

Lmd

Journal **Labour and Management in Development**

Volume 1, Number 4

Public sector reform in Papua New Guinea and the 1999 Budget¹

Tim Curtin



Asia Pacific Press at the
AUSTRALIAN NATIONAL UNIVERSITY

<http://ncdsnet.anu.edu.au>

© Asia Pacific Press 2000

This work is copyright. Apart from those uses which may be permitted under the Copyright Act 1968 as amended, no part may be reproduced by any process without written permission from the publisher.

ISSN 1443-6698

ISBN 0 7315 3637 1

Tim Curtin has spent most of his working life in developing countries in Africa and the Pacific. In 1988, after more than 11 years spent as Economic Adviser in the European Union's delegations in Kenya, Egypt, and Nigeria, he joined a World Bank-sponsored Crown Agents team in the Papua New Guinea Treasury. As Investment and Privatisation Adviser in the Treasury he specialised on issues of mining policy and financing. He retired from the Treasury in February 1999 and is now a Visiting Fellow at the National Centre for Development Studies, Australian National University.

Abbreviations

| | |
|-------|--|
| BCL | Bougainville Copper Limited |
| CRA | Con-zinc Rio of Australia |
| GDP | gross domestic product |
| GNP | gross national product |
| IMF | International Monetary Fund |
| LIBOR | London inter-bank offer rate for overnight funds |
| MP | Member of Parliament |
| NTI | Nautical Training Institute |
| PIP | public investment program |
| PSC | Public Service Commission |
| SAP | structural adjustment program |
| UBS | Union Bank of Switzerland |

Papua New Guinea's 1999 Budget was amongst the most radical ever attempted by any developing country. If implemented in full it would have reduced the country's public sector to residual administrative functions, with even the health and education services cut back and with significant reductions in the already small police, defence, and prison services. Usually governments' budgets are incremental affairs—a little more spending here, a little less there; some increases in taxes on one hand, some reductions on the other. Papua New Guinea's Budget went well beyond such marginal adjustments through

- termination of public funding for no fewer than 15 research, training, and other statutory institutions, including the National Research Institute, the National Agricultural Research Institute, the Institute for Medical Research, the Nautical Training Institute, the National Mapping Bureau, the Small Businesses Development Corporation, the Industrial Centres Development Corporation, and the Industrial Registrar, together with 'major restructuring' of 21 national government departments,
- reduction of funding for each university by 20 per cent,
- overall reduction in central and provincial government establishments by 7,000 or nearly 20 per cent, reductions of the police and defence force establishments by 10 per cent each, abolition of 140 posts in the Department of Education (school inspectors and so forth) and 200 (mostly drug procurement staff) in the Department of Health,

- a purported major reallocation of funding from recurrent to capital expenditure, within a total spending level reduced in real terms but similar in cash to the 1998 outcome.

This paper puts these 'public sector reforms' in the context of previous attempts by Papua New Guinea since 1990 to meet conditions laid down by the World Bank for Structural Adjustment Programme loans, and suggests that, on this occasion, the specific steps taken went beyond the World Bank's proposals in both scope and timing.

Section 1 contains a brief outline of the economy of Papua New Guinea; Section 2 provides an assessment of international aid donors' ongoing insistence since 1989 that Papua New Guinea should undertake reform of its public sector as the main condition for their provision of financial assistance.

Section 3 examines the apparent shift from government consumption to investment in some detail, showing how much of the increase comprised transfers of funding from departments to discretionary spending by MPs for which there is no guarantee that it will indeed constitute capital spending.

On the revenue side, the Budget assumed that although the new VAT to take effect mid-year is intended to be revenue neutral, and that some new taxes, such as the 15 per cent interest withholding tax, would not make major contributions to receipts, total revenue and grants would increase by 6 per cent. Section 4 analyses Papua New Guinea's fiscal policy, and the

flow-on effects for its monetary policy, in the context of the country's present macro-economic circumstances.

Section 5 suggests more appropriate remedial steps that could have been taken—with donor support—not to emasculate Papua New Guinea's public service, but to enable it to expand and perform more effectively, those functions which the private sector is usually unwilling to undertake, and to address critical issues of governance, such as minimising openings for corruption through politicisation of the public service.

Economy of Papua New Guinea

The territories of Papua and New Guinea, which had been under Australian administration since 1906 and 1915 respectively, were granted independence as a single nation on 16 September 1975. The country's population of 2.5 million in 1975 had increased to over 4.5 million by 1999. Ethnically the majority are Melanesians, with some mixed Polynesian groups on various smaller islands. Within the Melanesians there is a distinction between the Papuans of the coastal areas of the mainland and islands, and the highlanders of the interior of the mainland. Both these main groups are largely fragmented, especially linguistically, with over 700 quite distinct languages spoken, often by no more than a few hundred people.

Until shortly before its independence, the country's economy was wholly dependent on primary production. The majority of the population subsisted on what they produced for their own consumption, with food crop agriculture—sweet potatoes,

taro, yams—largely limited to vegetable production in the high altitude areas of the mainland. In other areas wild sago was the main staple food. The only domesticated livestock were poultry and pigs. Fishing was important in coastal areas.

Commercial agricultural production has always been dominated by tree crops, beginning with the copra plantations, mostly on the islands, of the first European settlers in the later nineteenth century. Cocoa became important in the next century, especially in the North Solomon and New Britain island groups. Coffee was established in the highlands in the 1950s and was soon taken up on a smallholder basis by the local inhabitants. Oil palm estates were established, mostly on former copra plantations, from the later 1960s.

The various colonial administrations did little to interfere with traditional patterns of land ownership and agricultural production. To this day only about 3 per cent of Papua New Guinea's land area has been alienated, and even there only leases of state land are allowed and freehold land tenure is not permitted. In the rest of the country, land is held communally—individuals have rights over their own holdings but cannot sell these rights. Recent increases in alienated land have been limited to the special mining leases granted to mining and petroleum projects.

Until 1970 the only significant mining activity was in the Morobe goldfields around Wau and Bulolo. In the late 1960s and early 1970s much larger gold and copper deposits were found at Panguna on Bougainville island, and at Ok Tedi and Porgera in the western highlands of the

mainland. The localised hostility to the 1972 start-up of the Panguna mine by Bougainville Copper Limited (BCL), 51 per cent owned by Con-zinc Rio of Australia (CRA) (now Rio Tinto), came to be associated with an attempt to declare a separate independence for this island in 1975. That attempt lapsed following the commitment of the central government to introduce devolution of some key central government powers and functions to eventually 19 provincial governments, including North Solomons Province (Axline 1986).

The establishment of 19 centralised provincial administrations, complete with cabinets, parliaments, secretariats and also with some autonomous revenue powers, made enormous demands on the country's limited resources of qualified manpower. By default if not design, it was carried through at the expense of the decentralised district-level administrative system that had been developed by the Australians.

BCL's Panguna mine later proved to be immensely profitable to its shareholders, ranking at one time as the sixth largest company on the Australian Stock Exchange. At its peak the mine employed some 3,000 workers, but, although over 80 per cent were Papua New Guineans, a large proportion of these came from other parts of Papua New Guinea. The mine had contributed over 40 per cent of Papua New Guinea's total exports from 1973 to 1989, and its contribution to central government's total domestic tax receipts peaked at 14.5 per cent in its last full year of operation in 1989.

Apart from BCL's exports of copper and gold, Papua New Guinea's economy benefited from substantial plantation and

small-holder cropping of cocoa, coffee, copra, and palm oil. In addition to its copper mine Bougainville also contributed largely to Papua New Guinea's cocoa and copra exports.

These diversified mining and agricultural exports contributed to Papua New Guinea's relatively strong economic performance from 1985 to 1995. World Bank data (1997) shows national income (GNP) growing at an average rate of 4.5 per cent p.a., or 2.3 per cent per capita, to US\$1,160 in 1995. The latter figure masked the fact that by 1995 the majority of the population still had no cash income and depended on its own food production for its subsistence. Formal wage employment was recorded at only 235,000 by the 1990 census (see also McGavin 1997, and for indications that estimates for later years are under-stated, see Curtin 1999).

