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DRAFT REPORT

on

**PROPOSALS FOR THE FUTURE OF THE
TARIFF REFORM PROGRAMME**

**Prepared for the Manufacturers'
Council of Papua New Guinea**

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Introduction

This report has been prepared at the request of the Papua New Guinea Manufacturers' Council. Its purpose is to review the Council's proposal for a temporary suspension of the Tariff Reform Programme. The report was prepared during a week-long visit to Port Moresby 3-8 October 2005.

Research undertaken for this report included a review of the Tariff Reform Programme itself, along with related documents including the Internal Revenue Commission's White Paper on the Tariff Reform Programme; the 2003 Tariff Review; the Papua New Guinea Manufacturers' Council's 2002 Review of the Tariff, VAT and Excise Reforms; the Papua New Guinea Government's Mid-Term Development Strategy 2005-2010; relevant chapters of the 2005 National Budget; and the DFAT Economic Analysis Unit's 2004 report Papua New Guinea: the Road Ahead. Consultations were held with manufacturers and other private sector representatives in Port Moresby and Lae, with representatives of ministries and other public agencies including the Department of Trade and Industry, the Ministry of National Planning and Monitoring, Internal Revenue Commission, Treasury, and the Bank of Papua New Guinea, and with representatives of donor agencies (Asian Development Bank and European Union delegation). Advantage was also taken of an opportunity to meet the Deputy Prime Minister. The report also draws on widely accepted principles of trade policy analysis and on relevant international experience.

Given the short time available for preparation of the report, it does not purport to provide a comprehensive analysis of all relevant aspects of Papua New Guinea's economic situation and business environment. Nevertheless the consultations indicated that there is broad agreement within both the private and public sectors on many of the features of the economic situation and business environment highlighted in this report.

The Tariff Reform Programme

The Tariff Reform Programme was introduced in 1999. Its principal features include:

- Duty rates for most goods, with the exception of goods that are produced or could potentially be produced in Papua New Guinea, were set at zero. As a result approximately three quarters of Papua New Guinea's imports now enter the country duty free .
- For goods that are produced or could potentially be produced in Papua New Guinea, duty rates were consolidated into three bands: the prohibitive rate, the protective rate, and the intermediate rate. Initial rates were set for each band, and the TRP then provided these rates to be reduced in three timetabled steps of 5%.

The protective rate is intended to provide protection for producers of finished goods. The intermediate rate applies to inputs into the production process that are produced or could be produced in Papua New Guinea. The prohibitive rate is designed as a major deterrent to imports of certain goods for which local production has been deemed to be especially valuable.

The timetable, together with the beginning and ending rates for each band, are set out below in Table 1.

Table 1: Timetable for Tariff Reduction Programme (1 January Basis) 1999-2006

	1999-2000	2001-2002	2003-2005	2006
Intermediate Rate	30%	25%	20%	15%
Protective Rate	40%	35%	30%	25%
Prohibitive Rate	55%	50%	45%	40%

Source: White Paper on Tariff Reform

All steps in the TRP except the final step have been implemented on schedule. It is the final step, scheduled for January 2006, reducing the prohibitive, protective and intermediate rates respectively to 40%, 25% and 15%, that the Manufacturers' Council is proposing should be temporarily suspended. This would leave the rates at the penultimate steps of 45%, 30% and 20% respectively.

There is no schedule currently in place for further reductions beyond 2006. The 2003 Tariff Review report recommended that the TRP should be continued beyond 2006, with further reduction of 5% in each rate every three years, commencing in 2009, until all tariffs are at 15%. On this basis the protective and prohibitive rates would reach 15% in 2012 and 2021 respectively. This recommendation has not so far been adopted.

Parallel to the introduction of the TRP the government introduced a VAT (now renamed GST) to offset revenue losses from reduced tariffs and to replace provincial sales taxes. The VAT/GST system is particularly useful for export industries because exports can readily be zero-rated, so that the VAT /GST does not have to be built into export prices. Exporters are also able to apply for drawback of duties paid on goods that have been used in producing exports.

