

Structural adjustment in Papua New Guinea

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Papua New Guinea's economy suffered an unprecedented financial crisis in 1994: the overall balance of payments position had been deteriorating sharply, the external debt stock rose by 50 per cent between 1989 and 1993, domestic public debt almost tripled between 1989 and early 1994, and foreign exchange reserves were being rapidly depleted. The crisis represented the outcome of several years of inappropriate macroeconomic policies. Resource sector revenues were used on large increases in recurrent government expenditure rather than public investment. As a consequence the quality and coverage of essential public services—including primary health care and basic education—deteriorated and public investment in physical infrastructure maintenance and upgrading was inadequate.

In August 1994, the new PNG government responded to the financial crisis by introducing measures aimed at stabilising the economy—the kina was devalued in August 1994 and then floated on 10 October 1994. The government subsequently requested financial assistance from the World Bank and International Monetary Fund in support of a broad-ranging economic reform program aimed at sustaining macroeconomic

stabilisation and implementing significant structural reforms to the economy. The reform program was presented to Parliament in early March 1995 along with the Budget.

The World Bank subsequently agreed to provide Papua New Guinea with a loan of US\$50 million (A\$62.55 million) to support the first phase of the government's economic reform program. Papua New Guinea's reform program, which was developed with the World Bank's analytic assistance, is designed to achieve five major objectives

- restore and maintain a stable economic environment by sharply lowering fiscal deficits and adjusting relative prices and improving fiscal management resources
- implement a series of structural reforms to enhance Papua New Guinea's competitiveness and restore business confidence to bring about a recovery in private investment, especially in the non-mining sectors by liberalising trade and investment regimes and privatising key government assets
- promote sustainable, environmentally sound natural resource development through implementation of effective forestry conservation and revenue policies

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- substantially improve public service delivery through restructuring of public expenditures and significantly increase public investment. Initiate new non-governmental mechanisms and recognise the differences in per capita incomes and increasing transfers to the poorer provinces

- improve project / program implementation including emergency relief programs to draw on concessional finance and improve project implementation.

An implicit condition of the World Bank's loan is Papua New Guinea's achievement of a satisfactory macroeconomic stabilisation program with the International Monetary Fund. The program's performance criteria involved restoring financial stability, restraint of CPI inflation and achieving an increase in gross international reserves. A stand-by arrangement allows Papua New Guinea to borrow SDR 71.5 m (A\$129 million) from the Fund in a series of tranches from July 1995 to December 1996. It also brought in loans to Papua New Guinea from the Japanese Exim Bank and Australia (through the Treasury) in support of the stabilisation program.

Achievements to date

Despite some well publicised matters of disagreement between the World Bank and PNG government on actions to be taken to successfully implement the economic reform program, considerable achievements have been realised over the relatively short (2 year) period of the reform process so far: the currency has been floated; the fiscal deficit has been reduced; market determined interest rates have been introduced; expenditure controls in the bureaucracy have been improved; non-tariff barriers are being converted to tariffs and tariff rates are being reduced. A logging code of conduct and a new forestry revenue system have been introduced.

Of course in the main, achievements to date represent intermediate requirements towards achieving the ultimate objectives of the economic reform program such as more broadly based and sustainable levels of economic growth, improved efficiency and competitiveness and improved delivery of public services.

Considerable reform measures still need to be taken in areas of creating an enabling environment for private sector development and diversification, natural resource management and improving public service delivery.

The need for change

In looking to areas in which Papua New Guinea needs to achieve real change, five stand out.

Civil service reform

Current efforts to reform the civil service are centred on three objectives: reduce the overall size of the civil service and wage bill; reallocate functions to provinces and district level to improve service delivery; and reform budgetary and management systems to improve operational efficiency and managerial autonomy: in 1995 the government announced a reduction of 4,500 (7.5 per cent of total civil service) to be completed over the following 18 months. Some of this will be achieved by removing 'ghost workers' from payrolls and removing unfilled vacancies from establishment lists. It is too early to know whether the government will be successful in achieving the full 7.5 per cent reduction target.

Despite stated intentions to reform the system of output budgeting and performance monitoring in Papua New Guinea, there are as yet few performance

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benchmarks and little effective integration of financial and operational systems. Nevertheless, the PNG authorities took a major step in the 1996 Budget by appropriating a single line item to each department and agency and requiring departments to submit detailed budgets and cash flow submissions for Department of Finance approval.

Expenditure control

Expenditure overruns have occurred between 1991 to mid-1994 and again in 1995. A primary cause of this problem is lack of accountability. Despite stringent cash management procedures to regain control of expenditure from mid-1994, a substantial blow-out in expenditure in 1995 (particularly school teacher salaries and expenditure in the Departments of Defence and Foreign Affairs) carried over into 1996, and cheques against 1995 expenditure held over until 1996, has shown that accountability, monitoring and control systems are still inadequate. Such blow-outs can mean that Papua New Guinea has great difficulty meeting the performance measures agreed with the International Monetary Fund. This points to one of Papua New Guinea's real challenges in achieving reform. On the one hand, to keep deficits low and satisfy the Fund's requirements a tight fiscal policy will be required. On the other hand, the World Bank requires Papua New Guinea to increase investment-related expenditure and improve services, necessitating significant refocusing of expenditure.

