Papua New Guinea’s Development Performance
1975–2008

September 2010

NRI
The National Research Institute
PAPUA NEW GUINEA’S DEVELOPMENT PERFORMANCE
1975–2008

Edited by
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&
Linda Duncan

NRI
National Research Institute
First published in September 2010

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Monograph No. 41

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ISBN 9980 75 178 9
National Library Service of Papua New Guinea

ABCD 20143210

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FOREWORD

The Hon. Sir Puka Temu, MP

In November 2009, the National Parliament approved Vision 2050, a roadmap for this country’s future. Vision 2050 outlines clear directions for Papua New Guinea’s development over the next forty years. It sets out what type of society, what type of people, and what type of economic, social and other transformations we want to see in forty years time.

Vision 2050 was developed after widespread consultations by a taskforce of eminent Papua New Guineans. It involved talking to people in their communities all over the country. It also involved workshops and meetings with key stakeholders from the public and private sectors, academia and civil society, as well as the analysis of information from key documents, literature and other sources.

The preparation for Vision 2050 started in early 2008 when I assumed the chair of the National Planning Committee. In my years as a senior public servant and later as a politician, I realised there was a lack of a coherent plan that would help to guide the people and institutions of this great country.

As I became further engaged in this process, I realised that it was also important to look back at the road we had traveled since independence and to mark out the significant events, the gains and losses that we had made, the results of decisions by governments and the impacts of national and global events. I realised that we needed to document the lessons we had learnt from the past and the mistakes to be avoided. These lessons could then be used to guide the development of more effective plans and strategies for the future.

PNG has developed and implemented various plans since Independence in 1975. What could these plans teach us as we prepared Vision 2050? It was for this reason that I requested the Director of the National Research Institute to undertake this analysis of PNG’s development since Independence.

The scale and complexity of the project delayed delivery of the report until after the National Summit in May 2008. This was regrettable, however, I know now that a better quality and a more enduring report has been the end result.

In December 2008, the Director of NRI presented me with an earlier version of this report. I took it with me to my home at Abau and as I celebrated Christmas with my family and the people of my electorate, I took time to read the document. It provided insights that were very valuable indeed and in early 2009 I gave the report my full endorsement.

Soon after, the report was presented to the National Planning Committee and circulated among National Executive Council colleagues. The information contained has since provided a better understanding of the past and useful lessons and insights to guide us as we finalised and endorsed Vision 2050 and, later, the National Strategic Plan.

I know that this report will continue to be useful for Papua New Guineans to read, to learn and to help to guide their contributions to the nation as we move towards 2050.

I highly recommend this report to current and future generations.
PREFACE AND ACKNOWLEDGEMENTS

Dr. Thomas Webster

The National Research Institute was established by the Government of PNG for the purposes of undertaking research and generating ideas that would assist in the development of the nation and the people of Papua New Guinea.

When the then Deputy Prime Minister, the Hon. Sir Puka Temu requested that the National Research Institute undertake this ambitious project, I could immediately see the great value of a publication that would give all Papua New Guineans the opportunity to learn valuable lessons from our development experiences over the last thirty years, in order to chart a course for the future.

I accepted the request with enthusiasm, realising the important role NRI would be able to play in the development of PNG. However, I knew the limitations of the Institute in terms of in-house capacity to undertake the kind of major, multi-disciplinary study that this review would entail. Analysing and drawing conclusions about PNG’s development performance is a difficult task. This is because of the many dimensions of development and the multiple perspectives through which it can be evaluated. I am therefore very grateful to the group of NRI researchers and external researchers who undertook this difficult but important task. Each author brought their special expertise to the study.

Professor Satish Chand continues his support of the NRI and in this report took on the role of lead author, synthesising the arguments of the different chapters and providing an overview that teased out the main lessons. Linda Duncan and Aaron Batten, with the assistance of Brian Gomez, gave us a multi-dimensional analysis of development and reviewed different indicators for measuring the different dimensions. Charles Yala and Ogis Sanida looked at the development and implementation of past national plans, their settings, objectives and outcomes. Aaron Batten analysed fiscal policy and its impact on development. Gae Kauzi analysed monetary policy and the outcomes of policy shifts in this area. Alphonse Gelu reviewed developments in politics and governance.

The study would not have been possible without Linda Duncan, then the Acting Head of the Economics Division, who managed the project. She drafted the scope of work and the terms of reference for the broader project and the specific components. She managed the recruitment of the researchers, organised the reviews, relayed the comments to authors and ensured that these were taken on board. She did the content editing and ensured that we had the report ready for presentation to the National Planning Committee.

I am also grateful to the anonymous reviewers for their thoughtful contributions.

Throughout the report the reader can see historical correlations across the report themes, revealing how shifts in politics and governance relate to shifts in fiscal and monetary policy. I do hope that the study provides useful insights and lessons as we move forward in implementing Vision 2050 and the National Strategic Plan.

Finally, I want to especially thank Hon. Sir Puka Temu for his confidence in the National Research Institute. I am proud of the quality of work that has been produced and look forward to the continued support and confidence of the Government of PNG.
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OVERVIEW

Satish Chand

1. Introduction

Times are good in PNG. In early 2008, macroeconomic indicators were as healthy as ever, or at least as healthy as they had been since independence in 1975. At that time, the economy was projected to experience record growth in gross domestic product (GDP) of 7.3 percent in 2008, following a growth of 6.5 percent in 2007 (GoPNG 2008). Much of this growth can be attributed to favourable external conditions and improvements in the terms of trade for PNG in particular. The prices of PNG exports close to doubled between 2005 and 2008. The kina is stable, government debt levels are subsiding from a high of 72 percent in 2002, and the budget has recorded several consecutive surpluses.

Recent increases in food and fuel prices have put upward pressure on inflation, which was estimated at 8 percent as of March 2008 (BPNG 2008). But of key concern are the stubborn statistics on the level of social development (discussed in Chapter 1), which compare unfavourably with the corresponding figures for the neighbouring East Asia and Pacific Regions.

Recent estimates suggest that some 37 percent of the population live below the poverty line; anywhere between 30 and 50 percent of rural children are malnourished; and pockets of severe malnutrition are emerging throughout the country (World Bank 1999). The then PNG Department of National Planning and Rural Development noted as recently as 2003 that social indicators of development were amongst the worst in the Pacific region, with a life expectancy of 54 years, literacy rate of 64 percent, infant mortality rate of 64 deaths for every 1000 live births, and maternal mortality rate of 370 deaths for every 100,000 births (DNPRD 2003). Some progress has been made in terms of social development, but it is questionable whether the progress is sufficient to be noticeable by the ordinary public.

Good times do not last forever. The focus of this report is on capitalising on the prevailing healthy macroeconomic conditions for economic and social development. The social indicators of development should receive a noticeable nudge when growth in per capita income exceeds 5 percent per annum over a decade at least. Achieving this target rate of growth is the challenge in the hands of the current leadership.

The past provides several lessons on what may be done and what to avoid in the attempt to induce and sustain the requisite level of growth in per capita income so as to accelerate the pace of development. PNG has experimented with a range of policies, most of which are documented in the country’s nine development plans (discussed in Chapter 2). Lessons from these plans, particularly from the six that have been formulated since independence, are drawn to assist in charting a path for the future. Clearly, several factors that impinge on economic performance are beyond the purview of the policymaker. This report, however, focuses on factors that are within the reach of policies; the rest must be taken as given. Since

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1 In compiling this overview, material has been drawn liberally, but not exclusively, from each of the other chapters, and from an earlier draft of Chapter 1 drafted by Brian Gomez. Helpful comments from Aaron Batten and Charles Yala on an earlier draft are gratefully acknowledged.
many of the eventualities of the future are unknown, policies will need to evolve to suit the circumstances of the particular period.

It is important to define a number of key concepts used in this report. Development, as used here, means improvement in the wellbeing of the population. Indicators of such improvements include (but are not limited to) persistent increases in per capita income, life expectancy, and literacy rates, and falls in the number of people living in poverty. Economic growth is defined as the rise in production relative to the level of a base (past) year. Budget refers to the national budget, which comprises items of revenue and expenditure together with the financing of any shortfalls, as passed annually by the national Parliament.

The key propositions of this analysis include the following:
1. Development has eluded the bulk of the PNG citizenry for the entire post-independence period.
2. Policymakers have been unsuccessful in raising economic growth, increasing local participation in the monetary economy, and achieving a more equitable distribution of income; that is, policy has failed to achieve the objectives espoused in the development plans of the past.
3. The prevailing macroeconomic conditions are favourable to policy interventions for sustained growth of income and with it an acceleration in the pace of development. Whether this is achieved will be known a decade from now. All else remaining equal, achievements then will be a reflection of the success of policies instituted now.

The rest of this overview is organised as follows. Section 2 summarises the causal link between economic growth and development. Section 3 provides a succinct narrative of the post-independence policy and developmental context. Conclusions and a discussion of policy implications bring the chapter to a close.

2. The link between economic growth and development

Economic growth is a necessary condition for improvements in the wellbeing of the general population, however measured. As an example, improvement in life expectancy requires improved access to healthcare services. Such improvements, moreover, do not take place overnight but are a culmination of sustained improvements in access to healthcare, nutrition, and information on how an individual may lead a healthy life. Conversely, life expectancies may remain weighed down by high infant and maternal mortality and/or by increased deaths from HIV/AIDS. Development, in short, requires both resources and time. The requisite resources, moreover, need to be generated from within the economy. This raises the centrality of economic growth to development.

PNG development policy remains highly interventionist in its approach, with the public sector active in many aspects of the economy. A clear logic for government involvement in the supply of goods and services within the economy remains to be articulated. Theory suggests that the role of government must be confined to addressing identified market failures. This would include creating an environment conducive to private investment and regulation so as to ensure competition. The government, however, has been an active supplier of goods and services, compromising its ability to be an impartial regulator of private commerce.
Growth in income could accrue to the public sector, in the form of taxes, or to the individual, who in turn could then purchase the required services from private providers. Either way, income growth is necessary to fund the services critical to development. Furthermore, sustained growth in per capita income over decades, as shown by international experience, is necessary for progress in terms of developmental outcomes. The higher the rate of growth, the shorter the time period required to bring about such change.

But what is the minimal level of growth necessary to bring about such change? The population of PNG has been growing at an annual average of 2.9 percent (this figure must be taken with some reservations for reasons alluded to in section 3). Thus, output, denoted as GDP henceforth, has to grow by at least 2.9 percent each year for per capita GDP to remain stationary. Anything less than that would cause per capita GDP to fall over time. Importantly, any improvement in employment opportunities for the growing population requires growth in GDP in excess of 4 percent. This is because technological progress alone accounts for approximately a percentage point of the total growth in GDP.

It is a matter of simple arithmetic to calculate the time it would take for per capita GDP to double at any given rate of growth. As an example, an annual per capita GDP growth rate of 5 percent, which in turn would require aggregate GDP to grow annually at a rate of approximately 8 percent given population growth of 2.9 percent, would lead to a doubling of per capita income in 14 years. Per capita income, as of 2006 at 2005 prices, was US$1761. This would double to $3522 by the year 2020 should aggregate GDP grow annually until then at a rate of 8 percent. Even this high rate of growth, if achieved, would leave little room for celebration: per capita income in PNG by 2020 under this favourable scenario would only be marginally above the 2006 level in Indonesia ($3348), and well below the 2006 levels in Fiji ($4408) and Malaysia ($12,149).²

Acceleration in the pace of development in PNG, therefore, requires a break from the low and volatile growth rates of GDP of the past — which have been declining on average since independence. According to figures published by the World Bank (2008), PNG’s GDP growth rate has exceeded the 8 percent threshold mentioned above in just three of the 33 years of independence. These years (1991, 1992, and 1993) occurred during the height of an unprecedented mineral boom. Furthermore, growth in GDP since independence, as shown in Table 1 in the Appendix, has been extremely volatile, ranging from contractions of 4 percent in 1997 and 1998 to growth of 18 percent in 1993.

Sustained growth in GDP has to be grounded in sustainable use of the resources of the nation. Such growth must draw into production the vast amounts of idle labour and under-utilised land. Policymakers, as will be argued, have targeted the above but with little success. The same old tricks, including another plan that recycles the ideas of past plans, are not likely to achieve anything different. A change in tack is required. But in order to choose it wisely, it is first necessary to understand past experimentation with policies.

3. Post-independence development

This section provides a historical narrative of social and economic development since independence. It is organised in five-year time frames, beginning with 1975–1980 and ending with the period from 2006 to 2008. It commences with a discussion of the pre-independence period.

² Data sourced from World Bank Indicators (accessed online on 2 September, 2008).
build-up with respect to development planning and then proceeds to the topics of fiscal and monetary policies, governance and politics, and economic and social development. Each of the above-mentioned issues is canvassed in considerable detail in the chapters of this report.

Self-rule commenced well before independence. Sir Michael Somare, who was then the chief minister and prime minister in waiting, noted recently (2001:6) that ‘after April 1972 the elected representatives in the House of Assembly felt that they were in reality the government’. Canberra by then had transferred full autonomy in charting the economic course for the nation to the local legislature, retaining only the responsibilities for defence and foreign relations until independence (Chand and Yala 2005).

The first five years after independence were characterised by euphoria, which was brought to a premature close by the second oil price shock in 1979. The second five years (1981–1985) were a time of economic consolidation. The distinguishing feature of the third five-year span (1986–1990) was the Bougainville crisis. As explained later, this crisis constituted a major malfunction in the economic and social development of PNG.

The fourth five-year span (1991–1995) was an era of fiscal excess during which the government tried to spend its way out of trouble. The deficit reached a high of 5.6 percent of GDP in 1993, compromising the capacity of the monetary authorities to maintain the fixed exchange rate policy. The kina, consequently, was floated on 10 October 1994. During this period, several new mines came on stream, but public expenditures raced ahead of incoming revenues, leading to rising deficits and accumulation of public debt.3

The fifth period (1996–2000) was ‘payback time’; government expenditure had to be trimmed drastically. During the El Niño drought of 1997, people in the Highlands went hungry. The tough times saw a retraction in access to basic public services due to cost cutting by the government. It was also a period of high political instability, with three changes in prime minister within a span of five years. Some tough decisions with long-ranging impacts were taken at the end of this era.

The sixth period (2001–2005) was one of reconsolidation, during which benefits from earlier legislative changes bore fruit in terms of political stability (emanating from the Organic Law and Integrity of Political Parties Act of 2001), policy stability (emanating from the Central Bank Act of 2000), and financial sector revival (following privatisation of the Papua New Guinea Banking Corporation and passage of the Banks and Financial Institutions Act of 2000).

The last period, that from 2006 to 2008, was one in which the economy was back on ‘full steam’, riding the commodity price boom propelled by growth of income in India and China and benefiting from continued political and policy stability. The above phases are summarised together with the key events of the time period in Table 2 in the Appendix. Since late 2008, the global financial crisis has hit PNG in terms of depressed commodity prices, but this period is outside of the time frame considered in this report.

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3 The perverse impact of a favourable revenue shock on the budget from this mechanism is what Tornell and Lane (1999) refer to as the ‘voracity’ effect.
The events and policy choices summarised above had a significant impact on development planning, fiscal and monetary policies, governance and politics, and economic and social development. These are discussed in turn in the following sections.

**Development planning**

Development planning in PNG, which dates back to 1963, is discussed in detail in Chapter 2 of this report. Two plans were developed and implemented by the colonial government prior to independence. The objective of these plans was to utilise the finite resources of the state to maximise development in the nation at large. As explained in section 1, this goal may be interpreted as that of utilising budgetary resources for maximisation of developmental outcomes. Progress on development could be quantified in terms of the number of people lifted out of poverty, gains in literacy rates, falls in infant and maternal mortality rates, and increases in life expectancy.

The first plan (1963–1967) was confined, as its name reveals, to Project Planning. It was succeeded by Economic Development Planning (1973–1975), which was more holistic in its approach and targeted economic development. Planners of the era raised concerns regarding deficiencies in the quality and quantity of data at their disposal and the need to link up with functional agencies of government for implementation of the plans. The Eight Point Improvement Plan (1973–1975), which was in place during the period of self-government, was the culmination of extensive consultation and research undertaken by a team of international consultants under the sponsorship of the World Bank and the United Nations Development Program. It targeted increased indigenous participation in the monetary economy, greater equity in income distribution, rural development, and reduced dependence on foreign aid. The same concerns remain valid today. This in itself is evidence of the limited success past plans have had in achieving their objectives.

The post-independence era (since 1975) has seen six separate development plans. The first, the National Development Strategy (1976–1985), was a ten-year plan that attempted to refine the ‘eight points’ of its predecessor. The two main objectives of this plan were to increase the range of goods available locally and to reduce inequities in income distribution and access to goods and services in the nation at large. The first objective encouraged localisation and greater participation in the monetary economy by citizens, while the second directed government expenditure to reinforce the first. These issues remain relevant today.

The tenth anniversary of independence heralded a new plan, the National Development Plan (1986–1990). Other than re-emphasising self-reliance (that is, localisation) and equitable distribution of income and improved access to services, this plan explicitly targeted economic growth as a means to sustained development. It also signalled a major shift in the development paradigm from state-led to state-facilitated growth of income as a means to development. Next, the Development Plan (1989–1997) was formulated as part of the Public Investment Program. The shift this time was more in process than substance and was driven by concerns regarding weaknesses in implementation of past plans. A National Public Expenditure Plan and a Medium Term Development Program were formulated to ensure greater alignment of public investment with national priorities as reflected in the development plans. Such alignment also attracted donor interest and funding. The Medium Term

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4 As discussed in Chapter 1, concerns regarding the availability and quality of data still exist.

5 The report became known as the Faber Report (Faber et al. 1973).
Development Strategy (MTDS) of 1997–2002 was framed during the second fiscal crisis and emphasised small and effective government in which the role of the state was further curtailed to that of a facilitator rather than the lead actor in development. The tighter fiscal situation meant that some hard and painful decisions had to be made. (This will be discussed in more detail below.)

The MTDS of 2003–2007 addressed the theme of recovery and development with the following objectives:

- Good governance.
- Export-driven economic growth.
- Rural development for poverty reduction and human resource development.

Accompanying this Strategy were a Medium Term Expenditure Framework, a long-term (to 2020) Poverty Reduction Strategy, and a sectoral resource allocations framework that prioritised expenditure on basic healthcare, primary education, transportation infrastructure, agricultural development, and law and order. A Public Expenditure Management framework was also put in place to protect the integrity of the budgetary process. The MTDS of 2003–2007 reached its final draft stage but then was superseded by the current MTDS (2005–2010).

The objectives of the current MTDS remain good governance, export-driven economic growth, and poverty reduction. The difference is that the current MTDS has resources earmarked for its implementation. It has also been accompanied by the Medium Term Fiscal Strategy (MTFS) and the Medium Term Debt Strategy. The second MTFS (2008–2012) has just been accepted by the government; it mandates a 40/60 split for mining revenues between debt repayment and investment. Chapter 2 provides a summary of each of the above-mentioned plans, their contents, and their shortcomings.

In summary, development planning over the past forty-five years in PNG, as for much of the developing world, has undergone an ideological shift from state-led to state-facilitated development. During the early phase of nationhood, policymakers in PNG aggressively pursued the state-led version of development. Many of the existing state-owned enterprises are a legacy of that earlier era. The shift to state-facilitated commerce, while evident in the rhetoric of the plans, has been slow and difficult to implement. As a result, subsidies, tax concessions, and preferential trading rights persist across the PNG business environment, stifling competition and discouraging the diversification of existing businesses. Why this may have been so will be covered in Section 5. While the perceived role of the state in development has undergone a transition, the priorities — growth of income, greater participation of citizens in the monetary economy, and improved access to basic services — are repeated in each of the plans, including those predating independence.

How much success did these plans have? The answer has to be little if any, given that the same objectives were repeated in each subsequent plan. The reasons for these failures are harder to identify. The following reasons are proposed by Yala and Sanida in Chapter 2 of this volume: lack of resources; lack of ownership of the plans; objectives that were too broad and thus not amenable to implementation; absence of quantifiable benchmarks and milestones for progress; and lack of high-quality data.
Fiscal and monetary policy

Fiscal and monetary policy in PNG are discussed in detail in Chapters 3 and 4 of this report. The two policies were closely linked for much of the post-independence period (from 1975 to 1994) due to the fixed exchange rate policy, under which fiscal policy had a direct bearing on the monetary stance. Following this, PNG adopted an unconventional strategy in which fiscal policy was used to maintain external balance and monetary policy was used to maintain price stability. The responsibility for internal balance, including full employment, was left to the domestic forces of demand and supply, which in turn required price and wage flexibility, a condition that did not exist. On fiscal policy, a budget deficit when not funded from domestic savings was reflected as a current account deficit. Thus, persistent budget deficits without offsetting private savings led to persistent current account deficits — a situation referred to by economists as twin deficits. The funding of this deficit led to debt accumulation, which in turn determined domestic interest rates. In the specific case where deficits were funded by the Central Bank, this mechanically drove the rate of inflation and directly undermined the price-stability goal of monetary policy.

Fiscal policy in the era of post-independence euphoria was targeted at weaning the budget from foreign (mostly Australian) aid. Budget support fell from almost 15 percent of GDP prior to independence to nil by 2001; project aid increased in this period, but by less than the decline in budget support. Overall aid fell in the post-independence era, with this decline amplified when measured in per capita terms.6

Despite the shift from budget support to project grant aid, there has been no significant increase in the proportion of government expenditure being allocated to the development priorities. Following an initial jump in development expenditures with the shift to project aid, grant revenues given as project aid and development expenditures converged between 1997 and 2005. This indicates a growing reliance on grant revenues rather than domestic funding between 1996 and 2006 for developmental outlays.

Monetary policy was targeted at maintaining the hard kina and price stability. Success was achieved on both of these fronts during the first five years of independence. The World Bank’s country assessment at independence was highly complimentary on the developmental prospects for the economy:

In the four years after its elections, the Somare government showed an impressive ability to deal with the young country’s financial, economic, and political problems. An effective set of institutions for economic and financial management has been created. These include a strong ministry of finance that has developed a tight system of budget controls, operating through a budget priorities committee; a planning office; and a central bank that, with International Monetary Fund assistance, has organised a set of international accounts. (World Bank 1978:5).

Australia, at independence, accounted for between 40 and 45 percent of the local budget and some 45 to 50 percent of the foreign exchange requirements. The Bank then had ‘reasonable grounds’ to believe that this dependence on Australian grants ‘might end entirely within the next 20 to 25 years (ibid:6). The external value of the kina was maintained, and even raised

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6 See chart 10 in Chapter 3 for a graphical representation of this.
against the Australian dollar in the first five years of independence so as to maintain price stability in the face of rising inflation abroad. The Central Bank adopted a stance of raising money supply commensurate with growth in real GDP, thus leaving prices stable.

A moderate degree of fiscal discipline was maintained from independence to the late 1980s, with persistent but relatively small budget deficits. Domestic spending (absorption), therefore, was consistent with a sustainable external sector. This was despite the slow weaning off of Australian budgetary support and the global recession following the second oil price shock in 1979. The Bougainville crisis of 1989 was a major blow to the economy. Bougainville Copper Limited’s Panguna mine, at its closure, was estimated to be at the halfway point of its 30-year life span and was then generating some 35 percent of total exports and 15 percent of government revenues and accounted for some 8 percent of GDP (Stein 1991:7).

While revenues fell, government expenditure on its security operations in Bougainville increased due to security concerns in the aftermath of the closure of the Panguna mine. The Bougainville conflict, with the mistaken expectation by the authorities of its early resolution, was a major drag on the development of PNG as a whole.

The late 1980s also saw a deterioration in PNG’s terms of trade. Fiscal discipline was jettisoned, in response to the rapidly slowing economy, in the hope of stimulating economic growth. Several new mines, including Ok Tedi and Misima, came on stream in the early 1990s. The ensuing boost to government revenues made the authorities confident that they could spend their way out of trouble. Government expenditure rose ahead of revenues, leading to the rapid accumulation of government debt. The mineral revenues and anticipation of their continuing into the future put upward pressure on the real exchange rate, thus penalising the competitiveness of non-mineral exports. These ‘Dutch disease’ effects were compounded by a ‘resource curse’ where the political masters did not feel obliged to account to the taxpayers for their extravagances — the revenues, after all, constituted a windfall to the budget. Despite revenues growing by 18 percent in 1993, and contrary to a planned deficit of 3.3 percent, the deficit for the year blew out to 5.5 percent. This trend continued, albeit at a lower pace: the deficit for 1994 amounted to 3.1 percent of GDP. During this ‘big spend’ era, fiscal discipline was lost, with direct repercussions on monetary policy.

The rise in government expenditure during the era of ‘big spend’ (1990–1995), saw a deterioration in the current account; that is, payments for imports far exceeded receipts from exports. A fixed exchange rate in the form of a hard kina with an accommodative monetary stance—taken at the behest of the political masters (see Chapter 4)—meant that foreign reserves were run down to finance this deficit. By the end of 1993, they had fallen to a low of 1.6 months of import cover. More worryingly for the Bank of Papua New Guinea (Bank of PNG), public confidence in its ability to maintain the fixed exchange rate waned as reflected by flight of capital. Matters just got worse in 1994, to the extent that by July the net foreign asset position of the Bank of PNG had turned negative. A balance of payments crisis was imminent. This forced Prime Minister Sir Julius Chan, who took office in August 1994, to freeze government expenditure and the Bank of PNG to float the kina. The expenditure cuts saw a retraction in access to public services in the nation, while the sharp depreciation of the kina in the aftermath of the float put upward pressure on inflation.

The years 1996–2000 were ‘payback time’ after the boom and bust of the earlier era. Nature in the form of an El Niño drought in 1997 dealt a heavy blow — both to the economy and the
people of PNG. Agricultural production fell sharply. The Asian financial crisis saw the terms of trade deteriorate; the cumulative effects of these problems were reflected in a contraction in GDP of 6.3 percent in 1997. Revenues to the 1998 budget fell by 10 percent compared to receipts of the previous year. The deficits continued to grow for the following two years, while their funding was shifted from external to domestic (mostly Bank of PNG) sources. This pushed the economy to the verge of another balance of payments crisis. Foreign reserves reached a low of 1.9 months of import cover in December 1999. The fiscal trauma was accommodated with a lax monetary policy, but this created downward pressure on the exchange rate and, via this channel, upward pressure on inflation.

Tough and uncertain times bring about risky behaviour. In the case of PNG, there were several reports of abuses of public office, allegations of rampant corruption, and reports of dubious deals with donors to replenish lost foreign reserves. A doubling of district support grants to members of parliament was used to hold the fragile coalition of Prime Minister Bill Skate together. Debt levels continued to spiral upwards. Interest rates on government paper in the domestic market reached a high of 28 percent.

Something had to give. The coalition withdrew its support for Prime Minister Skate in July 1999, which ushered in a new government led by Sir Mekere Morauta. The new government made a concerted effort, with donor support, to restore fiscal discipline, broaden the tax base, engineer political stability, induce financial stability, and enact monetary independence. On the last issue, a new Central Bank Act (2000) was passed that gave the Bank of PNG independence from political influence, and price stability was elevated as the primary goal of monetary policy. The Bank of PNG was also handed the responsibility for prudential supervision of the financial sector.

The fruits of these reforms were born in the era of economic reconsolidation (2000–2005). Intervening elections in 2002 saw some loss in ground on fiscal discipline, but this was quickly restored in the aftermath of the elections. A slow rebound in the economy, together with improvements in PNG’s terms of trade, increased government revenues and returned foreign exchange reserves to healthy levels. Both of the above led to a stable kina, low and stable inflation, and a sharp decline in interest rates. This created the perfect conditions for the Somare administration to tackle the longstanding issues of fiscal sustainability. Total debt as a share of GDP at the end of 2007 had fallen to 35 percent, while external debt was at 18 percent. The government’s investment program was targeted at rehabilitation and expansion of public infrastructure. The problem now was one of implementing spending plans as unspent funds were accumulating at a rapid pace. Development expenditure remains dominated by donor grants. While spending in the current boom has lagged revenue growth, the risk this time is that of a bust from a rapid cooling of global demand for PNG’s exports.

**Governance and politics**

Chapter 5 of this report outlines the political history and governance arrangements of PNG since independence. PNG is a democracy, thus policies are enacted and implemented by an elected government. Good policies, and particularly those formulated by bureaucrats and their technical support teams, are not sufficient; they must be well implemented. It is the politics that ultimately decides what is done and where public investments are made. An understanding and appreciation of the political context, therefore, is critical to the design of any development strategy.
PNG is far from a cohesive nation state. Until the last government, no prime minister had survived a full term in government. Political instability remained high until the election of the Somare government in 2002. Democracy has survived, but divisive politics has dominated the post-independence era. The nation has achieved little in terms of greater cohesiveness amongst its citizens. Some of this divisiveness is the product of history. Secessionist movements were active in the lead-up to independence and the formation of the nation. These have since constituted forces for further fragmentation. Spatially confined natural resource discoveries such as that of gold and copper on Bougainville added to the centrifugal forces of an already highly culturally and linguistically divided society.

Democratic politics continues to provide incentives for further fragmentation at the local level. The first-past-the-post electoral system encouraged aspirants to political office to pitch one community against another. The transition to limited preferential voting came in at the last election, and its success in engineering greater cohesion has yet to be evidenced. Cash and cargo have been major instruments used to acquire, maintain, and consolidate electoral support. Corruption within government, as argued by Gelu in Chapter 5, is high and well entrenched. ‘Carrots’ are sometimes used together with ‘sticks’ such as threats of violence to maintain the electoral base needed to retain office.

Highly fragmented communities, fierce electoral competition, a good sprinkling of resource rents from enclave developments, and the revolving-door nature of political office make up a recipe for poor governance. All but 3 percent of the land is held under customary title. This alone provides the communal bond and the identity to a clan, a bond that is transported well beyond the spatial confines of the traditional home. Legislative changes in the form of the Organic Law on the Integrity of Political Parties and Candidates have been made to provide greater political stability. Limited preferential voting has been introduced to broaden the electoral base of winning candidates. While it may be too early to judge the success of these initiatives, the initial assessments provide reasons for optimism (Reilly 2008).

A remaining challenge is engendering a national cohesiveness that runs deeper than clan and tribal allegiances. Notions of what it means to be a Papua New Guinean remain to be resolved. More difficult questions of how regional and communal affiliations meld into national obligations and responsibilities remain to exercise the minds of the ordinary voters. Finally, separating out ownership of land held under customary title to that of its use for production has remained a politically charged subject for most of the 33 years of independence. These questions will have to be tackled, sometimes head-on, in charting a course for economic and social development in PNG.

Why has democracy not delivered on its objectives of responsible, responsive, and accountable government in PNG? The decline in service delivery, social welfare, and economic outcomes corresponds with a continued decline in the work ethic and performance of the public sector bureaucracy. Some commentators have attributed this to a failure by the Australian colonial administration to properly equip the country for independence. Until independence, the majority of senior civil service positions continued to be filled by Australian nationals, which did not allow the citizens of the newly formed country time to learn how to establish a functioning and effective bureaucracy.

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7 For example, settlement patterns in Port Moresby as well as urban conflicts follow clan memberships carried from distant lands called home.

8 For the specific case of higher education, see Papoutsaki and Rooney 2006.
Elected leaders have, however, also played an active role in this decline in public sector capacity. From the 1980s onwards, successive governments began increasingly to politicise the civil service. In many cases, ministers have treated their department as a personal resource, which they can use to obtain political support. Governments have also been unwilling to implement the widespread public sector reforms that are required for improvements in the performance orientation of the civil service.

Is the system of government in PNG a true representative democracy? Is PNG’s democracy inclusive, participatory, and accountable? Gelu, in Chapter 5, seems to argue that the government is neither responsive to the needs of the people nor accountable to them. But why has democracy failed PNG? These difficult questions will have to be tackled if the next attempt at accelerating the pace of development is to have a chance.

**Economic and social development**

The first chapter of this report examines the concept of development and approaches that may be used to measure development in PNG. A substantial amount of research has been done on the economic and social development of PNG. Invariably, this work draws on published data from official sources. But even then, the story on economic and social development varies depending on the sources of the data. Care, therefore, has to be taken in reading too much into the reported statistics.

An example can illustrate the problems with officially reported data from PNG. Population figures are the simplest and possibly the most widely used of all socioeconomic statistics. Conceptually, counting the number of people living in the nation at a point in time should be a relatively straightforward exercise. Similarly, measuring the number of children born in a year and the number of people who died in the same year to arrive at a measure of the net natural increase in the population is just as straightforward. Counting the number of people leaving the nation and arriving home is also straightforward. But population statistics for PNG differ considerably across sources. The World Bank, for example, reports the population of PNG in mid-year 2006 to be 6.2 million and growing at a rate of 2.2 percent. The Asian Development Bank, in contrast, reports figures of 6.1 million growing at 2.9 percent.

These are large differences: a population growing at 2.9 percent doubles every 24 years, while one growing at 2.2 percent does the same every 32 years. No one knows who is right, but these numbers critically affect the assessment of economic and social progress. Assessments of growth in per capita income and changes in the rates of infant mortality, school enrolment, and literacy all depend on population figures. Furthermore, if population figures are as rubbery as suggested by the above discussion, then there is little room for comfort on figures reported for GDP, particularly given the large subsistence sector.

The figures for life expectancy at 57 years for 2006 are consistent between the ADB and World Bank sources. The ADB reports life expectancy at 55 years in 1990; thus, a gain of two years was achieved in a time span of 16 years, albeit from a comparatively low base. The ADB reports a 2008 literacy rate amongst adults of 58 percent, but the World Bank does not have figures on this. These statistics on economic and social development in PNG, crude and

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unreliable as they are, do not provide much room for comfort when compared to similarly endowed countries in the neighbourhood. (See for example AusAID 2001 and DFAT 2004.)

GDP per capita in the dozen years prior to self-rule was estimated to be growing at an annual average rate of 4 percent, a figure not repeated in any of the decades since independence (AIDAB 1994). Faal (2006) reports that real GDP grew at an annual average rate of 5.6 percent in the decade preceding independence, but then slowed to 2.6 percent from 1976 to 2004, 3 percent from 1986 to 2004, and 0.8 percent from 1996 to 2005. A more comprehensive picture is shown by growth in per capita GDP, which has been on a long-term downward trend for the past half century.\footnote{See Chart 1 in Chapter 2 for a graphical representation of this.} The narrative of poor growth in income over post-independence history, therefore, is consistent across commentators and data sources. Similarly, the poor record in terms of progress on development. The latter is not surprising since income growth, as pointed out in section 2 above, is necessary for improvements in the wellbeing of the general population. Reasons why the economy did not perform better are more difficult to fathom, however.

The major time-markers over the 33 years of independence for PNG in terms of its economic and social development may be summarised as follows. The policy focus in the lead-up to independence was on self-sufficiency and encouragement of greater local participation in the monetary economy. There was much euphoria over the birth of the new nation, the launch of a new currency, and the pride of being in charge of one’s own destiny. The second five years of independence continued to provide reasons for optimism. While the budget was weaned from foreign grant support, the kina was revalued against the Australian dollar, and the macroeconomic indicators appeared healthy. The Bougainville crisis was a major incident in PNG’s post-independence history. It left a major hole in the budget and a considerable dent in the economy. The Sandline scandal created political havoc, pushing the nation to the verge of a military coup. As a province, Bougainville was one of the most developed and progressive prior to the crisis, but it fell from this height to the bottom within a single decade. Both Bougainville and PNG as a whole are still recuperating from this shock.\footnote{The Bougainville crisis and its effect on fiscal policy and governance in PNG are discussed further in Chapters 3 and 5.}

The new millennium holds considerable promise for PNG. The economy is poised for growth, propelled by sharp improvements in terms of trade on the back of rising demand for commodities from China and India. Nature has also been kind to PNG thus far in that weather conditions have remained favourable for the growth of agriculture and mining. The risks are in terms of a global recession and potential adverse effects of climate change. Global conditions, particularly the deepening financial crisis, will have an adverse effect — which may shave off projected growth estimates for the economy for the next two to three years. The impact over the longer term, and particularly for the time horizon of the next plan, are envisaged to be minimal, however.

Past plans and their performances offer many lessons for the next plan. Past policy choices are responsible for some of the country’s poor economic performance. Binding minimum wages, and those that rose and thus became even more binding over time, caused increased unemployment (Levantis and Fane 1999). High unemployment and rapid urban drift, in turn, fuelled crime. The cumulative effects of these trends meant that the economy became trapped in low-growth equilibrium in which the costs of doing business remained punitive (Chand and Levantis 1997). The mineral boom and its ‘Dutch disease’ effects weakened the
competitiveness of non-mining exports even further. Making matters worse still was the Bougainville crisis, which amounted to a major shock to the budget, eroding the capacity of policymakers to fund access to basic public goods and services countrywide.

With the benefit of hindsight, what could have been done differently to improve the economic and developmental prospects of post-independence PNG? The answer is important only to the extent that it helps with charting the course for the future. Little could have been done to avert natural disasters, such as the drought of 1997 and the tsunami of 1999, except possibly a more rapid and coordinated response in their aftermath to mitigate some of their painful consequences. No one foresaw the Bougainville conflict, but the actions following its commencement left much to be desired. Bougainville offers important lessons on managing resource rents so as to prevent conflicts from erupting and mitigate their consequences if they do. Bougainville may have been the first major resource project in the nation, but it surely is not the last. As such, the lessons from Bougainville, and particularly the imperative to prevent such crises from taking hold in the first place, are worth repeated reminders.

There are several other lessons to be gained from the experiences of the past. Sustained growth of income is crucial for any progress on developmental indicators. Such growth demands sustainable use of the nation’s resources. Use of proceeds from liquidation of non-renewable resources such as logging and mining become critical policy challenges. The highly volatile nature of GDP growth and its long-term decline when measured in per capita form explain the poor record on economic and social development since independence.

There are several emerging challenges that policymakers will need to be cognisant of and for which the past provides little guidance. The challenge of restraining the spread of HIV, a newcomer on the development scene, is unlikely to be informed by past policy choices. The same may be said regarding the challenges of climate change and the deepening global economic crisis. Management of the new Liquefied Natural Gas project that is coming on stream, however, can well be informed by lessons from the mineral boom of the early 1990s. In summary, policymakers must be aware of the present whilst keeping the lessons of the past forever fresh in their thinking when making policy choices for the future. It is human to make mistakes, but less so to repeat them.

4. Conclusions and policy implications

PNG’s post-independence history has several lessons that could be of value in charting the future course of this nation of considerable promise. Policy choices made now have the potential to drastically improve the wellbeing of the current and future generations, while mistakes could do the very opposite. Several lessons can be drawn from past experimentation with development policy. The first is that good plans, when not implemented effectively, are a waste of scarce resources. Thus, it is the performance rather than just the plans that counts when development is the goal. The second is that a plan cannot be considered complete and successful without due consideration being given to the challenges of implementation. Each of the past plans failed to achieve its goals: economic growth, increased participation of citizens in the monetary economy, and more equitable access to basic services in the nation at large. Past plans’ neglect of political context and electoral incentives may have hampered their implementation — an omission that must be rectified in the next plan.

Despite numerous well-intentioned plans, post-independence PNG has had limited success in accelerating the pace of economic and social development. Nonetheless, the failures of the
past have value in informing the policies of the future. As a start, the shift in emphasis from state-led to state-facilitated development that was espoused in the mid-1980s has to be made in full. Next, it must be recognised that the resource constraints that have hampered implementation of the plans of the past are not as binding as before.


The failure of past development plans reveals clearly that plans on their own are not enough to induce the required changes in PNG. Politicians and other leaders must be willing to make the effort to ensure that the plans are implemented. For example, in Chapter 3, Batten highlights that a major constraint on the ability of fiscal policy strategies to achieve improvements in welfare outcomes during this period relates to its implementation rather than design. In this sense, a lack of public sector capacity at both the provincial and central government levels has undermined attempts to improve service delivery even in cases where sufficient resources have been allocated. The mantra of capacity building within the public service, however, has been recycled in all past plans. A major void within the public sector is the lack of performance orientation. Management structures offer poor incentives across all levels of the bureaucracy for output and efficiency. Promotions are based on patronage and length of service rather than merit and deliverables. Outdated employment practices and strict labour laws also mean that competence is seldom rewarded and incompetence equally rarely punished. Not surprisingly, the public sector remains lethargic.

