gone through a period of exponential growth that, over the recent past, places it among the world’s most rapidly developing economies. This growth benefitted from the huge increase in demand for commodities worldwide, particularly in Asia. However, it was also founded on stable fiscal and monetary policies that, together with deep structural reforms in banking, financial services, and telecommunications, unleashed the private sector’s job-creating potential. To ensure sustainable and inclusive future growth, PNG needs further reform to create opportunities for new and existing businesses to expand. Without linkages that promote private sector development, there is a risk that the benefits of future resource exports will not spread to the rest of the economy.

Making PNG a safer, more productive, and easier place to do business will depend on investments in infrastructure and operation and maintenance, reforming the way in which essential services are delivered in a geographically challenging environment, and focusing on improving safety in personal and business transactions. This report analyzes the many unique challenges that PNG faces in achieving its economic and human development goals, and also shows the immense and positive potential for capitalizing on the country’s vast wealth and opportunities well into the coming decades.

I sincerely thank the Government of Papua New Guinea and the numerous members of the private sector who contributed to the analysis. PSDI, a regional technical assistance facility cofinanced by ADB, the Government of Australia, and the New Zealand Government, produced the report. ADB’s Pacific Liaison and Coordination Office and Papua New Guinea Resident Mission provided valuable advice, significant inputs, and logistical support during report preparation.
I trust that this report will provide interesting information and ideas for further discussions and actions to promote a vibrant private sector in PNG.

**Xianbin Yao**
Director General
Pacific Department
Asian Development Bank
I  OVERVIEW

This private sector assessment (PSA) reviews the Papua New Guinea (PNG) key approaches to developing the economy, attracting private investments, and steering market-based growth. It also discusses the major hindrances faced by private investors. The research focuses on policies affecting private sector activities, and suggests and analyzes policy adaptations to place the economy on sustained, high growth rates.¹

ECONOMIC MANAGEMENT

Impressive record on growth, but disappointing impact on poverty. Between 2005 and 2013, the economy grew at an annual 6.4% average, with income per capita reaching $2,010 in 2013.² Growth benefitted from macroeconomic stability and reduced output volatility and, since 2009, was powered by large external inflows into the natural resources sector. However, poverty rates stagnated between 1995 and 2010 and PNG is lagging on progress toward the Millennium Development Goals.

A fraught business environment. PNG has one of the more difficult environments in the world for doing business. A 2012 business environment survey³ shows business security (law and order) is a major constraint, with low confidence in law enforcement and the judiciary. Government–business relations were weak, leading to opportunities for corruption. Other clear constraints lay in infrastructure and services; government regulations and policies; legal frameworks; and the functioning of key public bodies such as the competition authorities, the company register, and the securities commission. Some improvements since the 2007 survey were noted, particularly in political stability and macroeconomic performance.⁴

Transforming the private sector’s role. As international experience convincingly demonstrates, turning the “resource curse”⁵ into inclusive, widely spread growth requires extensive policy reforms that encourage private sector development:

- redefine the state to be a growth facilitator;
- allow an increasingly vigorous private sector to develop;
- strengthen governance with high, transparent, predictable standards in interactions with the private sector;
- adopt comprehensive structural reforms, especially in state-owned enterprises (SOEs);

¹ Research and writing took place in 2014.
⁵ A term used to describe wasteful public expenditures on “white elephant” projects, rent-seeking private sector activities, public corruption in procurement and use of public money, and benefits accruing largely to the well-connected and the wealthy, often seen in resource-rich developing economies.
overall competition within the economy; infrastructure; and land and natural resource management; and

- increase public investments in human capital and infrastructure.

**Commending the government’s development vision.** As early as 2007, the authorities had declared that promoting private-sector-led growth was central to their reform aims; yet, actual performance has not delivered. Little governance improvement has occurred, along with the continued heavy regulatory burden, a strong bias toward resource and credit allocation to SOEs, and weak competition.

**Fiscal stance supports the private sector.**

A rules-based approach to fiscal policy has stabilized the economy, encouraged capital inflows, and kept inflation under control. In future, the large increase in output and exports from 2015 onward arising from the liquefied natural gas (LNG) project will impart a positive shock to the economy. Future LNG projects may come onstream in the 2020s, leading to similar beneficial effects on output and fiscal revenues. However, PNG’s private sector can only thrive if it has confidence in stable, predictable, and prudent long-term fiscal and debt policies, as well as the government’s ongoing commitment to open trade and capital arrangements.

A strengthening of rules-based fiscal policies should smooth the fluctuations. How a sovereign wealth fund is designed and functions is therefore crucial. It should (i) stabilize and sterilize volatile foreign earnings, (ii) create fiscal savings, and (iii) diversify investments to earn higher returns.

**REFORMING BANKS AND CAPITAL MARKETS**

**Sound banks, but reluctant to lend.** The banking system’s soundness has been an important stabilizing factor in the PNG economy. Banks have stable deposit-based funding, high profitability, and adequate capital ratios. Yet, there are indications of insufficient competition and the system is highly liquid. Provisioning is more than adequate. The spread between prime lending rates and the deposit rate is large, recently ranging between 10% and 14%. However, banks have been reluctant to lend, credit to gross domestic product ratios trail those in comparable countries, and capital markets are poorly developed.

**Risk management needs strengthening.** The financial system’s high degree of liquidity indicates the loss of profitable lending opportunities. Other factors affect risk. An absent secondary market in government debt—suggesting that banks tend to hold such debt to maturity—means that government securities cannot be easily liquidated, especially at times of stress. The deposit concentration is also significant: deposits are mainly sourced from companies and government trust accounts which could either flee or convert to foreign currency, and retail deposits are low. These factors suggest that banks should hold capital ratios well in excess of regulatory requirements, which could be raised because of these findings.

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6 Domestic absorption is defined as domestic consumption and investment fed by earnings from hydrocarbon resources.
Encouraging banking sector competition.  
The spreads, high fees and charges, and high margins on foreign exchange trading amid near-monopoly conditions all suggest attenuated competition and highly risk-averse behavior from the commercial banks.

PNG’s central bank, the Bank of Papua New Guinea (BPNG), recognizes this constraint and is attempting to attract new entrants, domestic or foreign, into the market. Meanwhile, BPNG could investigate competition in the banking markets with outside expert assistance. Converting the Teachers’ Savings and Loan Society into a commercial bank could be encouraged, provided it met all the tests for a deposit-taking institution. The recent move by two finance companies to enter the foreign exchange trading market should be facilitated.

The implementation of the secured transactions law will reduce lending risk and provide the foundation for lower risk lending. It is essential that financial institutions rapidly adopt its use.

Reforming the government debt market.  
The current market consists of few participants, mainly the commercial banks and the two major superannuation funds. Widening participation is the key to financial market development, by lowering issuance costs for both government and the private sector. A more developed government debt market will also increase the supply of investible resources to PNG’s economy by attracting foreign capital.

The first reforms should center on the primary market. The number of dealers is too narrow; and the entry conditions, such as the minimum bid size, too restrictive. Given the strong incentives that banks and other current participants have to hold paper on their own books, steps need to be taken to permit retail bidders (the nonbank public, in general) to have a fair chance to bid. An early step could be reducing the minimum bid size, followed by further developing the central bank bill tap facility. Lengthening the duration of issues would also help.

The second set of reforms concern the secondary market. Current liquidity and trading are low, largely due to lack of competition, the financial system’s concentration, and bank behavior. Strengthening repo facilities is essential for secondary market development, as it broadens the demand for securities and increases trading liquidity. It would also permit banks to be opportunistic in trading from their books, knowing that sales would be repurchased at fixed, known prices. Over time, interest rate swap markets could be established.

Improving access to finance. PNG faces four main barriers:

(i) High levels of crime and corruption.  
These restrict cash movements in most of the country, raising transactions costs for all financial institutions.

(ii) Gaps in infrastructure. Particularly poor quality roads, transport links, and electricity shortages make operating financial service infrastructure costly.

(iii) An absence of clear titles to property, particularly land. A secured transactions framework is yet to become operational, and there is a lack of access to other legal (including identification) documents.

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7 The repo (repurchase) facility is a central bank tool for lending to banks using bonds as collateral that are then repurchased by banks at a future date at a fixed pre-agreed price, with the buy and sell price difference being the interest rate the central bank charges on its loan.
(iv) **Low levels of financial literacy.** This makes consumer choice difficult.

For the broader population, financial inclusion has developed rapidly over the 3 years since 2011, with

- renewed commercial bank efforts to offer retail banking services to a broader segment of the population;
- continued growth of microfinance banks; and
- widened mobile money services, permitting savings or deposit transactions and payments.

Legislation to introduce a system for notifying security interests on personal property has the potential to transform financing in PNG. Using movable property (including intangible assets) as loan collateral is an important means for the private sector to access finance for business operations.

The financial review\(^8\) could most usefully concentrate on a set of issues central to re-energizing the financial sector:

- measures to promote competition in the banking system;
- risks and crisis management response in the banking system;
- managing excess liquidity in the banking system—short-term responses and institutional reforms;
- payment systems regulatory reforms, particularly promoting financial inclusion;
- reforms in the primary government debt markets;
- developing a secondary government debt market with policy and institutional reforms;
- measures to promote private capital markets, corporate paper, mortgage instruments—policy and institutional reforms; and
- the role of superannuation funds.

**THE STATE’S ROLE**

The PNG government’s vision for development relies on the private sector as the engine for accelerated, sustained growth. However, translating vision into policy reforms is proving difficult. The state dominates the economy well beyond its traditional, widely accepted role as a supplier of public goods. The tendency toward protection through toughening local content rules or labor restrictions can greatly damage private investment prospects. There is no overall privatization strategy. Some policy reforms toward greater private participation—such as public–private partnerships (PPPs)—remain unimplemented. Experience shows that implementation success requires strong and sustained commitment.

**Clarifying the state’s role is vital, so that the private sector has an explicit framework for making long-term and/or risky investment decisions.** This involves defining a framework for increased private sector participation in the economy, including a role for privatization. The state should confine its role to providing essential public goods (defense, law and order, and justice) and essential services (education, infrastructure, and health). Unfortunately,\

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\(^8\) The government is commissioning a financial review to examine ways to promote financial intermediation and financial inclusion.
the state performs these core functions so poorly that PNG’s scores in human development are disappointingly low.

Security and justice emerged in the 2012 Institute of National Affairs survey as the most pressing concerns for businesses (footnote 3). Approximately 80% of respondents reported that law and order problems influenced their business and investment decisions. Exacerbating this is low confidence in law enforcement and judicial bodies. Current reform measures are constructed around five goals: (i) improved policing, safety, and crime prevention; (ii) increased access to justice and just results; (iii) improved reconciliation, reintegration, and deterrence; (iv) improved accountability and reduced corruption; and (v) improved ability to deliver law and justice services. Yet, progress has been slow and, to ensure improvement, the government needs to establish a tough system for monitoring results.

Gender-related barriers to growth are especially severe. A large gap persists in both the percentage of secondary school and tertiary education enrolments, and overall literacy rates. Health indicators, access to health services, and susceptibility to disease are worse for women. Education gender inequity results in women’s low formal labor force participation. Historically, PNG women exercise attenuated rights in parts of the country over land rights and access, and other assets. Customary law overrules formal equality in divorce and inheritance rights. However, recent reforms in secured transactions using movable assets will benefit women without formal title to land.

In tax and business registration policies, women face greater barriers to formalization such as knowledge and logistics gaps, and ability to pay costs. Those interacting with public officials are disadvantaged, especially where those officials make discretionary decisions. Though female participation is dominant in the rural semi-subsistence economy, women lack access to extension and information services apart from decision-making abilities in land use. Clearly, various public policy actions are essential if PNG is to fully use its labor force. In agriculture, women’s business entities for production and marketing need training and technical assistance to lessen gender disadvantages in marketing chain and cold storage services. In fisheries, enforcing improved compliance with working codes in the largely female fish canning workforce is advisable.

Small and medium-sized enterprises (SMEs) are critical for generating jobs and promoting geographically balanced growth. Public policy should address generic constraints—credit, land, market information, capacity, infrastructure, technology, and business enabling frameworks—as well as alleviating reforms. Policy interventions are important to address skills, with appropriate training services coupled with training incentives. Interventions also need to promote an enabling environment for entry and entry costs; licensing and inspection needs; and to improve the availability and reliability of infrastructure services, particularly electricity and water. Measures to support technology are also necessary, including important improvements in internet broadband quality, reliability, and cost. Business incubator services in selected activities need further attention. However, it is important not to use SME policy as an instrument to exclude potential entrepreneurs,
particularly those who are not PNG nationals. The country needs entrepreneurs desperately, regardless of their national origin.

**Discourage reliance on tax expenditures and subsidies.** The threshold for corporate income taxes, registration for value added tax, and similar should be examined to see the budgetary and tax administration implications of excluding all small and, possibly, some medium enterprises. Protection recommendations, such as reserving activities for nationals and prohibiting migrants with certain skills, are inadvisable. Growth, innovation, and technological advances (including in sectors such as small or medium-scale retailing, tourism services, or the hospitality industry) can come from imported ideas and practices, benefitting PNG’s competitiveness. Local content protection often leads to poor quality goods and services, corruption, or higher production costs that ultimately damage SME prospects.

**Poor governance seriously hinders private sector growth.** Government–business interactions, highly defective public procurement, and public financial management systems particularly invite corruption, with some serious gaps in budget management and accountability. Governance capacity is weak on budget administration, public expenditure choices and spending quality, and managing state ownership in various assets. It is also weak in how efficiently and fairly its regulatory functions are discharged. Significant government spending appears unreported in public accounts, partly due to spending funded from external sources, and partly to resource royalties. Lack of transparency and nonreporting SOEs and autonomous agencies increase fiscal risk.

**Credible and predictable government decisions are undermined by discord and frequent legislative and regulatory changes in policies and decisions.** Conflict of interest risks also arise from the close relationship between politicians and business owners, and from many politicians’ significant personal business interests.

**The tax regime is well designed, but administration is weak.** The regime itself is not a barrier to private sector development. Tax rates and rules (such as the corporate tax rate or rules governing depreciation) are comparable with those in competitor countries. Deficient tax administration is compounded by particularly weak enforcement. The government has established a tax review to improve the system’s competitiveness and efficiency, and encourage investment and employment. While there is a natural focus on personal income, company profits, goods and services, and natural resource taxes, the review should consider the role of taxes on undeveloped alienated land (i.e., land that is not under customary ownership) to encourage its commercialization, and develop well-functioning lease and sale markets. This would address a major constraint to the economy’s growth potential—too-rigid customary land arrangements. The existing ways of effectively taxing resource rents—the state equity participation and the additional profits tax on gas, mining, and other project earnings—should be examined in the tax review. In particular, the ability to make efficient commercial decisions on equity participation, and to manage it, needs closer investigation. A major area for reform is tax expenditures—the range of concessions, exemptions, and holidays introduced in the name of enticing investments, but many of which are counterproductive because they distort resource allocation and reduce the tax base.

**The commercial legal framework is the foundation for all private sector activity.** It establishes and safeguards property rights, provides the legal basis for contracting and exchange of
goods and services, and defends contract sanctity. Examining the existing company law is important, toward modernizing it for a competitive private sector that can raise capital cheaply and efficiently. The government has announced a policy framework supporting the formation of PPPs, with Parliament recently having passed the enabling legislation. Implementing this law will provide a transparent and predictable process for developing and implementing PPPs; this is welcomed by the private sector.

The private sector relies on well-defined property rights to establish, operate, and expand commercial activities. Secure tenure is associated with greater investment, greater savings, higher land prices, and (in some cases) more efficient use of land for agricultural purposes. Secure land tenure also enables private sector businesses to access finance more easily, but improving the ability to enforce rights to land is missing in initiatives to improve the security of customary land tenure. While security of tenure can be enhanced through reforming the communal ownership and registration system, private enterprises need the ability to enforce a right acquired from the traditional landowners to enjoy the full benefit of those rights. Finally, the land disputes management system is overly complex; simplifying it would boost efficiency in land use.

COMPETITION

Policies to promote competition in the economy have been strengthened since 2002. Institutional and regulatory improvements include the Independent Consumer and Competition Commission (ICCC), formed in 2002, regulatory reforms in telecommunications and the entry of private companies in mobile telephony from 2007, and the planned role for PPPs. Competition and efficiency are badly affected by poor or corrupt governance practices, including discretion in decision making and in tax administration. Recent trends toward local content requirements and labor protection dilute competition, leading to countrywide inefficiencies in resource allocation.

A thorough review of competition policy is necessary; it should be broad-based and encompass institutional reforms. Businesses are concerned that certain legislation adversely impacts, and is detrimental to, competition in various areas; and that administrative procedures impede businesses from entering and expanding in markets. Legal, regulatory, and administrative barriers to competition appear significant in some sectors. A comprehensive review is therefore underway, with a view to strengthen and modernize the competition framework.

Enforcing competition, preventing monopolistic or collusive behavior, and protecting consumer rights all require a strong, vigilant, and autonomous competition commission that PNG lacks. The ICCC Act 2002 makes inadequate provision for consumer protection; its competition provisions are expressed in dated and complicated language; and the range of recourse options following Act infringements is limited. This issue is part of the current review.

A further area for inquiry and eventual reform is the relationship between the ICCC and SOEs. SOEs declared “regulated entities” must comply with the terms of a “regulatory contract” issued by

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9 Parliament passed the enabling legislation in September 2014. The tabled bill was passed unanimously with 67 votes to zero, and will be known as the Public–Private Partnership Act 2014 when enacted.
10 Such as the Reserved List.
BUILDING A DYNAMIC PACIFIC ECONOMY—STRENGTHENING THE PRIVATE SECTOR IN PAPUA NEW GUINEA

the ICCC. However, these regulatory contracts may not be serving their intended purpose. The ICCC is concerned that regulated entities can delay responses to draft regulatory contracts and “game” the system. Broader questions are how best to infuse greater competition in some industries (such as ports and electricity), and address the natural monopoly element in some. The current review should examine if regulatory contracts are the best way to ensure SOEs’ adequate competition and high performance.

