Budget Strategy Paper - 2010

Presented by the
Hon. Patrick Pruaitch, MP
Minister for Treasury and Finance

Hon. Patrick Pruaitch, MP
Minister for Treasury and Finance

Government of Papua New Guinea

Budget Strategy Paper - 2010

A. Background

This Budget Strategy Paper (BSP) will help guide preparation of the 2010 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 2010 budgetary processes.

2. To set out the broad fiscal parameters for the 2010 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. 2010 Budget Strategy

Background

The 2010 Budget will be framed in the context of a global recession, and as a consequence, subdued commodity prices.

As a result of the global financial crisis, the world economy is in a deep recession which is expected to be the largest since the Great Depression in the 1930s. According to the IMF's latest update, world economic growth is projected to fall by 1.3 per cent in 2009. Advanced economies are expected to shrink by 3.8 per cent this year, and growth in emerging and developing economies will slow sharply from 6.1 per cent in 2008 to 1.6 per cent in 2009. The IMF has projected that the global economy is expected to experience a gradual recovery in 2010, with expected growth of 1.9 per cent.

In contrast to the global economy, the PNG economy remains resilient. Estimated GDP growth for 2009 has been revised down from the 2009 Budget forecast of a strong 6.2 per cent to a robust 3.8 per cent, with growth spread across both the mining and non-mining sectors. This downward revision to forecast economic growth still looks very good when compared with developments in most other countries. Banks are continuing to lend and investment projects and construction are progressing, although negative international developments have seen previously very strong domestic business sentiment take on a more cautious tone. In 2010, GDP growth is forecast to increase slightly and grow by 5.3 per cent, driven largely by increased mining activity by Ramu Nickel and Lihir Gold.

The substantial falls in commodity prices in late 2008 has had a significant impact on PNG's mining and petroleum taxes. Commodity prices in early 2009 have been highly volatile and the outlook for the commodity prices is very uncertain. While it is too early to be confident, commodity price improvements in April and May 2009 could indicate that prices may have bottomed out in the March quarter of 2009. Given the major uncertainties surrounding commodity prices, the assumptions used for 2010 are broadly around their 10 year averages, and will be reviewed again before the 2010 Budget is finalised. However, compared to recent budgets, commodity prices are expected to remain at modest levels in 2010.

In addition, expected falls in production from Ok Tedi and the oil producing companies contribute to lower expected mineral revenue in 2010. Although Ramu Nickel and Lihir are expected to significantly increase production in 2010, this will not directly add to tax revenue due to tax concessions granted to these projects. Hence, mining and petroleum taxes and dividends are expected to decline in 2010, relative to 2009.

As a consequence of lower mineral revenue, no Additional Priority Expenditure is expected in the 2010 Budget. Additional Priority Expenditure has previously been funded from the portion of mineral revenue in excess of 4 per cent GDP, as defined in the Medium Term Fiscal Strategy (2008 – 2012) (MTFS).

Mineral revenue in 2010 is expected to be around 2.4 per cent of GDP. This means that additional mineral revenue will not be available to fund one-off investment projects, as in previous budgets, and that normal mineral revenue is lower than envisaged in the MTFS. On the other hand, the MTFS allows continued drawing on existing trust funds to support infrastructure spending in 2010 of up to 4 per cent of GDP. The envisaged usage of these funds for infrastructure spending in 2010 will provide considerable fiscal support for the economy.

Non-mineral revenue is expected to grow in 2010, on the basis of robust underlying economic growth. The growth in non-mineral revenue is sufficient to more than offset the expected fall in mineral revenue, so that total (underlying) revenue is higher in 2010 than in 2009. However, the 2009 Budget benefited from a K423 million one-off boost to revenue from the gas equity trust fund, which was no longer required for its original purpose. As a result, total revenue is expected to fall slightly in 2010, relative to 2009 when the one-off injection of K423 million from the gas equity trust fund was accounted for as revenue.

The 2010 Budget will be strongly affected by the final decision on the LNG project. The final decision is not expected until very late in 2009, after the 2010 Budget preparations have been completed. This Budget strategy has been prepared on the basis that a positive decision is expected, but that the final approval is pending. If a final decision to proceed with the LNG project is made and construction commences in 2010, Box 1 provides details on the additional expected impact on GDP and revenue in 2010.

Box 1: Impact of construction of the LNG Project in 2010

If the LNG project proceeds and construction commences in 2010, the decision will provide a substantial boost to confidence in PNG. This will provide an additional boost to GDP and, to a lesser extent, revenue, over and above the estimates provided in this paper.

The direct economic impact on GDP of the LNG project proceeding is expected to be relatively small during the construction phase. This is because most of the expenditure will take place offshore, and/or will be paid to expatriate labour. The construction workforce is expected to peak at around 7,500 full time jobs in 2010, including direct employees, contractors, administrative and support personnel. PNG nationals are expected to make up around 20 per cent (or 1,500 at peak employment) of the workforce during the initial construction phase.

Preliminary analysis conducted for the 2009 Budget suggested that the estimated impact of the construction of the LNG project in 2010 would be around 3 per cent of GDP.