Taking ownership of plans and working with the implementing agencies remain challenges to be addressed. This is where the process of planning is possibly as important as the product itself. To promote ownership, the plans need to be formulated with participation of the population, at a minimum their representatives in parliament. The engagement of each stakeholder in the process is critical to the ownership of the ensuing product. In Chapter 2, Yala and Sanida argue for synchronisation of national development plans with election cycles. Chand (2007) takes this a step forward where he argues for the use of political party manifestos as the platform for the development plan for the incoming administration. Responsive and responsible democracy would then have a chance if voters rewarded (or punished) the government on the basis of its success (or failure) in achieving its promises while in power.

The planning rhetoric of the past has consistently raced ahead of reality. This danger remains for the current exercise in national planning. PNG has had nine plans and is on its way to formulating the tenth. The question to be asked is whether this plan will once again repeat the mistakes of the past, or whether it will herald a new beginning for more effective plans. The hope of this chapter, and the ensuing volume, is that lessons of the past will be used to inform future planning such that the mistakes of the past are not repeated. Time will tell.
References


### Table 1: GDP level and growth rate

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP per capita, Purchasing Power Parity (constant 2005 international $)</th>
<th>Annual GDP growth (%)</th>
</tr>
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<tbody>
<tr>
<td>1975</td>
<td>..</td>
<td>-0.88</td>
</tr>
<tr>
<td>1976</td>
<td>..</td>
<td>-3.39</td>
</tr>
<tr>
<td>1977</td>
<td>..</td>
<td>0.83</td>
</tr>
<tr>
<td>1978</td>
<td>..</td>
<td>8.55</td>
</tr>
<tr>
<td>1979</td>
<td>..</td>
<td>1.83</td>
</tr>
<tr>
<td>1980</td>
<td>1699.24</td>
<td>-2.30</td>
</tr>
<tr>
<td>1981</td>
<td>1653.56</td>
<td>-0.27</td>
</tr>
<tr>
<td>1982</td>
<td>1617.62</td>
<td>0.35</td>
</tr>
<tr>
<td>1983</td>
<td>1626.74</td>
<td>3.22</td>
</tr>
<tr>
<td>1984</td>
<td>1579.08</td>
<td>-0.35</td>
</tr>
<tr>
<td>1985</td>
<td>1600.21</td>
<td>4.00</td>
</tr>
<tr>
<td>1986</td>
<td>1632.96</td>
<td>4.69</td>
</tr>
<tr>
<td>1987</td>
<td>1636.09</td>
<td>2.77</td>
</tr>
<tr>
<td>1988</td>
<td>1641.55</td>
<td>2.91</td>
</tr>
<tr>
<td>1989</td>
<td>1577.60</td>
<td>-1.42</td>
</tr>
<tr>
<td>1990</td>
<td>1491.31</td>
<td>-3.01</td>
</tr>
<tr>
<td>1991</td>
<td>1592.04</td>
<td>9.55</td>
</tr>
<tr>
<td>1992</td>
<td>1766.15</td>
<td>13.85</td>
</tr>
<tr>
<td>1993</td>
<td>2033.85</td>
<td>18.20</td>
</tr>
<tr>
<td>1994</td>
<td>2098.63</td>
<td>5.94</td>
</tr>
<tr>
<td>1995</td>
<td>1975.75</td>
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</tr>
<tr>
<td>1996</td>
<td>2072.03</td>
<td>7.73</td>
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<tr>
<td>1997</td>
<td>1938.03</td>
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</tr>
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<td>1998</td>
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<td>-3.77</td>
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<td>1999</td>
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<tr>
<td>2001</td>
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</tr>
<tr>
<td>2002</td>
<td>1734.73</td>
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</tr>
<tr>
<td>2003</td>
<td>1730.51</td>
<td>2.2</td>
</tr>
<tr>
<td>2004</td>
<td>1736.20</td>
<td>2.7</td>
</tr>
<tr>
<td>2005</td>
<td>1753.69</td>
<td>3.3</td>
</tr>
<tr>
<td>2006</td>
<td>1761.00</td>
<td>2.6</td>
</tr>
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</table>

**Source:** World Bank, World Development Indicators (2008).
Table 2: Key events and issues in PNG since independence

<table>
<thead>
<tr>
<th>Time period</th>
<th>Key events and issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975-1980 Independence euphoria</td>
<td>• Independence on 16 September 1975&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>• Sir Michael Somare took office as the first prime minister</td>
</tr>
<tr>
<td></td>
<td>• Second oil price shock in 1979&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>• Efforts to wean PNG off foreign aid</td>
</tr>
<tr>
<td>1981-1985 Economic consolidation</td>
<td>• Economic slowdown from the second oil price shock</td>
</tr>
<tr>
<td></td>
<td>• Commodity price shock</td>
</tr>
<tr>
<td>1986-1990 Bougainville crisis</td>
<td>• Panguna mine shut down in May 1989</td>
</tr>
<tr>
<td></td>
<td>• Blockade of Bougainville imposed in May 1990</td>
</tr>
<tr>
<td></td>
<td>• Beginning of civil war</td>
</tr>
<tr>
<td>1991-1995 The great spend</td>
<td>• Wingti government came into office in 1992 and hardened its stance on Bougainville</td>
</tr>
<tr>
<td>Boom and bust</td>
<td>• First fiscal crisis, with budget deficit reaching 5.5% and 5.6% in 1992 and 1993,</td>
</tr>
<tr>
<td></td>
<td>respectively</td>
</tr>
<tr>
<td></td>
<td>• Kina floated in October 1994</td>
</tr>
<tr>
<td></td>
<td>• Mineral boom as Ok Tedi, Porgera, Kutubu, and Misima came on stream</td>
</tr>
<tr>
<td></td>
<td>• Sir Julius Chan became prime minister in August 1994 and took a conciliatory tone</td>
</tr>
<tr>
<td></td>
<td>on the Bougainville crisis</td>
</tr>
<tr>
<td>1996-2000 Payback time with major</td>
<td>• Prime Minister Chan ordered PNG defence forces to invade Bougainville in March 1996</td>
</tr>
<tr>
<td>political wobbles</td>
<td>• The ‘Sandline scandal’ led to a standoff between the military and the government,</td>
</tr>
<tr>
<td></td>
<td>which ended with the resignation of Prime Minister Chan in March 1997</td>
</tr>
<tr>
<td></td>
<td>• Mr Bill Skate became prime minister in July 1997</td>
</tr>
<tr>
<td></td>
<td>• Second fiscal crisis</td>
</tr>
<tr>
<td></td>
<td>• El Niño drought; Highlands hunger</td>
</tr>
<tr>
<td></td>
<td>• Prime Minister Mekere Morauta took office in August 1999</td>
</tr>
<tr>
<td>2001-2005 Reconsolidation</td>
<td>• Morauta reforms – Organic Law on the Integrity of Political Parties and Candidates</td>
</tr>
<tr>
<td></td>
<td>(OLIPPAC), limited preferential voting, Bank of PNG, finance, privatisation</td>
</tr>
<tr>
<td></td>
<td>• Sir Michael Somare became prime minister in 2002</td>
</tr>
<tr>
<td></td>
<td>• Commodity boom</td>
</tr>
<tr>
<td>2006-2008 Full steam ahead</td>
<td>• China/India locomotive</td>
</tr>
<tr>
<td></td>
<td>• Reconsolidation</td>
</tr>
<tr>
<td></td>
<td>• Global economic slowdown</td>
</tr>
</tbody>
</table>

<sup>a</sup> Self-government began in 1973.
<sup>b</sup> The first oil crisis occurred in 1973.
CHAPTER 1: MEASURING PNG’S DEVELOPMENT PERFORMANCE

Aaron Batten and Linda Duncan

1. Introduction

This chapter examines Papua New Guinea’s (PNG’s) development performance since independence. In order to do that, it first examines the concept of development and various approaches to its measurement. Statistics are used to provide insight into PNG’s development. Time series enable the reader to see changes (or a lack of change) that can indicate development (or a lack of development).

The statistics presented in this chapter do not all tell a good story.

The social indicators show that the incidence of poverty has been increasing and educational outcomes have been falling in recent decades. Other areas, such as average life expectancy and infant mortality, have recorded significant progress, but at far slower rates than other comparable countries in the region — and the most recent data indicate that this progress has stalled.

These poor results suggest that the government has struggled to overcome the substantial challenges it has faced in delivering services to a rapidly growing population that is both geographically and culturally fragmented. As shall be discussed in subsequent chapters, a weak political party system, deteriorating bureaucratic capacity, election spending cycles, and variable compositions of government expenditure have also greatly contributed to the poor levels of service delivery during the post-independence period in PNG.

Whilst a degree of caution is warranted in interpreting the economic indicators, the data indicate that the economic fortunes of PNG have varied considerably, with periods of substantial economic growth followed by periods of economic decline. This has created a high degree of economic volatility in the post-independence period, which has been accompanied by a long-term decline in per capita income levels. A lack of fiscal discipline and poor economic management have meant that PNG has often been unable to translate short- to medium-term economic booms into higher rates of long-term growth.

Judgments about PNG’s overall development since independence are left to readers, to be based on the information presented and their own views about which aspects of development are most important. Development is a complex concept, incorporating many aspects of life, not all of which are readily measurable or reported in this chapter. One of the key features of this approach is that it enables readers to attribute their own weights to the various indicators and make their own judgments about PNG’s overall development performance.

Although some of the linkages between the indicators are highlighted in the discussion, the causes of movement in the indicators are rarely straightforward. The chapters that follow provide information that may help explain this performance by

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1 The authors acknowledge work done on a previous draft of this chapter by Brian Gomez.
assessing the government’s policy choices across a range of key development areas. These include development planning, fiscal policy, monetary policy, and the political and governance system.

The remainder of this chapter examines the concept of development (section 2) and outlines various approaches that may be used to measure it (section 3). Of the three main approaches to measuring development, this chapter adopts what is referred to as the ‘suite of indicators’ approach, which entails reporting on a range of statistical indicators. This approach is explained in greater detail in section 4, together with an explanation of why the emphasis is on economic and social indicators. Readers are cautioned in section 5 to take care when interpreting and drawing conclusions from the information presented, before being presented with time series information on the indicators themselves in sections 6 and 7.

2. The multidimensional nature of development

A country’s development is its progress or change over time. But there are many different dimensions to a country’s progress, and development therefore is a subjective term, meaning different things to different people. A village elder, for example, may look at development in his community in terms of education or health services, or the type of houses built or clothes that are worn. A person in an urban area may think of development in more quantifiable terms like car ownership or average income.

Not only is development a subjective term, it is also difficult to quantify. While education or health services may be measured in terms of school enrolment rates or number of health clinics, other aspects of development are less quantifiable. For example, development may be seen as a path to a better quality of life, but people’s quality of life, their well-being, and how happy they feel are impossible to quantify.

Many measures have been used to assess a country’s development progress. The most basic of these measures is a country’s growth in gross domestic product (GDP) or GDP per capita. Another common measure is the proportion of a country’s population with an income of less than a given amount (often US$1 per day), which is used to gauge levels of extreme poverty. Both of these measures focus on economic aspects of development and in doing so overlook other important dimensions that affect the welfare, well-being, or quality of life of the population.

There is now a general consensus that while economic growth may be a necessary prerequisite for development in other areas, such as health and education, development in these areas does not necessarily follow from increases in income (UNDP 2007). In response to the acknowledged limitations of economic measures, there is a growing body of literature aimed at producing measures of development or societal progress that go beyond GDP to represent a broader view of the ways in which societies are progressing and regressing (OECD 2008). Over time, measures of

In some circumstances, development improvements can be attained without economic growth through improvements in the efficiency of policy implementation and service delivery. However, substantial and sustainable development improvements require economic growth.
development have evolved and become more complex; they now typically include social, environmental, and even political aspects of development.

3. Approaches to measuring development

There are three main ways of measuring and presenting information on a country’s development — the accounting framework approach, composite indicators, and the suite of indicators approach. Although each approach captures the multidimensional nature of development, they vary in terms of their complexity and accessibility. These measures, and their suitability for gauging PNG’s development performance, are discussed below.

The accounting framework expands on a country’s national accounts system by incorporating social, environmental, and other data into the economic accounts. This system is complex and requires detailed data at a national level on a wide range of variables. At this stage, due to poor availability of data, this approach would not be suitable for PNG and is not discussed further in this chapter.³

Composite indicators combine more than one indicator into a single measure by allocating weights to the different components. One example of a composite indicator is the Human Development Index (HDI), which is used by the United Nations Development Program (UNDP) to compare human development progress across countries. The HDI combines the following four indicators of development:⁴

1. Life expectancy at birth
2. Adult literacy rate
3. Combined gross educational enrolment ratio at primary, secondary, and tertiary levels
4. GDP per capita in purchasing power parity measured in US dollars

The HDI for PNG from 1975 to 2005 is discussed in Box 1.

Although a simple measure, the HDI encapsulates a number of aspects of development and as such is a more inclusive measure of development than single indicators such as GDP or life expectancy. It is also a useful tool for comparing and ranking PNG’s level of development against its neighbours and other developing countries. However, such comparisons should take into account that the weights accorded the different indicators may not reflect the values of the different societies being compared.

The suite or set of indicators approach takes an array of economic, social, environmental, and other indicators and reports on each individually. Readers can look at the changes in each of the indicators over time and make their own judgments about the country’s development and rate of progress based on their own unique values, preferences, and views of development.

³ For an example of an accounting framework approach, see Kazemier, Keuning, and van de Ven’s (1999) discussion of the application of the System of Economic and Social Accounting Matrices and Extensions to the Netherlands.
⁴ The HDI uses a scale from 0 to 1, with 0 indicating the lowest level of human development and 1 indicating the highest.
Box 1: PNG’s Human Development Index

The data presented in the figure below depict HDI scores for PNG and some regional groupings. PNG experienced a progressive increase in the HDI score from just over 0.4 in the mid-1970s to over 0.5 in the mid-1990s. From the mid-1990s onwards, PNG’s HDI score remained stagnant and even started to decline beginning in 2000. This contrasts with the other regions, where HDI scores have been increasing since the mid-1970s.

Trend of the Human Development Index, 1975–2005

Source: See chapter 2 (Yala and Sanida)

The suite of indicators approach recognises that there are many aspects to development and that some aspects may be more important to some people than others. Unlike the other two approaches, if the suite of indicators presented includes aspects of development that readers consider unimportant, readers can discount them in making their overall evaluation, or conversely, they can attribute additional weight to indicators they feel are the most important. For example, the village elder who views development in terms of health or education outcomes may pay little attention to economic or environmental indicators and focus his attention on school enrolment rates or infant mortality figures. People in more developed countries may care more about environmental and economic indicators because basic services are already provided at an acceptable level.

Presenting performance against a range of variables also enables readers to attribute their own relative weights to the different indicators. For example, one reader may view big improvements in health as balancing out small declines in education, leaving that reader with the overall view that the country has progressed. To another reader, the declines in education may be more meaningful than the gains in health indicators, leaving them with the impression the country is regressing.
The remainder of this chapter applies the suite of indicators approach and establishes an indicator framework with which the reader can assess PNG’s development performance. The next sections explain the selection of the suite of indicators and present a time series of each indicator over the period since independence.

4. A suite of indicators for PNG

Many suites of indicators have been developed to assess country development or progress. Examples include the following:

- The Asian Development Bank’s Key Indicators for Asia and the Pacific, encompassing data on purchasing power parity and social, financial, external trade, infrastructure, governance, and environment indicators (ADB 2008).
- The Millennium Development Goals Indicator Framework, which is used to monitor and assess country progress toward achieving the eight Millennium Development Goals (UNDP 2007).
- The UNDP’s Human Development Reports, which publish information on social, economic, political, or cultural influences on human development at a global, regional, country or sub-national level (UNDP 2008).

Data for PNG are already included in a number of these reports. However, no single, universally accepted set of indicators has been adopted. The different indicator sets reflect the fact that development means different things to different people and in different contexts.

There are a large number of indicators that have been used in international reports to measure country development that we could include in our set of indicators for PNG. For example, the Human Development Reports often include data on hundreds of indicators, while there are only forty-eight indicators of progress toward the Millennium Development Goals, and Australia measures its progress with just fourteen key indicators (UNDP 2007, ABS 2004). However, it is beyond the scope of this chapter to examine all the possible indicators that could be chosen, and there is an inevitable trade-off between the number of indicators reported on and the accessibility of the report to readers.

In choosing an appropriate set of indicators for PNG, it has been necessary to make some judgments about the areas of development that are most important in PNG. Some guidance on this has been drawn from the aims and objectives of the national development plans and vision statements that have been adopted since independence. For example, the Kumul 2020 outlines a vision that citizens of PNG will be healthy and learned by the year 2020 (among other things), reflecting that a value is placed on health and education (GoPNG 1998). As outlined in Chapter 2, many of the nation’s development plans have aimed to achieve economic growth and participation of citizens in the economy, reflecting the link between strong economic growth and social development outcomes.

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5 Although the Australian Bureau of Statistics identifies only fourteen key indicators, it also reports about 300 supplementary indicators (ABS 2004).
Although the development plans and vision statements outlined in Chapter 2 provide some indication of what is important to development in PNG, they offer little assistance in choosing a set of indicators to measure PNG’s development performance. This is because many of these aspects are subjective and difficult to quantify and cannot be readily translated into indicators that can be used to measure development performance. For example, the National Goals and Directive Principles embedded in the preamble to the National Constitution talk about achieving ‘integral human development’, ‘national sovereignty and self-reliance’, and ‘equality and participation’ (GoPNG 1975).

The latest development plan — the Medium Term Development Strategy 2005–2010 — adopts the United Nations Millennium Development Goals as the framework for measuring progress. These goals encompass a range of indicators and targets in the areas of income, education, health, gender equality, and the environment. Although these indicators may be used as the basis for measuring development in the future, the poor availability of data across the period since independence limits their usefulness for our current purpose.

In choosing the indicators, we focused on the two aspects of development that we think are most important for PNG at this time — social development and economic development. PNG’s development is at a stage in which basic services are still not reaching a large proportion of the population and health and education are major concerns. Therefore, the discussion of social indicators in section 6 includes a range of health and education indicators, which provide some indication of the level of these basic services in PNG.

Although the social indicators may have the most resonance with readers, the connection between economic and social development cannot be overlooked, as recognised in the objectives of the national development plans discussed in Chapter 2. Outcomes in health and education are intrinsically linked to the country’s economy and the government’s management of it. The government needs money to spend on the provision of services, and individuals need incomes to participate in the economy. Social indicators are unlikely to improve without growth in the economy, and how well the government manages the economy will affect its ability to deliver essential services. In PNG, management of the economy and government finances is particularly important to ensure that the gains from extraction of natural resources are capitalised on.

Our selection of indicators has been heavily constrained by data availability. Unlike other reports in which organisations collect their own data to report on, we have been limited to data that are already collected and in the public domain. Where possible, we chose indicators that were available across a time series to show indications of progress or regress. However, data are not available across the whole period since independence for all the indicators we have chosen. Data limitations have also precluded us from examining other environmental and political aspects of development, although the latter are discussed to some extent in Chapter 5.

The indicators we have selected, their definitions, and the rationale for their inclusion are outlined in sections 6 and 7 and summarised in the tables in the Appendix. This
5. Care in interpreting indicators

In assessing the indicators reported on in the sections below and drawing conclusions about PNG’s development performance, readers should take into account a number of limitations of the data presented.

First, readers should attribute their own weights to the indicators presented based on what they view as being most important to PNG’s development. As outlined above, the choice of indicators reported on reflects, to some extent, the views of the authors in terms of what is important to PNG’s development, and these views may not be the same as the reader’s. The authors’ rationale for including each of the indicators is further elaborated on in sections 6 and 7.

Second, readers should remember that the indicators reported do not represent all dimensions of development, particularly relating to the environment and governance. A more complete picture of PNG’s development performance will come from reading the discussions in the other chapters on specific policy issues.

Third, care should be taken not to place too much emphasis on movements in only one or two indicators. Although at first glance many of the indicators presented have a ‘good’ direction indicating progress, and a ‘bad’ direction indicating regress, this may become ambiguous when links between the indicators and links with omitted indicators are considered. For example, considered on its own, an increase in spending on education may seem positive, but when considered together with a decline in education outcomes, the outlook is not as good. Similarly, if environmental indicators were included, progress in economic indicators may be seen to have negative impacts on the environmental indicators because natural resources are being depleted, polluted, or degraded, which in turn may negatively impact future generations. Readers must take a holistic approach and consider the whole range of indicators when drawing any conclusions about PNG’s overall development performance.

Fourth, the indicators are presented at a national level. Therefore, they do not reflect or take account of differences within the population — between urban and rural areas or different provinces or income levels. As noted in the Millennium Development Goals Progress Report for PNG in 2004, these differences are likely to be significant, given the extreme demographic, socioeconomic, cultural, and environmental diversity in the country (UNDP 2004). Although the country as a whole may be shown to be progressing in the various indicators, the gap between rich and poor may be widening, increasing inequality within the population.

Fifth, the chapter reviews a mix of short- and long-term indicators. That is, only some of them will change in the short term in response to government policy changes. Although government policies in some areas, such as health, may have some effects in the short term, their full impacts may only be realised in the long term. For example, the impact on mortality rates of measures introduced to prevent disease or infection may increase over time as the incidence (and therefore the risks) of the disease or infection decreases. The time delay between implementation of government policy
and changes in indicators should be taken into account when viewing the statistics together with the historical narratives that occur in the following chapters.

Finally, as noted above, flaws in PNG’s statistical record make it problematic to analyse and comment on the country’s modern history. There is a dearth of high-quality data in PNG, particularly continuous time series data that cover the entire period from independence. This has resulted in numerous gaps in the data reported, particularly the social indicators. In some cases there are also concerns about the accuracy, consistency, and comparability of data over time. For example, estimates of PNG’s population vary wildly, and this affects the accuracy of per capita figures.

6. Social indicators

This section examines a number of indicators commonly used to measure progress in aspects of social development, such as health and education.

Three of the most common headline indicators used to encapsulate major health outcomes are life expectancy at birth, infant mortality rates, and child immunization levels.

Life expectancy at birth is measured as the average number of years a person is expected to live at the time he or she is born. As shown in Chart 1, the average life expectancy at birth for a Papua New Guinean increased from 45 years in 1974 to 57 years in 2006. As an average for the population as a whole, it does not capture differences between rural and urban populations. It is also only a measure of the expected length of life, not of the quality of life. Increases in life expectancy are generally seen as an indication of improved health of the population, and may be associated with improved health services.

The infant mortality rate represents the number of infants out of every 1000 that die before their first birthday. Infant mortality rates in PNG dropped from 100 to 55 between 1974 and 2007. This represents an improvement in this indicator, which may reflect an improvement in the general health of the population and improved health care services—but once again, this is a national average, and the mortality rate in rural areas is likely to be higher.

The child immunization rate measures the proportion of the population aged 12 to 23 months that has been immunized against diphtheria, whooping cough, and tetanus. Between 1974 and 2007, childhood immunization rates also improved, increasing from 35 percent to 75 percent. Improvements in immunization levels can reduce the rate of infection and the number of people dying from preventable causes, signalling an improvement in the health of the population.

As shown in Chart 1, PNG has made steady progress against all of the above indicators since independence, albeit from a very low base. However, this progress has stagnated over the last decade. When compared to other Melanesian countries, the extent of this stagnation is highlighted, as shown in Table 1.
**Measuring PNG’s Development Performance**


![Graph showing life expectancy, infant mortality, and immunization rates](chart1.png)

- **Mortality rate, infant (per 1,000 live births)**
- **Life expectancy at birth, total (years)**
- **Immunization, DPT (% of children ages 12-23 months)**

**Data source:** World Bank 2008.

**Note:** Observations have been linearly extrapolated for missing years.

### Table 1: PNG and other Melanesian countries’ social welfare indicators

<table>
<thead>
<tr>
<th></th>
<th>PNG</th>
<th>Fiji</th>
<th>Solomon Islands</th>
<th>Vanuatu</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Initial</td>
<td>Current</td>
<td>Initial</td>
<td>Current</td>
</tr>
<tr>
<td><strong>Health expenditure per capita (current US$) (2000 vs. 2005)</strong></td>
<td>25</td>
<td>34</td>
<td>82</td>
<td>148</td>
</tr>
<tr>
<td><strong>Immunization, DPT (% of children aged 12-23 months) (1980 vs. 2006)</strong></td>
<td>32</td>
<td>75</td>
<td>68</td>
<td>81</td>
</tr>
<tr>
<td><strong>Incidence of tuberculosis (per 100,000 people) (1990 vs. 2006)</strong></td>
<td>250</td>
<td>250</td>
<td>42</td>
<td>22</td>
</tr>
<tr>
<td><strong>Life expectancy at birth (years) (1977 vs. 2006)</strong></td>
<td>49</td>
<td>57</td>
<td>63</td>
<td>69</td>
</tr>
<tr>
<td><strong>Infant mortality rate (per 1000 live births) (1975 vs. 2006)</strong></td>
<td>97</td>
<td>54</td>
<td>41</td>
<td>16</td>
</tr>
<tr>
<td><strong>School enrolment, primary (% gross) (1991 vs. 2006)</strong></td>
<td>65</td>
<td>55</td>
<td>133</td>
<td>100</td>
</tr>
<tr>
<td><strong>Population living on less than SUS1 a day (%) (1996 vs. 2005)</strong></td>
<td>25</td>
<td>40</td>
<td>26</td>
<td>35&lt;sup&gt;c&lt;/sup&gt;</td>
</tr>
</tbody>
</table>

**Data sources:** World Bank 2008 and AusAID 2008.

<sup>a</sup> ‘Initial’ represents earliest available data. ‘Current’ represents latest available data (exceptions to the dates in the left-hand column: a = 1985; b = 2005; c = 2003; d = 1998).
From the table, it can be seen that whilst considerable progress has been made in each of the core health outcomes mentioned above, when compared with progress made in other Melanesian countries, these achievements are less impressive. PNG still has the lowest infant immunization rate of the countries considered, immunizing 75 percent of its infants compared to 81, 91, and 85 percent of infants in Fiji, Solomon Islands, and Vanuatu respectively. In other health-related areas such as the incidence of tuberculosis, the outcomes in PNG remained completely stagnant between 1990 and 2006, whilst other countries have all recorded significant drops in their recorded incidences.

Likewise, PNG’s life expectancy at birth is still the lowest in the region, whilst its infant mortality rates are almost three times those of Fiji, and at 54 per 1000 births, are comparable to those recorded in the Solomon Islands, which has just emerged from a period of substantial conflict and breakdown in law and order.

Finally, despite an increase from $US25 in 2000, PNG’s health spending per capita of $US34 in 2005 compared particularly poorly to Fiji and Vanuatu, which spent $US148 and $US67 per capita respectively in the same year. Whilst these figures reflect, in part, the high population growth rate, they also indicate that government revenues from the mineral boom have been diverted to other expenditure areas (see Chart 6 in the next section). Although the increases in health expenditure could be expected to lead to improvements in health services, this is not reflected in the indicators shown above. The explanation may be that the effects of increases in expenditure will only become evident in the long term, or it may be that this expenditure has not been spent well due to poor implementation or low capacity.

Although the above health indicators have shown little improvement in recent years, the most troubling components of PNG’s post-independence development performance are reflected in indicators such as school enrolment rates and more broadly the incidence of poverty.

In terms of education, the data show that the gross proportion of the school-aged population enrolled in primary school actually fell from 65 percent to 55 percent between 1991 and 2006. Meanwhile, all other compared countries in the region have managed to increase gross enrolment rates to cover their entire school age populations. Declining enrolment rates can reflect reduced access to basic education services, which may have long-term negative implications for economic and social development outcomes as a result of a poorly educated workforce and population.

The rise in the incidence of poverty between 1996 and 2005, on the other hand, reflects the declining long-term rates of per capita income growth recorded in PNG over the last three decades, as shown in Chart 2 in the next section. As a result, the proportion of PNG’s working-age population living on less than $US1 per day increased from 25 percent in 1996 to 40 percent in 2005. In addition, despite having a comparable proportion of its population living under this absolute poverty threshold

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6 The gross enrolment ratio shows general levels of participation in education. It is defined as the total enrolment, regardless of age, expressed as a percentage of the official school-age population for a given level. It can be over 100 percent due to the enrolment of over-aged and under-aged students. Ratios of 100 percent or more indicate that a country is, in principle, able to accommodate all of its school-age population.
just over a decade ago, according to the latest available data, PNG has now fallen behind Fiji, Solomon Islands, and Vanuatu in this regard. Notwithstanding significantly faster rates of economic growth during the post-2002 commodity boom, this situation reflects the inability of the PNG economy to effectively absorb the rapidly growing working-age population.

7. Economic indicators

As noted above, significant improvements in social indicators and the provision of basic services are unlikely to be achieved without strong economic growth. This has been recognised by successive PNG governments, which have made economic growth a key objective of national development plans since independence (see Chapter 2).

However, strong economic growth may not necessarily lead to improvements in social outcomes. A range of factors will affect whether economic growth is translated into social development outcomes, including efficient implementation of good policies, appropriate prioritisation of expenditure, and good fiscal and monetary policy management.

Therefore, this section examines not just economic growth but also other aspects of economic performance and the management of the economy. The history of fiscal policy and monetary policy in PNG and how these policies have influenced economic outcomes are discussed in detail in Chapters 3 and 4.

Economic growth and trade

Economic growth

GDP is a measure of a country’s income. Real GDP figures are adjusted for inflation. Therefore, the per capita real GDP is a measure of the average income of a country’s citizens, taking into account inflation. The growth rate shows how fast or slow an economy is growing relative to population growth. The trend in per capita real GDP, if sloping downwards, indicates that incomes (taking into account price effects) are decreasing over the long-term.

Chart 2 shows that, since independence, PNG has experienced volatile rates of real economic growth reflecting the economy’s reliance on mineral and resource extraction and the prevailing international markets for these goods. As discussed in Chapter 3, poor quality fiscal management has also tended to exacerbate these business cycles. Low average rates of GDP growth and high population growth have meant that across the post-independence era, growth in real GDP per capita has been on a consistent downward trend, albeit with significant fluctuations on a year-to-year basis. This trend has stabilised somewhat in recent years with the economic expansion associated with the commodity boom.
Chart 2: Real GDP growth and GDP per capita (1975–2008)


Note: LHS refers to the left hand side axis and RHS refers to the right hand side axis.

Note: GDP data have been deflated into constant 2000 kina using the consumer price index. Whilst this is a measure of consumption price levels rather than production, it was chosen in order to obtain a consistent time series across both indicators. Care should be taken in interpreting the data, however, as they may not necessarily align with the real GDP growth rates recorded within the official budget documents.

Exports and imports

Due to PNG’s reliance on a limited number of (mainly commodity-based) goods sold on international markets, economic outcomes are heavily influenced by the volume and value of trade. As discussed in Chapter 3, fluctuations in commodity prices have had major impacts on exchange rates, foreign exchange reserves, and the balance of payments position. In turn, each of these factors has had a large flow-through effect onto domestic fiscal and monetary variables such as the government’s fiscal position, public debt, inflation, and ultimately the overall economic and social performance of the country.

As can be seen in Chart 3, for example, the significant fluctuations in GDP growth shown in Chart 2 have to a large extent mirrored the changes in the value of exports sold over the last thirty-five years. The positive effects of this have been particularly pronounced both in the 1990s, which recorded a major boom in commodity and mineral exports, and in the most recent post-2002 commodity boom. In contrast, the downturn in the late 1990s led to a significant loss in export revenue, which contributed to the public debt crisis in 2000.
Fiscal performance

Budget outcome

The most basic indicator of a government’s fiscal performance is the budget outcome — that is, whether the budget has recorded a deficit (expenditure has exceeded revenue) or a surplus (revenue has exceeded expenditure). The budget outcome is generally expressed as either a percentage of GDP or a proportion of total expenditure to indicate its magnitude and significance relative to the overall economy. Although short- to medium-term fluctuations are generally considered beneficial for managing economic upswings and downswings, long-term trends towards deficit financing can give an indication of the government’s inability to ‘live within its means’.

While increases in revenue can indicate that the economy is growing and more money is available to the government to spend on development priorities, if expenditure also increases by a similar or greater amount, then this can have a negative impact on the economy. For example, continued deficits result in increases in government debt, the repayment of which diverts government revenue in future years away from priority areas such as health and education. As discussed in Chapters 3 and 4, government overspending and debt financing can also have broader implications for the economy.

Chart 4 illustrates the budget outcomes recorded by PNG in the post-independence era. Despite large inflows of foreign financial resources and a significant growth in domestic revenue collection, budget deficits have been persistent over the last 35 years. These deficits reached a number of peaks at independence, in 1981, and in

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7 Export earnings are measured free on board or FOB, whilst import earnings are measured including cost, insurance, and freight or CIF.
1993. Most recently, favourable commodity prices have led to a rapid growth in government revenue since 2002. Expenditures have increased in line with these increasing revenues; however, a degree of increased fiscal austerity allowed the government to record fiscal surpluses between 2003 and 2007.

**Chart 4: Government revenue, expenditure, and budget outcome (1974–2008)**

![Graph showing government revenue, expenditure, and budget outcome from 1974 to 2008.](chart4.png)

**Data source:** IMF Government Financial Statistics CD Database (2007).

**Note:** LHS refers to the left hand side axis and RHS refers to the right hand side axis.

**Government debt**

A natural outcome of sustained fiscal deficits has been a large growth in public debt in the post-independence era. When the government borrows from either foreign or domestic sources, these debts attract interest, which will accumulate over time if not repaid. As noted above, debt repayment obligations will reduce the money available to spend on development outcomes in future years. Further, as outlined in Chapters 3 and 4, accumulated foreign debt exposes the government to exchange rate risks, while domestic debt may reduce the ability of the private sector to borrow domestically.

The significance and magnitude of PNG’s debt is indicated in Chart 5, which shows domestic and foreign debt levels as a proportion of GDP. As shown in the chart, PNG public debt as a proportion of GDP rose from 30 percent in 1974 to a peak of 72 percent in 2002. Subsequent fiscal surpluses combined with a strengthening of the kina exchange rate have contributed to a significant downturn in foreign debt liabilities, which were expected to reach 31 percent of GDP in 2008.
Government expenditure priorities

How the government has chosen to implement its fiscal policy, and which sectors it has prioritised funding towards, are just as important to economic performance and development outcomes as aggregate expenditure and revenue decisions. Chart 6 illustrates the amount of funding received by three key development sectors — health, education, and infrastructure — vis-a-vis all other government expenditures.


Data source: IMF Government Financial Statistics (2008), PNG Budget Documents, various years.8

Note: LHS refers to the left hand side axis and RHS refers to the right hand side axis.

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8 See Appendix D in Chapter 3 for an explanation of how these figures were calculated by authors.
The chart shows that despite consistent growth in the ‘other’ expenditures category, real total funding levels for infrastructure and health have remained relatively stagnant across the post-independence era (notwithstanding some substantial fluctuations during periods of economic turmoil), indicating that these sectors have been given a lower priority than previously and that funding levels have not kept pace with population growth. Likewise, total real funding levels for education recorded substantial fluctuations until 2000, when a number of educational institutions were dismantled. This led to a sharp decline in total expenditures for the sector.

Most recently, the rapid growth in domestic revenue since the onset of the 2002 commodity boom has led to increases in each of these development expenditures, albeit with the ‘other’ category dominating total expenditure levels. As shown in section 6, this crowding out of key development sector expenditures by other expenditure priorities has mirrored poor social welfare outcomes during the post-independence era.

**Monetary performance**

As outlined in Chapter 4, controls over foreign exchange transactions have also been a major policy tool for PNG in the post-independence period. Exchange controls were aimed primarily at controlling the amounts and direction of foreign exchange transactions between PNG and the rest of the world and to preserve an adequate level of foreign exchange reserves. This in turn supported a stable domestic financial sector. Since independence there have been several periods of reform to the system of exchange controls, representing changes in both the domestic and international economic environment. In general, reforms have been categorised by a liberalisation of foreign exchange transactions, culminating in the floating of the kina exchange rate in 1994.

**Exchange rates**

The exchange rate is the price at which one currency can be converted into another. Under the fixed exchange rate regime, the kina’s foreign currency value was high and comparatively stable. Inflation during this period was relatively stable and low, also reflecting low inflation in PNG’s major trading partners and favourable international conditions. Persistent budget deficits, however, exacerbated the gap between PNG’s limited export revenues and large import propensity, leading to a severe foreign exchange shortage in the early 1990s. This subsequently forced the floating of the kina in 1994.9

The floating exchange rate has allowed the real PNG economy to become more flexible in response to changes in external conditions. For example, a depreciation of the kina will make exports more attractive (cheaper) overseas but imports more expensive in PNG. However, under the floating exchange rate regime, this flexibility has resulted in the value of the kina trending downwards, leading to higher and more volatile inflation. With the onset of the most recent commodity boom, the value of the kina has stabilised, also contributing to more stable levels of inflation (see Chart 7).

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9 See Chapter 4 for a more detailed discussion of monetary policy in this period.
**Chart 7: Exchange rate (1972–2008)**

![Chart 7: Exchange rate (1972–2008)](chart.png)

**Data source:** PNG National Budget Documents, Various years (1975–2008).

**Interest rates**

As shown in Chapter 4, a key tool of monetary management is the Central Bank’s management of domestic interest rates. Chart 8 shows the interest rate on deposits (which represents the gains on saving money) and the interest rate on loans (which represents the costs of borrowing money). High interest rates generally attract deposits, while low interest rates attract borrowing and can stimulate investment and demand in the economy.

**Chart 8: PNG domestic interest rates (1999–2008)**

![Chart 8: PNG domestic interest rates (1999–2008)](chart2.png)

**Data source:** Bank of PNG (2009) in Kauzi (Chapter 4).
The chart also shows the kina facility rate (KFR), which whilst not targeted directly, gives an indication of the direction in which the bank may intervene in the market to influence interest rates.

Since 1999, the KFR, 28 day Treasury bill rate, and commercial interest rates have all been on a relatively consistent downward trend. The drop in the KFR has reflected in large part the low inflationary environment during this period, which, combined with rapidly growing domestic liquidity from commodity revenues and post-2002 fiscal surpluses, has flowed through to lower commercial bank interest rates.

**Consumer price index and inflation**

The management of both the exchange rate and the domestic interest rate has a key impact on domestic price levels, which is most often measured by the Consumer Price Index (CPI). The CPI is calculated based on the average prices of a basket of goods and services that represent typical consumption patterns of urban households. The percentage change in the CPI is a measure of inflation. Increases in the CPI reduce the purchasing power of consumers and act as a tax on the poor, who can rarely achieve commensurate increases in wage levels. A key role of monetary policy, as outlined in Chapter 4, is to maintain moderate growth in the CPI.

In general, price levels in PNG have been volatile, particularly during the 1990s. PNG’s heavy reliance on imported consumption goods has meant that many price increases have been determined by the transfer effects from international markets.

Following a decade of relatively modest 3 to 7 percent inflation during the 1980s and early 1990s, inflation reached a peak of 17 percent in 1995. This occurred amidst a sharp devaluation of the kina following its liberalisation in 1994, which dramatically increased the price of imports. During the 1990s, inflation remained volatile; it then dropped sharply in the early 2000s, following the onset of the most recent commodity boom, a strengthening of the kina exchange rate, and the beginning of sustained fiscal surpluses between 2003 and 2007 (see Chart 9).

**Chart 9: Consumer Price Index (1973–2008)**

*Data source: PNG National Budget Documents, Various years (1975–2008).*
Private sector credit

Monetary policy can influence economic outcomes through the influence it has on the expansion and contraction of credit to the private sector. This reflects the amount of funds lent by financial institutions to the private sector for investment purposes. Private sector borrowing is affected by interest rates and can reflect business confidence in the economy. Private sector credit (and therefore investment) is a key contributor to economic growth.

As can be seen in Chart 10, growth in credit to the private sector maintained a relatively persistent downward trend between independence and the mid-1990s, when it actually became negative.

Chart 10: Private sector credit (1978–2008)

<table>
<thead>
<tr>
<th>Kina, millions</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1000</td>
<td>5</td>
</tr>
<tr>
<td>2000</td>
<td>10</td>
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<td>4000</td>
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<tr>
<td>5000</td>
<td>25</td>
</tr>
<tr>
<td>6000</td>
<td>30</td>
</tr>
</tbody>
</table>

Data source: Bank of PNG.
Note: LHS refers to the left hand side axis and RHS refers to the right hand side axis.

Following the liberalisation of the exchange rate, and a substantial inflow of foreign funds from a donor-backed foreign exchange bailout and favourable external conditions, private sector credit rose sharply in the mid-1990s, and then contracted slightly in the early 2000s as a result of the looming public debt crisis. Again with the onset of the most recent commodity boom and the subsequent rise in domestic liquidity and decline in interest rates, private sector credit has been expanding rapidly, reaching a peak growth rate of almost 40 percent in 2008.

