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OPTIMISING THE USE OF BUDGET WINDFALL REVENUES

By

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with

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NRI

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Agogo Mawuli

ACRONYMS

AIGS	Agriculture Innovations Grant Scheme
BWRs	Budget Windfall Revenues
DoT	Department of Transport
ECF	Enterprise Challenge Fund
EU	European Union
GDP	Gross Domestic Product
GoPNG	Government of Papua New Guinea
GST	Goods and Services Tax
LLGs	Local Level Governments
MDCs	More Developed Countries
MTDS	Medium Term Development Strategy
MTFS	Medium Term Fiscal Strategy
MTRF	Medium Term Resource Framework
NCD	National Capital District
NLDP	National Land Development Program
NTDP	National Transport Development Plan
OLPGLLG	Organic Law on Provincial Governments and Local-level Governments
PGs&LLGs	Provincial Governments and Local-level Governments
PNG	Papua New Guinea
RESI	Rehabilitation Education Sector Infrastructure
VAT	Value Added Tax

EXECUTIVE SUMMARY

Temporary Budget Windfall Revenues (BWRs) pose tough policy challenges for Papua New Guinea. BWRs are defined here as temporary surges in government revenues, which supersede the total budget revenues appropriated for a fiscal year. These are budget surpluses which have not been forecasted and therefore they should receive specific fiscal policy attention.

There are other windfall revenues of the Government which are considered permanent. One example is mineral boom revenues. These occur because of an increase in supply, which can result from the development of a new mine or a boost in reserves. These revenues will last for a medium- to long-term period. Separate policy attention to the specific use of BWRs emerges when there are urgent needs that require budgetary interventions.

This desktop study concerns the utilisation of sizeable BWRs. The study focuses on the unprecedented BWRs that accrued to the Government between 2003 and 2008 as the result of a commodity prices boom. These BWRs were quickly appropriated through five Supplementary Budgets.

The utilisation of these BWRs was a topical issue in those years. In a resource rich country, there is always the potential that these BWRs will resurge occasionally. There are diverse opinions on how the BWRs should be used. Country practices also differ widely. Any decision that is made to utilise BWRs comes under the domain of fiscal policy. The soundness of the BWRs policy measures depends on the identification of prime problems that should be addressed, a clear articulation of worthwhile objectives, and the ability of the policy measures to effectively address the problems.

This study illustrates an approach that should be adopted to determine the optimal use of temporary BWRs. The study has:

- set a defensible objective;
- reviewed opinions and other works on the utilisation of BWRs and country practices;
- presented an overview of the mainstream economic thinking on income creation and growth;
- constructed a framework of government policies, which fiscal policy must address in order to provide an enabling environment for economic growth and development;
- reviewed fiscal policy, which includes the Medium Term Development Strategy (MTDS), Medium Term Resource Framework (MTRF) and Medium Term Fiscal Strategy (MTFS), and how the BWRs have been used;
- set out evaluation criteria for determining the optimal utilisation of BWRs;
- put forward recommendations that are consistent with the size of Papua New Guinea's BWRs and the prevailing conditions of the political economy; and
- concluded that a new policy direction for BWRs is required;

The study recommends the following measures for the utilisation of BWRs. These recommendations may differ in time or space and can be likened to a stimulus package. A policy for BWRs should focus on:

- improving law and order in order to restore confidence in the economy, promote business viability and expansion, and open the country for marketing agricultural produce that is locked up in the farms or can be produced;
- improving transport connectivity in order to open up the economy and impact on income creation and employment generation in the same manner as already described;
- removing land development constraints that impede growth and development; and
- the reduction of public debt to a level that is consistent with growth and development.

The paper explains why the above expenditure areas have been chosen for the use of BWR funding. While there is no doubt that there are important expenditure areas which also require additional funding, by and large, in the context of Papua New Guinea's development, the selected expenditure areas will collectively open the economy, promote broad-based income creation, not inflate the total recurrent expenditure significantly, facilitate delivery of services, and stem the decline of health and education services in rural areas, in particular.

SECTION 1: INTRODUCTION

1.1 Budget Windfall Revenues

Temporary Budget Windfall Revenues (BWRs) pose a challenge for the Government of Papua New Guinea (GoPNG) in terms of deciding how they should be used because fiscal revenues have been inadequate in addressing the urgent needs of public infrastructure and programs. BWRs are government receipts which supersede total budget appropriations for a fiscal year. From 2003 to 2008, they accrued as a result of a temporary supply or price change in export commodities that yielded tax revenues and non-tax revenues such as dividends and royalties.

For the purpose of this paper, a distinction must be made between BWRs and resource boom revenues. There is usually a ‘grey line’ between the two which becomes clear through economic analysis. Resource boom revenues accrue as a result of a permanent shift in the supply to a higher production level of the product or a permanent increase in the demand for the product. The BWRs are perceived as excess annual budget revenues, resulting from a change in a variable such as commodity prices, supply boost, or underestimation of the government revenues during the fiscal year.

1.2 Background

Papua New Guinea realised large BWRs between 2003 and 2008. The BWRs have been made possible because of the rising prices of crude oil, gold, copper and other commodities that are exported by PNG. The BWRs have been sourced from income taxes, dividends, royalties, and other non-tax revenues. The government’s windfall profit tax had been abolished before the advent of the current windfall gains; otherwise the BWRs’ surge would have been larger.

These BWRs were budget surpluses which were not anticipated prior to 2003. The economy experienced low rates of growth from 1995 through to 2002, and negative growth in 2000, 2001 and 2002. The annual budget imposed a ceiling on the appropriations from 1997 to 2003. Then suddenly, the budget deficits turned into surpluses from 2004 to 2008, which required policy attention.

In recent years, the topical question has been, ‘How to utilise the BWRs?’ Opinions on the use of the BWRs have varied widely. Many opinion makers have also criticised the government’s utilisation of BWRs. The differences on the utilisation of the BWRs arise because of a lack of specification of clear goals, or problems that are contemplated, aimed at, or addressed. The diverse opinions about, and different country practices of, using BWRs’ have motivated this study, which is meant to illustrate the approach that should be adopted to design a policy for the use of BWRs.

1.3 Study Objective

The study objective is to determine the optimal use of BWRs. There is a strong case for using BWRs to create opportunities for broad-based economic growth, which will lead to poverty reduction in Papua New Guinea. The utilisation of BWRs falls within the fiscal policy domain, which is generally concerned with government receipts, expenditures, and budget balances.

2 *Optimising the Use of Budget Windfall Revenues*

Fiscal policy is one of the main means of influencing the nation's economic growth and development. However, it seems that fiscal policy has not focused on broad-based income creation. It is widely known that economic growth has been mainly driven by the output of the extractive industries, which are capital intensive. The development is urban biased. Eighty-five percent of the population live in the rural areas. Lack of development in the rural sector constrains the opportunities for enhancing income creation. Low incomes and limited development of the rural sector have led to rapid rural to urban migration. The migrants go out and seek jobs which do not exist. As a result, poverty is widespread because of huge urban unemployment and rural underemployment. The root cause of the poverty that prevails seems to be a lack of access to opportunities for gainful employment in PNG.

An enclave growth approach has been promoted in PNG since independence. The economic conditions and theory support this growth approach. The country is endowed with mineral resources. Land is abundant, relative to the population, but land use is restricted by a customary land tenure system and the landowners' resistance to releasing the land for development. Other factors of income creation, such as capital and expertise, are scarce. Economic theory underpins the practice of a nation that is starting to grow from its comparative advantage industries. It is rationalised that the revenues sourced from the growth sector will be used to broaden the nation's growth and development.

The mainly enclave-based growth in Papua New Guinea has been sluggish and unsatisfactory. It is characterised by high growth rates during short-lived export booms which have been interspersed with long spells of low growth rates. Development has also been unsustainable partly because of inadequate public funding of the economic and social infrastructure programs and partly because of unsound fiscal policy. The main fiscal shortcoming has been the inability to use the scarce public finances supplemented by generous donor grants to address a broad-based growth and sustainable development. BWRs, if any, offer an opportunity to pursue a broad-based economic growth and sustainable development.

1.4 Study Methodology

This desktop research was study conducted with the help of two research assistants over an eight-week period. Secondary data and other information were sourced through internet searches and document analysis.

1.5 Study Presentation

Chapter 2 reviews the literature that is relevant to the objective. Chapter 3 presents a policy framework, in order to depict the myriad of development policies, within which the measures for the BWRs policy should be set. Chapter 4 explains the basis for the budgetary policies and how the fiscal policy has been conducted. Chapter 5 presents how the BWRs have been utilised through Supplementary Budgets in Papua New Guinea. Chapter 6 recommends a policy package on the utilisation of BWRs that is consistent with the study objective, the literature guidance, the policy framework guidance, and the fiscal policy situation in PNG. Chapter 7 summarises the main findings, highlights the recommendations, and proposes a detailed study into aspects of the topic which this short study has not covered.

SECTION 2: LITERATURE REVIEW

2.1 Utilising BWRs: Views and Practices

The study objective may be considered in two parts — addressing the optimal utilisation of BWRs and improving income creation and employment generation.

The literature that is relevant to the objective has been reviewed in three parts:

- other country practices of using BWRs;
- the various views about the utilisation of BWRs; and
- mainstream economic thought on income creation and economic growth.

Country Practices

Many countries have earned significant BWRs during the relevant period of this study. The countries include Australia, Bangladesh, Bolivia, Canada, Chile, Democratic Republic of Congo, Finland, Indonesia, Iran, Iraq, Mongolia, Nigeria, Papua New Guinea, Philippines, Saudi Arabia, Sweden, Uzbekistan, Venezuela and Alaska (USA).

This paper reviews the fiscal measures that were employed by these countries to deal with their BWRs (see Table 1). The following policy measures for BWRs have been ranked according to the number of countries that employ them, starting with the most frequently employed measures. They are:

- appropriating budget surpluses in the next budget;
- appropriating the BWRs in supplementary budgets;
- reducing public debt;
- expropriating or nationalising foreign companies;
- imposing an additional profit tax on resources revenues; and
- saving for a rainy day (ranks least among the preferred policy options).

A breakdown of the use of BWRs differs significantly from country to country but the study has identified the six policy measures listed here to be of broad resemblance. There seems to be no strong indication that the BWRs policy is aimed at broad-based growth promotion, which is the concern of this study.

No significant academic works have been produced on the use of BWRs. This is partly because many countries have either traditionally utilised them as budget surpluses in subsequent annual budgets, or a few countries have operated a managed fund into which all public revenue surges flow. The occurrence of huge BWRs worldwide in many resource-rich countries, prior to 2003–2008, seems unprecedented.

Table 1: Windfall Revenues: International Practices

Country	Next Budget	Supplementary Budgets	Main BWRs Policy Measures
Alaska (USA)	yes	yes	Rainy day accounts established.
Australia	yes	-	Treated as budget surplus.
Bangladesh	yes	-	Budget surplus.
Bolivia	-	-	Expropriation of foreign companies.
Canada	yes	-	Budget surplus.
Chile	-	-	All windfall revenues in a managed fund.
Democratic Republic of Congo	-	-	Funding nationalisation of foreign companies.
Finland	-	-	Public debt reduction or management.
Indonesia	yes	-	Budget surplus.
Iran	yes	-	Budget surplus.
Iraq	-	-	Retained for future use because of lack of opportunity to use them.
Mongolia	-	-	Stance: Apply windfall profit tax on mineral companies, created development fund for social services programs (67%) and capital spending (33%).
Nigeria	yes	-	Excess crude account for the next budget (80%) with increased spending on priority areas, while 20% is reserved in the account.
Papua New Guinea	-	yes	Appropriated like 'mini' development budgets, as proposed in the MTDS and MTFs.
Philippines	-	-	Value Added Tax on oil revenue; subsidised power for poor families.
Russia	yes	-	Budget surplus.
Saudi Arabia	yes	-	Budget surplus and sovereign fund.
Sweden	-	-	Budget surplus.
Uzbekistan	-	-	Funding expropriation of foreign companies.
Venezuela	-	-	Funding expropriation of foreign companies.

BWRs have accrued to many resource-rich countries from 2003 to 2008 as a result of a commodity prices boom. PNG earned its windfall revenues from existing taxes, dividends, and royalties. Some countries such as Mongolia, Peru, and Chile imposed additional profit taxes and higher royalty rates. Venezuela, Peru, and Uzbekistan expropriated outright, and nationalised foreign mining and petroleum companies. The practices of a few countries that significantly stand out are presented here.

Democratic Republic of Congo, Venezuela, Bolivia, and Uzbekistan

These countries chose to expropriate foreign companies. Nationalism of foreign companies scares away foreign investors. A compulsory acquisition of investors' equity in boom periods means that one pays a high price which undermines the stream of benefits that will accrue when the boom is over. In addition, there is a big question as to who manages and operates

the company after the expropriation. Companies which merely fly the national flag have a problem of being viable.

Nigeria

The windfall revenues were used to top up the recurrent expenditures between 2005 and 2007. In 2007, the following reform package was put in place. The excess oil revenues which are derived from profit tax when the crude oil prices exceed US\$53 per barrel would be put in the 'Excess Crude Account', which is a government reserve fund. Appropriations from this fund will be 20 percent savings while 80 percent will be spent the following year (Nwanma 2008). Priority expenditure areas ranked according to their importance include agriculture, power, education, security, land reform, and mass transportation.

Chile

Chile has created a managed fund into which government revenue surges flow. The existence of a managed fund means that all windfall revenues are automatically managed. The fund does not distinguish between windfall revenues that are temporary or permanent. Chile and Nigeria apply an additional profit tax. The revenues that accrue from this tax may be considered as BWRs, if price increases are temporary. However, Chile does not have a policy for BRWs.

Finland

Although Finland has experienced huge BWRs, the annual budget has not been increased. Instead, the budget surplus has been earmarked for reducing public debt. The Finnish Minister for Finance has contemplated 'a total elimination of the public debt', which will save interest costs of approximately EUR2.5 billion per year.

Alaska (USA)

With its huge petroleum reserves, Alaska has earned considerable windfall revenues. It has forecast a budget surplus of US\$9 billion for the fiscal year 2008/2009. US\$4 billion was appropriated in a Supplementary Budget and US\$5 billion was set aside for future use, in preparation for a soft landing that would avoid painful budget cuts after the BWRs disappear.

Philippines

The Philippines' BWRs have been realised from value added tax (Gonzale 2008) because of underestimating (by default), the price of oil as it rises. Writing about subsidy funds rather than BWRs, Gonzale (*Ibid.*) pointed out that the government offered power subsidies to the very poor families. Most subsidies are difficult to remove at a later date. When the BWRs cease, where will the government find the money to fund the subsidies? The power bills are unlikely to come down as much as the level of BWRs will do because power billing rates are usually sticky downwards.

Mongolia

In 2006, the Mongolian Government imposed additional profit taxes and increased royalty rates on the mining sector, as gold and copper prices rose. Budget surpluses were paid into a

development fund which was established in order to manage the expenditure direction. Two-thirds of the fund will be used for social services programs and capital while the balance will be saved for future use.

Views on the Utilisation of Budget Windfall Revenues

Many people have expressed diverse views on how windfall revenues should be used. However, a distinction is not made between resource boom revenues and BWRs, in particular. Earlier discussions about the government's windfall revenues before the end of the Twentieth Century centred on resource boom revenues which were presumed to be long lasting (Parsons and Vincent 1991, Mawuli 1993). Academic discussions have generally treated all resource revenue surges as resource boom revenues, without clearly distinguishing between short- and long-term windfall revenue surges.

Concerns have also been raised about mismanagement and appropriate management of revenues derived by developing countries from commodity export booms (Cuddington 2008). Typically, misuse is a result of over-consumption and unsustainable spending on the public sector. When the boom ends, fiscal imbalance, in the form of budget deficits, emerges. On the other hand, the countries which manage the commodity boom revenues well are those that do not spend on wasteful and inefficient investments, projects, and programs.

