

# Papua New Guinea economic survey: fiscal discipline needed

Roderick Duncan

Improved macroeconomic management has been a significant achievement of the Somare Government and the Bank of Papua New Guinea. But, despite the high level of minerals revenue, in recent years the public debt has not been reduced significantly, recurrent spending has increased rapidly, and the 2007 Budget is very vulnerable to downturns in minerals prices. Further, the lack of progress in overcoming the institutional problems facing investors means that it is likely the economy will not achieve the 4 per cent GDP growth forecasts for future years. Of particular concern is the likelihood of a 'perfect storm' of election-year misappropriation, given the combination of huge windfall gains from the high mineral prices committed to vaguely defined investment programs and politicians having in mind the nearly 80 per cent turnover at the 2002 election.

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In the overview of its 2007 Budget, the Papua New Guinea Treasury predicted

The economy continues to improve, underpinned by solid global conditions and increased business and consumer confidence... The economy is expected to grow by around 3.7 per cent in 2006 and with solid domestic and external conditions as well as continued fiscal discipline, economic growth should continue to be strong in 2007 (Papua New Guinea 2007:22).

In 2007 the Somare Government moves into a national election. This will be the first time a PNG national government has managed to last an entire electoral cycle. In this survey

I examine in broad terms the economic achievements and failures of the Somare Government and look ahead to the upcoming election and what this year will bring for the people of Papua New Guinea.

There are two economic stories in Papua New Guinea—one a macro story and one a micro story. If you consider only the macro story, the PNG economy appears to be on the right track and the future prospects are bright. However, the micro story reveals an entirely different reality and set of prospects. There is good reason to believe that the rosy outlook presented in the 2007 Budget by the PNG Treasurer is not the correct one and that the micro story indicates troubling prospects for the country.

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## The macro story

The macro story would consider the usual macroeconomic variables that are discussed in the various policy papers on Papua New Guinea. On this level, the current Somare Government has performed very well. The economy appears to have settled into a low-inflation state and the government budgetary and debt problems inherited from previous governments have been reduced.

The national budget of Papua New Guinea has been in surplus in recent years (Table 1).<sup>1</sup> Initially, the reduction in the deficit and the shift to a surplus was the result of increasing revenues and restricted spending growth. The minerals boom has resulted in a greatly increased flow of revenue into the PNG Treasury. As a measure of how sensitive the budget figures are to a change in minerals prices, K1,900.6 million out of the K6,161.8 million in tax revenues in 2006 were from mining and petroleum taxes (equivalent to 31 per cent of the total).

While there was fiscal discipline in the early years of the Somare Government, in 2005 and 2006 expenditures rose as fast as, or even faster than, revenues. The rapid rise in expenditures during the minerals boom is a worrying sign. In boom times, the budget

should ideally be run in surplus to buy down the debt incurred in times of low minerals prices.

There is some (small) buy-down of debt proposed in the 2007 Budget; however, is the PNG government buffering itself sufficiently for the inevitable drop in minerals prices in the near to middle term? The wisdom of running a small deficit during a minerals boom seems doubtful indeed.

A further worrying sign is the increase in recurrent expenditure. Recurrent expenditure is budgeted to increase from K3,447.6 million in 2005 to K3,824.6 million in 2006—an 11 per cent increase. Likewise, the wage bill portion of recurrent expenditure is to rise from K1,265.8 million in 2005 to K1,404.2 million in 2006—also an 11 per cent increase.

The wages bill portion of recurrent expenditure is politically difficult to cut in Papua New Guinea. These rapid increases in the public sector wage bill will leave future governments in a difficult situation when revenues fall. If minerals revenues fall during the term of the next government, it will find itself in the same position in which previous governments found themselves. High levels of politically untouchable recurrent expenditures and falling tax revenues meant that the only recourse was to substantially

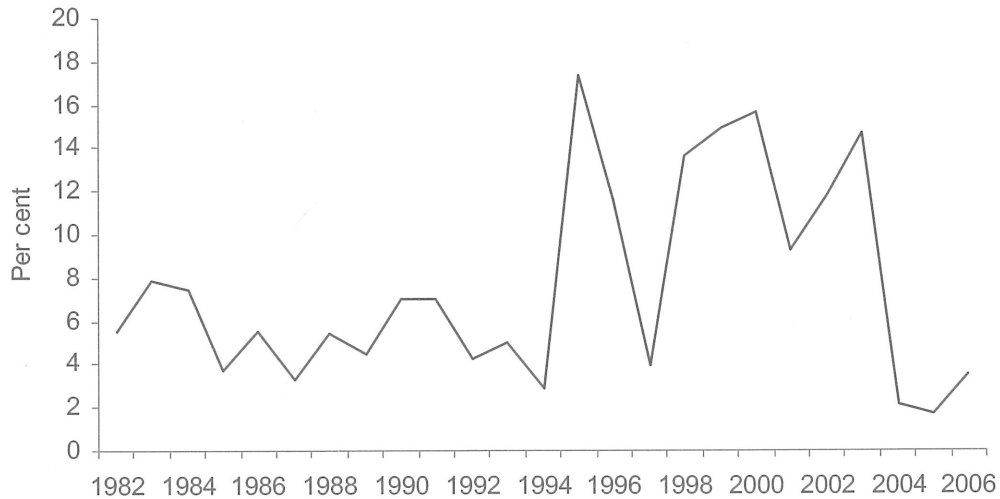
Table 1 Papua New Guinea: government financing, 2002–2007 (million kina)

