

PAPUA NEW GUINEA

**PUBLIC EXPENDITURE REVIEW
AND RATIONALIZATION**

OVERVIEW OF DISCUSSION PAPERS

SEPTEMBER 2003

PREFACE

This Public Expenditure Review and Rationalization (PERR) exercise represents a collaborative effort between the Government of Papua New Guinea (GoPNG) and a multi-donor team led and coordinated by the World Bank. From the Government side, the task was led by Mr. Koiari Tarata, Secretary of the Department of Treasury. The donor team, comprising the Asian Development Bank, AusAID and the World Bank, was led by Duvvuri Subbarao (Task Team Leader) and Cyrus Talati (co-Task Team Leader).

The discussions on this PERR began when a GoPNG team under the leadership of Hon. Bart Philemon, Minister for Treasury and Finance, visited Washington in September 2002 in connection with the World Bank Annual Meetings. Those discussions were followed by four donor missions in October 2002, December 2002, March 2003 and May 2003. During these missions, the donor team had opportunities to discuss issues and options with the Ministerial Budget Committee chaired by the Minister for Treasury and Finance, and with the Central Agencies Coordination Committee chaired by Mr. Joshua Kalinoe, Chief Secretary. The insights gained during those interactions have been reflected in the PERR analysis and recommendations.

The Government established a Committee of Deputy Secretaries representing the central agencies under the chairmanship of Mr. Simon Tosali, Deputy Secretary of Treasury, to lead the PERR effort at a technical level and to liaise with the external donor PERR Team. This collaboration was valuable in many ways, most notably for analyzing technical issues, understanding the systems and procedures and appreciating the inner dynamics of public finance management. There are several ways in which this collaboration can be improved and strengthened, and both sides need to work on this in the next and more critical phase of implementation of reforms. This would include more intensive and frequent interaction, complementing each others' strengths and weaknesses more efficiently and sharing responsibilities for analysis and drafting.

All through the PERR discussions, GoPNG, and particularly the Treasurer Sir Bart and Treasury Secretary Tarata, emphasized that the PERR should result in specific reforms in the area of public finance management that would be reflected in the 2004 budget rather than being oriented towards producing a report. In response to this request, the PERR resulted in the production of six Discussion Papers as follows: (i) Road Map to Fiscal Sustainability; (ii) Civil Service Size and Payroll; (iii) Restoring the Integrity of Budget Institutions and Systems; (iv) Expenditure Adjustment and Prioritization; (v) Improving Health Spending; and (vi) Improving Education Spending.

The drafts of the Discussion Papers were sent to the Government for review and for formulation of an action plan for implementation in July 2003. This summary overview paper, aimed at top policy makers including the National Executive Council, provides a synopsis of the Discussion papers. It is important that the Government consider the PERR recommendations and begin acting on them right away as part of the preparation for the 2004 budget.

Public Expenditure Review and Rationalization - 2003

Overview of Discussion Papers

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List of Acronyms

ADB	Asian Development Bank
AusAID	Australian Agency for International Development
BSC	Budget Screening Committee
CACC	Central Agencies Coordinating Committee
CPAR	Country Procurement Assessment Review
DNPRD	Department of National Planning and Rural Development
DPM	Department of Personnel Management
FER	Functional and Expenditure Review
FMIP	Financial Management Improvement Project
FMP	Financial Management Project (The ADB funded component of FMIP)
GDP	Gross Domestic Product
GNP	Gross National Product
GoPNG	Government of Papua New Guinea
HRM	Human Resource Management
ILPOCS	Integrated Local Purchase Order and Commitment
IMF	International Monetary Fund
LLG	Local Level Government
MTDS	Medium Term Development Strategy
MTEF	Medium Term Expenditure Framework
MTFF	Medium Term Fiscal Framework
NDoE	National Department of Education
NDoH	National Department of Health
NEC	National Executive Council (Cabinet)
NEFC	National Economic and Fiscal Commission
OLPLLG	Organic Law on Provincial and Local Level Governments
PEM	Public Expenditure Management
PERR	Public Expenditure Review and Rationalization
PFMA	Public Financial management Act
PGAS	PNG Government Accounting Systems
PPS	Public Payroll System
PSRMU	Public Sector Reform Management Unit
RIGFA	Review of Inter-Governmental Financial Arrangements
SRC	Salaries and Remuneration Commission
SWAP	Sector-Wide Approach
TSC	Teachers Service Commission

1. ROAD MAP TO FISCAL SUSTAINABILITY

Worsening Fiscal Situation

1.1 Papua New Guinea's (PNG) fiscal situation deteriorated markedly over the last decade, threatening its prospects for growth and poverty reduction. On the aggregate, public spending grew significantly faster than government revenues leading to an unsustainable accumulation of debt and debt servicing costs. The most striking indication of this is the rise in the ratio of public debt to GDP from 44 percent in 1992 to 74 percent in 2002. This sharp rise in public debt is a cause for concern on two counts. First, much of the debt financed expenditure went not into public investment that would yield returns in the medium to long term, but into unproductive recurrent expenditure.¹ Second, the growing debt servicing obligations will increasingly preempt resources available for development expenditure in the years ahead.

1.2 Recent developments in PNG suggest that the adverse consequences of the fiscal profligacy of successive governments may already be unfolding. In the domestic debt market, the near doubling of yields on Treasury bills, from 10.2 percent in June 2002 to 20 percent in May 2003, is a sign of the Government's declining creditworthiness. In recent months commercial banks have been reported to be circumspect in lending to the Government even at these high interest rates, suggesting that supply side constraints may be tightening. At the same time the maturity structure of domestic debt has shortened posing serious rollover risks. The situation on the external debt front is equally worrying. Between 1992 and 2002, foreign debt nearly doubled its share from 26.5 percent to 50.1 percent of GDP mainly as a result of the depreciation of the Kina. Contingent liabilities, which could be as high as K3 billion, exacerbate what is already a vulnerable fiscal situation.

1.3 A simulation analysis of the fiscal scenario carried out as part of the PERR exercise emphatically demonstrates the need for urgent and decisive action by the Government towards fiscal adjustment. There is simply no room for delay or half-hearted measures as the alternative will be a vicious circle of a crumbling public finance system, eroding investor confidence, collapsing public service delivery and a declining economy. On the other hand, a large up-front fiscal adjustment would signal the Government's seriousness of intent and help to restore investor confidence.

¹ As per the IMF's *Government Finance Yearbook 2002*, PNG ranks 53 out of a sample of 60 low and lower middle income countries in terms of the share of capital expenditure in total expenditure.

Not Short Term Fixes but Sustained Effort Required

1.4 PNG's debt build up occurred during a period of growing revenues and relative fiscal comfort. The country had weathered past crises through typically short-term solutions, and these reform efforts were not pursued after the crisis had abated. Consequently, the economy has got into a pattern of recurring crises. The PERR analysis shows that the scope for such short term fixes is now exhausted. The growing burden of debt, poor prospects for growth and PNG's vulnerability, as a small commodity producing open economy, to exogenous shocks underscore the need for effecting a sharp turn around through a sizeable fiscal adjustment, and importantly, sustaining the effort over the medium term. Moreover, this adjustment will have to take place under challenging circumstances. Mineral revenues which, in the past, had provided a buffer against fiscal shocks are expected to decline owing to resource depletion at most current projects while no new ones are slated to go on stream to replace them. Furthermore, there is a need to allocate a higher share of public expenditure to goods and services and infrastructure to build up the long term growth potential of the economy.

1.5 Typically, fiscal adjustment is effected by an appropriate combination of increased revenues and reduced public expenditures. The Government of PNG (GoPNG) should actively explore options for augmenting revenues, especially for improving the efficiency of tax collection through greater administrative effort. There is, however, a popular perception that public expenditure is prone to waste and leakage which will inhibit GoPNG efforts in this direction. If that perception can be reversed through improved effectiveness of service delivery, it will create a basis for increased taxation. In the short term, however, the bulk of the adjustment will have to come from the expenditure side, with the effort focussed on compressing public expenditure and improving its allocative and technical efficiencies.