How well has PNG managed its commodity prices boom from 2003 to 2008? The answer is mixed – partly well and partly not so well. The monetary policy has been cautiously managed by restraining the floating exchange rate from overshooting during the boom period, building up foreign exchange reserves, and lowering the kina facility rate (KFR), which is the Bank of PNG's interest rate indicator. The monetary authorities have permitted the exchange rate to be largely determined by the market, instead of supporting the rate using the large reserves accumulated during the boom period. However, caution has not been manifestly exercised in the case of the fiscal policy management of the windfall revenues. Prior to the boom, the Medium Term Development Strategy (MTDS), with the Medium Term Resource Framework (MTRF), and Medium Term Fiscal Strategy (MTFS) have planned for fiscal conservatism. The annual budget size has nearly doubled and BWRs have been appropriated through five supplementary budgets, which may be likened to 'mini-annual budgets'.

Duncan (2007) was of the view that 'fiscal discipline', which the Minister for Treasury and Finance also referred to in his 2008 Budget Speech, should guide the budgeting in order to reap good returns from public investment programs associated with the windfall revenues. Duncan (*Ibid.*) advocates running budget surpluses and buying down the public debt. He cautions that it would be politically difficult to reduce the recurrent expenditures, especially the wages and salaries bill, when tax revenues fall.

Manoka (2006) pointed to flawed budgeting and questioned whether the public service had the capacity to spend the first two Supplementary Budgets by 2006.

Views on BWRs are as diverse as the number of people who comment. Several commentators on the BWRs either laud certain aspects of the Supplementary Budgets or advocate expenditure priorities such as:

- public services delivery;
- sustained non-mineral sector growth, through strengthening transportation and communication infrastructure, land reform, education, and law and order;

- the pursuit of a restrained fiscal policy, saving a portion of windfall revenues in trust accounts or paying down debt;
- public investment (Rheeney 2006); and
- rural development.

Yadi (2005) pointed out that, while the National Budget needed to be controlled through down-sizing the public service, there was an urgent need to strengthen sectoral policies. Yadi's position is strengthened by this paper's stance on the BWRs.

2.2 Economic Thought on Growth and Development

The study's objective is to find appropriate BWR measures for promoting broad-based income creation. It surveys the history of thought on income creation and economic growth and development in order to find policy guidance or direction. Creating wealth in order to make a nation prosperous and powerful seems to have always engaged the thoughts of development economists, practitioners and politicians since economics became a distinct discipline. In today's economic parlance, wealth creation refers to economic growth. Interestingly, public finance, in the classical sense, which is about raising state revenues, has dominated the discussions concerning the resolution of this problem. There seems to be a disconnection between fiscal policy and broad-based growth which promotes the citizens' prosperity.

The early recorded history of economic thought on wealth creation by nations can be traced back to the Mercantilist school. This was a loose body of merchants and statesmen (without a leader or disciples) of the Fifteenth and Sixteenth Centuries, who wrote in defence of an acquisition of the specie; that is, money in coins, such as gold and silver coins, through trading and commerce, in order to make nation states rich and powerful.

They were followed by the Physiocrats in the Seventeenth Century who thought that all wealth was derived from land and its products, and therefore, direct land taxes were the proper source of state revenues. Hence, agriculture should be emphasised.

Adam Smith who is considered to be the father of economics, wrote the *Wealth of Nations* in 1776, which was about income generation at the dawn of the industrial revolution. He propounded the theory of division of labour and free enterprise as a powerful means of wealth creation. The economists that followed him from the Eighteenth Century to the first two decades of the Twentieth Century propounded the merits of *laissez faire* economics, that is, free enterprise for income creation. They belong to the classical school. Some of the economists who wrote during this period, especially in the Nineteenth Century, theorised that labour, or capital, was the primary factor of value creation. There were writers like such as Carl Max and Friedrich Engels, the utopians and socialists, who disagreed with the classicists, who lost their pre-eminence following the Great Depression of the early 1930s. Up to this time, economic management had been centred on public finance, which was about raising tax revenues for the state.

After the Great Depression, Keynes wrote the *General Theory*, which was concerned mainly with macroeconomic management to maintain equilibrium of the aggregate demand and supply of the national income in the developed industrialised Western economies. Since the second half of the Twentieth Century, development economists have embraced many aspects

of all these earlier thoughts, which may be grouped into three epochs of the growth and development thought.

The resurgence of interest in wealth creation dates back to the period following the Second World War in 1945. Country after country gained independence from colonial rule and joined the independent countries that formed the United Nations, as equal partners. Collectively, these countries were variously called ‘backward’, ‘underdeveloped’, ‘less-developed’, ‘developing’ and ‘Third World’ countries. It was possible to progressively shed derogatory names, especially as these countries became a dominant voting bloc in the United Nations General Assembly. However, one fact remains indisputable — most of them remain poor nations in an economic sense. It seems a misnomer to say that some of these countries are developing — a term that has gained currency because perhaps, it is least offensive.

Economic growth theories predated development economics, which first emerged as a separate subject of economics following the Second World War and de-colonisation (Haynes 2008). Writers in the 1950s and 1960s who were seeking an explanation of underdevelopment generally took the position that growth and development could take off, if certain preconditions were met or growth impediments were removed. Examples include:

- the Harrod-Domar (1948) growth model, which was named after its originators, postulated that if the capital-output ratio could be raised, satisfactory growth would be achieved;
- Rostow, in his *Stages of Economic Growth*, gave a historical account of how societies moved from a pre-industrial economy to a mature economy.
- Myrdal (1968) wrote prolifically about the ‘poverty of nations’, which seem to have some resemblance to Adam Smith’s *Wealth of Nations*. But unlike Smith’s work, Myrdal offers little guidance to a direction of policy to promote growth. Both works used empirical observations to explain income creation. Smith went one step further to expound the theories of division of labour and competition as growth drivers, which offer a guide to a policy direction for economic growth. If governments of developing countries took a cue from Smith’s work, their economies would perform better.
- Nurkse (1953), a founding father of classical development economics, propounded the theory of a ‘big push’ development approach, implying that virtually all the development constraints should be tackled simultaneously through emphasising a high savings ratio which would lead to high capital formation.
- The Lewis Model (1954) propounded a ‘surplus labour or zero-productivity’ of labour theory, implying that if the reservoir army of the active labour was employed, the economy would advance.

From the early 1960s to 1970s, the economic growth literature shifted to industrialisation and an import substitution strategy which was aimed at adding value to raw materials and foreign exchange savings of a developing economy. It was rationalised that domestic resources, including surplus labour, would be employed and scarce foreign exchange would be saved. This is one of those bankrupt or blind economic thinking models, which ignores key growth drivers, such as sound economic policies, efficient inputs, competition, and the availability and affordability of development finance. This strategy’s most serious shortcoming is its heavy dependence on scarce resources such as technology, human capital, and foreign exchange to promote growth and development, which consequently led to public indebtedness of most developing countries.

Beginning in the early 1980s, the history of development thinking has somewhat shifted back to the inquiry into how to promote growth. Supply-side economics thinking emerged, with the advent of economic globalisation. The merits of export-led growth and foreign direct investment have been expounded. The success of these growth strategies to generate adequate public finance for development may not necessarily lead to broad-based income creation. Appropriate development policies need to be formulated and implemented specifically.

The current push for pro-poor programs and gender development comes close to broad-based economic growth and sustainable development, which is the concern of this study (Haynes 2008). The concern for growth and development has not focused on broad-based income in creation, as revealed by the economic thought up to the end of the Twentieth Century.

This brief survey of the mainstream history of thought on income creation reveals that income creation was motivated by raising public finance in order to make the state rich and powerful. The current thinking is to reduce poverty in developing economies or generate employment in developed countries. However, how this should be done has not been addressed by the traditional mainstream economic literature (Powell 2007). In between these two motivations, the historical thinking and practice have been concerned with foreign exchange reserves accumulation, international trading to open the economy, industrialisation to advance value adding, import substitution to avoid balance of payments problem, and economic growth. The most recent emerging concern is about environmentally sustainable growth, which seems to shift the focus of the development paradigm from poverty reduction. However, it is conceivable to integrate poverty reduction considerations into environmental policies and regulations. Broad-based growth and sustainable development have not been sufficiently articulated and addressed through budgetary policies.

SECTION 3: ECONOMIC POLICY FRAMEWORK

3.1 Development Policies

The best that any government can do to promote broad-based growth and development is to promote equal opportunities for its citizens to engage in income generation and gainful employment. Creating macroeconomic policy stability is well recognised and usually practised. Providing opportunities such as access through social and economic infrastructure and/or programs in expenditure areas such as education, health, transport and information communication and technology (ICT) is also recognised. Social issues also impact growth and development. Conceptually, there is a myriad of development policy areas (see Appendix 2) that directly or indirectly impact the political economy that contribute to growth and development. The scarcity of the fiscal resources suggests prioritisation of, and focusing on, the expenditure areas, as necessary. If BWRs are realised, they should be utilised effectively on development policies that matter most for broad-based growth promotion.

This study has conceptualised a development policy framework that captures the overarching role that fiscal policy plays in the political economy. It puts every expenditure area on the table for consideration for a policy for BWRs. The study presents a model of economic growth and development policies. The model encapsulates what is referred to here as development policies, within which BWRs measures should be set (see Diagram 3).

3.2 BWRs and Fiscal and Macroeconomic Policy

Macroeconomic policy stability is essential for good economic performance. Its main objectives are stable growth, price stability, and full employment. It has two components that comprise fiscal policy and monetary policy. This study seeks to find an optimal utilisation of BWRs. As an instrument of the fiscal policy, the BWR measures must not destabilise the macroeconomic policy.

Macroeconomic policy stability is achievable through the pursuit of a disciplined fiscal policy and prudent monetary policy:

- Disciplined fiscal policy broadly refers to the pursuit of a low ratio of:
 - the budget balance to the Gross Domestic Product (GDP);
 - the public debt to the GDP;
 - public debt amortisation plus interest servicing to the budget; and
 - tax required to the payee's (government's) incomes or expenditures.
- Prudent monetary policy refers broadly to the Central Bank's:
 - management of the money supply in such a way that it does not cause an excess liquidity or tight liquidity in the banking system, which in turn triggers inflation or deflation, respectively. The financial institutions and the public have just about the right amount of money for smooth financial operations;
 - pursuit of interest rate policy, which achieves a price stability and investor confidence; and
 - pursuit of an exchange rate policy which achieves a fair and stable exchange rate that does not overshoot, produces innocuous balance-of-payment outcomes and maintains an internal equilibrium, whereby the aggregate supply and demand match up.

Macroeconomic policy instability can be triggered by a derailment of any of the fiscal and monetary instruments mentioned here. It adversely impacts economic performance through investment, production, consumption, prices, and interest rates. Macroeconomic policy stability creates an enabling environment for economic growth. It does not, *per se*, determine whether economic growth is narrowly or broadly-based. It requires other policies to bring about the type of economic growth that is desired. To optimise the use of the BWRs, which are, *de facto*, the budget surplus of the fiscal year, the measures must drive a broad-based income creation in the short term.

3.3 Fiscal Policy Framework

Fiscal policy has an exceptional role to play in order to influence other economic growth and development policies. The interactions of the fiscal policy with the other development policies are illustrated by policy blocks (Diagram 3 in the Appendix), which reveals several direct and indirect fiscal policy linkages to the other development policy blocks. These linkages are indicative of how the fiscal policy affects the other development policies. The vertical arrows show *direct impacts*, while the horizontal arrows show *indirect effects*, which can be conceptualised into the following well-known fiscal policy implications:

- first, the fiscal policy, A_1 is directly linked to macroeconomic policy, A , and indirectly linked to monetary policy, A_2 . This implies that a sound fiscal policy is necessary for macroeconomic stability and financial sector stability. For example, unsound fiscal policy will destabilise macroeconomic policy and necessitate a response from monetary authorities, when it adversely impacts on interest rates, prices, borrowings, lending, investment, or the exchange rate.
- second, the fiscal policy, A_1 is directly linked to budgetary policies, B_1 , which in turn are linked to cross-cutting development issues, B_3 , and interact with the financial section policies, B_2 , implying that:
 - the budgetary policies are a component of public sector policy, fostering the cross-cutting policies; and
 - the budgetary policies and financial sector influence each other.

The bridging policies, B_1 , B_3 , and B_2 , between macroeconomic policies, A , and microeconomic policies, C , influence investment decision, D_1 , which impacts macroeconomic performance, D_2 , which, in turn, determines the nation's wellbeing, D_3 . Some key bridging policies in policy blocks, B_1 , B_3 , and B_2 , are both means to an end and an end in themselves. For example, education, health, and law and order policies are worthy pursuits because they promote literacy, a healthy population, and peace and justice respectively. If these policies are merely designed and implemented as an end in themselves, the economy may be trapped in unsatisfactory growth and development. It is important to realise that these policies and some other bridging policies, such as transport and migration policies are needed to promote new investments, business viability, and investment expansion, in order to create incomes and generate employment.

Prioritisation of many weak bridging development policies therefore poses a challenge for normal budget formulation and implementation in a developing economy. However, when it comes to utilising BWRs, the policy must be aimed at those pressing economic problems which have not been sufficiently addressed in the normal annual budgets. Identification of the

most relevant fiscal impediments to broad-based growth or sustainable poverty reduction is a necessity.

BWR policy in Papua New Guinea should be aimed at the weakest bridging policy areas in order to achieve broad-based growth, taking into account the following roles that budgetary policies must play:

- first, sound fiscal policy operations are essential for macroeconomic policy stability;
- second, fiscal policy stability is necessary for monetary policy stability. A high ratio of budget deficit to the GDP tends to bring about inflationary pressures and financial instability which adversely impact economic performance and welfare;
- third, budgetary policies are necessary to strengthen or promote developments in sectors such as health, education, and law and order, in particular, and bridging development policies, such as land, population, gender, and environment development, in general; and
- fourth, from a low-level development, budgetary interventions are necessary to broaden monetary policies, such as microfinance policy, or to establish institutions that promote microeconomic policies. Such financial sector interventions diminish as the country becomes more developed.

3.4 Towards Creating Broad-Based Growth

The economy is dominated by primary production (see Figure 1). Industrial production in the form of manufacturing is relatively small. The tertiary sector is relatively large because it includes commerce, trade, and financing, which significantly relate to the external trade sector and informal domestic service activities.

Exports are the main source of real income generation, which is dominated by the mining and petroleum sectors. The exports comprise cash crops, fish, logs, minerals, and crude oil (see Figure 2). The main export commodities are gold, copper, crude oil, coffee, cocoa, logs, and palm oil. The performance of the mining and petroleum generally determine the growth trend of the economy.

Important inferences that can be drawn from the composition of the GDP and the income earning dynamics of exports are that the economy is:

- dominated by many small-scale producers in the agricultural and services sectors; and
- heavily dependent on the mineral and petroleum sectors for income generation.

With the pending development of huge gas reserves during the next two decades, perhaps beginning in 2014, the mining, petroleum, and the gas sectors are set to contribute more than 90 percent of the foreign exchange earnings. The dominance of these extractive industries will adversely impact income generation in other sectors, unless public investment strategy is geared to creating opportunities for income creation in the other sectors.

There is great potential for enriching the population in PNG. There are abundant natural resources for promoting commercialisation of agricultural staples, tourism, fisheries, and agro-industries. However, there are several impediments to the development of these sectors. The evidence is unconvincing that appropriate development policies have been emphasised in order to open the economy (see Appendix 2, Diagram 3).

Fiscal policy has a vital role to play in improving all other public policies. However, it is constrained mainly by the availability of development finance. When BWRs are realised, they should be used to promote priority expenditure areas, which, in turn, promote broad-based income creation.

In choosing optimal BWR measures, the consideration of these constraints ranks the highest.