It is important to recognise that the effective protection provided by the current structure will generally be substantially higher than the published (or nominal) tariff rates might indicate. While the tariff on finished goods applies to the product as a whole, protection is effectively concentrated on the value added in the local economy. The effective rate of protection will exceed the nominal rate whenever the tariff on finished goods is higher than the tariff on the intermediate inputs. The difference can be especially large for production processes where imported inputs account for a large proportion of the value of the finished product.

While the concept of effective rates of protection has some limitations, it provides a better measure than the nominal tariff of the impact of a tariff structure on economic efficiency, especially in industries where protection rates and dependence on imported inputs are both high. ¹

Table A1 in Appendix A provides some hypothetical examples based on the current tariff structure. For example, if the tariff on the finished product is 30% and imports account for 60% of the value of the final product, the effective rate of protection is 45% if the inputs are dutiable at 15%, and 75% if the inputs are dutiable at zero. These effective rates of protection rise to 60% and 120% respectively if imports account for 75% of the value of the final product.

Protection of domestic industry also results in negative effective rates of protection for export industries that have to sell their outputs on world markets at international prices while purchasing inputs from protected local industry at higher than world prices. In this case the negative effective rate of protection is a measure of the penalty imposed by the tariff structure on export industries.

Table B 1 in Appendix B shows the reductions in effective rates of protection for local industry achieved under the TRP, as reported in the 2003 Tariff Review. The table shows that the reductions achieved under the TRP from 1998 to 2003 were very substantial indeed. The largest reduction was by 107%, and reductions by over 30% were commonplace. It should be recognised that these reductions in effective protection are also an indication of the extent of the adjustment that has been required from local industry over the same period.

Table B2 also in Appendix shows the reduction in negative effective rates of protection for export industries reported in the 2003 Tariff Review. It shows that between 1998 and 2003 the TRP was able to successfully achieve substantial reductions in the penalty imposed on export industries by the tariff structure.

These reductions in effective protection for local industry and in negative effective protection for export industries represent very substantial achievements of the TRP. They indicate that the TRP has brought about a very substantial improvement in the efficiency of resource use across Papua New Guinea industries. Adjustment to changes of this magnitude are also a significant achievement by domestic industry.

¹ The economic concept of efficiency used here differs from the business concept of efficiency. It is possible for an operation to be efficient in the business sense of being well-managed while at the same time being inefficient in the sense of its use of the economy's resources. This could be because production costs are high by international standards for reasons that are outside management's control.

The Rationale for the Tariff Reform Programme

The TRP is consistent with the ten guiding principles of the Medium Term Development Strategy, in particular the fifth principle (Competitive Advantage and the Global Market): "to focus interventions on resources, products, and commodities in which Papua New Guinea enjoys a competitive advantage in global markets".

This principle implies acceptance of the opportunity provided by international trade for countries to make efficient use of their resources by specialising in the production of goods and services best suited to their resource endowments. It also recognises the need for international competitiveness in order to overcome the limitations of the domestic market by exploiting opportunities in the global economy.

High rates of protection contradict the fifth principle of the Medium Term Development Strategy by attracting resources into industries whose cost of production is high by international standards. In doing so they penalise existing and potential export industries in two ways, by increasing the attractiveness of investment in the higher-cost industries relative to investment in competitive export industries, and by contributing to a higher cost structure in the domestic economy.

The rationale for the IRP is that high rates of protection are inconsistent with an efficient development strategy, and as such needed to be reduced as a matter of priority. Lowering of protection rates is intended to reduce the attractiveness to investment of sectors with relatively high costs of production and to encourage the movement of resources into industries with cost structures that are more internationally competitive, as well as to encourage existing industries to become more cost-competitive. The IRP also assists movement in this direction by enabling producers to purchase cheaper inputs for their production processes. Consumers are expected to benefit through the resulting reductions in prices of goods and services. To the extent that the reduction in prices extends to basic commodities the IRP has the potential to make a significant contribution to poverty reduction. In fact of course, devaluation of the kina has raised the prices of many imported consumer goods, but the increase in price will have been less than if the IRP had not been in place.

The rationale for the TRP remains valid. The issue of how far rates of protection should eventually be reduced was left for decision later. This issue can be expected to come into focus as protection rates are reduced to more moderate levels.

