

Budgeting in a weak state: the new Somare government's first attempt

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The outgoing government of Sir Mekere Morauta left behind the biggest deficit in Papua New Guinea's history, despite Sir Mekere's reputation for fiscal responsibility.

Following its election early in 2002, Sir Michael Somare's third government was confronted by the news that, in the absence of an immediate revision of the current budget, the projected deficit for 2002 would be over 800 million kina, or 7.7 per cent of GDP before taking into account asset sales (for example, PNGBC and Orogen) or expected proceeds (for example, Telikom).

The Treasury proffered the following explanation in its Supplementary Budget presented to Parliament on 28 August.

- The economy continues to be in deep recession, with falls in real GDP per head of 4.3 per cent in 2000, 6.5 per cent in 2001, and a projected 3.4 per cent in 2002, indicating that real national income per person has fallen by 14 per cent since 1999.
- Interest rates were declining but have started to rise again.
- In 2002, the kina has depreciated by 4.4 per cent against the US dollar and by 13.5 per cent against the Australian dollar.
- Foreign exchange reserves fell by US\$16 million during the first half of 2002 (to US\$409 million) and are still falling.

- The 2002 Budget was already in deficit 210 million kina or 2 per cent of GDP by June 2002, equivalent to the deficit for the whole year in the original budget and, after allowing for debt servicing, creating a domestic financing requirement of 341.8 million kina.

The key factors explaining the potential deficit for 2002 were said to be

- shortfalls in revenue from taxation and grants, projected to be 165 million kina (or 5 per cent) less than in the original budget
- higher and/or unbudgeted expenditures totalling 458 million kina, including on elections (73 million kina), Yumi Yet bridges (115 million kina), new roads (103 million kina), salaries and wages awards (60 million kina), utilities and rents (43 million kina) and higher than expected interest costs of 68 million (due to the fall in the kina).

The Treasurer concluded that a 7.7 per cent deficit, if left intact, would have major adverse consequences for the exchange rate, inflation and foreign exchange reserves.

With the economy in almost continuous recession since 1997, the Treasurer should perhaps have given some consideration to what could be done to mitigate the recession before settling on the structure of the Supplementary Budget. Keynes, who was far

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from being a supporter of deficit finance for its own sake, noted 'there is no possibility of balancing the budget except by increasing national income' (cited in Ferguson 2001:128).

Instead, the Treasurer recommended policies to reduce the deficit by concentrating entirely on reducing expenditure, which

- cut the development budget by 179 million kina
- cut spending by national government departments for the remainder of 2002 by 123 million kina
- reduce grants to provinces by 34.4 million kina and to statutory authorities by 8.5 million kina
- make savings on interest payments (32.2 million kina).

The Treasury proposes that these cuts would need to be matched by further expenditure cuts of 369 million kina in the 2003 Budget, involving reductions in

- the education subsidy (75 million kina)
- the 2003 development budget (141 million kina)
- national government departments' goods and services (94 million kina)
- grants to provinces (32 million kina)
- transfers to statutory institutions (28 million kina).

The remaining deficit of 334.5 million kina (or 3.2 per cent of GDP) may still cause some alarm, not least in Washington, DC and Canberra with their addiction to balanced budgets. The original budget's projected deficit of 214.5 million kina (2 per cent of GDP) would have been more than covered by the 'below the line' projected privatisation proceeds of 303 million kina, allowing a reduction in domestic debt of 49 million kina. By treating asset sales as recurrent revenue, the 2002 Budget would thus have been in surplus. Using that approach, the deficit to be financed by net domestic borrowing for the new Somare government was 'only' 542.7 million kina.

This measure of the deficit also provides a yardstick for assessing the Supplementary Budget, since its expenditure cuts will only reduce net domestic financing of the budget to 103 million kina if an extra 88 million kina accrue from asset sales in the rest of 2002, which is unlikely, given the new government's decision to put the privatisation process on hold. Without that inflow, the final 2002 net domestic financing requirement is likely to be around 200 million kina, as against the original budget's surplus, despite the large expenditure cuts.

The Supplementary Budget's base deficit of 334.5 million kina would be considered unacceptably large by the International Monetary Fund, at 3.2 per cent of GDP. It should be noted, however, that Japan currently has a deficit of 7 per cent, and the United States and the European Union countries' deficits were around 5 per cent in the early to mid 1990s.

Indeed, the United Kingdom's average budget deficit from 1990 to 1999 was 3.8 per cent (hence its decision to stay out of the euro). This was a period when its average unemployment rate was well below that of some European Union members. Italy's deficit averaged over 7 per cent from 1945 to 1999, without any evident signs of hardship. Significantly, the United Kingdom's budget was in surplus throughout a long period of low unemployment, from 1945 to 1969. Could it be that Papua New Guinea should wait until it has achieved full employment before it aspires to budget surpluses?

In Papua New Guinea's case there could also be doubts about the specifics of the Supplementary Budget. The Treasury's advice was that no revenue measures should be put forward in the Supplementary Budget, on the grounds that such measures would have a significant negative impact on an already depressed economy, implying that expenditure cuts would not have any negative impacts.

