THE 2004 NATIONAL BUDGET

The Government Budget is the principal tool for fiscal policy; one component of a set of policy tools employed by the Government 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 2004 National Budget presented in Parliament in November 2003. The Budget focused on the achievement of macroeconomic stability with its likely impact on the economy and the proposed changes to the components of the 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 mainly on the broad aggregates and trends.

The fiscal strategy of the 2004 Budget aims to consolidate the fiscal adjustments introduced in the 2003 Budget. The adjustments are necessary in achieving macroeconomic stability and provides the conditions necessary for sustainable economic growth. Growth will 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 2004 recognises the difficult economic environment that PNG confronts, in particular the declining revenue trend from the mineral sector, and therefore necessitates the need to adjust expenditure, introduce new revenue measures and incentives.

In line with this strategy, 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 2004 Budget were; continued tax incentives for the agriculture sector in line with the Export Driven Growth Strategy, freeze on wages and new recruitment for the public service, cost rationalisation and expenditure cuts to non-priority departments, 2 percent import levy, reduction of tax rebates from four to three dependants and the strengthening of the Internal Revenue Commission (IRC) to improve its ability to collect tax revenue.

The Budget also took into account the Government's Structural Reform Programme (SRP) for 2003, with emphasis on 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.

Project Support Grants from donor countries continue to provide significant funding for development projects which otherwise, would have been difficult for the Government to undertake. Total project grant is expected to increase to K850.0 million due to higher grants from the Japanese International Cooperation Agency (JICA), while AusAID provides around 82.1 percent of the total amount.

The Budget was formulated in light of the expected economic developments in 2004 taking into account both domestic and international developments, which is expected to result in a real GDP growth of 2.0 percent in 2004. The main contribution to the turnaround in economic growth is expected from the petroleum, agriculture, and other non-mineral sectors, which more than offset declines in mining sector. The projected growth in the agriculture sector is due to the increase in production and prices of some commodities, combined with the tax incentives provided to the sector. Increased activity in the mineral sector is due to expected growth in exploration activities attributed to the tax concessions granted in the 2004 budget.

Table 1 summarises fiscal developments from 2001 to 2003 and the Budget indicators for 2004. The preliminary outcome of 2003 appropriation is lower than the original 2003 Budget appropriation, and represented an increase of K129.0 million, compared to the 2002 outcome. This reflects increases in recurrent expenditure, especially interest payments and grants to statutory authorities. The fiscal burden on the economy, as represented by the appropriations/GDP ratio is expected to increase to 31.9 percent in 2004, compared to 30.5 percent in 2003. The increase reflects higher Government expenditure, which more than offset an increase in nominal GDP.

The overall size of the 2004 Budget, at 31.9 percent of GDP, is large but typical of many developing countries.

Table 1: Budgetary Indicators
(K'million)

	2001		2002	2003 Original Budget	2003 Revised Budget	2003 Preliminary Outcome	2004 Budget
1. Total Internal Revenue & Grants	3185		3231	3490	3682	3400	3837
2. Appropriations	3544		3681	3764	3880	3552	4033
3. Surplus/(Deficit) =1-2	-359		-450	-274	-198	-153	-196
4. FINANCING	***359***		***448***	***274***	***197***	***153***	***196***
External	242		-127	35	-127	-306	-70
Domestic	118		575	239	324	459	266
Asset sales			201	200	40	40	0
Memorandum Items:							
5. Borrowed Funds	812		1011	724	904	989	691
6. GDP (Nominal)	9948	r	10992	11964	11631	11631	12623
(Ratios to Nominal GDP in %)							
7. Appropriations/GDP	35.6	r	33.5	31.5	33.4	30.5	31.9
8. Total Internal Revenue & Grants/GDP	32.0	r	29.4	29.2	31.7	29.2	30.4
9. Surplus or Deficit/GDP	-3.6	r	-4.1	-2.3	-1.7	-1.3	-1.5
10. Borrowed Funds/GDP	8.2	r	9.2	6.1	7.8	8.5	5.5
(Growth rates in %, year on year)							
11. Appropriations	10.7		3.9	2.2	5.4	-3.5	13.5
12. GDP (Nominal)	4.6	r	10.5	8.8	5.8	5.8	8.5
13. Headline Inflation (Over the Year)	9.3		11.8	13.2	10.7	8.4	10.4

Source: Bank of Papua New Guinea.
2004 Budget Papers, Volumes 1 , Department of Treasury and Planning.

