STRUCTURAL REFORM PROGRAM IN PAPUA NEW GUINEA

Overview

During the late 1990s, Papua New Guinea's economy was adversely affected by a severe drought, the Asian crisis, and falls in prices of mineral exports. The decline in the economic activity and exports led to a deterioration of the fiscal position, resulting in heavy borrowing by the Government from the Central Bank to finance the large budget deficits. This led to losses of international reserves, a protracted depreciation of the Kina and a sharp increase in inflation.

Coincident with the poor economic performance, the economy was on the verge of an economic and financial crisis due to years of deteriorating economic management, lax fiscal discipline, and a breakdown in budget processes and implementation, resulting in declining business and investor confidence, and breakdown in public service delivery.

While Papua New Guinea (PNG) has proven itself adept at stabilizing the economy in the face of domestic and external shocks, the platform for a resilient economy has been continuously undermined by the absence of sound institutions and administrative systems.

The current Structural Reform Program, undertaken over the last five years, introduced measures to address macroeconomic stability, international competitiveness, price and trade liberalization, taxation reforms, investment policy reforms, public expenditure management, control and effectiveness, and decentralization of responsibilities and finances from the national to the provincial and district levels. In addition, the reform agenda advanced further to address the more difficult assignment of improving the overall governance framework.

In all respect, the Government believes that continued adherence to the structural reform represents the best means for economic and human development. The Government has committed itself to four core Objectives of the reform program, which are: (i) Promoting Good Governance; (ii) Sustaining Macroeconomic Stability; (iii) Improving Public Sector Performance; and (iv) Removing Barriers to Investment and Economic Development. These four Objectives continue to remain as the focus of the reform agenda, as reiterated in the 2000 to 2004 Budgets.

The Government had a successful dialogue with the international financial institutions, particularly the IMF (Stand-By Arrangement), World Bank (Governance Promotion Adjustment Loan) and Asian Development Bank (Structural Adjustment Loan) to secure financing to support its reform program. In addition, the Governments of Australia and Japan provided concessional loans, while the European Union and the Government of the People's Republic of China committed grants to assist with the reform program.

The introduction of the reform agenda in the middle of 1999 saw export prices rebounding and output recovering strongly from the effects of the 1997 drought. The improved fiscal management and continued favorable commodity prices allowed the government to present budgets that envisaged a substantial reduction of deficit to under two per cent of GDP. Financial markets reacted favorably to the reform initiatives, and the local currency (Kina) has stabilized against the U.S. dollar and the other selected currencies.

The reforms are the beginning, and not the end, of a process of evolutionary development to put PNG back on economic recovery and growth.

1. Promoting Good Governance

The promotion of good governance is a necessary ingredient in supporting and sustaining other structural reforms that have been and that are being implemented. The reforms under this objective seek to improve good governance framework by cultivating institutions and administrative systems that will nurture and encourage proper management of public resources, and a stable and transparent economic and regulatory climate. The initiatives under this area range from reforms within the political sphere, strengthening of decision-making processes, and strengthening capacity of oversight agencies.

1.1 Improve Political Stability

The uncertainty surrounding the political environment in PNG has often proved to be detrimental to the objectives of economic and human development. In particular, the unstable political regime through constant change of governments has caused uncertainty amongst the business (both within and abroad) and donor communities, resulting in low level of investment and economic activities.

To increase political stability, the Integrity of Political Parties Act was passed by the Parliament to be effected after the 2002 General Elections.

1.2 Electoral reform to broaden Electoral Base

It has been recognized that the first-past-the-post voting system adopted in 1977 was unfair and unrepresentative. In most instances, Members of the Parliament were elected on the basis of electoral shares of no more than 10 per cent.

The reforms to the Electoral system were approved by the Parliament in 2002, with the introduction of the Limited Preferential Voting (LPV) system to overcome the parochial voting patterns and the discriminatory distribution of public resources in electorates. It is anticipated that the LPV system will:

- produce a wining candidate having much wider support than just that of his/her clan or tribe, resulting in fairer and broader representation;
- encourage candidates and political parties to address national issues and not just matters concerning their supporters; and
- create unity amongst different ethnic groups, strengthen political parties and provides an opportunity for women and minorities to win seats.

