THE NORFOLK ISLAND GOVERNMENT'S FINANCIAL POSITION – ONE YEAR LATER

This report was prepared for
the Norfolk Island Government
by Econtech Pty Ltd.

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Executive Summary

Econtech was commissioned in 2006 by the Norfolk Island Government (NIG) to examine their current and future financial position. As part of this analysis, Econtech constructed an economy-wide model of the Norfolk Island economy. The Norfolk Island (NI) Model provided the first comprehensive picture of the Island's economy.

The 2006 Econtech modelling showed that, under the existing policy, the NIG was expected to achieve a net positive operating cash flow position in each year over the five years to 2010/11. However, this net operating cash flow was not expected to be high enough to cover Norfolk Island's ongoing investment needs. It was estimated that, with no change to current policy, there would be an average annual budget hole of about $1.6 million over this period.

Since the Econtech 2006 analysis, the NIG has made a number of changes to its taxation and tourism policies. In addition, there is now more recent Government budget information. Thus, the NIG has now asked Econtech to update its 2006 modelling to reflect the latest data available and to incorporate the new policies and tourist initiatives.

As part of the model update, Econtech produced a new Baseline scenario, which estimates the size of the Island's economy and the NIG budget under the current policy arrangements. Specifically, the Baseline scenario:

- incorporates all the recent changes to taxation policy (including the 9 per cent GST);
- includes tourist numbers of 34,300 in 2006/07, growing at 7.6 per cent per year in the next two years (to reach 39,700 by 2008/09); and
- assumes real spend per tourist has grown (and will continue to grow) at 2 per cent per year since 2004/05, in line with rising living standards.

Econtech found that the higher number of visitors (related to the recent NIG tourist initiatives) is expected to lead to more tax being collected on the goods and services that tourists use. Higher economic activity (as a result of the higher tourism) will also flow through to boost demand for goods and services provided by GBEs. These two effects give an overall boost in the NIG's net operating cash flow in 2008/09.

The changes to taxation policy include replacing a number of more narrow based taxes with a more broad based Goods and Services Tax (GST). The overall effect is higher taxation compared to under 2005/06 policies. Higher taxes will dampen economic activity, leading to lower existing tax collections and lower GBE activity. However, additional GST collections are expected to more than offset the other lower tax collections and the lower GBE revenues. Thus the new tax policies are expected to give an overall boost to the NIG's net operating cash flow in 2008/09.

The modelling estimates that under the current Norfolk Island policies, the NIG will have a net operating cash flow of $3.3 million in 2008/09. This net operating cash flow is a significant improvement to recent year results (indicating that the new policies and initiatives are heading in the right direction). However, it still falls short of likely ongoing investment needs (with an average budget hole of around $0.4 million estimated over the three years to 2010/11).

1. Introduction

In February 2006, an inquiry into the governance arrangements on Norfolk Island was announced by the Minister for Local Government, Territories and Roads, the Hon Jim Lloyd.

As part of their contribution to this inquiry, the Norfolk Island Government (NIG) commissioned Econtech to examine the financial position of the NIG. The Econtech report (2006) examined the NIG's current and future financial position, assuming there was no change to current policy. It then looked at alternative strategies for the NIG, designed so that the NIG could achieve its service and infrastructure objectives while remaining viable. Finally, and importantly, the Econtech report showed that the initial information driving the Australian Government's inquiry contained a number of inconsistencies.

Following an intensive consultation process, Mr Lloyd announced on 20 December 2006 that the Australian Government had decided not to proceed with changes to the governance of Norfolk Island. He said in his press release that "the Government has taken account of the efforts of the Norfolk Island Government to increase revenue and to promote the growth of tourism to the island."[1]

Econtech's 2006 report showed that, while it was unlikely that the NIG's financial position was sustainable under their current policy framework, a few changes to its revenue and/or tourism policies should remedy this situation. In line with these findings, the NIG has introduced new tax policies and tourism initiatives (which will be discussed further in Section 4).

The Norfolk Island Government (NIG) has now commissioned Econtech to update its modelling of the Norfolk Island economy to reflect these new policies and to facilitate future projections. For this update, Econtech started by examining the NIG's current financial position under these new policies. The analysis then presents updated projections of the NIG's future financial position.

Thus, this report is structured as follows.

- Section 2 outlines the findings in Econtech's 2006 analysis.
- Section 3 provides a brief overview of the Norfolk Island Model (NI Model) and explains the steps undertaken during this update.
- Section 4 presents the current picture for the Norfolk Island economy and discusses the developments since the publication of the 2006 report.
- Section 5 presents estimates of the NIG's future financial capacity.

While all care, skill and consideration has been used in the preparation of this report, the findings refer to the terms of reference of the Norfolk Island Government and are designed to be used only for the specific purpose set out below. If you believe that your terms of reference are different from those set out below, or you wish to use this report or information contained within it for another purpose, please contact us.

[1] The Hon Jim Lloyd MP, *Norfolk Island Governance Arrangements*, Media Release 20 December 2006.

The specific purpose of this report is to update the Econtech model of the Norfolk Island economy to reflect changes in government policies since 2006, and to facilitate future projections.

The findings in this report are subject to unavoidable statistical variation. While all care has been taken to ensure that the statistical variation is kept to a minimum, care should be taken whenever using this information. This report only takes into account information available to Econtech up to the date of this report and so its findings may be affected by new information. Should you require clarification of any material, please contact us.

2. Econtech's 2006 Analysis

In response to a number of studies into the Norfolk Island Government's (NIG's) future viability (Acumen Alliance[2], Commonwealth Grants Commission[3]), Econtech was commissioned in 2006 by the NIG to examine their current and future financial position. As part of this analysis, Econtech constructed an economy-wide model of the Norfolk Island economy. The Norfolk Island (NI) Model provided the first comprehensive picture of the Island's economy.

The NI Modelling had a number of advantages over the previous studies. These advantages included the following.

- In the NI Model, GTP was estimated from both the industry and expenditure sides of the economy;
- The modelling captured both the direct and indirect impacts of policies.
- The model used an economy-wide approach, with consistent methodology. For example, there was consistent application of inflation across both expenditures and revenues.

The 2006 Econtech report showed that, under existing 2006 policy, the NIG was expected to achieve a net positive operating cash flow position in each year over the five years to 2010/11. However, this net operating cash flow was not expected to be high enough to cover Norfolk Island's ongoing investment needs. It was estimated that, with no change to current 2006 policy, there would be an average annual budget hole of about $1.6 million (in 2004/05 dollars) over this period.

The analysis also found that it was likely that this budget hole could be filled either by:

- increasing annual tourist numbers by around 10,000 visitors (boosting the economy); or
- raising the NSL rate from 1 per cent to 3 per cent (dampening the economy).

These two alternative policies would have the same result in terms of filling the budget hole. However, it was expected that they would have significantly different impacts on the level of economic activity on the Island. An increase in the number of tourists would boost activity across the economy. In contrast, an increase in the NSL rate would dampen activity across the economy.

Since the Econtech 2006 analysis, the NIG has made a number of changes to its taxation and tourism policies. These are discussed in more detail in Section 4, which examines NIG's current financial position. The NIG has now asked Econtech to update its modeling to reflect the latest data available and to incorporate the new policies and tourist initiatives. The following section provides background to the NI Model and information regarding the update.

