

# 7 REPUBLIC OF VANUATU

## 7.1 Introduction

The Comprehensive Reform Program (CRP) Loan of \$20 million to Vanuatu was approved in June 1998, and involved adjunct technical assistance of \$1.2 million for institutional support to two central agencies implementing CRP (the Department of Strategic Management and the Ministry of Finance and Economic Management).<sup>46</sup> The first tranche was to be released in two parts, the first part of \$10 million upon loan approval and effectiveness following satisfaction of 10 conditions, and a second part of \$5 million as an incentive subtranche (“First Tranche, 2nd Release Condition”) upon satisfaction of 5 conditions originally targeted for June-September 1998. The second tranche of \$5 million was scheduled for release, subject to 7 conditions, by October 1999. At the time of loan approval, the CRP loan was equivalent to 2,545 million vatu, which compared with an annual average level of total official development assistance to Vanuatu of 4,000 million vatu in 1992-95.

## 7.2 The Macroeconomic and Governance Context

Between independence in 1980 and 1995, Vanuatu achieved average annual growth in real Gross Domestic Product (GDP) of 3 percent - a rate only slightly above the population growth rate of 2.9 percent. This was accomplished in the context of a generally stable macroeconomic environment in which the inflation rate was

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<sup>46</sup> This TA constituted Phase II of a three-year program. The \$630,000 Phase I TA - TA No.2984-VAN: Institutional Support to Central Agencies for the Comprehensive Reform Program - was approved on 29 January 1998 as an interim support arrangement, following a November 1997 dissolution of Parliament and the calling of general elections for March 1998.

around 4 percent, external balance was maintained under a fixed exchange rate regime, and budgetary deficit financing was modest. The governance environment was complicated by an inheritance of two very different administrative traditions from a French-British colonial condominium government, which had “left the indigenous population ill equipped with the skills required of a modern economy, and highly dependent on external inputs” (ADB 1997c). In addition, in the 1990s, the quality of governance worsened as ministers appointed relatively large numbers of often poorly qualified political advisers and personal staff, who effectively substituted for professional public servants. Parliament became largely ineffective, meeting irregularly, and unable to hold the Executive accountable for its actions. Corruption grew and law enforcement was weakened.

During 1996-98, Vanuatu’s economic performance has deteriorated, some fiscal fragility has become evident, and political instability has contributed to some disarray in macroeconomic policy. There are no reliable national accounts data after 1995, but estimates provided by the Statistics Office suggest that real GDP growth has slowed from 3.5 percent in 1996, to 1.7 percent in 1997, and to about minus 2 percent in 1998.<sup>47</sup> The slowdown is the result of declining activity in the manufacturing, electricity and construction sector, compounded in 1998 by a substantial drop in primary sector production and sluggishness in tourism. The traditional exports of copra, beef, timber and cocoa have fallen because of the direct and indirect impacts of the Asian crisis and currency devaluations in Papua New Guinea, Solomon Islands and Fiji. Tourism has been affected by the declaration of a state of emergency during the January 1998 Port Vila riots, which occurred after publication of an ombudsman’s report questioning the soundness of investment decision-making at the Vanuatu National Provident Fund (VNPF). These riots, and another change in government in March, further eroded investor confidence.

In 1996, two changes of government occurred (after November 1995 elections), and in mid-year a fiscal crisis appeared imminent. It was averted primarily by postponement of planned expenditures, including compensation payments to ex-public servants who went on strike in 1993-94 and were fired, capital injections into

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<sup>47</sup> New accounts became available in mid-1999.

the National Bank of Vanuatu and the Development Bank, and other development expenditures. Reliable government finance statistics presented in a standard international format are not available, but IMF estimates indicate an overall budget deficit of 519 million vatu, or 1.8 percent of GDP, was the final outcome. The 1997 budget embodied a tight fiscal policy stance predicated on cost savings from public sector reform and increased revenue from removal of duty exemptions. The former did not eventuate, and domestic revenue actually was 8 percent below the budget estimate; but external grants were up on the 1996 level, while development expenditure was down. The overall budget deficit was estimated by the IMF at 199 million vatu, or 0.7 percent of GDP, though later government figures indicate a deficit of 1.8 percent of GDP.

Developments in early 1998 threatened to undermine macroeconomic stability. Following the January riots, the government of the day allowed unconditional withdrawal of retirement savings from VNPF, which led to a demand from members for 3,600 million vatu, 2,400 million of which was actually disbursed in February-April. Since VNPF itself could only provide 1,100 million vatu, Government as guarantor had to make up the shortfall, leaving it with a projected overall budget deficit of 4,100 million vatu, or 14 percent of GDP. Given the implications of the payouts for the balance of payments, and recent devaluations in Fiji and Solomon Islands, it was not surprising that a run on the currency began. Capital outflow combined with reduced exports of goods and services and higher import spending to cause a drop in foreign exchange reserves - from almost six months of import cover at the end of 1997 to 3.5 months at the beginning of April 1998. On 27 March, the governor of the Reserve Bank, on the last day of his term of office, unilaterally announced a 20 percent devaluation, but this was reversed on the same day by the Minister of Finance.

