THE 2006 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 macroeconomic management. 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 2006 National Budget against the 2005 revised Budget presented in Parliament in November 2005. The Budget focuses on sustaining the current macroeconomic stability and achieving positive economic growth through implementation of the Budget that is consistent with the Medium Term Fiscal Strategy (MTFS) and the Medium Term Development Strategy (MTDS). 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 for 2006 and the medium term is framed on the back of sound macroeconomic fundamentals, which aims to sustain the conditions necessary for economic growth by reallocating expenditure to priority areas identified in the MTDS. To achieve macroeconomic stability the Government targets a budget deficit of 0.6 percent of GDP in 2006. 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 MTFS for 2006 recognises the vulnerability of the current economic environment in PNG, in particular the potential for adverse developments and therefore, the aim for continued sound economic management.

In line with this strategy, the Government has identified infrastructure development, education, health, law and order, agriculture, public service reforms and revenue raising as priority areas. The key initiatives introduced in the 2006 Budget were; tax cuts to personal and company income, tax incentives to specific sectors involved in promoting trade and investment including increase in infrastructure tax credit scheme for agriculture, funding of district initiatives and road improvement, cost rationalisation and expenditure cuts to non-priority government departments and strengthening of the Internal Revenue Commission (IRC) to improve revenue collection.

The Budget also incorporated the Government's Structural Reform Program (SRP) introduced in 2003, with emphasis on public sector reforms. 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 necessary for sustained macroeconomic stability and to achieve 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 decrease by K289.1 million to K994.0 million in 2006, largely due to declines in the Japanese International Co-operation Agency (JICA) and AusAID grants. This is due to the completion of major projects undertaken by JICA and the withdrawal of the police component of the Enhanced Co-operation Program (ECP), which was included in the 2005 Budget. However, other donors including the European Union (EU), New Zealand and China have increased their commitments in 2006.

The formulation of the Budget was based on the expected economic developments in 2006, which is expected to result in a real GDP growth of 3.5 percent. The higher economic growth is expected from all sectors of the economy. The projected growth in the agriculture sector reflects increases in production due to tax incentives provided to the sector. The favourable economic environment is expected to broaden economic growth in the other sectors, including construction and manufacturing associated with rising activity in the mineral sector.

Table 1 summarises fiscal developments from 2002 to 2005 and the Budget indicators for 2006. The preliminary outcome for 2005 appropriation is K115 million more than the revised Budget appropriation, due mainly to higher recurrent expenditures. In 2006, the fiscal burden on the economy, as represented by the appropriations/GDP ratio is expected to improve from the 2005 out-turn of 35.0 percent to 30.4 percent. The improvement reflects lower 2006 Budget appropriation.

The easing in the fiscal burden reflects the Government's focus on expenditure controls due to the anticipated decline in revenue growth in 2006. However, the role of the Government in many developing countries has been its direct and indirect involvement in both economic and social development. In the absence of a

Table 1: Budgetary Indicators
(K'million)

	2002		2003		2004	2005 Original Budget	2005 Revised Budget	2005 Preliminary Outcome	2006 Budget
	Actuals								
1. Total Internal Revenue & Grants	3,286	r	3,650	r	4,350	4,640	5,054	5,313	4,739
2. Appropriations	3,737	r	3,774	r	4,148	4,777	5,151	5,266	4,829
3. Surplus/(Deficit) =1-2	-450		-124		202	-138	-97	47	-90
4. Primary Balance	-14		615		578	343	251	380	407
5. Financing	*450*		*124*		*449*	*138*	*97*	*-47*	*90*
External	-127	r	-307		325	-190	-156	-238	-124
Domestic	577	r	431		124	328	252	191	214
Asset sales	201		40		25	0	0	0	0
Memorandum Items:									
6. Borrowed Funds	1,013		814		1,434	1,150	1,330	1,544	1,383
7. GDP (Nominal)	11,567	r	12,765	r	13,692	14,491	15,041	15,041	15,886
(Ratios to Nominal GDP in %)									
8. Appropriations/GDP	32.3	r	29.6	r	30.3	33.0	34.2	35.0	30.4
9. Total Internal Revenue & Grants/GDP	28.4	r	28.6	r	31.8	32.0	33.6	35.3	29.8
10. Surplus or Deficit/GDP	-3.9	r	-1.0		1.5	-1.0	-0.6	0.3	-0.6
11. Borrowed Funds/GDP	8.8	r	6.4	r	10.5	7.9	8.8	10.3	8.7
(Growth rates in %, year on year)									
12. Appropriations	5.4	r	1.0	r	9.9	15.2	7.8	2.2	-6.2
13. GDP (Nominal)	16.3	r	10.4	r	7.3	5.8	3.8	3.8	5.6
14. Headline Inflation (Over the Year)	11.8		8.4		1.9	2.6	3.6	4.6	4.6