1.3 Strengthening of probity and oversight agencies (Ombudsman Commission, Auditor General etc)

The Government recognizes the need to continue with the efforts to reinstitute good governance in the public sector by revitalizing accountability and probity. The Government has implemented a number of reforms in a concerted effort to minimize the impact of corruption on governance.

The Ombudsmen Commission, Auditor General and other State agencies responsible for detection and investigation of possible cases of corruption have established a National Anti-corruption Alliance to co-ordinate activities of the oversight agencies.

The Parliamentary Public Accounts Committee (PAC) has also been revitalized in 2002 to review budgets and expenditures of government agencies, statutory authorities and provincial governments. The revitalization of PAC is a major step towards improving the transparency and accountability of the public sector and PAC will continue with its oversight of public bodies and follow up on its directions to agencies that have already being reviewed.

1.4 Strengthening Government Procurement Practices and Procedures

The legislation governing government procurement framework is unduly complex and limits competition, thus, restricting the government's ability to obtain "value for money. In addition, the lack of transparency in government procurement framework results in government not receiving competitive pricing and appropriate quality in the goods and services. It also affects PNG's ability to negotiate effective government procurement chapters in the free trade agreements because countries do not understand PNG's government procurement policies and practice.

As part of the procurement reform, the Government commissioned the Department of Finance to review the government's procurement arrangements in 2000. The outcome of this review resulted in the amendment to the Public Finance Management Act (sections relating to government procurement) in 2003.

In particular, the legislation was amended to restructure the government's Supply and Tender Boards (which now operate under the new Amended Act) to achieve the following:

- new procedures of appointment and revocation of members to the Central Supply and Tenders Board (CSTB) to ensure that appointments are made on merit and those appointed will act impartially;
- all national boards to be consolidated under the CSTB, except for those boards dealing with Bougainville Infrastructure, Gazelle Restoration Authority, and Pharmaceutical supplies;
- reduce Ministerial direction to create national boards to those circumstances where provinces have a clearly defined need to respond to natural or man made disasters;
- major institutional and structural reform in the CSTB to ensure that the basic principles of transparency, equity, and accountability are embodied in the tendering and procurement process, so that 'value for money' is realized; and
- CSTB to produce annual reports.

The government plans to undertake further reforms to the government procurement framework that will create network opportunities with the business sector and the international community. This requires the development of a simple, clear legislation governing procurement that does not restrict access to government procurement market.

The continuation of information sharing on best practice procurement initiatives, including the adoption of e-procurement systems, and assistance in capacity building will benefit PNG in its ambition to incorporate elements of transparency and 'value for money' in the procurement activities.

Outcome/Benefits

The current term of Parliament (2002-2007) saw for the first time, the political party with the highest number of elected members forming the Government and its Party Leader nominated and elected as the Prime Minister.

There have been a number of political upheavals in the current term of Parliament, testing the effectiveness of the new Act, but it seems that the new Act is withstanding the challenge. In particular, the Act is making it difficult for parties to move No-Confidence motions without the absolute support of the party members. In addition, where there are accusations of bribery to entice party members, those accusations are being investigated for possible prosecution.

The new preferential voting system is now being implemented in a number of by-elections conducted recently for the current term of Parliament. The full extent of whether the new voting system has achieved its objective is yet to be determined but preliminary outcome of the by-elections indicated voter satisfactory on the Member elected and appeals against the election results has been minimal or none.

The PAC directed a number of public bodies to improve their accountability after reviews of their budgets and expenditures indicated non-compliance with procedures and processes of the government accounting system. Warnings of administrative sanctions with the possibility of further investigation by the Auditor General Office and Ombudsmen Commission for prosecution were imposed on agencies that did not comply with the directions of the PAC.