The final closure of the Panguna mine in September 1989 had a major impact on the economy of the rest of Papua New Guinea. By 1991, the Bank of Papua New Guinea's non-mining employment index showed a decline of 8 per cent during 1989. Many businesses whose main trade was supplying the mining townships on Bougainville were forced to close, including one of the country's few banks. The loss of the largest single source of tax revenue (apart from the annual budgetary grant of some K200 million provided by Australia) led the government to apply to the World Bank and IMF for balance of payments and budgetary support loans in late 1989.

Coincidental with cessation of production at Panguna in May 1989, full production was reached at the copper and

gold mine at Ok Tedi, in the Western Province of the mainland, and construction began at the new and very rich gold mine at Porgera (Enga Province in the Highlands). Neither of these, however, would replace BCL's tax contributions until much later in the 1990s. Oil production at Kutubu had a much larger impact on government revenues when that began in 1993.

Public sector reform

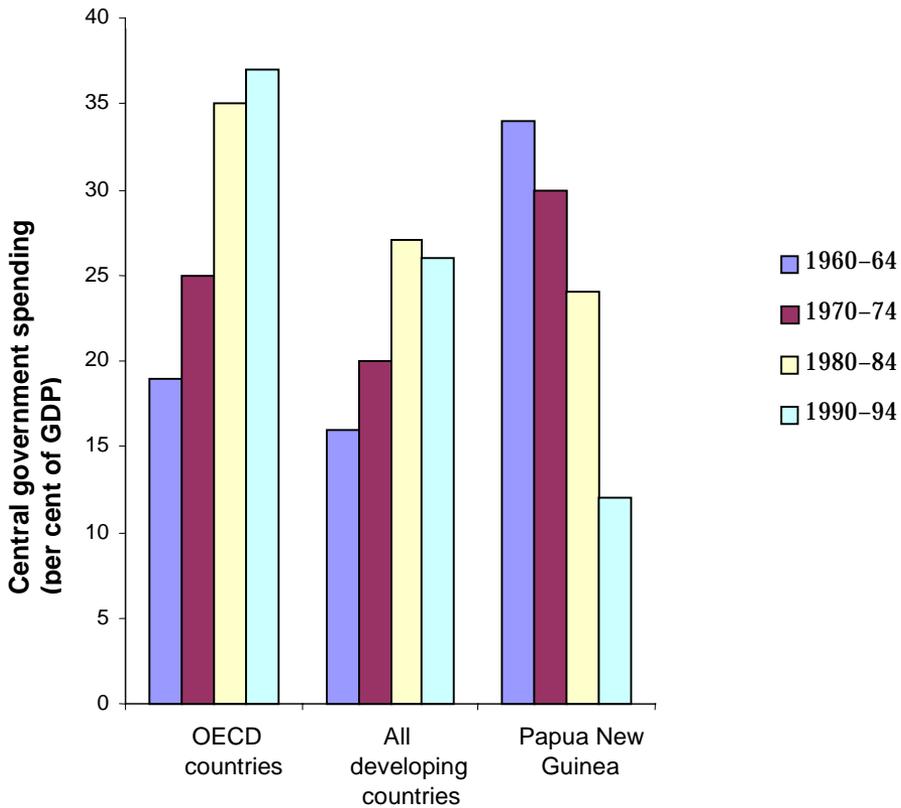
Papua New Guinea made its first application for a Structural Adjustment Programme (SAP) loan from the World Bank in 1989–90 after the closure of BCL's copper mine on Bougainville Island. Terrorist attacks on mine installations and personnel had been carried out by local inhabitants (usually referred to as 'landowners', a generic term for all Papua New Guineans despite their lack of title to any land) who sought the mine's closure as part of their wider ambitions of gaining independence of the island from Papua New Guinea.

'Reform' of Papua New Guinea's public sector became one of the chief conditions imposed by the World Bank and IMF for extending their loans. Public sector reform was already a standard requirement of the Structural Adjustment Programmes for all countries seeking 'programme' loans (as distinct from loans for specific projects) from the World Bank and associated donors. The international donor community was convinced that all developing countries could be characterised by grossly overblown bureaucracies and by economies in which the private sector

either struggled to survive under the weight of public enterprises that enjoyed monopoly status, but failed to deliver quality goods and services at internationally competitive prices, or was overly dependent on very high protective external tariffs.

Other less normative and more generic economic structural problems to be addressed by appropriate policy shifts in countries like Papua New Guinea included over-valued exchange rates (leading to import-dependence), low private savings rates, government 'consumption' (that is, recurrent expenditures) considered at any level to be too high a proportion of total public spending, which itself was also deemed to be too high a proportion of national income, even at levels below those in most donor countries (see Figure 1), and too great dependence on exports by extractive industries (for example, mining) (King 1997). The limited availability of post-school education and training was not considered by King or others to be part of these structural problems (see below).

Successive World Bank country reports on Papua New Guinea sang the same tune on the role of public sector reform in structural adjustment (1991:vii; 1992:i–x; 1993:62–63; 1995:1–18), but in a contradictory manner. They emphasised the country's backwardness in terms of the extent and quality of education and health services (for example, World Bank 1995:5), calling at the same time for reallocation of financing from the recurrent spending which funds such services to infrastructure projects. It will be shown below that this contradiction reached its zenith in the 1999 Budget.

Figure 1 All governments except PNG's have expanded since 1960

Source: World Bank, *World Development Report*, Washington DC, (various years).

It would be interesting to know the origins of the general perception both in Papua New Guinea and abroad that the country has too many public servants and needs fewer than developed countries with the same population size. For example, McGavin (1998:79) refers to the 'bureaucratic industry in Waigani', and the 1999 Budget Speech claimed that 'year after year we have allowed the public service to grow faster than our revenues'.

In fact, there has been a significant reduction of central government agency employment in Papua New Guinea since

1973, as may be seen by comparing the manpower data in Volume 2 of the 1998 Budget with the total manpower of the colonial administration as reported to the UN by the Commonwealth Government (Australian Government Publishing Service 1974:Appendix II). In 1973, there were 26,000 national public servants (including the *kiaps* who ran the districts, excluding the uniformed services and teachers); in 1998 as in 1992, (World Bank 1993:55) there were only 23,000 by the same definition but excluding district officials, to which should therefore be added about 8,000 provincial

public servants (that is, staff of the departments of the provincial governments funded by the national government—these correspond to the states' public servants in Australia. Papua New Guinea arguably has too many provinces, at 20 (including the National Capital District)—but with fewer than 1,000 public servants in each it is no surprise that the provincial governments perform so indifferently relative to the large tasks assigned to them (including all education up to year 12 other than in the five National High Schools, all primary health care, and extension services to all primary industry).

Past claims by both the World Bank and by Iario Lasaro, the Treasurer, in his Budget Speech, that Papua New Guinea has over 65,000 public servants, always included the 25,000 teachers and lecturers, 5,545 police, and the 5,191 defence force as 'public servants', implying that these form part of the bureaucracy. The grand total of centrally funded public servants as such is only around 31,000. The 1999 Budget speech also repeated the claim by the Prime Minister's economic adviser that Papua New Guinea's public service is expensive and exhibits low productivity.²

Some comparative data will suggest that this is not even half-true. The total cost of the salaries and allowances of the country's 30,926 national agency personnel (including prison warders, police, and defence personnel, tertiary education lecturers and the staff of other statutory bodies, but excluding teachers) as budgeted in 1998 was K398.72 million, or K12,892 per employee. On a per capita basis (assuming 5 persons per family head), this

works out at US\$1,134.55, which is almost exactly equal to the country's national income per head as stated by the World Bank. It is true that average wages in the public service tend to be higher than for Papua New Guineans in the private sector. This reflects differences in average skill levels, due to the greater preponderance of expatriates and higher proportion of unskilled Papua New Guineans in the foreign-owned enterprises that dominate the private sector.

