Budget Strategy Paper - 2009

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A. Background

This Budget Strategy Paper (BSP) will help guide preparation of the 2009 Budget. This is an important component of the Government's approach for improving the preparation of budgets and the management of public finances in Papua New Guinea (PNG). This document has been made available to the public, consistent with the Government's approach to improve public transparency and accountability.

B. Purpose

The BSP has several purposes:

1. To establish the *broad principles* that will guide the 2009 budgetary processes.

2. To set out the broad fiscal parameters for the 2009 budget year and indicate the key Government strategies and policies for the management and reform of revenues and expenditures.

3. To provide a framework for the preparation of departmental ceilings for budget estimates and for developing detailed budget policies.

4. To assist understanding of the fiscal situation and the Government's proposed budget strategies amongst government officials, the business sector and the general public.

The fiscal data and targets included in the BSP are *indicative* only. They are not binding on Government and may be adjusted if and when circumstances change during budget preparation. The macroeconomic and fiscal forecasts will be updated closer to Budget to reflect any changes in economic and financial conditions.

C. 2009 Budget Strategy

The 2009 Budget will be based on the strong foundation of the Government's prudent fiscal management and economic growth strategy, and is designed to enhance and promote a dynamic and competitive private sector. It will be framed against a background of continued high commodity prices, a strongly growing economy that is running up against binding capacity constraints and increasing inflationary pressures.

Higher expected revenue will provide opportunities to increase expenditure and service delivery to some of the Government's priority areas – both in the short and long term. However, decisions on higher Government spending will need to consider the impact on domestic demand in order to prevent a further build up in inflation or crowding out of private sector expansion.

The 2009 Budget will be guided by the medium term frameworks which include the Medium Term Development Strategy (MTDS), Medium Term Debt Strategy (Debt Strategy) and the new Medium Term Fiscal Strategy (MTFS) (2008-2012).

The first MTFS (2002-2007), started from a position of fiscal crisis – the Budget was deep in deficit, inflation and interest rates were high, and the economy was shrinking. The main aim was to get the Budget back in balance.

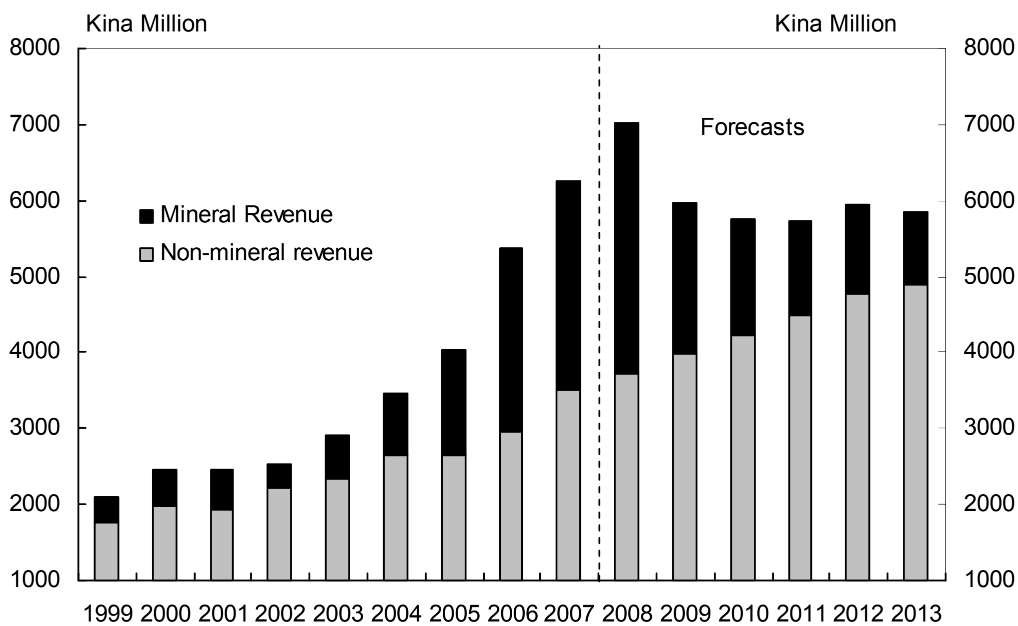
This was achieved – partly through adherence to the first MTFS, but mainly due to the favourable external environment and record high commodity prices. The economy is now growing strongly but the new environment has raised some challenges that have made the first MTFS obsolete. The increase in mineral revenues has been so large that simply targeting a Budget balance is less than what is needed for prudent economic management (Chart 1). If this was the target, the result would likely be poor quality spending, increased volatility in demand/economic growth, an inflation break out and higher interest rates which would crowd out private sector investment.

To avoid this scenario, the Government has used funds resulting from the high mineral prices in ways that provide for future benefits, are one-off in nature and are effectively isolated from recurrent expenditure. This provides for flexibility in the event of a downturn in commodity prices without a damaging impact on the recurrent budget. As a consequence, large amounts have been allocated to: trust funds for future public investment and maintenance; state equity in gas projects; and to repay debts and other liabilities. The new MTFS formalizes this approach and will be the main guiding framework for the 2009 Budget Strategy.

The MTFS (2008-2012) contains three key fiscal rules to ensure macroeconomic stability, and four principles to guide the use of additional revenue. These are outlined in Box 1.

With the economy growing strongly and prices of PNG's major export commodities expected to remain high in 2009, the Budget Strategy is framed on the expectation that there will be additional mineral revenues. However, commodity prices are highly volatile and it is difficult to predict how they will move. While there is a possibility of mineral revenue coming in much stronger than projected – as has been the case over recent years – there is also a possibility that prices could fall sharply, and revenue could come in much lower than projected.

