## THE 2002 NATIONAL BUDGET

The Government Budget is the principal tool of fiscal policy, one component of a set of policy tools employed to meet multiple objectives of economic management. At the macroeconomic level, the importance of the budget lies in its immediate impact on the level and structure of aggregate demand and hence, on the economy as a whole.

This article reviews the 2002 National Budget, presented in Parliament in November 2001, with its primary focus on macroeconomic stability, its likely impact on the economy and the proposed changes to the components of revenue and expenditure. As with previous budget articles the detailed budget data has been rearranged and aggregated. Some misclassification of data may occur as a result of this process but the primary focus here is the broad aggregates and trends.

The fiscal strategy of the 2002 Budget aims to establish the conditions necessary for sustainable growth by maintaining macroeconomic stability and increasing the amount of Government resources towards areas that are important for the on-going development of the economy. To maintain macroeconomic stability, the Government is committed to limiting the size of the 2002 Budget deficit to a sustainable level. A budget with no allowance for general financing from borrowing is seen as the appropriate strategy towards restoring stability and integrity to the economy and banking system. The Government plans to finance the 2002 Budget deficit through the sale of State assets and minimising the level of borrowing from the banking system. The Government has identified education, health, infrastructure development, law and order including one-off funding for the 2002 National elections, agriculture, public service reform, and revenue raising agencies as priority areas. The new key initiatives introduced in the 2002 Budget were: free education; financial support for the tree crop commodities in the agriculture sector and abolition of the controversial District Development Program; reduction of the mining levy; raising the tax- free income threshold from K5,000 to K6,000; and reducing the export tax on natural forest logs and exempting plantation logs from export duty.

The Budget has also taken into account the measures under the Government's Structural Reform Programme (SRP) for 2002, that rolls forward from 2001, with continued emphasis in areas of public and financial sector reforms and privatisation. Such structural reforms are crucial in providing the right conditions for macroeconomic stability and long term economic growth, by improving public sector performance, removing barriers to investment and economic development, and promoting good governance.

There will be no Budget support grants in 2002 except for project grant, which are expected to increase due to the depreciation of the kina against the currencies of the donor countries. External extraordinary financing is expected to decline sharply following the successful completion of the IMF and World Bank supported Structural Adjustment Programmes. In 2002, there will be exceptional funding of K117 million from the second tranche of the Asian Development Bank (ADB) for the Public Sector Reform programme.

The Budget was formulated in light of the expected economic developments in 2002 taking into account both domestic and international developments. Real GDP is projected to increase by 1.2 percent in 2002, compared to a decline of 3.3 percent in 2001. The main contribution to the turnaround in economic growth is expected to come from the agriculture sector, while the mining and petroleum and other sectors are expected to decline. The projected growth in the agriculture sector is due to the increase in production and prices for all cash crop commodities, combined with the budget support to several major export crops. The depressed activity in the mineral sector is mainly due to lower production from existing mining projects as reserves are depleted.

Table 1 summarises fiscal developments from 1998 to 2001 and provides the Budget indicators for 2002. The 2001 preliminary appropriation outcome is higher than in 2000 and lower than the original appropriation, due to an increase in recurrent expenditure mainly from wages and salaries and interest payments. The fiscal burden on the economy, as represented by the appropriations/GDP ratio, increased to 32.0 percent in 2001 compared to 30.8 percent in the 2001 Budget, but improved from the 2000 outturn of 33.2 percent. The improvement was due to lower expenditure growth in 2001. Total expenditure and revenue has been underestimated in the 2001 outturn due to delays in recording project grants. Once these are included the appropriations/GDP ratio would be higher in 2001. The increase in fiscal burden in the economy in 2002 is the result of the increase in development expenditure,