Above all, the per employee cost of the Papua New Guinea public service in dollar terms of US\$5,673 is not at all high compared with public service costs elsewhere. Comparative average rates of pay may well over-state relative productivity of Australian and Papua New Guinean public servants, but it seems unlikely that the latter are innately inferior—by a factor of four, with their average pay of A\$9,000 per annum compared with Australia's A\$36,000.

The productivity of any country's national public service is a function of trends in the level of real service delivered per head of the population per unit of currency taxed and spent in any period. McGavin (1998:79) merely states—without demonstrating—the 'general inefficiency and ineffectiveness in the delivery of public services in Papua New Guinea', yet in the key education sector, which accounts for one third of total public sector employment, despite imposed ceilings on pupil-teacher ratios, numbers enrolled per total staffing in education have increased. A major gain in productivity and cost-effectiveness since 1990 has resulted from the policy of

'topping-up' primary schools with grades 7 and 8, and high schools with grades 11 and 12, reducing overall unit costs of secondary education very substantially. The 1999 Budget's reduction of the number of school inspectors will, by one measure, increase 'productivity' but without necessarily reducing McGavin's 'ineffectiveness', as the coverage and frequency of school inspections declines.

On a persons per bureaucrat basis, there were 100 Papua New Guineans per public servant in 1973, and 245 in 1998, far more than in Australia, New Zealand, or Singapore. This would suggest that the country is very lightly governed, as even casual acquaintance with Papua New Guinea's rural areas shows. It also suggests that if there has been a decline since independence in the level of service provided, as the 1999 Budget claimed, this could well be at least partly because the public service has not grown commensurately with the population. Yet it would be hard to argue that productivity of the public service has declined across the board. The productivity of the education department has certainly increased, since there has been a much larger expansion (by 150 per cent) of the numbers enrolled in the country's schools since Independence than there has been in the staff of this department (although it is one of the very few to have expanded at all since 1973). There have been similar increases in throughput of patients in the country's hospitals despite minimal staff increases.

The decline in both the absolute and, even more, the relative size of the public service is due to the rigid ceilings on total

public spending enforced by the IMF and the World Bank. This has resulted in total expenditure falling both in real terms (that is, relative to inflation since Independence) and as a percentage of national income (also to its lowest level since 1975). Public servants in the health services can hardly be expected to perform miracles in rural health clinics that are deprived of funding for medicines—and a similar lack of the basic materials necessary for providing services is evident in many other national departments.

This is a structural problem, and one for which the solution is not further cuts in staffing levels—in 1973 there were close to 6,000 centrally funded health officers, and only 4,453 in 1998. It is just as inefficient to have health clinics well stocked with drugs but with no dispensers as to have dispensers but no drugs. Transferring district and local-level health functions and their funding to the provinces has not been helpful.

The real problem is not so much health's low share of total fiscal resources, since that meets the World Bank's 8 per cent target for the 1996 SAP, as the inadequate size of the total recurrent and capital budget of K2.57 billion (excluding amortisation): 8 per cent of that figure is not enough to provide a comprehensive public health service for 4.5 million people—it is less than the budget for medium size hospitals in Auckland or Sydney!³

Similar considerations apply to the widespread perception of the poor law and order situation in Papua New Guinea. None seem to relate the country's disappointing performance in these areas to the overall budgetary constraints. These have resulted

in a striking disparity between the number of police per capita in Papua New Guinea as compared with countries of similar size. Despite a population which is larger (by one million) than Singapore's, Papua New Guinea had a police establishment of 5545 in 1998, reduced by the 1999 Budget to 5,045—less than half of Singapore's 11,421, with its smaller and, of course, highly concentrated population. Papua New Guinea's police force has to ensure law and order over 500,000 square kilometres; Singapore's total area is smaller than Papua New Guinea's National Capital District (Port Moresby and district). Now one might argue that Singapore must be a lawless place if it needs double the number of police in Papua New Guinea, but anybody who has been there knows that crime is rare in Singapore. It could seem more reasonable to conclude that Papua New Guinea needs at least double Singapore's police force (for data comparing crime rates in Papua New Guinea with those of other countries, see Yala and Levantis 1998:8).

Likewise Papua New Guinea has more, not less, need of health services and doctors than say New Zealand. At the present output rate of the Taurama Medical Faculty it will take Papua New Guinea about 500 years to catch up with the 10,787 doctors New Zealand has for its smaller population. The 1999 Budget implied that improving public health does not require more doctors when it provided both for reductions in tertiary education of all kinds as well as no increase in the Natschol funding which would enable more of the country's qualified youth to embark on any tertiary, let alone medical, studies.

Recurrent versus development spending

The centrepiece of the 1999 Budget was the purported shift of resources from the recurrent budget to the development budget (Table 3). This conformed with the 'public sector reform' objectives of the 1996 World Bank-IMF Structural Adjustment Programme, but reflected a false analogy with the economic distinctions between consumption and investment. For clearly government spending on education, like an individual's, is investment and not consumption, even though it is classified as recurrent expenditure and therefore 'bad' in the language of the 1999 Budget.

Most donors moreover now recognise that there is no meaningful economic or operational significance in distinctions between governments' 'consumption' and 'capital' spending, and increasingly budget support and other adjustment loans are provided to 'consumption' activities like health and education services. For example, in Ghana the United Kingdom's Department for International Development has provided funding for teachers' salaries, and the World Bank is doing the same in many other countries.

The 1998 Budget allocated K1.9 billion to recurrent spending and net lending; the recurrent budget for 1999 is only K1.7 billion, a reduction of K225 million or nearly 12 per cent—certainly not a marginal change (Table 3). The development budget increases by almost the same absolute amount, K226 million, but, on a smaller base, by 42 per cent, to K861.6 million, or 10 per cent of GDP.

If true, a public investment programme amounting to as much as 10 per cent of GDP would be a numerical feat within total public spending (excluding amortisation) amounting to only 31 per cent of GDP. This is a much lower proportion than in countries like Australia and other members of the OECD where recurrent public spending alone is usually at least 40 per cent of GDP (see Figure 1). Much of the high ratio of public spending in the OECD countries is a result of transfer payments (from taxpayers to the unemployed and other recipients of welfare), and the scope for such transfers in developing countries may not be great. It will be indicated below, however, that a country like Papua New Guinea could well raise its tax effort above the present low 25 per cent of GDP.

Total recurrent government expenditure (including debt servicing) in Papua New Guinea averaged less than 20 per cent of GDP from 1980–94 (Figure 1), which is half the average of 40 per cent in OECD countries. Given the low quantum of public services available to the people of Papua New Guinea, which is what the recurrent budget is supposed to provide, it could be considered there was a strong case for increasing the level of total recurrent public spending above the 20 per cent in 1999 to at least the OECD level, not reducing it further as the 1999 Budget did. That case is subject to the proviso that higher public recurrent spending was productive in terms of meeting social needs and did not merely take the form of still larger transfers to politicians' 'slush funds' (the popular term in Papua New Guinea for the 'electorate development funds' paid direct to MPs that

have been amongst the fastest growing expenditure items in recent years).

While the 1999 Budget went a long way towards implementing the previously disregarded public sector reforms in the World Bank's 1996 Structural Adjustment Programme's conditionalities, the World Bank itself now appears to have reversed its previous position on this issue. The Bank's recent *World Development Reports (1997, 1998/1999)* recognise that one major reason for the poor economic performance of many sub-Saharan African countries relative to Southeast Asia is their lower level and quality of government services, especially health and education. Those services are delivered by recurrent spending, not the capital budget.

The claimed increase in the share of development spending in the total budget was, in any case, no more than an exercise in creative accounting. In all other fiscal regimes, as previously in Papua New Guinea, maintenance of roads and other infrastructure like hospitals and schools is treated as recurrent expenditure. Such expenditures are in the nature of consumption, and do not constitute new investment. Building new roads is investment; fixing up old roads is consumption.

