# CONTAINING THE CIVIL SERVICE WAGE BILL IN PACIFIC ISLANDS

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## Contents

# Foreword

This is the sixth of the *PFTAC HANDBOOK SERIES* publications. The purpose of this series of handbooks is to build capacity in the public sector for Pacific Island States. While there are some theoretical approaches included in the handbooks, the main intention is to provide *practical, hands-on, contextual* advice for counties at various stages of developing fiscal, monetary and statistical systems.

The 15 Pacific Island members of PFTAC all share certain similarities: small size, large distance from each other and the rest of the world, limited resources and capacity, and reliance to varying degrees on donor aid and/or large remittance inflows. At the same time, the countries have quite different situations in political and economic governance and institutions. Each country faces different challenges to fiscal management, and we hope the following pages provide pragmatic advice in all of those various situations.

Under the general guidance and support of the International Monetary Fund (IMF), the Pacific Financial Technical Assistance Centre (PFTAC) is fortunate to enjoy financial support from the Asian Development Bank (ADB) and the Governments of Australia, Japan, Korea and New Zealand. Most importantly, the PFTAC team has been privileged to work effectively over a number of years with Pacific Island States to achieve measurable improvements in economic management. The experience we have developed through our numerous in-country interactions provides the richest source of lessons for the writing of this handbook. We stand ready as a partner to carry that work and experience forward in the future, and hope that this handbook contributes effectively to that partnership.

We would also like to acknowledge the substantial editorial and production support of Ms. Elenoa Bogiwalu, PFTAC Senior Information Assistant, in the publishing of this handbook.

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# Chapter 1 Preface and introduction

The Pacific Island countries are committed to achieving the Millennium Development Goals set by World Leaders at the United Nations in 2000.[1] Achievement of these goals, in particular the first goal of eradicating poverty, will be dependent on ensuring that foundations for sustainable economic growth are in place. This in turn requires that a measure of macroeconomic stability has been achieved. For small Pacific Island countries, fiscal policies are a key determinant of macroeconomic stability, given that the public sector plays a large role in the economies of these nations.

The purpose of this handbook is to provide policymakers from middle level management to CEO level with information on how to address one of the key components of fiscal policy, namely the share of government spending on civil service wages and salaries. In many of the Pacific Island countries, a significant proportion of government spending is allocated to the wages and salaries of civil servants, to the point where spending on operations and maintenance must be curtailed for prolonged periods. Such actions inevitably hamper the ability of the government to invest more in needed areas of infrastructure and improvements in service delivery. The outcome has generally been disappointing growth rates, lower levels of job creation for a young and rapidly growing population, and limited scope for the government to address effectively unexpected shocks to the economy.

In these circumstances substantial changes in fiscal policy are usually required to achieve growth-oriented adjustment and, as such, form a major contribution to the reform commitments that so many Pacific Island countries have undertaken since the 1990s, particularly with support from bilateral aid donors and international financial institutions. While the focus of the handbook is to provide information on how to undertake specific activities relating to containing salaries, it is also necessary to lay out in the early chapters the foundation for a better understanding of why such activities are necessary. This includes many related

[1] United Nations (2000)

issues, such as good governance and political stability, which are important subjects but which are outside the remit of this study. The handbook can only make references to their importance but leaves it to the reader to follow up these topics as a separate exercise.

The second chapter of the handbook begins by providing a broad introduction to selected Pacific Island economies from a macroeconomic perspective. It reviews recent economic performance and highlights some of the key challenges that the countries as small states have to contend with, including size, remoteness and isolation, susceptibility to natural disasters, limited capacity, dependence on foreign aid and dependence on remittances.

The third chapter discusses in general terms the approaches to fiscal adjustment--namely, the ways governments can use their fiscal stabilization and structural policies to achieve macroeconomic objectives relating to growth, inflation, and the balance of payments. The focus is on the broad issues and practical policy options that need to be considered, rather than on the more technical or theoretical aspects of the literature on fiscal policy. The chapter discusses briefly the use of the financial program framework, as well as the adoption of a medium term expenditure framework, to provide a consolidated overview of options for addressing fiscal imbalances.

The fourth chapter outlines a practical approach to containing civil service wages and salaries by downsizing the civil service. It begins by discussing the reasons for the rapid growth of the civil service. It outlines and discusses administrative practices which contribute directly to high wages and salaries such as: recruitment and personnel policies; multiplicity of agencies and positions, as well as the delineation of functions; wage compression and reduction in real terms; skills shortages in certain fields; and the lack of strategic vision. The handbook outlines the approaches that are available to policymakers to adjust the size of the civil service to achieve a level of spending that should be sustainable in the medium term, while providing appropriate levels of delivery of services and thus contributing to sustainable economic growth. The chapter also discusses the key role of communication and skills development in ensuring the success of civil service reform.

The fifth chapter of the handbook discusses the social context of policy formulation in Pacific economies. Many Pacific economies are small and the social relationships in small communities are complex and should be factored in when fiscal policy measures are designed. The chapter also touches briefly on factors such as political parties and elections as factors to be addressed in designing policies.

The sixth chapter of the handbook reviews the actual experience of some of the Pacific economies, in particular Papua New Guinea, the Marshall Islands and Tonga, which have undertaken civil service reform. The chapter describes the rationale, implementation, costs and financing of civil service reform and impact on service delivery, amongst other issues. It discusses the outcomes of the policy measures and draws some lessons from the experiences of these countries, as well as discussing some guidelines for other Pacific economies facing similar challenges.

The final chapter provides a checklist and templates of activities for the reforms of the civil service. The chapter concludes with references for follow up by the readers, being designed to stand alone but with additional references for further research and assistance, such as web sites and models.

# Chapter 2 Overview of Pacific Island economies

## Introduction

This chapter provides a general introduction to the economies of the Pacific Island countries. It will focus generally, but not exclusively, on the countries which are members of the International Monetary Fund, including Fiji, Kiribati, Republic of the Marshall Islands (RMI), Federated States of Micronesia (FSM), Palau, Papua New Guinea (PNG), Samoa, Solomon Islands (SI), Tonga, and Vanuatu.

- Providing public services

The public sectors of the Pacific island countries face diseconomies of scale in providing public services and in carrying out the business of government administration. Pacific Island countries tend to have relatively large public sectors compared to other developing countries.

As they face the challenges and opportunities of globalization, the Pacific Island countries are also finding they do not have sufficient institutional capacity to participate fully in international finance and trade negotiations although the outcomes of can profoundly affect their economies. A lack of diversification and domestic competition can hold back domestic development.

## Economic Performance

The growth rates of the Pacific island countries have historically been low, at about 2 to 3 per cent per year.[2] Some of the Pacific Island countries have experienced negative growth as a result of political instability. As can be seen from Table 1, growth performance by the selected Pacific Island countries has averaged below 3% during the period 2000 to 2006, with the exception of Samoa which grew, on average, by 4.4%.

[2] AUSAID (2008)

Individual country growth tends to be diverse over time. Over the past year, resource-endowed countries such as Papua New Guinea performed better due to buoyant world prices for commodities. Others are driven by tourism growth such Palau, Samoa, and Vanuatu. The Solomon Islands' growth reflects post-conflict recovery. Some of the other countries show lower growth, including Fiji and Tonga, who have suffered from recent political instability and are estimated to have contracted in 2007.

**Table 1: Macroeconomic Indicators of Selected Countries (Average 2000-2006)**

| | GDP Growth (percent per annum) | CPI (percent per annum) | Central government balances (percent of GDP | Current account balance (percent of GDP) | Wages and salaries as percentage of GDP (Average 2000-2004) |
|---|---|---|---|---|---|
| Fiji | 2.0 | 2.6 | -5.0 | -7.4 | 11.8 |
| Kiribati | 2.4 | 1.4 | -5.2 | -4.2 | … |
| Papua New Guinea | 1.1 | 8.2 | -1.5 | 4.0 | 9.3 |
| Samoa | 4.4 | 4.4 | -1.2 | -3.4 | 13.5 |
| Solomon Islands | 0.1 | 8.0 | -1.2 | -11.7 | 10.1 |
| Tonga | 2.7 | 8.9 | -0.8 | -2.9 | 12.3 |
| Vanuatu | 2.2 | 4.3 | -1.1 | -6.0 | 11.5 |

Sources: IMF WEO database (2008) and Cas and Ota (2008).

While the Pacific Island countries generally enjoyed favorable domestic and external conditions at the time of their independence in the 1970s and 1980s, more recently they have faced an increasing number of macroeconomic hurdles.[3]

They have also experienced increased poverty, heightened governance concerns, lack of private sector activity, lack of regional integration (including of labor markets), and questions about aid effectiveness.

There have been additional concerns about the lack of fiscal discipline and potential political uncertainties. In addition some of the Pacific Island

[3] Browne (2006)

countries face growing health problems, increased environmental threats (including climate change) as well as higher population pressure.

These challenges are formidable obstacles to achieving the goal of faster, sustainable economic growth consistent with the United Nation's Millennium Development Goals.

- Fiscal balances

Many Pacific Island countries face negative fiscal balances. Some countries have succeeded in bringing their fiscal deficits under control, most notably in Papua New Guinea and Solomon Islands, but insufficient public expenditure control, transparency, and accountability remain of concern in many countries. The sizes of the fiscal deficits for some countries are significant, averaging over 5% of GDP during the period 2000 to 2005.

Many of the countries experienced reasonable economic conditions at the beginning of independence in the 1970s and 1980s, inheriting a broadly conservative approach to budgetary management, such as Papua New Guinea. Fiscal policy was aimed at achieving approximate budgetary balance, in recognition that a more expansionary policy would cause balance of payments pressures.[4]

From the early 1990s fiscal pressures began to emerge as many of the Pacific Island countries recorded budget deficits. For example, the Marshall Islands and Micronesia found it difficult to adjust in accordance with the new political agreements with the United States and had limited success in reducing civil service wage bills. Papua New Guinea faced the Bougainville issue and the loss of revenue that resulted in 1989, while Fiji faced political instability following the events of 1987.

[4] See Browne (2006)

- Fiscal balance and the size of the public sector

At the same time, following independence, political pressure grew for the expansion of public employment as a response to both the demand for services after change from colonial administrations, especially for health and education, and to the unemployment caused by stagnation in the agriculture and the private sectors. The changes in the demographics, in particular the rapid population growth and internal migration (as rural dwellers moved to urban areas in search of better services),, also placed increased pressure on the government to respond to these demands.

Several key drivers caused the sizes of the civil service of the Pacific Island countries to be relatively larger than most countries at similar stages of development during the 1990s.[5] Public expenditures made up a large share of gross domestic product. Although the size of civil services was large, they had limited skills; the budget and the regulatory institutions and processes were weak; services levels were declining; and revenues became more difficult to raise.

Furthermore the private sectors in most Pacific Island countries were small or functioned poorly. As a result the government, supported by foreign aid, expanded its activities to include public enterprises engaged in production, marketing, and trading. However, as the government grew, new opportunities for the private sector were not targeted. As a result through lack of alternatives, the government became the default employer of skilled and educated workers.

In many of the Pacific Island countries, the governments are engaged in a wide range of economic activities ranging from utilities, development finance and commercial credit to overseas trading. Government agencies, including state owned enterprises, also operated to market agricultural goods, operate fishing fleets, mines, plantations, timber mills, aviation services, hotels, and in a wide range of quasi-commercial activities.

[5] World Bank (1998)

- Dependence on foreign  aid and the size of the government

Studies show that there is a strong correlation between total government spending and aid flows.[6] The flow of foreign aid to the Pacific Island countries has been significant in recent years. The Pacific Island countries are among the highest recipients of foreign aid on a per capita basis. Aid flows which finance both recurrent and development expenditure contribute to the large size of the civil services.

- Dependence on remittances

Remittances are a key source of foreign exchange income in several Pacific Island countries, particularly Samoa, Tonga, and Fiji. In Tonga, remittance flows have been estimated to reach as high as 40% of gross domestic product.[7] Remittances therefore became an important source of revenue for the government through the taxation of imported goods. This in turn has enabled the government to sustain a relatively large civil service as these economies have a high degree of import penetration.

- External balances

While the Pacific Island countries have largely avoided balance of payments and debt problems, their current account balances in recent years are of magnitudes which require careful management. The Solomon Islands has sustained current account deficits averaging just below 12% of GDP over the period 2000-2006, while Fiji has sustained an average current account deficit of just under 8% of GDP over the same period. Exchange rate policies have been generally appropriate, with basket pegs or dollarization, except for the floating regime in Papua New Guinea.[8] These outcomes compare with the average for emerging and developing economies of a surplus of 1.9% for the same period. The current account deficits are linked to the persistent buildup

[6] Refer to World Bank (1998)
[7] World Bank Development Indicators 2008 (refer to 2002 where estimates are 46.6%)
[8] See Browne (2006)

of fiscal deficits and the tendency of some countries to resort to the domestic banking system for financing.

- Inflation

Inflation in the Pacific Island countries has been relatively high by international standards. For example, of the list of selected countries shown in Table 3, three countries had average inflation at or above 8% during the period 2000 to 2006, in comparison to 6.6% for emerging and developing economies. The high level of inflation is linked to the domestic financing of fiscal balances and the impact of imported inflation.

- Medium term growth prospects

Many of the Pacific Island countries face significant challenges in creating the foundations which will enable the achievement of the type of economic growth to attain the UN's Millennium Development Goals over the stated time period.

A 2008 report states that the success of Pacific Island countries in implementing the MDGs has been less impressive[9], due in part to slow economic growth. The report notes that the estimated average economic growth rate for the Pacific Island countries was about half that of the average for the developing economies of ESCAP. Furthermore, this modest growth had not been translated into improved standards of living for sizeable segments of Pacific Island populations. Population growth has outstripped the capacity to generate employment and many countries look to emigration to provide relief

Samoa has consistently been the most advanced in the level of implementation of its reform process, which had been under way for the past decade, with benefits increasingly evident in higher investment, including foreign direct investment. Fiji was beginning to attract foreign investment in

[9] ESCAP (2008)

the tourism sector after its political difficulties in 2000; however further political difficulties in 2006 have dampened such activity. For the other Pacific Island countries, investment interest was minimal owing to structural factors.[10]

Most of the countries have adopted their own medium-term development strategies, incorporating such measures as promoting fiscal consolidation and lowering public debt burdens, as well as introducing more modern monetary policy frameworks, ensuring sound financial systems, and creating more favorable business climates. At the same time these strategies were often not linked to specific national plans to ensure consistency with medium-term fiscal strategies due in the main to the lack of technical skills and institutional capacity to formulate and implement appropriate economic and financial policies.

Suggested further reading

There are many regular reviews of the performance of Pacific Island countries, such as the *IMF Article IV* reports of countries which are members of the IMF, as well as general reviews in the *Asian Development Outlook* from the Asian Development Bank and the *World Development Report* by the World Bank. The UN ESCAP also publishes an annual survey in its annual report. Browne (2006) provides an important update on the key Pacific Island countries covered by this handbook

## Useful websites:

**Asian Development Bank (ADB) - Fighting Poverty in Asia and the Pacific – www.adb.org**

**IMF -- International Monetary Fund Home Page, www.imf.org and www.pftac.org**

**United Nations Economic and Social Commission for Asia and the Pacific**

**http: www/worldbank.org/**

[10] Refer to World Bank Doing Business 2008 Pacific Islands (2008)

# Chapter 3 Assessing sustainable fiscal outcomes

## Introduction

The economic policy statements of most of the Pacific Island countries support the aim of promoting strong and sustainable economic growth and poverty reduction while maintaining sustainable levels of public debt and balance of payments positions. Since 2000, fiscal policy in the Pacific Island countries has been aligned to meet the Millennium Development Goals (MDGs). The MDGs are accepted as the framework for measuring development progress, and indicators of achievements of these goals are being monitored by the international community. The first goal is to eradicate poverty. The other goals include halving global poverty, achieving universal primary education, reversing the spread of HIV/AIDS, reducing child and maternal mortality, and ensuring environmental sustainability.[11]

## Achieving sustainable economic growth

Research shows that a reasonable level of macroeconomic stability is necessary for sustained growth and poverty reduction. A sound fiscal position is key to achieving macroeconomic stability. Economies cannot flourish in the midst of macroeconomic instability, since wild fluctuations in the price level, the exchange rate, the interest rate, or the tax burden serve as a major deterrent to private investment, the proximate driver of growth.[12]

The eradication of poverty in all its forms requires that the Pacific Island countries should achieve positive rates of economic growth that supports a steady increase in per capita gross national income. Evidence shows that the Pacific Island countries have had a poor record in achieving and maintaining sustainable economic growth in the 1980s and 1990s. A World Bank report notes that Pacific Island countries could only manage an average rate of growth of 2.4% between 1987 and 1997. This is despite having invested an average of 29% of gross

[11] United Nations (2000)
[12] World Bank (2008)

domestic product in their economies during the 1980s.[13] A recent ESCAP report, however, estimates that average growth has increased but it has not resulted in the effective reduction of poverty levels.[14]

The government sector in the Pacific Island economies is the key driver for a large part of economic activity through government spending and resource mobilization. It indirectly influences the way resources are used in the private sector. A World Bank report noted that in many cases, inappropriate fiscal management had been a major factor underlying such problems as high inflation, a large current account deficit, and sluggish or negative output growth.[15]

Loose fiscal policy has also resulted in budget deficits which, when financed by domestic bank credit, have contributed to high inflation and higher interest rates. The private sector investors, as a consequence, made inappropriate investment decisions which resulted in a lowered level of productivity. In addition, if the country had a fixed exchange rate, the budget deficit would put pressure on the level of international reserves, creating further instability in the domestic financial market. The private sector became uncertain about corrective measures which might be taken by the authorities, exacerbating the situation.