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While both revenue increases and expenditure cuts can have serious negative effects on an economy, spending cuts may reduce future tax receipts more than the same quantum of revenue measures. For example, much of the goods and services cuts have an immediate impact on sales of the private sector, and must be expected to reduce the Treasury's projections for proceeds of company income taxation and value-added tax (VAT) in 2003. In addition, there is the theoretical argument that a revenue increase combined with an equivalent expenditure increase for a budget neutral outcome is expansionary (as the marginal propensity to consume of consumers/business is less than one), and that in the context of Papua New Guinea's chronic recession since 1997, perhaps more attention should have been given to this aspect.¹

The Treasury includes an amount of 60.4 million kina in lower interest payments as one of the expenditure 'cuts'. However, existing interest payments cannot be 'cut' unless debt is paid off, and there is no indication of that. Interest on external debt is expected to be up by 34.7 million kina for the full year, given that by June, at 80.2 million kina, it was running below the pro rata budget projection to June of 97 million kina.

The Treasury's biggest cut is to the development budget (159 million kina), but this seems to be offset by a reduction in the 2002 Supplementary Budget for concessional loans of 80 million kina. Is this because cancelling counterpart contributions reduces concessional loan drawdowns? In reality, counterpart funding is usually not more than 40 per cent of the project amount, so for every 100 million kina of cuts in development spending, loan drawdowns could be reduced by 60 million kina, for a net reduction of only 40 million kina in the deficit.

The Treasury also recommended cuts in grants to the provinces. Such reductions without full consultation are contrary to the Organic Law and have already led to costly

court orders against the State (for example, Morobe and Eastern Highlands). It is not clear that the Treasury has taken all steps necessary to comply with the Organic Law.

Other proposed cuts for the remainder of 2002 and 2003 are goods and services allocations to the national government departments. Eighteen months ago most national departments were non-functional because of non-payment of rentals and electricity bills, among other goods and services, and it is surprising to see Treasury advocating a return to such inefficient solutions.

The blow-out in the 2002 Budget includes a large number of unbudgeted items, although the Constitution and the Public Finances Management Act do not provide for such items. The Treasury's projections for the 2003 Budget imply that the unbudgeted expenditures in 2002 will be repeated in 2003, necessitating further cuts. However, if the 2002 Budget ceilings are adhered to, there should be no need for further cuts, unless the impact of the proposed 2002 cuts is what largely explains the projected revenue shortfalls of 300 million kina in 2003. The main problem in 2003 seems to be largely one of lower revenues. If it is true that external debt servicing and repayments will be a major problem in 2003, the Treasury needs to take steps now to institute debt rollover negotiations.

A more balanced approach could have been taken to dealing with the 2002 deficit blow-out by putting forward a combination of expenditure cuts and new revenue measures. Additional revenue could be raised by a number of ways, including

- a general increase of 1–2 per cent in income tax rates, that could raise 20–40 million kina
- a temporary import surcharge of about 5 per cent, and
- a temporary waiving of VAT input refunds—the latter two measures could raise very large sums, of up to 250 million

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kina, but would need further examination in terms of the country's APEC obligations and other factors.

The Internal Revenue Commission advised the Treasury in August 2002 that a doubling of the VAT rate to 20 per cent would largely eliminate the budget deficit. This, of course, would be politically unacceptable, despite most Papua New Guineans decrying the lack of government services. The existing VAT is in reality little more than a general import duty of 10 per cent, since inland collections have been very difficult (if not impossible), especially in the Highlands. The advantages of an import levy are that it would not require the VAT system's input refunds, and it would further encourage a shift of consumption from imports to domestic production.

The latter point is just one example of the absence of 'strategic forward planning' in the 2002 Supplementary Budget. Another option with similar effect would be a temporary abolition of VAT credits on inputs. This would have the effect of turning the VAT into a cascading sales tax, but given the relatively few stages of processing imports and other commodity inputs in an economy with little manufacturing, this effect would not be very severe, and it would produce a substantial increase in internal revenue without the announcement effects of a doubling of VAT.

If the aim is mainly to reduce the net deficit to less than 3 per cent of GDP, then a combination of some of the above revenue measures and a smaller package of expenditure cuts to reduce the deficit by a total of 150–200 million kina would achieve this goal, and much less if GDP recovered in 2003 to above 10.52 billion kina, as it could with such a more balanced package of measures in the Supplementary Budget.

The years of no gross domestic borrowing (and reduction in domestic public debt) tend to coincide with IMF–World Bank Structural Adjustment Programs (SAP), in 1990–91, 1996–97 and 1999–2001. These years of overall surplus are followed by years of

overall deficit, in the sense of resumed gross domestic borrowing, that are in large measure attributable to the debt servicing of SAP loans.

Among the unbudgeted excesses noted by *The National* was the extra 70 million kina for the Yumi Yet Bailey bridges. Other items included an additional 60 million kina for public service wages, largely due to a predictable pay award and 29 million kina for the costs of privatisation. In addition to noting that Sir Mekere Morauta was 'at the end of the day... the chief executive, he was the chief accounting officer', *The National* further declared that 'the second group who must share the blame are the senior finance and planning and Treasury officials' (*The National*, 'Opinion', 29 August 2002).

Looking ahead, the Somare government's new Minister for the Public Service, Dr Puka Temu (formerly Secretary for Health), has promised Parliament that corrective measures would be taken to ensure that public officials once again become fully accountable (*The National*, 29 August 2002). Until that has been seen to be done, the jury will have to be out on the new government's ability to turn back the clock.

Notes

- ¹ I am indebted to Ali Noore for reminding me of this point.

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