More than 60 per cent of the increase in the 1999 Development Budget comprises spending on road maintenance or district support grants, neither of which amounts to 'Investment' in the normal sense. Road maintenance is allocated K70 million or 8 per cent of the total Public Investment Programme (PIP), while so-called Rural Development Projects (the new designation

for the old 'slush fund'; that is, money allocated for discretionary spending by MPs) receive K91 million (10.6 per cent), and district support grants amount to K33 million. There is neither a mechanism for ensuring that these grants totalling K124 million will be spent on projects generating income for any one except MPs and district officials—the unpublished guidelines are completely open-ended—nor, following the cutbacks in the implementing agencies of the central government, such as abolition of the Plant and Transport Branch of the Department of Works, any administrative structures to enable the more conscientious MPs to undertake design, tendering, and construction of roads and schools.

The Treasurer's Budget speech implied that mere diversion of funding from national government departments to MPs would be enough to ensure greater provision of health and education in the rural areas. As yet there is no evidence of MPs starting their own schools and health clinics and hiring teachers and doctors—nor would it be efficient for them to do so. But the total grants of K89 million provided for the MPs' discretionary funding could have raised total recurrent spending on health of the national government from the budgeted K108.5 million to K197.5 million.

The total rural development budget includes K15 million allocated for 'poverty alleviation', which is also deemed to be a capital project, bringing the total PIP funds allocated for administration by the new 'Office for Rural Development' to K139 million. 100 per cent of this funding is classified as investment, but it includes funds for administrative purposes of K2 million over and above the K1.5 million

provided to the Office in the recurrent budget. It is interesting to note that the Office's 12 officials have no less than K3.5 million to spend on themselves, almost as much as the total funding provided to the Goroka University, which is responsible for all Papua New Guinea's graduate teacher training.

In addition, more than half of the total Development Budget comprises allocations for recurrent items like wages and salaries and goods and services, which is the tactic some departments adopt to remain functioning. The precise numbers are K451 million on recurrent items, of which, as noted, more than 25 per cent comprises open-ended grants to MPs and the districts and only K407 million on capital spending as such. Of the latter, only K120 million constitutes capital spending on projects by the government itself (as opposed to AusAID) (Table 1 for a full breakdown).

Normal accounting defines investment as creation of new capital assets with a capacity to generate new income. Treating current spending as 'investment' is misleading. To take one example from the PIP Volume (Volume 2.3), the Development Budget for Department of Agriculture and Livestock in 1999 is K10 million. But K3.3 million of this is taken up by current spending on salaries and goods and services, and the K1.6 million supposedly devoted to capital formation is, in reality, for general office equipment to support the activities of the Department, unrelated to any income generating projects. Only the grant of K5 million to the Rural Development Bank for its lending programmes could be considered investment in the normal sense.

Macroeconomic framework of the 1999 Budget

World Bank–IMF structural adjustment programmes have customarily included balanced budgets as part of public sector reforms. In 1998, a divergence of views developed between the Bank and the Fund following the financial crisis of 1997 in Southeast Asia, with the Bank more prepared than the Fund to tolerate fiscal deficits. More recently the IMF has begun

to allow a few countries like Thailand to run larger budget deficits.

Papua New Guinea has been under continuous pressure from the World Bank and IMF to limit the growth of public expenditure ever since 1990. Although in nominal Kina terms this pressure might seem to have been disregarded, since expenditure has increased rapidly, in real terms (allowing for domestic inflation) government consumption declined from

Table 1 Papua New Guinea: Public Investment Programme 1999

| | K ' 000 | per cent |
|--------------------------------------|-------------------|------------|
| 1. By main agencies | | |
| Transport, works & aviation | 297,344.40 | 35 |
| Office of rural development | 139,000.00 | 16 |
| Education | 92,114.90 | 11 |
| Health | 74,827.40 | 9 |
| Bougainville affairs | 31,156.50 | 4 |
| Waterboard | 20,157.00 | 2 |
| East new britain | 17,456.60 | 2 |
| Other, nec | 189,543.20 | 22 |
| Total | 861,600.00 | 100 |
| 2. By economic classification | | |
| Current expenditure | | |
| Personal emoluments | 7,800.00 | |
| Goods & other services | 273,900.00 | |
| Current transfers | 169,800.00 | |
| Other | 300.00 | |
| Total current expenditure | 451,800.00 | 52 |
| capital expenditure | | |
| Capital formation | | |
| Construction, renovation etc | 196,000.00 | |
| Ausaid procurement | 189,700.00 | |
| Other, nec | 24,100.00 | |
| Total capital formation | 409,800.00 | 48 |
| As per cent of gdp | 4.81 | |
| Grand total | 861,600.00 | |
| As per cent of GDP | 10.11 | |
| memo: GDP | 8,518,500.00 | |

Source: Department of Treasury and Planning, Budget Documents, Volume 2

K618 million in 1994 (at 1985 prices) to the 1999 Budget's projected K404 million in 1999 (Table 2, 1999 Budget, Volume 1). Naturally, spending per person declined even more rapidly. What is not appreciated by the World Bank and IMF is that, in US dollar terms, there has also been a decline not merely *per capita*, but in absolute amounts. The 1999 Budget's *total* expenditure has fallen to US\$1.34 billion from US\$1.56 billion in 1995 (Table 3). This substantial fall in Papua New Guinea's social spending is remarkable for a country that has steadfastly attempted to comply with the ceilings laid down by the World Bank and IMF. Instead of providing sufficient fiscal assistance for Papua New Guinea to weather the downturns in its commodity export prices since 1995, they have in effect required cuts to real public spending roughly in line with the fall in dollar-denominated export earnings.

Part of Papua New Guinea's difficulties in 1999 were self-inflicted after inflows to the MRSF—mining and petroleum taxes—were projected to fall from US\$197.46 million in 1995 to US\$153 million in 1999 (that is, by 22.5 per cent, see Table 2). This clearly indicated a need for external support, but access to that support from the World Bank and IMF was compromised by the Government's appointment of Dr Hamidian-Rad as Chief Economic Adviser to the Prime Minister in June 1998. In September 1998, the World Bank informed the government that 'terminating the engagement of the economic adviser [Dr Hamidian-Rad] will be the most preferred option' for the Bank to resume its structural adjustment financing (*Post Courier*, 7 October 1998).

In the continued absence of World Bank support, the macro-economic stance of Papua New Guinea's 1999 Budget was unavoidably conservative, with a budgeted deficit-financing requirement of less than 1 per cent of GDP—well within IMF norms. This apparent self-denial did not save the government from a stinging attack on the budget by the IMF mission that visited Papua New Guinea in January 1999. The revised 1998 Budget had claimed that the country would end 1998 with a deficit of just 1.6 per cent of GDP at K124.3 million. In reality, according to the IMF mission, the final outcome was a net financing requirement of nearly K300 million, or nearly 4 per cent of the revised GDP of K 7.7 billion. Although it is possible Papua New Guinea's GDP estimates have been systematically under-stated since direct measurements ceased in 1993, the expanded deficit remains large and was largely due to *unbudgeted* outlays, funded by additional temporary advances from the central bank, the Bank of Papua New Guinea.⁴

These advances were to be refinanced by the proceeds of the Government's proposed commercial borrowing from Krediet Bank of the Netherlands. This loan was cancelled, however, in January 1999, on the grounds that it mortgaged Papua New Guinea's mineral taxation receipts.⁵

Non-receipt of the proposed US\$120 million (K273 million) left the central bank's advance unrequited well into 1999, and as of June 1999 repayment still depends on the government's success in raising up to US\$250 million, either by means of its first sovereign bond issue, or from the World

Table 2 Central government revenue and grants 1995–99

| | Kina | 1995 US\$ | % GDP | Kina | 1999 US\$ | % GDP |
|--------------------------------------|----------------|----------------|--------------|----------------|----------------|--------------|
| A. Tax revenue | 1207.20 | 928.62 | 19.14 | 1761.90 | 792.86 | 20.72 |
| A1. Personal income tax | 257.80 | 198.31 | 4.09 | 431.40 | 194.13 | 5.07 |
| A2. Company tax | 99.00 | 76.15 | 1.57 | 145.40 | 65.43 | 1.71 |
| A3. Mrsf taxes | 256.70 | 197.46 | 4.07 | 340.00 | 153.00 | 4.00 |
| A4. Excises etc. | 103.30 | 79.46 | 1.64 | 151.10 | 68.00 | 1.78 |
| A5. Import/export duties | 426.70 | 328.23 | 6.76 | 465.00 | 209.25 | 5.47 |
| A6. Other taxes | 63.70 | 49.00 | 1.01 | 229.00 | 103.05 | 2.69 |
| B. Non-tax revenue | 277.60 | 213.54 | 4.40 | 262.00 | 117.90 | 3.08 |
| C. Grants | 236.70 | 182.08 | 3.75 | 461.30 | 207.59 | 5.42 |
| D. Total revenue & grants | 1721.60 | 1324.31 | 27.29 | 2485.20 | 1118.34 | 29.22 |

Note: 'MRSF' denotes mining and petroleum taxation paid to Mineral Resources Stabilisation Fund.