|      | Government revenue<br>(million kina) | Government expenditure<br>(million kina) | Budget deficit<br>(million kina) |
|------|--------------------------------------|--|----------------------------------|
| 2002 | 3231.2                               | 3681.3                                   | -450.1                           |
| 2003 | 3650.1                               | 3774.4                                   | -124.3                           |
| 2004 | 4349.6                               | 4147.8                                   | 201.8                            |
| 2005 | 5326.8                               | 5319.1                                   | 7.7                              |
| 2006 | 6161.8                               | 6161.8                                   | 0                                |
| 2007 | 5421.6                               | 5456.6                                   | -35.0                            |

Source: Papua New Guinea 2006. *2007 Budget*, Papua New Guinea Department of Treasury, Port Moresby. Available from: <http://www.treasury.gov.pg/html/2007budget.html>

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Figure 1 Papua New Guinea: inflation, 1982–2006 (per cent)



**Source:** International Monetary Fund, 2006. *World Economic Outlook: financial systems and economic styles*, International Monetary Fund, Washington, DC. Available from <http://www.imf.org/external/pubs/ft/weo/2006/02/pdf/weo0906.pdf>

increase public debt. It would be good to see more of the 'fiscal discipline' that the Treasurer referred to in his Budget speech.

Bringing down inflationary expectations has been one of the big successes of the Bank of PNG and of the Somare Government. With continued budgetary stability, we should see a permanent move into a range of 'low' inflation (Figure 1).

The Bank of Papua New Guinea has been successful in reducing the rate of inflation from the 10–16 per cent range that it was in during the Skate and Morauta governments. Part of this reduction would be due to the reduced budget deficits of the Somare Government, and part would be due to the better performance of the Bank of Papua New Guinea under the Central Banking Act of 2000.

However, it is worrying that inflation was still so high in 2002 and 2003, the years following the new central bank legislation. Under the Central Banking Act of 2000, the Bank of Papua New Guinea was given four aims

1. keep inflation low
2. regulate the financial, banking and insurance systems
3. maintain the PNG international payments system
4. promote macroeconomic stability and economic growth.

The modern view in central banking is that a central bank should be given only one policy aim: to maintain inflation at a low and stable rate—an 'inflation target'. This is the policy that New Zealand moved to and was followed by Australia, amongst many other industrial countries. The second and third aims of the Central Banking Act 2000 are simple regulatory roles and are not incompatible with low inflation. However, requiring a central bank to maintain low inflation, the first aim, and promote economic growth, the fourth aim, is now recognised as asking too much. In a grudging nod to the modern view, the fourth aim has been made 'subject to' the other three aims. But 'subject

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to' is ultimately a matter of interpretation by the Governor of the Bank of Papua New Guinea and the Board.

We should ask what were the decisions of the Governor and the Board under the new Act in 2002 and 2003 that meant price stability was not promoted more? Obviously, it was felt that maintaining low inflation was a secondary priority to other policy aims. Hopefully, the next government will move to strengthen the independence and professionalism of the Bank of Papua New Guinea and support its focus on price stability. Ideally, the fourth aim would be removed from the Act, and the Bank of Papua New Guinea would only have the role of maintaining low inflation. The recommendation of a New Zealand Institute of Economic Research (NZIER 2006) report was that clearer guidelines on inflation for the Bank of Papua New Guinea would allow its Governor to better resist pressure from politicians with short-term macroeconomic concerns.

The reward for greater fiscal and monetary discipline is that interest rates in the Papua New Guinea economy have been falling. The Treasury bill rate has dropped in line with inflation, from 13.3 per cent when the Somare Government came into power in 2002 to a projected 5 per cent in 2006. According to the Bank of Papua New Guinea's 'weighted average advances' from the *Quarterly Economic Bulletin*, bank lending rates have likewise fallen from the 13–14 per cent range in 2002 to a level slightly above 10 per cent in 2006.

With the fall in interest rates, commercial banking sector loans increased from K1,421.0 million in December 2004 to K2,309.3 million in September 2006—an increase of 63 per cent in two years (Bank of Papua New Guinea 2006). However, total loans from the commercial banking sector are still quite small, particularly in the case of agriculture. This problem is addressed in the next section.

The nominal level of public debt has come down slightly under the Somare

administration, reducing total debt from K8,365.3 million in 2002 to K7,341.0 million in 2006. The slight fall in the nominal level of public debt, combined with the rise in nominal GDP over that time, has meant that the debt burden as a percentage of Papua New Guinea's GDP has fallen from 71.8 per cent to 42.5 per cent. This again is a significant achievement of the Somare Government.

