## THE 2005 NATIONAL BUDGET

The National 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 2005 National Budget presented in Parliament in November 2004. 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 2005 Budget aims to establish a framework for stronger economic growth by consolidating the fiscal adjustments introduced in the last two years and the priorities set in the Medium Term Development Strategy (MTDS). The adjustments are necessary in achieving macroeconomic stability and provides the conditions necessary for sustainable economic growth. Growth would 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 2005 recognises the difficult economic environment that PNG confronts, in particular the adverse developments and therefore aim for continued fiscal discipline.

In line with this strategy, the Government has identified infrastructure development, especially the maintenance and rehabilitation of the roads, education, health, law and order, agriculture, public service and revenue raising agencies as priority areas. The key initiatives introduced in the 2005 Budget were; continued tax incentives for the agriculture sector in line with the Export Driven Growth Strategy, reintroduction of the Tax Credit Scheme, cost rationalisation and expenditure cuts to non-priority departments and strengthening of the Internal Revenue Commission (IRC) to improve its ability to collect revenue.

The Budget also incorporated the Government's Structural Reform Program (SRP) from the last two years, with emphasis in public and financial sector reforms and privatisation on a more selected approach. Structural reforms such as improving public sector performance, removing barriers to trade and investment and promoting good governance are crucial in providing the appropriate conditions for macroeconomic stability and sustained economic growth.

The Government recognises that project support grants from donor countries continue to provide significant funding for development projects which otherwise could have been difficult to undertake alone. Total Project Support Grant is projected to increase by K438.0 million to K1,283.1 million, largely due to increases in JICA and AusAID grants, including the police component of the Enhanced Co-operation Program (ECP) in 2005.

The Budget was formulated against the expected economic developments in 2005, which is expected to result in a real GDP growth of 2.9 percent in 2005. The higher economic growth is expected from all sectors of the economy. The projected growth in the agriculture sector is due to the increase in production combined with tax incentives provided to the sector. Activity in the mineral sector is expected to result from the increase in exploration activities attributed to the continued tax concessions granted in the 2005 Budget.

Table 1 summarises fiscal developments from 2002 to 2004 and the Budget indicators for 2005. The preliminary outcome for the 2004 appropriation is lower than the 2004 Budget appropriation, and represented a decline of K28.9 million, compared to the 2003 outcome. This reflected lower interest payments and development expenditure. The fiscal burden on the economy, as represented by the appropriations/GDP ratio is expected to increase to 33.0 percent in 2005, compared to 27.0 percent in 2004. The growth reflects higher development expenditure reflecting the shift in spending to improve the road infrastructure to support the Export Driven Growth Strategy.

The fiscal burden 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 that Government has on economic growth.

**Table 1: Budgetary Indicators**
**(K'million)**

| | 2001 | 2002 | 2003 | 2004 Budget | 2004 Revised Budget | 2004 (p) | 2005 Budget |
|---|---|---|---|---|---|---|---|
| **1. Total Internal Revenue & Grants** | 3,185 | 3,231 | 3,610 | 3,837 | 4,284 | 3,940 | 4,640 |
| **2. Appropriations** | 3,544 | 3,682 | 3,734 | 4,033 | 4,129 | 3,706 | 4,777 |
| **3. Surplus/(Deficit) =1-2** | -359 | -450 | -124 | -196 | 155 | 234 | -138 |
| ***4. FINANCING*** | ***359*** | ***450*** | ***124*** | ***196*** | ***-155*** | ***-234*** | ***138*** |
| External | 242 | -126 | -307 | -70 | -156 | -338 | -190 |
| Domestic | 118 | 576 | 431 | 266 | 1 | 104 | 328 |
| Asset sales | 0 | 201 | 40 | 0 | 25 | 25 | 0 |
| **Memorandum Items:** | | | | | | | |
| **5. Borrowed Funds** | 812 | 1,013 | 814 | 691 | 1,439 | 989 | 1,150 |
| **6. GDP (Nominal)** | 9,948 | 11,767 | 12,948 | 12,623 | 13,727 | 13,727 | 14,491 |
| ***(Ratios to Nominal GDP in %)*** | | | | | | | |
| **7. Appropriations/GDP** | 35.6 | 31.3 | 28.8 | 31.9 | 30.1 | 27.0 | 33.0 |
| **8. Total Internal Revenue & Grants/GDP** | 32.0 | 27.5 | 27.9 | 30.4 | 31.2 | 28.7 | 32.0 |
| **9. Surplus or Deficit/GDP** | -3.6 | -3.8 | -1.0 | -1.5 | 1.1 | 1.7 | -1.0 |
| **10. Borrowed Funds/GDP** | 8.2 | 8.6 | 6.3 | 5.5 | 10.5 | 7.2 | 7.9 |
| ***(Growth rates in %, year on year)*** | | | | | | | |
| **11. Appropriations** | 66.5 | 3.9 | 1.4 | 8.0 | 10.6 | -0.8 | 28.9 |
| **12. GDP (Nominal)** | 27.7 | 18.3 | 10.0 | -2.5 | 6.0 | 6.0 | 5.6 |
| **13. Headline Inflation (Over the Year)** | 9.3 | 11.8 | 8.4 | 13.2 | 1.9 | 1.9 | 2.6 |