The design of the TRP also recognises the vital importance of credibility and predictability in economic policies that seek to influence private sector behaviour. Private sector behaviour will respond to policies that are seen to be credible. Policies are not credible if they are perceived as likely to be easily reversed or readily open to modification by the creation of special exceptions. In that case businesses may decide to defer responding to the policy in the manner intended, and to focus energies instead on lobbying for reversal of the policy or the creation of special exceptions favourable to themselves. Creation of special exceptions further undermines support for the policy by

generating a perception of unfairness. Business also needs policy predictability in order to plan its future investments. Uncertainty over the future direction of policy is likely to result in deferral of investment plans. A gradual phasing in of the changes over an extended timetable is also important in allowing business to adjust to the changes in a rational and orderly manner, rather than being forced to make abrupt and disruptive adjustments to large and sudden "once-and-for-all" policy changes.

The TRP provided credibility and predictability by applying uniform tariff reductions to all products through a series of steps in accordance with a timetable that was set in place by legislation. To a large extent discretion was thus taken out of the hands of the bureaucracy. Businesses were able to plan ahead with the near certainty that the programme would proceed as scheduled. While some high-profile exceptions have in fact been created, these cases are so far few in number. Although these cases do not appear so far to have undermined support for the TRP, they were nevertheless the subject of considerable dissatisfaction expressed by private sector representatives, and it appears likely that a proliferation of these "special deals" would indeed seriously undermine support for government tariff policy.

Unfortunately similar levels of credibility and predictability in other policies affecting the business environment have not yet been achieved in the eyes of the private sector. This issue and its implications are considered in the following sections of the report.

The TRP and the Business Environment

During consultations private sector representatives expressed serious concerns over the implications of implementing the next step of the TRP. The concern did not appear to be directed primarily against the rationale for the TRP itself, although question marks were definitely raised over how far a tariff reduction programme should reasonably be pursued in the PNG context. Rather, the most strenuous complaints were raised over the failure of government to fulfil its "side of the bargain", by implementing policies that could deliver improvements in the business environment in parallel to the implementation of the TRP. Instead the private sector view is that most aspects of the business environment have been seriously deteriorating, resulting in increased costs of doing business and undermining their ability to adjust successfully to the TRP. These concerns are similar to those expressed at the time of the 2003 Tariff Review. The business view appears to be that the business environment has not improved since that time, but rather has deteriorated further. Private sector representatives expressed both frustration and a deep sense of unfairness at this state of affairs.

Private Sector Views on the Business Environment

Key concerns over the state of the business environment include the following:

- Security and Insurance Costs
This issue is related to the law and order situation in Papua New Guinea. Private sector representatives report that insurance and security costs continue to escalate.

In Port Moresby the private sector representatives estimated that security costs now equate to one third of their wages bill. These costs tend to rise proportionately with the numbers employed, and act as a major deterrent to expanding operations. Security issues are also an impediment to the recruitment and retention of skilled staff, and add disproportionately to the costs of employing expatriates.

- Infrastructure

The deterioration in the country's infrastructure, particularly transport-related infrastructure (roads, port facilities, airline operations) was widely cited as a major impediment to existing business and to the development of new business opportunities. Rehabilitation and improvement of the economy's basic infrastructure was universally seen as a top priority.

- Transport Costs

High internal transport costs are seen as a major drain on the competitiveness of domestic producers. In part this problem is related to the deterioration of the transport infrastructure, but private sector representatives also stressed the importance of deregulation to introduce greater competition, especially in coastal shipping and aviation.

- Utilities

Both the cost and efficiency of utilities are of great concern to business. In the case of electricity private sector representatives stressed both the effect of the recent rapid increases in electricity prices and the unreliability of supply, which in many cases has necessitated the installation of costly private generating equipment. Telecommunications costs in Papua New Guinea are universally viewed as exorbitant, and deficiencies in the telecommunications services are an important impediment to efficient business operations.

- Import Monitoring

This issue was given a high priority by private sector representatives in Lae in particular, who highlighted numerous problems, including

- inadequate customs enforcement, resulting in widespread evasion of customs duty and GST, and frequent acceptance of undervaluation for duty purposes in customs declarations.