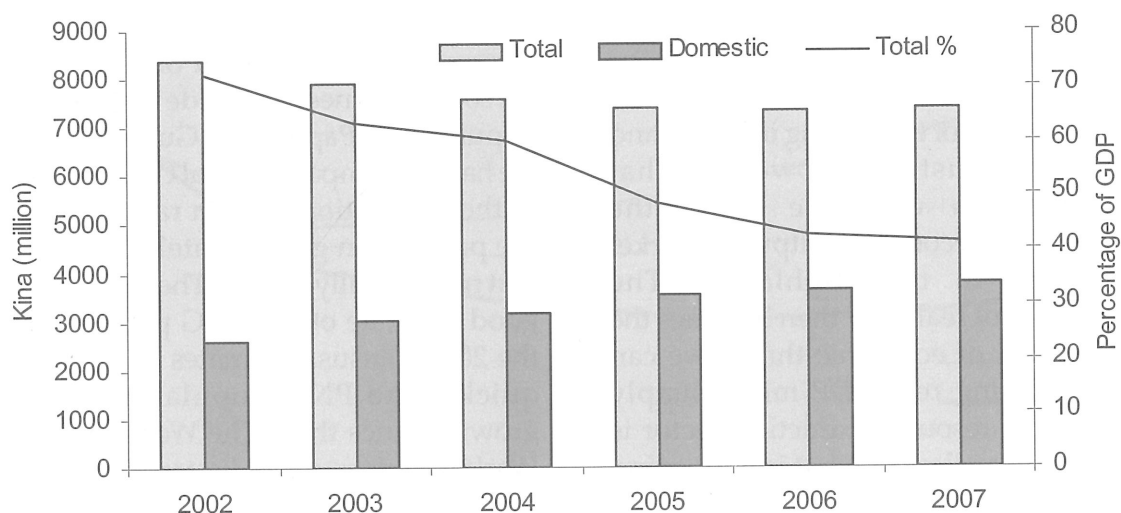
The international banking community has reacted to the improved management of the economy with a small improvement in the credit rating of Papua New Guinea. The latest Standard and Poor's rating for Papua New Guinea is B/Stable/B, with the comment that '[I]aw and order and political stability remain key constraints on the ratings' (Standard and Poor's 2007).

The government has also shifted the composition of the public debt. The level of public debt held in instruments such as Treasury bills and inscribed stock<sup>2</sup> has risen from K2,588.3 million in 2002 to K3,670.4 million in 2006. The amount of public debt held by international agencies and in commercial loans has been reduced at the same time. The proportion of public debt held in bills and stock has risen from 31 per cent to 50 per cent, a large change in the character of the public debt hopefully signifying a maturing of the Papua New Guinea financial system.

At 42.5 per cent of GDP, the level of public debt held by Papua New Guinea lies outside the range recommended by the International Monetary Fund. In a minerals boom it might be advisable to use the windfall to reduce the level of public debt. As planned in the 2007 Budget, total public debt will remain relatively constant over 2006 and 2007. The Treasury projects the level of public debt to fall from K7,402.8 million in 2005 to K7,341.0 million in 2006 and then to rise to 7,376.0 million in 2007. One might question the wisdom of increasing public debt during a minerals boom.

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Figure 2 Papua New Guinea: public debt, 2002–2007 (million kina)



Source: Papua New Guinea 2006. *2007 Budget*, Papua New Guinea Department of Treasury, Port Moresby. Available from <http://www.treasury.gov.pg/html/2007budget.html>

In the Treasury's two Supplementary Budgets and the Windfall Gains expenditures there is close to K2,400 million in spending in the 2006 and 2007 Budgets outside the usual budgetary procedures. This spending is examined in greater detail later in this survey. However of the K2,400 million expenditure for 2006 and 2007, the Treasury has budgeted only K100 million for retiring debt. Unless the public investments that the government is pursuing will achieve a higher rate of return than the interest rate on the public debt outstanding, the people of Papua New Guinea would be better off allocating these revenues to retiring debt than to increasing spending. In particular, the wisdom of allocating K130 million from the windfall gain into equity in state-owned enterprises must be open to serious question—given the low rates of return that these enterprises usually make.

A further concern is whether the windfall tax gains are likely to be spent in a prudent manner in an election year. There will be

great pressure in 2007 to divert some of this windfall spending to politicians for pay-outs to supporters and for buying votes. Given the high likelihood of graft and fraud, it would be a better long-term option for Papua New Guinea not to spend this money now, but rather to save the money by reducing debt.

For the period 2003–6, real GDP growth rates in Papua New Guinea have been positive and stable as compared to the boom-bust swings of the 1980s and 1990s (Figure 3). How much of this improved performance is due to the good fortune of the minerals prices boom and how much is due to a turn-around in the performance of the Papua New Guinea economy cannot be estimated at this point?