Wage rates

A significant deterrent to a supply and employment response to economic adjustment in Papua New Guinea is the country's very high nominal and reservation wage rates and low labour productivity. The government has taken steps to control wage growth following

the float of the kina. Rising inflation, arising substantially from significant exchange rate depreciation, and nominal wage rises in 1995 and 1996 of far less than inflation imply a real wage reduction yield of around 18 per cent in the public sector. If this reduction is matched by real wage reductions in the private sector and is not eroded by subsequent wage settlements, it will represent the most significant improvement in Papua New Guinea's international competitiveness since independence.

Privatisation/corporatisation

Recent PNG governments have stated their support for privatisation, corporatisation and commercialisation, but little tangible progress has been made. In addition to owning utilities the state has interests in mining, fisheries, forestry, transportation and finance. There is a general absence of performance indicators or benchmarks for public sector utilities and little external pressure for improved performance.

As part of the economic reform process the Government of Papua New Guinea has re-emphasised its commitment to establishing a smaller role for itself in the economy. During 1995 the government sold Roadco, ahead of schedule, and sold its preference shares in Ramu sugar. Significant sales are expected in 1996, for example, 5.1 per cent of Porgera to landholder groups; 50 per cent of the state's interest in PNG Forest Products; partial sale of state shares in New Britain Oil Products; the partial sale of Hargy Oil Palms; and 49 per cent of the Mineral Resources Development Corporation through the Orogen Minerals float.

The new role of the provinces

The economic reform program has been greatly complicated by parallel reforms of provincial and local governments under

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the new Organic Law. The devolution of national programs and services to the provinces has been introduced in an environment of budget stringency, and the transfer of funds has, in many cases, had to be effected in advance of adequate restructuring at the national level and capacity building at the provincial and district levels. National departments remain responsible for overall planning, policies and monitoring, but it is not clear what powers exist to enforce these policies in provinces and districts that are entitled to guaranteed independent funding.

Resources

Despite the move from direct budget support to program aid by Australia, Papua New Guinea's ability to finance domestically its budgetary needs is expected to continue to improve significantly over the medium term, particularly as a result of substantial increases in projected mining and oil revenues. In its PNG Country Assistance Strategy paper (August 1995) the World Bank indicated a major problem in Papua New Guinea was the gradually and steadily worsening performance in implementation of development projects due to deteriorating institutions, poor quality of project management and lack of counterpart funding. Failure to utilise available concessionary loan funds means lost developmental opportunities for Papua New Guinea, and forces a reliance on domestic financing with subsequent repercussions for financial stability.

At August 1995 there was US\$0.5 billion of undischarged concessional project assistance available. The Bank of Papua New Guinea *Quarterly Economic Bulletin* (June 1996) indicates that drawdowns from overseas concessionary

sources, during the first six months of 1996, totalled only K9.4 million or only 10 per cent of the budgeted amount for the year. (This does not apply to Australia's aid program, which is grant based and has been fully expended each year.)

There are clear reasons for Papua New Guinea failing to draw down on concessional loans. Infrastructure projects have experienced long implementation delays due to cumbersome contracting procedures, law and order problems, difficulties in securing land, and inadequate interdepartmental coordination.

Australian budget-support aid accounts for about 10 per cent of Papua New Guinea's central government expenditure in 1996. This will decline and cease by 2000 with the move from budget support to program aid. Australia is, however, delivering this program assistance in very flexible ways, often through PNG agencies. This means a move away from funding recurrent costs towards more public sector investment by Australia. Australia's aid changes will be reflected in an increase in Papua New Guinea's development budget over the coming years to 2000.

Papua New Guinea's economic outlook in the next few years is fundamentally linked to the current IMF/World Bank programs. However, the current program of reform will only begin the task, which will take more than a decade to implement fully.

If implemented as envisaged, the reform program is expected to, in the short term, help stabilise the economy and protect its creditworthiness.

In the medium term, Papua New Guinea should move onto a more sustainable growth path. The quality and coverage of public services would be

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expected to improve as a result of more focused and rational distribution of resources in favour of basic social services and economic infrastructure rehabilitation.

In addition, current global developments in trade and investment liberalisation through bodies such as the World Trade Organisation and APEC will provide Papua New Guinea with opportunities to gain from the freer flow of international trade and investment, if its economy is reformed to become more competitive and attractive to international and domestic private investment.

Recent developments in the relationship between the World Bank and Papua New Guinea are positive. For example, the PNG government's action taken to rescind the controversial 24 July 1996 Amendments to the 1991 *Forestry Act* and an extension to the closing date for the Bank's economic recovery program loan—from 30 September 1996 to 31 December 1996—provide encouraging signs of a genuine commitment by both the government and the Bank to remain engaged with the reform process.

This is very important. Postponement or withdrawal of international technical assistance would weaken Papua New Guinea's planning and implementation institutions.

In a nutshell, much of the pain of adjustment has already been borne by Papua New Guinea. The policies in place will yield longer-term benefits to the people of Papua New Guinea if the country is able to maintain its commitment to the reforms announced in 1995.

The views expressed in this note are those of the author and not necessarily those of the Australian Government or the Australian Agency for International Development (AusAID).