The legal framework regulating telecommunications providers has improved since the National Information and Communications Technology Act 2009. Wholesale internet access arrangements (through the introduction of PNG DataCo Limited) need monitoring to ensure equal access for internet service providers and fair pricing models. Internet access and pricing are still concerning, with very low rates of market penetration (focused around Port Moresby) and high access prices. This situation arises partly because Telikom PNG owns the only licensed international gateway for internet services through its subsidiary, Tiare. If wholesale internet service pricing follows the tariff schedule in the draft National Broadband Policy, the private sector should experience decreased costs in accessing internet services.

STATE-OWNED ENTERPRISES

The SOE sector is a major source of inefficiency in the economy. It wastes capital, distorts market conditions, tilts the playing field against private investment, and imposes an implicit heavy tax on consumer welfare. It is sheltered by preferential low interest rates; the underlying return on equity is even lower than reported. The corporate governance environment within which SOEs operate is highly defective, and contributes to poor commercial performance. Noncompliance with key elements of the Independent Public Business Corporation of Papua New Guinea (IPBC) Act 2002 has been a problem from the outset, leading to weak governance and accountability. The IPBC has consistently failed to publish annual reports with audited financial statements, and corporatization has not prevented political interference in SOE operations.

There are two further major impediments to efficient SOE operation:

(i) Regulatory contracts for monopoly service providers do not encourage realizing productivity gains. The most promising solution lies in greater contestability through increased private sector participation, backed by hard budget constraints and no SOE bailouts.

(ii) SOEs have been obliged to shoulder a large community service obligation (CSO) burden, without any compensating fiscal transfers. This should change following the 2013 cabinet approval for a new SOE policy, allowing private companies to bid for CSOs.

11 The Minister for Public Enterprises oversees PNG’s SOE portfolio.
12 In March 2014, the government established a new SOE—PNG DataCo Limited—as the wholesale provider for the new National Transmission Network.
13 As agreed with the ICCC.
There is a fundamental need to define SOE policy; or, more broadly, policy on private sector participation. Official SOE policy appears contradictory. While greater private sector participation is envisaged, a recent White Paper on SOE policy and commercial activities calls for expanding SOEs into new sectors under the guise of economic diversification. This ignores decades of international experience.

SOE efficiency will rise with private sector participation under the right incentive structures. PPPs can help raise efficiency and service quality. While it is encouraging that Air Niugini (PNG’s national airline) is to be partially privatized, this should be done within an open and vigorously competitive market. There should be no nationality shareholding restriction. The government has declared that other privatizations will follow, notably in the electricity sector. This is positive. However, developing a clear framework for expanding private sector participation is important, of which privatization is just one element.

The proposed SOE trust structure has no clear direction, with many unanswered questions. The architecture of the Kumul Trust and their operations should closely consider efficiency and governance gains. The Kumul Trust structure would represent an advance in fiscal responsibility and corporate governance, only if:

- The state exercises a professional, arm’s length oversight over its share assets, removing political interference and management.
- Efforts are directed toward achieving higher rates of return through greater commercialization, using market principles and prices and removing all subsidies.
- SOEs’ corporate governance and disclosure standards are raised to best practice standards.
- Regulatory reforms, including reforms of regulatory contracts, are implemented.
- The state indicates its expectations and insists on appropriate SOE dividends, with thoroughly appraised SOE investment plans financed through an appropriate mix of capital, borrowings, and retained earnings.

The relationship between the government asset holding in the Kumul Trust and the sovereign wealth fund operations needs clarifying. Asset management should be seen in a unified context, as both the Kumul Trust and the sovereign fund represent government wealth holdings. It would be advisable to shrink the Kumul Trust holdings into domestic utility, infrastructure, and commercial company shares; and to transfer the resource-related SOE shares to the sovereign wealth fund.

AGRICULTURE

PNG’s reform strategy relies on private sector-led growth. It must consider agriculture and, more broadly, the rural economy (nonfarm rural income, services, and infrastructure) upon which 80% of PNG’s population depends for their livelihood. There has been insufficient public policy and

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15 The Kumul Trust comprises Kumul Mining Holding Limited (including Bougainville Copper, Ok Tedi Mining Limited, and the Ramu Nickel project), Kumul Petroleum Holding Limited (including the PNG LNG Project), and Kumul Corporation Holding Limited.
investment focus on semi-subsistence agriculture, smallholder food crops, livestock, forestry, and fishery activities.

**Public policy’s role lies in strengthening smallholder competitiveness through a range of information and extension services, particularly technology and management.** Complementary investments in roads and power are necessary. Active private sector (particularly exporter) involvement in designing and implementing policy interventions would ensure relevance and effectiveness. Contracting out extension services would enhance their effectiveness.

Agricultural policies are another striking example of how public policy choices need to be reshaped to sharpen future growth’s private sector orientation. Two broad sets of policy questions need to be addressed: prices and intervention, and institutions. Though there has been a significant move toward price liberalization and greater freedom for farmers to sell or export their crops, intervention still prevails. The Kokonas Industri Koporesen (until 2002, the Copra Marketing Board) retains a virtual exports monopoly and the Coffee Industry Corporation has restricted sales, including banning all roadside cherry buyers except in remote areas not serviced by registered processing centers. Licensing operators in trading and exports restricts competition; licensing reforms to allow freer entry of new entrepreneurial talent is therefore advised. Negative effective protection against agriculture is also evident.

**For institutions, the critical constraint is land regime and policies.** Communal (traditional) forms of landholding, rigid tenure, lack of clear titles, and absence of land markets, all show the difficulty in redeploying land to the most productive use. In a world of changing prices and inventive technologies, large potential growth in the agribusiness sector is being stifled. A further institutional gap is knowledge use and dissemination relating to techniques and marketing.

**INFRASTRUCTURE**

**The high cost (or absence) of infrastructure is a major contributor to the cost of doing business.** The state—as the monopoly infrastructure provider—has failed to deliver the scale of needed services. Available services lack quality and are unreliable, and competition and regulation policies need modernizing to meet the growing economy’s needs.

The government has developed sector-specific strategies that give a much larger role to the private sector. Supporting reforms in competition and regulation are highly appropriate and need enacting. Much will depend on whether private sector investments actually occur. Clearly, the regulatory regime, confidence in policy stability, and the appropriate structuring of PPPs supported by a well-functioning concessions law are critical.

**Electricity investments have been fragmented and nonstrategic.** The authorities intend to

- expand private provision;
- rely on competition and reform regulation to assign rights to supply the grid or customers directly;
- limit government to a facilitator and regulator; and

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• adequately fund CSOs from the budget to subsidize supply for below-threshold loads, mainly in rural areas.

It would be important to make markets fully contestable to ensure efficiency of the entire supply chain (from generation to retail). This needs maximum reliance on competition, no national power company privileges, and a level playing field. Implementing the PPP framework will be critical. International experience shows that if the electricity supply’s quality and reliability is satisfactory, households will pay.

**Key infrastructure policy goals are to (i) expand and restore the road network; (ii) ensure adequate maintenance, fully funded (where feasible) through user charges; and (iii) strengthen institutional and management capacity.** The government intends to bring all-weather transport access within easy reach of 95% of the population, by attracting private investment to provide transport services in roads, sea, and air transport. Yet, the government also envisages retaining full asset ownership in roads, ports, and airports with supporting infrastructure—this would significantly constrain private sector expansion and may need reconsidering. PPPs could significantly increase the supply of infrastructure services, particularly transport; and ownership limitations may damage PPP prospects.

**A greatly expanded role for the private sector is envisaged for infrastructure construction (new roads) or maintenance.** This highly welcome development could finally address the serious maintenance deficit buildup if the contractual relationship with the private sector is properly managed. Long-term, performance-based maintenance contracts with local private companies will be vital. This approach will also need government agencies to desist from providing subsidized services through SOEs. The National Roads Authority has made progress in these areas.

**KEY RECOMMENDATIONS**

The PNG government’s development strategy of diversified growth stresses a larger role for the private sector, especially in energy and infrastructure. The recommendations below provide the foundation for identifying reform priorities (Table 1). The recommendations focus on current policies affecting private sector activities, and analyze policy adaptations that are recommended to place the PNG economy on a sustained, high growth path. Since there is an overlap between the various issues and sectors, similar recommendations may appear more than once.

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Table 1: Key Recommendations

<table>
<thead>
<tr>
<th>Challenges</th>
<th>Key Recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transform the role of the</td>
<td>• <strong>Support</strong> the development of a vigorous private sector</td>
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<tr>
<td>private sector</td>
<td>• <strong>Redefine</strong> the state’s role as facilitator of growth, and confine its purpose to provider of essential public goods</td>
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<td></td>
<td>• <strong>Adopt</strong> tough structural reforms in competition, infrastructure, state-owned enterprises (SOEs), land and natural resources management, and the financial market</td>
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<tr>
<td>Reform the finance and</td>
<td>• <strong>Strengthen</strong> risk management policies, and establish a secondary debt market to more easily free up government securities during times of market stress</td>
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<td>banking sectors</td>
<td>• <strong>Encourage</strong> competition in retail banking markets, by investigating potential options for introducing existing financial institutions, which meet the regulatory tests and standards</td>
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<td>• <strong>Define</strong> the structure and operations of the sovereign wealth fund, and communicate intent with the private sector through ongoing dialogue and information dissemination</td>
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<td>• <strong>Encourage</strong> more entrants into the foreign exchange trading market</td>
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<td>• <strong>Reform</strong> the government debt market by lowering issuance costs for both the government and private sector</td>
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<td>• <strong>Reduce</strong> minimum bid size, develop the Central Bank Bill Tap facility, and lengthen duration of issues</td>
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<td>• <strong>Strengthen</strong> the Central Bank’s repurchase facility</td>
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<td>• <strong>Progress</strong> the secured transactions framework by implementing the Personal Property Securities Act 2011; and appoint a secured transactions registrar to advance the new registry (when operational), allowing it to record security interests</td>
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<tr>
<td></td>
<td>• <strong>Conduct</strong> a financial sector review to investigate key issues surrounding market reform</td>
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<table>
<thead>
<tr>
<th>Challenges</th>
<th>Key Recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Clarify the state’s role</strong></td>
<td></td>
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<tr>
<td>• Discourage</td>
<td>toughening of local content rules or labor restrictions</td>
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<tr>
<td>• Develop</td>
<td>an overall privatization strategy which incorporates greater focus on public–private partnerships (PPPs)</td>
</tr>
<tr>
<td>• Establish</td>
<td>a rigorous system to monitor the results of the government’s reform measures to address system law and order problems, including those impacting business and investment</td>
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<tr>
<td>• Implement</td>
<td>clearly defined, accountable, and transparent governance reform and monitoring initiatives to mitigate fiscal risk to both public and independent agencies</td>
</tr>
<tr>
<td>• Discourage</td>
<td>parliamentary discord, and restrict frequent and disruptive legislative and regulatory changes in policies and decisions</td>
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<tr>
<td>• Expand</td>
<td>the current tax review to consider the role of land taxes in redefining land use for commercial purposes</td>
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<tr>
<td>• Reform</td>
<td>the tax expenditures regime and remove the current range of concessions and exemptions (including tax holidays)</td>
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<tr>
<td>• Progress</td>
<td>the policy framework to support PPPs and clarify the nature of the concessions law</td>
</tr>
<tr>
<td>• Strengthen</td>
<td>implementation of the Companies Act 1997 and ensure that the Companies Office has the capacity to effectively manage the registry</td>
</tr>
<tr>
<td>• Simplify</td>
<td>the land disputes management system to allow greater efficiency in land use</td>
</tr>
<tr>
<td>• Reform</td>
<td>the communal ownership and registration system, and strengthen the private sector’s ability to legally enforce acquired land rights</td>
</tr>
<tr>
<td><strong>Promote, encourage, and enforce competition</strong></td>
<td>Carry out a comprehensive review of competition policy, and focus on methods to reduce multisector legal, regulatory, and administrative barriers to competition</td>
</tr>
<tr>
<td>• Make</td>
<td>the Independent Consumer and Competition Commission (ICCC) Act 2002 provisions more accessible and easily understood in simple terms, through an appropriate knowledge and dissemination strategy; clearly outline the existing range of recourse actions following infringement; and consider expanding the range of recourse actions available within the Act’s existing parameters</td>
</tr>
<tr>
<td>• Examine</td>
<td>the relationship between the ICCC and SOEs, and review the current regulatory contract format against best practice SOE performance-based indicators</td>
</tr>
<tr>
<td>• Monitor</td>
<td>wholesale internet pricing arrangements, and ensure that equal access and fair pricing result from following the tariff schedule proposed in the draft National Broadband Policy</td>
</tr>
</tbody>
</table>
### Challenges

#### Continue to reform state-owned enterprises
- **Continue** to implement recent policies toward greater SOE commercialization, and target less political interference in the process
- **Articulate** expectations of dividend payments from SOEs, insist on higher rates of return, raise corporate governance standards to international best practice levels, and fully implement regulatory reforms
- **Enforce** greater contestability through increased private sector participation in providing services traditionally delivered by SOEs
- **Allow** private companies to bid for community service obligation contracts
- **Clarify** the relationship between the government asset holding in the Kumul Trust and the sovereign wealth fund operations
- **Consider** placing the country’s commercial assets into the sovereign wealth fund; and reduce Kumul Trust holdings to domestic utility, infrastructure, and commercial company shares

#### Increase focus on agriculture and agribusiness as a major sector of the domestic economy
- **Integrate** agriculture and the rural economy in the current reform strategy
- **Increase** public policy and private and public sector investment focus on agriculture, fishery, and related activities
- **Actively** involve the private sector in designing and implementing policy interventions
- **Increase** competition by stopping the practice of licensing operators in trading and exports, and implement licensing reforms to encourage entrepreneurial activity

#### Address the crippling cost of inadequate infrastructure and inefficient maintenance services to the economy
- **Modernize** competition and regulation policies to allow the private sector to deliver critical infrastructure and manage asset maintenance services
- **Remove** government SOE asset ownership limitations to increase private sector participation in service delivery and asset maintenance
- **Utilize** PPPs to increase opportunities in infrastructure services delivery
- **Establish** and enforce long-term, performance-based infrastructure operations and maintenance contracts with local private companies
2 INTRODUCTION

This private sector assessment (PSA) supports the Papua New Guinea (PNG) government’s vision by proposing ideas to promote the private sector as the engine of growth. It analyzes the environment affecting private sector businesses, identifies main constraints to private sector growth, and recommends policy adaptations.

Impressive record on growth; disappointing impact on poverty. PNG’s economic record has been successful. Between 2005 and 2013, the economy grew at an annual 6.4% average, with income per capita reaching $2,010 in 2013 (footnote 2). Growth benefitted from macroeconomic stability and reduced output volatility, which was powered by large external inflows into the natural resources sector. Inflows were supported by buoyant commodity prices, improvements in the business climate, and a stable banking industry shielded from the 2008–2009 global financial crisis.

PNG’s economy is open to trade and investment, benefiting economic efficiency and attracting large volumes of foreign capital. The record in ensuring macroeconomic stability and dampening trade and capital flow volatility has improved. Domestic savings and foreign direct investment have supported high investment rates and promoted stability. Resource allocation has become more market-based, although inefficient state-owned enterprises (SOEs) still dominate several critical sectors of the economy. The government’s commitment credibility has improved with greater parliamentary stability.

Still, non-income poverty dimensions have also not advanced, and the country is far behind the Millennium Development Goals. Poverty rates essentially stagnated between 1995 and 2010. Poverty estimates show a rise from 40% in 1996 to 50% in the early 2000s, before returning to 40% in the 2010 household survey.18 About 40% of citizens consumed less than a minimum basket of food and other goods and services in 2010 (footnote 18). Chronic undernutrition and infant and maternal mortality indicators are among the Pacific region’s worst, and improvements have stalled.

Fraught business environment. PNG has one of the more difficult environments globally for doing business. The Institute for National Affairs’ 2012 business environment survey shows business security (law and order) to be a top constraint, with low confidence in law enforcement and the judiciary (footnote 3). Government–business relations were weak, leading to opportunities for corruption. Other clear constraints lay in infrastructure and services; government regulations and policies; legal frameworks; and the functioning of key public bodies such as the competition authorities, the company register, and the securities commission.

Some improvements since the previous survey in 2007 were noted, particularly in political stability and macroeconomic performance (footnote 4).

**Ensuring sustained growth and transforming the private sector’s role.** PNG is the third poorest among Pacific island countries. In spite of the recent rapid growth, income per capita is about 50% below the region’s median. For example, PNG’s income per capita in 2012 was $1,625, while Tonga’s was $4,150 despite the latter’s population being 70 times smaller than PNG in that year. In 2004–2012, PNG’s income per capita averaged around $830, which was the second lowest among eight Pacific neighbors. This gap would be reduced by capitalizing on hydrocarbon resources, but resource exports would be insufficient to ensure high and stable growth beyond 10 years. As international experience convincingly demonstrates, turning the “resource curse” into inclusive, widely spread growth requires these deep policy changes:

- redefine the role of the state to be a growth facilitator, rather than that of intervening in private sector activity;
- allow an increasingly vigorous private sector to develop by improving the business environment;
- strengthen governance with high, transparent, predictable standards in private sector interactions with the private sector;
- adopt comprehensive structural reforms (especially in SOEs), overall competition within the economy, infrastructure, and land and natural resource management; and
- increase public investments in human capital and infrastructure.20

**Encouraging diversification.** Reduced social and ecological vulnerability needs expanded employment, and this requires growing economic diversification. Today’s narrow resource-based output is a source of vulnerability, and expansion in manufacturing (related to agribusiness and light manufacturing) and services (tourism potential is largely untapped) must be given more priority. The need to broaden PNG’s economic base highlights the importance of creating the most favorable conditions for encouraging private sector investment.