The LNG project will not pay income or royalty taxes or dividend payments to Government revenue during the construction phase. However, there is expected to be a modest indirect impact on Government revenue in 2010, estimated to be broadly in the order of K200 million. For example, this is likely to come from increased goods and services taxes due to increased business activity experienced by local companies that supply goods and services to the mining project and its employees.

However, this additional indirect revenue is lower than the additional expenditure in 2010 from the LNG project. Under the LNG BSA agreement, the Government has committed to fund K216 million of infrastructure and business development grants in 2010, plus a further unspecified (but likely to be significant) share of around K460 million in other infrastructure commitments. These amounts will be required to be met in 2010 through the development budget and existing trust funds.

A more complete analysis of the fiscal implications of the LNG project will be provided after final agreement is reached.

On the other hand, in the event that the decision is made not to proceed with the LNG project as scheduled, this would be expected to have a negative impact on overall confidence and on the PNG economy and Government revenue in 2010, and consequent reductions in Government expenditure may be required.

2010 Budget framework

The 2010 Budget will be guided by the Medium Term Development Strategy (MTDS), Medium Term Debt Strategy (Debt Strategy), Medium Term Fiscal Strategy (2008 – 2012) (MTFS) and the *Fiscal Responsibility Act 2006*.

The MTFS decomposes mineral revenue into normal mineral revenue and additional mineral revenue. The MTFS indicates that ‘normal mineral revenue’, equivalent to 4 per cent GDP, is to be reliably expected in the absence of a commodity boom. Mineral revenue in excess of this is considered as additional mineral revenue. As indicated above, there will be no additional mineral revenue in 2010, as mineral revenue in 2010 is only expected to be around 2.4 per cent of GDP.

The MTFS recommends a number of options when an unexpected Budget deficit situation arises and when normal mineral revenue falls below 4 per cent of GDP. The options are to:

- cut ongoing expenditure;
- allow a temporary Budget deficit; or
- a mixture of both.

The Government has already run a temporary Budget deficit in 2008, and the 2009 Budget position is under considerable pressure and may need adjusting to avoid running a budget deficit. A balanced budget in 2010 is needed to avoid ongoing budget deficits, especially in light of economic growth that is forecast to be very robust, easing but still relatively high inflation and the additional spending in the economy from existing trust funds.

In addition, it is a requirement under the *Fiscal Responsibility Act 2006* that the Government does not raise the level of debt and maintains a balanced Budget during its term in Government. The Act also states that the Government should produce a Budget that is affordable and sustainable during its term.

A further Budget deficit in 2010 would make it difficult for the Government to meet the requirements of the *Fiscal Responsibility Act 2006*. It would also risk a larger contraction in Government spending in future years, due to the expected continued decline in mineral revenue as oil fields continue to decline.

In order to meet the requirements imposed by the *Fiscal Responsibility Act 2006* and to maintain a prudent and sustainable fiscal policy, a balanced budget is required in 2010. To achieve a balanced budget from a modest deficit position will require an increase in revenue and some expenditure moderation and control. Due to limited options to raise additional revenue without harming private sector growth, and given that non-mineral revenue growth estimates continue to be strong, an emphasis on adjusting the expenditure side of the budget is desirable, especially in light of the very large increase in Government expenditure contained in the 2009 Budget.

While modest expenditure reductions are likely to be required in 2010, far deeper expenditure cuts would have been required if not for the fiscally prudent measures of this Government to save additional mineral revenue in trust funds over the commodity boom period. These measures, as outlined in the Government's MTFS, have reduced the need for a substantial contraction in recurrent Government spending, and will continue to support PNG's economic growth and development over coming years.

Furthermore, the Government will still be running an expansionary fiscal policy through expenditure from trust accounts of up to 4 per cent of GDP per annum. This will provide an ongoing fiscal stimulus to the economy, and is consistent with the MTFS. Government spending decisions from trust funds must strictly adhere to the annual 4 per cent of GDP limit. This is in order to avoid boom-bust cycles of Government spending, and associated inflationary and import demand pressures. Capacity constraints in the private sector remain, and to avoid crowding out private sector expansion, Government spending from trust funds needs to be contained. The MTFS also requires that the annual 4 per cent of GDP trust expenditure will need to be devoted to uses which are MTDS priorities to benefit future generations.

Finally, almost all of the major developed countries are currently running large budget deficits. One risk that stems from the substantially higher borrowings of developed countries is a crowding out of access to foreign borrowings by developing countries, and/or an increase in the international cost of borrowing. Given it is possible that the Government may need more finance surrounding its equity stake in the LNG project, priority for additional borrowings in PNG should be reserved for this purpose and not to fund a budget deficit in 2010. This provides further support for the strategy to run a balanced budget in 2010.

Implications for Expenditure in 2010

Total recurrent and GoPNG funded development expenditure has increased substantially in recent budgets. In the 2009 Budget, recurrent expenditure increased by K265.2 million (or 7 per cent) and GoPNG funded development expenditure increased by K857.5 million (or 112 per cent).

In contrast with recent budgets, the funding envelope for expenditure in the 2010 Budget is lower than the previous year. This largely reflects one-off additional expenditures in the 2009 Budget (funded by a one-off revenue injection from the gas equity trust account, which was no longer needed for its intended purpose) and lower mineral revenue in 2010. Mineral revenue is projected to be 2.4 per cent of GDP in 2010, significantly lower than the 4 per cent of GDP envisaged in the MTFS.