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[2] Acumen Alliance, Norfolk Island Government Financial Advisory Report, November 2005

[3] Commonwealth Grants Commission, *Review of the financial capacity of Norfolk Island*, 2006

3. The NIG Model Update

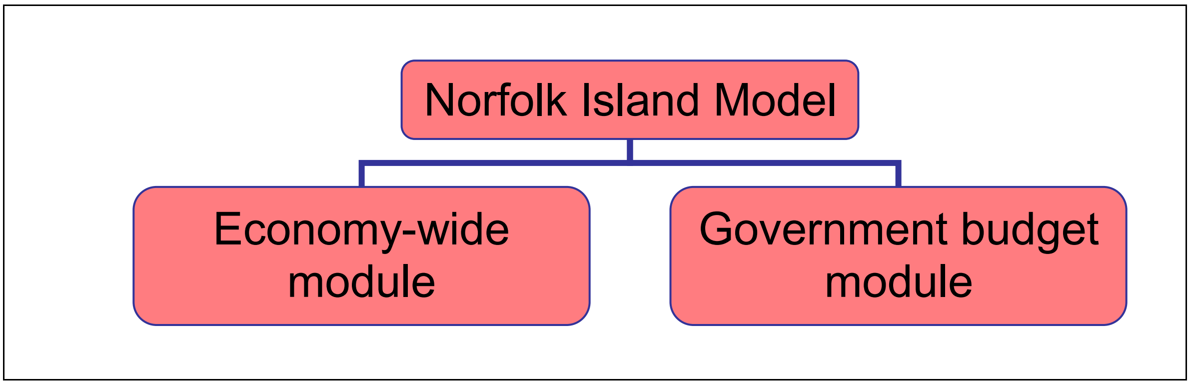
This section provides details of the methodology used in this (and the previous Econtech (2006) report) to estimate the current and future financial position of the NIG. It also describes the process undertaken and data used to update the 2006 modelling.

This section is structured as follows. Section 3.1 discusses the main features of the NI model, which is used to estimate the NIG's current and future financial position. Section 3.2 outlines the updating process. Section 3.3 discusses scenarios that are simulated using the NI model to analyse the impacts of the different current Norfolk policies.

3.1 The Norfolk Island Model

To estimate the current and future financial position of the NIG, Econtech constructed an economy-wide model of the Norfolk Island economy. The Norfolk Island (NI) Model is made up of two modules: the economy-wide module and the government budget module (as shown in Figure 3.1).

Figure 3.1
Structure of the Norfolk Island Model



As shown in the figure above, the NI model is an economy-wide model integrated with a budget model. This is distinct from a budget (or partial indicators) model that is driven by indicators that are not forecast in a consistent manner.

The NI modelling is based on "real" 2004/05 prices. In this way the modelling in this report avoids the problem of allowing for price inflation in some places but not others.

The two modules are each now discussed in turn.

Economy-wide Module

The NI model's economy-wide module uses an input-output model framework. It distinguishes the following 11 industries, which are largely based on the industry classifications used by the ABS in their Norfolk Island business survey.[4]

- Agriculture, forestry & fishing
- Mining, manufacturing & construction
- Retail trade
- Accommodation
- Cafés, restaurants & takeaway food services
- Clubs (hospitality), pubs, taverns & bars
- Travel agency & tourist arrangement services
- Government
- Government Business
- Ownership of Dwellings
- All other industries

In addition to industry detail, the NI model's economy-wide module also separately identifies 9 taxes, including the temporary NSL and the new GST:

- Customs Duty
- Accommodation Levy
- Norfolk Sustainability Levy (NSL)
- Norfolk Goods and Services Tax (GST)
- Vehicle Registrations and Licenses
- Departure Fees
- Financial Institutions Levy
- Fuel Levy
- Land Title Fees

The NI model's economy-wide module is demand driven. This means that activity across the economy depends on residents, tourists and government demand. This is reasonable for this model for two reasons.

1. The Island can expand labour supply through temporary residents. It is understood that Norfolk Island currently has the ability to meet labour demand through its Temporary Entry Permits (TEPs) scheme.
2. The tourism accommodation industry has spare capacity. Norfolk Island currently has 582 accommodation units[5] operating across varying standards of accommodation. While tourist numbers have recently ranged between 25,000 and 35,000, in the past (2000/01) the Island has successfully accommodated over 40,000 tourists.

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[4] ABS, *Norfolk Island Business Statistics*, Catalogue no. 8139.0

[5] There is also another 12 accommodation units not operating/not yet developed, but with secured quota positions. This means there is currently capacity for a total of 594 units.

The economy-wide model provides a picture of the Norfolk Island economy under a Baseline (or current policy) scenario from 2004/05 to 2010/11. This picture is in terms of GTP by both industry (separated into the 11 industries outlined above), and by four expenditure categories (private final demand, NIG final demand, Australian Government final demand and net exports). It also provides data to the NI model's budget module.

Budget Module

The NI model's budget module is used to estimate the current and future financial position of the NIG. To do this, the budget module draws on data from the economy-wide module. This data is then allocated across revenue and expenditure items either directly or based on existing relativities.

The budget module provides estimates of the current and future financial position of the NIG under the Baseline (or current policy) scenario from 2004/05 to 2010/11. It is also used to estimate the impact of alternative scenarios on government revenue and expenditure.

For a complete picture of the implications of the current policy and alternative policies on the NIG, the budget module includes estimates relating to both General Government (Revenue Fund) and Government Business Enterprises (GBEs).

3.2 The Model Update

The original NI Model that was used in the Econtech 2006 report was based on a complete set of 2004/05 data covering both the government sector and private sector activity. The government sector and budget data was sourced largely from the Norfolk Island Government accounts[6]. The private sector data was predominately sourced from a survey of Norfolk Island businesses conducted by the Australian Bureau of Statistics[7] and information on visitor numbers provided by Norfolk Island Tourism[8].

To update the model, the first step is to establish the extent of new data available. Obviously, the best outcome is if there is updated information covering all data sources used in the modelling. However, it is still possible to update a model using a "jagged edge" approach. This approach is used when there are different end dates for the different data sources used in the model.

For this update, the Administration of Norfolk Island Financial Statements for the 2006/07 financial year provided updated data covering the NIG's demand and the government budget components. Further, new information on visitor numbers was also available to June 2007. The remaining data was that used in the 2006 analysis.

[6] Norfolk Island Government, *Chart of Accounts*, 2004/05; Norfolk Island Government, *Customs Duty Statistics*, 2004/05; Norfolk Island Government, *The Administration of Norfolk Island Financial Statements, Year Ended 30 June 2005*, 2004/05.

[7] Australian Bureau of Statistics, Norfolk Island Business Statistics (Catalogue no. 8139.0), June 2006.

[8] Norfolk Island Tourism, *Inbound Passenger Statistics*, June 2006.

The model update comprised of two main steps.

- The first involved recalibrating the Economy-wide module by incorporating the new government revenue data and the new information relating to tourist and government demand. This step provides an updated picture of the structure of Norfolk Island economy.
- The second step was to use this new picture of the economy to calculate new budget parameters. The new parameters are based on the latest government budget information. These parameters are then used to produce later year budget forecasts.

