Where next for job creation in PNG? Views from the private sector

Over the past decade, the strong performance of PNG’s non-mineral economy has seen formal employment grow by an average of 6% per year. This has almost doubled the size of the private sector workforce, and created new opportunities for an emerging middle class. However, as the construction phase of the PNG-Liquefied Natural Gas (LNG) project winds down and external conditions become less favorable, growth in PNG’s non-mineral economy continues to slow. Non-mineral GDP growth [pdf] fell from 9.1% in 2012 to 5.5% in 2013 and is now expected to further decline to around 1.3% in 2014.

Overall GDP growth will receive a large boost in late 2014 and 2015 from the onset of LNG exports and other new mining operations. However, stimulating growth in the more labour intensive non-mineral sectors will be crucial in ensuring that the pace of job creation does not slow.

What needs to be done to fuel the next round of non-mineral employment growth in the PNG economy?

A business survey carried out by the Institute of National Affairs (INA) with financial assistance from the Asian Development (ADB) offers a number of insights on how PNG’s investment environment might be improved and complements similar surveys that were carried out in 2002 and 2007.

As in the previous two surveys [pdf], law and order was again identified by business as the top business constraint, with the investment decisions of 36% of respondents being either highly or very highly affected by crime. Effectively, crime imposes a large tax on businesses, especially smaller ones. Corruption was listed as the second most important constraint.
to business activity, with transport and electricity infrastructure ranking third and fourth, respectively. Other top constraints in descending order of importance included the availability of skilled labor, a lack of political and regulatory stability, transport and telecommunications infrastructure, inflation, high cost of goods, and land access and compensation issues.

Although there are few surprises amongst this list of business constraints for people familiar with PNG’s development challenges, the data does reveal some informative trends.

The most significant progress can be directly attributed to improvements in macroeconomic management over the last decade. Inflation, interest rates and exchange rate variability all recorded significant declines as problems for business and investment. This is a testament to the value of stable monetary and fiscal settings in fostering more inclusive economic growth, and reinforces the need to maintain that stability as the external environment now becomes less favorable.

Further, while law and order issues remain an acute constraint for business, the severity of the problem appears to have fallen – or perhaps businesses have become more adept at dealing with it. The percentage of respondents who were highly or very highly affected dropped from 59% in 2002 to 36% in 2013. Similarly, the proportion of respondents that said they were highly or very highly affected by political and regulatory uncertainty has also declined significantly since 2002.

Concerns relating to telecommunications infrastructure also showed significant improvement between 2007 and 2012. Undoubtedly, this result is closely tied to reforms in the sector during 2006 that introduced competition into the mobile telecommunications market and the resulting drop in prices and increasing coverage this facilitated. It also powerfully
illustrates how the entry of the private sector into areas of the economy formally reserved for state owned enterprises can benefit the population as a whole. Nevertheless, telecommunications remains a key concern for business, suggesting the need for more reforms to increase access and reduce costs further.

On the downside, there appears to have been little or no progress in a number of key areas. Corruption is rated as a major problem for business and does not appear to have improved in the last 10 years. In 2012, 28% of businesses said their investment decisions were highly or very highly affected by corruption. Poor transport and electricity infrastructure also continues to cause severe problems for business, and these concerns appear to have increased since 2007.

Much attention has been paid to the great potential PNG has to develop its mineral sector. However, long term job creation from current and future mineral projects will be limited since these are highly capital intensive activities. Broader employment growth will depend on PNG’s ability to improve the business environment by addressing the core constraints to private sector investment. As PNG looks back on a decade of impressive job growth, the stage is now set for further reforms to foster the next wave of investments that are needed to create employment opportunities for PNG’s rapidly growing population.

The INA private sector survey is supported through ADB’s Private Sector Development Initiative, (PSDI). PSDI will be releasing an analytical summary of the survey to complement the INA’s report in December 2013.