- lack of enforcement of the PNG Packaging Act, resulting in circulation of cheap non-complying packaged products in competition with complying domestically-produced products

- inadequate application of quarantine and other SPS controls --

- counterfeit and parallel imports

- inadequate control of inbound cargoes, with the result that theft of loaded containers is a not infrequent occurrence.

Private sector representatives complain that these activities result in their being increasingly faced with competition from businesses dealing with illegal goods, or goods on which the proper duty and/or GST has not been paid, to the extent that

in some cases the viability of their businesses is being undermined. The problems are compounded when the competing goods are being sold by illegal immigrants operating illegal businesses. Business representatives are strongly of the view that current provisions for enforcement are completely inadequate to deal with the problem. There were strong suggestions that customs enforcement should be outsourced to a professional agency such as SGS, or alternatively that expatriates on short-term contracts should be employed to address problems in the customs service.

Dumping is another problem cited by some private sector representatives. From the examples cited it was not always easy to assess whether dumping in the technical sense is occurring, or whether the foreign suppliers (for example of New Zealand barracouta) are using the Papua New Guinea market as a "dumping ground" for low-quality off cast products that are unsaleable elsewhere. In any event private sector representatives see themselves as disadvantaged by the inability of Papua New Guinea to establish formal procedures for undertaking antidumping actions.

- Level of Economic Activity

While the economy has clearly grown in the last two years, some private sector representatives maintain that most of this growth has been occurring in the extractive industries such as oil gas and minerals, and that the rest of the economy, which effectively constitutes their domestic market, has continued to stagnate, with a significant decline in consumer buying power being felt by domestic businesses. It was not possible in the time available to locate data that would enable this claim to be assessed, but it is one that is strongly maintained by private sector representatives.

- Inflation

Private sector representatives are sceptical of official inflation figures, which are based on a consumer price index that has not been re-based since 1977. They consider that inflation is running well ahead of official estimates, and that this is a further factor negatively affecting their businesses. The recent rapid escalation in fuel prices was widely mentioned although it was recognised that this is to a large extent a global problem rather than one affecting Papua New Guinea alone. Nevertheless the private sector representatives considered that pricing arrangements for the output of the local refinery have exacerbated the problem in Papua New Guinea.

Business representatives did acknowledge that improvements have occurred in some aspects of the business environment. In particular, macroeconomic conditions have stabilised over the last 12 months, and reforms in the financial sector have resulted in significant improvements in the availability of finance for business. It was noted however that the spread between the cost of funds and lending rates remains high, and that financial institutions are currently experiencing excess liquidity, indicating among other things a shortage of profitable business opportunities.

Private Sector Views on the TRP

Private sector representatives acknowledged that the initial phase of the TRP, involving the reduction of duties on many products to zero, had been very helpful for business. The combination of this initial phase with the introduction of VAT, with the facility for zero-rating of exports, was especially helpful for export industries.

There was also widespread support for the proposition that the final scheduled step of the TRP should be suspended until the government has implemented policies to deliver promised improvements in business conditions.

Looking beyond the possible suspension of the final step of the TRP, a wide range of views was expressed on the desirable future direction of tariff policy. Some expressed the view that the 30% rate for finished goods should become permanent. At the other end of the spectrum were those who advocated the eventual abolition of all duties. Between these two extremes there was support for varying degrees of ongoing tariff reduction. A number of proposals were made for reductions or elimination of duties on specific products (for example various inputs to the fishing industry), increases in duties on some products (for example polyethylene pipe and tuna "blood meat"), or the retention of certain specific provisions (for example the current alternative value-based and volume-based duties on beer).

A wide range of views were also expressed on future business prospects. Some businesses are continuing to expand, or see opportunities to expand if uncertainties over the future business environment could be removed. Others claimed to be at the point where a further reduction in duties would tip the balance between continuing to produce locally or replacing local production by imports. In Lae some businesses claimed that their viability is at risk from illegal imports, regardless of what happens to the TRP.

There was considerable emphasis on the employment implications of possible plant closures or downsizing. Some plants whose viability was claimed to be under threat are substantial employers of labour, in one case more than 1000. It was recognised that tariffs are only one factor, and not necessarily in many cases the most important factor affecting employment decisions. Other factors include changing technology and the general deterioration in business conditions.