Figure 1: The Production Structure: Composition of the GDP (%)

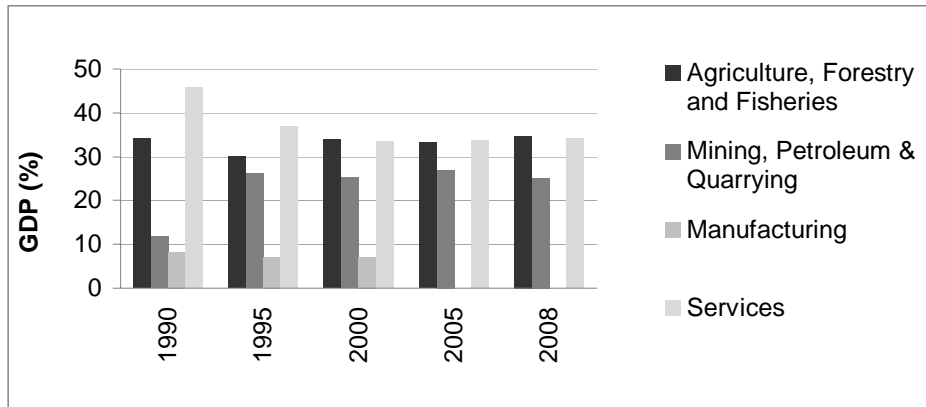
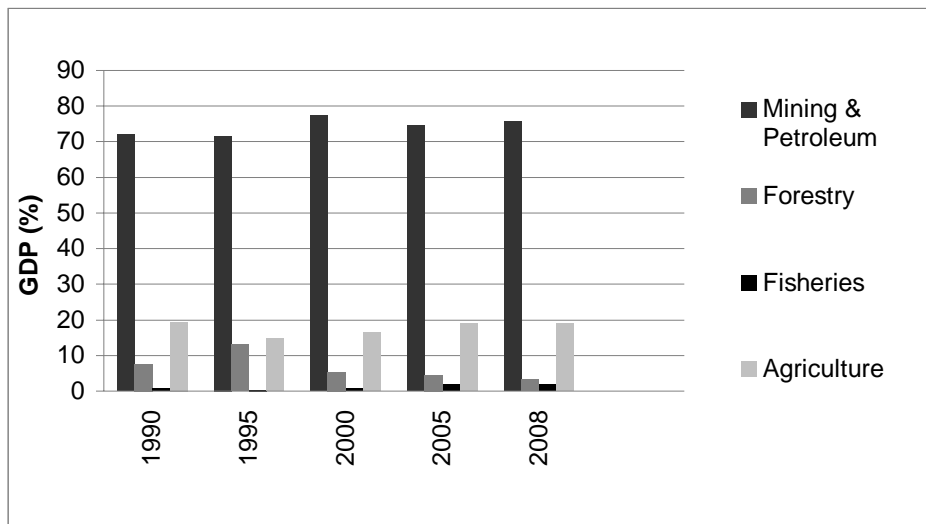


Figure 2: The Export Structure: Sectoral Contributions (%) to the Export Revenues



SECTION 4: BUDGETARY POLICIES

4.1 The Basis of Fiscal Policy to Promote Broad-Based Growth

Macroeconomic policy is the foundation of economic performance. Fiscal policy is one of the components of macroeconomic policy. Budgetary policies refer to fiscal policy. In addition to maintaining macroeconomic policy stability, which is fundamentally necessary to economic growth, there are three main reasons why fiscal policy should create opportunities for broad-based income generation.

The Constitutional Basis for Broad-Based Income Creation

Fiscal policy should give effect to the National Goals and Directive Principles, which were incorporated in the *Constitution* of the Independent State of Papua New Guinea in 1975 (See Box 1). In particular, the interpretation of the first four National Goals and Directive Principles requires the creation of equal opportunity for every man and woman to work and earn an income.

The MTDS and Broad-Based Income Creation

The government's Medium Term Development Strategy (MTDS) 2005-2010, has targeted broad-based economic growth promotion (see Box 2). To this end, the MTDS has identified eight economic activity areas:

- primary sector economic activities, such as agriculture, fisheries and forestry;
- tourism;
- mining, petroleum, and gas;
- manufacturing and downstream processing;
- the urban informal sector;
- foreign investment;
- manpower planning, and
- land utilisation.

The MTDS's identification of these economic activities seems to underrate the tertiary sector as the main sector with the potential to generate employment. However, the Medium Term Resource Framework (MTRF) 2005-2007 has not specifically prioritised these development areas, even though it has included income-earning opportunities as one of the seven areas for government priority expenditures. Overall, the MTDS model, which is reinforced by the MTRF indicative appropriations, has not sufficiently focused on broad-based income creation.

Other Considerations for Broad-Based Income Creation

The need for budgetary policies to focus on broad-based growth seems obvious and necessary. About 85 percent of the population live in rural and urban settlements. Most of them are underemployed. The rural subsistence or semi-subsistence producers will generate increased output, if their need to access niche markets for their products is facilitated. Poverty, in the sense of inadequate incomes to meet basic needs and wants, is widespread. Poverty may be a partial, yet significant, contributing factor to serious social ills such as rampant crimes, corruption, HIV/AIDS, illiteracy, and communicable and preventable

diseases. Focusing fiscal policy on these manifestations, without a substantial poverty reduction, is a losing battle.

The government's stance on budget balances, receipts, and expenditures merely mimics the orthodox approach to economic growth and development. This is reflected at the beginning of this section, with the overview of the impact of fiscal policy on macroeconomic stability.

Box 1: National Goals and Directive Principles

The National Goals and Directive Principles were incorporated into the *Constitution* of the Independent State of Papua New Guinea in 1975.

- *Integral Human Development*
We declare our first goal to be for every person to be dynamically involved in the process of freeing himself or herself from every form of domination or oppression, so that each man or woman will have the opportunity to develop as a whole person in relationship with others.
- *Equality and Participation*
We declare our second goal to be for all citizens to have an equal opportunity to participate in, and benefit from, the development of our country.
- *National Sovereignty and Self-Reliance*
We declare our third goal to be for Papua New Guinea to be politically and economically independent and our economy basically self-reliant.
- *Natural Resources and Environment*
We declare our fourth goal to be for Papua New Guinea's natural resources and environment to be conserved and used for the collective benefit of us all, and to be replenished for the benefit of future generations.
- *Papua New Guinean Ways*
We declare our fifth goal to be to achieve development, primarily through the use of Papua New Guinean forms of social, political, and economic organisation.

Box 2: MTDS's, 2005-2010 Designated Areas for Promoting Broad-Based Growth

The Primary Sector – Agriculture, Forestry, and Fisheries

- ensure that local producers adopt international best practice in quarantine, marketing, and quality control standards;
- ensure that logging is managed in an ecological sustainable manner;
- reinvigorate the government's efforts to explore options for the inclusion of natural rainforests under the Kyoto Protocol's carbon trading mechanism; and
- increase the level of local participation in the fisheries industry.

Tourism

- examine options for tax concessions for tourism industry participants.

Mining, Petroleum, and Gas

- transform the non-renewable income streams into sustainable income streams;
- enhance policy stability and accord law and justice to further improve international sentiments towards Papua New Guinea as an investment destination; and
- promote small-scale mining in an environmentally friendly manner.

Manufacturing and Downstream Processing

- increase the value of exports produced by Papua New Guinea's value-adding manufacturers;
- ensure local industries take maximum advantage of new opportunities as they emerge in the global market;

- consider tax incentives for businesses that enter into downstream processing and manufacturing for the export market;
- strengthen Papua New Guinea's investment and trade promotion capability; and
- assist local investors to secure investment finance from the banking system and other services.

Foreign Investment

- pursue credible policies that preserve macroeconomic stability and address constraints to investment, such as law and order.

Manpower Planning

- develop a manpower strategy to address skill shortages, and to lift workforce productivity.

The Urban Informal Sector

- address obstacles to the development and coordination of the informal sector.

Box 2 (continued)**4.2 Overview of Developments in Fiscal Policy*****Fiscal Policy Deficiencies***

Since independence in 1975, macroeconomic stability has been derailed three times as a result of fiscal policy deficiency. The fiscal policy seems flawed. Not only has it failed to consistently maintain macroeconomic policy stability, it has also not met recurrent expenditures and has hindered the development budget from being fully implemented. The development policies have rarely, if ever, focused on creating an enabling environment for broad-based income creation and employment generation. Consequently, this potentially rich country continues to be underdeveloped.

Less than a decade after independence, there was a budget deficit blowout as a result of fiscal mismanagement. In the early 1990s, there was a slump in fiscal revenues following the closure of the Bougainville Copper Mine and the collapse of cash crop prices. The impacts of these events should have been anticipated by policy makers, in order to use fiscal policy to avert or mitigate the Bougainville crisis and to lessen the export slump. Between 1991 and 1994, there was a huge build-up of public debt, which more than doubled during that period, inducing a foreign exchange crisis. This triggered a chain reaction of economic crises, both fiscal and financial, and macroeconomic instability that lasted until 2002.

Export Performance and Macroeconomic Policy and Performance

In Papua New Guinea, export booms have created opportunities for restoring macroeconomic policy stability. The export boom revenues boosted the government's receipts. Three factors that have impacted favourably on the government's mineral revenues are:

- opening of a major mine (when production increases until it peaks);
- export commodities prices booms; and
- other occasional boosts from mineral exploration.

The macroeconomic policy instabilities which were prompted by fiscal policy mismanagement were substantially restored by increased public revenues as a result of a boost in mineral production or rising commodity prices. Although the macroeconomic policies were not equally significant in the restoration of the macroeconomic stability, they

were necessary and important *post hoc* factors which led to the restoration of fiscal stability. Some factors which led to the restoration of fiscal stability include:

- The reversal of the 1981–1983 fiscal derailment was aided by the mineral production boom of the Ok Tedi Copper and Goldmine from 1984 to 1986, and possibly the ‘de facto’ kina devaluation in March 1983, when the kina was allowed to depreciate with the Australian dollar’s 10 percent devaluation and the large-scale retrenchment of 3 300 public employees in 1983 (Bouraga 1983:41).
- The short-lived fiscal crisis of 1991 was restored because of the commencement in production of the Porgera Goldmine in 1991 and a quick and decisive policy response, which comprised a 10 percent devaluation in January 1990 and orthodox austerity put in place to reduce the aggregate demand.
- Between 1991 and 1994, there was a loss of fiscal control, which was accommodated by the easy monetary policy, low interest rates, and high exchange rate that peaked in 1993. The public debt increased from 43 percent of GDP to 54 percent, and the domestic borrowing nearly tripled (Duncan *et al.* 1998, Mawuli 1996). The fiscal mismanagement during this period triggered a financial crisis, leading to the 12 percent devaluation, and subsequently, the flotation of the kina and macroeconomic policy and performance instability from 1994 to 2002. The commencement in production of a Kutubu oilfield in 1997 had a limited impact in abating the crisis. The 1994–1995 structural adjustment reforms, with the kina flotation in October 1994 and tight monetary policy from 1994 to 2002, might have abated the severity of the crisis. However, it was the commodity prices boom of 2003–2008 which restored the macroeconomic policy and performance stability.

This achievement can be significantly attributed to rising commodity prices, which contributed to huge government revenues. The Government must be given credit for not indulging in spending binges, as in the past. However, there is no significant evidence that the fiscal operations have been aimed at creating opportunities for broad-based income creation.

4.3 Government Revenues and Other Receipts

The Main Budget Receipts

The government’s total receipts comprise tax revenues, non-tax revenues, and foreign grants. In addition, the government’s borrowings are used to finance budget shortfalls, when the expenditures exceed the actual receipts, or to finance public infrastructure. It is important to understand the derivation constraints of the government receipts from these sources in order to appreciate the opportunities that budget windfall revenues bestow on the Department of Treasury to tackle deficiencies in budgetary financing policies.

Six main sources of the total receipts have been identified for the following discussion, including mineral receipts; personal income tax; goods and services tax (GST); non-tax revenues; foreign grants; and government borrowings because of their significance in terms of their sizable contribution to the total receipts or the budgetary financing.

Increasing Dependence on the Mining Sector

The first fiscal revenue constraint is posed by the government receipts from the mining sector. The mining sector’s contribution to the total receipts is now more than 50 percent and

is increasing. In 2006, the mining sector contributed 56 percent, as compared to 34 percent in 2004. Rising commodity prices largely account for the increase. However, the sector is poised for a greater increase in its output from the exploitation of the known reserves and potential reserves. When that happens, the economy and government receipts will be heavily dependent on the mining sector. The economy will be more exposed to macroeconomic policy and performance instability than before.

Furthermore, the non-renewable resources will eventually be exhausted, undermining the fiscal capacity. Therefore, it is important that, while budget windfall revenues are realised from the mining sector, the Government would do well to create opportunities for broad-based income creation, which are likely to broaden the tax base and eventually lift the pressure on the mining sector for revenue generation.

Personal Income Tax

The second fiscal revenue constraint is concerned with personal income taxes. This tax is already high and narrowly based because less than 20 percent of the population are the payees. Currently, it contributes about 20 percent of the total revenues and is the second largest revenue source. The personal income tax contribution was decreased from 40 percent in 2000 to 20 percent in 2006, because of the increasing dominance of the government's mining revenues.

The marginal tax rates for payees, who earn between K60 000 and K200 000 per annum, are too high to attract the highly qualified domestic and expatriate staff that are required in the relevant positions. High-level manpower is scarce. High personal income taxes discourage the work efforts of the payees. Eventually, this causes public employees to move to the private sector, international organisations, and overseas, where remunerative packages are more attractive. However, the more serious threat to public finance is that since this tax is already high, it cannot be increased without broadening the tax base. Faced with this constraint, the Government introduced the Goods and Services Tax (GST).

The Goods and Services Tax

The third fiscal revenue constraint is concerned with the GST, which was introduced in 1999, and has been implemented ever since. There are several reasons why the GST is seen as an inappropriate indirect tax at this stage of the nation's growth and development. However, the fiscal authorities have continuously pointed to its ability to broaden the tax base.

What is the point when its net benefit is negative? The most compelling reason against the GST is that it undermines the grassroots economy and also broad-based income creation in primary producing economy.

The grassroots economy refers to the production, distribution, marketing, and consumption of goods and services which are undertaken by the poor people, small businesses, micro-enterprises, and self-employed people, whose enterprises are generally informal activities that are not registered to get reimbursement for the GST paid by them to run their businesses.

The informal economic activities dominate the economy and will continue to do so. However, they are undermined by the GST, which favours big and formal businesses and companies.