8. Conclusions and policy implications

This chapter has sought to analyse data that can be used to assess the development performance of post-independence PNG. A range of indicators have been presented that show PNG’s performance in the areas of economic and social development,
which have been listed as key development areas for PNG in the national development plans (discussed in the next chapter).

Although judgments about PNG’s overall development performance are left to the reader, trends that can be seen in some of the individual indicators presented may raise concern.

The data show that PNG has experienced periods of strong economic growth and that government revenues have doubled since independence. However, this economic growth — fuelled largely by commodity booms — has not translated into social development outcomes. Enrolment rates have regressed, and progress in key health indicators has stalled in recent years. Further, population growth has outpaced economic growth, so that real GDP per capita has actually declined.

The statistics presented here make clear the importance of good fiscal management and sound monetary policies for the development of the economy and the realisation of social development outcomes. These policies are discussed further in Chapters 3 and 4.

The important insights that can be gained from analysing these relatively basic indicators also highlight the importance of expanding and deepening the range of economic and social indicators currently available. A lack of reliable and consistent economic and social data for PNG is a commonly cited problem for researchers, policymakers and the private sector alike. Hughes (2003) blames the deterioration of data quality in PNG and the Pacific more generally on the removal of the Pacific data bank from the National Centre of Development Studies in Canberra, which during the 1970s reported economic data through its Pacific Economic Bulletin. This, the author argues, occurred as a result of putting politics ahead of performance with pressure placed on the Australian aid agency, AusAID, to devolve responsibilities for data collection to the Pacific, which lacked the statistical and economic expertise to carry out the specialised work required.

Obtaining the necessary technical skills and capacity to collect accurate, timely, and hence useful information on the economic and social conditions facing the citizens of PNG is certainly a key priority for improving data collection and hence development performance in PNG.

Indeed, the importance of data collection cannot be overemphasised. As argued by Walker (2004:5): ‘timely, useful, reliable and transparent information is the single most important and powerful tool we have to facilitate strategic planning, assess progress, inform decision-making and strengthen accountability’. In addition, keeping citizens informed of their developmental progress is also an essential component of promoting accountability to both government and the bureaucracy as people are able to better understand which programs, policies, functions, and activities are working and which are not.

It is a positive step forward, then, that the recently signed Partnership for Development between the Australian and PNG governments has identified statistics collection as one of its priority development areas (GoA and GoPNG 2008). Ultimately, however, for this to occur, domestic political leadership is a must, as PNG
must address a significant number of bureaucratic challenges if it is to be able to achieve these objectives.

References


### Table 2: Social indicators

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Definition</th>
<th>Link to development</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life expectancy at birth</td>
<td>This indicates the number of years a newborn infant would live if prevailing patterns of mortality at the time of its birth were to stay the same throughout its life. It is an average for the population. However, it is likely that life expectancies would be different for people in rural and urban areas and for those in different income brackets. It is a measure of the length of life, but does not capture quality of life.</td>
<td>Increases in life expectancy are an indication of improved health of the population and can be associated with improved health services.</td>
</tr>
<tr>
<td>DPT immunization levels</td>
<td>This is the proportion of the population aged 12–23 months that is immunized against diphtheria, pertussis (whooping cough), and tetanus.</td>
<td>An increase in the rate of immunization against disease reduces the rate of infection and the number of people dying from preventable causes. This signals an improvement in the health of the population.</td>
</tr>
<tr>
<td>Infant mortality rate</td>
<td>This is the number of infants who die before their first birthday out of every 1000 babies born in a country. This is a country average, and the rate in rural areas is likely to be higher.</td>
<td>A decrease in the infant mortality rate can reflect an improvement in the general health of the population as well as improved health care services.</td>
</tr>
<tr>
<td>Incidence of tuberculosis</td>
<td>This is the estimated number of new cases of tuberculosis per 100,000 people.</td>
<td>A reduction in the incidence of tuberculosis can reflect improved health care services and hygiene in a community. It can indicate better health of the population.</td>
</tr>
<tr>
<td>Health expenditure per capita</td>
<td>This is the sum of public and private health expenditures as a ratio of total population. It includes the provision of health (preventive and curative), family planning, nutrition, and emergency health services but does not include provision of water and sanitation.</td>
<td>An increase in health expenditure can be expected to lead to an improvement in health services and in the health of the population, although this may only be seen in the long term.</td>
</tr>
<tr>
<td>Gross primary school enrolment</td>
<td>This is the ratio of total enrolment, regardless of age, to the population of the official primary school age group.</td>
<td>An increase in the primary school enrolment rate can reflect improved access to education services. Higher enrolment rates suggest improvements in the education of the population, which can have positive economic and social development outcomes.</td>
</tr>
<tr>
<td>Proportion of the working-age population living in poverty</td>
<td>A common way to measure poverty is to measure the proportion of the population that earns less than US$1 per day.</td>
<td>When estimating global poverty, a common unit is needed across countries. The US$1 and US$2 poverty lines are commonly used for the purpose of global aggregation and comparison.</td>
</tr>
</tbody>
</table>
### Table 3: Economic indicators

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Definition</th>
<th>Link to development</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Growth rate of per capita real GDP</strong></td>
<td>Gross domestic product (GDP) is a measure of a country’s income. Real GDP figures are adjusted for inflation. Therefore, the per capita real GDP is a measure of the average income of a country’s citizens, taking into account inflation. The growth rate shows how fast or slow an economy is growing relative to population growth.</td>
<td>A downward trend in per capita real GDP indicates incomes (taking into account price effects) are decreasing over the long term.</td>
</tr>
<tr>
<td><strong>Export earnings and import values</strong></td>
<td>Export earnings are the amount of money coming in to a country as a result of exports. Import values are the amount of money being spent on imports.</td>
<td>Export earnings and import values indicate how dependent a country is on trade and how susceptible it is to international price shocks and exchange rate fluctuations.</td>
</tr>
<tr>
<td><strong>Total government revenue, expenditure, and budget outcome (surplus or deficit)</strong></td>
<td>These are the most basic indicators of a government’s fiscal performance. Government revenue includes revenue from taxes and dividends. Government expenditure includes expenditure on goods and services, public service salaries, investments, and interest payments. The budget outcome will be a surplus if revenue exceeds expenditure and a deficit if expenditure exceeds revenue. Measuring the size of the surplus or deficit as a proportion of GDP gives an indication of its magnitude.</td>
<td>When expenditure exceeds revenue (a deficit), the government must borrow to make up the shortfall. A long-term trend toward budget deficits can indicate that a government is unable to live within its means. Increases in revenue indicate that an economy is growing and the government has more money to spend on development outcomes.</td>
</tr>
<tr>
<td><strong>Proportion of government debt to GDP (foreign and domestic)</strong></td>
<td>The government may borrow from foreign or domestic sources to finance expenditure. Such borrowings attract interest, which will accumulate over time if not repaid. Showing the total amount of government debt as a proportion of GDP gives an indication of its magnitude and significance.</td>
<td>Large debts increase the debt repayment burden on the government, reducing the money available to spend on development outcomes in future years. Accumulated foreign debt exposes the government to exchange rate risks, while domestic debt may reduce the ability of the private sector to borrow domestically.</td>
</tr>
<tr>
<td><strong>Government expenditure by sector (infrastructure, health, education) per capita</strong></td>
<td>This is the amount the government spends per capita on the health, education and infrastructure sectors, which are seen as key development areas.</td>
<td>The level of government funding given to each sector reflects the government’s spending priorities. A decrease in funding relative to spending in other sectors indicates that this area has become a lower priority. Decreases in the level per capita can also reflect increases in population relative to increases in spending.</td>
</tr>
<tr>
<td><strong>Exchange rate</strong></td>
<td>This is the price at which one currency can be converted into another.</td>
<td>The exchange rate reflects the demand for a currency relative to its supply. Depreciation of a country’s currency will make exports cheaper and thus more attractive but imports more expensive.</td>
</tr>
<tr>
<td>Indicator</td>
<td>Definition</td>
<td>Link to development</td>
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</tr>
<tr>
<td>Domestic interest rates, kina facility rate</td>
<td>Interest rates on deposits are the gains from saving money. Interest rates on loans are the costs of borrowing money. In 2001 the Bank of PNG introduced the kina facility rate as a mechanism to indicate how it will seek to influence interest rates.</td>
<td>High interest rates attract savings (deposits), while low interest rates attract investment (borrowing). Low interest rates can stimulate investment and demand in an economy, but they may lead to an oversupply of money (and inflation).</td>
</tr>
<tr>
<td>Consumer Price Index (CPI)</td>
<td>The CPI is an indication of price levels. It is calculated based on the average prices of a basket of goods and services that represent typical consumption patterns of urban households. The percent change in the CPI is a measure of inflation.</td>
<td>Increases in the CPI reduce the purchasing power of consumers and act as a tax on the poor, who can rarely achieve commensurate increases in wage levels. Where consumption is dominated by imported products, as in PNG, the CPI will be heavily influenced by international prices. A key role of monetary policy is to maintain moderate growth in the CPI.</td>
</tr>
<tr>
<td>Private sector credit</td>
<td>Private sector credit is the amount of money lent by financial institutions to the private sector.</td>
<td>Private sector borrowing is affected by interest rates and can reflect business confidence in an economy. Private sector credit (and therefore investment) is a key contributor to economic growth.</td>
</tr>
</tbody>
</table>

*Table 3 (continued)*
CHAPTER 2: DEVELOPMENT PLANNING

Charles Yala and Ogis Sanida

1. Introduction

Papua New Guinea (PNG) has made significant investments in designing development plans aimed at promoting economic growth and development. The Medium Term Development Strategy (MTDS) for 2005–2010 is the ninth national development plan. The first two plans were designed and implemented by the colonial government in 1963 and 1967. The third plan was launched during the period of self-government, 1972–1975. Just after independence, the fourth development plan was formulated. The rest, five in total, were designed during the post-independence period. In addition to the national plans there have been sectoral plans, provincial and local plans, corporate plans, and annual budgets.

The impact of these development plans on national development appears negligible, as shown in Chapter 1, with poor performance evident across a range of indicators. With a view to improving these development trends, we propose a new approach to development planning that imparts ownership and accountability to the political parties, technical oversight for the design and implementation to the bureaucracy, and overall oversight and accountability to the wider community. This approach builds on the framework provided by three democratic political institutions: the five-year electoral cycle, the Organic Law on the Integrity of Political Parties and Candidates, and the limited preferential voting (LPV) system.¹

The rest of the chapter is organised as follows. Section 2 reviews the different types of development plans that PNG has tried to implement. Section 3 discusses the impact of these plans on development. Section 4 proposes a new approach to development planning and implementation, and section 5 offers conclusions and explores policy implications.

2. History of development planning in PNG

Scarcity of resources to meet an increasing array of demands necessitates reliance on a framework to guide the allocation of limited resources. Centralised planning and socialist systems have relied heavily on development planning to allocate resources. In contrast, democratic and capitalist societies rely much more on political platforms put forward by political parties seeking election.

PNG, a democratic and free-market-oriented country, has failed to develop ideology-based political parties. This has necessitated the reliance on development plans, largely coordinated and designed by technocrats. For the purposes of discussion, past development plans are grouped into two types — national and other. National development plans are initiated by the central planning agency, now the Department of National Planning and Monitoring. Other plans have included sectoral plans, provincial and local government plans, corporate plans, and annual budgets.

¹ These topics are discussed in Chapter 5 on Politics and Governance.
National development plans

The MTDS for 2005–2010 is the successor to eight national development plans. Each plan’s name reflects the planning approach that was adopted at that time:2


Table 1 summarises these plans.

Table 1: National development plans, 1963–2007

<table>
<thead>
<tr>
<th>Planning document</th>
<th>Objectives</th>
<th>Contents</th>
<th>Shortcomings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Project Planning</td>
<td>General economic development</td>
<td>Development projects for the then Territory of Papua and New Guinea</td>
<td>Lack of resources, Planning done on an ad hoc basis</td>
</tr>
<tr>
<td>1963–1967 Colonial administration</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Economic Development Planning</td>
<td>Economic growth</td>
<td>Focus on economic sectors, Collection of economic statistics</td>
<td>Insufficient dialogue with government agencies and private enterprises, Lack of reliable and high-quality data</td>
</tr>
<tr>
<td>1967–1972 Colonial administration</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eight Point Improvement Plan (EPIP)</td>
<td>Economic growth, More equal distribution of benefits</td>
<td>Eight national aims, Report on development strategies for PNG, Faber report, EPIP to be a reference point for future planning</td>
<td>Lack of resources, Overly broad plan</td>
</tr>
<tr>
<td>1973–1975 Self-government under Somare</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>National Development Strategy (NDS)</td>
<td>Economic growth, Reducing inequality</td>
<td>National Public Expenditure Plan (NPEP) as a resource framework, based on purposes, Eight NPEPs produced between 1978 and 1985</td>
<td>Lack of resources, Objectives were too broad and difficult to implement, Lack of ownership</td>
</tr>
<tr>
<td>1976–1985 Somare, Chan, and Wingti governments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>National Development Plan (NDP)</td>
<td>Economic growth, Sustainable development, Self-reliance, Equity and participation</td>
<td>MTDS (1986–1990) focused on economic growth, MTDP contained the resources framework, MTDP followed NPEP in procedure but focused on high priority rather than just purposes</td>
<td>Lack of resources, Lack of ownership</td>
</tr>
<tr>
<td>1986–1990 Wingti and Namaliu governments</td>
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</tbody>
</table>

2 Mawuli et al. (2005) analyse these plans in detail.
## Development Planning

<table>
<thead>
<tr>
<th>Planning document</th>
<th>Objectives</th>
<th>Contents</th>
<th>Shortcomings</th>
</tr>
</thead>
</table>
| Development Plan 1989–1997 Namaliu, Wingti, and Chan governments | • Integral human development  
• Economic growth  
• Job creation | Planning through the Public Investment Programs | • Lack of resources  
• Lack of ownership |
| Medium Term Development Strategy (MTDS) 1997–2002 Skate and Morauta governments | • Strengthening Structural Adjustment Program  
• Improving government role  
• Improving private sector role  
• Encouraging effective provincial governments  
• Empowering people | • Medium Term Resources Framework (1997–1999)  
• Kumul 2020  
• Road Map for Our Future  
• National Development Charter | • Lack of resources  
• Lack of ownership  
• Lack of alliances |
| Medium Term Development Strategy (MTDS) 2003–2007 Somare government | • Good governance  
• Export-driven growth  
• Rural development  
• Poverty reduction  
• Human resource development | • Expenditure priorities  
• Poverty reduction strategy  
• Sectoral policy and priority  
• Resources framework  
• Public expenditure management | Plan did not get to implementation stage due to formulation problem; was reworked to become the current MTDS. |
| Medium Term Development Strategy (MTDS) 2005–2010 (Somare government) | • Broad-based economic growth of 5 percent per annum  
• Improving basic education and preventative health programs  
• Addressing key social problems  
• Combating HIV/AIDS  
• Reducing population growth  
• Improving urbanisation  
• Improving communication infrastructure | • Ten guiding principles  
• Six key objectives  
• Four strategies (implied)  
• Six priority areas  
• MTRF as the resources framework | • Weak protocols for implementation, evaluation, and monitoring  
• Inadequate specification of performance indicators and targets  
• Weak on the macroeconomic policy framework  
• Weak linkages between the objectives, strategies, performance indicators, and implementation entities  
• Weak linkages with the plans of lower-level governments |

| Table 1 (continued) |

Official interest in development planning in PNG probably first surfaced when the Central Planning Office was established in 1963 by the colonial administration of the then Territory of Papua and New Guinea (Project Planning Team 1963). In conjunction with the formation of the Central Planning Office, a Project Planning Team was formed. This was the main group responsible for planning development projects for the territory.

In 1967, the concept of economic development planning became more prominent as a development agenda amongst the colonial administrators. Consequently, an economic adviser, A.W. McCasker, was appointed in 1967 to take charge of economic development planning in the territory. Under the economic adviser’s directives, relevant statistics from all economic sectors were gathered and reviewed. Based on the directives of the adviser, short-term plans were drafted, passed, and implemented.3

Economic development planning by the colonial administration ended in 1972, as the territory was preparing for self-government in 1973. Two main lessons, still applicable to the present, were mentioned by McCasker (1970). First, effective development planning could only be successfully carried out through constant contact and dialogue with the functional agencies of government and the private sector. Second, economic planners need a healthy suspicion of the data with which they are presented, and an equally healthy realisation of their own weaknesses, in order to plan effectively.

The first comment highlights the importance of investing in a process that institutionalises and builds stakeholder ownership. The second can be broken into two: (1) the importance of having a good database as part of the development planning system,4 and (2) the importance of a sound analytical framework to guide the analysis of the data and the assumptions and ideas behind these plans.

Eight Point Improvement Plan, 1973–1975

Between 1973, when PNG gained self-government, and 1975, when it gained political independence, planning focused on the Eight Point Improvement Plan (EPIP), also known as the Eight National Aims. The EPIP developed out of the Report on Development Strategies for Papua New Guinea, better known as the Faber report (Faber et al. 1973), which was produced in September 1972 by a team of advisers from the University of East Anglia (Bill 1982). The work was sponsored by the World Bank and the United Nations Development Program (UNDP).

Initially, the Faber report was intended to be used in developing a five-year plan that was expected to commence in 1973. The plan did not eventuate. Instead, proposals were used as a basis for designing long-term national objectives, which included the following:

- Increased local and indigenous control of the economy, through the maximum involvement of citizens in many forms of economic activity.
- Growth of income for nationals, while avoiding gross disparities in income distribution.
- Greater emphasis on rural development.
- Adaptation of the economy to make it progressively less dependent on foreign grant aid and, ultimately, foreign investment capital.

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4 The importance of data, and the lack of quality reliable data in PNG, are also discussed in Chapter 1.
This report placed emphasis on redistributive policies — equal distribution of benefits between foreigners and citizens, and between citizens themselves. In December 1972, the Cabinet adopted a number of the main ideas as objectives. In 1973, when PNG gained self-government, the Somare government adopted these objectives as the EPIP. At independence in 1975, the EPIP was adopted in the preamble of the National Constitution as the National Goals and Directive Principles.


When PNG gained political independence from Australia in 1975, the EPIP was two years old. Upon taking office, the Somare government saw it as being too general and without clear directions. Accordingly, the government embarked on reviewing the patterns of change in the economy and associated changes in population over the years leading up to independence, in an attempt to come up with a new development plan. The review culminated in the production of the National Development Strategy (NDS) in 1976 (National Planning Office 1976). The NDS attempted to refine the Eight Aims, taking into account the development alternatives and strategies that would best achieve them and giving clear and detailed instructions that would overcome their ambiguities.

Two main objectives of the NDS were as follows:

1. Increase the range of goods and services available to the people of PNG. This was to be achieved using the following alternatives:
   a) Citizens should meet some of their own needs using traditional methods.
   b) Citizens should get involved in the cash economy by selling goods and services or through employment.
   c) The government should intervene to increase the total supply of goods and services that citizens were unable to provide.

2. Reduce the existing inequalities in the distribution of goods and services by encouraging efforts to generate income-earning opportunities in all rural areas, where the bulk of the population lived. Special effort was also to be made to create opportunities where incomes were low. Alternative ways of generating income included the expansion of opportunities for wage employment and self-employment in both urban and rural areas. To increase income-earning opportunities, government expenditure was to be tailored towards the following:
   a) Agricultural production for the domestic food market.
   b) Production of cash crops for export markets.
   c) Fishing for both domestic and export markets.
   d) Provision of transport, trading, and other services.
   e) Small-scale rural manufacturing, ranging from artefacts to agricultural implements.

In order to ensure that the prescriptions of the NDS were addressed in the national budget, a National Public Expenditure Plan (NPEP) was introduced together with the NDS (National Planning Office 1976). The first NPEP was introduced in 1978. It was aimed at directing all new expenditure towards specific development objectives, to enable the government to manage, monitor, and progressively reallocate its
expenditure in relation to its policies and priorities.\(^5\) The NPEP was intended to be organised around projects and programs — budgetary allocations based on purposes rather than on general expenditure headings. The NPEP was a four-year rolling plan that was revised each year following its introduction. Between 1978 and 1985, eight NPEPs were produced.

**National Development Plan, 1986–1990**

Coinciding with the tenth anniversary of independence in 1985, the government developed a ‘fully-fledged’ National Development Plan (NDP) (Department of National Planning and Development 1985b). The NDP was the culmination of a comprehensive review of policies and programs that began in early 1984. It drew on many trends in policies and practices that had evolved over time. The NDP was viewed as the new NDS, based on a review of past policies and programs that were guided by that earlier plan. The NDP went through a reappraisal over an extended period and was the subject of much national debate and consultation.

The main objectives of the NDP were to achieve:

- Economic growth that would create more productive workers for PNG.
- Sustained development based on planning and investing for the long term.
- Increasing self-reliance for PNG.
- Equality and participation by all Papua New Guineans in the country’s development.

The NDP had two main parts: the Medium Term Development Strategy (MTDS) and the Medium Term Development Program (MTDP).

According to Wingti (1985), the production and development of the MTDS for 1986–1990 marked a change in the national planning system. Its overriding objective was to create productive work opportunities — that is, to encourage growth and income creation in the economy. It was emphasised that the new planning system should bring the benefits of growth, which would be equally shared by the people of PNG, through the process of employment creation.

The MTDP, which replaced the NPEP, was the mechanism through which the MTDS would be funded (Department of National Planning and Development 1985a). The procedures of the MTDP basically followed the NPEP system. However, certain procedural requirements were introduced, which were in line with the changes made to the planning system in order to achieve an evaluation of agencies’ ongoing, recurrent, and proposed initiatives and activities. The general thrust of the MTDP was the redirection of government expenditure into areas of high priority, rather than just purposes, as was the case under the NPEP. The MTDP gave specific details of projects and programs that the government had decided to fund (based on priority), over the plan period, in order to achieve the sectoral development strategies and targets of the MTDS.

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\(^5\) The NPEPs had limited success in prioritising and constraining expenditure due to a reduction in foreign aid and the growing cost of the bureaucracy. Fiscal policy during this period is discussed in detail in Chapter 3.

The development plan for the period 1989–1997 was formulated as part of the Public Investment Program (PIP). Planning (through the PIP) for the period occurred in two phases: 1989–1993 (Pora 1989) and 1993–1997 (Pora 1993).

The first PIP was introduced in 1988. As a mechanism for planning and management of the investment program, the PIP was described as having a number of features that made it considerably more effective than its predecessors, the NPEP and MTDP. These features included the following:

- Project selection, which was based closely on national and sectoral objectives.
- A five-year planning horizon, which was based on a medium-term financing plan that was predetermined by a schedule of project activities.
- Programs that grouped together projects representing genuine investment initiatives.
- A style of presentation aimed at the donor audience.

The PIP represented the primary means by which the government was to implement its sectoral strategies to achieve the central objectives of integral human development, economic growth, and job creation. The overall objective of the PIP was to improve the process of converting problems and needs, at the individual and community levels, into government programs and projects.

Medium Term Development Strategy, 1997–2002

The MTDS for 1997–2002 was developed in the context of the five National Goals and Directive Principles (Avei 1996). Its main elements were as follows:

- Adhering to or strengthening policies under the structural adjustment program.
- Redefining the functions and roles of government.
- Redefining the role of the private sector.
- Encouraging effective government in the provinces.
- Focusing resources on the people.

In order to address the inefficiencies in government spending and the need to reorient to the demands of the new provincial government system, the MTDS allowed for the development of a Medium Term Resources Framework (MTRF) for 1997–1999 for priority activities. The MTRF showed the level of resources that would be expended on priority programs in order to achieve their objectives. The MTRF related the costs of the priority programs and projects to the resources available from revenue and new borrowing. The priority programs and projects included the following:

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6 The change in the Australian Aid arrangement from budget support to project aid, starting in 1995, was a major contributing factor. See Chapter 3 for a discussion of this.

7 See Chapters 3 and 4 for a detailed analysis of the structural adjustment program, which sought to adhere to the terms of a bailout loan from the International Monetary Fund and the World Bank.

8 The Organic Law on the Provincial and Local Level Government was adopted in 1995. See Chapter 5 for details.
Health sector: preventative and rural health delivery; raising the standard and numbers of healthcare workers; improving administrative efficiency; and restoring and upgrading buildings and equipment.

Education sector: setting and implementing appropriate curricula; raising teacher numbers and standards; upgrading buildings and equipment; and reducing administrative costs.

Transport infrastructure: immediately restoring existing infrastructure and maintaining it thereafter; planning and constructing new infrastructure, where appropriate; rationalising current departmental structures; and clarifying the responsibilities of the various levels of government.

Private sector activity promotion: increasing access to appropriate credit facilities; improving access to extension, training, and development services; increasing research activities that increase productivity; and monitoring and surveillance of commercial activities


The MTDS for 2003–2007 was drafted but not implemented. It was described as the government’s overarching plan for economic and social development, to provide the guiding framework to ensure that the government’s policy, especially expenditure policy, focused on its goals for economic growth and development, and to adopt a theme of recovery and development by means of good governance; export-driven economic growth; and rural development, poverty reduction, and human resource development.

The following documents were produced to accompany this MTDS:

- A Medium Term Development Strategy for Expenditure Priorities, which provided a supporting policy framework for the MTDS.
- A Poverty Reduction Strategy, as part of the long-term vision for PNG, in reference to the Kumul 2020.
- A Sectoral Policy and Priority Resources Framework, which detailed the main government objectives in the key sectors of health, education, transport infrastructure, agriculture, and law and order, and provided estimates of projected expenditure (both recurrent and development) required over the medium term for the government to meet these objectives.
- A Public Expenditure Management framework, intended to protect the integrity of the budgetary process and improve fiscal governance, as required under the MTDS.

Medium Term Development Strategy, 2005–2010

The MTDS for 2005–2010 (the current plan) has been described as ‘PNG’s overarching plan’ for the advancement of economic and social development and as the ‘guiding framework’ for other plans that address the development process. In framing the MTDS, the aim was to drive and reflect the government’s program for recovery and development, which is premised on three key agendas: good governance; export-driven economic growth; and poverty reduction. (Department of National Planning and Monitoring 2004: i)

The MTDS has six key objectives:
1. Achieving a broad-based economic growth of 5 percent per annum.
2. Improving basic education and preventative health programs in the social sector, and addressing key social problems.
3. Combating HIV/AIDS.
4. Reducing population growth.
5. Improving urbanisation.
6. Improving communication infrastructure.

It implicitly recognises the existence of the following plans, to which it should relate, or vice versa:

- Kumul 2020, which is the government’s visionary plan, and which must influence the formulation particularly of the MTDS.
- The previous plans, whose lessons should also influence its formulation, particularly the MTDS for 1997–2002, which was singled out for this purpose because its implementation largely failed.
- The government’s annual budgets, which should be influenced by it.
- All other plans of public entities such as line departments, statutory agencies, and provinces, districts, and local governments.
- Future plans, which may draw on its lessons.

The current MTDS is mainly concerned with strategies that will guide other development plans. Its success will be measured by its effectiveness in guiding the other plans. The current MTDS does not have goals of its own. Instead, it adopted the targets of the Millennium Development Goals.

*Long-term visions*

Three other documents emphasizing longer-term visions were produced between 1998 and 2001. These were the Kumul 2020, the Road Map for Our Future, and the Development Charter Program, 2001.

**Kumul 2020**

In 1998, the government set up the Planning the New Century Committee — also known as the Baloiloi Committee — to create a vision for PNG’s development over the next 22 years. The committee’s major assignment was to revisit PNG’s roots, as found in the Preamble of the National Constitution, and to formulate a vision, a destination for the long-term, and a path towards that destination. This was achieved through a consultative process with selected provinces, agencies, and interested people. Out of the consultation, the committee was able to formulate three vision statements for citizens, families, and the nation. Apart from the National Goals and Directive Principles, the Kumul 2020 vision statements, summarised in Table 2, constitute the second attempt to define a long-term vision for PNG.
Table 2: Vision statements in the Kumul 2020

<table>
<thead>
<tr>
<th>Citizens</th>
<th>Families</th>
<th>Nation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>By the year 2020, for PNG to be a nation of people who are:</strong></td>
<td><strong>By the year 2020, for PNG to be a nation that is built on families that:</strong></td>
<td><strong>By 2020, for PNG to be a nation that has:</strong></td>
</tr>
<tr>
<td>• Healthy</td>
<td>• Have spiritual and physical health</td>
<td>• Loyal and prosperous citizens</td>
</tr>
<tr>
<td>• Learned</td>
<td>• Are honest and accountable</td>
<td>• Unity, whilst celebrating its rich culture and ethnic diversity</td>
</tr>
<tr>
<td>• Autonomous</td>
<td>• Are peaceful and compassionate</td>
<td>• Strong democracy</td>
</tr>
<tr>
<td>• Progressive</td>
<td>• Are literate and numerate</td>
<td>• Political stability and transparent and accountable government</td>
</tr>
<tr>
<td>• Industrious</td>
<td>• Are built on mutual love, trust, respect, and fairness</td>
<td>• A fair and just legal system</td>
</tr>
<tr>
<td>• Harmonious</td>
<td>• Are self-reliant and industrious</td>
<td>• Secure and guaranteed sovereignty</td>
</tr>
<tr>
<td>• Caring</td>
<td>• Are tolerant and respect the rights and differences of others</td>
<td>• Strength in the moral fabric of its society where the family unit is the fundamental basis of society</td>
</tr>
<tr>
<td>• Resilient, with civic pride and noble virtues</td>
<td>• Have responsible parents</td>
<td>• Economic self sustainability</td>
</tr>
<tr>
<td>• Of moral and intellectual character</td>
<td></td>
<td>• A rural sector that is productive and resilient, with a strong smallholder sector</td>
</tr>
</tbody>
</table>

**Source:** Department of National Planning and Implementation 1998.

The Road Map for Our Future

The government adopted the Road Map for Our Future in order to create an environment that would enable all Papua New Guineans to mobilise their own resources — land, labour, and skills — as the principal means of bringing about sustainable improvement in living standards. The program was to be guided by three principles (Department of National Planning and Development 2001a):

1. The government to focus on clearly defined core functions and priority activities.
2. The government, at all levels, to form partnerships in order to lay down the foundations for effective development.
3. Papua New Guineans to drive the development process by utilising their own resources and assisting the government in providing the necessary resources, as a two-way process of cooperation in development.

The Development Charter Program, 2001

The Development Charter Program was a key initiative of the 2001 PIP and the Development Budget, which mapped out the delivery mechanism of public services (Department of National Planning and Development 2001a). The core activities are as follows:

- Basic services improvement.
- District roads and bridges improvement.
• Less developed districts improvement.
• Planning systems support.
• Strategic activities support.

Other development plans

The other development plans include provincial and local government plans, sectoral plans, corporate plans, and the annual budget.

Provincial and local government plans

The successful implementation of a national development plan depends on the successful implementation of the development plans of the provincial and local levels of government. Intuitively, the success or failure of the plans of lower levels of government has a large bearing on whether or not the relatively broad goals and objectives of the national plan are realised. That is, the lower levels of government are closer to people, and the successful implementation of their development plans, guided by the national development plan (goals and objectives), would have more widespread and tangible impacts on development. The existence of an efficient link between the plans of the three tiers of government is therefore crucial.

In practice, however, the relationship between national development planning and planning at the lower levels of government has been disjointed and weak since independence. Some improvement has been made since the introduction of the Organic Law on Provincial Governments and Local Level Governments, which requires five-year planning at the two lower levels of government. Overall, however, planning remains weak at the lower levels of government, and only a few provinces and districts have managed to formulate their development plans, despite the legal obligation.9

Sectoral development plans

The success of the national and lower-level government development plans and each sectoral plan depends on the successful implementation of related sectoral plans. For example, the successful delivery of health and education services, which would be contained in the national, provincial, and local government development plans, and the respective health and education sector plans depend on efficient transportation and communication services, brought about by the successful design and implementation of the transport and telecommunication sector plans. These synergies have to be understood and incorporated into the design of national, lower level, and sectoral plans. Otherwise, these plans remain disjointed.

Corporate plans

In recent years, corporate plans, which are three-year plans, have become prominent. These plans have been launched by individual government departments and agencies at the national level, as well as by some provincial governments. Corporate plans

9 In 2007, the National Research Institute undertook research on planning by provincial and local governments, led by Agogo Mawuli and Ogis Sanida.
should be aimed at strengthening the capacity of implementing entities in order to be able to implement the development plans and sectoral plans. However, corporate plans face the same constraints as the national, lower-level, and sectoral plans.

**Annual budgets**

The annual budget is the process through which the activities within a development plan are funded and implemented. There are two parts to the annual national budget: recurrent expenditures, which are administered by the Department of Treasury, and expenditures for development programs and projects, which are administered by the Department of National Planning and Monitoring. The history of PNG’s budgets since independence is outlined in Chapter 3.

**Shortcomings of the past development plans**

Past development plans suffered from several shortcomings, including lack of ownership, impractical objectives, inadequate resources, problems with performance indicators and data, and lack of synchronization.

**Lack of ownership**

The fact that objectives with the same theme were pursued irrespective of the change in government (see Table 1) demonstrates that these plans lacked political ownership and oversight for their implementation. This is an inevitable outcome because PNG does not have ideology-based political parties. Rather, political parties were formed purely for the purpose of gaining election, and governments changed frequently through votes of no confidence. This was more evident prior to the enactment of the Organic Law on the Integrity of Political Parties and Candidates (OLIPPAC) in 2002,\(^{10}\) since which PNG has experienced political stability.

In the absence of stable political leadership, incumbent governments often formed a committee made up of technocrats and consultants to develop and submit for approval a development plan. This approach to development planning is bound to fail at implementation, because the plans are a collection of nicely packaged ideas without ownership and not accountable to anyone. PNG needs to invest in the development of political parties so that there is ownership and accountability in both the design and implementation of development plans at all levels of government and across the various sectors of the economy.

**Quantity and quality of objectives**

The number of objectives included in plans has increased over time. Effective policy design and implementation requires one instrument per objective. It is, however, difficult to make this connection in the case of the past development plans in PNG.

Two objectives that have been consistently stated in all the development plans are economic growth and equality. Although there is no direct evidence to demonstrate a

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\(^{10}\) See Chapter 5 for a more detailed discussion of the development of democracy in Papua New Guinea and the impact of the OLIPPAC.
competition between the emphasis on growth and equality, the potential for tension between the two exists because the short-term life of governments, documented in Table 1, creates incentives for redistribution at the expense of growth.

Kurer (2006) argues that the adoption of the redistributive ideas from the Faber report helped to cause the problems inhibiting growth and good governance that PNG faces up to the present. If Kurer’s argument holds true, then PNG needs to reorient the basis on which development plans are framed and implemented because (1) redistributive ideas are embedded in the preamble to the National Constitution, (2) The Kumul 2020 document reiterates these ideals, and (3) the MTDS for 2005–2010, despite being promoted as a ‘Plan for Economic and Social Advancement’, is heavily tilted in favour of social programs. The latter is further evidence that socialist ideologies continue to influence development planning to the present.\(^\text{11}\)

**Resources**

Most plans had a fiscal framework that was supposed to fund their implementation. The resources framework has been explicitly provided for in the NPEPs (1976–1985),\(^\text{12}\) MTDP (1986–1990), PIP (1989–1997), and MTRF (1997–present).

Unfortunately, lack of resources continued to emerge as a reason for poor implementation. There could be two reasons for this. First, it is indeed difficult to factor all the uncertainties and accurately cost each program and its respective projects and activities. Furthermore, there was no sound and rigorous economic modelling process guiding the design, implementation, and monitoring of these development plans. It was also an inevitable outcome given the short time that incumbent governments spent in office. The frequency with which governments changed through votes of no confidence created political instability.\(^\text{13}\) This meant that actual expenditures were largely dictated by political realities. More importantly, incumbent governments did not have any real incentive to commit resources to long-term programs, projects, and activities.

**Performance indicators and data**

None of the past development plans had quantifiable objectives, targets, or performance indicators. When they have been included, indicators have been vaguely expressed. Furthermore, PNG lacks a complete and updated database for planning and decision-making. As noted in Chapter 1, social and economic statistics are often nonexistent or incomplete. This not only compromises the formulation and implementation of good plans, but also hinders the monitoring of a plan’s progress.

Although the importance of high-quality and reliable data was highlighted by McCasker in the 1970s, little attention has been paid to generating data useful for

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\(^\text{11}\) See Kurer (2006) for a detailed analysis of this issue. It is not a surprise that equity became a permanent feature of the Papua New Guinea development planning approach as far back as the self-government period. There were strong socialist elements in the thinking of British colonial administrations from the 1950s to the 1970s, which influenced countries newly independent from Britain in Africa and the Pacific, including PNG.

\(^\text{12}\) Eight NPEPs were produced during this period.

\(^\text{13}\) See Chapter 5 for a detailed discussion of political instability in PNG.
development planning. It could be a worthwhile investment to generate and manage important key economic and social data (as discussed in Chapter 1). This would assist in objectively monitoring and measuring the effectiveness of development plans.

Need for synchronisation

The terms of current development plans are five years for the MTDSs, five years for lower-level government plans, three years for corporate plans, and ten years for many of the sectoral plans — for instance, the National Education Plan (2000–2012), National Health Plan (2001–2010), National Transport Plan (2000–2010), and National Agricultural Development Plan (2005–2015). The inconsistency in the length of these plans highlights the need to synchronise and harmonise with the view to streamlining the entire development planning system.

3. Impact of national development plans on development

It is impossible to objectively assess how the nation has fared vis-a-vis its planning goals because there are no quantifiable targets in the past development plans — only general objectives, such as those listed in Table 1, and vision statements, such as those listed in Table 2. As discussed in Chapter 1, the concept of development is complex and difficult to measure. With a view to maintaining objectivity, we opted to assess the impact of the past development plans in four key areas of development: economic growth, health, education, and the Human Development Index.

Economic growth

We focus on growth in real per capita gross domestic product (GDP), because by incorporating population, the per capita GDP growth rate gives a better reflection of the average income of the country’s citizens. Obviously, as an average measure, the per capita GDP is not a perfect measure or indicator, but it is the best alternative and widely used.15

We use growth (percentage) in per capita GDP to draw some inferences as to whether development planning in PNG has been successful in enhancing economic development. Chart 1 shows both the annual growth rates of per capita real GDP and the general trend since 1960. Table 3 supplements the graph. The following are the key observations.

Despite the spikes in the growth rate caused by enclave mining outputs, especially from the 1990s onwards, the overall growth rate of per capita GDP has declined over time, as shown by the trend line. The analysis for before and after independence, presented in Table 3, reveals that for the fifteen years before independence, there was positive per capita GDP growth overall, averaging 3.7 percent. After independence, for the first fifteen years (1976–1990), the average growth rate was -1.21 percent. For the next fifteen years (1991–2005), the average was 1.22 percent (despite the big

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14 Hardly any analysis of sectoral plans has been carried out. The first major review of a sectoral plan, currently in draft form, is the review of the National Transport Plan by the National Research Institute, led by Agogo Mawuli and Ogis Sanida.

15 GDP is the total value of all (final) goods and services produced in an economy over a given period of time, usually one year.
contribution of mining developments to GDP from the early 1990s onwards). The average for the whole thirty-year period after independence (1976–2005) has been a dismal 0.03 percent. This analysis implies that development plans may not have worked to increase wealth for the average citizen or to improve national welfare.