Further, while the model is still based (and built using) 2004/05 data, the results sheets and charts have been updated to also provide results in "real" 2006/07 prices. The base prices are clearly indicated in each of the model sheets.

3.3 Model Scenarios

To examine the current and future financial position of the NIG under the Island's current taxation policies and tourism initiatives, Econtech produced an updated Baseline scenario. This Baseline scenario includes the following assumptions.

- It incorporates all the recent changes to taxation policy (discussed further in Section 4). For example, while the original 2006 modelling incorporated a 1 per cent (compounding) NSL into its baseline, this updated Baseline scenario instead includes the new 9 per cent GST.
- It includes tourist numbers of 34,300 in 2006/07, growing by 7.6 per cent per annum in the following two years to reach 39,700 by 2008/09. This is higher than the original baseline used in the Econtech 2006 modelling (35,100 in 2008/09). This reflects effective marketing of the Island as a holiday destination through the combined efforts and funding from the NI Tourism Bureau, Norfolk Air and internal and external wholesalers. The higher tourist baseline is based on the recent growth in arrival numbers over 2007, and assumes this growth is maintained over the next 18 months.
- It assumes real spend per tourist has grown (and will continue to grow) at 2 per cent per year since 2004/05, in line with rising living standards. This is the same assumption used in the original 2006 modelling.

In addition to the Baseline scenario, this analysis includes four alternative scenarios.

The first two alternative scenarios are designed so that the recent changes in taxation policy and tourism initiatives can be examined separately. These two scenarios are outlined below and discussed in the main body of the report.

- The ***2005/06 Tourism*** scenario estimates the size of the Island's economy and the NIG budget if tourist numbers had remained at their 2005/06 level.
- The ***2005/06 Taxation*** scenario estimates the size of the Island's economy and the NIG budget if there were no changes to the taxation policy that was in place in 2005/06 (for example, no 9 per cent GST).

The difference in the economic and budget outcomes between these two alternative scenarios and the Baseline scenario is used to determine the impacts of the new tourism initiatives and taxation policies.

It should be noted that the two alternative scenarios have been modelled independently. That is, the tourism scenario uses the same taxation assumptions as the Baseline scenario. Similarly, the taxation scenario uses the same tourist assumptions as the Baseline scenario.

In addition, a second set of two alternative scenarios have been modelled and the results are presented in the attachment. These two scenarios look at the impact (and illustrate the sensitivity of the Norfolk economy) if tourists significantly change their average spending habits. These two scenarios are outlined below.

- The ***Higher Tourist Spending*** scenario examines the impact if average tourist spending is significantly higher than estimated in the baseline (increasing from $1,300 to $2,000 per tourist in 2008/09 and 2009/10).
- The ***Lower Tourist Spending*** scenario examines the impact if average tourist spending is around half that estimated in the baseline (falling to $650 per tourist in 2008/09 and 2009/10).

These two tourist spending scenarios both illustrate a significant change tourist expenditure and, hence, to the Island's economy. Thus, it is expected that some of the impacts of such a dramatic change would not be felt immediately and would depend on whether it was expected that the change was temporary or ongoing. As a result, the outcomes under these two scenarios are presented for 2009/10, once the economy has settled into a new level of ongoing tourist spending.

The following section looks first at the current NIG financial position. The discussion in that section looks at what has changed since the last report, in terms of taxation policy and tourism initiatives. It draws on the first two alternative scenarios to illustrate their individual impacts. It also provides some Baseline scenario results for comparison.

A more complete and detailed discussion of the Baseline results is then provided in Section 5.

4. The Norfolk Island Government's Current Financial Position

Following the release of the Econtech 2006 report, the Norfolk Island Government (NIG) has been working towards a more sustainable future. There have been two main areas of change: in terms of tourism and taxation.

The NIG recognises the importance of tourism to the Norfolk Island economy, and has been putting in place strategies to attract more visitors. Since the collapse of Norfolk Jet Express in June 2005, the Norfolk Island Government has worked to maintain air services to Australia by establishing Norfolk Air. Norfolk Air is a government business enterprise (GBE) operated by the Norfolk Island Government. Norfolk Air initially provided direct flights from Brisbane and Sydney. More recently, Norfolk Air has expanded its schedules to include direct flights from Melbourne and Newcastle[9]. In addition, Norfolk Island has been working to strengthen relationships with travel industry partners and to focus more on the group and events market[10].

The NIG has also recognised the need to raise sufficient taxes to remain viable. In assessing the right mix of taxation in Norfolk Island, the NIG has removed a number of more narrow based taxes (such as the Accommodation Levy) and replaced these taxes with a more broad based Goods and Services Tax (GST). Further details on the recent taxation policy changes will be discussed in sub-section 4.3.

In examining the effects of the NIG's recent tourism and taxation policy changes, this report first examines recent changes in the NIG's current financial position (sub-section 4.1). This is followed by a discussion of the changes in tourism numbers (sub-section 4.2) and taxation policy (sub-section 4.3), which have both affected the NIG's financial position. Section 5 summarises the likely impact of these combined policies on the NIG's future financial position.

4.1 The NIG's Financial Position

The table below compares the NIG's current financial position (as reflected in 2006/07) with results from 2004/05 and 2005/06. The results in each year have been adjusted to remove variations due to price inflation. By presenting the results in constant 2006/07 dollars, this allows a direct comparison to be made across the years.

Table 4.1
NIG Financial Position (constant 2006/07 prices, $'000)

	2004/05	2005/06	2006/07
Government Revenue	7,733	6,694	9,295
Government Expenditure	11,064	10,974	12,312
General Government Balance	-3,330	-4,280	-3,018
GBE balance	4,212	4,474	5,513
Net Operating Cash Flow	**882**	**194**	**2,496**

Source: Norfolk Island Government's Financial Statements

[9] http://www.norfolkair.com/schedules.aspx
[10] http://www.norfolkisland.com.au/special_features/21.cfm

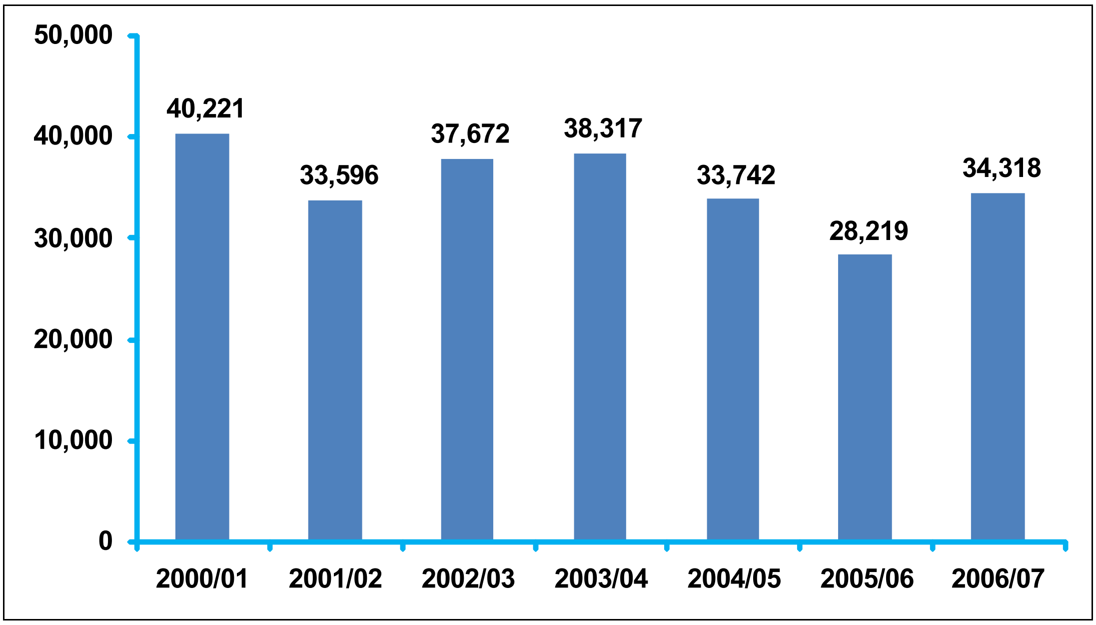
The 2006/07 budgetary position represents an improvement in real terms on that of the preceding two years. As can be seen in Table 4.1, the Net Operating Cash Flow increased to $2.5 million in 2006/07 after dipping to a low of $195 thousand in 2005/06.