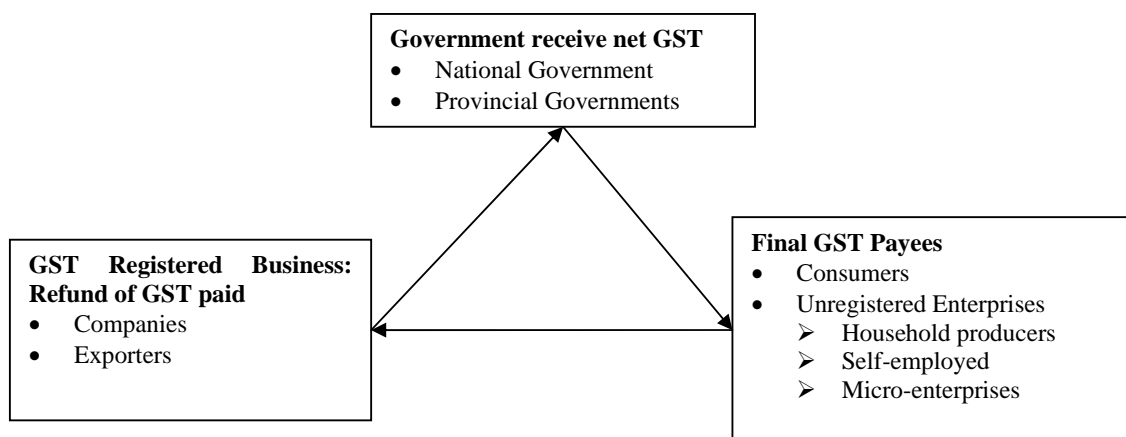
The GST is like a triangular tax transaction, with the Government at the apex and businesses and the final consumers at the base ends (see Diagram 1). The registered businesses collect the tax, deduct their input credit and pass onto the government the value added tax, which is paid by the consumers or end users. The adverse impacts of the GST on a predominantly primary producing economy are not widely expounded. They include:

- The GST, which is being implemented as a value added tax (VAT) is an inappropriate instrument for generating adequate tax revenue for the national government and many provincial governments. The following rationalisation and the GST results lend support to this proposition:
 - First, the GST is a preferred taxation instrument for developed economies. It is inappropriate for a predominantly primary producing economy, where a scant value is added to goods which are produced domestically or imported. This is explained by the predominance of semi-subsistence producers and a large number of businesses and enterprises which do not register for the tax, and whose economic activities do not contribute to the GST collection.
 - Second, the greater the number of trading stages that a product goes through to reach the end user, the more GST revenue is generated because of the value adding at each of those stages. Many less-developed economies cannot expect large GST collections because of the predominance of the informal activities, and small businesses and enterprises.
 - The GST is mainly collected in the more developed provinces. Some 50 percent of the total GST is collected in the National Capital District (NCD) alone. Two other provinces out of the 19 provinces are big collectors. There is overwhelming evidence that the least developed provinces are the most disadvantaged. For example, Gulf Province and Central Province collect less GST because many of their people purchase goods and services in the NCD.
 - The GST revenue distribution; that is, the revenue sharing between the national government and the provinces, undermines economic development in the least developed provinces, where not enough GST is generated for development in these provinces.
- The GST has a limited ability to promote broad-based economic growth in PNG because:
 - domestic manufactured goods are not significantly exported;
 - domestic products face stiff competition from 'gross substitutes', which are imported; and
 - the production of staples is undermined by the GST in two important respects. First, the cost of inputs includes the GST, which is not refunded as the input credit to the staple producers who are not GST registered. Second, the GST is imposed on the staples if they are formally marketed; that is, they are sold in GST registered outlets such as supermarkets.
- The impact of GST on consumers is more regressive than the one-off application of a tariff in the pre-VAT period. This regressiveness is explained by the application of a value added tax on an imported item, which passes through the chain of import-distribution-consumption. Consequently, a person who buys a good at the tail end of its marketing chain pays a higher GST than a person who buys it at a wholesale outlet or in a supermarket. People who shop in registered and unregistered tradestores or other retail outlets in the rural areas or in the urban settlements, pay a higher GST than those who

purchase goods in the urban centres. This implies that the poor and the rural people generally pay more GST on a good than the rich and the urban dwellers.

- The GST undermines the production of small businesses and self-employment enterprises which are generally not registered to claim input credit. However, these businesses pay the GST as final consumers on inputs into their business. Therefore, the GST constrains broad-based income creation.

Diagram 1: GST Triangular Transactions



Non-Tax Revenues

The fourth source of public revenue generation is non-tax revenues, which includes dividends, interest, fees or charges, and the sale of state assets. Currently, dividend payments to statutory bodies comprise some 60 percent of non-tax revenues. The dividend payments to the State are insignificant compared to the large amounts invested by the Government on various institutions and other sources. In most cases, the country would be better off if the statutory bodies and entities, such as the PNG Harbours Board, Air Niugini and Telikom PNG, were run or owned by the private sector and the public money spent on them was used to broaden the productive capacity of the economy.

Donor Grants

The fifth distinct source of government receipts is external donor grants. Currently, the grants constitute 22 percent of the total revenues. Prior to the realisation of the windfall revenues, the percentage contribution of donor grants to supplement the domestic government revenues was higher in the 1990s and in early 2000. In 2001 and 2004, it was 37 percent and 34 percent, respectively.

The dominant foreign grant is the Australian Government's grant aid program, known as AusAID, which has increased from AUS\$5 million before independence in 1975 to more than AUS\$300 million today. Up to the mid-1990s, the grants supported the annual budgets. The rationale that the grant aid would assist economic growth and development has been somewhat wishful and elusive. Economic growth has remained unimpressive, except during short-lived export booms. The grants were later switched to project aid, beginning in the mid-1990s. Whether as budgetary support or project aid, the grants have the ability to enlarge the fiscal capacity because they help create public infrastructure and programs and resultant

recurrent expenditure. The donor grants have not been geared towards a fast-growing economy that would strengthen the fiscal capacity and thus reduce donor dependence.

As windfall revenues emerged, the relative share of grant aid has diminished. However, it has been geared towards programs in the development budget, which are largely prioritised by the Medium Term Development Strategy. The BWRs are therefore reinforcing donor grants that have aided the normal budgetary policies, especially social projects and programs or recurrent expenditures which do not promote growth in the short- to medium-term that will lead to a significant enlargement of the taxation capacity. The substantial donor contributions have led to the development of a 'donor dependency syndrome' (Mawuli 2007).

Government Borrowing

The sixth significant source from the government's receipts derivation is external and domestic borrowings. The budgets have frequently resorted to deficit financing. Occasionally, a surplus is realised. The government's external and domestic borrowings to finance the budget have resulted in a huge public debt in the 1990s. When the economic growth was the fastest between 1991 and 1994, the public debt nearly tripled. The high public debt in the 1990s led to heavy debt amortisation and interest servicing, which consumed a big proportion of the budget. It resulted in lean budgets from 1997 to 2003, when the appropriations to many line departments and agencies were capped. The economic consequences of reckless government borrowings to spend or to pay previous debts, had a devastating impact on financial stability and economic performance from 1995 to 2003. The interest rates and inflation were at their highest levels, the exchange rate quickly depreciated, and economic growth was most sluggish.

Government Revenues and Broad-Based Income Growth

The public revenue generation capacity is severely limited because income levels are low and the tax base is narrow and heavily dependent on mineral receipts. Furthermore, the personal income taxes, and the GST, in particular, tend to impoverish the relatively poor income earners and frustrate broad-based income creation.

The government's revenues have been substantially supplemented with government borrowings domestically and externally and with foreign grants, which have failed as a catalyst for broad-based growth. Grant aid is now being shifted to assist income creation and development projects and programs that benefit the poor. This study cites examples under the sub-heading 'Income Creating Activities for Poverty Reduction' (see Section 6.2). This policy has been repeatedly advocated by Mawuli (1997, 2004 and 2007).

4.4 Budget Expenditure Policies

Government Expenditure Direction

With inadequate public finance, the budget expenditure policy to address broad-based growth has been severely limited. The direct government appropriations to the development budget were inadequate and the development budgets have often not been fully implemented, as the allocations are shifted to make up for the shortfalls in the recurrent expenditures. The fiscal shortcomings to address broad-based growth are discussed in two parts. Part 1 discusses the role of Provincial Governments and the Local-level Governments (PGs & LLGs) and Part 2

discusses the policy direction of the Medium Term Development Strategy (MTDS) with the Medium Term Resources Framework (MTRF). The Medium Term Fiscal Strategy 2002-2007, plays a limited role in guiding the expenditures (see Section 5).

The annual budget comprises the recurrent budget and the development budget. The recurrent budget appropriates the government's expected operating costs, while the development budget appropriates public funds for public investment projects and programs. The development funds are sourced from government revenues, donor grants, and borrowings. The development projects and programs are funded by any combination of these three government receipts. Donor-funded projects and programs that require the government's counterpart funding and the government's sole funding, are partially, or never, implemented. The recurrent expenditures are met first, and the development budget is usually underspent.

The Role of Provincial Governments and Local-level Governments

Revenue sharing by the three tiers of government has implications for, and influences, growth and development. The government's total receipts are shared between the national government and the provincial and the local-level governments. The provincial government level is divided into 19 provinces and the National Capital District (NCD). The 89 districts of PNG are then sub-divided into local-level governments. The shares of the revenue that go to provincial and local-level governments are referred to as grants from the revenues which are collected by the Internal Revenue Commission. All the grants are prescribed by the *Organic Law on Provincial Governments and Local-level Governments* (OLPGLLG), according to set formulas.

The national government has been unable to comply with OLPGLLG directives, partly because there is not enough public finance to meet the obligations. Usually, the national parliament introduces a 'sunshine' law to shelve the national government's obligation to meet all of the grant entitlements. Some of the revenue sharing formulae are short-sighted. For example, there is one that is K20 per head entitlement for each province. It has been found that there were not enough government revenues to pay some heavily populated provinces. The Morobe Province took the government to court for defaulting on the payment of this entitlement. It won the case and was awarded K20 million.

Sharing the GST revenues is referred to as the GST distribution, which is based on the province of derivation. This distribution is very unfair for the least developed provinces. The case of Central Province illustrates this contention. Every day, hundreds of people take public motor vehicles (PMVs) from Central Province to shop in the NCD. Many residents of Central Province commute to work and buy their food and store goods in the NCD. As a result of these purchases and because of the size of the NCD population, and a high per capita income, the NCD collects more than 40 percent of the GST that is generated nationally. Central Province's share of the GST revenue is very small, relative to its population and expenditure on taxable goods and services. Its GST distribution is inadequately supplemented by a grant from the NCD through a bilateral agreement. In this regard, the GST perpetuates the poverty of the least developed provinces which cannot realise enough public finance for their development.

During the commodity prices boom, there have been huge additional transfers of public finance to the LLGs in order to spread wealth. This policy reinforces the policy redistribution or spread of wealth, which has been emphasised (Kurer 2006). The districts do not have the

capacity to effectively utilise the money to build the infrastructure and programs that are needed to integrate their segmented development and markets into the national development, which would promote broad-based growth. Transport connectivity, in particular, is lacking and constrained by lack of integrated policy of infrastructure development.

The MTDS 2005-2010 and the MTRF 2005-2007

The MTDS is the government's overarching five-year development plan, which is basically a vehicle for budget formulation and implementation. It incorporates the MTRF, which is a rolling three-year plan that projects financial appropriations to the MTDS priority expenditure areas.

Annual budgeting is supposed to be initially driven by the MTDS with the MTRF. These planning documents have been formulated, based on the perennial scarcity of public funds to meet the nation's financial needs. However, when the parameters changed as result of the emergence of the BWRs, the budgetary policies did not change to take account of the changed revenues' environment.

The primary goal of the MTDS is to achieve broad-based economic growth, specifying the five economic activities and the three functional areas that are expected to generate rising incomes (see Box 2). The budget allocations for agriculture, tourism, and transport development do not lend credibility to the promotion of broad-based growth.

The MTDS also identifies the following essential expenditure areas, which must be funded with scarce government revenues and other receipts:

- within the health sector - *primary health care* and *HIV/AIDS*;
- education - *basic education* and *development-oriented informal adult education*;
- transport - *rehabilitation and maintenance of transport infrastructure*;
- *law and justice*; and
- *promotion of income-earning opportunities*.

The MTRF was formulated when huge windfall revenues were unexpected. It was rationalised that, with scarce government development funds, these areas should be accorded priority funding. Annual budget expenditures have increased substantially in 2005, 2006 and 2007 (see Table 2). The main underlying assumption of the MTRF forecast was that the mining and petroleum sectors' production would fall. It was assumed that the current mines had reached the peak of their production, outputs would decline, and no new mines were expected to be developed during the period.

Despite a forecast that the total budget would fall in 2007, the MTRF appropriated rising funds to each of the seven priority areas. This meant that the budget allocation to the non-MTDS, as a whole, would decline.

The MTRF formulation seems deficient with regard to promoting broad-based income creation which is the main goal of the MTDS. The following four main rationalisations illustrate the shortcomings of the MTRF.

Over-Emphasising the MTDS Priority Programs

The first shortcoming is that, out of the seven expenditure priority areas, income-earning opportunities have been allocated the least funding in terms of an absolute amount and the percentage growth rate of 0.1 percent per year. Low growth rates have also been projected for the transport and law and justice sector programs. The growth rates for education and health programs, with the exception of adult education, are fastest. Less emphasis is placed on the other MTDS priority expenditure areas. The implication is that broad-based growth and development is not a priority in the short- to medium-term.

The second shortcoming is that the MTDS, along with the MTRF, do not cap the percentage of the Development Budget that should be allocated to the priority expenditure areas. It has been planned that from 20 percent in the late 1990s, this percentage would rise to 43 percent in 2005, and 49.4 percent in 2007 for the priority expenditures. This open-ended trend seems inappropriate. Several non-priority areas in the health, education, and transport sectors, such as the health-care problems of the economically active population, beneficiaries of middle and higher education, and expansion of transport connectivity, respectively, have a very important role to play and influence broad-based growth and development. However, they have not received policy attention for more than a decade. The formulation and implementation of the Development Budget on the priority areas is questionable. For example, it is inappropriate to assign an increasingly disproportionate share of the Development Budget to the MTDS programs.

The third shortcoming of the MTRF formulation is that the absolute appropriations have been expressed. This means that, in case of a budget short-fall or surplus, the proportions should be proportionately scaled up or down, without any consideration of the relative importance of the MTDS priority areas, compared to the non-priority expenditure areas.

The fourth shortcoming of the MTRF is that it does not plan for any contingency, such as a disaster or unexpected parametric change in the economic or social environment. Consequently, with the emergence of the budget windfall revenues, there has been no alternative appropriation strategy option to follow. The flawed MTDS, along with the MTRF, have led to a benign neglect of the key non-priority expenditure areas of transport, law and order, and health, and education since 1997.

Table 2: The MTRF Indicative Appropriations and the Budget Expenditures

Year	MTRF Indicative Appropriations (K' million)	Budget Expenditures (K' million)
2005	4777	5319
2006	4789	6161
2007	4762	6879

Source: Department of Treasury (2005).

Use of Donor Aid

There seems to be a limited capacity to draw down and spend foreign aid. Donors, like AusAID usually supervise the spending of their own grant money. In economics, a delayed implementation of projects and programs has adverse impacts on growth, development, public costs or the beneficiaries, which can be devastating.

Foreign aid projects and programs have often suffered from the government's provision of counterpart funding or a bungled policy implementation. For example:

- after the Chinese Government provided funding of K23 million to build seven dormitories and 20 houses at the University of Vudal, it took the government nine months to release K12 million to purchase white goods and other furnishings, such as students' beds and wardrobes; and
- several of the projects and programs supported by the Asian Development Bank (ADB) have been delayed for various reasons including:
 - delayed government counterpart funding;
 - the government's inability to fulfil the requirements or procedures and prerequisites for actual implementation; and
 - some contractors that are awarded tenders do not have the capacity to deliver.

The ADB Loan No. 1709, for a Road Maintenance and Rehabilitation Project, which was scheduled to be implemented from 2000 to 2006 has been rescheduled to close in 2010. The Multi-Partners' Microfinance and Employment Project, L1768-PNG, estimated at a cost of US\$20 million is composed of funding from:

- ADB (\$9.6m loan);
- Government of PNG (\$4.7m);
- Institute of Banking and Business (\$1.2m);
- AusAID (0.9m);
- Bank of PNG (\$0.05m); and
- Microfinance Institutions (\$3.7m).

The project was signed in October 2000 and the agreement effected in September 2001. The project was initially scheduled to be completed in September 2006. However, as at January 2008, the Government had paid less than one-third (only K4 million out of a total of K14 million) of its contribution to the project.

4.5 Managing Windfall Revenues

With the development of the mining industry which started with the Bougainville Copper Mine in 1974, the Government created the Mineral Resource Stabilisation Fund (MRSF). This Fund was meant to smooth the use of mineral revenue surges so that they would not destabilise fiscal operations. However, the MRSF was mismanaged and was not used to address this objective. In 1986, the provision of the *MRSF Act* was amended to give the Government discretion in making withdrawals from the fund (Batten, 2008). As public debt mounted, the Government decided to use the balance, and as a result, in December 2000, the fund became defunct.

The question of temporary mineral revenues would not have arisen as any fiscal revenue surges would have been paid directly into the fund. The BWRs would have been paid into the MRSF. However, budgeting with or without BWRs in PNG is inappropriate. There is a need for a change of policy that favours the pressing needs of national development when BWRs emerge.

SECTION 5: THE SUPPLEMENTARY BUDGETS AND THE BWRs

5.1 The Budget Windfall Revenues

As mentioned earlier, Papua New Guinea experienced huge BWRs from 2003 to 2007, as a result of rising commodity prices. The main export commodities include gold, copper, silver, crude oil, cash crops, and logs. High world prices of the exports during this period have fuelled the government's receipts, particularly from the mining and petroleum sectors. Mineral taxes, dividends, and royalties doubled during these four years.