Source: *Budget 1999*, Volume 1, Economic and Development Policies, Government Printer, Port Moresby

Table 3 Central government expenditure, 1995–99

| | Kina | 1995 US\$ | % GDP | Kina | 1999 US\$ | % GDP |
|----------------------------------|----------------|----------------|--------------|----------------|----------------|--------------|
| 1. Recurrent budget | | | | | | |
| A. National departments | 781.60 | 601.23 | 12.39 | 712.60 | 320.67 | 8.38 |
| A1. Salaries & wages | 334.40 | 257.23 | 5.30 | 299.20 | 134.64 | 3.52 |
| A2. Goods & services | 447.20 | 344.00 | 7.09 | 413.40 | 186.03 | 4.86 |
| B. Provincial departments | 346.10 | 266.23 | 5.49 | 500.00 | 225.00 | 5.88 |
| B1. Staffing grants | 105.00 | 80.77 | 1.66 | 105.00 | 47.25 | 1.23 |
| B2. Teachers' wages | 151.10 | 116.23 | 2.40 | 186.30 | 83.84 | 2.19 |
| B3. Goods & services | 78.80 | 60.62 | 1.25 | 93.20 | 41.94 | 1.10 |
| B4. Grants to provinces | 11.20 | 8.62 | 0.18 | 115.50 | 51.98 | 1.36 |
| C. Transfers to statutory bodies | 126.70 | 97.46 | 2.01 | 95.00 | 42.75 | 1.12 |
| D. Interest payments & fees | 273.10 | 210.08 | 4.33 | 401.20 | 180.54 | 4.72 |
| D1. Domestic | 179.30 | 137.92 | 2.84 | 238.10 | 107.15 | 2.80 |
| D2. External | 93.80 | 72.15 | 1.49 | 163.10 | 73.40 | 1.92 |
| E. Net lending | -3.20 | -2.46 | -0.05 | -5.00 | -2.25 | -0.06 |
| F. Total recurrent budget | 1524.30 | 1172.54 | 24.16 | 1703.70 | 766.67 | 20.03 |
| 2. Capital budget | | | | | | |
| G. Development budget (pip) | 230.70 | 177.46 | 3.66 | 861.60 | 387.72 | 10.13 |
| H. Amortisation | 266.40 | 204.92 | 4.22 | 345.70 | 155.57 | 4.06 |
| H1. Domestic | 43.30 | 33.31 | 0.69 | 47.80 | 21.51 | 0.56 |
| H2. External | 223.10 | 171.62 | 3.54 | 297.90 | 134.06 | 3.50 |
| I. Loan repayments | 3.20 | 2.46 | 0.05 | 5.00 | 2.25 | 0.06 |
| I. Total capital budget | 500.30 | 384.85 | 7.93 | 1212.30 | 545.54 | 14.25 |
| J. Public sector retrenchments | | | | 65.00 | 29.25 | |
| K. Total expenditure | 2024.60 | 1557.38 | 32.09 | 2981.00 | 1341.45 | 35.05 |

Source: *Budget 1999*, Volume 1, Economic and Development Policies, Government Printer, Port Moresby.

Bank and IMF. Initially the Government decided to test the market for its sovereign debt. The marketing of the bonds was organised by the American investment bank, JP Morgan. The Krediet Bank's syndicated loan would have carried interest at 3 per cent over the London inter-bank offer rate for overnight funds (LIBOR), that is, just over 8 per cent in the first half of 1999. The Government conceded that the interest on the bonds could well be higher, as much as 10 per cent over LIBOR, because they were unsecured. Such a margin over LIBOR would imply junk bond status.⁶

The Government also stated that the bond issue was preferable to bank loans (commercial or from the World Bank) because the bonds would be term loans, that is, repayments would be deferred until the bonds matured, whereas bank loans would be repaid continuously (*Treasury Weekly* 22–28 February 1999). There is indeed a clear economic benefit from deferred repayments, if

- (1) the uses to which the borrowed funds will be put take time to yield a return, and
- (2) those returns are sufficient to recover, not just the principal amount, but also the higher total amount of interest payable when repayments are delayed.

Bonds have a less obvious political benefit to governments in a country like Papua New Guinea, where no government has won a second consecutive term in office. In this situation it is unlikely that the government which sells the bonds would ever need to find the funds to repay its bonds when they fall due, because it would

no longer be in power. This is not a problem if the bonds have been used productively, but when the bulk of the government's development budget is disguised recurrent spending (such as the grants to MPs and district councils) there is no certainty that this will occur. Thus the next government may well find that its revenues have not increased sufficiently, if at all, as a result of this government's use of the bonds.

The budgetary impact of a single lump sum repayment of US\$250 million (K595 million at the April 1999 exchange rate of K1.00 = US\$0.42) will be considerable. In the 1999 Budget it would have brought total extra external debt amortisation to K893 million, or 10 per cent of GDP and 34 per cent of total government expenditure. The Government conceded this point with its comment that, when the time came, new bonds could be issued to repay the old (*Treasury Weekly*, 22–28 February 1998). That kind of approach is exactly what led to much of the Third World's debt problem (see Caufield 1997:136–37).⁷

In the event, the bond issue had failed by June, and the government announced on 7 June 1999 that it would, after all, turn to the World Bank and the IMF (*Treasury Weekly*, May 31–June 7). Perhaps because the government would then have been forced to swallow the IMF's medicine and raise the missing K300 million by increasing taxes, with higher rates for value-added tax (VAT), log taxes (already announced on 7 June 1999), and fuel excises, despite the Treasury Minister's explicit rejection of these recommendations (*The National*, 15 March 1999), it emerged that it was seeking funding of over US\$2.5 billion from Taiwan

in exchange for diplomatic recognition. Before that transaction could be finalised, however, Prime Minister Skate resigned, and Sir Mekere Morauta was elected as his successor (on 14 July 1999). In his acceptance speech, Sir Mekere announced that his first actions would include revision of the 1999 Budget (*Post Courier*, 15 July 1999).

The need was urgent. Within a month of the presentation of the 1999 Budget the IMF had passed its own judgement on the Budget and its revenue forecasts, noting the 'quite optimistic assumptions'. Until April 1999 actual prices of the country's main mining exports, gold and copper and oil were well below the Budget forecasts. Unfortunately, while oil prices recovered after April from the 12 year lows of the first quarter, the gold price fell from US\$289 per ounce in early May to as low as \$253 in July 1999.

Of course it was possible that, over the course of 1999, all these prices would validate the Budget's assumptions. The initially low export prices in 1999 could be deemed to be just bad luck which would have affected any government, but the 1999 Budget's determination to show only a modest deficit when a much larger deficit was probable, was a high risk strategy.

Thus in the last analysis the 1999 Budget, like most of its predecessors, and no doubt that of 2000, failed to grasp the nettles of increasing both the tax base and the tax yield from those Papua New Guineans best able to bear a larger share of the cost of national development. The Government's total internal revenue is projected to be only 24 per cent of GDP in

1999 (Table 2). That is low compared with the standard 40 per cent or more in OECD countries. Papua New Guineans are no fonder of paying taxes than the rest of us, but they also complain bitterly about the poor availability of public services. The cash economy, which accounts for the bulk of GDP, could well be considered rich compared with the rest of the economy and seriously under-taxed, especially when, for example, the threshold of the highest rates of personal income tax was much higher in Papua New Guinea (K100,000) than in Australia (A\$50,000) (when the currencies were at par), and when its top rate comes in at an income level more than ten times higher than the average wage (the comparable ratio in Australia is 1.4, for comparative OECD income tax rates see *The Economist* 17 April 1999:118). Similarly, the non-mining corporate tax rate of only 25 per cent is particularly favourable to the owners of the closely-held private companies that dominate the enterprise sector.