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Managing fiscal risks amid resource booms: lessons from Papua New Guinea and Timor-Leste

The two largest developing member countries in the Asian Development Bank’s (ADB’s) Pacific region – Papua New Guinea (PNG) and Timor-Leste – also continue to be the region’s fastest growing economies. PNG has now recorded 11 consecutive years of economic growth averaging around 6% per annum, while Timor-Leste has been growing at around double digit rates since 2007. A major driver of the rapid growth in both countries has been their resource export sectors. Government spending from the Timor-Leste Petroleum Fund rose by 65% in 2012, with the ratio of expenditure to non-oil GDP reaching 193%—surpassing the previous high set in 2011. Resource revenues and higher government spending have also helped to drive growth in the PNG economy over the last decade. Since 2009, the economy has further benefitted from a large surge in resource sector investment, the most notable being the $US19 billion liquefied natural gas (LNG) project due for completion in 2014.

The increasing fiscal space facilitated by resource exports has created a sense of optimism in both countries that Government can begin to play a larger role in overcoming the critical development constraints which they face. In Timor-Leste, this optimism has translated into an ambitious national plan to reconstruct and expand its national port, power and road infrastructure and to more broadly distribute the benefits of its oil through veterans’ payments as well as
conditional cash transfers. Likewise, PNG’s 2013 Budget commits Government to a significant scaling up of infrastructure, health and education investment, while also attempting to deliver funding more directly to its citizens including an almost 90% increase in sub-national government funding.

While the justifications for significant increases in government expenditure in both countries are clear, it is also vital that these priorities be balanced with maintaining, or in some cases strengthening, the fiscal buffers required for managing the volatility that is endemic to small open resource-export-based economies.

What policy measures can the PNG and Timor-Leste governments adopt to reduce fiscal risks against a backdrop of increased government spending?

First, credible plans to lower future spending growth need to be created. PNG’s ability to return its Budget to surplus, and keep public debt below its target of 35% of GDP, will be difficult to achieve because of unrealistic assumptions which have been included in its forward budget estimates. These assumptions include zero growth in the public sector wage bill until 2017, along with very low growth in goods and services spending. Likewise, while Timor-Leste enjoys an enviable level of national savings equal to 135% of non-petroleum GDP, the spending growth seen in recent years has necessitated withdrawals from the Petroleum Fund that exceed what the Ministry of Finance estimates can be sustained over the long run. One outside estimate even suggests Fund resources could be depleted by 2018 if recent expenditure increases continue—although government plans indicate expenditures should plateau soon. It will be vital for future spending plans to take proactive measures to ensure that the longevity of this fiscal buffer is not threatened.

Second, both countries need to ensure higher spending does not
create an unsustainable level of national infrastructure. Analysis continues to **highlight** the tendency for PNG Government’s to focus on building new infrastructure, rather than investing in sustainable funding streams for the operation and maintenance of existing assets. This has amplified budgetary pressures, contributed towards higher overall costs, and undermined the quality of service delivery, as new facilities sit idle and funding remains insufficient to adequately maintain new assets. If implemented, the restrictions on goods and services and wages and salaries spending identified in the 2013 PNG Budget have the potential to further amplify this trend. Timor-Leste has also focused on the creation of new infrastructure assets, and is now nearing completion of a national electrical system with generating capacity significantly in excess of current needs. It is important that plans to develop the national road system and south coast be phased gradually and be developed at scales commensurate with near term demand to avoid generating operational and budget demands that could become unsustainable in the future. Greater analysis and modeling of the likely long term costs and benefits of some of the major development initiatives proposed would be helpful. Further, expenditures on social safety nets, that have been greatly expanded in recent budgets, need to be designed to ensure improved targeting of benefits in the future as the need for such programs diminish as the Timor-Leste economy continues to grow and develop.