Specifics of Adjustment

1.6 In quantitative terms, the adjustment will have to be aimed at reducing the debt-GDP ratio to 60 percent by 2008, and further down to 50 percent by 2013.² This will involve containing the average annual fiscal deficit at 0.1 percent of GDP over 2004-08, and generating a primary surplus averaging 3.8 percent of GDP over the period.³ That should allow for a modest relaxation in the fiscal deficit to 0.8 percent of GDP over the subsequent period to 2013 corresponding to an average annual primary surplus of 2 percent of GDP. The salient features of this road map, which will require an overall expenditure compression of 4.5 percentage points of GDP in the five years to 2008, are summarized in the following Table.

² Although the appropriate debt-GDP ratio is a very country specific parameter, it is instructive to note that the Maastricht Treaty places an upper limit of 60 percent on the debt-GDP ratio of member countries of the European Union.

³ Primary surplus (deficit) is the fiscal surplus (deficit) before interest payments.

**Fiscal Framework Underlying Proposed Adjustment, 2003-08
(Percent of GDP)**

	2003	2004	2005	2006	2007	2008
Revenue ⁴	29.0	28.4	28.2	27.8	27.7	27.6
Expenditure	32.5	29.0	27.9	27.5	27.9	27.9
Fiscal Balance	-3.5	-0.6	0.3	0.3	-0.1	-0.4
Public Debt	68.7	66.2	63.8	62.0	61.8	60.0

Strategy for Adjustment

1.7 What should be the strategy to achieve budgetary savings as dictated by the above road map? There are two ways of generating savings. First through cutting expenditures and pruning agencies, and second, through systemic improvements across the board. In the past, the Government's focus had largely been on the first method, but the result was a failure to generate any significant savings on a sustainable basis. This is disconcerting, but not surprising. The root causes of PNG's fiscal malaise lie in poor governance in public finance management. Although most of PNG's budget systems are sound, and by some accounts even sophisticated, poor governance over the years has led to an erosion of budgetary discipline, weakening of accountability and proliferation of waste, leakage, irregularities and malpractices across board.

1.8 Addressing these governance issues is critical to attaining fiscal sustainability. Superficially tinkering with budget numbers and mandating ad-hoc expenditure cuts, as the Government had tried in the past, can hardly be expected to be effective in such a flawed system. On the other hand, systemic governance reforms will not only lay the foundation for expenditure restructuring, but will by themselves yield large upfront savings. And what is more, focusing as they do on overall efficiency improvements, they will yield savings without compromising service levels.

The Logic of the Proposed Reform Agenda

1.9 Indeed, the central message of the PERR is that to return to a path of fiscal sustainability, fiscal austerity is important and necessary, but not sufficient. It needs to be backed up by comprehensive governance and structural reforms. Informed by this consideration, this first phase of the PERR focuses on the following topics: (i) Civil Service Size and Payroll; (ii) Restoring the Integrity of Budget Institutions and Systems; and (iii) Adjustment and Prioritization of Expenditures.

⁴ Revenue forecasts are from the IMF Staff Report for the 2003 Article IV Consultation, EBS/03/55, April 2003 .

1.10 The focus on *Civil Service Size and Payroll* (Discussion Paper 2) is warranted by the fact that public sector employment in PNG is larger than the country needs or can afford. Mainly because of weak governance, the payroll system is flush with waste, leakage and irregularities while discipline and productivity levels of the civil service are on the decline. Regaining control of the payroll and disciplining the growth of the civil service can therefore yield large up-front fiscal dividends.

1.11 PNG's budget systems are quite good. Also the capacity of the civil service to implement the systems, although in need of considerable strengthening, is quite good by developing country standards. The main problem is that because of pervasive poor governance, many of the systems and processes are flouted in practice. Budget appropriations are routinely breached, procurement procedures are bypassed, "trust accounts" facilitate off-budget transactions, spending agencies accumulate arrears apparently without any threat of penalty, and control systems for accountability appear impotent. Adding to these systemic failures is the routine practice of adding expenditure commitments to the budget through the course of the year with no corresponding additional resources, with the result that "arrears" are carried on to the following year. What PNG needs is not new systems and procedures. What it needs is simply the strict implementation of the systems and processes that already exist on the books. A significant part of the PERR, *Restoring the Integrity of Budget Institutions and Systems* (Discussion Paper 3), is therefore devoted to reviewing Government's efforts to date to correct the maladies and to outlining the priority steps for action over the next year.

1.12 The savings generated by reasserting control over the budget should be used partly to reduce the deficit and partly for deployment to productive uses. This calls for thinking through *Adjustment and Prioritization of Expenditures* (Discussion Paper 4), the final theme of the first phase of the PERR. This adjustment should be informed by an appropriate role of the Government and its policy priorities. The Government should focus only on those functions which it alone can perform (public goods and merit goods) while yielding to the private sector in respect of all the others. This process of adjustment also calls for reviewing the role, functions, outcomes and outputs of each spending agency in order to identify ways of improving the overall allocative and technical efficiencies of public expenditures. By its very nature, adjustment and prioritization is a longer term undertaking and will yield dividends over a period. But it is important to direct attention towards this task right away in order to consolidate gains from the emerging savings as well as to build capacity to better manage public finances.

1.13 Towards this effort, the PERR reviews the Government's Medium Term Development Strategy (MTDS) and the need for subordinating the MTDS to the resources available. It goes on to discuss the usefulness of bringing budget formulation within the discipline of a Medium Term Expenditure Framework (MTEF). Two separate Discussion Papers *Improving Health Spending* (Discussion Paper 5) and *Improving Education Spending* (Discussion Paper 6) review the broad patterns and practices in public spending in these two sectors and recommend measures for improving the development outcomes of public spending on health and education. Since spending in these two sectors is largely administered by provinces and local level governments, the

discussion inevitably leads to issues of accountability of sub-national governments and the responsibility of the central government in this regard. Health and Education have been chosen for this first round attention in expenditure adjustment both because of their importance to poverty reduction and their relatively large spending shares.

1.14 Finally, the PERR team recognizes that difficult and deep-rooted reforms of the type discussed herein require that significant effort go into building the demand and support for these reforms. This requires, among other things, deepening our understanding of the winners and losers from these reforms through further political analysis. This is one of the issues that needs to be addressed in the next phase of the PERR.

2. CIVIL SERVICE SIZE AND PAYROLL

The Payroll Malaise

2.1 Public sector employment in PNG is larger than the country needs or can afford. Salaries and wages account for as much as 30 percent of total expenditure.⁵ Between 1999 and 2002, the number of personnel on the central payroll system increased from 60,074 to 67,233, reflecting a growth of 11.9 percent. And during the same period, expenditure by national departments on salaries and wages grew by 33 percent, more than 10 percentage points above inflation. Undoubtedly, the rapid increase in payroll costs is one of the chief reasons for the accentuating fiscal pressures.

2.2 Not only does the burgeoning wage bill lead to increased public debt, but it also distorts the *composition of spending* (allocative efficiency of the budget) by displacing government spending on goods and services (which grew by only 5 percent over the same period 1999-2002). The 2003 budget was particularly notable for sharply reduced spending on goods and services of national departments but continued growth in payroll spending.⁶ For example, the education sector suffers from simultaneous wasted spending on salaries and under-spending on school-books and school maintenance.

Why Has the Payroll Grown So Fast?

2.3 This rapid growth in payroll has partly resulted from policy commitments in education and health sectors which have increased public sector staffing without any reference to its affordability. This reflects the Government's public commitment to minimum standards of health services, and the recruitment of teachers to meet a commitment to universal basic education.⁷

2.4 However, it also reflects the failure to control waste, leakage and malpractices. There are at least 2000 unattached officials doing no work, a large number of 'ghosts' on the payroll, lack of control over growth in casual employees (many of whom do no work in return for their pay) and extraordinarily high rates of absenteeism. A significant proportion of the 78,000 public servants on the payroll are non-productive, and some even non-existent.