Chart 1: Total Revenue – Mineral and Non-Mineral



Source: Department of Treasury

It would be extremely risky to base plans for ongoing spending on revenue derived from high commodity prices. If ongoing spending increased in line with higher revenues, difficult decisions would have to be made to reduce ongoing expenditure (recurrent and development) if commodity prices were to drop suddenly. Therefore, in line with the MTFS (2008–2012), the 2009 budget strategy is to keep ongoing spending in line with normal revenue – revenues that can be expected in the absence of a commodity price boom. This is vital in order to ensure that ongoing spending can be sustained and in order to contain demand pressures in a higher inflationary environment.

Box 1: Fiscal Rules & Principles in the MTFS (2008- 2012)

The MTFS (2008-2012) provides a stable, responsible and prudent framework for the Government to manage its fiscal resources. A key part of the strategy is a framework to manage varying, volatile and highly uncertain amounts of additional revenue from PNG's commodity exports.

The MTFS will assist the Government in achieving the national goals in the Constitution and the objectives of the MTDS. There are three key fiscal rules:

- Keep ongoing expenditure in line with normal revenues, which is defined as all non-mineral revenues and the 4 per cent of GDP of mineral revenues that we can reasonably expect to collect if commodity prices fall to long-run levels.
- Use the additional mineral revenue to pre-fund public investment projects and repay debt and other liabilities, using a 70:30 split between the two uses as a guide.
- In order to promote macroeconomic stability and avoid inflationary pressures, limit the actual amount of public investment expenditure sourced from the additional revenues in any given year to 4 per cent of GDP.

The strategy lays out 4 principles which should be followed when allocating the additional mineral revenues. The use of these revenues should:

- benefit future generations;
- be flexible, in case the additional revenues do not materialize;
- be made while considering the impact on domestic and import demand; and
- be compared to and assessed against all other potential investment projects.

The strategy complies with the Fiscal Responsibility Act, which limits the Government to keeping the level of public debt below the level at the beginning of the term. This limit on borrowing does not apply to investment projects by State-owned enterprises (SOEs) which they fund by themselves, and investment projects with funding arrangements fully independent of the State.

In the out years, mineral and petroleum revenues are projected to decline, due to a combination of lower oil production and falls in the projected prices of PNG's key export commodities.

Normal revenues, made up of all non-mineral revenue, as well as the 4 per cent of GDP worth of mineral revenue that could be expected even if commodity prices fell sharply, are expected to continue to grow strongly in line with economic activity and higher inflation both in 2009 and in the out years.

As a result, forecast normal revenues in 2009 are greater than current expenditure projections on a no policy change basis. This provides scope to increase ongoing spending to match total normal revenue. The Budget Strategy will be to provide for responsible spending increases in the MTDS expenditure priority areas of education, health and roads maintenance, with a particular focus on assisting to alleviate capacity constraints in the economy.

As a starting point, the MTFS (2008-2012) proposes a 70:30 split for the use of additional mineral revenue with 30 per cent to repayment of public debt and other liabilities and 70 per cent to be allocated to public investment programs guided by the following principles. The use of these revenues should:

- benefit future generations;
- be flexible, in case the additional revenues do not materialize;
- be made while considering the impact on domestic and import demand; and
- be compared to and assessed against all other potential investment projects.

The Government recognizes that there is already an amount more than 17 per cent of GDP either held in or soon to be transferred into trust for public investment programs which are yet to be utilized. This reduces the imperative to allocate more funds to these investment programs while there are substantial amounts yet to be utilized.

With the economy growing strongly, inflationary pressures are building up. Too much Government spending over a given period of time can cause excess demand, resulting in higher inflation and interest rates, a surge in imports and crowding out of private sector investment. A rapid drawdown of funds held in trust could contribute to higher inflation, which is why the MTFS limits actual government expenditure from additional mineral revenue to a maximum of 4 per cent of GDP per annum. In order to adhere to this rule, the Government will improve efforts to closely monitor and control spending from trust funds.

In assessing the application of the MTFS 70:30 guide in 2009, the higher inflation outlook combined with large sums already in trusts suggests that an even higher allocation to debt/liability repayment should be considered. Although PNG's debt to GDP ratio has fallen by a little over half over the last 5 years to be 34.1 per cent at the end of 2007, PNG's debt and other liabilities are still considered by the IMF/World Bank to be at an unsustainable level. Other countries in a similar situation to PNG have used the opportunity provided by the commodity price boom to reduce debt much more aggressively. For example, Nigeria has used its elevated oil revenues to reduce its debt from US$35 billion to US$3 billion over the last 4 years.

The 2009 budget strategy will keep in line with the MTFS 2008-2012 by allocating additional mineral revenues to the following areas:

- Debt and liability repayment, including superannuation liabilities.
- Equity in the gas commercialization project.
- The National Investment Development Program (NIDP).

The advantages of repaying public debt/liabilities include:

- An immediate positive effect on the spending side of the Budget, continuing every year, as resources are freed from debt servicing. These funds could be used for service delivery, maintenance of public infrastructure, or new investments.

- Strengthening of the Government's financial position or "balance sheet", which increases investors' confidence and helps to lower interest rates. This reduces borrowing costs for PNG households and businesses.

- Reduction of interest rate risks and foreign exchange rate risks for the Budget. This provides the greatest flexibility for future Budgets, including for further financing of State investments when necessary.

- In a higher inflationary environment, the repayment of debt does not directly add to demand pressures like additional Government spending.

In comparing benefits of alternative uses of the additional mineral revenues, the returns of debt repayment are guaranteed. This is a benchmark against which all other investment proposals should be measured.

The 2009 Budget will also provide another opportunity to reduce further the State's very large unfunded superannuation liability. Though some inroads have been made on this front, the outstanding performance of the superannuation industry means that the State's liability is also increasing. This may also be considered in the allocation of normal revenues.

The application of additional mineral revenue to repaying debt/liabilities will not only benefit future generations but is quite flexible in that there will be no disruption to investment plans should there be any shortfalls in revenue.

