THE 2003 NATIONAL BUDGET

The Government Budget is the principal tool for 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 of aggregate demand and hence, on the economy as a whole.

This article reviews the 2003 National Budget presented in Parliament in November 2002. The Budget focuses on macroeconomic stability with 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 2003 Budget aims to consolidate the fiscal adjustments introduced in the 2002 Supplementary Budget and restore it to a sustainable fiscal position. The adjustments would assist in achieving macroeconomic stability and provide the conditions necessary for sustainable economic growth. Growth should be achieved by redirecting expenditure towards productive areas that generate export revenue, create employment and maximise social welfare in the medium term. The fiscal strategy for 2003 recognises the difficult economic environment that PNG confronts, in particular the decline in revenue from the mineral sector and therefore the need to adjust expenditure, and introduce new revenue measures.

The Government has identified education, health, infrastructure development, law and order, agriculture, public service reform, maintenance and rehabilitation of the roads and revenue raising agencies as priority areas. The new key initiatives introduced in the 2003 Budget were; financial support for the tree crop commodities in the agriculture sector, freeze on wages and new recruitment for the public service, cost rationalisation and expenditure cuts to non-priority departments, reduction in education subsidies, reduction of mining and petroleum taxes, increasing corporate taxes from 25 percent to 30 percent, the introduction of withdrawal tax and the conversion of log export tax into US dollar terms to provide some certainty to the logging industry and the strengthening of the Internal Revenue Commission (IRC) to improve its ability to collect revenue.

The Budget has also taken into account the measures under the Government's Structural Reform Program (SRP) for 2003, that rolls forward from 2001 and 2002, with continued emphasis in areas of public and financial sector reforms and privatisation on a more selected approach. Such structural reforms are crucial in providing the appropriate 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 is no Budget Support Grants expected in 2003 except for project grants, which are expected to increase due to the depreciation of the kina against the currencies of the donor countries. Extraordinary financing of K336.1 million is expected, K140.0 million relating to the Asian Development Bank (ADB) second tranche for the Public Sector Reform Program (PSRP), which was delayed from 2002 and the financing gap of K196.1 million assumed to be financed from other external sources.

The Budget was formulated in light of the expected economic developments in 2003 taking into account both domestic and international developments. Real GDP is projected to increase by 1.8 percent in 2003, compared to a decline of 0.5 percent in 2002. The main contribution to the turnaround in economic growth is expected from the agriculture, mining and petroleum sectors and other non-mineral sectors. The projected growth in the agriculture sector is due to expected increased production, combined with budget support for several major export crops. The increased activity in the mineral sector is due to an expected increase in exploration activities because of tax concessions granted in the 2003 budget.

Table 1 summarizes fiscal developments from 2000 to 2002 and the key Budget indicators for 2003. The 2002 preliminary appropriation outcome is higher than the 2002 Supplementary Budget appropriation, and represented an increase of K125.0 million, compared to the 2001 outcome. This reflected increases in recurrent expenditure and interest payments, which more than offset lower development expenditure. The fiscal burden on the economy, as represented by the appropriations/GDP ratio, decreased to 33.5 percent in 2002, compared to 36.1 percent in 2001, reflecting a growth in GDP.

Table 1: Budgetary Indicators (K'million)

	1999	2000	2001	2002 Original Budget	2002 Suppl. Budget	2002 (a)(p)	2003 Budget (b)
1. Total Internal Revenue & Grants	2569	3009	3185	3286	3219	3214	3490
2. Appropriations	2801	3201	3544	3500	3581	3669	3764
3. Surplus/(Deficit) =1-2	-232	-192	-359	-215	-362	-454	-274
4. Financing	232	192	359	215	362	454	274
External	179	70	242	-39	-63	-167	35
Domestic	54	122	118	254	425	621	239
Asset sales				478	259	201	200
Memorandum Items:							
5. Borrowed Funds	766	754	812	674	829	989	724
6. GDP (Nominal)	8781	9651	9821	10521	10745	10963	11964
(Ratios to Nominal GDP in %)							
7. Appropriations/GDP	31.9	33.2	36.1	33.3	33.3	33.5	31.5
8. Total Internal Revenue & Grants/GDP	29.3	31.2	32.4	31.2	30.0	29.3	29.2
9. Surplus or Deficit/GDP	-2.6	-2.0	-3.7	-2.0	-3.4	-4.1	-2.3
10. Borrowed Funds/GDP	8.7	7.8	8.3	6.4	7.7	9.0	6.0
(Growth rates in %, year on year)							
11. Appropriations	4.0	14.3	10.7	-1.2	1.0	3.5	2.6
12. GDP (Nominal)	12.7	9.9	1.8	7.1	9.4	11.6	9.1
13. Headline Inflation	15.0	15.6	9.3	8.3	10.2	11.8	13.2

(a) The preliminary 2002 Budget outcome on domestic interest expenditure and financing is still subject to reconciliation with the Department of Treasury.
(b) The K140m budgeted for 2002 is brought into 2003. Therefore, the figures are different from the budget.