⁵ This is decidedly an underestimate as a significant portion of wages is not captured under the salary and wages head of public expenditures because of accounting practices and limitations.

⁶ In the 2003 budget estimates, planned spending on goods and services was reduced by 17.4 percent while payroll was increased by 3.6 percent.

⁷ The fact that service standards have deteriorated even as public expenditures in the relevant sectors grew is striking evidence of poor governance.

2.5 Payment of inappropriate entitlements, overpayment of allowances, and excessive higher duties and overtime payments are pervasive. Overtime and higher duties allowances are used as a surrogate for increased rates of pay, since agency payrolls are not constrained by the release of budget warrant, and both overtime and higher duties are paid as a matter of course. The overtime bill is difficult to reconcile with the high rate of absenteeism which pervades the PNG bureaucracy.

2.6 Data cleansing as part the Concept HRM Project revealed that an average of 30 percent of the employees get paid remuneration higher than their entitlement, a proportion that rises to as high as 60 percent in the worst agency. Sick leave forms for teachers have not been processed for several years, encouraging absenteeism. An informal estimate suggests that 10-15 percent of teachers' pay is for services which are not, in fact, delivered (at a cost to the budget of at least K30 million).

2.7 Since neither the Department of Personnel Management (DPM) nor the Teachers Service Commission (TSC) is undertaking inspection activities to eliminate spurious payments, this waste in the payroll has accumulated over several years. The public sector payroll has largely drifted outside the framework of budget control.

Priority Actions to Reform Civil Service Size and Payroll Management

2.8 There are five key areas warranting attention for payroll savings in the 2004 budget. Together they will contribute to reducing waste and leakage as well as better management of the payroll.

Getting Rid of Ghosts and Unentitled Payments

2.9 Data cleansing, undertaken over the past year as part of the transition from the Public Payroll System (PPS) to the Concept HRM System, has resulted in detection of irregularities such as identification of names on the payroll which are not linked to establishment positions, more than one pay going to the same bank account and mismatches between bank and payroll names.

2.10 While what has been accomplished to date through data cleansing is significant, it only addresses part of the problem. Many irregularities persist. There will still be inappropriate salary payments to, for example, ghost names in real establishment positions and real names in inappropriately senior establishment positions. It is therefore necessary to launch a second stage of data cleansing which focuses on headcount and physical verification of both general and teacher payroll systems to identify: (i) ghosts in real establishment positions; (ii) overpayment of allowances; (iii) casuals who are unproductive.

Reducing and Eventually Eliminating the Unattached Pool of Officials

2.11 A manpower audit conducted by DPM in 2002 revealed that there were close to 800 employees on the unattached list for national departments and 1200 for provincial administrations. Even this is likely to be an underestimate since some important agencies

were excluded from the audit. Reportedly, in one province there are as many as 150 unattached staff out of a total of 450 employees. A perverse consequence of the frequent restructuring of GoPNG agencies is that even when the number of positions is reduced, the process of spilling positions invariably results in displacement of employees onto the unattached list (where they continue to be paid) and to hiring of new employees in the resultant vacancies who also have to be paid. Restructuring therefore increases total payroll costs. The existence of an unattached pool of officials who get paid without doing any work is bad enough; allowing the pool to grow in size is worse.

2.12 The following measures should be adopted to address this chronic and growing wastage on account of the unattached pool:

- (i) DPM and Treasury should formulate a policy for centrally managing the unattached staff. This should be based on a ‘sunset’ policy whereby unattached staff on full pay are either reassigned or made redundant within a specified period.
- (ii) Reportedly one of the hurdles to retrenching the redundant employees is the high cost of severance packages which is a drain on the budget. This can be addressed by: (a) negotiating with the public sector unions a scheme of payment spread over two or more years rather than a lump-sum as is currently required; and (b) exploring the possibility, with appropriate legal advice, of a downward revision of the retrenchment package.

Linking Pay Increases to Affordability

2.13 Substantial increases in pay scales in the past, without any reference to either affordability or public sector productivity, have also contributed to the payroll blow-out. The Government agreed to a 7 percent increase in pay scales as part of the 2000 award. It is reportedly considering another large increase in the current round of negotiations. This is on top of performance increments approved for two thirds of public servants amounting to between 3-4 percent under the Public Service Performance based Salary Structure introduced in 1994. Given that PNG is incurring sizeable budget deficits, any increase in pay has to be financed at the margin by additional borrowing, a clearly unsustainable situation. The NEC’s inclination to allow a significant increase in pay scales in the current round is fundamentally inconsistent with its earlier decision in 2002 to effect a 10 percent pay cut when the overall fiscal situation has, in fact, deteriorated in the interim.⁸ The NEC must take a view on the increase it can allow within limits of affordability and stand firm on this in the pay scale negotiations. It will also help to include Treasury in the pay negotiations to bring fiscal discipline into the negotiations.

Enforcing Budgetary Control Over Payroll

2.14 A glaring malady of the payroll system is the total lack of pressure on government departments and agencies to keep their payroll within the limit of the budget appropriation. Departments unattach existing staff, recruit new staff, award higher duty

⁸ The parliament rejected the NEC decision on pay cut and as such the proposal did not go into effect.

and overtime allowances without any accountability for exceeding the budget ceiling or threat of sanctions. The Treasury routinely issues ex-post warrants to the full extent of the actual payment thereby validating the transgressions. By acquiescing in these irregularities and indiscipline, the Treasury has virtually forfeited the use of warrant release as a mechanism for enforcing budgetary control over payroll. Nothing short of iron-fisted discipline by the Treasury will remedy the situation. Spending agencies must be held accountable for keeping payroll costs within the budget appropriations under pain of disciplinary action. Supplementing this Treasury effort, DPM should reassert its authority across all agencies on human resource management. Two management tools in this regard are: (i) to adapt the new Concept HRM System for use by DPM to monitor establishment positions; and (ii) installation of the Budget and Commitments Module of Concept to monitor year to date payments against each agency's budget appropriation.

Preparation of Realistic Budget Votes by Treasury

2.15 The budgetary appropriation for salaries of spending agencies has degenerated into a ritualistic exercise without any budgetary significance. Treasury sets the salary appropriation for each agency based on the data supplied by the agencies. Such data is typically manually prepared and is of variable and questionable accuracy. Faced with such a poor information base, Treasury cuts the proposed appropriation without any consultation or evaluation of the needs and priorities of the agencies. Instead Treasury is guided more by the need to keep total spending within the overall fiscal limits. Typically, the salary appropriations end up being short of the realistic needs of the agencies. The spending agencies, in turn, are disinclined to negotiate realistic appropriations ahead of the budget vote with the Treasury as they are fairly confident that they can pay out as they like during the course of the year and that Treasury will regularize the excess by, what has become a routine and standard practice, the ex-post warrant mechanism. Consequently, the whole exercise of appropriations for salary votes has lost budgetary significance.

2.16 It is important to reverse this trend as this looseness is much more detrimental than it seems. It permits a host of irregularities and malpractices to creep in resulting in waste and leakage. The only way of arresting this is for Treasury to prepare realistic budget votes setting hard but realistic budget constraints on the spending agencies. The quick implementation of Concept across all spending agencies and its roll out to the provinces can help as an effective management tool. This should be accompanied by data cleansing through field inspections, especially in high risk agencies as well as through an institutional process of consultation between the Treasury, DPM and the spending agency as part of the budget formulation process.

Potential Savings from Payroll Management

2.17 Rough estimates indicate that savings from better management of civil service size payroll can be as high as K80 million. These savings will flow from elimination of waste and leakage rather than reduction in productive labour inputs or service delivery.