It is important to stress that maintaining total expenditure in 2010 at the 2009 level would be unsustainable, have serious budgetary implications in future years, and probably cause the Government to contravene the *Fiscal Responsibility Act 2006*. Total expenditure in the 2010 budget should reflect the fiscal envelope available in 2010.

However, the 2009 Budget allocated a substantial amount to one-off expenditures. This included around K159 million in one-off recurrent expenditures and broadly around K600 million (based on preliminary analysis only) in one-off GoPNG funded development expenditures. Major one-off projects in 2009 included the DSIP, the Provincial Roads Program, the Waigani Office Redevelopment, a capital injection for Air Niugini and payments to the Civil Aviation Authority.

These one-off expenditures in 2009 are expected to broadly offset the required reduction in the fiscal envelope in 2010. Accordingly, the 2010 Budget will be broadly balanced, after removing these one-off expenditures and accounting for other expenditure commitments. However, this leaves no funding for new spending decisions. Consequently, new spending decisions in the 2010 Budget will need to be funded through expenditure reprioritisation, or from existing trust funds where appropriate (from within the 4 per cent of GDP of annual expenditure from trust accounts).

However, the 2010 Budget will have a number of expenditure pressures that have not yet been funded and which the Government will need to seriously consider. These are outlined below.

- Financing of the significant Government spending commitments from the Benefits Sharing Agreement on the LNG project, as outlined in Box 1; and

- The Government has agreed to consider a significant investment in the development of PNG through the PNG–Australia Partnership for Development program. The Partnership for Development program is currently been developed between the both countries. Critical areas identified to be considered for funding under this partnership include:

    - universal basic (elementary and primary) education;
    - transport, especially the national road network;
    - basic health; and
    - public sector and statistics.

The above areas identified are also in line with the ADB's Millennium Development Goals for the developing countries including PNG. The program is expected to provide a redirection of aid funding from Australia to support a range of critical public investments.

Overall, the PNG economy is well positioned to manage the global financial crisis and collapse of commodity prices due to its prudent fiscal policy in managing the additional revenue from the commodity price boom. However, the 2010 budget will be challenging for the Government, in particular to return to a balanced budget after the temporary budget deficit of 2008 and ongoing fiscal pressures in 2009, given the expected fall in mineral revenue, and managing a number of key expenditure pressures.

C.2 Complementary Policies

The very strong economic growth experienced in the last few years has assisted PNG to better cope with the impacts of the current global economic recession. This has been partly due to introduction of the appropriate complementary micro and macro economic policies by the Government to better manage and grow the economy.

In 2009, the Government will build on the benefits of the past policies by continuing with ongoing reforms including realigning existing policies where necessary to appropriately respond to the unfavourable economic condition and create an environment that is conducive for a vibrant and dynamic private sector development.

Development of a sustainable wage policy is important to better manage the Government's wage bill. This is especially important in light of the current global recession which is affecting commodity prices and therefore a fall in Government revenue.

A strategic approach is therefore needed to minimize the impact of public sector salaries and wages expenditure on the recurrent budget and the overall 2010 Budget. This will require addressing factors that can potentially influence the growth of public sector wage bill. Some of these factors include: poorly negotiated industrial awards (MOAs) and their implementation; insufficient budgeting of the government's ongoing superannuation obligations; lack of monitoring and prudent management of casuals being paid outside of the government's payroll system; the unconstrained growth in the Provincial Governments' payroll; and the impact of the devolution of HR powers by the DPM to heads of government agencies.

The need for improved negotiation for new industrial awards (MOAs), in particular the PEA Agreement, in 2010, will need to be consistent with the economic outlook for the duration of the agreement in order to determine the capacity of Government to meet such obligations. In addition, any outstanding implementation of MOAs will require proper costing and appropriation. The State's employer superannuation contribution of 8.4% will be fully paid and remitted fortnightly to Nambawan Superannuation Limited, allowing time to gradually address the Government's unfunded superannuation liability over time.

The devolution of HR powers by the DPM to Government agency heads gives them the flexibility to do their own recruitment. Monitoring and control mechanisms need to be instituted through the Alesco payroll system to prevent overspending in personnel emoluments arising from the devolution exercise.

The Government should continue to enhance and increase competition in key service sectors (telecommunications, aviation, electricity and tourism) of the economy. This not only results in increased efficiency, productivity and lower prices but it also improves the quality of service delivery and promotes innovation.

The Government through the ICCC will identify and undertake further reviews of key sectors to address possible impediments to competition and opportunities for private sector development in various sectors. This demonstrates the Government's ongoing commitment to competition policy and structural reform.

The Government will continue to improve public infrastructure and remove barriers to business and investments. This is key to promoting and providing a favourable environment for private sector growth.

The Government has implemented the National Land Development Program (NLDP), which was based on the National Land Development Taskforce (NLDT) recommendations. The historic passage of the *Land Groups Incorporation (Amendment) Act 2007* and *Land Registration (Customary Land) (Amendment) Act 2007* in March 2009, provides opportunity for enhancing mutual interests of customary landowners and investors. Further implementation of other recommendations will be considered in 2010.

