COMMENTARY ON THE 2007 BUDGET

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Chamber President, ladies and gentlemen, thank you for giving me the opportunity to address you, together with my colleagues from Deloittes, on the 2007 Budget. In Parliament the Budget process seems always to be performed at a great rush, with Members keen to move on from all these dry numbers. I hope that we can hold your attention, with information that's as digestible as the breakfast here.

The Treasurer, Rt Hon Sir Rabbie Namaliu, tabled the 2007 Budget in Parliament last Tuesday 14th November. As the Treasurer indicated, not to be outdone by his long standing predecessor, Bart Philemon, he actually tabled an extra couple of Supplementary Appropriations for 2006 and 2007, bringing to four the number of Budgets he's launched during his comparatively short term in the Treasury portfolio!

These multiple appropriations have made it a hard budget for commentators to define, and perhaps more so for observers to comprehend. They simultaneously raise budgeted expenditure and net lending for 2006 to K6.1 billion, whilst approving K5.4 billion of expenditure for 2007, with a budgeted K35 million deficit, or 0.2% of GDP. But in practice the two current supplementary appropriations for 2006 and 2007 are to be managed together, therefore somewhat blurring the annual distinctions; – *Most government officials, but perhaps not all, were relieved to learn that they are not expected to spend all the latest 2006 allocations before Christmas!* Unlike the first 2006 Supplementary Budget, which was incorporated under Department recurrent expenditure, the latest two Supplements are intended to be managed at arms length from both the recurrent and development budgets. The perhaps confusing K8 billion plus figure, headlined in one of the dailies, refers to the total amount being appropriated, including the second supplementary for 2006, but also including K2.2 billion of ongoing amortisation (notably of domestic borrowing: now largely comprised of inscribed stock, along with Treasury Bills), which will be succeeded by the same level of new borrowing, plus a forecast K35 million in additional domestic borrowing.

The Budget is the Government's key single annual policy and legislative instrument, which serves multiple functions. It's the government's vehicle for planning and managing the public funds entrusted to it; as with any business, planning and managing its income and expenditure and the timing of its cash flow. It's also the vehicle through which government policies are reflected, through the level of funding for different public goods and services, or taxes or subsidies on different groups or activities. It's also one of the Government's principal mechanisms for determining wider economic activity, through

fiscal management influencing the level of demand, and influencing consumer or investor behaviour through the level of taxation, including excise duties.

The final Budget of the former government, tabled in 2001, badly dented its credibility, following its commendable programme of constructive reforms, by providing a giveaway budget at a time when there was little to give away, boosting debt levels and undermining confidence.

On the face of it the 2007 Budget, by contrast, appears to be a highly responsible money plan, which should provide confidence to the private sector and the wider community, at a time when some other, somewhat spontaneous actions from government of late, have provided cause for concern.

By contrast to 2001 this Budget comes at a time of relative plenty, when fortuitous good commodity prices (notably for oil, copper and gold) have provided a windfall of revenue, and boosted foreign exchange reserves and our balance of payments. It also comes at a time when the tough political and institutional reforms largely introduced by the former government, together with the firm application of fiscal restraint by this government, and, until this year, relative political stability, have contributed to four years of steady economic growth. This growth in 2006 is estimated at 3.7%, exceeding the population growth by about 1%, and is forecast in the Budget to reach 4.5% in 2007. This remains lower than the expected global average growth rate, and that of many other developing countries (driven on by China and its demand), and inadequate to substantively raise living standards throughout the community, but is nevertheless a positive achievement, which highlights that much has been done right in recent years, to create the right platform for growth, but that a drive to firmer reforms in the future is required if that rate is to be sustained and improved.