There was acknowledgement that many businesses have streamlined their operations to achieve very significant cost reductions. As with employment decisions it is not possible to identify what proportion of this is due to tariff changes. Changes in business conditions, especially unavoidable cost increases, have also been major contributing factors. The need for ongoing productivity improvements to maintain competitiveness, for example through introducing new technology, is also a factor that is to some extent independent of tariff policy. Inevitably some cost reduction measures have resulted in job losses.

Public Sector Views

Among public sector officials consulted there was little or no disagreement with the private sector's assessment of trends in business conditions. In some cases the improvements that have taken place were understandably emphasised. Treasury emphasised the benefits of the reforms that have taken place in the financial sector. The Bank of Papua New Guinea emphasised the improvement in macroeconomic conditions and monetary management.

Nevertheless there was clear recognition among government officials of the importance of pursuing and achieving improvements in law and order, infrastructure development, transport costs, and competitively-priced utilities. The problems associated with import monitoring appeared to be less widely recognised.

There are signs that some improvements may be under way. For example a project to rehabilitate the Highlands Highway is reportedly close to being approved, and there are other initiatives at various stages of planning. Nevertheless it is also clear that major challenges remain to be overcome. Serious coordination problems between Treasury and the Ministry of National Planning and Monitoring appear to be an obstacle to converting the aspirational statements of the Medium Term Development Strategy into an operating reality. Another key challenge is to manage some redirection of government expenditure from current expenditure to development expenditure while still maintaining overall fiscal control.

There is also recognition that a fundamental objective of all of these policy initiatives must be to encourage investment and the development of commercial activity in agriculture and other primary-producing sectors, which are the sectors where both Papua New Guinea's long-term comparative advantage and the majority of the population are located. Development in these sectors is crucial for improving the standard of living of the majority of Papua New Guinea's population. It will also make an important contribution to enhancing the business environment in which the manufacturing sector operates.

Policy Considerations

Although the simple average tariff in Papua New Guinea is now around 6%, this is largely because of the zero tariff rate applying to around three quarters of Papua New Guinea imports, representing goods that are not currently produced in Papua New Guinea and unlikely to be produced there in future. For purposes of assessing the future of the TRP the important tariff rates are those that remain in place to protect domestic industry. These tariffs are still high by international standards. The protective and prohibited rates for example are both higher than the maximum rates applying in Fiji, and significantly higher than the maximum rates applying in Samoa to products other than some tobacco products. Effective protection rates are likely to be much higher again, as can be gathered from the hypothetical examples in Table A 1 in Appendix A.

The 2003 Tariff Review also found that high effective rates of protection remain, although the rates shown in that report are somewhat lower than the rates indicated in Table A1 in Appendix A. This is almost certainly because the rates shown are, as the report indicates, weighted averages for groups of commodities subject to varying rates of protection. The inclusion of some finished products subject to a zero tariff rate would greatly lower the average rate for such groups.

Reductions in high rates of protection for domestic industry is a standard component of the outward-looking development strategy typically followed by successful developing countries, and also embraced in Papua New Guinea's Medium Term Development Strategy. The standard advice for Papua New Guinea would therefore be to continue bringing down effective rates of protection from their current high levels.

At the same time it must be acknowledged that trade liberalisation as part of an outward-looking development strategy has not always been a successful approach for developing countries. It is now well understood that in order for trade liberalisation to deliver its anticipated benefits it must be embedded within a broad programme of policy reform encompassing a set of coherent, complementary and appropriately sequenced policies. Trade liberalisation in the absence of appropriate complementary policies can and sometimes does produce perverse results.

This consideration poses a problem for further implementation of tariff reform in Papua New Guinea, because key elements of the intended policy reform package have so far been missing. These deficiencies have been reflected in the deterioration in business conditions emphasised by the private sector representatives. Under these conditions there is a risk that further tariff reductions could create unnecessary dislocation in domestic industry. Perhaps more worrying still are the possible implications for employment. The rationalisation that is bound to follow from a substantial programme of tariff reduction will inevitably lead to some job losses. In a well-functioning economy these job losses will be offset by increases in job opportunities elsewhere in the economy as tariff reduction produces a reallocation of resources between industries, and there is thus no reason to fear that tariff reductions will lead to an overall loss of employment beyond a possible short-term adjustment period. However if the economy is not functioning well, and/or if accompanying policies are absent or set inappropriately, there is a risk that the anticipated increase in jobs elsewhere in the economy may not materialise, so that the tariff reductions result in a substantial increase in unemployment and economic hardship.