2. Sustaining Macroeconomic Stability

The reforms under this Objective focus on improving fiscal management and transparency of budgeting, and improving debt management function.

2.1 Strengthening Fiscal Discipline

Too often, policy and planning decisions are insufficiently disciplined by the realities of the budget constraint over the medium term. In PNG's experience, the absence of restraint early in the budgeting cycle results in weak expenditure control further down the line.

As of 2003, the Government changed its budgetary planning from an annual process to a medium term approach by adopting a Medium Term Fiscal Strategy (MTFS). The MTFS is an important part of the sound public expenditure management that accommodates both the countries economic needs and its fiscal realities. It allows the Government to address national priorities, while improving the budget balance and reducing government debt over time.

Government expenditure is currently being controlled through monthly warrant ceilings, which is determined by the monthly revenue forecast. The on-going expenditure and revenue performances are monitored on a daily and weekly basis, while the reports are produced on a monthly basis.

2.2 Improving Allocation of Resources (Public Expenditure Review and Rationalization Exercise)

The Public Expenditure Review and Rationalization (PERR) exercise was carried out in early March 2003 to review public expenditure and identify adjustment policies that will help to address both the 2004 and medium term (2004-2008) requirements for fiscal adjustment; provide a scope and opportunity for significant rationalization of expenditures over the medium term; and eventually identify reforms that will provide SAVINGS, which can then be used to:

(i) retire debt to reduce debt level; and

(ii) provide additional resources to priority and productive activities that would yield returns in the medium to long term.

The PERR exercise noted that governance measures should be supplemented by a detailed exercise in adjustment and prioritization of expenditure. A detailed time-bound action plan is currently being implemented as the highest priority reforms for 2004 to restore fiscal stability, regain control of civil service employment size and payroll, restore the integrity of budget systems, adjust and reprioritize expenditure, and improve service delivery in health and education.

2.3 Improving Debt Management

The Government has often been criticized for borrowing heavily from the financial market through the issuance of treasury bills to finance its fiscal operations, resulting in "crowding out" liquidity. On the other hand, the Government is also concerned about the size of its short-term domestic debt portfolio and the inherent risks involved, particularly the interest costs and roll-over risks.

In this regard, the Government developed a debt strategy to restructure its debt portfolio by lengthening the maturity of domestic debt portfolio with the introduction of the Inscribed Stock Program in 2004. In addition, the Government is in the process of developing a medium term debt strategy, which will:

(i) Assess the portfolio risk profile;

(ii) Establish benchmarks and determine the composition of Treasury Bills and Inscribed Stock;

(iii) Determine the currency composition of external loans and debt ratios; and

(iv) Determine the composition of external and domestic debt ratios.

2.4 Improving Accounting and Computing System

As part of the Government's medium to long term reform agenda, the Financial Management Improvement Program (FMIP) was implemented to improve planning, budgeting and accounting systems in government agencies, provinces and local level governments, and delivering competency training so that there are skilled and adequately trained people available to carry on the reforms when the program ends.

This program reviews current systems and where weaknesses are identified, corrective measures are taken so that principles of proper training, budgeting and accounting are complied with at all levels of management. The key improvements that the program intends to achieve are:

(i) Establishing an iterative relationship between the agencies and national budget in preparation and monitoring;

(ii) Decentralization of budget monitoring and information to agencies, provinces and local level governments;

(iii) Looking at the whole of government financial information and integrating trust accounting systems; and

(iv) Strengthening cash and debt management.

2.5 Improving Expenditure Control

A number of initiatives have been undertaken by the Ministry of Finance and Treasury to improve expenditure control. Initiatives range from conducting quarterly reviews, appointing financial controllers to major spending agencies to amending the legislation to combat the build up of arrears resulting from claims made outside of the government financial management system.