While repaying unfunded superannuation liabilities will have a larger impact on domestic demand relative to the repayment of external debt, it will have the long-term benefit of allowing Nambawan Super to continue investing in PNG, which can be expected to increase the future productive capacity of the economy.

While a total of K600 million has already been set aside for purposes of taking up equity in the gas commercialization project, the size of the Government's equity stake is yet to be determined. Setting aside some of the additional mineral revenues for the Government's equity stake would ease the pressure and risks associated with borrowing externally. In this way, the principles of the Fiscal Responsibility Act and Debt Strategy are upheld and future generations would benefit from the current high mineral prices. Importantly, the Government setting aside funds to finance an equity stake in a gas project would not add to inflationary pressures. Given the enormity of the Exxon/Mobil project that is entering the front end engineering and design stage, the Government will need to consider its equity take up as part of the 2009 Budget process.

The gas project is one of many investment projects that are currently under consideration by the Government. Some of these include Ramu Hydro power, Central City, housing development, Lae and Wewak ports, Port Moresby Sewage Upgrade and various road expansions.

However, the State will not be able to afford all proposed and potential projects that are put forward while maintaining fiscal sustainability and keeping within the rules set out in the Fiscal Responsibility Act, the MTFS and the Debt Strategy.

This means that the proposals will need to be compared with each other, weighted for risks and benefits and only those that can be undertaken without threatening fiscal sustainability or macroeconomic stability will be implemented in 2009.

The 2009 Budget Strategy is to look at all of these investment proposals together to assess their relative priority, risks, costs and benefits. In order to ensure macroeconomic stability and avoid inflationary pressures, the MTFS (2008-2012) limits the actual amount of public investment expenditure sourced from the additional revenues in any given year to 4 per cent of GDP.

The MTFS (2008-2012) and the 2009 Budget Strategy lay out a fiscally sustainable and economically responsible approach to allocating Government revenues that have increased substantially over recent years. Allowing the additional mineral revenue to be built into ongoing expenditure would risk the fiscal sustainability built up over recent years. A rapid expansion of expenditure from the additional mineral revenue would result in higher inflation, interest rates, crowding out the private sector and risk macroeconomic instability. Unfortunately, PNG has endured this path many times in the past and it is crucial that these past mistakes are not repeated. Too much Government spending in an environment of higher inflation will only lead to wastage of funds and instability.

Unlike in previous years, the 2009 Budget will not target a specific overall budget balance but will be designed to manage the varying but volatile mineral revenue in a manner consistent with prudent fiscal management.

By adopting and adhering to the MTFS (2008-2012), the Government will ensure that macroeconomic stability and fiscal sustainability are maintained. With capacity constraints and higher inflation evident in the economy, the Government will continue to pursue structural reforms in order to make the economy more competitive and efficient – the recent changes in the mobile phone sector demonstrate how greater competition can reduce prices and improve the level of service provided to the public.

C.2 Complementary Policies

The recent very strong growth of PNG's economy resulting from sound macroeconomic management, favourable global economic conditions, political stability and some reform demonstrates the Government's commitment to developing the private sector and creating an environment that is conducive for their operations.

The ongoing economic growth and revenue outlook for 2009 provide an opportunity for the Government to undertake further structural reforms to provide further impetus for sustaining economic growth.

The Government has made real progress in building a stable investment climate. However, consistent Government support is vital for existing achievements to deliver in the long term. Hence, the Government will continue to address impediments to business and investments, improve competition in key sectors of the economy, open up the economy to markets and investment, improve public infrastructure and support rural activities.

An important part of the Government's growth strategy is to have an efficient, effective and affordable public sector. The poor service delivery by the public sector is an impediment to business and the welfare of the public, and government agencies need to be administered more efficiently in order for effective use of scarce resources for them to improve public service delivery.

It is a concern that the size and expected growth of the public sector payroll is not linked to productivity in public service delivery – this has been a consistent problem for the Budget over the medium term. The Government will continue to address this under the ongoing Public Expenditure Review and Rationalisation (PERR) program. The PERR Mission pointed out in March this year that the delays in retrenchments, regularizing casuals and recent devolution of power have the potential to stretch the problem even further. However, the Government will be monitoring developments in this regard very closely and will institute appropriate control mechanisms to address the problem.

Consistent with the existing medium term strategies, the Government's approach to public sector reform includes reviewing and rationalising the functions of government agencies and their resource requirements. The intention is to provide increased funding allocations to priority areas of the government. The recommendations of the 2005 Rightsizing Report remain outstanding and this important area of reform needs to be reinvigorated.

The Government demonstrated its commitment to improving financial management, the national budget process and efficiency of public sector institutions by making good progress in these areas under the PERR. It will continue to address the challenges that emerge in these areas.

The Government acknowledges that improvement in the efficiency of utility service provision is particularly important for businesses. Hence, it will continue to look at options including greater private sector involvement to address this on a long-term basis.

The Government has introduced competition in the mobile phone segment of the telecommunication sector and reviewed regulation and competition in wholesale and retail trading and in the provision of fire and general insurance. It will address key issues that emerge in these areas.

Furthermore, the Government commenced work on the formulation of a Public Private Partnership policy, which is expected to be completed in 2009, while work on sectoral policies for the water and postal sectors will be undertaken.

The Government will also consider other structural reforms, particularly implementation of recommendations of the task force on land tenure systems and the 2007 Tariff Review Report, which recommended for further tariff reduction.

D. Economic Developments and Outlook

The economic growth outlook has strengthened in the short term and economic growth is expected to be around 4 per cent over the medium term (2009-2012).

2007 Economic Update

The economy continued to grow very strongly in 2007, due to stable macroeconomic policies, improved business confidence, microeconomic reforms and high commodity prices.

The economy grew by an estimated 6.5 per cent in 2007, up substantially from the 2.6 per cent in 2006 and slightly higher than the 6.2 per cent forecast at the time of the 2008 Budget. This strong growth marks the sixth and strongest successive year of economic growth. Economic activity increased across all sectors of the economy with the exception of the oil and gas extraction sector. Robust growth was recorded in the communication, construction, manufacturing, mining, agriculture, forestry and fisheries, and wholesale and retail trade sectors.