Total government spending on wages and salary

Research indicates that small states, including Pacific Island countries, tend to have a higher relative level of public spending than larger ones. In 2004 total spending by small states averaged about 37% of GDP although this masks considerable variation from state to state.[16]

[13] World Bank (1998)
[14] ESCAP (2008)
[15] World Bank (1998)
[16] Cas and Ota (2008)

| | Total Expenditure | Of which: | | | |
|---|---|---|---|---|---|
| | | Capital | Wages & Salaries | Goods & Services | Transfers & Subsidies |
| Fiji | 30.3 | 5.2 | 11.8 | 4.3 | 4.5 |
| FSM | 68.4 | 11.5 | 24.8 | 27.4 | 3.7 |
| Papua New Guinea | 31.9 | 9.7 | 9.3 | 5.3 | 1.8 |
| Samoa | 37.2 | 13.5 | 8.6 | n.a | n.a |
| Solomon Islands | 35.2 | 10.0 | 10.1 | 5.7 | 2.2 |
| Tonga | 28.0 | 1.7 | 12.3 | 8.4 | 2.2 |
| Vanuatu | 2.2 | 4.3 | -1.1 | -6.0 | 11.5 |

Source : Cas and Ota (2008)

Government wages and salaries often make up a large proportion of total government spending in many developing countries, along with transfers and spending on goods and services. Small state spending on civil service salaries averaged 10.7% of GDP over the period 2000-2004, with the Federated States of Micronesia at the high end spending nearly 25%.

As discussed in Chapter 2, many of the Pacific Island countries are very young states. Following independence, many of these governments expanded rapidly in size to reflect the provision of services in areas such as security, justice, and regulation of economic activity, which were no longer provided by the former colonial administrations. However the cost of such services in small states is expensive whenever there are indivisibilities in production.[17] Many Pacific Island countries began to accumulate many of the institutions typical of a large country, including representatives to multilateral organizations, embassies abroad, and central banks. This increased the share of wages out of the total budget. On the other hand, the private sectors in many of these countries were also small or functioned poorly. The situation was exacerbated when the governments took

[17] World Bank (2008)

on the role of the default employer of skilled and educated workers as a result of a small private sector.[18]

The impact of foreign aid on the size of the government budget

The World Bank 1998 report noted that there was a strong correlation between total government expenditure and aid flows.[19] The Pacific Island countries are among the largest recipients of official development assistance on a per capita basis. A significant proportion of aid flows has been in the form of technical assistance to support the provision of the services which would otherwise have been constrained given the low level of skills within the public service of Pacific Island countries. While such technical assistance has often included the training and upskilling of local staff, poor pay has often meant that such skilled staff were difficult to retain. This caused a cycle whereby increasing amounts of foreign aid was used to train local staff who eventually left for higher paid employment, often in the countries which provided the aid in the first place.

Fiscal policy and external sector balance

The Pacific Island countries have open economies with very high import penetration and they are often thinly resource based. In this situation, persistent fiscal imbalances very quickly lead to instability via external sector imbalances.

Where the public sector increased spending, without taxes or other measures to restrain private sector demand, imports tended to grow relative to exports of goods and services, and the current account balance deteriorated. This generally placed downward pressure on the international reserves level, resulting in the risk that there might be inadequate foreign reserves available to meet payments due to overseas entities for imports of goods and services.

Virtually all the Pacific island countries, with the exception of Papua New Guinea, have fixed exchange rates, other than for countries which use a large regional country's currency such as Australia, in the case of Kiribati, Nauru and Tuvalu.

[18] World Bank (1998)
[19] World Bank (1998)

The policy options for addressing fiscal imbalances in the Pacific context

The key to addressing fiscal imbalances lies with addressing the issue of the large proportion of total spending taken up by civil service wages and salaries. The following sections describe interlocking diagnostic processes which should assist the policymaker in determining the most appropriate options to be considered in addressing fiscal imbalances.

- The use of the financial program framework

One of the most widely used tools in assessing the nature of fiscal imbalances is the financial programming framework. The whole process of financial programming is intended to assist policymakers in clarifying their economic objectives, in determining the nature of problems and finalizing the appropriate policy.

There are several types of programs.[20] The first is the passive program where a particular policy has been identified, such as a general salary increase for the public service, and the purpose of the program is to identify the repercussions of that decision. There is the active program, where the authorities, for example, may wish to reduce the balance of payments deficit, and the purpose of the program is to identify the kinds of policies and measures that must be implemented to achieve such an objective. There is also the stabilization program which has a short term focus, such as how to solve an immediate problem, such as a balance of payments difficulty.

The development plan, is geared to achieving certain long-term objectives, such as economic growth or structural changes of the economy, and which involves policies and measures that will not necessarily achieve results in a short period of time. Often the use of the financial program in Pacific Island countries identifies fiscal imbalances as one of the key causes of balance of payments difficulties, and therefore much analysis is carried out on how to contain these fiscal imbalances. A financial program is defined as any

[20] Caiola (1995)

comprehensive set of coordinated policy measures aimed at achieving a set of objectives[21] which may comprise of the following steps:

(1) identifying the problems;
(2) setting targets;
(3) estimating the demand for money;
(4) setting domestic credit ceilings;
(5) setting budget targets;
(6) making projections under existing policies;
(7) assessing the need for adjustment given present objectives;
(8) deciding on the policy package;
(9) making protection under a new policies; and
(10) checking for consistency.

- <u>The medium term expenditure framework (MTEF)</u>

To complement the financial program, the policymaker would benefit from the use of a medium term expenditure framework. According to the World Bank's public expenditure management handbook "the MTEF consists of a top down resource, a bottom up estimation of the current and medium term costs of existing policy and, ultimately, the matching of these costs with available resources… in the context of the annual budget process".[22] The "top down resource envelope" is fundamentally a macroeconomic model that indicates fiscal targets and estimates revenues and expenditures, including government financial obligations and high cost government-wide programs. To complement the macroeconomic model, the sectors engage in "bottom-up" reviews that begin by scrutinizing sector policies and activities (similar to the zero-based budgeting approach), with an eye toward optimizing intra-sectoral allocations[23].

The MTEF is intended to facilitate a number of important outcomes such as an improved macroeconomic balance, including fiscal discipline, to be attained

[21] See for example Bart and Hemphill(2000)
[22] World Bank (1998)
[23] See PFTAC Handbook 1, "Medium Term Framework in Public Finance," ed. Suhas Joshi (Suva: PFTAC, November 2006)

through good estimates of the available resource envelope, which are then used to make budgets that fit squarely within the envelope. It also conveys the capacity of government to maintain aggregate fiscal discipline by prioritizing and reallocating resources to reflect changing strategic priorities.

- Unproductive expenditure

The process of financial programming and the MTEF should assist the policymaker by bringing out the magnitude of unproductive expenditure present in the budget system. Unproductive expenditure has been defined as the difference between the actual government spending on a program and the reduced spending that would yield the same social benefit with maximum cost-effectiveness.[24]

Unproductive expenditures arise due to many factors, including uncertainties, the lack of a well trained civil service, inadequate checks and balances in the political and budgetary process, and corruption. Unproductive expenditures add to the tax burden. This implies a larger deficit or higher taxation compared to the case when spending programs are efficient.

Assessment of unproductive expenditure is therefore important for addressing fiscal imbalance. Failure to carry out proper assessments can result in perverse outcomes. For example, the use of a blanket prescription to reduce expenditures, such as an across the board reduction in public sector wage rates, may not always be appropriate. It is also often unproductive to maintain, for the sake of equity, uncompetitive low public sector wages, particularly for skilled and managerial and professional staff, and inadequate wage differentials across skill groups. Such practices have several outcomes including absenteeism, low morale, corruption or the inability to attract qualified personnel, thus contributing to an inefficient provision of public services.

[24] IMF (1995)

As discussed earlier, many Pacific Island countries have small populations matched by small land areas which are often spread out over a large area of ocean. This makes the provision of public goods a particular challenge, especially for remote communities. The policymaker, by assessing the extent of unproductive expenditure, has to balance service delivery to remote island communities, with capacity constraints with regards to skilled workers, and with expenditure constraints. The policymaker also needs to recognize the impact that the type of national administration has on the role and functions of the civil service. As noted earlier, many of the Pacific Island countries gained independence during the 1970s, and in the process followed the civil service structure handed over by the former colonial administrations. In some instances, the Pacific Island countries extended the civil service structure with the adoption of several layers of government, comprising the central government, provincial government, and local government. These are all financed to a greater or lesser degree from the central budget and have an impact on the overall budget balance. Such decentralized layers present an added challenge that policymakers in a country with a unified civil service structure do not face. At the same time such decentralized structures present a challenge where the pool of skilled workers is constrained, and where there is a tendency for political tension between the centre and the periphery. Such a framework provides a fertile ground for unproductive expenditure to grow.

<u>Civil service rationalization</u>

As the size of the wages and salaries of the civil service is often one of the largest items of spending within the government's annual budget, civil service rationalization has to be given priority by the policymaker to be scrutinized for improved efficiency and cost-effectiveness for achieving fiscal balance in the medium term.

<u>Financial versus economic cost/benefit issues of civil service rationalization</u>

One of the key issues that a policymaker ought to consider, when assessing the option of civil service rationalization is the trade-off between financial and economic benefits of civil service rationalization. Experience in many countries has shown that while the financial benefits can be significant in the short term, the economic cost in the long term can also be substantial, throwing into doubt the outcome of the whole rationalization exercise. This is the case when skilled staffs are lost through retrenchment and new staff must be hired to replace them. Given the issue of adverse selection, the policymaker must carefully consider the option of "no rationalization" vs. wrong rationalization". If the cost exceeds the benefits, then it would be inappropriate to proceed with the rationalization exercise.

The use of benchmarking and the problem of adverse selection

The policymaker must carefully consider the issue of benchmarking. Often civil service rationalizations are carried out over a short time period, and separation packages are often copied from other operations and the formulas are ad hoc. It is important to undertake appropriate benchmarking, using the experience of other countries with a similar economic structure and stage of development. This will provide a useful guide to the policymaker in determining the appropriate level and size of rationalization.

The policymaker must also consider the issue of **adverse selection**. This poses a serious challenge for many Pacific Island countries when workers with much needed skills are made redundant, while low level skilled worker are retained. Often voluntary separation packages are more attractive to productive workers and there is therefore the increased likelihood that these skilled workers will accept separation packages.

The role of the state and the private sector

There is a need to clearly define the role of the state, and by implication, the role of the private sector. As noted earlier, many Pacific Island countries have become the default employer as a consequence of small and weak private sectors. The policymaker needs to review the situation and set out a new framework whereby the role of the state is redefined so that public expenditures are consistent with macroeconomic stability and the level of revenue that the government can raise. A key concept is to match the state's role to its capabilities.[25] Unless this is done in a consistent manner, any attempt by the policymaker to implement civil service rationalization is likely to face considerable obstacles.

It is also necessary to define the role of the private sector to complement the key role of the state. Again, given the size of the private sector in some of the Pacific Island countries, the options facing the policymaker are often limited and not easy.

Suggested further reading

The IMF and the World Bank have published a lot of studies on sustainable economic growth and the role of fiscal policy. The key ones relevant to this study include: Caiola (1995), Bart and Hemphill (2000), World Bank (1998), IMF Fiscal Affairs Department (1995), Sanjeev, et al. (1995). A working paper by Cas and Ota (2008) which reviews the size of government of small states is a recent contribution, as is the report by the Commission on Growth and Development (2008). The World Bank has made several important studies of Pacific Island economies including World Bank (1998) and World Bank (2000).

The following web page provides additional information on the challenges faced by small states:

Projects - Small States – www.web.worldbank.org
Projects - Small States Network for Economic Development – www.web.worldbank.org
http://www.growthcommission.org/

[25] Chhibber (1997)

# Chapter 4 Containing the Civil Service Wage Bill

## Introduction

The policymaker, having determined that the containment of wages and salaries must be the focus of reform, should initiate the process of fiscal adjustment by preparing a comprehensive plan reviewing the factors underpinning the growth of wages and salaries.

## Step I: Plan Preparation

Preparing the comprehensive plan should be carried out with the support of experts in the field of human resources and the public service to undertake the preparations. This should entail:

(1) Drawing up appropriate terms of reference and identifying outputs which will form the foundation for the initial study on the key drivers of the growth of civil service wages and salaries;
(2) The terms of reference should also outline measures which should be considered to correct the sources of unproductive expenditure.

## Step 2: Identifying The Causes of The Level of Civil Service Wages and Salaries

Considerable resources have been committed by aid donors to the reform of the civil services in many countries and these experiences have been documented and analyzed as reference by other countries. Several broad areas have been identified as being common causes across countries and should be addressed in the report to be prepared, and summarized in the matrix: [26]

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| ***Surplus employees*** | Many government agencies in developing countries suffered from surplus employees due to the following factors:<br><br>• high rate of population growth;<br>• low average economic growth rate leading to higher unemployment;<br>• an education system which is inappropriate to the needs of the labor market; |

[26] Shihata (1994)

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| | • political expectation that the state should be the employer of last recourse;<br>• social values that attach a high premium to personal relations and patronage in recruitment and promotion;<br>• in direct response to the demand for services after independence, particularly in health and education, and;<br>• to alleviate the unemployment caused by economic stagnation. |
| ***Government recruitment and other personnel policies*** | Many governments have recruitment practices that are inconsistent with the absorptive capacity of the national economy or to the needs of the civil service.<br><br>Often the education system produces graduates in several specializations and at low academic levels in numbers that far exceed the needs of the national economy. In some countries the government guarantees jobs to recruit graduates sponsored on scholarships. Mandatory service, whereby students who benefit from a state financed scholarship must repay part of their debt through government employment, is another recruitment system that leads to surplus employment, often to the detriment of both the state and the workers.<br>There are often extreme rigidities in the processes and policies relating to the recruitment and promotion of staff including the principle of seniority, as well as excessive legal guarantees and administrative and judicial control. This often results in many ineffective employees attaining and holding onto high level positions from which it is difficult or impossible to remove them. It has also deprived the civil service of youthful leadership. |
| ***Multiplicity of agencies and positions and inadequate delineation of functions*** | There is often a multiplicity of ministries and agencies responsible for a single sector. This results in policy inconsistencies and is compounded by inadequate delineation or overlap of the functions and mandates of the ministries and agencies. |
| ***Wage compression and decline in real wages*** | In the 1990s, civil service salaries in general declined and those of senior officials became compressed relative to the lowest levels. The decline in real wages was caused by high rates of inflation, which led to declining standards of living. |

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| | Many civil servants supplemented their incomes by moonlighting during working hours or collecting financial considerations from the public for performing their normal duties. Petty bribes were perceived as a legitimate gratuity in functions that entailed regular dealings with the public.<br><br>Wage compression, the reduction in the difference between the highest and the lowest salary paid by the government, caused generally by greater increases in lower salaries at the expense of the higher salaries, makes it difficult for the government to attract and to retain high level staff. This outcome has increased significantly, as a result of a combination of factors, including trade union negotiations and strike action, equity concerns, egalitarian socialist policies, and populist political leanings.<br><br>Some governments have also instituted increases in supplementary financial benefits, under such classifications as "incentives" and "duty allowances". Nonfinancial fringe benefits, such as housing, here favored high salaried civil servants who needed these benefits least and represented an inefficient allocation of resources. These supplementary benefits mask the real salaries paid to civil servants, particularly those in senior posts. |
| ***Shortages of employees and skills in certain fields*** | Many countries' civil services, despite their large size and their surplus employment in many areas, often suffered from severe employee shortages in remote locations or in areas that have to deal with substantial numbers of the public, with resulting overcrowding and delays in performance. |
| ***Lack of strategic vision*** | Studies have shown that many countries often lack a strategic vision of the role of the civil service, defined as a clear concept of the bureaucracy as a politically neutral institution with high professional standards and an administrative body assigned specific tasks to serve developmental and social goals. Under such a vision, the civil service would act according to objective principles in several areas including:<br><br>(i) its decision-making process,<br>(ii) its dealing with the public<br>(iii) its internal procedures for recruiting, promoting and terminating staff; and<br>(iv) its governance by an established control and auditing system. |

In many developing countries, the role of the bureaucracy has expanded along with the role of the government. As a result, the role of the civil service has sometimes undermined the development process, and had been marked for the most part by restrictions and complexities as well as significant centralization.