Third, both countries need to carefully manage the risks and opportunities associated with increasing their stock of public debt. For PNG, a budget deficit expected to reach 7.2% of GDP in 2013, has raised the importance of restructuring the domestic debt portfolio to reduce refinancing risks. PNG’s external debt is mainly long term and highly concessional, but its domestic debt stock (roughly 70% of the total) has a short, and uneven, maturity profile. About 30% of domestic debt is made up of Treasury bills with maturities between 3–6
months. The rest is longer-term debt, but with bunching maturities which means much of it needs to be refinanced around the same time. If government revenues were to unexpectedly fall, or one of the three major commercial banks decided to reduce their exposure to PNG government debt, rolling over existing debt may become difficult. Shifting the domestic debt stock to a longer term maturity profile, with a smoother repayment schedule, would help to significantly lower the risks associated with debt refinancing, and bolster the economy’s ability to handle economic shocks.

With large savings in its Petroleum Fund, Timor-Leste has little need for additional financial resources. However, it may benefit from the utilization of external resources so long as they can be used to address difficulties the government has faced in scaling up its capacity to plan and implement new public infrastructure and development programs. Further, the Petroleum Fund’s financial performance in recent years means that if Government is able to retain revenues in the Petroleum Fund—and finance projects through concessional loans—it could command returns in excess of interest rates on the loans. This would help to generate financial returns as well as enhance the sustainability and impact of its expenditure.

Finally, fiscal risks created outside the budget process must be managed more transparently. In PNG, the reduction in public debt from near 80% of GDP in 2002 to 26% in 2012, has been offset in recent years by a rise in off-budget borrowing, which now equals between 15%–20% of GDP. Major components of this debt include borrowing to finance the state’s equity in the LNG project, large unfunded superannuation liabilities, and contingent liabilities surrounding the successful completion of the LNG project. Progressively reducing these state liabilities and recognizing them explicitly in public debt figures will be important to the transparent management of fiscal risks. Fortunately, in the case of Timor-Leste, all
government liabilities remain subject to the formal budget process and the level of transparency in the management of the Petroleum Fund continues to be exemplary, so extra-budget fiscal risks appear minimal. That said, the Government is entering into a number of long-term expenditure commitments which risk becoming politically binding over time and make budgetary reversal very difficult. Clarifying these arrangements and recognizing the ongoing fiscal liabilities which long-term agreements create in Budget documents would help to reduce uncertainty surrounding this aspect of the fiscal outlook.

Even as global commodity prices moderate, PNG and Timor-Leste’s medium term growth outlooks remain strong. PNG’s public debt remains low by historical standards, while Timor-Leste continues to build an enviable level of national savings. While Government plans to increase investment in critical national infrastructure and social services are commendable, this priority must be balanced with maintaining fiscal buffers that will allow these countries to withstand future economic shocks. Raising the economy’s resilience to shocks will be vital to avoid the boom-bust cycles of growth that have tended to plague small open resource rich economies.

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PNG slowdown pushing regional growth lower in the Pacific
In 2013

In the latest issue of the Pacific Economic Monitor, released yesterday (March 26), the ADB forecasts that the average rate of growth in its 14 developing member countries in the Pacific region will fall to 5.2%, as earlier gains from major foreign investments and public infrastructure projects fade. The performance of the region’s larger natural resource exporting economies (Papua New Guinea (PNG) and Timor-Leste) continues to drive the economic outlook, with these two economies comprising about two-thirds of the weight in the regional growth average.

Pacific growth projections 2013-14
In PNG, growth is projected to slow to 5.5% in 2013—from 9.2% in 2012. Most importantly, construction work on the $19 billion liquefied natural gas (LNG) project will shortly peak, with declines in construction and transport activity expected over the coming 18 months. Lower activity in these sectors is expected to spillover to other sectors, such as retail and wholesale trade. Falling prices of key agricultural exports and a strong kina are also expected to reduce rural incomes. To counter the effects of a slowing—albeit still strong—economy, PNG authorities plan to undertake a period of expansionary fiscal policy. The 2013 Budget will target a 27% increase in expenditure and a budget deficit of 7.2% of GDP in 2013, moderating to a deficit of 5.9% in 2014. Even with these increases, public debt is expected to remain low by historical standards—peaking at around 35% of GDP in 2014.