Table 1: Budgetary Indicators
(K'million)

| | 1998 | 1999 | 2000 | 2001 Original Budget | 2001 (p) | 2002 Budget |
|---|---|---|---|---|---|---|
| 1. Total Internal Revenue & Grants | 2348 | 2569 | 3009 | 3223 | 2864 | 3286 |
| 2. Appropriations | 2486 | 2801 | 3201 | 3364 | 3227 | 3500 |
| 3. Surplus/(Deficit) =1-2 | -137 | -232 | -192 | -141 | -363 | -215 |
| 4. Financing | 137 | 232 | 192 | 141 | 363 | 215 |
| External | -116 | 179 | 70 | 231 | 246 | -39 |
| Domestic | 254 | 54 | 122 | -90 | 118 | 254 |
| *Asset sales* | | | | | | *478* |
| ***Memorandum Items:*** | | | | | | |
| 5. Borrowed Funds | 341 | 766 | 754 | 559 | 876 | 674 |
| 6. GDP (Current Prices) | 7789 r | 8781 r | 9651 | 10931 | 10078 | 10521 |
| ***(Ratios to Current Price GDP in %)*** | | | | | | |
| 7. Appropriations/GDP | 31.9 r | 31.9 r | 33.2 | 30.8 | 32.0 | 33.3 |
| 8. Total Internal Revenue & Grants/GDP | 30.1 r | 29.3 r | 31.2 | 29.5 | 28.4 | 31.2 |
| 9. Surplus or Deficit/GDP | -1.8 r | -2.6 | -2.0 | -1.3 | -3.6 | -2.0 |
| 10. Borrowed Funds/GDP | 4.4 r | 8.7 r | 7.8 | 5.1 | 8.7 | 6.4 |
| ***(Growth rates in %, year on year)*** | | | | | | |
| 11. Appropriations | 13.7 | 4.0 | 14.3 | 5.1 | 0.8 | 8.4 |
| 12. GDP (current prices) | 10.3 r | 12.7 r | 9.9 | 13.3 | 4.4 | 4.4 |
| 13. Headline Inflation (average year on year) | 13.6 | 15.0 r | 15.6 | 11.6 | 9.8 | 8.3 |

Source: Bank of Papua New Guinea.
2002 Budget Papers, Volumes 1 , Department of Treasury and Planning.
(a) Figure for asset sale is K175 million higher than the 2002 Budget due to inclusion of the proceeds from sale of PNGBC.

which more than offset an increase in nominal GDP.

The overall size of the 2002 Budget, at 33.3 percent of GDP, is large but typical of many developing countries where the Government has extensive direct and indirect involvement in both economic and social development. In the absence of a measure of the efficiency of Government expenditure, it is not possible to estimate precisely the impact Government has on economic growth.

The 2001 preliminary out-turn showed a deficit of 3.6 percent of GDP, which is higher than the projected 2001 National Budget deficit of 1.3 percent of GDP. This reflects a higher deficit, which more than offset a nominal growth in GDP. Total revenue was K2,864 million, K359 million below the Budget, while total expenditure was K3,227 million, K137 million below the Budget, resulting in a higher deficit of K363 million. The Budget deficit was financed through a net external financing of K246 million, and net domestic financing of K118 million. Net external financing resulted from an extraordinary loan draw down of K478 million, which more than offset net loan repayments of K148 million to concessionary sources and K84 million to commercial sources. Draw downs under the extraordinary financing comprised: K64 million from the Australian Government; K202 million from the World Bank; K132 million from the ADB; and K80 million from the JBIC. The net domestic draw down of K118 million comprised