In addition, the political neutrality of the civil service is frequently undermined by ethical conflicts. The principle of avoiding conflicts of interest has not been fostered in the civil services of many developing countries, and some employees engage in activities that are inconsistent with the nature of their work or the requirements of their public functions.

## Step 3: Preparing Action Plan for Containment of Wages and Salaries

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| ***Planning phase*** | The study commissioned in Step (2) above should form the basis for identifying the areas on which to focus corrective measures.<br><br>The study should begin by outlining a framework for developing a strategic vision of the role of the government.<br><br>The strategic and corporate planning exercises are a disciplined effort to produce fundamental decisions and actions that shape and guide what an organization is, what it does, and why it does it; they are essential steps that should be taken before any decisions on the appropriate size and composition of the workforce are attempted.[27] |
| ***Designing A Strategic Vision*** | The study should prepare recommendations and guidelines to the policymaker on how to determine the role of the government in society, and in the economy.<br><br>If a state is committed to economic reform, and to limiting its role in the production process, it must be prepared to assess how it intervenes in the economy.<br><br>This perspective will shape the government's general approach to reforming the civil service. It will determine those functions that the government should assume or retain, those that can be left to the private sector, and those that the private sector will |

[27] United States General Accounting Office (1995).

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| | be assigned to undertake on a contractual basis with the oversight of the appropriate government agency.<br><br>Such a strategic vision should determine the design of a more rational model for the government structure with the Cabinet at the top of the system, including the number of ministries and their mandates.<br><br>Studies suggest that an effective government plays a catalytic role in development, and encourages and compliments the activities of individuals and private businesses.[28]<br><br>In this framework, the role of the state should be based on a two-part strategy:<br><br>(1) Matching the government's role to its capabilities**.** Where government capability is weak, how it intervenes—and where—should be carefully assessed. Governments that try to do too much with too few resources and too little capability often end up doing more harm than good.<br><br>(2) Increasing the government's capability by reinvigorating public institutions. This means designing effective rules and restraints to check arbitrary government actions and combat corruption, subjecting public institutions to greater competition to increase their efficiency, and offering better pay and incentives to civil servants to improve performance. And it means making the government more responsive to people's needs. |
| ***Designing a Strategic Framework for Containment of Wages*** | The design plan must incorporate a strategic framework for the reform program which will incorporate wage containment.[29]<br><br>This framework must identify the different elements of the program, the linkages between them and establish a time frame.<br><br>The design plan must incorporate a comprehensive framework in which short term measures are crafted explicitly to support long-term objectives.<br><br>A long-term strategic perspective should reduce the political |

[28] Chibber (1997)
[29] Shihata (1994)

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| | difficulties resulting from the implementation of certain elements of a reform program, such as downsizing.<br><br>The study should identify shortfalls in strategic and workforce planning because these will hinder downsizing efforts.<br><br>In terms of sequencing, identifying and correcting these shortfalls should take priority. Failure to address this will often incur long term costs, such as where skills imbalances after a downsizing exercise can cause the rehiring of some of the civil servants, or new ones are hired who have to be trained. Factors such as legislation and agreements with employee unions sometimes limit the manner in which downsizing can be carried out.<br><br>On the basis of experience, the strategic framework should exercise caution with across-the-board personnel cuts in order to control costs and increase efficiency and productivity. Such cuts are not sufficiently tied to a larger strategy and often exacerbate the problems, as they do not take into account an organization's structure and workflow. Effective planning must include a strategic review involving analysis of the distribution of staff and resources to determine where to cut and where to consolidate. Strategic approaches based on corporate planning result in downsizing being targeted to specific skills.<br><br>While headcount reductions without changing the work itself can be appealing in terms of speed, visibility, measurability, and demonstrable results, such reductions are often costly, indiscriminate, and inconsistent with accomplishing a continuing productive. |
| ***Engagement of stakeholders*** | Given that civil service processes are based on inherited behavioral patterns, widespread engagement by the policymaker is essential. Studies have shown that successful administrative reform has been characterized by active participation in the reform process by the head of state, followed by Cabinet members and eventually the entire civil service.<br>A successful reform has typically involved the participation of civil servants in working groups that design new systems and oversee their implementation. Commitment by the executive and ownership of the reform program are critical elements in the process of cost containment, particularly for its long-term sustainability. In some situations, the involvement of a foreign |

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| | aid agency or foreign consultants can provide useful legitimacy to specific programs or, inversely, can provide a scapegoat for government-directed criticism.<br><br>The policymaker therefore needs to engage all levels of the government to solicit support for the strategic objectives, as the exercise of cost containment has significant political implications. It is therefore important to obtain the full commitment of the government, including both the legislative and the executive branches. |

## Step 4: Methods for implementing cost containment measures

Following the determination of the government's strategic vision and the role of the government and of the civil service, it is necessary to plan the process of implementation to achieve the goals determined within the strategic framework. The process requires that some activities must be carried out simultaneously.

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| ***Step 4A: Regulatory Review*** | Careful consideration must be given to the enabling environment. A key function of any civil service is to ensure the proper application of the government's laws and regulations. Regulations are often complex and sometimes inconsistent.[30] These conditions must be rectified at the inception of a reform program, or the effectiveness of the reform process will be undermined.<br><br>It is also essential that participation in the process of drafting regulations by the general public also ensures the sound application of those rules. The practice of seeking public comments and submissions on draft regulations is often an effective way of achieving this.[31] |
| ***Step 4B: Upgrading systems and processes*** | At the same time as implementing Step 4A, it is necessary to review and upgrade the management systems in key government agencies. |

[30] See World Bank Doing Business in the Pacific (2008)

[31] In some countries this is done via the internet or by using "road shows" to visit remote regions.

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| | One approach is to establish ground rules and general guidelines and allow the agencies to work out the details. The framework would include the following:[32]<br><br>• A *strategic* planning system at the ministry or agency level that forecasts future requirements over the medium term period, and the consequent job reclassification and specification of inputs, and that avoids a buildup of surplus staff;<br><br>• A *modern data collection and dissemination system* that ensures accuracy and includes rules governing the confidentiality of information. Disclosure of information is an issue with which some developing countries have been overly concerned, and its objectives and dimensions may need to be reviewed;<br><br>• A *decision-making system* that clarifies the process for making decisions in a ministry or agency and ensures that such decisions rely on objective analysis rather than personal preferences;<br><br>• A *financial system for budgeting and expenditure* that includes budget planning and preparation, the control of expenditures, and a procurement and contracting system;<br><br>• An *accounting and* auditing *system* that ensures sound financial auditing;<br><br>• A *human resources management system* that ensures that the required skills will be made available and will be developed continuously by training programs designed to broaden experience and improve efficient performance and by relocation programs; |

[32] Shihata (1994)

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| | • A *control and* oversight *system* that monitors staff performance and provides rewards and sanctions based on performance;<br><br>• A *personnel recruitment and management system* that is effective in recruiting and promoting qualified staff, particularly to high-level positions. This system may differ in the degree of centralization of the personnel function.<br><br>The main objective of the management system is to ensure more productive performance by civil servants. At the same time, another important objective is to guard against rigidity, to avoid the transformation of the civil service into an institution that serves the interests of its employees, thereby constraining the achievement of fiscal balance. |
| ***Step 4C: Set a manpower target by setting criteria***<br><br><br><br><br><br><br><br><br><br>A five pronged approach can be taken to workforce downsizing that considers: | The next activity, to be implemented simultaneously is to set a target in terms of the following:<br><br>1. total staff numbers;<br>2. skill levels;<br>3. seniority;<br>4. value added work;<br>5. performance; and<br>6. span of control (number of employees supervised by one individual).<br><br>1. size;<br>2. skills mix;<br>3. skills distribution;<br>4. costs; and<br>5. organizational capability and culture. |
| ***Step 4D: Implementation of cost containment measures*** | The following main broad steps should be planned:<br><br>1. the freezing of recruitment;<br>2. suspension of automatic salary increases and promotions;<br>3. the elimination of guaranteed entry to the civil |

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| | service from the educational or training system;<br>4. the elimination of 'ghost' or non-existent names and workers on the payroll<br>5. the elimination of officially sanctioned posts which are not currently filled;<br>6. the retrenchment of temporary or seasonal workers;<br>7. the redeployment of existing staff;<br>8. the enforcement of retirement age (or retirement after fixed years of service) stipulations;<br>9. the voluntary, or induced by incentives, retirement of surplus workers; and finally<br>10. the dismissal of compulsory retrenchmetn. |

A number of techniques can be utilized to support the steps outlined above, including:

1. Civil Service Censuses
2. Functional Reviews
3. Payroll Computerization
4. Competency Testing
5. Public Information Campaigns
6. Redeployment Training and Credit Programs
7. Salary Supplements
8. Skills Mobilization—Senior Executive Programs

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| **Civil Service Census**<br><br>***Part A*** | The first step in the civil service census is to determine the number of staff needed for each specialization and function to enable the government ministry concerned to deliver services outlined in the administrative reform strategies and the operational systems determined in Step 4 A and B.<br><br>Normally an interdepartmental committee of senior officials would be responsible for this task supported by external experts. |
| ***Part B*** | The second step is to carry out a survey of the civil service (age, |

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| | qualifications, grade, performance review of the functions performed, and assess comprehensive compensation assessment (including allowances, incentives, and other benefits). |
| ***Part C*** | The third step is to reconcile the numbers and specializations needed with those that exist by first taking steps to reduce the number of employees without resorting to summary dismissal. |
| ***Part D*** | After the reconciliation exercise, the policymaker needs to address the issue of surplus workers with the measures as detailed in Step 4D.<br><br>The measures should be based on the new strategic framework and should be consistent with the review of the regulatory framework, as well as the identification of unproductive expenditure. |
| **Part E**<br><br>***Redeployment*** | <br><br>Redeploying staff to other positions in the ministry can be effective in terms of lifting overall productivity. In this manner, the number of staff who otherwise would have been retrenched is reduced, and the ministry should be able to retain more skilled staff instead of hiring new ones to fill needed positions.<br><br>For example, as part of its civil service reform, a government paid all the costs associated with relocating civil servants and their families. In those instances where the new jobs were at lower salaries, the government paid allowances equal to the difference in salary for 2 years. Civil servants could also receive an equalization allowance, payable in two lump sums, if they chose to take part-time positions. If a geographic move was not required but the new job location resulted in additional public transportation costs for commuting, the government would pay the extra expenses for up to 12 months. If the new job was in the same locality but the civil servant had to commute more than 30 minutes longer one way by public transport, the civil servant could move closer to the new job within 1 year and the government would pay all relocation expenses.<br><br>Where necessary, the government provided training for civil servants who chose to be redeployed to new jobs. Other potential assistance for civil servants who relocated included loans for mortgage financing; reimbursement of realtor and legal fees; bridge loans (to finance a new home until credit had been approved); guaranteed sale of the existing home; and reimbursement, for 1 year, of any additional child care expenses incurred. |

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| | In another case, the government decided that hiring officials had to consider surplus civil servants for retraining or redeployment before new ones could be hired. Any civil servant whose position was deemed to be surplus was to be guaranteed one reasonable offer of another public service position. The government paid for up to 2 years' retraining for its surplus civil servants to prepare them for other positions in the government.[33] |
| ***Attrition and Freezing posts*** | A government could reduce the size of its workforce by not hiring replacements for civil servants who left. At best this would be a short term option. Experience suggests that normal attrition, even with hiring freezes, is often not sufficient to reduce employment levels in a short time frame. While natural attrition rates in some large countries can be quite high, as large numbers of civil servants leave public employment to take up private sector jobs, withdraw from the labor force altogether, or reach retirement age, this is not the case in the Pacific Island countries.<br><br>Relying on attrition to reduce employment levels can also result in skills imbalances in the workforce. It can even be counterproductive. There are examples from the private sector where hiring freezes resulted in the need to hire new staff to acquire needed skills.<br><br>Another approach is to centralize the hiring process. Each hiring decision had to be approved at a high level in the government rather than allowing departments to decide who would be hired. This would only slow the whole process where Cabinet ministers ended up deciding on the hiring of lowly clerical positions.<br><br>While, in principle, the process of attrition can be accelerated by reducing remuneration through the erosion of the real wage rate through negligible or delayed nominal wage increases less than the prevailing inflation rate, it has the drawback of discouraging skilled workers from joining the civil service. It is also unlikely to be successful in encouraging civil servants to join the private sector in small states if the private sector is small and weak and its wage rates lag the civil service rates of wages and salaries.<br><br>Eroding real wages is a mechanism to generate savings and ease inflationary pressure from incomes used by many governments. At the same time nominal wage cuts imposed on existing employees are |

[33] United States General Accounting Office(1995)

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| ***Eroding real wages*** | likely to be politically difficult to sustain, but there are alternative measures to adjust the civil service pay-scale which could achieve sizable wage bill savings. For example, government grading systems typically set base salary compensation according to the qualifications and experience of new recruits, implying some link to work productivity. But this link is dissipated over time when advancement to higher grades depends on seniority rather than performance. Introducing measures that tie promotion to output would create performance incentives, thereby encouraging higher productivity among government workers. |
| ***Voluntary Separations*** | The policymaker faces a range of options with regards to voluntary separation schemes. The following are examples of some of the incentives offered to encourage voluntary separations:<br><br><u>Determining the criteria for voluntary separations</u><br><br>The policymaker needs to have a clear vision of the type of civil servants to whom the voluntary separation package should be offered to. Given that the overall objective is to contain spending on wages and salaries while enhancing productivity, the policy maker needs to design a scheme that will address the issue of unproductive civil servants. The policymaker must decide on criteria on whom to offer to the voluntary separation package. In principle, non performers should be terminated for cause.<br><br><u>Adverse selection issues</u><br><br>As noted earlier adverse selection occurs when highly productive civil servants accept voluntary separation packages resulting in a net decline in average productivity. This can happen, for example, when retrenchment compensation is linked to tenure or salary, and the government has an incentive to lay off more recently hired civil servants whose departure involves a lower unit cost than more senior staff who may be relatively less productive.<br><br>Furthermore, civil servants with the highest alternative earning power and the smallest adjustment costs to finding alternative employment will often choose to be retrenched, resulting in adverse selection. The relatively unproductive civil servants are left behind, causing average productivity to fall, and at a substantial financial cost.<br><br>The problem of adverse selection could be addressed by a targeted scheme in which less productive civil servants reveal themselves by choosing a severance package linked to individual characteristics. One |

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| | such proposal is to create incentives for productive workers to stay, for example by offering a better-paid fixed-term contract to all workers. The intention is that productive workers will choose the new contract, but less productive workers will not, since they risk losing more by giving up tenure. The choice reveals information about effort, identifying workers who should be targeted for layoff. On the other hand, if unproductive workers also choose the fixed-term contract because they fear being laid off, the result would be little change in overall employment, since both desirable and undesirable workers would be retained, but at considerable additional cost to the firm. Alternatively this could be addressed by offering a choice between a fixed-term contract and a severance cash-out option.[34]<br><br><u>Additional benefit of voluntary separation scheme</u><br><br>Voluntary schemes are especially useful for achieving staff reductions in countries where retrenchment is not lawful, or where political constraints preclude any possibility of retrenchment.<br><br><u>Early Retirement</u><br><br>Many governments have offered public sector early retirement programs, although the results have often been mixed due to failure to target specific groups appropriately. Generally, the incentive programs gave civil servants credit for a specified number of years of service and/or a specified number of years added to their age toward retirement eligibility and calculation of benefit amounts. Early retirement age requirements often range from 10 to 15 years younger than regular retirement age requirements. Early retirement service requirements ranged from 10 to 15 years fewer than normal service requirements.<br><br>On the surface, this option can appeal to countries with a young population age structure and that want to make room in the public sector for new labor force entrants. Thus when replacement workers are hired, the only wage bill savings will come from displacing older and thus higher paid workers with young job seekers who enter at the bottom of the pay scale.<br><br>However, this does not take into account the associated costs, both in terms of severance pay and in early access to pension benefits. Retrenching workers eligible for early retirement can actually |

[34] See Rama (1999)

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| | increase the long-term liabilities of the government.<br><br>If the problem of adverse selection is significant as a result of early retirement, the losses of output can be large if new staff must be hired as a result.<br><br>Buyouts or Lump-Sum Payments<br><br>Some countries have offered the option of incentive programs for civil servants to separate voluntarily and receive lump-sum payments. The amount of the payment was usually based on a severance pay formula—such as 1 or 2 weeks' pay for each year of service with a maximum of a year's salary. These lump-sum payments are available to employees electing early retirement, regular retirement, or resignation.<br><br>Paid Tuition<br><br>In some countries, the government pays separating civil servants' tuition for up to 2 years for college or training programs to enhance their skills and help make them marketable for employment elsewhere.<br><br>New Business Start-Up Assistance<br><br>Some countries have sponsored workshops to teach separating civil servants how to start their own businesses. |

Examples of alternative combinations of packages for voluntary separation[35]

In the 1990s, the Australian government offered its Public Service Act employees (about 30 percent of all Australian public servants) a separation incentive of 2 weeks' pay for every year of service, up to a maximum of 48 weeks' pay. Employees who retired immediately received an extra 4 weeks' pay. Employees also had the option of receiving a refund of their contributions to the retirement fund, the interest that had accrued on these contributions, plus a payment equal to 2½ times their contribution. This amount could either be taken as a lump-sum payment or rolled into another retirement fund.