Timor-Leste’s economy is expected to continue to be the fastest growing in the region, with non-petroleum growth of 10.0%, down slightly from 10.6% in 2012. Although public expenditures in the 2013 Budget are 8.8% lower than in 2012, the weaknesses in project implementation experienced in previous years, along with expected improvements in 2013, means actual expenditures are likely to increase. The economy will also benefit from modest increases in private investment outside the petroleum sector.

Economic growth in the Pacific islands will be much slower than the resource exporting economies and is expected, on average, to continue to moderate, falling to 2.2% in 2013 (from 2.5% in 2012 and 2.8% in 2011). Across the 12 economies, ADB expects growth slowdowns in seven during 2013.

The largest, Fiji, is expected to suffer from the impact of Cyclone Evan as well as ongoing declines in sugar production, which ADB expects will slow growth to 2.0% in 2013, from 2.5% in 2012. However, if progress continues to be made towards planned elections in 2014, there could be a significant upside risk to this forecast.
Reduced stimulus from completed or nearly completed public construction projects is expected to weigh down growth in Cook Islands, the Federated States of Micronesia, Samoa, and Tonga. Samoa’s growth this year is also expected to be impaired by the impacts of Cyclone Evan. The Solomon Islands economy will be hurt by ongoing declines in log production. However, at 5.5% in 2012 and 4.0% in 2013, Solomon Islands growth remains relatively strong by regional standards due to rising agricultural production and gold output. Slightly lower growth in 2013 is also expected in Palau’s economy as the country addresses challenges associated with peak-period capacity constraints in its tourism facilities.

In more positive news, five of the Pacific island economies are forecast to grow at higher rates in 2013. The largest of these is Vanuatu, which ADB expects to grow by 3.2% in 2013 (compared with 2.0% in 2012). This higher growth emerges from expected rises in tourist arrivals and the implementation of previously delayed public infrastructure projects. Nauru expects sharply accelerating growth due to increased economic activity associated with the Asylum Seekers Regional Processing Center and despite a modest decline expected in phosphate production. Kiribati, Marshall Islands, and Tuvalu are also expected to grow at higher rates in 2013 due to increased public infrastructure development and strong fishery revenues.

Looking forward to 2014, growth across the Pacific economies is forecast to pick up modestly due mostly to planned increases in public infrastructure investment in the larger economies of PNG, Timor-Leste, Fiji, as well as in several of the smaller economies (e.g., Kiribati, Federated States of Micronesia, Samoa, Tuvalu, and Vanuatu). The tourism outlook for the region also remains bright, with visitor numbers in 2012 building on historic highs set the previous year. Strong arrivals from the main markets of Australia and New Zealand, as well as a rise in numbers from East Asia, are driving the
gains.

As growth remains sluggish to moderate across the Pacific region and the broader global economy as well, a worrying trend is the increasing number of countries turning to fiscal stimulus to try to push growth higher. Many countries in the region are planning to increase the size of their budget deficits and public debt in 2013. While debt sustainability indicators suggest low to moderate risks for most countries, higher rates of spending will add to the macroeconomic vulnerability of the region.

Ambitious fiscal expansions in PNG and Fiji stand out in terms of these concerns, if only because of the high rates of expenditure growth being undertaken in each of them. Even Timor-Leste, with its large accumulated reserves, has some worrying signs that the long term sustainability of its national savings may be challenged in coming years due to its ambitious expenditure plans. A number of smaller Pacific countries—that depend largely on public expenditure for their growth—also find themselves in fiscal positions that leave few options for sustaining growth in the face of macroeconomic fluctuations. With these developments, slowing spending growth and rebuilding the fiscal buffers required to withstand future economic shocks seems likely to continue to be a major policy challenge for the region in the years to come.

These trends and developments are discussed at greater length in the *Pacific Economic Monitor* which can be downloaded for free [here](#).