One important step to broaden the tax base that was in the 1999 Budget is the long-delayed introduction of a value-added tax. This may tax more of the spending of those with incomes that escape the payroll income tax, such as landowners receiving mineral and forestry royalties. In general, however, the VAT was intended to be revenue neutral; merely replacing import duties and provincial sales taxes without increasing the total yield of indirect taxation.

The abolition of the provincial sales taxes following introduction of VAT will have some serious consequences for the standard of governance at the provincial level. It

completes the process of separation of spending and taxing powers arising from the further devolution to the provinces effected in 1996 with the establishment of the 19 regional (that is, provincial) members of parliament (20 with the National Capital District) as provincial Governors. The increased devolution of spending power was not matched by any effective decentralisation of taxing authority, and as detailed in the 1999 Budget replacing the provinces' own sales taxes with a national VAT removed their only source of autonomous revenues.

Instead of raising personal tax rates, the 1999 Budget introduced some new taxes which are likely to have a negative impact on new investment in the country's main wealth generating sector. The 15 per cent withholding tax on interest income has at worst only a cash flow impact on most taxpayers, because it is a withholding tax (which could be refundable to those in the lower tax brackets). For mining companies and others borrowing finance from overseas, however, the tax is designed to be a final tax. It had an immediate negative impact on profitability—and hence ultimately on the higher rate mining tax payments—as at Lihir, with interest on its US\$300 million loans from the UBS syndicate now becoming taxable in advance of the mine earning taxable profits. This tax will likewise do little to bring forward the Queensland gas and Ramu nickel projects—the latter seems likely to be deferred until next year at the earliest with nickel mines currently being closed in Australia, because they are not viable at present prices.

The IMF January 1999 mission was severely critical of the government's resort to the central bank in financing its expenditure over-runs in 1998. But the mission could have taken this opportunity to press for introduction of a currency board system, whereby issuing of new currency unbacked by foreign exchange reserves, such as occurred throughout 1998, would no longer be possible. Growing experience of currency boards in countries like Hong Kong and Argentina shows that they are the best guarantee against the kind of slack fiscal management that has beset Papua New Guinea in recent years.

Papua New Guinea would, in any case, be well advised to adopt the currency board system of its own volition, for that is probably the only route to what all its governments seek—a strong Kina and low interest rates. Interest rates in Argentina are rarely above 5 per cent, Papua New Guinea's are rarely below 10 per cent, and through 1999 have been well over 20 per cent (PNG Treasury 1999:2). In June 1999 Argentina's peso had remained at par with the United States dollar since 1991; in the same period the Kina depreciated from K1.00=US\$1.04 to K1.00=US\$0.32.

Quite apart from the economic and financial benefits of reverting to a currency board, this could well make the largest single contribution to genuine public sector reform. A currency board formalises a commitment not to allow the public sector to outgrow public revenues, and would thereby help to focus governments on the need to match new expenditures with new revenues. Given the pre-existing desire of all Papua New Guinea's governments to

have a stable Kina, donors should offer all necessary technical assistance both to explain the merits of the currency board system and for its implementation.

Discussion

Public versus private service provision

The 1999 Budget's termination of public funding for research services appears to reflect a world view which denies either the possibility of market failure—shown by the inability or unwillingness of the private sector to provide certain goods and services—or the existence of public goods, and takes Ronald Coase's views perhaps further than he would by leaving even air traffic control to market forces. Most of the world outside Chicago looks to the public sector to provide those goods which the private sector in practice fails to provide even when it could find a way of charging for them.⁸

There is of course no difficulty in charging airlines landing fees sufficient to cover the costs of air traffic control, but, with only two or three international flights a day landing at Jackson's Airport in Port Moresby, unit fees would have to be set very high to recover the minimum costs of air traffic control. Without some air space services, probably no international flights would land at Jackson's; with such services provided by the government, volume may in time reach levels which will render private provision viable with respect to the providers' relatively short investment horizon. Thus Coase's example does not address market failure caused by the small absolute size of the market. Thurow (1997)

has described how the Rural Electricity Authority (REA) set up in the United States in the 1920s was a response to market failure, in the shape of the unwillingness of the wholly private power utilities to deliver electricity to farming areas. Such deliveries are now highly profitable following the high degree of industrialisation of US agriculture facilitated by the availability of power. The REA demonstrated the high returns available in the long run.

Papua New Guinea's state-owned Elcom has signally failed to see the opportunity to exploit its cheap hydro power on the Ramu grid which straddles the country's richest agricultural areas in the Ramu valley and the eastern highlands. Previous World Bank-IMF inspired directions that rural power distribution should meet very high rate of return thresholds (Whitworth 1996), and loan covenants requiring a high overall tariff, whereby Ramu's hydro power was charged at rates intended to cross-subsidise the even higher rates that would otherwise have been necessary to cover Elcom's exceptionally high-cost thermal generation in Port Moresby.

The largest market failure world-wide, however, is the unwillingness of the private sector to provide a healthy and well-trained labour force. The 1999 Budget assumes that the private sector will take on this task if the public sector is shut down. But private firms in Papua New Guinea as elsewhere have yet to contribute to general training and health services other than for their own workers. Some, like the mines—BCL was especially noted for its training programmes at Panguna—may provide specific on-the-

job training, but general skill training has so far been left to the public sector just as much in Papua New Guinea as elsewhere. The 1999 Budget, however, not merely made no provision for expanding technical and vocational training, it actually reduced it.

Papua New Guinea's private sector employment does not grow slowly because there is a shortage of cheap unskilled labour. There is, in reality, no such shortage, and there is nothing to stop employers offering jobs at the low minimum wage of just K22.96 (A\$15) per week, but they do not do so despite some 500,000 unemployed presumably willing to work at that wage if offered jobs (McGavin 1997). The reality is that in today's world employers seek qualified workers. In Papua New Guinea there is such a severe shortage of such workers that this was stated by Comalco to be a consideration in their decision not to locate their new alumina refinery in Papua New Guinea rather than Gladstone, despite the former's greater proximity to the gas required for the project.

These comments echo those in the Deputy Leader of the Opposition's Reply to the Budget (Hansard and *Post Courier* 25 November 1998). Perhaps that speech contributed to the government announcement in March that it was reinstating most of the Budget's cuts to tertiary education and training. Among the reprieved institutions was the Nautical Training Institute (NTI) in Madang. Despite its name, this institution provided general training in such fields as electrical mechanics and electronics. The Budget assumed that the private sector would provide the total funding of NTI (and the

other abolished public sector training and research agencies). In reality, small electrical firms, for example, do not have the resources to provide such basic training which costs about K10,000 per trainee per year (including forgone output while the worker is being trained).

Similar comments hold for the Budget's termination of all public funding of applied research in Papua New Guinea. The assumption here must have been that if the private sector did not step forward to provide all necessary financing, the research could not be justified. But this approach ignores the concept of public goods being those which no private individuals or agencies willingly provides because of the absence of the benefit exclusion principle. In free labour markets this principle limits the extent to which private firms will offer non-specific (to them) training and research. Significantly, in Papua New Guinea only the mining companies provide much training, and they know that their trainees will have few employment opportunities outside the mining industry. The exclusion principle also limits the interest of private firms in research in preventive medicine, especially when that could also reduce demand for their own prophylactics.

Human capital and the 1999 Budget

Professor Robert Barro's study (1997) of economic development since 1965 in over 100 countries led him to the conclusion that while one of the strongest determinants of these countries' development performance is the proportion of their population that has secondary and higher education,

primary education alone has a negligible impact on economic growth. This finding may well explain why the World Bank has, in its *World Development Report 1998/99: knowledge for development*, admitted that 'knowledge is critical for development, because everything we do depends on knowledge'. This contrasts with its previous insistence that countries like Papua New Guinea should provide as little as possible post-school education and training, and evidently found no response in the 1999 Budget.