Total estimated non-mining GDP grew by a strong 7.3 per cent in 2007, up substantially from 3.8 per cent in 2006. This reflected exceptionally strong growth in the communication and construction sectors, as well as robust growth in the wholesale and retail trade sectors, manufacturing and agriculture, forestry and fishery sectors.

The communication sector grew exceptionally strongly in response to microeconomic reform that allowed competition in the mobile phone sector, where the existing operator and new entrant have expanded operations. This has increased subscriber numbers substantially, with the mobile phone users increasing from around 60,000 three years ago to around 900,000 currently. This has contributed greatly to increased domestic economic activity.

The stronger construction sector was driven by increased private investments in the mineral sector, in particular the Ramu Nickel and Cobalt project. It also reflected Government's increased capital spending into the rehabilitation of the country's infrastructure (i.e. construction of roads, wharves, utilities and airstrips); as well as increased private sector activity as businesses expand into other provinces or due to new business prospects.

Economic activities in the wholesale and retail trade sector, the manufacturing sector, and other smaller sectors grew strongly driven by improved business confidence and profitability, low interest rates, increased private sector investments, spin-off activities of larger robust sectors and higher household consumption.

Employment grew by a strong 10 per cent in 2007, with particular strength in the retail sector, agriculture sector; building and construction; transport, storage and communication sector and manufacturing sector. This very strong employment growth reflected increased confidence, profitability and growth in the non-mining sectors of the economy.

The headline inflation outcome for 2007 was 0.9 per cent in year average terms compared to 2.4 per cent in 2006. The relatively low year-average headline inflation figure masks an acceleration of inflation that occurred in 2007, and is expected to continue into 2008. Headline inflation was up 3.2 per cent in the year to the December quarter 2007, while underlying inflation (which excludes volatile items) was up 6.0 per cent – around the highest rate since inflation was brought under control in 2003. The difference between the headline and underlying rate was due to some sharp declines in volatile food items – a trend which has since been reversed. The rise in underlying inflation is more indicative of overall rising inflationary pressures over 2007.

The acceleration of inflation during 2007 was due to the massive terms of trade boom, rapidly increasing money supply, higher fuel and food prices, higher government spending with further potential spending in trust accounts, the private sector expanding rapidly and the exchange rate depreciating slightly against most major currencies other than the US dollar.

2008 Outlook

Economic growth is expected to increase further in 2008 to a very strong growth rate of 7.6 per cent, up from 6.5 per cent in 2007 and higher than the forecast of 6.6 per cent contained in the 2008 Budget. Non-mining GDP is expected to grow by 7.1 per cent in the year. The forecast acceleration in growth is largely due to: the continuation of strong growth in the construction and communication sector; a rebound in the mining sector from weaker performance in 2007; and a more robust agriculture sector.

Annual inflation in 2008 is expected to rise substantially to 8.1 per cent, well up from the 0.9 per cent in 2007. This outlook reflects the build up of inflationary pressures from the fast growth in money supply, higher import prices including for oil and some foods, the increased terms of trade and the fiscal stimulus from the Supplementary Budgets in 2006 and 2007.

Furthermore, the expected government spending arising from the 2007 Supplementary Budget and 2008 Budget, especially on maintenance and infrastructure projects, will inject further stimulus into the economy as the funds for the projects are used to buy goods and services. It will be important that additional government spending in 2008 is contained so that it does not add to existing inflationary pressures.

2009 Outlook

The outlook for 2009 is for a moderation of economic growth to 5.1 per cent from the exceptionally high growth rates in 2007 and 2008. This reflects less expansion of the communication sector; as well as a slow down – albeit at very high levels – of growth in construction activity. It also reflects two opposing trends in the mining and petroleum sectors, where a large fall in oil production due to the decline of existing oil fields, is expected to be offset by strong growth in the mining sector where a number of new mines are scheduled to commence (see Box 2).

Inflation is expected to subside in 2009, with forecast year average growth around 6 per cent. This is based on continued stable macroeconomic policies, a stable exchange rate and no further large increases in food prices.

Box 2: Outlook for the Mining and Petroleum Sectors in PNG

The outlook for the Mining and Petroleum sectors shows two opposing trends. The mining sector is expected to increase production, at least until 2013 when Ok Tedi mine's operations are due to end. A number of potential projects are in the pipeline which may add to production in the medium to longer term. However, production of petroleum is expected to decline with the natural depletion of oil reserves, although this could be overshadowed by new production from 2 potential LNG projects.

The mining sector is expected to grow very strongly over the projection period. This reflects ongoing and increased production from the major mines, namely Ok Tedi, Porgera and Lihir and smaller mines of Tolukuma and Kainantu and the commencement of production from the new mines of Simberi, Sinivit, Hidden Valley and Ramu NiCo. In the longer term, a number of prospective projects, such as Wafi, Freida, Yandera, and Nautilus (Solwara) have the potential to increase production even further.

Of the major existing mines, the Ok Tedi gold and copper mine has reached its maturity and the production level should be steady through to the end of 2013, when the mine is scheduled to shut down. There are possibilities for the mine to continue although this is at early stages of consideration and the outlook after 2013 is highly uncertain.

The Porgera gold mine is still ramping up production in accordance with its ongoing mine expansion plans. It is expected to continue production until 2017, although there is a possibility of continuing until 2023. Lihir recently announced capital expenditure plans that will bring annual production up from around 700,000 to 1 million ounces of gold. At current levels of production, Lihir will continue through to 2021, with processing of lower grade stockpiles able to continue through to 2030.

The smaller scale Tolukuma and Kainantu gold mines have been producing well below capacity over recent years due to ongoing production related difficulties.