As discussed in the introduction to this section, there have been two major changes to NIG policy which will have impacted on the NIG's financial position. These are in the areas of tourism and taxation. Increased tourist numbers and NSL/GST tax collections can partly explain the improvement in NIG's financial position in 2006/07. It is expected that these policy initiatives will further improve the NIG's position over the coming years. The following sub-sections explain the two changes in more detail.

4.2 The Impact of Changes to Tourism Initiatives

The Norfolk Island economy relies heavily on its tourism industry, meaning that tourist numbers are an important driver of economic growth. Chart 4.1 shows annual tourist activity in Norfolk Island over the past few years.

Chart 4.1
Annual Tourist Numbers



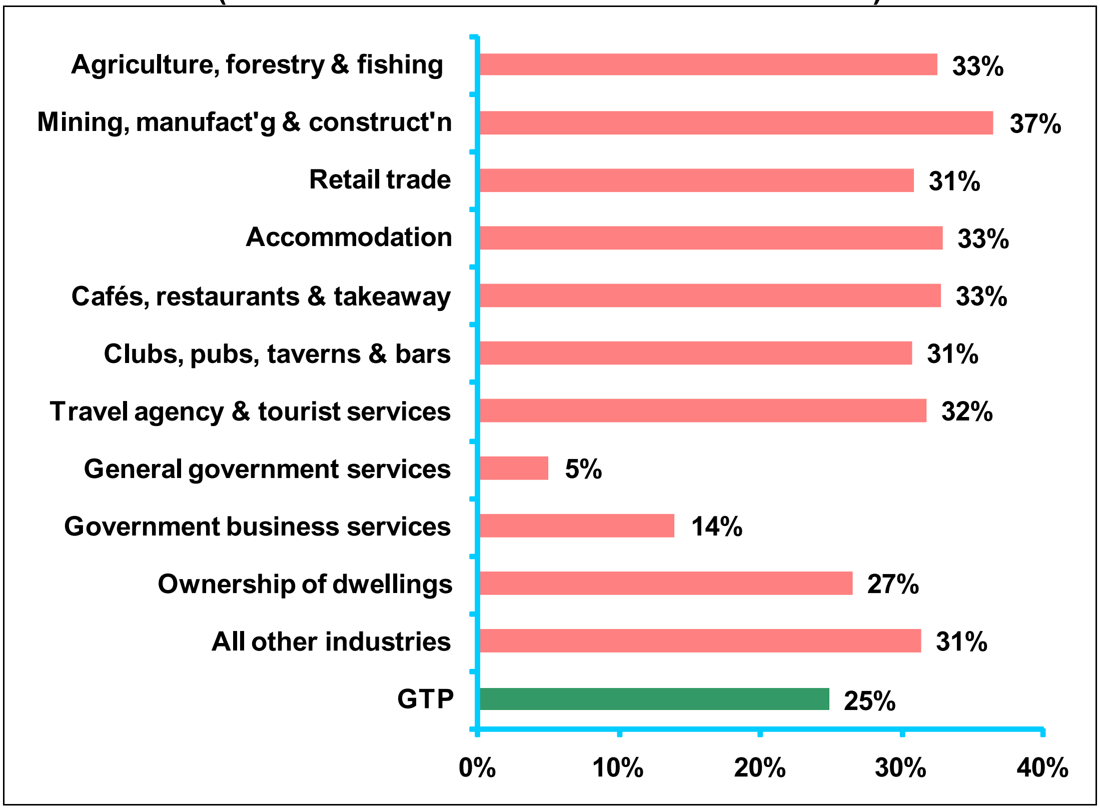
Source: Norfolk Island Tourism, Inbound Passenger Statistics 2006-07

As discussed earlier, there was a significant dip in tourist numbers in 2005/06, following the collapse of Norfolk Jet Express. However, the establishment of Norfolk Air, combined with increased marketing activity, has meant that there was a strong recovery in tourist numbers in 2006/07. In fact, the final tourist numbers in 2006/07 were close to those modelled in the "higher tourism scenario" in Econtech's 2006 analysis.

During 2008/09, additional funding of $900,000 ($500,000 from external grant partnership funding and $400,000 from Norfolk Air) has been invested into tourism marketing. In addition, the NI Tourism Bureau has implemented a comprehensive marketing plan which should see more strategically focused marketing expenditure. This contribution to marketing is expected to continue into the future.

Chart 4.2 shows the expected impact of additional tourist activity on industry activity in the Norfolk Island economy. Under the Baseline scenario, the recovery in tourism (building to approximately 39,700 visitors by 2008/09) is estimated to add 25 per cent to GTP in 2008/09, compared to if visitor numbers had remained at 2005/06 levels (the *2005/06 tourism* scenario). This effect includes both the direct and indirect impact of the increase in tourist numbers.

Chart 4.2
Industry Activity with Baseline Tourist Activity in 2008/09
(Deviations from *2005/06 Tourism* Scenario)