Despite highly inadequate National statistics, the indications are that PNG's formal employment has grown by a record 7.8% for 2006. This covers most sectors, especially building and construction, agriculture and wholesale, and to a lesser extent mining, but it must be recognised that formal employment only embraces a small portion of PNG's population, although supporting a significantly larger portion. The inflation rate has remained low, with Treasury forecasting 1.7% for the year, which seems surprisingly low considering the major hike in fuel prices during the year. Interest rates, as a result, have remained low and borrowing is now internationally competitive, with private sector borrowing rising K600 million to K2.6 billion over the year to mid-2006, (although there remain concerns by business over the spread between deposit and borrowing rates, even if justified by communications and security factors). The current account surplus for 2006 is estimated to stand at a record K2.5 billion (with a K4.1 billion trade surplus), driven by the high minerals prices, but forecast to fall back firmly in 2007. Our foreign exchange reserves have reached a record of approximately US$1.3 billion, providing about 9 months of total foreign exchange cover. Exchange rates have been steady and slightly appreciating against the US dollar, providing reassurance to investors and wage earners, although tending to undermine our competitiveness in production and manufacturing, including prospects for agricultural development for both exports and import substitution.

By and large Sir Rabbie's first full Budget as Treasurer, at a time when various pressures are clearly strong in the lead up to the 2007 Election, maintains the tradition of his predecessor, in terms of adherence to the medium term fiscal and debt strategies and responsible money management, whilst taking advantage of the windfall revenue to address a number of "once off" issues (including related to financing and management of the 2007 Election), and a backlog of outstanding dereliction, notably restoration of decaying infrastructure and addressing long overdue commitments, such as overdue salary payments.

This Budget seeks to deal responsibly with the issue of windfall income, by, in accordance with IMF recommendations to sanitise the core budget from major fluctuations, placing it under two separate appropriations of K650 million and K450 million, nominally for 2006 and 2007 apiece. However, as with the K682 million Supplementary Budget in mid-2006, where nothing was allocated for debt reduction, one would have expected a larger portion than K100 million of this windfall to be allocated to debt reduction.

PNG's Debt to GDP has fallen substantially from its 2002 level of 72% to 42% in 2006, and forecast to reduce to 41% next year. This decline is largely the result of GDP growth, rather than a major fall in the principal debt itself, which has been reduced by about K1 billion over the past five years. At K7.34 billion, and still with a poor mix, it remains well above the IMF's recommended 30% sustainable level, and, as stated in Volume 1 of the Budget, "the government has an unsustainable level of debt, the debt portfolio has excessive financial risks and the government debt markets are rudimentary".

The composition of public debt has been improved and exposure to foreign exchange risk reduced through the debt management strategy over recent years, and government is now further disciplined by the new *Fiscal Responsibility Act* forbidding (in theory at least) significant debt financing of the overall Budget. The reality is, however, that our economy remains very dependent upon volatile commodities and retaining high debt levels can be risky, imposing a major burden, threatening core expenditure if and when export earnings fall following lower market prices or supply (as during an El Nino year) and in the event of lower kina exchange rates.

It's certainly true that there's a major backlog of outstanding infrastructure and services needing restoration, and that using windfall funds for debt reduction seems relatively unappealing in the shorter run, and of limited effect in the face of the substantial level of debt, but nevertheless reducing long term debt servicing costs (particularly from less concessional debt) would have a significant long term impact at safeguarding funds for priority activities in the longer term, whilst also incidentally improving the country's credit rating (of value to the private sector; the major generator of growth).

The question, therefore, comes down to which provides a more effective use of funds. If the funds can be used more efficiently in improving infrastructure and services, providing a multiplier effect, and boosting the overall economy to a greater extent, then this would

be a better option. However, given government's poor track record for planning and implementing expenditure in a timely manner for set priorities, the idea that the 2006 supplementary budget could be planned and spent effectively in the second half of this year, and then that the two supplementary appropriations be administered responsibly in their entirety, in a timely manner, seems unrealistic, given that many of the implementation mechanisms are not yet in place.

I would suggest, therefore, that it would have been more responsible to have plumbed for a different mix with the windfall, with a greater proportion on debt reduction and more selective allocations for upfront infrastructure and service provision, based upon what can realistically be achieved. That said it must be recognised that, whilst 2006 brought unbudgeted windfall revenue, the Budget, including especially the windfall component, is premised upon World Bank and IMF price forecasts, and the only thing we know from experience is that those will inevitably prove wrong!