Chart 1: Growth rate (%) of per capita real GDP, 1960–2008

![Chart 1: Growth rate (%) of per capita real GDP, 1960–2008](image)


Table 3: Average growth rates (%) of per capita GDP before and after independence

<table>
<thead>
<tr>
<th>Growth periods</th>
<th>Average GDP per capita growth (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-independence:</td>
<td></td>
</tr>
<tr>
<td>1961–1975 (15 years)</td>
<td>3.70</td>
</tr>
<tr>
<td>Post-independence:</td>
<td></td>
</tr>
<tr>
<td>1976–1990 (first 15 years)</td>
<td>-1.21</td>
</tr>
<tr>
<td>1991–2005 (second 15 years)</td>
<td>1.22</td>
</tr>
<tr>
<td>1976–2005 (30 years)</td>
<td>0.03</td>
</tr>
</tbody>
</table>


Health

Tables 4a and 4b depict rapid change in the rates of infant mortality and life expectancy between 1960 and 1980. The infant mortality rate declined from 212 in 1960 to 102 in 1985, which is a reduction by more than half within 25 years. Life expectancy increased from 39 years in 1960 to 52 years in 1980. The rates of both infant mortality and life expectancy stagnated beginning in the mid 1980s. The infant mortality rate remained above 74 deaths per 1000 live births throughout this period. The difference between PNG’s infant mortality rate and those of the developing countries within the East Asian and Pacific region is huge — 41 deaths per 1000 live
births above the rates of its neighbours. PNG finds itself performing poorly within a well-performing region.16

Table 4a: Infant mortality rate (under 5 per 1000 live births)

<table>
<thead>
<tr>
<th>Year</th>
<th>PNG</th>
<th>East Asia and Pacific</th>
<th>Least Developed Countries</th>
<th>World</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>212</td>
<td>..</td>
<td>276</td>
<td>186</td>
</tr>
<tr>
<td>1965</td>
<td>183</td>
<td>..</td>
<td>258</td>
<td>..</td>
</tr>
<tr>
<td>1970</td>
<td>158</td>
<td>123</td>
<td>244</td>
<td>147</td>
</tr>
<tr>
<td>1975</td>
<td>137</td>
<td>98</td>
<td>227</td>
<td>136</td>
</tr>
<tr>
<td>1980</td>
<td>118</td>
<td>75</td>
<td>208</td>
<td>116</td>
</tr>
<tr>
<td>1985</td>
<td>102</td>
<td>61</td>
<td>190</td>
<td>103</td>
</tr>
<tr>
<td>1990</td>
<td>94</td>
<td>56</td>
<td>180</td>
<td>92</td>
</tr>
<tr>
<td>1995</td>
<td>87</td>
<td>50</td>
<td>168</td>
<td>88</td>
</tr>
<tr>
<td>2000</td>
<td>80</td>
<td>41</td>
<td>154</td>
<td>84</td>
</tr>
<tr>
<td>2005</td>
<td>74</td>
<td>31</td>
<td>144</td>
<td>74</td>
</tr>
</tbody>
</table>


Table 4b: Life expectancy (at birth, total years)

<table>
<thead>
<tr>
<th>Year</th>
<th>PNG</th>
<th>East Asia and Pacific</th>
<th>Least Developed Countries</th>
<th>World</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>39</td>
<td>39</td>
<td>40</td>
<td>50</td>
</tr>
<tr>
<td>1970</td>
<td>44</td>
<td>59</td>
<td>44</td>
<td>59</td>
</tr>
<tr>
<td>1980</td>
<td>52</td>
<td>65</td>
<td>48</td>
<td>63</td>
</tr>
<tr>
<td>1990</td>
<td>55</td>
<td>67</td>
<td>51</td>
<td>65</td>
</tr>
<tr>
<td>2000</td>
<td>57</td>
<td>69</td>
<td>53</td>
<td>67</td>
</tr>
<tr>
<td>2006</td>
<td>57</td>
<td>71</td>
<td>55</td>
<td>68</td>
</tr>
</tbody>
</table>


The rate of increase in life expectancy stabilised after the 1990s (55 to 57 years) and has remained stagnant (at 57 years) since the start of the new millennium. This is in contrast to the large increase between 1960 and 1990 (39 to 55 years). Comparatively, the life expectancy rate for the East Asia and Pacific region increased to 71 years during the same period. PNG’s performance is also far below that of the global trend.

Education

We use the adult literacy rate to discuss the status of education development in the country.17 According to UNESCO (2008), the adult literacy rate shows the intellectual capacity of the population to contribute to economic-socio-cultural advancement of a society or country. Table 5 shows the adult literacy rates for 1970—2005 for PNG, East Asia and the Pacific, and the world, using data gathered from various issues (1990–2007) of the United Nation’s Human Development Report.

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16 The East Asia and Pacific region covers countries such as China, Malaysia, Indonesia, Papua New Guinea, and the other Pacific Island countries.
17 The adult literacy rate is defined as the percentage of the population aged 15 years and over who are able to read and write with understanding a short simple statement in a particular language. Obviously, there are other measures of educational progress, such as the gross enrolment rate and number of graduates, which can be used as well to analyse education standards.
Table 5: Adult literacy rate (15 years and above, %)

<table>
<thead>
<tr>
<th>Year</th>
<th>PNG</th>
<th>East Asia and Pacific</th>
<th>World</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>32</td>
<td>58</td>
<td>63</td>
</tr>
<tr>
<td>1980</td>
<td>45</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>1990</td>
<td>52</td>
<td>82</td>
<td>75</td>
</tr>
<tr>
<td>2000</td>
<td>56</td>
<td>92</td>
<td>82</td>
</tr>
<tr>
<td>2005</td>
<td>57</td>
<td>93</td>
<td>82</td>
</tr>
</tbody>
</table>


Between 1970 and 1980, PNG’s adult literacy rate increased from 32 percent to 45 percent; that is about 41 percent growth. From 1980 to 1990, the adult literacy rate grew by only 16 percent. In 2000, it was 56 percent, an increase of only about 8 percent over the preceding 10 years. In 2005, the literacy rate was 57 percent. Overall, although the literacy rate has increased since 1970, its growth rate has decreased, particularly after the 1990s. In terms of absolute values, PNG has much lower rates than the rest. Thus, from the 1960s to the 1990s, the increase in the growth of the literacy rate was high, but it diminished beginning in the 1990s.

**Human Development Index**

The Human Development Index (HDI) measures the average achievement of each country in three areas of human development — life expectancy, adult literacy, and school enrolment — and the standard of living as measured by the gross national product per capita. The HDI uses a scale from 0 to 1, with 0 indicating the lowest level of human development and 1 indicating the highest level. It is divided into three categories: high (0.80 or higher), medium (0.50 to 0.79), and low (below 0.50). The trend of the HDI from 1975 to 2005 is depicted in Chart 2 for PNG and several regional groupings.

**Chart 2: Human Development Index, 1975–2005**

For PNG, there was a progressive increase in the HDI score from just over 0.4 in the mid-1970s to over 0.5 in the mid-1990s — from the low to the medium category. From the mid-1990s onwards, PNG’s HDI score stagnated, and it began to decline in 2000. This contrasts with the other regions, where HDI scores have continued to increase.

Thus, the rate of growth in all four indicators — per capita income, education, health, and HDI score — has declined over time, indicating a deterioration in citizens’ welfare.

If the development plans were properly designed and implemented, subsequent plans would have built on the achievements of the preceding plans. The cumulative and aggregate impacts would have been captured in a strong or accelerated growth in the development indicators analysed in this section. Unfortunately, the rate of growth of the four development indicators has slowed down. Because the 1990s seem to be associated with slower growth in the four indicators, we hypothesise that the two earliest plans, designed and implemented by the colonial government, could have positively affected development, with possible lagged effects continuing until the 1980s, but this effect withered away as the plans designed during the post-independence era failed to build on their success.\(^{18}\) With a view to reversing this dismal outcome, we propose a new approach to development planning in PNG.

### 4. A new approach to development planning and implementation

The proposal for a new approach to development planning devolves the ownership of development planning to the political parties, technical oversight of formulation and implementation to technocrats, and oversight and accountability to the wider electorate. Greater involvement of political parties and the electorate are important ingredients for creating political ownership and independent oversight.

This proposal builds on three key democratic institutions: the five-year election cycle, the Organic Law on the Integrity of Political Parties and Candidates (OLIPAC), and the LPV system.\(^{19}\) Collectively, these institutions would provide incentives for political parties to conceive a long-term development plan in their political party manifestos and formulate and implement a five-year medium-term development plan while in government. The wider electorate would judge political parties based on their party manifestos and elect them through a process defined by the LPV system and the OLIPAC law. Figure 1 provides a conceptual framework capturing this approach.

The main features are as follows. First, the conceptual framework defines the current system of development planning in PNG. On the right are the development plans of lower-level governments, on the left are the development plans of national government departments and agencies, and in the middle are the national development plans. The upward pointing small arrows depict determinants of plans, while the downward pointing small arrows depict resource flows. The boxes with broken lines

\(^{18}\) Chand and Yala (2005) earlier reached a similar conclusion and remarked that economic policy was exemplary during the early period given the capacity constraint at that time. This contrasts with the independence era, during which poor planning, implementation, and governance have predominated.

\(^{19}\) These topics are covered in Chapter 5. See also Reilly 2006 for an empirical analysis of the application of the two laws in Papua New Guinea.
and arrows depict interaction between the development plans (top left), the political parties (top right), and the electorate (bottom centre).

Figure 1: Decentralising the ownership of development plans

Because they desire to be in government, political parties would have the incentive to engage with the electorate at the grassroots level and formulate policies in their long-term (vision), medium-term, and annual plans that depict the demands and expectations of the wider electorate. Their visions and strategies would be marketed to the wider electorate during the election campaign. The electorate would be able to vote for whichever party they chose and hold the party in government accountable for implementation by voting again in the next election.

Political parties in their manifestos would define the National Long-Term Plan captured in their vision statement and have a Medium Term Development Strategy to guide their annual budgets during their term in Parliament. Political parties would have the incentive to interact with local communities to ensure that their vision, five-year plans, and annual budgetary appropriations and disbursement reflect the demands of the electorate. The role of the technocrats and bureaucrats is relegated to providing technical oversight, from formulation to implementation to monitoring and evaluation.

Chand (2007) documents the kinds of visions that political parties could have in their manifestos and the strategies to achieve the visions. This approach is consistent with the way mainstream democratic institutions function. The OLIPPAC law and the LPV system provide the framework for pursuing this path of developing policy-oriented political parties. The five-year election cycle in PNG provides the framework for synchronising the life of the various development plans.
5. Conclusions and policy implications

Since 1963, national development planning has left an accumulated trail of experience and knowledge, which might have helped and guided the formulation and implementation of each subsequent development plan. Unfortunately, this has not been the case in the past.

Using the lessons learnt from this review, a different approach to developing and implementing development initiatives is suggested. The proposed approach gives responsibility for development planning to the political parties, technical input and implementation to the technocrats, and oversight to the wider electorate. Greater involvement of political parties and the electorate should impart ownership and accountability. These are crucial ingredients for the successful formulation and implementation of development plans. Without political ownership and oversight by the wider electorate, development plans are neither owned by nor accountable to anyone. The foundations for achieving this are provided for by the OLIPPAC, LPV system, and five-year election cycle, three important democratic institutions in PNG.

In the short to medium term, political ownership of policies is less likely because PNG currently does not have ideology-based political parties. To secure the long-term political ownership of growth-enhancing initiatives, incentives should be provided to help the development of political parties, differentiated by distinct ideologies. Further, political parties should be encouraged to develop long-term visions in their platforms, and technocrats should help to help formulate development plans like the MTDS, within the framework of the ruling party’s vision. The duration of the MTDS should be synchronised with the election cycle so that there is both political ownership and independent oversight by the electorate. Responsibly formulated and implemented, this new approach to development planning has the potential to reverse the trend of poor economic growth and development that has been a legacy of past development plans.

References


United Nations Development Program, Human Development Indicators Report, various Issues.


CHAPTER 3: FISCAL POLICY

Aaron Batten

1. Introduction

Fiscal policy is the process through which a government relates its revenue streams to the level and allocation of its expenditure and the accumulation of debt. This process is managed predominantly through the national budget. The budget process thus determines how government expenditure is to be financed and how it is to be allocated. The financing of government expenditure can have important consequences for demand in the economy and is closely linked to monetary policy through the effect that debt financing has on interest rates, inflation, and exchange rates. The allocation of government spending is central to the effective provision of core government goods and services and the achievement of development outcomes.

The main task of fiscal policy is to balance the level of government expenditure with the costs of raising revenue or obtaining finance to fund this expenditure. The effective management of domestic revenue, public debt, and expenditure levels supports long-term economic growth by maintaining fiscal discipline and creating the macroeconomic stability required for broad-based economic growth.

Effective fiscal policy also supports widespread wealth creation through a productive expenditure mix. This includes investing in core public goods, such as infrastructure and law and order, and socially desirable goods, such as health and education. Such productive expenditure ensures the existence of a stable and secure social environment that is conducive to private investment and economic activity.

Fiscal policy in Papua New Guinea (PNG) has failed to achieve consistent macroeconomic stability or widespread wealth creation across much of the post-independence period. At the aggregate level, PNG has suffered from a persistent lack of fiscal discipline, with sustained fiscal deficits and high levels of public debt contributing to a lack of confidence in the PNG market as a stable investment environment. Excessive government spending has also led to three economic crises, each requiring donor-financed bailout packages to save the economy from bankruptcy.

Declining per capita expenditure levels in key service delivery sectors have also meant that since independence, resources for items such as health, education and infrastructure have been falling. This effect has been worsened by declining public sector capacity to efficiently implement the expenditure priorities established by government. As a result of these poor fiscal policy outcomes, PNG has continued to lag behind both the rest of the region and other developing countries in the level of progress which it has made on key development outcome indicators, as shown in Chapter 1.

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1 For the period 1975–2002, this chapter uses the IMF Government Financial Statistics database. From 2002 onwards, it draws mostly on PNG government budget documents. Unless otherwise stated, figures in this chapter are drawn from these data sources for the corresponding years. More specialised information has been obtained from other sources, as referenced.

2 The link between fiscal policy and monetary policy in PNG is discussed in greater detail in Chapter 4.
The most recent decade has seen significant improvements in fiscal outcomes. Domestic revenue has grown strongly, facilitating a number of fiscal surpluses and large reductions in public debt. Some re-prioritisation of expenditures towards key development sectors has also taken place, although per capita levels are still well below previous decades. These spending improvements are also still being hampered by a lack of capacity within the public sector to efficiently deliver services. Nevertheless, the current level of macroeconomic stability now provides current and future governments with a solid basis from which to start clawing back some of the losses of past years.

Central to these efforts will be the continued restoration of the integrity of budgetary and financing processes. It will also include improving the performance orientation of the public sector and clarifying the financial and organisational delineations between sectors of government responsible for service delivery at both provincial and central government levels. In addition, the establishment of democratic accountability and responsible fiscal management are forged simultaneously. Whilst the fiscal performance of changing governments varies, strengthening the institutions of budget oversight and the agencies of public finance integrity is undoubtedly the most important way to ensure long-term improvements in fiscal management in PNG.

This chapter reviews the successes and failures of fiscal policy in PNG since independence and draws out the main lessons for future fiscal policymakers. For those unfamiliar with the topic of fiscal policy, Appendix A provides a short, non-technical overview of the role and importance of fiscal policy, its link to development, and the attributes of good fiscal policies. Appendixes B and C contain charts representing the data discussed throughout the chapter, which indicate trends over time.

2. History of fiscal policy in PNG

Pre-1975: Origins of the PNG fiscal system

Pre-independence PNG had a small, mostly agriculture-based economy. Domestic revenue came from a limited number of domestic businesses, and the PNG money supply was largely determined by foreign capital inflows dominated by budget support grants from the Australian government and international loans (Fallon 1992:10). Fiscal policy during this period focussed on the delivery of balanced budgets aimed at enhancing the country’s limited infrastructure base (BPNG 1998).

In 1973, a major world oil price shock occurred. PNG’s reliance on imports, along with the associated inflation of other consumption goods prices, led to a significant deterioration in its terms of trade index leading up to independence. The effects of this shock were exacerbated by Australia’s decision to devalue its own dollar, which, whilst aimed at increasing its international competitiveness, spurred on domestic

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3 The terms of trade index measures the ratio of export prices to import prices. A deterioration in the terms of trade thus indicates that the price of exports has fallen relative to imports. This can often lead to an expansion of the current account deficit, as imports cost more while exports earn less revenue. An increase in import prices can also lead to an increase in domestic inflation as the price of goods increases, otherwise known as imported inflation.
Australian inflation. Without its own currency to absorb this shock, PNG inflation also rose — averaging approximately 17 percent in 1973 and 1974. These domestic pressures, coupled with the uncertainty surrounding upcoming independence, contributed to the adoption of a fixed exchange rate policy at independence. After obtaining full monetary independence in 1976, this involved pegging the value of the kina to major world currencies such as the US and Australian dollars (Garnaut and Baxter 1983).

In terms of fiscal policy, the limited domestic production base meant that changes in domestic demand from government spending tended to directly affect the balance of payments, with higher rates of consumption met by increasing imports. Because of this, PNG fiscal policy at the time of independence focussed on maintaining a level of domestic spending compatible with a sustainable external sector. This meant that it could not encourage too many imports or excessively high government spending levels because it needed to ensure that the country maintained enough foreign currency reserves and a degree of exchange rate stability. In essence, fiscal discipline was essential to PNG’s ability to create a stable, growth-inducing macroeconomic environment. As shall be discussed, however, the persistent inability to achieve this became a defining feature of PNG fiscal policy over the coming decades.

1975–1980: Fiscal independence and declining Australian budget support

Following independence, the first national government, led by Sir Michael Somare and the Pangu Party, initiated a National Development Strategy (NDS) in 1976. Until 1985, the NDS was the primary guiding force behind the conduct and operation of fiscal policy. The NDS set a number of fiscal priorities for government. In particular, it sought to improve rates of economic growth by investing in resource development and rural areas as well as to increase the country’s self-reliance by importing fewer goods and enhancing domestic revenue generation (Turner 1986:477). To ensure that a coherent fiscal approach was taken to financing these priorities, and to maintain expenditure levels within the government’s means, a National Public Expenditure Plan (NPEP) was also introduced. The NDS and NPEP are discussed in more detail in Chapter 2.

However, the government began to feel immediate pressure for increases in domestically financed public expenditures, both in light of the expectations of an independent PNG government and from a significant decrease in real levels of Australian foreign assistance (Hinchliffe 1980:820). Foreign assistance was still substantial, with grants comprising 47 percent of government revenue in 1975, 33 percent in 1976, and 42 percent in 1977.

Implementation of the government’s fiscal strategy was, however, limited. In particular, fiscal resources were increasingly absorbed by the growing cost of the domestic bureaucracy. This arose both from rapidly increasing minimum wage levels (in part to compensate for the high rates of inflation induced by the 1973 oil price shock) and from the additional costs of a continuing decentralisation of government service delivery in the early stages of independence — particularly with the

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4 See Chapter 4 for a detailed discussion of the fixed exchange rate policy and its implications.
establishment of provincial governments in 1977. The Bank of Papua New Guinea, for example, estimated that in 1978, up to 58 percent of government expenditures went to salaries and wages (BPNG 1978).

Strong growth in gross domestic product (GDP) and an expanding tax system did lead to significant domestic revenue growth in the early post-independence period, increasing by almost 20 percent between 1976 and 1978. However, as outlined in Chapter 1, despite aggregate expenditure levels remaining relatively constant and the increase in domestic revenues, the government continued to record successive fiscal deficits. Between 1975 and 1980 these deficits averaged approximately 3.5 percent of GDP. This occurred largely as a result of significant declines in Australian budget support, which fell by an average of 8 percent per annum between 1975 and 1980.

Revenue pressures also had a significant impact on the composition of government spending during this period. In particular, whilst spending on education and health remained stable, the growing public sector wage bill meant that government spending on infrastructure was increasingly squeezed out. Between 1974 and 1980, it declined at a relatively constant rate from a high of K130 per capita to K65 per capita by 1980.

1980–1985: Global recession, effects of second oil price shock, and declining terms of trade

PNG entered the 1980s facing a number of severe external shocks to its economy. The tripling of oil prices following the second global oil price shock in 1979 led to a rapid decline in the economy’s terms of trade and a subsequent deterioration of its balance of payments position, as the cost of imports rose. The emergence of a global recession in 1980 also contributed to these outcomes with a considerable drop in the prices of many of PNG’s key agricultural export commodities. The impact of this was further augmented by a period of reduced output from the Bougainville mining operations (Wolfers 1981). Capital inflows originating from the development of the Ok Tedi mine helped to contain these pressures, but the current account still remained in deficit, recording a value of 8.3 percent of GDP in 1980 and almost doubling in 1981 to 15.1 percent of GDP.

These external pressures posed significant challenges for the government in terms of fiscal management. Domestic GDP growth was negative in 1980, recording a decline of 2.3 percent, and inflation levels jumped to 12 percent. Reduced Australian budget support also led to grant revenue declining to approximately 31 percent of total revenue. Combined with almost static domestic revenue collection between 1980 and 1982, this led to a tight fiscal constraint on the government in the early 1980s.

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5 This followed Parliament’s passing of the Organic Law Establishing Provincial Governments in February 1977. The Organic Law and the introduction of provincial governments is further discussed in Chapter 5.

6 The current account is one of the primary components of the balance of payments (the other being the capital account). It is the sum of the balance of trade (exports minus imports of goods and services), net factor income (such as interest and dividends), and net transfer payments (such as foreign aid).

7 See Chapter 1 for a graphical representation of the budget outcome over the period since independence.
As a result, a number of expenditure cuts were made during this period. The share of total expenditure for capital projects and ongoing maintenance dropped from 15.2 to 12 percent between 1980 and 1982 (BPNG 2007b). Cuts also extended to the education sector, with per capita spending falling by approximately 20 percent, from K130 to K105 per capita. Health and infrastructure spending also fell, but only slightly.

These expenditure cuts, combined with a renewal of domestic revenue growth from 1982 onwards, led to a sharp improvement in the fiscal balance: between 1981 and 1984, the deficit contracted from 6 percent of GDP to 1 percent of GDP.

The government also became publicly concerned for the first time during this period about the impact of the inflated size of its bureaucracy. Public employment numbers had reached 50,000 in 1982, soaking up approximately 33 percent of total budget expenditures (King 1983:165). A retrenchment exercise was announced in the November 1982 supplementary budget that aimed to reduce the number of public sector employees by up to 3000. Again, however, the implementation of this fiscal savings plan was poor. King (1983) notes, for example, that a relatively small number of senior public servants took large severance packages, which used up the allocated retrenchment funding. The limited impact of these expenditure cuts was further undermined when the majority of these workers reappeared a few months later in other public service jobs.

In the same year the government commissioned the Garnaut and Baxter review (1983), which assessed the country’s macroeconomic policy settings, focusing in particular on the fixed exchange rate system. Motivated by the upcoming floating of the Australian dollar in 1983, it supported a continuation of the hard kina policy (Garnaut and Baxter 1983). However, the report also emphasised that to maintain a pegged exchange rate the government would have to reduce its expenditures and increase fiscal discipline in order to correct the macroeconomic imbalances that had emerged since independence. The report highlighted that efforts to reduce the price of labour (which had grown significantly with increases in the minimum wage) relative to other tradable goods in the economy would be central to this task. This in turn would help to offset the contractionary effects on employment that would occur from the required reduction in the level of government expenditure. The report recommended that wages should be decreased by approximately 25 to 30 percent.

The government chose not to implement any wage growth constraints. It did, however, seek to put its macroeconomic and fiscal policy on a more sustainable footing by committing itself to improved fiscal discipline and devaluing the kina to encourage greater international competitiveness (Hegarty and King 1983:224). This renewed commitment to fiscal stabilisation helped shrink the budget deficit to 1 percent of GDP by 1985.

Consistent with the advice of the review, fiscal restraint also contributed to an improvement in the current account, from a deficit of 15 percent of GDP in 1981 to a

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8 The fixed exchange rate system is further discussed in Chapter 4.
9 In terms of the US dollar, this led to a drop in the exchange rate, from K1.36/US$1 in 1982 to parity in 1985.
surplus of 0.7 percent of GDP in 1985. Other macroeconomic fundamentals also improved during this period, with GDP growth returning to positive territory, averaging 1.8 percent per annum between 1981 and 1983, and inflation levels declining from 12.1 percent in 1980 to 3.7 percent in 1985.

In summary, the PNG economy weathered the global recession and declining terms of trade moderately well. Maintenance of the hard kina strategy forced the PNG government to adopt a degree of fiscal restraint in order to avoid balance of payments problems. Nevertheless, sustained budget deficits meant that government debt continued to increase, from 27 percent of GDP in 1980 to 45 percent in 1985.

**1986–1990: The emergence of macroeconomic instability and the first IMF structural adjustment bailout**

Between 1986 and 1988, the PNG economy remained on a relatively stable footing. A high of 5.6 percent real economic growth was recorded in 1986, and growth averaged just over 3.7 percent per annum between 1985 and 1988. The current account also remained positive, recording surpluses of 2.6 percent and 0.7 percent of GDP in 1986 and 1987, respectively.

By the end of 1988, however, the economy and its fiscal management began to deteriorate. This was partly a result of the growing conflict and civil unrest around the Bougainville copper mine, which led to its closure in May 1989 (see Box 1). A drop in agricultural prices also occurred, which meant the economy contracted by 1.4 percent in 1989 and by just under 3 percent in 1990.

**Box 1: The Bougainville crisis and fiscal outcomes**

At the end of the 1980s, PNG was plunged into a domestic conflict in Bougainville, in the North Solomons Province. A struggle by local residents for greater compensation and less environmental damage from the Panguna Copper Mine, run by Bougainville Copper Limited, grew into an island-wide struggle for independence. In 1989 the Bougainville Revolutionary Army closed the mine by launching a secessionist war (Masono 2006:35). It was not until 1997 that a degree of peace was restored following the government’s controversial hiring of the Sandline mercenary group to remove the leadership of the Bougainville Revolutionary Army and secure control of the mine (May 2006:160). Later in 1997, peace talks commenced, brokered by Australia and New Zealand, which eventually led to the establishment of the Autonomous Bougainville Government (Regan 1998).

By the time of its closure, the mine, estimated then to be about halfway through a thirty-year lifespan, was generating approximately 35 percent of total exports, 15 percent of government revenue, and 8 percent of GDP (Stein 1991:7). As a result, the abrupt cessation of activities in this mine had a large destabilising affect on the economy. The effects of this on fiscal policy were compounded by a large drop in cocoa production on the island because of the conflict as well as a large drop in the country’s terms of trade for a number of other agricultural products such as coffee, copra, and palm oil. Adding to the fiscal pressures facing the government was a considerable drop in foreign grant revenue during this time, with direct budget support dropping from just over 10 percent of GDP in 1986 to 6 percent of GDP in 1989.

With increasing military obligations placing pressures on the expenditure side of the government’s fiscal envelope, this led to a sharp deterioration in the fiscal balance between 1989 and 1990, with the budget deficit increasing from 1.15 percent of GDP in 1989 to 3.5 percent of GDP in 1990. Following a slight recovery in 1991, this situation continued to worsen throughout the early 1990s.
Lower revenues and inflation placed significant pressure on government expenditures. This was compounded by the growing shift in Australian aid from direct budget support to project aid. The amount of budget support almost halved from K200 per capita in 1986 to K110 per capita in 1989. Whilst total foreign grant levels remained relatively constant during this period, this did mean that the PNG government was increasingly left to finance non-donor-financed sectors with its own resources, adding to the difficulty of restraining expenditures. As a result, the budget deficit continued to increase, rising from 1.15 percent of GDP in 1989 to 3.5 percent of GDP in 1990.\(^\text{10}\)

The sustained bias towards deficit financing also continued to stimulate domestic demand and encourage import growth during this period, further increasing the current account deficit. As such, the loss of foreign exchange earnings from the Bougainville mining operations, combined with public sector debt reaching 47 percent of GDP in 1990, meant that the government faced a considerable shortage of foreign exchange reserves at the end of the decade. In 1990, the World Bank through the International Bank for Reconstruction and Development issued a $US50 million loan to PNG to help cover its foreign exchange requirements (World Bank 1990). This bailout included a stabilisation conditionality package aimed at improving both the competitiveness of the PNG economy and the development orientation of its fiscal expenditures (\textit{ibid.} 1990).

The program of structural adjustment included a 10 percent devaluation of the kina, a renewed commitment to improving international competitiveness by again trying to restrain wage growth, and commitments to substantially reduce recurrent expenditure items.\(^\text{11}\)

\textbf{1991–1995: Commodity boom, aggressive fiscal policy, and the beginning of the lost decade of development}

In 1990, the economic fundamentals of the economy showed signs of improvement. Following negative GDP growth in 1990, the economy expanded by 9.5 percent in 1991, 13.8 percent in 1992, and 18.2 percent in 1993. This was accompanied by a current account surplus of nearly 5 percent of GDP in 1991, which increased to a high of 24.5 percent of GDP by 1993. Combined with the structural adjustment loans, this allowed the Central Bank to rebuild its foreign exchange reserves to more substantial levels.

This economic recovery was largely a result of increased resource extraction from the opening and increasing production of a number of new mines in the 1980s, such as Ok Tedi and the Misima Mine. The revenue effect of this was enhanced by a substantial increase in resource prices during this period, creating PNG’s first major commodity

\(^{10}\) This period also saw a reversion of the current account surpluses back to deficits of 3.0 percent and 4.1 percent of GDP in 1988 and 1989 respectively. Inflation rates also began to increase in the later 1980s, from a low of 3.3 percent in 1987 to a high of 7 percent in 1990.

\(^{11}\) Other longer-term structural policies included reforming public services to improve their performance and reduce their cost, increasing public investment expenditures, broadening the tax base, and the commercialisation, privatisation, and corporatisation of a number of government enterprises. This included the creation of a new Investment Promotion Authority charged with encouraging more foreign investment and reducing the excessive levels of regulation which its predecessor, the National Investment Development Authority, had encouraged across the economy since independence.
boom. As a result, domestic revenue increased by almost 40 percent between 1991 and 1995.

These rapid revenue increases also more than compensated for the increasing shift in Australian aid from budget support to project aid. This stemmed largely from the continuation of the Bougainville crisis and the Australian government’s desire not to be seen funding conflict-related expenditures through its aid program. This policy was formalised in the Development Cooperation Treaty, signed by the two governments in 1989 and revised in 1992, which offered comparable levels of financial support but committed Australia to a complete phasing out of budget support by the end of the decade.

A poor control of expenditures and rising spending needs from the Bougainville conflict meant that expenditure growth also increased significantly during this period. As a result, the budget continued to remain in deficit, recording a 2 percent of GDP deficit in 1991. Similarly, in 1992 the final budget outcome blew out considerably to record a deficit equal to 5.2 percent of GDP, over four times the budgeted amount (King and Sugden 1996:17). Despite rapidly growing revenues and a strong economy, unrestrained expenditure meant that government debt continued to increase during this period.12

This period also saw a deterioration in the composition of government expenditures. Education spending fell from a high of K135 per capita in 1990 to K100 in 1992, whilst health and infrastructure remained stagnant. In contrast, spending for general government consumption activities, particularly defence, increased by almost 37 percent between 1990 and 1993.

Within this boom environment, the 1993 budget marked a structural shift in the approach taken by government to the conduct of its fiscal policy. Under a perception that progress on development outcomes had been too slow and that rapidly expanding revenue streams from resource extraction had given it a considerable degree of fiscal space13, the government rebutted the attempts at fiscal restraint experienced since independence. The Wingti government, which came to office in July 1992, made the following statement in its 1993 budget:

The 1993 Budget heralds in something of a new era in fiscal policy in that the revenue and balance of payments constraints have to some extent been relaxed, at least in the short term. The relaxation occurs as a result of receipt from 1993 of very rapidly improving revenues from mining and especially petroleum. Recognition of the new situation has led the government to believe that a somewhat more aggressive fiscal policy is now appropriate. (quoted in BPNG 2007b).

On the expenditure side of this fiscal policy, a new system of financial incentives was also introduced in an attempt to correct the poor progress that had been made on

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12 See Chart 4 in Chapter 1 for a graphical representation of the budget outcome over the period since independence.
13 Fiscal space, which is discussed further in Appendix A, is the room in the government’s budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy (Heller 2005).
human development outcomes since independence (as outlined in Chapter 1). This included financial assistance for the expansion of various agricultural industries as well as the enhanced supply of subsidies for basic and primary education, with total education spending increasing to K130 per capita by 1994. These growing expenditure levels, however, had a limited impact on the funding for other key service delivery sectors, with health and infrastructure spending remaining stagnant during this period.

On the revenue side, the government’s fiscal policy sought to stimulate the supply side of the economy by lowering personal income and company tax rates. Minerals industry policy also changed to emphasise more of a state planning approach to development with the acquisition of equity in all major resource projects. In turn this required much of the additional resource revenues to be diverted to cover the loans required to finance these purchases (BPNG 1998).

These new spending and revenue commitments led to a planned budget deficit of 3.3 percent of GDP in 1993. But despite revenue growth of just over 18 percent between 1992 and 1993, the government still failed to remain within this deficit target, recording a final deficit equal to 5.5 percent of GDP.

As a result of this lax fiscal discipline, PNG again came up against its external sector constraint, which created further macroeconomic instability. The country’s reliance on imports for consumption and investment goods meant that unrestrained expenditure led to a significant increase in the demand for foreign exchange. Under the fixed exchange rate regime, this led to a significant winding down of foreign exchange reserves. By the end of 1993, foreign exchange reserves were enough to cover only 1.6 months of imports (BPNG 2007b). A loss of public confidence in the Government’s fiscal and foreign exchange operations also led to significant capital flight, further depleting foreign exchange reserves.

Nevertheless, despite an expected lower level of revenues from the mining sector, which was weakening due to lower production levels, the 1994 budget maintained high levels of spending with a planned deficit of K243 million, or 3.1 percent of GDP. There was, however, a significant revenue shortfall in 1994, arising from a drop in global oil prices and exacerbated by declining output levels in a number of mines and a drop in agricultural output (Mawuli 1997:14).14

By the middle of the year, the deficit had already exceeded its yearly target, reaching K277 million (ibid.:12). The subsequent 1994 supplementary budget recognised this, but rather than cutting back on planned expenditures, the government sought unprecedented levels of domestic borrowing to fund the planned development expenditures. By the middle of 1994, this had resulted in an almost complete running down of the government’s foreign exchange reserves, and the government faced a severe balance of payments crisis (King and Sugden 1996:18).

A new government led by Sir Julius Chan came to power in August 1994, immediately froze government expenditures to avoid the impending bankruptcy of the

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14 This, combined with some uncertainty regarding the government’s share of the Kutubu mine, led to the handing down of a supplementary budget in March 1994.
PNG’s Development Performance 1975–2008

As part of its reform package, the new government also sought to abandon the fixed exchange rate for the kina in favour of more flexible convertibility. In October 1994, the kina was officially floated, with the Central Bank beginning to conduct open call auctions with commercial banks. This meant that the government no longer needed foreign exchange to support a fixed exchange rate regime. However, it also meant that the value of the kina would be largely determined by international market forces rather than government policy.16

Following its efforts to control spending, in July 1995 the International Monetary Fund (IMF) and World Bank approved another standby loan facility arrangement and structural adjustment loan of US$111 million in support of the government’s economic reform program (IMF 1995). This called for structural reforms, including another attempt to reduce public service staff numbers, removal of a number of regulations causing price rigidities in key sectors of the economy, trade and investment liberalisation, improvement in the transparency of the logging industry, and improvement in public information on the performance of government fiscal policy (BPNG 2007b).17

1996–2000: Another fiscal crisis and IMF structural adjustment loan

The following year saw substantial economic recovery from the prior year’s instability. Real GDP growth rose from -3.4 percent in 1995 to 6.6 percent in 1996, largely on the back of a resurgence of the commodity sector and increases in agricultural output. A considerable surplus on the balance of trade and a rise in currency inflows from the development of the Lihir gold mine also led to a significant increase in foreign exchange reserves during this period. With a declining but still high inflation rate of 11.6 percent and further improvements in expenditure control, combined with increasing revenues from the economic recovery, the government managed to record its first ever budget surplus in 1996, equal to 0.5 percent of GDP.18

15 Expenditure control measures included requiring all government cheques to be cleared by the Finance Department except those related to salaries and prohibiting the use of overdraft facilities to finance recurrent expenditures. An Executive Expenditure Control Committee was appointed by the Cabinet to monitor all expenditures (Mawuli 1997:13).
16 The floating of the exchange rate is discussed in more detail in Chapter 4.
17 The government did follow through on a number of its other structural adjustment loan commitments. These included the sale of the government’s share of New Britain Palm Oil and Orogen Resources as well as the corporatisation of the Post and Telecommunication Corporation, which split the organisation into two entities, Telikom PNG and Post PNG (Chand and Stewart 1997).
18 The 1996 budget also saw moderate attempts to implement the terms of the structural adjustment loan program aimed at increasing the market orientation of the economy with the establishment of macroeconomic stability, non-distorting regulations and trade policies, and a more conservative fiscal policy.
After this short period of fiscal austerity, the new government led by Sir Bill Skate, which came to power in July 1997, faced a number of serious macroeconomic and fiscal challenges. A combination of internal and external factors shook the economy in 1997 and affected output levels, revenue collection, and ultimately service delivery. This included cyclones, an ongoing drought, which had a severe effect on agricultural production, as well as the closure of the Ok Tedi and Porgera mines due to inadequate water supplies. These natural shocks were compounded by the Asian financial crisis and by the high cost and political instability originating from the Sandline intervention in Bougainville, which seriously disrupted business and consumer confidence and macroeconomic stability (Curtin 2001). Real GDP contracted by 6.3 percent in 1997. Despite this, the fact that these events did not have their worst effects on revenues until late in the year meant that the government still managed to record a second consecutive surplus, 0.2 percent of GDP in 1997.

The fiscal consequences of this decline in GDP were felt most heavily in 1998, with government revenues declining by almost K200 million, or 10 percent of total, from the previous year. With constant expenditures, this led to a shift from a surplus of 0.2 percent of GDP in 1997 to a deficit of 1.8 percent of GDP in 1998.

The government made further commitments to establish more responsible fiscal management in the 1998 and 1999 budgets. However, weak expenditure control by a number of ministries, combined with the effects of drought and of the 1997 Asian financial crisis, brought the country into another period of significant fiscal instability (Standish 2001).

Another indication of the government’s weak commitment to achieving fiscal balance was the doubling of district support grant payments to ministers, from K500,000 to K1 million. This occurred despite growing acknowledgment of their misuse, including a number of court cases alleging inappropriate expenditure, and, perhaps most important, the lack of significant change in the quality of service delivery to the districts since the payments were implemented in 1995 (Ketan 2007).

This contributed to an increase in the budget deficit to 2.7 percent of GDP in 1999. A limited ability to attract financing from commercial sources, and little desire by donors to fund further loans, given that the conditions of the previous ones had yet to be met, meant that the government had to place pressure on the Central Bank to fund its deficits. This led to another decline in foreign exchange reserves, to 1.9 months of cover by December 1999.

During 1998 and 1999, a substantial amount of government revenue came from the drawdown of the Mineral Resource Stabilisation Fund (MRSF), which had been set up in 1974 to smooth expenditure of mineral revenues stemming from the extraction of natural resources (see Box 2). Although the Fund had been built up during the 1990s due to the commodity boom, it was closed in 2000 following the drawdown of more than K1 billion during 1998 and 1999 as a result of the public debt crisis.

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19 The Sandline intervention in Bougainville is discussed in Chapter 5.
Box 2: Mineral Resource Stabilisation Fund

With the commencement of the Panguna Copper Mine in Bougainville, the government created the Mineral Resource Stabilisation Fund with legislation coming into force in 1974. The MRSF was designed to receive all of the government’s revenue derived from mining taxes rather than having them flow directly into the budget. The Fund was then used to distribute these revenues to ensure a smoother allocation and more effective use of resources.

Despite a promising start, the MRSF was notoriously mismanaged. Even prior to the closure of Bougainville Copper in 1989, moves were made to relax the provisions of the Act in 1986 to give government greater discretion in making withdrawals from the Fund. Following this, despite a rapid build-up in the end-of-year balance of the Fund during the mid-1990s, drawdowns exceeded payments to the fund in 1998, something that had not been possible originally. In 1998, the drawdown from the MRSF to the public account (K330.1 million) comprised 18 percent of the government’s domestic revenue. In 1999, a decision was made to drawdown the entire remaining balance of the fund (a total of almost K1 billion) to cope with the public debt crisis (Banks 2001:30).

In addition to withdrawing excessive amounts from the Fund, successive governments paid little attention to establishing processes and policies to ensure revenue was spent on building infrastructure or other productivity- and capacity-enhancing projects (Parsons and Vincent 1991:33). Following the emptying of the Fund, a decision was made to repeal the MRSF legislation, which became effective in December 2000.

Widespread anecdotal evidence also indicates that the poor accountability and transparency mechanisms surrounding the government’s fiscal operations meant that corruption and misuse of government funds flourished during this period. For example, the National Provident Fund, which held public servants’ superannuation, was brought to the verge of bankruptcy by corruption and mismanagement (see Biggs 2007). A number of state-owned enterprises and statutory authorities also became highly politicised with the government regularly changing senior management positions, which eroded the quality of governance and bred a culture of compliance rather than constructive dialogue between government departments and ministers (see Garnaut 2000, Duncan and Temu 1995b).