Source: NI model

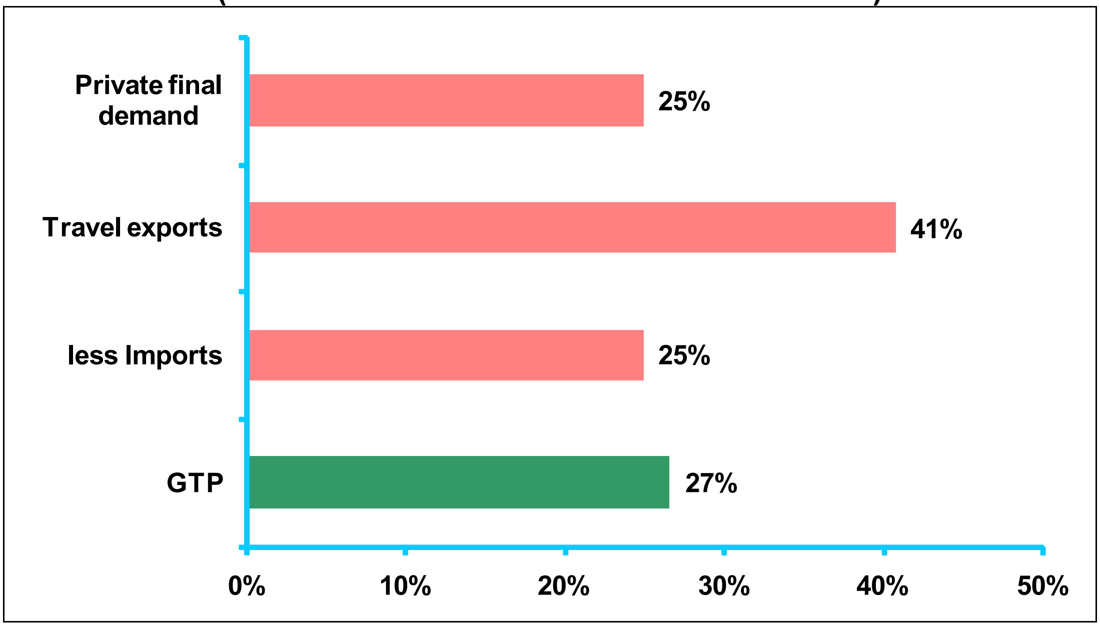
The direct impact arises because extra tourists will demand extra goods and services such as accommodation services and restaurant meals. The chart above shows activity in the tourist related service industries (such as the Accommodation industry, the Café's, restaurants and takeaway services industry; the Clubs, pubs, taverns and bars industry, and the Travel agency and tourist services industry) is all expected to be around 32 per cent higher with higher tourism, compared to if visitor numbers were the same as in 2005/06 (the *2005/06 tourism* scenario).

This in turn will flow through to higher demand by the tourist related industries for the goods and services that they use in producing their output. For example, in servicing more tourists, the restaurants industry is likely to demand more ingredients. This means that there is more demand for, and consequently more activity in the food manufacturing industry. This, in turn, will flow through to increased demand by the food manufacturer for the goods and services that are used in the production of those restaurant ingredients. All of these flow-on (or indirect) impacts are captured in an economy-wide model such as the NI model.

Chart 4.2, above, shows that the industry gains (relative to the *2005/06 tourism* scenario) range from 5 per cent for government services to 33 per cent for the Accommodation industry.

As discussed above, the boost to industry activity is driven by a boost in demand for industry output. Chart 4.3, below, shows the expected impact of additional tourist activity on demand in the Norfolk Island economy.

Chart 4.3
Change in Expenditure with Baseline Tourist Activity in 2008/09
(Deviations from *2005/06 Tourism* Scenario)

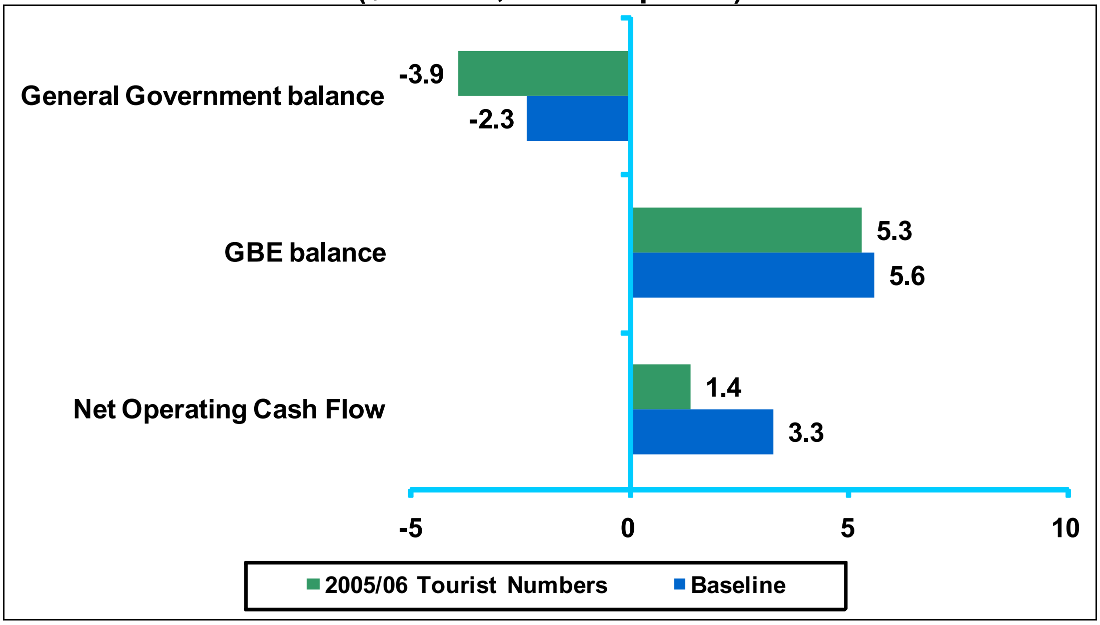


Source: NI model

Chart 4.3 shows that more tourists mean higher travel exports of around 41 per cent. With more tourist spending across the economy, the boost in economic activity leads to increased private disposable income. With more money to spend, consumption by Norfolk Islanders (private final demand) is expected to be around 25 per cent higher than under the *2005/06 Tourism* Scenario. Additional demand will lead to more local production and imports, with Chart 4.3 showing imports are expected to be around 25 per cent higher, relative to the *2005/06 Tourism* Scenario.

The increase in tourist spending and economic activity across the Norfolk Island economy is expected to flow through to a higher net operating cash flow for the NIG. Chart 4.4 shows the NIG's cash flow position under the Baseline in 2008/09 compared to the cash flow if tourist numbers had remained at 2005/06 levels.

Chart 4.4
The NIG's Net Cash Flow with Baseline Tourist Activity in 2008/09
($ million, 2006/07 prices)



Source: NI model

The higher tourist spending under the Baseline is expected to lead to more tax being collected on the goods and services that tourists use. In particular, Customs Duty and GST collections are both expected to be higher. This boost to taxation revenue will flow through to lower the General Government's deficit.

Higher economic activity will also flow through to boost demand for goods and services provided by GBEs. For example, an increase in Accommodation services is likely to lead to an increase in the use of telecommunication and electricity services, which are both provided by GBEs. The chart shows that the GBE balance is expected to be a higher $5.6 million under the Baseline in 2008/09 compared to $5.3 million if tourist numbers had remained at 2005/06 levels.

These two effects give an overall boost in the NIG's net operating cash flow in 2008/09 of $1.9 million ($3.3 - $1.4) compared to the *2005/06 Tourism* Scenario.

4.3 The Impact of Changes to Taxation Policies

In addition to tourism initiatives, the NIG has made some significant changes to its taxation policies since the Econtech 2006 report. The main change has been the introduction of a broad based consumption tax (GST). This tax has been used to both replace some of the more narrow based taxes, and to boost revenue collections. The taxation policy changes are summarised in Table 4.2.

Table 4.2
Recent Changes to Norfolk Island Taxation Policy

	introduced	repealed
Accommodation Levy (Cold Bed Tax)		02-Apr-07
Liquor fee		
- renewal of a general licence		02-Apr-07
- renewal of restaurant licence		02-Apr-07
FIL (financial institutions levy)		S9: 2/04/2007
NSL	01-Aug-06	01-Apr-07
GST	02-Apr-07	
General Customs Duty		
- 6% for food		02-Apr-07
- 10% for food, base reduced	02-Apr-07	
Fuel Levy		09-Oct-07

Source: The Administration of Norfolk Island

The table above shows that the NIG made significant changes to the Island's taxes in April 2007. The group of taxes that were introduced/adjusted and the group that were repealed are now discussed in turn.