**DEVELOPMENT VISION**

The private sector has a central role in realizing PNG’s reform vision to support sustained growth. The government has declared strengthening competition a key priority, and plans ambitious reforms in six areas to boost productivity and international competitiveness:21

(i) encourage SOE efficiency and increase competition in the markets in which they operate, focusing on the telecommunication, electricity, and transport sectors;

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ensure that a strong regulator enforces the competition and consumer protection law so that markets operate competitively; and ethical traders, small businesses, and consumers are not treated unfairly, misled, or deceived;

build productivity in sectors particularly important to rural and remote PNG, e.g. tourism and agriculture;

reduce the cost of doing business and remove regulatory impediments to private sector growth;

develop the small and medium-sized enterprises sector; and

support the informal economy, while encouraging participants to transition to the formal economy.

As early as 2007, the authorities had declared that promoting private-sector-led growth was central to their reform aims; yet, actual performance has not delivered. Little governance improvement has occurred, along with the continued heavy regulatory burden, a strong bias toward resource and credit allocation to SOEs, and weak competition. These points are detailed throughout this report.

PRIVATE SECTOR ASSESSMENT 2008

The Asian Development Bank, through the Pacific Private Sector Development Initiative, completed PNG’s previous PSA in 2008. It found PNG to be high-risk for investment and business, with very high transactions costs—only partly due to geographic challenges. Inconsistent government policies, macroeconomic instability, fluctuations in commodity prices, and a high crime rate resulted in a high risk environment. Meanwhile, factors limiting competition—weak property rights, poor infrastructure, lack of competition, the state’s dominant role in the economy—resulted in high transactions costs. The crime rate also added substantially to doing business costs, which could be likened to a development tax.

The PSA highlighted the private sector’s strong perception of the public sector’s apparent lack of transparency and accountability. PNG also fared poorly in international corruption and governance ratings. The government intruded through ownership and regulation, raising costs and weakening competitiveness. Government ambivalence toward competition resulted in highly inefficient monopolies, while inefficient SOEs provided poor, high-cost services and crowded out the private sector.

Financial markets did not support investment and entrepreneurship. Despite a low ratio of private sector credit to gross domestic product, financial institutions had substantial liquidity, illustrating the risks of lending.

PNG’s rural economy is typically remote, and the 2008 PSA showed it to be poorly served by infrastructure and other services. Getting information and transporting goods to market was an overwhelming challenge, making the transition to a market economy difficult. Yet, there was some optimism. Political stability had improved, the
The macroeconomic situation had stabilized, and the government was committed to strengthening the private sector’s role in the economy.

The 2008 PSA recommended eight policy reforms, and progress (by June 2014) is summarized below (Table 2).

**Table 2: Private Sector Assessment 2008 Recommendations and Progress as of 30 June 2014**

<table>
<thead>
<tr>
<th>Summary of 2008 Recommendations</th>
<th>Progress by June 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Promote competition vigorously by eliminating state-owned enterprise (SOE) monopolies. Generally, policies should be directed at reducing costs and improving service, instead of protecting incumbent SOEs</td>
<td>Little action has been taken in eliminating SOE monopolies.</td>
</tr>
<tr>
<td>Promote competition by supporting Papua New Guinea’s (PNG) Independent Consumer and Competition Commission (ICCC)</td>
<td>ICCC is insufficiently strong to fulfill its wide-ranging mandate, and lacks financial resources and technical skills.</td>
</tr>
<tr>
<td>Promote public–private partnerships (PPPs) to increase investment and improve productivity in infrastructure and service provision</td>
<td>PPP Policy issued in 2008 and Parliament passed the Public–Private Partnership Bill in September 2014. PPP transactions still prepared ad hoc with no fiscal risk management.</td>
</tr>
<tr>
<td>Modernize the legal system to better meet the needs of modern commerce, and to reflect the realities in PNG</td>
<td>Some modernization (the credit bureau and secured lending framework), but critical weaknesses remain in legal system and in enforcing laws and property rights.</td>
</tr>
<tr>
<td>Simplify the system of licenses, regulations, and taxes</td>
<td>Some improvements, but public sector’s discretionary power is too strong and leads to governance failures.</td>
</tr>
<tr>
<td>Promote financial market development by reforming the collateral framework, establish a system for credit information, and promote access to financial services in rural areas.</td>
<td>Impressive progress achieved in all these areas. At end-2014, the electronic secured transactions registry had not been installed.</td>
</tr>
<tr>
<td>Formalize private and public sector consultation mechanisms to arrive jointly at a consensus on reform initiatives and priorities</td>
<td>Fitful progress with some effective dialogue, but no structured systems in place.</td>
</tr>
<tr>
<td>Promote agriculture as a fundamental private sector component</td>
<td>Pricing and marketing reforms initiated, but state intervention still too great.</td>
</tr>
</tbody>
</table>

3 ECONOMIC POLICIES TO SUPPORT PRIVATE SECTOR GROWTH

Recommendations:

- Support the development of a vigorous private sector
- Redefine the state’s role as facilitator of growth and confine its purpose to provider of essential public goods
- Adopt tough structural reforms in competition, infrastructure, state-owned enterprises, land and natural resources management, and the financial market

Quality of overall macroeconomic management is critical to private sector economy success. A steady, predictable, and credible framework for fiscal and monetary policies encourages growth, keeps inflation low, and permits the financial sector to channel credit and encourage savings. Such a framework also gives confidence that unexpected relative price movements will not threaten profitability. Output or inflation volatility creates investment uncertainties and risks.

Fiscal discipline entrenched through rules-based taxation and public expenditures helps anchor private sector expectations. Hallmarks are limited public spending that does not crowd out the private sector, and viability in deficits and public debt. These factors are particularly important in Papua New Guinea’s (PNG) resource-based economy; and the economic stability over the 5 years since 2009, accompanied by an orderly approach to fiscal policy, has been welcome.

Economic management has supported private sector confidence, and economic growth has averaged 6% since 2004. A $19 billion liquefied natural gas (LNG) development project commenced in 2010, with a 20-year production life. This project temporarily accelerated growth to 9%–12% during 2010–2012, and 6% on average in 2013–2014. Growth is expected to peak at 20% in 2015 as gas output goes onstream, but is projected to average at 3%–4% over the medium term. Growth over the medium term could be much higher if future LNG plants are developed as planned.

Predictability in exchange rate policies would assist private sector development. The highly volatile kina appreciated by 37% between October 2009 and June 2012, driven by strong commodity prices. However, it depreciated by 9% between April 2012 and August 2013. Central bank intervention is designed to smooth volatility. In late 2013, the authorities were concerned that a strong kina would...
damage external competitiveness, putting pressure on the nonmineral sector (footnote 23).

In July 2014, authorities acted to counter fundamental market forces and imposed a trading band of 150 basis points around the designated official rate. This led to the kina appreciating by 18%. As foreign exchange from official reserves was not released in sufficient amounts to hold the kina freely within the new band, shortages of foreign exchange at the imposed band were experienced. Worryingly, exports were disadvantaged, particularly agriculture during PNG’s peak harvesting and exporting season.

Such exchange rate actions destabilize production and exports and lead to unpredictable and large swings in profitability across sectors. This dampens private investment. Greater stability is desirable, and can be best achieved through a free, clean kina float, supported by tight, rules-based fiscal and monetary policies. The Bank of Papua New Guinea (BPNG) would intervene as needed to smooth fluctuations and maintain orderly market conditions. Attempting to set exchange rates through administrative decree has a long history of failure worldwide.

Fiscal stance supports the private sector. Two major factors underlying economic management have helped strengthen the private sector. First, the authorities are increasing spending in four “growth enablers” using increased revenues from minerals and hydrocarbons: law and order, education, health, and infrastructure. Second, the authorities have followed a rules-based approach to fiscal policy and have limited public debt to prudent levels. This has helped stabilize the economy. However, there is a need for more stable, predictable, and prudent fiscal and debt policies.

Greater stability needed in fiscal rules. The first fiscal rule was applied over 2002–2007, and called for a balanced budget; that was achieved. The rule for 2008–2012 partly apportioned resource-derived revenues to savings, seeking to insulate the economy from volatility. Resource revenues above the equivalent of 4% of gross domestic product (GDP) were to be used for reducing debt and accumulating trust funds for future public investments. Annual withdrawals from the trust funds were also capped at 4% of GDP. These two rules placed an 8% ceiling on resource revenue spending.

In the Medium Term Fiscal Strategy 2013–2017 (MTFS), the fiscal rule for absorbing resource revenues was suspended; instead, the authorities capped central government debt in relation to GDP at 30% by the end of the MTFS period from 35% in 2013–2014, with the budget also being in surplus by 2017.

The significant relaxation in fiscal policy in 2013–2014 (partly to compensate for a terms of trade deterioration) will need reversing. Besides central government debt projected at 35% of GDP by end-2014, the government has accrued arrears in a superannuation fund and taken a commercial $1.1 billion loan to finance a significant stake in the LNG project through a largely private oil exploration

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analysis/ups-and-downs-kina-has-experienced-notable-volatility-late


26 Terms of trade describes the relative export price compared with imports, expressed as the ratio of export to import prices. For example, see M. Obstfeld and K. Rogoff. 1996. Foundations of International Macroeconomics. Cambridge, MA: MIT Press.

27 Superannuation funds are private pension funds that cover civil servants and private sector employees.
company, Oil Search. The government’s earlier shareholding in Oil Search was mortgaged to finance its stake in the ExxonMobil LNG project. These liabilities brought total gross public debt to nearly the equivalent of 50% of GDP. The official guarantee equivalent to $2.7 billion (15% of GDP) associated with the completion of the LNG project will be extinguished in 2015.

A $1.7 billion loan from the Abu Dhabi International Petroleum Investment Company, in bonds exchangeable upon default for the government’s 14.7% stake in Oil Search, was settled in March 2014.

Finally, the government has a contingent liability through committing large transfers to private landowners affected by natural resource projects.

Credible fiscal rules contribute to private sector confidence. There are two main conclusions from recent experience with stability-oriented fiscal policies. First, despite the evolution of fiscal rules in changing economic circumstances (especially volatility in resource-related earnings), authorities have credibly followed a rules-based and responsible approach to fiscal policy. This removes a major source of uncertainty and benefits private sector investment.

Second, the large increase in output and exports from 2015 related to the LNG project will be a (favorable) shock to the economy, and will need managing. In parallel, there will be a beneficial impact from the projected increase in government revenues (about 5% of GDP). However, the full impact will be felt toward 2020 as accelerated depreciation write-offs against tax payable associated with the LNG project’s capital costs will need unwinding.

Future LNG projects will also come onstream in the 2020s, leading to similar shocks to output and fiscal revenues. These considerations suggest that domestic absorption of hydrocarbon rents should be smoothed, partially through strengthening rules-based fiscal policies. The design and operations of a sovereign wealth fund are crucial.

A well-functioning sovereign wealth fund is crucial for private sector development. PNG’s private sector can only thrive if it has confidence in stable, predictable, and prudent fiscal and debt policies. Investments from capital inflows critically require similar confidence in exchange rate arrangements, open capital markets with full repatriation of dividends and invested capital, and open trade arrangements.

Sharp and unexpected movements in the real exchange rate, and sustained appreciation in the real value of the kina, create uncertainties for relative prices, and deter domestic and foreign investment in the nonresource sectors. Large domestic absorption of hydrocarbon rents also deters investment in traded goods and service sectors. These necessary prerequisites to private sector growth—exchange rate stability, avoidance of large real appreciation, and limiting domestic absorption—can be safeguarded through a well-designed and operated sovereign wealth fund.

Operating rules for the sovereign wealth fund are necessary. The PNG Parliament legislated for a sovereign wealth fund in 2012, but its purpose and governing rules remain undecided. Sovereign funds—investments created and managed by governments or their agents to hold and manage financial assets, usually offshore—can serve three broad purposes: (i) stabilize and sterilize volatile

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28 This investment is being challenged in the courts on constitutional grounds.
foreign earnings, (ii) boost fiscal savings, and (iii) diversify investments to earn higher returns. In resource economies such as PNG’s, the first objective is usually important. But if the volume of earnings over decades is significant (likely with PNG’s untapped mineral and hydrocarbon wealth), the savings motive can help smooth intertemporal equity effects, fund longer-term liabilities like pensions, self-insure against global terms of trade and financial sector shocks, and bolster fiscal sustainability.

In his 2014 budget speech, the treasurer noted that revenue flows from LNG would be volatile, and the sovereign wealth fund was a mechanism to help insulate the economy. The law would be reviewed for the trusts being set up to handle state-owned enterprise (SOE) assets and for intergenerational equity. Thus, there are two objectives to the fund in PNG: insulation against volatility, and savings. To be decided are the relative weights to be accorded to these objectives, and the resulting implication for the operating rules.

**Trade-offs between savings abroad and domestic investment need careful management.** For the private sector, placing a large weight on the savings objective would be desirable, as the tradable sector would be more competitive. However, any savings rule has to operate with balance. PNG suffers from an acute infrastructure deficit, and the rates of return to well-judged and appraised public investments are high. This constitutes a powerful consideration for domestic investment. Indeed, public investment complements and attracts private investment. Simultaneously, savings in a fund insure against future shocks and help safeguard fiscal sustainability. The fund’s operating rule must reflect these considerations.

Expenditure smoothing rules intended to guard against volatility rely on long-term reference prices for the natural resource, typically based on long-term (more than 10-year) moving averages. PNG needs a rule determining these prices for hydrocarbons and different minerals. The savings rule is usually based on some variant of the permanent income hypothesis. That would conserve the underlying asset value (real or financial), and restrict consumption to the earnings from this sum of real and financial assets—the sum of the real return on financial assets plus the present annuity value of the expected resource wealth. A more restrictive approach calls for transfers to the budget to be limited to the returns on financial assets only. This rule makes sense when the overall resource wealth is not large in relation to the economy, and its value or volume is uncertain. Arguably, this is PNG’s case, but it implies tough restrictions on domestic absorption at a time of high infrastructure and social needs.

**PNG could follow these examples.** The private sector economy would benefit from a rule that leads to significant savings, while ensuring that priority investments are undertaken. Timor-Leste offers a practical example; its fund withdrawal formula is 3% of the sum of the value of the fund and the present value of future resource production. Norway operates similarly, with business cycle adjustments; larger withdrawals are permitted in economic downturns. The Alaskan fund mandates that withdrawals can finance only income-generating investments; and only fund earnings, never the

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principal, can be spent or distributed. It also has a countercyclical element. The Russian fund receives oil and gas revenues exceeding 10% of GDP. Withdrawals from the Chilean fund are used to first fund pensions and other liabilities.

The PNG fund operating rules need to be fully consistent with the fiscal rules outlined in the MTFS, limiting deficits and debt. The MTFS illustrates choices and trade-offs, which should be communicated and established transparently. Tensions arise between domestic investment, savings for unfunded liabilities such as pensions, and dealing with future shocks and fiscal risks. To follow countercyclical policies, PNG authorities could focus on structural deficits and determine a variable path.

The government has stated that the fund would have a single governance framework, and be onshore managed, offshore invested, and fully integrated with the budget and fiscal framework. Governance, transparency, disclosure, accountability, and asset management rules would be based on the Santiago Principles. An independent board will oversee the fund. These important principles will help promote private sector confidence in the prudence of future macroeconomic management.

Finally, it is crucial to ensure consistency between the operation of the sovereign wealth fund and that of the Kumul Trust being established to hold other public sector assets. Some of the Kumul Trust will enjoy foreign exchange earnings. This issue is discussed in the SOE chapter.

31 The Santiago Principles are voluntary guidelines reflecting best practice investment objectives and practices for a sovereign wealth fund’s operations.
Domestic financial markets are critical to efficiently and cost-effectively transform savings into credit that finances investment. A freely operating and competitive financial system is necessary for high, sustained growth. While oversight and regulation imposed on the system needs to address safety, prudence, and consumer protection, official intervention should avoid financial repression and distortions in fund allocation. Particularly important is the need for interest rates and the exchange rate to be freely determined, allowing credit to flow according to market forces, and maintaining active competition within the financial sector. Including all sections of society in financial markets through financial literacy and enabling easy deposits, withdrawals, and payments will greatly improve human development indicators.

Recommendations:

• Strengthen risk management policies, and establish a secondary debt market to more easily free up government securities during times of market stress
• Encourage competition in retail banking markets, by investigating potential options for introducing existing financial institutions that meet the regulatory tests and standards
• Define the structure and operations of the sovereign wealth fund, and communicate intent with the private sector through ongoing dialogue and information dissemination
• Encourage more entrants into the foreign exchange trading market
• Reform the government debt market by lowering issuance costs for both government and the private sector
• Reduce minimum bid size, develop the Central Bank Bill Tap facility, and lengthen the duration of issues
• Strengthen the Central Bank’s repurchase facility
• Progress the secured transactions framework by implementing the Personal Property Securities Act 2011; and appoint a secured transactions registrar to advance the new registry (when operational), allowing it to record security interests
• Conduct a financial sector review to investigate key issues surrounding market reform

FINANCIAL MARKETS

Sound banks, but reluctant to lend. PNG’s banking system soundness has been important for stabilizing the economy, shielding the country from the global financial crisis, and supporting private sector confidence.

Banks’ provisioning against nonperforming loans (NPLs) is very high—exceeding 200%—and NPLs to total loans continue to be very low at around 1.5% (Figure 1).

Capital adequacy ratios are high—30% for Tier 1 capital—and comfortably exceed regulatory requirements. These reflect a small loan book, balanced by high holdings of zero-weighted government debt. The loan-to-deposit ratio is just below 50% (Figure 2). However, banks have been reluctant to lend, credit to gross domestic product (GDP) ratios trail those in comparable countries, and capital markets are poorly developed.