World commodity prices are usually volatile and unpredictable. The current trend of rising prices of the minerals and crude oil is predicted to continue because it is not expected that India's and China's growth will slacken soon, and they are the main consumers driving demand for mineral and petroleum commodities. However, before the end of 2008, the commodity prices collapsed.

Between 2005 and 2007, four Supplementary Budgets appropriated K4.7 billion of the BWRs through the supplementary budgeting process (see Table 3). There seems to be a rush to appropriate and spend the windfall revenues.

The Annual Budgets have also grown bigger. The 2007 Budget nearly doubled that for 2003. The budget surpluses from 2004 to 2007 were larger than the estimated budget balances. Before 2004, a budget surplus was a dream.

Table 3: Budget Windfall Revenue Appropriations

Date	Supplementary Budget (K'million)
2005 November	400
2006 August	688
2006 November	1100
2007 October	1687
2008 September	850
Total	4725

Source: GoPNG, 2008 Budget, Volume 1.

5.2 The Supplementary Budgets and the MTDS

The MTDS, with indicative appropriations that are set up in the MTRF, is the government's overarching development plan to guide budgeting. The appropriations of the first four Supplementary Budgets and that of the MTRF approximately correspond. However, as of 31 December 2007, the actual expenditures of the BWRs have been grossly underspent on the MTDS priority programs (see Table 4). A Supplementary Budget which appropriates the BWRs should not be formulated as a mini-annual budget. If it does, the cost to the annual budget in terms of the resultant recurrent expenditures, cannot be met when the BWRs are no longer realised. The Medium Term Fiscal Strategy (MTFS) formulation in 2008 explicitly recognised this after the 2005-2007 appropriations.

The Supplementary Budget Allocations to the MTDS Priority Areas

Fifty-one percent of the BWRs have been allocated to the MTDS priority areas. This allocation is slightly higher than the indicative appropriation in the MTRF. However, the appropriations to the individual MTDS priority expenditure areas present a mixed picture. Those for health, transport and income-earning opportunities were higher than those for law and justice and education. No reasons have been given for altering this pattern of the appropriations. How can a lower appropriation of the BWRs to the law and justice be justified when serious crimes and corruption rage on?

Table 4: Windfall Revenue Appropriations and the MTRF Indicative Appropriations

Expenditure Areas	MTRF 2007	BWRs	BWRs
	(%)	2007 Appropriations (%)	Spent (%)
Health	8	10	2
Education	14	12	2
Transport	10	17	15
Law and Justice	15	9	3
Income-Earning Opportunities	2	4	>1
MTDS Priority Areas	49	51	24
Non-MTDS Priority Areas	51	49	76
Total Development Budget	100	100	100

Source: PNG Department of Treasury. Medium Term Development Strategy 2005-2010, and 2007 and 2008 Budgets.

The Supplementary Budget Allocations to the Non-MTDS Priority Areas

The appropriations of the BWRs to the non-MTDS priority areas are slightly lower than those proposed in the MTDS. Included in the expenditure allocations for the non-MTDS infrastructure development and programs are two major appropriations – *debt repayment* and *gas equity investment*. Seventeen percent of the total BWR appropriations has been allocated to pay the public debt and to retire other outstanding debts, in particular, super liability, which is defined as a state liability, that is, debts owed to former public employees. Using BWRs to reduce public debt is popular. Further discussions will address this policy measure later.

The other appropriation is for investment in equity of gas development, with production expected to begin in 2012. State investment in speculative ventures is debatable. However, many people, including some top political leaders and bureaucrats, favour state participation in domestic resources development. It is politically expedient, otherwise the general population feel left out in the development of their resources. The alternative utilisation of BWRs to promote broad-based income creation and employment generation in the Papua New Guinean economy is hardly considered. The opportunity cost of holding on to BWR appropriations for several years is undesirable because of the urgency to open up the economy, which, if done, will, within the short-term, bring about several benefits, such as an increase in the GDP, improvement in the incomes of rural producers, and facilitation of service delivery.

5.3 The Appropriations and the Expenditures

Trust Funds

The BWR appropriations and actual expenditures seem to be poles apart. In between the two poles, there are the disbursement, non-disbursement, actual expenditures, and the amount that is appropriated but not yet spent.

In Papua New Guinea, the BWR disbursements are paid into Trust Accounts. To date, there is no proven case of mismanagement of the BWRs in the Trust Accounts. However, it is too early to jump to any conclusion. The Trust Accounts have not yet been audited by the Auditor-General. This paper was sent for a review in December 2008, and since then, revelations made by the Auditor-General's Office to Parliament in March 2009 have alleged mismanagement of some Trust Accounts.

It seems that too much trust has been placed in the Trust Accounts into which the BWRs are parked. There are approximately 300 Trust Accounts. The Department of Finance manages less than 25 and the heads of line departments, agencies, other statutory boards and provincial administrations manage their own Trust Accounts (Minister for Finance and Treasury, December 2007: 39). Trust Accounts are governed by stringent regulations and procedures which makes the timely release of funds difficult. Why not hold it in a consolidated account and set up a high-powered Commission headed by a Chief Executive for easy administration. This approach could expedite the release and facilitate accountability by one or two persons instead of many heads.

As already mentioned, there seems to be no urgency to utilise the BWRs when very large proportions of the appropriations have been left in the Trust Accounts. However, the BWRs have been quickly appropriated through Supplementary Budgets. The fiscal operations of the BWRs raise the following concerns:

- nearly all of the K3.8 billion appropriated was released by 31 December 2007. This is not a very good budget disbursement performance. Normally, there is a problem of disbursement of budget appropriations. There seems to be too many managers of the Trust Accounts;
- only four percent of the appropriations to the MTDS priority programs were spent, whereas 76 percent of that for non-MTDS priority areas was spent as of December 2007;
- nearly 60 percent of the Supplementary Budget appropriations were still sitting in the Trust Accounts as at 31 December 2007. Curiously, only 16 percent of the appropriations to the non-MTDS priority areas are in the Trust Accounts; and
- out of the total amount of K1 946 million appropriated to the MTDS priority areas, only 19 percent had been spent and 80 percent was held in the Trust Accounts. What makes them MTDS priority expenditure programs?

The utilisation of the BWRs on the MTDS priority programs is rather gloomy. However, the utilisation rate of BWRs for the non-MTDS priorities is higher than that for the MTDS priority programs. Nearly all of the appropriations to non-MTDS priorities have been disbursed. Sixty-three percent of the amount disbursed has been spent and only 16 percent of the total appropriations are being held in the Trust Accounts. This pattern of utilising the BWRs seems inappropriate when there is an urgency to reduce mass poverty. Why does a

substantial amount of the BWRs end up in Trust Accounts awaiting an uncertain fate? The authorities rationalise that holding the appropriations in Trust Accounts:

- will lead to avoidance of inflationary pressure on the economy; and
- will buy time for designing the projects to be financed.

Trust Accounts and Inflation

Spending budget surpluses on infrastructure and development programs in a depressed and very open economy like that of PNG will not cause inflation. Theoretically, this is not one of the causes of rising general price levels unless the rationalisation is grounded on the defunct quantity theory of money; that is, too much money is chasing too few goods, which assumes that goods and services will remain relatively scarce. The assumption is unrealistic in an open economy, without import restrictions or control in a competitive economic environment. It is a well-known fact that the quantity theory can be represented by a definitional equation that translates into a tautology. It has no explanatory variables, and therefore the theory cannot be modelled by a behavioural equation.

The BWRs are budget surpluses which, if appropriated through supplementary budgets on mainly infrastructure and programs, bear resemblance to stimulus spending in a recessionary or depressed economy. The spending will not lead to credit expansion in the banking system, as is the case of most stimulus packages, which cause inflation. Neither will the spending exert inflationary pressure on the cost of inputs which happen in an over-heating economy.

Any talk of a knock on inflation or inflation feeding on itself is a far cry. There is no imported inflation or domestic import constraint or rising input costs a result of overheating of the economy or rising prices because of exchange rate depreciation. During the relevant period, PNG's major trading partners, such as Australia and the South-East Asian countries, were not experiencing inflation. Furthermore, the kina was gradually appreciating from AUD\$0.42 and US\$0.31 in 2004 to AUD\$0.44 and US\$0.37 in 2008. This factor would dampen imported inflation.

In PNG, a high liquidity in the banking system has not caused inflation, either because of less dependence on credit for financing business or because the banks reluctance to relax lending to the public. The commercial banks would rather maintain a high liquidity assets ratio and high interest rates rather than lend to the public at low interest rates. They complain about the quality of loan applications. The *Quarterly Economic Bulletin* of the Bank of PNG recorded high liquidity in the banking system during periods of low and high inflation.

Since independence in 1975, inflationary pressure has been triggered by imported inflation, a blowout of budget deficits, or exchange rate depreciation. The inflationary pressure related to imported inflation was tackled in the late 1970s and early 1980s by revaluations of the kina and the hard kina policy. In the second half of the 1990s, the high inflation was resulted from a rapid depreciation of the kina which was triggered by budget deficits. The current creeping (spiral) inflation, estimated to be 11.2 percent at the end of 2008, is difficult to explain. However, it was becoming clear towards the Third Quarter of 2008 that the commodity price boom was losing steam. This realisation might have ignited the psychological guess that it was time to increase the prices of imported goods in anticipation of the depreciation of the kina in order to undermine import businesses' viability when the exchange rate starts falling, which has happened since December 2008. Locking Supplementary Budget appropriations in

Trust Accounts in fear of inflationary pressures seems to be a far fetched cry. It seems to be economic rationalisation in defence of the inability to formulate sound policies to combat the widespread depressed rural economies.

Non-Provision and Delivery of Public Infrastructure and Services in the Rural Sector

The excuse that Trust Accounts have been established in order to buy time is largely untrue. The non-delivery of urgent government services, especially in the education, health and transport sectors, raises the question of 'How much time is needed to formulate projects for utilisation of budget surpluses.' Crumbling public infrastructure and failed programs are observable. Inappropriate policies, and not project designs, cause the delays in holding BWR appropriations or foreign aid such as the K230 million allocated for the Rehabilitation Education Sector Infrastructure (RESI) or funds made available by the EU-PNG cooperation package. The European Union (EU) has made available K470 million for the period 2002-2007 through the 9th EDF for programs in human resources, rural economic, water supplies and sanitation development which have not been significantly drawn down. The EU's Ambassador to PNG was reported by *The National* (Friday, March 27, 2009), to blame this failure on inadequate capacity mechanism.

The fact is that the bulk of the funds in the Trust Accounts have been earmarked for vaguely defined expenditure areas. For example, by the stroke of the pen, K890 million is allocated to 89 Districts whose administrations are headed by a district administrator who is aided by an average of one public employee in the key service delivery sectors. The appropriations to a district are managed by the Joint District Planning and Budget Priorities Committee, which is chaired by the local Member of Parliament and whose governance capacity is inadequate and questionable. Services and infrastructures in most districts are very poor.

There is a capacity constraint not only in the district administration, but also in the rural private sector. Huge amounts in the Trust Accounts are held against the MTDS priority programs in education and health. This poses the question, 'Which entities and experts design projects and implement the projects in the districts?' A district is staffed with a few public servants whose capacity to implement a range of sectoral projects is limited. The impediments to growth and sustainable development of the districts and their local-level governments, with a constant stream of grants for their development, require urgent studies.

What project designs are pending, in order to spend the money that is being held in the Trust Accounts? Millet (2007) does not think that the MTDS economic model is appropriate for the economy in the first place. Consider this scenario. Imagine the scenario if the Government succeeds in establishing universal primary education throughout the country, but it does not expand education at the secondary and tertiary levels. The middle and higher level manpower will be scarce to promote the development of the economy. The country will end up with the problem of producing half-educated persons trekking through the bush, or flying from depilated airstrips, or paddling canoes to the urban centres for jobs and ending up with undesirable self-employment, which society condemns, but cannot enforce the laws to curb crimes and corruption. There is anecdotal evidence that the less-educated migrants who are moving to the urban areas are youths searching for formal employment, which is hard to find.

There is an urgent need to 'open-up' the country first, before meaningful rural growth and development can be achieved. The remote district schools and health posts are no longer doing well as they did in the past when missionaries established and managed them. In any

case, school teachers and health workers no longer want to work in remote areas as they did in the 1960s up to the 1990s, mainly because of the deteriorating crime situation and poor service delivery.

Table 5: Utilisation of BWRs

Expenditure Areas	Appropriations (K' million)	Spent (K'million)	In Trusts (K'million)
MTDS Priority Areas	1946	372	1561
Health	388	31	354
Education	452	37	416
Transport	633	236	397
Law & Justice	333	44	289
Income-Earning Opportunities	140	4	115
Non-MTDS Priority Areas	1872	1187	680
Public Debt and Super Liability	647	647	–
Gas	500	–	500
Others include important expenditure areas of health, education and transport	725	540	180
Total	3820	1559	2241

Source: Papua New Guinea 2008. 2007 Final Budget Outcome Report, Department of Treasury and Finance.

There is a close correspondence between the appropriations of the Supplementary Budgets which are guided by the MTDS and MTRF. The fiscal policy objectives and the goals remain the same (see Tables 4 and 5). The fiscal policy therefore does not target a broad-based growth promotion. Without enough development funds, this makes sense. However, with the BWRs, the fiscal policy direction should be changed to facilitate opportunities for broad-based income creation.

5.4 Medium Term Fiscal Strategy

The BWRs and the Supplementary Budgets, 2005-2008 have already been discussed with reference to the MTDS and the MTRF, which is part of the MTDS, in order to examine their conformity to the MTDS. There is the government's Medium Term Fiscal Strategy (MTFS), which like the MTRF is also meant to guide budgeting. Two MTFSs have so far been formulated — one in 2002 and another in 2008. The formulation of the MTFS, 2002-2007 was based on assumptions which became unrealistic during its implementation. The Department of Treasury projected a gloomy economic picture for the MTFS, which did not prevail during its implementation period. The main assumptions were:

- the government's mineral revenues would decline because mineral production had peaked and the known reserves were depleting;
- the macroeconomic policy and performance were unsatisfactory and deteriorating since 1999;
- inflation was greater than 10 percent and rising;
- interest rates were nearly 20 percent and had continued to rise after reaching a peak of 28 percent in 1998;
- the budget deficit was approximately 5.5 percent of the GDP and expenditures were uncontrollable and rising;

- the public debt rose to almost 70 percent of the GDP; and
- the GDP growth rate was negative for three successive years, 2000-2002.

Against this background, the MTFS, 2002-2007 laid out a policy of fiscal conservatism to immediately cut down on discretionary expenditure, and to be followed by systematic review and restructure of the budget processes, while putting in place policy measures in favour of the private sector growth, including no tax increases.

The MTFS, 2002-2007 targeted the following budget balances: -1.7, -1.5, -1.0, -0.6 and -0.2 percent, respectively, for 2003 to 2007. In all these years, the budget balances had outperformed the targets because of the emergence of the BWRs, which were appropriated by the Supplementary Budgets.

The MTFS, 2002-2007 was irrelevant to the macroeconomic environment brought about by the commodity prices boom. There was hardly any evidence of fiscal restraint in the Annual Budgets. The budget nearly doubled between 2003 and 2007. Appropriating the windfall revenues resulting from the commodity prices boom, as usual, led to escalating recurrent revenues, which impeded full implementation of the development budgets. It seems that the fiscal authorities had belatedly focused policy attention on this, as revealed in the second MTFS.

In May 2008, the Department of Treasury formulated the second MTFS, 2008-2012, which is as flawed as its predecessor. Previously, a scarcity of financial resources was assumed. This time the economic prospects were upbeat. Consequently, the MTFS, 2008-2012 was formulated on the assumption that normal mineral revenues would gradually rise, while additional mineral revenues would be realised from 2008 to 2011.