**Table 2: Distribution between Revenue and Financing items in the 2002 Budget (K' million)**

| | 1998 | 1999 | 2000 | 2001 Original Budget | 2001 (p) | 2002 Budget |
|---|---|---|---|---|---|---|
| 1. Total Internal Revenue & Grants | 2348 | 2569 | 3009 | 3223 | 2864 | 3286 |
| 2. Direct Taxes | 1008 | 1198 | 1470 | 1520 | 1509 | 1510 |
| 3. Indirect Taxes | 590 | 723 | 845 | 956 | 786 | 907 |
| 4. Department Rev. & Services | 182 | 86 | 123 | 105 | 172 | 107 |
| 5. Revenue from Assets | 97 | 86 | 64 | 92 | 0 | 94 |
| 6. Grants | 470 | 477 | 507 | 551 | 399 | 668 |
| ***Memorandum Item:*** | | | | | | |
| 7. Borrowing | 341 | 766 | 754 | 559 | 876 | 674 |
| ***(Ratios(%))*** | | | | | | |
| 8. Direct Taxes/Total Revenue | 42.9 | 46.6 | 48.8 | 47.2 | 52.7 | 45.9 |
| 9. Indirect Taxes/Total Revenue | 25.2 | 28.1 | 28.1 | 29.7 | 27.4 | 27.6 |
| 10. Dept. Revenue/Total Revenue | 7.8 | 3.3 | 4.1 | 3.3 | 6.0 | 3.3 |
| 11. Revenue from Assets/Total Revenue | 4.1 | 3.3 | 2.1 | 2.9 | 0.0 | 2.9 |
| 12. Grants/Total Revenue | 20.0 | 18.6 | 16.8 | 17.1 | 13.9 | 20.3 |
| ***Memorandum Item:*** | | | | | | |
| 13. Borrowings/Total Revenue | 14.5 | 29.8 | 25.1 | 17.3 | 30.6 | 20.5 |

Source: Table 1

of K226 million from the non-banking system and K151 million from other domestic sources, which more than offset K259 million in net repayments by the banking system.

The projected headline Budget deficit of K215 million for 2002 is 2.0 percent of GDP, compared to a preliminary outturn of 3.6 percent of GDP for 2001. The 2002 headline deficit comprises of payment of arrears of K16 million, K87 million in payments relating to structural adjustment, K45 million for the national elections, K20 million support for tree crop commodities and an underlying deficit of K47 million. Net external loan repayment of K39 million is budgeted, comprising a net concessionary loan repayment of K123 million and a net commercial loan repayment of K33 million, which more than offset an external extraordinary loan draw down of K117 million from the ADB for Public Service Reform programme. A positive net domestic financing of K254 million is projected for 2002, reflecting K478 million from asset sale and more than offset repayments to the banking system and other domestic sources.

Table 2, which presents the distribution between revenue items, shows that the projected total direct taxes as a percentage of total revenue will decline to 45.9 percent in 2002, compared to 52.7 percent in 2001. The lower growth ratio is mainly due to projected increases in other revenue categories, mainly indirect taxes and grants. Indirect taxes as percentage of total revenue is projected to increase to 27.6 percent in 2002, compared to 27.4 percent in 2001. Total grants as a percentage of total revenue is expected to increase to 20.3 percent in 2002, compared to 13.9 percent in 2001, reflecting higher project grants.

The 2002 National Budget continues to implement recommendations of the Taxation Review Committee with the aim of improving and simplifying the tax administration, which in turn would encourage investment and economic growth in the long term. Measures will be taken to increase spending to streamline the existing tax system in order to improve compliance and collection. The 2002 Budget did not introduce any new tax measures, except minor changes consistent with the recommendation of the Taxation Review Committee. As a result, the projected increase in both direct and indirect taxes in 2002 reflects the improvement in tax collection and an expected pick up in economic activity, especially in the agriculture sector. Total budgeted revenue for 2002 is projected to be 14.7 percent higher than in 2001. Direct tax receipts are projected to increase by 0.1 percent and account for 45.9 percent of total revenue. The marginal increase is attributed to collection of tax arrears and higher wages and salaries resulting from the proposed 7 percent salary increase in 2002. This will more than offset a projected decline in the mining and petroleum tax receipts due to lower international oil prices and production of minerals, and loss in personal income tax of approximately K13 million resulting from the increase in the tax-free threshold.

Indirect taxes are expected to increase by 15.4 percent in 2002 and account for 27.6 percent of total internal revenue. Non-tax revenue and grants are expected to increase due to higher revenue collection by national departments.