The new government that took office on 30 March sought to restore credibility to macroeconomic policy. A new Reserve Bank governor was appointed and the previous government's reversal of the devaluation decision endorsed. Monetary policy was tightened through the replacement of the 10 percent statutory reserve deposit requirement with a 16 percent prescribed asset ratio, and a substantial rise in the Reserve Bank base lending rate. Foreign exchange controls were effectively imposed on capital transactions. Though the devaluation reversal and the maintenance of capital controls

initially intensified speculative pressure, the monetary tightening persuaded the public of government's determination to defend the vatu and facilitated a recovery in the foreign reserves position. Pressure to maintain a tight monetary stance in the immediate future will arise from VNPF payouts yet to be made, payments to public servants retrenched under the CRP, and the net inflationary impact of tariff reform and the introduction on 1 August of a value added tax.

Approximately 87 percent of the projected 1998 budget deficit of 4,100 million vatu is one-off expenditure arising from payments to the 1994 strikers, the VNPF payout, and CRP-related payments funded by ADB. The underlying budget deficit is 1.7 percent of GDP (Vt29,700 million), and largely reflects the intention to almost double expenditure on law and order and increase development expenditure. Indications in early November 1998 were that, despite a shortfall in domestic revenue, the actual overall deficit was likely to be around 3,000 million, or 10 percent of GDP, as CRP-related and other loan-financed expenditure fall short of their estimated levels, and recurrent expenditure also comes in under budget (Table 7.1). The underlying deficit is expected to be under one percent of GDP. Public debt will reach 10,100 million vatu, or 34 percent of GDP, at the end of the year.

In the Budget Policy Statement for 1999 that was presented in October, there is no projection of an overall deficit. However, a reduction is implicit in an expected move to balance between domestic revenue and expenditure and a reduction in development expenditure that is to be entirely financed by external concessional loans. The stated budget intentions will be hard to fulfil. In particular, a 6.3 percent rise in domestic revenue in the context of a forecast 4.5 percent growth in nominal GDP is implausible. Additionally, pressures for wage increases may threaten the anticipated 10.5 percent reduction in domestically-financed expenditure (Table 7.1). The growth forecast is a revision downwards from the 7 percent growth rate in nominal GDP that was presented in the 1998 budget papers, which became available in June. No forecast is offered for inflation in 1999; but assuming it will be in the range of 3-4 percent, real GDP growth is expected to be slow, at 0.5-1.5 percent.

**Table 7.1: Vanuatu Budget Estimates 1998 and 1999 (Vt million)**

	1998 Budget	1998 Estimates	1999 Estimates
Domestic revenue	7,162	6,782	7,207
Foreign grants	1,430	549	n.a.
<b>Total revenue &amp; grants</b>	<b>8,592</b>	<b>7,331</b>	
Domestically-financed exp.	9,255	8,148	7,200
Foreign-financed exp.	3,457	2,183	n.a.
<b>Total expenditure</b>	<b>12,712</b>	<b>10,331</b>	
<b>Deficit</b>	<b>4,120</b>	<b>3,000</b>	
Foreign Financing			
– ADB	1,800	1,311	
– Other	707	371	
Domestic Financing			
– VNPF	1,600	1,595	
– Other	13		
Discrepancy		277	
Memo Item:			
Domestic revenue			
less domestically-financed			
expenditure (Vt m.)	-2,093	-1,366	7
(% of GDP)	-7.0	-4.6	0.0

Note: Aid in kind is excluded from the figures.

Source: Government of Vanuatu, Budget Policy Statement, October 1998.

## 7.3 The Process of Program Design

### ***7.3.1 Ownership and appropriate participation in the design process***

Against a background of stagnant average income and the 1996 fiscal uncertainties, the government that took office in October 1996 sought to introduce a variety of cost-saving measures into the 1997 budget, and announced its intention to undertake a major reform of the public service. The Council of Ministers was subsequently persuaded by the Bank that reform needed to extend beyond the public service to include public enterprises and the

creation of an enabling environment for the private sector. This broader scope for reform was expressed in a Memorandum of Understanding signed by Government and the Bank in February 1997. The MOU included a request for the assistance of external funding agencies in the formulation and implementation of a Comprehensive Reform Program (CRP).

From the outset, government adopted a participative and consultative approach that was overseen by a National Task Force chaired by the Prime Minister and including two senior Government ministers. Two task teams were established, each including 18 representatives from non-government organizations, the Council of Chiefs, church groups, trade unions, and private business. One team focussed on economic reform and was chaired by the Prime Minister; the other examined public sector reform and was chaired by the Deputy Prime Minister. The teams were supported by a technical secretariat within the Prime Minister's Office, which consisted of a ni-Vanuatu (indigenous) person as full-time CRP co-ordinator and several external advisers. Technical assistance was also forthcoming from ESCAP's Pacific Operations Centre and bilateral funding agencies.