Note: The above figures may not correspond to S25 due to some reclassification.

**Source: Bank of Papua New Guinea.**
**2005 Budget Papers, Volumes 1 , Department of Treasury.**

The 2004 preliminary fiscal out-turn showed a surplus of 1.7 percent of GDP, which is higher than the revised 2004 Budget projection of 1.1 percent of GDP. The budget surplus combined with net domestic loan draw downs, was used make a net external loan repayments.

The projected budget deficit of K138.0 million for 2005 is 1.0 percent of nominal GDP. The 2005 deficit comprise of payment of arrears of K35.0 million, K65.6 million in payments relating to structural reform program (SRP) and an underlying deficit of K37.4 million. Net external loan repayment of K190.2 million is budgeted, comprising mainly of extraordinary sources of K165.4 million, K19.1 million in concessional sources and K5.7 million from commercial sources. A positive net domestic financing of K328 million is projected to be raised through the issuance of Inscribed stocks and net new Treasury bills.

Table 2 shows that the projected total direct taxes as a percentage of total revenue will decrease to 47.0 percent in 2005, compared to 49.9 percent in 2004 revised budget. The decline in ratio reflect the growth in total revenue, combined with a decline in direct taxes. Indirect taxes as a percentage of total revenue is projected to decline to 19.7 percent in 2005, compared to 24.5 percent in the 2004 revised budget. Total project grants as a percentage of total revenue is expected to increase to 27.7 percent in 2005, compared to 19.8 percent in the 2004 revised budget, reflecting higher project grants from international donor agencies.

The 2005 National Budget continues to implement recommendations of the Taxation Review Committee (TRC) with the aim of improving and simplifying tax administration, 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 Budget neither introduced any new tax measures nor increased existing tax rates. It also ceased the import levy in 2005 and reduced the mining levy to attract foreign investment in the mineral sector. The Government renewed the Tax Credit Scheme for the rehabilitation of the Highlands Highway. The focus of the Government's revenue

Table 2: Distribution between Revenue and Financing items in the 2005 Budget
(K' million)

| | 2001 | 2002 | 2003 | 2004 Budget | 2004 Revised | 2004 (p) | 2005 Budget |
|---|---|---|---|---|---|---|---|
| 1. Total Internal Revenue & Grants | 3,185 | 3,231 | 3,610 | 3,837 | 4,284 | 3,940 | 4,640 |
| 2. Direct Taxes | 1,509 | 1,491 | 1,747 | 1,821 | 2,139 | 2,223 | 2,183 |
| 3. Indirect Taxes | 785 | 879 | 931 | 971 | 1,051 | 997 | 913 |
| 4. Department Rev. & Services | 74 | 74 | 80 | 83 | 83 | 80 | 78 |
| 5. Revenue from Assets | 98 | 96 | 160 | 113 | 161 | 160 | 183 |
| 6. Grants | 719 | 691 | 693 | 850 | 850 | 479 | 1,283 |
| Memorandum Item: | | | | | | | |
| 7. Borrowing | 812 | 1,013 | 814 | 691 | 1,439 | 989 | 1,150 |
| *(Ratios(%))* | | | | | | | |
| 8. Direct Taxes/Total Revenue | 47.4 | 46.2 | 48.4 | 47.5 | 49.9 | 56.4 | 47.0 |
| 9. Indirect Taxes/Total Revenue | 24.7 | 27.2 | 25.8 | 25.3 | 24.5 | 25.3 | 19.7 |
| 10. Dept. Revenue/Total Revenue | 2.3 | 2.3 | 2.2 | 2.2 | 1.9 | 2.0 | 1.7 |
| 11. Revenue from Assets/Total Revenue | 3.1 | 3.0 | 4.4 | 2.9 | 3.8 | 4.1 | 3.9 |
| 12. Grants/Total Revenue | 22.6 | 21.4 | 19.2 | 22.1 | 19.8 | 12.2 | 27.7 |
| Memorandum Item: | | | | | | | |
| 13. Borrowings/Total Revenue | 25.5 | 31.4 | 22.5 | 18.0 | 33.6 | 25.1 | 24.8 |

Source: Table 1

efforts in 2005 will be to improve compliance with existing tax laws.