The main highlight of the MTFS, 2008-2012 is that additional mineral revenues will be appropriated between additional public investment and the repayment of public debt in the ratio of 60:40. The 2008 September Supplementary Budget, like its predecessors, has not appropriated the BWRs in accordance with the MTFS. Less than 34 percent has been appropriated to reduce the public debt. The allocation to public investment is much less than what was proposed in the MTFS. The 2008 appropriations covered a wide range of expenditure areas and were classified under the following categories:

- public debt and other liabilities were allocated K285 million, of which only K50 million was earmarked for public debt reduction;
- transport infrastructure was allocated K250 million, which conformed to the MTFS;
- the National Executive Council (NEC) received K127.4 million; and
- other spending priorities were allocated K187.1 million.

These first appropriations have not conformed to the strategised expenditure patterns of the MTFS, which is based on unrealistic assumptions that there will be additional mineral revenues.

The formulation of the two MTFSs is very much akin to the famous Cobweb Model in economics, where the naïve farmers predict the next crop price based on the previous price only, even though the price keeps on fluctuating. In the case of the MTFS, the prediction has been based on the prevailing conditions only. Future MTFSs should create plausible scenarios which will guide the budgeting, even if none of the scenarios prevails.

5.5 Misusing the BWRs: Prospects

The BWRs should be effectively utilised to address the top deficiencies of the Annual Budgets. Otherwise, when the BWRs disappear, the fiscal policy will continue to be afflicted by the same old problems. The following fiscal constraints have simply been hibernating since the surge of the BWRs:

- normally, there are not enough budget allocations for goods and services that the Government must provide;
- the fiscal gap is filled by donor grants and government borrowings which dominate the Development Budget;
- high loan repayments and interest servicing take a big proportion of the total government receipts;
- the line departments, agencies, and lower-level governments do not receive adequate appropriations and the entitlements of their constitutional grants;
- most of these institutions have received about the same level of funding for many years;
- partly because of the annual budget constraints, unsound budget policies, and a policy vacuum, the impediments to broad-based income creation and employment generation have not been largely addressed; and
- the nationwide economic and social infrastructure development and maintenance programs have not been sustained.

SECTION 6: OPTIMISING THE USE OF BUDGET WINDFALL REVENUES

6.1 Facts and Considerations

The surge of Budget Windfall Revenues (BWRs) challenges the policy maker to implement policies for the optimal utilisation of these revenues. The objective of this paper is to propose an appropriate policy that will create opportunities for broad-based growth. This chapter determines which BWR policy measures are most deserving of the funding in order to meet the most pressing needs of Papua New Guinea's economy. There are three main reasons for the pre-eminence of the study objective.

First, the collection and utilisation of BWRs is the part of budgetary policies known as fiscal policy. Papua New Guinea's fiscal policy has many shortcomings which need to be addressed. The revenue generating capacity is narrowly based and there is not enough public money to meet the recurrent expenditures, development programs, and public investments. Broad-based growth will broaden the tax base and increase tax revenues.

Second, low income levels and widespread poverty are having a debilitating effect on Papua New Guinea's economy. There is not enough public finance to strengthen the weak bridging development policies between the macroeconomic policy and the microeconomic policies. With weak bridging development policies, the nation's richly endowed renewable resources, such as agriculture, fisheries, and tourism cannot be sufficiently developed.

Third, the BWRs should be used to extricate the economy from the enclave growth, which, produces the BWRs in the first place. As already mentioned, using the public finance that is sourced from the enclave growth to promote broad-based growth is strongly underpinned by theory. The BWRs create this opportunity.

Drawing from the recommendations and suggestions of political leaders, bureaucrats, and academics, as well as international practices, this paper assembles the following policy measures that merit consideration for the utilisation of the BWRs:

- the MTDS priority expenditure areas;
- health and education;
- rural development or district development projects;
- additional grants to the lower-level governments;
- data collection;
- equity participation in resource developments;
- creating or funding a sovereign wealth fund or managed fund;
- saving for a rainy day;
- tax reduction or subsidies;
- promotion of agriculture;
- improving utilities such as water supplies, sewerage infrastructure and power plants;
- promoting pro-poor programs that create opportunities for the poor to earn an income;
- repaying public debt;
- promoting land reform programs;
- improving transport infrastructure connectivity and programs; and
- reducing serious crimes and corruption and effectively promoting the rule of law.

These policy measures are evaluated against the backdrop of this paper's objective, the discussion of the policy framework, the model of development policies and the empirical considerations, including the international practices and the formulation and implementation of the Annual Budgets and Supplementary Budgets. A policy measure is selected for BWR utilisation, if it meets all of the following evaluation criteria:

- it is more relevant to the objective than any other policy measure;
- its inclusion among the selected few BWR measures promotes efficiency;
- its inclusion with the other selected measures does not destabilise macroeconomic policy stability;
- it is a bridging development policy that strongly influences private investment decisions and microeconomic performance;
- it is pragmatic in the sense that it is underpinned by both theory and empiricism;
- it addresses an impediment to broad-based income creation; and
- it has the ability to create an opportunity for broad-based income creation, not only in the short term, but arguably, also in the medium- to long-term.

6.2 How Not to Utilise the Budget Windfall Revenues

While all of these above measures are worthy of consideration, only a few meet all of the evaluation criteria. The study has found that the supplementary budget appropriations heavily favour the MTDS priority programs. However, out of all of the MTDS priority programs, (as mentioned in Section 4.4), only one meets the stated evaluation criteria. The common reason for the exclusion is that a considerable amount of the normal budget is appropriated to them in accordance with the MTDS and MTRF. Approximately 49 percent of the Development Budget should be spent on the MTDS priority programs in 2007.

The Law and Justice Sector is excluded from the MTDS priority programs list. However, it deserves BWR policy attention for two reasons: First, the MTRF Development Budget policy attention is paltry. Second, the serious crimes and corruption, which rage on unabated, have a detrimental effect on the economy as they impede personal security, business expansion, and start-ups, which fuel economic growth.

Another reason for the exclusion of all except one of the MTDS priority expenditures is that the BWRs are only short term and only a few would qualify. Also, a corollary to this reason is that the MTDS priority areas, which are already receiving relatively adequate budgetary policy attention, are not as qualified as the four measures that are ultimately chosen.

The other policy measures that should not be funded by the BWRs are grouped into the following seven categories.

Education and Health

The education and health infrastructure and programs are important drivers of growth and development and are not being underrated by their exclusion for BWR funding. They are unsustainable unless income levels are correspondingly high. Unfortunately, Papua New Guinea's education and health infrastructure have significantly degenerated over the years. Education and health programs operated much better in the 1980s and during the early 1990s than in the period after 1995. For example, the University of Papua New Guinea and the PNG University of Technology were better financed in those days and the quality of the education

might also have been better. In the case of health, approximately 50 percent of the aidposts and health centres in the 1980s have now disappeared and most health indicators point to worsening health performances overall. Education infrastructure and programs are also falling apart in the rural areas. The education and health infrastructure and programs should always receive the normal budget policy attention.

It is a tough decision to exclude education and health from BWR funding because of their obvious importance. Both do not just benefit the individual. Human capital and a healthy population are both means of increasing income creation. The MTDS has largely excluded these two sectors in the priority expenditure areas, which is controversial. Undoubtedly, excluding these sectors from BWR funding will be equally controversial. However, if the evaluation criteria are strictly adhered to, then these two important sectors would not be preferred to those policy measures that have been selected. The two sectors need to be planned and financed by the Annual Budget in a sustainable way.

Additional Grants to the Lower-level Governments

Appropriating large amounts of BWRs as additional grants to the districts for development is not appropriate because the districts do not have the administrative capacity to design projects which will properly dovetail into the national infrastructure and programs, or to implement them effectively. There is anecdotal evidence that constitutional grants and other public money receipts have not been efficiently utilised. Health, education, and transport infrastructure, including airstrips, wharves and jetties, are in total disrepair in the districts. Feeder roads which have been constructed by local people using electoral funds from Members of Parliament have quickly disintegrated. The passengers resort to pushing vehicles that are meant to transport passengers and cargo, through mud and potholes. Many of the aidposts and health centres and airstrips have become dysfunctional.

Improving Statistical Data

It is true that there is a noticeable paucity of data, incomplete data, or data lacunae. This makes the use of secondary data for development planning, predicting trends, forecasting, or research, unreliable. This is not a problem that should be addressed by BWRs. The actual GDP compilations have always been delayed for many years. Normal budgetary policies should be used to address the overall data compilation problem.

Taxes and Subsidies

It seems inappropriate to suggest that, because considerable BWRs have accrued, high income taxes should be reduced, the GST should be reformed, and the fuel prices should be subsidised. High income taxes are a disincentive to work effort and impede the recruitment of highly qualified persons, if there are competitive jobs. For example, the 35 percent and 48 percent, marginal tax rates, respectively, on K60 000 or K150 000 salaries, respectively, are rather too high for a country which has scarce high-level manpower. The GST adversely impacts on the grassroots economy and hinders broad-based growth. It is difficult to remove subsidies, in particular, or adjust to lower tax revenues when the export prices slump. There seems to be a strong case for reforming the whole tax structure, but not because of the BWRs.

Pro-poor Programs for Poverty Reduction

The promotion of pro-poor income-earning activities is essential, but not through the use of BWRs. What is initially required is to put adequate public infrastructure in place for broad-based income creation.

The Government, through its budgetary policies, should cooperate with other stakeholders to promote economic activities that are aimed at poverty reduction. Two examples from which may guide the government to formulate programs to effectively reduce poverty, include:

- the AusAID Enterprise Challenge Fund (ECF) which was launched towards the end of 2007. The ECF aims to reduce poverty by helping the poor to earn incomes in Papua New Guinea, Fiji, Indonesia, the Philippines, and in other countries in the Asia-Pacific Region. Through open competition, a private entrepreneur, whose business promotes broad-based income and employment generation, can bid for an ECF grant from a minimum of K 245 000 up to K3.6 million to be invested in the business. Donor grants that are used this way are likely to be more effective than budget support grants (Mawuli 1997, 2004, 2007); and
- the Agricultural Innovations Grants Scheme (AIGS) which is a joint initiative of the Papua New Guinean Government and the Australian Government. The AIGS is a funding program for Agricultural Research and Development Support Facility that is aimed at helping research institutions to increase opportunities for rural smallholders in Papua New Guinea to promote income generation and food security.

State Equity Participation, the Budget Surplus or Sovereign Fund, and Managing the BWRs

State investment in equity for resource exploitation is somewhat comparable to saving for a rainy day. Resource development takes a long time to yield good returns. The rainy days come often, last longer, and outlast the savings. The BWRs should not be used for a speculative purpose. Mekere Morauta (2006) stated that, while government services are not functioning properly, maintaining a fiscal surplus is inappropriate.

The establishment of a Sovereign Wealth Fund should be rejected for the same reasons that are advanced against equity in resources development and fiscal surpluses. However, this measure could be considered for a resources boom (Mawuli 1993). For example, expected huge gas revenues and any extractive industry boom surpluses should be used to establish a fund which will be managed for the benefit of the present and future generations. The design of the policy and regulatory framework should be underpinned by the best principles and practices of funds such as Papua New Guinea's Mineral Resources Stabilisation Fund, Sovereign Wealth Funds, and PNG Sustainable Development Program Limited.

Managing the BWRs

Finally, this paper does not recommend establishing a BWR fund which should be managed. It recognises that there are appropriate procedures and processes in place to appropriate the BWRs and account for the spending of the appropriations. However, there is a problem of enforcing the rules and regulations of non-financial compliance in PNG, which requires a separate study.

As already mentioned, the BWRs are short term and should not be misconstrued as resources boom revenues. This paper rejects the use of the BWRs as a designated managed fund or special off-budget fund that is managed like the PNG Sustainable Development Program Fund, a Sovereign Wealth Fund to earn investment income, the Kuwait fund which is managed for multi-purposes, or PNG Trust Accounts, in which appropriations of Supplementary Budgets are held for future use.

Papua New Guinea's BWRs can only create a small-sized fund whose management will not be justified by economies of scale. The opportunity cost of using the BWRs to create infrastructure and programs to promote broad-based growth will be higher than managing a small sized-fund. Furthermore, the spectre of mismanaging and misspending a state-managed fund seems real and is empirically supported. For example:

- Papua New Guinea's Mineral Resources Stabilisation Fund was established in the second half of the 1970s to stabilise fiscal operation, but did not last long or serve any useful purpose. The fund was afflicted by the non-compliance of the financial and operational regulations, despite the sound regulatory framework with a high-powered committee to oversee it. Millions of Kina have not been satisfactorily accounted for;
- year after year, the Office of the Auditor-General has reported on the misappropriation of budget allocations, but not a single case has been prosecuted;
- there have been reports of irregular withdrawals being made from the Trust Accounts in which the appropriations of the BWRs have been kept. *The National* (26 November 2008) reported the disappearance of K100 million from the Agriculture Trust Account, but no-one was held accountable. The Auditor-General reported to Parliament that over K1 billion from the Works Department's Trust Accounts was misappropriated; and
- in March 2009, K230 million was withdrawn from the Trust Account created for the Rehabilitation of Education Sector Infrastructure (RESI) and put into an account at the Bank of South Pacific. The Minister for National Planning and Monitoring explained to Parliament that the money was urgently needed for the purpose for which the appropriation had been made. This paper argues that the reasons given for depositing the BWRs into trust accounts are questionable. There is no need to establish trust accounts in the first place, if the BWRs are to be optimally utilised.

6.3 How to Spend the Temporary Budget Windfall Revenues

To claw its way out of underdevelopment, PNG needs to vigorously pursue broad-based growth. To achieve broad-based growth and development, the country requires a solid infrastructure and a committed Government. The bridging development policies are generally unsound. The BWRs cannot effectively address all of the measures that have been suggested. This is the reason why this study, after conducting a situation analysis of the policy framework and empirical considerations, selects the following four policy measures that can be effectively addressed:

- a reduction of the public debt to an acceptable level;
- promotion of a Land Reform Program, as recommended by the National Land Development Taskforce;
- promotion of the connectivity of the transport infrastructure; and
- promotion of the law and order sector to curtail serious crimes and corruption nationwide.

Public Debt Reduction

Using the BWRs to reduce the public debt is a topical issue. It is a policy measure that is widely suggested, practised, and rationally sound. There were positive developments in relation to the public debt between 2005 and 2007. The most significant one is that K647 million out of the K3 820 million windfall revenues was appropriated by the four Supplementary Budgets and used to reduce the public debt and super liability, which is mainly the debt owed to former public employees. The public debt itself was reduced by K327.4 million out of the K647 million which was allocated, bringing the level of public debt to 34.1 percent of the Gross Domestic Product (GDP) (Department of Treasury, 2008).

The public debt of 30 percent of the GDP has been found to be the historical norm, which is sustainable for the sampled emerging countries studied by Abiad and Ostry (2005). The study is relevant for the more developed emerging countries such as Brazil and China which are included in the study sample, rather than for developing countries such as PNG. For PNG, what matters most is the percentage of the total budget that is spent to repay the public debt and service the interest. In 2007, this percentage was 10 percent, which seems rather high. The current government revenues, less the 10 percent, cannot sustain the Recurrent Budget and contribute significantly to the Development Budget. This is one good reason why the BWRs should be used to further reduce the public debt until a sustainable public debt repayment is achieved. As long as the public debt does not destabilise the macroeconomic policy, its domestic component acts like oil in the engine of a vehicle, by influencing monetary aggregates such as inflation and interest rates.

Land Reform Program

The acquisition of land by investors from customary landowners is a big problem in PNG where land registration and the purchase of land are culturally unacceptable practices. Negotiations by investors concerning leasing land for development can take several years to accomplish. The Government also has difficulty acquiring customary land for public infrastructure. The customary landowners are militant and their demands often seem endless. After failing to find a solution to the land problem, the Government established the National Land Development Taskforce in 2005, and with the support of the (former) Deputy Prime Minister, Sir Puka Temu, developed an innovative approach to facilitate the acquisition of land for development (Webster 2008). The Taskforce has recommended a package of land reform programs which includes improving land administration, customary land registration by the landowners through Incorporated Land Groups (ILGs), and the establishment of a parallel Land Court to expedite land litigation (Webster *Ibid.*: 2). The 2008 Annual Budget appropriated K31 million to promote the program. However, the importance of accessing land for development suggests setting aside a large amount of the BWRs for this purpose.