Of the new mining developments, the Simberi gold mine started producing in February 2008, with a confirmed mine life of 8 years, and the possibility of an extension of another 15 years. Sinivit's first gold production is expected in May 2008, although it only has an expected mine life of 3 years. Hidden Valley mine is currently under construction, with production expected to start in March 2009. It is expected to produce both gold and silver with a mine life of 10 years.

The Ramu Nickel and Cobalt project has just started construction and is expected to go into production by early 2010.

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Box 2: Outlook for the Mining and Petroleum Sectors in PNG *(continued)*	
Its annual estimated production is 33,000 tonnes of nickel and 3,280 tonnes of cobalt with a mine life of 20 years plus. The projects outlined above are included in the Government's economic and fiscal projections as they are either currently in production, or in the construction phase. There are a number of other projects that are at earlier stages, which Treasury is monitoring. These projects are not yet included in the forecasts, but will be incorporated if and when it becomes clear that they will proceed. For the prospective mines, Wafi gold and copper mine is in its feasibility stage, which is expected to be concluded in 2010, and production is expected to commence in 2012 with 3 mtpa and a 13 year mine life. Yandera copper and molybdenum mine is under feasibility study. The pre-feasibility results indicate that the production could start around 2011 with an expected mine life of 10 years. Nautilus (Solwara) is a deep sea mining prospect with significant underwater deposits, which has the potential to produce 1.8 million tonnes of minerals (gold, copper, zinc and silver) per annum. Depending on progress, production could possibly start in 2010 or 2011, although this technology is as yet untested.	Frieda River gold and copper project is yet to undergo a feasibility study to determine its commercial viability. A pre-feasibility study has shown potential for development of a large amount of low grade ore. The reopening of Bougainville gold and copper mine, the largest open pit mine in PNG, is still pending negotiations between the State, BCL and resource owners. In the petroleum sector, production declines are expected in the next few years, reflecting the natural decline in the oil reserves from the existing oil fields. In the medium term, oil production is expected to fall from around 17 million barrels in 2008 to around 10 million barrels in 2012. By 2015, it is estimated the oil reserves would have been depleted if there are no new discoveries made in the intervening period. However, gas production has a huge potential for contributing to the economy and government revenue. There are two gas commercialization proposals that are currently being pursued. One is with the Exxon Mobil led project and the other with Inter Oil. The Government remains committed to actively participate in the commercial development of PNG's significant gas reserves. The Exxon Mobil led project is now entering the FEED stage.

Risks

The major risks currently facing the PNG economy are:

- Large fluctuations in commodity prices – both up and down – are a major concern. Currently prices are at very high levels, but the markets are extremely volatile. Economic Forecasts (Table 1) shows oil and gold prices based on IMF forecasts but adjusted for some downside safety margin, while copper forecasts are as given by the IMF. With global economic growth conditions weakening considerably, the risks to the downside are increasing. The MTFS and 2009 Budget Strategy have been formulated to shield both the Budget and economy from big swings in commodity prices.

- The reliance on a small number of major producers also presents a major risk, given the possibility of production disruptions. This is particularly the case in the minerals sector where a number of recent strikes and landowner problems have affected production.

- There are significant risks to the inflation outlook. Inflation has accelerated over the past year, and with the strong growth in the economy, shortages of skilled workers, higher fuel and basic food prices, the depreciation of the Kina against the Australian dollar, the price pressures are all on the upside and may become entrenched.

- In addition, there are possibilities of weather related risks such as droughts, floods and landslides that could abruptly affect production, as experienced in the past.

The core principle of the 2009 Budget Framework is to maintain fiscal discipline by adhering to the MTFS (2008-2012).

By adopting and adhering to the MTFS, the Government will help to ensure that macroeconomic stability and fiscal sustainability are maintained. With capacity constraints and higher inflation evident in the economy, the Government will continue to pursue structural reforms in order to make the economy more competitive and efficient – the recent changes in the mobile phone sector demonstrate how greater competition can reduce prices and improve the level of service provided to the public.

2010 to 2013

Looking further ahead, economic growth is expected to remain robust over the next few years but tail off towards the end of the projection period. The forecast growth is driven largely by the non-mining sectors of the economy.

Table1: Economic Forecasts

	2006 Actual	2007 Actual	2008 Proj	2009 Proj	2010 Proj	2011 Proj	2012 Proj	2013 Proj
Economic Growth								
GDP	2.6	6.5	7.6	5.1	4.2	3.7	3.2	2.7
Non-mining GDP	3.8	7.3	7.1	4.8	4.0	3.9	3.6	3.6
Inflation								
Average on Average (%)	2.4	0.9	8.1	5.9	4.4	3.1	3.0	3.0
Dec on Dec (%)	-0.9	3.2	7.6	5.8	3.5	3.0	3.0	3.0
Interest rate								
T/Bills (average for the year)	5.0	5.0	6.0	6.0	6.0	6.0	6.0	6.0
Inscribed Stock (3 year yield)	6.0	5.7	6.0	6.0	6.0	6.0	6.0	6.0
Mineral Prices								
Gold (US$/oz)	604.3	697.0	819.0	788.0	812.0	840.0	864.0	876.0
Copper (US$/lb)	3.053	3.2	3.3	2.7	2.0	1.6	1.5	1.5
Oil (Kutubu Crude: US$/barrel)	64.3	72.3	91.4	76.0	74.4	74.4	74.4	74.0

Source: Department of Treasury

Beginning in 2008, the petroleum sector is expected to detract from economic growth due to natural production declines in existing fields. While some of the major potential projects that are currently being announced could commence over the projected period, they are not yet sufficiently certain to include them in the projections. However, some proposals are extremely large and could be expected to have a significant positive impact on the economic growth outlook if one or more of them commence production.

E. Fiscal Developments and Outlook

The Budget outcome for 2007 was a cash surplus of K454.4 million or 2.4 per cent of GDP, compared with the surplus of K535.8 million (or 3.1 per cent of GDP) for the 2006 fiscal year.