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Growing the future, but can government manage the risks? PNG’s 2013 Budget

PNG maintained its position as one of the fastest growing economies in Asia and the Pacific in 2012. Preliminary GDP figures show growth of 9.2% in 2012, on the back of 11.1% growth in 2011. While the construction and transport sectors led this growth, driven by peak building activity of the liquefied natural gas (LNG) pipeline, other sectors of the non-mineral economy such as manufacturing, financial services, and wholesale/retail trade also performed strongly. The 2012 preliminary GDP figure marks an impressive 11 years of expansion for the PNG economy, averaging growth of just under 6% per annum.

A number of factors point to a more challenging economic environment in 2013. Maturing mining and oil operations, and the scaling down of LNG construction, are expected to contribute to slowing economic growth (forecast by ADB at 4.5%). Lower international agriculture prices and a persistently strong kina are likely to depress rural incomes derived from the sale of export crops.

Against this backdrop, the 2013 National Budget foreshadows a significant slowdown in government revenue growth, as modest growth in consumption, income, and company taxes are offset by declining mining and oil revenues. Notwithstanding a tighter revenue scenario, the $US6.5 billion 2013 Budget plans for a 23% increase in nominal expenditure, raising the size of the expected Budget deficit to 7.2% of GDP.

On a sectoral basis, the 2013 Budget continues to scale up funding to priority sectors of health, education, transport infrastructure, and law and order. The proportion of
expenditure allocated to these four sectors has grown from less than 20% in 2007 to an expected 32% in 2013.

The 2013 Budget also focuses on scaling up development funding to sub-national levels of government, with provincial, district and local level government grants increasing by a total of 87%. As a result, the majority of additional development funding for core service delivery priorities in 2013 will be channelled through provincial expenditure systems, with sub-national grants allocated at a ratio of 30% infrastructure, 20% health, 20% education, 10% law and order, and 20% other economic and administrative activities. Increasing the control and execution of development funding by sub-national government, and away from national departments, constitutes a significant decentralisation in the Government’s approach to allocating and planning development expenditure in rural areas.

The significant economic stimulus that this spending will provide is well timed to counter falling domestic demand as LNG construction begins to wind down next year. Further, while the Fiscal Responsibility Act (2006) will be amended to raise the maximum debt to GDP ratio from 30% to 35% to accommodate additional borrowing, if medium term plans to return the budget to surplus by 2017 are achieved, then public debt will remain within ‘sustainable’ limits.

The 2013 Budget does however bring with it a number of significant risks which will need to be carefully managed if PNG is to maintain the macroeconomic stability that has underpinned the last decade of economic growth.

Central to this challenge will be achieving the level of expenditure growth restraint required to return the budget to surplus by 2017. Between 2013 and 2017, the recurrent budget (approximately 60% of total spending) plans for zero nominal growth in wages and salaries across both national and provincial government, and just 2.5% annual nominal growth in
goods and services spending. The Budget indicates that savings will be made by the reduction, or closure, of up to 17 government agencies. This will be a very challenging task, with numerous prior public sector downsizing and ghost worker removal efforts having met with limited success.

A further fiscal challenge relates to the financing of deficit spending. While domestic bank liquidity remains high, local commercial banks are approaching limits on their ability to lend additional funds to the government. As a result, the government has signalled that it may be required to source deficit financing from international markets. If additional concessional sources of finance cannot be mobilised, then this is likely to significantly increase the cost of borrowing, as well as PNG’s exposure to exchange rate risk.

Finally, while the large increase in sub-national funding will allow resources to be channelled more directly to rural and remote areas, concerns exist about the ability of sub-national government to effectively implement such a rapid increase in funding. The National Economic and Fiscal Commission continues to highlight the challenges which provincial governments face both in being able to receive their funding in a timely manner, and in being able to convert that funding into service delivery projects. A large influx of new funding will accentuate these challenges.