The Department of Treasury conducts quarterly reviews to ensure that there is no over-spending or over-commitment by agencies, and administrative penalties (constraining warrants) on entities that do not maintain expenditures within warrants and appropriation limits

Financial Controllers have also been appointed within 12 major spending agencies to ensure that agencies adhere to the Public Finances (Management) Act and Financial Instructions when committing expenditures

Claims resulting from outside the Government Accounting Systems build up to arrears, and have a negative impact on the government's ability to achieve the deficit and macroeconomic targets laid down in the budget each year.

In order to combat this problem, the Claims By and Against the State and the Public Finances (Management) Acts were amended to prevent the generation of claims outside of the government's procurement and accounting system.

Outcome/Benefits

The implementation of the policy initiatives has seen a considerable improvement in the economy and in government's budgetary position in 2004. In particular, the budget deficit in 2003 was less than 1.5 per cent of GDP and this good outturn has continued in 2004. Inflation has fallen sharply from as high as 20 per cent to as low as 2.9 per cent in the corresponding quarters (June 2003 – June 2004).

The introduction of Inscribed Stock, which is done in a more timely and consistent manner, to lengthen the maturity of domestic debt portfolio has resulted in decline in the issuance of Treasury bills, resulting in a sharp fall on Treasury bill rates from 16 per cent in January 2004 to an average of 7 per cent in June 2004. The government gained a windfall from the interest cost savings and these savings are being used to retire debt and directed towards infrastructure development.

3. Improving Public Sector Performance

The reforms under this Objective seek to revitalize the public sector's capacity to design and implement sound policies as well as revive the erosion on its ability to manage its responsibility. The main initiatives in this area range from Functional Expenditure Reviews of agencies, reducing public sector staffing levels, to improving public sector performance to improve delivery of public service.

A total of 15 agencies have already had their functional expenditures reviewed, resulting in a number of agencies amalgamated, separated and abolished.

The Public sector reform program based around performance oriented management will continue but will undergo major revisions refocusing on addressing national strategic directions and priorities.

The Public Services (Management) and Public Finances (Management) Acts has been reviewed and amended to modernize and decentralize management, personnel and financial powers to entity Heads but within a framework of significantly enhanced accountability/responsibility of Managers and overall control of the speed of decentralization, according to the demonstrated capacity of different organizations to manage.

Outcome/Benefits

Work is still on-going in this area which no greater benefits realized yet.

4. Removing Barriers to Economic Growth and Development

The reforms under this Objective focus on removing inefficient and anti-competitive trade and investment restrictions and regulations, as well as making fundamental changes to improve governance and to strengthen basic institutional arrangements needed for the private sector to operate efficiently.

The cross-cutting theme of the microeconomic reforms is Deregulation, with the government's objectives of promoting closer adherence to:

- *Simplicity* – especially in terms of transparency and reducing the scope for arbitrary interpretation;
- *Neutrality* among alternative economic activities; and
- Encouraging *competition* by reducing barriers to entry to economic activities and reducing discrimination among alternative ways of supplying goods and services.

As part of this reform initiative, a National Working Group (NWG) on Removing Impediments to Business and Investment was established to identify structural impediments to investment and business and develop strategies to eliminate impediments. The NWG comprises of membership from the private sector and the government.

4.1 Financial Sector Reform

One of the most important reforms undertaken by the government was to strengthen the legislative framework pertinent to the domestic financial system as a means to allow effective mobilization of capital to stimulate private sector investment in the economy.

The first course of action involved the enactment of the Central Bank Act in 2000 to make the Central Bank of PNG fully independent from political interference in the management of the monetary and exchange rate policies. This was an important legislative reform in an economy where the government tends to borrow heavily from the reserve bank to finance its fiscal operations, resulting in 'crowding out' of liquidity by the government.

The Central Bank was also given the responsibility of prudential supervision and regulation of the financial system, including the prudential supervision of commercial banks, superannuation (pension) funds, life insurance companies and credit unions (savings and loans societies). The objective of prudential supervision and regulation is to protect public interest and stability of the financial system to avoid financial crises.