We expect primary commodity markets to hold up, driven by continued Chinese and Indian demand, but slip back modestly from their peaks, as oil already has. Movements, of course, would be more marked with notable global events or disputes in major supply areas overseas. Likewise, whilst production from Porgera should recover in 2007, following the major mine slippage in 2006, the effect of a major expected El Nino would undermine mining and some agricultural exports, and increase food import demands, as occurred in 1997/98, with balance of payments and some budgetary, as well as social, implications. Even the Elections themselves, falling in the midst of the coffee season always causes some loss of production and earnings, as well as additional costs. Growers find it easier to await political handouts than harvest their own produce! Whilst seeking to forecast and minimise risk and uncertainty, we should be prepared and, where practical, insure against its inevitable appearance. Apart from the vagaries of global markets and natural hazards, the biggest risk to the 2007 Budget is the loss of fiscal discipline, and it will require great resilience to keep the reins kept in check, particularly with the large numbers of new project activities and limited planning and implementation arrangements and capacity.

Incidentally, in terms of oversight processes, it is critical that the powers of the Treasury's Finance Inspectorate are gazetted promptly to enable them to perform their inspections over public finances. The inspectorate has regularly have played a critical initial role in identifying financial abuse, as with the former National Provident Fund, but it need to be re-empowered to perform their function.

One concern will be the pressure for undue front-end loading of expenditure in 2007, in advance of revenue being received, both to satisfy commitments to development partners over counterpart contributions, but also to release funds in advance of the Election.
There are certainly more mechanisms in place now providing for greater budgetary (and monetary) transparency and oversight, but many of the schemes are new and untried, or, as with agriculture, still just a shopping list of project proposals. The composition of the windfall expenditure is:

- Rehabilitation of education infrastructure takes the biggest slice, at K200 million, followed by
- State-owned enterprises, K130 million;
- Transport infrastructure, K120 million;
- Health infrastructure, K110 million;
- Gas pipeline and debt reduction at K100 million apiece;
- Law and justice infrastructure, K75 million; and progressively smaller amounts down the list, including K20 million for the overdue task of supporting the upgrade of fresh produce markets around the country….which hopefully can be implemented a bit faster and more reliably than in the past by some (nameless) town councils!

Apart from implementing these tasks in a timely manner, the challenge will be to institutionalise the maintenance of all this new or restored infrastructure, and simply await another possible windfall, or go back to donors, like AusAID to restore the Lae roads they so recently built! Are mechanisms like the National Roads Authority the way? If so, isn't it about time the government and other stakeholders ensure that the NRA becomes operational?

The continued adherence to the Medium Term Fiscal Strategy provides a basic rigour to the Budget, and the virtually balanced Budget since 2003, and planned 0.2% deficit for 2007, provides some evidence of the success of the strategy, and assurance to investors. But there's limited purpose in collecting revenue or balancing it with expenditure unless that expenditure if performing the government functions effectively. For years government was maintaining a large payroll, without providing the operating funds for the staff to get out and perform their duties. That scenario has improved in some cases, with some institutions performing priority functions also having basic operating funds. Many still do not, and at the provincial and district levels, where much of the interaction with the community lies, there are still totally inadequate funds to deliver essential services, particularly in some provinces.

This Budget seeks to connect the priorities, as specified in the Medium Term Development Strategy, better with planned expenditure, and apply the 2007 Budget Strategy of at least 52% of the total budget going to MTDS priorities and 84% of the development budget, partly also to meet commitments to donors and benefit from associated performance rewards. The 2007 Budget has succeeded in allocating 53% to the priorities for total expenditure, and 88.5% of the development budget. Just to remind you, the priorities in the MTDS are: - income earning opportunities, rehabilitation/maintenance of existing transport infrastructure, basic education, development-orientated informal adult education, primary and preventive health, HIV/AIDS prevention, and law and justice. It certainly makes strong progress in this regard.

The Government has put money where its mouth is with respect to the Development Budget, which at K1.6 billion, although slightly down in total from 2006, is now nearly half funded by the PNG Government, with the largest PNG contribution to date, at K757

million, including K163 million in concessional funds and K85 million in tax credits. Transport maintenance and rehabilitation takes the lion's share of that Government input, at K377 million.