[35] See United States General Accounting Office (1995).

One of the provincial governments in Canada offered early retirement separation incentive programs in 1986, 1988, and 1992. In the 1986 and 1988 programs, civil servants could elect to have the government pay all costs of their health, dental, and life insurance coverage until age 65 or continue to share the costs and receive a payment of 10 percent of their annual wages, up to $5,000. The 1992 program dropped the cash option and life insurance payments and required all retirees to share health and dental insurance costs.

Involuntary retrenchment of surplus employees

Involuntary retrenchment is often a part of the civil service reform exercise in many countries, since it is at the core of the policy of containing wages and salaries. This option has important human dimensions as well as economic and political ramifications which require careful consideration that must be carefully handled. The policymaker must assess the net benefit to be gained by this course of action, not only in terms of productivity but also in terms of political consequences.

This option is usually the last resort. The types of packages offered for involuntary retrenchment are similar in some ways to voluntary retrenchment, but there is no option for continuing employment with the government.

Issues for consideration

There is no such thing as “best practice” or optimal involuntary retrenchment policy.  The policymaker has a range of issues to resolve prior to implementation, including:

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| (1) Total targeted number to be retrenched | In principle, the total number of civil servants to be targeted should be the outcome of the exercise following the civil service census and the reconciliation with a revised civil service structure. |
| (2) Level of compensation | In principle, it is assumed that the retrenched employee should be paid compensation proportional to his or her value. This is the present value of the difference between his or her expected income stream while in public sector employment and his or her expected Income stream in the best alternative employment. The compensation payment should not exceed the present value of the worker's expected salary payments between the date of dismissal and his or her normal retirement date. The goal would be to design a redundancy scheme that minimizes the overcompensation paid to workers with low rents and retains productive workers.<br><br>The policymaker has the option of compensating retrenched civil servants either as a lump sum payment at the moment of separation or as periodic benefit paid over time. The latter approach is most common in some OECD countries and falls under the umbrella scheme of unemployment benefits. Retrenched civil servants receive a monthly or twice-monthly cash transfer providing income support to those laid off and to their dependents.<br><br>The period of benefit payment depends on the government's administrative capacity. This is why many countries opt for one time severance payments. However, this puts a strain on the fiscal balance because the amount involved can be significant.<br><br>In most countries the level of compensation may be specified in existing legislation. Similar to the options for voluntary retrenchment, the practice is to base the amount on a formula related to the seniority and the length of service of the civil servant. |

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| | Lump sum payments can be a source of inflationary pressure if the retrenched civil servants spend their payments on physical capital items. Often in small countries, there are limited options for savings, increasing the likelihood that payments will be spent on unproductive investment leaving the unemployed without revenue. In very small countries, there is also the possibility that such injections of consumer demand might lead to bubble phenomena in the housing or credit markets and eventually to external imbalances. At the same time offering lump-sum payments can help the civil servants and their unions to buy into the government's need to contain wages and salaries. |
| (3) How the retrenchment is to be financed. | There are usually four possible sources to finance retrenchment. While the cost of retrenchment, particularly where it involves only severance pay, in the private sector is financed by the firms themselves, retrenchment in the public sector is financed from either the general budget revenues of by foreign aid loans and grants. |

The policy must design a retrenchment scheme based on parameters specific to the country.

It is generally considered that to achieve the objective of containing wages and increasing productivity, direct government financing would be least distortionary vis-a-´vis the equilibrium cost of labor, since it would avoid raising taxes on firms and workers. On the other hand, fiscal constraints may preclude this option. Furthermore, raising other taxes generates welfare costs, due to the marginal cost of public funds.

The final option is that foreign aid donors make concessional loans available to the government to finance the costs of retrenchment. In this case the repayment stream of the loans (over a long term) is likely to make only a small impact on the overall government budget.

Impact of retrenchment

Where a significant proportion of the civil service is affected without appropriate compensation, it is likely that social and political consequences will occur, particularly where there is no unemployment benefit.

Attempts to provide generous compensation can cause further fiscal imbalances. The consequences of further fiscal imbalances have been discussed in earlier sections. Increasing the level of unemployment within a small country can also lead to higher social tensions, which can spill over into political difficulties for the government.

In addition to these issues, the policymaker should also ensure that the policies are implemented within the confines of existing legislation.

Public perception plays an important role in the success of involuntary retrenchment of redundant employees. The benefits of retrenchment will dissipate quickly unless it takes place within a credible long-term framework. And its political acceptability may depend on the perception that it is being undertaken as part of a large scale reform program.

Dismissal should be based solely on objective criteria, and any subsequent recruitment should be based on real needs. In more general terms, the perception of government employment should be changed so that it is no longer seen merely as a means of income distribution, but as employment in which effective remuneration is given in exchange for essential services.

Unless governments exercise due caution, the constant increase in population and graduates may bring about a resumption of the growth in the number of civil service employees, regardless of needs, leading to increased pressure on the budget and declining performance levels in the civil service. This in turn would undermine public confidence in administrative reform and, at the same time, weaken the government's ability to effect credible economic reform.

Next steps after downsizing

Once the number of employees in a ministry or agency has been reduced, the next step for the policymaker is to improve performance and reduce costs. This requires implementing the functional reviews referred to in the previous section, focusing on the functions assigned to the agency as a whole or to each position.

Furthermore the policymaker ought to focus as well on the upgrading of systems and processes as outlined earlier in the chapter. Also important is putting in place the correct incentives for improved performance. This should include reviewing a new salary scale to address the issues of wage compression and erosion of the real wage rate as well as preventing excessively wide gaps between salaries in the civil service and those in public enterprises and private corporations.

The policymaker should also review the supplementary remuneration (such as "duty allowance") that has lost its original purpose. The policymaker should also assess the need to introduce performance-based criteria into the determination of salary increases and promotions.

Role of communication and skills development

When the government initiates cost containment policies which include the retrenchment of civil servants, it is not unreasonable that civil servants become apprehensive. They become concerned about issues such as:

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| 1. possible job loss; |
| 2. uncertainties about career advancement; |
| 3. relations with new supervisors; |
| 4. revised performance expectations; and |
| 5. other matters that may affect them personally as the government restructures. |

The policymaker should design a communication strategy to ensure that all stakeholders become engaged with the strategic framework. The government must communicate effectively with civil servants as part of the downsizing strategies. It is typical that governments establish programs to help affected employees through counseling, outplacement assistance, and retraining.

Designing a new strategic framework often creates a host of sentiments among the civil servants—both those at risk of losing their jobs and those who are ultimately retained—including anxiety, distrust, self-pity, frustration, bitterness, anger, depression, and guilt. It is important that civil servants are told in a straightforward way what to expect to help lend credibility to the reasons for the downsizing and the actions that are being taken.

The policymaker should develop a strategy that ensures that communication should be delivered quickly and frequently. In developed countries the following approaches are used:

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| 1. information videos; |
| 2. memoranda; |
| 3. electronic messaging; |
| 4. newsletters, |
| 5. telephone hotlines; |
| 6. personal discussions; and |
| 7. tailored messages. |

Face-to-face communications such as managerial briefings and small group meetings are a persuasive approach for disseminating news of organizational restructuring to employees. Face-to-face communication also gives civil servants the opportunity to provide input and to seek clarification. Experiences in some countries suggest that, to get an accurate message to civil servants and dispel rumors, information must be disseminated constantly through multiple media.

For example, in Canada, government officials communicated in various ways during the merger of Canada's Customs and Excise and Taxation agencies into a single department, Revenue Canada.[36] Before the merger, each agency had its own distinct corporate culture and history. During the merger, managers were responsible for informing and involving staff in the restructuring decisions. The Canadian deputy minister personally met with many staff at the headquarters, regional, and field levels, and managers were responsible for keeping employees informed of developments in an open and timely manner. Many forms of communication were used, including memoranda to employees, employee meetings, newsletters, electronic mail updates, special bulletins, and telephone hotlines. Managers also regularly consulted with union leaders.

The New Zealand experience was similar in the sense that the government encouraged effective communications with its employees during the reorganization and reform that began in the late 1980s. Communication guidelines were prepared for senior managers to use during their restructuring. The guidelines encouraged the managers to speak directly to employees about the changes that were taking place and to arrange for constant and consistent information on the reorganization of their departments through a mix of communication approaches such as: telephone hotlines, newsletters, regular visits and progress reports from upper management, information and support networks, staff meetings, discussion groups, and face-to-face meetings with individual employees.

The government ensured that information provided in writing was clear and easy to understand and was to be communicated to the employees before any public announcements were made. The guidelines required that employees be provided information on the following:

[36] United States General Accounting Office (1995) - [USE A CANADIAN CITATION?]

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| • reasons for the restructuring; |
| • objectives of the restructuring; |
| • timetable for decisions and announcements; |
| • locations affected; |
| • numbers of staff affected; |
| • new jobs available; |
| • training available for staff whose skills would become surplus; |
| • options for displaced staff; |
| • relocation assistance, and |
| • support networks for both displaced staff and those who remained. |

Support for retained civil servants

Studies suggest that civil servants who keep their jobs often have anxieties about whether they are next to be terminated.[37] They may have doubts about the organization's loyalty to its employees, and can feel guilty that they are still working while many of their colleagues are losing their jobs.

Losing a job can be a traumatic experience. Not only does job loss disrupt an individual's personal life and social status, but also displaced employees may have real concerns about their abilities to locate other work.[38]

Some governments provide counseling to assist both displaced employees and survivors in dealing with the upheaval associated with downsizing. Often civil servants became very emotional when it comes to losing their jobs, especially those of long tenure or those who expected job security.

Some governments develop programs designed to help displaced civil servants overcome the fears and insecurities that accompany job loss. It incorporates counseling, resume writing, and other workshops in addition to job placement services.

[37] Atwood et al (1995); Peake (1996)
[38] United States General Accounting Office (1995)

In the Canadian government's restructuring, one department issued guidelines to help in the employees' search for new employment in the Canadian public service as well as in the private sector. Each affected employee was also assigned a mentor. Within two days of notifying employees they were being displaced, the department encouraged them to begin one-on-one counseling, take resume writing and other workshops, and obtain job search counseling.

The New Zealand government, for example, gave displaced employees who were not eligible for early retirement the opportunity to be trained for new jobs in the government.

Suggested further reading

There are many resources to choose from, and the most important ones on downsizing which have formed the foundation of this chapter are:

*Shihata (1994) and United States General Accounting Office (1995)*
*The World Bank and other organizations also have several web pages dedicated to civil service reform as follows:*
*Shrinking Smartly which is dedicated to assisting governments in dealing with the problems of downsizing;*
*Research - DOSE: Downsizing Options Simulation Exercise which is an EXCEL based simulation exercise designed to assist policymakers in assessing the consequences of different downsizing strategies;*
*Administrative & Civil Service Reform - Downsizing deals with the issue voluntary retrenchment issues*
*Administrative & Civil Service Reform - Civil Service Censuses focuses on how to carry out an accurate head count of civil servants*
*List of documents on public sector reform from the OECD*
*Public Sector Reform | Centre for Parliamentary Studies lists documentation on civil service reform by country.*

# Chapter 5 Some practical challenges in Pacific economies

## Introduction

The physical and economic structures of the Pacific Island countries have been covered in the earlier chapters. This chapter focuses on the social organization of small societies. The size of many of the Pacific Island countries plays a key role in social organization and on the policy choices that their governments make with regards to macroeconomic stability.

## Social organization

Individuals in small societies play multiple roles. One way of looking at the role-characteristics of small-scale societies is by using the concepts of 'particularism' and 'universalism'. 'Particularism' refers to the relationship of persons to each other in all their particularity or uniqueness.[39] It is considered that this characteristic best describes social relationships in Pacific societies. It underpins the wantok and big-man characteristics in Melanesian countries.

Using this framework, the standards of judgment in the role depend on *who* the person *is* rather than what he does. This contrasts with a model stressing 'universalism', in which the relationship of individuals is based on more or less fixed standards and criteria. In this model an individual treats all others with whom he comes in contact in this role-relationship in terms of universal categories.

The relationship, at least ideally in terms of a model, is affectively neutral. It also has a very limited time span, even though it may be repeated at intervals. The standards of judgment are based on criteria of achievement, *what* a person *does* rather than who he is. It is performance and efficiency, not hereditary qualities, which are relevant.

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[39] Benedict (1967).

It is suggested that universalistic relationships are found in larger societies and that it serves as a foundation for rapid economic development.

These are polar models and it is obvious that both sets of features are characteristic of most role-relationships which could be placed along a continuum. Role-relationships change over the course of time as the same individuals continue to interact in the same roles.

In small societies a strong network of particularistic relationships does not mean social harmony. The affectivity of such roles can be negative as well as positive. Intense factionalisms in small societies are just as fractious in larger groups.

Rapid economic growth, it is suggested, would appear to be most dependent on universalistic role-relationships. The number of alternatives open to a population in the economic field would also seem to relate to these variables. Smaller territories with their economic specialization might therefore be at a disadvantage in developing universalistic criteria.

In a small scale society it is not possible to be anonymous. Choices of values are limited, alternatives are few, and the choice of an individual may have considerable effect throughout the social structure. As the government is often the largest single employer, its decisions can have a very rapid impact on society. Decisions in the economic, political, and legal fields have pervasiveness in small-scale societies which they lack in societies of larger scale. This is again because people are connected to each other in so many different ways in a small-scale society.

Sociological factors also affect the political structure of small states. First, all government activities predominate all sectors of the economy. Thus the government is an active party to nearly every sizeable economic activity, not only officially, but again because of the multi-stranded networks connecting the members of a small-scale society to each other. Furthermore, opportunities for upward mobility are limited and are often easily controlled by those in power again because the social field is smaller. Also, when different factions form they are not only on the basis of political issues, but extend throughout the social fabric. This is further complicated when there are ethnic, religious, and linguistic differences, so that the areas of differences become even wider and more irreconcilable. Whereas, in a large-scale society, political relationships are only partial relationships, they are much more inclusive in a small-scale society. Closely knit family organization, particularistic ties within the community, traditional bonds of clientage or servitude, colour bars, etc. all militate against social mobility whether in the political or the economic sphere. These factors become important in countries such as Papua New Guinea with 820 different languages.

In principle, the basic criteria for the recruitment of staff by the government and the assignment of tasks are the ability to do the required work and a sense of responsibility in performance. Exceptions, when they occur, often mean the difference between success and failure. As a result the particularistic role (based on who an individual is) which dominates in many small societies, both in economic activities and in public life, and which tends to place personal loyalties and obligations to kin and friends above other considerations, is inconsistent with the present standards of accountability. This tends to foster practices of nepotism

Self sufficiency and sustainability

Prior to European contact, small Pacific island countries were considered to be self-sufficient, interdependent communities. Following colonization the monetized sectors of these countries became urbanized areas, dependent on wage-paying jobs to provide their sustenance. Imported foods, materials and consumer goods became "necessities" for the islanders, and they needed paid employment to pay for these items. Traditional values were relegated and supplanted by new values. The Pacific Island countries became dependent upon funds brought in through aid, remittances, and the exploitation of existing natural resources.