The legislation governing each of the financial sector industries i.e. commercial banks and non-bank financial institutions that take deposits [Banks and Financial Institutions Act], superannuation [Superannuation (General Provisions) Act] and life insurance [Life Insurance Act], were also reformed in 2000 to promote competition and strengthened in accord with international "best practice" such as bringing minimum capital requirements. The provisions of the legislation gave the Central Bank, the legal power to administer the legislation and regulate these industries.

The existing regulations pertinent to foreign exchange control is being reviewed in 2004, with the view to liberalize exchange controls on the inflow and outflow of foreign exchange, which is in line with opening the domestic market for foreign investment. The review intends to recommend substantial removal of foreign exchange control, except those necessary to guard against balance of payment crises and money laundering.

The assessment of foreign exchange inflows and outflows, contractual agreements and other legal documents will be transferred to commercial banks by the Central Bank. A well-developed contingency plan will be put in place to counter risks of economic or political shocks that may destabilize capital flows.

4.2 Competition and Regulatory Reforms

The competition and regulatory policy reforms commenced in 2000 to encourage economic development, technological innovation and efficiencies of production. The government adopted an approach that guarantees an equitable sharing of the benefits derived from increased competition due to the fact that the relatively small market size of PNG presents a real constraint on the ability to disaggregate existing monopolies and create competition to the extent that might occur in other larger economies. In addition, PNG's unique political, cultural, economic and geographic characteristics limit the application of some principles in developing efficient industry and regulatory structures for sectors of the economy.

A regulatory approach has been adopted through the placement of a strong regulatory framework in situations where it was not possible or practical to introduce or strengthen competition, to ensure that the incentive for firms to abuse their market power are eliminated, and thereby encouraging the firms to act in a more competitive manner.

The government also developed a structural control to encourage the development of a market structure that mirrors competitive conditions in the case of the monopoly utility sectors such as electricity, telecommunications, port services, postal services, water, aviation, and third party motor vehicle insurance. This is in response to the weak economic and technical regulation of these sectors over the recent years, which has led to higher prices, lower quality of services and lack of innovative solutions to the difficulties faced in supplying services throughout PNG.

An Independent Consumer and Competition Commission (ICCC), was also established in 2002 with its own legislation, replacing the administrative function of the Consumer Affairs Council and Price Control Unit of the Department of Treasury. The ICCC protects the interests of the consumers by promoting competition and fair trading. The ICCC also administers regulatory contracts with the major State Owned Enterprises, by determining how prices are set and specifying minimum service standards.

The provisions of the ICCC Act governing anti-competitive behavior came into force in 2003. These provisions prohibit anti-competitive behaviors such as price-fixing, anti-competitive covenants, mergers and acquisitions that will substantially lessen competition in the market and primary boycotts (exclusionary provisions).

4.3 Facilitation of Business and Foreign Investment

The government recognizes immigration laws as a useful tool to facilitate economic growth and development, especially through the support for growth in tourism and facilitation of increased levels of inward investment. In this regard, the government commenced review of migration laws in 2000, as part of the review of PNG's foreign policy.

In recognition of the potential benefits of these laws, the government has given priority to the review of Migration, Passport, and Citizenship Acts, as well the formulation of new laws for people smuggling and refugee. A number of specific initiatives that the revised laws will facilitate are; maintaining the visa on arrival facility, which includes introducing Permanent Residency Visa to enable business owners to apply for an indefinite period of stay in the country; participating in the APEC Business Travel Card to facilitate travel by business people from the APEC member economies; introducing single entry business visa and additional provisions to facilitate changes of status in the country to enable business to continue operations and allowing movement of personnel under the same parent company.

The government has also reviewed and amended the Investment Promotion Act to shift from case by case approval of foreign investments (certification) to a simpler system of registration of businesses, with ex-post monitoring of investments.

4.4 Privatization of Selected State Owned Enterprises

There strong evidence that effective privatization attracts new investment and increases the efficiency of all businesses concerned. The government has committed itself to pursue the sale of selected State Owned Enterprises, since it believes that this will lead to greater investment in infrastructure and improved quality of public service provision.