In terms of additional taxation, the main change was the introduction of a 9 per cent Goods and Services Tax (GST). The GST replaced the (short-lived) NSL.

Partly offsetting this additional tax burden is the removal of a number of more narrow based taxes. These include the Accommodation Levy (Cold Bed Tax), Liquor fee and FIL.

Also on 2 April 2007, the Customs Duty rate was standardised to 10 per cent. Further, Customs Duty now only applies to items that are for personal home consumption over $100 and any capital item procured for the purpose of carrying on a business.

Finally, on 9 October 2007, the Norfolk Island Administration became the supplier of fuel. The fuel levy ceases to apply if the Administration is the supplier. This situation will remain over (at least) the next five years. However, the Energy GBE will still collect an equivalent amount of revenue (as was previously collected through the levy) through an adjustment to its wholesale pricing to retailers. This will be distributed to the Revenue Fund and allocated to the Roads GBE.

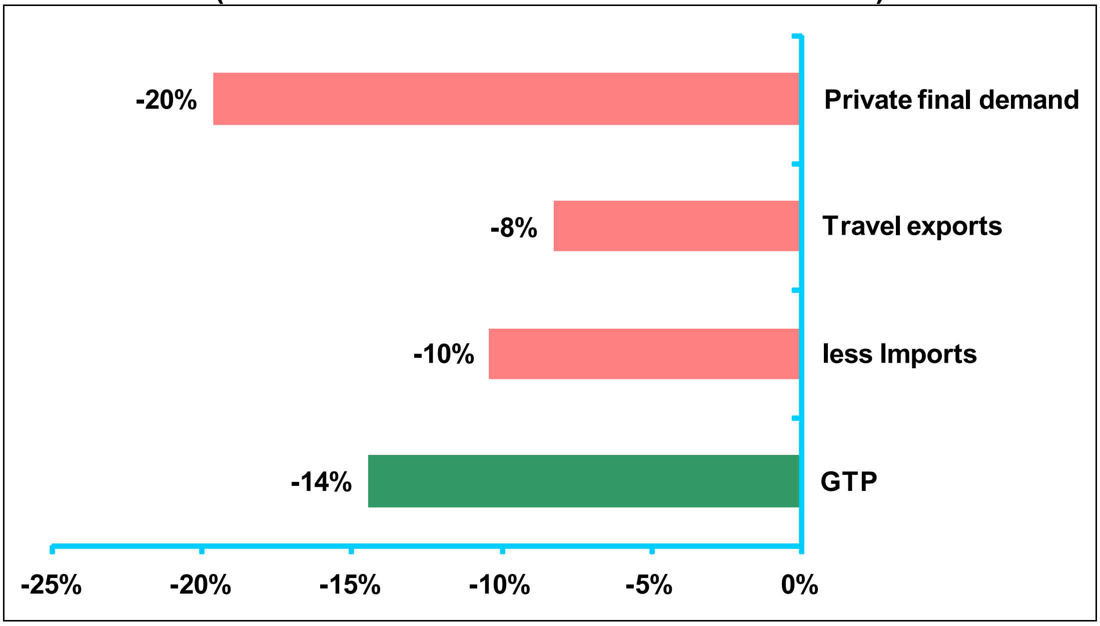
On balance, these tax changes mean that, on average, residents will pay higher taxes than before. Higher taxation will reduce the spending power of residents. This, in turn, will lead to a reduction in private final demand.

Chart 4.5 shows private final demand in 2008/09 is likely to be around 20 per cent lower than it would have been under a *2005/06 Taxation* scenario[11]. Imports are also likely to be

[11] It is important to note that the *2005/06 Taxation* scenario is separate from the *2005/06 Tourism* scenario presented in the previous section. That is, this alternative scenario uses the same tourist assumptions as the Baseline scenario.

lower, at about 10 per cent below the *2005/06 Taxation* scenario. Lower consumer demand flows through to lower GTP. Chart 4.5 shows GTP is estimated to be around 14 per cent lower under the current (Baseline) taxation policy compared to the *2005/06 Taxation* scenario.

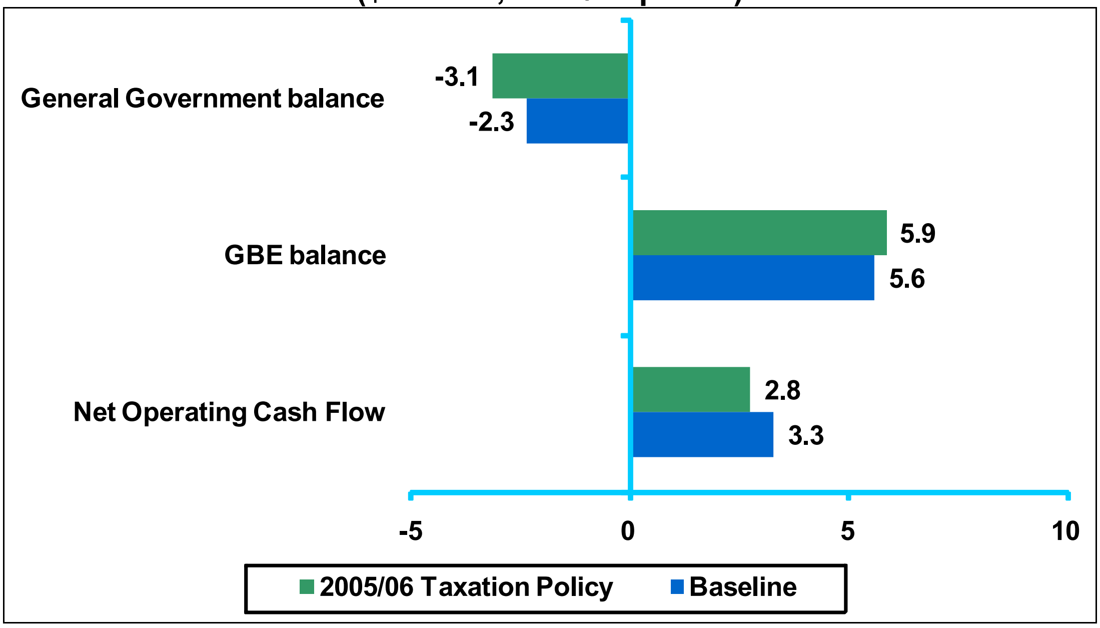
Chart 4.5
Change in Expenditure under Current Tax Policy in 2008/09
(Deviations from *2005/06 Taxation* Scenario)



Source: NI model

However, despite a reduction in economic activity, the higher taxation is still expected to boost the NIG's net operating cash flow in 2008/09. Chart 4.6 shows the NIG's cash flow position under the current taxation policy in 2008/09, compared to the cash flow position under the *2005/06 Taxation* scenario.

Chart 4.6
The NIG's Net Cash Flow under Current Tax Policy in 2008/09
($ million, 2006/07 prices)



Source: NI model

The introduction of a 9 per cent GST is expected to lead to higher tax collected on the goods and services purchased in the economy. The removal of some taxes, along with the reduction in activity across the economy, is expected to lead to a slightly lower level of other tax collections, compared to the *2005/06 Taxation* scenario. However, the higher GST collections are expected to more than offset these lower other taxes.