Some of the Pacific Island countries are still adjusting to the impact of the former colonial administrations. As discussed earlier, in many cases, they are heavily dependent upon outside funding sources for their continued survival. For example, the Federated States of Micronesia (FSM), which were part of the former Trust Territories of the Pacific Islands, and affiliated with the US through a Compact of Free Association, by 2001, had received a total of US $907 million over the 15-year period of the original Compact[40]. In addition, aid funds in the form of grants and loans have also been received from other countries such as Australia and Japan, and from regional development organizations such as the Asian Development Bank.

Many Pacific island countries are models of the MIRAB form of economies: they survive through migration, remittances from relatives abroad, aid from other countries and development organizations which sustain their overlarge bureaucracies. There is debate over whether, in the long run, these economies can be sustained, as they are overly dependent on outside financial resources, tend to foster an excessively large public sector and have paid little attention to issues of self-sufficiency for the people who remain on the island.

It been suggested that MIRAB economies have sustained themselves for the following reasons.[41]

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| 1. Previous colonial administrations had raised living standards in some of the small Pacific island economies above the level which could be "sustained" on the basis of local subsistence-sector production; |
| 2. The growth of remittances, government budgetary assistance and other similar rent incomes, derived largely from the metropolitan economies, have supported the rapid growth of consumption levels in some of the Pacific Island countries 1945. Commodity export production has not functioned as a leading sector; |
| 3. These economies have not based their development on free market capitalism as a system of production except where it was introduced as a deliberate act of social engineering by policymakers, with subsidies provided to ensure profitability; |
| 4. Given that these economies are driven by rents rather than by income from productive export-oriented activities, the focus of analysis must be not on production constraints |

[40] Federated States of Micronesia, 1995.
[41] Bertram (1986)

| | |
|---|---|
| | but on questions of incentives, rent-seeking behavior by households, and the political economy of aid bargaining; |
| 5. | It therefore follows that for Pacific island countries to sustain current living standards, they must manage the sustainability of existing and future sources of rent income; |
| 6. | Under these circumstances, it is suggested that the key issue for policymakers is not so much the promotion of modern capitalist, tradable-goods-producing sectors within the island economies, but rather the question of how rent incomes should be made more secure and predictable. |

It further implies that attempts to treat the Pacific island countries as autonomous units, separate from the regional economy into which they are inextricably linked, are likely to prove to be misdirected.

Election cycles

Many of the Pacific Island countries, with the exception of Tonga[42], have democratically elected governments. Recent research suggests that elections do have an impact on economic fluctuations.[43] The literature on opportunistic budget cycles argues that electoral pressures force the incumbent party to manipulate economic policy in order to increase the probability of re-election. On the other hand, partisan theory argues that policies are predetermined by ideology. Specifically, left-wing parties are concerned more with unemployment than inflation, the inverse of right-wing parties. As a result, economic fluctuations arise from the policy changes that different parties pursue while in office.

In reviewing the situation in Papua New Guinea, evidence of opportunistic political business cycles was found. In general, the findings were consistent with the predictions of the rational opportunistic political models. The estimation results showed a clear pattern of pre-election manipulation of fiscal instruments by incumbent governments—mainly increased development spending and overall primary expenditure—followed in most cases by a retrenchment in the post-election period. The evidence also showed that credit to government increased in post-election years, as politicians sought some means of financing their election-year extravagance. A broader implication of these findings pointed to the

[42] And recently Fiji since 2006.
[43] Faal (2007).

potential incompatibility between the pressures motivating the political business cycles and ongoing efforts on economic and political reform, including the objective of long term fiscal sustainability. Given the Papua New Guinea study, it may not be unreasonable to assume that similar findings could be found in other Pacific Island countries.

## Fiscal discipline

In view of the apparent impact of social organization in small states, the legacy of colonial policies, and the continuing impact of political activities on macroeconomic management, it is appropriate that a broad ranging policy mix geared towards fiscal discipline, perhaps by means of fiscal responsibility legislation, should be considered by the policymaker.

A recent study suggested that the main reason to have fiscal responsibility legislation was the perception that fiscal discipline had not been maintained voluntarily and that it was necessary to introduce additional legislation in order to guarantee compliance.[44] Many factors could explain the failure to exercise appropriate discretion, including: the short-term horizon of politicians, political and distributive conflicts in budgetary allocation, and time inconsistency in relation to fiscal policy.

The study recognized that procedural and transparency rules might not be sufficient to strengthen fiscal policies; however, they might help by making the budget process more hierarchical.

On the other hand, numerical fiscal rules might help to contain a deficit bias and address problems of time inconsistency, address the expenditure bias, and target pro-cyclical expenditure. The potential disadvantages of numerical rules include the lack of flexibility in fiscal policy and incentives to rely on low-quality measures to meet the targets.

[44] Kumar and Ter-Missanian (2007).

The study further noted that fiscal responsibility legislation by itself was not enough to guarantee fiscal discipline. Other factors such as the existence of sound budget institutions, political consensus for prudent fiscal policy, political commitment to observe the rules, existence of a sound public financial management system, quality of fiscal information, adequate coverage of the budget, and overall transparency of budget execution and reporting were essential elements of fiscal discipline.

Social capital

It would seem that the social norms of small societies would have to be aligned with the requirements for fiscal discipline if civil service reform is to be effective and contribute to sustainable growth in the medium term. There is a view that the development of social capital is an important element to such an alignment.

The concept of social capital has received a lot of attention in the field of social sciences in the last few years, as an important factor in promoting wellbeing, socioeconomic development and better government in societies, both in the developed and in the developing world.[45] Much attention has been focused on the development of social capital in Papua New Guinea. The wantok and "big man" characteristics of Papua New Guinea society have been blamed as the source of the challenges that policymakers face in fostering conditions of macroeconomic stability. Such characteristics promote behavior, for example, which directly undermines the concepts of merit-based appointments in the civil service. It also undermines behavior deemed to be consistent with promoting and sustaining fiscal discipline.

Further research is needed on the concept of social capital, as it appears to offer a basis to understand social behavior in small countries as the platform for designing effective strategies to implement policies to contain civil service wages and promote fiscal stability.

[45] Renzio and Kavanamur(1999).

Notwithstanding that culture and social relationships may be blamed for undermining the effective implementation of downsizing attempts in Pacific Island countries, an increasing body of research has been targeting anti-corruption behavior and the promotion of good governance. This can only be beneficial for the policymaker who is implementing activities to contain the cost of the civil service and promote fiscal stability.

<u>Suggested further reading</u>

The following articles provide further information on the issues of social relationships in small societies and how these need to be factored into designing effective downsizing policies in Pacific Island countries:

*Krishna and Shrader (1999)*
*UNDP (1997)*
*World Bank (1997)*

# Chapter 6 Experiences of containing civil service wages in selected Pacific Island economies

## 1. PAPUA NEW GUINEA

Introduction

The territories of Papua and New Guinea, which had been under Australian administration since 1906 and 1915 respectively, were granted independence as a single nation on 16 September 1975. In 1975 the country had an estimated population of 2.5 million, with the majority of the population being ethnically Melanesians with some mixed Polynesian groups on various smaller islands. Within the Melanesians there is a distinction between the Papuans of the coastal areas of the mainland and islands, and the highlanders of the interior of the mainland. Both these main groups are largely fragmented, especially linguistically, with about 820 distinct languages spoken.

At the time of independence, the economy was dependent on primary production. The general population subsisted on what they produced with food crop agriculture. Poultry and pigs were the main domesticated livestock. Fishing was important in coastal areas. Commercial agricultural production was dominated by tree crops, beginning with the copra plantations.

The structure of the central government did not follow the process of indigenous state formation to be interrupted by colonial rule. The colonial administrations, Germany and Australia—did not take over an existing centralized, bureaucratic structure of government. They had to create a unified state. The colonial administrations' rule took several decades to be established in Papua New Guinea. At the end of the 1940s the civil service numbered about 1,000. By 1975 the civil service had increased to 50,000. It grew a little in the late 1970s, before contracting in the early 1980s.

Prior to 1970 the most significant mining activity was in the Morobe goldfields around Wau and Bulolo. In the late 1960s and early 1970s much larger gold and copper deposits were found at Panguna on Bougainville island, and at Ok Tedi and Porgera in the western highlands of the mainland. In 1972 the Panguna mine was opened by Bougainville Copper Limited (BCL), 51 per cent owned by Con-zinc Rio of Australia (CRA).

It drew localized hostility and came to be associated with an attempt to declare a separate independence for this island in 1975. That attempt lapsed following the commitment of the central government to introduce devolution of some key central government powers and functions to eventually 19 provincial governments, including North Solomons Province.

The result was the establishment of 19 centralized provincial administrations, comprising cabinets, parliaments, secretariats and also with some autonomous revenue powers. This made enormous demands on the country's limited resources of qualified manpower and it was also carried through at the expense of the decentralized district-level administrative system that had been developed by the former colonial administration. This was a significant event which would shape the framework for the civil service ever since.

By 1995 the civil service consisted of about 150 different agencies. The largest of these were the 24 national and 19 provincial departments, but a lot of other agencies also existed, including a Narcotics Bureau, a Rubber Board and a Sheriff.

In 1989, the Panguna mine was highly profitable, employing about 3,000 workers. It contributed over 40 per cent of Papua New Guinea's total exports from 1973 to 1989, and its contribution to central government's total domestic tax receipts peaked at 14.5% in its last full year of operation in 1989[46].

[46] Curtin (2000).

The key issues

In 1989, outbreaks of terrorism on Bougainville island threatened the operations of the mine. The government failed to recognize the effects on the economic situation by assuming that the violence would subside and the mine would re-open shortly. With the indefinite closure of the mine at the beginning of 1990 and the decline in the prices of the country's major exports in the first half of the year, it became apparent that the country faced a crisis.[47]

Prior to 1989 Papua New Guinea had sustained increases in its per capita income for four years. The mine was estimated to have accounted for 35% of total exports, 14.5% of government revenue and 8% of GDP.

The mine closure was accompanied by two other factors which compounded the country's challenges. These were disruption of the North Solomons Island's cocoa industry which yielded 45% to 50% of Papua New Guinea's total cocoa output and a 15% fall in the country's terms of trade caused by large drops in the prices of coffee, cocoa, copra, and palm oil.

The World Bank estimated that in the absence of corrective measures, Papua New Guinea would have faced a 1990 balance of payments deficit in excess 10.5% of GDP. The World Bank convened a meeting of the Consultative Group for Papua New Guinea in Singapore in May 1990 and at this meeting a program was agreed upon.

The program had two main components: the first component was concerned with the attainment of macroeconomic stability in the short term; and the second component was geared towards structural adjustment measures over the medium term.

[47] Cole (1990).

Macroeconomic stabilization

The stabilization measures to attain short term macro economic stability comprised the following:

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| • devaluation of the kina by 10% in January 1990; |
| • reductions in government spending and measures to increase revenue; |
| • wage restraint; |
| • moderation of the growth of credit; and |
| • curbs on public borrowing from foreign commercial sources. |

The government had budgeted spending of K 1,082.3 million for 1990. The government proposed reducing spending by K70.1 million as part of the stabilization program. However it failed to materialize as total spending exceeded the original budget at K1089.1 million. The increase in expenditure was attributed to higher wages and salaries associated with law enforcement agencies and education, as well as higher than expected retrenchment allowances. As a consequence, the budget deficit grew to 3.3% of GDP, much higher than the previous year.

For 1991, the government targeted a budget deficit of 1.8 per cent of GDP. However, after only 6 months, the budget deficit was reforecast at 4% of GDP. In July 1991, the government capped the level of aggregate expenditure at K1,100.1 million and imposed new revenue measures.

The difficulties encountered in achieving targeted budget deficits were attributed to failure to effectively contain the growth of the size of the government bureaucracy and of wages and salaries. Generous retrenchment packages were offered to entice a reasonable number of civil servants to terminate their employment. Although only 1,250 was targeted,  2,500 staff took the generous early retirement packages.

The outcome also led to the issue of adverse selection since some of the early retirees included the more competent employees who subsequently either had to be rehired or to be replaced.[48] The size of the overall civil service basically remained intact due to increases in the number of new recruits in the security and education sectors. The size of total wages and salaries increased because of retrenchment payments. The outcome of the initiative to contain the growth of wages and salaries did not produce the desired result.

The government subsequently began a process of rightsizing[49], which comprised the abolition of some departments, the merger of others as well as the introduction of program budgeting, complemented by departmental reviews.

In 1990, the government also entered into an agreement with the Public Employees Association entailing a scaled discount from the Minimum Wages Board determination. This resulted in real wages falling by 4.4 per cent.

One of the key challenges for the government has been the structure of wages which were relatively high and which was attributed to the influence of the previous colonial administration and the presence of a rather large expatriate workforce.

<u>The outcome of the 1990 stabilization measures</u>

In terms of macroeconomic stability, in 1989, real GDP fell by 1.4%, followed by a further 3.0% decline the following year. In the aftermath of the stabilization program, in 1991, real GDP increased by 9.5%, following a massive upsurge in mining activity[50]. For the years, 1989, 1990 and 1991, inflation rates were 4.5%, 6.9% and 7.0% respectively. On the balance of payments front, the overall balance moved from a deficit of 0.5% in 1989 to a surplus of 1.4% surplus in 1990. This was attributed to mobilization of official capital (the result of a World Bank

[48] Stein (1992).
[49] Refer to Government of Papua New Guinea Budget Policy Statement 2008.
[50] ADB (2007).

structural adjustment loan), and a large inflow of private investment in the oil and mining sectors as well as a large fall in imports. The import decline ensured that the trade balance moved from a negative to a positive amount. In 1991 however, the overall balance moved to a deficit of 2.3% of GDP due mainly to large increases in imported goods and services in connection with the gold mine at Porgera and the oil project at Lake Kutubu.

Although the civil service was expected to bear the main brunt of the austerity measures in 1990, no net reduction of its workforce was accomplished. The mining boom provided some transitory relief in 1990 and 1991, but since no headway was made with containing the share of wages and salaries out of total government spending, the risks for macroeconomic instability remained high. The political environment changed significantly in the 1990s, and together with the size of civil service wages and salaries, Papua New Guinea faced further challenges in its attempts to achieve macroeconomic stability.

A brief overview of attempts to downsize the civil service after 1990

Prior to 1989, the World Bank had provided funding and expert support to assist the Papua New Guinea government to upgrade the civil service. For example, in 1984, as part of a World Bank-assisted public sector reform, a Program Management Unit (PMU) was set up to oversee a restructuring of the public service, and a Resource Management System (RMS) was introduced with a view to creating an integrated planning system to meet the deficiencies identified earlier by the World Bank.[51] In 1986 the *Public Finances Management Act* was amended to provide departmental heads with delegated financial authority, and performance-based accountability systems were developed.

Despite the support by aid donors, the period from 1985 to 1994 was characterized as one of 'creeping crisis in public sector management'. The PMU engaged in earnest objective-writing, timetable-setting and mission-debating to little long term effect. The RMS was not regarded as the guiding force for the

[51] May (2006).

public sector. Various training initiatives, such as the World Bank-funded National Training Policy, launched in 1989, also fell below expectations.

Following the 1990 crisis, the government made several attempts to downsize the civil service, to little avail. In 1992, the government created a Rationalisation Task Force with a mandate to examine ways in which the national departments could be restructured and their management practices improved. A Policy Coordination and Monitoring Committee was duly established.

At the same time the World Bank and other foreign aid donors supported a policy of corporatization, which commencing in 1991. In the period 1995 to 1999 several key events occurred: the parliament passed a new *Organic Law on Provincial Governments and Local-level Governments*, which provided for a National Monitoring Authority to develop minimum service standards and monitor performance; a series of public sector reforms (including improved personnel management and payroll controls and some restructuring of departments and agencies) under World Bank structural adjustment programs were implemented; further efforts were made at public service downsizing, and several institutional strengthening projects were undertaken. In 1999 a World Bank review of public sector performance identified existing personnel management practices as contributing to inefficiency and corruption. By then various official reviews had concluded that the civil service exhibited the following:[52]

- a deterioration in a sense of nationalism within the public service of the 'one nation one public service' concept;
- compartmentalization and fragmentation of departments rather than a sense of belonging to a larger public service;
- envy and rivalry between departments at both provincial and national levels;
- a politicization of the public service to the point that advancement was a political decision rather than a professional one, resulting in an undermining of responsible managers;
- lack of accountability in the financial management of departments so that expenditures were properly allocated and controlled; and
- legislation which created overlapping functions for various departments or agencies.