Note: The above figures may not correspond to the QEB Table, S25 due to some reclassification.

In the absence of a measure of the efficiency of Government expenditure, it is not possible to estimate precisely the impact that the Government has on economic growth.

The 2003 preliminary fiscal outcome showed a deficit of 1.3 percent of GDP[1], which is lower than the deficits for both the original and revised 2003 Budgets. The budget deficit combined with net external loan repayments was financed from domestic sources, mainly through the net issuance of Treasury bills and draw down of deposits with the banking system.

The projected headline budget deficit of K196 million for 2004 is 1.5 percent of projected nominal GDP. The deficit comprise of payment of arrears of K20 million, K48 million in payments relating to structural adjustment and an underlying deficit of K128 million. Net external loan repayment of K70 million is budgeted, comprising mainly of external loan repayments to extraordinary sources of K186 million and K61.0 million to concessionary sources, which more than offset net loan draw down of K176 million from commercial sources. A positive net domestic financing of K266 million is projected to be raised through the issuance of K150 million in long term Inscribed stocks and the balance in new Treasury bills.

Table 2 shows that the projected total direct taxes as a percentage of total revenue will decrease to 47.5 percent in 2004, compared to 52.6 percent in 2003. The decline in the ratio reflected growth in total revenue, which more than offset an increase in direct taxes. Indirect taxes as a percentage of total revenue is

[1] See footnote 1 on page 5.

Table 2: Distribution between Revenue and Financing items in the 2004 Budget
(K' million)

	2001	2002	2003 Original Budget	2003 Revised Budget	2003 Preliminary Outcome	2004 Budget
1. Total Internal Revenue & Grants	3185	3231	3490	3682	3400	3837
2. Direct Taxes	1509	1491	1524	1744	1787	1821
3. Indirect Taxes	785	879	942	906	891	971
4. Department Rev. & Services	74	96	107	87	72	83
5. Revenue from Assets	98	74	90	149	160	113
6. Grants	719	691	827	796	490	850
Memorandum Item:						
7. Borrowing	812	1011	724	904	989	691
(Ratios(%))						
8. Direct Taxes/Total Revenue	47.4	46.1	43.7	47.4	52.6	47.5
9. Indirect Taxes/Total Revenue	24.7	27.2	27.0	24.6	26.2	25.3
10. Dept. Revenue/Total Revenue	2.3	3.0	3.1	2.4	2.1	2.2
11. Revenue from Assets/Total Revenue	3.1	2.3	2.6	4.0	4.7	2.9
12. Grants/Total Revenue	22.6	21.4	23.7	21.6	14.4	22.1
Memorandum Item:						
13. Borrowings/Total Revenue	25.5	31.3	20.7	24.5	29.1	18.0

Source: Table 1

projected to decline to 25.3 percent in 2004, compared to 26.2 percent in 2003. Total project grants, as a percentage of total revenue is expected to increase to 22.1 percent in 2004, compared to 14.4 percent in 2003, reflecting higher project grants from international donor agencies and possible under-reporting of grants.

The 2004 National Budget continues to implement the recommendations of the Taxation Review Committee (TRC) with the aim of improving and simplifying tax administration, and to 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 a strategic review with the assistance of the Australian Taxation Office. The 2004 Budget introduced several new revenue measures and a number of tax reforms in an effort to offset revenue declines in the mining and petroleum sector. The two major tax measures include the import levy of 2.0 percent and a reduction in rebates for dependants from four to three. In addition, technical amendments have been made to the relevant tax acts to prevent tax avoidance and protect the existing revenue base. Measures will be taken to increase spending on improvements and simplify existing taxes in order to improve compliance and collection. As a result, the projected increase in both direct and indirect taxes in 2004 reflects the improvement in tax collections and an expected pick up in economic activity.