There are significant problems with the real GDP data for Papua New Guinea, and these require all analysts to regard the figures with skepticism. We can be reasonably confident about price data such as the CPI and interest rates, as these prices are based on observed market prices that hold true in some market at some point in time. Budget

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data represent accounting details that can also be verified and cross-checked against other accounts. Government revenues and expenditures are quantities that represent real amounts of money. We can also be reasonably confident of measuring the economic output of the mining industry and the export industries. However, what confidence can we have about the measurement of economic output or market transactions in the Highlands? The measurement of real GDP then becomes the 'measurement of economic things we can measure'. Rising real GDP might simply mean that the resource extraction sector is growing—regardless of what is happening in the rest of the economy.

Assuming we fall back on a rationalisation such as 'assuming the changes in the goods and services that we measure in real GDP are correlated with the changes in the total level of resources available to Papua

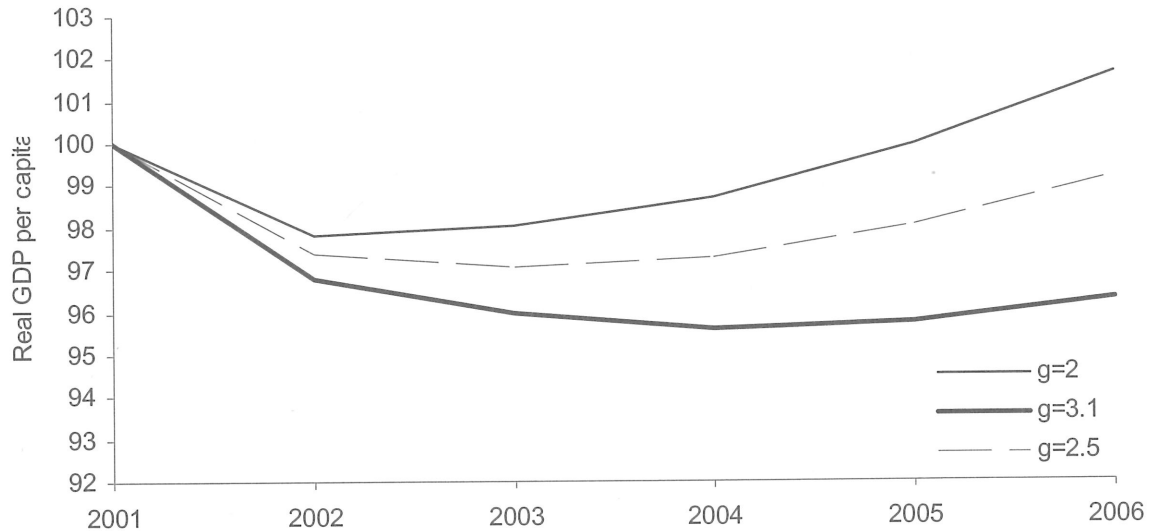
New Guinea, we can use the growth rate of real GDP as a measure of whether the people have more resources available to them', we run into the problem that what we are really interested in is the level of resources per person. So we need to divide real GDP by the population of Papua New Guinea. Therefore, we have to compare the real GDP growth rate to the population growth rate. But what is the population growth rate? The answer is that no one really knows. The last reasonably good estimate of the PNG population was the 2000 Census. Estimates vary as to how quickly the PNG population has been growing since then. The World Bank in its *World Development Indicators* put the PNG population growth rate at 2 per cent per annum (World Bank 2006). The International Monetary Fund in its *World Economic Outlook* (2006) puts the Papua New Guinean population growth rate at 3.1 per cent. Rao et al. (2006) put the population growth rate

Figure 3 Papua New Guinea: real GDP growth, 1982–2006 (per cent)



Source: International Monetary Fund, 2006. *World Economic Outlook: financial systems and economic styles*, International Monetary Fund, Washington, DC. Available from: <http://www.imf.org/external/pubs/ft/weo/2006/02/pdf/weo0906.pdf>

Figure 4 Real GDP per capita, 2001–2006 (2001=100)



Source: Derived from Papua New Guinea 2006. *2007 Budget*, Papua New Guinea Department of Treasury, Port Moresby. Available from <http://www.treasury.gov.pg/html/2007budget.html>

in the middle at 2.5 per cent. Therefore, at the lower World Bank estimate, the economy has been growing in per capita terms since 2003. Only in 2005 did the PNG economy stop shrinking in per capita terms using the higher IMF figure.

Our ignorance of GDP and population growth rates means that we should provide a range estimates of real GDP per capita changes over time. Imagine we were to ask the question asked during US presidential campaigns: 'are you better off than you were five (four) years ago? For the people of Papua New Guinea our best estimate is that their answer would be 'no'. There has been zero or negative growth in real GDP per capita since the Somare Government came into power.