The 2013 Budget is a bold attempt at stemming the flow of deteriorating service delivery quality across PNG, particularly at the provincial and district level. But that boldness also brings with it increased risks. The emergence of a large structural budget deficit, and difficult to meet recurrent expenditure constraints, will make a ‘return to surplus’ by 2017 particularly challenging. If expenditure growth cannot be contained in future years, or new unfunded expenditure pressures emerge, such as the requirement for additional LNG equity payments due to increasing project costs, then public debt sustainability will become a growing
issue. PNG’s government will need to find new, international, sources of financing for its borrowing while a large scaling up of sub-national funding will put further pressure on provincial expenditure systems. As always in PNG, the real challenge will be in implementation, and converting lofty expenditure plans into tangible improvements in service delivery.

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The final Pacific Buzz for the year has been held back for a week, and will be published next Wednesday, December 19th.

Confronting the economic challenges facing PNG’s new government

Papua New Guinea’s (PNG’s) incoming government will inherit an economy buoyed by a decade of rapid economic growth and poised to reap the benefits of its vast natural wealth. Emerging from a state of near bankruptcy in 2001, real $US per capita income has risen by 150% – recovering the lost ground made during the volatile 1990s – and private sector employment has more than doubled. This year ADB projects economic growth of 7.5%, supported by a $US16 billion liquefied natural gas (LNG) project, now entering its peak construction phase, high government spending and commodity prices. Business is also booming. A recent survey of PNG’s top 100 Chief Operating Officers (COOs) found that 90% expect company profits to be
higher in 2012 than in 2011, with none expecting a decline. Two thirds said their 2011 profits had exceeded expectations. With over $US27 billion, equivalent to 190% of 2011 GDP, expected to be invested in the mining, oil and gas sector before the end of the decade, PNG’s medium term growth outlook is strong.

Part of this economic success has been due to high commodity prices for mining, oil and agriculture exports boosting government revenues, stimulating output growth and buffering the economy against some major global economic shocks. It has also been a result of better policies. Sensible monetary and fiscal policies have combined with structural reforms in financial services, telecommunications and aviation to boost business investment and encourage economic diversification. In June 2012, the International Monetary Fund downgraded PNG’s risk of sovereign debt distress from moderate to low – the first time PNG has achieved this rating.

The benefits of strong economic growth are being undermined by rising inequality.

But PNG’s macroeconomic success masks a growing sense of unease about the distribution of the benefits of growth and the government’s ability to translate wealth and macroeconomic stability into better public services. Progress has been made in some areas. The proportion of the road network classified as being in ‘good’ condition has risen from 10% in 2003 to 33% in 2011, and under-5 mortality rates have fallen in many provinces. However, available evidence suggests that many areas of core public services have deteriorated over the last decade, particularly in rural and remote areas. PNG is one of a handful of countries not on track to meet any of the Millennium Development Goals [pdf].

Rising inequality is partly a result of constraints on diversified business investment. Whilst the stock of private sector employment has doubled over the last decade, ADB
estimates show that less than 5% of the population, (or roughly 10% of the working age population) are currently able to earn a wage in the formal economy. PNG’s COO survey highlights that a shortage of skilled labor, poor law and order, lack of technical expertise, unreliable utilities from state owned enterprises (SOEs) and the poor state of transport infrastructure impose major barriers on investment in the more labor intensive and pro-poor, non-mineral economy. These constraints combined with rising firm profitability, have led to a dramatic outflow of investment funds from PNG over the last decade. For example, PNG’s investment in Australia reached $US1.2 billion (equal to 12.8% of GDP) in 2010—350% higher than the amount of money invested by Australian companies in PNG.

High inflation also undermines the inclusiveness of growth. Although wage earners can negotiate higher wages when costs rise, the roughly 85% of the population reliant on cash crops for their semi-subistence livelihoods have seen their purchasing power deteriorate rapidly in recent years. Structural constraints in land and housing markets have restricted the supply response to rising property demand and contributed to sharply increasing rental prices. As a result, a growing portion of urban residents are now forced to live in informal urban settlements, which have poor access to power and sanitation facilities, and significant security risks.