In addition to promoting the land reform program, the Government could also consider serving as an intermediary between the landowners and investors, by leasing tracts of land for development from the ILGs, and, on-leasing them to the investors. Spending the BWRs on leasing land from the customary landowners, which will eventually be paid for by the investors, will help to create opportunities for broad-based economic growth and development.

Transport Infrastructure

The transport system is underdeveloped. The fiscal policy undermines the transport infrastructure development and maintenance that would facilitate broad-based income creation and sustainable development. In particular, it underrates the important role that transport infrastructure connectivity plays in promoting growth and development.

A good transport network system provides opportunities for:

- the expansion of commerce and industry to enhance production, distribution, and marketing;
- rural dwellers to gain access to markets in order to sell staples, cash crops, and other products, and to buy store goods which will serve as an economic incentive for further income creation;
- the delivery of more efficient services such as:
 - law and order;
 - health;
 - education; and
 - administration;
- the satisfaction of social needs, such as attending weddings, churches, sporting activities, cultural ceremonies and other social events, thereby promoting social capital creation and development; and
- the provision of basic utilities such as clean water supplies, power plants, and postal services.

Fiscal policy has failed to focus on transport infrastructure development, maintenance, and connectivity. Papua New Guinea has three modes of transport — *road transport*, *maritime transport*, and *air transport*. It has diverse physical and geological features such as steep mountains, gorges and extensive river systems, which have been described as the ‘tyranny of the topology’ (Ranasinghe 2002). Papua New Guinea’s population is estimated at 6.2 million, which is small relative to the geographical area of 463 000 square kilometres and is widely dispersed on a main island and 400 out of 600 small, inhabited islands and atolls. The main island is shared with Indonesia to the west.

In 2005, the entire country’s road network comprised some 26 000 km, of which 7 598 km are national roads, and approximately 17 000 km are feeder roads for which lower-level governments are responsible. Maritime transport is just as important as the road transport, as 14 of the 19 provinces and the NCD are maritime provinces. This mode of transport is also underdeveloped, with eight wharves, 47 jetties and 166 marine navigational lights. Road and maritime transport are complemented by air transport. In the 1970s and 1980s, aviation transport connected many remote interior land areas and islands to several major population centres. In the late 1980s and early 1990s, there were more than 400 airstrips, of which less than half are now operational. Benign fiscal policy neglect and outright government policy bungles have led to this appalling state of transportation. For example, the largest third level air operator, Talair, withdrew its operations in PNG because of disagreement on the government’s aviation policy.

The Government provides the road infrastructure, which is costly and does not attract private investment. The private sector operations are limited because the transport market is thin.

Given fiscal resources constraints, especially in terms of funding the public transport infrastructure, the apparent policy neglect is obvious.

For example, although the MTDS, 2005-2010 has given highest priority to transport rehabilitation and maintenance, this has not been consistently addressed by the fiscal policy. The Department of Transport (DoT), which is responsible for the policy, was forced to abandon its ten-year National Transport Development Plan (NTDP), 2001-2010 because of a lack of funding. Inadequate maintenance has led to the appalling state of the transport infrastructure. The DoT estimated that it would cost K700 million each year for five years to rehabilitate and maintain the poor infrastructure. However it planned for less than K420 million per year because it could not secure that level of funding for the NTDP, 2005-2010, which replaced the ten-year plan. This planned expenditure is meant to clear the existing maintenance backlog of the transport infrastructure by 2010. When the infrastructure is usable, the security of the users and their cargo will also need to be assured.

Law and Order

The Law and Justice Sector is perhaps the most important sector that should be prioritised for windfall revenue spending in order to promote broad-based income creation. However, it will be difficult, or too expensive, to effectively combat serious crime and corruption nationwide, without a good transportation system in place.

Without modern transport access to the remote districts and islands of Papua New Guinea, it would be futile to pour public money into the provision of public social infrastructure and programs and services, which will be dysfunctional and not sustainable. Furthermore, income creation across the nation will be severely limited.

Rampant serious crimes and corruption exert a considerable toll on business start-ups and expansion. Their impacts on the economy are manifested in various forms, including:

- high costs of doing business (Duncan and Lawson 1997);
- the lowering of investor confidence;
- diminishing good governance; and
- the ineffectual delivery of public services.

For example, consider the extreme breakdown of the rule of law in Kompiam District in Enga Province. There are many similar depressed districts throughout Papua New Guinea where transportation constraints, tribal wars, or serious crime situations impede broad-based income creation, sustainable development, and the delivery of basic public services by schools, health centres and aid posts.

A focused rapid assessment of Kompiam District is reported by key informants, Dr. Charles Yala, a Senior Research Associate at the National Research Institute and a visiting research scholar at the Australian National University, and Dr. Ken Ngangan, Senior Lecturer at University of Papua New Guinea, who produced a development plan for the Kompiam District in June 2008. Out of the 16 primary schools which were built in the 1960s, 1970s, and the 1980s, only one still ran regular classes (see Table 6).

The only existing primary school in the district is at Kompiam, which has a 65 km road access from the provincial capital, Wabag. The closure of schools in the districts is mainly

because of tribal wars, during which properties such as schools, houses, and farms have been destroyed. The primary schools in the villages have closed, because they no longer have access roads to Kompiam. The aidposts in the district are also in a similar depressed state.

The case of Kompiam District illustrates the cost to the society of rampant violence, serious crimes, and corruption. Beyond the toll on the victims, violent crimes and corruption carry heavy economic costs. Their adverse, indirect impacts on income creation and development can be inferred. They retard broad-based growth and the advancement of the nation's prosperity.

Tribal wars seem to be remotely related to serious crimes and corruption which prevail in PNG. However, a link exists between serious crimes and illegal guns that are financed by corrupt leaders and drug traffickers who have virtual disregard for human life. Similarly, the narcotics and the gun-trade fuel murders, and drive kidnappings, extortions, and bank robberies.

Table 6: Breakdown of Rule of Law Impacts on Primary Schooling in Kompiam District, Enga Province

Primary Schools 1960s-1990s	The State of the Schools in 2008		
	Closed	Frequently Closed	Operational
Kompiam			yes
Ayulites	yes		
Elem	yes		
Isakoe		yes	
Lapalama	yes		
Mapai	yes		
Maramb	yes		
Okananda	yes		
Pakalilyan	yes		
Sauanola		yes	
Tapenjo	yes		
Warawali	yes		
Yamanda		yes	
Yangis	yes		
Yaubutok	yes		

Millions of kina of public money, which should have been used to create an enabling environment for economic growth and development, are lost because of widespread public corruption and misuse of public funds for private gains and non-state interests. The following examples of corrupt practices that are rife in the public sector include:

- the outright theft of a public funds;
- diversion of public project;
- kickbacks in public procurement (locally referred to as 'cuts');
- bribery;
- embezzlement;
- fraudulent compensation claims against the State; and
- the misuse of public office to subvert public regulation or law.

Successful prosecutions are minimal and suggest a capacity constraint on the part of institutions that are responsible for maintaining law and order, which must be addressed through fiscal spending (Chand 1997).

The law and order problem in Papua New Guinea is so serious that professional bodies issued a paid media release in the *Post-Courier* (4 August 2008), urging for action from the Government. The media release contends that the law and order situation:

- is falling into a complete state of lawlessness;
- criminal activities are perpetrated everyday, with innocent people being robbed, kidnapped, tortured, and murdered, and properties burned down. PNG police are under-resourced to effectively deal with this; and
- organised and systematic corruption at the community, district, provincial and national levels is widespread and is destroying the value of life and setting a false life and economy for the younger generation.

The media release further recommended “external assistance to the under-strength and under-resourced Royal Papua New Guinea Constabulary; Law Reforms; Correctional Services, Office of the Public Prosecutor and the Office of the Public Solicitor”.

The media release was a joint statement issued by the following professional bodies after a two-day meeting in July 2008:

- Certified Practising Accountants of Papua New Guinea;
- Institute of Directors;
- Media Council of Papua New Guinea;
- National Doctors Association of PNG;
- PNG Association of Surveyors;
- PNG Bankers Association;
- PNG Institute of Architects; and
- PNG Institute of Engineers.

The professional bodies have called for government action to combat the degenerative law and order problems, but it may go unheeded. There have been many such calls by businesses, political leaders, academics, researchers, the media, and commentators for more than a decade (Dinnen 1996). Levantis, in his PhD thesis, estimated the direct cost of crimes of larceny at K270 million, which was 4.7 percent of the GDP when the exchange rate of the kina was US\$0.72(cited in Chand 1997). Chand (*Ibid.*) therefore suggested that five percent of the GDP should be used to control the law and order situation.

The culture of heinous crimes, violence, and corruption has progressively developed, especially since the second half of the 1980s. There has been a benign neglect of focusing fiscal spending on the law and order situation; that is, the fiscal policy has been ineffective in dealing with the seriousness of the surging crimes, violence, ethnic clashes, and corruption. The use of the windfall revenues to boost enforcement of the rule of law is absolutely essential.

SECTION 7: CONCLUSION

This paper is concerned with how Budget Windfall Revenues (BWRs) should be optimally utilised. Papua New Guinea has experienced windfall revenues from 2003 to 2008. As commodity prices rose during this period, the Government quickly appropriated K4.7 billion through five Supplementary Budgets, from 2005 to 2008.

BWRs are government receipts over and above total Annual Budget appropriations, and are distinctly different from resource boom revenues. BWRs are realised in the short term, whereas resource boom revenues are more permanent and last over a longer term.

The Government has appropriated substantial amounts of the BWRs through the Annual Budgets, thereby swelling spending capacity above revenue generation capacity. When the commodity prices collapsed in September 2008, the impact of inappropriate spending started to emerge. The 2008 budget balance outcome has already recorded a deficit.

Literature on BWRs

Opinions varied on how to use BWRs, because worldwide applications of BWRs differ widely. Suggestions for the use of the windfall revenues in Papua New Guinea and worldwide country practices are summarised and ranked in order of their frequency of occurrence: BWR measures suggested for PNG are:

- public debt reduction;
- health and education;
- rural infrastructure;
- rural development;
- law and order;
- land for development; and/or
- saving for the future.

Country practices include:

- windfall revenues retained for the next budget appropriations;
- supplementary budget appropriation to be used for priority programs;
- public debt reduction;
- expropriating or nationalising foreign companies; and/or
- saving for a rainy day.

The appropriations of BWRs reveal the budgetary policy focus a lot more than the government's rhetoric which is designed to draw attention and promote public acceptance of the budget. The rationales are embedded in the BWR measures employed and the relative size of the appropriations manifest the policy focus. BWR practice reveals populist policy.

Faced with the diverse options for utilising BWRs, a country must make a choice because of the BWRs' limitation in size and time.

Choosing an optimal package of BWR measures is not as simple as it seems. The collection and use of BWRs fall into the domain of fiscal policy, which concerns government revenues

and expenditures, and budget balances. BWRs are measures of fiscal policy and may also be loosely referred to as BWR policy.

The mainstream economic literature offers scant direction for BWR policy. Similarly, country practices do not provide a guide. Any country must therefore use its BWRs rationally, by addressing the top challenging problems that they face in prioritising expenditure.

The Problems and BWRs

Papua New Guinea faces a myriad of impediments in its attempt to achieve a reasonable level of national well-being or development. For example, impediments include inadequate health care, education, human resources capacity, transport infrastructure, and personal incomes, as well as constraints on land for development, and law and order.

The single most pressing problem in PNG has been underdevelopment, which is derived from the lack of income-creation opportunities for the majority of the population to earn cash incomes in order to adequately meet their basic needs and wants.

Poverty in PNG is widespread and largely explained by the persistent pursuit of enclave growth and segmented development, unsound economic policies, and a fiscal policy vacuum to address broad-based growth. The public revenues, which have been mainly raised from mineral and petroleum resources development and trade, have been used to pursue this pattern of growth and development. Many people suffer from lack of opportunities to create cash income.

Inadequate public finance, unsound fiscal policy, and non-commitment to sound development policies and good governance consistently frustrate the promotion of broad-based economic growth and sustainable development.

The Objectives of BWRs

BWRs should be used to promote broad-based economic growth and sustainable development; that is, for the sustainable reduction of mass poverty which is suffered in PNG. Even during fleeting resource booms from 1991–1993, the budgetary policies have remained more redistributive oriented, rather than emphasising broad-based economic growth and sustainable development.

The budgeting of BWRs has also not focused on the most important impediments to broad-based growth and development. Instead it has focused on spreading wealth on questionable projects across the country. By and large, they have been formulated as ‘mini-annual budgets’.

Medium Term Development Strategy and Medium Term Resources Framework

The Medium Term Development Strategy (MTDS) 2005-2010 with the Medium Term Resources Framework (MTRF) 2005-2007 and the Medium Term Fiscal Strategy (MTFS) 2002-2007, were put in place to guide budgeting. The main assumption underlying the formulation of the MTDS and MTFS is fiscal resource scarcity. Therefore, the MTDS and

MTFS have been ill-suited to drive the use of BWRs. However, the MTDS, together with the MTRF, has provided budgeting policy direction which has been somehow used to appropriate the BWRs.

The first four Supplementary Budgets appropriated large amounts of the BWRs to the priority expenditure areas of the MTDS. The appropriations nearly conform to the guidelines in the MTRF. The priority development areas are relatively small subsectors of the dominant sectors, such as health, education, and transport. It became obvious that the subsectors have capacity constraints to quickly spend the large amounts that have been allocated. Substantial appropriations to the priority subsector have therefore been placed in Trust Accounts. The authorities have advanced two main reasons — first to buy time to design projects, and second, to stem inflationary pressures (which this paper has dismissed as not valid).

The management of more than 200 Trust Accounts is strictly guided by financial compliance regulations. However, this paper contends that locking up BWRs is inappropriate on two grounds. First, it is inappropriate to park appropriations to meet urgent public needs, and second, the funds in the Trust Accounts may be subject to misuse, if the Auditor-General's reports are any indication. Recent reports by the Auditor General to the Parliament have alleged disappearance or inadequate accounting for K1 billion in the Department of Works' Trust Account.

Windfall Revenues Utilisation

A clear distinction must be drawn between BWRs and huge resource boom revenues which can be utilised to establish a multi-purpose fund. The goals for optimal utilisation of the BWRs should be to:

- select a few measures that offer opportunities for effectively promoting broad-based economic growth and sustainable development in the short term, as well as the long term;
- encourage and facilitate private investment and nationwide microeconomic performance; and
- promote macroeconomic policy stability and performance.

How Not to Use BWRs

The BWRs are perceived as temporary, and should not be used to finance the following activities:

- virtually all of the MTDS priority expenditures and sectors, such as health, education, and public sector capacity building, which are very important and should be continually emphasised by annual budgetary policies;
- pro-poor programs;
- public utilities which must be driven by sound policies; and/or
- state equity participation and subsidies, because state expenditures on resources development equity and subsidies are economically unsound and inadvisable. In the long term, the gains from such expenditures will be less than their life-cycle opportunity costs; that is, the gains which will be derived from alternative public sector undertakings.

How to Utilise BWRs

The following BWR measures offer opportunities for broad-based income creation (growth) in the short term, as well as in the long term in Papua New Guinea, and are ranked in descending order of importance:

- *Public Debt*: Appropriate debt reduction is needed in order to reduce the recurrent expenditures and make them available for other important public programs or projects. However, the debt ratio is already low and only needs fine tuning.
- *Land for Development*: Normally, any acquisition of land from customary landowners poses costly problems for investors. The use of BWRs to implement the current land reform program and to lease land for onward leasing to investors is expedient.
- *Transport Connectivity*: The use of BWRs to extend transport infrastructure and promote inter-modal transport will create opportunities for broad-based growth. The Department of Transport has the responsibility of formulating transport policy. However, its plans are often ignored or abandoned, which undermines transport connectivity.
- *Law and Order*: This sector is ranked first for the use of BWRs. It is one of the priority MTDS areas for annual budgetary expenditures, but receives insignificant appropriations for its infrastructure and programs. The law and order programs, and institutions such as the Royal Papua New Guinea Constabulary, the Correctional Services, the Ombudsman Commission of Papua New Guinea and the Department of Justice and Attorney-General seem grossly underfunded. Their capacity building is urgently needed because their efficiency is necessary for personal security, justice, and business viability and expansion.