[52] Larmour (1995).

During the period 1991 to 1999, the overall fiscal balanced showed an average deficit of 2.1% of GDP, peaking at a deficit 5.6% of GDP in 1993. The average inflation rate for the period was 8.9%, with a peak of 17.3% in 1995. The balance of payments was precarious, with the overall balance averaging 0.2% of GDP over the period, but only because the government was forced to abandon its strong kina policy and float the kina in 1994, so that between 1991 and 1999, the value of the kina vis-à-vis the US dollar declined by 65%. The government took appropriate steps to address the challenge of macroeconomic stability but, as in 1990, the size of the civil service remained an impediment.

Towards the later years of the 1990s the government faced a period of deteriorating governance, economic decline, and rising tensions in relations with the World Bank and other donors.[53] This culminated in a vote of no confidence against the Prime Minister, Bill Skate, and in 1999 Sir Mekere Morauta replaced Skate as Prime Minister. Morauta promptly moved to initiate policies designed to achieve reconstruction and development.

After the initial Bougainville crisis, the next major economic shock occurred in 1994. The economy suffered an unprecedented financial crisis: the overall balance of payments position had been deteriorating sharply, the external debt stock rose by substantially between 1989 and 1993, and domestic public debt also increased rapidly, and foreign exchange reserves were being rapidly depleted. The crisis represented the outcome of several years of inappropriate macroeconomic policies. Resource sector revenues were used on large increases in recurrent government expenditure rather than public investment. As a consequence the quality and coverage of essential public services—including primary health care and basic education—deteriorated and public investment in physical infrastructure maintenance and upgrading was inadequate.

Furthermore between 1989 and 1993 the average annual fiscal deficit was 3.5% of GDP, which was financed entirely by the domestic banking system. Given that

[53] See May (2006).

the government and the central bank had a strong kina policy, the outcome was downward pressure on the level of international reserves.

In 1992 a new government took office, and in light of a booming mineral sector, introduced a budget with selective cuts in revenues and increased spending for 1993, while projecting that the fiscal deficit would decline from the level of 5.5% of GDP for the previous year. The 1993 outcome was very different in that revenue was weaker than projected and spending exceeded the budgeted allocations. Commitments by the government to commodity price support schemes also increased outlays by some 2% of GDP.[54] Fiscal conditions worsened in 1994, despite the introduction of a mini budget in March 1994 to introduce new revenue measures and spending cuts.

As the balance of payments position deteriorated, the government introduced a package of emergency measures in July. In August 1994 a new government took office. Further measures were designed to restrain government expenditure by controlling cash payments and prioritization in line with available budgetary funds. Furthermore, central bank financing of the budget was suspended. The measures had the intended effect of reversing the deterioration of the fiscal position and sharply curtailed net credit from the banking system in the second half of the year. The cost, however, came in the form of reductions in investment and outlays for essential services.

The new government also responded to the financial crisis by introducing measures aimed at stabilizing the economy—the kina was devalued in August 1994 and then floated on 10 October 1994.

The government sought financial assistance from the World Bank and International Monetary Fund in support of a broad-ranging economic reform program aimed at sustaining macroeconomic stability and implementing significant structural reforms to the economy.

[54] IMF (1998).

The reform program was presented to Parliament in early March 1995 along with the Budget. The World Bank approved a loan of US$50 million to support the first phase of the government's economic reform program.

An implicit condition of the World Bank's loan was Papua New Guinea's achievement of a satisfactory macroeconomic stabilization program with the International Monetary Fund. The program's performance criteria involved restoring financial stability, restraint of CPI inflation and achieving an increase in gross international reserves.

The IMF approved a stand-by arrangement of SDR 71.5 million in a series of tranches from July 1995 to December 1996. It also brought in loans to Papua New Guinea from the Japanese Exim Bank and Australia (through the Treasury) in support of the stabilization program.

The government continued its efforts to reform the civil service by reducing the overall size of the civil service and wage bill; reallocating functions to provinces and district level to improve service delivery; and reforming budgetary and management systems to improve operational efficiency and managerial autonomy.

In pursuit of these objectives, the government in 1995 announced the proposed reduction of the size of the civil service.[55] The retrenchment program sought to reduce the size of the civil service by 3,000 (5 percent of the total) by end 1996, with significant savings on the total wage bill envisaged over the medium term. At the same time, there would be no immediate savings from the retrenchment program due to substantial up-front costs as a result of generous retrenchment packages. It was envisaged that the savings would be achieved by removing 'ghost workers' from payrolls and removing unfilled vacancies from establishment lists.[56]

[55] See IMF (1998)
[56] Proctor (1996)

As in the earlier attempts at retrenching the civil service, the outcome was below expectations. The projected savings from the retrenchment exercise over the medium term proved elusive. This was caused, amongst other things, by weak centralized hiring controls which offset employment cuts achieved through the retrenchment program. Furthermore, the planned reallocation of workers from the central government to the provincial and local levels did not occur. The outcome was that the containment of wages resulted mostly from a squeeze in real wages, as cost-of-living increases were kept below the inflation rate.

The government's ability to launch new policy initiatives was stymied by its failure to reduce the size of the civil service. Furthermore the share of expenditures that was fixed by contract, law, or agreement increased, thereby squeezing expenditures on essential goods and services. For example, in the 1997 Budget, interest payments, wages, and transfers to provinces and statutory authorities made up 73 percent of recurrent expenditures, up from 66 percent in 1995.

The failures of implementation by the government meant that funding by donors, which was subject to progress with the agreed conditions, ran into difficulties. Despite these difficulties the fiscal balance improved, reaching a surplus of 0.5% of GDP in 1996 and 0.2% in 1997.

The period leading up to 1999 was a very challenging period for Papua New Guinea. In 1997, events were dominated by the Sandline affair which had serious political and constitutional implications and unbudgeted spending of K28 million.[57] In 1998, output was affected by a drought together with the impact of the Asian crisis. Tax revenue from mining and petroleum fell sharply. Additional pressures on the budget were caused by tax cuts intended to counter recessionary trends. In light of the severe decline in revenue, the government brought forward profit transfers from the central bank by negotiating lower interest rates for the government securities managed by the central bank. The

[57] Refer to IMF (1998).

1998 budget was only passed in March, and appropriations for goods and services were severely cut in nominal terms.

The fiscal deficit was 1.8% of GDP. The size of the civil service wages continued to be a major factor in government spending, and often operations and maintenance spending had to be cut to accommodate the payment of wages. Notwithstanding these efforts, the government required substantial borrowing from the central bank, breaching the statutory credit limits. In addition, the government accumulated arrears and other outstanding obligations.

In the first half of 1999, the state of government finances continued to worsen. Despite intense fiscal pressures, the government approved increased transfers to local governments and introduced a costly Rural Development Program, which placed resources at the disposal of parliamentarians. The cash flow difficulties of the government intensified as financing opportunities (from official and commercial sources) became increasingly elusive.

In 1999 the government announced plans to reduce the public service from 60,000 to 52,500, with costs to be met from privatization of public enterprises. However, the proposal was not based on any review of functional requirements and substantially underestimated the costs of the retrenchment, with the result that many ‘retrenched’ personnel remained on the payroll. Furthermore, in view of non performance with regards to the conditions, draw downs were delayed and the government tried to raise funds on the Eurobond market. After lukewarm responses this proposal was suspended, and the government sought to attract aid from Taiwan in exchange for official recognition. This, too, was later suspended.
In early July 1999, the government resigned. A new government quickly introduced a supplementary budget to reverse the intense pressures on the fiscal balance. It comprised new revenue measures as well as suspending the retrenchment program, pending further study. The government also re-opened dialogue with international financial institutions after a period of non cooperation. That year the fiscal balance reached a deficit of 2.4% of GDP.

With the re-opening of talks with the international financial institutions, the government was able to source much needed resources to address the issue of containing wages and salaries of the civil service.

In 2001, the ADB provided a loan of US$70 million to support the government's Public Sector Reform Program (PSP), in particular policy reform measures in four areas: (i) building a performance-oriented public service, (ii) reorienting personnel management systems and processes, (iii) strengthening probity and oversight agencies, and (iv) improving delivery of major services. The PSP focused on improved human resource management; civil service administration; policy changes across the public sector; general management systems at government level; strengthening of the probity and oversight agencies; and improvement of service delivery, particularly for basic services, at the national and provincial levels.

The loan was only half drawn before it was terminated due to inability of the government to act consistently with the conditions of the loan. The ADB review of the project noted that the program loan was to be disbursed in two tranches of $35 million each, the first on loan effectiveness, and the second after seven specific conditions were met. [58] However, in 2003, while legislation was being prepared to amend the Constitution to reinforce the authority of the Public Service Commission (PSC) to select agency and department heads, the acting head of the National Fisheries Authority was selected in contravention of the agreed new procedures. The lack of transparency in this process raised concerns with the ADB and it led to a delay in the Program which closed 2 years late, and before the second tranche could be disbursed.

The government issued *The Medium Term Fiscal Strategy* which included a four-point plan for fiscal sustainability including (i) immediate cuts to discretionary expenditure; (ii) systematic reviews of expenditure programs; (iii) structural improvements in government budget processes; and (iv) fostering an

[58] ADB (2008)

environment for private sector driven growth. The *Medium Term Debt Strategy* aimed to reduce total public debt from 55% of GDP in 2004 to 45% of GDP in 2009; reduce the proportion of foreign currency debt from 59% to 40-45%; lengthen and smooth the maturity profile of domestic debt; and restructure the currency composition of external debt to match foreign exchange reserves and reduce foreign exchange risk.

In 2003 the World Bank, with active participation by the Papua New Guinea Government, ADB and AusAID, carried out a Public Expenditure Review and Rationalization (PERR) analysis. Annual (joint) follow-up missions have been conducted to monitor progress and define priority areas for future emphasis in the Government's reform efforts.

The PERR review in 2003 outlined the issues in stark terms.[59] It reported that, despite the policy intentions announced by the government, between 1999 and 2002, the number of civil servants on the central payroll system increased from 60,074 to 67,233, a growth of 11.9 percent. During the same period, expenditure by national departments on salaries and wages grew by 33 percent, more than 10 percentage points above inflation. Salaries and wages accounted for as much as 30 percent of total expenditure and were pinpointed as the key reasons for the continuing fiscal pressures. The report concluded that public sector employment was larger than the country needed or could afford.

The report focused on the rapid growth in payroll which partly resulted from policy commitments to increase public sector staffing in education and health sectors without any reference to its affordability. This reflected the government's public commitment to minimum standards of health services, and the recruitment of teachers to meet a commitment to universal basic education.

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| (i) the government's commitment to minimum standards of health, and the recruitment of teachers to meet a commitment to universal basic education; |
| (ii) failure to control waste, leakage and malpractices including 2,000 unattached officials doing no work, a large number of 'ghosts' on the payroll, lack of control over growth in |

[59] World Bank (2003).

casual employees (many of whom did no work in return for their pay) and extraordinarily high rates of absenteeism;

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

(i) Getting rid of ghost workers and unentitled payments

Many irregularities existed in the payroll system. For example, inappropriate salary payments were being made to ghost names in real establishment positions and real names in inappropriately senior establishment positions. It was considered appropriate to carry out a proper headcount and physical verification of both general and teacher payroll systems to identify: (a) ghosts in real establishment positions; (b) overpayment of allowances; and (c) casuals who are unproductive.

(ii) Reducing and eventually eliminating the unattached pool of officials

According to the report, a manpower audit conducted in 2002 revealed that there were close to 800 employees on the unattached list for national departments and 1,200 for provincial administrations. Reportedly, in one province there were as many as 150 unattached staff out of a total of 450 employees. A consequence of the frequent restructuring of government agencies was that even when the number of positions was reduced, the process of spilling positions transferred the retrenched employees onto the unattached list (where they continued to be paid) and to hiring of new employees in the resultant vacancies who also had to be paid. Restructuring in this manner actually increased the total payroll costs. The report proposed that the government should formulate a policy for centrally managing unattached staff and negotiating with the public sector unions a revised scheme of payment to ease the government's cashflow while seeking to adjust the retrenchment packages to be more affordable.

(iii) Linking pay increases to affordability

The report recommended that future pay increases should be linked to both affordability and public sector productivity.

(iv) Enforcing budgetary control over payroll

The report noted that some government departments detached existing staff, recruited new staff, and then awarded higher duty and overtime allowances without any accountability for exceeding the budget ceiling or threat of sanctions.

(v) Preparation of realistic budget votes by Treasury

Budgetary appropriation for salaries of spending agencies had turned into a formal exercise which was undermined by the use of poor quality data. The report recommended that Treasury ought to prepare realistic budget votes setting hard but realistic budget constraints on the spending agencies.

Several factors were clearly reflected, including:

Subsequent internal reviews revealed that about 30 percent of the employees were paid remuneration higher than their entitlement, a proportion that increased to as high as 60 percent in some agencies. Sick leave forms for teachers had not been processed for several years, encouraging absenteeism. Informal estimate suggested that 10-15 percent of teachers' pay were for services which had not been delivered. In effect the public sector payroll had largely drifted outside the framework of budget control.

The report proposed five key areas for urgent action in the 2004 budget, including:

It was estimated that the effective implementation of the recommended steps could save up to K80 million through the elimination of waste and leakage rather than reduction in productive labour inputs or service delivery.

In 2004 the government set out its medium term development strategy (MTDS) for 2005-2010. The strategy focused on specific targets and commitments including: (i) agriculture, forestry, fisheries and tourism, with the support by mining, petroleum, gas and manufacturing, to achieve growth of 5 per cent annually in real terms towards the end of the period 2005-2010; (ii) in the MTDS, the government would seek to increase the level of expenditure on priority areas by redirecting funds from lower priority activities, and by improving the cost-effectiveness of service delivery across all levels of government; and
(iii) macroeconomic stability as a key requirement for achieving its overarching goals.

Over the medium term, the strategy statement conceded that the level of resources available to the Government was forecast to decline marginally in nominal terms. Therefore, it could only increase funding to the MTDS priorities by identifying savings from non-priority activities and by achieving cost-efficiencies across the board. The statement identified two vehicles for achieving these savings: (1) the Government's Public Sector Reform program, and (2) the Public Expenditure Review and Rationalisation (PERR) program.

The statement highlighted that the Government's Public Sector Reform program would play an integral role in the implementation of the MTDS by ensuring that the administrative structure of government conformed to the development priorities. It would reduce the cost of government, abolish waste and non-priority activities, improve service delivery and strengthen accountability and other systems of good governance.

As a component of the Public Sector Reform program, the PERR would be a key vehicle for generating the savings and cost efficiencies that will be necessary for increased funding to the MTDS priorities. The PERR would be focused on the three broadly defined themes of fiscal sustainability: expenditure adjustment and prioritization; civil service size and payroll reform; and restoring the integrity of budget institutions and systems.

The MTDS also helped to strengthen government's public expenditure management (PEM) system. Effective PEM encompassed fiscal discipline, the prioritization of resources, and the cost-effective implementation of programs and projects.

The 2008 budget policy statement[60] emphasized that one of the pillars in the Government's growth strategy was an efficient, effective and affordable public sector. It noted that poor service delivery by the public sector was an impediment to business and the welfare of the public, and that agencies needed to be

[60] Government of Papua New Guinea (2008)

administered more efficiently and use resources for the delivery of services to the public.

The statement continued that the government's approach to public sector reform included reviewing the resourcing of agencies to ensure they had enough funding for priority functions, but focused less on non-priority areas.

The statement stated that the principles in the 2005 Rightsizing Report had been accepted by the government, which remained committed to improving financial management and efficiency in public sector institutions.

This reaffirmation of commitment to rightsizing the civil service in order to achieve macroeconomic stability was matched by ongoing work on public sector reform driven by the *Public Sector Management Reform Unit* (PSRMU), a small, high level unit established in 2000 to drive and support the public sector reform process.

The government had put in place a merit-based appointments system for departmental heads, provincial administrators and heads of statutory authorities. It also endorsed a 10-15 year framework for public sector workforce development, with action plans addressing both the supply and demand issues affecting workforce development.

A program of *functional expenditure reviews* (FER) had been completed in at least 17 agencies, providing a platform for internal organizational reforms aimed at reducing expenditure and improving services. The FER process was directly supported by a *Services Improvement Program* (SIP), introduced in 2000 to provide national and provincial government agencies with the skills needed to evaluate their practices and procedures.