During the period March-April 1997, the task teams prepared a number of papers on reform issues, seminar discussions of short reports on the issues were conducted in Bislama, and a weekly newspaper column and radio broadcasts were used to facilitate nationwide involvement. A draft CRP document was generated from this process and presented at a National Summit on 26-27 June. The Summit was attended by 300 representatives of government, the private sector, and the wider community, and broadcast live throughout the country. Following debate and some amendments, the document was endorsed as the basis for future action, and subsequently approved by the Council of Ministers. It outlined a vision and a set of strategies for economic and social development: the major components were stable government (macroeconomic stability, good governance and public sector reform); private sector development; and social equity and sustainability. A key mandate was the convening of Annual Summits as a means of providing the community with an opportunity to review progress in the implementation of the reform program.

### **7.3.2 *Partnership and consultation with other external funding agencies***

The February 1997 MOU included a request that ADB take the lead role in co-ordination of external assistance to the reform program. Accordingly, the Bank organized a Consultative Group Meeting in Noumea, New Caledonia on 31 July 1997 at which the CRP document was presented. Funding agencies were unanimous in their support both for the participative process through which the CRP had been formulated and for its content. The Bank was asked to assist in the preparation of a CRP matrix that would serve as a monitorable action plan. This assistance was provided in September as part of the fact-finding mission for a proposed Bank loan.

Since implementation of the CRP began in August 1997, there has been ongoing consultation and close co-ordination with external funding agencies, especially AusAID and NZODA. Special attention has been given to ensuring that the various programs of technical assistance are complementary in their support for the CRP. A program co-ordinating committee is expected to be established for this purpose.

### **7.3.3 *Effectiveness of internal processing procedures***

From the fact-finding mission, through the appraisal and post-appraisal missions, to loan agreement, the processing procedures for Bank assistance to Vanuatu seem to have been efficient and effective. Appraisal was completed between 17 November and 3 December 1997; and post-appraisal was undertaken between 20 April and 1 May 1998. Board approval for the loan was granted on 16 July. Loan agreement was finalized on 6 August and the first disbursement of \$10 million made the following day. The only noticeable delay - between appraisal and post-appraisal - was the unavoidable result of the November 1997 dissolution of Parliament and the calling of a general election for March 1998. As explained below, while the speed of processing helped create and sustain the momentum for reform, it carried some costs in terms of public understanding that surfaced later.

## 7.4 The Content of the Program

### 7.4.1 *The Comprehensive Reform Program*

The CRP Matrix that Government developed in September 1997 was subsequently reformulated into a Program Loan Reform Matrix. It should be noted that the Program Loan Reform Matrix is smaller than the CRP Matrix, leaving out (1) two columns on monitoring mechanisms and risks and assumptions, and (2) some policy areas, strategies and actions that are to be implemented. The reformulation into the smaller matrix reflected the decision to give Bank priority to assisting public sector reform, improved governance, strengthening of public financial institutions, and institutional strengthening.

In addition to its apparent over-optimism, a notable feature of the reform scenario is its focus on real GDP growth alone. Given that the ultimate concern is with real GDP growth in per capita terms, some attention might have been paid to population growth - especially since it is so high in Vanuatu. An annual increase of approximately 3 percent means the population doubles every 24 years, placing increased pressure on land, environment and government.

Three subsidiary objectives corresponding to the three major components of the CRP are listed in the Program Loan Reform Matrix:

- Redefine the role of Government and enhance the quality and delivery of its policy, regulatory, and development services.
- Increase the productivity and growth of the commercial and private sector in both the urban and rural areas.
- Support improvement of social development indicators, particularly for the disadvantaged and rural population.

The achievement of these objectives involves the production of 46 "Program Outputs", with the primary focus being on redefining the role of government and improving public sector performance. Nine of these outputs were conditions for loan approval and release of the first part of the first tranche. Six required the enact-

ment of legislation; and the others involved the establishment of a department to co-ordinate the CRP process, the appointment of an independent, professionally qualified board of directors for the National Bank of Vanuatu, and a start to the implementation of a formally adopted strategic business plan for the National Bank.

It is surprising that the phrase “to the satisfaction of the Bank” was not routinely added to the six conditions involving new legislation, in order to ensure that formal compliance was matched by acceptable content. In the case of one of the loan conditions, namely “Enact the Foreign Investment Act to create a favorable environment for private sector operations”, there has been compliance in that an Act has been passed. However, schedules were added immediately prior to presentation to Parliament that are contrary to the spirit of CRP and discouraging of foreign investment (see section 7.6.4). Similarly, there is no evidence that other key pieces of legislation were discussed with the Bank prior to presentation to Parliament.