The ratio of credit to the private sector to GDP at end-2013 was 34.6%, indicating a significant degree of financial underdevelopment.33

However, this has increased significantly, growing by an average 12% annually over 2010–2013, or in excess of nominal GDP. The financial system remains constrained by geography and remoteness, high levels of crime, corruption, and insecurity restricting cash movements in most of the country; and by commercial laws and justice system weaknesses impeding access to finance. Banking tends to be urban-based with little attention to agriculture and semi–subsistence farming, despite

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80% of the population depending on the farming sector. Bank loans are extended mainly to large and medium-sized formal sector companies; smaller firms find it difficult to access credit. Export-oriented resource projects are typically financed from external sources.

Commercial banks dominate the financial sector, with an aggregate asset to GDP ratio of 120%. Four banks constitute the sector; Bank South Pacific (BSP), Australia and New Zealand Banking Group (ANZ), Westpac PNG, and Maybank PNG. The three larger banks dominate; BSP accounts for half the banking system assets, with ANZ PNG and Westpac PNG sharing the bulk of the remainder.

BSP dominates domestic and regional banking as the largest bank with the widest branch outreach and customer base. It has significant banking relationships with other banks, and is important in payments system operation and other financial architecture.

**Nonbanks are agile.** National superannuation funds hold the equivalent of 22.4% of financial system assets, the largest being the National Superannuation Fund (or “Nasfund”) and Nambawan Super.

There are several savings and loan societies, insurance companies, and finance companies, as well as a microfinance industry with minor aggregate asset holdings. Finance companies’ asset holdings are less than 3.1% of commercial bank assets. Yet, these companies broaden access to credit by lending to nonprime, mainly corporate borrowers; and they are active in the property sector. Their portfolio has a higher risk and return profile (much needed in PNG), and funding through deposits is also more expensive. Their debt–equity ratio is close to 1:1, with the return on equity nonetheless high.

**High bank profits amid insufficient competition.** The prime lending and deposit rate spread is large; in the second half of 2014, it ranged between 10% and 14%. The return on bank equity ranged between 25% and 33% in 2009–2013, while the return on bank assets fluctuated at around 20% over the same period (Figure 3). These rates of return reflect large interest rate spreads, a conservative and risk-averse lending approach; and dominant foreign exchange transactions in overall banking profits with large spreads and fees. Normal banking fees are high, including unusual fees to deposit or withdraw from an account. All these factors point to limited banking system competition.

**Figure 3: Banks’ Return on Assets and Equity, 2010–2014 (%)**

![Figure 3: Banks’ Return on Assets and Equity, 2010–2014 (%)](image)

<table>
<thead>
<tr>
<th>Month</th>
<th>Return on Assets (lhs)</th>
<th>Return on Equity (rhs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 2010</td>
<td>0.0</td>
<td>0.0</td>
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<tr>
<td>June 2010</td>
<td>0.0</td>
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<tr>
<td>December</td>
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<tr>
<td>March 2011</td>
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<td>June 2011</td>
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<td>December</td>
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<td>March 2014</td>
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<tr>
<td>December</td>
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<td>0.0</td>
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lhs = left hand side, rhs = right hand side.
Source: Bank of Papua New Guinea.

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Superannuation funds uniquely provide long-term funding. Superannuation funds are important to PNG’s financial landscape and the only institutions with long-term instruments. PNG has compulsory pension contribution coverage for all public employees and private employees in firms with more than 15 staff, with a lump sum payout upon retirement based on a defined contribution formula. There are currently four authorized superannuation funds (Nasfund and Nambawan Super, Defense Force Retirement Benefit Fund, and Aon Master Trust), and the largest two (Nasfund and Nambawan Super) account for over 93% of total assets.36 Under Bank of Papua New Guinea (BPNG) regulatory requirements, funds can be flexibly invested domestically or overseas. The foreign asset holding is low (the two largest funds’ assets ranged between 9.7% and 13% of their respective portfolios at end-2013)37 for exchange rate risk reasons. Domestic assets are listed and unlisted equity (about 35% of the domestic portfolio), government paper, real estate, and cash (footnote 37). Premature withdrawals from the fund can support a house deposit, as part of a mortgage package.

These funds are important (beyond size) because they dominate long-term investments. With continued economic growth and a youthful demographic, superannuation funds will be important for long-term savings and need careful management. The government needs to eliminate its contribution arrears for public employees, estimated at 6.5% of GDP.38 This will bolster that fund’s soundness. Some asset concentration in property holdings and in BSP equity may need lightening. These funds could also be important in the future development of capital markets, and in the government bond market.

Microfinance serves the less privileged. While microfinance institutions contributed just 0.7% of total assets of the banking sector at end-June 2014, they have a growing role in the rural economy.39 They also serve small urban enterprises otherwise excluded from financial services. The two largest institutions are Nationwide Microbank (NMB) and PNG Microfinance Limited, both established in 2004. These institutions are largely used for savings; deposits greatly exceed loans, with a variety of other assets (including vehicle loans and commercial loans) comprising the balance. Therefore, the microfinance sector is a substantial provider of liquidity to PNG’s financial system, with some liquidity arising from the deposit base used for commercial loans.

BPNG supervises and regulates deposit taking. Microfinance institutions face major challenges in nurturing a borrowing culture. Responsible lending and loan repayment issues, plus high crime rates, are major impediments to expanding microfinance institutions’ loan book.

POLICY REFORMS PROMOTING PRIVATE SECTOR GROWTH

Encouraging Competition

The spreads, high fees and charges, and high margins on foreign exchange trading in near-monopoly conditions all suggest attenuated competition. BPNG appears to recognize this, and is attempting to interest new domestic and foreign entrants in the market. Meanwhile, BPNG could investigate competition in banking markets, assisted by deeply experienced, outside experts with several countries’ expertise in bank competition. Converting the Teachers’ Savings and Loan Society into a commercial bank could be encouraged, provided it met all the tests for a deposit-taking institution. The recent move by two finance companies to enter the foreign exchange trading market should be facilitated.

To infuse greater competition in foreign exchange trading, BPNG could enter the market solely to narrow the spread and reduce transactions costs. Such actions should not influence the exchange rate, which should be freely determined. They should be limited to bringing down the spread and transactions costs. The impact on BPNG’s international reserves and its profitability would be neutral, and the action may only be temporary.

Reforming Government Debt Market

The government debt market has few participants, mainly the commercial banks and two largest superannuation funds.40 Widening participation is key to financial market development, through lowering issuance costs for the government and private sector. This can be directly through forming corporate paper issuances, or indirectly by increasing the supply of bank credit as banks’ return to holding government paper fall. PNG’s macroeconomic conditions, particularly low inflation and a moderate debt burden, are favorable for developing capital markets.

A more developed government debt market will also increase the supply of investible resources to the economy; and attract foreign capital, particularly due to growing interest in liquefied natural gas (LNG) projects and PNG’s future as a resource economy. Foreign participation will help deepen markets, reduce transactions costs, and make funding costs keener. A well-functioning government debt market provides the benchmarks for issuing corporate paper for the market to make risk-adjusted judgments. It is a prerequisite for establishing corporate issuances.

Prioritizing the primary market. The first reforms should center on the primary market, where dealers are too few and entry conditions, such as minimum bid size, too restrictive. Expanding the primary dealers’ group means the investor base and the retail public would be served through a larger set of intermediaries, and benefit from keener prices and greater competition. The commercial banks dominate through their balance sheet, financial infrastructure, and payments and settlement linkages. Further, they supply no liquidity to the bond markets as they purchase bonds to hold to maturity.

40 At end-2013, government securities were Treasury bills (47% of total domestic securities) and government bonds (53%). At the same time, domestic government debt was K8.8 billion ($3.7 billion), equivalent to 74% of total government debt. Sources: Government of Papua New Guinea, Department of Treasury. 2014. 2015 National Budget. Volume I: Economic and Development Policies. Port Moresby. The Bank of Papua New Guinea exchange rate at 31 December 2013 was K1 = $0.413. http://www.bankpng.gov.pg/historical-rates-mainmenu-275 (accessed 12 January 2015).
Modernizing Capital Markets Legislation

The government and the Securities Commission of PNG are proposing reforms and an updating of laws on capital markets. A consultation memorandum has been circulated. The proposed legislation will update the Securities Act 1997 and the Securities Commission’s powers, to widen the range of capital market activities, modernize regulation, and create a central depository body. The securities legislation will improve corporate governance in market participants, create conflict of interest provisions and disclosure requirements, and improve the commission’s enforcement ability. Rules and regulations will comply with the International Organization of Securities Commissions’ international securities principles, and with antimony laundering standards.

The capital markets legislation will introduce a range of securities in equity, debt, and derivatives; widen the range of possible participants and market intermediaries; and better regulate them. Investor protection will also be strengthened.

As the consultation memorandum does not specify the proposed legislative changes, much will depend on the details. While this exercise is important, timely, and much needed in corporate governance areas, an essential purpose must be to strengthen or create incentives for private sector participants in capital markets. Framing the regulations is therefore important. The consultation memorandum proposes that the commission’s approval will be required for potentially intrusive activities, including acquiring or disposing of assets and securities listing and quotation. These should lie with the stock exchange generally, with the

A further step could be to reduce the minimum bid, and develop the central bank tap facility. The duration of issues is unduly short. Given the demand for long-term investments from superannuation funds to match their long-term liabilities, it should be possible to issue and place long-term government debt. Lengthening maturities—measured by average duration of stock outstanding and offering a higher share of inscribed stock of longer maturities (up to 16–18 years)—will also help develop a mortgage market, currently in its infancy.

Strengthening the secondary market. The second set of reforms should concern the secondary market, where liquidity and trading are low, largely due to lack of competition, the financial system’s concentration, and bank behavior. Commercial banks’ dual role as investors for their own accounts and as brokers to retail holders creates a conflict of interest.

Strengthening repo facilities is essential for secondary market development, broadening demand for securities and increasing trading liquidity (footnote 7). It would also permit banks to be opportunistic in trading from their books, knowing that sales would be repurchased at fixed, known prices. Over time, interest rate swap markets could be established again and benefit liquidity in secondary markets. Government bonds transactions clearing and settlement need modernizing. Affiliation with an international clearance system would greatly help bonds marketability, provide liquidity to the market, and promote international recognition for PNG government bonds. Foreign bond holders or bond funds will then be attracted to holding PNG bonds for diversification and yields.

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41 Legislation under consultation are the drafts of the (i) Capital Market Bill 2014; (ii) Securities Commission Bill 2014; and (iii) Central Depository Bill 2014.

commission consulted exceptionally. The possibility of discretionary power should, therefore, be minimized.

**Access to Finance**

With an estimated 85% of the population without any form of banking or financial accounts,43 lack of access to finance critically impedes private sector development. Widening public access, particularly for rural and remote dwellers, to noncash payments or savings has become a policy priority. Authorities have adopted the National Financial Inclusion and Financial Literacy Strategy 2014–2015,44 with an elaborate governance structure for coordination across its diverse objectives under BPNG leadership. The strategy calls for creating a regulatory framework and supporting policies, to widen access to financial products (particularly payments and savings) and improve financial literacy. The envisaged outcome is 1 million new clients becoming banked by end-2015, meaning nearly 25% of PNG’s population would then be banked. At the same time, measures are planned to strengthen consumer protection.

The strategy also calls for including small and medium-sized enterprises (SMEs) through education, and by developing risk-sharing facilities to enable informal sector lending. Mobile and branchless banking through digital technologies is a major focus. Expanding mobile banking will require regulatory reforms on existing systems’ interoperability; and on making wage, pension, and social transfer payments electronically. Prudential guidelines on consumer protection are needed.

**Encouraging progress with inclusion.** Financial inclusion has rapidly progressed since 2011, because of (i) commercial banks’ renewed efforts to provide retail banking services to the broader population, and (ii) microfinance banks’ continued growth. These financial institutions have both introduced branchless banking services (agent networks, and mobile and electronic banking products). BSP and NMB have promoted access to financial services, with Westpac PNG and ANZ PNG becoming active more recently.

The spread of mobile money services permitting savings or deposit transactions, as well as payments, has also been significant. The internet, mobile telephones, and landlines can now be used to place payment or deposit instructions. Five mobile financial service providers have in excess of 300,000 users (BSP’s mobile Wantok Moni, NMB’s MiCash, Digicel’s Cellmoni, Post PNG’s mobileSMK, and ANZ’s goMoney),45 and the number of financial services agents exceeds the number of bank branches in the country. BPNG reported 380,000 active subscribers by July 2013, and 70 million transactions through mobile and electronic funds transfer at electronic point of sale in 2012. In 2013, BSP saw a 100% growth in transaction volumes.46 In July 2014, BPNG’s governor said that the “Bank also made a commitment under the Maya Declaration in Malaysia in 2013 to achieve several goals by 2015, one of which is to increase financial services access

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to one million more of the currently unbanked population in PNG, of which 50% of them will be women (footnote 44). However, while card payments are growing, no common interbank card platform hampers optimal use of automatic teller machines and point of sale architecture.

The mobile payments system is based on the Digicel mobile telecommunications network and linkages with financial institutions’ core banking system. Some payments use the PNG Power Limited prepaid connections system, adding value by spending airtime to purchase power. Other payments systems operate, where participating retailers are paid using payers’ prepaid accounts with a payments service provider. Balance transfers between individual accounts (mobile wallets) are also possible through the telephone and at designated service points. Retail financial institutions and telecommunications companies need to work closely to provide the least cost and effective services—with protection for consumers with weak literacy. There is also a need to fill a regulatory gap to ensure high prudential standards in these new financial services.

Commercial finance provision—market-based, without subsidies, and with proper risk evaluation—should guide policies to increase access to finance and further financial inclusion.

**Secured transactions reform assists financial inclusion.** Legislation to introduce a system for notifying security interests on personal property is welcome. However, its implementation and financial institutions’ take up require monitoring to ensure that it enables businesses to more easily access finance.

Using movable property (including intangible assets) as loan collateral is an important means for the private sector to access finance for business operations. This is especially true for small to medium-sized enterprises that often do not own land to use as security. PNG has substantially progressed reforms in the personal property security system.

The Personal Property Security Act 2011 regulates security interests over most forms of movable property, including equipment, inventory, crops, and vehicles (footnote 47). Act rationalizes the former complex system of security instruments, including pledges, chattel mortgages, and company charges. Further, it simplifies the process for entering into security agreements.

The Act will be effective after the Personal Property Securities Online Registry is fully implemented, scheduled for 2015. Once implemented, the new Act is predicted to reduce transaction costs, provide greater transparency on security interests, and improve creditors’ capacity to enforce their rights upon default.

These considerable efforts at improving inclusion are being supported by donor projects assisting microfinance expansion, and investments in microbanks and BSP.

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Supported by the Asian Development Bank, the Microfinance Expansion Project strengthens microfinance institutions’ and borrowers’ institutional capacity, helps develop lending to small enterprises and the legal and regulatory environment for microfinance, and carries out rural advocacy activities. Further, the Pacific Financial Inclusion Programme supports policies to improve inclusion, and is funded by several donors.

**Financial Review**

The government will review financial sector services, to support private sector development. The review’s focus and terms of reference are unpublished.

**The review should focus on critical reform priorities.** The review should concentrate on issues central to re-energizing the financial sector, to vigorously participate in financing investment and growth.

Issues discussed earlier in this report are:

- measures to promote competition in the banking system;
- risks and crisis management response in the banking system;
- managing excess liquidity in the banking system—short-term responses and institutional reforms;
- payments systems regulatory reforms, particularly promoting financial inclusion;
- reforms in the primary government debt markets;
- development of a secondary government debt market development with policy and institutional reforms;
- measures to promote private capital markets, corporate paper, and mortgage instruments—policy and institutional reforms; and
- the role of superannuation funds.
5 THE POLITICAL ECONOMY

Recommendations:

• Discourage toughening of local content rules or labor restrictions

• Develop an overall privatization strategy which incorporates greater focus on public–private partnerships (PPPs)

• Establish a rigorous system to monitor the results of the government’s reform measures to address system law and order problems, including those impacting business and investment

• Implement clearly defined, accountable, and transparent governance reform and monitoring initiatives to mitigate fiscal risk to both public and independent agencies

• Discourage parliamentary discord, and restrict frequent and disruptive legislative and regulatory changes in policies and decisions

• Expand the current tax review to consider the role of land taxes in redefining land use for commercial purposes

• Reform the tax expenditures regime and remove the current range of concessions and exemptions (including tax holidays)

• Progress the policy framework to support PPPs and clarify the nature of the concessions law

• Strengthen implementation of the Companies Act 1997, and ensure that the Companies Office has the capacity to effectively manage the registry

• Simplify the land disputes management system to allow greater efficiency in land use

• Reform the communal ownership and registration system, and strengthen the private sector’s ability to legally enforce acquired land rights

THE STATE’S ROLE

The Papua New Guinea (PNG) government’s vision for development relies on the private sector as engine for accelerated, sustained growth. Authorities are enacting policy changes and measures to strengthen the competition and regulatory framework, improve public administration, sharpen incentives for private sector investment, reform the financial system, invest in security and infrastructure, build human capital, and enable a series of sector-specific improvements.

Translating vision into policy reforms is difficult. The state dominates the economy well beyond its traditional, widely accepted role as supplier...
of public goods. It plays an important role in production and infrastructure through state-owned enterprises (SOEs), utilities, and in services such as aviation. Several sectors are closed to private participation; others are contestable (in theory), but SOEs dominate and their significant privileges disadvantage private investment. There is a tendency toward protection through toughening local content rules or labor restrictions. These policies greatly damage private investment prospects.

An overall policy framework for private sector participation in the economy is needed, including privatization. Some policy reforms toward greater private participation are in early development, e.g., through public–private partnerships (PPPs). Yet, these reforms risk being compromised by other draft policies, such as the White Paper on state investment and participation in commercial activities aiming to actively expand SOEs’ role in the economy (footnote 14).