3. RESTORING THE INTEGRITY OF BUDGET INSTITUTIONS AND SYSTEMS

Poor Governance – the Root Cause for the Fiscal Malaise

3.1 That poor governance is the root cause of PNG's current fiscal pressures can hardly be overemphasized. Even though the budget systems and processes laid down are sound, poor governance over the years has allowed them to be ignored, neglected, misused and abused. Waste, leakage, corruption and malfeasance pervade budget execution at all levels. This is reflected in:

- Wasteful spending on goods and services
- Arrears in government payments
- Extensive non-compliance with the Public Financial Management Act (PFMA) [as indicated in depth by the recent Auditor General's Report on the Works Department]
- Flouting of procurement procedures
- Mismanagement and abuse of trust accounts and proliferation of off-budget transactions
- Lack of transparency and accountability in provincial budgeting, including a major 'missing funds' problem.
- Poorly researched, costed and coordinated budget preparation.
- Erosion of accountability systems as manifested by poor follow-up on audit reports, Public Accounts Committee findings and cases initiated by the Finance Inspections Division.

3.2 As indicated earlier, restoring the integrity of budget institutions and systems is critical to turning around the fiscal situation. Unless these deep rooted governance and structural issues are addressed, no amount of ad-hoc budget cuts to generate savings is going to be effective in solving PNG's recurring and mounting fiscal problems. On the other hand, if the overall governance of the budget is set right, it will not only yield large up front savings by cutting waste and leakage, but also lay the foundation for further savings through an agency by agency evaluation of outputs and outcomes. The following is a synopsis of the priority areas needing attention in this regard.

Controlling Wasteful Spending on Goods and Services

3.3 Much of the spending on goods and services in PNG does little to improve or increase the flow of government services. Wasteful spending occurs through:

- ◆ inflated claims, sometimes grossly inflated claims, for supply of items such as stationery, transport, freight, security, etc;
- ◆ fraudulent claims, with the complicity of senior officials and accounting staff, where fictitious firms are created, fictitious letterheads and invoices are used, and commitment authorizations (ILPOCS⁹) are issued to these firms and claims later processed;
- ◆ large progress payments being made out of trust accounts or suspense accounts, often with the complicity or intimidation of officials, in respect of contracts that have been awarded outside of Supply and Tender Board arrangements;
- ◆ claims against government for damages for fictitious events or accidents that are pursued through the courts in the expectation (oftentimes successful) that the claim will not be properly defended, or that an out of court settlement will be reached.

3.4 Elimination of these forms of waste should yield significant savings in GoPNG spending without any service reduction. Some steps have been taken already taken towards this endeavour.

Making Financial Controllers Effective

3.5 Among the more important steps in this regard is the decision by the Department of Finance to appoint Finance officials as Financial Controllers in seven key departments, to pre-audit claims prior to processing them through the PGAS system. This is to ensure that purchasing and procurement by the department in which they are placed is carried out in accordance with the requirements of the Public Financial Management Act (PFMA) and the Financial Instructions contained in the Financial Management Manual (FMM).¹⁰

3.6 A potentially important savings measure for the 2004 budget will be to ensure that these Financial Controllers are effective. This is not going to happen unless proactive steps are taken to institutionalize their place and authority. Indeed the experience of private sector financial controllers that have operated in the Office of Rural Development and the Department of Health strongly suggests that several other mechanisms and linkages need to be in place for the financial controller function to be effective. These include the following:

- ◆ Bank reconciliations need to be kept up to date, and be accessible to the Financial Controller (to ensure other officers are not making payments without the Financial Controllers knowledge, or indeed that new bank accounts have not been opened).

⁹ An ILPOC is an Integrated Local Purchase Order and Commitment which combines purchase and payment orders.

¹⁰ The Financial Controllers will confirm and endorse claims for payment from private suppliers after they have been processed by examiners in the relevant department, and only release the claim for payment when they are satisfied that the PFMA and Financial Instructions have been complied with. There is currently a proposal from the Secretary Finance to extend these arrangements to eleven new departments.

- ◆ Budget comparison reports of actual expenditure against budgeted expenditure (pro rata or historic profile) need to be prepared and be accessible to the Financial Controller.
- ◆ Financial Controllers need to have ready access to PGAS and to the Treasury Management System (TMS)¹¹ reports, to monitor journals, movements in trust accounts and suspense accounts, commitment history and payments history (to monitor whether orders or payments are bypassing the Financial Controller).
- ◆ Restrictions need to be placed on after hours and weekend access to the accounting system to prevent officials processing payments without the scrutiny of Financial Controllers.
- ◆ Financial Controllers need to be given free access to project and contract files and documents to monitor all progress payments and contract formalities, whether those files are held in the spending agency or some other agency such as the Department of National Planning and Monitoring. This is especially the case for development budget funds, trust account or suspense account spending.
- ◆ Financial Controllers need the sponsorship and full support of the Treasurer. They are not in a line position, and can be bypassed, sidelined, ignored, or even threatened by other officers or politicians if they are not perceived to have the full support of the Treasurer.
- ◆ There need to be clear lines of reporting to the Financial Inspections Branch of Treasury or to the Auditor General's Office when irregularities are uncovered. Alternative lines of reporting should be available if the Financial Controllers suspect complicity by senior departmental officials.
- ◆ The Financial Controllers need to be perceived as being independent of the relevant department, so that their jobs or careers cannot be used as threats against them.
- ◆ The number of Section 32 officers authorized to approve expenditure should be reduced in each department to minimize their exposure to pressure and intimidation from suppliers, relatives, and other officers. A basic internal control measure is to ensure that only skilled and honest officers are entrusted with this responsibility.

Enforcing Compliance With the Public Financial Management Act

3.7 Paradoxically, PNG has more than its share of public watch-dog bodies with a mandate to enforce compliance with the PFMA and identify corruption and waste. These include the Auditor General's Office, the Public Accounts Committee of Parliament and the Financial Inspections Division of Treasury. The basic problem though is that all these watchdog bodies have been rendered ineffective because of absence of follow-up action on the irregularities they uncover. Indeed the PERR Team gathered that it is quite common for cases referred for legal action to be delayed, blocked or even abrogated because of political pressures and vested interests.

¹¹ TMS is the general ledger accounting application used by Department of Finance

3.8 The reasons for this state of affairs are complex, and include both cultural factors and, apparently, political and senior bureaucratic interests. Clearly, the solution lies not in proliferating systems or institutions but making the existing ones work. And the only thing this requires is deep political commitment to enforce accountability.

3.9 A starting point could be for the recommendations of the Auditor General's Office, the Public Accounts Committee of Parliament and the Financial Inspections Division of Treasury to be listed in a central register. This register should also log follow up actions on each recommendation. Regular reports, at least half-yearly, should be provided from the register to the parliament.

Making Internal Audit Effective

3.10 A first line of defense against fraud and waste of funds by a spending agency is its internal audit unit. These units can respond flexibly to concerns about financial management expressed within the agency, and can have important deterrent effect on irregular use of funds.

3.11 Although there are internal audit units in GoPNG, anecdotal evidence suggests that they have been largely undermined by lack of management support and lack of capacity. Their suggestions are not taken on board and the irregularities identified by them are not followed up. Consequently they are reduced to near impotence. There are, however, contrarian examples where internal audit units have made a positive contribution. A notable example is the Department of Health where the Secretary raised the profile of internal audit by providing leadership and training. An important lesson herein is that merely instituting a system delivers no gains unless an effective enabling environment is provided. There is little point in expanding the internal audit function unless there is seriousness of intent to follow up on its advice and recommendations. A potential savings option could be to resource and empower internal audit units in agencies with reformist management, in which there is an expectation that the recommendations of internal audit will be reviewed and implemented.

Tightening Public Procurement

3.12 Flouting of the prescribed procurement procedures has become quite pervasive. A frequently used practice is to bypass the requirement for competitive bidding by invoking the 'inexpediency' clause. Presumably this clause was incorporated in the guidelines to meet the procurement requirements in an emergency situation, but its intent and purpose have been vitiated by providing a pass through to as much as 40 percent of total procurement through this 'inexpediency' window.

3.13 A source of foregone savings is the Government's lack of effort to take advantage of its bulk purchasing power by negotiating discounts on common use items such as fuel, stationery, vehicles, tires, computer equipment, travel etc. If the Government tied procurement of these items to common use and period contracts, savings of as much as 20-30 percent would be possible.