At the time of the 2008 Budget, the 2008 Budget surplus was projected to be K202.3 million or 1.0 per cent of GDP. It is now projected to be K1, 230.4 million or 5.7 per cent of GDP, given the high commodity prices of PNG's main exports and stronger domestic economic conditions. Total revenue is projected to reach its peak in 2008. The principal reason for the expected increase in tax revenue is the stronger mining tax collections, supported by moderate tax collections and growth in most other tax revenues.

However, with only one tranche of Mining and Petroleum Tax receipts collected so far, a more complete picture of the 2008 fiscal environment will be released in the Mid-Year Economic and Fiscal Outlook (MYEFO), where the implications of higher than projected commodity prices will be explored in more detail and with more available information.

The 2009 Budget expenditure strategy is in accordance with the MTFS (2008-2012): First, to keep ongoing expenditure in line with normal revenues. Second, additional mineral revenue is to be used to pre-fund one-off public investment projects and repay debt and other liabilities.

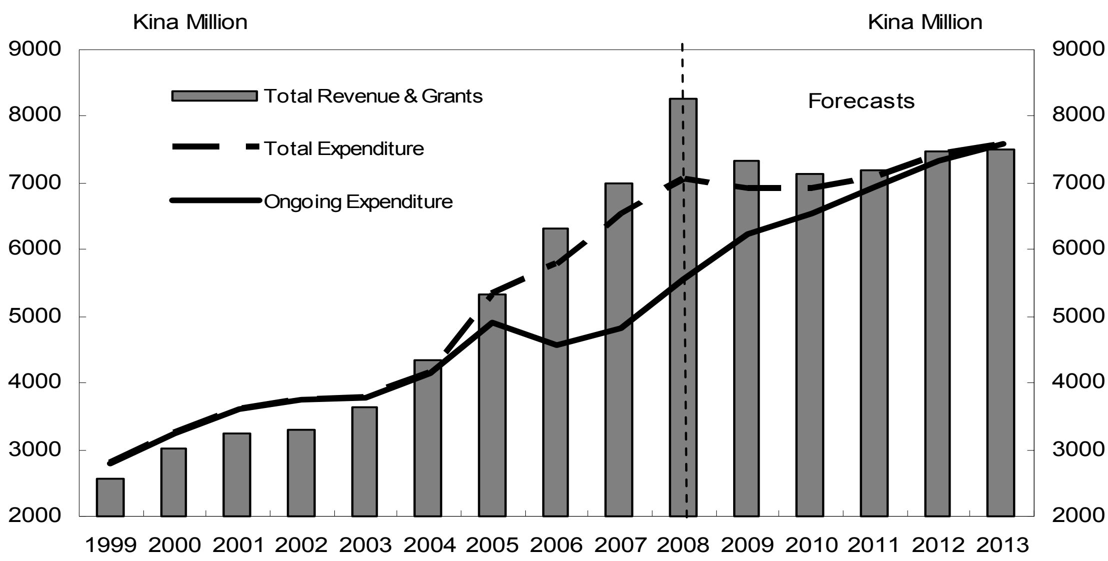
The Government is expected to have no financing requirement in 2009.

Medium Term Fiscal Outlook

Total revenue is expected to decline from its peak in 2008. The principal reasons for the expected decline are: the fall in mining and petroleum tax revenue over the medium term as commodity prices ease from historically high levels; natural declines in production from existing projects; and new projects taking time to move to more profitable operations or for tax exemptions to expire.

The decline in mineral revenue collections are expected to be offset by continued increases of non-mineral revenues, as non-mining economic activity continues to grow through the out years, generating increased employment and profits, and providing for increased income, company and activity based tax collections.

Chart 2: Medium Term Expenditure and Revenue Projections



Source: Department of Treasury

Over the medium term, increases in expenditure are largely driven by ongoing growth in personal emoluments due to expected public servant pay increases, increment advancement and higher provisions for superannuation. The increase in superannuation provisions is due both to the Government's decision to increase funding of employer superannuation contributions for public servants from 75 per to 100 per cent in 2009 and to a more accurate methodology for estimating all public service employer superannuation contributions. By fully funding superannuation, the Government will no longer be building up unfunded liabilities which will have a significantly positive effect on the Government's balance sheet and the fiscal position over the longer term.

The combination of pay increases, increment advancement and increased superannuation provisions means that, even with staffing levels remaining at current levels, personal emoluments are expected to increase significantly. Any decision to further expand the public sector, without a renewed commitment to rationalisation elsewhere, will exacerbate this already strong growth in personal emoluments spending.

Additional mineral revenue has been isolated from recurrent government expenditure and has been used for one-off investments and debt/liability reduction. However, as one-off investment expenditure occurs, some parts of future increases in recurrent expenditure may be required to support ongoing costs associated with these investments. This need will become more evident when the nature of the investment projects become clearer.

Included in the expenditure projections are provisions for increased ongoing expenditure in the priority areas in line with the MTFS, as well as increased public investment expenditure in line with the 70:30 rule in the MTFS.

With Government revenues temporarily elevated, and sizable Budget surpluses over the past few years, it is easy for the importance of expenditure control to move into the background. However, the need to prevent current high revenues from being factored into ongoing expenditure takes on great importance. There is a continuing need to consolidate Government expenditure into a long-term sustainable position, in order to prevent large, unnecessary and painful adjustments later.

F. Fiscal Parameters for the 2009 Budget

In line with the MTFS (2008-2012), the fiscal parameters for the 2009 Budget are based on current forecast of revenues and expenditures.

- Total revenue and grants are expected to be K7,341 million.
- Total expenditure and Net Lending is expected to be K7,009.6 million.
    - total recurrent expenditure is forecast at K4,187.9 million.
    - total development expenditure is forecast at K2,048.3 million.
    - total additional priority expenditure is forecast at K773.4 million.
- Total debt/liability repayment of K331.4 million.