Sources: (1) Bank of Papua New Guinea, and
(2) The 2003 Budget Document, Volume 1 , Department of Treasury.

The overall size of the 2003 Budget, at 31.5 percent of GDP is 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 that Government has on economic growth.

The 2002 preliminary fiscal out-turn showed a headline deficit of 4.1 percent of GDP, which is higher than the 2002 Supplementary Budget projection of 3.4 percent of GDP. The Budget deficit combined with net external loan repayments, was financed from domestic sources, mainly through the net issuance of Government securities and borrowings under the Temporary Advance Facility (TAF), and draw down in deposits with the banking system.

The projected headline Budget deficit of K274.0 million for 2003 is 2.3 percent of projected GDP. The 2003 headline deficit comprises of payment of arrears of K60.0 million, K35.0 million in payments relating to structural adjustment and an underlying deficit of K179.0 million. Net external loan draw down of K50.1 million is budgeted, comprising mainly of external extraordinary loan draw down of K131.1 million, which more than offset net loan repayments of K80.4 million and K15.3 million to concessionary and commercial sources, respectively. A positive net domestic financing of K239.0 million is projected for 2003, reflecting K200.0 million from asset sales and K39.0 million from other domestic sources.

Table 2 shows that the projected total direct taxes as a percentage of total revenue will decline to 43.7 percent in 2003, compared to 46.3 percent in 2002. The decline in the ratio reflected growth in other revenue items, which more than offset an increase in direct tax revenue. Indirect taxes as a percentage of total revenue is projected to decline to 27.0 percent in 2003, compared to 27.5 percent in 2002. Total project grants, as a percentage of total revenue is expected to increase to 23.7 percent in 2003, compared to 21.5 percent in 2002, reflecting higher project grants from international donor agencies.

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

	1999	2000	2001	2002 Budget	2002 Suppl-Budget	2002 (p)	2003 Budget
1. Total Internal Revenue & Grants	2569	3009	3185	3286	3219	3214	3490
2. Direct Taxes	1198	1470	1509	1510	1414	1487	1524
3. Indirect Taxes	723	845	785	907	939	883	942
4. Department Rev. & Services	86	123	74	107	130	79	107
5. Revenue from Assets	86	64	98	94	52	74	90
6. Grants	477	507	719	668	684	691	827
Memorandum Item:							
7. Borrowing	766	754	812	674	829	989	724
(Ratios(%))							
8. Direct Taxes/Total Revenue	46.6	48.8	47.4	45.9	43.9	46.3	43.7
9. Indirect Taxes/Total Revenue	28.1	28.1	24.6	27.6	29.2	27.5	27.0
10. Dept. Revenue/Total Revenue	3.3	4.1	2.3	3.3	4.1	2.5	3.1
11. Revenue from Assets/Total Revenue	3.3	2.1	3.1	2.9	1.6	2.3	2.6
12. Grants/Total Revenue	18.6	16.8	22.6	20.3	21.3	21.5	23.7
Memorandum Item:							
13. Borrowings/Total Revenue	29.8	25.1	25.5	20.5	25.8	30.8	20.7

Source: Table 1.

The 2003 National Budget continues to implement recommendations of the Taxation Review Committee (TRC) with the aim of improving and simplifying the tax administration, which would encourage investment and economic growth in the long run. The Government has also directed the IRC to improve its ability to collect revenue by carrying out strategic review with the assistance of the Australian Taxation Office. The Budget introduced the following new tax measures: increase in corporate tax from 25 percent to 30 percent, abolition of the additional profits tax for the mining sector and converting log export tax into US dollar terms to provide some certainty. Measures will be taken to increase spending on improving and simplify existing taxes in order to enhance compliance and collection. As a result, the projected increase in both direct and indirect taxes in 2003 reflects the improvement in tax collection and an expected pick up in economic activity, especially in the agriculture sector. Total budgeted revenue and grants for 2003 is 8.6 percent higher, compared to 2002. Direct taxes are projected to increase by 2.5 percent and account for 43.7 percent of total revenue. The increase in direct taxes is also attributed to the improvement in economic activity in the agriculture sector, improvement in the collection of tax arrears and an increase in the corporate tax rate. This will more than offset a decrease in the mining and petroleum tax receipts due to lower international oil prices and production of mineral exports.