Unfortunately, whilst starting the overdue process of reforming provincial and local level financing, the Government has deferred the hard, and not entirely popular reforms recommended by the "Right Sizing Committee", entailing some pruning of low priority institutions and functions, and merging of others, in order to focus public funds towards priority infrastructure and basic services and away from administrative overheads. Whilst not everyone will agree with all the recommendations of the Committee, there are certainly considerable duplication, excessive overheads and better mechanisms for delivery of certain services, at the national and provincial levels, which needs firm action by Government. Many institutions, from a potentially merged cocoa and coconut institution, to the tourism authority should perform better by operating under more genuine public-private partnerships, with greater user and less government or political control.

Constructively, under the Recurrent Budget, whilst no significant cuts are made, the modest increase in Personal Emoluments provides for needed extra teachers, in line with population growth, and there is a more substantial increase for goods and services to make organisations more operational. Throughout the Budget, however, it appears that disproportionate funding is always provided for the National Departments, in relation to the provinces. There does appear, incidentally to be an anomaly of K104 between the allocation for the national Departments in the Appropriation and the figure in the Budget volumes themselves. Maybe there's a simple explanation for that, although to date the Treasury has not provided it.

Under the National Departments an excessive amount of K98 million is being paid for office rentals, when both the vast Central Government Offices and Pineapple buildings remain vacant. The former has essentially nothing significant structurally wrong with it, whilst the latter would require substantial expenditure. One has to question why no action has be taken after all these years to restore these facilities, or dispose of them to others who can, when this rental amount is almost the total allocation to the provinces (excluding their bloated administration costs) for currently largely inadequately funded services. Likewise, despite the sound commitments to basic services, there is a readiness to release major funding for extravagant, but in reality relatively unproductive expenditure, for the privileged in the Capital, from Members allowances, to a K600,000 executive vehicle to continual overseas travel and allowances for politicians and officials and statutory body staff. No doubt this is no worse than in various other countries, except that when one relates these costs with the deficient services and atrocious social indicators for PNG's rural areas, and the impact of a relatively small additional allocation there. There still needs to be more rigorous prioritisation of expenditure, with greater input and monitoring from impartial sources.

The NEFC's highlighting of the inadequate funding for basic services at the provincial and local levels, particularly in some provinces, but excessive funding for administration,

is finally starting to be addressed in this Budget, with a better system of distribution, and increased funding and a more rational system for local level governments, enabling them to perform functions other than merely attending meetings. In 2007 this entails a change to the system of distribution of GST to make it more sustainable, to be based upon last year's actual rather than forecast collections in each province, with a guarantee that this will not entail a reduction to any provinces for the year. In 2008 it will be merely based upon 2007 collections. In 2007, the interim year, the goods and service grants to the provinces, for health, education, transport and now also village courts, will be raised from the Organic Law formula of K10 per head and K4 per sq km, to K13 per head and K4 per sq km.

Derivation grants will remain unchanged in 2007, but planned to become a new agricultural function grant in 2008. More critically in 2007 the town service grant will be raised from K9 to K11 per head, and the LLG grant from K3 to K7 kina per head, a substantial increase which should make LLGs' operational , beyond the basic cost of holding meetings. This is a major step in making local government functional, and has been long cried out for in the CIMC National and Regional Development Forums. To become effective, however, there will need to be active training for planning, management and oversight at the local level, reinforcing the relationship with the local administration, including the District Treasuries. It also requires that the funds are actually released to the respective provincial and local authorities in a timely manner. To date staff and councillors at the District level have little idea of how much, if and when funds will be released, making proper planning and implementation impossible, and, as with District conditional and unconditional grants, there is always a fear of undue interference or control of the process (as with the DJP& BPC) by the local national Members.

In 2008 it is planned to more rigorously overhaul the provincial and local level funding, with the addition of the bookmakers' tax going to Provinces, and a system of overdue equalisation of national allocations to the Provinces and LLGs, again with a proviso that no-one loses out for five years.

The District Services Improvement Programme, launched in 2006 to support provision of services and utilities at the District level, and complement the District Treasury Roll-out programme, will be continued in 2007 with a further allocation of K71 million. Again, much more awareness of this programme is needed at the local level to make it operational and answerable, and ensure we're not simply adding a new mechanism, which may be corrupted, because of a reluctance to reform the widely abused existing District Development Grants – or "Members' non-discretionary grants..