These risks are not easy to evaluate. Consultations with private sector representatives suggested that the risk to employment is substantial. On the other hand employment data from the Bank of Papua New Guinea indicates that after a downturn during the depressed economic conditions of 2001 employment in the manufacturing sector grew by 2.7% in 2002, by 5.2% in 2003, and by 4.4% in 2004. Assuming these figures are accurate, they would indicate a degree of success on the part of the manufacturing sector in adjusting to the TRP. The Manufacturers Council maintains that this rate of employment growth represents an inadequate contribution by the manufacturing sector to the employment

needs of the country. According to Council figures there were approximately 34,000 persons employed in manufacturing at the end of 2003, equating to around 23% of private sector employment or 15% of formal sector employment. On this basis the Bank of PNG figures would indicate that employment in manufacturing grew by just under 4000 in the three years 2002-2004. By contrast, potential new entrants to the labour market include around 42,000 school leavers each year. In light of this contrast the Council view is that much higher employment growth is needed in the manufacturing sector.

The report of the 2003 Tariff Reform correctly points out that high and increasing costs of doing business in Papua New Guinea is not in itself an argument for suspending the TRP. The best way to address these problems, and other difficulties such as obstacles to labour market adjustment, is to address them by policies designed to address the problems directly, rather than indirectly through tariff policy. By common consent however, these problems have not been adequately addressed over the last two years, and in certain respects the problems have become worse. There are signs that a more adequate policy response is in the making, but this will inevitably require time to be implemented and take effect.

It is these circumstances that provide the potential economic justification for the manufacturers' proposal for a temporary suspension of the TRP. From an economic perspective the case is that a better overall outcome from the reform process will ultimately be achieved if the pace of tariff reform is slowed down to allow reform in other areas to catch up. It is important to emphasise that this is an argument about the pace and sequencing of reform, and not about whether reform is necessary.

There are also important issues of policy credibility and predictability that come into play. The TRP has been a credible and predictable instrument of reform. It is important that other elements of the economic reform package should acquire similar credibility, thereby underpinning the credibility and predictability of the overall package. It is also important however that this should be achieved while at the same time maintaining the credibility of the government's ongoing commitment to tariff reform.

At the same time potential uncertainty is created by the lack of any firm programme for tariff reform after the final step of the current TRP timetable. In the interests of policy credibility and predictability it is desirable that this vacuum should be filled. One approach would be to design a further series of across-the-board steps, as proposed in the 2003 Tariff Review. An alternative approach would be to commission an industry-by-industry review, as the Manufacturers' Council is also proposing, and to use the results of that review as an input into the formulation of post-TRP tariff policy.

A review would provide the opportunity to consider individual industry circumstances, to assess how the pace and structuring of tariff reform could be calibrated to achieve the best overall outcome, and also to prioritise the improvements in the business environment that are necessary if businesses are to respond to the reform process in the most

advantageous way. If done well a review could assist in building private sector support for the ongoing reform process.

The Future of Tariff Policy

The Manufacturers Council has proposed that the final step of the TRP be deferred until after the proposed industry review has been completed. Delaying the final step of the TRP would mean a delay in the benefits of further reductions in effective protection. Tables B1 and B2 in Appendix B however indicate that the improvements in effective protection anticipated from the final TRP step, although significant in some cases, are generally small and in virtually all cases much smaller than the improvements achieved from the earlier TRP steps. The economic cost of delaying the final TRP step may thus not be great, particularly if this cost is offset by an improved overall outcome to the reform process, as suggested above.

The danger must also be recognised however that suspension of the TRP and commissioning of an industry review could undermine policy credibility, by creating the impression that there is a prospect of reversing the direction of reform, and/or that the government is becoming more rather than less open to "special deals". It would be very important to avoid creating impressions such as these.