Thus the Budget's original appropriations rejected the recommendations of the Treasury's Budget Priorities Committee for boosting enrolment numbers in higher education. Instead the universities' budgets were cut by 20 per cent, and the funding for Natschol, which provides air fares and costs of accommodation for some 5,000 students in post-secondary training colleges, was, as in 1998, held below the 1997 level. Natschol determines how many of the growing numbers of ordinary Papua New Guineans with Grade 12 can get to college. There are some parents who do not need Natschol for their children to go to college since they can afford to pay their fees and air fares, but these are a tiny minority. The long standing inadequate funding of Natschol results in the country's universities enrolling far fewer students than they have the capacity to teach, creating exceptionally low student-lecturer ratios at the country's universities (less than 10).

At pre-tertiary levels, the 1999 Budget continued the trend of reductions in spending on education in real terms. As

shown in Table 3, funding for teachers has fallen from 2.4 per cent of GDP in 1995 to 2.2 per cent in 1999, and in US dollar terms from \$116.2 million in 1995 to only \$83.8 million in 1999. Such amounts are absurdly small for a country whose mineral exports exceeded US\$1.87 billion in 1995 and were projected at US\$1.5 billion for 1999.

Until 1996, Joseph Stiglitz, Chief Economist at the World Bank, was, in his capacity as Chairman of President Clinton's Council of Economic Advisers, in a similar role to that assumed by Dr Hamidian-Rad. In this capacity and in his textbook on public sector economics (1998) Stiglitz takes care to avoid the extremes of statism and the nil public sector approach of *laissez-faire* economics, noting the 'great achievements of the public sector in the USA, from mass education to a cleaner environment'. But the World Bank's own data shows (1998:Annexure) that in Papua New Guinea only one person per thousand of those aged 20–24 study natural sciences, less than 4 per ten thousand study mathematics and computer science, and only two per thousand do engineering. Most other countries educate at least 10 per **hundred** of their youths in these subjects. Papua New Guinea does not manage even 10 per **thousand**, and outside Africa only Afghanistan educates fewer of its young people in these subjects—yet knowledge is what private sector employers look for in their work forces.⁹

Governance

The World Bank's *World Development Report 1997* highlighted the importance to the private sector of not having to face unpredictable changes in laws and policies,

instability of governments, insecurity of property, and high levels of corruption. To avoid these a public service must be able to maintain continuity of policies and check abuses of office and corruption. The steady whittling away of the independence of the public service in Papua New Guinea—both directly by political appointments to heads of departments, and indirectly by denying the staffing and support costs needed for the public service to perform its duties effectively—has contributed to the decline in the standard of governance in Papua New Guinea.

In 1996 the World Bank insisted on reversal of amendments to the country's Forestry Act, which had allowed the Minister for Forests to swamp the Board of the Forests Authority (which licences logging) with his own nominees. Despite the determination of the then Prime Minister, Sir Julius Chan, and his Deputy, Chris Haiveta, to assert the sovereignty of the Papua New Guinea Parliament on this issue—they even threatened to have Dr Hamidian-Rad (then employed by the World Bank) arraigned for contempt of Parliament—in the end they gave in and secured the World Bank's required reversal of the amendments to the Forestry Act. The Government had been forced to recognise that the total package of some US\$250 million of loans under the Structural Adjustment Programme would otherwise not be forthcoming (from the IMF and other donors, including Australia, in addition to the World Bank).

That episode showed what could be done by donors to secure changes in governance when effectively marshalled to

act in concert as they were by the World Bank. This paper's analysis suggests that the time has come for this precedent to be enlarged and extended to the general governance of the country.

The perceived poor performance of the public service in Papua New Guinea is at least partly due to its politicisation, especially at the top management level. The donor community has rarely addressed this issue, except with the World Bank's imposed amendment of the Forestry Act in 1996. That episode suggests the following minimalist programme for effective intervention by the donor community to achieve much more fundamental changes to the structure of governance in Papua New Guinea

- Amendment of relevant legislation to re-establish a permanent and pensionable senior public service. Heads of department and other agencies and their deputies should have tenure independent of the government of the day; all new appointments should be at the sole discretion of the Public Service Commission (PSC), following advertisement; all existing heads of department and agencies (for example, POSFB, Telikom) should be required to resign but would be eligible to re-apply. The PSC should itself be a strengthened and clearly independent body. Donors can and should insist that the Cabinet has no role in this selection process.
- Amendment of the Central Banking Act to remove the powers of Treasury Minister and the Cabinet over appointment of the Governor of the Bank of Papua New Guinea, and establish instead a process of internal

succession based on a minimum of ten years service within the Bank as a prior qualification for this appointment.¹⁰

- Further amendment of the Central Banking Act to establish a Currency Board regime for the Kina's exchange rate as the most viable method of preventing the use of the Central Bank to fund unbudgeted expenditures of the government, such as occurred in late 1998.
- Enactment of legislation for establishment of the proposed Independent Commission Against Corruption as part of a strengthened Ombudsman authority with more clearly defined powers of independent prosecution and detention.
- Abolition of all discretionary funding provided to Members of Parliament, so that all public spending is provided exclusively to statutory departments and agencies.

Ironically the many manpower cuts in the 1999 Budget included a major reduction in the resources of the Forest Authority, cutting its administrative and research staff by no fewer than 100 positions (about 40 per cent of its 1998 establishment), and reducing funding for the supervision of logging by Societe Generale Superintendance (the Swiss firm contracted to undertake monitoring of log exports), thereby once again reducing its ability to withstand ministerial pressures for resumption of large scale logging approvals. Not only should the donor community again insist on maintaining the integrity of the Forests Authority, but it should likewise act to rescue the Bank of Papua New Guinea from direct government intervention in the conduct of monetary

policy, and generally to re-establish the independence of the public service from political appointments and other interference.

Summary and some more suggestions for better governance

The following are the main findings of this paper:

1. Public sector reform as applied in Papua New Guinea has been shown to have been largely misdirected, going far beyond stripping out from the public sector those activities which can and should be undertaken by the private sector, by cutting back also on those services which the private sector worldwide has shown little or no interest in providing.
2. Papua New Guinea's 1999 Development Budget appeared to reflect a major shift of spending from recurrent expenditure, but that has been shown here to have been largely cosmetic and to have resulted in a diversion of resources from defined projects and programmes, including health, education, and law and order, to the essentially discretionary and non-accountable Rural Development Fund.
3. The international donor community should recognise (1) and (2) and take steps to provide resources which enable the public sector in Papua New Guinea to fulfil better its proper responsibility for delivering those services which the private sector provides only to those who can afford to pay for them, and which promote a new emphasis on defined projects and other activities with measurable returns in Papua New Guinea's annual budgets.

4. The donor community could also make its financial support conditional on tax increases sufficient over say 5 years to allow public expenditure to expand to at least 40 per cent of GDP without enlarging fiscal deficits inappropriately, the increases to be allocated definitively to the health and education departments in order to allow them to expand their services to ensure full access for the whole population.

In the absence of interventions along these lines by the donor community, the present decline of the public services in Papua New Guinea will continue until the country finally joins that select group of countries, including Sierra Leone, Liberia, and Somalia, enjoying all the 'benefits' of zero government—chronic civil war, and nil social services.