3.14 A further problem in procurement is the weak capacity for tender evaluation. Competing tenders need to be compared on a 'like with like' basis, requiring technical skills in reducing competing proposals to a common denominator.

3.15 The above and other issues in procurement have drawn both GoPNG and donor attention. A recent review of procurement arrangements through AusAID assistance to the National Supply and Tenders Boards identified significant weaknesses in systems and procedures for tendering and contracting. The Government's own review of its procurement arrangements as well as the joint World Bank-ADB coordinated Country Procurement Assessment Review (CPAR), currently under way, have both confirmed that significant savings in expenditure can be achieved by reforming general purchasing arrangements, as well as Supply and Tender Board procedures.

3.16 The Public Sector Reforms Management Unit (PSRMU) has reportedly submitted a proposal to the NEC in May 2003 for procurement reform. Even as the details of this proposal are not yet available, any comprehensive procurement reform should include:

- Exploiting options for savings
- Plugging loopholes in guidelines
- Enforcing compliance with the provisions of PFMA
- Enforcing accountability for procurement decisions
- Building capacity for tendering and contracting.

Bringing Arrears Under Control

3.17 In recent years GoPNG has witnessed a growing loss of control over spending by individual agencies on goods and services. To circumvent the established procedures as well as to escape the budget ceilings, spending agencies have taken to issuing orders outside of the PGAS (without generation of an ILPOC).¹² Frequently this involves collusion with the suppliers. The supplier then claims payment for goods and services thus supplied outside the established system.

3.18 However, when funds available from PGAS have been exhausted, or where the accounting officers refuse, and correctly so, to honor these claims, the suppliers pursue their claims through the Departments of Finance and Treasury. If that option fails, they approach the courts, where they hope to reach an out of court settlement, or to obtain judgment on a case that is poorly defended. This obviously results in waste and in spending exceeding the budget vote.

¹² An ILPOC is an Integrated Local Purchase Order which combines purchase and payment orders. A General Expenses Form is used for utilities and other payments involving standing arrangements. PGAS is the computerized accounting system used by each government agency to manage its commitments and disbursements and to input into the General Ledger.

3.19 Where the claims are not paid they become arrears, effectively a forced and unanticipated increase in government borrowing which typically does not become transparent even at the time of the year-end closing of accounts. Accumulated liabilities such as unpaid leave fares, leave entitlements, superannuation obligations etc add to these future liabilities, but are not technically reckoned as arrears because no claim has been lodged against GoPNG and hence have not become overdue. Nevertheless these are real liabilities of government and present a looming financing problem for the future.¹³

3.20 Recent amendments to the PFMA should arrest, or at any rate, slow down the growth of arrears. However, it is important that these amendments are actively enforced, with tight checks to ensure that irregularities do not continue notwithstanding the amendments. If oversight is weak at the beginning, malpractices will creep back in and it will be difficult, if not impossible, to eliminate them once they are deeply entrenched.

Managing Trust Accounts More Prudently

3.21 Trust accounts provide a major avenue for utilizing public resources with loose accountability. The stated GoPNG policy is that Trust Accounts should be used only for genuine third party funds held in trust by the Government or where it is a requirement under donor funded projects. In practice, however, Trust Accounts are used as a device for circumventing budget and expenditure control provisions of the PFMA and the Financial Instructions. Funds going into Trust Accounts are often revenues, especially provincial revenues, that have been diverted from the consolidated fund. Once funds are in a trust account, they are not subject to the normal appropriation and warrant limitations. Many Trust Accounts have their own bank accounts, use manual cheque books and can be overdrawn. Even Trust Accounts that share the Waigani Public Account with the Consolidated Revenue Fund have been allowed to become overdrawn. Trust Accounts are also not subject to audit. It is therefore quite difficult to identify what the trust account funds are being used for, let alone evaluate the appropriateness of that spending. Despite earlier decisions of the NEC that no new Trust Accounts should be established, anecdotal evidence suggests that new Trust Accounts are in fact being created.

3.22 As part of the PERR analysis, the Government has prepared a listing of all Trust Accounts. This base data should be used to implement a reform agenda as follows:

- (i) Review the list of Trust Accounts to identify which ones need to be continued and which need to be closed. This review should be based on transparent and objective criteria.
- (ii) Prepare a timetable for closing all Trust Accounts that need to be closed.
- (iii) Present the position on (ii) and (iii) above to the parliament. Also present a position paper on Trust Accounts to the parliament annually as part of the budget documents. This should contain information on the uses to which

¹³ There is still considerable uncertainty regarding the size of the arrears as of December 31, 2002, with estimates ranging from K60 to K130 million.

trust funds have been put, any irregularities detected and action taken thereon and information on new trust accounts allowed to be opened, if any.

- (iv) Enforce the existing requirements for Trust Accounts to be reconciled and transactions posted to the ledger monthly. Hold heads of department accountable for failures to comply.
- (v) Document procedures covering the life cycle of Trust Accounts in accordance with the recommendations of the FMP, and update the Financial Management Manual accordingly.
- (vi) Enforce the ban on opening of Trust Accounts effectively, especially on the provincial governments.

Improving Budget Management and Accountability at the Provincial Level

3.23 It is now widely acknowledged that decentralization is a double edged sword. Handled properly, it can deliver significant benefits; handled badly, it can result in erosion of accountability and poor social and economic outcomes. In PNG, from a public expenditure point of view at least, the costs of decentralization seem to be outweighing the benefits. Decentralization has led to an erosion of budgetary control both in terms of ensuring that national service delivery priorities are met and in ensuring that public funds are prudently deployed and accounted for. Reforming public expenditure systems and procedures at the provincial and district levels therefore warrants priority attention.

3.24 There are early indications from the ongoing Review of Inter-Governmental Financial Arrangements (RIGFA) of a lack of transparency about the quantum of provincial own source revenues and of expenditures sourced from those revenues. There is evidence that some provincial revenues are not being accounted for in the provincial budgets, but are being processed through trust accounts or are simply being misappropriated. Furthermore, it is not very clear if the current financial management system is capable of compelling all revenue to be reported or how the system is programmed to automatically detect unreported revenues. Also, notwithstanding the broad consultative and planning mechanisms set out in the OLPLLG to ensure that the needs and wishes of remote communities are reflected in resource allocation decisions, in many provinces, administrative expenses eat up a disproportionate share of the resources. The estimated cost of paying the SRC determined allowances to LLG councilors, for example, actually exceeds the total LLG grant!

3.25 Savings measures in previous years have concentrated largely on the national level budget. It is essential that expenditure management reforms now encompass sub-national levels of government where potential savings can be sizeable. The focus has to be on both resource and expenditure sides. On the resource side, it is particularly necessary to come to grips with funds which are not formally reflected in the provincial budget accounting by enforcing transparency on the collection and deployment of provincial own source revenues. Also there are off-budget transfers from the national government, mainly comprising VAT and mining revenues, whose distribution across

provinces is highly inequitable.¹⁴ Thus although the aggregate transfers to the provinces for health, education, road maintenance and village courts (the four priorities) are sizeable, their distribution is such that some provinces have far more than what they need while others receive woefully short of their minimal requirements. On the expenditure side, the most important issue in provincial financial management is the absence of any transparent financial data which can be used to determine expenditure priorities, if any, that inform resource allocation.

3.26 Indeed, there are provisions in the OLPLLG and PFMA that enable the Treasury to influence and monitor provincial and district budgets. There are also enabling provisions to enforce accountability of the sub-national governments to the central government as well as the Auditor General without compromising their autonomy. The main problem is that these are inadequately or ineffectively exercised. Moreover, some of these provisions have been struck down by courts.

3.27 The ineffectiveness, in practice, of the existing enabling provisions in disciplining sub-national spending demonstrates the weaknesses and flaws of the current arrangements. While granting autonomy to sub-national entities is laudable and desirable, such autonomy can be risky and counter-productive if it is not accompanied by a sense of accountability. Also, decentralization appears to have attenuated links with the citizenry it is purporting to serve. Reportedly, the NEFC is grappling with many of these issues in its comprehensive review of inter-governmental arrangements. The reform agenda that the NEFC recommends should, at the minimum, include provisions for (i) the National Government being enabled to mandate minimum spending on priority sectors by provinces and LLGs; (ii) balance between recurrent and capital spending; (iii) full disclosure of provincial own source revenues in their respective budgets; (iv) incentives for minimizing staffing levels; (v) enforcing the system for quarterly review by Treasury of expenditures; and (vi) effective audit and penalties for transgressions.