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

Source: Bank of Papua New Guinea.
2006 Budget Papers, Volumes 1 , Department of Finance and Treasury.

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

The 2005 preliminary fiscal out-turn showed a surplus of 0.3 percent of nominal GDP, compared to the deficits projected for both the original and revised budgets. The budget surplus combined with net domestic financing, was used to make net external loan repayments.

The projected budget deficit of K90 million for 2006 is 0.6 percent of nominal GDP. The 2006 deficit comprises payment of arrears of K5 million, K69 million in payments relating to SRP and an underlying deficit of K16 million. Net external loan repayment of K124 million is budgeted, comprising mainly of K40 million to extraordinary sources, K18 million to concessionary sources and K66 million to commercial sources. A positive net domestic financing of K214 million is projected to be raised through the issuance of Inscribed stocks and new Treasury bills.

The primary balance (as shown in table 1) measures the effects of discretionary budgetary policy by excluding interest payments from the conventional measure of fiscal deficit. This deficit indicates how the fiscal actions of the Government affect the Government's net debt position and is important in assessing the sustainability of fiscal deficit. A surplus in the primary

Table 2: Distribution between Revenue and Financing items in the 2006 Budget
(K' million)

	2002	2003	2004	2005			2006
	Actuals			Original Budget	Revised Budget	Preliminary Outcome	Budget
1. Total Internal Revenue & Grants	3,286 r	3,650 r	4,350	4,640	5,054	5,313	4,739
2. Direct Taxes	1,491	1,787 r	2,223	2,072	2,530	2,794	2,468
3. Indirect Taxes	934 r	931	1,031	1,024	1,012	993	1,050
4. Department Rev. & Services	74	80	80	78	78	78	82
5. Revenue from Assets	96	160	165	183	150	165	145
6. Grants	691	693	850	1,283	1,283	1,283	994
Memorandum Item:							
7. Borrowing	1,013	814	1,434	1,150	1,330	1,544	1,383
Ratios (%)							
8. Direct Taxes/Total Revenue	45.4 r	48.9 r	51.1	44.7	50.1	52.6	52.1
9. Indirect Taxes/Total Revenue	28.4 r	25.5 r	23.7	22.1	20.0	18.7	22.2
10. Dept. Revenue/Total Revenue	2.2 r	2.2	1.8	1.7	1.5	1.5	1.7
11. Revenue from Assets/Total Revenue	2.9 r	4.4	3.8	3.9	3.0	3.1	3.1
12. Grants/Total Revenue	21.0 r	19.0 r	19.5	27.7	25.4	24.1	21.0
Memorandum Item:							
13. Borrowings/Total Revenue	30.8 r	22.3 r	33.0	24.8	26.3	29.1	29.2

Source: Table 1

balance in 2006 indicates that the projected deficit is sustainable and implies that the Government's net debt and total public debt to GDP ratio is expected to improve.

Table 2 depicts that the revenue components of the 2006 Budget as a percentage of total revenue increased for all tax revenue measures, except the project grants. The total budgeted revenue and grants for 2006 is 6.2 percent lower, compared to the 2005 revised Budget. The decline was mainly due to lower direct taxes and project grants.

Total direct taxes are projected to decrease by 2.3 percent, compared to the 2005 revised budget. The decline is due to lower personal and company income tax receipts. However, total direct taxes as a percentage of total revenue is projected to increase to 52.1 percent in 2006, compared to 50.1 percent in the 2005 revised Budget. The increase in the ratio reflects a decline in total revenue by more than the decline in direct taxes.