Ultimately, continued macroeconomic instability, rising public debt levels, and a lack of accountability for spending levels in non-priority areas of government greatly limited the extent to which the government was able to reallocate expenditures towards its own 1997–2002 Medium Term Development Strategy (MTDS) targets.

The growing public debt crises also had a number of important impacts on funding levels for key service delivery sectors. In 1998–1999, then Prime Minister Skate turned to a foreign adviser, Dr. Pirouz Hamidian-Rad and his consultancy firm Ikub, to put together the 1999 budget (Standish 1999). Out of a need to reduce the deficit, the 1999 budget adopted extensive cuts to many government departments and abolished fifteen statutory bodies, including a large number of research and educational institutes. It was widely reported during this time, for example, that a

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20 The issues of corruption and politicisation in the public service are also discussed in Chapter 5.
21 The MTDS is discussed in more detail in Chapter 2.
22 The 1999 budget, for example, demanded a 20 percent cut in public service employment numbers with the retrenchment of 7000 public servants, well beyond the recommendation of 2000 made by the World Bank. In the event, however, the large cost of carrying out these retrenchments remained unfunded, and only limited reductions in public sector employment numbers took place (Standish 1999).
number of universities had lost up to 20 percent of their government grants, which led to the closure of whole teaching programs (Standish 1999).

One of the most dramatic impacts of the 1999 fiscal crisis was a large decline in the funding of the education sector, which fell from its high of K120 per capita in 1999 to a low of K35 per capita in 2004. Infrastructure funding also declined during this period, from K45 per capita in 1999 to K15 per capita in 2001, whilst health funding remained relatively constant at just under K40 per capita, albeit continuing the long-term decline that had begun in the mid 1980s. Despite these cuts to education and infrastructure spending, reductions in other government expenditures were not forthcoming. Indeed, between 1998 and 1999, expenditures in the ‘other’ category actually rose from K350 per capita to K425 per capita.

In July 1999 a new government came to power under the leadership of Sir Mekere Morauta. This government committed itself to a more conservative and restrained approach to fiscal policy, adopting a range of measures to improve the transparency of expenditures and responsible payment and acquisition of debt. The first step in this process was the handing down of a supplementary budget that tried to account for the full amount of government liabilities accrued over the previous years. The situation had become increasingly critical. Unpaid departmental spending (mainly in defence, but also in health and many other areas) had accumulated to approximately 16 percent of the recurrent budget or 10 percent of the total budget (BPNG 2007b).

The inability of the new government to repay all of its debts forced many suppliers to request up-front payments from departments before delivering critical supplies. This in turn further cut the quality of key service delivery sectors even in urban areas.

The government sought to finance some of these debts by making wide-ranging expenditure cuts, except for a number of priority items such as health, education, law and order, agriculture and livestock, transport and works, civil aviation, and revenue-raising measures (BPNG 2001:4). The reorganisation of fiscal policy under the new government also included some unpopular policies to increase personal and corporate tax rates as well as replacing the pre-existing sales tax with an across-the-board value-added tax in 1999 to broaden the government’s revenue base, which had relied increasingly on commodity and resource revenues throughout the 1990s (BPNG 1999, 2000).

These and other reforms in the areas of monetary and competition policy acted to reassure international donors of the government’s commitment to more responsible fiscal and economic management and encourage further loans.23 In mid-2000, the

23 Amongst others, in early 2000 a new Central Banking Act and a new Banks and Financial Institutions Act were introduced. Under this new legislation, the Central Bank was given autonomy from the government in the operation of its monetary policy, and the government’s ability to borrow from the bank was limited to a small (liquidity bridging) amount. The bank was thus given the core objective of maintaining price stability in the economy, which was combined with stronger safeguards against government demands to finance its budget deficits (Osman 2001:10). These monetary policy reforms are discussed further in Chapter 4.
PNG government agreed to another structural adjustment program and standby facility loan from the World Bank and the IMF (IMF 2000).24

Continued fiscal pressure was placed on the government when real GDP declined by almost 2.5 percent in 2000 following only modest growth of 1.8 percent in 1999. This occurred in spite of relatively strong growth in the agricultural, fisheries, and forestry sectors, as this was counteracted by a drop in the mineral sector due to declining crude oil and copper production.25 Ultimately, these fiscal pressures were too much, and despite a focus on the need for balanced budgets in order to curtail government debt levels, the 1999 and 2000 final budget outcomes recorded deficits of 2.7 and 1.9 percent of GDP, respectively.

In summary, the 1990s were categorised by unrestrained spending in light of a sustained commodity boom, a number of internal and external shocks, and a deterioration in the composition of government expenditures towards key development sectors. This contributed to macroeconomic instability and greatly limited the quality and coverage of government services. This meant that PNG entered the twenty-first century with declining per capita income, worsening social indicators, and a growing international perception that corruption and government malfeasance were responsible for inadequate levels of service delivery.26

2001–2005: Increased political stability and the first Medium Term Fiscal Strategy

Output continued to decline in 2001, with real GDP contracting by 0.12 percent as a result of lower activity both in the mineral sector and in agriculture and forestry. Despite this, other economic fundamentals started to improve. Inflation returned to single-digit levels at 9.2 percent, down from 15.6 percent in the previous year, and the current account recorded a surplus of 6.5 percent of GDP on the back of strong export growth and weaker domestic demand for imports because of the economic uncertainty.

This, along with improved expenditure restraint, resulted in an improvement in the budget position in 2001, although it still recorded a deficit equal to 1.3 percent of GDP. This outcome was also quite an improvement because it occurred on the back of a decline in aggregate revenue by approximately K30 million (1.1 percent of total revenue and grants) from the previous year, which meant that total expenditure had to be cut by 2.6 percent to achieve this result.

The positive intentions of the previous year were again emphasised in the 2002 budget, which focussed heavily on the need to reallocate expenditures towards the priorities of the final years of the first MTDS (1997–2002). The underlying philosophy of this strategy had been to ‘help out, not hand out’ private sector activity,

24 Whilst the IMF loan stipulated strict controls on fiscal and external account management, the terms of the World Bank’s structural adjustment loan required the government to significantly cut public expenditures on wages and salaries and redirect its expenditures towards priority human development areas (IMF 2000).
25 The government also faced high inflation rates during this time, reaching 14.9 percent in 1999 and 15.6 percent in 2000.
26 See Chapters 1 and 5 for a further discussion of economic and social indicators and governance.
which would be underwritten by a stable macroeconomic environment with investment-friendly regulatory settings.  

Despite this, government expenditures increased rapidly in the lead-up to the 2002 election, beginning another period of expenditure overshooting. Large government expenditures in the first half of the year were accompanied by the release of considerable funds held over from previous years in the trust funds of parliamentarians in order for them to fund election campaigns (ADB 2003). With a further contraction of the mining and oil sector (which accounted for more than 20 percent of GDP), real GDP growth again declined by 0.15 percent, increasing pressure on the fiscal position.

Following the August 2002 election, the new government led by Sir Michael Somare soon released a supplementary budget again with the central goal being “to restore the deficit to a manageable level and stabilise the macro economy” (GoPNG 2002). This budget revised upward the expected deficit from 2 percent to 3.4 percent of GDP.

Despite the government’s stated commitment to improved fiscal discipline, poor expenditure control meant that the 2002 budget outcome was again above this new higher targeted amount, recording a deficit equal to 3.9 percent of GDP. Combined with an inflation rate of just under 12 percent, this began to create more concern over the government’s ability to maintain macro-economic stability. 

Given the government’s poor credit rating and high levels of debt, the 2002 budget deficit had to be funded largely by domestic sources. With the falling value of the kina, this led to an increase in the ratio of external debt to GDP from 31 percent to 46 percent over the five years to 2002. Combined with foreign loans, this led to foreign debt reaching a peak level of 72 percent of GDP in 2002.

In response to this troubling fiscal situation and large government debt, this period saw the introduction of a Medium Term Fiscal Strategy (MTFS) for 2002–2007. The central aim of the MTFS was to support the implementation of the MTDS expenditure priorities within a framework that kept the central government’s budget close to balance and progressively reduced public debt relative to GDP.

On the back of a rise in global commodity and agricultural prices, both the economic and fiscal situations improved dramatically from 2003. Resource and agricultural sector growth had flowed onto a number of other industries, such as manufacturing and construction and services. This led to strong real GDP growth of 2.1 percent, 2.7 percent, and 3.4 percent in 2003, 2004, and 2005, respectively.

The commodity price boom also contributed to a 46 percent increase in government revenues between 2003 and 2005 as well as a 120 percent growth in foreign exchange

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27 This approach emphasised the growing recognition within government that subsidising inefficient and uncompetitive industries had been draining government revenues and constraining the rate of growth of the economy. The MTDS is discussed in Chapter 2.

28 This situation also forced the newly independent Bank of Papua New Guinea to tighten liquidity conditions in the economy in order to try and moderate inflationary pressures resulting from high government spending (Chand 2003). This is further discussed in Chapter 4.
reserves. This led to consecutive budget surpluses in 2004 and 2005 equal to 1.7 percent of GDP and 0.05 percent of GDP, respectively.

Whilst global commodity prices played a large part in this fiscal and economic progress, there were also some improvements in fiscal management during this period. The revenue windfalls of the 1990s, for example, had led to more than proportionate increases in spending, worsening fiscal outcomes and increasing government debt. In this case, a significant proportion of the increased revenues were used to retire government debt, allowing it to fall from 72 percent of GDP in 2002 to 47 percent in 2005. Also, for the first time in a number of years, expenditure by national departments on wages and salaries remained relatively constant. However, management over the previous decade meant that it was consuming almost half (49.3 percent) of the government’s total recurrent expenditures (ADB 2004).

The savings permitted by the repayment of debt also allowed a reallocation of public resources towards a number of development sectors. Funds were also used to pay off arrears and cover the costs of certain verified legal claims against the government (ADB 2005). The progress made in fiscal management during this period was noted in an August 2005 review of the World Bank-led Public Expenditure Review and Rationalisation (PERR) report (IMF 2006), which found that improvements had been made in debt management, budget transparency, and health and education spending.

Beneath this story of improved fiscal management, debt reduction, and external account stability is, however, perhaps a more important trend: continued stagnation in the levels and quality of service delivery across the country. The large-scale instability and subsequent expenditure cuts during the 1990s also meant that despite rapidly growing revenues, expenditure levels in social services were all still well below what they had been during the early post-independence years. Indeed, even after significant funding increases beginning in 2003, in 2005, health, education, and infrastructure spending were approximately half, one third, and half what they were in per capita terms in 1975.

This period of increasing financial resources also made it clear that another key constraint on expansion of service delivery to the provinces and rural areas was the lack of capacity of the financial processes in Port Moresby and the lack of accountability and transparency of people delivering services. These challenges were also overlaid with an increasing sense of frustration over the impact of corruption and bureaucratic malfeasance (Chand 2004). Although trust accounts have been used to smooth expenditure over time, limited bureaucratic capacity to disburse funds combined with unclear management responsibilities and governance arrangements have reduced their effectiveness (see Box 3).

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29 This was also in compliance with the Public Finances (Management) Act, which required that 90 percent of un-forecasted revenues be used to retire government debt (IMF 2006:31).

30 The 2005 PERR Report also emphasised this point. It argued that, whilst progress had been made in expenditure reallocations and the fiscal discipline of government, in order for service delivery levels to significantly improve greater effort was needed in the area of implementation. This included efforts to maintain greater control of expenditures related to public service payroll, to increase the amount of fiscal space for development-related expenditures, and to strengthen the performance orientation and competitiveness of the public sector though leadership, improving the capacity of managers and individual staff (IMF 2006:12).
Box 3: Managing resource revenues with trust accounts

Just like in the 1990s, trust accounts are shaping up to be a defining component of how PNG manages its resource revenues in this decade. Unlike the 1990s, however, current revenues are being channelled into numerous smaller trust accounts instead of the single consolidated Mineral Resource Stabilisation Fund (MRSF) described in Box 2. By the end of 2007, windfall revenues in trust, which had been designated for future investment, reached about 17 percent of GDP (World Bank 2008). In addition, if unspent funds had been treated as savings for the 2007 budget, this would have raised the estimated budget surplus to 11.4 percent of GDP (ADB 2008).

The major advantage of using these trust accounts is that they allow government to smooth expenditures over time. This limits the impact of the current revenue boom on the already stimulated levels of aggregate demand, helping to curtail inflationary pressures, which have recently reached double digits. A slower release of mineral funds also improves the ability of the bureaucracy, with its limited implementation capacity, to focus on the quality of expenditures and limit the amount of economic rent-seeking within the economy. An advantage of these trust funds over a consolidated fund such as the MRSF is that they allow additional unspent revenues to be allocated to a specific purpose, whereas expenditures financed from the MRSF tended to fund general government consumption.

Whilst these trust accounts have been playing a useful role in the management of the current revenue boom, they have also created a number of issues. The first and most obvious disadvantage of this approach is that holding such a large amount of revenue in trust for extended periods is clearly a second-best policy to simply repaying the (declining but still high) government debt. New borrowing in the future would then allow inter-temporal expenditure smoothing and forego current debt repayment obligations. The political reality of PNG fiscal management, however, suggests that this would be a difficult approach. The government is already allocating a large portion of its resources to debt repayment, in line with the MTDS, and it must be seen to be making new large-scale productive investments in the physical and human capital of the country.

Perhaps the most important issue to be raised by the dramatic increase in the use of these trust funds is the lack of clarity regarding management responsibilities and governance arrangements. There is, for example, no clear screening process for the management of expenditures. In the 1990s and early 2000s, trust accounts were the source of widespread misuse and extortion of government funds. During this period, there were an estimated 3000 separate accounts, which, combined with poor financial controls, meant that it was difficult to trace or prevent illegal activities. Following a review in 2004, many of these accounts were deemed redundant, and the number was brought down to about 300 (PIR 2008). Whilst the reduced number of accounts and improved financial controls will help prevent further misuse, confusion over their number, size, and management still exists and may reduce their effectiveness and create further bottlenecks in financial control.

Some progress has been made in terms of transparency with the publishing of trust account details in the 2007 Mid Year Economic and Fiscal Outlook. The MTFS for 2008–2012 also places a limit on spending from trusts, with total expenditures not to exceed 4 percent of GDP. This may help to limit potential raiding of these accounts, but the threshold has not been reached yet, and therefore its enforceability has not been tested. Finally, the government has not articulated a strategic policy to address the implementation bottleneck (Yala 2007). Whilst holding revenues to limit their inflationary impact is important, much of the current lack of disbursement almost certainly reflects limited public sector capacity. For this to change, a more competitive system of public sector employment conditions needs to be implemented so that the bureaucracy is more capable of managing productive investments, which expand the supply of physical and human capital in the economy.

In this period the government also committed itself to another round of public sector reform. This time it occurred under the auspices of the World Bank-led PERR program and was also included in the second MTDS (2005–2010). This included public expenditure reform to free resources for priority expenditure, including a reduction in the size of the civil service by 10 percent by 2007, improving accountability and compliance by strengthening monitoring and audit systems,
continuing the privatisation program, and strengthening the performance of provincial and local governments (IMF 2006). As in the past, the implementation of these measures was limited.

**2006 onwards: Solid fiscal and economic performance but with emerging vulnerabilities**

The commodity boom continued in 2006 with strong GDP growth and low inflation. Most importantly, however, the high prices for copper, gold, and oil, as well as for palm oil and logs, led to further large increases in government revenue. Indeed, in 2006 total revenues ended up being 60 percent above the level required to achieve the government’s original deficit target of 0.6 percent of GDP (GoPNG 2006).

Dramatic revenue growth gave the government considerable scope to improve its fiscal situation. The 2006 budget and the August supplementary budget made a significant step forward in the implementation of the second MTDS (2005–2010). In the supplementary budget, for example, K544.6 million, or 80 percent of this additional spending, was directed towards MTDS priority areas (Supplementary Budget 2006:9). Of this, 35 percent was allocated to the rehabilitation and maintenance of transport infrastructure, 14 percent to primary health care, and 11 percent to law and justice. Education and the promotion of income-earning opportunities also each received 7 percent of this additional funding.31

The 2006 budget also continued to pay down and reorganise the government debt in line with its MTDS and MTFS. This included replacing external debt with domestic debt and restructuring domestic debt from short-term to longer-term maturities (GoPNG 2005a). Total debt fell by approximately 1 percent in 2006 to just over 42 percent of GDP, whilst external debt was brought down to 21 percent of GDP. Whilst still high, this significantly lowered the government’s exposure to exchange rate risk as well as its annual recurrent debt repayment obligations.

These rapidly growing revenues also began to pose a number of risks to the government’s fiscal position. In particular, the growing dependence of revenues on high commodity prices exposed the budget balance to a significant drop in either agricultural or resources prices. This situation was further compounded by the continued strong growth in recurrent expenditures within the budget, including but not limited to wages and salaries (Warner and Omuru 2008).

Nevertheless, despite concerns over potentially high spending in the lead-up to the 2007 election, the government recorded another budget surplus, equal to 1.7 percent of GDP, in 2007. This again occurred on the back of continued strong growth in oil and mining revenues and a 6 percent GDP growth rate. Debt levels fell further to an estimated 35 percent of GDP, underwritten by the paying down of external debt in particular, which reached 18 percent of GDP. The surplus outcome did, however, mask an almost 20 percent increase in expenditures for the year as the government sought to allocate additional resources to investment priorities such as the

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31 These longer-term approaches to fiscal policy were in part facilitated by a relatively stable political environment as the government looked set to serve its full term in office, with general elections scheduled for June-July 2007 (see Chapter 5).
rehabilitation of public infrastructure, direct investment in economic projects, and the repayment of debt.

Implementation issues again limited the impact of these re-allocations on service delivery, however. For the most part, these funds continued to remain unspent, with significant proportions remaining in government trust accounts. If, for example, unspent funds were treated as savings, this would raise the estimated budget surplus to 11.4 percent of GDP (ADB 2008) (see Box 3).

Whilst resource allocations towards human development outcomes improved during this period, many key MTDS development expenditures continued to be dominated by donor organisations. As shown in Table 1, domestically funded development expenditures allocated to primary and preventative healthcare increased from K27.6 million in 2003 to K44 million in 2008. Likewise, basic education development funding increased from K2.8 million to K12.2 million, and law and order increased from K3.9 million to K31 million between 2003 and 2008.

Table 1: Domestic development financing of key human-development-related MTDS priorities (kina, millions)

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
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<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
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<tbody>
<tr>
<td>Primary and preventative health</td>
<td>27.6</td>
<td>8.2</td>
<td>23.3</td>
<td>45.8</td>
<td>48.0</td>
<td>44.0</td>
</tr>
<tr>
<td>Basic education</td>
<td>2.8</td>
<td>5.9</td>
<td>15.7</td>
<td>14.4</td>
<td>26.9</td>
<td>12.2</td>
</tr>
<tr>
<td>Law and justice</td>
<td>3.9</td>
<td>0.8</td>
<td>23.5</td>
<td>26.8</td>
<td>30.5</td>
<td>31.0</td>
</tr>
</tbody>
</table>


However, as Chart 1 shows, donor grants comprised between 94 percent (2004) and 70 percent (2007) of total development expenditures in primary and preventative health over the same six years. A similar situation is also observed in other key MTDS priority areas, as shown in Appendix B.

Chart 1: Development expenditures in primary and preventative health

Data source: PNG Budget 2008 and author’s calculations
Note: LHS refers to the left hand side axis and RHS refers to the right hand side axis.
Strong economic performance was expected to continue in 2008 with real GDP growth reaching up to 6.6 percent, spurred on by high export prices, and improved business confidence arising from more sensible economic management. September 2008 then saw the onset of the global financial crisis. Barring some jitters on the stock exchange, the PNG economy weathered the immediate effects of the crisis relatively unscathed. In large part, this was because of the healthy foreign exchange reserves and domestic bank liquidity built up over previous years, which gave the financial sector flexibility to cope. However, one of the flow-on effects of the crisis was the sharp downturn in the prices of most of PNG’s key primary commodity exports, which had been driving revenue and output growth. This decline had an immediate impact on the government’s fiscal position, with the 2009 budget predicting a 25 percent decline in domestic tax revenues.

A number of challenges now lay on the horizon for future fiscal management. Pulling back recurrent expenditure in line with a sustained downturn in revenues will be a challenge. To an extent, these can be covered in the short to medium term by drawing down on the large quantity of funds held in trust accounts from the previous unspent budget surpluses. But in the event that commodity revenues stay depressed for a number of years, a return to sustained deficit financing will be difficult to avoid.

Perhaps just as important, however, is the need for continued improvements in the composition and implementation of spending priorities. The commodity boom period showed that, in many ways, the key constraint on making large-scale improvements in service delivery across PNG has not been lack of financial resources. Rather, it has been the limited public sector capacity to efficiently and effectively utilise these spending allocations to make productive investments in social goods. Carrying through with a meaningful series of reforms that encourage performance and develop capacity within the public sector is thus just as essential as further increasing spending for these sectors.

3. Conclusions and policy implications

Aggregate levels of public spending need not be determined solely by whether the final short-term fiscal outcome is a surplus or a deficit, but rather by the point at which the marginal economic benefit of an additional unit of spending equals the marginal economic cost of an additional unit of taxation. In this light, the role of policymakers is to balance the economic costs of different means of generating revenue against the economic benefits that the expenditure of that taxation can provide.

In the case of PNG, persistent budget deficits led to continued growth in public debt during the first three decades of independence. This has added to the country’s already high vulnerability to macroeconomic instability, arising from its status as a small open economy that is highly dependent on commodity and agricultural prices. On three separate occasions, lack of fiscal discipline has led to the need for donor funded bailouts, which further added to government debt levels.

32 The development of new mining projects such as the Sinivit and Simberi gold mines and the Ramu nickel mine added to this confidence in the fiscal position. The 2008 budget thus forecasted maintenance of the budget surplus over the coming years, combined with continued reductions in government debt and a reallocation of more expenditure to MTDS priority sectors.
The impacts of this macroeconomic instability on service delivery have been enhanced by a deterioration in the funding levels for core service delivery sectors such as health, education, and infrastructure. Also, low levels of public sector capacity to effectively utilise funds has further amplified these costs.

The task facing successive PNG governments has not been easy. A plethora of cultural, institutional, and geographical issues have conspired to make fiscal discipline a major challenge in PNG. Between 1975 and the mid-1990s, governments also had to deal with significant declines in foreign grant support, which at independence had been larger than domestic revenue sources. This often meant that despite stagnant spending and rising domestic revenue, pressures on the budget deficit continued to increase.

On the other hand, the rapid paydowns of government debt, growth in domestic revenue, and minor improvements in the composition of spending since 2003 have now set the stage for what can be a significant turnaround in PNG fiscal management — even amidst the global financial crisis.

The key to this task will be underwriting continued macroeconomic stability with continued fiscal discipline that supports expenditure reallocations to key MTDS priority areas. This will help to enhance the productive potential of the economy, further adding to the country’s economic dynamism. The capacity of the public sector to implement government fiscal strategies does, however, need to be addressed before any significant turnaround in service delivery will occur. A key reform target should be improving the performance orientation of public sector workers so as to improve the quality of their outputs and to encourage efficiency savings. The other key issue for implementation is improving the relationship between levels of government. This will include improving the accountability and transparency of expenditures made in provincial and local governments.

Internal and external shocks are not unique to the PNG economy, but a heavy dependence on a limited number of resource-based industries has made revenue sources more volatile when they do occur. Productive fiscal investments in the economy should also be aimed at diversifying the production base so as to reduce the country’s fiscal exposure to economic shocks. This includes encouraging foreign investment in non-mining sectors of the economy such as the manufacturing and service sectors. Economy-wide measures such as establishing macroeconomic stability with sound fiscal aggregates, a stable investment climate, and improved infrastructure are more likely to encourage diversification of the economy than specific industry support.

Maintaining levels of productive investment should remain a priority for the government, but the focus on reducing recurrent debt repayment obligations is a positive development and should be continued. This will increase the government’s resilience to future negative shocks and is akin to investing in the welfare of future generations.
References


Appendix A — Fiscal policy and human development

This appendix provides a short, non-technical overview of the role and importance of fiscal policy, its link to development, and the attributes of good fiscal policies.

What is fiscal policy?

Fiscal policy can be defined as a government’s use of revenue, expenditure, and debt management to influence economic outcomes. The government’s decisions regarding revenue, expenditure and debt are listed in the annual national budget. The state of fiscal policy is usually summarised by looking at the difference between what the government pays out (expenditures) and what it collects (revenues). When expenditures exceed revenues, the budget balance is said to be in deficit, and when revenues exceed expenditures, it is said to be in surplus. Fiscal policy is typically assessed by looking at the change in the level of the surplus or deficit. In this sense, reducing the budget deficit (or increasing the budget surplus) is generally considered contractionary fiscal policy. In contrast, increasing the budget deficit (or decreasing the budget surplus) is generally termed expansionary fiscal policy.

Why is fiscal policy important?

Fiscal policy has a number of important effects on economic outcomes at both the macroeconomic and microeconomic level. At the macroeconomic level, traditional theory focuses on the role of fiscal policy as a countercyclical measure that can be used to either stimulate or reduce demand for goods and services in the economy (henceforth aggregate demand) — what is generally termed Keynesian theory. For example, a fiscal expansion raises aggregate demand directly by increasing government expenditures whilst keeping taxes the same. Also, if the government cuts taxes or increases transfer payments, people's disposable income rises, and they will spend more on consuming goods and services. This rise in consumption in turn raises aggregate demand. Aggregate demand is important because it influences the level of economic activity, employment, and output of the economy.

Fiscal policy is also closely linked both with monetary policy and with the management of a country’s external account. A fiscal deficit, for example, requires the government to obtain funds in order to meet its current spending requirements. This can take place in three ways, each with its own costs. The first is to simply print new currency. The effectiveness of this approach is, however, limited by its effect on domestic inflation, both by increasing the amount of domestic liquidity and by depreciating the value of the domestic currency vis-a-vis other currencies.

In most instances, the government will choose to borrow money from either domestic or international sources. Domestic borrowing requires the issuing of government bonds, which leads to a reduction in the supply of money in the economy. This forces the government to compete with private borrowers in the economy for the available funds, which have been accumulated by domestic savers. This increased demand for savings, puts upward pressure on interest rates, and often crowds out private investors, which can reduce the proportion of output that is used for private investment.
A rise in interest rates, which can occur as a result of government borrowing, also creates a greater incentive for foreign capital to flow into the country, as it seeks out higher rates of investment returns. Foreign capital inflows increase the demand for the kina, which puts upward pressure on the exchange rate — otherwise known as a kina appreciation. This makes it more expensive for foreigners to buy PNG exports and cheaper for PNG to buy imports. The natural consequence of this is to increase imports whilst decreasing exports, leading to a decline in the trade balance. This situation is commonly referred to in terms of the twin deficits theory, whereby an increase in the fiscal deficit leads to an increase in the trade deficit and a deterioration of the current account.

External borrowing, on the other hand, tends to ease the short-term constraints on the availability of capital, but it exposes the country to changes in its exchange rate, as a depreciation of the kina will increase the cost to the government of servicing its debt. This can cause a balance-of-payments or currency crisis if there are insufficient foreign exchange reserves to meet these obligations.

Fiscal policy also has a number of important microeconomic implications because it can change the incentives facing people and businesses. Increasing the income tax rate reduces people's incentive to earn income. Likewise, increasing corporate tax rates reduces companies' incentive to produce output. These effects are commonly referred to as economic distortions and occur for all types of taxation and revenue collection.

What fiscal policy is conducive to improved human development?

Determining the optimal size of a government’s fiscal envelope relates both to the needs of the country and to the cost of obtaining finance. This will be determined by the presence of services that have public good characteristics (such as the provision of law and order and public infrastructure) as well as those related to goods which have substantial positive externalities such as public health, education, and social protection. The purpose of raising government revenue then is to encourage economic growth and social welfare by expending resources on public goods that will not be provided or will be under-provided by the private sector and to make socially desirable transfers on equity grounds.

Aggregate levels of public spending need not be directed solely by whether the final short-term fiscal outcome is a surplus or a deficit but rather by the point at which the marginal economic benefit of an additional unit of spending equals the marginal economic cost of an additional unit of taxation. In this light, the role of policymakers is to balance the economic costs of different means of generating revenue against the economic benefits that the expenditure of that revenue can accrue. Even in cases in which there could be a role for government, policymakers also need to determine whether the good in question can be equally well or better supplied by the private sector with some level of public support.

Fiscal policy performance is also closely linked with human development outcomes. The recent literature on fiscal policy and human development has focused in particular on the Millennium Development Goals (MDGs). Following their adoption by Members of the United Nations in a resolution on 8 September 2000, these goals
have been widely accepted as a framework for measuring progress in human welfare across the developing world (UN 2000).33

Research shows that fiscal policy that consistently records large public deficits and leads to substantial increases in public debt has significant negative effects on long-run rates of economic growth and human development (see for example Fischer 1993; Easterly and Rebelo 1993; Easterly, Rodriguez, and Schmidt-Hebbel 1994; and Bleaney, Gemmell, and Kneller 2001). In contrast, fiscal policy that achieves low budget deficits and maintains low levels of public sector debt tends to be conducive to higher rates of growth and development. Maintaining a small budget deficit reduces a country’s exposure to economic shocks, as more resources are available to counter their negative affects. It also limits apprehension over the ability of the government to meet its debt repayment obligations, which can lower its cost of borrowing. The macroeconomic stability associated with the absence of such crises yields numerous benefits, including higher rates of investment, growth, and educational attainment, all of which are essential elements of improving human development.34

How the government allocates its expenditures also affects human development outcomes. In particular, expenditures on education, health, infrastructure, and research and development have been shown to boost long-term growth (see for example Lucas 1988). These expenditures are commonly referred to as productive expenditures. The aggregate impact of fiscal policy thus depends both on whether it is characterised by distortionary or non-distortionary taxation and productive or unproductive expenditures (see for example Lucas 1988; Romer 1990; and Bloom, Canning, and Sevilla 2001).35

Recent discussions on the role of fiscal policy in promoting human development have also centred on the importance of the creation of fiscal space — the room in the government’s budget that allows it to provide resources for a desired purpose without jeopardising the sustainability of its financial position or the stability of the economy (Heller 2005). Fiscal space emphasises that any higher short-term expenditures, and any associated future expenditures — including recurrent spending on operations and

33 The MDGs involve a wide range of objectives including halving global poverty, achieving universal primary education, reversing the spread of HIV/AIDS, reducing child and maternal mortality, and ensuring environmental sustainability.
34 There is also a growing recognition that expansionary fiscal policy may not have the intended stimulatory effect on economic activity, particularly when the level of public debt is high and unsustainable (Gupta, Clemens, and Inchauste 2004). For example, research now suggests that when the level of public debt is high and unsustainable, reducing budget deficits can actually accelerate growth over the medium term, as investor confidence is spurred, which leads to higher rates of investment and domestic economic activity. This occurs because reduced government borrowing to finance deficit spending pushes down interest rates, resulting in higher levels of private investment. Lower interest rates also raise asset values, and this wealth effect encourages private consumption. Furthermore, shrinking deficits can lead the private sector to reduce its estimates of current and future tax liabilities, providing a further boost to investment and consumption. In turn, higher investment can also ease supply constraints on growth. As a result, fiscal contractions can actually in some cases have expansionary effects (ibid.).
35 Even if fiscal policy involves non-distortionary taxation and productive expenditures, its effects are likely to be subject to what is known as diminishing marginal returns. Seminal work by authors such as Barro (1990) suggests, for example, that an inverted U-curve relationship exists between productive government expenditure and economic growth, as the rising cost of taxation necessary to finance spending overtakes the declining benefits of productive spending.
maintenance required by an infrastructure investment, or by the establishment of a school or hospital — can be financed from current and future revenues. The central idea is that a sufficient degree of fiscal space can allow governments to allocate expenditures to high-priority areas whilst maintaining an ability to respond to exogenous internal and external shocks without creating large macroeconomic imbalances.

Ultimately, fostering an environment conducive to long-term fiscal responsibility requires high levels of transparency and accountability in the management of public finances at all levels of government. Strengthening the institutions of oversight and accountability in public finance management, such as the National Parliament and external audit agencies, limits the risk of excessive executive discretion in public budgeting. This in turn limits the use and abuse of executive discretion in public budgeting, which in the case of PNG has often led to serious economic mismanagement, pervasive corruption, and state capture by lobby groups.
Appendix B — Development expenditures in MTDS priority areas

As discussed above, domestic funding of MTDS priority areas improved substantially between 2002 and 2008. However, total development expenditure in these priority areas has continued to be dominated by donor funding, as indicated in Charts 2 and 3.36

**Chart 2: Development expenditures in basic education**

![Chart 2: Development expenditures in basic education](image)

Data source: PNG Budget 2008 and authors’ calculations.
Note: LHS refers to the left hand side axis and RHS refers to the right hand side axis.

**Chart 3: Development expenditures in law and justice**

![Chart 3: Development expenditures in law and justice](image)

Data source: PNG Budget 2008 and authors’ calculations.
Note: LHS refers to the left hand side axis and RHS refers to the right hand side axis.

36 The large spikes in expenditure levels for 2005 relate mostly to the commencement and subsequent scaling back of the Australian bilateral Enhanced Cooperation Program.
Appendix C — Charts

Chart 4: GDP and GDP per capita

Data source: Government PNG budget documents (various years).

Chart 5: Budget balance (% of GDP)

Chart 6: Government expenditures by sector — infrastructure, health, education, and other (kina per capita, constant 1999)

Data source: Government PNG budget documents (various years) and authors’ calculations. See Appendix D for an explanation of the calculations.
Note: LHS refers to the left hand side axis and RHS refers to the right hand side axis.

Chart 7: Government expenditure, domestic revenue, and total aid flows (kina per capita, constant 1999)

Data source: Government PNG budget documents (various years, Appendix 5.1).
Chart 8: Consumer Price Index (%)

Data source: PNG national budget documents, various years (1975–2008).

Chart 9: International reserves (level at end of year, millions of kina)

Data source: PNG national budget documents, various years (1975–2008).
Chart 10: Budget support, project aid, and GDP per capita

Data source: Government PNG budget documents (various years).
Note: The left hand side axis applies to budget support and project aid, and the right hand side axis applies to GDP per capita.

Chart 11: Total government debt — domestic and foreign (% of GDP)

Data source: PNG national budget documents, various years (1975–2008).
Appendix D — Calculations reflected in Chart 6

This appendix shows how government expenditures by sector were calculated for Chart 6. Expenditure allocations between 1974 and 2002 were listed in accordance with the IMF Government Financial Statistics Database (IMF GFS 2008). In this case, expenditures were classified into 5 categories. These included health, education, law and order, infrastructure and other. The classifications used from the IMF database to allocate these expenditures are shown in Table 2 below.

The most recent version of the IMF database, published in 2008, only covers up to 2002. As a result, another data collection effort was undertaken placing recent government expenditures into the five classifications listed above. This involved allocating expenditures from both the recurrent and development budgets.

Recurrent expenditures were allocated according to Volume II, Part 1, Table 2 of the budget, which calculates recurrent expenditures on a functional basis. These expenditures were first allocated according to the IMF categories and then allocated into each of the five expenditure categories shown above.

Table 3 below shows the allocation rules used for the transfer from budget to IMF classifications.

Development budget expenditures are not calculated on a functional basis. Thus, this component of the budget was allocated to each of the five categories through departmental allocations from both the national department and statutory authority tables from Volume II, Part 1, Section III of the Budget Documents.

Table 4 below lists the allocation rules that were used.

<table>
<thead>
<tr>
<th>Table 2: Expenditure categories</th>
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</thead>
<tbody>
<tr>
<td>Category</td>
</tr>
<tr>
<td>Health</td>
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<tr>
<td>Education</td>
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<tr>
<td>Law and order</td>
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<td>Infrastructure</td>
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<tr>
<td>Other</td>
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</tbody>
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Table 3: Recurrent budget expenditures by IMF classifications

<table>
<thead>
<tr>
<th>IMF classification</th>
<th>Budget classification code</th>
</tr>
</thead>
<tbody>
<tr>
<td>General public services</td>
<td>11, 13, 14, 15, 19, 41, 51, 52, 53</td>
</tr>
<tr>
<td>Public debt transactions</td>
<td>51, 52, 53</td>
</tr>
<tr>
<td>General public services (less public debt transactions)</td>
<td>11, 13, 14, 15, 19, 41</td>
</tr>
<tr>
<td>Defence</td>
<td>18</td>
</tr>
<tr>
<td>Public order and safety</td>
<td>17</td>
</tr>
<tr>
<td>Economic affairs</td>
<td>12, 31, 32, 33, 34, 35, 36, 39</td>
</tr>
<tr>
<td>Agriculture, forestry, fishing, and hunting</td>
<td>31</td>
</tr>
<tr>
<td>Fuel and energy</td>
<td>33</td>
</tr>
<tr>
<td>Mining, manufacturing, and construction</td>
<td>35</td>
</tr>
<tr>
<td>Transport and communications</td>
<td>36</td>
</tr>
<tr>
<td>Other economic affairs</td>
<td>12, 32, 34, 39</td>
</tr>
<tr>
<td>Housing and community amenities</td>
<td>24, 25</td>
</tr>
<tr>
<td>Health</td>
<td>22</td>
</tr>
<tr>
<td>Recreation, culture, and religion</td>
<td>27, 28</td>
</tr>
<tr>
<td>Education</td>
<td>16, 21</td>
</tr>
<tr>
<td>Social protection</td>
<td>23</td>
</tr>
<tr>
<td>Other expenditure</td>
<td>42</td>
</tr>
</tbody>
</table>

Table 4: Allocation of development budget expenditures

<table>
<thead>
<tr>
<th>Category</th>
<th>National department (N) or statutory authority (S)</th>
</tr>
</thead>
</table>
| Health   | 240: Department of Health (N)  
241: Hospital Management Services (N)  
519: National AIDS Secretariat (S)  
520: Institute of Medical Research (S) |
| Education | 235: Department of Education (N)  
236: Commission for Higher Education (N)  
512: University of PNG (S)  
513: Unitech, Lae (S)  
514: University of Goroka (S)  
515: Vudal University (S) |
| Law and order | 226: Department of Corrective and Institutional Services (N)  
228: Department of Police (N)  
223: Judiciary Services (N) |
| Infrastructure | 258: Department of Information and Communication (N)  
259: Department of Transport (N)  
264: Department of Works and Implementation (N)  
540: Water and Sewerage Board (S)  
567: National Road Authority (S) |
| General | All remaining national department and statutory authority development budget expenditures |
CHAPTER 4: MONETARY POLICY

Gae Kauzi

1. Introduction

This chapter discusses the evolution of monetary policy management in PNG from 1975 to 2008. It explores how monetary policy relates to other macroeconomic policies, especially fiscal policy, and the influence monetary policy has on economic and financial variables that can affect economic growth and development in general.

Monetary policy concerns the supply of, and demand for, money in the economy. The Bank of Papua New Guinea (Bank of PNG or Central Bank) uses monetary policy tools to influence the quantity or the price of money to ensure that there is neither too little nor too much money in the economy at any one time. By striking a balance between money supply and demand in the economy, the Central Bank aims to create macroeconomic stability that is conducive to economic growth and development.

If the supply of money exceeds the demand, interest rates will fall. Lower interest rates encourage borrowing and increase investment, which are in turn conducive to economic growth. However, too much money in the economy tends to lead to an increase in the costs of goods and services (inflation). On the other hand, if there is too little money in the economy to meet demand, although inflation may be contained, interest rates will rise and have a negative effect on credit growth and investment, which in turn can hinder economic growth.

The Central Bank sets monetary policy to steer a course between promoting economic growth, which risks having too much money in the economy (leading to inflation) and managing inflation, which risks having too little money in the economy (stifling investment).

From independence until around 1999, the Central Bank’s focus was on economic growth. During this time, monetary policy was reasonably successful in creating an environment conducive for low but stable economic growth, and the adoption of a fixed exchange rate helped keep inflation under control. Excessive government spending in the early 1990s led to the depletion of the country’s international reserves and the subsequent floating of the kina in 1994, and although inflation became a concern for the Central Bank, monetary policy during this time was preoccupied with managing the national government’s debt.

In 2000, legislative reforms increased the independence of the Central Bank. These reforms, combined with a stable exchange rate and improved fiscal discipline, have enabled the Central Bank to concentrate on managing monetary policy and keeping inflation stable and low in recent years. However, the global financial crisis and the end of the commodity boom led to an increase in inflation in 2008.