The Government supports and values the contribution of the private sector as an important development partner in nation building. Through the Public Private Partnership (PPP) policy, the Government will strengthen cooperation between state institutions and private enterprise in the provision of infrastructure and service delivery by utilizing private sector capital, management, innovation, technology and other resources. The Government is now in Phase II of the PPP policy, which involves (i) development of the institutional arrangements and standard operating procedures of the PPP centre (ii) further development of the PPP policy including amending the existing legal and commercial framework to accommodate a PPP program, and (iii) development of a PPP project pipeline through the formulation of a National PPP Infrastructure Pipeline, which will be completed in 2009 and implemented in 2010.

The Government is committed to improving and sustaining its fiscal performance through the Public Expenditure Review and Rationalization (PERR) program by streamlining public sector resource allocations under the public sector reform program. There has been good progress in achieving the PERR objectives. The Government will continue to implement initiatives of this reform in 2010, with particular attention to some aspects of the reform which are progressing slowly or are yet to take place.

A further Tariff Reduction Program (TRP) planned for implementation in 2010 will be deferred once again and implemented in 2011 when there is expected to be an improvement from the current global economic recession and confidence has been restored in the domestic economy. This should provide a more conducive environment for any changes to be made to the tariff structure.

D. Economic Developments and Outlook

Economic growth in PNG is beginning to show signs of moderation in 2009 after very strong growth in the preceding years of 2007 and 2008. This comes in light of the deep global recession brought on by the global financial crisis – which is still unfolding in both the advanced economies and developing economies such as China and India. World economic growth is also estimated by the IMF to grow moderately over the medium term at around 3.1 per cent per annum (from 2010 to 2014).

2008 Economic Outcome

Despite the deteriorating state of the global economy in the latter part of 2008, PNG's economy continued to grow strongly due to upbeat business confidence, microeconomic reform and the benefit of higher commodity prices in the first half of the year.

The economy grew by an estimated 6.7 per cent in 2008, up slightly from 2007 but lower than the 7.2 per cent forecast at the time of the 2009 budget. Economic activity increased in all sectors of the economy with the exception of the oil and gas extraction sector. Total estimated non-mining GDP grew by a strong 7.5 per cent in 2008, slightly up from 7.3 in 2007. Strong growth was again recorded in the communication, construction, wholesale and retail and manufacturing sectors.

The communication sector continued to expand in 2008 with subscriber numbers believed to have eclipsed 1 million. The interconnectivity of the two mobile telecommunications networks further expanded operations and contributed to increased domestic activity.

The construction sector reached capacity constraints and growth eased in 2008 after growing at more than double digit growth rates in the previous two years. Any further growth in construction demand, from either the private or public sectors, would most likely have increased prices rather than the level of construction.

Activity in the wholesale and retail trade sector, the manufacturing sector and other smaller non-mining sectors grew strongly in 2008, driven by continued upbeat business confidence, increased private sector investment profitability and a buoyant economy.

Employment grew by a strong 8 per cent in 2008, with strong growth recorded in the following sectors: building and construction; manufacturing; transport, storage and communication; retail sector; finance and business and agriculture. The strong employment growth reflected the benefits of microeconomic reform, continued business confidence and profitability and buoyant growth in the non mining sectors of the economy.

Nevertheless, by the December quarter 2008, it was apparent that the severity of the international financial crisis and the fall in commodity prices had resulted in domestic business and banks adopting a more cautious tone.

The year average headline inflation increased by 10.6 per cent in 2008 compared to the low headline inflation increase of 0.9 per cent recorded in 2007. The acceleration of inflation in 2008 was due to the rapid increase in money supply and credit growth, higher fuel and food prices (particularly over the first half of 2008), higher government spending including from trust accounts, the private sector expanding rapidly, and the economy running up against capacity constraints.

2009 Economic Outlook

Economic growth is expected to moderate in 2009 to a robust rate of 3.8 per cent, down from 6.7 per cent in 2008 and 6.2 per cent forecast at the time of the 2009 Budget, with non-mining GDP also expected to grow by 3.8 per cent in the year. The 2009 growth outlook has eased since the 2009 Budget, largely because of the rapidly slowing global economy and the impact on domestic confidence and spending. While the expected growth rate in 2009 is significantly below the very strong growth experienced over recent years, it compares favourably to economic growth rates in the overwhelming majority of key developed and developing countries.

The growth forecast in 2009 largely reflects a rebound in production in the mining sector from weaker performance in 2008; a more robust agriculture sector; and more moderate growth in the construction sector and the transport, storage and communication sector.

Annual inflation in 2009 is expected to fall to 6.6 per cent; down from 10.6 per cent in 2008 but slightly higher than the forecast in the 2009 Budget. This outlook reflects a moderation in world inflation, particularly an easing in the international drivers of inflation in 2008 such as high oil and food prices, lower growth in domestic credit and money supply, and, to a lesser extent, the lagged effects of the appreciation of the kina in 2008, partly offset by the effect of the recent depreciation of the kina in the March quarter of 2009.