Indirect taxes are expected to increase by 3.8 percent in 2006, compared to the 2005 revised Budget. The increase is due to higher Goods and Services Tax (GST) receipts and excise collections. Indirect taxes as a percentage of total revenue is projected to increase to 22.2 percent in 2006, compared to 20.0 percent in the 2005 revised budget. Non-tax revenue is expected to decline marginally due partly to lower dividend payments to the Government.

Total project grants are projected to decline by 22.5 percent in 2006, compared to the 2005 revised Budget. The significant decline was mainly the result of the reduced Enhanced Co-operation Programme (ECP) by the Australian Government. Total project grants as a percentage of total revenue is projected to decrease to 21.0 percent in 2006, compared to 25.4 percent in

Table 3: Appropriation Between Sectors
(K' million)

	2002		2003		2004	2005			2006
	Actuals					Original Budget	Revised Budget	Preliminary Outcome	Budget
1. Total Appropriation	3,737	r	3,774	r	4,148	4,777	5,151	5,266	4,829
2. Current Expend. National Level (a)	1,954		2,101		2,130	2,261	2,650	2,760	2,396
3. Development Expenditure (b)	1,195	r	1,079	r	1,327	1,888	1,822	1,849	1,687
4. Provincial Governments (c)	588		595		691	628	679	657	746
Ratios (%)									
5. Current Expenditure/Total Appropriation	52.3	r	55.7	r	51.3	47.3	51.4	52.4	49.6
6. Dev. Expenditure/Total Appropriation	32.0	r	28.6	r	32.0	39.5	35.4	35.1	34.9
7. Provincial Govts/Total Appropriation	15.7		15.8	r	16.7	13.1	13.2	12.5	15.4

Source: Table 1

Notes:

(a) Current Expenditure, National Level includes interest payments and transfers to CSAs.

(b) Development expenditure includes Australian project grants

(c) Provincial Government's is recurrent expenditure only.

2005.

The 2006 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 Budget neither introduced any new tax measures nor increased existing tax rates. However, the only tax reforms introduced include tax reductions to personal income, removal of double taxing on company dividends, and tax incentives for specific sectors involved in tourism and agriculture. The Government will continue to focus on strengthening tax compliance including improvements in collection of non-tax revenue in 2006.

Table 3 shows that the share of recurrent expenditure to total appropriation will decrease to 49.6 percent in 2006, compared to 51.4 percent in the 2005 revised budget. This trend is consistent with the MTFS, which follows a path of deficit reduction to achieve a balanced budget in the medium term. The share of development expenditure to total appropriation is 34.9 percent in 2006, compared to 35.4 percent in the 2005 revised Budget. The slight fall in development expenditure reflects the decline in donor funding due to the exclusion of the police component of the ECP in 2006. However, the Government has increased funding for the Development Budget to partially cater for the shortfall in project grants. This is in line with the Government's Export-Led Growth Strategy by increasing service delivery at the district level and improving the country's road infrastructure.

The 2006 Budget shows that total expenditure is 6.3 percent lower than the 2005 revised Budget. National recurrent expenditure is projected to decrease by 9.6 percent and development expenditure by 7.4 percent, while recurrent Provincial Government spending is expected to increase by 9.9 percent, compared to the 2005 revised Budget. The decrease in National recurrent expenditure is due to lower goods and services, arrears and SRP payments. The decrease in development expenditure reflects a fall in donor funding. The increase in Provincial Government expenditure is due to higher salaries and wages.

The new expenditure control measures for 2006 include further improvements to existing expenditure controls, reallocating spending to high priority programs identified in the MTDS, and continued public sector reforms.

Achieving the 2006 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 within the budgeted appropriations and effectively utilise any windfall revenue to retire debt and finance public works or infrastructure. This would avoid excessive injections of liquidity into the monetary system, because of its implications on the exchange rate and domestic inflation. The major threat to monetary conditions, the exchange rate and inflation, remains any fiscal slippages in the 2006 Budget. Therefore, the Government's MTDS and MTFS, which encourages prudent management of Government finances to achieve balanced budget and sustainable debt levels in the medium term are the 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 2006, the Government must refrain from excessive expenditure over-runs and live within the parameters of the 2006 budget.

Given the neutral 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 undermine the macroeconomic stability gained over the last three years. In this context, it is important that the structural reforms are continued by the Government and expenditure priorities are implemented consistent with the MTDS in order to achieve long term sustainable growth.