Improving the 2004 Budget Preparation and Monitoring

3.28 If recent experience is any guide, GoPNG's approach to budget preparation and budget monitoring seems incapable of reducing waste in public spending. Typically the focus is on 'numbers management' rather than policy development. The Government has been unable to identify and realize the potentially large savings available from such areas as unattached officials, rationalizing the use of office space, identifying overstaffed schools etc. Neither has it been able to access the large savings available from reforming poorly managed spending programs.

3.29 There is no sense of collective responsibility for the overall budget strategy. The entire burden of fiscal management is borne by the Departments of Treasury and Finance with almost all other departments and spending agencies having no sense of ownership for the budget or responsibility for fiscal rectitude. Admittedly it will take several years to build healthy and robust institutions of budget management based on principles of

¹⁴ These off-budget transfers are significant. They are estimated to be of the order of K220 million for 2004.

democratic decision making and collective responsibility. Even as a 1000 mile journey has to start with a first step, the following suggestions are offered towards making a beginning in that direction.

- (i) **Budget Strategy Paper:** The practice of preparing a Budget Strategy Paper and getting NEC endorsement for it early on in the budget process should be revived.¹⁵ This practice will have several advantages. First, it will give the political executive a comprehensive overview of the fiscal problem and strategy. Second, members of the NEC will tend to see the budget formulation as a collective endeavor and refrain from the ‘tragedy of the commons’ approach. Third, individual members of the NEC will feel empowered in having a say in the budget strategy. Fourth, NEC endorsement will send the right signals across the board about the need to generate savings and give the Budget Screening Committee (BSC) greater clout in negotiating budget ceilings with the spending agencies. In the absence of such an authority, the BSC will be seriously handicapped in getting the spending agencies to acquiesce in savings proposals.
- (ii) **Budget Screening Committee:** The Budget Screening Committee, with a mandate for negotiating budget ceiling with spending agencies, should be re-established comprising Treasury (to lead the team), Finance, Planning and Personnel Management. Other members could be co-opted as may be necessary – for example, PSRMU, PERR Working Groups, the Teachers Service Commission, or Health and Education Department representatives for screening provincial budgets. The consultative process underlying the BSC mechanism will not only give greater transparency to the budget but also improve the appreciation across Treasury & Finance and spending agencies of each others’ problems and options.
- (iii) **Budget Time-table:** The revised budget time-table with a longer lead time should be adhered to. This will give the spending agencies as well as the sub-national governments adequate time to tailor their spending plans to the available resources.
- (iv) **NEC Procedures for Authorizing Additional Expenditures:** The NEC procedures for approving new expenditures during the year should be streamlined. There is already a requirement that the financial implications of spending proposals should be vetted by the Treasury and Finance Departments. This prescription should be scrupulously followed. Also the Department sponsoring the proposal involving additional expenditure should be required to identify how the proposal will be funded. In general, no proposal should be approved mid-year unless it is funded by compensating savings from within the department. Or else, there should be Treasury concurrence for funding along with an indication of the source of funding.

¹⁵ When this idea was first discussed by the PERR mission with the Treasury Secretary, he indicated that there used to be a practice like this in the past which had evidently gone into disuse.

4. EXPENDITURE ADJUSTMENT AND PRIORITIZATION

Towards a Medium Term Expenditure Framework

4.1 As indicated earlier, the road map to fiscal sustainability requires an expenditure adjustment of 4.5 percentage points of GDP over the five year period 2003-08. This translates, in absolute terms, to annual expenditure compression of about K500-600 million. Indeed, expenditure savings have to be larger than this as part of the savings will be needed for redeployment in poverty sensitive sectors while the remaining savings go to reduce the fiscal deficit. Rough estimates indicate that the governance measures recommended above (better governance of payroll and budget) will yield savings of a minimum of K200 million annually. The impact of better governance could, in fact, be larger if vigorous action is taken to arrest arrears, extinguish the unattached pool of officials and defend court cases.

4.2 The governance measures outlined in Sections 2 and 3 above should therefore be supplemented by a detailed exercise in adjustment and prioritization of expenditure that will involve an agency-wise review of (i) functions; (ii) expenditure patterns and staffing levels; (iii) outputs and results; (iv) evaluation of whether the functions need to be performed by the Government or can be shifted to outside the state sector (rationale for public intervention); (v) if rationale exists, how efficiency of performance/delivery can be improved; and (vi) if to be shifted, to whom, how and when. A good beginning appears to have been made in this direction through the Functional Expenditure Reviews.

4.3 A critical requirement to this task of adjustment and prioritization is a Medium Term Expenditure Framework (MTEF) aimed at improving the efficiency and result orientation of public expenditure. Through the Financial Management Improvement Program (FMIP), and other work supported by donors, GoPNG is making progress, albeit hesitant progress, towards development of an MTEF approach to public expenditure management that will:

- improve fiscal sustainability by developing and applying a consistent and realistic resource framework (which is derived from the Medium Term Fiscal Framework exercise);
- introduce a strategic basis to budget preparation so that expenditures are aimed at achieving agreed objectives;
- produce integrated, broad based budgets that contain both recurrent and development expenditure funded by GoPNG, donors and the community;
- increase commitment to predictability of both policy and funding so that ministries can plan ahead and programs can be sustained;
- provide line agencies with a hard budget constraint; and

- increase agency autonomy in the context of incentives for efficient and effective use of funds.

The Medium Term Development Strategy

4.4 The Medium Term Development Strategy (MTDS) prepared by the Department of Planning represents a modest beginning towards taking a medium term perspective to public expenditure programming. The MTDS defines a set of priorities for public expenditure, driven by an overarching development strategy focusing on export growth, rural development and poverty reduction.

4.5 The MTDS, in its current shape, suffers from two major shortcomings. First, by its own admission, it does not encompass the whole of government. It does not provide comprehensive guidance for the allocation of public resources nor for how non-spending instruments may be used to achieve some objectives. It would appear that the programs identified in the strategy are those that are earmarked for priority access to incremental resources and/or relative protection from spending cuts. Just because an activity or function is *not* identified as a spending priority by the MTDS, it does not mean that it will not be funded. Second, the MTDS reflects 'blue sky' planning; it has not taken account of the resource constraints and therefore shows the resource requirement in an unconstrained setting. Despite these shortcomings, the MTDS provides a good platform to build further work on. What is required now is to iterate between resources available, after meeting all non-discretionary obligations, and spending priorities and come up with an MTEF that strikes a balance between recurrent and capital expenditures.

4.6 This is a complex and demanding task even under the best of circumstances. In the current PNG situation, it is even more complex because of the depth and diversity of decentralization and the difficulty in getting data on spending patterns at the sub-national level, let alone influencing it. The National Economic and Fiscal Commission (NEFC) has done some commendable work in aggregating data for the general government (national government together with sub-national governments) under economic classification for some major sectors. While this one off exercise has been very useful in improving our understanding of spending patterns, what is needed really is to institutionalize reporting of expenditures on economic and functional classification for the general government on an annual basis.

4.7 Going beyond data issues, adjustment and prioritization of expenditure needs to address two generic issues. The first is an evaluation of expenditures, agency-wise in the national government, and the second is improving expenditure allocation, efficiency and accountability mechanisms at the sub-national levels. Both these avenues will yield considerable savings. But they will do so not on a stand alone basis, but only if they are built on a platform of good governance. However, preparation for them should start right away so that they can be launched on the heels of governance reforms suggested above for implementation as part of the 2004 budget. The following are the important steps in this direction:

- The Budget Screening Committee should start an evaluation of some of the larger spending agencies with a view to gaining experience in expenditure evaluation and drawing up a systematic list of questions/issues to be addressed. This template can then be applied across all major spending agencies.
- There should be a parallel assessment of the structure of ministries and departments as well as statutory agencies with a view to streamlining them.
- The NEFC recommendations on a revised framework of inter-governmental financing arrangements should be expeditiously considered and acted upon. That needs to be followed up by instituting arrangements for improving expenditure allocation and accountability at the sub-national levels of governments.