2010 Economic Outlook

Economic growth is expected to pick up to 5.3 per cent in 2010, from 3.8 per cent in 2009. The stronger growth forecast reflects the commencement of production at the Ramu Nickel mine and expanded production at Lihir Gold mine, accompanied by robust economic activity in the non-mining sectors. Non-mining GDP in 2010 is forecast to grow at a robust 3.8 per cent. The high rate of mining GDP growth in 2010 is partly offset by negative growth in the petroleum sector as oil fields are depleted.

Inflation is expected to decline slightly to 5.8 per cent in 2010. The interest rates assumptions have also been revised up slightly in 2009 and 2010 since the 2009 Budget, reflecting increases in the Central Bank’s Kina Facility Rate, as monetary policy has been tightened.

2011 to 2014 Economic Outlook

Over the medium term (2011-2014), the economy is estimated to grow at a more modest real GDP growth rate of close to 3 per cent. This reflects robust non-mineral real GDP growth of around 3.5 per cent per annum, offset by slower mineral GDP growth due to lower oil production as fields are depleted.

The bulk of the growth in the medium term reflects continued robust growth in the non-mineral sectors that are more insulated from recent negative global developments and supported by continued political stability, business and investor confidence, the benefits of past microeconomic reforms and relatively low interest rates. Offsetting non-mineral growth is the effect of the petroleum, mining and quarrying sectors, where production is expected to continue to decline in the maturing oil fields and with the expected scheduled shut down of the Ok Tedi copper mine in 2014.

Inflation is expected to subside slightly in the out years from 5.8 per cent in 2010, to projected year average inflation of 3.8 per cent in 2014.

Table 1: Economic Forecasts

	2008 Actual	2009 Proj	2010 Proj	2011 Proj	2012 Proj	2013 Proj	2014 Proj
Economic Growth							
GDP	6.6	3.9	5.3	3.8	3.0	2.9	0.3
Non-mining GDP	7.5	3.8	3.8	3.7	3.8	3.6	3.7
Inflation							
Average on Average (%)	10.6	6.6	5.8	5.0	3.9	3.8	3.8
Dec on Dec (%)	11.2	5.0	6.7	4.0	3.8	3.8	3.8
Interest rate							
T/Bills (average for the year)	5.9	8.0	8.0	8.0	8.0	8.0	8.0
Inscribed Stock (3 year yield)	7.6	8.2	8.2	8.2	8.2	8.2	8.2
Mineral Prices							
Gold (US$/oz)	871.7	750.0	600.0	500.0	500.0	500.0	500.0
Copper (US$/lb)	3.2	1.6	1.5	1.5	1.5	1.5	1.5
Oil (Kutubu Crude: US$/barrel)	97.0	45.0	40.0	40.0	40.0	40.0	40.0

Source: Department of Treasury

Economic risks

In light of the global economic recession, significant risks of deterioration to the economic outlook remain, particularly if the world economy remains in a prolonged and deep recession. Furthermore, the large commodity price falls have been accompanied by a significant increase in volatility, making it exceptionally difficult to project commodity prices. This greatly increases the risk of forecasting errors in preparing the revenue projections for 2010.

The LNG project, which is expected to receive approval later this year, presents another large risk to the 2010 Budget. However, if the LNG project does not proceed as expected, for example due to a significant delay in construction, this could have a significant negative impact on business confidence and the economy. This could lead to a reduction in economic growth projections in 2010 and beyond.

The economic outlook for 2010 and beyond assumes no significant disruptions to major mining and petroleum projects. Past experience suggests that there is always some risk of supply disruptions due to strikes and landowner problems. In addition, there are risks of weather related supply disruptions, such as droughts, floods and landslides. There would potentially be significant fiscal implications if there were any sustained disruptions to resource flows from the major projects.

More generally, the economic outlook assumes that fiscal discipline is maintained, with the Government continuing to meets the MTFS targets. If the Government does not adhere to the MTFS rule that limits Government expenditure from trust funds to a maximum of 4 per cent of GDP per annum, this will further add to demand pressures and inflation in the economy.

E. Fiscal Developments and Outlook

The Budget outcome for 2008 was a deficit of K478.5 million or 2.2 per cent of GDP. This was substantially higher than the deficit of K9.5 million expected for the 2008 fiscal year at the time of the 2009 Budget. The deficit was principally due to lower than expected revenue receipts as a result of lower receipts from the mining and petroleum sector and lower dividend receipts.

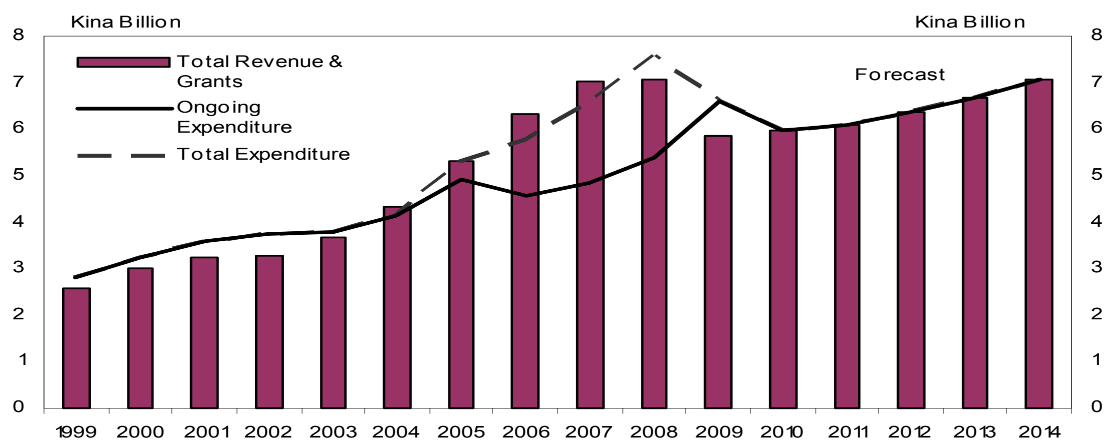
The 2009 Budget estimated a deficit of K10.3 million. Since this time, the fiscal outlook has deteriorated. The deterioration in the fiscal position in 2009 reflects the loss of dividends from Ok Tedi and lower dividends from State Owned Enterprises, and a softening in GDP growth as a result of a deeper global recession.