Monetary policy does not operate on its own, and the Central Bank must contend with other factors that affect the supply of and demand for money, including government

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1 The views expressed are those of the author and do not necessarily reflect those of the Bank.
spending and the level of economic activity. The review of monetary policy since independence presented in this chapter shows that when the external sector is healthy, the exchange rate is stable, which then leads to stability in the inflation rate, which is conducive to economic growth and general stability.

With the Liquefied Natural Gas (LNG) project expected to generate substantial government revenue in coming years, the challenge for monetary policy will be dealing with the likely expansion in fiscal policy to control inflationary pressures. One way of dealing with these pressures would be to establish a special fund, along the same principle as the past Mineral Resource Stabilisation Fund, to absorb the potentially high government revenue from the LNG project so that it does not directly affect money supply and liquidity in the banking system.

The remainder of this chapter reviews the successes and failures of monetary policy in PNG since independence. The main lessons for the future are drawn out in the conclusion. For those unfamiliar with the topic, Appendix A provides a short, non-technical overview of the role and importance of monetary policy and its link to development. Appendix B contains tables and charts summarising financial and economic variables of interest that are discussed in the chapter.

2. **History of monetary policy in PNG**

1973 to 1979: Rudimentary monetary policy instruments and the hard kina policy

*Tools of monetary management*

Monetary policy in the early years of PNG’s nationhood cannot be discussed without reference to the exchange rate policy. The two are intertwined. Upon the introduction of kina and toea in April 1975, from 1966 to 1975, the territory of Papua and New Guinea was part of the Australian dollar monetary area.

2 the government adopted the hard kina policy. The then Minister for Finance, Julius Chan, explained that the essence of the policy was to take deliberate action to ensure that the external value of the kina in relation to key foreign currencies did not weaken, so as to achieve low inflation and avoid balance of payments problems (BPNG 1975).

This implies that the exchange rate policy was designed to keep inflation low, enabling monetary policy to concentrate on providing sufficient liquidity for the economy to grow. Having a fixed exchange rate would ensure stability in the foreign currency value of the kina. A fluctuating or volatile exchange rate would cause large fluctuations in the values of exports and imports and therefore large swings in the balance of payments position. An increase in imports and decrease in exports under a large kina appreciation can cause a big swing in the balance of payments into the deficit side with a decline in international reserves and low liquidity for the banking system. A decrease in imports and increase in exports under a large kina depreciation can cause a big swing in the balance of payments into the surplus side, with too large a build-up in reserves and a bigger than desired increase in liquidity. Imports necessary for industries to develop will be lacking and inflation will rise.
Monetary Policy

Revaluation of the kina against the Australian dollar initially and later against a basket of key currencies in May 1977, which was an essential part of the strategy, was repeated several times during periods of rising international inflation and a depreciating Australian dollar to keep domestic inflation low. Consequently, by December 1979, the kina had appreciated by 31 percent against the Australian dollar from its original par value in 1975.

The strong currency strategy became a cornerstone around which other macroeconomic policies evolved. The strategy was a crucial part of monetary management in that it took care of stability in prices and inflation while monetary policy per se was passive — being influenced by the balance of payments position and fiscal policy, and allowing for growth in money supply that was perceived as sufficient for economic growth.

The minimum liquid asset ratio (MLAR), a direct instrument, was the principal instrument of monetary policy management. It requires commercial banks to keep a certain percentage of their total deposits and other prescribed liabilities in the form of liquid assets, namely cash deposits, with the Bank of PNG. A ratio may be stipulated for liquidity management purposes as part of monetary policy or for prudential purposes to ensure that the commercial banks hold sufficient liquidity to meet the needs of depositors. An increase in the ratio can be made either under a tightening monetary policy stance, as it will have the effect of reducing the level of liquidity available for depositors, or under an easing stance when there is an increase in liquidity, so that the banking system is not too flushed with liquid. A reduction in the ratio can be made either for an easy monetary policy, as it will have the effect of freeing up reserves for borrowing when the liquidity level is tight, or under a tightening stance, to ensure that the commercial banks hold sufficient liquidity to meet the needs of depositors when the liquidity level is tight.

Stance of monetary policy

In most of the years from 1975 to 1979, the Bank of PNG adopted an accommodative (easy) monetary policy stance in support of the fiscal stance, providing a stable economic environment conducive to development and providing sufficient liquidity for the economy to grow at a sustainable rate. This was pursued by not permitting the broad money supply to grow in excess of the planned gross national expenditure for the year, and through the use of the interest rate, which in this period was low. The Central Bank monitored the growth in the money supply by adopting the basic guideline that its growth should accommodate real increases in gross domestic product, unavoidable price changes, and monetisation. The reason for administering interest rates reflected the Central Bank’s view that there was insufficient depth in the domestic financial system to allow rates to be determined solely by market forces. Leaving the rates to be determined by the market in this situation may lead to higher interest rates, which would be detrimental to investment growth.

The monetary policy stance and economic performance of the economy were largely influenced by external developments. The first oil-crisis-induced recession in the early 1970s was followed by high agricultural commodity prices from 1976 to 1979.

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3 Fiscal policy during this period is discussed in Chapter 3.
Consequently, PNG’s external sector improved. The strong export performance, the positive balance of payments position, and the resulting increased liquidity level enabled the bank to adopt an easy monetary policy stance. The money supply grew strongly with high net foreign assets in the banking system. In response to the high level of liquidity, which had the potential to be inflationary, the Bank of PNG raised the MLAR from 15.0 percent in December 1976 to 25.0 percent in June 1977.

The hard kina strategy can be sustained if there are enough foreign reserves. Therefore, a crucial precondition for its success was a restraint on public expenditure and wages, in order to avoid balance of payments problems at the chosen exchange rate. If excessive government spending and large increases in wages took place, a large part of the increases would be in imports, given the import dependency of the economy. A continuous increase in imports would mean an increase in the use of international reserves, and that could lead to a depletion of reserves, making it impossible to sustain the policy. Restraint on public expenditure and careful spending was something that the government planned and implemented, largely successfully, from 1975 to 1989.

**Evaluation**

The strong export performance in the early years after independence led to a build-up in the various agricultural stabilisation funds. The level of lending was low despite low interest rates in this period, perhaps reflecting the infancy of the entrepreneurial culture and the uncertainty of the business environment after independence. With the strength of the external sector and the low level of lending, monetary policy was essentially passive and complementary to fiscal policy.

Given the high kina exchange rates, the high fuel prices and overseas prices of goods and services were the source of inflation (imported inflation). These were mitigated to an extent by the hard kina. Inflation from 1973 to 1979 averaged 9.96 percent, with highs of 11 to 14 percent in the first three years, attributable to the oil crisis of the early 1970s, and lows of around 5 percent in the latter half of the 1970s. The objective of containing imported inflation and attaining low inflation in the domestic economy was achieved, given the extent of overseas inflation stemming from the oil crisis.

**1980 to 1989: Continued use of rudimentary monetary policy instruments, introduction of some market-oriented instruments and a fixed exchange rate regime**

**Tools of monetary management**

The MLAR continued to be the principal instrument of monetary policy management. It was used to ease tight liquidity under both a tightening and an easing monetary policy stance, or increased to lower the liquidity level under a tightening stance.

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4 This represents commercial banks’ earnings from investment abroad — for example, returns on term deposits held with banks overseas.

5 The impact of the second oil crisis in 1979 was felt from 1980 to 1982, as discussed in the next section.
In 1980 there were three significant developments in monetary management. The first was the formal introduction of the lender of last resort facility. This is a Central Bank facility for commercial banks to borrow funds from during periods of tight liquidity. Its introduction was necessitated by a substantial reduction in liquidity in the banking system. The tight liquidity situation was caused by a balance of payments deficit when export commodities prices were low and import demand was high, which in turn caused the money supply to decline by 4 percent, and by an increase in lending.

The second major change was the introduction of Treasury bill auctions. 6 This is a debt instrument, which is a convenient means of providing revenue to the government. It is basically a promissory note (paper) issued by the government and administered by the bank. In the weekly auctions, money is paid by institutions, especially commercial banks, and members of the general public (bidders) for certain volumes for four different maturity terms in exchange for the paper. The government raises money, while buyers earn interest at the end of the maturity terms. The act of making payment to the Central Bank for the paper takes away money from the commercial banks, thus liquidity is diffused (reduced). In this way, it is a liquidity management tool for the Bank of PNG.

Treasury bills were introduced in response to a large pool of funds deposited by commercial banks with the Bank of PNG that could be invested in some returnable assets, and the desire to increase the scope for domestic borrowing by the government. In tandem with the introduction of Treasury bill auctions, some of the deposit facilities offered by the bank were abolished to free up commercial bank funds for investment in Treasury bills. In this way, liquidity management became more active and market-oriented, instead of the more direct way of locking funds away in a deposit, and the development of the markets for securities and short-term funds was encouraged. Nonetheless, the MLAR remained the principal instrument of monetary policy management.

The third change to monetary management was the inclusion of liabilities incurred under term letters of credit in the calculation of the MLAR. Before the change, commercial banks could evade monetary policy control by incurring direct foreign liabilities through term letters of credit to finance imports. This means that in times of tight liquidity, banks could use this external trade financing to finance importers and undermine the effect of contractionary monetary policy on domestic demand. That is, import demand could still rise through the use of term letters of credit, even when monetary policy was intended to curtail import demand. The inclusion would therefore encourage the intended effect of monetary policy (BPNG 2007a:125).

There were other developments in monetary policy management during this decade. In 1983, a discount facility designed to assist commercial banks with their liquidity needs was introduced. The facility was introduced in response to the pressures placed

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6 Initially, bills were sold at monthly auctions, with the bank setting the volume on offer and bids being allocated at the lowest accepted yield bid. The legislative limit on the amount of Treasury bills on issue was increased, and the Central Bank undertook to buy and sell from its own portfolio through the nominated government security dealers (the commercial banks and one merchant bank). While participation in the auction was open to anyone, the Bank of PNG undertook to deal only with the nominated dealers outside the auction. It was believed that this would encourage secondary trading between the dealers and the public.
on banks’ liquidity by the seasonal financing demands of exporters and processors. In times of tight liquidity, the discount facility ensured that seasonal pressures could be accommodated without curtailing non-seasonal lending. Commercial banks can borrow additional reserves from the Bank of PNG up to an assigned quota\(^7\) at a discount rate set by the Central Bank. The interest rate on the facility was initially set at one percentage point below the rate on the lender of last resort facility, making it attractive for commercial banks to borrow from it.\(^8\)

Until 1984, the Bank of PNG set interest rates on its loans to the commercial banks and issued guidelines or directives on interest rates on commercial banks loans, for instance by stating a maximum rate above which commercial banks could not charge. In this way, the interest rates on loans extended by commercial banks were more or less uniform across banks. In 1984, the Central Bank deregulated interest rates paid on all loans to commercial banks and to the public, except for rates paid on savings deposits. This was to encourage competition between the commercial banks for the determination of interest rates and the efficiency of the commercial banks and the money market, with the aim of market-competition-induced lower interest costs being passed to the public. The bank moved towards monitoring the spread between borrowing and lending rates as a measure of the degree of competition within the system. The move towards a more liberalised environment was triggered by the establishment of two new banks in 1983, increasing the number of commercial banks operating in the country from four to six. In the same year, the bank also abandoned money supply targeting and opted for a non-seasonal lending ceiling as the quantitative target of monetary policy. The latter was a more specific and easier target to aim at or influence than the former.

In 1985, the Bank of PNG relinquished its last remaining direct control on commercial bank interest rates — the minimum rate on savings accounts.

*Stance of monetary policy*

Monetary policy went from being tight at the start of this decade, to being easy from 1982 to 1988, and to being tight again at the end of the decade, dictated by the balance of payments position. In 1980 and 1981 the balance of payments deteriorated and deficits were recorded as a result of high import demand, increased import prices — mainly caused by the threefold increase in oil prices that triggered the second oil crisis — and low export prices. Despite the declining export prices and thus a projected decline in government revenue, government expenditure was projected to increase.\(^9\)

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\(^7\) The quotas were based on each bank’s deposit levels. Initially, banks could borrow for periods of seven to ninety days.

\(^8\) From 1991, the rate on the facility was maintained above comparable market rates, and the maximum term was shortened to twenty-eight days. By varying the rate on the facility, the Bank of PNG could vary the cost of liquidity at the margin and influence market interest rates. The rate on the facility was a key official rate and could be used to signal changes in the direction of monetary policy. Given these changes, the instrument can be considered a hybrid between direct and indirect, beginning in 1991. The facility was abolished and replaced by the kina auction facility in May 1995.

\(^9\) See Chapter 3 for more detailed discussion.
When the balance of payments is in deficit, the level of foreign reserves declines, the amount of foreign exchange converted to kina declines, and therefore, money supply and liquidity levels decline. Together with an increase in lending, this led to a decline in money supply and thus a decline in liquidity level. The bank had to opt for a tight (restrictive) monetary policy, reflecting the declined liquidity level in the banking system, attesting that when the balance of payments position deteriorates and international reserves decline, for a given kina exchange rate, monetary policy has to be tightened. To indicate the tightening stance, the Central Bank announced an increase in interest rates of 2 percent across the board and asked commercial banks to limit new credit approvals. On the other hand, to ease the liquidity situation, the Central Bank reduced the MLAR from 25 percent to 20 percent in 1980 and to 18 percent in 1981.

In 1982, economic activity was stagnant and credit growth over the year was low. An easy monetary policy, indicated by a reduction of 2 percent on administered interest rates, was adopted to stimulate an increase in credit growth and assist in economic growth. The MLAR was used as an indicator of the monetary policy by its reduction from 18 percent to 16 percent to free up reserves for lending. The MLAR was further reduced by 2 percent to 14 percent in 1983 to address the tight liquidity situation and let the commercial banks have sufficient funds to lend. In the latter half of 1983, the balance of payments improved and consequently liquidity levels increased. Growth in monetary aggregates and liquidity continued into 1984. Under the low interest rate environment, credit demand rose, with lending increasing by a record K101 million in 1984. But a large portion of the credit growth was for the refinancing of overseas loans and a bridging loan for a government firm, as reported in the Bank of PNG’s 1984 annual report. With the increased level of liquidity, the MLAR was raised from 14 percent to 18 percent in 1984.

The easy or accommodative monetary policy stance continued from 1985 to 1987. Demand for credit by the private sector increased, leading to a decline in the levels of money supply and liquidity in the banking system. Towards the end of 1985, the tight liquidity level led to a significant rise in nominal interest rates. A good portion of the increase in credit growth was attributed to domestic refinancing of overseas debt and domestic borrowing by expatriates to remit pending their gratuity payments and dividends amidst speculation that the kina might devalue. The Central Bank subsequently issued guidelines restricting banks from lending to foreign-owned companies to refinance off-shore debt so the limited commercial bank funds available for lending could be lent for domestic activities. In November 1985, the discount facility was suspended and the rate on the lender of last resort was increased. The Bank of PNG did this to impress upon the commercial banks that their lending had been funded by short-term Central Bank sources and not by the fundamental strength of the balance of payments, so they should use a bit more of their own funds freed up through reductions in the MLAR. Thus, the MLAR was reduced from 18 percent to 15 percent and further to 12 percent by December 1985 to help offset the effect of the suspension of the discount facility and the increase in the rate on the lender of last resort.

Liquidity levels remained tight in 1986. Interest rates soared as a result. On the direction of the minister for finance, the Central Bank issued directives on maximum rates for indicative lending rates and a ceiling on the maximum loan rate. The
discount facility was reintroduced in 1986, but the rate on it was raised to a premium above the Treasury bill rate and maximum quotas set at 4 percent of each bank’s deposit base. The MLAR remained at 12 percent throughout the year.

The MLAR was used more actively in 1987 to maintain a 3 to 4 percent margin of free liquidity. It was raised to 14 percent but reduced several times in response to tight liquidity. The bank took other measures to ease the tight liquidity situation. These included increasing bank quotas under the discount facility and reducing the rate to below those prevailing on large term deposits, encouraging mining companies to bring funds onshore, and encouraging banks to make maximum use of offshore borrowing facilities for trade finance or lending. Despite these initiatives to ease the liquidity situation and ease the pace of increase in interest rates, interest rates increased rapidly (due to the continued low level of liquidity), leading to the introduction of a package of remedial measures in August. The rate on the discount facility was lowered, and banks could access the facility for indefinite terms, given that the unrestricted rollover of due commitments was permitted. The facility became a low-cost source of funds available to banks to improve their liquidity position. In contrast to the substantial build-up that occurred in the mid-1980s, balances with the commodity stabilisation funds were drawn down in 1987, following a sharp reduction in world coffee prices and lower prices for cocoa and copra. As the balance of payments position improved towards the end of the year and helped ease the liquidity situation, the MLAR was raised again to eventually reach 14 percent by the end of the year.

The high rise in interest rate in 1987 came about because of high demand on a contracted liquidity level to meet a fixed target for credit growth.¹⁰ For 1988, the lending target for non-seasonal credit set was regarded as signalling greater flexibility in monetary policy targeting. Monetary policy remained accommodative in 1988. In January, the government revised its lending guidelines, introducing quantitative targets with the objective of redirecting credit towards predominantly Papua New Guinean-owned enterprises and to the agriculture, forestry, and fisheries sector. Within three years, two-thirds of commercial bank loans were to be made to enterprises having at least 75 percent local ownership; 20 percent of loans were to be allocated to enterprises in the agriculture, forestry, and fisheries sector; and 5 percent of loans outstanding were to be for housing.

The goal of monetary policy was to support medium- to long-term sustainable non-mineral GDP growth. The target of monetary policy became the growth rate of total credit as opposed to a non-seasonal lending target. The Bougainville crisis and the resulting loss in export revenue led to the Bank of PNG tightening monetary policy in 1989. In 1989 the MLAR was reduced from 14 percent to 12 percent in response to sluggish growth in private sector credit.

**Evaluation**

Monetary policy cannot directly influence the desired outcomes of growth in economic activity and employment. It can, however, influence it indirectly through

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¹⁰ This is the desired growth in non-seasonal lending that the Central Bank wants to achieve to facilitate economic activity.
growth in credit to the private sector. If monetary policy is judged against its objective of providing sufficient liquidity for economic activity, then it was able to do that to an extent as the targets in credit growth were more or less achieved, except for one or two years in which the growth in credit was directed towards offshore interests. The success (or lack of success) of monetary policy is manifested in credit growth being a determinant of growth in money supply, thus liquidity level, during the period, which in turn can influence inflation, the magnitude and the lag of which was not clear. The rate of growth in credit to the private sector is shown in Chart 3 in Appendix B.

On the whole, fiscal spending was in line with the yearly appropriations and together with monetary policy, the economy was sound, and there was slow to moderate but steady economic growth in the 1980 to 1989 period, driven by favourable agricultural commodity prices, the commencement of production at the Ok Tedi mine in 1984, the consequent positive balance of payments position, and the discipline in government spending. Inflation remained at low single-digit figures, owing to low overseas inflation and the high foreign currency value of the kina. The Central Bank’s index of formal, non-mineral private sector employment recorded increases for most of the years, although the increases were small for some years, consistent with the growth in economic activity. Employment is mentioned here because it is linked to investment and economic activity. Growth in credit influences investment growth, which in turn affects economic activity and employment. So credit growth influenced by monetary policy can link to employment, and if the employment level increases, that is good for the economy.

Inflation was still kept in check by the hard kina policy. It averaged 6.3 percent during the period. Monetary policy was considerate, although perhaps not intentionally, in this regard too, as money supply growth was mostly moderate.

1990 to 1994: Use of market-oriented monetary policy instruments in liquidity management and collapse of the fixed exchange rate regime

Policy developments

Monetary policy in this period cannot be described without a discussion of fiscal policy and exchange rates. This is because excessive government expenditure had to be financed domestically, and monetary policy had to accommodate this and became preoccupied with government debt management. The excessive government spending (outlined in Chapter 3) had adverse implications for the fixed exchange regime. This was under a legislative framework that allowed ministerial direction over the Central Bank and monetary policy on the use of government funds held at the bank and financing of mismatches between revenue and expenditure.

This period was marked by excessive government expenditure over and above the budgeted amounts. The breakdown in adherence to budgeted government expenditures was a key development in the economy in the first half of the 1990s, which would lead to a dramatic transformation in the macroeconomic policy landscape, the conduct of monetary policy, and the livelihood of the people. There were substantial slippages in government expenditure, resulting in higher than

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11 Fiscal policy during this period is discussed in Chapter 3.
planned budget deficits in 1991 and 1992. This meant that the crucial condition of fiscal restraint — necessary for the sustenance of the hard currency policy — was violated, and it laid the foundation for a balance of payments crisis.

The high kina exchange rate under the fixed exchange regime could only be maintained by having foreign exchange reserves. Under this artificial rate, one kina bought more than one US dollar. In order for this to work, there had to be enough US dollars in the domestic financial market so that people wishing to buy goods or services from abroad could exchange their kina for US dollars. When the government increased its spending, most of the expenditure was on imported goods and services, and more and more foreign reserves were used up. The government did not see the dangerous implications of its high spending on foreign reserves as it went on to adopt and implement expansionary fiscal policies in 1993 and 1994. Instead, it stated in the 1993 budget that the rapidly increasing revenues from the mineral sector heralded a new era in fiscal policy in that the revenue and balance of payments constraints had been relaxed to some extent. This belief was a shift from expenditure control to the temptation, inspired by windfalls from the resource sector, to excess spending beyond budgeted levels.

Stance of monetary policy and tools of monetary management

In response to the fiscal onslaught, monetary policy had to be eased to accommodate the increased government expenditure. The accommodation was conveniently and timely catered for by a key change made by the Bank of PNG in 1992: moving into trade in government securities as the principal tool of liquidity management. The government issues Treasury bills, which are administered and managed by the Central Bank. When buyers buy bills of four different maturities at differing interest rates, payable to them upon maturity, they give money to the Central Bank. Liquidity is thus diffused from the banking system. The funds are then used to fund part of the government’s budgeted expenditure. Spending these funds adds liquidity to the banking system. From a monetary policy management standpoint, trade in securities allows for more refined changes in the conduct of monetary policy compared to variations in the MLAR. The diffusion (absorption) of liquidity out of or injection of liquidity into the banking system is done through the market demand and supply of Treasury bills and the available level of liquidity. In this way, the allocation of financial resources is not controlled by the Central Bank but by the market players. From a fiscal standpoint, it provides a neat avenue for increased domestic financing of the budget (BPNG 2007a).

The government resorted to more domestic borrowing in this period. Apart from issuing more Treasury bills, it resorted to using more of the temporary advance facility (TAF), to get advanced funds to finance its expenditures. Consequently, net credit to the government increased even more and was a principal determinant of money growth. For example, in 1992, net credit to the government increased by 53 percent. Combined with injections by the Central Bank for the agricultural commodity

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12 See Chapter 3 for a detailed discussion of fiscal policy in these years.

13 The TAF, provided for under the Central Banking Act, is a mechanism that gives the national government access to short-term financing to resolve mismatches between revenue and expenditure. Under the old Act, the provision on how much could be advanced in a given period and when it should be repaid was not strict. This led to an over-usage of the facility.
price support and interest rate subsidy schemes, it led to a 9.4 percent increase in money supply. This can be tough on monetary policy, but fortunately, the healthy position of the external sector, particularly the trade account, enabled the policy to support the fiscal policy. The increasing trend in credit advanced to the government in the 1990s is summarised in Chart 4 in Appendix B.

In support of this change, interest was no longer paid on exchange settlement accounts to ensure they were used solely for facilitating inter-bank transactions. The discount facility rate was set at a premium above short-term deposits to encourage banks to seek liquidity elsewhere, and the 14-day minimum borrowing period was abolished. The MLAR, the principal tool of the 1980s, was retained for prudential purposes.

The bank warned the government that the 1994 national budget, with a planned domestic financing requirement of K252 million, would not be sustainable. This was because between 1990 and 1993, 63 percent of the government’s accumulated deficits were unplanned, and the continual recourse to domestic financing had led to a substantial build-up of excess liquidity. Further injections, to the extent planned in the 1994 budget, could result in a run-down on the foreign exchange reserves and undermine monetary stability.

Despite the warning, under the instruction of the minister for finance, the Bank of PNG adopted an accommodative monetary policy for 1994. In its statement of monetary policy, the bank noted that, given the recent vast injections of liquidity and the projected injections in 1994, it could not, without recourse to indirect controls, ensure a money supply growth rate consistent with the projected increase in nominal non-mineral GDP. The predictable relationship between credit and nominal non-mineral GDP growth was weakened in the latter part of the first half of 1990s when some of the exchange control measures were liberalised, tax reductions were introduced, and increasing net credit was going to the government. Investors, especially foreign ones, can source funds from offshore for investment and projects in PNG. Thus, not only domestic credit growth but also overseas funds will have linkage to non-mineral GDP growth. The weakening of the link between credit growth and activity was underlined by an increase in real non-mineral GDP in 1993 despite a decline in lending, excluding advances for the price support schemes. The bank therefore changed to adopting money supply rather than credit as its main monetary target in 1993, to support growth in non-mineral private sector GDP.

The diverging trend between government revenue and expenditure, which had characterised the previous three years, continued over the first six months of 1994. By June, the deficit stood at K277 million with a domestic financing requirement of K323 million, well in excess of the already high budgeted amount. Although strict cash controls were placed on government expenditure, fiscal laxity compounded by a loss of public confidence in the management of the economy precipitated a rapid decline in foreign exchange reserves. By July, the Central Bank had a negative net foreign asset position. If the message was not clear months earlier that the hard kina strategy could no longer be sustained, its inevitable demise arrived with the rude awakening of bad fiscal management, a lack of good governance, and the reality that monetary policy had to be accommodative and could not be independent of government debt management. In September, the kina was devalued by 12 percent. Subsequently, the floating of the kina commenced on 10 October 1994.
Evidence of government spending over the budgeted amount was clear.\textsuperscript{14} The overall budget deficit for the whole of 1994 was K124.9 million. The deficit would have been higher in the absence of exceptional revenue items and the tight expenditure controls imposed in July, which curtailed expenditure. This followed the deficit of K272.7 million in 1993 (BPNG 1994). The financing of the deficit came mostly from domestic sources.

The deficit and net loan repayments to overseas sources left a domestic financing requirement of K243.4 million, higher than the K179.8 million in 1993. This was financed by advances of K174.9 million from the Bank of PNG compared to K112.1 million in 1993, an increase of K74.3 million in the holdings of government securities by the non-banking system, and through other domestic financing of K71.6 million, which mainly represented unpresented cheques. The holdings of government securities by the commercial banks declined by K77.4 million. The government again relied heavily on the temporary advance facility at the Central Bank over these two years (\textit{ibid.}).

\textit{Evaluation}

Monetary policy became preoccupied with financing of government debt. This means funds that could have otherwise gone for private sector investment were used by the government.

Inflation for this period averaged 5.2 percent. The economy experienced its best ever growth in output in this period. Real GDP growth averaged 11.2 percent, with a high of 18.2 percent in 1993, driven by the mineral boom. Employment growth in the non-mineral private sector averaged 1.32 percent, with a high of 7.3 percent in 1994. The increased government spending and the high GDP growth and their effect on aggregate demand through imports did not translate into high inflation because of the high kina exchange rates under the fixed exchange rate regime. The favourable inflation rates reflected low inflation in PNG’s major trading partner economies and whatever domestic demand-induced price rises there may have been from a rise in aggregate demand.

\textit{1995 to 1999: Development and use of more market-oriented monetary policy instruments}

\textit{Policy developments and tools of monetary management}

Two major events occurred in this period insofar as macroeconomic management and monetary policy management were concerned. First, the culmination of the economic and political mismanagement in 1994 forced the government to enter into negotiations with the International Monetary Fund (IMF) and the World Bank, and the second IMF standby arrangement for balance of payments support and World Bank structural adjustment program were agreed to in July 1995.

Second, the transition to a floating exchange rate regime introduced some fundamental changes to the nature of monetary management. Under a fixed exchange

\textsuperscript{14} This overspending is discussed in more detail in Chapter 3.
rate regime, foreign exchange reserves acted as a shock absorber, allowing injections of liquidity to be diffused without an adverse effect on inflation. Under a float, with the Central Bank no longer obliged to buy or sell foreign currency on demand, imbalances between demand and supply are brought into equilibrium through changes in exchange rates. Anyone wishing to exchange kina must find a counterpart wishing to exchange foreign currency so that domestic liquidity remains unchanged. This gives the Bank greater control over domestic liquidity conditions. A further feature of a floating regime is that the consequences of fiscal or monetary laxity are more immediate and widespread.

Under the fixed exchange rate regime, an expansionary fiscal policy can be sustained so long as foreign exchange reserves are available, and a conscious decision needs to be taken to redress the situation through a reversal of fiscal policy or through monetary tightening. Under a floating regime, fiscal expansion leads automatically to a downward pressure on the exchange rate, and a conscious decision needs to be taken to intervene to support the exchange rate and maintain the expansionary policy. Private sector sentiment also imposes a greater degree of discipline on the government under a floating regime than under a fixed regime, given that it is more sensitive to exchange rate changes than movements in foreign exchange reserve levels. An increase in government spending that enters the foreign exchange market for imports exerts downward pressure on the kina exchange rate, under the floating exchange rate regime, as demand for foreign currency increases. The Bank of PNG therefore had to contend with this implication of excessive government spending and account for it in its monetary management. Therefore, new instruments for monetary management were introduced in the latter half of the 1990s to deal with the increasing complexity of the financial market.

From 1995 to 1998, there was no explicit monetary target as the paramount concern was the need to restore stability. The main threat to monetary stability was the high level of liquidity in the banking system generated by the unsustainable level of domestic borrowing by the government over the previous four years. The Bank of PNG used both the Treasury bill auction and the MLAR to manage the high level of liquidity.

In May 1995, the discount facility was abolished and replaced by the kina auction facility.15 The new facility marked a further step towards the adoption of more market-oriented monetary instruments for liquidity management to enable the Central Bank to respond quickly to liquidity fluctuations by buying or selling liquidity. It is a weekly auction process for liquidity management whereby the Central Bank offers to buy an amount of money considered to be excess liquidity in the banking system, to diffuse liquidity, or offers to sell an amount of money considered to be needed by the banking system, to inject liquidity. Interest is paid by the bank to those who sell and paid by those who buy to the bank. The need to diffuse the high levels of liquidity saw the new facility being used only on the buy side and also necessitated an increase in the trading of Treasury bills. The volume of Treasury bills increased, and consequently the yields (interest rates) on Treasury bills reached 21.5 percent by

15 The kina auction interest rate became a key official rate, as it determines the price of liquidity at the margin. The facility can operate on both sides of the market, providing short-term liquidity when required (selling kina) or, when necessary, absorbing liquidity through the acceptance of deposits (buying kina).
December, with deposit and lending rates increasing in line with the restrictive monetary regime.

In August 1998, the Central Bank, on the advice of the government, introduced a special deposit requirement called the cash reserve requirement as a direct instrument for tightening monetary policy. This was done at a time when the total liquidity level of the commercial banks had built up from 1997, when the balance of payments was in surplus, government spending continued to be high, and high commercial bank lending exerted downward pressure on the kina exchange rates, when some of the credit entered the foreign exchange market. Commercial banks were required to have a certain portion (initially set at 10 percent) of their total liquid assets deposited at the Central Bank at a zero rate of interest, thereby reducing excess liquid reserves (loanable funds) within the banking system and hence restraining overall bank lending and helping to stabilise the foreign exchange market. It worked the same way as the MLAR but was solely a liquidity management tool, not used for prudential purposes and not used as frequently as the MLAR.

The bank continued its efforts to develop a market-oriented monetary management regime by expanding the market for government securities. It opened the Treasury bill market to retail purchases in October 1998. This is a retail sale of Treasury bills called the tap facility. The minimum amount for purchase under the facility was initially set at K10,000. These measures were intended to encourage non-bank institutions and the public at large to participate in the purchase of government securities: small entities and ordinary people who did not have the minimum K100,000 to invest in Treasury bills could now do so with a smaller amount. The retail purchase is conducted on Fridays after the main auction on Wednesdays, and the interest rate is set at 1 percent lower than the successful weighted average rate of the main auction. It is a further development of the market-oriented monetary management regime, as diffusion and injection of liquidity are accomplished indirectly through the sale of Treasury bills, this time involving more of the public, further to the main Treasury bill auction and the kina facility auction.

**Stance of monetary policy**

Under the float, monetary policy was still directed towards ensuring that growth in the money supply was compatible with developments in non-mineral private sector GDP.

A high level of liquidity has the potential to exert downward pressure on the kina exchange rate and upward pressure on inflation under a floating exchange rate regime. Hence, the Central Bank pursued a restrictive monetary stance, increasing the MLAR to 32 percent by May 1995. The implementation of the tight monetary policy led to a 3 percent contraction in private sector lending. Nonetheless, total money supply still increased over 1995 and was mainly attributable to an increase in foreign currency inflows associated with the government’s structural adjustment program, although the government continued to rely on additional domestic sources to fund its deficit.

The tight monetary policy stance was continued into the first half of 1996, but was relaxed in June following some stability in nominal exchange rates since April 1995 and reduced inflationary pressures. The MLAR was reduced by 5 percent to 27 percent, while yields on 182-day Treasury bills declined substantially from 21.5
percent in January to 9.2 percent in December 1996. Deposit and lending rates declined rapidly, and by the December quarter had returned to the levels prevailing prior to the float. The total money supply increased by 32 percent, the second largest annual increase since 1977. The rapid increase was a consequence of a strong external position and the bank’s implementation of the policy of building up its foreign exchange reserves, following the events of 1994. The bank continued to sterilise the reserve money injected into the banking system through the sale of short-term government securities and the purchase of liquidity in the kina auction facility. Commercial banks’ holdings of public debt increased from K115 million in 1990 to K1132 million by the end of 1996. The implication of this is that some of the funds that commercial banks could have lent to industries and households went instead to Treasury bill holdings. Despite the easing of monetary conditions, lending remained subdued with an annual rate of increase in loans outstanding of 1.0 percent.

The El Niño-related drought, the Asian financial crisis of 1997, and the Sandline affair (described in Chapter 5), had the combined effect of deterioration in the balance of payments position and depreciation of the kina, which led to high inflation in 1997 and 1998. Monetary policy was tightened in the latter part of 1997 in anticipation of this. The balance of payments went into deficit for the second year in a row in 1998, and monetary policy was tightened to contain inflationary pressures. Subsequently, there were increases in both the official interest rates and the average deposit and lending rates. Despite the high interest rates, the increase in lending in 1997 continued into 1998 with an unprecedented high rate of credit growth. Inflation increased to 13.6 percent.

A marked deterioration in control over government expenditure occurred again in early 1999, with political pressure being applied on the bank to finance the growing budget deficit. There was failure in the implementation of the public sector reform — specifically, the retrenchment of 10 percent of public service employees, privatisation of the Plant and Transportation Board, and transfer of several national government functions to the provincial governments. These failures were further exacerbated by government arrears totalling K107.5 million, which were not provided for in the original budget, and additional unbudgeted expenditures incurred by the government during the year. The government recorded a budget deficit of K241.8 million in 1999, higher than the deficit of K137.4 million in 1998.

There was a net overseas borrowing of K152.3 million, while the domestic financing requirement was K89.5 million, following a massive K253.7 million in 1998. There was no advance from the Bank of PNG in 1999, following a massive K409.8 million in 1998. The development in 1998 had already put a lot of strain on the Bank of PNG and the banking system going into 1999 (BPNG 1999). All this had several consequences: the kina underwent significant depreciation in 1999 to average lows of A$0.6086 (a 37 percent fall from the average 1996 level) and US$0.3922 (a 48 percent fall from the average 1996 level); access to concessional external financial aid was difficult; and efforts to tap international financial markets failed to attract interest. These factors, combined with two successive years of deterioration in the balance of

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16 The proceeds from the Plant and Transportation Board’s privatisation were intended to fund the retrenchment exercise, but this had to be delayed as most provincial governments did not have the capacity to implement the transferred functions.
payments position, led the economy to the verge of a second balance of payments crisis in the same decade.

A new government took office on 14 July 1999, after the previous government was defeated in a no-confidence motion. It introduced a supplementary budget that was structured to lay the foundation for restoring stability by significantly tightening fiscal policy, with new revenue measures netting a budgeted K72.4 million and expenditure to be reduced by K140 million.

The government entered into an IMF standby arrangement and the World Bank structural adjustment program loan in 1999. This was aimed broadly at promoting good governance, sustaining macroeconomic stability, improving public sector performance, and removing barriers to investment and economic development — and specifically at achieving a sustainable fiscal position, reducing inflation, building up international reserves, and improving the public service machinery for the effective delivery of goods and services.

**Evaluation**

In the 1990s, PNG experienced a mineral boom and a consequent windfall gain in government revenue. The economy experienced its best ever growth in output in the 1991 to 1994 period, with real GDP growth averaging 11.9 percent and reaching a high of 18.2 percent in 1993 (National Statistical Office estimates). Inflation was contained in this period with the second lowest annual increase since self-governance, 2.9 percent, recorded in 1994. This is attributable to the low imported inflation, as the inflation rate in Australia, the main producer of the country’s imports, was low (2.6 percent), and the lag effect of the appreciation of the kina before its devaluation and floating.

However, there was also macroeconomic mismanagement and the demise of the hard kina strategy. It was a period of macroeconomic instability. The ultimate price was a lack of business confidence and rise in inflation. Inflation averaged 12.3 percent, with a high of 17.3 percent in 1995. Restoring macroeconomic stability took precedence over providing sufficient liquidity and an economic environment conducive for growth as the main concern and objective of monetary policy.

With the IMF balance of payments support and the World Bank structural adjustment program, and some control in government spending, macroeconomic stability was restored in 1996, albeit briefly. The fiscal blowout in 1999 compounded the deteriorating external sector positions of 1997 and 1998, and low business confidence induced by the Sandline crisis brought the economy to its knees again in 1999. Government budget financing through borrowings from the Central Bank reached its peak. All these had the following effects: limits on the effectiveness of the Central Bank operations; an increased money supply; a very high level of liquidity and increased interest rates; depreciation of the kina; and high inflation.

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17 The circumstances surrounding the vote of no confidence and the reforms introduced by the new government, led by Sir Mekere Morauta, are outlined in more detail in Chapters 3 and 5.
The financial system was under considerable stress. There was a breakdown in governance, serious mismanagement, fraud, and outright theft that contributed to the stress within the financial system. The government-owned commercial bank, controlling 50 percent of the banking business, was mismanaged and on the verge of insolvency. Pyramid schemes were flourishing, supported by people in authority, and a large superannuation fund was close to bankruptcy as a result of corrupt practices by the trustees and management. In all the large superannuation funds, the ignorance and incompetence of management and the board and ministerial control of the decision-making process resulted in serious failures. There was a lack of confidence in the financial system and the economic management of the country, which also contributed to the depreciation of the kina (Kamit 2008).

Given all these developments, it became apparent that major reforms were needed in the financial sector to enable the Central Bank to rectify the problems within the financial system and instil confidence in the economy.

2000 to 2008: Independence of the Central Bank and monetary policy and a more market-oriented monetary management regime

Policy development and tools of monetary management

Reforms to the financial sector were part of an overall structural reform Program introduced by the government that included strengthening public expenditure control, enhancing the effectiveness and transparency of development spending, initiating privatisation of and instilling operational discipline in large state enterprises, and carrying out comprehensive civil service reforms (ibid.).

The problems in the 1990s — failure of government expenditure controls, large government borrowings from the Central Bank, and frequent changes in governors — necessitated the move to increase the powers of the bank and the independence of monetary policy. Of all the government’s policies for influencing the economy, monetary policy through the exchange rate had proven to be the most flexible instrument for achieving medium-term stabilisation through its direct effect on inflation.

In April 2000, the new Central Banking Act 2000 and the revised Banks and Financial Institutions Act 2000, both containing significant changes to the financial system, were passed by Parliament. Also enacted by Parliament in the same year were the Superannuation Act (General Provisions) 2000 and the Life Insurance Act 2000. Under the new Central Banking Act, the bank has more independence, debt management is separated from the conduct of monetary policy, and the relationship between the bank and the government was redefined to safeguard against excessive financing of budget deficits by the Central Bank. The total amount of advances was limited to K112 million in a six-month period, “or such other adjusted amount as agreed by the governor and the National Executive Council from time to time and published in the National Gazette for the sole purpose of taking into account movements in the general level of prices in Papua New Guinea” (Central Banking Act 2000).
The total amount of advances has to be repaid to the bank not later than six months from the date of advance. The limit cannot be changed on the direction of the minister for treasury and planning, as was the case under the amended Central Banking Act of 1993. This safeguards against excessive government borrowing and thus allows monetary policy to concentrate on pursuing its objective rather than worrying about debt management.