PNG’s booming mining sector is creating growing inequalities at the village level as well. With low education and financial literacy, members of some segments of the PNG population find it difficult to hold leaders to account for the equitable distribution of mining royalty payments. A particularly difficult challenge for government during the next 12 months will be managing the 8,000 local workers who will begin to be retrenched from the LNG project. Landowner groups are now highlighting the potential for social unrest if alternative work arrangements for their workers cannot be
The Government’s ability to confront these challenges will be tested by a tightening fiscal envelope.

Contrary to some public expectations (spurred on by LNG and election rhetoric), the new government will have to manage a period of much slower growth in government revenue. Later this year, the Government will finalize its third Medium Term Fiscal Strategy (MTFS 2013-2017) which will play an important role in establishing the fiscal rules required to balance PNG’s large social and physical infrastructure investment needs with maintaining the macroeconomic stability that has underpinned the last decade of economic growth. However, maturing mining and oil operations will contribute to a 5 to 10% decline in real government revenue between now and 2014. The addition of LNG revenues in 2015 will help, but as a result of generous taxation concessions, these revenues will not peak until after 2020. Current expectations are that there will be zero net savings made within the newly created Sovereign Wealth Fund during the next 5-year MTFS period.

Adding to this fiscal challenge is the already low level of revenue per capita the PNG government is able to generate – which at $US650 per capita is amongst the lowest in the South Pacific. To put this in perspective, if revenues expected at the projected peak of LNG production in 2028 were added to the 2011 national budget, PNG government revenue per capita would still be below that of Tonga, Samoa and Fiji.

Three main factors contribute to PNG’s low government revenue per capita. Firstly, only 5% of the population is engaged in formal private sector employment, which gives the government a small income tax base. Secondly, as a result of tax concessions and the abandoning of the additional mining profits tax in 2003, the average effective tax on PNG’s mining, oil and gas companies is now on the low side of fiscal regimes across the world. The recently opened Ramu Nickel and
Cobalt mine has a ten year tax holiday before it will contribute to national revenue. Many other similarly beneficial concessions have been made to firms across the sector. Thirdly, PNG suffers from poor tax compliance and enforcement. The PNG tax office lacks the manpower and resources to effectively pursue individuals, firms and industries it suspects of not paying full tax obligations.

**Structural reforms will contribute to more inclusive growth, as would a review of resource sector taxation arrangements.**

PNG has achieved remarkable economic revival over the last decade. A large pipeline of mining, oil and gas investments will underwrite strong economic growth for a number of years to come. However, if present trends continue, this growth is likely to benefit only a small percentage of the population.

In addition to addressing long standing issues of expenditure quality, the incoming PNG government will have to manage a growing need for fiscal austerity. Expenditures will be usefully focused on the rehabilitation of existing service delivery infrastructure, rather than the creation of new assets, which may further undermine the ability of the state to fund recurrent maintenance. Strengthening revenue compliance and reviewing resource sector taxation arrangements would help to alleviate some fiscal pressures over the medium term.

Improving the inclusiveness of economic growth over the next decade will require re-invigoration of the microeconomic reform agenda to strengthen competition, lower barriers to new business, and stimulate growth in the non-mineral economy. To complement these efforts, there must also be a renewed effort to improve the quality of service delivery by SOE’s through the creation of more accountable, performance orientated, management structures, and greater private sector participation.
The 2012 National Budget targets a number of these reforms, outlining plans to restructure SOE governance and accountability frameworks. If these initiatives can be implemented by PNG’s new government, they will go a long way to creating the enabling conditions for much faster growth in the non-mineral economy. This will be a crucial step, not only in avoiding the potential pitfalls of becoming overly reliant on commodity exports, but also in improving the range and quality of employment opportunities for the people of PNG.