Medium Term Fiscal Outlook

Fiscal pressures are expected to continue to mount over the medium term, as revenue growth is reduced by declining mineral revenue (including declining mining and petroleum tax revenue and dividends). Slower revenue growth is expected to be exacerbated by medium term expenditure pressures, which are over and above ongoing expenditure contained in the forward estimates.

Total revenue is expected to fall substantially from its peak in 2008, following the end of the commodity boom in late 2008 and expectations of more moderate commodity prices over the medium term. Mineral revenue is expected to continue to decline over the medium term, due to the natural depletion of oil and copper reserves. Non-mineral revenue is expected to continue to grow, supported by robust non-mining economic activity, generating increased employment and profits, and providing for increased income, company and activity based tax collections. If the LNG project proceeds as scheduled, first gas production is not expected until around 2014.

Chart 1: Medium Term Expenditure and Revenue Projections



Source: Department of Treasury

Over the medium term, most recurrent and development expenditures are expected to increase modestly.

Personal emoluments are expected to increase due to public servants' pay increases, increment advancement and higher provisions for superannuation. Interest payments are also expected to increase with the drawdown of new loans and following the recent budget deficit.

In addition, there are a number of major expenditure pressures that the Government is looking to fund over the medium term. These include major infrastructure funding in the Benefits Sharing Agreement for the LNG project, and the PNG Government's budgetary commitments under the Partnership for Development program between PNG and Australia.

Any significant funding in the medium term will require expenditure reprioritization, or new sources of revenue.

F. Fiscal Parameters for the 2010 Budget

The fiscal parameters for the 2010 Budget are based on current forecast of revenue and expenditures. In order to have a balanced budget in 2010:

- Total revenue and grants is estimated to be K5,959.0 million
- Total expenditure and net lending is estimated to be K5,959.0 million
  - Total recurrent expenditure is estimated to be K4,050.6 million
  - Total development expenditure is estimated to be K1,908.4 million

The total recurrent expenditure estimate in 2010 has been derived by removing one-offs in the 2009 Budget, indexing of items as appropriate and inclusion of existing commitments. The estimate of K4,050.6 million for recurrent expenditure in 2010 compares with the estimate contained in the 2009 Budget of K3,950.5 million.

The total development expenditure estimate for 2010 has been derived to ensure a balanced budget position in 2010. This is broadly expected to be achieved through the removal of one-off expenditures. The estimate of K1,908.4 million in 2010 compares with estimate contained in the 2009 Budget of K1, 979.2 million.

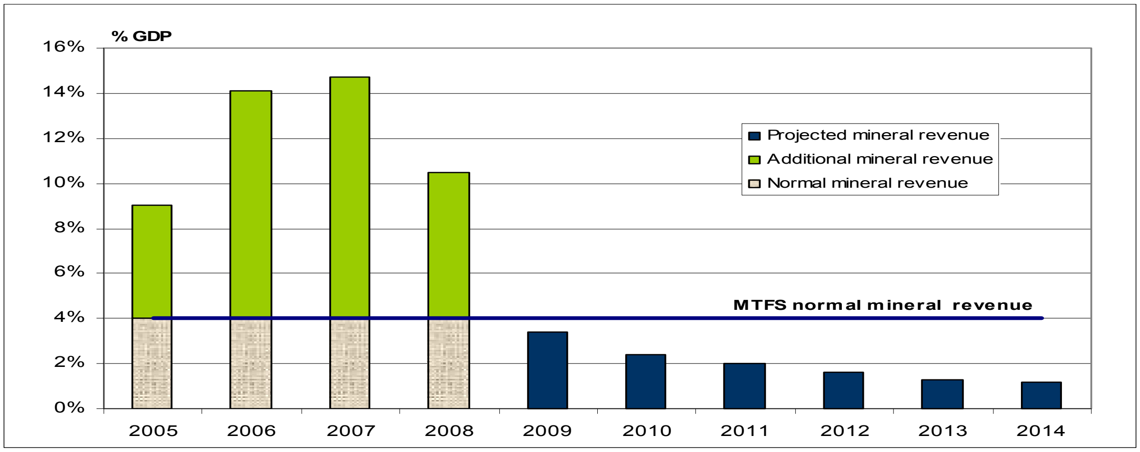
F.1 REVENUE

Government revenue in late 2008 and 2009 has fallen sharply as a result of the collapse in commodity prices and the deepening global recession. While the outlook for commodity prices is highly uncertain, commodity prices are not expected to rebound strongly through to 2010.