Another area of reform from which this government has baulked, but where the previous government was more courageous, if at excessive cost, is privatisation. Under the supplementary appropriations there's K130 million for extra equity in the State-owned enterprises (more than for debt reduction), apart from extra K100 million of equity in the planned pipeline, (or perhaps an alterative gas option). There is no question that the Commercial Statutory Authorities and corporations, including utilities and Air Niugini,

are undercapitalised, but surely resolving that deficiency was one reason for privatisation, namely that they would cease to be financial burdens on the State, securing their own capital from the market and paying their own way, preferably in competitive markets, or at least under effective oversight, leaving Government to expend it funds upon core public goods and services. Some, such as Telikom, were more readily saleable than others, such as PNG Power with its long un-maintained plant and equipment, which needed further prior consolidation and investment.

Clearly, delivery of some services to remote locations (including shipping, air services, rural power and telecommunications) justifies explicit investment and subsidies, as under the newly commencing ADB-funded coastal shipping pilot initiative, but much of this can be administered with commercial operators, not just handed out to largely inefficient State providers. There are certainly some advantages from aspects centralised management of debt and other support under IPBC, but why hold back services for the whole community to protect organisations performing functions better provided by the private sector, and falling outside the State's own core functions. These organisations may have improved over recent months, but the fact that, despite a large potential market, if Telikom is unable to connect urban lines for months, or provide reliable and affordable hi-speed data transmission to main centres, and runs such an inadequate and unreliable mobile monopoly indicates how hard it would be for them to provide services to rural areas, and suggests that they should be a prime case for privatisation, but not hopefully through a process like the recently flawed mobile tender. The primary objective for these utilities should be reliable and affordable services, for household and business consumers, right out to rural areas, which may not coincide with simply safeguarding the interests of state owned enterprises.

With respect to revenue measures and business incentives, no new taxes and generally minimising tinkering with the tax system (at least until a wider comparative review) is advantageous and provides stable and simpler investment conditions. The continued income tax reforms and phasing out of the mining levy are sound, although in principle it is desirable to extend the number of tax payers, to enable more feeling of ownership of the State and its instruments, in line with CIMC's programme of "opening the Budget", and in turn banishing the idea that largesse of funds or employment is the gift of leaders.

Generally, the fewer specific fees, charges and levies and explicit incentives the better. Seeking to establish a level and consistent playing field for investment is the goal, as differential arrangements invariably provides preferential treatment for some players, which may be a disincentive to other investors or industries. The recent reforms to mining and hydrocarbon tax rates contributed to the revived interest in exploration and development, although tending to provide unhelpful inconsistencies with other sectors. Exclusive arrangements for the Ramu Nickel mine, affirmed in this Budget, improves further distortions within the sector, tending to provide uncertainty and pressure for further future, or existing concessions to other players. Careful assessment of the net benefits or otherwise of individual project concessions is needed before approvals are granted (whether regarding tax, employment or waste management, concessions, for example), including the impact upon other industries and the wider community.

The tourism incentives, which complement those in the 2006 Budget, are constructive as far as they go. However, why so much emphasis on hotels or facilities of over US$ 10 million and 150 rooms, when most tourist coming to PNG are looking for smaller eco-tourism type lodges? This seems unfortunate, and there's no consideration in the Budget of the deluge of excessive air-passenger charges, levies and the tourism visa, which, combined, make PNG uncompetitive with other destinations in the region and beyond.

The forestry revenue reforms have brought sarcastic observations from many quarters; "*why would the Government give away K30 million in revenue just like that, when the industry is clearly doing just fine! Must be something to do with the forthcoming election*". In fact some components of this reform are long overdue. The Government-commissioned revenue study in 2001 stated that the resource owners were the main losers, having not had their royalties increased from the K10 per cu metre since 1996, since when there has been considerable depreciation of the kina. It seems reasonable that at least a portion of the proposed increase under a "Premium Levy" should come off the State's portion of revenue. As it is, all of it does. It seems unreasonable, however, that this increased (or restored) landowner benefit doesn't apply to landowners whose logs are being processed at mills. These processed logs are already being exempted from any export tax, so the State is missing out an increasing level of revenue, which is hardly justified. But why the resource owners should also miss out is certainly most unreasonable.