There are five conditions for the release of the \$5 million second part of the first tranche - the so-called incentive subtranche that effectively is a second tranche. Two require enactment of legislation. Two require formation of a Development Committee of Officials and appointment of managerial staff to the National Bank. The most demanding requires a 10-15 percent public service downsizing by 1 September 1998. In this regard, it is noteworthy that the ADB economic report observes:

*Vanuatu has amongst the lowest number of Government employees per hundred country inhabitants...[3, compared with 18 for the Cook Islands in 1990]..public sector reform does not necessarily have to start with, or have a compelling imperative to, immediately reduce the size of the public service. Reductions in the public sector employment may well occur, but as a result of rationalization of the role of Government and its activities. (ADB 1997c, pp.104-105).*

Be that as it may, the downsizing conditionality is specified ambiguously. The output is described as “Reduce total number employed in public sector by between 10 percent and 15 percent”, whereas the expected impact refers to “public service rightsizing” (emphasis added).

There are seven second tranche conditions that require establishment of an Expenditure Review Committee, a government remuneration tribunal, and a decentralization committee; the absorption of "good" Development Bank loans into the National Bank's portfolio; and the development of plans in the areas of management improvement, national infrastructure, health and education.

Given the central role the Vanuatu National Provident Fund has played in the macroeconomic instability of 1998, and given that rehabilitation of the Fund is a major component of financial sector reform, one or more of the conditions listed in the Program Loan Matrix might have been considered for elevation to the status of a tranche condition. Also, it is surprising that there is no specific mention of the Vanuatu Commodities Marketing Board in the matrix, given its economic importance and poor financial performance (despite the heavy taxes it reportedly imposes on rural producers).

As indicated above, the CRP is more ambitious than would appear from the Program Loan Reform Matrix alone. Law enforcement, commercialization and privatization of public enterprises, and private sector development (through improving access to land, for example), all receive greater coverage. Issues such as labor relations and gender and development are included. Of particular importance, is a commitment to "Improving the reliability and affordability of inter-island shipping by, amongst other actions, progressively allowing foreign competition in the coastal shipping market". Under Schedule II of the new Foreign Investment Act, inter-island shipping is identified as an area reserved for ni-Vanuatu.

#### ***7.4.2 Rationale and appropriateness of loan amount***

The loan amount proposed in the RRP is for the funding of the one-off costs of (1) restructuring and rightsizing of the public sector, (2) restructuring and rehabilitating Government-owned financial institutions, and (3) fiscal stabilization (that is, reducing the need for an inflationary domestic financing of the budget deficit). The allocation of the \$20 million to these is 35 percent, 40 percent, and 25 percent, respectively. Release of the first tranche of \$15 million was expected to occur in two stages in 1998, and to finance 44 percent of the budget deficit. Other foreign aid was to finance a further 17 percent, and domestic borrowing the remaining 39 percent. In the event, only the first \$10 million of the first tranche will

be released in 1998, and will fund 44 percent of a reduced deficit, which apparently will be overfinanced (see Table 7.1).

The authorities are confident that the ADB loan will permit the necessary structural and fiscal adjustments, and that a move to recurrent budget balance shall occur in 1999, followed by a surplus in 2000 – with development expenditure being financed by foreign grants and concessional borrowing. It should be noted, however, that even though revenue estimates have been revised downwards since mid-1998, nominal increases of 6.3 and 8.7 percent are still forecast for 1999 and 2000, respectively, compared with nominal GDP increases of 4.5 and 5.4 percent. These are optimistic. Additionally, domestically-financed expenditure is forecast to fall 10.5 percent in 1999 and to increase by 3.3 percent in 2000. It has to be acknowledged that, at base, the absence of reliable information prevents preparation of convincing macroeconomic projections. The budget deficit on a cash basis will need to be monitored closely as the key indicator of government's changing fiscal position. For this to occur, it is essential that line-item budgeting be re-introduced alongside the new program classification.

### **7.4.3 Consistency with country and Pacific strategy**

Both the rationale for the program loan and the content of the CRP are consistent with the Bank's Pacific strategy. On the rationale, the Strategy for the Pacific states:

*The provision of loan funds will...be used to facilitate the broader reform process. Such efforts will be designed in the context of system-wide reforms and with the full cooperation of the government and other external agencies (ADB 1996, p.26).*

On content, the Strategy observes:

*the Bank should make its assistance more effective in helping create an environment that will lead to improved productivity, increased private sector investment and sustained economic growth. This implies a focus on ensuring that better policies are put in place both at the macro and sector level... It also involves strengthening*

*the institutional capacity of governments to develop and implement better policies themselves...*

*...public sector reform and the promotion of private sector activity have been identified as key strategic areas (ADB 1996, pp.23,26).*

The program loan is also consistent with the country strategy:

*The strategy envisages a more active role for the Bank to support the Government's ongoing efforts at liberalizing the economy and carrying out policy changes to improve its efficiency. This is to be accomplished by strengthening the public service and policy environment to support further reforms of the economy; supporting the efficient development of economic infrastructure (physical, social and financial) by both public and private sectors; and catalyzing more private sector investments (Country Strategy, p.72).*

#### **7.4.4 Relevance and focus**

The CRP's relevance is clear. Though public service downsizing is not the self-evident imperative it was in the Cook Islands case, there is an unquestionable need for reform that includes the replacement of unqualified political appointees and the creation of a professional ethos in the public service. Public enterprise reform is also an accepted need, with many government-owned entities operating at a loss, and the Development Bank and National Bank insolvent. If government fulfils its core functions efficiently and effectively, including that of creating a stable macroeconomic environment, the prospects of the private sector performing to its potential are enhanced.

The CRP is a wide-ranging and ambitious program that places heavy demands on ni-Vanuatu politicians, officials, and the wider community. Convergence has occurred on the key theme of improving governance. The Bank's priorities in assisting the reform process are clearly stated in the RRP.

#### **7.4.5 *Appropriateness and Sustainability***

It is accepted that the human resource constraint in Vanuatu is especially severe. The formulation and implementation of the CRP therefore inevitably have relied, and will continue to rely, on relatively large numbers of expatriate advisers: 42 consultants are identified in the October 1998 report on CRP implementation.<sup>48</sup> There are consequent concerns that ni-Vanuatu officials may feel a loss of control and ownership, and that self-reliance will be undermined. Such concerns make even more urgent the tasks of capacity building and development and implementation of a human resource development plan, which are recognized in the CRP as long-term exercises. They also draw attention to a basic program design issue, namely the appropriateness of any proposed importation of foreign technologies. The gap between domestic capabilities and skills requirements obviously is widened if new, more sophisticated systems are introduced. There is no clear evidence that the design of the program was informed by an assessment of the evidence on other developing countries' experience with reform - except for the Cook Islands example.

#### **7.4.6 *Likely impact on governance***

A key outcome expected of CRP is improved governance. Proposed measures to increase the accountability, transparency and predictability of government, and to increase participation of the wider community in the business of government, include

- Passage of new legislation (the Government Act, the Public Finance and Economic Management Act, the Expenditure Review and Audit Act, the Public Service Act, the Leadership Code Act, the Ombudsman Act).
- Selection of Directors-General on merit.
- Independent functioning of the Public Service Commission.

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<sup>48</sup> The RRP notes that "it is anticipated that further financial and technical assistance will be provided beyond the initial three-year time frame to ensure the sustainability and effectiveness of the reforms" (paragraph 71).

- Strengthening the office of the Auditor General.
- Strengthening the judicial system and the Public Prosecutor's Office.
- Organization of National Summits to review CRP progress.

Finally, although there may be reservations about the appropriateness of the technology transfer involved, and alternative ways of achieving the desired outcome exist, the introduction of program budgeting under CRP encourages public servants to focus on the provision of services, as opposed to drawing salaries and spending available budgets. It would also enhance transparency to the extent that the cost of various government programs is actually clarified (see section 7.6).

## **7.5 Implementation**

### **7.5.1 Actions to date**

The Consolidated Report on CRP Implementation Accomplishments that was prepared for the 1998 National Summit (originally scheduled for 20-22 October 1998 but delayed to 3-5 November because of a coalition reshuffle) provides a detailed description of achievements since implementation began in August 1997. Officials continued to work on implementation between the dissolution of Parliament in November and the formation of a new coalition government in March 1998. The immediate preoccupation was restoration of macroeconomic stability; but this was accompanied by further implementation of the CRP that was conducted in the context of active public consultations and included the first National Task Force meeting in July.

The nine conditions for loan release were satisfied formally with the establishment of the Department of Strategic Management, the commencement of restructuring the National Bank, and the June 1998 passage of new legislation. However, as mentioned above, the new Foreign Investment Act was passed with the late addition of two schedules, which clearly violate the letter and spirit of the CRP

by prohibiting foreign investment from a range of sectors in the economy. Schedule 1 states in reference to a number of sectors that “ni-Vanuatu will not be granted a business license should they either intend to form a partnership with, or in association with a foreign investor(s)”. This is not a legislative change worthy of support and underlines the importance of adding to legislative conditionalities the phrase - “to the satisfaction of the Bank”. The Vanuatu government has formed a working committee to review the legislation.<sup>49</sup>

All first tranche second release conditions have been met, except for the 10-15 percent downsizing of public service employment. In late October, 232 retrenchments from a workforce of 4,250 had been achieved. Plans are in place for further cuts, but implementation is complicated by the quarantining of health and education (for which no net reduction is to occur), and by possible de facto quarantining of the police force. There is therefore an implied cut for the remainder of the public service of 25 percent. Implementation of other reform measures in the Program Loan Reform Matrix is ongoing. The fundamental interest now lies in how effectively the changes introduced so far translate into improved governance and economic management.