Indirect taxes are expected to increase by 6.7 percent in 2003 and account for 27.0 percent of total revenue. Non-tax revenue is expected to increase due to higher dividend payments from statutory bodies, including the Bank of Papua New Guinea, as well as arrears collection. Foreign grants are also expected to increase.

Table 3 shows that the share of recurrent expenditure over total appropriation increased to 54.1 percent in 2002, from 51.8 percent in 2001. This trend is inconsistent with the Government's policy over the last three years to shift more expenditure to development budget. The increase in unbudgeted expenditure and election related expenses, combined with lower revenue collections accounted for the increase in the ratio. In 2003, the ratio is projected to decline to 52.3 percent, due to strict expenditure control measures and the continued shift towards development expenditure. The share of development expenditure to total appropriation declined in 2002, representing 29.9 percent of total appropriation, compared to 31.6 percent in 2001, and

Table 3: Appropriation Between Sectors
(K' million)

	1999	2000	2001	2002 Budget	2002 Suppl-Budget	2002 (p)	2003 Budget
1. Total Appropriation	2801	3201	3544	3500	3581	3669	3764
2. Current Expend. National Level	1472	1788	1836	1785	1927	1985	1970
3. Development Expenditure	736	849	1119	1161	1098	1096	1201
4. Provincial Governments	594	564	589	555	556	587	593
Ratios (%)							
5. Current Expenditure/Total Appropriation	52.6	55.9	51.8	51.0	53.8	54.1	52.3
6. Dev. Expenditure/Total Appropriation	26.3	26.5	31.6	33.2	30.7	29.9	31.9
7. Provincial Govts/Total Appropriation	21.2	17.6	16.6	15.9	15.5	16.0	15.8

(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.

Sources: (1) Bank of Papua New Guinea, and
(2) The 2003 Budget Document, Volumes 1 & 2, Department of Treasury.

is expected to increase to 31.9 percent in 2003. The decrease in 2002 was attributed to a lower draw down of concessionary project loans and counterpart funding by the Government. The increase in 2003 reflects the Government's policy towards export driven economic development. The largest share of the development budget in 2003 is allocated to infrastructure maintenance, which reflects the Government's commitment to improve the country's road maintenance, followed by health and education.

The 2003 Budget indicates that total expenditure is 2.6 percent above the preliminary 2002 outturn. National recurrent expenditure is projected to decline marginally by 0.8 percent and development expenditure is expected to increase by 9.6 percent, while recurrent Provincial Government spending is expected to increase by 1.0 percent, compared to 2002. The decline in National recurrent expenditure is due to the wage freeze and ban on new recruitment in the public service. The increase in development expenditure reflects the shift in expenditure towards infrastructure maintenance to support the export driven growth and development strategy. The increase in Provincial Government expenditure is due to the hiring of new graduate teachers from colleges.

The 2003 Budget revenue, expenditure and financing measures will impact on the exchange rate, inflation and monetary condition. With a floating exchange rate, excessive injections of liquidity into the monetary system may 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 conditions, remains the vast build up of liquidity generated by unsustainable levels of net domestic financing in previous years, 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 deterioration in the balance of payments and loss of public confidence in the Government's management of the economy.

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 2003, the Government must refrain from excessive expenditure over-runs, which can exert additional pressure on the domestic financial system and foreign exchange market. Moreover, if the targets for Government revenue, external financing and asset sales fall short of expectations, expenditure levels should be reviewed and cut, rather than reliance on domestic financing to meet budgeted and unbudgeted expenditure levels. Any increase in domestic financing to cover shortfalls in revenue, external financing and asset sales 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 expenditure priorities are implemented, in order to achieve long term sustainable growth. Papua New Guinea's previous experiences testify to the need for broad-based economic and social development, which requires the fundamentals, as identified by the Medium Term Development Strategy (MTDS) and the structural reform program, to be corrected and firmly put in place.