Table 4 shows three paths of real GDP per capita relative to the real GDP per capita in 2001. The highest path is based on the World Bank's estimate of population growth of 2 per cent. In this optimistic case, real GDP

per capita is 1.6 per cent higher in 2006 than it was in 2001. The lowest path is for the IMF estimate of 3.1 per cent population growth. In this pessimistic case, real GDP per capita is 3.7 per cent lower in 2006 than in 2001. A middle-of-the-road scenario of 2.5 per cent population growth is also shown, following Rao et al. (2006). In this case, real GDP per capita is 0.8 per cent lower in 2006 than it was in 2001. The PNG economy is likely then to have shrunk in per capita terms between 2001 and 2006, unless population growth is lower than most estimates.

### The micro story

The second story is the micro story—the story of the institutions of Papua New Guinea. On the micro front, the current government has made no progress or, has gone backwards in some areas. Most importantly,

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the success in the macro area may not be sufficient to compensate for the failures in the micro areas. A long-term concern is that Papua New Guinea may become a country of 'reform without growth'.

One feature of Papua New Guinea that strikes a visitor from Australia is the large number of urban unemployed. As with the estimates of population growth, there are no reliable statistics of the level of urban unemployment. From the 2000 Census the National Statistical Office lists the urban unemployment rate at 16.2 per cent (National Statistics Office of Papua New Guinea 2000). Purely from a visual assessment, this is surely a huge under-assessment. As Levantis (1997) pointed out, the Census questions may confuse categories such as 'employed', 'self-employed' and 'unemployment'.

A visiting economist would be surprised to see such a large amount of resources (labour) lying around relatively unused. Why hasn't an entrepreneur gathered up the cheap labour and used it in a labour-intensive activity such as textiles? Or in other words, 'why doesn't Papua New Guinea have a garment sector?'

Creating a garment industry would also be a social good, as taking a large number of people off the streets of Port Moresby or Lae and employing them in factories would reduce the level of crime and prostitution with which the urban unemployed are supporting themselves. Levantis (1997) found that 70 per cent of unemployed males were involved with *raskols* or criminal gangs, while 40 per cent of unemployed females were involved in prostitution. Yet despite the private and social benefits, there are no entrepreneurs lining up to start shift factories. The answer lies in the institutions of Papua New Guinea.

In a survey of 133 businesses in Papua New Guinea, Manning (1999) found the top six impediments to private sector development were (in declining order of importance)

1. crime and theft
2. corruption
3. poor infrastructure
4. policy instability
5. inflation
6. tax levies and regulation.

These results are similar to those reported in Duncan and Lawson (1997). These factors raise the cost of doing business in Papua New Guinea to any potential domestic or foreign investor. In order to operate, an investor must provide security to prevent crime and theft, pay off government officials, and maintain independent infrastructure services such as electricity, water treatment or roads if these are necessary for the investment. All of these factors turn the 'cheap' labour of Papua New Guinea into not-so-cheap labour from an investor's point of view.

The Manning results may actually under-represent the true burden of these impediments on the Papua New Guinea economy. Manning surveyed businesses that were in operation in Papua New Guinea at the time of the study. What he did not do was to interview investors who had withdrawn from business activities in Papua New Guinea or those who had never started a business because of these impediments. A more informative study would have been a survey of investors who had invested somewhere else in the Asia Pacific region and ask them how they rated the Papua New Guinea investment climate and its impediments to investment. In addition, one might want to consider all of those investments that have never started in agriculture because of the poor institutions in the Papua New Guinea economy.

But formal employment is only a small part of total PNG employment. The informal sector employs a much larger share of the workforce, as well as being a large employer of the poorest of the PNG population—the urban landless population. Improvements in

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the productivity and size of the informal sector would have the best chance of improving the lot of the most disadvantaged.

In an Asian Development Bank-funded survey of informal market participants, Eugenio (2001) questioned 1,265 participants in informal markets about the impediments that they faced in operating in the informal sector. The participants in the survey responded that the major challenges they faced were

- lack of access to finance/banking
- lack of infrastructure, such as markets, to support informal production
- regulations that restrict informal trading, harassment by police or other officials
- lack of skills and training in running a business.

There were other issues raised in the Eugenio study, however the above were the problems that should and could be addressed by changes in government policy.

Hausmann, Rodrik and Velasco (2006), and in their much larger 2005 working paper, argue that economic reform should be focused on only one or two targets—the ‘most binding constraints’. In their opinion, reformers who have tried to target all the problems in an economy tend to dissipate their political capital and/or end up targeting constraints that are not crucial to growth. Hausmann et al. provide a ‘decision tree’ framework for determining the binding constraints leading to low levels of investment and entrepreneurship in a country (Figure 5).

Interest rates are not relatively high in Papua New Guinea, suggesting that the binding constraint to investment is not the high cost of finance, and therefore we would start looking down the left hand side of the decision tree. Investment in Papua New Guinea is plagued by both low social returns and low private appropriability of the returns on investment. The Manning (1999)

survey identified law and order and corruption as the most important constraints on investment. These factors constitute the ‘micro risks’ in the decision tree, suggesting that low appropriability is a problem. The Manning survey also identified poor infrastructure as a constraint, which means that low social returns is also a problem. Policy instability and inflation, which were identified as less important in the Manning survey, would be part of the ‘macro risks’ faced.