In view of the extensive non-compliance by a number of forest industry participants over recent years, as highlighted in rigorous reviews, one could ask why the industry should be rewarded by a tax reduction. However, a reduction in log export tax could be justified on the basis that it might encourage more sustainable forestry practices and transparent pricing, discourage transfer pricing. In which case, however, there should also be appropriate mechanisms set in place to ensure that occurs. A more impartial system to vet export contracts is needed to ensure acceptable market prices are agreed and minimise potential transfer pricing. Currently, for a start, there is always an excessive range of contracted prices recorded for the same species being exported.

No new measures have been introduced for agriculture under the "Green Revolution" measures since the 2006 Budget. These measures, which largely apply to large investors, but in some cases benefit outgrowers as well, are continued, and being slowly being adopted by a few companies. Greater awareness is promised by government of the facility, but it also requires greater readiness by relevant government agencies to implement the scheme. The draft National Agricultural Development Programme, prepared for DAL with FAO, was too late to influence the 2007 Budget substantially. There has been K40 million set aside in the Supplementary appropriations for agriculture projects to be determined. What is often overlooked by many planners in government is that encouraging farming is not simply about extra funds for DAL, research or extension, or even about various tax concessions, which may be rather exclusive, but, setting the overall conditions in which the farmer can make a profit or adequate return to his land and labour.

The INA commissioned study of agriculture options, undertaken by NZIER, recommended a "no industry assistance" policy across the board (not just in agriculture), and concentrating upon tackling the fundamental constraints on viability, including inadequate kina prices for export crops with the kina remaining too strong against the US dollar, and PNG productivity not having kept pace in a competitive world market. Poor transport and infrastructure, law and order, inadequate research and extension, have all played their part, but the report emphasised the need to respond to the issue in their totality, not address individual constraints in isolation, as the ensuing costs may be high with a limited impact. With respect to the Budget and the NADP, therefore, the investment in transport infrastructure and law and order are more likely to provide an agricultural stimulus than government expenditure on expensive agriculture projects, although effective research and information dissemination is critical and improved industry coordination and more cost effective and answerable institutions important.. But allowing the kina to continue gradually appreciating, under pressure from strong mineral commodity prices and exports, would progressively undermine the prospects for agriculture, plantation forestry and aquaculture, unless there was some unlikely concomitant increase in world agricultural prices, or major productivity gains..

The targeted reduction in tax on Zoom and Avgas have been long sought, and are justified on a welfare and local economic basis. Diesel is the standard fuel for economic activity, including agriculture and land transport, but coastal communities are largely dependent upon zoom in their banana boats, and the high price and excise rates on petroleum have penalised coastal producers of copra and other products. This is a pilot trial, as applying separate rates for zoom and petroleum used in wheeled motor vehicles may prove impractical. In the longer term, however, encouraging safe vessels using fuel efficient, probably diesel engines, including bio-fuels should be encouraged. The main problem with AvGas, the fuel used for light service aircraft and helicopters, is that it is not refined in PNG, and is now imported in small quantities at high unit cost. Reducing the already low tax will make little impact on the limited supply and high price, but it's a positive step.

The temporary increase in import duties to protect local canned dark-meat tuna, carbonated soft drinks and baked beans does not seem justified on the basis of protecting essential local industries, especially as the ingredient beans are themselves to be imported duty free, so it's really just protecting some domestic packaging, against the interests of the consumers. It sends the wrong message, that domestic ventures experiencing difficult competition from overseas products can readily seek protection, and why select these products, why not next time a selected group of others. Providing some tariff protection for the thousands of producers of vegetables is one thing, but forcing consumers to pay over the odds with a 25% protective tariff to safeguard domestic packaging of an imported product seems against the public interest. The tariff, of course, would not apply to produce imported from fellow MSG member states.

In conclusion, the Treasurer, and his team at the Treasury and colleagues in Planning, should be commended for responding to a significant challenge, and producing a budget

which is responsible but innovative, advancing a number of reforms and addressing a backlog of overdue tasks. On the other hand it will require considerable coordination and commitment to ensure that delivery mechanisms are established and funds used properly and effectively. Projects and activities drawn up and implemented unduly hastily, accessing funds because they're available, have a poor track record of implementation. The windfall funds provide a potential once-off opportunity, which must be carefully and transparently managed, and not squandered.

Thank you.