It is therefore recommended that if government decides to adopt the Manufacturers' Council proposals, it should do so on the following basis:

- that the modification of the TRP be adopted not as a suspension of the TRP itself, but as a delay in the final step of the TRP, with the final step to be implemented 1-2 years (preferably 1 year) after the date originally scheduled.
- that the industry review be commissioned on the basis that it is intended to produce recommendations for post- TRP tariff reform, leading over time to further reductions in effective rates of protection, and that these reductions in effective protection are to be linked to the delivery of specific policies to produce necessary improvements in the business environment to be identified by the review.
- that in line with the above intention, the existing TRP tariff rates be established as the ceiling for future tariff rates, with the ceiling to be lowered by a further 5% when the final TRP step comes into effect.
- that any tariff rates that are currently exceptions to the standard TRP rates are to be brought into line with the standard TRP rates as soon as legal considerations permit.

An alternative to delaying the final step of the TRP until after the industry review would be to implement the final step as scheduled, with the industry review to follow. On a purely economic calculus this might have some advantages. An offsetting disadvantage however is that this would leave a vacuum in tariff policy until after the review is completed and its recommendations adopted. Such a vacuum would give rise to increased opportunities for lobbying for a reversal of tariff reform and/or "special deals".

It is also strongly recommended that government resist pressures to begin using tariffs as an instrument of industry policy. This approach, implying a requirement for government to "pick winners", would fly in the face of experience and current thinking in East Asia and elsewhere. There is little in the recent experience of developing economies to suggest that such an approach is likely to be successful. Even in economies where particularly capable bureaucracies have traditionally been thought to have successfully implemented industry policy, such as Japan, recent re-assessments have concluded that the record was much more mixed than indicated by the "traditional wisdom", with many failures as well as successes. In a poor developing economy with limited bureaucratic resources and capacities the danger is that such an approach will lead to a proliferation of "special deals", leading to a large number of projects of questionable economic value, or worse.

Consultations both in the private sector and with some government policymakers produced a number of very firm statements to the effect that the Papua New Guinea government's role in the development process should focus on the provision of economic infrastructure (including human resource infrastructure and research and development where appropriate) and a favourable policy environment for business (including but not limited to macroeconomic stability, effective law and order, and an appropriate regulatory environment), leaving commercial development in the hands of the private sector. These statements were illustrated by reference to successful developments in Papua New Guinea where these principles were followed. These views are strongly endorsed here.

It can also be emphasised that it is a well-established principle of economic policy that policy objectives are most efficiently pursued by the policies that most directly address the objective. Tariffs are an indirect instrument for achieving most policy objectives, and as such are almost never the most efficient instruments for achieving any worthwhile policy objective. Poverty reduction, good governance, and rural development, for example, are all worthy policy objectives, but they are all best addressed by more direct policy measures rather than indirectly by means of tariffs. There is no credible argument for suggesting that tariffs are the most efficient policies for achieving these objectives, much less that they are the only policies for that purpose.

It is inevitable that government will from time to time be faced with requests for special tariff treatment for specific industries, including but not limited to requests for "infant industry" status. It is important that clear guidelines are established and implemented for consideration of such cases, designed to ensure that these requests are decided on a basis that is consistent with the principles and objectives of tariff reform policy. The procedures for consideration of such requests should be transparent and designed to ensure that a proper economic evaluation of the request is undertaken. It is therefore recommended that:

- a guideline be established whereby any special treatment granted in response to such requests should not exceed the TRP rates in force at the conclusion of the current phase of the TRP, and that such rates be brought into line with the

standard tariff rates applicable under the tariff policy provisions applicable at the time within a period not exceeding four years

- a formal procedure be established for consideration of such requests, along the lines set out in Recommendation 4 of the 2003 Tariff Review Report.

APPENDIX A

EFFECTIVE RATES OF PROTECTION

The basic formula for the effective rate of protection (e. r. p.) is

$$\text{e.r.p.} = \frac{\text{VAd} - \text{VA}_w}{\text{VA}_w}$$

Where

- VA = value added in domestic manufacturing i.e. the difference between the price of the finished goods and the cost of imported inputs
- VAd = value added under the tariff regime i.e. the difference between the price of the finished goods and the cost of imported inputs with any applicable tariffs added in both cases
- VA_w = value added under free trade i.e. the difference between the duty-free price of the finished goods and the duty-free cost of imported inputs.