4.8 Admittedly, all the three tasks above are complex and demanding in terms of expertise and time. The PERR Team and consultants sponsored under the PERR exercise can help the Government in designing and launching these tasks.

5. IMPROVING HEALTH SPENDING

Deterioration in Health Outcomes Despite Increased Resources

5.1 The health sector in PNG is in a serious condition. Rural health services - the backbone of the system - deteriorated dramatically in the last decade to the point of near collapse. Health outcomes are very poor for a country of PNG's per capita income and the nation is on the verge of a widespread and rampant epidemic of HIV/AIDS, which will stretch the already overstrained capacity of the hospital system beyond its limits and crowd out treatment of other diseases.

5.2 There has been a significant increase in resources allocated to the health sector in the last five years, driven largely by expanded donor funding. But this increase has not translated into improved system performance and health outcomes.

5.3 Given the deep rooted deterioration of the system, some lag in response to increased resources is to be expected. But there are serious institutional and systemic problems that work against effective translation of funding into outcomes. These problems have been compellingly diagnosed in recent evaluations of the sector, including the 2001 Functional and Expenditure Review (FER) of Health Services, and include:

- the breakdown of the overall integration of the health system since the introduction of the new Organic Law on Provincial and Local Level Government (Organic Law) and the related adoption of inappropriate provincial health structures;
- the lack of priority accorded to spending on health by provinces;
- the dissipation of resources across activities with relatively low impact on the burden of disease and the failure to allocate resources to higher impact, cost-effective interventions;
- the crowding out of critical operational expenditure - especially on drugs and medicines - by spending on personnel; and
- fragmentation of funding and management caused by the nature of donor support and some perverse incentives created by heavy reliance on this support.

5.4 Under the Financial Management Improvement Program, NDoH is being assisted to develop a medium term budgeting system for the department – a prerequisite for the proposed Sector Wide Approach (SWAP) to be operationalized. This is an important initiative, but it will require the close support of and attention from central agencies, especially since improvements in system performance and outcomes will require coordination among central and provincial agencies and donors, changes in expenditure planning and budgeting practices, and most likely changes to the Organic Law.

The Short Term Agenda

5.5 In the short term, and in preparation for the SWAP, attention still needs to be focused on better prioritization of health expenditures and on action to address systemic problems impacting on efficiency (such as personnel spending, addressing the burden of large numbers of unattached officials and general improvements in budget execution and financial management).

5.6 The challenge for the 2004 budget and for the next couple of years (as these initiatives will take time to take effect) is that to have any real impact, expenditure reprioritization activities must work on provincial as well as national budgets. National agencies are directly responsible for only limited parts of the health system (mainly hospitals and procurement of pharmaceuticals). Their influence over other elements of the system, most importantly rural health, is limited to policy setting and shaping donor support. Provinces and local level governments are in charge of key elements of the system and its funding on the front line. For most parts of the health system, coordination across different levels of government and different types of spending is essential, and a shared view of priorities has to be developed.

5.7 Coordination of health spending and activities is heavily affected by the well-recognized general problems with the current system of inter-governmental relations. The NEFC is undertaking a comprehensive review of inter-governmental finance, and should come up with proposals to address many of these problems. But gaining acceptance for and implementing the Commission's recommendations will take time. In the interim, GoPNG will have to use other instruments at its disposal to address problems in health across all levels of government.

5.8 Clearly the budget preparation process is a key instrument, and the refinements of this process proposed by the PERR team should enable a better engagement with problems in sectors like health. However, the process will need to be supported with detailed knowledge of sector issues, and must make best use of whatever influence it can muster over the whole-of-government issues to the extent current limitations under the Organic Law allow. This will require close collaboration between central agencies, the Budget Steering Committee (BSC), NDoH and provinces.

Way Forward

5.9 The following recommendations, which are drawn largely from recent diagnostic work, address the development of instruments and mechanisms for improving health spending over the medium term, as well as suggestions that can and should be acted on in preparation for the 2004 budget. These recommendations are predicated on success in addressing the governance issues in public expenditure management discussed in earlier sections.

Developing a Medium Term Expenditure Framework for Health

- Collaborate closely with NDoH, provincial health advisers and the donor community, in their work on establishing a clear set of priorities for the PNG health sector in the medium term. This work, which effectively entails revision and development of the National Health Plan, should:
 - set out which outcomes have the highest priority and a timeframe over which they will be addressed;
 - consider what services the public sector should fund and deliver to have the maximum impact on the burden of disease and how to improve the organization and management of service delivery, including use of non-government agencies and facilities;
 - indicate how to operationalize the priority accorded to primary health care in the Medium Term Development strategy; and
 - develop policies on cost recovery that take account of equity and public health issues.
- Engage with NDoH, the FMIP and development partners involved in the establishment of a SWAP and the medium term expenditure framework to:
 - provide inputs on likely medium term resource availability;
 - develop a better understanding of emerging spending priorities to inform a policy-based dialogue with health agencies in the budget preparation process;
 - identify ways of building on the emerging multi-year expenditure planning process in preparation of annual health sector budgets; and
 - provide support with technical issues such as demand-based costing for health priorities.

Restructuring Provincial Health Services

- Initiate a review of FER recommendations on structural reform to develop a plan of implementation. The review should involve central agencies, NDoH and provincial administrations. Specific recommendations to be considered include:
 - restructure provincial health administrations so that district health staff report directly to the provincial health adviser, and eliminate the requirement in the Organic Law for health staff to report to the District Administrator;
 - design organization structures around the priorities emerging from the proposed review of the National Health Plan;
 - reflect the importance of health by establishing a separate division of health within provincial administrations; and
 - reintegrate hospitals into the provincial health system.

Improving Health Expenditures in the 2004 Budget

Addressing systemic inefficiencies

- Task NDoH, DPM and Treasury to develop a program to deal with the large number of unattached health workers and casuals - especially in the provinces.

Prioritization

- Endorse prioritization of health sector activities for 2004 according to principles established by NDoH for national and provincial annual plans, targeting service delivery and interventions that address the highest burden of illness and are cost-effective. This prioritization should be indicated in the budget circular for health agencies (national and provincial) and should be used in determining budget allocations.
- Require health agencies to demonstrate consistency of budget submissions with these priorities, and also explore scope for short-term efficiency improvements or savings in selected activities or spending items suggested in this review.
- Subject all proposals to build new infrastructure by donors and under the District Development Grants to evaluation by NDoH to ensure consistency with priorities and availability of funding for future recurrent costs.

Improving provincial health expenditure

- Assess, and if appropriate, implement options to quarantine funding of rural health services in national grants to provinces, or to fund directly from the NDoH budget, as is now being done for church health facilities.
- Seek and include in the budget circular to provinces a directive from the NEC regarding adequate provision for health in provincial goods and services budgets.
 - Enlist assistance from NDoH in determining adequate levels of funding, and in evaluating provincial budget submissions.
 - BSC should seek assistance from NDoH in evaluating provincial budget submissions, covering, *inter alia*, the adequacy of funding of activities needed to deliver national priority services (for example distribution of essential drugs procured by NDoH).

Aid management

- Task central agencies, NDoH and donors to work out clear protocols on the use of donor funds to finance activities that should be covered by local resources.
- Request donors engaged in the health sector to include in all aid project and program documentation estimates of the on going recurrent and capital cost implications of each project.
- Request donors to provide information on planned and actual disbursements using the GoPNG budget chart of accounts for health.