Technical amendments have also 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.

Total budgeted revenue and grants for 2005 is 8.3 percent higher, compared to the 2004 revised budget. The increase is due to higher project grants, which more than offset declines in tax receipts.

Direct taxes are projected to increase by 2.1 percent and account for 47.0 percent of total revenue. The growth is due to higher personal and company tax receipts.

Indirect taxes are expected to decrease by 13.1 percent in 2005 and account for 19.7 percent of total revenue. This is due to the ceasation of the 2 percent import duty and lower mining levy receipts. Non-tax revenue is expected to decrease due to lower dividend payments by the mining and petroleum companies. Total project grants as a percentage of total revenue is expected to increase to 27.7 percent in 2005, compared to 19.8 percent in 2004 reflecting higher projects grants from international donor agencies.

Table 3 shows that the share of recurrent expenditure to total appropriation will decrease to 47.3 percent in 2005, compared to 52.2 percent in 2004 revised budget. This trend is consistent with the Government's policy to improve efficiency and delivery mechanisms through the establishment of District Treasuries, combined with lower interest payments. The share of development expenditure to total appropriation is 39.5 percent in 2005, compared to 33.1percent in 2004. The increase in development budget reflects the Government's policy in shifting expenditure towards infrastructure maintenance to support the Export Driven Growth Strategy as well as the grant funding associated with the ECP. The largest share of the development expenditure is allocated to infrastructure, which reflects the Government's commitment towards improving the country's road infrastructure, followed by health,

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

| | 2001 | 2002 | 2003 | 2004 Budget | 2004 Revised Budget | 2004 (p) | 2005 Budget |
|---|---|---|---|---|---|---|---|
| **1. Total Appropriation** | 3,544 | 3,682 | 3,734 | 4,033 | 4,129 | 3,706 | 4,777 |
| **2. Current Expend. National Level** | 1,836 | 1,954 | 2,101 | 2,149 | 2,156 | 2,130 | 2,261 |
| **3. Development Expenditure** | 1,119 | 1,140 | 1,039 | 1,277 | 1,366 | 904 | 1,888 |
| **4. Provincial Governments** | 589 | 588 | 595 | 607 | 608 | 672 | 628 |
| **Ratios (%)** | | | | | | | |
| **5. Current Expenditure/Total Appropriation** | 51.8 | 53.1 | 56.3 | 53.3 | 52.2 | 57.5 | 47.3 |
| **6. Dev. Expenditure/Total Appropriation** | 31.6 | 31.0 | 27.8 | 31.7 | 33.1 | 24.4 | 39.5 |
| **7. Provincial Govts/Total Appropriation** | 16.6 | 16.0 | 15.9 | 15.1 | 14.7 | 18.1 | 13.1 |

**Source: Bank of Papua New Guinea.**
**2005 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

education and law and order. This is in line with the Government's aim to eradicate barriers to investment. The 2005 Budget shows that total expenditure is 28.9 percent above the preliminary 2004 outturn. National recurrent expenditure is projected to increase by 6.2 percent and development expenditure is expected to increase significantly, while recurrent Provincial Government spending is expected to decrease by 0.1 percent, compared to 2004. The increase in national recurrent expenditure is due to higher salaries and wages, SRP and arrears payment. 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 decline in Provincial Government expenditure is due lower administrative grants.

The new expenditure control measures for 2005 include improving expenditure control, reallocating spending to high priority areas, reassess the proportion of recurrent expenditure on wages and salaries, and goods and services and continue public sector down sizing.

Achieving the 2005 Budget revenue and expenditure targets are important because of its implications on financing and 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 can lead to a decline in the exchange rate and consequently, increase pressures on domestic inflation. The major threat to monetary conditions, the exchange rate and inflation, remains any fiscal slippages in the 2005 Budget. Therefore, the Government's MTDS, which encourages prudent management of Government finances to achieve balanced budget and sustainable debt levels in the medium term is key to macroeconomic stability.

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 2005, the Government must refrain from excessive expenditure over-runs and live within the parameters of the 2005 budget.

Given the easing stance of monetary policy adopted by the Central Bank, continued fiscal discipline will complement the gains on macroeconomic stability. 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 will further compound the current economic recovery, and undermine the macroeconomic stability gained over 2003 and 2004. 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 and the priorities identified in the MTDS.