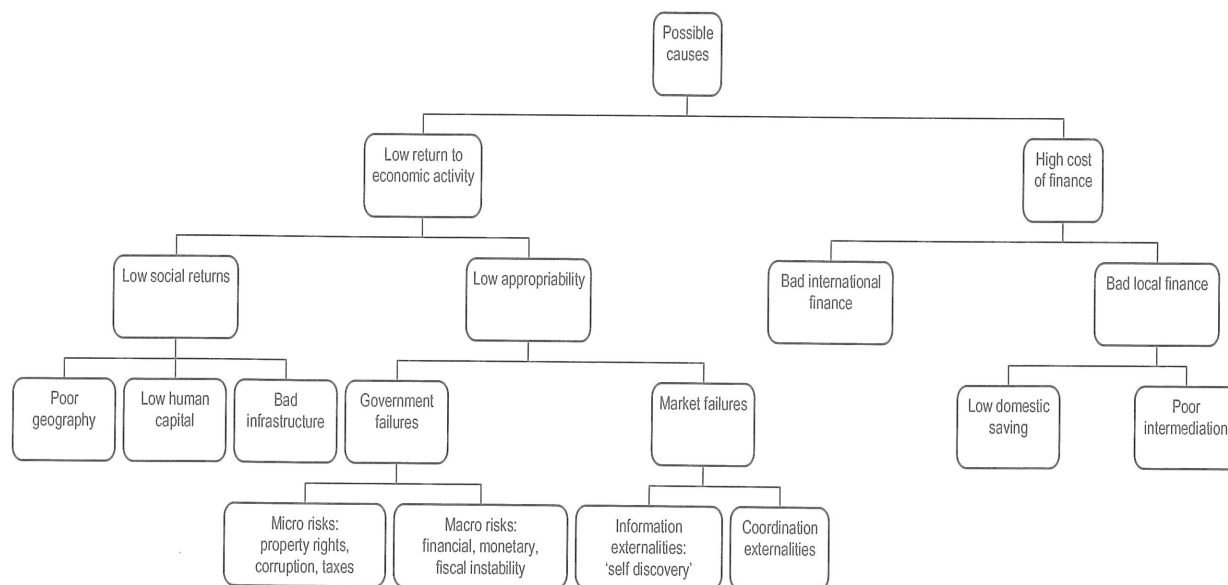
There have been few efforts by the Somare Government to address the major problems or binding constraints facing the formal and informal sectors. A supporter could argue that the Somare Government has reduced inflation and some regulatory burdens on some industries; however, these are the fifth and sixth most important impediments in Manning’s (1999) list. The more important impediments of lack of security, official corruption, low quality of infrastructure services, and government policy instability have not been rectified.

An exception to the above statement is that in an important development for both the formal and informal sectors, the National Executive Council adopted the recommendations of the National Land Development Taskforce and provided funding for a Land Development Program in the 2007 Development Budget. This program will move ahead with administrative, legal and institutional land reforms to improve land development in Papua New Guinea, although slowly and methodically as land tenure reform is a sensitive issue.

The lack of secure individual property rights over land has restrained the growth of the Papua New Guinea commercial banking sector and limited the availability of credit to the largest part of the Papua New Guinea economy—the agricultural, forestry and fishing sector. In September 2006 outstanding

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Figure 5 Decision tree to identify constraints on private investment



Source: Hausmann, R. Rodrik, D. and Velasco, A., 2006. 'Getting the diagnosis right', *Finance and Development*, 43(1):1-8.

loans to the manufacturing sector stood at K100.4 million, which is similar to outstanding loans to the agricultural, forestry and fishing sector at K102.7 million (Bank of Papua New Guinea 2006). However manufacturing's contribution to GDP is only K999.5 million, while the contribution of agriculture, forestry and fishing is nearly six times larger at K5,819.5 million. Similarly, the commercial trading sector has outstanding loans of K445.9 million, while the contribution of that sector to GDP is only K1,011.7 million.

A Manning-type survey of impediments to business may be significantly underestimating the difficulties that the unavailability of finance places in front of businesses in the agriculture, forestry and fishing sector. The lack of credit means that those businesses will not show up in a business survey in the first place. However, if processes are established to allow customary land to be the basis of commercial

loans, this sector may finally get the kind of access to credit that it needs and warrants.

There have also been some moves to support the informal sector. Public markets have received some government support and there have been efforts to remove the regulations that restrict the informal sector. In the 2007 Budget, K20 million is budgeted to develop district markets to assist informal sector traders.

While the commercial banking sector is still largely inaccessible to participants in the informal sector, some banking services are provided by PNG Microfinance, which has been allowed to operate in Papua New Guinea since 2004. But for the most part the informal sector seems to operate 'in spite of' the PNG government rather than 'because of' the government.