6. IMPROVING EDUCATION SPENDING

Progress and Setback in the Education System

6.1 The largest parts of the PNG education system - in terms of enrolments and expenditures - are on a policy and demographically driven growth path at a time of serious resource constraints. The pursuit of the laudable goal of universal primary education has resulted in rapid expansions in enrolments in elementary and primary education, with costly follow-on effects for secondary education as well.

6.2 The restructuring associated with the education reform agenda has led to significant efficiencies in the system. But the rapid growth rate of schools and students has stretched capacity and resources, while quality and learning outcomes have suffered. Even if additional funding were available over the next few years, the timetable for completion of the reform agenda would need to be adjusted.

6.3 The difficulties in achieving the Government's goals for access, equity, retention and quality in the school system in the current situation of fiscal distress are exacerbated by the lack of policy and administrative control over key elements of the education budget - specifically the wage bill and provincial spending. As a result, expenditure on teacher salaries is crowding out other inputs. Heavy reliance on donor funding for capital spending, and increasingly for significant parts of the recurrent budget, is adding to the problems of expenditure management. In addition, resource allocation within the sector does not properly reflect the national priority being accorded to basic education. The tertiary sector receives a disproportionate share of public funding for education, despite greater opportunities for cost recovery through beneficiary contributions in higher levels of education.

6.4 The Government is developing a new National Education Plan for the period 2005-2014, and is implementing an Affordability Study to guide resource allocation for the sector for the coming years. This work may not be ready in time to serve as an input to the 2004 budget preparation process. There is, however, scope to begin to address some of the imbalances in spending in the sector and, most importantly, to gain policy and budgetary control over the teachers' salary bill.

6.5 Given the enrolment pipeline created by past and current policies, the options for significantly scaling back the growth of the school system are limited and would be inconsistent with long held national development priorities. Opportunities do exist, however, to contain growth in the secondary education sector and to shift costs for tertiary education to the students. In addition, greater cost-effectiveness can be achieved across the whole system.

6.6 The largest potential for savings and greater efficiency of resource use will come from exerting policy and managerial control over the recruitment and deployment of

teachers. This, along with the related step of establishing policy control over the establishment and operation of schools, is a pre-condition for improving the efficiency and effectiveness of the education system.

Way Forward

6.7 These are difficult options in practice due to the disconnect between policy formulation and resource allocation arising from the introduction of the Organic Law. The Government is currently considering reforms to the Organic Law, but in the meantime it will be important for central and line agencies to collaborate to reach agreements on resource constrained policies and to persuade provincial administrations and other stakeholders to comply with these agreements. The mechanisms for establishing and enforcing such agreements may not be readily available, but the situation is so pressing that the National Department of Education (NDoE) and central agencies should explore whatever options may be available until reforms to the Organic Law can be implemented.

Recasting Goals

- Revisit the National Education Plan and its enrolment targets for elementary, primary and secondary education in light of resource availability.
- Initiate development of a medium term budgeting framework for education at the earliest opportunity.

Teachers' Salaries and Benefits

- Establish central policy and administrative control over the creation of teaching positions and the enforcement of staff ceilings in the teaching system.
- At the same time, establish policy control over the establishment of new schools to take account of costs and resource availability.
- Rectify discrepancies between actual and approved number of teachers on payroll, including the removal of “ghost” workers through field reviews.
- Enact a system for teacher deployment based on agreed national criteria, with annual determination of teacher numbers and additional recruitment requiring central approval. Within this system, deploy teachers to schools according to the number of students rather than the number of classes.
- Reduce the growth of enrolments in secondary schools, especially in grades 11 and 12, by (among other things):
 - declining all further requests to establish schools and to create new teaching positions, pending approval of the new or updated Education Plan;
 - establishing and enforcing cost-effectiveness criteria for according approval to schools; and

- refusing to certify enrolment of students who are not selected through the official process and endorsed by the National Education Board.
- Increase student/teacher ratios and mandate greater use of multi-grade classes.
- Examine the scope for and implications of converting National High Schools to Secondary Schools under provincial management.

School Subsidies

- Phase out subsidies to post-primary schools.
- Reduce administrative costs of school subsidy by, for example, discontinuing hand delivery of cheques.

Administrative and Operational Costs

- Restrict the role of the inspectorate to teacher assessments, reduce the staffing complement and reallocate staff to teaching positions.
- Review the status of the management cadre in the National Department of Education to explore the possibility for further reduction.
- Establish a mechanism for DPM and NDoE to collaborate in establishing more efficient staffing structures for Provincial Divisions of Education.
- Transfer the National Capital District's Division of Education from the NDoE to the District's own administration.
- Extend the current program of out-sourcing non-core activities of NDoE.

Grants to Statutory Authorities

- Consolidate the tertiary sector, shifting costs increasingly to students and reallocate the savings towards priority areas of basic education.

Cost Recovery and Resource Mobilization

- Charge for the provincial costs associated with national examinations.
- Increase rental rates on teacher housing.
- Introduce a user-pays contribution for recipients of the National Scholarship Scheme for tertiary students.
- Embed into the budget preparation process a mechanism for NDoE and the Budget Screening Committee to examine provincial budgets to investigate the adequacy of allocations for education.
- Enable and require NDoE and the Teachers Service Commission to make approval of new schools and creation of new teaching positions conditional on meeting the centrally prescribed guidelines for budgetary allocation for education.

7. CONCLUSION

7.1 The need for PNG to make a strong and decisive adjustment to arrest the growing burden of debt and to redirect public resources towards growth and poverty reduction can hardly be overemphasized. The fiscal adjustment will have to be aimed at reducing the debt to GDP ratio to 60 percent by 2008, and calls for budgetary savings of the order of 4.5 percentage points of GDP. There is no room for quick fixes or half hearted measures. The consequences of inaction or even delayed action will be a crumbling of the public finance system and rapid economic downturn.

7.2 At the heart of the fiscal problem is loose governance bordering on mis-governance which has, over the years, permitted irregularities, malpractices, waste and leakage to creep into public finance management and vested interests to become deeply entrenched. Addressing these governance issues is critical to restoring the integrity of budget institutions and systems and returning PNG to fiscal sustainability. This central premise informs the thrust of the PERR and its central message.

7.3 Many ministers and senior civil servants in GoPNG are sensitive to the dimensions of the problem and the challenge of addressing it. However, there seems to be a notion, at least in parts of the Government, that what needs to be done is to prune expenditure by cutting budgetary allocations of spending agencies. This has been tried in the past – and it failed. That is only to be expected. As much as these expenditure tightening measures are called for and preparation for them has to start right away, they are not going to be effective on a stand alone basis unless the governance issues underlying public financial management are addressed up front. Fiscal reforms need to be based on a platform of sound governance.

7.4 The silver lining in this dismal governance and fiscal scenario is that the solution to PNG's problems are within its control. In this regard PNG is better off than countries facing externally imposed fiscal crises due to collapse in export earnings and exchange rates. Moreover, in contrast to many developing countries, the elements of a sound budgeting system and the capacity to implement them are already in place.

7.5 What is required is a will to reform and set things right. Without leadership at both ministerial and senior bureaucratic levels, reforms will not happen, both because there are groups who benefit from the status quo and have an interest in its perpetuation, and because the honest and capable among senior policy makers have little incentive to perform better when the system all around them is so perverse.

7.6 Above all implementation of the PERR reforms requires ministerial leadership. Governance reforms of the type required and budgetary savings of the size warranted cannot be delivered by civil servants, no matter how capable or willing. And there are no

painless options. Hard decisions need to be taken and opposition to reforms from vested interests needs to be managed and quenched. This is inherently a political challenge to be managed by the political leadership, not a technical fix to be handled by civil servants.

7.7 Some recent initiatives such as amendments to the PFMA show that PNG's political leadership is capable of decisive action. What is required now is a shift from such one off initiatives into a mode of sustained and vigorous reform. And this has to begin right away as GoPNG prepares for the 2004 budget.

7.8 The multi-donor team that spearheaded this PERR looks upon the PERR as the beginning of a long process of engagement with the Government and the start of a collaborative multi-faceted effort. The donor team is willing to extend help, advice and technical assistance as may be necessary. But the way forward has to be led by GoPNG.