A review of the privatization program in 2002 drew a distinction between core[1] and non-core[2] assets. It was concluded that the privatization of non-core assets will proceed first, since these assets continue to be a drain on the National Budget and act as a constraint on the private sector. In the case of core-assets, a Public-Private Partnership approach was adopted, with the issues of equity and efficiency as the priority.

4.5 Tariff Reduction Program

The Tariff Reduction Program is one of the key reform agenda, mainly because it was one of the perquisites for the drawdown of the IMF Stand-By-Arrangement to support the deteriorating balance of payment situation. The government approved a seven-year tariff reduction program in 1999, and which will end in 2006.

Outcome/Benefits

The amendment to the Central Bank Act prohibited the Central Bank from lending to the government to finance its fiscal operations, thus forcing the government to undertake stringent expenditure controls and prudent fiscal management. This relieved the pressure on inflation and interest rates.

The Kina Facility Rate (KFR),[3] which was introduced in 2001 by the Central Bank as an official rate to indicate the monetary policy stance, has improved since its inception (falling from 15.5% in 2001 to 10.0% in May 2004). The fall in the KFR indicates that inflation and interest rates have improved and the fall in the rates have stimulated private sector participation in the market.

The enactment of the Superannuation and Life Insurance Acts has resulted in the development of stringent ‘fit and proper’ requirements for appointment of Directors/Trustee members, and the development of prudent investment strategies has resulted Superannuation funds experiencing growth beyond expectations in 2003.

Reforms in competition and regulatory policies have resulted in each sector now having its own competition policy and regulatory arrangements, which were previously non-existent. The establishment of regulatory contracts with each of the State Owned Enterprises also defines a period (up to 10 years) for the regulatory and pricing principles and formulae used to determine the initial 10 year price paths, service standards, provisions for adjustments and trigger events to allow either party to review contracts as part of the privatization process.

The establishment of ICCC has improved pricing principles and resolved confusion by the private sector as to which goods have been declared priced-control items, which was a function previously performed ineffectively by the Price Control Unit of the Department of Treasury. The introduction of the provisions governing anti-competitive behaviors by firms is a positive step

[1] ‘Core assets’ include all enterprises owned by the State.

[2] ‘Non-core assets’ include buildings and properties owned by the State.

[3] The Kina Facility Rate is a monthly rate which is based around 28-day Treasury bill weighted average rate. Any changes to the rate should translate into market interest rate.

towards improving market conduct, given the fact that there was no legislation governing anti-competitive behaviors.

In the case of the Tariff Reduction Program, a review conducted in 2003 concluded that the reduction of tariff had a positive impact on the PNG economy. In particular, the fall in effective rates of protection have improved the agriculture and mining sectors, and service industry. Industries whose tariffs have been reduced are making necessary adjustments to be more competitive and these adjustments are taking place in all cost areas, including capacity, labor and marketing. Industries are also stepping out and exploring other markets, both within and abroad.

TRP had a positive impact on the ordinary Papua New Guineans, particularly the lower level income earners. Although prices of most goods purchased by these groups have increased in recent years due to the declining Kina and other increased costs, the TRP has resulted in prices increasing less than if the higher tariffs remain.

Conclusion – Challenges

The successful implementation of the reform program can be seen with the improvement in the economic condition. Economic growth has picked up and employment is growing. On the external front, the exchange rate has stabilized, the external position is improving and foreign exchange reserves are at record levels.

The government of PNG, however, acknowledges that the reforms are the beginning, and not the end, of a process of evolutionary development to put PNG back on economic recovery and growth. The task is enormous and requires a collective and partnership approach with its development partners, including the international financial institutions.

It is also important that the civil society and more importantly, the implementing agencies participate effectively in the reform process. Otherwise, the development of a well-defined system might useless and will eventually lead to a breakdown in the system, if no one understands how the system operates.

Some of the reforms have been painful, with financial, social and employment implications, but time will tell whether this will lead to greater prosperity for the economy and the population at large.