The 2007 Budget reveals few new plans to address the problems with PNG institutions and infrastructure. The revenue

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measures that the 2007 Budget puts forward are

- tax incentives for the tourism industry
- change in taxes on log exports
- tax concessions for agricultural research extensions
- a drop in tax on a certain fuel
- a change in GST allocation, and
- an increase in tariff rates on certain imported foods.

The last measure is obviously a retrograde step in providing protection to a few manufacturers at the expense of consumers.

In providing support to forestry and tourism, the government is providing support to those industries that can largely isolate themselves from Papua New Guinea's economic environment. Mining and logging have been successful industries, despite the impediments to investment, because they can isolate themselves from the poor institutions in the Papua New Guinea economy. These industries typically provide their own infrastructure and, apart from tourism, bring in their own workers, so they do not face the problems that a garment manufacturing project would.

But mining and forestry will never employ many Papua New Guineans. Tourism would employ more local workers; however, the success of tourism in Papua New Guinea will be limited as long as the tourists have to be protected from problems such as gangs of *raskols*, poor drinking water, electricity and telecommunications failures, and inadequate transport.

The institutional problems will ensure that future economic growth will not reach the levels predicted by the Treasury. The mining and other resource extraction sectors will grow, but mining is buffered from the rest of the economy. To the extent that the mining sector grows, it will provide additional revenues to the PNG government. However,

the value to the general population and particularly to the urban landless of an additional K1 in government revenue is probably very low.

The failure of reform to proceed at the micro-level can be seen in the lack of any total factor productivity (TFP) growth in recent years. During successful reform periods we would expect to see gains in output due to the reforms, holding constant the level of factor inputs. In a growth accounting framework, such gains in output would show up as an increase in the TFP growth of the economy, representing all factors other than those explicitly accounted for. TFP growth would then represent improvements in economic institutions, political stability, external conditions, and measurement errors.

However, there is no evidence as yet of a turnaround in TFP growth due to any actions by the PNG government. Rao et al. (2006) estimated zero TFP growth in Papua New Guinea from GDP accounting figures for the period 1972–2003/4. Faal (2006) estimated TFP growth to be negative one per cent per year for the period 1996–2004.

So have the macroeconomic reforms of the Somare Government and the macroeconomic policy papers produced by development assistance agencies been a waste of effort? Macroeconomic issues have been a development problem, but they are not the binding constraint in the sense of Hausmann, et al. (2006). Solid macroeconomic performance is a necessary foundation for future economic growth, but it is simply not sufficient. Will foreign investors flood into Papua New Guinea (outside the resource extraction sector) now that the macroeconomic policies are more sensible? The Manning survey suggests that investors, both domestic and foreign, will still look at the high level of corruption, the poor quality of public services, poor law and order, and other difficulties and decide that investment opportunities outside Papua

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New Guinea are a safer bet. The low social returns and low private appropriability have simply not been addressed by reform, and these are the real constraints on the Papua New Guinea economy.

Papua New Guinea is likely to join the group of 'unsuccessful reformers'. These are countries that have followed the advice of international development assistance agencies but yet have not seen any returns on their reforms in terms of higher growth rates. A concern is that the apparent failure of past reforms will lower the interest of PNG politicians in the far more difficult institutional reforms that have yet to be implemented. Politicians might respond to future suggestions for reform with, 'we tried reform, and it didn't work.'

### Windfall gains and the 2007 Budget

The 2007 Budget contains several special items that may present some difficulties in 2007 and, in particular, leading into the election. These are the 2006 Supplementary Budget, what the Treasury calls the 2006 and 2007 windfall gains, and the latest 2007 Supplementary Budget.

These are large budget items with the 2006 Supplementary Budget being K682.5 million, the 2006 windfall gain being K650 million, the 2007 windfall gain being K450 million, and the 2007 Supplementary Budget being K700 million<sup>3</sup>. All four items have been placed in the budget at short notice in reaction to the large increases in tax revenues due to the minerals boom. The total amount of spending in these mini-budgets is K2,382.5 million (as K100 million unspent from the 2006 Supplementary Budget is included in the 2007 Supplementary Budget).

How is all of this money going to be spent? Of the 2006 Supplementary Budget spending K445.8 million is allocated to the Medium-Term Development Strategy Priority

Areas. According to the budget these priority areas are

- primary and preventative health
- HIV/AIDS
- law and justice
- transport
- income-earning opportunities
- basic and adult education.

The Medium-Term Development Strategy (MTDS) is described in the budget as the long-term basis for the PNG budget. In 2007, these priority areas are budgeted to receive 52 per cent of total government spending.

These MTDS categories are worthwhile, if narrowly defined, priorities for government expenditures. Some, such as law and justice and transport, would be considered priorities for reducing impediments to investment by the formal sector on the basis of surveys such as Manning (1999). Income-earning opportunities and adult education could address some of the skills-building that the informal sector participants in the Eugenio (2001) survey highlighted. The other priorities can be defended on an equity or welfare basis as desirable areas for spending.