The revised Banks and Financial Institutions Act aimed at broadening and improving the regulation, supervision, and effectiveness of the financial system, and expanded the supervisory function of the Bank of PNG to include superannuation funds and life insurance companies, which were not covered previously, in addition to the commercial banks and non-bank financial institutions, including private sector finance companies, merchant banks, and savings and loan societies (BPNG 2007a:143).

Under the Central Banking Act 2000, the Bank of PNG is empowered to pursue the following functions:

- Formulating and implementing monetary policy with a view to achieving and maintaining price stability.
- Formulating financial regulation and prudential standards to ensure stability of the financial system in PNG.
- Promoting an efficient national and international payments system.
- Promoting (subject to the above) macro-economic stability and economic growth in PNG.

Price stability became the key objective of monetary policy. This is a more focused and specific objective of monetary policy, compared to the previous broad objective of providing sufficient liquidity in a stable monetary environment to be conducive to economic growth. Monetary policy cannot do more than it can do. Under the complexities of the floating exchange rate and the growing financial market and financial system, monetary policy cannot pretend to aim for things that it can not affect directly. It should concentrate on things that it can influence within its realm. Increasingly around the world, central banks have narrowed their focus to concentrate on achieving low inflation. Experiences in both developing and industrialised economies show that low inflation helps promote economic efficiency and growth in the long run. The fact that high inflation is detrimental to the economy has long been recognised. The Bank of PNG therefore is moving in that direction — to concentrate on what it can influence and achieve: low inflation to help assist growth of the economy (BPNG 2000).

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19 This is in contrast to the previous arrangement, in which the government debt held by the bank during a financial year could be increased to 12.5 percent from the limit of 10 percent of the government’s estimated ordinary revenue, and although the Bank of PNG must ensure that the total debt outstanding to the government, less government deposits held, did not exceed 20 percent of the estimated ordinary revenue for the year, this could be raised to 25 percent on the direction of the minister. Furthermore, in line with the separation of debt management from the conduct of monetary policy, commencing in 2000, the government and the bank agreed in August 2000 to use the weighted average interest rates for different maturities, determined at the government’s weekly Treasury bill auction, for payment of interest on the bank’s holdings of Treasury bills. The use of this market-determined rate allows the Central Bank to be considered as a market participant for trading in government securities.
The start of the new century saw the continuation of the development of a market-oriented monetary management regime by the Bank of PNG. In February 2001, the Central Bank introduced a new price-based policy signalling mechanism, the kina facility rate (KFR). The KFR is an official monthly rate indicating the bank’s stance on monetary policy. Changes to the KFR, based on assessment of economic fundamentals (realised developments on inflation, balance of payments, real sector, monetary aggregate, fiscal operations and exchange rates, and projections on some of these variables), are announced by the governor at the beginning of each month as a benchmark for inter-bank trading.

The process is that any changes in the KFR would trigger consistent realignment of the commercial banks’ deposit and lending interest rates, although not necessarily by the same amount. The KFR was accompanied by the introduction of the repurchase agreement facility (Repos). It is a money market instrument used by the bank to lend (inject liquidity) to or borrow (diffuse) from the commercial banks, for liquidity management. The terms of these loans range from overnight to fourteen days. The rate for the facility is at a margin of the KFR. Initially, the Repos was an overnight facility between the commercial banks and the Bank of PNG. To improve the efficiency of the facility, the bank refined it in April 2003 by allowing the term structure to vary from overnight to seven days. This helps in having the intended effect when liquidity is diffused and does not go back into the system for seven days as against one day. The change effectively ended the use of the kina auction facility. The term for the Repos increased to fourteen days in 2005 (ibid.:143).

Stance of monetary policy

For most of the years after 2000, the Bank of PNG eased monetary policy, especially after 2003. The policy signalling rate — the monthly kina facility rate — was reduced from a high of 16 percent in June and July 2003 to a low of 6 percent by September 2005, and maintained at 6 percent until May 2008. Significant improvements in the balance of payments position underpinned this stance. Open market operations through the Treasury bill auction, Central Bank bill auction (introduced in 2005), and inscribed stock tender20 was the tool used for liquidity management to influence the market interest rates in line with the KFR. In line with the stance, the indicative lending rates, lending and deposit rates of commercial banks, fell and were consistently low for this period. This led to increased lending to the private sector in the years 2004 to 2008. The growth in credit was broad based, with lending to agricultural, forestry, fishing, manufacturing, transport and communication, commerce, building and construction, mining and quarrying, the household sector, and other business services sectors.

High international prices, hence improved terms of trade, led to annual surpluses in the balance of payments beginning in 2003. Increased foreign exchange reserves, combined with prudent management of fiscal and monetary policies, had the effect of stable appreciation of the kina. Together with low imported inflation, this resulted in low single-digit inflation for the years 2004 to 2007. Macroeconomic fundamentals have been sound, and the economy has been stable relative to the 1990s.

20 This is a government debt instrument sold to the public for a maturity term of one year or longer for budget financing.
The legislative reforms in 2000 allowed the Bank of PNG to formulate and implement monetary policy independently of political influence and government debt management in the 2000s, among other things, in contrast to the experiences of the 1990s. In return for this independence, the bank had to be more transparent and accountable in the conduct of its monetary policy and other operations. For this, the bank, through the governor, publishes a monetary policy statement for the public every six months, in addition to the monthly KFR announcement. Monetary policy management has been prudent since 2000.

Fiscal policy management since 2000 has also been prudent, especially after 2002. Government expenditures under the budget appropriations had been within budget, and more-or-less balanced budgets were achieved from 2003 to 2007, with a surplus recorded for some of these years. Consequently, there was no budget deficit financing from either domestic or external sources, and the government’s domestic and foreign debts were reduced when repayments were made. A large part of this had to do with the windfall revenue made possible by high international prices for PNG’s export commodities.

In sum, prudent management of fiscal and monetary policies since 2000, increased foreign exchange reserves, and stability in the exchange rate — driven largely by high international commodity prices — enabled the Central Bank to achieve and maintain price stability (low inflation) from 2003 to 2007. The year 2008 was an exception, with respect not only to inflation but also to fiscal management. High international prices for food and fuel, starting in 2007, strong aggregate domestic demand reflecting growth in activity and income, and the downturn in world economic activity, especially in the second half of 2008, fuelled by the US-led global financial crisis, led to high inflation for the year. These trends are illustrated in the charts on interest, exchange, and inflation rates for the period starting in 1999–2000 in Appendix B.

Due to the high inflation, monetary policy was tightened starting in June 2008, and the KFR was increased progressively, reaching 8.0 by December. The government incurred a budget deficit of 2.2 percent of GDP against an original budgeted surplus of 1 percent of GDP and a revised balanced budget. Most of the excessive spending occurred in the second half of the year, particularly in the last quarter, at the beginning of a decline in commodity prices, and thus in government revenue, induced by the downturn in global economic activity.

With respect to supervision of the financial system, independence allowed the bank to clean up the financial sector, in addition to its ongoing strengthening of on-site and off-site supervision of the banks and non-bank financial institutions. In 2000, the bank replaced the board and management of the troubled government-owned PNG Banking Corporation. It was revamped and successfully sold off under the government’s privatisation program in 2002. The commercial banks performed well following the reforms. Chart 1 shows the decline in non-performing loans since 1999 (Kamit 2008).

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21 See Chapter 3 for a discussion of fiscal policy during this period.

22 Price stability (low inflation) does not mean there is no increase in domestic prices, but that there are only small increases over a sustained period of time.
The clean-up process included closing 86 dormant savings and loan societies, placing other financial institutions under management, with a view to enable them to trade themselves back into business, and liquidating a number of financial institutions that had been mismanaged and were beyond rescue. The Superannuation Act also enabled the bank to effectively supervise the industry as reflected in Chart 2, which shows a rapid increase in the profitability of the superannuation industry (ibid.).
The Bank of PNG has had to act at a time of crisis, which is not the most desirable environment in which to implement such reforms. However, the outcomes have been very favourable and the results very positive.

**Evaluation**

With the increased independence of the Central Bank, monetary policy since 2000 has concentrated on the mandates of price stability and better and more effective supervision of the financial system. The Bank of PNG has developed and consolidated its market-oriented instruments for liquidity management. The formulation and implementation of national budgets were consistent with the ideals of reforms and good economic management, except for 2002 and 2008, when there was overspending. The formulation and implementation of monetary policy, independent of political and fiscal biases under the financial sector reform, and ‘living within our means’ fiscal management, helped to restore stability in the economy in the 2003 to 2008 period, although it may be argued that the stability was underpinned largely by high commodity prices (Kauzi and Sampson 2009). These distinguish the years since 2000 from the 1990s. Increased foreign exchange reserves and stable kina exchange rates relative to the 1990s led to the low and stable inflation, given the strong link between exchange rate and domestic prices (Sampson et al. 2006). The rate of inflation averaged 7.7 percent for the period 2000 to 2008, with particularly low single-digit rates from 2004 to 2007. Monetary stability, as indicated by internationally competitive levels of interest rates, and low inflation were achieved for most of the decade, while growth in monetary aggregates was moderate to high.

The high commodity prices, stability in the exchange rate and inflation, improved business confidence, and some major development projects laid the foundation for the sustained growth in real GDP from 2003 to 2008 (an average of 4.1 percent per year), the longest period of continuous growth since independence. Consistent with the growth in economic activity, the bank’s employment index for the formal non-mineral private sector showed an average annual growth in employment level of 5.6 percent in this period, with a high of 10.1 percent growth in 2007.

3. **Conclusions and policy implications**

The experience in PNG generally has been that when the external sector is healthy, the exchange rate is stable, which then leads to stability in the inflation rate, itself conducive to economic growth and general stability. PNG’s experience with monetary policy in the last four decades can be summed up as follows.

In the 1970s and 1980s, the key prerequisites for the hard kina strategy — restraint in government expenditure and adequacy of foreign exchange reserves — were met. Monetary policy was able to influence credit growth and money supply to enable low but steady economic growth, subject to developments in the external sector. When the balance of payments was in surplus, there was generally growth in liquidity. The reverse was generally the case when the balance of payments was in deficit. The balance of payments situation itself depended largely on external developments and world market prices for PNG’s export commodities. The fixed exchange rate regime aided greatly in the attainment of low inflation in PNG relative to many developing economies.
The 1990s were characterised by gross economic mismanagement by several successive governments. The windfall in revenue from the mineral boom was not put to good use, such as improvement in infrastructure. There was excessive spending with a high proportion of consumption expenditure, and budget deficit was prevalent. The highest economic growth occurred in this period, but there was great macroeconomic instability. Monetary policy was at the whim of fiscal mismanagement, and it became too preoccupied with the national government’s debt management.

Giving the Central Bank more independence and power in the conduct of monetary policy and strengthening financial sector supervision were in line with worldwide trends. The consensus in the 1990s was that central banks contribute positively to economic stability and maintain credibility if they have a sufficient degree of autonomy and are independent of political interference.

With the increased independence of the Bank of PNG enabled by the legislative reforms of 2000, monetary policy has been able to concentrate on its core objective of achieving price stability through sound liquidity management and with a stable exchange rate — driven by high commodity prices and significant growth in international reserves. Together with discipline in fiscal management, there was relative stability in prices after 2003 (until the rapid increase in oil and food prices in 2008), and business confidence was very high. The last five years have seen broad-based economic growth, with a low real GDP growth ranging from 2.1 percent in 2003 to 7.2 percent in 2008, for an annual average real GDP growth of 4.1 percent, according to the Treasury Department’s estimates. The economy has attained good ratings from international rating agencies, with a B+ foreign currency rating by Standard and Poors in 2007.

The prospect for growth in the PNG economy looks good. The IMF, in its 2007 Article IV Consultation Report, projected a growth average of 3.5 percent (baseline) in the medium term, in the absence of a change in current policy trends (IMF 2007). The Bank of PNG’s projection puts real GDP growth in the range of 4 to 8 percent in the next three years, assuming continued high but slowly declining export commodities prices, prudent fiscal management, and a stable exchange rate. The IMF scenario assumes higher but not excessive fiscal spending and channelling of expenditure to productive areas, limited structural reforms, mineral revenue inflows declining from their current peak, and the external current account deteriorating in line with the expected decline in mineral exports. The IMF report stated:

Macroeconomic vulnerabilities have intensified, including the potential for unproductive spending raising demand pressures and spurring inflation, a weaker global economy leading to lower commodity prices, further acceleration of HIV/AIDS infection rates, and no action or a reversal of progress on the structural reform agenda. Upside risks include further crowding-in of private activity from the increase in public investment, and new production from gas and mining discoveries or improved extraction (IMF 2007:2–3).

The question for monetary and fiscal policies is how to manage under the downside risks. As the IMF report put it:
Against the background of high mineral revenues in the short run and increased downside risks, the central issues are: (i) how best to manage the large, but temporary, fiscal surpluses to promote macroeconomic stability and higher sustainable growth; (ii) how monetary policy should deal with a possible looser fiscal stance and other emerging inflationary pressures; and (iii) how to encourage a vigorous resumption of reforms in the fiscal and other structural areas to improve prospects for lifting non-mineral sector growth (ibid.:3).

For monetary policy, the IMF mission noted in its report that ‘the monetary policy stance remains appropriate for the period, given the Bank of PNG’s ability to date to constrain inflation’ (ibid.:6). As we know now, the risk of inflationary pressure and high inflation was realised in 2008.

In the context of falling commodity prices, foreign reserves will fall and the kina will be under downward pressure. The Bank of PNG should look to tighten monetary policy further, where appropriate, using its open market operations tools and intervening in the foreign exchange market when necessary to support the kina while not trying to influence the underlying market trend of the exchange rate. Such intervention will be backed by the high level of international reserves that has built up.

Looking further down the line, it is important for the Bank of PNG to continue to undertake research to better understand the workings of the money market, the financial market, the financial system, and the economy at large, to better design and apply monetary policy. The Bank of PNG, together with the Departments of Treasury and Finance, should also examine options to absorb the potentially high government proceeds from the LNG project, so that these do not directly affect the liquidity of the banking system. These options could include establishing a special fund, following the same principle as the former Mineral Stabilisation Fund, or a foreign currency account, or a futures fund.

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Appendix A — Monetary policy and development

This appendix provides a short, non-technical overview of the role and importance of monetary policy and its link to development.

What is monetary policy?

Monetary policy is the policy that determines or influences the supply of money to meet the demand for money in an economy. It attempts to strike a balance between supply and demand so that neither too much nor too little money is being created at any given time (BPNG 2007:86). For most countries, the institution that is mandated to formulate and manage monetary policy is the central bank. The central bank in PNG is the Bank of Papua New Guinea, established by the Central Banking Act 1973.

Money supply

Money supply, in its simplest form, is the amount of cash or currency (the legal tender) that is issued by a central bank and is in circulation in the economy. This is the most liquid form of money, meaning it is hard cash and can readily be exchanged for goods and services. The Bank of PNG definition of money supply is expanded to include demand/cheque deposits — items that can be easily converted to cash on demand, and savings and term deposits — items that are not easily convertible to cash on demand. The expanded definition of money supply is similar across central banks, although the details vary. The cash held by commercial banks, together with their exchange settlement account balances23 and securities (such as Treasury bills and inscribed stocks) of less than three-year maturity, make up the liquid assets or liquidity of the banking system.

Money demand

Money is supplied because there is demand for it as the medium of exchange; it also functions as a store of value and unit of account. The need to have money constitutes the demand for money. Demand for money can come from the general public for consumption, C, the private sector for investment, I, the government for fiscal spending, G, exporters for exports, X, and importers for imports, M. Together these components make up aggregate demand, Y: \[ Y = C + I + G + (X - M). \]

Changes to money supply and money demand

The amount of money supply in the economy can change when the central bank restricts or increases the issuance of the currency in a given period. Change in money supply can also come from a change in the balance of payments position (a surplus or positive change can add to the money supply, and a deficit or negative change will reduce the money supply); and the number and volume of loans extended by commercial banks will cause the volume of currency in circulation and demand deposits to change. A crucial variable that influences the amount of credit extended by commercial banks is the interest rate charged on the loans. If the interest rate is high,

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23 Exchange settlement accounts are accounts that the commercial banks hold with the central bank for settlement of transactions with each other.
the cost of borrowing is high so there will be less demand for loans. If the interest rate is low, the cost of borrowing is low so there will be more demand for loans. The interest rate is the price of money. The change in the money supply through the lending process is part of the money creation process, and the interest rate is a key determinant of supply of and demand for money.

Changes to the supply of and demand for money can also be determined by the level of economic activity, especially if it is being induced by an external factor such as high international export commodity prices, as has been the case for PNG in the last five years and periodically over history. In this instance, producers will be willing to produce more to earn more. Increases in production can have spin-offs for other industries such as transportation. This can lead to an increase in demand for money, and in that case, the money supply has to increase as well — both of which will, to an extent, depend on the level of the interest rate. There has to be a balance between money supply and demand in order for economic activity to take place.

If the supply of money is greater than the demand, then like any other commodity, its price — the interest rate — will fall, which is conducive to credit and investment growth and ultimately economic growth. But the prices of goods and services will rise (inflation), because there is more money floating around for an unchanged amount of goods and services in the short run. On the other hand, if the supply of money is less than the demand, interest rates will rise and tend to discourage demand for loans and investment. There is an unchanged or reduced amount of money for the prevailing amount of goods and services, so the prices will tend to fall, remain constant, or increase at a lower rate than under the scenario of increased money supply.

**The importance of monetary policy**

To strike a balance between the supply of and demand for money is where monetary policy comes in. The central bank, through its monetary policy, can influence money supply through direct means, such as lending policies and control of interest rates, or indirect means, such as Treasury bill auctions to influence inflation and economic growth.

A monetary policy that encourages growth in monetary supply is called an easy or accommodative monetary policy. It lets money supply grow to accommodate growth in government spending or economic activity while unintentionally allowing for inflation to rise. A tight monetary policy is one that aims at restricting growth in the money supply and suppressing inflation. The choice of what monetary policy stance to adopt in a given period is dependent on the goal to be achieved and the existing or projected economic conditions.

To be able to conduct monetary policy to influence the supply of money, a central bank must have at its disposal policy instruments or tools to influence monetary conditions toward achieving its monetary targets. The application of monetary instruments affects monetary conditions by acting on the quantity of money or on the price of money (interest rates). Four elements can be identified to illustrate the process of monetary policy (BPNG 2007:94).
Instruments → intermediate target → monetary target → ultimate objective

Policy instruments are the tools manipulated by the central bank in the conduct of monetary policy to have an impact on intermediate targets. Intermediate targets include reserve money holdings of the commercial banks and short-term interest rates. Intermediate targets influence the growth rates of monetary aggregates such as total money supply and credit, which have both been used as monetary targets in PNG. Monetary aggregates then influence the ultimate objective variable of monetary policy, which changed under the Central Banking Act 2000 from one of supporting sustainable economic growth to one of achieving price stability.

The management of monetary policy and its instruments in the PNG economy has evolved over the years, from a passive approach with rudimentary policy instruments to a more active approach with indirect and market-oriented policy instruments. Table 1 shows the evolution of monetary policy instruments used by the Bank of PNG and the intermediate or monetary targets they aimed to influence.

Table 1: Monetary policy instruments, 1975-present

<table>
<thead>
<tr>
<th>Period</th>
<th>Instruments</th>
<th>Intermediate or monetary target</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975–1983</td>
<td>MLAR, Treasury bills, discount window, lending guidelines, interest rate directives, lender of last resort</td>
<td>Growth of credit</td>
</tr>
<tr>
<td>1984–1988</td>
<td>MLAR, trade in government securities, lending guidelines, interest rate ceilings, lender of last resort</td>
<td>Growth of credit</td>
</tr>
<tr>
<td>1989–1992</td>
<td>MLAR, lending guidelines, discount window, trade in government securities, lender of last resort</td>
<td>Growth of credit</td>
</tr>
<tr>
<td>1993–1999</td>
<td>MLAR, trade in government securities, kina auction, deposit standing facility, lender of last resort</td>
<td>Growth of money</td>
</tr>
<tr>
<td>2000–present</td>
<td>Trade in government securities, KFR, repurchase agreement, moral suasion, MLAR, Cash Reserve Requirement, lender of last resort</td>
<td>Key short-term interest rates</td>
</tr>
</tbody>
</table>

The link between monetary policy, exchange rate policy, fiscal policy, and economic development

Between 1973 and 1999, the objective of monetary policy in PNG was to allow certain growth rates in credit or a broad money supply or generally sufficient liquidity in the banking system to support economic growth. This meant that monetary policy was to allow growth in the money supply to meet an anticipated growth in the aggregate demand for money to facilitate the growth of economic activity. As discussed in Chapter 1, increased economic growth in turn can lead to development of social and economic infrastructure, growth in per capita income, and improvement in the standard of living of the people of the economy. In this way, monetary policy can facilitate the growth and development of the nation.

Starting in 2000, the objective of monetary policy, under the Central Banking Act 2000, has been to achieve and maintain price stability — low inflation supported by stable exchange rates and interest rates (BPNG 2005, 2006, 2007b, 2008).

As hinted in the introduction, these two objectives of monetary policy, economic growth and price stability, can conflict. To promote economic growth, monetary policy usually has to be easy or accommodative; that is, allow the money supply to
grow enough to facilitate economic activity, which could lead to a rise in inflation. To keep inflation low, monetary policy usually has to be tight — and high interest rates may not be conducive to economic growth.

Given that the PNG economy is small, open, vulnerable to international market developments beyond its control, and dependent on imports, monetary policy is unlikely to be effective in controlling inflation. Even if it were to work via the exchange rate to affect inflation, it would not succeed, because the market economy is small and fragmented, the financial market is yet to be developed, and monetary policy does not have the instruments. Therefore, although in theory a tight monetary policy, vis-a-vis high interest rates, could result in an appreciating kina and thus combat inflation, in reality this would not occur. It was with this kind of thinking that policymakers opted for the hard kina strategy in 1975, when the national currency was introduced, to address inflationary concerns while monetary policy concentrated on providing sufficient liquidity for the economy to grow.24

The logic of the hard kina policy insofar as inflation is concerned is that the value of the kina can be set above the level that would be determined by the market. The more the kina is worth in foreign currency, the lower the cost of imports, and the lower the prices paid by consumers in PNG. Therefore, with a strong kina, imported inflation can be manageable.

Under the fixed exchange rate regime in PNG, when a good portion of the government spending was on imports, an expansionary fiscal policy could be sustained so long as there were enough foreign exchange reserves,25 while monetary policy could only assist the situation through monetary tightening to counter or mitigate the adverse effect of the expansionary fiscal policy on the exchange rate. Changes (whether improvement or deterioration) in the balance of payments might increase or reduce the level of international reserves but would not influence the exchange rate.26 The position in the balance of payments influences money supply when exporters convert their foreign exchange earning to kina, and thus the liquidity level is also affected. The tendency for monetary policy has been that when the balance of payments position improves and the liquidity level increases, monetary policy would generally be eased; the reverse is true when the balance of payments deteriorates. The stance of monetary policy was thus largely dependent on the balance of payments position, as in many economies, especially small, open economies.

Under the floating exchange rate regime, an expansionary fiscal policy or an easy monetary policy can lead to a downward pressure on the exchange rate. Imbalances between supply and demand for foreign currency are brought into balance through changes in the exchange rate. Under a floating exchange rate, the exchange rate acts as the shock absorber, while under a fixed exchange rate, foreign exchange reserves act as the shock absorber. The consequences of fiscal and monetary laxity are more immediate and widespread with a floating exchange rate.

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24 The author has not encountered this interpretation in policy documents or literature about the PNG government’s macroeconomic policies; it is the author’s own.
25 The linkage between monetary policy and fiscal policy is discussed in Chapter 3.
26 It can be argued that when the kina is strong under a fixed exchange rate regime, the current account surplus and therefore foreign exchange earnings are lower than they otherwise would be.
As discussed in the previous chapter, fiscal policy is concerned with the government’s budget, which exists primarily for delivering public goods and services in the country. Monetary policy has to take into account the budget appropriations through the provision of growth in the money supply for the latter to be feasible. If there is a planned fiscal deficit, the portion of the deficit that is to be financed domestically (borrowed from the central bank or from the public) has to be factored into the formulation of monetary policy, in the provisioning of the growth in broad money supply. Domestic financing of a fiscal deficit can have three effects: ‘crowding out’ of lending to the private sector; increase in liquidity, which can be inflationary; and reduction in foreign exchange reserves due to spending on imports.

Together, monetary and fiscal policy, the two overriding macroeconomic policies in any economy, can drive economic growth and broad development in PNG. Monetary policy, with stability in the exchange rate, can lead to the desired low inflation, which in turn can provide a business climate that is conducive to economic growth and development, in support of fiscal policy. The latter can be the catalyst for economic growth and development if there is prudent management and effective spending on social and economic infrastructure such as health, education, and transportation. If there is a lack of good governance, national budget appropriations are not adhered to, expenditures are of the nature that exerts downward pressure on the exchange rate, and monetary policy is ineffective in stabilising prices, including interest rates, then efforts to promote macroeconomic stability and economic growth will be futile.
Appendix B — Tables and charts

The tables and charts in this appendix illustrate financial and economic variables discussed in the chapter.

Chart 3: Private sector credit level and growth

![Chart 3: Private sector credit level and growth]

Data source: Bank of PNG
Note: LHS refers to the left hand side axis and RHS refers to the right hand side axis.

Chart 4: Government credit level and growth

![Chart 4: Government credit level and growth]

Data source: Bank of PNG
Note: LHS refers to the left hand side axis and RHS refers to the right hand side axis.
### Table 2: Interest rates

<table>
<thead>
<tr>
<th>182-day Treasury bills</th>
<th>Deposits</th>
<th>Large term ((%) per annum)</th>
<th>Weighted average lending rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976</td>
<td>..</td>
<td>7.8</td>
<td>12.0</td>
</tr>
<tr>
<td>1977</td>
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<tr>
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<td>..</td>
<td>5.8</td>
<td>10.1</td>
</tr>
<tr>
<td>1979</td>
<td>..</td>
<td>6.3</td>
<td>10.1</td>
</tr>
<tr>
<td>1980</td>
<td>..</td>
<td>7.1</td>
<td>11.2</td>
</tr>
<tr>
<td>1981</td>
<td>8.6</td>
<td>11.6</td>
<td>14.5</td>
</tr>
<tr>
<td>1982</td>
<td>14.8</td>
<td>12.8</td>
<td>15.2</td>
</tr>
<tr>
<td>1983</td>
<td>11.7</td>
<td>11.8</td>
<td>13.8</td>
</tr>
<tr>
<td>1984</td>
<td>9.0</td>
<td>8.7</td>
<td>12.3</td>
</tr>
<tr>
<td>1985</td>
<td>9.5</td>
<td>16.4</td>
<td>16.1</td>
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<tr>
<td>1986</td>
<td>12.3</td>
<td>9.5</td>
<td>12.9</td>
</tr>
<tr>
<td>1987</td>
<td>9.4</td>
<td>10.5</td>
<td>14.3</td>
</tr>
<tr>
<td>1988</td>
<td>9.5</td>
<td>11.7</td>
<td>13.9</td>
</tr>
<tr>
<td>1989</td>
<td>12.0</td>
<td>12.9</td>
<td>14.8</td>
</tr>
<tr>
<td>1990</td>
<td>10.8</td>
<td>9.9</td>
<td>16.0</td>
</tr>
<tr>
<td>1991</td>
<td>10.5</td>
<td>9.6</td>
<td>15.2</td>
</tr>
<tr>
<td>1992</td>
<td>6.5</td>
<td>6.6</td>
<td>13.8</td>
</tr>
<tr>
<td>1993</td>
<td>6.0</td>
<td>4.6</td>
<td>10.7</td>
</tr>
<tr>
<td>1994</td>
<td>10.8</td>
<td>4.5</td>
<td>10.0</td>
</tr>
<tr>
<td>1995</td>
<td>21.5</td>
<td>9.4</td>
<td>15.4</td>
</tr>
<tr>
<td>1996</td>
<td>9.2</td>
<td>4.0</td>
<td>10.2</td>
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<td>1997</td>
<td>14.5</td>
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<td>10.6</td>
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<td>1998</td>
<td>23.9</td>
<td>8.7</td>
<td>20.2</td>
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<td>1999</td>
<td>20.4</td>
<td>8.5</td>
<td>18.2</td>
</tr>
<tr>
<td>2000</td>
<td>14.9</td>
<td>6.7</td>
<td>15.5</td>
</tr>
<tr>
<td>2001</td>
<td>10.2</td>
<td>4.1</td>
<td>14.6</td>
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<td>2002</td>
<td>13.5</td>
<td>4.7</td>
<td>13.7</td>
</tr>
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<td>2003</td>
<td>16.9</td>
<td>1.6</td>
<td>13.5</td>
</tr>
<tr>
<td>2004</td>
<td>4.6</td>
<td>1.1</td>
<td>12.1</td>
</tr>
<tr>
<td>2005</td>
<td>4.9</td>
<td>0.8</td>
<td>10.7</td>
</tr>
<tr>
<td>2006</td>
<td>3.3</td>
<td>1.0</td>
<td>10.2</td>
</tr>
<tr>
<td>2007</td>
<td>5.0</td>
<td>1.6</td>
<td>9.3</td>
</tr>
<tr>
<td>2008</td>
<td>7.4</td>
<td>1.6</td>
<td>8.8</td>
</tr>
</tbody>
</table>

**Data source:** Bank of PNG

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*a* Treasury bill rate is the weighted average of the last auction of the year.


*c* Simple average rate on 182-day term deposits of K500,000 and over as of the end of December.
**Chart 5: Headline inflation (percent)**

Data source: Bank of PNG and NSO

**Chart 6: Total credit level and growth**

Data source: Bank of PNG

Note: LHS refers to the left hand side axis and RHS refers to the right hand side axis.
Chart 7: Interest rates

Data source: Bank of PNG

Chart 8: Kina exchange rates

Data source: Bank of PNG
Chart 9: Broad money supply (M3*) and growth

Data source: Bank of PNG
Note: Broad money (M3*) comprises M1* and quasi-money. Quasi-money comprises savings and term deposits of other financial corporations, provincial and local governments, public non-financial corporations, and the private sector (other non-financial corporations and other resident sectors) with the Bank of PNG and other depository corporations. LHS refers to the left hand side axis and RHS refers to the right hand side axis.
CHAPTER 5: POLITICS AND GOVERNANCE

Alphonse Gelu

1. Introduction

At independence, Papua New Guinea (PNG) adopted the Westminster system of government, which comprises a democratically elected legislature, an executive, and a judiciary. In examining the history of governance in PNG since independence, this chapter will explore how decisions have been made and power has been exercised within this system.

The term governance refers to the traditions and institutions by which authority in a country is exercised. It is said to include the process by which governments are selected, monitored, and replaced; the capacity of government to effectively formulate and implement sound policies; and the respect of citizens and the state for institutions that govern economic and social interactions among them (Kaufmann, Kraay, and Zoido-Lobatón 1999).

Studies have shown governance to be both a precursor to and a driver of development (Kaufmann and Kraay 2002). The term became part of the language of negotiations between aid donors, banks, and developing countries in the 1990s, and according to Larmour (1998:1), most donors now believe that development depends on governance.

Good governance can improve foreign investment in a country, leading to economic growth, and can also help to ensure that public resources are spent efficiently and effectively, thus improving social development outcomes. Elements of good governance, such as political stability, can improve the consistency of government policies and the ability to implement long-term strategies as well as improve investor confidence.

There are many aspects to governance, including both economic and political dimensions. Economic governance in PNG has been examined in the previous chapters, which outlined issues relating to financial management and macroeconomic stability in PNG since independence.

This chapter focuses on the political dimensions of governance and examines just a few of the many attributes that are commonly associated with good governance. It examines the representation and stability of government through a historical narrative of elections, political parties, votes of no confidence, and the formation of government in PNG since independence. It also outlines some issues relevant to the effectiveness and accountability of government in terms of the history of decentralisation policy, the public service, and corruption.

As indicated in Table 1, there have been thirteen coalition governments and six different prime ministers in PNG since independence. One of the major challenges for good governance in PNG has been reconciling the political system that was inherited at independence with the traditional system based on custom and culture.
Table 1: Coalition governments since 1972

<table>
<thead>
<tr>
<th>Year</th>
<th>Prime minister (party)</th>
<th>Deputy prime minister (party)</th>
<th>Mechanism of change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1972</td>
<td>Michael Somare (Pangu)</td>
<td>Julius Chan (PPP)</td>
<td>National election</td>
</tr>
<tr>
<td>1977</td>
<td>Michael Somare (Pangu)</td>
<td>Julius Chan (PPP)</td>
<td>National election</td>
</tr>
<tr>
<td>1980</td>
<td>Julius Chan (PPP)</td>
<td>Iambakey Okuk (NP)</td>
<td>Vote of no confidence</td>
</tr>
<tr>
<td>1982</td>
<td>Michael Somare (Pangu)</td>
<td>Paia Wingti (Pangu)</td>
<td>National election</td>
</tr>
<tr>
<td>1985</td>
<td>Paia Wingti (PDM)</td>
<td>Julius Chan (PPP)</td>
<td>Vote of no confidence</td>
</tr>
<tr>
<td>1987</td>
<td>Paia Wingti (PDM)</td>
<td>Julius Chan (PPP)</td>
<td>National election</td>
</tr>
<tr>
<td>1988</td>
<td>Rabbie Namaliu (Pangu)</td>
<td>Ted Diro (PAP)</td>
<td>Vote of no confidence</td>
</tr>
<tr>
<td>1992</td>
<td>Paia Wingti (PDM)</td>
<td>Julius Chan (PPP)</td>
<td>National election</td>
</tr>
<tr>
<td>1994</td>
<td>Julius Chan (PPP)</td>
<td>Chris Haiveta (Pangu)</td>
<td>Court ousted previous prime minister</td>
</tr>
<tr>
<td>1997</td>
<td>Bill Skate (PNC)</td>
<td>Chris Haiveta (Pangu)</td>
<td>National election</td>
</tr>
<tr>
<td>1999</td>
<td>Mekele Morauta (PDM)</td>
<td>John Pundari (PAP)</td>
<td>Previous prime minister resigned</td>
</tr>
<tr>
<td>2002</td>
<td>Michael Somare (NA)</td>
<td>Allan Marat (PPP)</td>
<td>National election</td>
</tr>
<tr>
<td>2007</td>
<td>Michael Somare (NA)</td>
<td>Puka Temu (NA)</td>
<td>National election</td>
</tr>
</tbody>
</table>

Source: Okole 2005

Abbreviations: NA = National Alliance; NP = National Party; Pangu = Pangu Party; PAP = People’s Action Party; PDM = People’s Democratic Movement; PNC = People’s National Congress; PPP = People’s Progress Party.

*After Allan Marat, four other deputy prime ministers were appointed during this parliamentary term, creating a sense of instability in the government and its coalition partners.

PNG has experienced a degree of political stability, with elections held regularly and changes of government following constitutional procedures. However, these positive aspects of governance have been undermined by elections characterised by violence and administrative problems, and power struggles within the Parliament.

PNG is facing an unprecedented window of opportunity for economic growth with the imminent commencement of the LNG project. However, capitalising on this opportunity will depend on the credibility of government and the confidence of international investors. The most important development challenge for PNG is how to make the state functional and more responsive to the issues facing the people. Development can only happen through making improvements to the political system and making the government effective through a proper system of governance.

The remainder of this chapter describes key events and discusses the aspects of political governance outlined above, with the main points summarised in the conclusion. For those unfamiliar with the system of government in PNG, an overview is included in the Appendix.

2. Politics and governance in PNG

1975–1980: The foundations of the nation

The period that began in 1975 was important for PNG in many ways, but the most important event was the achievement of statehood for the newly independent country and the coming into operation of its Constitution. The Constitution clearly outlined its foundations or pillars, which included a desire to respect the traditions and customs of the people, democracy and its principles, and Christianity. Though there may be a degree of conflict between the three, the relationships between them are clearly spelled out in the Constitution.
As a newly sovereign state, PNG had to identify the direction that would take it forward. This came in the form of the National Goals and Directive Principles, which formed part of the Preamble to the Constitution. The Constitution in PNG was a people’s Constitution, because it was put in place after an exhaustive consultation process.

But the most important task for the government was setting the foundation for the future of the country. The trend in politics and, most importantly, the rise to prominence of the new political culture relating to practices of governance, defined the political process in the years after independence.

The Constitution of PNG follows the liberal democratic tradition. It affirms the basic rights of citizens and defines the relationships between the three arms of government. The positive effect that the Constitution has had on the development of politics in PNG has been summarised as follows:

The Constitution has survived and with it the political and legal system. The Constitution provides the framework for national politics. Papua New Guinea is an open society, where most rights are protected. No-one can accuse the governments since independence of being tyrannical and no dictator has emerged to undermine the constitutional order. Elections have been conducted regularly and have been free and fair. Changes to governments have been conducted peacefully. To a significant degree, the rule of law has been maintained (Ghai 2001:53).

Besides the coming into place of the Constitution, this period witnessed the first post-independence election in 1977. The voting system was changed from the optional preferential vote system to the first-past-the-post system. Only four major parties contested the first election (Gelu 2005; Hegarty 1998). The nature of the party system greatly affected the ability of parties to act as vehicles for developing policies for development. As discussed in Chapter 2, there was no direct link between the policies of parties and the policies that governments adopted.

During this initial post-independence period two features emerged that would become part of the political culture in PNG: votes of no confidence and coalition formation. In the period since independence, votes of no confidence have helped shorten the life span of governments from five years to an average of only two and a half years. The many votes of no confidence have marked a great deal of political instability in the executive branch of government and have therefore affected the ability of governments to concentrate on delivering services to the people.

Coalition formation has typically not been based on rational grounds but has been more or less a means of maintaining or gaining power and prestige. From 1977 to 1997, the average number of parties in a coalition was around seven to ten, but the number increased dramatically after the 2002 election, with twenty-two parties in the coalition, dropping to fifteen after the 2007 election. The coalition governments are not based on concrete agreements on policy or ideology. The smaller parties in the coalition governments are largely powerless and exist at the whim of the ruling party, which greatly limits their ability to propose policies or even to bring their agendas to the attention of key members of government.
On 11 March 1980, then Prime Minister Michael Somare was defeated when a third attempt to pass a vote of no confidence succeeded by 57 votes to 49. This effectively ended Somare’s eight-year reign as the leader of PNG. This period was the most turbulent in the history of PNG due to the three attempts to oust the prime minister. Logically, how can leaders govern if they must continuously deal with moves to oust them from office?

Decentralisation was a major achievement of the government after independence. It was the most controversial part of the Constitutional Planning Committee’s consultation and finally, in August 1975, it was not included in the Constitution. However decentralisation was enacted after independence through an organic law. Decentralisation was adopted to dismantle the highly centralised administrative system that was left behind by the colonial administration.

Logically, decentralisation would transfer powers from the central government to lower-level governments. In February 1977, Parliament passed the Organic Law on Provincial Governments, which divided powers into provincial, concurrent, and national. Decentralisation in PNG came under a unitary arrangement whereby supreme power would remain with the national government. Since its inception, the provincial government system has not been viewed favourably.

Much of the criticism of the decentralised system came from the national members of Parliament (MPs). This has contributed to a lack of commitment at the national level to radically improving the decentralised system of government. As noted by Gelu and Axline (2008), reform initiatives that were categorised as technical changes were rarely acted upon; instead, the political considerations of national MPs took precedence and thus changed the original vision of decentralisation in the country.

One issue that showed the division between provincial governments and the national government was the decision by Cabinet to allocate sectoral transport Program funds, which would normally have gone from the central government to the provinces, directly to national MPs. The explanation given by the leader of the National Party, Iambakey Okuk, was that these allocations would significantly increase the power and status of national MPs over the provincial governments (Hegarty 1998:342). This practice opened the way to the abuse of government expenditure for blatantly political and personal purposes.