There is a need to urgently reduce the state’s role, except in public goods. Clarifying the state’s role is crucial, so that the private sector has a clear framework for long-term, potentially risky investment decisions. It would be wise to almost completely diminish political risk, and create a strategy for increased and integrated private sector participation in the economy. This must encompass SOE management and governance policies, privatization, private capital access, and changes in taxes and regulations.

For PNG, there is a strong argument that the state should confine its role to providing essential public goods (defense, law and order, and justice) and essential services (education and health). Unfortunately, the state performs these core functions so poorly that PNG’s scores in human development are disappointingly low. Moreover, public expenditures on these functions are low (despite increases envisaged in recent budgets), and severe capacity limitations exist. Expending resources and talent on running SOEs is wasteful. If the private sector is allowed to expand into SOE-controlled or -dominated areas, resulting output gains and tax revenue increases could pay for essential public goods and services.

This chapter examines the state’s role in boosting private sector prospects. It discusses two critical public goods the state must supply: security and justice; and high standards in governance. It also analyzes the legal framework and other factors affecting business.

**SECURITY AND JUSTICE**

Law and order’s constraints to business were highlighted in the Institute of National Affairs’ 2012 survey, emerging as the most pressing concern and the top priority for government action (footnote 3). Approximately 80% of respondents reported that law and order problems influenced their business and investment decisions. The state’s highly inadequate security provision is never fully resolved by private spending on safety and security services. Many growth opportunities are unmet because the movement of cash, goods, and personnel is too risky. This particularly disadvantages the poor, and rural and remote areas. Security spending erodes competitive advantages. A 2002 paper calculated

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that businesses’ “crime tax” amounted to nearly 9% of turnover—equivalent to around 30% of profits, assuming an average return on capital.

**Poor confidence in enforcement and justice.** An exacerbating factor is most businesses’ low confidence in law enforcement and judicial bodies, falling dramatically in recent years. Around 50% of those surveyed were unconvinced that the judicial system would prosecute law breakers and enforce contracts.

**Complex security and justice problems.** The problems reflect a rapidly modernizing and urbanizing economy, still predominantly rural and geographically difficult. Intrasocietal competition partly arises from unequal access to public services, such as education and skills training. This exacerbates the causes of lawlessness and conflict. Poverty worsens with crime and insecurity’s effects on investment, poor property rights protection, and theft. Lack of access to justice, and its weak quality, especially trap the poor and dampen economic activity.

**Slow reform results.** The government has pursued a law and justice reform agenda since 2009, but results have been slow. This agenda reflects PNG’s development vision, and is expressed in medium-term development strategies and sector documents. The approach recognizes that complementary formal, informal, and traditional justice systems will be effective. The strategy is based on institutional improvements in security and justice systems, and on greater focus on crime prevention and restorative justice. Budgetary outlays for law and justice are to be increased over the medium term, as security is considered one of four major growth enablers.

Reform measures are constructed around the goals in Table 3.

Despite reform efforts, clear improved results in law and justice are elusive. Security problems are partly cultural and partly gender-based, but reflect the state’s weak capacity. Institutional law and justice improvements and improved practices have not led to significant gains in service delivery. An analysis stated, “[…] there is little evidence of a causal relationship between institutional strengthening elements sponsored under [donor–supported] programmes and impact at the real world level.”51 The report concluded that results would be achieved only through coordinated multiagency presence and responses.

For policy reforms to achieve transformational change, support for agencies and institutions (such as village courts) must be supplemented by approaching people’s needs directly and focusing on issues which enjoy political mobilization and support for change. Incentives must encourage agencies to collaboratively find solutions. This requires a thematic, problem-solving approach and flexible implementation to support shifting and emerging priorities and opportunities. It also requires working with communities and stakeholders to innovatively mobilize the private sector.

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### Table 3: Reform Measures

<table>
<thead>
<tr>
<th>Goals</th>
<th>Recommendations</th>
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</table>
| 1. Improved policing, safety, and crime    | **(i) Rebuild a professional police service that meets all legitimate community expectations**  \[
|   prevention                               |   • Strengthen structures to improve police accountability and discipline                                                                      |
|                                             |   • Involve the community in determining policing priorities                                                                                |
|                                             |   • Improve core operational and administrative practices                                                                                  |
|                                            | **(ii) Increase support for community-based crime prevention**  \[
|                                             |   • Increase support for local-based initiatives                                                                                        |
|                                             |   • Promote coordinated engagement with the formal sector                                                                                   |
|                                            | **(iii) Support select high priority initiatives**  \[
|                                             |   • Improve urban safety, especially in Port Moresby                                                                                  |
|                                             |   • Improve highway and resource project safety, especially in the Highlands                                                               |
|                                             |   • Reduce the number and use of guns                                                                                                       |
| 2. Increased access to justice and just    | **(i) Remove obstacles that prevent access to just results**  \[
|   results                                   |   • Develop community awareness of legitimate human rights and the legal system                                                          |
|                                            |   • Simplify key laws                                                                                                                      |
|                                            |   • Improve access to legal, paralegal, and community-based advocacy services                                                            |
|                                            |   • Resolve cases in courts and commissions quickly and fairly                                                                               |
|                                            | **(ii) Strengthen locally based nonviolent dispute resolution**  \[
|                                            |   • Recognize, reinforce, and support mediation and customary practices that restore harmony in relationships between people and within communities |
|                                            |   • Strengthen village courts to resolve cases quickly and fairly                                                                            |
|                                            |   • Support magistrates to work regularly in each district                                                                                |
|                                            |   • Increase capacity to resolve land disputes                                                                                              |
|                                            | **(iii) Promote robust and independent courts and commissions**  \[
|                                            |   • Guarantee independent judges, magistrates, state law officers, and ombudsmen                                                            |
|                                            |   • Support courts and commissions to maintain due process and fairness                                                                    |
| 3. Improved reconciliation, reintegration, | **(i) Encourage and support communities to reconcile offenders and victims nonviolently**  \[
|   and deterrence                            |   • Build capacity to support crime victims                                                                                                 |
|                                            |   • Develop and promote rehabilitation initiatives including diversion                                                                     |
|                                            |   • Support integrating offenders into their communities                                                                                |
|                                            | **(ii) Provide alternatives to imprisonment for less serious crimes and those awaiting trial**  \[
|                                            |   • Promote new national sentencing policies                                                                                               |
|                                            |   • Support increased use of alternatives to imprisonment                                                                                  |
|                                            | **(iii) Maintain a national correctional system for persons who are a risk to society**  \[
|                                            |   • Contain serious offenders humanely and securely                                                                                         |

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Table 3  continued

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<th>Goals</th>
<th>Recommendations</th>
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<tr>
<td>4. Improved accountability and reduced corruption</td>
<td><strong>(i) Ensure accountability for corruption and the abuse and misuse of power</strong></td>
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<td></td>
<td>• Review and propose improvements regularly for leadership, accountability, and criminal laws</td>
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<td></td>
<td>• Reduce officials’ abuse of power and corruption when dealing with the public</td>
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<td></td>
<td>• Increase state capacity to detect, investigate, expose, and prosecute corruption and the abuse and misuse of power</td>
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<td></td>
<td>• Enforce anticorruption laws</td>
</tr>
<tr>
<td></td>
<td>• Increase awareness and education about ethics, and leadership values, roles, and responsibilities</td>
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<td></td>
<td><strong>(ii) Encourage civil society oversight of public administration</strong></td>
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<td></td>
<td>• Support civil society activities that expose corruption and the abuse and misuse of power</td>
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<td>• Encourage agencies to respond openly to public scrutiny</td>
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<td><strong>(iii) Reduce claims against the state</strong></td>
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<td></td>
<td>• Reduce opportunities for making claims against the state</td>
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<tr>
<td></td>
<td>• Improve agency capacity to defend claims</td>
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GENDER-RELATED BARRIERS TO GROWTH

The private sector thrives best in economies that fully use all their people’s skills. International research shows that a diverse workforce with gender-equal treatment produces the highest productivity gains as it maximizes employed labor’s contribution. Therefore, private sector assessments (PSAs) must analyze barriers to economic participation for both men and women. Around 85% of PNG’s rural population operates in the informal sector, relying on subsistence farming, fishing, and gathering. Creating conditions to shift from the informal to the formal economy will allow this group to access the formal economy’s many advantages. This includes access to credit and dispute resolution systems, and protection from harassment as entrepreneurs and workers.

Women are severely disadvantaged in PNG’s private sector economy, as social and cultural practices militate against them. Public policies have inadequately addressed women’s opportunity and achievement gaps. Given human capital’s important role in sustaining growth, it is disappointing to see a large, persistent gap in female secondary school and tertiary education enrolment and literacy rates, especially in rural areas. Gender-based violence remains an immense constraint to women’s autonomy, and girls’ safety affects their school attendance. Women fare worse in health indicators, access to health services, and susceptibility to disease.

Gender inequity in education is one cause of women’s low formal labor force participation. While better represented in the public service, women still constitute less than 25% of public sector52 employees. Only 12% of senior level public sector employees are women, and the judiciary is nearly 90% male. Entering the formal sector is difficult as women cannot access the collateral required for loans, and often need their salaried husbands as guarantor. Initiatives aiming to expand access to financial services, including for women, include the ADB-supported Microfinance Expansion Project (footnote 44) and the Pacific Financial Inclusion Programme. The recently opened Women’s Micro Bank53 focuses on women’s economic empowerment, offering loans to members with a savings account with the bank. While the bank’s Meri Business Loan product provides K1 million–K15 million for informal and formal businesses, larger small and medium-sized enterprise loans are offered to those with a 30% equity contribution.

Women face greater harassment than men when doing business. Mobile telephone banking technology attempts to address this problem, by enabling women to deposit their earnings into a bank account before leaving the markets. This method could prove useful elsewhere.54

Lack of access to finance and the judicial system could disadvantage women seeking to register a business, and successful women entrepreneurs are usually landowners or well educated. In 2013, more women in rural PNG were in paid work, than

53 The first Women’s Micro Bank Limited branch opened in Port Moresby in August 2014.
in 2003. However, these jobs tend to be unskilled, menial farm and factory work with few women actively participating in the private sector.\textsuperscript{55}

Historically, PNG women exercise attenuated rights in parts of the country over land rights and access, and other assets. Formal equality in divorce and inheritance rights is abridged by customary law and a pluralist dispute resolution system. However, recent reforms in secured transactions using movable assets will benefit women who lack formal land titles (footnote 47). Women dominate retail marketing, subsistence sector, and rural semi-subsistence food production, but have limited autonomy in decision making and controlling businesses and assets.

In tax and business registration policies, barriers to women’s formalization include knowledge and logistics gaps and ability to pay fees. Women dealing with public officials also face disadvantages due to discretionary decisions; it is therefore very important to simplify or eliminate regulatory processes. Making payments and saving through mobile telephones has significantly benefitted women’s financial inclusion, but a large potential for improvement remains.

Though women predominately participate in the rural semi-subsistence economy, they are disadvantaged in accessing extension and information services in land use. Greater female employment in the extractive industries would help productivity by fully using the available labor force. This would also ease social burdens arising in a mostly male labor force, including the toll on families and prostitution. Greater representation of women’s interests in mining decisions—including environmental impacts of mining operations and community sustainability beyond the exhaustion of mines—has led to more effective outcomes elsewhere and should be standard good practice.

Clearly, public policy action is essential if PNG is to fully use its labor force. Attention to the Millennium Development Goals on education, gender parity in secondary school enrolment, quality tertiary and vocational education, and equal access, are critical to long-term results. Equal opportunity for private sector participation requires continued attention to appropriate deregulation and simplifying business processes. Improvements in access to finance, and using movable property as registered collateral, also do much to correct the gender disadvantage.

In agriculture and fisheries, it would be important to foster women-owned companies for production and marketing. These companies—owned by several women farmers—should receive training and technical assistance to lessen gender disadvantages in marketing chains and cold storage services. This will also enforce improved compliance with working codes in the largely female fish-canning workforce. In the extractive industries, sound models for training women in skilled employment such as machine operators and truck drivers should be encouraged as best practice for other companies (footnote 52). It is also vital to reform the Employment Act 1978, which prohibits women’s employment between 6 p.m. and 6 a.m. in certain types of work, and from holding

certain positions in extractive industries unless in a managerial role.56

ENCOURAGING SMALL AND MEDIUM-SIZED ENTERPRISES

Adopt an effective strategy to support SMEs. The government has detailed a strong strategy to support the sector, noting its potential for generating jobs and promoting geographically balanced growth. The strategy examines generic development constraints—credit, land, market information, capacity, infrastructure, technology, and business enabling frameworks—and policy reforms to alleviate these constraints. It also discusses a large range of sector-specific policies.

Need to focus on the business environment for SMEs. It would be advisable to concentrate efforts on generic problems, especially skills (training services coupled with training incentives) and the enabling environment. The environment relates to entry and entry costs, licensing and inspection needs, availability and reliability of infrastructure services (especially electricity and water), and measures to support technology. That should focus on improving the quality, reliability, and cost of internet broadband, and also on business incubator-type services in selected activities.

Discourage reliance on tax expenditures and subsidies. The threshold for corporate income taxes, registration for value added tax, and similar measures should be examined to see the budgetary and tax administration implications of excluding all small, and possibly some, medium enterprises. Local content protection—with certain activities reserved only for nationals, and prohibiting migrants with certain skills—is inadvisable. Much growth, innovation, and technological advance (even in small or medium-scale retailing, tourism, or hospitality) can come from imported ideas and practices. These add to a country’s competitiveness. Protection often leads to poor quality goods and services, corruption, or higher production costs that ultimately damage SMEs’ prospects.

GOVERNANCE

Poor governance seriously hinders private sector growth. Prevailing governance standards greatly affect prospects for private sector growth. Success relies on a standard, well-understood process for making government decisions, predictability in policies and decisions, respect for the law, and rules-based government behavior with minimal discretion. PNG has enjoyed a much more stable government in recent years. This follows constitutional and legal changes, though arguably some limitations on Parliament test limits of acceptable democratic practice. This stability has led to greater confidence in policy formulation and implementation. Even so, the principle of collective cabinet responsibility is often breached; ministers make varying policy pronouncements, often inconsistent, resulting in a lack of clarity for government policy. This is experienced in sensitive areas such as taxation, financial sector reforms, and the business climate.

Governance, commitment, and quality should be addressed. The private investor and general public are both interested in three main issues: governance capacity and incorruptibility, commitment to adhere to decisions, and the quality and availability of public goods. The 2012

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Institute of National Affairs survey showed that 57% of respondents had been “fairly” or highly affected by government corruption (footnote 3). About 30% of companies said that, in their experience, it was “mostly or always” common to make irregular additional payments to government officials. Land administration was a focal point for corruption, followed by finance, tax and customs agencies, tenders (procurement), SOEs, and labor regulations. In the 2014 Corruption Perceptions Index prepared by Transparency International, PNG ranked 145 out of 175 countries.57

**Government–business interactions offer opportunities for corruption.** As in many countries, interactions over licensing, inspections of business premises and equipment, access to infrastructure connections, and permits of various kinds offer opportunities for corruption. As discussed later, the case-by-case negotiation of tax exemptions and other fiscal privileges for businesses—affecting potentially millions of revenues foregone—is particularly problematic. It is crucial to remove the discretionary powers of the state, state ministers, and officials. Further, authorities need to enact rules-bound criteria over the widest range of regulatory decisions, minimizing face-to-face interactions between business and government. Other countries have shown that electronic applications and decisions, online systems, and e-governance would help lessen corruption.

**Public finance management invites corruption.** Governance capacity relates to budget administration, public expenditure choices, and spending quality. It concerns state ownership management for various assets, and how efficiently and fairly the state discharges its regulatory functions. Public procurement is a particular problem, with a highly defective system in PNG that resists reforms, despite strong development partner efforts over many years. There is no impartial tender system, processes are weak and widely evaded, and corruption is believed rampant.

Procurement corruption results in many businesses being deterred from competing, and from offering quality goods and services at the most competitive prices. Companies with connections, and who are willing to “work the system,” find success. The system rewards those who corrupt the system.58

The legislative framework underlying budget and public finance management is sound, and budget preparation and information disclosure are appropriate because of the Fiscal Responsibility Act 2006.59 The budget is now presented with current and capital spending integrated, in a medium-term context. As noted, the operation of the fiscal rules has promoted stability.

However, budget management and public financial management and accountability include serious gaps. Implementation of the budget and public finances reveal governance weaknesses that give rise to corruption. Though expenditure controls exist on paper, they are routinely violated with impunity—undermining budget accountability and integrity. There appears to be unauthorized funds diversion, particularly in regional transfers for development; and transparency in budget execution is lacking. Accounts remain active well beyond the end of the fiscal year.

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58 Encouragingly, the draft PPP law provides for transparency and predictability in procurements, and is an example for further reforms.
There also appears to be significant unreported government spending, partly related to spending funded from external sources and from resources royalties. Inadequate monitoring and reporting of SOEs and autonomous agencies enhances fiscal risk. Areas requiring particular attention to minimize general risk of diversion of funds are the effectiveness of internal controls for non-salary spending, cash balance recording, debt and guarantees, and internal audit effectiveness. One important concern is control over disbursements from bank-held trust fund accounts. Reforms are important in all these areas.

The implications of these public finance management deficiencies for private sector development prospects are clear. Unauthorized spending is diverted to favored companies and not subject to even the weak procurement system. A budget with limited meaning or significance provides little guidance on government priorities.

A formal Commission of Inquiry into the Department of Finance in 2009 found serious violations in public funds use. It also found evidence of serious corrupt practices in land, police, and civil works; and in procurement of goods and services. In natural resources, a 2012 Greenpeace report found that public revenues through the extractive industries had been widely dissipated. Moreover, land has been a rich source of corruption, especially through improper leases extended under a public scheme, the Special Agricultural and Business Leases.