In addition, production of oil and copper is expected to decline significantly over the medium term (2010-2014), as key projects near the end of their effective life. While production from new mining projects is expected to commence in 2010, this is not expected to generate additional tax revenue because of tax concessions granted to the projects.

Consequently, mineral revenue (including tax revenue and dividends) is expected to decline in both 2010 and across the medium term, as depicted in Chart 2.

Chart 2: Decomposition of Mineral Revenue 2005-2014

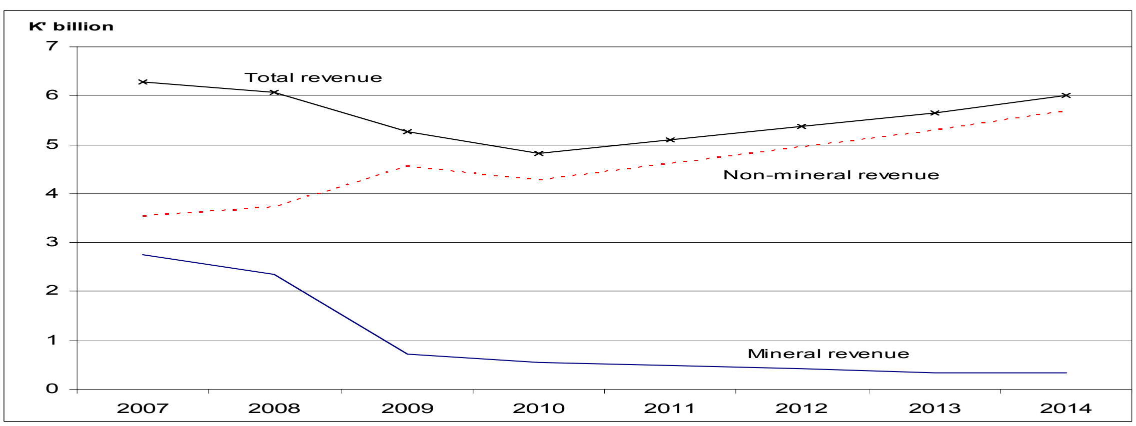


Source: Department of Treasury

Revenue from the non-mineral sectors, including agriculture, construction and services, is expected to continue to grow because of economic growth in these sectors. The growth of non-mineral revenue is expected to more than offset the decreases in mineral revenue. The revenue outlook is depicted in Chart 3.

However, because of a net one-off revenue injection in 2009 of K423 million from the gas equity trust fund, which was no longer required for its intended purpose, total revenue is expected to fall slightly in 2010, compared to 2009. Abstracting from this one-off injection in 2009, tax revenue is expected to grow modestly in 2010.

Chart 3: Revenue Outlook 2007-2014



Source: Department of Treasury

Revenue in 2010, and growth in the PNG economy, is contingent on the final decision on the LNG project. A decision is expected later in 2009 after budget preparations have been completed. While the direct impact of the project on revenue during the construction phase would not be substantial, other indirect benefits such as increased business activity, increased domestic spending by expatriate employees and increased goods and services taxes is expected to bring in modest additional revenue. This will partly offset new Government expenditure commitments associated with the LNG project.

Due to the uncertainty associated with the global financial crisis and in waiting for the final decision on the LNG project, the implementation of the recommendations of Tariff Reduction Program (TRP), which was expected in the 2010 Budget, will be delayed to the 2011 Budget.

The commodity boom years of 2005-2008 have provided additional mineral revenues which have been allocated to fund Additional Priority Expenditures (APE) and other major one-off expenditures. However, commodity prices have since declined to such a large extent that there is now no projected additional mineral revenue over the medium term. Consequently, there will be no allocations for Additional Priority Expenditures (APE) in 2010. However, the Government will continue to spend from funds held in existing trust accounts.

Project support grants are expected to increase in line with donors support in various projects and from the PNG – Australia Partnership for Development program currently been developed.

Expenditure

The MTFS and the MTDS are the key policy documents that have guided the Government's funding decisions in past budgets. While the MTDS provides the overarching development strategy, the MTFS sets out the resource envelope available for recurrent and development expenditure.

Since the drop in commodity prices in late-2008, expected mineral revenue has declined substantially to around 3.4 per cent of GDP in 2009 and 2.4 per cent of GDP in 2010, considerably lower than the 4 per cent envisaged in the MTFS. This situation is expected to continue over the medium term. In order to avoid ongoing budget deficits, modest expenditure adjustments are likely to be required to balance the budget and keep it on a sustainable path.

Furthermore, the *Fiscal Responsibility Act 2006* (FRA) states that the Government has to balance its budget over its term. If further budget deficits were to occur in the coming budgets, there would be a high risk of the Government contravening this Act, which would undermine Governments achievements in been fiscally responsible. As such, the 2010 Budget will target a balanced budget to be consistent with the FRA as well as the MTFS.

Unless there are large and sustained increases in commodity prices by 2010, modest adjustments to Government expenditure are required to achieve a balanced budget.

Recurrent Expenditure

Recurrent expenditure increased significantly in the 2008 and 2009 budgets. The increase in the 2009 Budget was partly funded through the use of gas equity trust funds.