The public sector reform work being carried out should be viewed as work in progress. Despite the many past failures in attempted reforms, there was a view of guarded optimism of continued progress. The economy has made steady progress in recent years, with GDP growth averaging 3% per annum in 2002 to 2006. The challenges, however, for containing civil service wages and contributing to macroeconomic stability should not be underestimated.

## 2. THE REPUBLIC OF MARSHALL ISLANDS (RMI)

In July 1987 the United States formally terminated the forty year's trusteeship of the Marshall Islands and the Republic (RMI) entered a 15-year Compact of Free Association with its former trustee. Under the Compact, the Marshalls would face gradual reductions in external grants from the US government. In 1990 the Marshalls joined the ADB.

In 1995 the government clearly faced serious financial challenges. The key challenge was for the government to transition from a heavily aid-dependent, public sector dominated economy to one less dependent on external grants under the Compact with the United States. Grant reductions were to occur in 1992 and 1997. In the period FY 1991-1995, US grants accounted for an average 71 percent of total government revenue and 59 percent of total expenditure. The budget deficit averaged average 16.6% of GDP between 1991 and 1995.

During this period, capital expenditure increased, high levels of subsidies to public enterprises (especially Air Marshall Islands) remained, and the public sector payroll grew. The number of public sector employees increased by 53 percent between 1991 and 1995 - from 2,671 to 4,086. By the end of September 1995, with government's financial reserves had declined to $3 million (from $47 million in 1991) and external debt stood at $141 million (134 percent of GDP).

In December 1996 the ADB approved a Public Sector Reform Program (PSRP) loan for $12 million to the Republic of the Marshall Islands to be released in three tranches.[61] A key element of PSRP was the reform and downsizing of the civil service. The civil service reform program was a joint effort between the

[61] ADB (1998)

Government, ADB and UNDP. The main aim of the program was to create a civil service that was more affordable than the existing service, and focused on three elements as follows:

(i) to reduce costs where possible, and on an ongoing basis;
(ii) to produce a simple, rational, and easily understood system; and
(iii) to produce a structure geared toward achieving the government's objectives, both economic and social.

A joint government/UNDP review had recommended:

(i) the reduction of the number of civil servants to 1,480 ( equivalent to 30 percent in the number of civil servants);
(ii) reduction of the number of ministries from ten to six; and
(iii) the reorganization of various administrative functions.

The government also opted for a severance payment scheme which consisted of two major parts, a retrenchment package and a training programme. The retrenchment package comprised a lump-sum payment, equivalent to three to nine months of salary, depending on the length of service; and a monthly maintenance benefit to be paid over a period of three years as a form of social safety net. Former civil servants who found new employment within this period would lose their benefit entitlement.

The training and counseling services was also supplemented by a UNDP-funded program for small business training.

On the basis of salaries paid in the civil service (which ranged from $4,000 to $10,000 per year and averaged $7,000) and average length of service, it was estimated that an average of four months of salary would be paid as lump-sum, at a total cost of $1.75 million. The maintenance benefit would be paid out on the basis of the benefit rules then in place for the Marshall Islands Social Security administration (MISSA). This amounted to an average payment of $175-$245 per month per person and at a total cost of around $1 million per year. The exercise (including training and counseling) was estimated to cost $3 million in the first year and $1 million in each of the two subsequent years.

The retrenchment exercise was not without its difficulties. The key challenge was the absence of reliable data on the actual size of the civil service, as the Public Service Commission (PSC) records were not up to date or accurate. For example, there was the case of ghost workers, with employees who had left the service but who were still on PSC's books as active.

The government concluded that the most constructive approach to assist retrenched civil servants (who were likely to face difficulties in finding re-employment in the private sector) was by way of making reasonable severance payments to the employees affected. The payment of the monthly maintenance benefit, which was to be administered by MISSA, would be through normal channels, i.e., the commercial banks in Majuro. At the same time it was considered that it might encourage people to remain in Majuro, instead of returning to their home island.

In terms of implementation, the first tranche of the loan was disbursed on signing to reflect the fact that some of the conditions in the loan policy matrix had been implemented. The second tranche conditions included the key actions to reduce government’s recurrent expenditure, including downsizing the public service, cessation of subsidies to Air Marshall Islands, and the continuation of the three-year wage freeze. Three risks were identified as potentially preventing successful implementation and effectiveness of the reform program:

- (i) insufficient capacity in government;
- (ii) a loss of government commitment to the pace of reform as opposition grew with the retrenchment of public servants; and
- (iii) a failure of the private sector to respond to reforms as expected.

The government acted to forestall the impact of these risk factors as follows:

(i) The first risk was to be minimized through the use of a Program Coordinator who was to be assigned to the government's Rationalization Committee.
(ii) The second risk was to be reduced through a 1997 public information campaign, and through the provision of a safety net for retrenched public servants.
(iii) With regard to the third risk, expert advisors were to design strategies expected to improve the policy environment in the fisheries and tourism sectors.

The disbursement of the second tranche was delayed because the key reform conditions were not met. Specifically, the government failed to downsize the civil service. The ADB and the government subsequently agreed on a revised timetable for implementation of the conditions, which provided that the downsizing would take place in 1999.

Eventually, with much difficulty and delay, the government reduced the number of civil servants from 1,800 in 1997 to fewer than 1,500 by mid-2000, compared to the target number of 1,484 employees. The annual payroll expenditures was reduced from $16.4 million in 1997 to $15.4 million in 2000. Expenditures were also reigned in by combining the Ministry of Public Works with the Ministry of Resources and Development, abolishing the Ministry of Social Services, imposing Government-wide wage and hiring freezes, cutting ministerial operating expenditures, and reducing subsidies to several state-owned enterprises.

In terms of budget balance, the government succeeded in reversing the growing fiscal deficits; between 1996 and 2000 the budget balance was positive, averaging 11.3% of GDP during that period. External debt was slowly brought towards more sustainable levels, declining from 122% of GDP in 1996, to 63.8% by 2000. Real GDP growth, after contracting by 12.3% in 1996 began to turn around and by 2000 it grew by 5.6% after 4 years of negative growth. Inflation during the reform period declined from 9.6% in 1996 to 1.6% in 2000. The overall balance of payments also stabilized. After a deficit of 18.9% of GDP in 1996, by 2000, the overall balance had improved to 4.3% of GDP.

However, the apparent gains from containing wages and salaries were soon reversed after 2000. A review of the Marshall Islands economy[62] noted that:

(i) Public sector reforms initiated in the late 1990s were unraveling, but the costs of undertaking them remained,
(ii) The poor productivity of public services exacerbated poverty, as the poor depended on them most, and
(iii) Reforms had to be reinstated to improve governance and reduce poverty.

The report stated that in terms of formal employment, the public sector, (including the national Government, Government agencies, public enterprises, and local governments) since 2000 had grown by 16.5%, from 3,258 to 3,795 employees. The national Government increased by nearly 300 employees or about 20% since 2000. This had occurred despite the Government's official wage and hiring freeze. At this rate, it was estimated that the public sector appeared on course to undo the downsizing of the late 1990s by the end of 2005.

By 2005, the fiscal balance was showing a deficit of 2.2%. GDP growth declined to 1.4% in 2000, after averaging 4.3% over the previous 4 years. Inflation had picked up to 4.4% that year, and the overall balance of payments showed a deficit of 17.6% and 4.3% of GDP in 2004 and 255 respectively. The issue of regaining macroeconomic stability had again become a challenge for the government.

## 3. THE KINGDOM OF TONGA

Background

[62] ADB (2005).

Tonga's GDP grew at an average rate of 2% over the period of 1990 to 1999. During the same period, the budget of the Tonga government on average showed a negative overall balance of 0.5% of GDP. Inflation averaged 4.4% per annum, while the overall balance of the balance of payments showed an average deficit of 1.6% of GDP. Although the statistics were not particularly worrisome, they were not particularly impressive either.

In 1998 the World Bank conducted a public expenditure review of Tonga.[63] The main findings of the report included the following:

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| (i) While Tonga had made commendable social progress with a life expectancy of 69 years (1994) and a literacy rate of almost 100 percent (in the Tongan language), among the highest in the region, further improvements in the quality of life might not be possible without sustainable economic growth and corresponding increases in government revenues. The report noted that past growth rates averaging only two percent per year were totally inadequate to meet future demands for jobs and goods and services for the growing population; |
| (ii) It was recommended that, in order to meet the challenge of raising the quality of life, the government should consider pursuing a higher growth development strategy based on a progressive right-sizing of the public sector and a gradually increasing role for the private sector, church groups and NGOs. It further noted that the key issue was the ability of the private sector to generate both jobs for the growing labor force and increased export earnings to offset potential declines in aid and remittances; |
| (iii) The re-emergence of fiscal deficits and rising public debt in 1997 and 1998 indicated that the level of aggregate expenditure remained unsustainable in relation to the resources available through domestic resources and external grants. Government therefore had to halt further expansion of the public sector and thereafter consider measures by which public expenditure could be reduced progressively; |
| (iv) With a public service of 4,195 employees in FY 95/96, the size of the wage bill amounted to an estimated 54 percent of total current expenditures. As a result, non wage expenditures had suffered, given the limits of the aggregate resource envelope. The compression of funds for non-wage expenditures had adversely affected the quality and performance of public expenditure programs. It noted that a large number of public enterprises also placed a heavy burden on public finances; |
| (v) It was recommended that the Government should consider more concerted reform |

[63] World Bank (1998).

efforts in a number of areas in which reform initiatives had been initiated including: (i) national economic management and planning; (ii) public expenditure management; and (iii) institutional capacity building and rationalization of the civil service. All of these reform areas related to the need to make the public sector, and public expenditure programs in particular, more effective and cost-efficient.

At the same time, the Government had commissioned a report, "*A Proposed Human Resource Development Project and Related Interventions",* prepared for the New Zealand Ministry of Foreign Affairs & Trade and the Government of Tonga. That report outlined several specific problems, including:

- Over-staffing within the civil service;
- Generous leave of absence;
- Unwiely romotion provisions;
- Inappropriate salary and gradings;
- No Government superannuation;
- Insufficient management training;
- Lack of skilled professionals for the private sector;
- Lack of formalized channels of communication between the government and the private and NGO sector;
- A lack of defined national direction on which to base any planning; and
- Lack of awareness by the government as to the importance of NGO activity.

The report further noted that, with the exception of the Customs service, ministries and departments reported up to 20 – 25% overstaffing.

The World Bank report had recommended that there was a need to continue to build administrative capacity and at the same time rationalize the civil service. Further there was considerable scope for doing away with duplication of functions, cutting or transferring and re-training staff, increasing decentralization and delegation of power, introducing appropriate office technology and communication systems, and improving the cooperation among different parts of the administration. While there was a need for a strong central focal point for national economic planning and management, including well-coordinated monetary and fiscal policies, it was also essential to have strong capacity among sectoral ministries and technical agencies. A key for effective sectoral coordination and implementation of public expenditure programs and development projects was to strengthen the institutional capacity of sectoral ministries and technical agencies.

Following the receipt of the World Bank report, the government started talks with various aid donors about possible options to fund the implementation of the recommendations. The constrained capacity within the key ministries had resulted in slow progress. At the same time the issue of the inability of the government to maintain prudent fiscal policy continued to be a matter of concern to aid donors as well as to the IMF, despite continuous advice about the need to make timely progress on civil service reform and implementing a policy of effective containment of wages and salaries.

The IMF reported that, despite its advice over several consultations leading up to 2002, and while the Ministry of Finance and the Reserve Bank had agreed with most of these policy recommendations, the Government's record of implementation had been poor, owing to difficulties in building up political consensus and to capacity constraints.[64]

The IMF’s policy advice had stressed the need for restoring sound macroeconomic policies and for addressing long-standing structural weaknesses to arrest increased macroeconomic instability, ensure external viability, and enhance long-term growth prospects. The major recommendations included: (i) restoring a sound budget position by scaling back the public sector wage bill and broadening the tax base; (ii) enhancing the effectiveness of monetary policy by recapitalizing the Reserve Bank to restore its ability to conduct open market operations; (iii) encouraging private sector development mainly through foreign direct investment, an improved regulatory environment, and land reform.

The slow response was apparently based on the belief that the Government’s trust fund of about US$20 million was invested in safe instruments which would

[64] IMF (2003).

bring about significant return and provide it with room to maneuver with regards to financing policy options. In 2001, it became evident that the investment of the trust monies had been misappropriated by the investment adviser appointed by the Government, and this effectively removed any financial buffer that the government had. This provided an incentive for the Government to act expeditiously on the advice of the IMF.

In 2002, the Government began discussions with the Asian Development Bank for a program loan to facilitate the reform measures recommended by the World Bank in 1998.

<u>The program rationale</u>

In 2002 the ADB approved the loan.[65] The objective of the program loan was to foster macroeconomic stability and encourage private sector-led economic growth. Preconditions to enable these objectives to be met included: (i) achieving a sustainable fiscal balance, and (ii) improving the efficiency and effectiveness of service delivery by the public sector.

The Government's overall reform program comprised four main areas:

(i) fiscal reform
(ii) public service reform
(iii) financial sector reform, and
(iv) private sector reform.

The program loan focused on the first of these two areas, namely:

(a) fiscal reform measures aimed at achieving a sustainable fiscal balance through strengthening public expenditure management, enhancing revenue generation, and improving the efficiency and effectiveness of resource use in the public enterprise sector.

[65] ADB (2002).

(b) public service reform measures that sought to improve public service delivery to the private sector and the general public by means of establishing the institutional framework for a performance-oriented public service, and promoting efficient and effective performance management.

The loan amount was US$10 million. In recognition of the progress made by the government in addressing its structural challenges the ADB agreed to disburse half of the loan soon after formal approval and signing of the loan.

The Government agreed that ADB would disburse of the second part of the loan after the following conditions were met:

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| 1. Enact a Public Finance Management Act designed to strengthen the ability of the Ministry of Finance to maintain the integrity of the fiscal framework; |
| 2. Amend the current tax and customs legislation with a view to strengthening tax administration, and enforcing compliance in customs, sales and income tax; |
| 3. Enact a Public Enterprise Act establishing rules and procedures regulating the relationship between public enterprises and Government; |
| 4. Enact a Public Service Act to regulate the operations of the public service; |
| 5. Develop a human resource management information system (HRMIS) and operationalize it within the Prime Minister's Office/Establishment Office; and |
| 6. Establish an economic and social impact monitoring unit within the Prime Minister's Office/Central Planning Department. |

In 2002, the Tongan Legislative Assembly approved the Public Finance Management Act, the Revenue Administration Amendment Act, the Public Enterprise Act, and the Public Service Act. The Government also established and operationalized the human resource management information system as well as the economic and social impact monitoring unit. This enabled the disbursement of the balance of the ADB loan.

Establishment of Public Service Commission (PSC)

In April 2003 the Public Service Commission Act became effective. The establishment of the PSC led to decentralization of personnel management decisions from the Cabinet to the PSC. In July 2003, the PSC placed all Heads of Departments under a 12-month employment contract, which was subsequently replaced with a two-year contract in July 2004. The contract included a performance agreement, specifying 8 key results areas. The performance of the Heads of Departments will be evaluated against the key results areas. Starting in October 2005, the PSC implemented a performance-based appraisal system across the board in the public service.

In mid 2003, the Government established the Human Resources Management Information System (HRMIS**).** Full integration with the payroll system was achieved. By the end of 2005 all Government ministries/departments, with the exception of a few, such as the Ministry of Marine and Ports and the Palace Office, were connected to the system.

As part of the exercise, the PSC carried out an evaluation of government posts. A job classification and merit-based remuneration policy was approved by the Government. The PSC also reclassified and regraded all Government posts with job descriptions and skill requirements which were later endorsed by the Cabinet.

This work resulted in a proposed package for comprehensive restructuring of public service remuneration. The principal characteristics of the package involved some broad banding of pay scales and assessment of the work value of positions against objective criteria, with testing of a sample of positions against such criteria. The package represented an increase in aggregate salary costs of some 13% but with the increase applying to any individual dependent on a full assessment of the work value of their position. The job evaluation had found inconsistencies within the existing grade levels. Of 4,143 positions filled, about 429 positions were assessed as being paid above the new scale maximum and would have received no increase in salary, and 1,728 were considered to be paid within the new scale and consequently would have received pay increases of lesser magnitude than the average of 13%.

At the same time the government had commissioned a review of ministerial and other salaries by an independent committee. The committee had made recommendations on the salaries of the prime minister and other ministers as well as other office holders who were covered by the Public Service Act. The Committee was subsequently commissioned to produce a second report covering the remuneration of all employees paid from public funds.