**Credibility in commitment is low.** As noted, government predictability in decisions is undermined by discordant voices, and by frequent legislative and regulatory changes in policies and decisions. Moreover, the 2012 Institute of National Affairs survey showed serious concern with stability of rules, regulations, and policies, with an extraordinary 80% being concerned or highly concerned (footnote 3). Similar percentages of respondents were also concerned about retrospective changes to rules and regulations. Retrospective changes are particularly damaging to business confidence, as they undermine credibility in the investment environment. Changes also impose severe adjustment costs on business, and reverse judgments on profitability. Business confidence in the full implementation of policy announcements is worryingly low.

**Conflict of interest rules are absent.** Due to the close relationship between politicians and businessmen, many politicians’ strong business interests severely deter private investment as favoritism could be seen to affect fair business conditions. A 2003 review of medium-sized businesses showed that many were partially or fully owned by current or former politicians. The lack of conflict of interest rules is a serious governance weakness, encouraging political nepotism and a patronage system.

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The anticorruption strategy is much needed.
In 2011–2012, the government reinvigorated its anticorruption efforts by improving its strategy and setting up institutions. The Prime Minister stated in Parliament that the strategy would counter corrupt acts such as public official bribery, misappropriation of public money or assets through abuse of office, procurement violations, conflicts of interest in decisionmaking, and nepotism. Various agencies and task forces exist and authorities intend making efforts to implement the recommendations of past corruption inquiries and developing modern legislation, such as freedom of information. The Independent Commission Against Corruption legislation was passed in 2014, and the Ombudsman Commission remains active as the administrator of the leadership code. Much will clearly depend on implementation.

REFORMING THE TAX SYSTEM
A well-designed regime, but weak administration. The tax regime is not a barrier to private sector development, with tax rates and rules (e.g., the corporate tax rate or rules governing depreciation) similar to competitor countries. Yet, tax administration is deficient, with particularly weak enforcement. The resulting tax burden on companies is unpredictable, and those that escape taxation through enforcement gaps present unfair competition to tax-paying companies. This is magnified with poor tax department administration, partly due to inadequate human resources management and insufficient public sector salaries. Customs administration has similar weaknesses.

Tax review offers a reform opportunity. The government is reviewing the tax system’s competitiveness and efficiency to encourage investment and employment; boost fairness and simplicity; recommend practical options to change the mix between the taxation levels on land (including resources), capital, and labor; and improve taxpayer compliance. The review encompasses

- personal income tax;
- corporate income tax;
- excise and customs tariff arrangements;
- goods and services tax;
- mining and petroleum taxation;
- land, property, and capital gains tax;
- nontax revenue (including charges and levies);
- tax administration (including its efficiency and simplicity, and taxpayer compliance);
- small business taxation; and
- the role of tax incentives.

Land taxes. While naturally focused on capital and natural resource taxes, the tax review should consider the role of land taxes to encourage its commercialization and develop well-functioning land lease and sale markets. This would potentially address a major economic growth constraint—too-rigid customary land arrangements. This topic is discussed in the following chapter. If land tax proceeds were to entirely or largely flow to provinces and local governments, political economy resistance to such a tax might ease greatly.

Natural resources. Improvements in the tax regime on minerals, oil, and gas would sharpen PNG’s international investment competitiveness

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54 Parliament passed the Independent Commission Against Corruption Bill in February 2014, with an overwhelming vote of 91 to zero in favor.
and also ensure sufficiency of tax revenues. Natural resources have a bright future. Copper, gold, nickel, and other mines have commenced operations and two major copper–gold projects look promising. Mining companies pay the standard corporate tax, an ad valorem royalty of 2.25%, but enjoy a number of concessions on other taxes and tax rules (such as depreciation). They can also enter into fiscal stability agreements with the government.

The gas sector also has great potential. Besides the current liquefied natural gas (LNG) project with an estimated gas reserve of 9 trillion cubic feet, three other projects are under consideration: the InterOil Corporation’s LNG project (also 9 trillion cubic feet), the Gulf Province LNG project of 2–3 trillion cubic feet, and a potential offshore aggregation project. New exploration has increased.

The petroleum and gas sectors pay the standard corporate tax rate, plus a 2% ad valorem royalty. Gas projects pay additional profits tax beyond certain thresholds, the tax regime thereby capturing part of the rent element. The hydrocarbon sector’s concessions include project-specific agreements with the government, with tax concessions and stabilization clauses. The royalty is effectively transferred to local governments and landowners related to the project site. The state is then entitled to an equity participation interest of up to 22.5% in any project, with proportionate cost-sharing obligations on exploration, exploitation, and development, under terms and conditions specified in the project agreement.

**Balancing state and investor interests.** For private sector development, the central issue is contract stability and confidence in enforceable agreements. The government’s central issue is that rents are appropriately taxed to the benefit of budget revenues, while safeguarding foreign investment incentives. By focusing on taxing resource rents appropriately, the tax regime would become more progressive—this is likely to reduce political pressure to alter tax rates at times of commodity price booms. As a result, tax regime stability would rise, making PNG more attractive to potential investors.66

**Taxing rents effectively.** The two existing ways of effectively taxing resource rents are the state equity participation, and the additional profits tax on gas earnings.

Decisions on equity participation are sensitive to underlying factors such as project costs, expected earnings, and the opportunity cost on state capital. There are also governance questions surrounding the state’s ability to make such commercial judgments and objectively manage its assets without altering project conditions, especially in difficult times.

The additional profits tax has the characteristic of being a rent tax without the state having to bear any equity-related costs. It requires careful design to preserve investment incentives, especially in determining the uplift or allowance for costs and normal profits before additional taxes become due.

**Equity considerations in local windfalls.** Reforming resource taxation may unequally benefit a landowner or a group of landowners with project royalties. This may lead to political and social pressures, and requires some form of equalization to best fight poverty.

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65 A tax based on real estate or property value, usually paid either at the time of transaction, or annually.
Reforming tax privileges is critical. A major area for reform is tax expenditures, i.e., the range of concessions, exemptions, and holidays provided to entice investments. The legislative framework permits tax and duty concessions to be complex, opaque, and not centrally controlled. Rationalization of these concessions should be considered, as well as amending legislation to vest control of the process in a centralized and transparent committee.

PNG has a wide range of tax exemptions and concessions for the private sector. These are ordinarily exemptions from company tax or deferment of income tax liabilities. The government has commenced policy work on reviewing the overall tax regime and restricting tax incentives. Box 1 discusses typical issues surrounding tax incentives.

Box 1: Shortcomings of Tax Incentives

Tax incentives

- involve a loss of current and future revenue. If a revenue target is to be achieved, taxes must be higher in other activities, harming economic efficiency and compliance and causing inequities.

- are inequitable and inefficient as they create different tax treatments between, and in, sectors; and this leads to distorted resource allocations. Another danger in providing incentives for only a small portion of the economy is that it encourages “exemption creep”—that is, providing an exemption to one sector or activity creates pressure from other similar “worthy” taxpayers for the same exemption.

- create opportunities for tax abuse and corruption. An example is transfer pricing between related parties to ensure profits are made in exempt activities and deductions in taxable activities.

- complicate tax administration and compliance. These complications often arise because of the need to monitor the incentives due to concerns with abuse. The administration and compliance difficulties are especially likely in countries with weak tax administration.

- tend to attract footloose firms that leave as soon as the incentive expires, without lasting employment effects. This is especially so for tax holidays.

- may be redundant as they do not lead to change in the intended behavior. The incentive simply benefits those firms that are, or were intending, to undertake the sought behavior.

Taxes are not the most important factor in investment decisions. Studies suggest that other factors—such as market size, labor costs, infrastructure, and a stable economic and political environment—are likely to be equally or more important.

The benefits of tax incentives may be reversed if a foreign investor is from a country that taxes its residents worldwide (e.g., the United States). In those cases, foreign profits repatriated to the country of residence will be taxed at the residence country rate with a credit given for any tax paid in the source country. Therefore, the effect of a tax incentive is to transfer revenue to the residence country.

Tax holidays are inefficient in promoting investment in new enterprises, which are often unprofitable in the early years and unlikely to benefit from the incentive.

Many tax incentives benefit extractive industries. Special conditions are often negotiated in mining development contracts as required under the Mining Act 1992 and Regulation.67 Conditions can include exemptions, concessional tax rates, and tax holidays. As conditions are individually negotiated, this practice leads to nontransparent negotiations, inconsistency in granting tax concessions, and unfair treatment among businesses in and between sectors.

**Widespread tax incentives complicate and undermine the tax regime.** These incentives encourage business to engage in activities designed to avoid tax, or achieve the best before-tax return on investment. This does not necessarily lead to long-term investment benefitting PNG’s economy, or the business environment as a whole.

**Clear, simple policies on exemptions are necessary.** Rationalizing tax exemptions into a clearer system that avoids increased taxes on businesses is preferable. The system should be centrally controlled, with specific guidelines for business operations guidelines that attract tax and duty concessions. An appropriate model may be an intergovernmental committee that considers tax and duty exemptions; however, the Department of Treasury should have primary responsibility for the committee. Reasons for decisions would be required (and published), with limited ministerial discretion in granting exemptions.

Centralized and rationalized tax and duty concessions would enable businesses to operate evenly and encourage activity where the market sees opportunities. This can be balanced with the need to develop rural areas, with specific guidelines to advance rural development.

**COMMERCIAL LEGAL FRAMEWORK**

The commercial legal framework is the foundation for all private sector activity. It establishes and safeguards property rights, provides the legal basis for contracting and exchange of goods and services, and defends contract sanctity. The content of legislation and regulation is clearly of first importance, as are the speed and efficiency in adjudicating and enforcing legislation, regulation, and judicial decisions.

**A modern Companies Act is crucial.** PNG has two main Acts which govern business formation and operation. First, the Companies Act 1997 is based on New Zealand’s Companies Act 1993. While serviceable, it had not undergone any legislative updates since enactment and needed refreshing. Second, the Business Names Act 1963 was wholly inadequate for the modern world.

The Investment Promotion Authority (IPA) is the registrar for companies and business names, and also for nonprofit associations and family-owned business group entities. IPA also processes foreign investment certification applications. Since 2010, IPA has undertaken a significant legislative and information technology (IT) project designed to update business law and modernize its own operations, including championing legislative reform to the Companies and Business Names Acts.

Unfortunately, the reform was not staged in the proper sequence. A new online registry system went live in December 2013. This system posted biographical information about all registered entities to the internet, which was a significant step forward for IPA and PNG. However, planned amendments

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to the Companies Act and Business Names Act were not passed until October 2014. While the overall reform impetus was correct and some initial results have been achieved, this poor sequencing has resulted in a disappointing overall implementation.

The primary implementation problem was that, as the new IT system was designed to comply with the new legislation, there was nearly a year in which the law and the registry system were unaligned. The mismatch in legal and IT system requirements limited the available functionality of the online system, preventing many filings from being submitted online. This has resulted in a backlog of filings at IPA. It has also prevented any company annual returns being filed in over 12 months.

The government’s top priority, now that the legislation is in place, should be to address the accumulated backlog of filings. While IPA has hired temporary staff to assist, it is uncertain whether enough people are available to process the huge inflow of annual returns expected over the coming months.

In the long term, completing the legislative update and implementing an online registry system will be very beneficial for PNG. IPA’s vision should be applauded in moving this reform forward. In the short term, IPA must process backlog filings more efficiently and move as many clients to the online system as possible.

The Associations Act 1966 also requires fundamental reform. The Act was originally intended to allow the formation of nonprofit entities to serve local communities, and this mandate continues today. However, over time, this entity type has also been transformed into something very different. Many incorporated landowner groups controlling significant mineral reserves now band together under an umbrella association, exploiting a loophole in the Act that leads to lack of transparency. Since reporting requirements regarding an Association’s internal financial matters are very fluid, royalty payments can be directed to the Association rather than to the landowner groups, who have little or no recourse in determining monetary distribution.

Political parties commonly use associations, so determining exactly how funds are received and spent is difficult or impossible. However, reforming the Associations Act 1966 requires significant high level political support, as a significant number of vested interests oppose any changes in the Act.

Clearances for foreign investment are widely seen to hinder investment. Such clearances can be lengthy, require elaborate applications, and could cause misgovernance. Simplifying the information required and clearance processes is advisable. The proposal to establish a 4-week service standard for clearing a properly completed application is encouraging.

Public–private partnerships are the best instrument to address infrastructure deficits. The government has announced a policy framework to support public–private partnerships (PPPs), with the enabling legislation passed into law in September 2014 (footnote 9). This legislation enables concessions. PPPs would help address PNG’s large infrastructure deficit, which damages competitiveness and private investment prospects. PPPs will also enable private sector investments, operations, and service delivery to agreed standards and costs. The government would share risk, guarantee some minimal volumes for goods
or service uptake, and provide the regulatory framework.

The authorities see PPPs providing value for money by using the state’s resources to maximize output, through incentives for the private sector. This approach uses private expertise and skills in capital, risk, financial management, and innovation. PPPs should support only sound projects with high economic and social returns. Private sector firms should undergo a competitive process, with high standards of governance and transparency. The Act also establishes a new PPP Center, reporting to the minister for treasury, to manage PPPs.

Reforming land laws. Approximately 97% of all land in PNG is customary, 2.5% being public land and 0.5%, freehold. Customary title, while recognized in PNG law, disallows temporary or permanent land alienation while under this form of title.

Some form of secure rights over land is vital for private sector growth. This will require a more predictable land leasing system. While legislative reforms have improved the system, there are frequent disputes with lessees. Better dispute resolution and enforcement mechanisms are needed to encourage further private sector investment using customary land.

The private sector relies on security of tenure to establish, operate, and expand commercial activities. Secure tenure supports greater investment in localities, more efficient use of land for agriculture, greater savings, and higher land prices. Secure tenure over land can also enable private sector organizations to access finance more easily.

In 2005, the government began a policy dialogue for releasing land for development. This has entered implementation, with the National Land Development Program. Under this program, PNG has moved to reform its customary land registration system with the Land Groups Incorporation (Amendment) Act 2009 (LGIAA) and the Land Registration (Customary) Amendment Act 2009 (LRCAA). Both were enacted on 1 March 2012.

A common way for landowners to make their land available for private sector development is by forming incorporated land groups (ILGs). Previously, ILGs were fraught with management difficulties, multiple registrations of persons across groups, and competing groups within clans incorporating splinter ILGs. The LGIAA has instituted important reforms, including:

- defining and limiting ILG membership;
- empowering the Registrar of Incorporated Land Groups to refuse or delay registering ILGs when internal disputes relate to the ILG’s representatives, officers, or membership;
- outlining claimed boundaries and disputed areas in the ILG incorporation process; and
- improving ILG management requirements, and defining the minimum number of female management committee members.

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69 Part I. Preliminary, Section 2(1)(e) of the Land Act 1996 states: ‘[...] “customary land” means land that is owned or possessed by an automatic citizen or community of automatic citizens by virtue of rights of a proprietary or possessory kind that belong to that citizen or community and arise from and are regulated by custom.’

ILGs incorporated pre-reform still exist in mid-2014, and must reincorporate under the reformed LGIAA by 1 March 2017.

Reforms to the customary land registration process complement ILG reforms. The LRCAA promotes ILGs voluntarily registering customary land, to be called “clan land.” Clan land can be individual land parcels, rather than customary land in its entirety. This is an additional and more flexible legal arrangement from previous options, in which customary land could be converted to freehold or subject to a complex leasing arrangement. Once registered as clan land, all customary law, except inheritance rights, ceases to apply.

Clan land cannot be registered unless the claimant group owns the land absolutely, or when internal ownership disputes exist. Thus, where land has been registered under the new system, the private sector has additional confidence that there will be fewer land disputes. This provides more security in tenure.

Improved ability to enforce rights to land is missing in the discussion of security of customary land tenure. While security of tenure can be enhanced by reforming the communal ownership and registration system, private enterprises need the ability to enforce a right acquired from the traditional landowners to enjoy these rights.

PNG’s experience shows that customary landowners may not apply to these bodies to settle disputes. Customary landowners have removed tenants from former customary land, regardless of the tenants’ legal rights to occupy and use the land. From a systemic perspective, this reduces business confidence in investing in such land. While this issue could be mitigated by strong relationships with customary landowners, potential investment in these areas is likely to be reduced.

The state’s capacity and willingness to enforce legal rights to land against customary landowners are weak, at best. Landowners are politically powerful, and some will acquire added political strength by receiving natural resource-based royalties.

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71 Land (Tenure Conversion) Act 1963.
72 Land Act 1996. Part III, Division 4, Section 11: Acquisition of Customary Land for the Grant of Special Agricultural and Business Lease.
6 COMPETITION

Recommendations:

• Carry out a comprehensive review of competition policy, and focus on methods to reduce multisector legal, regulatory, and administrative barriers to competition

• Through an appropriate knowledge and dissemination strategy, make the Independent Consumer and Competition Commission (ICCC) Act 2002 provisions more accessible and easily understood in simple terms, clearly outline the existing range of recourse actions following infringement, and consider expanding the range of recourse actions available within the Act’s existing parameters

• Examine the relationship between the ICCC and state-owned enterprises (SOEs), and review the current regulatory contract format against best practice SOE performance-based indicators

• Monitor wholesale internet pricing arrangements, and ensure that equal access and fair pricing result from following the tariff schedule proposed in the draft National Broadband Policy

Policies to promote competition in the economy have strengthened since 2002, with institutional and regulatory improvements, notably the formation of the Independent Consumer and Competition Commission (ICCC), telecommunications regulatory reforms, the entry of private companies in mobile telephony, and the planned role for public–private partnerships (PPPs). These actions will also improve external competitiveness and attract higher volumes of foreign direct investment. However, serious deficiencies stifle competition; and threaten sustained, high rates of market-driven growth.

Weak competition leads to large efficiency losses. Inadequate competition in the financial industry leads to costly services, restricting competitiveness among private firms. Poor or corrupt governance practices (discretion in decisionmaking or tax administration) undermine competition and efficiency. Recent trends toward local content requirements and labor protection dilute competition, leading to countrywide inefficiencies in resource allocation.