The problem arises in the implementation of these priorities. A large amount of money is being thrown at problems, but as the Mawuli et al. (2006:38) report asks, 'Which entity does what, with what, when, how and for what?'

These are all desirable goals. But how do we get from goals to programs, and then from programs to effective spending of the money? Once the spending areas are identified and the money is budgeted, we still need to

- develop specific programs to spend the money to address the goals
- administer the programs, and
- evaluate whether the programs were effective.

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These tasks will be difficult enough to achieve, given the low level of capacity in the PNG public service. Add to existing problems in developing, administering and evaluating programs to spend the 52 per cent of the budget allocated to the MTDS goals the fact that the government has allocated an extra K445.8 million expenditure in 2006 and up to K700 million in 2007. Who will be responsible for the new programs within the MTDS goals to absorb all of this money? Does the PNG public service have the capacity to develop new programs so rapidly in response to the new money? And if it does, will diverting resources to developing new programs detract from the ability of the public service to oversee and evaluate the spending that takes place?

Due to the limited public service capacity, these problems are even worse for the 2006 and 2007 Windfall Gains expenditure. The budget items for this spending are vague descriptions such as 'Rehabilitation of Education Infrastructure K200 million'. Of this particular K200 million, K50 million is allocated to the University of Papua New Guinea and K5 million each to four old National high schools. The remaining K130 million is to be 'allocated between primary schools, provincial high schools and technical and vocational centres, utilising a sector-wide approach' (Papua New Guinea 2006:43).

The end result is that in the nearly K2,400 million in these budget items for 2006 and 2007, there is a large amount that is un-programmed, 'free' money. Some of the money is directed, such as the K50 million to the University of Papua New Guinea or the K130 million to be put into PNG Power, Telikom and Air Nuigini, but a large portion of this spending is not directed.

There is an election coming up. The politicians will need cash to provide to their constituents to shore up voting support. Politicians are also not very popular. In the

2002 election, some 75 per cent of incumbents lost their seats. This turnover contrasts with a typical 95 per cent re-election rate for incumbents in Australia and the United States. There is no reason to believe that the electorate is presently happier with their representatives than it was in 2002, given that real GDP per capita figures show they are no better off today than in 2001.

What this presents then is a 'perfect storm' of misappropriation. We have

- an election
- unpopular incumbents, and
- large amounts of undirected cash in the budget.

A concern is that with a large amount of money in the current budget that is not tied to particular programs it will end up being used as re-election cash by politicians, rather than building roads or clinics as the MTDS might wish. There might be big parties in the Highlands and the Islands, but the people of Papua New Guinea will be no better off after the election.

Groups who are able to influence the PNG government might suggest that the short-term minerals boom revenues should not be spent in an election year, but rather saved for a year when the need to gather election cash is not so great. With nearly K2,400 million at stake, this is too large an amount of money to risk.

## Conclusions

From a macroeconomic perspective the Somare Government has brought a level of stability to the economy of Papua New Guinea. Budget deficits have been eliminated, inflation has been brought down and the burden of public debt has been reduced. Improved economic management has been a significant achievement by the Somare Government and the Bank of Papua

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New Guinea, and officials should be rightly proud of their accomplishments.

Unfortunately, spending has increased rapidly in the recent budgets, the public debt has not been significantly reduced in nominal terms and the current budget is very vulnerable to downturns in the prices of minerals exports. The Treasury talks about fiscal discipline, but there is not much evidence of discipline in recent budgets. In per capita GDP terms the PNG economy is no more productive than it was in 2001.

While macroeconomic management has been an improvement over past governments, the lack of progress on the institutional problems facing Papua New Guinea means that future GDP growth is not likely to match the 4 per cent forecasts that Treasury puts forward. The continuing high levels of corruption and the significant law and order difficulties mean that future foreign and domestic investment will be concentrated in the resources sector and of little value to the majority of Papua New Guineans.

Of particular concern in this election year is the K2,400 million in extra spending that the Treasury has added in the last few months. The 2006 and 2007 Supplementary Budgets along with the 2007 Windfall Gains expenditures are significant new burdens on the public service. There is reason to doubt that the public service has the capacity to properly spend and administer this money, particularly in a year when politicians will need money to purchase votes and support in their electorates. Given the risk of misappropriation, a better use would be to buy down the public debt or to otherwise tie up the money for future years. Considerable fiscal discipline is required.

## Notes

- <sup>1</sup> Unless otherwise noted, all the figures in this paper come from the Papua New Guinea Department of Treasury 2007 Budget papers. Available from <http://www.treasury.gov.pg/html/2007budget.html>
- <sup>2</sup> Public debt held as Treasury bills and inscribed stock is labeled 'domestic debt' by the Treasury.
- <sup>3</sup> Isaac Nicholas, 'Govt to hand down K700 million extra budget', *The National*, 14 February 2007. Available from <http://www.thenational.com.pg/021407/nation4.htm>

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