The following table provides some hypothetical effective rates of protection calculated under the above formula, using the current TRP tariff rates, depending on the percentage of the value of the finished good (duty-free basis) that is accounted for by imported inputs (also on the duty-free basis)

Table AI: Illustrative Effective Rates of Protection at Current TRP Tariff Rates

Duty Rate on Finished Goods	% of imported input cost in value of finished product (duty free basis)	e.r.p with 20% duty on inputs (TRP Intermediate rate)	e.r.p with zero duty on inputs
30%	50%	40%	60%
30%	60%	45%	75%
30%	75%	60%	120%
30%	80%	70%	150%

APPENDIX B

CHANGES IN EFFECTIVE RATES OF PROTECTION UNDER
THE TARIFF REFORM PROGRAMME

Table 81: Percentage Reductions in Effective Rates of
Protection under the Tariff Reform Programme

	1998-2003	2006
limber Products	39.89	2.98
Processed Food	39.04	2.46
Beverages and Tobacco	76.8	3.51
Metals and Engineering	40.83	0.67
Machinery and Repairs	12.57	0.48
Chemicals and Oils	34.69	0.76
Other Manufacturing	33.62	0.76
Flour	38.33	11.19
Biscuits	13.23	10.47
Tinned Fish	74.31	11.19
Soap	30.54	12.91
Cooking Oil, bottled for retail	-23.08	12.87
Cooking Oil, other	107.56	-0.04
Clothing	32.24	8.09
Steel Products	68.29	9.84
Sugar	19.19	-1.3
Rice	14.02	-0.07
Salt	-81.43	61.39
Large Scale Fruit and Vegetables	25.67	4.29
Fishing	1.02	1.09
Industry specific commodity production in multi-commodity agricultural industries		
Other agriculture	5.32	0.19
Fruit and Vegetable production in multi-commodity agricultural industries		
Traditional agriculture	24	4
Smallholder coffee	25.44	4.49
Smallholder cocoa	24.69	4.06
Smallholder palm oil	25.26	4.2
Smallholder copra	25.77	4.31
Other smallholder tree crops	25.96	4.45
Other agriculture	n.a.	n.a.
Livestock production in multi- commodity agricultural industries		
Traditional agriculture	18.4	0.4
Smallholder coffee	20.15	0.41
Smallholder cocoa	18.84	0.42
Smallholder palm oil	19.77	0.45
Smallholder copra	20.21	0.44
Other smallholder tree crops	19.82	0.44
Other agriculture	24.06	0.45

Source: ABARE Report (Appendix 2 of 2003 Tariff Review Rep<

Table 82: Percentage Reductions in Negative Effective Rates of Protection under the Tariff Reform Programme

	1998-2003	2006
Large Scale Coffee Plantations	3.48	0.3
Large Scale Cocoa Plantations	1.35	-0.01
Large Scale Palm Oil Plantations	4.17	0.02
Large Scale Copra Plantations	1.21	0.01
Other Large Scale Tree Crop Plantations	0.63	0.02
Forest Products	7.72	0.1
Industry specific commodity production in multi-commodity agricultural industries:		
Traditional agriculture	n.a.	n.a.
Smallholder coffee	0.1	0
Smallholder cocoa	0.27	0
Smallholder palm oil	0.16	0
Smallholder copra	0.025	0.001
Other smallholder tree crops	0.009	0
Road Transport	3.75	0.06
Water Transport	5.93	0.09
Air Transport	13.19	0.01
Education Health	1.35	-0.03
Electricity and Garbage	2.91	0.09
Building and Construction	1.28	0.05
Commerce	19.98	0.13
Hotels and Accommodation	2.08	0.02
Restaurants and Fast Food	11.75	0.44
Finance and Investment	9.55	0.3
Other Private Services	0.27	0.02
Security Services	1.74	0.02
	0.34	0.01

Source: calculated from ABARE Report (Appendix 2 of 2003 Tu