A thorough review of competition policy is needed; it should be broad-based and encompass institutional reforms. Businesses are concerned that certain legislation adversely impacts and is detrimental to competition in various areas, and that administrative procedures impede businesses from entering and expanding in markets.

Legal, regulatory, and administrative barriers to competition appear significant in some sectors. Where such barriers impede market entry or expansion, they are likely to damage competition both domestically and internationally. Unless countervailing benefits justify those barriers remaining, they should be reduced and eliminated over time.

Enforcement of competition is weak. The enforcement of competition, prevention of
monopolistic or collusive behavior, and consumer rights protection all require a strong, vigilant, and autonomous competition commission. This is lacking in Papua New Guinea (PNG), where the ICCC is under-resourced and inadequately staffed. Other regulatory institutions in services, including financial services, need strengthening.

**A comprehensive reform agenda is necessary.** Reforms must begin with overhauling the ICCC’s legal and regulatory basis and functions, and its operating methods, skills, and budget adequacy. The ICCC has varied and important functions, including industry regulation, product safety regulation, competition enforcement, review of business acquisitions, and regulatory contracts administration. The fundamental law, the ICCC Act 2002, has three major weaknesses:

- It makes inadequate provision for consumer protection.
- Its competition provisions (Part 6) are expressed in dated and complicated language.
- Remedies for Act infringements are limited.

**Consumer protection is lacking.** The ICCC Act’s lack of effective consumer protection provisions needs redressing. The Act currently provides for product safety standards and compliance monitoring, with weights and measures regulations. Government departments presently perform consumer protection functions. The Act should include a general provision prohibiting misleading and deceptive conduct; and legislation to amend the ICCC Act should insert consumer protection provisions, list competition provisions in plain English, and expand the range of remedies available to the ICCC for any infringements.

**Regulatory contracts are outmoded.** A further reform area is the relationship between the ICCC and state-owned enterprises (SOEs). Under the ICCC Act, SOEs declared “regulated entities” must comply with an ICCC-issued “regulatory contract.” This may specify maximum prices to be charged and minimum service levels. Currently, the regulated entities are PNG Power Limited, PNG Ports Corporation Limited, Post PNG Limited, and Motor Vehicles Insurance Limited. Chapter 7 discusses such contracts.

As the private-sector-led development agenda advances, questions will arise on how best to infuse greater competition in industries (such as electricity generation and distribution) and lessen the natural monopoly element in some of these. The telecommunications regulatory authority is concerned about earlier telecommunications decisions that may have weakened competition, due to structural changes and strategic conduct within the industry.

Examining whether regulatory contracts can ensure high performance for SOEs should be part of any future review. The ICCC’s procedures and resourcing for regulatory work should also be examined, while its resources and staff skills profile should also be explored.

**Improving telecommunications is essential.** The legal framework regulating telecommunications providers has improved with the National Information and Communications Technology Act 2009 (NICT Act). Wholesale internet access arrangements through a new government-established SOE, PNG DataCo Limited, need monitoring to ensure equal access for internet service providers and fair pricing models.
PNG has gradually liberalized its telecommunications sector since 2007. The previous state monopoly, Telikom PNG, was reincorporated as an SOE and operating licenses issued to other telecommunications providers. Telikom PNG’s mobile service provider arm was spun out into Bemobile Limited (trading as bemobile) and partly privatized. Because of increased competition in the sector, the number of people accessing basic telephony services soared to 1.8 million mobile subscribers by January 2011; and call rates reduced by approximately 60%.

The NICT Act established the National Information and Communications Technology Authority (NICTA) as the government authority for regulating and licensing information and communication technology (ICT). The Act’s key objective is providing a regulatory framework to promote both consumers’ long-term interests, and the ICT industry’s efficiency and competitiveness. While the NICT Act focuses on competition and market forces, it can encompass regulatory interventions to ensure sustainable competition. Encouragingly, NICTA is engaging in policies supporting the business environment.

These include:

- developing the Universal Access Scheme policy to guarantee access to telecommunication services in rural areas;
- reforming the operator license scheme to a technology neutral scheme, enabling providers to provide multiple services to consumers; and
- publishing the draft National Broadband Policy to achieve higher economic growth and economic efficiency, and ensure sustainability.

The trend toward increased telecommunications sector competition should benefit the private sector. Increased telephone access and decreased service charges have positively impacted PNG’s economy. In the 2008 budget speech, the then Minister for Treasury and Finance noted that, in only a few months, telecommunications deregulation had added approximately 0.7% to PNG’s GDP. A regulatory framework supporting new operators to enter the system, drive competition, and increase services in metropolitan and rural areas will assist in achieving these outcomes.

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75 Independent State of Papua New Guinea. 2009. National Information and Communications Technology Act 2009 (NICT Act). Port Moresby. Part I, Division 2, Section 2(a)(i)(ii) states: “The objective of this Act is to ensure that the ICT industry contributes to the greatest extent possible to the long-term economic and social development of Papua New Guinea, by means that include (a) providing a regulatory framework consistent with the regulatory principles in Section 3 that promotes (i) the long-term interests of Papua New Guinea and its people, taking account of the National Goals and Directive Principles and the Basic Social Obligations of the Constitution; and (ii) the efficiency and competitiveness of the ICT industry in Papua New Guinea.”

76 NICT Act, Part I, Division 2, Section 3 (Regulatory Principles).


Internet access and pricing are still concerning, with very low rates of market penetration (mainly focused around Port Moresby)\(^{79}\) and high access prices.\(^ {80}\) This is partly because Telikom PNG owns the only licensed international gateway for internet services through its subsidiary, Tiare.

In March 2014, the government established a new SOE—PNG DataCo—as the wholesale provider for the new National Transmission Network. At the time of writing, DataCo was still setting up its business operation.\(^ {81}\) If wholesale internet service pricing follows the tariff schedule in the draft National Broadband Policy, the private sector should experience decreased costs in accessing internet services.

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\(^{79}\) World Bank. 2014. *World Development Indicators: Papua New Guinea.* Washington, DC. The World Bank estimates that in 2012 there were 9,200 fixed broadband internet subscribers, and just over 250,000 total internet users. In 2013, World Bank estimates increased to 11,300 fixed broadband internet subscribers (a 22.8% increase), with the total number of internet users increasing to around 475,000. This is an increase of just under 90% in only 12 months. [http://databank.worldbank.org/data/views/reports/chart.aspx#](http://databank.worldbank.org/data/views/reports/chart.aspx#) (accessed 1 December 2014).


The state-owned enterprise (SOE) sector is a major source of inefficiency in the economy. It wastes capital, distorts market conditions, tilts the playing field against private investment, and imposes an implicit heavy tax on consumer welfare.

Papua New Guinea’s (PNG’s) large SOE sector’s total assets amount to K6 billion, with four companies being dominant: PNG Power Limited, PNG Ports Corporation Limited, Telikom PNG, and Air Niugini Limited (Figure 4). There are also holdings in other utilities, and in financial and production companies. In 2013, there was a change in the shareholding of Ok Tedi Mining Limited, valued at $2 billion. The government also re-incorporated the National Petroleum Company of PNG as an SOE, mandated to manage the state’s

Recommendations:

- Continue to implement recent policies toward greater state-owned enterprise (SOE) commercialization, and target less political interference in the process
- Articulate expectations of dividend payments from SOEs, insist on higher rates of return, raise corporate governance standards to international best practice levels, and fully implement regulatory reforms
- Enforce greater contestability through increased private sector participation in providing services traditionally delivered by SOEs
- Allow private companies to bid for community service obligation contracts
- Clarify the relationship between the government asset holding in the Kumul Trust and the sovereign wealth fund operations
- Consider placing Papua New Guinea’s commercial assets into the sovereign wealth fund; and reduce Kumul Trust holdings to domestic utility, infrastructure, and commercial company shares

WASTED PUBLIC RESOURCES

Figure 4: Papua New Guinea State-Owned Enterprise Portfolio Assets, FY 2012 (K6 billion)

FY = financial year, PNG = Papua New Guinea.
$2.9 billion equity in the PNG liquefied natural gas project. These interventions greatly expand the SOE sector, and seem to contradict the official policy for private-sector-led development.

The sector’s asset growth has been rapid—averaging 21.8% annually between 2002 and 2012—but capital use is inefficient with a return on equity of only 3.4% over 2007–2012.

The SOE sector is sheltered by preferential low interest rates. The underlying return on equity is even less. While interest rate subsidies have reduced, SOEs’ preferential rates disadvantage private companies and distort capital allocation in the economy.

The corporate governance environment is defective, contributing to SOEs’ poor commercial performance. The SOE portfolio is held in a trust managed by the Independent Public Business Corporation (IPBC). IPBC is both trustee and SOE monitor. Amendments to the IPBC Act in 2012 reversed previous changes that weakened the legal framework. Yet, notable remaining deficiencies include the absence of an explicit SOE commercial objective. Since 2002, noncompliance with the Act’s key elements has led to weak governance and accountability. IPBC has also consistently failed to publish annual reports with audited financial statements for both itself, and individual SOEs. Greater transparency and accountability would strengthen SOE performance incentives.

Corporatization has not prevented political interference in SOE operations. While the government recognizes the benefits of corporatizing and commercializing SOEs, undue political intervention in management and operations dampens their performance. Recent moves to replace Telikom’s chief executive officer, direct the National Development Bank to reduce its interest rates, and overturn an electricity price increase approved by the regulator all undermine SOEs’ commercial mandate and independence. Short-term political decisions will result in long-term value destruction.

Regulatory contracts are oblivious to efficiency considerations. The Independent Consumer and Competition Commission (ICCC)–agreed regulatory contracts for monopoly service providers militate against realizing productivity gains. The ICCC regulates all nonfinancial enterprises, except the telecommunications sector. Regulatory contracts of up to 10 years establish a largely cost-plus price path tied to agreed performance standards and investment plans. They have no productivity performance requirements or other incentives to save costs. Frustration at SOEs’ slow improvement in services has encouraged changes in market regulation, such as enhanced performance monitoring. However, this is likely to be ineffective without fundamentally restructuring regulatory contracts. The best approach is greater contestability through increased private sector participation, backed by hard SOE budget constraints.

Community service obligations are an unfair burden. SOEs have delivered burdensome community service obligations (CSOs) without any compensating fiscal transfers. An inefficient and economically unjustified cross-subsidy system pays for the CSOs. Under this structure, there is

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82 These changes are not reflected in the portfolio size or performance reported in this report.
84 The Papua New Guinea General Business Trust was established by the Independent Public Business Corporation of Papua New Guinea Act 2002.
no incentive to provide efficient services, and laws and regulations prevent better private providers entering the market. These are contradictory to widely-accepted frameworks for effective SOE governance (Box 2). A formal CSO policy, approved by cabinet in December 2013, requires greater SOE commercialization and full compensation for CSOs. This CSO policy follows international best practice; when implemented, it will help improve outcomes for SOEs, consumers, and the government, ensuring that private companies are allowed to bid for CSOs (footnote 83).

TOWARD POLICY REFORM

Need to clarify SOE policy. There is a fundamental need to define SOE policy—or, more broadly—the policy on private sector participation. Official policy on SOEs appears contradictory. While it envisages a role for greater private sector participation, and some actions have been taken and others are being contemplated, there is no well-developed or consistent strategy for expanding private participation and realizing efficiency gains in SOEs. Also, a 2014 government policy document on SOEs is confused, ignores international experience and best practice, and calls for expanding SOEs into new economic sectors under the guise of economic diversification (footnote 14).

SOE efficiency will improve through increased private sector participation under the correct incentive structures. Public–private partnerships (PPPs) can help to raise efficiency and service quality, while privatization will lock in efficiency gains and eliminate the state’s exposure to commercial risk. It is encouraging that the

Box 2: Characteristics of Effective Legislative and Governance Frameworks

- An overarching state-owned enterprise (SOE) law that sets common standards and rules on the establishment, disestablishment, governance, reporting, management, ownership oversight and commercial objectives for all SOEs
- A primary objective for each SOE maximizing the government’s investment value
- A crucial, robust competition framework ensuring competitive neutrality for SOEs
- A mechanism for the government to exercise ownership oversight without undermining the board’s commercial independence
- Competitive community service obligation (CSO) tendering
- Removal of regulatory functions from SOEs
- Separation of government ownership responsibility for SOEs from the responsibility for regulatory functions and purchasing CSOs
- Appointment of skilled SOE directors representing the owner’s commercial objectives and not others’ interests
- SOE board authorized and accountable for decisions affecting SOE performance

government is considering partially privatizing the national airline, Air Niugini. Successful privatization will depend on carefully defining the resultant civil aviation regime, the freedom to operate routes commercially, and predictable and adequate budget transfers for loss-making routes that the airline has a social obligation to operate—all within an open and vigorously competitive market sector. There should be no shareholding restriction by nationality, and regulation should focus on safety.

The government has declared that Air Niugini’s partial privatization will be followed by other SOEs, notably in the electricity sector, and this should be encouraged. However, it is important to define a framework for increased private sector participation by transferring state-owned assets to the private sector more generally, including privatization as one element.

**Procompetition measures taken.** The government has moved toward promoting competition in the power and telecommunications sectors, but risks exacerbating the existing low degree of banking sector competition. In 2011, the government endorsed the Electricity Industry Policy, which supports greater private sector participation in power generation to enable service improvements and efficiency gains. In 2013, PNG Power was directed to contract with private power suppliers rather than develop new capacity itself. Chapter 5 discussed PNG DataCo, to be available as open access, and the government instructing the National Development Bank to reduce its lending rate to 6.5% to win business on subsidized terms. This direction could harm competition by undermining private banks’ sustainability.

Further, PPPs could help improve SOE efficiency and profitability. If credible partners are chosen and the contracting framework is robust, PPPs can help SOEs operate more efficiently (Box 3).

**Shrinking the SOE sector is critical.** The draft White Paper presents policies that can only be described as “antireform” and have failed globally. Although the White Paper states the following, its recommended policies would achieve the opposite:

> The government believes that, firstly, it is the growth of the private sector that grows a nation. Secondly, a government should not place itself in the awkward position of being the policy-maker, regulator and the regulated [footnote 14].

If implemented, the White Paper’s recommendations would expand SOE numbers and roles; crowd out the private sector; and make government the producer and regulator, as well as the regulated and policy maker. Despite the proposals for better governance controls and monitoring, experience with SOEs does not definitively show new SOEs to be efficient and competitive. Instead, international studies have consistently shown that SOEs are comparatively higher cost, and are less efficient and productive, than privately owned firms.

Further, entering sectors in which privately-owned businesses already operate would divert public resources from core government functions, create conflicts of interest in market and industry regulation, and undermine private investment. Importantly, the proposals to create new SOEs could undermine PNG citizens’ basic commercial freedoms.

Particularly concerning is the proposal to allow only PNG citizens to own privatized companies and companies with mixed private–public ownership.
The draft proposals would preclude foreign investors as majority owners. As international experience shows, such measures would deter foreign investment, lower the value of companies, and act as a tax to future investment. Foreign investment introduces new technologies, lowers the cost of local production and inputs into economy-wide production, employs local labor and other resources, and stimulates growth far more than protection measures could.

**SOEs should realize efficiency gains.** PNG’s economy would greatly benefit from more efficient SOEs, and reforming the existing SOEs would deliver rich dividends. Citizens rightly expect that electricity, water, shipping, aviation, post, telecommunications,
and insurance are widely available, of reliable quality, and affordable. Business competitiveness is undermined by SOEs’ poor quality and high cost services. Increasing current SOEs’ commercialization, accountability, and political independence would all help, as would greater use of PPPs, and restructuring markets to enable greater competition. Creating new SOEs will not. First priorities should include reforms to achieve SOEs’ full commercial orientation, strong governance without political interference, performance incentives and results accountability, hard budget constraints, and sound regulation.

THE KUMUL TRUST HOLDINGS: UNCLEAR PURPOSE

The proposed SOE trust structure has no clear direction, with many unanswered questions. The government has decided to reorganize its SOE shareholdings into three trusts: mining SOEs; hydrocarbon SOEs; and commercial SOEs (including utilities and infrastructure). All three will exist under an umbrella trust, the Kumul Trust; however, trust structure policies, workings, and oversight are vague. SOE efficiency and governance gains, and an improved climate for private sector growth, should guide decisions.

The Kumul Trust could represent an advance in fiscal responsibility and corporate governance if the state (i) exercises professional, objective supervision over its share assets, and removes political interference and management, (ii) puts greater commercialization in place, (iii) raises corporate governance standards, and (iv) establishes reformed regulatory contracts. The state should also demand appropriate SOE dividends; and SOE investment plans should be properly appraised and financed through an appropriate equity and debt mix.

The White Paper indicates that the overarching board will include the Prime Minister and ex-prime ministers, which is unjustified and will lead to politicization. The document details the SOE boards’ responsibilities, particularly financial responsibilities and controls. Yet, PNG’s experience shows that rules and regulations alone do not drive outcomes, but rely on incentives and stamina for implementation. Without fundamental reforms at the incentives and governance level supported by increased accountability and transparency, the Kumul change may, ultimately, amount to little. If these assets must be held through a common ownership structure, a holding company—a well understood and standard corporate structure—is preferable to, and is a lower risk than, a trust.

The trust and sovereign wealth fund relationship should be strengthened. The relationship between the Kumul Trust and the sovereign wealth fund needs further clarifying. The Kumul Consolidation Agenda will manage the state’s assets, including SOEs and mining and petroleum interests. Asset management should be seen in a unified context, as both the Trust and the sovereign fund represent government wealth holdings. Sovereign wealth fund holdings arise from transforming foreign currency earnings into foreign exchange equity and bond assets (property and commodity assets may play a minor role). The Kumul assets are constituted partly from widely held, foreign exchange-denominated shares in the resources sector; and partly from local currency-fixed and

Footnote 14. Recommendation 5(d) in the White Paper states that “existing SOEs be allowed to operate independently and competitively governed by their own Boards without the additional oversight and control of a holding company or trust […]”

portfolio long-term assets. Some of the latter have a market price (given by the share price), but most have no market prices (e.g., value of roads or power stations). As SOE assets are liquidated through sales, privatization, or loss recognition, any proceeds should be transferred to the sovereign wealth fund so that state assets continue to be preserved for stabilization and savings.