These measures offer opportunities such as opening up the economy in order to augment the GDP, starting with immediately boosting business operations and including marketing agricultural surpluses, which normally rot in the rural areas because of transport and security constraints. They will also enhance investor confidence in the economy, and thereby promote business start-ups and expansion, and stem closures of existing businesses.

Future Studies

In addition to addressing the optimal utilisation of the BWRs, this desktop study is meant to identify relevant topics for further studies. The recommendations suggest that a detailed investigation should be carried out into the following research questions in order to improve budgeting:

- What will constitute an optimal public debt ratio that maintains macroeconomic policy stability?
- How should resources boom revenues (or the imminent huge gas revenues) be managed?
- How does post-investment in transport, land accessibility for development, or rule of law impact on the economic growth?
- How can BWR appropriations to Districts and local-level governments impact the economy?
- What are the constraints to implementing projects and programs in the districts?

- What are the constraints to financial compliance or enforcing compliance of financial regulations of the public sector?

Concluding Remarks

First and foremost, Papua New Guinea's BWRs should be used to open up and grow the economy in order to reduce poverty. This study recommends measures that may be likened to a fiscal stimulus package, which is to be financed by the BWRs, rather than budget deficits. The BWR measures are designed to address Papua New Guinea's growth recession, which has been perennial and characterised at times by GDP growth, without employment growth or job loss. There is growing unemployment and mass underemployment, especially in the urban settlements and rural areas, mainly as a result of the economic expansion constraints that are emphasised by this study.

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APPENDIX 1: ECONOMIC POLICY

Economic policy is an action plan, which is meant to tackle a problem. It has two key components — *the objective* and *instruments*. An instrument of economic policy is a measure that is implemented to achieve the objective. In its entirety, the following constituent parts of an economic policy are presented in a circular model (see Diagram 2):

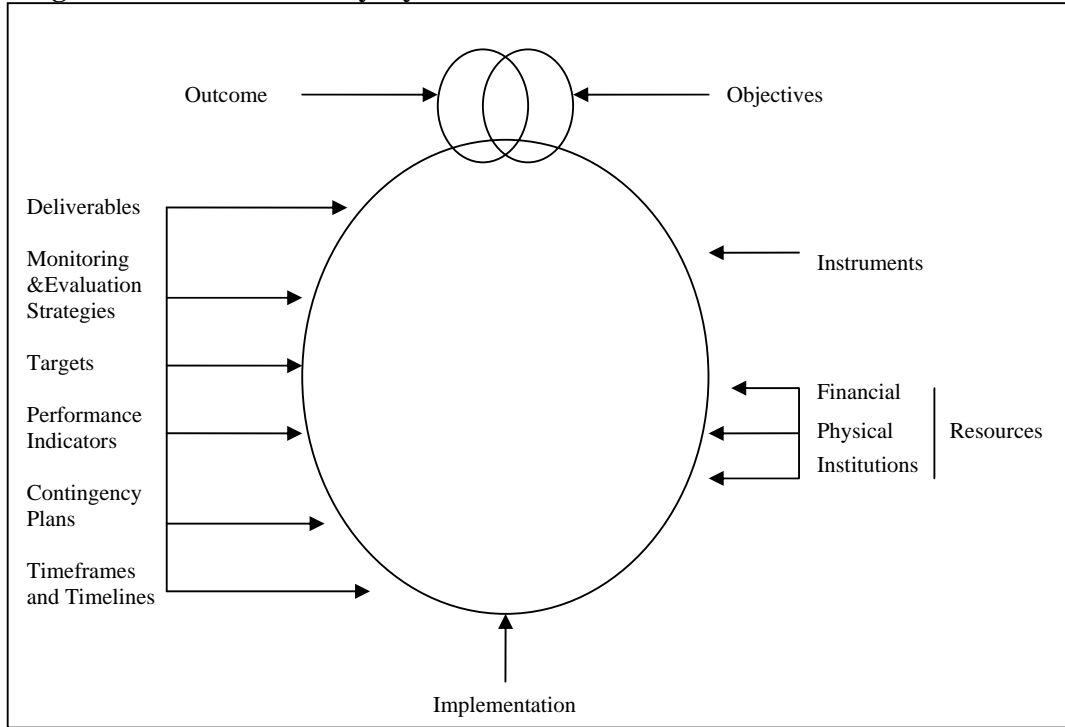
- the problem that is addressed, which may be stated, implied, or understood once the policy is expressed;
- the objective is a key constituent, which may imbed the goal that is explicitly or implicitly stated in the policy statement or phrase;
- the instruments are measures that are designed in order to achieve the objectives;
- resources, including implementing entities that should be employed to execute the instruments;
- the implementation protocols, including targets, timeframes or timelines for actions and deliverables, contingency plans and monitoring and evaluation; and
- the policy outcomes.

Economic policy is usually framed in terms that include the subject matter, the objective, or the key instrument, or any combination of the three. It is not unusual to refer to an instrument as policy. Some examples of nomenclature of economic policies used in this paper include:

- macroeconomic stability policy is an example of naming the policy by its subject matter and objective. This policy is about steady growth or dynamic stability of economic aggregates or outcomes such as the national output, employment, interest rates, and prices;
- fiscal policy is about government expenditures, revenues, and budget balances. In a broader sense, it is about government receipts that include revenues, grant aids and borrowings, appropriations, and expenditures;
- budget deficit policy may be considered as an instrument of fiscal policy; and
- windfall revenue policy is used here as an instrument of achieving broad-based growth and development. It can also be used as an instrument of fiscal policy.

Diagram 2 represents a conceptualisation of economic policy. In practice, all the constituent parts of economic policy are not explicitly stated or sequenced as they appear in the diagram. For example, deficit financing or interest rate tightening simply states the instrument, as done here, in order to refer to fiscal policy expansion or monetary policy tightening, respectively.

Diagram 2: Economic Policy Cycle



APPENDIX 2: DEVELOPMENT POLICIES

Diagram 3 is a conceptualisation of all government policies, subsequently referred to as development policies, which interact to create an environment that enables the nation's economic performance and hence well-being. They have been perceived in the diagram as building policy blocks with:

- macroeconomic policy stability as the foundation block;
- bridging policy blocks as public policies in a broad sense; that is, all government policies that link macroeconomic policies and microeconomic policies; and
- microeconomic policies.

All these policies influence investment decision making, which leads to outputs of goods and services that are aggregated as the Gross Domestic Product (GDP). The GDP is roughly used as an indicator of the nation's well-being. Diagram 3 helps to bring into focus the development policies that must be put in place in order to address broad-based economic growth and sustainable development.

In this discussion, development policies refer to a combined policy-mix of all government policies, which comprise macroeconomic policies and microeconomic policies, and other policies which are loosely referred to as 'bridging development policies'. The ultimate goal of all development policies is to improve the nation's well-being. Diagram 3 conceptualises the development policies as building policy blocks, A, B, and C, representing the above three classifications of development policies, with their components designated as policy subblocks with subscripts. The policy outcomes are investment decisions, economic performance, and national well-being, respectively, denoted as D_1 , D_2 , and D_3 . Each of the policy subblocks contains a host of imaginary policy instruments. The development policies are represented by the following conceptualised policy blocks:

- Block A represents macroeconomic policies, which comprise:
 - Policy subblock A_1 representing fiscal policy; and
 - Policy subblock A_2 , representing monetary policy which includes the exchange rate policy. Both A_1 and A_2 impact on each other, implying that any significant change in an instrument of fiscal policy would affect and necessitate a monetary policy response, and vice versa.
- Block B broadly represents bridging development (public) policies, which are classified into three subgroups — *direct budgetary policies*, *cross-cutting policies*, and *financial sector policies*;
 - Policy subblock B_1 representing direct budgetary policies which are concerned with government receipts, disbursements, and expenditures. Government total receipts comprise tax and non-tax revenues, grant aid and government borrowings. The direct budgetary policies are concerned with government receipts, including tax revenues, appropriations, expenditures, sectoral and functional institutions such as agriculture, education, health and transport, foreign affairs, and other government

- entities, such as agencies, authorities, commissions, departments, and programs. They are direct offshoots from fiscal policy.
- Policy subblock B₂, representing financial sector policies which are direct offshoots from the monetary policy, A₂. The Central Bank has the responsibility for the financial sector policies, which concern the money supply, credit or loans, interest rates, other financial institutions and their operations, exchange rate, and official international transactions. The financial sector policies, B₂, and the direct budgetary policies, B₁, impact on one another. The relationship is like action and reaction of forces. For example, a budget deficit blowout that caused inflation would require monetary response — interest rate tightening. On the other hand, higher interest rates would lead to the high cost of the government's domestic borrowing domestically or interest servicing. This type of interaction between the policy blocks, for example, B₁ and B₂, is represented as an indirect link which is shown by a two-way disjointed arrow.
 - Policy subblock B₃, represents cross-cutting policies, which are not included in the so-called direct budgetary policies or in the financial sector policies. They may receive government subventions for their implementation. Examples of cross-cutting policies include population policy, migration policy, and foreign direct investment policy. These policies also require public funding, but not in the same way that appropriations are made on education, health, and transport infrastructure and their operations in order to achieve their objectives. The link between the direct budgetary policies, B₁ and cross-cutting policies, B₃, is indirect. Likewise the link between B₂ and B₃. However, B₁ and B₂ are, respectively, directly linked to fiscal policy, A₁, and monetary policy, A₂, and indirectly impact on each other. The bridging development policies, B₁, B₃, and B₂ directly impact or influence microeconomic performance.
- Block C represents microeconomic policies which need strong support from the bridging development policies in order to produce satisfactory outcomes and hence, a good economic performance. Microeconomic study is concerned with individual economic units or agents, such as firms or companies, costs, consumers, markets, goods, services, prices, wages, dividends, and interest on capital or loans. These economic units, agents, or variables are influenced by microeconomic policies, such as the government's competition policy, liberalisation policy, deregulation policy, and regulatory measures or controls. These policies are grouped into two — namely *free market* and *interventionist policies*:
 - Policy subblock C₁ represents interventionist policies, such as price controls, quotas, and regulatory measures that specify how businesses operate; and
 - Policy Sub-Block C₂ represents free market policies, such as competition policies, deregulation, and liberalisation. The distinction between C₁ and C₂ may sometimes be blurred. For example, the Government may put a regulation in place to prevent a monopoly or oligopoly from thriving. In a real world, the microeconomic policies are a mixed bag of free market policies and regulatory policies, which, respectively, are less costly and more costly to the Government, with regard to budget implications.

The linkages between microeconomic policies, the bridging development policies, and macroeconomic policies are not obvious; consequently their significance is hardly recognised for policy attention. This would not matter if the three sets of policies, which are called development policies here, were individually sound.

Ordinarily, government revenue collections and the disbursement and expenditures to meet different needs are not commonly perceived as development policies, even though they are. An interest rate policy, migration policy, foreign direct investment policy, foreign aid policy, tax policy, budget deficit policy, health policy, transport policy, or population policy has its setting in Diagram 3.

The second level building policy blocks, B_1 , B_3 , and B_2 form a bridge between the microeconomic policies and the macroeconomic policy. Their importance can easily be realised. With weak links to the microeconomic policy block, their effectiveness on investment decisions and microeconomic performance would be insignificant, which would undermine economic growth and development, even if the macroeconomic policy was sound. Their design and implementation will play a role in the determination of the type of economic growth and development that is experienced. The soundness of the bridging development policies will determine whether the economic growth is broad-based and sustainable.

Diagram 3 represents a model of development policies, with complex interactions that are designed into building policy blocks in order to discuss each policy block's setting and the role it plays to bring about growth and development. The disconnection between the policy blocks is not easily perceived and addressed in the real world. The government's macroeconomic policy influences businesses that produce goods and services. The bridging public policies and microeconomic policies also influence business start-ups and expansion. These three policies blend into a policy-mix that influences or impacts investment decisions, D_1 , which, in turn, impact the economic performance, D_2 . All economic goods and services which are produced in a year are aggregated as the Gross Domestic Product, the GDP. The growth of the GDP may be considered as an indicator of economic performance, which underpins the nation's wealth and well-being, D_3 .

The GDP in PNG is much larger than the national income which accrues to the citizens. The GDP accrues to the productive factors, some of which are from overseas. The GDP, less the amount of the GDP that is repatriated to overseas factors of production, is called the Gross National Product, GNP, which is relatively small. In PNG a considerable proportion of the GDP is produced in the extractive industries – minerals, petroleum, and logging. These industries also generate substantial government revenues. Unless the government's take is partly used to promote sound development projects and programs, economic growth would be stalled in the predominant non-extractive industries sector. The primary exports occasionally yield windfall revenues, which should be utilised to broaden income creation in order to enhance a greater participation of the citizens.

Despite the fact that all development policies matter in a nation's wealth creation, a focused fiscal policy on broad-based growth drivers should be a must. However, many developing countries, including PNG, emphasise macroeconomic policy stability. When they get it right, they seem to rest on their achievements, while the

economy remains underdeveloped and while essential infrastructure and programs, such as law and order and transport, are ignored or decline.

Fiscal and monetary policies need to be proactively formulated to address broad-based growth or sustainable poverty reduction, which is the main problem facing these countries. The focus on macroeconomic stability policy is important, but not sufficient. Scant policy attention is paid to this contention which is easily explained:

- Many relatively less-developing countries seem to simply mimic the policy orthodoxy. Macroeconomic policy is much stressed and talked about because:
 - it is necessary for growth;
 - its literature is readily available; and
 - there is empirical evidence, which strongly supports a high positive correlation between macroeconomic policy stability and economic performance.
- Macroeconomic stability policy is relatively simple to formulate and implement in order to achieve its stability. Fiscal discipline is significantly what is required to match the government's expenditure to the total receipts in a sustainable way. With fiscal stability, monetary policy must focus on price stability.
- The development literature provides unclear guidance about a policy-mix that promotes broad-based growth, and hence, sustainable poverty reduction. The more developed countries (MDCs) already have in place growth and development drivers that only need fine tuning. The MDCs hardly have fiscal impediments to develop sectors such as education, health, law and order, transport, and agriculture, and other key areas, such as the financial sector, in order to promote broad-based growth and development. However, for a country such as Papua new Guinea, the gross fiscal policy deficiencies cannot be resolved in the short- to medium-term — not even by application of windfall revenues.
- However, the development policies, in particular, most bridging development policies that are needed to complement sound macroeconomic policy to promote broad-based growth and development, are difficult to put in place in a developing country because of:
 - the inadequacy of development finance;
 - the complexity of the interaction of the development policies;
 - the inadequacy of bureaucratic capacity or political interventions;
 - a benign neglect of appropriate development policies that are required to achieve mass poverty reduction;
 - the economic dependence of primary exports whose performance is substantially determined by exogenous factors, such as world prices for the dominant commodity prices or supply responses to weather or exploration findings; and
 - lack of institutional capacity to minimise corrupt practices.

An emerging economy from an agrarian or traditional society to a monetised economy faces onerous challenges to build adequate development policy blocks (see Diagram

3). Sufficiency of development policies is highly correlated with the level of development. Developing countries are less likely to have in place, formulate, and implement the bridging public policies, B₁, B₃, and B₂. Generally, most developing countries lack adequate development finance, bureaucratic experience and capacity, and good governance. Sound economic policy measures are usually not popular. Political commitment to tough policies is usually soft.

It is highly likely that several of the policy blocks in Diagram 3 would have weak links to their immediate block, inappropriate instruments, or vacuous measures. The question is, ‘How and when can sufficient bridging development policies be put together and implemented in order to tackle the impediments to satisfactory growth?’. The BWRs should be used to address the top ranking constraints in order to broaden growth.

Diagram 3: Building Policy Blocks