### ***7.5.2 Use of loan and counterpart funds***

Counterpart funds were to be utilized for the funding of the one-off costs of (1) restructuring and rightsizing of the public sector, (2) restructuring and rehabilitating Government-owned financial institutions, and (3) fiscal stabilization. These have been the uses of the \$10 million released to date.

### ***7.5.3 Effectiveness of monitoring***

The Vanuatu Government monitors implementation of the CRP through the Department of Strategic Management and the National Task Force, and reports on progress through the media and National Summits. This has been an impressive aspect of CRP implementation. Quarterly program reports are to be submitted to the Bank; and six-monthly reviews are to be conducted by the Bank and

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<sup>49</sup> The legislation was amended in mid-1999.

representatives of Government and the major external funding agencies. Standard reporting requirements for technical advisers funded by the Bank are in place, and monitoring is conducted from the South Pacific Regional Mission office in Port Vila.

## **7.6 Results**

### **7.6.1 Participation and ownership**

This is a major and critical strength of the reform process in Vanuatu. Public consultation and media coverage have been continuous. The holding of Annual Summits has involved stakeholders from various segments of society, and allowed wide-ranging and open critique of the Government's stewardship of the reform process. Encouragement of a deep involvement of private sector and non-government organizations in the process has catalyzed their commitment to it.

Some of the important consequences of this participative approach include:

- The relatively smooth introduction of difficult reform measures such as civil service downsizing and the introduction of VAT.
- A public at large that is increasingly vocal about its expectations of government, thus ensuring continuing progress to greater transparency and accountability of government.
- A reform process that is substantially internally driven, and that is responsive to the country's development priorities as perceived by the general populace.
- Facilitation of government efforts to mobilize and coordinate external support for CRP.

### **7.6.2 *The public sector and governance***

The key theme of the CRP is redefining the role of government and facilitating an improvement in accountability, transparency and performance of government. It is the theme to which the population has responded most favorably—the central hope of the program, around which local ownership has converged. In public management, the CRP has four parts: (i) simplifying government; ii) improving public servants' autonomy and efficiency while reducing their number; (iii) modernizing formal rules; and (iv) improving fair, effective and uniform enforcement of rules and regulations. All of these changes are aimed at the ultimate objective of more effective public service provision.

Simplification of government has occurred through a reduction in the number of ministries from 28 to nine. There has been some internal restructuring within the nine ministries. In addition, there has reportedly been progress in the introduction of performance measures and their monitoring in some departments. This exercise will undoubtedly contribute to the streamlining of operating processes and the improvement of service effectiveness. The intention to introduce corporate plans is welcome, but should be kept very simple and indicative.

Public servants' autonomy and efficiency have already improved substantially:

- The selection of the Directors-General on the basis of competence and merit, and the good and independent functioning of the Public Service Commission (PSC), are two highlights of the internal administrative reforms. Any backtracking on these would jeopardize the success of the reform, create lasting skepticism in the public administration and among the population.
- The process of retrenchment so far seems to have been effective and fair, with individuals judged on the basis of merit and only five complaints lodged with the PSC from 232 retrenchments (one of which was successful). Retrenchment of at least 10 percent of the total number of employees (approximately 430 persons) implies a cut of 25 percent in sectors other than education and health (for

which no net reduction in personnel is envisaged). Also, delicate issues are at stake for the police force, further complicating the prospects of reaching the target. It is important that, following retrenchment, there are mechanisms assuring that (1) the government workforce will not grow back thereafter (a prescriptive and normative wage bill ceiling for each ministry and department is being incorporated into the budget process); and (2) other aspects of the administrative reform are strengthened further (as discussed below).

Modernization of formal rules and new legislation has been extremely rapid, as envisaged in the CRP and required by the Bank loan. Twenty-two pieces of legislation have been passed. In hindsight, however, the speed of formulation and presentation of new laws and regulations has entailed a number of problems:

- There has been inadequate local expertise to cope with the complex requirements of introducing the reform program. This has led to an unavoidably high dependence on expatriate experts. In this connection, there are several means of improving technical assistance: (1) more precise specification of performance measures by which the contributions of advisers may be assessed; (2) greater involvement of ni-Vanuatu managers in the selection process; (3) use of a diversity of sources of advice, particularly taking account of advisers' capacity to appropriately respond to the specific realities of Vanuatu; and (4) ensuring that the skills recruited match actual requirements. In this context, the preparation and implementation of a human resource development strategy is a deservedly high priority on which government is acting.
- The speed of formal rule-making has made it difficult to adequately explain to the population the key aspects of the reform, thus weakening the impact of the remarkable and unusual process of consultation followed by the Government since early 1997.