Importantly, the state’s commercial assets in enterprises such as Oil Search and the LNG plant should be placed in the sovereign wealth fund (not the Kumul Trust), so that they are professionally and seamlessly managed with the state’s other foreign assets. These shares are essentially foreign-exchange-dominated, as their underlying value—export earnings—arises from commodity exports priced in foreign currencies. Some of these shares are also quoted in foreign stock markets. It would be advisable to shrink the Kumul Trust holdings into domestic utility, infrastructure, and commercial company shares; and to transfer the resource-related SOE shares to the sovereign wealth fund.
A private-sector-led growth strategy must carefully consider agriculture and, more broadly, the rural economy. The latter, upon which 80% of the population relies for its livelihood, encompasses nonfarm rural income, services, and infrastructure; and, in mid-2014, still constituted nearly one-third of Papua New Guinea’s (PNG’s) total economy. Development policies have focused on the natural resource sectors (minerals, hydrocarbons, and commercial logging) and four major export crops (coffee, palm oil, cocoa, and copra). However, there is insufficient public policy and investment focus on semi-subsistence agriculture, smallholder food crops, livestock, forestry, and fishery activities. The smallholder tree crop economy—cocoa, coffee, and copra—has clearly been ignored.

The cash crop economy is linked to smallholder agriculture, as over two-thirds of value added in coffee bean and cocoa exports accrue to smallholder farmers, if roads exist to transport the crop. Coffee production suffers from low quality and productivity, but dominates in PNG’s highlands. About 2.1 million citizens live in coffee-growing households (Box 4). Smallholder cocoa production, processing, and sales account for about 20% of the rural economy. Fewer than 1 million citizens live in cocoa-growing households. High transaction costs hamper smallholder production efficiency, and transport constraints impede market access. Similarly, information gaps, archaic technologies and agricultural practices, and outdated quality requirements and standards affect the ability to export. High transaction costs also greatly affect the value added for the producer. Value chains are therefore critical to linking exporters, agribusiness enterprises, and trader-agents to the smallholder producer.

Public policy should strengthen smallholder competitiveness. This should focus on information and extension services, particularly technology and management. Complementary investments in roads and power are necessary. Actively involving the private sector, particularly exporters, in designing and implementing policy interventions would ensure relevance and effectiveness. Using public–private partnerships (PPPs) for providing smallholders with extensive services is also promising.

Previous unsuccessful attempts at government-supported intervention through cooperatives or collective interest groups highlight many institutional difficulties and risks. For example, while agribusiness involvement is essential for establishing

**Recommendations:**

- Integrate agriculture and the rural economy in the current reform strategy
- Increase public policy and private and public sector investment focus on agriculture, fishery, and related activities
- Actively involve the private sector in designing and implementing policy interventions
- Increase competition by stopping the practice of licensing operators in trading and exports, and implement licensing reforms to encourage entrepreneurial activity
Box 4: Tree Crop Production in Papua New Guinea and Household Welfare

Tree crop income is the primary source of cash income for thousands of Papua New Guinea’s (PNG) rural households. An estimated 270,000 households’ main activity is growing coffee, with 140,000 growing cocoa, and around 18,500 mainly involved in smallholder oil palm production. Income from tree crops comprises a significant share of these households’ income; and, for many other households, tree crop production supplements other income. A recent survey of households producing coffee across the Highlands revealed that, on average, 45%–60% of a household’s net income derives from coffee. For households producing cocoa in East New Britain (ENB) and the Autonomous Region of Bougainville (ARB), cocoa constitutes about 25% of net household income. Cocoa-producing households appear to rely more on off-farm income, with about 45% of off-farm income compared with about 12% of off-farm income among coffee-growing households. Unlike other countries in the Pacific region, tree crop farmers are more likely than the average household to face hardship, and most of the poorer households grow tree crops.

PNG is a small coffee producer globally, contributing roughly 1% of global output. It exports nearly everything produced, averaging close to one million 60-kilogram (kg) bags annually. Experts recognize that PNG’s production could rise significantly by improving yields and efficiencies on the existing land area. A survey in four Highland provinces revealed that average coffee yields are around 380 kg per hectare (ha). To compare, Brazil’s average yields of Arabica coffee are reportedly 1,200 kg per ha.

Increasing PNG’s coffee yields requires significant replanting, as most coffee harvested grows on very old trees. It will need better farm management and husbandry, good agricultural practices, more planting of higher-yielding varieties, more pest and disease resistance activities, and adapting better to the changing climate. It will also need improved quality and postharvest processing.

Like coffee, PNG’s low cocoa yields are due to minimal attention to management and agronomy. The same household survey of coffee and cocoa farmers indicates that average cocoa yields in ENB and ARB are about 169 kg per ha dry bean equivalent. By comparison, Indonesia’s average cocoa yields are 430 kg per ha. The recent baseline survey for the Productive Partnerships in Agriculture Project by UQ International (the University of Queensland, Australia) revealed the highest yields were on younger mature blocks of land in ENB. Blocks that were 3–6 years old reported yields of 427 kg per ha, compared to an average 258 kg per ha on blocks over 10 years old. Within PNG, there are huge differences in yields between provinces with young, mature blocks. For example, those in North Bougainville only achieve yields of 62 kg per ha.

Cocoa pod borer (CPB) also threatens PNG cocoa growers. A staggering 99% of households surveyed in ENB reported that CPB affected their cocoa. It is also an increasing problem in ARB. Most households report a substantial decrease in the number of trees producing cocoa, compared to before an outbreak.

Yields in the palm oil sector compare favorably with other growing countries, yet are lower among smallholders. They are usually reluctant to replant aging trees, and they suffer from poor infrastructure. Unlike smallholder-dominated coffee and cocoa production, the plantation sector produces 70% of PNG’s palm oil. With average yields of about 21 tons per ha in 2010, this sector’s productivity compares well with yields in top producing countries, such as Indonesia and Malaysia. However, smallholder sector yields are much lower, averaging about 14 tons per ha in 2010. Unlike smallholder coffee and cocoa producers, smallholder palm oil growers usually use far
value chains, transaction costs and risks have prevented sufficiently large-scale success. A worthy reform would be scaling up those market-oriented interventions, with judicious selective public funding using clear eligibility and selection criteria. This approach would manage the high transactions cost and risks, toward strengthening links between private enterprises and smallholder farmers.

The government is in the late stages of implementing the 10-year National Agricultural Development Plan, adopted in 2007.87 This strategy calls for

- emphasizing agricultural research, extension information, and training;
- developing food and horticultural crops by reviving the nucleus estate system to increase production, transfer skills, and improve quality;
- developing tree and industrial crops;
- promoting livestock for import replacement by rehabilitating breeding centers;
- revitalizing the spice industry, and improving processing and marketing systems;
- expanding women’s role;
- improving regulatory and technical services; and
- formulating a strategy to manage the National Agricultural Development Plan.

However, the plan has been criticized heavily for

- not focusing on the critical difficulties facing the agricultural sector;88
- failing to address landholding, land tenure, and communal property issues;
- failing to recognize transport issues as central to connecting agricultural products to markets;
- relying too heavily on the smallholder nucleus estate model, which in most industries (palm oil excepted) has fallen into disrepair after land invasions and neglect;


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• failing to consult with farmers on their problems; and

• failing to show how agricultural extension can be revived using a model that has not succeeded for many years.

The government has acknowledged that the plan experienced significant corruption, with program funds diverted through cronyism.

Reforming pricing policy and institutions is critical. Agricultural policies are another striking example of how public policy choices need reshaping to sharpen the private sector orientation of future growth. Two broad sets of policy questions need addressing: (i) prices and intervention, and (ii) institutions.

(i) Prices and intervention. Though there has been a significant move toward price liberalization and greater freedom for farmers to sell or export their crops, intervention still prevails. The Kokonas Indastri Koporesen (until 2002, the Copra Marketing Board) retains a virtual exports monopoly; and the Coffee Industry Corporation has restricted sales, including banning all roadside cherry buyers except in remote areas not serviced by registered processing centers. Licensing operators in trading and exports restricts competition; so licensing reforms to allow freer entry of new entrepreneurial talent is advised. Negative effective protection against agriculture is also evident, particularly coffee, cocoa, and palm oil. This bias against agricultural production arises chiefly from tariffs on inputs into agriculture, and is clearly a policy outcome that militates against poverty reduction and growth of a sector with clear competitive potential. Only further comprehensive tariff reductions can remove this bias against agriculture.

(ii) Institutions. For institutions, the critical constraint is land regime and policies. Communal landholding may not be a significant barrier to smallholder production, but it is to commercial farming and agribusiness formation. Communal (traditional) forms of landholding, rigid tenure, lack of clear titles, and absence of land markets, all show the difficulty in redeploying land to the most productive use. In a world of changing prices and inventive technologies, large potential growth in the agribusiness sector is being stifled. A further institutional gap is on knowledge use and dissemination relating to techniques and marketing.

Addressing the lack of infrastructure and breakdowns in law and order in the rural economy is critical, with weak air and sea links unable to compensate for poor roads and theft or destruction of equipment and crops. True growth opportunities are being lost if farmers merely produce what they can best protect, as opposed to what yields the greatest returns.

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Papua New Guinea’s (PNG’s) geography and poor security often conspire against providing cost-effective infrastructure investments, including those needed for effective communications, roads, air services, water transport, urban and peri-urban utilities such as water and waste disposal, energy, and electricity services. Mountainous terrain makes many road networks prohibitively costly, and other physical linkages—electric cables, substations, or telephone towers—are vandalized or stolen. The high cost (or absence) of infrastructure is a major contributor to the cost of doing business. The state—as the monopoly infrastructure provider—has failed to deliver the scale of needed services. The available services lack quality and are unreliable, and competition and regulation policies need modernizing to meet the growing economy’s needs.

The government has developed sector-specific strategies that recognize and give a much larger role to the private sector in generating and providing infrastructure services. Supporting reforms in competition and regulation are highly appropriate and need enacting. The strategies allow for cost recovery by companies so that their services and investments can be sustainably financed. To meet social needs, the authorities plan to make specific allocations from the budget for subsidies aimed at low-income households. The community business obligations in different services are to be competitively provided and paid for from budget funds.

Especially important are the regulatory regime, confidence in policy stability, and the appropriate structuring of public–private partnerships (PPPs) supported by a well-functioning concessions law. These are all important reforms, are the adequacy and predictability of budget allocations for subsidies and community investments.

**ELECTRICITY**

The Development Strategic Plan seeks to raise the rate of electrified households from 13% to 70% by 2030.\(^9\) This ambitious target requires

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investments in generation, transmission, and distribution; appropriate subsidies to ensure household penetration; and fiscal and regulatory changes to attract needed private capital. The electrification plan, to be supported by appropriate amendments to the third part access code and grid code, will enable the private sector to participate.

**Electricity policies and investments have been fragmented and nonstrategic.** The vertically-integrated PNG Power holds the monopoly and generates most power for households and companies. Large industrial generators have about two-thirds of PNG Power’s capacity, but their output is dedicated off-grid. Some independent power producers supply the grid. The authorities’ strategic approach intends to (i) expand private provision; (ii) rely on competition and reform regulation to assign rights to supply the grid or customers directly; (iii) limit the government to a facilitator and regulator; and (iv) adequately fund community service obligations (CSOs) from the budget to subsidize supply for below-threshold loads, principally in rural areas.

Private electricity generation will be assisted by using future gas supplies under offtake agreements.

**Promoting contestability is necessary.** It will be important to make markets fully contestable to ensure efficiency of the entire supply chain (generation to retail). This needs maximum reliance on competition, no national power company privileges, and a level playing field. Various generating and distribution concessions could be employed. With the enactment and implementation of the Public–Private Partnership Act 2014, these contracts will be allocated through competitive bidding for subsidies, guarantees, and other conditions for fixed yet extendible periods; clear performance targets; and responsibilities for all parties.

The uniform tariffs principle would need amending to reflect both supply costs and market conditions. Price regulation will need to be rules-based and encourage productivity gains.

**Rural households are willing to pay for services.** It is too easily assumed that rural households are unable, or unwilling, to pay for energy. International experience shows that if the electricity supply’s quality and reliability are satisfactory, households will pay. Households usually acknowledge that better energy supplies lead to increased household output, build human capital through more opportunities for education, and increase the value of leisure hours. An Independent Evaluation Group assessment notes:

> It has long been claimed that rural electrification greatly improves the quality of life. Lighting alone brings benefits such as increased study time and improved study environment for school children, extended hours for small businesses, and greater security. But electrification brings more than light. Its second most common use is for television, which brings both entertainment and information. The people who live in rural areas greatly appreciate these benefits and are willing to pay for them at levels more than sufficient to cover costs. [...] The willingness to pay for electricity is high, exceeding the long-run marginal cost of supply. 

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Ensuring financial viability is important. Clearly, financial viability is at the heart of any sustainable investment. Subsidy transfers to companies to cover less-than-cost-recovery prices charged to eligible households must be paid fully, on time, with guarantees. Such subsidies should be transparently awarded, well targeted, and consistent with supply and consumption efficiencies. Examples include lifeline tariffs (usually for consumption up to 25 kilowatt hours per month) and transfers to targeted households.

International experience shows that subsidies are needed to ensure that household connections to the grid are made, particularly in the poorer rural population. The design of such subsidies can be complex. The same considerations underlie the CSOs’ design.

Support for public guarantees must be addressed. Ensuring their obligations and guarantees to potential private investors—whether financial or performance-related—will be challenging for the authorities. Examples relate to maintaining the transmission line, or take-or-pay agreements. Nonperformance or default risks can be insured against through international financial institutions (such as the Asian Development Bank or the Multilateral Investment Guarantee Agency) or bilateral agencies.

ROADS

PNG’s road infrastructure is widely cited in business surveys as a major impediment to efficient business. The network’s poor condition state imposes large costs; time costs may cause internal commerce or export possibilities to fail; and vehicle maintenance costs are high, given the roads’ poor condition.

Connectivity costs. The highly undeveloped road system leads to poor connectivity, blocks access to services such as schools and health clinics, and causes lost growth opportunities by imposing high costs on labor and goods movement. There is no nationwide connecting road network; even Port Moresby is isolated, and interprovincial connections are often poor. Less than a third of national roads are considered satisfactory, and much of the road network has lacked maintenance for years. This has led to severe deterioration, rendering critical segments of the country’s national roads network impassable, particularly during the rainy season.

PNG’s difficult geography and low population density explain many of these issues. Roads have been affected by inadequate budget outlays and poor institutional and management capacity. The authorities are in the initial stages of a practical reform strategy which, if implemented, would lead to large gains and significantly reduce the private sector’s disadvantages.92

Reform strategy. The strategy’s central goals are to expand and restore the road network; ensure adequate maintenance, fully funded (where feasible) through user charges; and strengthen institutional and management capacity. The government intends to bring all-weather transport access within easy reach of 95% of the population, to provide transport access to 95% of developable agricultural land, and to upgrade urban traffic networks and public transport systems.

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This strategy is based on attracting private investment to provide transport services in roads, sea, and air transport. The government sees fully retained asset ownership in roads, ports, and airports with supporting infrastructure—this would significantly constrain private sector expansion and may need reconsidering. PPPs could significantly increase the supply of infrastructure services, particularly transport, and ownership limitations may damage PPP prospects. The government plans to outsource service delivery but will be tempted to protect or extend privileges to state-owned companies, which will provide a test of government commitment to such plans.

**Maintenance reforms.** A greatly expanded role for the private sector is envisaged for infrastructure construction (new roads) or maintenance. This highly welcome development could finally address the serious maintenance deficit buildup if the contractual relationship with the private sector is properly managed. Long-term, performance-based maintenance contracts with local private companies will be vital. The National Roads Authority has been making commendable progress in these areas, with planned reforms and some experimentation with these types of contracts already occurring. This approach will also need government agencies to desist from providing subsidized services through state-owned companies to preserve competitive neutrality.

**Procurement reforms.** Nontransparent transport investments and maintenance, which are not based on economic criteria, are a major problem and waste public funds. As a key element of public procurement reform, this requires urgent attention. This report’s governance chapter discusses this issue.

**Fiscal transfers.** Similarly, government will have to take seriously the obligation to properly cost and pay for CSOs to be discharged by private companies through competitively awarded contracts. Subsidized services from state-owned enterprises (SOEs) should be eschewed if the new schemes are to succeed. Internal, transport public company cross-subsidies must also end.

Important policy implications from this reform strategy are the following:

(i) The need to price road services to the market (and, more generally, transport services; including sea ports, sea freight, and air services) and demonstrate willingness to impose select user charges where PPPs or other forms of private sector service provision occur. Security issues make it wise to avoid cash transactions; the strategy therefore needs a mobile-telephone-led electronic payments system. Alternative forms of revenue collection less directly tied to road use are a fuel levy, or a well-designed registration charges system.

(ii) Clearly define the respective roles of the national and provincial authorities in asset management, along with asset transfers to support funding and maintenance responsibilities.
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References


Building a Dynamic Pacific Economy
Strengthening the Private Sector in Papua New Guinea

This report critically analyzes the complex environment for private sector development in Papua New Guinea, showing the country’s potential to capitalize on its vast wealth well into the coming decades. However, to ensure sustainable and inclusive growth, Papua New Guinea needs ongoing reform so that the benefits of future resource exports benefit the entire economy.

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About the Asian Development Bank

ADB’s vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region’s many successes, it remains home to approximately two-thirds of the world’s poor: 1.6 billion people who live on less than $2 a day, with 733 million struggling on less than $1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.