F.1 Revenues

The projected moderate economic growth in 2009 will have an impact on Government revenue.

Total revenue for the year is expected to decline moderately from its peak in 2008. The decline is mainly due to the expected fall in mining and petroleum tax revenue as commodity prices ease from historically high levels this year coupled with natural production declines from existing projects. In addition, new projects will take time to move to more profitable operations or for tax exemptions to expire.

However, there will be continued increases of non-mineral revenues as this sector is expected to continue growing, generating increased employment and profits, and provide for increased income, company and activity based tax collections. The revenue growth in this sector will help offset revenue reduction in the mining and petroleum tax.

This trend is expected to continue into the medium term (2009-2012).

The major risk on the revenue side relates to changes in commodity prices, but the possibility remains of supply disruptions through landowner disputes, employee strikes and weather related problems such as those experienced recently.

As in 2007 and 2008, there are no new taxes and no increases in existing taxes proposed at this stage for 2009. The implementation of the second phase of the income tax reduction, the reform of beer excise and abolishment of a number of stamp duties in the 2008 Budget will have some impact on Government revenue. There will be a reduction in the gaming tax as the Government relinquishes its share of the gaming revenue to provincial governments and no mining levy due to its phasing out.

Project support grants are expected to rise moderately in line with donors' support in various projects that they are involved in.

To build on from the benefits of the past Tariff Reform Program, the Government will consider the Recommendations of the 2007 Tariff Review and will announce the details of a further tariff reform in the 2009 Budget. This is intended to encourage a more efficient and productive private sector through greater exposure to international competition by way of reducing the tariffs on imports, hence reduce costs of basic goods and services for the bulk of the population. With inflation projected to be uncomfortably high in 2008, any tariff reductions will assist to ease inflationary pressures on imported goods.

F.2 Expenditures

The key policy documents that will guide the Government's funding allocation decisions in the 2009 Budget are the MTDS and the MTFS. The MTDS provides an overarching development strategy that provides the basis for development expenditure allocation decisions.

The seven MTDS priority expenditure areas are:

- Primary and Prevention Health
- HIV/AIDS Prevention
- Basic Education
- Development Oriented Adult Education
- Transport Rehabilitation and Maintenance
- Promotion of Income Earning Opportunities and;
- Law and Justice

The 2008 Budget allocated 55.5 per cent of the total Budget and 82.7 percent of Development Budget to the MTDS priority areas. The Government will aim to maintain this trend in 2009. However, capacity constraints may result in slow draw down of funds in 2009 affecting timely implementation of projects.

The 2008 Budget included additional ongoing spending which brought it up to the forecast amount of total normal revenue. This practice will continue in 2009.

Recurrent Expenditures

In the proposed 2009 Budget ceilings, recurrent expenditures are forecast to increase by around K554.8 million in 2008 to around K4, 187.9 million in 2009.

2009 personal emolument expenditure ceilings for Departments, Provinces and Agencies have been determined by using the appropriation for personal emoluments in the 2008 Budget as the starting point. These ceilings have been reduced to take account of one-off items, including specific policy decisions made by the Government. The impact of annual salary progression for public servants is included.

Ceilings for expenditure on goods and services for National Departments and agencies have been determined in a similar fashion, by removing one-off funding from the 2008 appropriation for each agency and then including any increases for new policy decisions by the Government. This new baseline has then been indexed in accordance with the inflation estimates contained in this budget strategy to account for the higher costs of delivering services.

Goods and services expenditure ceilings for Provinces have been determined on the basis of the assumed passage of amendments to the *Organic Law on Provincial Governments and Local Level Governments.* These amendments will provide for new funding arrangements for sub-national governments arising from the Review of Intergovernmental Financing Arrangements (RIGFA). The amendments received unanimous support in the first parliamentary vote in February 2008, and it is anticipated that they will be considered by Parliament a second time before the 2009 Budget.

Under the RIGFA funding arrangements, a single goods and services ceiling for all Provinces and Local Level Governments, other than the National Capital District and Bougainville, is set at a fixed percentage of net national revenue (total revenue minus volatile revenue arising from mining and petroleum activities) in the year two years prior to the Budget year. Under these arrangements, funding for the Provinces will be provided on a sustainable basis that will keep pace with growth in government revenue. For 2009, the total ceiling is K177.3 million, or 5.12 per cent of net national revenue.

If the RIGFA amendments are not passed by Parliament, the ceilings for Provinces will still provide the same net level of funding. If it is passed, the RIGFA legislation will redistribute, as grant funding, those GST payments to Provinces that exceed 60 per cent. Consequently, if the legislation is not considered by Parliament before the Budget process, the grant ceilings for Provinces will be reduced by K16 million, recognising that they will still receive this money through the distribution of GST.

Advice on goods and services expenditure ceilings for individual Provinces and Local Level Governments for the 2009 Budget will be provided to Treasury by the National Economic and Fiscal Commission, which will assess the fiscal needs of provincial governments on the basis of a ‘costs minus revenues’ formula, with additional available revenue being directed to those areas where the need is the greatest.

The National Government and the Autonomous Bougainville Government (ABG) have now agreed that the 2008 Budget for the ABG establishes acceptable baselines for all the grants required under the *Organic Law on Peace Building in Bougainville*. The 2009 Budget Ceilings for the ABG have been determined by indexing the 2008 grants in accordance with the requirements of the Organic Law.

In addition to increased agency ceilings, there are a number of planned one-off payments and increased provisions in 2009, including:

- an additional provision of K74 million for superannuation arising both from the Government's decision to fund 100 per cent of public servants' employer superannuation contributions, and from a more accurate methodology for estimating the annual cost of public servants' superannuation;
- up to an extra K72m to meet the Government's commitment to increase funding for the National Agriculture Development Plan to K100 million;
- a provision of K65 million to cater for an additional public service payday which will occur in 2009;
- K20 million to complete work on maritime boundaries;
- K20 million for Improved Hospital Services; and
- an additional K10 million for Expanded Education Services.