Lower economic activity will flow through to lower demand for goods and services provided by GBEs. Chart 4.6 shows that the GBE balance in 2008/09 is expected to be lower, at $5.6 million (compared to $5.9 million under the *2005/06 Taxation* scenario).

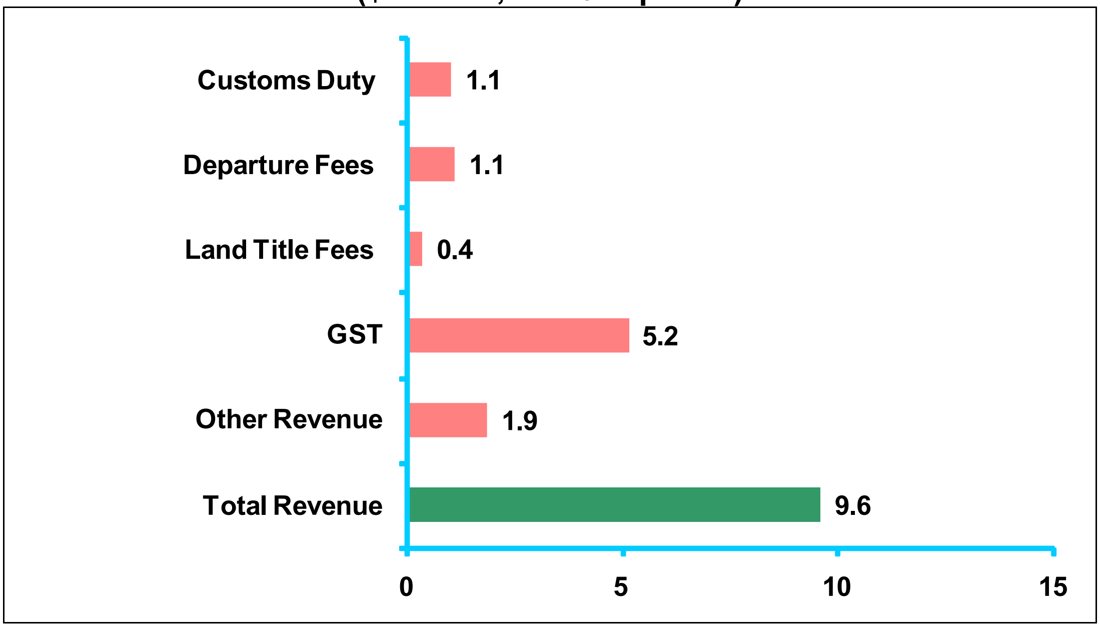
However, the additional GST collections more than offset the lower other tax collections and GBE revenues. This gives an overall boost in the NIG's net operating cash flow in 2008/09 of $0.5 million ($3.3 - $2.8) compare to the *2005/06 Taxation* scenario.

5. NIG's Future Financial Capacity under Current Policy Arrangements

The previous section examined the individual impacts of recent changes to the NIG's current taxation policies and tourism initiatives. In particular, it looked at the likely separate impacts of the taxation policies and tourism initiatives; compared to if these policies/initiatives had not been introduced.

This section brings the two together to show the estimated financial capacity of the NIG under the full current policy arrangements (Baseline scenario). Chart 5.1 starts by examining the Island's estimated General Government revenue under the current policy arrangements.

Chart 5.1
General Government Revenue under Current Policy Arrangements in 2008/09
($ million, 2006/07 prices)

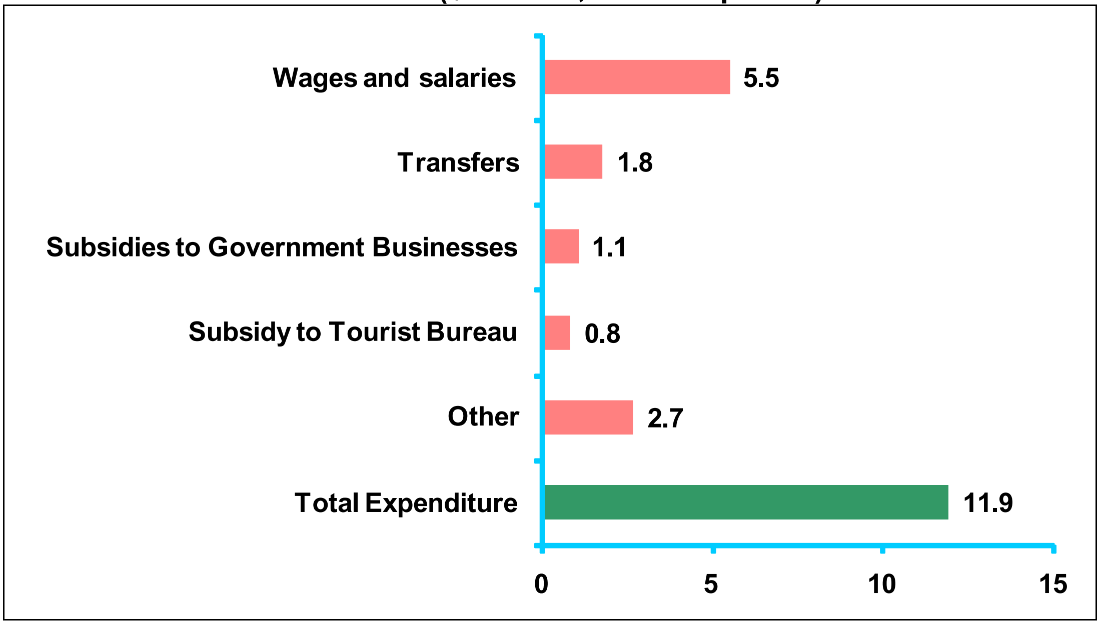


Source: NI model

The chart shows that, in 2008/09, the Island's General Government revenue is expected to be dominated by GST revenue, estimated at around $5.2 million. Customs Duty, Departure Fees and Other Revenue should also be significant revenue raisers, providing around $1.1 million, $1.1 million and $1.9 million, respectively. In 2008/09, total General Government revenue for the NIG is estimated at around $9.6 million.

Chart 5.2 shows the Island's estimated General Government expenditure under the current policy arrangements. The chart shows that almost half of the General Government expenditure in 2008/09 is expected to be for wages and salaries, estimated at around $5.5 million. The remaining costs are largely in terms of transfers and subsidies to GBE's and statutory bodies.