- Parliament has been required to approve complex legislation with little scrutiny and reflection. Reasons include the sheer volume of legislation in a restricted timeframe, the lack of an effective parliamentary committee system, and inadequate supporting staff and administrative resources. It is essential for good governance that Parliament enjoy the same autonomy over its staff, budget, and administrative resources as is given to any other state entity—naturally, within the limits consented by the budget.

It is in rule enforcement—effective, predictable, transparent and fair—that the major concerns lie. Problems in this area long pre-dated the CRP, and have generated broad skepticism among the population, concerning both public malfeasance and basic law and order. Vigorous and visible action, however, can remedy this skepticism quickly, if sustained. The five key links in the enforcement chain are the Auditor-General office, the Ombudsman office, the public prosecutor's office, the judiciary and, of course, the police:

- With the appointment of a new qualified Auditor-General, there are prospects for better and more aggressive functioning of the Auditor-General office—notwithstanding its financial and human resource limitations. However, these prospects cannot materialize if the other links in the enforcement chain do not work better as well.
- The Ombudsman Office has been exceptionally active in Vanuatu, partly to fill the vacuum caused by weaknesses in the other areas. It is therefore reassuring that after some delay a new Ombudsman Act was passed on 26 November 1998.
- The Public Prosecutor's Office is being strengthened with external assistance. Prospects for improved functioning exist, but greater resources are clearly necessary as well. The most important and urgent step in this regard is the appointment of a permanent ni-Vanuatu public prosecutor.

- The functioning of the judicial system, particularly the Supreme Court with its present leadership, is encouraging, especially in view of its severe resource and staff limitations. It is to be hoped that these limitations in the future can be eased, and that in the interim the judiciary's resources are protected.
  
- Most importantly, an effective police force subject to civilian authority and responsive to citizens' needs is crucial for economic activity and public efficiency. A strategic review conducted with external assistance has concluded that a separate military or paramilitary force is unnecessary and highly undesirable in Vanuatu, and that the police force requires a total staff of 680 to function properly in its diverse roles (which include immigration, prisons, and fire-fighting). Hence, the retrenchment required under the program from the present size of 635 is particularly contested. There is also reportedly a sense of demoralization among the police from having been insufficiently consulted and not brought into the process of restructuring as a full partner. On the other hand, the dissatisfaction with police services is strong and widespread among the government and the public alike. These complex issues can probably best be resolved by a coordinated restructuring and strengthening process, based on partnership and full consultation with the police and citizenry, and benefiting from an external review of staffing needs, current availabilities, and appropriate training requirements.

### **7.6.3 *Fiscal management***

Considerable progress in improving fiscal management has been made in a short period:

- The passage of the Public Finance and Economic Management Act established the legislative framework for responsible fiscal management, clarifying the roles of Parliament, the Council of Ministers, and the Minister of Finance in decision-making, and establishing the principles guiding fiscal policy.

- A Government Remuneration Tribunal Act to determine public sector salaries and allowances has been passed.
- A reduction and simplification of import duties and business license fees have been accomplished, and a Value Added Tax introduced.
- A process of extending budget coverage to incorporate all development projects has begun.
- Performance concepts have been introduced into public administration in association with the adoption of program budgeting.

However, several issues require further attention in order to consolidate the gains from these changes :

- Macroeconomic databases remain inadequate, making it difficult to adhere to the requirements of the Public Finance and Economic Management Act, and to conduct economic and policy analysis. Technical assistance with a strong training element is the only hope for durable improvement in this area.
- Restoration of fiscal balance remains a fundamental policy objective and challenge.
- Also, rehabilitation of the Vanuatu National Provident Fund is recognized as an essential element of ensuring fiscal stability. This hopefully can now proceed following amendments to the relevant legislation.
- Tariff reductions and introduction of the VAT have been accomplished despite severe time and human resource constraints, but will need to be protected through ongoing staff training and associated efforts to ensure compliance. The impact on the price level also needs monitoring.
- Considerable further effort is needed to consolidate the extension of budget coverage, so that the Government

Investment Program presents only economically and socially viable projects with assured and identified funding for the coming year, and reasonable prospects for two subsequent years. Also, the total cost of each project must be clearly identifiable before its inclusion in the budget. Finally, a start must be made on the difficult but essential task of quantifying the recurrent costs of development projects.

- In order to ensure effective expenditure control and transparency, it is essential to present, at least at the Ministry level, the economic classification of expenditure alongside the new program classification, and to impose a post-retrenchment wages and salaries ceiling. Currently, in the absence of personnel recruitment controls and given the reporting format of “program budgeting”, there is a risk of loss of expenditure control in general, and of the wage bill in particular. It is understood that government is working towards a presentation of economic classifications at the departmental level.
  
- Program budgeting is a new system that will take longer than expected to implement, and that makes substantial demands of domestic capacities that are acknowledged to be severely limited. Not surprisingly, program budget narratives for 1998 are incomplete, sometimes do not correspond completely with sectoral strategies, and contain performance measures that are a mixture of output, process and outcome indicators, most of which are not monitorable. In the next stage, it will be essential to cost programs accurately, and to define meaningful and monitorable indicators, focusing on a few selected government activities for which this is a realistic exercise given the domestic capacity constraint. An independent, expert and in-depth review of the workings of the public financial management system could provide useful support.