Notes

1. This paper is based on a seminar presentation to the State, Society, & Governance in Melanesia group, at the National Centre for Development Studies, Australian National University, Canberra, 17th March 1999
2. Dr Pirouz Hamidian-Rad became the Chief Economic Adviser to the Prime Minister in June 1998, shortly after his resignation as Country Officer in the World Bank's Country Team for Papua New Guinea. Dr Hamidian-Rad later informed the Prime Minister of Papua New Guinea that he had left the Bank because of pressure from his superiors to 'push as much lending as possible to PNG', when in his own view Papua New Guinea had no need for 'additional project lending for agriculture, health, and education' (*Post Courier*, 29 September 1998). The World Bank judged this appointment to be a breach of contract and initially suspended dealings with Papua New Guinea (*Post Courier*, 21

September 1998; 7 October 1998). Subsequently its visits to the country resumed on condition that Dr Hamidian-Rad did not represent or appear for the Government. It was also reported that Dr Hamidian-Rad would be employed through his firm, Ikub Consultants, along with several associates, including the partner of the Secretary of Treasury, for a total contract reported to be worth K7 million of which K2.75 million was for Dr Hamidian-Rad personally (*Post Courier*, 11 September 1998). The then Governor of the Bank of Papua New Guinea, which had also employed staff of Ikub, is a shareholder in Ikub. Dr Hamidian-Rad was reported to have resigned on 25 June 1999, and was later restrained from leaving the country prior to being charged with fraud (*National; Post Courier*, 29 July 1999).

3. The state-owned North Shore and Waitakere Hospital in north Auckland spent NZ\$169.74 million in 1997/98, more than the *total* expenditure (K184 million) on health by both the national and provincial governments provided by the 1999 Budget in Papua New Guinea (see *Annual Review*, Waitemata Health Limited, June 1998). The Royal North Shore Hospital, a public hospital in Sydney, spent A\$240 million in 1996–97.
4. For an account of the IMF mission's unpublished but leaked report, see *The National*, March 1999. Since 1993 Papua New Guinea's GDP estimates have been based only on gross output of the exported resources sectors, with output of other sectors mostly assumed to rise or fall in line with the export sectors and adjusted for relative price movements, apart from the subsistence sector where output is assumed to rise in line with the population growth rate. There are no direct income estimates. For example, GDP in the oil palm sector is based only on gross export sales value, not on actual value added in the sector, even though that is known to have increased at a substantially faster rate than gross output.

5. In 1994 the then government had raised US\$90 million from Union Bank of Switzerland at a margin of 1 per cent over LIBOR (the London inter-bank offer rate for overnight funds). This loan was securitised by allowing the bank a lien over the Government's mineral tax receipts, which were required to be paid into an offshore account which the bank could access in the event of any default of debt service payments. This arrangement had technically breached the World Bank's 'Negative Pledge' whereby borrowing countries commit themselves in their loan agreements with the World Bank not to grant liens on their revenues to other lenders without the consent of the Bank, which was only reluctantly bestowed in this case. The UBS loan was paid off in 1997 without default, with all net mineral taxes having been duly paid to the Bank of Papua New Guinea.
6. JP Morgan played a notable role in the first 'third world' debt crisis, with 'its almost violent' pursuit of borrowers in the late 1920s. Peru was provided with US\$100 million (some billions in today's money) even though 'its treasury was flat on its back'—within 5 years Peru had defaulted. JP Morgan reported in 1927 that 85 per cent of those buying these bonds were small investors—schoolteachers and the like—who were persuaded of the bonds' soundness because of the reputation of the banks selling them (see Caufield 1997:32–33). Then as now, however, JP Morgan does not itself subscribe to the bonds it markets on behalf of its clients.
7. Papua New Guinea has been one of the few developing countries that did not suffer from the kind of external debt problem where interest on old loans exceeds inflows from new. The 1999 Budget projects its total external public debt prior to the bond issue at only \$1.2 billion (K2.9 billion with K1.00=US\$0.42), with projected amortisation and interest due of \$207 million (15 per cent of total expenditure of K2.98 billion in 1999).
8. Coase (1990) famously argued that in Britain in the eighteenth century, the lighthouse system, often cited as an example of a public good that cannot be charged for at the point of consumption because it is available to all passing ships, had in fact been financed by port dues levied when ships docked in ports. Fortunately for Coase, enough ships docked in British ports for their dues to cover the costs of the lighthouses. Supposing however, the majority had used the lighthouses to navigate the Channel only to proceed to Dutch, Belgian and French ports?
9. For discussions of education financing in Papua New Guinea, see Curtin (1996, 1997) and Curtin and Nelson (1999).
10. As this paper went to press legislation was put forward to amend the Central Banking Act, giving partial effect to this suggestion by giving Governors tenure for 5 year terms, with the appointing power transferred from the Treasurer to the full cabinet (see Rowan Callick, *Australian Financial Review*, 24 March 2000

References

- Australian Government Publishing Service, 1974. *Administration of Papua New Guinea 1 July 1972–30 June 1973*, Canberra.
- Axline, W.A., 1986. *Decentralisation and Development Policy: provincial government and the planning process in Papua New Guinea*. PNG Institute of Applied Social and Economic Research, Boroko.
- Barro, R.J., 1997. *Determinants of Economic Growth: a cross-country empirical study*. The MIT Press, London.
- Caufield, C., 1997. *Masters of Illusion: the World Bank and the poverty of nations*. Pan Books, London.
- Coase, R.H., 1990. *The Firm, the Market and the Law*. University of Chicago Press, Chicago.

- Curtin, T., 1996. 'Project Appraisal and Human Capital Theory, *Project Appraisal*, June 1996
- , 1997. 'Ethics of User Pays in Higher Education in Papua New Guinea', *South Pacific Journal of Philosophy and Culture*, 2:33–53.
- , 1999. 'Employment trends in Papua New Guinea', *Monthly Economic Monitor*. Department of Treasury & Planning, Waigani.
- Curtin, T.R.C. and E.A.S. Nelson, 1999. 'Economic and health efficiency of education funding policy', *Social Science and Medicine*, 48(11):1599–1612.
- Department of Treasury and Planning, 1998. *1999 Budget. Economic and Development Policies*, Treasury, Waigani.
- King, T., 1997. 'Structural reform versus stabilisation', in I.Temu, *Papua New Guinea: a 20/20 vision*. National Centre for Development Studies and Research, School of Pacific and Asian Studies, Australian National University, Canberra.
- Lasaro, I., 1998. *Budget Speech*, Government Printer Port Moresby.
- McGavin, P.A., 1997. *Labour Resource Utilisation in Melanesia*. National Centre for Development Studies, ANU, Canberra.
- McGavin, P.A., 1998. 'Building productivity culture in Papua New Guinea: changing labour market roles for government', in S. Chand (ed.), *Productivity Performance in the South Pacific Islands*, National Centre for Development Studies, Australian National University, Canberra.
- Ministry of Labour, 1997. *Report on the Labour Force Survey of Singapore*, Ministry of Labour, Singapore.
- National Parliament, 1998. *Draft Hansard. National Parliament Debates 1998*, National Parliament, Port Moresby.
- Papua New Guinea Treasury, 1999. *Treasury Weekly*, 12–18 April. Available online at www.treasury.gov.pg
- Stiglitz, J.E., 1998. *Economics of the Public Sector*, W.W.Norton, New York.
- Thurow, L., 1997. *The Future of Capitalism*, Morrow, New York
- Temu, I., 1997. *Papua New Guinea: a 20/20 vision*. National Centre for Development Studies and Research, School of Pacific and Asian Studies, Australian National University, Canberra.
- Whitworth, A., 1993. *Public Enterprise Policy: Independence to 1991*, Institute of National Affairs, Port Moresby.
- World Bank 1991. *Papua New Guinea. Structural Adjustment, Growth, and Human Resource Development*, Report No.9396-PNG, IBRD, Washington DC.
- World Bank 1992. *Papua New Guinea. Competitiveness, Growth and Structural Adjustment*, Report No. 10319-PNG, IBRD, Washington DC.
- World Bank, 1993. *Papua New Guinea. Jobs, Economic Growth and International Competitiveness*, Report No. 11653-PNG. IBRD, Washington DC.
- World Bank, 1995. *Papua New Guinea. Delivering Public Services*, Report No. 14414-PNG, IBRD, Washington DC.
- World Bank, 1997. *World Development Report 1997*. IBRD, Washington DC.
- World Bank, 1998. *World Development Report 1998/99*. IBRD, Washington DC.
- Yala, C. and Levantis, T., 1998. 'Recent economic events in Papua New Guinea: a continuing drought in development', in *Pacific Economic Bulletin*, 13(2):1–17.