However, following the reduction in funding envelope for 2010, the recurrent budget in 2010 will include cuts to various non-ongoing expenditures. The expenditure ceilings for personal emoluments and goods and services for National Departments, Provinces and Agencies will be determined by using their respective appropriations in the 2009 Budget as the starting point, with appropriate indexation.

An increase in the expenditure ceiling for Personal Emoluments of 13.8 per cent is expected in 2010.

This increase is largely due to a combination of the full funding of the State's contributions to Nambawan Super, Retirements Benefits Fund and other statutory pensions, as required by legislation, additional funding for retrenchments and expected salary increases for public servants.

The Organic Law on Provincial Governments and Local Level Governments (LLGs) was amended in 2008 to provide new funding mechanisms for provinces and LLGs. The Review of Inter-Government Financing Arrangements (RIGFA) provide that a single Goods and Services ceiling for all Provinces and LLGs, excluding Bougainville and NCD, must be set at a fixed percentage of Net National Revenue (NNR) in the two years prior to the Budget year. Under this arrangement, funding for Provinces will be provided on a sustainable basis that will keep in pace with growth in government revenue. In 2010, the total ceiling is K207.4 million or 5.48 per cent of the NNR.

Expenditure ceiling for Goods and Services to Provinces including Autonomous Bougainville Government and LLGs will increase modestly. This is due mainly to the RIGFA funding requirement which increases the ceiling to 5.48 per cent of NNR. However, the total level of expenditure ceiling for Goods and Services for Departments, Provinces, LLGs and Agencies are expected to reduce by 5.1 per cent from K1,621.8 million to K1,538.9 million due to reductions in one-off payments made in 2009.

Interest payments and fees for external debt are expected to increase in 2010. This is due mainly to the new multi-tranche ADB loan acquired for the Highlands Highway upgrading. Other factors such as exchange rate movements are also expected to influence the level of interest payments. Interest payments on internal debt are expected to increase in 2010 due to the Budget deficit in 2008.

Overall, recurrent expenditure is expected to increase by about 5.2 per cent in 2010.

Fiscal risks

Risks pertaining to personal emoluments expenditure could arise through: PEA wage agreements; Defence and Police wage rise agreements; Doctors or Nurses wage issues; and other union-related wage concerns. These all pose a significant risk to recurrent expenditures.

The devolution of Human Resources Management powers from Department of Personnel Management to agencies also presents additional risks to personal emolument expenditures. For example, there has been a tendency for overspending on personal emoluments in recent years by some national and provincial departments, which presents further risks to the expenditure estimates.

Additional funding requests outside of budgetary allocations from Departments and provinces also pose a risk to Government expenditures.

Development Expenditures

In light of the slowing global economy brought on by the global financial crisis, the objective of the 2010 Budget will be to maintain as much of the Development Budget allocation as possible to the MTDS priority areas.

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 Development Budget is made up of four funding components: direct government financing; the tax credit scheme; concessional loans; and grants.

The Government's contribution to the Development Budget is 2009 Budget was 53.0 per cent. This is significantly higher than the shares of 41.0 and 40.5 per cent in 2007 Budget and 2008 Budget respectively. In 2010, it is not possible to maintain development expenditure at 2009 levels and maintain a balanced budget (unless offsetting expenditure cuts were identified elsewhere).

A detailed analysis of fixed commitments in the Development Budget in 2010 is still being undertaken. However, a preliminary analysis suggests that around K600 million of development expenditure in 2009 may not be ongoing. Removal of these one-off expenditures is broadly enough to balance the 2010 Budget (noting the expenditure pressures associated with the BSA agreement or the PNG-Australia Partnership for Development will need to be accommodated from within this funding envelope).

Prioritising Development Expenditure

In order to translate the MTDS into an efficient set of expenditure choices, the Government will continue to pursue its Expenditure Sequencing and Matching Funds Strategy.

These two Strategies are applied to Government's expenditure decisions through the Medium Term Resource Framework (MTRF) which is the Government's expenditure planning tool that will 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, health and income earning opportunities. 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 best results and that can be proven to be within the MTFS (2008-2012).

In line with the MTDS the Development Budget will channel funds into projects and programmes aimed at promoting rural transformation. In particular, the Development Budget will aim to improve economic and social infrastructure in rural areas, with focus on improving transport infrastructure and education and health infrastructure. This strategy is in line with the aim to improve accessibility to services and improve human capital of the people in Papua New Guinea.

Performance Management of the Development Budget

The Performance Management Framework (PMF) is used to monitor and implement the performance of the MTDS. For disseminating this data, the PMF database and pocket book was compiled and published in 2007 and updated in 2008.

With this performance framework, the Government had chosen a sample of key performance indicators that reflected MTDS implementation in each focal sector. The indicators had been determined through collaboration and consultation between relevant Government agencies and wider stakeholders. The 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 2010 Budget.

G. Financing

In 2010 the Government is expected to have no financing requirement. However, the Government 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 2006* and the Government's debt management strategy. This means the Government's external borrowing will be entirely driven by the MTFS (2008-2012), the Fiscal Responsibility Act 2006 and the Debt Strategy. No commercial borrowing is required.

During 2010 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 2010 Budget.