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Service Delivery and Resource Revenues in PNG

This is a guest post by Aaron Batten.

The $US15 billion Exxon-Mobil Liquefied Natural Gas (LNG) project stands to be the largest resource project in PNG’s history. Projections indicate that Government revenues accruing from the project could be as high as K2bn for the first ten years of production (2014-2024) and K3bn thereafter – representing a 22 per cent and 33 per cent increase to total revenue and grants in the 2011 Budget, respectively.

These revenues have the potential to greatly increase funding for social service delivery which, despite improvements over recent years, is still chronically inadequate for large parts of the population.

In some measure, a lack of service delivery is a result of weak public sector capacity to implement expenditure plans. It
is also because real per capita funding for key items such as health, education and infrastructure persisted along a long term decline during the first 30 years of independence.

Since 2002, the Government has made significant progress in reversing this trend, but there is still much to be done. In 2010 real per capita expenditures for health and infrastructure were still 15 per cent and 30 per cent lower than in the early 1980s, respectively. Real education expenditure per capita was still only two thirds of what it was before huge cuts were made in the late 1990s.

What impact will LNG resources have on further increasing spending on key social service sectors such as health, education and infrastructure? Alternatively, how much of these resources might be used for other purposes such as replacing domestic revenue sources, lowering debt levels or financing general government consumption expenditure?

**Analysis of historical PNG fiscal data** reveals that past resource revenue inflows have had a weak impact on lifting central government expenditure in key service delivery sectors. Estimations show that on average, 2.5% of resource revenues have been spent on health and education whilst 5% have been allocated to infrastructure. The majority of remaining funds have been used to finance other general government expenditure as well as to lower domestic revenue collection.

If this past behaviour is continued then LNG revenues will have only a moderate impact on the funding directed towards these sectors – with real per capita health and education spending still remaining below 1980s levels.

**Analysis also reveals** that whilst aid revenues have had a bigger impact on increasing health, education and infrastructure spending than resource revenues, a rapidly growing population and the projected high growth in resource
revenues, means donor aid will comprise an ever declining proportional share in PNG’s total resource envelope. Donors have an important role to play in providing targeted interventions that improve the efficiency of public expenditure and alleviate constraints to growth, but their ability to influence aggregate recurrent expenditures in social services will decline.

What implications do these findings have for managing the post-2014 revenue boom period?

1. Past behaviour is not necessarily a guide to future expenditure patterns. Government’s change, as do their policy decisions and expenditure priorities. Growing real per capita expenditure for health, education and infrastructure in the post-2002 commodity boom period is a positive indication that more priority is being place on these activities than in the past.

2. Maximising the impact of resource revenues on service delivery must also be balanced against the broader challenge of managing the many well known risks that a resource project of this scale entails. Exchange appreciation and realignment of domestic production away from other tradable good sectors is the primary example.

3. PNG will also have to remain vigilant against the negative patterns of political and institutional behaviour that can be encouraged by large inflows of funds from resource extraction.

The Government has made good progress in managing these risks by creating a new Sovereign Wealth Fund (SWF) which will sterilise export earnings and promote a high level of accountability over fund usage.

The SWF also places a large focus on smoothing expenditure over time. This is particularly important for service delivery items such as health and education which are predominately recurrent in nature. Achieving a long term increase in funding
to these sectors will thus be dependent on the ability of the SWF to provide consistent and predictable revenues which allow budgetary planners to expand recurrent expenditure items without fear of eroding fiscal sustainability.

However, as PNG’s past experience with its former Mineral Resource Stabilisation Fund illustrates, without sufficient political commitment to long term expenditure management institutional structures such as this can be easily abused.

The most important factor in transforming resource revenues into improved long term development outcomes will therefore be the strengthening of domestic accountability mechanisms across all levels of government. At its core, these efforts should focus on continued strengthening of the domestic budget process, its oversight institutions and the integration of the Government’s Strategic Plan (2010-2030) objectives into medium term expenditure planning.

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