These proposals were accepted by the Government. The recommendations also related to senior positions not covered by the Public Service Act. The Government incorporated the estimated costs of the salary package, T$ 7.1m, as an allowance in the 2005-6 Budget.

The proposed salary reform was widely debated with public service groups during its design and refinement, and produced a range of levels of dissatisfaction. Civil servants were dissatisfied that each individual position was, theoretically, to be examined in relation to a set of work value criteria and be slotted into the structure accordingly. This became the focus of the concerns by civil servants as it was perceived that senior positions were being provided with disproportionately larger increases – it was recommended, for example, that ministers should receive an increase of 57%.

Industrial action

Following the approval by the Government of the new grading and salary adjustments, civil servants, despite being briefed on the basis of the regrading launched a strike in July 2005 for the deferment of the new structure for 2 years, and for the civil service be awarded increases ranging from 80% for the lower scales, 70% to the middle scales, and 60% for the upper scales. The strike lasted for six weeks and resulted in a pay settlement, in September, under which the government agreed to the demands and further agreed that it would not seek to raise taxes to finance the cost of the increased salaries. It was agreed that the adjustments would be made over 2 years with 60% paid in the 2005/06 financial year. The 40% arrears would be paid in the 2006/07 financial year. The civil servants returned to work in September 2005.

Cost of wage awards

The total cost of the wage increase was about 4¼ percent of GDP for the 2005/2006 financial year, reflecting the first phase of the wage increase, a partial adjustment of paychecks. In 2006/2007, the additional cost of the settlement was estimated at about 4¼ percent of GDP, reflecting not only the full wage adjustment but also the balances of the first year's partial adjustment of the pay rise. On account of these two developments, average wages increased by about 92 percent in financial year 2006/2007 from their base level in financial year 2004/2005, albeit only temporarily, returning in FY 2007/2008 to a level 70 percent above this base.[66]

Economic Consequences of the Settlement

It was estimated that the general consequence of the settlement would lead to higher inflation in the economy, as prices were pushed up by rising wage costs. Higher demand resulting from higher wages increased demand for imported goods. Many inputs to Tongan business are imported, and the increased costs of imports gave rise to further inflation in domestic prices.

The level of inflation depended primarily on the extent to which wages increased in the private sector to follow those of the public service. The more private sector salaries rose in response to the public sector increase, the greater the generation of inflation in the economy. On the other hand, the impact of the settlement was expected to be moderated by the continuing inflow of remittances. For some families, remittances cushioned the impact of redundancies on family incomes.

It was estimated that if wages in the private sector rose by an average of 15% and import prices rise by 10%, overall inflation could rise by something around 13%, on top of inflation already in the system. If private sector wages rose by an

[66] IMF (2007).

average of 20% and import prices by 15%, the resultant overall rate of inflation could be pushed up to 20% and perhaps a little more.

It was further estimated that the consequences of the settlement implied difficult conditions for companies in the private sector as the increases in wages, taxation, and rises in interest rates would raise costs. Many would find it difficult to expand revenues sufficiently to offset cost increases by raising sales, and as a consequence some companies were likely to lay off staff. Those losing their employment in private and public sectors would be amongst the worst affected by the settlement. In addition new school leavers would find it more difficult to gain employment. The reduction in opportunities was likely to mean that more Tongans would migrate overseas, thus increasing further the loss of talent and training, and reducing the growth prospects of the economy.

Government action to stabilize the financial position

The Government responded to the need to finance unbudgeted spending of about $17 million for the wage increase in 2005/06 by taking the following measures:

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| 1. Freezing vacant positions of about 923; |
| 2. Deferring awards of salary increments; |
| 3. Freezing meeting fees; |
| 4. Reducing operational spending on travel, fuel, electricity, etc; |
| 5. Deferring all capital spending and selected subsidies and transfers; |
| 6. Enforcing the compulsory retirement age; and |
| 7. Improving revenue collection, especially tax arrears. |

The Government succeeded in financing the increased costs of the wage increase in 2005/06 using the measures outlined above. At the same time it faced the need to finance the significant increase in wages for 2006/07. The consequent compression of spending on operations and maintenance affected service delivery. The Government decided to rationalize the civil service using voluntary retirement as its main instrument.

Review of structure of public service

In November 2005, the government, in order to offset the destabilizing macroeconomic impact of the wage increases for the civil servants, commissioned the services of a human resource firm to assist the Public Service Commission to examine, review and develop alternative structures for the public service bureaucracy, as well as to analyze of costs associated with those alternatives and other resultant organizational.

After the review of the public service, it was recommended that the 31 Government agencies (including the disciplined forces) totaling about 5,000 personnel, should be rationalized. The review basically reaffirmed the findings of the earlier 1995 report by New Zealand-funded advisers.
Different conceptual approaches for reorganizing the structure of the Government ministries were considered by the Government, including structures that would result in 15 ministries, and other structures that would result in 8 main ministries.

A common thread with all the approaches was the creation of a shared service for corporate services comprising HR, IT, finance and payroll staff, which then totaled about 1,000 staff. It was estimated, after benchmarking the size of the total civil service with the private sector and other public services in the region, that the same service could be delivered by 25% to 50% of the level at the time. This meant a possible reduction in staffing by 500 to 750 civil service positions, and supplemented by outsourcing of appropriate activities.

Constraining wages and salaries

The Government estimated that to regain a position of approximate fiscal balance, it needed to reduce the public service by between 800 and 1,000 positions, at the new higher wage level. The results of the studies indicated that the government could use targeted voluntary retrenchment to constrain civil service wages and salaries, and regain approximate fiscal balance.

In March 2006, the government decided to target a balanced budget for 2006/07. It also approved that the Government should target 1,000 civil service positions for voluntary retrenchment, in order to regain fiscal balance. At the same it decided to finance the cost of the retrenchment by selling Government assets, including its shares in a domestic commercial bank[67], and if needed, by further reductions in operational and capital expenditure, as well as by drawing down on the proceeds of the program loan from the ADB and its own cash reserves built up over several years. The Government decided to keep compulsory redundancy as a reserve option.

Following the decision, the Government established a task force to implement the policy incorporating senior officers of the PSC, Ministry of Finance, and the Crown Law Department.

The task force developed a separation package, to be paid in a lump sum, which comprised the following:

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| 1. accrued pre-termination leave entitlements; |
| 2. relevant ceasing service benefits from the Retirement Fund; |
| 3. an additional severance benefit of three (3) months' basic salary plus five (5) percent of basic salary for each completed year of service paid at the employee's substantive appointed level, subject to qualifications; |
| 4. a minimum additional severance payment of three (3) months' pay; |
| 5. a maximum additional severance payment of twelve (12) months' pay; |
| 6. in addition to the amounts above, a cash incentive payment component in VR packages was offered to employees; and |
| 7. an early application bonus was payable where an employee lodged application before a date prescribed within the VR offer. |

The Government estimated that the cost of the separation package would be $34 million. The task force had identified 1,200 posts that were deemed to fall within the criteria of those targeted for separation. Letters were issued to the holders of the positions inviting them to consider the offer of the separation package.

[67] Westpac Bank of Tonga, of which the government owned 40% of the shares.

A total of about 820 staff accepted the offer. The outcome was that staffing cuts reduced personnel by 18 percent, although the short-term costs of severance packages added to total Government spending.[68] Staff cuts were achieved in a short round of voluntary redundancies implemented in the last weeks of June 2006.

The severance package for the voluntary redundancies was estimated at 5½ percent of GDP, while under the Retirement Fund Board Act, the Government funded the pension liabilities of departing civil servants, at a cost of 2 percent of GDP. The government's proposed asset sale could not be concluded in time, and as a result, the program was financed by the Government is withdrawing its domestic bank deposits, which depleted the fiscal cushions accumulated during previous years, as well as the proceeds of the ADB loan.

The wage settlement reversed the Government's efforts in 2003/04 and 2004/05 to bring the wage bill down to comparable levels with regional peers, causing additional wage expenditure of an estimated 2¾ percent of GDP in 2005/06, increasing the civil service wage bill well above levels elsewhere in the region. The full wage increase, as well as deferred payment from 2005/06, were implemented in 2006/07, increasing the total wage bill to above 18 percent of GDP. For 2007/08, despite the elimination of all one-off payments related to the settlement, the wage bill was projected to remain over 15 percent of GDP, substantially higher than the regional average of 10½ percent. It was estimated that the number of public employees also remained high in Tonga, even after the retrenchment program, accounting for 3.6 percent of the total population, compared to an average 2.6 percent in middle-income countries.

It was noted that between 1981 and 1995 the number of full-time civil servants had increased by 60 percent, bringing the size of Tonga's public sector work force up to 5 percent of the total population. Reflecting this expansion, the wage bill

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68 IMF (2007).

continued to increase until the mid-1990s and reached about 15 percent of GDP by 1995/96. Tonga's civil service wages are reviewed every 5 years, and a major review of public compensation in 1989/90 had awarded a 50 percent wage increase over two years, accelerated the rising trend of the wage bill. In 1999/2000 a similar review resulted in a 20 percent increase for cost of living allowances. These reviews caused the wage bill to continue to increase through early-2000, risking fiscal sustainability.

The government had implemented a large reduction in the size of the public service over a short period of time, reducing the wage bill by a significant amount, although the voluntary redundancy package was also considered to be generous. It has been estimated that Tonga achieved a reduction in the number of public workers equal to 0.8 percent of its total population in three months compared to other countries which had undertaken relatively large retrenchment programs over many years, averaging a period of five years. It is also estimated that, although the total cost of severance payments was relatively high, at five times the cross-country average, the reduction of the wage bill by over 3 percent of GDP, was significantly higher than in other countries.

Impact on service delivery

The aftermath of the wage containment exercise is still being evaluated. It is suggested that although the retrenchment program was initially intended to be a targeted redundancy, there were significant risks of rehiring over time, as several public workers with valued skills accepted the redundancy package, and this started to disrupt public service delivery. This was especially the case with teachers. While the original target was to focus redundancy on surplus administrative positions, the government agreed to extend eligibility to those holding skilled positions, including those who were due to retire.

As a result, the problem of adverse selection occurred to a certain extent, especially in the Ministry of Education with a loss of over 200 trained teachers, and the Ministry of Health with a loss of trained nurses, and other ministries.

The situation was worsened by the delay by the PSC in initiating appropriate re-engineering of work processes and practices within the Ministries with a view to changing the way they carried out activities. All that happened was that fewer people came to work, and the existing workload was redistributed to those who remained working, increasing their workload and adding to low morale.

The chief executive officers of the Ministries responded by seeking to increase staffing to make up for those who had taken the redundancy package. They did this by increasing the number of the daily paid workers (over whom they had delegated authority), thereby undermining the overall objective of the exercise of increasing productivity.

Furthermore, those who had taken the redundancy package took the view that after 2 years (the period for which they could not be re-employed by the civil service), they would be eligible to be reinstated to their former positions.

Given the short-time period over which the program was carried out, the Government could not provide sufficient assistance, such as necessary training to retrenched workers. The preliminary results of a follow-up survey conducted by the Government almost a year after the event indicated that there were many retrenched workers still seeking employment, and that the majority of them needed assistance, such as job advisory services, training, and contact lists.

Impact on macroeconomic stability

The retrenchment exercise supported the achievement of macroeconomic stability in the short term and had given the Government time to undertake longer term structural adjustments. The share of wages and salaries in local government spending was reduced, while the level of international reserves and the rate of inflation were maintained within acceptable levels. This minimized the negative impact of the salary increase on the potential growth rate of the economy, and thus contributed to keeping the economy on a sustainable growth path.

General observations

The experiences of the three countries discussed above suggest that the challenge of containing the wages of the civil service is a common issue for most, if not all, the Pacific Island countries. It is also apparent that the process of containing wages of the civil service cannot be dealt with in isolation, but as part of an integrated approach to public service reform, which must receive political support at all levels. Without political support, the process of containment of wages becomes very difficult, particularly if changes of Government bring changes of policy which reverse earlier gains.

The need for effective political support cannot be overstated. This was only too apparent in the case of Papua New Guinea and the Marshall Islands, where earlier gains were reversed by new Governments. The decentralized system of government in Papua New Guinea posed its own special set of challenges, made more complicated by the social structure and the political framework. At the same time the Government of Papua New Guinea, with a growing economy forecast for 2008 and 2009, seems to have the best chance to make progress.

The need for a clear vision of the role of the state is the first key challenge. Once there is political support for this, then the consequential changes should be reasonably straightforward. The matter of social relationships is another key challenge that must be addressed in small countries. This is where effective communications is crucial, in order to explain that the changes and downsizing of civil servants are necessary to create fiscal space so that more resources are freed up for investment in social priorities. Once there is overriding social consensus, and safety nets are put in place for retrenched civil servants, the foundations are set for the implementation of the types of activities outlined in Chapter Four to give effect to the containment of civil service wages.

The three countries' experiences discussed in this chapter demonstrate the difficulties of achieving social consensus, which is crucial to the success of civil service reform. The lack of social consensus has been a key reason for the lack of success of civil service reform in many countries. The imposition of fiscal responsibility laws are useful tools to support fiscal discipline measures, but political will is necessary to ensure that the laws are complied with, and that the benefits of macroeconomic stability are eventually translated into sustainable economic growth.

Suggested further reading

The following articles are suggested readings to provide more detailed discussions on the reform efforts in the three countries discussed in this chapter:

*Government of Papua New Guinea (2008).*
*Curtin (2000).*
*International Monetary Fund (1998).*
*International Monetary Fund (2007).*
*The World Bank (2003).*
*The World Bank (1998).*

# Chapter 7 Checklist and Templates

This following checklist puts together a stylized framework that a policymaker may wish to follow when required to undertake the process of fiscal adjustment, as discussed in the preceding chapters.

## Check list

| Task Name | Reference |
| --- | --- |
| **Getting Started** | |
| • Appoint a team of experts to provide specialized support.<br>• Identify the key challenges relevant to the achievement of macroeconomic stability focusing on the size of the civil service wage bill.<br>• Outline the options for achieving macroeconomic stability.<br>• Seek Cabinet and political support for the options. | Refer to page 26<br>Refer to page 16 |
| **Defining The Project** | |
| • Design a vision of the role of the state<br>• Design a strategic vision for the civil service<br>• Design an overarching plan to correct the challenges of the civil service wage bill<br>• Overview any key risks<br>• Design a communications strategy | Refer to page 30<br>Refer to page 31<br>Refer to page 49 |
| **Planning The Project** | |
| • Prepare project planning checklist<br>• Prioritize planned activities<br>• Make a communication plan and communicate it with all concerned<br>• Carry out a full risk analysis<br>• Set a realistic deadline for the project | |
| **Implementation** | |
| • Initiate the implementation of civil service reform following steps outline in Chapter 4<br>    ○ Review the regulations | Refer to page 32 |

| | |
|---|---|
| ○ Upgrade systems and processes<br>○ Set manpower target<br>○ Implement cost containment measures through<br>• freezing recruitment;<br>• suspending automatic salary increases and promotions;<br>• eliminating guaranteed entry to the civil service from the educational or training system;<br>• eliminating 'ghost' or non-existent names and workers;<br>• eliminating officially sanctioned posts which are not currently filled;<br>• retrenching temporary or seasonal workers;<br>• redeploying existing staff;<br>• enforcing of retirement age (or retirement after fixed years of service) stipulations;<br>• enabling the voluntary, or incentives - induced retirement of surplus workers; and<br>• dismissing poorly performing civil servants | |
| **Project Completion** | |
| • After downsizing, initiate re-engineering of civil service to improve service delivery, complemented by outsourcing, and privatization<br>• Review compensation of remaining civil servants to address wage compression and erosion of real wage rates. | |

## Templates

As part of the preparation for undertaking adjustments to contain civil services wages, the following World Bank websites have been compiled as an indicative source that policymakers may refer to for further information:

*Administrative & Civil Service Reform - Downsizing*

*Administrative & Civil Service Reform - Civil Service Censuses*

*Poverty and Social Impact Analysis - Public Sector Downsizing*

*Working on Administrative & Civil Service Reform*

*Public Finance - Strengthened Approach to Public Financial Management Reform*

*Research - DOSE: Downsizing Options Simulation Exercise*

*Shrinking Smartly - Helping Governments to Downsize Efficiently*

*Expenditure - Public Finance Management*

*Public Finance - Medium-Term Expenditure Framework (MTEF)*

*Public Finance - Handbooks and Manuals*

*Global Data Monitoring Information System*

*PFM blog: Promoting Fiscal Discipline - Fiscal Responsibility Laws*

The above sites are by no means exhaustive, but they do provide resources and links that the policymaker may wish to use.

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