Risks

There continue to be a number of expenditure side risks, in particular with regard to personal emoluments. Substantial increases in staffing, for example for the defence or police forces, would be unsustainable without balancing reductions elsewhere. Further risks arise from agencies and statutory authorities seeking wage increases outside the PEA agreement and the devolution of human resource powers from the Department of Personnel Management to agencies. On the one hand, HR devolution offers the potential for agencies to operate with greater flexibility and efficiency. However, it is important that the devolution of these powers to agency heads be matched by increased accountability on them to manage within their agencies' personal emoluments appropriations.

Development Expenditures

A key objective of the 2009 Budget will be to at least maintain the proportion of the Budget allocated to the MTDS priority areas.

The Development Budget is made up of four funding components: direct government financing; the tax credit scheme; concessional loans; and grants. In 2009, development expenditure is expected to increase to K2, 048.3 million, a rise of K115.7 million on 2008. This increase is made possible by increases in the value of donor grants. The recent improvements in bilateral relations between Australia, the largest development partner, imply that these could increase by even more than the projections shown in Table 2.

In 2009, the Government's contribution to the Development Budget is expected to represent around 37.0 per cent of total development expenditure. This is a reduction compared to the previous years (41.1 per cent, 41.0 per cent and 40.5 per cent in 2006, 2007 and 2008 respectively). It would not be sensible to keep increasing funds each year when there are capacity constraints affecting timely implementation of projects.

Table 2: 2009 Development Budget (Kina Million)

	2008	**2009**	**Change**
GoPNG Funded Projects	763.4	757.5	-5.9
Direct Financing	*526.7*	*524.5*	*-2.2*
Tax Credit Scheme	*73.7*	*70.0*	*-3.7*
Concessional Loans	*163.0*	*163.0*	*0*
Grants	1,123.7	1,240.8	+117.1
TOTAL	**1,932.6**	**2,048.3**	**+115.7**

Source: Department of National Planning and Monitoring

Around K206.8 million of the Government's contribution to the Development Budget is expected to be in fixed commitments.

Table 3: Fixed Commitments in the Development Budget (Kina Million)

	2008	2009	Change
District Support Grant (including Members Non-Discretionary Funds)	54.5	54.5	0
Ongoing MOA Obligations	48.3	48.3	0
Ongoing Special Support Grant Obligations	49.7	49.7	0
Project Grants to Bougainville	14.0	14.0	0
Counterpart funding for Loan Funded Donor Projects	200.1	40.3	-159.8
TOTAL	**366.6**	**206.8**	**-159.8**

Source: Department of National Planning and Monitoring

The fixed commitment estimates are subject to change except for the District Support Grants. Special Support Grants (SSGs) are particularly hard to predict given their correlation with commodity prices. The figures for the Memorandum of Agreement (MoA) and the SSG obligations may be revised in light of the production figures obtained from the extractive industries.

Prioritising Development Expenditure

Building on the approach taken in the 2007 and the 2008 Budgets, the Government will continue to pursue its Expenditure Sequencing and Matching Funds Strategy to translate the MTDS into an efficient set of expenditure choices.

These two Strategies are applied to Government's expenditure decisions through the Medium Term Resource Framework (MTRF). The MTRF is the expenditure-planning tool that enables Government to direct future donor and Government expenditure to fill existing funding gaps. The MTRF will be used to generate indicative sector ceilings to guide Government's development expenditure over the seven expenditure priority areas.

Possible Future Expenditure Areas

The Government is currently identifying high impact projects to be funded from the Development Budget. There is likely to be an increased focus on infrastructure, education, and health in the Government's policy.

A lot of good proposals have been initiated and new proposals are still expected to flow through in the name of economic growth. However, the increased focus in these areas will again be evaluated in terms of the MTFS (2008-2012). Priorities will be given to areas that are likely to yield the most viable results and that can be proven to be within the MTFS (2008-2012).

Performance Management of the Development Budget

To monitor the implementation and performance of the MTDS, the Government established a Performance Management Framework (PMF). In 2007, an MTDS PMF database and a pocket book was compiled and published respectively as a means of disseminating this data. The database has been updated in 2008.

To establish this performance framework, the Government has chosen a sample of key performance indicators that reflect MTDS implementation in each focal sector. These indicators have been determined through collaboration and consultation between relevant Government agencies and wider stakeholders. It is envisaged that performance against these indicators will be used to influence discrete budgetary decisions when the various Government committees presiding over Budget formulation sit to deliberate over the 2009 Budget.

F.3 Additional Priority Expenditure

In line with the MTFS (2008-2012), it is expected that 70 per cent of additional mineral revenues will be directed towards public investments. These expenditure areas will be guided by the following principles:

- benefit future generations;
- be flexible, in case the additional revenues do not materialize;
- be made while considering the impact on domestic and import demand; and
- be compared to and assessed against all other potential investment projects.

G. Financing

The Government is expected to have no financing requirement in 2009. However, it will continue to engage with international financial institutions for limited external borrowing on concessional terms, as long as the expenditures are consistent with government priorities and are within the Budget ceiling and are consistent with the Fiscal Responsibility Act and the Government's debt management strategy. This means the Government's external borrowing will be entirely driven by the MTFS (2008-2012) and the Debt Strategy. No commercial borrowing is required.

During 2009, the Government will continue with the inscribed stock program in order to lengthen the maturity structure of government debt and to reduce rollover and interest rate risk. Together with the reduction in external debt, which reduces foreign exchange risk, this should considerably strengthen the Government's financial position and help to insulate the Budget from short-term economic volatility.

H. Conclusion

The above set of policies has the specific endorsement and approval of the Cabinet and will guide and direct central agencies and departments in preparation of the 2009 Budget.