Total budgeted revenue and grants for 2004 is 12.9 percent higher, compared to 2003. Direct taxes are projected to increase by 1.9 percent and account for 47.5 percent of total revenue. The growth is due to increases in personal and corporate income tax receipts consistent with the projected growth in nominal GDP, combined with improvements in arrears collection and audit activities.

Indirect taxes are expected to increase by 9.0 percent in 2004 from 2003, and account for 25.3 percent of total revenue. This is due to the increase in excise duties on imports as a result of the newly introduced 2 percent import duty. Non-tax revenue is expected to decrease,

Table 3: Appropriation Between Sectors
(K' million)

	2001	2002	2003 Original Budget	2003 Revised Budget	2003 Preliminary Outcome	2004 Budget
1. Total Appropriation	3544	3681	3764	3880	3552	4033
2. Current Expend. National Level	1836	1954	1970	2111	2121	2149
3. Development Expenditure	1119	1140	1201	1177	836	1277
4. Provincial Governments	589	588	593	592	595	607
Ratios (%)						
5. Current Expenditure/Total Appropriation	51.8	53.1	52.3	54.4	59.7	53.3
6. Dev. Expenditure/Total Appropriation	31.6	31.0	31.9	30.3	23.5	31.7
7. Provincial Govts/Total Appropriation	16.6	16.0	15.8	15.3	16.7	15.1

Source: Bank of Papua New Guinea.
2004 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

due to lower dividend payments by the mining and petroleum companies and corporate bodies. Total project grants as a percentage of total revenue is expected to increase to 22.1 percent in 2004, compared 14.4 percent in 2003 reflecting higher projects grants from international donor agencies.

Table 3 shows that the share of recurrent expenditure to total appropriation will decrease to 53.3 percent in 2004, compared to 59.7 percent in 2003. This trend is consistent with the Government's policy to shift more expenditure from recurrent to development budget to support the Export Driven Growth Strategy. The share of development expenditure to total appropriation was 23.5 percent of total appropriation in 2003, compared to 31.0 percent in 2002. In 2004, it is expected to increase to 31.7 percent. The decrease in 2003 was attributed to a decline in the draw down of concessionary project loans, due to lower counterpart funding by the Government, slow implementation by the implementing agencies combined with non-reporting of expenditures relating to the AusAID grants. Therefore, the 2003 development expenditure may be understated. The increase in development budget in 2004 reflects the Government's policy towards its Export Driven Growth Strategy. The largest share of the development budget in 2004 is allocated to infrastructure maintenance, which reflects the Government's commitment to improve the country's road infrastructure, followed by health and education.

The 2004 Budget shows that total expenditure is 13.5 percent above the preliminary 2003 out-turn. National recurrent expenditure is projected to increase by 1.3 percent and development expenditure is expected to increase by 52.8 percent, while recurrent Provincial Government spending is expected to increase by 2.0 percent, compared to 2003. The increase in National recurrent expenditure is due to higher salaries and wages, structural adjustment programme (SAP) and arrears payments. The increase in development expenditure reflects the shift in expenditure towards projects deemed to contribute significantly towards the Government's Export Driven Growth Strategy, including the road maintenance and the rehabilitation of the Highlands Highway. The increase in Provincial

Government expenditure is due to higher salaries and wages. The new expenditure control measures for 2004 include improving expenditure control, freeze on recruitment of non-essential casual employees and tightening of controls to eliminate overrun on salaries.

Achieving the 2004 Budgeted revenue and expenditure are important because of its implications on financing, and consequently the level of public debt. A responsible Government should always maintain strict expenditure controls to avoid excessive injections of liquidity into the monetary system, which may lead to a decline in the exchange rate and consequently, increase pressures on 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 of budget deficits in previous years. Therefore, the Government's Medium-term Fiscal Strategy, which encourages prudent management of Government finances to achieve a balanced budget and sustainable debt level by 2007 is essential for macroeconomic stability and investor confidence. This is paramount for the success of the Government's Export Driven Growth Strategy under its economic recovery and development programme.

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 2004, the Government must refrain from excessive expenditure over-runs, which can exert excessive pressure on the domestic financial system and foreign exchange market. Moreover, if the targets for Government revenue and external financing 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 and external financing will further compound the current economic recovery and undermine the macroeconomic stability gained over the last year. 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.