Table 3 provides a breakdown of total expenditure into National and Provincial Government recurrent and development expenditure. The share of recurrent expenditure over total appropriation increased further

**Table 3: Appropriation Between Sectors**
**(K' million)**

| | 1998 | 1999 | 2000 | 2001 Original Budget | 2001 (p) | 2002 Budget |
|---|---|---|---|---|---|---|
| 1. Total Appropriation | 2486 | 2801 | 3201 | 3364 | 3227 | 3500 |
| 2. Current Expend. National Level | 1329 | 1472 | 1788 | 1728 | 1836 | 1785 |
| 3. Development Expenditure | 535 | 736 | 849 | 1051 | 803 | 1161 |
| 4. Provincial Governments | 622 | 594 | 564 | 585 | 589 | 555 |
| ***Ratios (%)*** | | | | | | |
| 5. Current Expenditure/Total Appropriation | 53.5 | 52.6 | 55.9 | 51.4 | 56.9 | 51.0 |
| 6. Dev. Expenditure/Total Appropriation | 21.5 | 26.3 | 26.5 | 31.2 | 24.9 | 33.2 |
| 7. Provincial Govts/Total Appropriation | 25.0 | 21.2 | 17.6 | 17.4 | 18.2 | 15.9 |

Source: Bank of Papua New Guinea.
2001 Budget Papers, Volumes 1 & 2, Department of Finance & Treasury.

(a) Current Expenditure, National Level includes interest payments and transfers to CSAs.
(b) Provincial Govt's is recurrent expenditure only.
(c) Development expenditure includes Australian project grants

from 55.9 percent in 2000 to 56.9 percent in 2001 contrary to the budget figures for the two years, which reflect the Government's policy to shift more expenditure towards the development budget. This does not imply a change in policy, but reflects the unbudgeted increase in salaries and wages bill and interest payments, combined with lower than budgeted revenue collections in 2001 which made it difficult to achieve this policy objective. The share of development expenditure in total appropriation declined in 2001 representing 24.9 percent of total appropriation, compared to 26.5 percent in 2000, and is projected to increase to 33.2 percent in 2002. The increase in 2002 is attributed to the inclusion of donor activities that were not previously recorded in the Budget and a projected increase in draw downs on concessionary project loans. The largest share of the development budget in 2002 is allocated to infrastructure, which reflects the Government's commitment to improve the country's road maintaince, followed by health and education.

The 2002 Budget indicates that total expenditure will be 8.5 percent above the preliminary 2001 outturn. Recurrent National Government expenditure is projected to decrease by 2.8 percent and development expenditure to increase by 44.6 percent, while recurrent Provincial Government spending is expected to decline by 5.8 percent, compared to 2001. The increase in the National Government recurrent expenditure is due to the introduction of free education, increase in wages and salaries combined with the centralisation of funding for church health services, which was previously administered at the provincial level. This also explains the decline in recurrent Provincial grants.

The 2002 Budget revenue, expenditure and financing measures will impact on the exchange rate, inflation and monetary control. With a floating exchange rate, excessive injections of liquidity into the monetary system, will lead to a decline in the exchange rate and consequently, increase pressure on prices of imported goods and domestic inflation. The major threat to the exchange rate, inflation and monetary control, remains the vast build up of liquidity generated by past unsustainable levels of net domestic financing, which therefore explains the importance of prudent management of Government finances. If this situation is not contained it could potentially lead to macroeconomic instability, with declining foreign exchange reserves or a deterioration in the balance of payments and loss of confidence.

The appropriate fiscal policy that should be adopted must, in addition to being internally consistent and compatible with the broader objectives of the Government, be sustainable. If the Budget deficit and a sustainable level of domestic financing are to be achieved in 2002, the Government must refrain from excessive expenditure over-runs, which can exert excessive pressure on the domestic financial system and the foreign exchange market. Moreover, if Government revenue targets or external financing targets fall short of expectations, expenditure levels should be reviewed and cut, rather than reliance on domestic financing to meet budgeted expenditure levels. Any increase in domestic financing to cover revenue or external financing shortfalls will further compound the current economic fragility and difficulties, and will undermine the macroeconomic reforms and stability gained over the past two years. In this context, it is important that the structural reforms are continued by the Government and that expenditure priorities are implemented, in order to achieve long term sustainable growth. The succession of economic crises in Papua New Guinea testify to the need for broad-based economic and social development, which requires the fundamentals, as identified by the Medium Term Development Strategy and the SAP, to be corrected and firmly put in place.