The adoption of the Leadership Code in March 1978 by Prime Minister Somare was a major achievement of the government. In his statement to Parliament, the prime minister said:

For some time now . . . I have been increasingly disturbed by some of the trends I see in our country. I have become convinced that there are dangerous tendencies at work in our society and that if allowed to

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1 The provisions of the Leadership Code are contained in ss.26–31 of the Constitution and in the Organic Law on the Duties and Responsibilities of Leadership. The provisions ‘take the form of (a) extensive requirements that all leaders and constitutional office holders must disclose their assets and income; (b) prohibitions on certain activities by such persons; and (c) procedures which allow the Ombudsman Commission to investigate alleged breaches of the Code and to initiate prosecutions’ (Goldring 1978:189).
continue these tendencies will corrupt our policies, subvert our efforts at national development, and set us on the wrong road (quoted in Hegarty 1998:316).

The tendency that worried the prime minister, according to Hegarty, was that national leaders, both politicians and bureaucrats, were becoming too closely involved with foreign business interests. Leaders were putting themselves in a position where they were bound to be tempted to place personal gain above the national interest. The decision by Somare to introduce the Leadership Code, however, was faced with great opposition.

The Leadership Code and the functions and responsibilities of the Ombudsman Commission were included in the Constitution. This was an indication of the commitment of the government in this period to institute a system of good governance in the political and administration systems. However, this has changed dramatically over the years as a result of increases in infringements of the code by leaders, both political and administrative.

1981–1985: Loss of focus and party infighting

The government of Sir Julius Chan, which came to power in 1980, was still in power when this period began. Peter King (1998:347) noted that ‘the PNG party system has shown great vitality of a kind in the years since independence. The parties, having little ideological distinctiveness, or discipline, or grass roots support, are not very cohesive, even in government.’

By 1981, King (ibid:353) noted:

Apart from the post-independence deterioration of many services being accelerated by economic hard times, the savage program cuts in the budget, the worsening (on the whole) law and order problem, the growing unemployment, the mediocre to bad performance of statutory bodies (Posts and Telegraphs and Harbours were exceptions), and the continuous decline of education standards (an enquiry was opened), there was much else to lament in 1981.

Furthermore, there was decay in infrastructure and a decline in economic performance. Political leadership was another strongly felt problem. Political parties remained weak and failed to develop grassroots support or offer serious policy alternatives. The coalition government that took charge after the vote of no confidence was said to be floundering with inter-party bickering and creating the impression that the government was drifting away from society.

The 1982 election was the only national election held during this period. It was contested by 1125 candidates representing eight significant parties — a marked increase from the 1977 election in the number of parties represented. Some candidates were endorsed by two or even more parties, and party platforms were quite similar in calling for subsistence and rural development, better transport, improvements in health and education, and attracting foreign capital as a means to economic growth.
The Pangu Party outpolled all the other parties, winning 50 of the 108 seats in Parliament. (The polling was postponed in one electorate after the death of a candidate.) This was the only election after independence that saw a party winning more than 30 seats in a single election. The most influential issue in the election was the economy, which worked in favour of Pangu and against the coalition government. Of 103 incumbent candidates, only 50 retained their seats, continuing the pattern of previous elections. Somare was once again elevated to the prime minister’s role.

After the election of 1982, the Ombudsman Commission attacked corruption in government (King 1998). By 1982, Somare was already hinting that it would be his last term as prime minister despite being only forty-seven years old. The issue of Somare’s successor led to a great deal of instability in the government and in the Pangu party.

One of the major developments in this period was the attempt to change the character of the public service. In 1984:

[The] Public Service Minister introduced two bills, the Constitutional Amendments (Public Services Commission) Law 1984 and the Organic Law on the Public Services Commission (Repeal) Law 1984. The basic objectives of these bills were to (a) emasculate the existing Public Services Commission and (b) to increase the government’s political leverage over the public service (Saffu 1998:382).

The implication of this change was important as it threatened the impartial nature of the public service:

The first objective was to be achieved by transferring the executive powers of appointing, promoting, and disciplining and making decisions about terms and conditions in the public service from the [Public Services Commission], leaving it with only an advisory and quasi-judicial function of determining, on request, whether or not established rules have been followed or breached in dealings between authorities and public servants. (ibid.).

This change was made to alter the entire relationship between the political executive and administrative executives as well as the operations of the entire public service machinery. The period after the changes were passed by Parliament led to a massive politicisation of the bureaucracy, especially at the top.

In 1984, infighting within the ranks of the Pangu party led to the opposition working hard to attract various factions to its side and topple the government through another vote of no confidence. Much of the infighting was the result of a ministerial reshuffle, which became a norm for the executive government in PNG. Political instability in the period after independence was a result not only of motions of no confidence, but also of the frequent ministerial reshuffles. One of the main reasons for the infighting was the issue of party leadership.

Despite the adoption of decentralisation, which saw the creation of provinces, the decentralised system became an issue after clear divisions emerged between the
provinces and the national government, and even within the government between ministers on the progress of the system. Some MPs wanted to change the system into four regional governments, a move others opposed. There was success in a few provinces, while the list of problem provinces was long.

By 1983, the decentralised system had come under heavy fire at the national level, especially from national MPs. There was growing animosity among national politicians towards provincial MPs. By the second half of 1984, a number of provincial governments had been suspended for a number of reasons, a main reason being the mismanagement of public funds. A report by the auditor general’s office cited financial mismanagement and lack of accountability, and this was further testimony to the growing indiscipline and lawlessness in the affairs of most provincial governments (Saffu 1998). Votes of no confidence were also prevalent within the provincial governments.

A select parliamentary committee, led by Anthony Siaguru, was set up in August 1984 to review the provincial government system. The evidence collected by the committee on its travels around the country was overwhelmingly unfavourable. However, the Wingti government (which took power in 1985) did not act on its recommendations.

The growing discontent with the provincial government system made it difficult for initiatives to improve the system. Certain reforms were instituted at the national level by technocrats, but the political thinking at that time did not support what was proposed. As a result, many initiatives were overshadowed by threats to do away with the decentralised system altogether.

On the vote of no confidence, Pangu was on the verge of disintegration. The infighting within Pangu resulted in Wingti announcing his resignation from Pangu and the Cabinet; on the same day, a motion of no confidence was made. The vote was defeated; this defeat was a result of the manoeuvrings that usually occur during the tabling of a vote of no confidence. There was no guarantee that a team that has been together for some time would remain intact. These events provide a good example of the sometimes irrational outcome of political events in PNG (ibid.). On 28 March 1985, Wingti formed a new party, the People’s Democratic Movement. Upon assuming the leadership of the opposition, Wingti promised to change the Somare-led coalition.

Wingti’s formation of a new party did not stop the attempts to oust Somare from office. In this period, the parliamentary system was clearly disrupted — parliament and the executive government had little opportunity to pass important legislation and make good policies due to the continuous attempts to topple the government and the continuous movements of parties and individual MPs from one alliance to another. Good governance was lacking. Adjourning Parliament to try to avoid a motion of no confidence became the norm; this continued into the 1990s.

On 21 November 1985, a vote of no confidence succeeded and Somare was removed as prime minister for the second time. Wingti became prime minister, with Chan as his deputy.
1986–1990: The Placer affair and the commission of inquiry into the forestry sector

The late 1980s witnessed numerous instances of infighting between the different ministers of government. This infighting clearly showed the weakness in maintaining control over the affairs of the different ministers and their involvement in the running of their respective departments. Even more troubling, the ministers became heavily involved in pushing their own agendas, such as appointing cronies to the boards of statutory bodies.

State institutions also became targets for ministers to influence, especially if they were in control of finance. One such example was the Agriculture Bank, which became heavily contested by Chan and Okuk. The Fisheries Development Authority also became an issue when Okuk attempted to get his Australian adviser to act as a consultant to it. In all these cases, there was a clear disregard of due process and of the procedures that governed the activities and decisions of the ministers and their control over state agencies and personnel.

Corruption became a major issue in this period. Two cases that weakened the ability of the government to be responsible and accountable were the Placer affair and the Forest Inquiry.

These cases highlighted the depth of corruption that was invading the leadership of the country. They involved individuals using knowledge and position to enrich themselves and their close associates. If everyone implicated had been removed from public office, many political and administrative leaders would have lost their jobs.

Parliament’s decision regarding the Placer affair and its ramifications, and Wingti’s assertion that the Leadership Code was obsolete, triggered a massive student demonstration on 2 December 1986, the same day a vote of no confidence in Chan as deputy prime minister was taken.

The forestry sector has always been marred by illegal practices and bribes, and even today it is still very much affected by perceptions of corruption. In 1987, a commission of inquiry was established to investigate the forestry sector, and uncovered massive fraud and corruption — including numerous instances of abuse of power, conflict of interest, graft, transfer pricing, contravention of customs regulations, contravention of laws prohibiting foreign funding of parties and election campaigns, breach of the Leadership Code, and other issues on the part of Ted Diro, who had been the minister for forests in the previous government.

In defending himself, Diro is quoted as lamenting that:

Graft, foreign funding, illegal operations by his firm and so on were all entered into for the sake of Papua New Guinea … It is common in PNG for politicians to use the returns from business to secure votes. Electoral benefits (votes) through commercial linkages are not self-interest of a sinister kind (quoted in Saffu 1998:443).

2 Diro was first voted into Parliament in the 1982 election as the member for Central Province. Prior to entering politics, he had been the first commander of the Papua New Guinea Defence Force.
Corruption came to be seen as normal in PNG politics and became well entrenched, which only made it more tempting to politicians.

In relation to decentralisation, provincial government affairs were greatly undermined by some unprecedented practices during this period. The provincial government system suffered from infighting within provincial administrations and at different levels of government. Votes of no confidence continued to affect many provincial governments, and provincial elections were marred by violence. By 1990, there were renewed calls to abolish the provincial government system, which led to a parliamentary committee (the Hesingut Committee) being appointed to review the system.

Preparations for the 1987 election saw political parties surfacing in all corners of the country and an increase in the number of candidates running for office.

A practice that emerged during this period, and that persisted into the 1990s, was the free spending of public funds a few months before an election. This practice has to be scrutinised carefully. On one hand, it could be interpreted as legitimate financing of development, but the reality is that the government and political parties are using the money to induce people to vote for them. In 1987 it consisted of the distribution of minor works funds to government MPs to fund projects. The amounts of money have increased over time, and something has to be done to address this practice.3

Voter turnout was high (72.9 percent) in 1987. This high turnout was also seen in earlier and later elections. However, the use of s.141 of the Constitution, which allows anyone to vote at any polling station without being on the electoral roll, greatly inflated the number of actual voters. Violence also became part of the election process and greatly undermined its free and fair conduct.

In the 1987 election, Wingti’s coalition won the right to form government with 55 out of 109 votes. Fr. John Momis, of the Melanesian Alliance Party, branded Wingti’s victory as "not a triumph of democracy but a triumph of money, manipulation, and backroom deals which have subverted the will of the people" (Saffu 1998). The period leading up to the vote was marred with exchanges of cash and promises of ministerial posts and other privileges. A new style of politics was emerging in the country, fuelled very much by the personality of the leadership in place at that time.

The Wingti government immediately put in place processes that would further cement the positions of politicians. The first was the appointment of MPs to boards of statutory bodies, an attempt to get MPs into the provincial assembly which was later defeated, and the creation of deputy ministers, which was also defeated.

April to June 1988 are said to be the most confusing period in the political history of PNG. This was a result of negotiations between Wingti and Somare for a grand coalition, which never eventuated. While Somare saw the grand coalition as a means of strengthening stability and unity, Wingti saw it as strengthening the government and making the opposition weak.

3 The effects of these pre-election increases in expenditure are noted in Chapter 3.
Votes of no confidence were again experienced in this period. After the effectiveness of Somare’s leadership of the Pangu Party began to be questioned, he stepped down as the leader of the party in May 1988, and Rabbie Namaliu was elected the new leader. However, the possibility of a split within the party continued. In June 1988, a vote of no confidence was called for, and in the week preceding the vote, there was a mass exodus from the ruling coalition to the opposition. The motion of no confidence succeeded, and Namaliu became prime minister.

A further motion of no confidence was made in March 1989, naming Wingti as the alternate prime minister. However, the vote was avoided when the government adjourned Parliament until July. This was the third use of the early adjournment ploy, after earlier uses by the Somare government in 1985 and the Wingti government in April 1988. In 1988, the government was criticised for adjourning early. In 1989, popular anger was stronger and was directed, not at the government, but at the opposition. The March issues of the national newspapers (the Post Courier, Niugini Nius, and the Times) made it clear that public opinion overwhelmingly opposed the use of the motion of no confidence by any party. Seven months was not long enough to judge the performance of a government; the people had become rather tired of the MPs’ numbers game (Saffu 1998:477).

Despite the popular outcry from the public against the vote of no confidence, opposition MPs were not impressed. Some argued that:

> Votes of no confidence have nothing to do with the public except the MPs. The power to reason and judge is vested in the MP when he or she is voted into parliament, our actions and decisions must not be directed or influenced by sectional demands, pressures or interests. Politics should be left to the politicians (quoted in Saffu 1998:477).

An event that contributed to the near disintegration of PNG was the Bougainville crisis, which began in November 1988. This came about as a result of the landowners around the Panguna mine demanding an increase in royalties. The crisis started due to the lack of urgency given by the government to the demands of the landowners. The case of the Panguna landowners was the beginning of the awareness of landowners throughout the country about resource development on their land. At the same time, the government also became aware of the need to urgently deal with such situations.

In 1989 and 1990, the Bougainville crisis dominated the politics of PNG. Despite the ongoing conflict, MPs and leaders in Bougainville and in the rest of the country continued their attempts to find a solution to the crisis. One such solution was the granting of greater autonomy for Bougainville, an idea proposed by Fr. John Momis and Joseph Kabui.

In 1989, the government realised that there was a great need to reform the system of government and other constitutional matters. Commentators called for urgent

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4 The crisis also had a significant impact on the nation’s economy, which is discussed in Chapter 3.

5 Kabui was a prominent leader in Bougainville, serving as the provincial premier and then as a commander in the Bougainville Revolutionary Army. In 2004, he became the first elected president of the Autonomous Region of Bougainville. He died in 2008.
constitutional reforms. However, with Parliament paralysed by infighting and political insecurity, many of the important constitutional amendments were not discussed.

Saffu (1998) has attributed this to weakness in the political party system (which allowed MPs to do exactly as they liked), the self-interest of MPs (which was best served by the no-confidence numbers game), and the short sittings of Parliament (four two- or three-week sessions a year, which were sometimes made even shorter by an early adjournment to avoid a no-confidence vote). With such short sessions, the lengthy periods devoted to question time, and the time lost through suspension of sessions (because of lack of quorum, or so that the speaker could restore control over proceedings), important legislation kept piling up on the parliamentary agenda.

The lack of quorum and persistent absenteeism have come to define the nature of Parliament in PNG. MPs do not see the importance of their role to intelligently debate bills and other issues. Even the speaker has taken excessive liberties within his role, gagging debate, especially by the opposition. This has contributed to a weak Parliament in PNG and the dominance of the executive.

In a famous statement on a vote of no confidence, Chan, leader of the People’s Progress Party, said that the opposition could win because Namaliu was presiding over mutinies and coups, not break and enters, a reference to the soldier’s rampage earlier in the month (ibid.:476).

Governance became a real issue in 1990, when various decisions were made that greatly affected the laws and standard of leadership in the country. One such case was the paying of huge amounts of money to four Pangu MPs who were removed as ministers to make way for new coalition partners. The matter was referred to the Ombudsman Commission for investigation. The failure to provide good governance also became a concern for foreign governments and aid donors, who came to see the inability of the bureaucracy and the MPs to effectively implement some of the outstanding aid to the country. For the most part, the blame is usually pointed at the bureaucracy.

1991–1995: Changes to the Organic Law

In 1991, the Bougainville crisis was still going on, and demands were made to conduct a referendum for secession. No referendum was carried out, and the peace process continued to take the time of the government and leaders in Bougainville and PNG.

On 20 May 1991, the Parliamentary Salaries and Remuneration Commission recommended a salary increase for MPs, both national and provincial, and constitutional office holders, and on 22 May Parliament quietly and quickly approved the increase effective 1 July. The Commission was criticised as being dominated by the politicians and thus not impartial or independent.

On 11 July 1991, Parliament rescinded its decision for a pay rise — the first time in the history of PNG that Parliament did this. The opposition, however, was not happy when Wingti argued that Parliament had set a terrible precedent by giving in to pressure:
If we are pressured by the people we should not give in . . . if we make decisions that do not suit the people we represent, they have the democratic right to get rid of us in the ballot box. There is no point for us to panic and shift around when a group of people are unhappy with our decisions. We are so fearful of making hard decisions. I don’t know why we are so scared. (quoted in Saffu 1998:503)

In 1991, several important constitutional amendments were passed. These included Constitutional Amendment No. 14, which addressed motions of no confidence. Passed on 18 July, it increased from six to eighteen months the grace period of immunity from votes of no confidence for an incoming government. The vote of no confidence has been responsible for high instances of corruption and instability in the parliamentary system. Amendments to the Organic Law on National Elections and the Organic Law on the Calling of Meetings of the Parliament passed in the November session, incorporating reforms which had been sought for several years. These included the abolition of the so-called sectional vote, which, by allowing people who were not on the electoral roll to vote upon making a simple declaration that they were eligible to vote, substantially legalised fraud and multiple voting. The shortening of the voting period from three to two weeks, and the period of horse trading between the return of the writ and the first session of Parliament from three weeks to one week, were also intended to contribute enormously to the reduction of burgeoning corruption (Saffu 1998).

A minor constitutional crisis surfaced in September 1991, when Governor General Sir Serei Eri, who was once an executive of the People’s Action Party, refused to dismiss Ted Diro from office after a Leadership Tribunal found him guilty on 81 counts of misconduct. Under the Constitution, the governor general has no independent or reserve powers. He acts strictly on the decisions of appropriate bodies, such as the National Executive Council, the speaker of Parliament, and the Leadership Tribunals. Under s.28(2) of the Constitution, the governor general had no choice but to dismiss Diro, in accordance with the findings of the Tribunal. Decisions of the Leadership Tribunals are not subject even to appeals before the Supreme Court (ibid.). Sir Serei resigned before he could be sacked by the government.

The year 1992 saw the return of Wingti as the prime minister and Chan as his deputy in the national election. This was a coalition government that had seemed to be unworkable in the past, because of open disagreements between members of the coalition. In addition, there was a public perception of distrust of this government’s style of rule, which was associated with disrespect for the rule of law and the processes of governance. After Namaliu was defeated as the prime minister, he resigned his position as the leader of Pangu and Jack Genia took over the leadership. After Genia’s death, Chris Haiveta took over.

In 1994, just before the lapse of the eighteen-month grace period during which he was exempt from a vote of no confidence, Wingti resigned as the prime minister and was re-elected as the prime minister the next day, giving him another eighteen months in office without facing a vote of no confidence. This move was challenged in court, which nullified Wingti’s actions and eventually saw his downfall. Upon the resumption of Parliament, a new government was installed with Chan as prime minister and Haiveta, the leader of Pangu party, as his deputy. One of the key moves
for which the Chan government would be remembered was reform of the Organic Law on Provincial Governments which would significantly change the decentralised system of government.

Reports and reviews of provincial government reform can be generalised into two categories: technical reports from committees comprising public servants and reviews emanating from the political branch of government. The most recent report, the Bi-Partisan Committee Report (National Parliament 1993), was conducted by a committee of national-level politicians, who were backbench MPs from the government and the opposition. Gelu and Axeline (2008:4) suggest that:

The Bi-Partisan Committee Report was different from previous technical proposals for reform because it started from a very different premise. Previous reports took the continued existence of provincial political institutions as given; that is, they assumed that provincial governments were here to stay, and proposed specific changes within that system as a means for improving them.

The Bi-Partisan Committee started with the premise that provincial governments were to be replaced with an institutional structure which was designed to obviate the problems that emanated from the very existence of politicians at the provincial level of government. The recommendations of the Bi-Partisan Committee did not build upon the earlier studies and proposals for reform. They ignored previous recommendations, and often simply did not address the same problems at all.

In 1995, the Organic Law on Provincial Governments and Local-Level Governments replaced the 1976 Organic Law on Provincial Governments as the fundamental legal basis of the decentralised system. The new law followed the lines of the Bi-Partisan Committee Report and preserved the commitment to a decentralised system of government, which could not be easily changed on the basis of short-term political considerations.

**1996–2000: The Sandline crisis and the passing of the OLIPPAC**

Chan’s main concern as the prime minister in this period was to address the crisis in Bougainville. The fighting between the soldiers and the rebels had intensified, increasing casualties on both sides. Chan’s government engaged Sandline International to provide military training and logistical support for the PNG Defence Force, as allegedly stipulated in a Defence white paper (Ivarature 1998). The action by the government was heavily criticised by Bill Skate, the MP for the National Capital District. Skate alleged that the National Executive Council had approved the hiring of Sandline International to carry out a surgical strike against the Bougainville Revolutionary Army.

On 17 March 1997, three months before the national election, Jerry Singirok, commander of the PNG Defence Force, announced on the radio that he had lost confidence in the leadership of the prime minister and that the foreign mercenaries
that had been hired must be stopped from entering Bougainville. A two-day public protest in the main urban areas in the country followed.

The crisis, which is known as the Sandline crisis, became a major issue in this period. It saw the military undermining the authority of the state. Most of the issues relating to the Sandline crisis stem from the failure by leaders to follow rules in engaging the mercenaries. At the same time, the military and the government were perceived not to be doing enough to address hardships faced by the soldiers in Bougainville.

The Sandline crisis dominated the 1997 national election, resulting in the defeat of high-profile politicians including Chan. This election was badly affected by violence and corruption and gave the people of PNG a government that was completely out of touch with practices of good governance. Skate, who managed to manoeuvre between the different factions, put together a team and was elected prime minister. Skate was vocal in his opposition to the use of mercenaries in Bougainville and had led the protest against the government. Despite his strong stand against corruption, he appointed Haiveta, a leading figure in the crisis, who was alleged to have received money from Sandline International, as Deputy Prime Minister. Gelu (2006) describes the Skate regime as one of the worst in the history of PNG. He displayed a leadership style that was out of touch with the political realities in the country. The practice of cronyism became entrenched, and mismanagement and corruption became part of the system of government. On 14 July 1999, Skate resigned and was replaced by Sir Mekere Morauta as prime minister.

Morauta steered the economy back from bankruptcy,6 and his regime would go down in the history of PNG as a reformist government. He displayed a style of leadership that was decisive and forward looking. After witnessing many instances of corruption and mismanagement in the government and its institutions, Morauta instituted a number of important initiatives. As May (2003:159) said, ‘Sir Mekere Morauta announced that one of its main goals would be to restore integrity to our great institutions of state’. His reform initiatives included the following:

- Proposed amendments to the Organic Law on the Duties and Responsibilities of Leaders for a total ban on leaders found guilty of misconduct from holding public office (the ban was eventually reduced to five years).
- Privatisation policy to protect state institutions and statutory bodies from influence by politicians. This policy, together with land reform, became controversial, leading to a massive student protest, which resulted in the death of three students and an outsider.
- Removal of politicians from the affairs of the City Council.
- Changes made to the National Superannuation Act to remove politicians from control over the industry. This took place after revelations of massive fraud and corruption in all superannuation organisations, including the National Provident Fund.
- The proposal for an Organic Law on the Integrity of Political Parties and Candidates (OLIPPAC), which was passed in 2001. This was a major achievement by the Morauta regime. The main objectives of OLIPPAC were to strengthen political parties and to create political stability in the executive government.

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6 This is discussed further in Chapter 3.
2001–2005 and beyond: The introduction of limited preferential voting

Morauta remained prime minister until the national election of 2002, which saw the return of Somare as prime minister.

In 2001, ‘politicians themselves lived up to their notoriety in terms of appropriating funds from the public coffers for personal use. In 2001 the Ombudsman Commission referred ten ministers of parliament to the public prosecutor on charges of misconduct’ (Kavanamur 2002:457). Eight of these ministers were alleged to have misused funds belonging to the National Gaming Board, a state body that became a milking cow for ministers under the Skate regime.

Besides the reform initiatives in 2001, a change to the voting system was also made, in which the limited preferential voting system replaced the first-past-the-post system. Limited preferential voting was intended to ensure that winning candidates had a mandate based on an absolute majority (at least 50 percent plus one). It was to be used in all the by-elections after the 2002 national elections and in the 2007 national elections.

As stated earlier, one of the greatest achievements of the Morauta regime was the OLIPPAC, which was passed in 2001 and became effective after the 2002 election. Mekere unfortunately did not enjoy what he developed; Somare did instead when his party, the National Alliance, was asked by the governor general to form a government as per s.63 of the OLIPPAC.

Although the OLIPPAC promised stability, instability remained the norm within the executive government. Between 2002 and 2005, Somare made five ministerial reshuffles and had four different deputy prime ministers. The speaker of the Parliament also gave his own interpretations of the OLIPPAC, which became a concern especially when he made inconsistent statements. Gelu (2005) says that the failure of the OLIPPAC was evident in the attempt to use s.145 of the Constitution to move a motion of no confidence against the government.

The 2002 election was problematic:

Even before voting began, signs of persistent problems remained. The number of candidates continued to swell, for instance, reaching 2875 — a figure that exceeded 1997’s total by 17 percent. Although the proportion of candidates with no official party affiliation was down from the 1997 level of around 70 percent, it remained a hefty 43 percent. Despite new incentives to encourage the nomination of female candidates, the number of women vying for seats actually fell from 55 to 41, and only one of these actually won a seat. As voting got underway, major problems of electoral administration began to appear. In 1997, there had been deficiencies in the common roll; some voters’ names appeared more than once, there were ghost names, and other citizens who claimed to have registered did not appear on the roll at all (May 2003:157).
Besides the problems stated by May, the 2002 election was marred by intimidation and violence. The failure to declare six seats in the Southern Highlands Province was indicative of the massive problems faced during the election. The 2002 election posed a great danger to the democratic process in the country.

After the 2002 election and after the formation of the government, in which the National Alliance took the lead, there was little effort by the national government to address the problems that surfaced during the election before the next election in 2007.

In 2003, the first by-election using the limited preferential voting system was conducted in Abau. A strong awareness campaign was conducted by the Papua New Guinea Electoral Commission to educate the people on how to mark their preferences and also on the counting process. The new system was used in 10 other by-elections after Abau.

The Somare government immediately went into action, attempting to revive the economy and to put a stop to the privatisation policy initiated by the Morauta regime. The Somare regime in fact was more in favour in maintaining the interests of the state in its various statutory bodies.

A positive approach undertaken by Somare was his announcement that his regime would continue to build on the reforms that were instituted by the Morauta regime, one being public service reforms in the form of merit-based appointments to senior positions and to the boards of statutory bodies.

In 2003 and 2004, a number of reports painted a damaging picture of the performance of the government and the general picture of the economy and the social sector in the country. The reports by the Centre for Independent Studies in Australia lamented that PNG was going down the same road as its Melanesian neighbour the Solomon Islands (Windybank and Manning 2003; Hughes 2003). Windybank and Manning (2003) argued that many of the social indicators in PNG were similar to those of countries in sub-Saharan Africa in terms of population growth, fertility rates, school attendance, and infant and maternal mortality. After this report PNG began to be labelled as a failed, vulnerable, or broken-back state.

The decentralised system of government continued to function; however, it was sometimes ineffective in the delivery of services to the people. The national government continued providing assistance to lower-level governments, but not at a level that was expected to bring about real change. It was evident throughout the country that all the districts and local governments were in a decline in terms of their administrative capacities and even more in terms of their infrastructure. Basic services such as health and education were in decline, and agricultural extension services were not in existence in many districts.

The National Economic and Fiscal Commission carried out a detailed study of the delivery of services and the associated costs and discovered that service delivery was in decline in the majority of districts. It argued strongly that something had to be done to address the cost of service delivery. It called for a change in intergovernmental funding arrangements, which it saw as the main cause of the decline (Badu 2008).
In addition, the Department of Provincial and Local Level Government Affairs, with support from AusAID, instituted a program called the Provincial Performance and Improvement Initiative, targeted towards enhancing the capacity of provincial administrations and districts to deliver services.

3. Conclusions and policy implications

The progress of political development for PNG has been interesting. Just like other developing democracies that emerged after a long period of colonial rule, PNG had to fulfil its duty by being responsive to the needs of its people. The government, soon after achieving self-rule in 1973 did exactly that with an extensive consultation process leading to the adoption of the Constitution and the Eight Point Plan. However, there are still massive problems in the country relating to the legitimacy of the state.

Parliamentary democracy in PNG has been distorted by practices that are parochial and not beneficial to the majority of the people. According to Ghai:

The whole parliamentary system is now lubricated by cash. Candidates unable to count on party organisation or the loyalty of supporters to win elections, rely on monetary or other material incentives to win votes. Reciprocity and ethnic ties have become the basis of politics (Ghai 2001:54).

Elections have featured prominently in the politics of the country and have always been highly anticipated events. Unfortunately, though, many elections have been marred by violence, intimidation, and administrative problems, particularly regarding the electoral roll, which successive governments have failed to address. Although the number of political parties contesting elections increased significantly in post-independence elections, elections have not been won on the basis of party policies but rather on the basis of the personalities of the individual politicians. The establishment of the OLIPPAC after the 2002 election has introduced some stability to the political party system, but further review of it is needed.

The large number and fragmented nature of political parties has also contributed to the instability of PNG’s political leadership since independence. The inability of any single party to form a government has meant that coalition governments have been formed after every election, with the number of coalition parties reaching a high of 22 after the 2002 election.

The party infighting and frequent shifting of MPs between government and opposition has resulted in a preoccupation of MPs with numbers and with maintaining their tenuous hold on political power, sometimes through the exchange of cash and material goods. Votes of no confidence have reduced the average lifespan of PNG governments to just two and a half years, and prevented any government from remaining in office for a full five-year term until 2007. Votes of no confidence have also been common at the provincial level.

Repeated ministerial reshuffles and votes of no confidence have distracted MPs from their main task and affected the ability of governments to concentrate on delivering services to the people. The adjournment of Parliament to avoid votes of no confidence
has been a common practice, which demonstrates how political instability has adversely affected the ability of governments to govern.

Although there have been some important constitutional amendments and periods of reform, one area that seems to have suffered as a result of political infighting is decentralisation and reforms to the system of provincial and lower-level governments. The adoption of a unitary system of government soon after independence and the creation of provincial governments resulted in ongoing hostility between national MPs and their provincial counterparts. Changes to the Organic Law in 1995, which gave national MPs greater leverage over affairs in the provincial and district administrations, have clarified the respective roles to some extent, but greater attention to this policy area is required to improve the system.

Overall, fragile leadership and frequent power plays have greatly undermined the democratic nature of Parliament. The long adjournments to avoid votes of no confidence, the weak parliamentary committee system, dominance of the executive, lack of public debate and scrutiny of bills, and high absenteeism are some of the problems that have faced Parliament in PNG since independence. While short sittings of Parliament, lengthy periods devoted to question time, and time lost through the suspension of sessions, many important legislative debates have been postponed. As one commentator has stated, ‘Parliamentarians in PNG regard themselves more as leaders of their people than as their representatives’ (Dorney 2000:54). This has resulted in MPs overlooking the importance of their role to debate legislation and other issues.

The failure of MPs to see themselves as representatives of the people has also led to numerous examples of MPs acting in their own self-interest. While the Leadership Code has, to some extent, provided an important framework to guide the actions of the nation’s leaders, there have been too many instances in which it has not been enforced. This has weakened PNG’s governance record, and corruption has remained a major issue, rendering the government and its agencies ineffective. It is time for a review and reinforcement of the Code to re-establish a strict code of conduct for leaders.

In the post-independence period, PNG’s public service has been functional, but major improvements are needed to make it more effective in delivering services and responsive to the needs of the people. There are major concerns regarding the terms and conditions of employment of public servants, with constant political interference resulting in a high level of politicisation since 1975. Despite a number of reviews and attempts to reform the public service, successive governments have not been active in instituting changes, and the public service continues to be perceived as ineffective and inefficient.

Looking to the future, it is important that the appointment of public servants continues to be merit based and free from any interference or influence from politicians. Additional improvements to the public service can come from greater transparency regarding policies, activities, and spending of public funds.
References

Badu, N., 2008. Review of the Inter-Government Funding Arrangement, report to the Governor’s Conference by the Chairman of the National Economic and Fiscal Commission (NEFC), Manus, 2 June.


Hughes, H., 2003. 'Aid has Failed the Pacific', *Issue Analysis* 33, Centre for Independent Studies.


Appendix — The system of government in PNG

The structure of government that came into place after independence in 1975 was the Westminster parliamentary system. This was the system that the indigenous leaders were familiar with, and a strong preference for it was evident towards the end of decolonisation (Ghai, 1988).

In the Westminster system, real political power is vested in the executive. According to Heywood (1997:295), ‘a parliamentary system of government is one in which the government governs in and through the assembly or parliament thereby fusing the legislative and executive branches’. The chief features of the parliamentary system in PNG are summarised below.

Democracy

PNG is a democracy, meaning that citizens have a free and equal right to participate in the election of political representatives. Democracy is both a political ideal and a political system. As a political system, it establishes a framework that guides the conduct of citizens, institutions and leaders. In PNG, the ideals of democracy are clearly outlined in the preamble to the Constitution and the ensuing provisions — an important democratic document that clearly spells out what type of society and government the country should have.

Like in many other developing democracies, the democratic system in PNG continues to be affected by more authoritarian traditions and cultural practices. The two conflicting ideals have created a system that is perceived to be undemocratic and unresponsive to the needs of the people. Democracy in PNG has been given different labels, including illiberal (Gelu 2000) and abnormal (Siaguru 2001).

Elections

Elections in PNG are conducted every five years, which is also the term of a Parliament. Since 1975, seven national elections have been conducted — 1977, 1982, 1987, 1992, 1997, 2002 and 2007. There are 89 open seats and 20 provincial seats, which represent the 89 districts and the 20 provinces in the country. The distribution of the open seats varies from province to province depending on the size and population of the province (see Table 2).

In the elections, voters cast two ballots, one for the open seat and the other for the provincial seat. In 1977, the optional preferential voting system that was used prior to independence was replaced with the simple plurality first-past-the-post system. Following the 2002 election, the voting system was changed and limited preferential voting was introduced.
Table 2: Distribution of open and provincial seats

<table>
<thead>
<tr>
<th>Province</th>
<th>Open seats</th>
<th>Names</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bougainville</td>
<td>3</td>
<td>Central Bougainville, North Bougainville, and South Bougainville</td>
</tr>
<tr>
<td>Central</td>
<td>4</td>
<td>Abau, Goilala, Kairuku-Hiri, and Rigo</td>
</tr>
<tr>
<td>Chimbu</td>
<td>6</td>
<td>Chuave, Gunine, Karau-Nomane, Kerowagi, Kundiawa-Gembogl, and Sinasina-Yongumul</td>
</tr>
<tr>
<td>East New Britain</td>
<td>4</td>
<td>Gazelle, Kokopo, Pomio, and Rabaul</td>
</tr>
<tr>
<td>East Sepik</td>
<td>6</td>
<td>Ambunti-Dreikikir, Angoram, Maprik, Wewera-Gawi, and Yangoru-Saussia</td>
</tr>
<tr>
<td>Eastern Highlands</td>
<td>8</td>
<td>Daalo, Goroka, Henganofi, Kainantu, Lufa, Obura Woninara, Okapa, and Unggai-Bena</td>
</tr>
<tr>
<td>Enga</td>
<td>5</td>
<td>Kandep, Kompiam-Ambum, Lagaip-Pogera, Wabag, and Wapenamanda</td>
</tr>
<tr>
<td>Gulf</td>
<td>2</td>
<td>Kerema and Kikori</td>
</tr>
<tr>
<td>Madang</td>
<td>6</td>
<td>Bogia, Madang, Middle Ramu, Rai Coast, Sumkar, and Usino Bundi</td>
</tr>
<tr>
<td>Manus</td>
<td>1</td>
<td>Manus</td>
</tr>
<tr>
<td>Milne Bay</td>
<td>4</td>
<td>Alotau, Esa’ala, Kiriwin-Goodenough, and Samarai-Muruia</td>
</tr>
<tr>
<td>Morobe</td>
<td>9</td>
<td>Bulolo, Finschafften, Huon Gulf, Kabwun, Lec, Markham, Menyamya, Nauwe, and Tewai-Siasi</td>
</tr>
<tr>
<td>National Capital District</td>
<td>3</td>
<td>Moresby Northeast, Moresby Northwest, and Moresby South</td>
</tr>
<tr>
<td>New Ireland</td>
<td>2</td>
<td>Kavieng and Namatanai</td>
</tr>
<tr>
<td>Northern (Oro)</td>
<td>2</td>
<td>Ijivitari and Sohe</td>
</tr>
<tr>
<td>Southern Highlands</td>
<td>8</td>
<td>Ialibu-Pangia, Imbonggu, Kagua-Erave, Komo-Magarima, Koroba-Lake Kopia, Mendi, Nipa-Kutubu, and Tari</td>
</tr>
<tr>
<td>West New Britain</td>
<td>2</td>
<td>Talasea and Kandrian-Clousester</td>
</tr>
<tr>
<td>West Sepik (Sandaun)</td>
<td>4</td>
<td>Aitape-Lumi, Nuku, Telefomin, and Vanimo Green River</td>
</tr>
<tr>
<td>Western</td>
<td>3</td>
<td>Middle Fly, North Fly, and South Fly</td>
</tr>
<tr>
<td>Western Highlands</td>
<td>7</td>
<td>Angalimp-South Wahgi, Baiyer-Mul, Dei, Hagen, Jimi, North Wahgi, and Tambul Nebilyer</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>89</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Parliament**

PNG has a unicameral legislature with a total membership of 109. Sections 100 to 137 of the Constitution outline the powers and nature of the legislature in PNG. There is no separately elected executive. A government is formed from within Parliament with the election of the prime minister from the party securing the majority of seats in the election. For PNG, no one single party has ever been able to win a majority of seats and govern on its own. Every government since 1972 has been a coalition government. The passing of the Organic Law on the Integrity of Political Parties and Candidates in 2001 has provided some predictability and sanity in the formation of governments.

The government is responsible to the Parliament in the sense that it rests on the Parliament’s confidence and can be removed through votes of no confidence. However, the confidence is usually based on the selfish whims of the members of the assembly.
The head of government is the prime minister, who is a parliamentary officer; a separate head of state, the governor general, represents the British monarch. The speaker is elected by the Parliament, and the prime minister selects his Cabinet from the Parliament, usually from the leaders of the party or parties that have majority control, as well as independent members and members of smaller parties and even members of parties that are in the opposition. Sections 149 to 153 of the Constitution deal with the powers of the political executive.

Governments in PNG can be removed from office through a vote of no confidence as stipulated in s.145 of the Constitution. This means of removing the government has been so frequently used that until 2007, no government formed after an election was able to complete its five years in office (see Table 1). The average life span of governments in PNG is two and a half years.

**Levels of government**

PNG has three tiers of government with a unitary system of decentralisation — a national government, nineteen provincial governments, and 303 local governments. The relationship between the three levels of government is clearly expressed in the Organic Law on Provincial Governments and Local-Level Governments as well as ss.187A to 187J of the Constitution. In its unitary nature, ultimate authority resides with the national government.

**Public service**

PNG has a public service that is responsible for implementing government policies. Sections 188 to 225 of the Constitution specify the nature of the public service. The operation of the public service is also regulated by the *Public Services Management Act*. The public service is divided into two categories, departments and statutory bodies. Each department has a minister, who is the political head of the department, and a departmental head, who is the administrative head. Ministers are appointed by the prime minister, while departmental heads are appointed by the Cabinet through a public service process. A minister is also responsible for each statutory body.

The public service has been functional but has been accused of not being responsible in delivering basic services to the people. The public service has undergone major changes since 1975; however, it is still perceived to be ineffective and inefficient. It has also faced constant interference from politicians, resulting in a high level of politicisation since 1975.

**Judiciary**

PNG’s third arm of government, the judiciary, has been the most effective arm and has remained independent and free from undue influence. Sections 154 to 187 of the Constitution define the role and nature of the judiciary. The judiciary has several levels, with the Supreme Court at the top followed by the National Court, District Courts and Village Courts. The Judiciary is headed by a chief justice, followed by a

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7 The National Capital District has a provincial member of parliament but does not have a provincial government.
deputy chief justice and judges. Magistrates are located in all the district courts throughout the country.

Despite the effectiveness of the judiciary, many outstanding cases remain to be resolved in the courts, and many remandees are waiting for their cases to be heard in court, resulting in overcrowding of jails. The Correctional Services institution has faced constant problems, including overcrowding, deterioration in infrastructure, prison escapees, and inhuman living conditions.