#### **7.6.4 Economic reform and growth**

Reform of the financial sector is central to the private sector development component of the CRP, and focuses on the restructuring and streamlining of government owned financial institutions (DBV, NBV and VNPF), and the enactment of related legislation to ensure their sustainable effectiveness. Significant progress to date includes:

- The Financial Institutions Restructuring Steering Committee is operational and is supervising the restructuring of financial institutions.
- A local Project Manager has been appointed to implement the strategic business plan for the restructuring and rehabilitation of the three financial institutions. The Project Manager reports to the Steering Committee.
- The Development Bank of Vanuatu has been merged with the National Bank of Vanuatu to create a commercially viable bank. This process has been facilitated by the transfer of DBV's good loans to the NBV as of 30 October 1998 and the bad loans portfolio to the Asset Management Unit. AMU was created by an Act of Parliament in June 1998 to manage and recover bad debts from DBV, NBV, and VNPF. An externally recruited General Manager is in place now and the office is fully operational.
- An externally recruited Managing Director took up his post with the NBV on 28 October 1998, and the other three senior officers are expected to be in post in November 1998.
- The VNPF Act has been amended in the November session of Parliament in order to restructure and focus the Provident Fund on its main functions of contribution management and benefit payments.

Concerns and challenges remain however:

- NBV is insolvent and its recapitalization requirements need to be assessed. To become an efficient and effective bank servicing the needs of ni-Vanuatu, the bank needs a renewed focus on client relationships, especially those involving services to the outer islands.
- The capacity for monetary management is relatively weak and there is a recognized need for institutional strengthening of the Reserve Bank. (The concept of a currency board is worthy of investigation).
- Related to the foregoing concern, banking legislation and supervision require improvement.
- The Credit Union League, which plays an important role in the outer islands, feels excluded from the financial sector reform process.

Tax and tariff reform has made a positive contribution to improving investor confidence in the economy and its management. However, the economy is characterized by imperfect competition, including monopolies with price-fixing power, and is open to collusive political-economic arrangements. Consequently, tariff reductions and introduction of the VAT apparently have provided some opportunities for unwarranted price rises. Especially in the outer islands, these have gone unchecked in the absence of any price monitoring mechanism.

Plans for privatization of public enterprises should also be informed by an awareness of the market structure and pay due regard to the regulatory framework required to protect the public interest. The need for utilities and telecommunications regulation is recognized in the CRP, and the World Bank has assisted in preparation of a policy framework for these areas. Planned corporatization of Civil Aviation, Ports and Marine, and the Post Office will also involve design of a regulatory framework. As in many other areas of the public sector, implementation capacity is the major concern.

The worst outcome of the reform process so far is the Foreign Investment Act in the form that it was passed. Schedules I and II of

the Act are contrary to the letter and spirit of CRP, will discourage foreign investment, and will hamper Vanuatu's efforts to join the World Trade Organization. The Act itself is sound, but the Schedules need to be revised.<sup>50</sup> A drastic reduction in the reserved areas is urgent and essential. Inter-island shipping and kava exports, among others, are areas where restrictions of competition will be especially damaging to the Vanuatu economy.

This last observation is made at a time of recession for the Vanuatu economy, when prospects of recovery to a sustainable rate of economic growth (of perhaps 3 percent per annum) depend heavily on a recovery of private sector confidence and investment.

## 7.7 Looking to the Future

Government has made considerable and rapid progress in implementation of an ambitious reform program, and has demonstrated a commitment to completing this implementation. A strong partnership between the Bank and Government has been forged, and the Bank loan has been crucial to funding adjustment costs and avoidance of macroeconomic instability. Although implementation of the CRP is in its early stages, and an assessment of its economic and social impacts will need to be made at a later date, there are some key lessons that emerge from experience so far:

- When new legislation is a tranche condition or required policy measure deemed crucial to the success of a reform program, the phrase "to the satisfaction of the Bank" should be included in the program matrix, and prior agreement with government should be reached to consult the Bank on the draft bill.
- Program design should take account of the inverse relationship between the speed of passing new legislation and the effectiveness of its implementation.

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<sup>50</sup> As already footnoted, this has happened.

- Given the first two lessons, a more proactive involvement of the legal counsel is needed at all stages of program design and implementation.
- Reforms need to be more carefully designed and phased to take account of domestic capacities; and appropriate specialized expertise must be utilized
  - In particular, the experience of developing countries with public sector management methodologies should be assessed and reflected in appraisal.
- Full account needs to be taken of the imperfectly competitive market structures of small island economies and appropriate regulatory frameworks designed.
- Renewed attention needs to be paid to population growth in those countries where population is doubling every two decades.