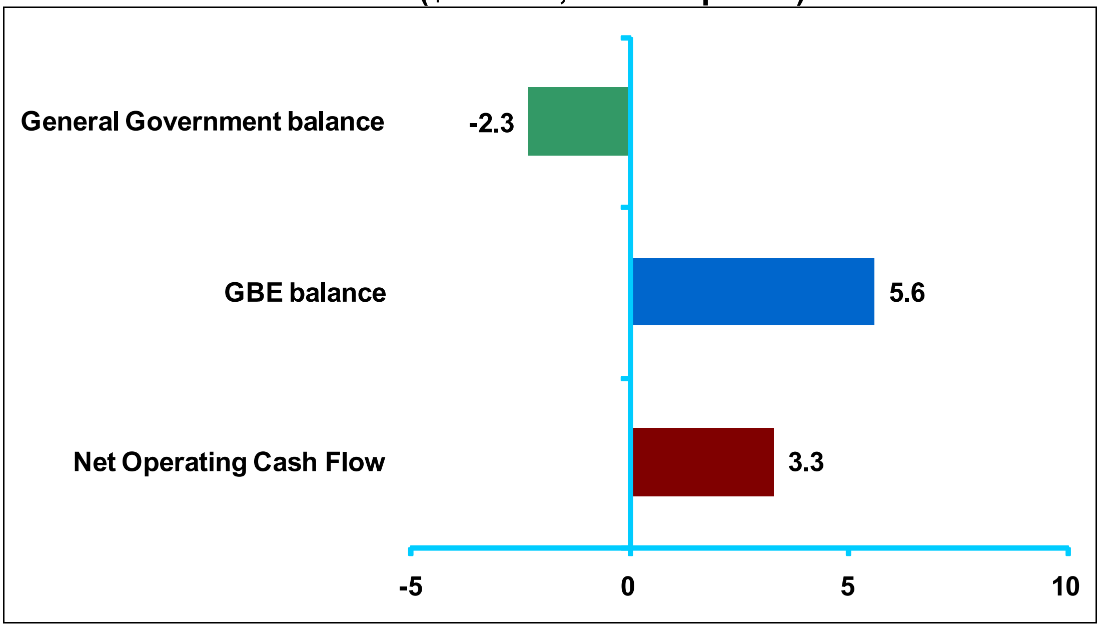
Chart 5.2
General Government Expenditure under Current Policy Arrangements in 2008/09 ($ million, 2006/07 prices)



Source: NI model

Chart 5.3 shows the NIG's Net Operating Cash Flow position. This position includes the contribution by GBEs.

Chart 5.3
The NIG's Net Operating Cash Flow under Current Policy Arrangements in 2008/09 ($ million, 2006/07 prices)



Source: NI model

Chart 5.3 shows that, under the current policy, the NIG is expected to have a net operating cash flow of $3.3 million in 2008/09. This is a significant improvement compared to the cash flow achieved in previous years, under the old tourist and tax policies.

As shown in Chart 5.3, General Government activity is expected to contribute a net deficit of $2.3 million (with the $9.6 million in revenue being more than offset by the $11.9 million in General Government recurrent expenditure). The remaining $5.6 million is expected to come from GBEs. This gives an overall net operating cash flow of $3.3 million in 2008/09.

As discussed in Econtech's 2006 report, the net cash flow will be used to cover the costs of likely ongoing investment. As such, it is not enough for the NIG to simply be in a neutral or positive net cash flow position. The net cash flow must also be significant enough to cover these likely investment needs. Econtech's 2006 report estimated that, at that time, a realistic annual public investment figure for Norfolk Island would be around $4 million (in 2004/05 prices). This would cover depreciation of current capital, and make allowance for new capital – to cater for both economic growth and the renewal of old infrastructure.

Using the 2006 estimates as a starting point, Econtech has updated its estimate of Norfolk Island's ongoing investment needs.

- In 2006/07 Norfolk Island's annual depreciation charge was around $2.9 million.[12] This is significantly higher than previous years, where depreciation was averaging around $2.0 million. Around $0.8 million of this **depreciation** charge can be attributed to higher Airport depreciation – arising from additional investment in the Airport. At the minimum, the cash flow surplus would need to at least cover the total depreciation charge.
- In addition, the cash flow surplus would also need to allow for additional infrastructure to cater for **economic growth**. The previous report estimated annual infrastructure investment requirements of around $670 thousand[13]. Assuming that the recent additional investment in the Airport will cover the Airport component of this annual additional investment requirement for a number of years, this leaves a requirement of around $440 thousand to cover further additional annual infrastructure investment.[14]
- As discussed in the 2006 report, there is also a need to allocate funds for **renewal of infrastructure**. An annual allowance of $1.1 million dollars[15] was estimated in the previous report (equivalent to 5 per cent of the current capital stock). Again, assuming that the recent additional investment in the Airport covers the Airport component of this annual renewal allowance for a number of years, this leaves an annual allowance of around $736 thousand to cover further renewal of infrastructure.

Thus, Econtech's updated estimate for a realistic annual investment figure for Norfolk Island is around $4.0 million ($2.9 million + $0.4 million + $0.7 million). This would cover the depreciation of current capital, and make allowance for new capital – to cater for both economic growth and the renewal of old infrastructure.

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[12] *The Administration Of Norfolk Island Financial Statements*, Year Ended 30 June 2007.

[13] The original report estimated annual infrastructure investment requirements of around $750 thousand in 2004/05 prices. This is equivalent to $670 thousand in 2006/07 prices.

[14] The new investment in the Airport is estimated to contribute to around one third of total capital stock on the Island. Thus, the additional investment is estimated to cover about one-third of ongoing investment needs.

[15] The original report estimated annual infrastructure renewal allowance of around $1.25 million in 2004/05 prices. This is equivalent to $1.1 million in 2006/07 prices.

Therefore, the NIG's net operating cash flow (of $4.0 million in 2008/09) falls short of the likely ongoing investment needs in Norfolk Island. There is a budget shortfall of up to $0.9 million in 2008/09, or an average annual shortfall of around $0.4 million over the next three years.

Attachment A: Impact of Alternative Levels of Tourist Spending

Table A1.1
Alternative Tourist Spending Scenarios:
Modelling Assumptions for 2008/09 and 2009/10 ($, 2006/07 prices)

	Average spending per tourist
baseline scenario	1,324
higher tourism spending	**2,000**
lower tourism spending	**649**

Table A1.2
Alternative Tourist Spending Scenarios: Results 2009/10

	units	baseline scenario	higher tourism spending	lower tourism spending
Economy				
Gross Territory Product	deviation from baseline		35.4%	-35.4%
Private final demand	deviation from baseline		35.5%	-35.5%
imports	deviation from baseline		35.5%	-35.4%
Budget				
General Government (Revenue Fund)				
Revenue				
General Customs Duty	$'000, 2006/07 prices	1,103	1,494	712
General Departure Fees	$'000, 2006/07 prices	1,195	1,627	763
General Land Title Fees	$'000, 2006/07 prices	387	530	243
GST	$'000, 2006/07 prices	5,410	7,712	3,111
Other Revenue	$'000, 2006/07 prices	1,962	2,657	1,267
Total Revenue	$'000, 2006/07 prices	10,056	14,020	6,097
Expenditure				
Wages and salaries	$'000, 2006/07 prices	5,571	5,699	5,443
Transfers	$'000, 2006/07 prices	1,827	2,166	1,488
Subsidies to Government Businesses	$'000, 2006/07 prices	1,123	1,351	895
Subsidy to Tourist Bureau	$'000, 2006/07 prices	854	1,028	681
Other	$'000, 2006/07 prices	2,740	2,877	2,604
Total Expenditure	$'000, 2006/07 prices	12,115	13,122	11,110
Balances				
General Government balance	$'000, 2006/07 prices	-2,059	899	-5,013
GBE balance	$'000, 2006/07 prices	5,673	6,230	5,118
Net Operating Cash Flow	**$'000, 2006/07 prices**	**3,614**	**7,128**	**105**